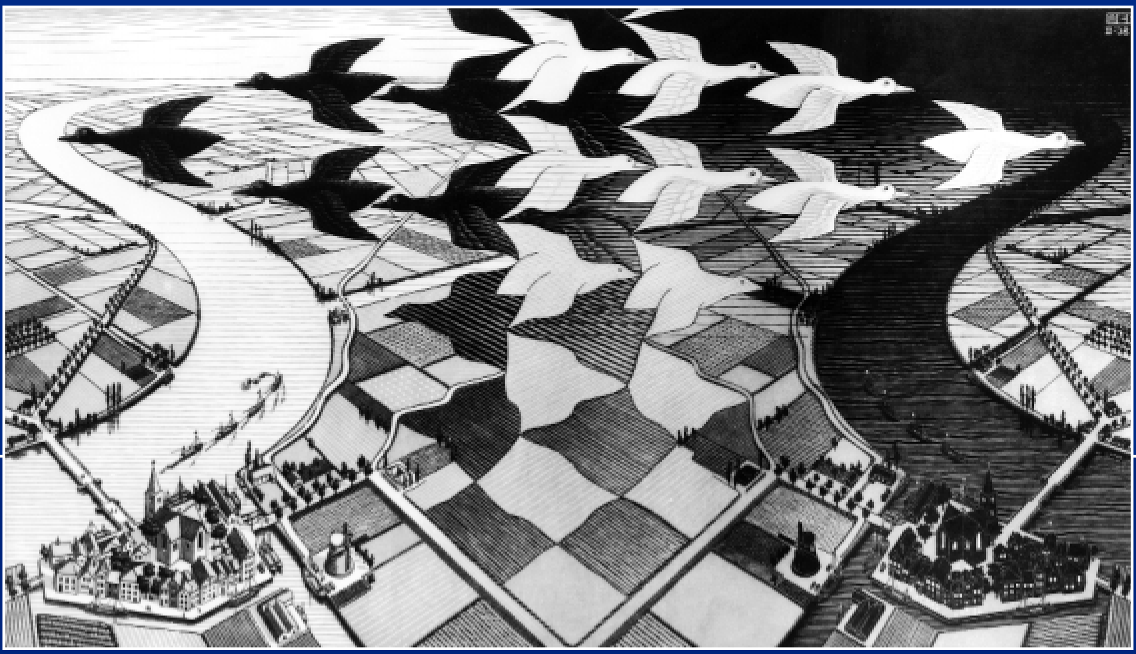
COMPARATIVE ECONOMICS IN A TRANSFORMING WORLD ECONOMY

Second Edition



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Preface

Although it has been eight years since our first edition appeared, the analysis presented in the preface to that edition remains largely valid. Indeed, we venture to say that we were foresighted in our first edition, with the changes that we made to the standard approach then in place among comparative economics texts to have proven to be more relevant today than they were when we introduced them. We argued that not only was the world economy being transformed, but that comparative economics as a discipline was being transformed as well. We feel that we were on the front wave of that transformation and called its direction reasonably well.

When we wrote the first edition, the traditional approach of comparative economics had focused on comparing market capitalism and command socialism. The breakup of the Soviet bloc after 1989, culminating in the breakup of the Soviet Union itself in 1991, the paradigmatic example of command socialism, and the subsequent move away from this system by most of the nations in this group, underlay the transformation of comparative economics as an intellectual discipline. Although some have argued that these events meant that the field itself should simply be absorbed into other fields, perhaps economic development as argued by Russian Premier Yegor Gaidar in 1992 (see the opening quotation to our final chapter), we did not and do not agree. In order to understand the difficult and complicated transitions that the former socialist economies have undergone, it is necessary to understand where they came from, partly because many of them retain crucial elements of their former systems. Also, several of these economies have made relatively few changes from the old system and are still largely command socialist economies. Thus we continue to discuss the ideas behind the command socialist system as well as its history in this edition, thereby preserving fundamental elements of the traditional approach to comparative economics.

The major innovation of our first edition was the concept of the **new traditional economy,** an idea that appeared in print for the first time in that book. We argued that the end of the Cold War meant that the competition between market capitalism and command socialism would be replaced by the emergence of new forms that would serve as alternatives to the apparently victorious market capitalism. The new traditional economy is a form that reflects an effort to embed a modern economic system into a traditional socio-cultural system, usually one tied to a major world religion.

The leading example in our first edition was Islam, with a chapter in the book devoted to the case of Iran. The importance of Islamic fundamentalism in the world has increased enormously since 1996, especially since the attacks in New York and Washington by al Qaeda on September 11, 2001. The aftermath of these events saw an emerging de facto alliance between the former global rivals, the United States and Russia, apparently forming a common front against radical Islamic movements, with even China joining in to a certain degree, despite differences over the war in Iraq. We would argue now that as the process of transition gradually winds down in the various former socialist economies, the significance of the new traditional economy will only increase in importance as the main alternative to the dominant market capitalist form. Thus we see the emergence of neo-Confucian elements in the Chinese economy, as well as the familistic groupism of the non-socialist Japanese economy, which can be viewed as a traditional remnant in an advanced economy.

Related to the emphasis on the new traditional economy was the argument advanced in two different chapters that the former Central Asian republics of the Soviet Union would emerge as a central locus of the global competition between different economic systems, including the Islamic economic system. The events surrounding the war in Afghanistan and the entry of American armed forces into this region have shown that we were on the right track with this prediction.

Another innovation of our first edition was to introduce an extended section on North Korea, with a fully developed comparison between North and South Korea, a comparison that we are unaware of in any other text. Although this was arguably a reiteration of the capitalism versus socialism perspective of the older comparative economics, it has proven prescient in that the world has come to be seriously concerned with the nature and developments of the mysterious North Korean regime, the last and purest example of a command socialist economy in the world, and the evolving nature of its relationship and possible eventual reunification with South Korea. That a unified and nuclear-armed Korea could be a formidable economic and political power in the world is increasingly clear.

Finally, although several other comparative economics texts continue to have chapters discussing the old worker-managed market socialist system of the former Yugoslavia, ours was the only one to discuss the relative success of the former Yugoslav republic of Slovenia, which has continued to maintain certain elements of its former economic system. We have expanded our discussion of the Slovenian case in chapter 14 in this edition, noting especially how Slovenia has gone against much of the advice given to it by international advisory bodies. That it is unarguably the most successful of all the transition economies suggests that it should be more closely studied than it has been.

The most important changes to the book as compared to the first edition are that one chapter has been eliminated while two new ones have been added. The one eliminated was that on the old traditional economy, which dealt substantially with economic anthropology. Certain elements of it have been preserved in chapter 4 on the new traditional economy. The two new chapters, 5 and 16, are on the economic systems of the United States and of India, respectively.

The first of these chapters was added at the suggestion of various reviewers and our publisher. Although there was some limited discussion of the U.S. economy in the second chapter on market capitalism in the first edition, it seemed desirable to provide a more extended presentation in this edition. This is not only because of the clearly more dominant position that the American economy and its system have in the world today, but also because it was the origin of several crucial institutional forms of the market capitalist system, such as the modern limited liability corporation and the system of interchangeable parts that energized the rise of the industrial economy. The emergence and problems of the information-based new economy in the United States also have implications for the entire world.

India is important both because of its sheer size and recently accelerated growth, but also as another example of where the question of the new traditional economy is very important, with India now being ruled by a Hindu nationalist political party. At the same time, India retains important elements both of indicatively planned socialism and market capitalism, making it arguably the most complexly mixed economy in the world. It also remains the world's largest repository of the old traditional economy in its still poverty-stricken rural areas where the Hindu caste system remains in place. The Indian case allows for a broader discussion of the problems of persistent poverty and the increasing global divide between rich and poor as well.

In response to a request, we provide a few more remarks about ourselves than we did in the first edition. Both of us have taught courses in comparative economics or economies in transition at various times. J. Barkley Rosser, Jr. received his education at the University of Wisconsin–Madison where he first encountered the questions involved in this book as an undergraduate in the course on capitalism and socialism taught by the late Jack Barbash, for which he served as a grader later. This course was originated by Barbash's predecessor, Selig Perlman, who was a close associate of Wisconsin's influential institutionalist economist, John R. Commons. Although Barkley often takes a mathematical approach to studying questions of complex evolutionary economic dynamics, this book reflects, at least in part, influences from this other side of the Wisconsin tradition of economics. He also spent 1981 working in Saudi Arabia, an experience that led him to think about the questions related to Islamic economics that now underpin our new traditional economy approach.

Marina V. Rosser was born in Moscow, Russia, then a part of the Soviet Union, and was educated at Moscow State University in the 1970s. She worked during the early 1980s at the Institute for World Economy and International Relations, at the time a senior advisory think tank for the top decision-making bodies of the former USSR. She was involved both in studying the relations between the Soviet economy and the rest of the world, including the United States and China, and also in working on the long-range planning process of the Soviet Union. She also personally experienced the political repressiveness of that regime before it began its long reform process. After moving to the United States in 1987 she became involved in advising on transition policy through the U.S. Agency for International Development and remains in contact with numerous persons in high decisionmaking and academic positions in Russia and other transition countries. This background and knowledge provides both the depth as well as the touch of personal experience to the chapters on transition in the former Soviet Union and in its former satellites in Central and Eastern Europe, as well as in our coverage of the Chinese economy, which she studied while in Moscow.

As we did in the first edition's preface, we confess to having our biases and predilections, which inevitably appear in various places in the book. Nevertheless, we have continued to present as many sides and perspectives and positions as is reasonably possible regarding controversial matters and subjects, and we have continued to report relevant facts and data, even when they do not coincide with our various views and prejudices. We would like to think that it is a mark of our fair-mindedness that some critics have complained that we are "obviously hard-core Marxist propagandists" while others have complained that we are "obviously flacks for hard-edged, Austrian style, pro-laissez faire libertarianism." In any case, we hope that readers will come away wary of any too vigorously advocated generalizations, and will understand that we live in an exceedingly complicated and constantly changing world.

We both remain grateful to the late Lynn Turgeon, who was responsible for introducing us in the Orwellian year of 1984 and who was also an independent source of ideas for us regarding many of the issues discussed in this book.

Among the numerous individuals thanked in the preface to our first edition, many have continued to advise and help us. We would like to especially thank again Ehsan Ahmed, Ralph Andreano, Bruce Brunton, David Colander, William Duddleston, Éva Ehrlich, Loretta Grunewald, Roger Guesnerie, Robert Horn, Robert McIntyre, Paul Phillips, Frederic Pryor, Dorothy Rosenberg, James Stodder, and Wei-Bin Zhang.

We also wish to recognize and thank others who have helped us either with advice or materials for this edition. Besides a group of anonymous reviewers, these include Peter Boettke, Loren Brandt, Daniel Cohen, Mark Foley, Robert Frykenberg, James Galbraith, Hermann Haken, Donald Hester, Richard Holt, Michel Juillard, Roger Koppl, János Kornai, Honggang Li, Julio Lopez, Akio Matsumoto, Claude Ménard, Branko Milanovic, Maria Minitti, Joaquin Oliveira, Elliott Parker, Matti Pohjola, Clifford Poirier, Victor Polterovich, William Pyle, Ajit Sinha, Bernard Vallageas, Clas Wihlborg, and the staff of the Korea Economic Institute. We also would like to thank the numerous adopters of our first edition who have encouraged us to produce this second edition, and hope that they are pleased with the result.

We would like to thank Deborah Dove for technical assistance.

Finally, we would like to thank the people at MIT Press for their advice, encouragement, and faith in this effort, including especially our senior editor, Elizabeth Murry, her assistant, Jane MacDonald, and her predecessor, Terry Vaughn, as well as the various people involved in production and marketing, especially Nancy Lombardi.

We again dedicate this edition of this book, as we did its first edition, to our mothers, Annetta Hamilton Rosser and Nata Borisovna Vcherashnaya, without whose love and care we would not be here to write it.

I OVERVIEW OF COMPARATIVE ECONOMICS

Part I of this book contains four chapters that present the theoretical and conceptual framework used in the remaining parts, which consist mostly of sets of country case studies grouped into broad categories.

Chapter 1 presents definitions and basic examples of the categories used in this book: tradition, market, and command for allocative mechanisms and capitalism and socialism for ownership systems. Broad trends in the world economy and in these systems are laid out. In addition, a comparison of many basic economic characteristics for 26 countries is presented.

Chapter 2 lays out the theory of market capitalism, the world's increasingly dominant system. It discusses the efficiency advantages of market capitalism as well as how these may not be achieved in a purely laissez-faire setting. The kinds of government interventions that might ameliorate these problems are presented.

Chapter 3 examines the theory and history of socialism in its various forms, of which command socialism has been the most important. However, command socialism has now largely disappeared, and the future importance of socialism is likely to come from other forms. The chapter concludes with an overview of the problems of transition from socialism.

Chapter 4 considers the new traditional economy, a system that seeks to combine a traditional approach, usually based on a traditional religion, with modern technology. The Islamic economy is the most developed example of this emerging form and is discussed in detail, but it also plays a role in the neo-Confucian societies of East Asia.

A central issue running through all these systems is the role of government in the economy. How much should it be involved and in what ways? Certainly in the contrast between market capitalism and command socialism in their pure forms, this issue is very clear. But an examination of the variations within each of those forms reveals that the varying role of government plays a critical role. Although it is less obvious, government also plays a role in the traditional economies, especially the new traditional economies. The Islamic economic system becomes established only if a government passes laws mandating it, despite the spread of privately owned Islamic economic institutions such as banks in predominantly non-Islamic economies.

1 How Do We Compare Economies?

As mankind approaches the end of the millennium, the twin crises of authoritarianism and socialist central planning have left only one competitor standing in the ring as an ideology of potentially universal validity: liberal democracy, the doctrine of individual freedom and popular sovereignty. . . . In its economic manifestation, liberalism is the recognition of the right of free economic activity and economic exchange based on private property and markets.
—Francis Fukuyama, *The End of History and the Last Man,* 1992

INTRODUCTION

We have witnessed a profound transformation of the world political and economic order since 1989, the ultimate outcome of which is difficult to foresee. The former Soviet Union (FSU)[1] broke up, its empire of satellite states dissolved, and most of the former constituent parts are trying to fulfill Fukyama's prophecy quoted above. In his view, the end of the Cold War means the convergence of the entire world on the American model of political economy and the end of any significant competition between alternative forms of political or economic systems.

Has this prophecy come true? We think not. Certainly during the second half of the 1990s, the economic boom in the United States pushed it forward as a role model that many countries sought and still seek to emulate. But with the outbreak of financial crises in many parts of the globe and the bursting of the American stock market bubble in March 2000, its economic problems such as continuing poverty and inequality loom large.

Furthermore, it is now clear that the problems in the FSU are deeply rooted, with the transitions in various former Soviet republics stalled. Other market capitalist economies, such as the world's second largest, Japan, have deep problems of their own, with Japan's having stagnated since 1990.

Furthermore, the collapse of Soviet Communism coincided with a surge of missionary activity in the formerly Soviet Central Asian republics by advocates of fundamentalist Islam. They present their view not just as a change in personal moral codes, but as a total system of economic and political organization of society, a possible "third way" between capitalism and socialism. Throughout the Islamic world, fundamentalist groups either have taken control of governments or are the leading opposition to existing governments. The terrorist attacks on New York City and Washington, D.C., on September 11, 2001, and

1. Prior to 1917 the Russian Empire included many nationalities ruled by the tsar. With the Bolshevik Revolution, several nationalities gained independence, some permanently, like the Finns and the Poles, and some only briefly, like the Ukrainians. Then there was Soviet Russia. In 1922 it became the Union of Soviet Socialist Republics (USSR) or the Soviet Union, which ceased to exist at the end of 1991. Now there is a loose confederation of 12 of the former 15 republics of the USSR called the Commonwealth of Independent States (CIS). When referring in the present to all of the 15 republics as a group, we shall use the term *former Soviet Union (FSU).*

the subsequent war in Afghanistan made the entire world aware of the seriousness of this global movement. Even after the replacement of the Taliban regime by the U.S.-backed one led by Hamid Karzai, Islamic rules remain largely in place, with women wearing traditional clothing even in Kabul, the capital city.

In other nations, movements based upon fundamentalist versions of local religions have emerged and become prominent. In East Asia, many see the cultural heritage of Confucianism creating a special economic environment. In India, a Hindu fundamentalist regime confronts Muslim Pakistan in a deep conflict. This appeal to economic systems based on traditional religions is the **new traditional economy,** and it presents a serious alternative on the world stage. Global economic difficulties have been further exacerbated by a series of financial crises that have spread havoc and produced sharp recessions throughout much of the world, including many East Asian nations in 1997, Russia in 1998, and the collapse of Argentina in 2001. These crises have aggravated the deeper systemic crises that many of these economies are experiencing.

In *The End of History and the Last Man,* Fukuyama recognizes that the rise of Islamic fundamentalism constitutes a potential exception to his thesis, but responds that it will be limited to the zone of existing Islamic predominance, thus ruling it out as a "potentially universal ideology." But the spread of Islam in Europe and other places raises doubts about this claim. However, the emergence of similar movements within other religions raises the possibility that the new traditional economy concept could be universal even while differing in significant details across religions. Cold War has given way to Holy War.

Even if Fukuyama is right that the socialist alternative will completely die out and that religious fundamentalism will be limited in its appeal, economic tensions between the United States, Japan, and Western Europe have focused attention on deep structural differences between these and other market capitalist economies. There are many varieties of market capitalism, and as various economic problems continue to plague the world economy, the significance of these differences increases and the global search for efficient and humane economic systems accelerates. Many countries sought to emulate some aspects of the Japanese economic system, but now Japan is in deep stagnation. Western Europe and Japan resist the homogenizing influence of the United States and the pressure to imitate its system, with its comparatively greater economic inequality and insecurity. These divergent economic tendencies have been exacerbated by political tensions that have arisen between the United States and many of these nations since 2001.

Indeed, the socialist alternative continues both as an existing system and as a possibility in some form still unseen. Classical socialism in its purest form persists in relatively obscure countries such as North Korea and Cuba. But despite the general dismantling of central planning bureaucracies, legalization of market activities, and privatization drives, portions of the FSU remain effectively socialist in the sense of widespread state ownership of the means of production. In China, the most populous nation on earth, a grand drama is unfolding as the system remains officially socialist while engaging in piecemeal marketization and the spread of capitalism.

Furthermore, even though Yugoslavia has collapsed both as a nation and as an economic system in a horribly tragic way, the idea of workers' management that its economy imperfectly represented persists and may have a new lease on life in the form of workers' ownership. This takes a variety of forms, from the profit-sharing **share economy,**[2] to classic cooperatives, to employee stock ownership plans (ESOPs), all of which exist in the United States and other market capitalist economies and are popular in the privatization efforts of many Eastern European countries.

This systemic turmoil coincides with the intense conflict between the "urge to merge," by which we mean the push for integration of the world economy and its subparts in trade and policy, and the "drive to divide," the push for independence and isolation by increasingly small entities. Also continuing are the deep problems of the less developed countries, many of the poorest of which are in outright economic decline as they search for appropriate systems in this changing environment. These difficulties are further exacerbated by a global stagnation of economic growth that aggravates the systemic crises many economies are experiencing.

Thus, the study of comparative economics has never been more important. The subject itself is undergoing transformation, just as its objects of study undergo transformation. Achieving a deep understanding of this transformation of economic systems depends on understanding the cultural and social contexts within which these historical processes evolve.

CRITERIA FOR CLASSIFYING ECONOMIES

How Do We Classify Economies?

In thinking about the nature of economic systems with the intention to compare them, we need to think fundamentally about what we mean by an *economy.* An economy is made up of a group of people who are located within a political entity that has particular geographical characteristics and who are producing and consuming goods and services. Most important for our perspective, an economy functions according to certain rules, customs, and laws that underpin the institutional framework within which the people operate. It is these institutional frameworks and their basic rules, customs, and laws that we are most interested in comparing across different economies.

2. See Martin Weitzman, *The Share Economy* (Cambridge, Mass.: Harvard University Press, 1984).

There is an endless variety of aspects of these institutional frameworks that can be considered in classifying economic systems. We shall focus upon six that combine and interact with each other in different ways. They are the allocation mechanisms, the forms of ownership, the role of planning, the types of incentives, the method of income redistribution and the nature of social safety nets, and the political and ideological system.[3] However, the first two of these are perhaps the most important in terms of classifying economic systems overall.

Allocation Mechanisms

All economies must answer the questions of "what, how, and for whom" goods and services are produced. Fundamentally, economies produce and distribute goods and services among members of their societies. Production involves allocating factor inputs between different goods and services, and distribution involves allocating produced goods and services among people.

There are three basic kinds of allocation mechanisms: traditional, market, and command. In a **traditional economy** allocation decisions depend on custom, what has been done in the past. Usually such customs or traditions are associated with a broader social context defined by a dominant religion. Economic decision making becomes embedded in the broader social context.[4]

An example is the **caste system** associated with Hinduism in India. Technically illegal since India's independence from Great Britain in 1947, the caste system still dominates both social and economic structures in much of the nation, especially rural areas. The caste system is a system of allocating labor: What one does is what one's parents did, not unlike the system under European feudalism. Each caste has an economic activity and is self-reproducing in that there is a very strong social inhibition against marrying outside one's caste. At the top are the Brahmins, the priestly caste; at the bottom are the Untouchables, who gather dung for fuel and perform other unpleasant functions. Hinduism justifies this

3. An alternative approach is that of Egon Neuberger, "Comparing Economic Systems," in Morris Bornstein, ed., *Comparative Economic Systems: Models and Cases,* 7th ed. (Burr Ridge, Ill.: Irwin, 1994), pp. 20–42. He posits four criteria for classifying systems: their decision-making structure, their information structure, their motivation structure, and their coordination system. These can be seen to relate to the categories we use to some extent, with the decision-making structure tied to the political system, the information structure tied to planning or nonplanning, the motivation structure tied to incentives, and the coordination structure tied to the allocation mechanisms—that is, the contrast of tradition, market, and command—although we see the allocation mechanism as being tied to decision making as well, making it a very central concept.

4. Karl Polanyi, *The Great Transformation* (Boston: Beacon Press, 1944). The earliest traditional economic systems reflect the systems within which the human species evolved as hunter-gatherers, with their balancing of individual interests and group interests through such mechanisms as reciprocity (Eric A. Smith and Robert Boyd, "Risk and Reciprocity: Hunter-Gatherer Socioecology and the Problem of Collective Action," in E. Cashdan, ed., *Risk and Uncertainty in Tribal and Peasant Economies* [Boulder, Colo.: Westview Press, 1990], pp. 167–195).

hierarchy through the doctrine of karma and reincarnation. When one dies, the caste into which one will be reborn is determined by one's karma, one's accumulated account of past good and evil behaviors. Thus everyone is where he or she deserves to be. In a new traditional economy, the effort to embed decision making within a traditional context coincides with an effort to adopt modern technology and to be involved in the world economy.

In a **market economy** allocation decisions are made by individuals or firms on the basis of price signals emanating from the interaction of supply and demand. These signals generally reveal themselves as individuals and firms engage in exchanging money for factor inputs, goods, or services. That such a system can be very efficient is eloquently argued by Adam Smith in his 1776 book *Wealth of Nations*. Every economy ever observed has at least some exchange activity, including tightly controlled command economies such as North Korea and very simple traditional economies such as that of the hunter-gatherer Khoi-San of the Kalahari desert in southern Africa. What marks a market economy is that a majority of economic decisions are made according to market forces rather than tradition or command.

In a **command economy** the most important allocation decisions are made by government authorities and are imposed by law or by force. Command economies were the last of the three forms to emerge historically. They rose in ancient empires such as Sumer and Egypt, which were the first strong and extended states wielding absolute power over crucial economic decision making. There is good reason to believe that the traditional and market allocation mechanisms long predated the command economies of these empires, which date back only 5,000 years.

Forms of Ownership

Karl Marx and Friedrich Engels in their 1848 *Communist Manifesto* argue that the key to understanding an economy is to know who owns the means of production. Ownership determines the distinction between **capitalism** and **socialism,** defined in strictly economic terms. In capitalist economies, land and produced means of production (the capital stock) are owned by private individuals or groups of private individuals organized as firms. In socialist economies the state owns the land and the capital stock.

This explanation attributed to Marx and Engels is simplistic. There are a variety of intermediate forms and cases such as cooperatives or worker ownership. Generally such forms are viewed as still being capitalism, although some argue that they constitute "true socialism." Indeed, aside from the variation of ownership forms, some follow certain ideas in Marx, saying that how one class relates to another is the crucial matter rather than specifically who owns what, with true socialism involving a lack of exploitation of one class by another. This kind of argument can lead to the position that the Soviet Union was not really socialist but a form of **state capitalism** in which the government leaders exploited the workers.[5] We shall adhere to the more standard view that the form of ownership is the key element in defining capitalism versus socialism.

It makes a big difference under socialism if ownership is predominantly by the central government or by local governments. The former is more likely to be associated with command decision making, whereas the latter may coincide with market-based decision making. An example of the latter is China, where there has been a tremendous expansion of firms owned by local units of government that operate in the market economy independently of the central authority in Beijing.

A third possibility is ownership by organized religious groups, which is consistent with a traditional economy system. In parts of Western Europe between 1000 and 1500, nearly one third of the land was owned by the Roman Catholic Church, with major technical innovations being made in abbeys, economically self-sufficient religious communities. In Iran after 1979 under the Islamic Republic, formerly privately owned businesses were seized by religious authorities and remain under their control, if not their formal ownership. Generally the concepts of *property* and *ownership* vary enormously from society to society. These distinctions arise not only from local traditions and practices but also from legal rules and definitions as argued by institutionalist economists.[6]

Considering the division between capitalism and socialism raises the question of the ownership system's relationship to allocative mechanisms. We often see economies that are largely capitalist, like the one in the United States, also being largely market-oriented. We have also seen the most prominent examples of socialism, notably the Soviet Union, also being command-oriented. This leads us to describe two extreme categories: **market capitalism** and **command socialism.**

But this simple dichotomization raises the possibility of "cross forms," namely, **market socialism** and **command capitalism.** Although less common than the previous two, both have existed.

The classic example of market socialism[7] was Yugoslavia. The state owned the capital stock (land was privately owned), but allocative decisions were made by worker-managed firms within a market framework. The collapse of Yugoslavia has raised questions regarding

5. For further discussion of this perspective, see Stephen Resnick and Richard Wolff, *Knowledge and Class* (Chicago: University of Chicago Press, 1989). These ideas have been further developed by the postmodernist school of Marxism whose ideas often appear in the journal *Rethinking Marxism*.

6. John R. Commons, *The Legal Foundations of Capitalism* (Madison: University of Wisconsin Press, 1931). This approach is sometimes labeled *old institutional economics,* with the *new institutional economics* emphasizing how institutions evolve to minimize transactions costs, a central process in economic history. This approach was initiated by Ronald H. Coase, "The Nature of the Firm," *Economica* 4 (1937): 386–405, with Douglass North and Oliver Williamson being important in its development.

7. Variations on this term include *socialist market economy,* used by the Chinese to describe their system of market socialism, and *social market economy,* used by the Germans to describe their essentially market capitalist economy marked by extensive income redistribution and welfare programs.

the long-term viability of this particular hybrid. China has done well with its peculiar form of market socialism, although it appears to be gradually evolving into a peculiar form of market capitalism.

Yugoslavia's collapse and the rush toward market capitalism by most of Eastern Europe can be argued to confirm the argument of the Austrian economist Ludwig von Mises[8] that rational market calculation is possible only with capitalism because of the need for the profit motive to drive private property-owning decision makers to optimize and generate efficient price signals. (However, Yugoslavia's collapse may have been caused principally by regional and religious conflicts rather than economic failure.)

The classic example of command capitalism was Nazi Germany. Although the proper name of the Nazi Party was the National Socialist German Workers' Party, Adolf Hitler avoided nationalizing such privately owned corporations as Krupp and I. G. Farben. Nevertheless, these industries produced what his economic planners recommended. Similar systems appear temporarily in wartime in market capitalist economies, as in the United States during World War II, when no private cars were produced in response to government orders (although the automobile industry remained privately owned). A more recent example of command capitalism may have been the South Korean economy during the 1970s.

An important point to understand is that there are no pure examples of any type of system. *All* real economies are mixed economies exhibiting elements of various allocation and ownership systems, even if they can be categorized one way or the other.

Role of Planning

Many comparative economists emphasize the contrast of "market versus plan" as a central defining characteristic of economic systems rather than our choice of "tradition versus market versus command." Planning deals with coordination in an economy. In a centrally planned economy, **planners' preferences** dominate allocative decision making, whereas in a market economy **consumers' sovereignty** dominates allocative decision making.

There is a strong correlation between allocation decisions following a central plan and the general presence of command socialism, as in the Soviet Union and most of its empire. But this correlation misses the crucial point: that planners' preferences determine allocative decision making only within a command framework. It is command that rules out consumers' sovereignty.

It is possible to have command without planning. An example is Soviet Russia during the period of **War Communism** (1917–1921) immediately after the **Bolshevik Revolution,** when civil war was compounded by invasion by foreign troops. Production followed

8. Ludwig von Mises, "Economic Calculation in Socialism," in Morris Bornstein, ed., *Comparative Economic Systems: Models and Cases,* 7th ed. (Burr Ridge, Ill.: Irwin, 1994, pp. 273–279), originally published in German in 1922.

commands from the center, but in a "shock" pattern whereby commands for production of certain goods were given when goods viewed as critical to the war effort became scarce. A pattern resulted of dashing higgledy-piggledy from producing one "deficit" good to another, with little effort to consider the impact of each decision or to coordinate such decisions. There was no time to plan or to even set up a planning mechanism.[9]

It is possible to have central planning coincide with market capitalism, the **planned market economy.** Such planning is known as **indicative planning** because it lacks the command element. Examples of indicative planning have been France and Japan, although such planning is less influential than in the past.

Even in thoroughly market capitalist economies there is planning by specific government agencies involved in infrastructure investment such as transportation networks, functions that in most economies seem to be in the public sector. For such cases, even the very pro-market capitalist magazine *The Economist*[10] argued in a lead editorial that there is a strong case for planning if it is carried out intelligently and is accompanied by the use of market mechanisms such as congestion tolls on highways to ensure efficient use of the resulting infrastructure.

It should also be noted that although ideologists of market capitalism generally eschew planning, most large corporations engage in long-range planning. This formed an important part of the argument by John Kenneth Galbraith in the 1960s that the American and Soviet economic systems were converging on partly planned, partly marketized *new industrial states*.[11]

Types of Incentives

Economies vary according to the incentive schemes that motivate people to work and produce. The most common incentive scheme is material, paying people according to their productivity. In market capitalism this involves paying them their marginal product that maximizes profits for competitive firms hiring labor in such a system.

Material incentives under market capitalism also take the form of rewards for entrepreneurship and capital investment as economic profits and for savings as interest. In theory, socialism rejects receiving profits; also in theory, Islam rejects receiving interest payments. Both socialism and Islam generally see material incentives as significant in motivating

9. The process of "planning how to plan" was labeled **planification** by Russian and French planners and economists, referring especially to the problem of coordinating micro-level plans at the macro level. Despite the low quality of the planning involved, it has been argued that, at least ideologically, the War Communism period saw the most serious attempt to achieve a true communist economy (Peter J. Boettke, *Calculation and Coordination: Essays on Socialism and Transitional Political Economy* [London: Routledge, 2001], chaps. 6, 7).

10. "The Case for Central Planning," *The Economist,* September 12, 1992.

11. John Kenneth Galbraith, *The New Industrial State* (Boston: Houghton Mifflin, 1965).

labor.[12] But sometimes this motivation may be tied to pleasing some ideological or religious prescription or satisfying an elite, as in the system of perks given to top leaders in the former command socialist states.

An alternative that has sometimes been advocated and less frequently tried is **moral incentives,** trying to motivate workers by appealing to some higher collective goal. Efforts to implement moral incentives occurred in China under Mao Zedong during the **Great Proletarian Cultural Revolution** from 1966 to 1976 and during certain periods in Cuba under Castro. The Chinese effort followed the slogan "Serve the people." In both China and Cuba, these periods were characterized by serious economic stagnation.

But before dismissing moral incentives, note that they have been used temporarily when market capitalist economies have gone into a command mode during wartime. Thus production surged in the United States during World War II, despite the imposition of wage and price controls limiting the material gains from hard work. Part of the motivation to work came from the wartime appeal to patriotic national sacrifice.

The new traditional economy depends partly on appealing to moral incentives. Islam and most great world religions do not completely deny the pay-for-work principle that undergirds material incentives. But these belief systems also see limits to this principle, both from the need to provide charity for the poor and from the general argument that excessive concentration on acquiring material goods distracts from spiritual matters. Arguably in the extreme case of Afghanistan under Taliban rule, moral incentives became especially important, with the idea of martyrdom driving many actions.

Income Redistribution and Social Safety Nets

Economies vary based on the extent to which and the methods by which governments intervene to redistribute income. This depends partly on how unequal income is to begin with before any redistributive policies are implemented. Thus the Japanese government does much less redistributing than the governments of many other capitalist countries because Japan has a more equal distribution of wages than most other capitalist countries. Command socialist economies also have had less income redistribution because governments initially control the distribution of income by setting wages and forbidding capital or land income.

People differ greatly about the appropriate goal of income redistribution, much less the method. Ludwig von Mises and many in the **Austrian School of economics** argued that a just income distribution reflects a free market outcome in a context of well-defined property rights and complete equality of opportunity for all individuals, although his follower, Friedrich A. Hayek, occasionally argued that government should act to prevent individuals

12. That socialism has not always successfully implemented material incentives for workers is shown by the old Soviet joke that "they pretend to pay us and we pretend to work."

from falling below some minimum standard of living. The von Mises view suggests an ideal economy in which there is no government income redistribution.

Sharply contrasting with the preceding idea is John Rawls's's[13] view that the justness of a society is to be judged by how well off its poorest individual is, the **maximin criterion.** He argues that selfish and rational individuals would support such a criterion if they fully understood the uncertainty of the future and realized that there is always the possibility that "there but for the grace of God go I." This suggests substantial redistribution toward absolute equality, limited only by disincentive effects becoming so great that the poorest individual's income drops.

Rawls's view echoes that of many traditional religions. None insist on absolute equality of income, but most place an emphasis on charity and taking care of the poor. Although organized religions may court the wealthy for their possible financial support, there is a vein of contempt toward wealth as exemplified by the remark of Jesus that "It is easier for a camel to pass through the eye of a needle than it is for a rich man to enter heaven."

In his 1871 *Critique of the Gotha Program,* Karl Marx enunciated the ideal goal of **pure communism** as being "from each according to his ability, to each according to his need." This does not imply complete equality of income, as people have different needs, for example, different family sizes or health problems. Marx contrasted this goal with that of socialism, which would be "from each according to his ability, to each according to his work."

Clouding this entire discussion is the **equity-efficiency trade-off,**[14] which states that greater efforts to make income more equal will result in less efficiency, meaning less rapid economic growth. The argument is that material incentives are what draw forth productive and entrepreneurial effort. Thus vigorous efforts to redistribute income reduce the rewards for work and entrepreneurship and thus reduce the rate of economic growth. Such arguments have become influential in many countries to scale back redistributive programs. This view had its most vigorous advocates among *supply-side* economists associated with the "Reagan revolution" in the United States and advising Margaret Thatcher in Great Britain.

Most societies struggle with intermediate approaches of one sort or another, although very poor countries generally cannot afford to do much redistributing, as there is not much to redistribute. Most carry out some redistribution through their tax codes and through some sort of **social safety net** for certain categories of people: the aged, the unemployed, single mothers with children, the sick, and sometimes others as well. In advanced capitalist countries, aging populations and medical care costs rising faster than the rate of inflation

13. John Rawls, *A Theory of Justice* (Oxford: Clarendon Press, 1972).

14. Arthur Okun, "Rewards in a Market Economy," in Morris Bornstein, ed., *Comparative Economic Systems: Models and Cases,* 7th ed. (Burr Ridge, Ill.: Irwin, 1994), pp. 71–77.

are putting tremendous fiscal pressure on social safety nets. Countries that have largely market capitalist economies but have very large amounts of income redistribution with large social safety nets are said to have **social market economies.** Germany and many of the Scandinavian economies are the leading examples of this system.

Generally in the command socialist economies a wider array of activities and people have been protected by social safety nets, although sometimes the quality of that protection has been questionable, as in the case of Soviet medical care. A major problem of the current transition period, with substantial economic declines in the FSU, has been the partial dismantling and weakening of these social safety nets without adequate replacements.

A final point regarding the equity-efficiency trade-off is that it is frequently false. Some of the most rapidly growing economies in the world have reasonably equal distributions of income, such as the East Asian **newly industrializing countries** (NICs), whereas some of the countries with very unequal income distributions have had poor growth records, such as many in Latin America. It is crucial that income and wealth inequalities arise from differences in productivity and entrepreneurship rather than from corruption or inheritance. If inequality is perceived as unfair, then the result may well be strikes, guerrilla war, or revolution, none of which are conducive to economic growth.[15]

Role of Politics and Ideology

The relationship between politics and economics is subject to deep debate. Until nearly 100 years ago no distinction was made between the two disciplines, there being only political economy. Many still think that is the way the subjects should be analyzed, and believe that they cannot be realistically separated. At the heart of the linkage is ideology, in which certain political and economic systems are linked in distinct packages and given labels such as *communism* and *liberal democracy.*[16] A central controversy has been whether or not political democracy is indissolubly linked with market capitalism and command socialism with dictatorship. Friedrich Hayek forcefully argues this position in his 1944

15. This problem plagues the former Soviet bloc economies in their transition efforts in that many new entrepreneurs are either former Communist Party officials with special privileges or former black marketeers whose sources of initial finance are viewed as illegitimate by most people. Indeed, there appears to be a link between corruption and inequality in these economies (J. Barkley Rosser, Jr., and Marina V. Rosser, "Another Failure of the Washington Consensus: Inequality and Underground Economies in the Transition Countries," *Challenge* 44 [March-April 2001]: 39–51). For further discussion of the argument that equality and growth may be positively related, see Torsten Persson and Guido Tabellini, *Political Economics: Explaining Economic Policy* (Cambridge, Mass.: MIT Press, 2000, chap. 14). They note that too much inequality can lead to excessive redistributive programs that damage incentives.

16. This use of *liberal* is the classical or European usage, meaning individual freedom and minimal government. The modern American usage, meaning support for government intervention in the economy, arose in the twentieth century from the evolution of the British Liberal Party toward such a position from its earlier classical position.

The Road to Serfdom, in which he claims that welfare state redistribution can lead to command socialist dictatorship. Milton Friedman supports this view in his *Capitalism and Freedom*. Friedman argues that even if expanded government activity does not lead to full-blown dictatorship, it constitutes a reduction in the freedom of the individual to choose what to do with his or her income because of higher taxes. Such views are labeled *libertarian* and have deep roots in American and British thought. The view that there should be minimal government economic intervention is called **laissez-faire,** a French term from the mid-1700s literally meaning "let them do it," them being businesspeople.

Both Hayek and Friedman associate socialism with dictatorship and lack of individual freedom. Complete socialism reduces economic freedom insofar as private ownership of capital and land is forbidden. The FSU was characterized by both economic socialism and political dictatorship. These countries are now generally moving toward both market capitalism and democracy.

But in Western Europe, social democratic political parties exist that call themselves socialist[17] but support neither extensive nationalization of the means of production nor political dictatorship. They support income redistribution and extensive social safety nets, although even in their heartland in northwestern Europe such approaches are under retreat. Nevertheless we have seen over 70 years of such **social democracy** in Sweden without the Hayekian prediction of political dictatorship coming true.

The split in Europe between socialist and communist political movements occurred after the 1917 Bolshevik Revolution in Russia, when Vladimir Lenin imposed a **dictatorship of the proletariat** under the leadership of a *vanguard party,* later combined with a command socialist economy by Joseph Stalin. Although many Western European socialist parties continued to support nationalization and central planning for a long time, they opposed dictatorship.

Ironically, the ideological father of communism, Karl Marx, claimed that communism entailed the withering away of the state. The dictatorship of the proletariat was to be a strictly temporary phenomenon. Well aware of this, the Soviet Communists never claimed to have achieved communism, always labeling their own system *socialist* rather than *communist* and viewing their system as in transition to communism.

The key libertarian claim that full-blown economic socialism has never coexisted with political democracy is true. But in some Western European countries, democratic governments have carried out substantial nationalizations without becoming dictatorships, such as Great Britain and Austria (even though both of these countries have more recently undone

17. Some of the former Communist parties of Eastern Europe have taken variations of this name. Thus in Germany there is the old Social Democratic Party, while the former Communists are now the Party of Democratic Socialism.

many of those nationalizations). Although absolutely forbidding private enterprise is incompatible with political democracy and personal freedom, having a great portion of the economy nationalized is not.

A further complication is that market capitalism has coexisted with authoritarian political regimes in parts of East Asia and Latin America. Many of these countries have recently experienced a trend toward democracy. Nevertheless market capitalism is no guarantee of political democracy even if the two are historically correlated. Indeed, the economy that is arguably currently the most market capitalist, Hong Kong, is not a fully functioning democracy, while another of the most market capitalist economies, Singapore, is quite authoritarian while formally democratic.

Another competing ideology is new traditionalism, especially Islamic fundamentalism. The focus in Islamic fundamentalism is not on either politics or economics as an end, but rather on religion and its rules. The basic demand of the Islamic fundamentalists is the imposition of an Islamic law code, a **Shari'a.**[18]

These codes address many issues, ranging from social matters such as restrictions on women's behavior to economic matters such as forbidding the charging of interest. But there is no definitive position on capitalism versus socialism. Nor is there a political theory of Islam other than the basic demand that a *Shari'a* be implemented and obeyed. It does not matter whether the enforcer of the law is a king, a mullah, a military dictator, or a democratically elected president. Indeed, the current Islamic Republic of Iran is a functioning, if limited, parliamentary democracy. But it is not a liberal democracy because individual rights and freedoms are subordinated to a *Shari'a* and the will of religious authorities.

Thus every generalization seems subject to exceptions rendering it almost unusable. But although liberal democracies have adopted the command mode of allocative decision making on a temporary basis during wartime, none has done so on a permanent basis during peacetime. Here is a more definitive hypothesis: Permanent command control of an economy implies unequivocal loss of personal freedom because none can be allowed to challenge the system of such control. Thus it is permanent command that is incompatible with liberal democracy, not economic socialism.

CRITERIA FOR EVALUATING ECONOMIES

Morris Bornstein[19] presents nine criteria by which the relative performance of economic systems can be compared.

18. There is more than one such code. See chapter 4 of this book.

19. "The Comparison of Economic Systems: An Integration," in Morris Bornstein, ed., *Comparative Economic Systems: Models and Cases,* 7th ed. (Burr Ridge, Ill.: Irwin, 1994), pp. 3–19.

First is the level of output. This figure should be corrected for population and the price level, giving us real per capita output as the measure that equals **real per capita income.** Despite difficulties in making cross-country comparisons because of differences in data gathering, this is probably the best measure of the material standard of living in a society available to us. The highest levels of real per capita income exist in market capitalist economies.

Second is the growth rate of output. This figure must be corrected for population growth. It is often easier for middle- to low-income countries to grow faster than either the very poorest or the very richest. The very poorest often are caught in **Malthusian low-level equilibrium traps** where little investment can occur because nearly all output is absorbed by consumption in an effort merely to stay alive. The middle- to low-income countries that have escaped from such traps can borrow technology from the most advanced countries and play catch-up according to the **relative backwardness hypothesis.**[20] Such borrowing can bring dramatic productivity improvements in an economy that is more backward than the world's leading economies. The growth of the richest countries is limited by the general advance of technology at the frontier of knowledge. Command socialist economies have sometimes grown quite rapidly for extended periods of time, but they suffer from a tendency toward serious stagnation in the longer run. More recently, evidence suggests links between measures of economic freedom in general and economic growth.[21]

Third is the composition of output. The most notable variables of composition are the breakdown between consumption and investment, the share of military output, and public versus private goods. Command socialist economies generally have higher shares going to investment, although the East Asian market economies, such as Japan, also have high rates of investment.

Fourth is **static efficiency.** Formally this means **Pareto optimality,** the idea that no one in society can be made better off without making someone else worse off. In this situation, resources are being fully utilized to their best potential given the existing technology, and as much is being produced as can be produced. Static efficiency implies that the labor force is fully employed and that the composition of goods being produced is what people want. It is widely argued that market economies are more successful in this area, although relative success is rather difficult to measure, and market economies tend to have worse unemployment than command economies.

20. "Alexander Gerschenkron, *Economic Backwardness in Historical Perspective* (Cambridge Mass.: Harvard University Press, 1962).

21. See James D. Gwartney, Robert A. Lawson, and Randall Holcombe, "Economic Freedom and the Environment for Economic Growth," *Journal of Insitutional and Theoretical Economics* 155 (1999): 643–663. For a recent overview of characteristics separating successfully developed economies from those caught in deep poverty, see David S. Landes, *The Wealth and Poverty of Nations: Why Some Are So Rich and Some Are So Poor* (New York: W. W. Norton, 1999).

Fifth is intertemporal or **dynamic efficiency,** which involves the allocation of resources over time to maximize long-run sustainable growth. An example of nonsustainable output maximization was the effort by the Soviet Union to pump large amounts of oil in short periods of time. This push led to depletion of pressure in the wells, making it difficult or impossible to get out later the remaining oil that could have been accessible. Long-run sustainability of growth ultimately depends on maintaining a viable environment, and it is now seen that failure to do so was an important factor in bringing about the fall of the Soviet bloc command socialisms. Indeed, the few remaining command socialist economies, such as North Korea, are having severe problems maintaining positive economic growth.

Sixth is **macroeconomic stability,** the lack of large oscillations of output, employment, or the overall price level. It is usually argued that strict command economies achieve greater short-run macroeconomic stability, although there have been some spectacular exceptions. Indeed, the few remaining command socialist economies, such as North Korea, have tended to exhibit extreme macroeconomic instability since the breakup of the Soviet Union.

Seventh is economic security of the individual in terms of income, employment, and related matters such as health care. This criterion is partially related to the previous one, but it also depends on the broader social safety nets of an economy.

Eighth is the degree of equity of the income and wealth distributions. Generally the socialist and social market economies have more equal distributions than the strictly market capitalist economies.

Ninth is the degree of freedom available to the individual in terms of work, consumption, property, investment, and more broadly in the civil and political realms. This last variable is difficult to quantify, but market economies are well ahead of command economies in this area.

Many of the criteria listed above are difficult to quantify. Nevertheless, a summary of indexes of some of these criteria is presented in the tables below. Table 1-1 focuses on overall indicators, including per capita gross domestic product (GDP), an index of real per capita GDP, average rate of inflation, share of gross private investment in GDP, the quintile ratio (ratio of national income going to the top fifth of the population to that going to the bottom fifth), life expectancy at birth, and the United Nations **Human Development Index** (**HDI**), which is constructed from real per capita income, life expectancy, adult literacy rates, and measures of educational enrollment. This index can vary from 0.0 (bad) to 1.0 (good). The highest-scoring country for 2000 was Norway at .942 and the lowest was Sierra Leone at .275.

Table 1-2 focuses on the role of government, including the shares of GNP going to central government consumption, central government taxes, defense spending, spending on education, and spending on health. It also reports values for an **Economic Freedom Index** (**EFI**) that is constructed by the Heritage Foundation and the *Wall Street Journal*. It is based

Table 1-1
General Condition/Performance of Various Economies

Country	Real GDP (per Capita)	Growth Rate	Inflation Rate	Investment Share	Quintile Ratio	Life Expectancy	Human Development
Market Capitalist							
United States	34,142	2.2	2.7	21.0	9.0	77.0	0.939
Ireland	29,866	6.5	2.3	23.0	6.4	76.6	0.925
Hong Kong	25,153	1.9	5.8	28.0	n.a.	79.5	0.888
New Zealand	20,070	1.8	1.8	21.0	17.4	77.6	0.917
Colombia	6,248	1.1	20.6	12.0	20.3	71.2	0.772
Ivory Coast	1,630	0.4	7.2	10.0	6.2	47.8	0.428
Planned Market Capitalist							
Japan	26,755	1.1	0.7	26.0	3.4	81.0	0.933
France	24,223	1.3	1.6	21.0	5.6	78.6	0.928
S. Korea	17,380	4.7	5.1	27.0	5.3	74.9	0.882
India	2,358	4.1	9.1	24.0	5.7	63.3	0.577
Social Market Capitalist							
Germany	25,103	1.2	2.2	23.0	4.7	77.7	0.925
Sweden	24,277	1.6	1.9	18.0	3.6	79.7	0.941
Costa Rica	8,650	3.0	15.6	18.0	11.5	76.4	0.820
Sri Lanka	3,530	3.9	9.9	26.0	5.3	72.1	0.741
Market Socialist							
China	3,976	9.2	8.6	39.0	8.0	70.5	0.726
Egypt	3,635	2.5	8.8	23.0	4.0	67.3	0.642
Former Market Socialist							
Slovenia	17,367	2.8	24.6	28.0	4.1	75.5	0.879
Hungary	12,416	1.9	20.3	31.0	3.5	71.3	0.835
Command Socialist							
Cuba	3,967	6.2	−0.1	n.a.	3.3	76.0	0.795
Laos	1,575	3.9	28.2	24.9	6.0	53.5	0.485
Former Command Socialist							
Czech Republic	13,991	1.0	7.8	30.0	3.5	74.9	0.849
Russia	8,377	−4.6	99.1	22.0	12.2	66.1	0.781
Ethiopia	668	2.4	5.3	17.0	6.7	43.9	0.327
New Traditional							
Iran	5,884	1.9	26.0	20.0	n.a.	68.9	0.721
Pakistan	1,928	1.2	9.7	15.0	4.3	60.0	0.494

Source: Real per capita gross domestic products (GDPs) are for 2000 in U.S. dollars, adjusted for purchasing power parity (PPP) from the *Human Development Report 2002* (New York: Oxford University Press for the United Nations Development Program, 2002), pp. 149–152. Growth rates are annual average rates of per capita GDP for 1990–2000 from the *Human Development Report 2002,* pp. 190–193, except for Cuba, which is for 2000–2001 from Gerald P. O'Driscoll, Jr., Kim R. Holmes, and Mary Anastasia O'Grady, *2002 Index of Economic Freedom* (Washington, D.C., and New York: Heritage Foundation and Wall Street Journal, 2002), p. 167, and *Human Development Report 2000,* p. 224. Inflation rates are annual average increases in consumer price indexes (CPIs) for 1990–2000 from *Human Development Report 2002,* pp. 190–193, except for New Zealand, which is from *Human Development Report 2001,* p. 169, and Cuba, which is from *2002 Index of Economic Freedom,* p. 168. Investment share is gross domestic investment as a percentage of GDP for 2001 from *World Development Report 2003* (New York: Oxford University Press for the World Bank), pp. 238–239, except for Laos, which is for 1998 from *Human Development Report 2000,* pp. 206–209. Quintile ratios are for the most recent year between 1991 and 1999 from *Human Development Report 2002,* pp. 194–197, except for Cuba, which is for 1978 from Claes Brundenius, *Revolutionary Cuba: The Challenge of Economic Growth and Equity* (Boulder, Colo.: Westview Press, 1984), p. 15. Life expectancy is in years at birth for 1995–2000 from *Human Development Report 2002,* pp. 174–177. Human development index (HDI) is from *Human Development Report 2002,* pp. 149–152, and is for 2000. The index is constructed from real per capita income based on PPP, life expectancy at birth, adult literacy rates, and educational enrollment measures, and it can vary from 0.0 to 1.0. Countries with an HDI above .80 are considered to have "high human development," those with an HDI between .50 and .80 are considered to have "medium human development," and those with an HDI below .50 are considered to have "low human development."

Table 1-2
Role of Government in Various Economies

Country	Government Expenditure	Taxes Spending	Military Spending	Education Spending	Health	Economic Freedom
Market Capitalist						
United States	21.1	20.5	3.1	5.4	5.7	1.80
Ireland	35.5	31.6	0.7	6.0	5.2	1.80
Hong Kong	15.1	15.0	n.a.	2.9	2.1	1.30
New Zealand	33.4	32.1	1.0	7.3	6.3	1.70
Colombia	16.0	10.1	2.3	4.4	5.2	2.85
Ivory Coast	24.0	20.8	0.9	5.0	1.2	2.90
Planned Market Capitalist						
Japan	13.7	13.7	1.0	3.6	5.7	2.45
France	46.6	39.2	2.6	6.0	7.3	2.70
S. Korea	17.4	17.3	2.8	3.7	2.4	2.50
India	14.4	8.6	2.4	3.2	0.6	3.55
Social Market Capitalist						
Germany	32.9	26.5	1.5	4.8	7.9	2.10
Sweden	42.7	35.8	2.1	8.3	6.6	2.05
Costa Rica	30.1	23.1	0.0	5.4	5.2	2.65
Sri Lanka	25.0	14.5	4.5	3.4	1.7	2.80
Market Socialist						
China	8.1	5.7	2.1	2.3	2.1	3.55
Egypt	30.6	16.6	2.3	4.8	1.8	3.55
Former Market Socialist						
Slovenia	42.0	35.0	1.2	5.7	6.7	3.10
Hungary	43.4	31.4	1.5	4.6	5.2	2.40
Command Socialist						
Cuba	n.a.	n.a.	n.a.	6.7	8.2	4.75
Laos	24.8	n.a.	2.4	2.1	1.2	4.55
Former Command Socialist						
Czech Republic	35.0	31.6	2.0	5.1	6.6	2.40
Russia	25.4	18.4	4.0	3.5	4.5	3.70
Ethiopia	24.6	12.2	9.4	4.0	1.2	3.55
New Traditional						
Iran	26.7	11.2	3.8	4.0	1.7	4.55
Pakistan	21.4	12.6	4.5	2.7	0.7	3.30

Source: Government expenditures and taxes spending are percentages of GDP of central government expenditures and central government taxes for 1998 from *Human Development Report 2000,* pp. 205–209, except for Hong Kong, Slovenia, and Laos, which are for 2000 from *2001 Index of Economic Freedom,* pp. 198, 331, and 237, respectively, and Japan and Ethiopia, which are for 1990 from *World Development Report: Attacking Poverty 2000-2001,* pp. 300–301. Military spending, education spending, and health spending are amounts spent by central governments as percentages of GDP for 1998, 1995–1997, and 1996–1998, respectively, from *Human Development Report 2000,* pp. 214–217. Economic freedom is an index ranging from 1.0 (fully free) to 5.0 (fully unfree) for 2002 from *2002 Index of Economic Freedom,* pp. 22–28. Index ranges of 1.00–1.95 are labeled as "free," 2.00–2.95 as "mostly free," 3.00–3.95 as "mostly unfree," and 4.00–5.00 as "repressed." This index is an average of numbers using the same scale and weighted equally for the following nine categories: trade policy, fiscal burden of government, monetary policy, capital flows and foreign investment, banking and finance, wages and prices, property rights, regulation, and black market activity.

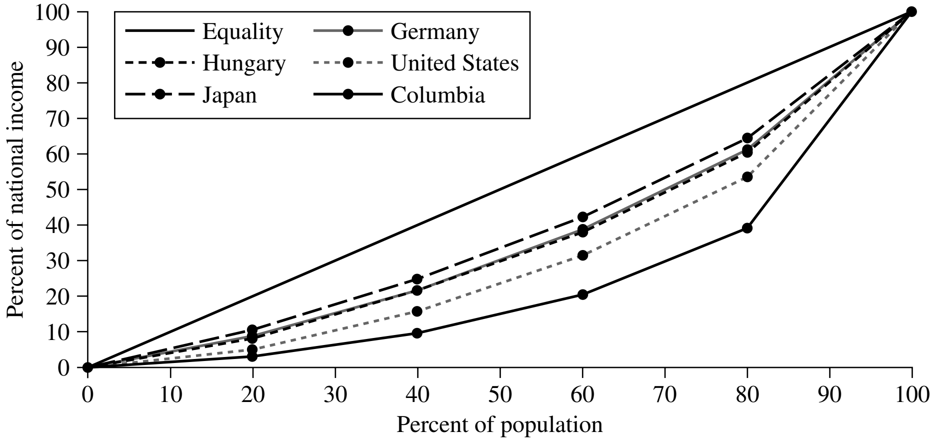

Figure 1-1
Lorenz curves.
Source: World Development Report 2000–2001 (World Bank), Table 5.

on 10 subindexes and can vary from 1.0 (economically free) to 5.0 (economically unfree). For 2002, Hong Kong was the freest at 1.3, while North Korea and Iraq were the least free, both at 5.0.

Data for many countries are unreliable, especially for many less developed countries that do not have money for gathering data. For former and current socialist countries, data unreliability arose from past propagandistic lying and corruption, as well as the bureaucratic tendency toward secrecy. Even officials in these countries could not get accurate data.[22] Unsurprisingly, there were massive revisions of data in some of these countries during the 1990s.

Figure 1-1 shows income distribution in several countries using **Lorenz curves.** These rank a country's population on the horizontal axis according to income, with the vertical axis showing the percentage of national income going to that group of the population. As the curve moves away from the diagonal 45-degree line, income becomes more unequally distributed. The rankings provided by Lorenz curves correlate strongly with the rankings provided by the quintile ratios.

The Lorenz curve can be used to generate another measure of income distribution used later in this book, the **Gini coefficient.** This is the area between the Lorenz curve and the

22. Many top think tanks of the USSR used data on their own economy estimated by the U.S. Central Intelligence Agency (CIA) in the belief that it was the best available. Ironically, after the collapse of the USSR, there was criticism in the U.S. Congress of the CIA for the alleged inaccuracy of those estimates.

45-degree line divided by the total area under the 45-degree line. Thus, Gini coefficients range from 0 to 1, with higher values indicating greater inequality.

The numbers presented in tables 1-1 and 1-2 are broadly consistent with the generalizations made earlier despite various anomalies and odd cases. Some of these may be the result of data imperfections, but certainly not all of them. A close examination of these numbers should emphasize the uniqueness of each economy and the difficulty of attempting to classify economies into neatly defined categories. There is ultimately a degree of arbitrariness to such a procedure.

SUMMARY AND CONCLUSIONS

Fukuyama argues that the world economy is converging on American-style market capitalism. But this is a very complex process in a troubled and transforming world economy. In comparing economies, central issues are the allocation system—traditional, market, or command—and the ownership system—capitalist or socialist. Economies vary in their income redistribution approaches, as well as in their political systems and ideologies. Bornstein presents nine criteria for evaluating the outcomes of economies, and we provide data related to these criteria for 25 countries, both for general performance indicators and for the role of government in their economies.

Although many of the data are consistent with our expectations for the economic systems identified for the respective countries, numerous anomalies exist. Thus, there are many other elements besides those listed in this chapter that are important to the functioning of an economy and its essential nature. A short list includes its openness to international trade and investment; its industrial organization; its policies with respect to the environment; the sectoral breakdown of its industries; its degrees of literacy and urbanization; its population density; its labor-management relations; its macroeconomic policies; the nature of its legal system; its level of corruption; its level of generalized trust, or **social capital;** and the broader cultural attitudes of its people, among others. Many of these will be discussed later in the individual country studies.

QUESTIONS FOR DISCUSSION

1. Why does Fukuyama think that we are at “the end of history” and how is his idea relevant to comparative economics?
2. Are market economies necessarily capitalist and are command economies necessarily socialist? Why or why not?

3. Even though the U.S. economy is probably the most modern and market capitalist–oriented economy in the world, it contains elements of a traditional economy. What are some examples?

4. Is market capitalism necessary for freedom? Why or why not?

5. Distinguish between the Rawlsian, socialist, and pure communist views of how income should be distributed.

6. Considering tables 1-1 and 1-2, what are some countries that exhibit characteristics or performances not in accord with the generalizations made in this chapter with regard to the systemic category into which they are placed? What are those characteristics or performances and how are they anomalous?

7. Based on table 1-1, what are some examples of countries that have a somewhat higher HDI while having somewhat lower real per capita GDPs? How can this happen, and can you see evidence of this in the table?

8. Based on table 1-2, do you see any patterns regarding the relationship between the EFI and the category of economic system? Does this make sense? Is there any pattern of relationship between the EFI and the HDI? Does this make sense?

9. How have developments in the world since September 11, 2001, affected the way we analyze economic systems and their relationships with each other?

SUGGESTED FURTHER READINGS

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2 The Theory and Practice of Market Capitalism

All the bad things you hear about markets are true: unemployment, inflation, inequalities of income and wealth, monopoly power, negative externalities, and insufficiently supplied public goods. You know, there is only one thing that is worse than the market, and that is no market.
—Csaba Csáki, Rector of Economics, Budapest University of Economic Sciences (formerly Karl Marx University), speech, August 1990

INTRODUCTION

The vast changes sweeping through the world economy have focused attention upon the nature of the market capitalist economic system, the system that is the goal of many reformers in power in the former communist countries. Even many predominantly market capitalist economies are making efforts to move toward a purer version of this system, although this effort may be slowing down in some places. It seems, as Fukuyama argues, to be the victorious universal ideology of the world.

We have never seen a pure version of the market capitalist system anywhere in history, nor are we likely to. The U.S. and British economies in the middle to late nineteenth century were probably the closest achievement of pure market capitalism. These economies represented the culmination of a historical line of development that, originating in the murky mists of time, formed a coherent system in the 1200s in northern Italy and Flanders with the invention of modern accounting and accelerating urbanization, and transformed itself into a dominating structure with the **Industrial Revolution** in Great Britain in the late eighteenth century. These processes also involved an evolution of institutions that allowed capitalist markets to operate without excessive transactions costs.[1] But even at the apogee of pure market capitalism in the nineteenth century, governments intervened in many ways, from trade protectionism to subsidizing the building of transportation infrastructure to maintaining military forces.

These economies exhibited both the advantages and difficulties of unfettered market capitalism. They experienced enormous technological advances and growth as they underwent the Industrial Revolution. Even those critics of market capitalism, Karl Marx and Friedrich Engels, recognized the enormous ability of the system to "revolutionize the means of production" in ways unprecedented in world history.

However, both the American and British economies experienced large macroeconomic fluctuations with serious downturns in the 1870s and 1890s and increasingly unequal distributions of income associated with increasing concentrations of industrial monopoly

1. The New Institutional School of economics especially emphasizes the role of the historical evolution of legal frameworks that support the enforcement of contracts and property rights and the reduction of transactions costs more generally as fundamental to the rise of market capitalism. Douglass North has particularly studied this element in the historical rise of market capitalism in Western Europe (Douglass C. North and Robert Paul Thomas, *The Rise of the Western World: A New Economic History* [Cambridge: Cambridge University Press, 1973]).

power. After 1900 these problems triggered substantial movements toward greater government involvement in both economies, in the United States especially after the Great Depression of the 1930s.

Today three economies that come closest to the ideal of pure laissez-faire market capitalism are Hong Kong, Singapore, and New Zealand.[2] The first two have highly successful records in many ways. In recent decades both Hong Kong and Singapore have enjoyed among the highest growth rates in the world along with very low unemployment. We shall consider the case of Hong Kong in chapter 15, but for now note that, much like Japan, there has been indicative planning by the Hong Kong authorities. There has also been state ownership of land with long-term leases. Hong Kong is not an independent country, having been a crown colony of Great Britain before 1997 and a part of the People's Republic of China since then. Despite interventions in the stock market during the Asian financial crisis of 1997 and despite coming under the control of the Communist government in Beijing, Hong Kong has largely retained its mostly laissez-faire system, marked by very low taxes, free trade, no state enterprises, and few business regulations. In Singapore, there are more state-owned enterprises that supply about 28 percent of government revenues. Neither Hong Kong nor Singapore is a properly functioning democracy, with Singapore having a reputation for political authoritarianism despite its free-market economy.

Whereas Hong Kong has long had a very laissez-faire economy, New Zealand has become such an economy only since 1984 with a major wave of tariff reductions, privatization of formerly state-owned enterprises, more general deregulation, and reduced social safety nets. Although the growth rate increased after these reforms occurred, New Zealand's performance has not been as impressive as that of Hong Kong or Singapore. New Zealand had an annual GDP growth rate of 1.8 percent during the 1990s and as of 2000 was only 23rd in real per capita income in the world. It also has a striking degree of income inequality, as can be seen in table 1-1, where its quintile ratio of 17.4 is the highest among all high HDI nations. Thus, it is unsurprising that a reaction against the cuts in social safety nets occurred after 1999. New Zealand has undone some of its moves toward laissez-faire capitalism by renationalizing the accident compensation scheme, raising the top marginal income tax rate, and increasing environmental restrictions on natural resource use. This shows the limits of laissez-faire in political democracies. Thus, despite their high EFI ratings, neither Hong Kong nor Singapore nor New Zealand is a pure example of a laissez-faire economy.

2. Ratings of economic freedom in 155 countries can be found in Gerald P. O'Driscoll, Jr., Kim R. Holmes, and Melanie Kirkpatrick, *2001 Index of Economic Freedom* (Washington, D.C., and New York: Heritage Foundation and the *Wall Street Journal,* 2002). Hong Kong rates as the most economically free country in the world, with Singapore second and New Zealand third, according to this volume. The United States is tied for fourth place with Estonia, Ireland, Luxembourg, and the Netherlands. North Korea is 155th.

Some very poor less developed countries have smaller state sectors relative to GDP than these three—for example, desperately poor Sierra Leone.[3] But most of these nations also have poorly developed markets and little modern industrial capitalism. Among the larger countries, the economy most oriented to market capitalism is probably the United States, despite its substantial increase in government intervention since the 1930s, discussed in more detail in chapter 5.

It is the **dynamic efficiency** or technological dynamism of market capitalism that is its greatest appeal to countries seeking to emulate its success. But this dynamism has come through the macroeconomically destabilizing process of **creative destruction,** as described by Joseph Schumpeter.[4] With respect to static efficiency, market capitalism can be seen as possessing significant advantages, although Adam Smith strongly argued for both market capitalism's dynamic and static advantages. Both of these efficiencies require market capitalism to operate within an institutional framework that allows transactions and contracts to take place and be enforced without excessive cost.

THE THEORETICAL EFFICIENCY OF MARKET CAPITALISM

Why do some of the world's highest real per capita income countries have economies that are market capitalist, such as the United States? Probably the strongest reason is the general ability of markets to allocate goods and resources *efficiently* through the law of supply and demand. This general ability is summarized in the following theorem: *A complete, competitive, full-information general equilibrium is efficient.*

To understand this theorem, its implications, and its limitations, it is necessary to know what the terms in it mean. **Complete** means that for any good or service that affects someone's utility, there is a market. **Competition** means that there are many buyers and sellers with free entry and exit, there are well-defined homogeneous goods and services, and no individual supplier has any control over the price in his or her market. **Full information** means that all agents in the economy know everything about consumer preferences, production technologies, prices, and anything else they might need to know in deciding how to act. **General equilibrium** means that every single market is in equilibrium in the sense that the quantity supplied equals the quantity demanded of the good or service in question. If only a few markets are in equilibrium, this is **partial equilibrium. Efficiency** means Pareto optimality, after the Italian economist Vilfredo Pareto. No one in the economy can be made

3. There is an argument known as **Wagner's Law** that asserts that as an economy's income rises the relative size of its state sector expands.

4. Joseph A. Schumpeter, *The Theory of Economic Development* (Cambridge, Mass.: Harvard University Press, 1934), originally published in German in 1911.

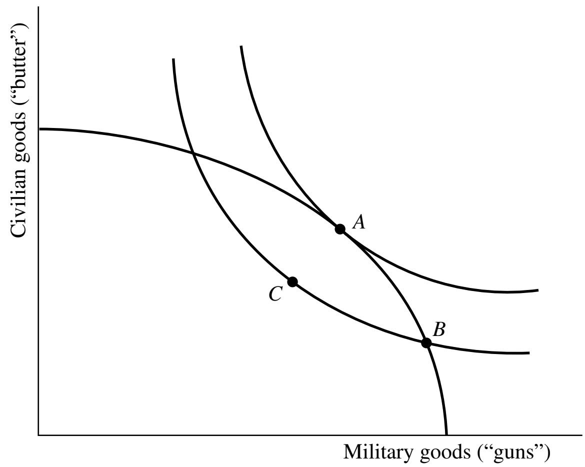

Figure 2-1
Production possibilities frontier.

better off without making someone else worse off. If someone can be made better off without making someone else worse off, then the economy is not producing as much as possible of what people want. But if Pareto optimality holds, no more of what people want can be produced; all that can be done is to reshuffle existing goods and services between people.

Thus the economy is on its **production possibilities frontier** (PPF), defined as the set of maximum possible output combinations the economy can produce given its resources and technology. But not all points on the PPF are efficient; some may represent combinations of goods and services that people do not want. The former Soviet economy may have been on its PPF but was thought to produce too much military equipment and not enough civilian consumer goods.

An efficient economy must be a fully employed economy. Otherwise, it would be lying inside the PPF because the unemployed could presumably produce at least some more of one good without reducing the output of another. Thus microeconomic efficiency implies macroeconomic full employment.

Figure 2-1 shows a PPF with point *A* being Pareto optimal at the tangency between the social indifference curve[5] and the PPF, while *B* lies at a lower level of utility on the PPF and *C* represents a point of unemployed factors located inside the PPF.

5. To draw such a curve implies that everyone has identical preferences, a strong simplifying assumption. For a discussion of the difficulties in forming such a social welfare function democratically when people's preferences differ, see Kenneth J. Arrow, *Social Choice and Individual Values,* 2nd ed. (New York: Wiley, 1963).

This concept of efficiency says nothing about income distribution. An economy might be efficient according to Pareto if it has completely equal distribution of income or if one person has everything and everyone else is starving to death, just as long as no one can be made better off without making someone else worse off, the necessary condition for Pareto optimality. The tendency to unequal wealth and incomes under market capitalism has been one of the major arguments against it raised by socialist critics. But this is a criticism distinct from the issue of economic efficiency. The existence of a general equilibrium presupposes a prior distribution of wealth, with the income distribution arising from the general equilibrium itself.

Returning to the main argument, why is a complete, competitive, full-information, general equilibrium efficient? The underlying intuition dates to Adam Smith's invocation of the **invisible hand** of the market working across all sectors to allocate goods in a way that maximizes the "wealth of nations," although Smith had no formal concept of a general equilibrium, which was first defined by Léon Walras in 1874. Although Pareto argued for the link between general equilibrium and efficiency in 1909, it was Kenneth Arrow and Gérard Debreu in 1954[6] who presented a formal mathematical proof of both the existence and efficiency of competitive general equilibrium.

The efficiency of competitive general equilibrium is most easily seen by looking at a partial equilibrium case, the outcome in a single market. Figure 2-2 shows a typical competitive market with an upward-sloping supply curve (S) and a downward-sloping demand curve (D). The solutions for three different prices are shown: P_1 above equilibrium, P^* at equilibrium, and P_2 below equilibrium.

At P_1 suppliers produce more than they would at equilibrium but buyers buy less than they would at equilibrium, resulting in a surplus equal to the quantity produced that no one wants to buy. The amount that is both produced and sold is less than occurs at equilibrium. At P_2 demanders buy more than they would at equilibrium but suppliers produce less than they would at equilibrium, resulting in a shortage equal to the quantity buyers want that has not been produced. Again, the amount that is both produced and sold is less than occurs at equilibrium.

It is at the equilibrium price that the maximum amount will be both produced and sold and thus actually consumed by the public. This argument extends to all markets in the general equilibrium case. Thus, to maximize the amount of all goods available for consumption, every market should be in equilibrium.

6. For a discussion of this history and these arguments, see Kenneth Arrow and Frank Hahn, *General Competitive Analysis* (San Francisco: Holden-Day, 1971), chap. 1.

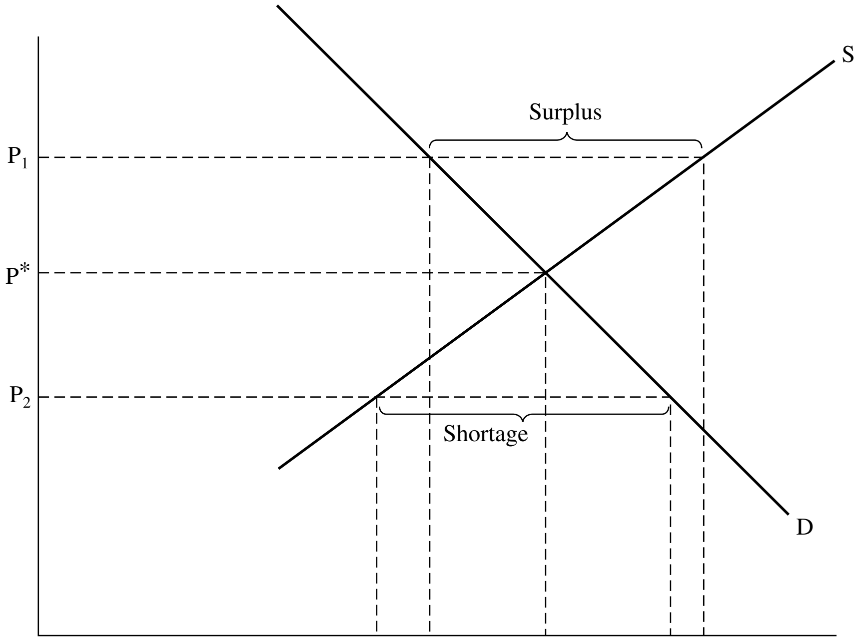

Figure 2-2
Equilibrium of competitive supply and demand.

LIMITS TO THE EFFICIENCY OF LAISSEZ-FAIRE MARKET CAPITALISM

Monopoly Power

No one should underestimate the power and significance of the preceding efficiency theorem as it is used to support market capitalism. However, no one should be fooled into thinking that absolute laissez-faire market capitalism fulfills the conditions of the theorem and is, therefore, automatically efficient. In general, laissez-faire market capitalism will not be completely efficient; this situation is called the problem of **market failure.**

One condition of efficient equilibrium is that it is competitive. Monopoly power is a source of inefficiency and can arise in a laissez-faire economy. This type of market failure happened in the United States at the end of the 1890s, culminating in a great concentration of monopoly power that was attacked by President Theodore Roosevelt, the “Trust Buster,” after 1901.

Figure 2-3 compares a pure monopoly outcome with a perfectly competitive solution. The monopolist will maximize profits by setting marginal cost (MC) equal to marginal

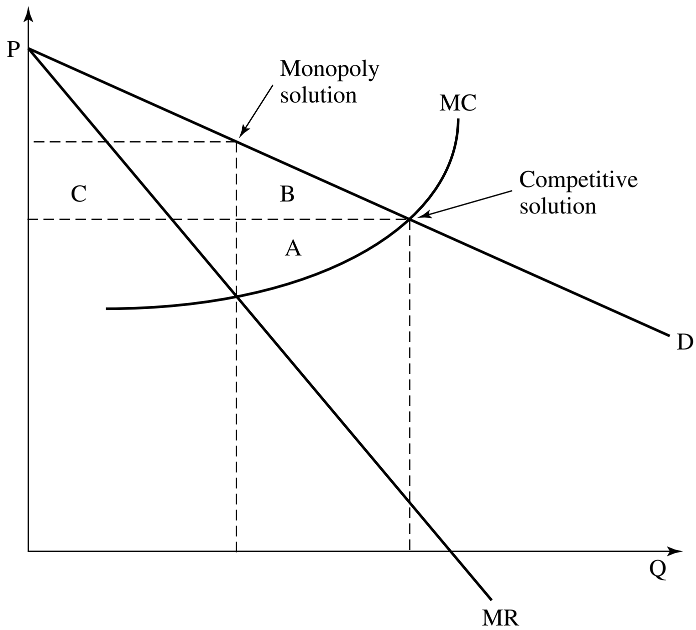

Figure 2-3
Monopoly and perfect competition compared.

revenue (MR), whereas if the industry is perfectly competitive, the equilibrium will be at $P =$ MC, where MC intersects the demand curve. The monopolist will produce less and charge a higher price than would the competitive industry. Triangle *A* shows lost **producer's surplus** (net income for the producer), and triangle *B* shows lost **consumer's surplus** (net utility) caused by the reduced production. Despite losing triangle *A*, the producer gains on net because she obtains the larger rectangle *C* of **monopoly rent** from the consumer as a result of the higher price.[7] This market failure would not occur in a perfectly competitive situation.

Despite this general critique caused by monopoly power, some qualifying caveats are in order. The first is the situation of **natural monopoly,** characterizing an industry with economies of scale (declining long-run average costs) even at a level of output equal to total

7. Probably the basis for political support for antitrust policy in the United States is this *rectangle of redistribution* (Tullock rent) rather than the missing *triangles of inefficiency* (Harberger triangles). Consumers get angry when "ripped off" by a visibly rich monopolist. The missing triangles are invisible because they do not exist, and according to some estimates are only on the order of 1 percent of GDP in the United States anyway.

market demand. If a single firm can produce the total market demand at a lower cost than can many firms, then it is desirable to enjoy these efficiencies of large-scale production.

The existence of natural monopoly presents an inevitable trilemma. Either laissez-faire can be followed, in which case consumers will experience losses, or the government can regulate the monopoly, as state governments traditionally did in the United States with respect to electric utilities prior to the recent interstate deregulation movement. But regulation often leads to inefficiencies, such as overinvestment in capital stock, when such firms are guaranteed a particular rate of return on invested capital. Or the natural monopoly can be run by the government, which entails socialism with all its bureaucratic inefficiency. This is the system in much of Western Europe for electric utilities.

Another caveat involves technological dynamism. It is argued that more competitive industries will be more technologically progressive. But if research and development (R and D) exhibit economies of scale, then a large monopolist with large monopoly profits may generate more R and D if it can be sufficiently motivated, as argued by Joseph Schumpeter in *Capitalism, Socialism and Democracy* (1943). One possible such "technologically progressive monopoly" in the United States may have been Bell Laboratories, owned by AT&T prior to its breakup in 1982. But it can be argued that AT&T was innovative because it perceived the threat of potential competition that eventually arrived.

Intermediate market forms, notably **monopolistic competition** and **oligopoly,** lie between monopoly (one firm) and perfect competition (many firms, none with any control over price). Monopolistic competition involves many firms, each having some price-setting power as a result of product differentiation, such as restaurants. Some customers will remain with the firm when it raises its price because of the perceived uniqueness of its product. In the long run, such firms produce at a lower level of output than the one at which their average costs would be minimized: the **excess capacity theorem.** However, there is little that any government can do about this problem, and none have tried.

Oligopoly, with a small number of firms in the industry, is more complicated. There are many different models of oligopoly behavior because the optimal behavior of an oligopolist will depend on how its fellow oligopolists react to any action it takes. Different reactions imply different outcomes. Many manufacturing sectors subject to substantial economies of scale, such as automobiles and aircraft, fall into this category.

Oligopolistic industries range from very monopolistic to very competitive. At the monopolistic extreme is **perfect collusion,** the joint profit-maximizing cartel. These industries tend to be unstable because a member of the cartel can make extraordinary profits by cheating through price cutting. The oil cartel, OPEC (Organization of Petroleum Exporting Countries), raised oil prices in 1973 and 1979, but in 1986 lost control of world prices as Saudi Arabia increased production to punish Iran and Iraq for cheating on their production quotas (although OPEC has regained some of its market power in more recent years).

Probably the longest surviving cartel in the world is the diamond cartel, based in South Africa. In the United States most cartels are illegal.

At the other extreme, some oligopolistic industries behave like perfectly competitive ones, charging prices almost equal to their marginal costs. These are known as **contestable markets** and are most likely to occur where there are few barriers to entry and exit and the threat of potential, if not actual, competition is ever present. The U.S. airline industry might have been an example prior to facing airport capacity constraints, and Microsoft essentially argued that it behaves like a firm in such an industry in its defense in its antitrust case. This suggests a laissez-faire attitude to oligopolies because they may be reasonably efficient, constantly innovating and investing to keep ahead of potential competitors.

Among market economies, historically the United States has had the most vigorous antitrust policy. The beginning of its policy, and still its most frequently used instrument, was the **Sherman Act of 1890,** which forbids "combinations in restraint of trade" and "efforts to monopolize interstate trade." The Sherman Act was supplemented by the Clayton Act of 1914, which forbids monopolistic stock mergers, interlocking directorates, tying contracts, and price discrimination; the Federal Trade Commission (FTC) Act of 1914, which forbids false advertising; and several later laws as well. The FTC and the Antitrust Division of the Department of Justice have been the main antitrust enforcement bodies of the U.S. government.

Since 1890, U.S. antitrust policies have oscillated back and forth between vigorous and lax enforcement. From 1901 to 1920 there was quite vigorous enforcement, from 1920 to 1945 enforcement was relaxed, and from 1945 to 1982 enforcement was more robust. Since 1982 enforcement has been more relaxed, largely because increased competition from foreign imports, especially from Japan, has reduced the need for enforcement, although there was some increase in vigor in the 1990s, symbolized by the Microsoft case during the Clinton administration, with more of a relaxation again in the administration of George W. Bush.

Controversy exists regarding the actual time path of industrial concentration in the U.S. market share, although the ownership of assets by the very largest firms appears to have increased some over time. But taking into account foreign competition, competitiveness has probably also increased.

Generally, the United States has a more competitive and less concentrated economy than other countries. This is because of its sheer size—it can support more firms in most industries than can many smaller economies. But this also reflects the stronger tradition of U.S. antitrust enforcement. A limited cross-country comparison is shown in table 2-1.

The major anomaly in table 2-1 is the apparently lower degree of concentration in Japan than in the United States. In Japan, many firms that are officially independent have very close relationships with other firms through the "family of companies" groupings known as

Table 2-1
Industrial Concentration Compared

Country of Top Ten Firms	Average Size Top Ten Firms	Percent Employment Concentration Ratio	Average Three-Firm Concentration Ratio
United States	310,554	13.1	41
Japan	107,106	7.3	n.a.
W. Germany	177,173	20.1	56
United Kingdom	141,156	23.1	60
France	116,049	23.2	66
S. Korea	54,416	14.9	n.a.
Canada	36,990	15.3	71
Switzerland	60,039	49.4	n.a.
Sweden	48,538	49.4	83

Source: The first column shows the average number of employees in 1985 in the 10 largest firms, and the second column is the percent of industrial employment in those firms in 1985; both figures from Frederic M. Scherer and David Ross, *Industrial Market Structure and Economic Performance* (Boston: Houghton Mifflin, 1990), p. 63. The third column shows simple average of market share held by the three largest firms in 12 industries in 1970 and is from Frederic M. Scherer, M. Alan Beckenstein, Erich Kaufer, and R.D. Murphy, *The Economics of Multi-Plant Operations: An International Comparisons Study* (Cambridge, Mass.: Harvard University Press, 1975), pp. 218–219 and 426–428.

keiretsu.[8] South Korea has similar groupings known as **chaebol.**[9] Both Japan and South Korea have higher degrees of concentration relative to the United States than table 2-1 indicates.

A final remark on monopoly is that it is a serious problem in the transformation of many of the former command socialist economies into market capitalist ones. Many industries in the former command socialist economies were state-owned monopolies. Eliminating central planning and controls on prices has allowed these firms to behave monopolistically, with resulting aggravation of inflationary tendencies, unresponsive output, and rising resentment by consumers. Furthermore, many of these firms are so big that shutting them down threatens social upheavals from high unemployment.

Externalities

Another source of inefficiency in a laissez-faire equilibrium can be externalities. These are either costs or benefits that are borne by or accrue to an agent other than the agent generating them. External costs are **negative externalities,** the most controversial one being environmental pollution. External benefits are **positive externalities,** such as technological invention without patent protection for inventors.

8. See chapter 6 of this book.

9. See chapter 19 of this book.

To illustrate the effects of externalities, consider the case of a firm that generates pollution damaging another industry but does not reduce that damage if it does not have to pay for it. The private marginal cost to the firm does not equal the social marginal cost and too much pollution is produced, resulting in inefficiency. If an inventor has no patent protection, then other firms can steal her invention and she may make no money even if her invention generates great social benefits. Private marginal benefit to the inventor does not equal marginal social benefit of the invention and too little inventing will occur, resulting in inefficiency. The case of a negative externality is depicted in figure 2-4.

For the efficiency theorem, the problem raised by the existence of externalities, either positive or negative, is an **incompleteness of markets.** For unaccounted-for pollution there is no market for environmental quality, even though environmental quality is something that people desire and that provides utility for them. It has long been argued that the solution to the problem of pollution, or of externalities in general, is to "internalize" them, that is, to make sure that those generating the externalities either bear the costs or receive the benefits they generate.

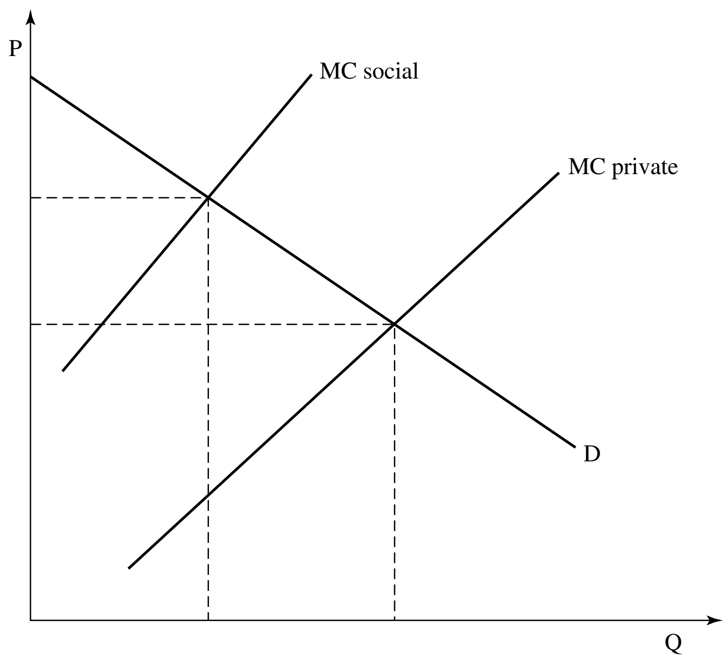

Figure 2-4
Negative externality.

Four broad approaches to resolving the problem of externalities have been proposed within market economies. The earliest approach was provided by A.C. Pigou,[10] who suggested taxation of negative externalities and subsidies of positive externalities. For pollution, the tax equals the difference between the marginal private cost and the marginal social cost, as shown in figure 2-4. There will be a higher price for the commodity whose production generates the pollution and a reduction of its production. The people who consume the polluting commodity ultimately bear the cost.

This taxation strategy has been little used in the United States. Countries using it include France and Germany, with the thrust of their policies being not to raise the cost so high as to discourage polluters from polluting but to raise money for subsidy programs that pay polluters to clean up.

A second policy, widely used in the United States, is command and control quantitative or technological restrictions. In terms of figure 2-4 an efficient strategy moves the equilibrium from the private one to the social one. The optimal size of such a move will vary from industry to industry and from region to region. The social costs of pollution are higher in New Jersey than in North Dakota because of the greater number of people affected by pollution in New Jersey. Nevertheless, until recently, the tendency has been to apply the same emissions or technology standard for a given industry everywhere. This is inefficient, although it might be justified on the grounds of minimizing administrative costs or on some "fairness" notion of everyone doing the same thing.

A third approach takes a more laissez-faire attitude and emphasizes the clear definition and enforcement of property rights. This approach derives from the **Coase Theorem.**[11] This states that if property rights are well defined and transactions costs (or negotiation costs) are negligible, then externalities will be automatically internalized by a market capitalist economy. Ronald Coase presents the example of a railroad whose trains generate sparks that start fires on property adjacent to the railroad's tracks. By mutual negotiation a solution is worked out, such as the railroad compensating the property owners or buying their property.

When property rights are poorly defined and a natural resource is an open-access, common property resource, such as fisheries in international waters, there is a tendency for the resource to be overexploited. No one accounts for the effects of his behavior on others using the resource, so a gap between private and social costs emerges. For fisheries such overexploitation leads to the collapse of fish populations, as has happened to many species. But the essential issue is that of open access rather than common property. Thus the Soviet

10. A. C. Pigou, *The Economics of Welfare* (London: Macmillan, 1922).

11. Ronald Coase, "The Problem of Social Cost," *Journal of Law and Economics* 3 (1961): 1–44. This article is often cited as a foundation of the New Institutional School, which emphasizes the role of transactions costs in how economies are organized.

Union managed the Caspian Sea caviar fisheries well by controlling access, but after its dissolution there was drastic overfishing and a collapse of caviar production because newly independent republics bordering on the Caspian Sea all wanted access.

The Coase Theorem implies serious limits: Property rights may be impossible to define, and negotiation costs may be very high. These conditions are likely to coincide when the externality involves an inherently collective good "owned" by large numbers of people, such as the global air quality and global climate in discussions about global warming. As the inability of world leaders to agree on how to implement the Kyoto Protocol on global warming demonstrates, negotiations to resolve disagreements are far from costless.

Awareness of the Coase Theorem has stimulated the search for market mechanisms to use where possible to resolve pollution problems. An innovation now used widely in the United States is **tradeable emissions permits.** These involve some level of government setting an overall quantitative limit for the emission of a particular pollutant for a particular area and then issuing permits for emissions adding up to that total limit that firms may buy and sell from each other, thereby creating an artificial market for pollution cleanup. The U.S. Clean Air Act of 1990 successfully relied on this approach to deal with sulfur dioxide (SO_2) pollution.

Marketable emissions permits directly attack the problem of *incomplete markets* underlying the inefficiency of unresolved externalities. As long as there are enough parties to make such a market reasonably competitive, it will achieve the least costly solution to cleaning up the given amount of pollution. Those firms that can clean up cheaply do so and sell their "permits to pollute" to those that cannot. One form of this program involves offsets as described in box 2-1.

Active efforts to deal with environmental problems originated in the highest-income countries first and generally in the market capitalist countries before the command socialist countries, despite the theoretical ability of the latter to plan to avoid pollution. This may be more a result of the greater democracy of the advanced market capitalist economies than of their respective economic systems.

The level of development of an economy and its amounts and kinds of pollution seem to be strongly related. Poorer countries seem to have worse water pollution and more particulate matter in the air. Richer countries tend to emit more greenhouse gases, especially carbon dioxide (CO_2) from fossil fuel burning. Middle-income countries tend to emit the most SO_2 responsible for acid rain, largely as a result of burning high-sulfur coal.

Data on different air pollutants in different countries are shown in table 2-2. CO_2 per capita shows a strong correlation with income levels, reaching a peak in some oil-rich Persian Gulf states, although with the United States not too far behind. Nitrogen oxide (NOX) comes largely from automobiles and also shows an income relation, with more pollution from market capitalist economies with more cars; the United States is at the top of the list of per

Box 2-1
Trading in Offsets in the United States.

The U.S. Environmental Protection Agency has set upper limits on the emissions of particular pollutants within certain regions. Thus, if a region is at its limit and a new business wishes to open that would put the region over the limit, it must negotiate a deal with an existing business to reduce emissions by the requisite amount. Such a deal is known as an *offset* and has been used increasingly to maintain air quality without hampering economic growth. Examples include the following:

1. The Narragansett Electric Company has two generating stations in Providence, Rhode Island. Under the bubble policy they were allowed to use high-sulfur oil (2.2% sulfur) at one plant when the second plant was burning natural gas or was not operating, instead of being required to burn 1% sulfur at both plants. This action resulted in a savings of $3 million annually, reduced the use of imported oil by 600,000 barrels per year, and reduced sulfur emissions by 30%.
2. Manufacturers of cans were allowed to comply with existing regulations for each individual can-coating line by averaging emissions of volatile organic compounds on a daily basis, so long as the source did not exceed the total allowable plantwide emission per day. This was expected to save the industry $107 million in capital expenditures, $28 million per year in operating costs, and 4 trillion BTUs of natural gas per year, chiefly because add-on pollution control equipment that would have been energy-consuming is no longer necessary.
3. A cement company in Texas entered into an agreement with another local company providing for that company to install dust collectors. The cement company paid for the equipment while the other company agreed to accept the maintenance costs, which were negligible.
4. A company wanting to build an oil terminal to handle 40,000 barrels a day in Contra Costa County, California, was granted a permit when it acquired, for $250,000, an offset created when a local chemical company shut down.

Source: Tom Tietenberg, *Environment and Natural Resource Economics,* 6th ed. (Boston: Addison-Wesley, 2003), p. 378.

capita output. SO_2 comes from burning dirty coal and oil; per capita emissions are highest in heavily industrialized former command socialist countries, although the United States has the highest levels among the market capitalist countries. Although the United States shows some improvement for SO_2, it shows little for either NOX or CO_2. The former command socialist economies experienced substantial reductions in SO_2 emissions between 1989 and 1996 that go beyond what could be explained by reduced GDP levels.

Collective Consumption Goods

Another source of inefficiency for laissez-faire equilibrium can be **collective consumption goods,** also known as *public goods.* The source of the inefficiency problem with such goods in laissez-faire economies is again incomplete markets. Because of the nature of such goods, it is difficult for private markets to organize themselves to provide these goods in optimal quantities. Thus it often falls to the public sector to do so, leading to inefficiencies associated with that sector. National defense is an archetypal collective consumption good, and the cost overruns and excessive spending of the U.S. defense establishment are infamous.

Table 2-2
Pollution Emissions in Various Countries

	CO_2 (per Capita)		NOX (per Capita)		SO_2 (per Capita)	
Country	1989	1996	1989	1996	1989	1996
Niger	0.15	0.12	n.a.	n.a.	n.a.	n.a.
Egypt	1.54	1.54	n.a.	n.a.	n.a.	n.a.
Costa Rica	0.88	1.28	n.a.	n.a.	n.a.	n.a.
Mexico	3.70	3.75	n.a.	n.a.	n.a.	n.a.
China	2.16	2.73	n.a.	n.a.	n.a.	n.a.
India	0.77	1.05	n.a.	n.a.	n.a.	n.a.
Laos	0.07	0.07	n.a.	n.a.	n.a.	n.a.
S. Korea	5.20	9.00	n.a.	n.a.	n.a.	n.a.
Japan	8.46	9.28	n.a.	n.a.	n.a.	n.a.
Iran	3.11	4.20	n.a.	n.a.	n.a.	n.a.
Saudi Arabia	12.79	14.22	n.a.	n.a.	n.a.	n.a.
Qatar	37.59	n.a.	n.a.	n.a.	n.a.	n.a.
Albania	3.06	0.62	2.8	n.a.	15.6	n.a.
Bulgaria	11.87	0.65	16.7	11.5	114.6	80.6
Czech Republic*	14.47	12.28	60.7	35.3	178.9	90.2
Hungary	6.05	5.83	24.5	20.2	115.2	76.8
Poland	11.54	9.23	39.1	35.2	103.3	76.2
Yugoslavia†	5.61	3.41	8.0	6.9	69.6	59.5
Russia‡	13.26	10.68	14.6	10.0	32.4	19.5
E. Germany§	10.48	10.51	42.6	n.a.	313.3	n.a.
W. Germany	10.48	10.51	48.4	n.a.	24.2	n.a.
Austria	6.82	7.36	27.7	23.3	16.3	6.3
France	6.38	6.21	30.1	31.2	27.1	21.5
Sweden	7.00	6.13	35.4	27.7	25.9	18.1
United Kingdom	9.89	9.53	43.9	33.2	62.1	33.6
United States	19.68	19.67	79.6	78.3	83.2	68.7

*Figures for 1989 are for the combined Czechoslovakia.
†Figures for 1989 are for the former Yugoslavia.
‡Figures for 1989 are for the Soviet Union.
§Figures for CO_2 for the two Germanies are for Germany overall for both years. There are no figures for the separate parts for 1996, but the NOX figures in 1996 are 70 percent of those in 1989 and the SO_2 figures in 1996 are only 29 percent of those in 1989 for Germany overall. The especially sharp decline of the latter almost certainly reflects a major decline in what had been very high emission levels in the former East Germany after unification.
Source: Figures for 1989 are from World Resources Institute, *World Resources, 1992–93* (Oxford: Oxford University Press, 1992), pp. 64–65 for NOX and SO_2 (which are in kilograms) and pp. 346–47 for CO_2 (which is in metric tons). Figures for 1996 come from World Resources Institute, *World Resources 2000–2001* (Washington, D.C.: World Resources Institute, 2000), p. 284 for NOX and SO_2 and pp. 282–283 for CO_2, based on certain calculated adjustments.

The characteristics of a pure public good are *nonexcludability of consumption* and *nondepletability of consumption;* the former is more crucial. These two characteristics together imply that the good is collective in nature; everyone consumes it simultaneously, and no individual's consumption reduces any other individual's consumption. National defense is a classic example and is almost universally provided publicly, even in strongly market capitalist economies. If one individual is defended from foreign invasion then all individuals are so defended, irrespective of whether or not they paid for it.

The essential problem for private market provision of true collective consumption goods is the **free rider problem.** The collective nature of the good breaks the link between paying for it and consuming it. If it exists, everyone consumes it whether or not he or she paid for it. Thus, if the private sector were to attempt to provide the good, it would have a great deal of trouble selling the good because of free riders who would consume it without paying for it. Even though people want the good, they will not pay enough for it to be provided to the Pareto optimal level. This may lead to government taxation to provide the good.

One criticism of this view comes from a radical version of the philosophical perspective known as **methodological individualism,**[12] associated with the mostly pro-laissez-faire Austrian School. An extreme version of this view is in the *objectivist* philosophy of novelist Ayn Rand, who argued that there is no such thing as a human collectivity; ultimate reality is individual people. Apparent collectivities are illusions created to subject individuals to arbitrary tyrannies. However, at least Friedrich Hayek of the Austrian School recognized the existence of some minimal public goods, notably the constitutional maintenance of basic law and order for the protection of property rights and the functioning of free markets.[13]

Between the extremes of pure private goods such as food and pure public goods such as basic law and order, there is a wide spectrum of intermediate goods that have both private and collective aspects. One example is education, which is provided by a mix of public and private sources in the United States, with the public more prominent at lower educational levels and the private gaining in significance at higher levels. Widespread literacy and elementary education of the populace have a significant collective component element for citizens behaving within society. At higher levels of education individuals are more able to appropriate for themselves the benefits of their education, although there are still broader spillovers.

This broad spectrum allows room for variation across societies, even among largely market capitalist economies, regarding the public versus private provision of such intermediate

12. Methodological individualism implies analysis of society from the viewpoints of individuals. This is not inconsistent with the existence of public goods, as their possible existence can be demonstrated from its perspective.

13. There are divisions within the Austrian School, with followers of Friedrich Hayek more willing to accept government action, in contrast with the more firmly pro-laissez-faire followers of Hayek's mentor, Ludwig von Mises, such as Murray Rothbard.

goods. The recent movement in many countries to privatize previously public activities highlights this debate, with no clear criteria regarding optimal outcomes.

Compared to most other market economies, the United States has more of these intermediate activities provided privately. Nevertheless the U.S. economy has a substantial public sector, the most rapidly growing part of which has been at the state and local levels. At the federal level there has always been substantial government ownership of land, especially in the western states. Overall public ownership of land and also of structures is on the order of 15% of the respective totals. These figures represent moderate declines from 1939, which ended a period of increasing government ownership. Areas with significant public participation in the United States include law and order, national defense, the National Forest Service and National Park Service, major dams, the space program, the Tennessee Valley Authority, and numerous local public services such as education, fire protection, local transportation, airports, harbors, highways, garbage collection, water, sewage disposal, libraries, and even some locally owned utilities. Most of these are subject to debate as to whether or not they should be privatized.[14]

Finally, the **public choice school**[15] observes that decisions regarding private versus public ownership are made by legislative bodies at any level of government. These bodies are subject to complexities of majority rule, logrolling, lobbying by special interest groups, and sheer inertia, suggesting that they are ill suited to efficient decision making regarding the proper balance between the private and public sectors. Even though there is a case for public provision of collective consumption goods, the public choice school sees the public sector as so inefficient and corrupt that generally privatization is the preferred market solution.

Imperfect Information

Of all the assumptions needed for the efficiency of an equilibrium outcome, that of perfect information is the most unrealistic. There is no perfect information anywhere about anything, but special problems arise when one party in a transaction knows more than another; this is known as **asymmetric information.**

George Akerlof analyzed the used-car market, in which there is asymmetry of information between the owner of the used car, who knows its flaws, and the potential customer, who does not.[16] But the potential customer understands this disparity and therefore is suspicious of all used cars, suspecting them to be "lemons" their owners wish to dispose of. The inefficiency exists for anyone who seeks to sell a used car that is *not* a lemon at a decent

14. In some cases, partial privatization is what has happened, as with the Federal National Mortgage Association (Fannie Mae), which is involved in the secondary mortgage market.

15. Also known as the Virginia School, its founders were James Buchanan and Gordon Tullock.

16. George Akerlof, "The Market for Lemons," *Quarterly Journal of Economics* 84 (1970): 488–500.

price. Recognition of this by potential sellers simply reinforces the situation; those with good cars who do not *have* to sell won't.

Such asymmetries are rife in market economies. In contractual relationships this is known as the **principal-agent problem,** in which someone is hired who does not do what is best for the employer because of his ability to mislead the ignorant employer. Such information asymmetries can lead to suboptimizing behavior because of **moral hazard,** especially in the insurance industry. Those most needing insurance will seek it out and will conceal their need from the insurers, thereby raising rates for those who need insurance less. Those who are insured then may behave more carelessly than they would if they were uninsured. The U.S. Savings and Loan crisis was an example of a situation in which financial institutions engaged in reckless lending practices, as depositors were not scrutinizing the institutions' behavior because their deposits were insured by the government.

There is no easy way out of the dilemmas posed by imperfect information and asymmetries of information. However, a possible remedy available to government is simply to increase the amount of relevant information generally available. This constitutes an economic efficiency justification for government data-gathering agencies such as the Bureau of Labor Statistics and the Census Bureau. A trial balloon to privatize information gathering and dissemination by the U.S. National Weather Service that was floated during the Reagan administration created a storm and was rejected, showing the strength of support for such activities to be carried out by the public sector.

Another perspective is that the essence of markets is information transmission about relative scarcities through price signals. Hayek argues that a central planner can never possess adequate information for carrying out optimal or even remotely intelligent planning. Free capitalist markets may suffer from imperfect information, but according to this view, they beat command socialist planning in this regard. Decentralized and profit-motivated market capitalists respond to price signals to move the economy along optimally, even though the individual actors possess only limited knowledge.[17] But ultimately, the problems of imperfect and asymmetric information remain unresolved for all economic systems.

THE ROLE OF LABOR UNIONS

Another issue arising in market capitalist economies is the organization of labor into unions. If labor markets are perfectly competitive and lacking in discrimination on characteristics irrelevant to productivity, unions may not contribute to economic efficiency. They

17. That prices may not always accurately transmit information is shown by the example of speculative bubbles, in which prices rise because agents expect them to rise. Some argue that the instability of prices is so endemic as to render market capitalism more generally dysfunctional (Michael Perelman, *The Natural Instability of Markets: Expectations, Increasing Returns and the Collapse of Markets* [New York: St. Martin's Press, 1999]).

redistribute income to their members and deal with safety, job security, benefits, social functions, and political lobbying for broader social outcomes. If they do not offset the monopsonistic power of big firms doing the hiring, their exercising monopolistic power in supplying labor may result in inefficiency.[18]

Although craft unions resemble the medieval European guilds, modern labor unions arose from the revolutionary socialist movements in the nineteenth century, even though independent labor unions were snuffed out by actually ruling command socialist regimes once in power. The Grand Consolidated Trade Union of Britain in the 1830s and the Knights of Labor in the United States in the 1870s were such unions, devoted more to the idea of a general working-class revolution than to negotiating bread-and-butter issues. Given these roots, labor unions have been weakest in the more strongly market capitalist countries such as the United States.

As the harshness of nineteenth-century capitalism moderated in the twentieth century, labor unions became more legally accepted and moderated their approaches to negotiation and political activism. In the United States, the American Federation of Labor (AFL) was founded in 1881 by Samuel Gompers and eschewed radicalism for **business unionism.** This group consists of unions of workers in craft unions, organized like guilds by skill categories (carpenters, plumbers, etc.). Although in Europe acceptance of unions came earlier, the environment in the United States remained fundamentally hostile until the New Deal of Franklin D. Roosevelt passed the Wagner Act of 1935, which established the modern U.S. system of collective bargaining.

The Wagner Act triggered a period of intense organizing and a conflict between the AFL and the newly formed Congress of Industrial Organizations (CIO). In the CIO, unions were organized on industrial lines such as the United Auto Workers and the United Steel Workers, which were more radical and had less-skilled workers. In 1947 a reaction set in with the Taft-Hartley Act, which put restrictions on union activities. By 1955 the percentage of U.S. workers in unions had peaked and the two federations united as the AFL-CIO. Their base in heavy industries means that their membership and influence have declined in the United States as its economy has evolved toward a postindustrial service pattern.

In contrast, Western European countries have larger proportions of their labor forces as union members; the unions are more centrally organized, are more accepted by the political establishment, and are more influential in pushing for greater government intervention in their economies. They serve as the main political-economic base for Western European social democracy.

In some countries labor-management relations have been cooperative, as in Sweden and Germany, whereas in others they have been contentious, as in France and Great Britain. In

18. The original applications of the Sherman Antitrust Act in the United States in the 1890s were against labor unions, although they were very weak at the time. The Clayton Act of 1914 exempted unions from antitrust law.

Table 2-3
Percentages of the Labor Force Belonging to Unions

Country	1955	1975	1995
United States	24.7	21.7	14.2
Japan	n.a.	34	24
Austria	63	59	41.2
Belgium	53	66	n.a.
Denmark	59	67	80.1
Finland	31	75	79.3
France	25	25	9.1
West Germany*	34	33	28.9
Italy	n.a.	47	44.1
Netherlands	38	40	25.6
Norway	54	61	n.a.
Sweden	68	82	91.3
United Kingdom	44	51	32.9

*Unified Germany after 1991.
Source: Data for the United States are from *Economic Report of the President* (Washington, D.C.: USGPO, 1990). Japanese figures are from Richard B. Freeman and M.E. Redick, "Crumbling Pillar? Declining Union Density in Japan," *Japanese and International Economies* 3 (1989): 578–601. European figures are from Jan-Erik Lane and Svante Ersson, *Comparative Political Economy* (London: Pinter, 1990), p. 164, and *The European,* November 6, 1997, p. 23.

Japan, union membership is higher than in the United States, but labor-management relations have been more cooperative. When labor-management cooperation involves economywide negotiating under government encouragement for macroeconomic stabilization, this is known as **corporatism.**[19]

Table 2-3 shows percentages of labor forces belonging to unions for 1955, 1975, and 1995 for 13 countries. The U.S. percentage has continued to decline and is now less than 15 percent. The Japanese percentage has declined to 28 percent. There is no relation between the degree of unionization and the degree of radicalism of unions. The two least unionized countries in table 2-3 are the United States and France. In political terms the former has the most moderate unions on the list, whereas in the latter many unions have strong links to the still fairly orthodox Communist Party of France.

Table 2-4 shows days lost to strikes per thousand nonagricultural wage earners and salaried employees for 1985–1989 and 1990–1994 for 15 countries. Generally disputes have declined markedly except in the United Kingdom, Sweden, New Zealand, and especially Denmark. The most disputatious countries were Italy and Canada, and the least contentious one was Switzerland.

19. Originally corporatism was an authoritarian system promoted by fascists, but now it is a more voluntary system found largely in European social democracies.

Table 2-4
Days Lost to Labor Disputes (per 1,000 Workers)

Country	1985–1989	1990–1994
United States	86	43
Australia	227	157
Belgium	52	57
Canada	424	231
Denmark	235	37
France	57	30
West Germany	2	23
Italy	300	240
Japan	5	3
Netherlands	9	16
New Zealand	491	105
Norway	135	72
Sweden	121	57
Switzerland	0	1
United Kingdom	180	37

Source: U.S. News & World Report 120(16), April 22, 1996: 18.

The impact of unionization on an economy depends on many factors. In the United States, unionized workers are paid more than nonunionized workers. This pay differential may have contributed to the weakening of unions as high wages led to unemployment in the auto and steel industries. If unions cooperate with management and support flexibility in labor policies, high unionization may coexist with low unemployment, as in Sweden until recently. Unions may lead to productivity improvements by giving workers a voice. But if unions insist on restrictive laws, such as ones limiting the ability of firms to fire workers (which discourages firms from hiring workers in the first place), then high unionization may lead to high chronic unemployment, as in Belgium.

MACROECONOMIC INSTABILITY OF MARKET CAPITALISM

The General Picture

Although involuntary unemployment of labor due to macroeconomic fluctuations implies that inefficiency exists, the significance of macroeconomic fluctuations goes beyond cyclical unemployment to constitute a central and distinct issue for market capitalism as a system. It is no accident that the popularity of the U.S. Communist Party peaked in the Great Depression. Mass unemployment and unequal distributions of income and wealth, rather than inefficiency, have provided the most pungent propaganda for socialist critics of market capitalism.

Table 2-5
Percentage of Labor Force Unemployed

Country	1921	1931	1951	1961	1971	1979	1993	2000
Australia	5.9	17.9	1.3	2.3	1.8	6.1	10.7	6.6
Austria	n.a.	9.7	3.5	1.8	1.2	1.7	5.7	3.2
Belgium	6.1	6.8	4.4	2.5	1.7	7.1	13.5	10.7
Canada	5.8	11.6	2.4	7.0	6.1	7.4	11.6	6.8
Denmark	3.0	9.0	4.6	1.9	1.1	5.2	12.3	5.6
Finland	1.8	4.6	0.3	1.2	2.2	6.0	n.a.	n.a.
France	2.7	2.2	2.1	1.5	2.6	5.9	11.7	9.2
Germany	1.2	13.9	7.3	0.7	0.7	3.3	7.5	9.2
Italy	n.a.	4.3	7.3	3.4	4.9	7.1	11.3	11.4
Japan	n.a.	n.a.	1.7	1.4	1.2	2.1	2.5	4.6
Netherlands	1.7	4.3	3.2	0.9	2.3	6.6	6.2	2.7
Norway	n.a.	10.2	1.5	1.8	1.5	2.0	n.a.	n.a.
Sweden	1.3	4.8	1.6	1.5	2.5	2.1	9.0	3.9
Switzerland	n.a.	1.2	0.0	0.0	0.0	0.3	4.6	1.9
United Kingdom	11.0	14.8	2.2	2.0	3.8	5.1	10.4	5.3
United States	11.4	15.2	3.2	6.5	5.9	5.8	5.8	4.0

Source: Data for 1921–1979 from Angus Maddison, *Phases of Capitalist Development* (Oxford: Oxford University Press, 1982), pp. 206–208, except for 1993, which are from *The Economist* (August 20–26, 1994), and 2000, which are from *The Economist* (January 20–26, 2001), p. 106.

The major market capitalist economies have been less than perfectly stable over time, as shown in table 2-5 and figure 2-5. The former shows unemployment rates[20] for a variety of countries in various years. There was a general increase in unemployment rates after the early 1970s in many countries, associated with a general stagnation of economic growth, that appears to have been reduced more recently.

Figure 2-5 shows the maximum peak-to-trough decline of GDP over a business cycle for various countries for various periods, a crude measure of instability. There was more such variability before World War II than afterward.

Examination of the components of GDP indicates that the most variable element is capital investment, sometimes characterized as a “flighty bird.” The considerable variation in capital investment can be explained by factors ranging from exogenous fluctuations in new technologies that can serve as the basis for investment, to fluctuations in government monetary policies affecting interest rates, to psychological fluctuations due to the “animal spirits” of those making investments. The question is, why do these variables lead to fluctuations in the unemployment rate, since in a perfectly competitive labor market, wage rates should fall when the demand for labor falls, thereby preventing the emergence of any

20. Some variation across countries and over time is attributable to variations in labor force participation rates.

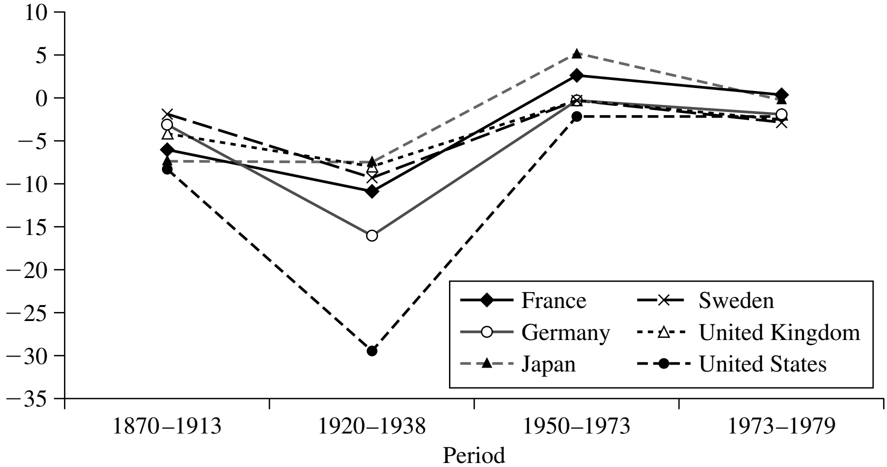

Figure 2-5
Maximum peak-to-trough GDP decline over cycle.
Source: Angus Maddison, *Phases of Capitalist Development* (New York: Oxford University Press, 1982), table 4-1, "Amplitude of Recessions in Aggregate Output, 1870–1979, p. 67.

involuntary unemployment? The **Keynesian School** and the **Classical School** answer this question differently.[21]

Deriving its views from British economist J. Maynard Keynes and his *General Theory of Employment, Interest and Money* (1936), the Keynesian School argues that rigidities of various sorts exist in labor markets and that capital investment can collapse and stay down for extended periods of time, as in the Great Depression. The implication is that government intervention through fiscal or monetary policies is advisable to stimulate the economy and to stabilize and smooth out business cycles. Some Keynesians, such as James K. Galbraith, argue that stimulative macroeconomic policies can also increase the equality of the income distribution.

The Classical School, deriving from nineteenth-century classical political economists such as David Ricardo, argues that market capitalist economies are powerfully self-stabilizing. Conscious government intervention merely generates inflation and aggravates fluctuations. To minimize unemployment, unions should be broken up and a stable fiscal and monetary environment should be maintained within a laissez-faire environment.

21. These two schools have various subcategories including old and new classicals and Keynesians, Post Keynesians, and supply siders. To the left and right of this broad division stand the pro–command socialist Marxists and their ideological opposites, the pro-laissez-faire Austrians.

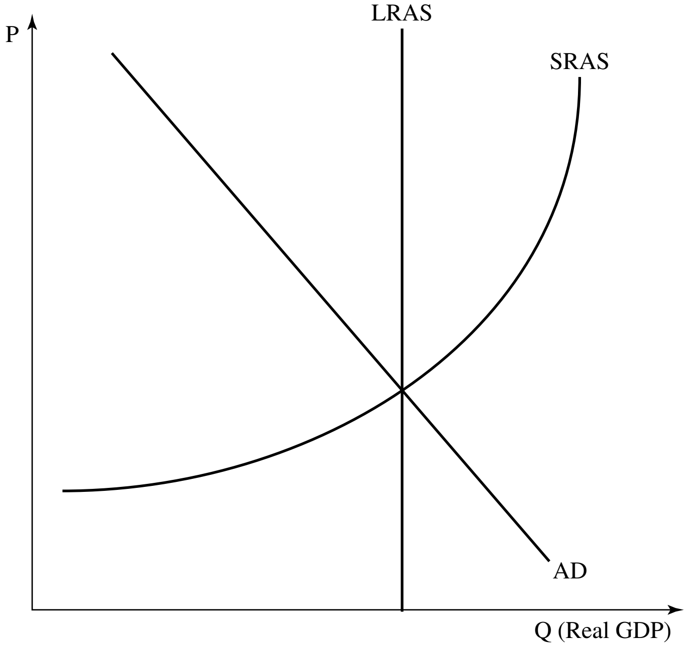

Figure 2-6
Alternative views of macroeconomic equilibrium.

Figure 2-6 depicts alternative views of macroeconomic equilibrium. *P* now represents the overall price level of the economy, and *Q* represents the aggregate level of real output. Aggregate demand (AD) is downward-sloping. However, short-run aggregate supply (SRAS) represents an upward-sloping curve as conceptualized by Keynesians. Its shape implies that a decline in aggregate demand will cause a decline in real output and a decline in employment. Long-run aggregate supply (LRAS) represents a curve as conceptualized by classicals. Most classical economists recognize that output can decline in the short run for a variety of reasons, but they argue that *very quickly* a laissez-faire economy will return to behavior depicted by the LRAS. Declines in aggregate demand will lead to declines in the price level rather than in real output or employment.

Tools of Macroeconomic Policy

Two main macroeconomic policy tools are fiscal and monetary policy. Fiscal policy is a nation's government budget, its package of spending and tax rates. Generally, the higher spending is and the lower tax rates are, the higher will be the stimulus to aggregate demand. Monetary policy is the expansion or contraction of a nation's money supply and the lowering or raising of interest rates in its economy. Expanding the money supply or lowering interest rates stimulates aggregate demand, while contracting the money supply or raising interest rates dampens aggregate demand.

In parliamentary democracies, where the executive leaders are also the legislative leaders, responsibility for fiscal policy is well defined. In the United States, the separation of the executive and legislative branches of government creates a messier situation. Executive agencies propose spending packages that are filtered through the Office of Management and Budget (OMB), which generally acts as the president's executive agent on spending proposals. The Treasury makes tax proposals. These are combined and submitted to Congress, which chops them up and sends them through a plethora of committees and subcommittees, rarely succeeding in actually passing a complete budget in time for when it is supposed to take effect. Disagreements between Congress and the president then are worked out through negotiation or, in cases of more conflict, through the veto process or even threats of government shutdown, as happened in 1995. What finally emerges and is actually implemented by the executive agencies may not resemble the desired plans of anybody involved. In general, Keynesians favor the use of discretionary fiscal policy for stabilizing macroeconomic fluctuations more strongly than the Classical School, which tends to be skeptical regarding the efficacy of this policy tool.

In all modern market capitalist economies, monetary policy is carried out by a central bank that controls the domestic money supply and at least short-term interest rates. The concentration of decision making in one body generally allows a greater degree of purposiveness and control of monetary policy than exists for fiscal policy. It has been argued that the second most powerful person in the world after the U.S. president is the Chairman of the Board of Governors of the U.S. Federal Reserve System, the U.S. central bank (the *Fed*).

Nations vary considerably in the way their respective central banks relate to the entities in charge of fiscal policy. Some central banks have considerable autonomy and independence, such as the recently created European Central Bank (ECB), which has been modeled on the notably independent Bundesbank of Germany. Others are subordinated to fiscal policymakers, notably the Bank of England, which is administratively under the control of the budget-proposing Chancellor of the Exchequer, although it has been granted effective autonomy since the Labour Party came to power. The U.S. Fed is somewhere in between. It was created by and is subject to rules established by Congress, and its Board of Governors are appointed by the president for 14-year terms. It is widely argued that the more independent central banks have had better records of controlling inflation, and there has been a general global trend toward granting central banks more autonomy.

While the Keynesian School has generally favored discretionary monetary policy responding to recent macroeconomic conditions, with a focus on managing interest rates, the Classical School has tended to favor *monetarism,* the idea that central banks should focus on controlling the growth of the money supply so that it increases steadily at a rate equal to that of the rate of real GDP growth in order to control inflation.[22] This view peaked in the United States during the 1979–1982 period. More recently, most central banks have focused on managing interest rates, but with the goal of targeting inflation rather than other macroeconomic variables.

A RECAPITULATION OF THE STRONG CASE FOR LAISSEZ-FAIRE

A major theme of the recent world political economy has been a strong shift toward supporting more laissez-faire economic policies. The enormous changes in Eastern Europe have had much to do with this shift, but so have changes in the market capitalist economies. In the former communist world, disillusionment with the old ideology of command socialism has led to great fascination with its extreme opposite, laissez-faire market capitalism. Even the backlash to this system, with former communists winning elections in some countries, has been marked by all of them supporting market-oriented reforms of one sort or another, if only as promises for a more gradual approach to a transition to some form of market capitalism.

There is a tension between asserting the efficiency of competitive equilibria and recognizing the limits of the applicability of that theorem. While recognizing these limits, the stronger advocates of laissez-faire argue against their significance or relevance.

The most straightforward case is made by the **Chicago School,** whose most prominent spokesman is Milton Friedman.[23] The Chicago School's argument draws directly from the efficiency theorem and follows by asserting the irrelevance or unimportance of the various exceptions and limits. Markets are almost always efficient, so government should keep its hands off.

Monopolistic or oligopolistic market structures reflect efficient and competitive behavior by the firms involved unless their behavior is enforced because of some government restriction on entry. Friedman's opposition to government restrictions on entry leads him to oppose the licensing of doctors by government. According to the Chicago School, government-initiated antitrust suits are just a waste of time, distracting firms from their market-appointed task of efficiently providing goods and services to consumers.

22. This policy has been most eloquently and influentially defended by Milton Friedman in *The Quantity Theory of Money* (Chicago: University of Chicago Press, 1957).

23. A sign of Friedman's special prominence is that when the former Soviet leader, Mikhail Gorbachev, visited the Hoover Institution at Stanford University, where Friedman was then located, Gorbachev made a special point of seeking him out for praise and a handshake. His ninetieth birthday was celebrated by a visit to President George W. Bush at the White House. The classic statement of a strong version of Friedman's views is found in his *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962).

The Chicago School argues that most externalities will be resolved by private markets if property rights are properly defined and enforced, as suggested by the Coase Theorem. If they are not, then externalities are probably not very significant and the benefits to be obtained from any possible government intervention will be more than offset by the inefficiencies and waste associated with government activity, it is argued.

The Chicago School of free markets holds that many of the goods provided by the public sector are not really collective consumption goods and could be more efficiently provided privately. Thus privatization of public goods provision should be vigorously pursued.

The Chicago School also argues that information costs are inevitable and cannot be avoided. Again, inefficient governments are unlikely to be very helpful in improving matters in this area.

In macroeconomics the Chicago School supports the Classical School approach. Milton Friedman is the most prominent advocate of monetarism in the United States and has proposed that the money supply should grow at a constant rate per year. Beyond that, fiscal policy should involve low to no deficits and should not be actively used for stabilization efforts.

With respect to the distribution of income, people should be allowed to keep what they earn from the free market. Inequalities are the necessary outcome of providing sufficient incentives for production, investment, and growth. The equity-efficiency trade-off is real, and efficiency should be favored. So, government should not redistribute income.

A more general criticism of government intervention is made by *public choice theory,* which argues that the government agencies designated to carry out the market-correcting activities are self-interested entities that become captured by special interests operating through their legislative connections. This analysis became more focused after the discovery of the concept of **rent-seeking** by Gordon Tullock and Anne Krueger, with *rent* defined as the return to a factor with a fixed supply, like land or a unique individual, that then has monopoly power. Government agencies through regulatory actions can create artificial scarcities, such as a limited number of import licenses in a less developed country. This artificially creates rents that can be captured by special interests, including the bureaucrats in charge of allocating these scarce items by means of bribery. Devoting large amounts of economic resources to the creation and capture of these rents often involves corruption, which has become an increasingly serious problem in many countries (box 2-2).

Finally, we note that the Austrian School generally supports laissez-faire quite strongly, but from a different theoretical perspective. In contrast to the Chicago School's acceptance of the Pareto efficiency theorem of a static Walrasian general equilibrium, the Austrian School rejects equilibrium analysis and emphasizes dynamic market processes in the context of a strictly subjectivist, demand-side theory of value. In their view, entrepreneurs are the most important agents in the economy. They must be allowed to function freely, without

Box 2-2
Does Rent-Seeking Explain National Destinies?

The rent-seeking theory has been broadly applied by Mancur Olson in his *The Rise and Decline of Nations* (1982). He revives the Jeffersonian notion that every society needs a revolutionary shakeup from time to time in order to maintain its dynamism. Without such occasional shakeups, often brought about by defeat or conquest by a foreign power, interest groups accumulate power and influence and are able to expand their rent-seeking activities to the point where the economy loses all ability to change or grow as it becomes encrusted with more and more regulations and restrictions designed to protect the increasingly bloated rents of the outdated special interests. Olson presents the stagnation of never-conquered-since-1066 Great Britain and its ossified class system as a leading negative example and the postwar economic dynamism of defeated Germany and Japan as positive examples. The Olson theory suggests that Russia and its former allies may have bright futures if they can get through their difficult transitions.

government restriction, so that they can lead the market to evolve in conjunction with the evolution of consumer preferences through an ongoing process of innovation. This view draws strongly on the creative destruction ideas of Joseph Schumpeter, although he did not agree with the more laissez-faire views of his fellow Viennese natives of Austria, Ludwig von Mises and Friedrich Hayek. For the Austrian School, static efficiency is relatively unimportant. It is the dynamic success of market capitalism that is its most important attractive economic feature.

SUMMARY AND CONCLUSIONS

Modern market capitalism evolved out of the merchant capitalism of northern Italy and Flanders in the late medieval period, achieving its closest approach to laissez-faire in the Industrial Revolution in Britain and the United States in the nineteenth century. These economies saw increased government intervention in the twentieth century, leaving Hong Kong, Singapore, and New Zealand as the most laissez-faire advanced economies in the world today.

A complete, competitive, full-information general equilibrium, in which supply equals demand in all markets, is efficient in the Pareto sense. Thus no individual can be made better off without making some other individual worse off. This theorem does not address the question of income distribution, and critics of market capitalism emphasize its tendency toward inequalities of income and wealth, which seem to be worsening over time. Supporters of market capitalism, however, argue that such inequalities are necessary to bring about economic growth because they provide incentives for work effort and investment.

The efficiency theorem suggests that a minimal-government, laissez-faire economy might be inefficient because of monopoly power, externalities, insufficient public goods, imperfect information, and possible macroeconomic instability. During the twentieth century the U.S. economy developed mechanisms for dealing with these problems, many of them involving some sort of government activity or intervention.

Despite this evolution, controversy and debate continue regarding the appropriate scope of government involvement in mixed-market capitalist economies. Strong supporters of laissez-faire critique proposed and actual ways in which governments seek to correct the inefficiencies of unfettered markets. This suggests that as the former socialist countries continue to move toward market capitalism, they will increasingly encounter serious questions regarding the ultimate balance between the public and private sectors within their economies.

Although the United States is much closer to laissez-faire than most market capitalist economies, its government actively intervenes in a variety of ways to deal with the above problems. A recent trend has been toward policies that may involve establishing a market where none existed before, for example, for tradeable pollution permits. Compared with other market capitalist economies, the United States has a very high real income, a high level of competitiveness, greater income inequality, weaker unions, more per capita air pollution, a smaller public sector, and historically somewhat greater volatility of its GDP. Thus it shows the dynamism but also the difficulties of market capitalism as a system.

QUESTIONS FOR DISCUSSION

1. "Income inequality is necessary for Pareto optimality so that people will work as hard as they can." "If income is distributed equally, then there must be Pareto optimality because you can't make one person better off without making someone else worse off." Are these statements true or false? Why or why not?

2. How does the U.S. economy compare with other market capitalist economies with respect to its degree of industrial concentration and the nature of its antitrust policies?

3. Socialist critics of market capitalism argue that businesspeople will not care about the environment because they are concerned only about profits, whereas socialist planning will be able to take care of the environment. Why then have environmental conditions generally been better in the industrialized market capitalist economies than in the industrialized command socialist ones?

4. What are some publicly provided goods in the United States that could be efficiently provided privately instead? Why are they not so provided?

5. Looking at the tables in this chapter, can you find any evidence that the influence of Keynes might have contributed to improved macroeconomic performance among market capitalist economies? How might his influence have failed to improve their performance?

6. How might you critique the strong case for laissez-faire presented at the end of the chapter?

7. How do the defenses of laissez-faire by the Chicago School and the Austrian School differ?

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3 The Theory and History of Marxism and Socialism

What is the difference between capitalism and socialism? Under capitalism man exploits man, but under socialism it is just the opposite.
—Old Soviet Joke

What is socialism? It is the longest road from capitalism to capitalism.
—Later Soviet Joke

INTRODUCTION

Socialism is an economic system characterized by state or collective ownership of the means of production, land, and capital. With the possible exception of state-dominated ancient empires such as Babylonia and Egypt, socialism did not actually exist as a system until the early twentieth century. Its emergence reflected a long theoretical, ideological, and political development based on criticism of feudal and capitalist systems that existed prior to its modern appearance. This criticism originated from religious sources favoring egalitarian income distributions and collective sharing and evolved into a secular theory of history and society in the writings of Karl Marx and his followers.

At the present time, with very few exceptions, countries that have identified themselves as socialist are attempting to move toward either intermediate or complete market capitalism. Nevertheless, there are still sound and compelling reasons to examine the socialist economic system and its origins. One reason is that despite the considerable efforts to change such economies, many are still substantially socialist in actual practice. Another reason is that frustration with efforts to move toward some form of capitalism have led to a revival of socialist ideology in some of these countries. Finally, the difficulties experienced in the market capitalist world have stimulated reconsideration of at least limited elements of the socialist model as reformist devices. Entirely new forms may yet emerge out of the changes sweeping the world economy.

THE DEVELOPMENT OF SOCIALIST IDEOLOGY

Religious and Philosophical Precursors

Socialist ideology originated in religious and philosophical criticism of inequalities in existing societies and the formulation of ideal alternatives in which collective sharing and equality reign supreme. In the Old Testament the prophet Amos railed against the rich, and in the New Testament Jesus expressed sympathy for the poor. The ancient Greek philosopher Plato described an ideal society in his *Republic,* although it included nonsocialist elements such as slavery.

In Europe, Christianity provided fertile ground for germinating socialist ideology. Marx and Engels in the *Communist Manifesto* note that “Nothing is easier than to give Christian asceticism a socialist tinge." Fundamental to the connection between Christianity and socialism was the **millennarian tradition** of expecting the Second Coming of Christ, when all would be judged and there would be heaven on earth for the saved, called the *millennium*. Outbreaks of millennarian expectations often brought a desire to purge society of all inequalities, especially among the more radical elements of the Protestant Reformation after 1500.

The discovery by Columbus of naked people in America who owned no property and seemed to live in a paradisaical state influenced Thomas More in 1516 to write his book *Utopia,* which described an island where everyone shared and was equal. Expecting the imminent end of the world in 1525, Anabaptists led by the millennarian Thomas Munzer rose up at Mulhausen to institute collective sharing, only to be suppressed later by the Lutherans.

During the Enlightenment of the 1700s, this egalitarian impulse became secularized in French philosophy, especially by Jean-Jacques Rousseau, and led to the French Revolution in 1789. Despite emergency economic controls during the dictatorship of the Committee of Public Safety, the peak of the revolution, in 1793–1794 under Robespierre, was predominantly a democratic and procapitalist revolution against the feudal aristocracy. A radical egalitarian fringe emerged but it was suppressed. In 1796, François "Gracchus" Babeuf, often identified as the founder of modern communism,[1] led an unsuccessful revolt by the "Conspiracy of Equals" who called for the abolition of private property and the holding in common of land.

Utopian Socialism

What came to be known as **utopian socialism** was the first movement to label itself *socialist.* Its founders, Henri de Saint-Simon, Charles Fourier, and Robert Owen, held diverse views. The label best applies to the latter two, with Saint-Simon being the father of command central planning.

Whereas the heyday of utopian socialism was the 1830s, Saint-Simon's ideas first appeared in his 1803 *Letters from an Inhabitant of Geneva to His Contemporaries*. In *The Fatal Conceit: The Errors of Socialism* (1988), Hayek fingers Saint-Simon as the ultimate father of the "fatal conceit," which he labels *constructivism,* the idea that a rational order of society can be planned and constructed from scratch from the top down. This reflects Saint-Simon's background in science and engineering, which led him to support **social engineering,** a rational central plan ordering society for the benefit of those least well off.[2]

1. The term *communism* initially appeared in France around 1840 among those inspired by Babeuf. Local units of government in France were and are called *communes*. The term *socialism* originated in the early 1830s with the British utopian socialist Robert Owen.

2. Through such followers as Auguste Comte, a mathematician and founder of social science and positivism, his influence continues in France today in its technocratic and indicative planning tendencies.

Another Frenchman, Charles Fourier, probably came closest to fitting the label of *utopian socialist*. In the 1830s he criticized industrialization and urbanization and called for the creation of small communities of about 1,600 people in rural areas called **phalansteries.** Everyone would share all things, including each other sexually, and would do many different kinds of work. Fourier argued that "mutual attraction" was the driving force of the universe and that this could be used to order production and all relations within the phalanstery, in which all would live in harmony with each other and with nature.

Fourier made no serious effort to establish phalansteries. But various communities were developed by others, such as Brook Farm in Massachusetts, organized by George Ripley in 1841 and lasting for five years, supported by the transcendentalist literary figures Bronson Alcott, Margaret Fuller, and Ralph Waldo Emerson. The most successful communities were founded by religious groups, such as the **Amana Farms** of Iowa, now a subsidiary of a major multinational corporation.[3]

The Welshman Robert Owen was the practical utopian who actually carried out his schemes. Coming from a working-class background, Owen became a successful capitalist at an early age. From 1800 to 1824 he owned and managed a successful textile company in New Lanark, Scotland, where he introduced numerous reforms, including higher wages, restrictions on child labor, and education for the workers. Although his fellow capitalists scoffed at his concern for his workers, Owen made money. From 1824 to 1829 he attempted to start a utopian community in New Harmony, Indiana, a project that failed. He became leader of the first national labor union in Britain, the **Grand National Consolidated Trades Union,** suppressed in 1834.

In the *Communist Manifesto* of 1848, Marx and Engels sneered at these figures, whom they labeled with the epithet *utopian*. They argued that the utopian socialists just concocted ideal societies and engaged in vague moralizing while failing to analyze historical dynamics "scientifically" and working to change entire societies.

But some utopian ideas crept into the work of Marx and Engels, through them into modern socialism,[4] and beyond into modern societies more generally. One example is the utopian plank in the *Communist Manifesto* calling for the "gradual abolition of the

3. Established in the mid-nineteenth century by strict German pietists, the Amana Farms gave up their communalistic isolation during World War II after the pressures of the Great Depression and increasing contact with the outside world by the automobile wore down their resistance. Usually successful utopian communities are absorbed by the larger economy as the idealistic founding generation dies out and its children desire to become "just regular folks." Something along these lines is apparently happening in many Israeli **kibbutzes** today, although the religiously orthodox ones seem to be preserving their communalistic practices longer than the more secular ones.

4. The influence of utopian ideas on the radical Russian intelligentsia who preceded the Russian Revolution of 1917, which first introduced actual socialism, is depicted in the 2002 trilogy of plays by Tom Stoppard, *The Coast of Utopia*.

distinction between town and country." This idea has been admired by modern urban planners, both socialist and nonsocialist. Capitalist but planned "new towns," such as Reston, Virginia, have been founded on the basis of this inspiration.

THE MARXIAN[5] WORLDVIEW

Some General Observations

Karl Marx (1818–1883) was born in Trier in the German Rhineland, studied philosophy and jurisprudence in Berlin in the early 1840s, became a radical journalist who participated in the uprisings of 1848 in the Rhineland, and spent most of the rest of his life in penurious exile in London, supported financially by his collaborator, Friedrich Engels, who owned a textile mill. Together they developed the Marxian worldview in writings that profoundly influenced socialist thought.

One reason for Marx's enormous influence is that his worldview constitutes a **holistic system** by seeking to explain virtually everything in a unified whole. This allows it to function as a quasi-religion, with people "converting" to it and following it with great intensity. The essence of Marx's holistic theory is his integration of three major strands of nineteenth-century European thought: German political philosophy, French political sociology, and British political economy. A brief discussion of how these ideas influenced Marx follows.

The Hegelian Dialectic

The dominating figure of German philosophy in the first half of the nineteenth century was Georg W.F. Hegel, the first great intellectual influence on Marx. He developed the idea of the **dialectic,** meaning that all phenomena reflect a conflict between pairs of unified opposites whose mutual opposition evolves over time to critical breakpoints where reality qualitatively changes. These opposites were labeled the **thesis** and its **antithesis.** At the critical breakpoint their opposition generates something brand new, the **synthesis,** which in turn can generate its own antithesis.

The ultimate Hegelian thesis is the *Universal Idea*—God; the antithesis is the individual person. The synthesis is the State: In Hegel's particular argument from a disunited Germany came the idea of an emergent powerful and nationalistic German state. Such ideas influenced the movement for German unification that accelerated toward its culmination under Bismarck in 1871 and influenced the ultranationalist Nazi movement in the twentieth century.

5. The term **Marxian** refers to the writings and views of Marx himself, whereas the term **Marxist** refers to any view or idea strongly influenced by Marx.

In the 1840s when Marx was studying in Berlin, a major split occurred among Hegel's followers. Hegel declared that "the real is rational and the rational is real." The Old, or Right, Hegelians emphasized the first part; existing reality and state structures are rational and therefore should be accepted. The Young, or Left, Hegelians emphasized the second part; rational ideals are the ultimate reality, and actual reality should be changed to conform to them if it does not, by revolutionary means if necessary. Marx identified with this second group.

Historical Materialism

A central aspect of Hegel's philosophy was its idealism; ultimate reality is spiritual rather than material, and God is the Universal Idea driving all history. Many Left Hegelians agreed. But Ludwig Feuerbach disagreed in his *The Essence of Christianity,* denouncing religion for being used by ruling elites to delude and control people. He asserted that reality is ultimately material: "You are what you eat." Marx saw Feuerbach as "standing Hegel on his head" and agreed.

Marx "materialized" Hegel's dialectic by using the French idea that the French Revolution was a conflict between socioeconomic classes. After a major strike in Lyons in 1831, followers of Babeuf such as Pierre-Joseph Proudhon identified the central class conflict of the emerging industrial society to be between the **bourgeoisie** (capitalists) and the **proletariat** (workers). Here Marx found the key to **historical materialism:** the idea that the driving force of history is the dialectic between conflicting socioeconomic classes.[6] This was crystallized in the line that opens the main body of the *Communist Manifesto*: "The history of all hitherto existing society has been the history of class struggles."

This struggle concerns ownership and control of the means of production: One class owns and controls the means of production and thus exploits the other class, which does not. The technology of a society (**forces of production**) combines with the structure of classes (**relations of production**) to determine the **mode of production.** This is the *substructure* or base of a society that determines everything else, the *superstructure,* that is, religion, politics, culture, and so forth.

As the dialectic of class struggle proceeds, the mode of production becomes qualitatively transformed into something different. The mode of production of ancient Greece and Rome was slavery, characterized by the struggle between master and slave. The fall of the Roman Empire thus arose from this contradiction, resulting in the mode of production

6. In orthodox Soviet dogma, Marx's philosophy was labeled **dialectical materialism,** which implied extension of a similar methodology to all science and culture. Although broached by Engels after Marx's death, the term was never used by either Marx or Engels. It was introduced by Lenin's initial mentor, Georgi Plekhanov, and justified Joseph Stalin's ideological control of cultural and scientific activities, such as his foolish suppression of genetic research.

transforming from slavery to feudalism. In turn, feudalism was driven by the struggle between lord and serf and was transformed into capitalism, with its own struggle between the capitalist, who owns the means of production, and the worker, who does not.

As this struggle was to reach its apex in the most advanced capitalist countries such as England and Germany, there would be a revolutionary transformation into socialism, with state ownership of the means of production, direction of production by a *common plan,* income inequalities and wage payments, and control by a *dictatorship of the proletariat*.[7] In his *Critique of the Gotha Program,* written at the beginning of the 1870s, Marx declared that eventually communism would develop, and then all classes and property ownership would disappear and the state would wither away.

The Labor Theory of Value and the Breakdown of Capitalism

After the crushing of the revolutions of 1848 in Germany, France, and other European countries, Marx fled to London and immersed himself in the study of classical British political economy to understand more fully the dynamics of capitalism. There he found David Ricardo's labor theory of value, which argues that the value of a commodity is determined by the amount of socially necessary labor time it takes to produce it. This idea contradicts the neoclassical economic theory that value is codetermined by supply and demand, with capital and land contributing to the supply side of the equation.

Marx saw land and capital as productive but not as contributing to value. Following Ricardo, he argued that land rent was due only to differences in the productivity of different land locations and that marginal land earns zero rent, the true *return to pure land*. Also following Ricardo, he saw capital goods as being the product of past labor, simply *indirect labor*. But he went beyond Ricardo in asserting that the true reality of capital is not the capital good itself but the social relation of exploitation between the capitalist and the worker. *This assertion is the core of the Marxian doctrine.*

The value of a commodity, W, consists of three components: constant capital, c, variable capital, v, and surplus value, s. The first, c, corresponds roughly to fixed capital stock, as measured in the labor time required to produce it.

The second component, v, represents the value of labor power used in production. Applying the labor theory of value to labor itself, it is the amount of socially necessary labor time it takes to reproduce labor, equal to a subsistence wage.

The third component, s, is Marx's modification of the labor theory of value, **surplus value,** that value created by the worker but taken by the capitalist, leading to the **exploitation** and

7. There are numerous places in his writings where Marx states support for democracy. Based on his forecast that a majority of the population of advanced capitalist countries would be workers, this "dictatorship" might be democratic. But there are places in his writings where Marx sneers at "bourgeois freedom and individuality," an attitude emphasized by Lenin in his contempt for democracy.

alienation at the heart of capitalism. According to Marx, it is out of surplus value that the capitalist obtains profit.

$$W = c + v + s. \tag{3.1}$$

Marx then defines the **organic composition of capital** as

$$q = c/(c + v), \tag{3.2}$$

the **rate of exploitation** as

$$s' = s/v, \tag{3.3}$$

and the **rate of profit** as

$$p' = s/(c + v). \tag{3.4}$$

Then Marx argues that capitalists are inevitably driven to engage in capital investment by their competition with each other, thereby raising the organic composition of capital. "Accumulate, accumulate! That is Moses and the prophets!" It is easy to see that if c rises while s and v are constant, then the rate of profit will decline, which Marx argues is the fundamental tendency of capitalism.[8] The capitalists destroy themselves as a group as each tries to gain a competitive edge on the other.

The dialectic leads capitalists to try to increase the rate of exploitation, s/v, either by lowering wages, thereby immiserating the workers, or by working them longer and harder. These efforts intensify the class struggle and the increasing severity of *commercial crises* (now called *recessions*). Thus, "One capitalist always kills many." This leads to an increasing concentration of capital in fewer and fewer hands, while the proletariat expands and becomes more miserable and more conscious of its condition. Eventually the contradiction between the forces of production and the relations of production becomes so intense that the system is overthrown by the revolutionary working class. In Marx's words: "Centralization of the means of the production and socialization of labor at last reach a point where they become incompatible with their capitalist integument. The integument is burst asunder. The knell of capitalist private property sounds. The expropriators are expropriated"[9] (box 3-1).

8. Ricardo saw a tendency toward a falling rate of profit caused by rising population leading to rising food prices, with land rent squeezing out profit, a Malthusian scenario. Some modern Marxists claim to have found empirical evidence of a tendency toward a falling rate of profit in the U.S. economy (Fred Moseley, *The Falling Rate of Profit in the Postwar US Economy* [New York: Macmillan, 1991]). Others defend the falling rate of profit idea and Marxian theory by arguing that they must be viewed in a sequential nonequilibrium context (Alan Freeman and Guglielmo Carchedi, eds., *Marx and Non-Equilibrium Economics* [Cheltenham, UK: Edward Elgar, 1996]). Standard neoclassical theory accepts that without technical change, the rate of profit will decline as the capital-labor ratio rises.

9. Karl Marx. *Capital,* vol. 1 (Hamburg: Verlag von Otto Meissner, 1867), chap. 32.

Box 3-1
Marxism as a Quasi-Religion

Bertrand Russell made a comparison between the Marxist system and Christianity that suggests how Marxism came to acquire a quasi-religious status among many of its adherents. It involves an equivalence of concepts between the two systems as follows:

Yahweh (God) = Dialectical Materialism
Messiah = Karl Marx
The Second Coming = The Revolution
The Saved = The Proletariat
The Church = The Communist Party
Damnation to Hell = Expropriation of the Capitalists
The Millennium = The Socialist Commonwealth

CONTROVERSIES IN SOCIALISM UP TO THE BOLSHEVIK REVOLUTION

Orthodoxy and Revisionism

By the time of Engels's death in 1895, difficulties had arisen for the Marxists of the German Social Democratic Party. Not only had capitalism not collapsed but real wages were rising, thus undermining the expectation of the imminent arrival of revolution. The first Marxist to point this out was Eduard Bernstein, in his 1899 book *Evolutionary Socialism*. He argued that since conditions were improving, a reformist and gradualist approach through parliamentary democracy should be used to achieve gains for the working class. This eventually became the policy of the German Social Democratic Party, which still exists, and more generally of modern European social democracy.

This view was labeled **revisionism.**[10] Bernstein's arguments provoked a counterattack by the orthodox Marxist, Karl Kautsky, who argued that economic crises were becoming ever more severe and that eventually there would be a chronic depression. But Kautsky as a leader of the German Social Democratic Party practiced revisionism as a policy while waiting for the expected revolutionary upheaval. Yet when the Bolsheviks seized power in Russia, Kautsky criticized them and openly supported revisionism's parliamentary reform program. Besides influencing social democracy, revisionism influenced market socialist reformers later in Eastern Europe.

10. This became a standard Marxist term of opprobrium. Thus, after Nikita Khrushchev denounced Joseph Stalin in 1956, defenders of Stalinist orthodoxy, such as Mao Zedong in China, denounced Khrushchev for "revisionism."

The Theory of Imperialism and Marxism-Leninism

Another explanation for the failure of capitalism to collapse, proposed in 1902 by John Hobson, was the theory of imperialism. The advanced capitalist countries had reduced their internal contradictions by engaging in the conquest of less developed countries, especially exemplified in the "scramble for Africa" among the major European powers in the late nineteenth century. There they could create captive markets and supply themselves inexpensively with raw materials. This imperialism theory gained followers among the left wing of the German Social Democrats, led by Rosa Luxemburg, and among the Bolsheviks in Russia, led by Lenin. Supporters of this view opposed entry by their countries into World War I. But Luxemburg supported democracy, while Lenin did not.

Vladimir Illich Ulyanov, known as Lenin, further developed the **imperialism thesis** in his 1916 *Imperialism: The Highest Stage of Capitalism*. Written during World War I, it set the stage for withdrawing Russia from the anti-German war effort after Lenin seized power in 1917.[11] Lenin saw Marx's increasing concentration of capital dominated by bankers who paid off the "labor aristocracy" of workers in the advanced capitalist countries with surplus value exploited from the colonialized periphery. Revolution would come in capitalism's "weakest link," which he saw as Russia since it had industrialized too late to participate in the carving up of Africa and was dominated by foreign investment from the leading capitalist powers of the West, especially Great Britain, France, and Germany.

Refocusing revolutionary expectations on less developed countries became **Marxism-Leninism,** the official Soviet doctrine after 1917, and the guiding light of Marxist revolutions in the twentieth century in less developed countries from China to Cuba to Vietnam. This concept included the idea of the *dictatorship of the proletariat* to be led by a vanguard elite within the revolutionary party, since workers left to themselves would follow *opportunistic* (revisionist) paths. Originally enunciated in Lenin's 1902 book, *What Is to Be Done?,*[12] this view was adopted by the **Bolsheviks** (majority) of the Russian Social Democratic Labor Party in 1903 against the prodemocratic **Mensheviks** (minority).

In August-September 1917, during the brief rule of the post-tsarist Provisional Government, Lenin authored his influential *The State and Revolution*. Following Marx and Engels's views regarding the failed **Paris Commune** uprising of 1871, he argued that the

11. Lenin spent most of the war years in Zurich, Switzerland. Aware of his views, the German government transported him in a sealed train to Russia after the fall of Tsar Nicholas II in early 1917, hoping that he would take power and withdraw Russia from the war. Their hope was rewarded.

12. This title was identical to an earlier one used by the populist (*Narodnik*) Tchernishevsky, who saw the possibility of a Russian revolution based on the communal traditions of the rural peasantry. In a parliamentary election held in December 1917, immediately after the Bolshevik takeover, the party winning the most votes and seats was the pro-Narodnik Social Revolutionary Party. Lenin responded by abolishing the parliament (Duma) and later outlawing all parties but the Communist Party.

idea of the withering away of the state implied an initial smashing of former state power and then establishment of a state ruled by the vanguard of the proletariat that would crush the remnants of the former ruling class. Only when this was accomplished would the state wither away. This argument supported the later Soviet assertion of state power under Joseph Stalin in purging political opponents and imposing a command economy.

Anarchism and Syndicalism

Another strand of radical thought and activity was that of **anarchism** and its close relative, **syndicalism;** both concepts argued that the state should be abolished outright. For the anarchists this often led to conspiratorial violence directed at assassinating heads of state. Successful efforts included the 1881 assassination of Alexander II, the "liberal tsar," who emancipated the Russian serfs, and the 1901 assassination of U.S. President William McKinley.[13] Such philosophies fundamentally disagreed with standard socialism's support of ownership and control of the means of production by the state.

Anarchism was founded in 1793 by William Godwin of Britain, whose wife, Mary Wollstonecraft, is regarded as the founder of feminism. Influenced by Rousseau, Godwin argued that without government, people will peacefully organize themselves into a harmonious, nonoppressive order. This view has links with both utopian socialism and modern libertarianism.

In 1840 Pierre-Joseph Proudhon linked anarchism with communism and the revolutionary working-class movement in his *What Is Property?* (Proudhon's blunt answer: "Property is theft!"). In the 1860s he became the father of the French trade union movement, which was long anarchist. Marx viewed this position as fuzzy-minded and unscientific.

Marxism and anarchism competed in the 1860s after Marx founded the **First International.** His main rival was the Russian anarchist Prince Michael Bakunin, who supported conspiratorial and violent revolution and ridiculed Marx for his "statist" tendencies. Bakunin had strong support among the workers' movements in Spain, Italy, Switzerland, and France and in 1872 appeared on the verge of taking control of the First International, leading Marx to dissolve the organization.

In the 1890s, proanarchist trade unions in the above countries argued that after the abolition of the state, society should be run by the trade unions themselves, with production being directly controlled by the workers at the production site. This philosophy is known as *syndicalism*.

In Russia syndicalist influence showed up in the Bolshevik revolutionary slogan "All power to the Soviets!", which in 1917 were workplace advisory bodies based on local

13. Not all anarchists supported violence, as is shown by the example of the Russian Prince, Peter Kropotkin, whose ideas were similar to those of the utopian socialists.

unions supporting the Bolsheviks.[14] In 1921 Lenin crushed a syndicalist uprising at the Kronstadt shipyard near Petrograd,[15] thereby asserting the supremacy of state power in the new regime.

Although anarcho-syndicalism faded after the 1930s, it continues to have an important influence on modern socialist thought through the ideas of workers' management and workers' ownership, as well as on some environmentalist movements. Anarchism also continues as a right-wing movement in the form of radical individualistic libertarianism. Left-wing anarchism has been visible in antiglobalization protests, such as the one in Seattle in November 1999 against the World Trade Organization.

SOME DIVISIONS OF SOCIALISM SINCE 1917

General Remarks

The 1917 Bolshevik Revolution in Russia transformed Marxist and socialist ideology. Henceforth all socialist movements had to define themselves in relation to the Marxist-Leninist movement emanating from Moscow. Most newer movements developed out of splits within the world movement whose main base was initially the Communist Party of the Soviet Union. Each of these movements sought to distinguish itself from Soviet orthodoxy, with three main varieties discussed following.

Trotskyism

Leon Trotsky, a former Menshevik and founder of the Red Army in the Soviet Union, was Joseph Stalin's chief rival for power after Lenin's death in 1924. Exiled in 1927, Trotsky founded the **Fourth International,** which fragmented into factions after his assassination in 1940 in Mexico by a Stalinist agent.

Trotsky and Stalin agreed about the need for rapid industrialization in the Soviet Union. But they disagreed about whether this should be done in isolation or in an international context. Trotsky supported the idea of an international **permanent revolution,** believing that true socialism could not be achieved in the Soviet Union without an international revolution. He criticized Stalin for his dictatorial and bureaucratic tendencies.

Trotskyism has never achieved power anywhere, perhaps because this is a movement that tends to appeal mostly to intellectuals. More recent Trotskyists, such as the Belgian

14. The Russian word *soviet* comes from the verb meaning "to advise." Today a soviet is a local unit of government. Mossoviet is the city government of Moscow, even in this post-Soviet era.

15. From 1703 to 1914 and since 1991, this city has been named Saint Petersburg. It was called Petrograd from 1914 to 1924 and Leningrad from 1924 to 1991.

economist Ernest Mandel,[16] argue that the class struggle is an international phenomenon that has spread to include white-collar workers as well as the industrial blue-collar working class. Trotskyist views have been influential among the **New Left** in the United States and Western Europe, with three Trotskyist candidates running in the 2002 French presidential election, excluding then Premier Lionel Jospin, a socialist, who was a Trotskyist in his youth.

Titoism

Titoism developed as a practice before it became an ideology. Josip Broz, known as Marshall Tito, led Communist partisans in throwing the Nazis out of Yugoslavia during World War II, with little assistance from the Soviet Red Army. Initially a strong Stalinist, Tito broke with Stalin in 1948 and declared the political independence of Yugoslavia from Soviet influence. This led to an effort to develop a distinctive economic system for Yugoslavia that would reinforce the separate path Tito had chosen. The system adopted was **worker-managed market socialism,** described by some as *quasi-syndicalist*. In Tito's Yugoslavia it consisted of state-owned enterprises in a one-party state operating with little central planning according to market forces and with managements appointed by worker-selected boards.

After Tito's death in 1981, the economic system deteriorated in Yugoslavia, eventually culminating in the complete disintegration of the country, to be discussed in more detail in chapter 14. Yet ideas similar to Titoism continue to be influential, even in capitalist economies, the major difference being that current versions advocate workers' ownership rather than state ownership and multiparty democracy rather than a one-party state.

Maoism

In 1949 a Communist insurgency led by Mao Zedong took power in mainland China. The Maoist road to power was characterized by reliance on a rural guerrilla movement that encouraged egalitarian economic development in zones of revolutionary control.

Immediately after its 1949 communist revolution, China was quite friendly with the Soviet Union and imitated the centrally planned command industrialization model of Stalin's country. Nevertheless in China there was always more emphasis upon rural agricultural development, as well as upon egalitarianism and the use of moral incentives. After Nikita Khrushchev's 1956 denunciation of Stalin in the USSR, Mao defended Stalin against the "revisionism" of Khrushchev. But in the **Great Leap Forward** of 1957–1959 and

16. Ernest Mandel, *Marxist Economic Theory* (New York: Monthly Review Press, 1969). The term *Trotskyite* is widely used, although it is considered insulting by followers of Trotsky. The term *Stalinite* was briefly used by some of Stalin's admirers in the late 1920s in the United States until Stalin himself banned it (Theodore Draper, *American Communism and Soviet Russia,* 2nd ed. [New York: Vintage Books, 1986], pp. 410–411).

Box 3-2
A New Type of Marxism?

The purest active Maoist group, and arguably the latest development in Marxist ideology, is the Communist Party of Peru, known as **Sendero Luminoso** (Shining Path) since it became an active guerrilla movement in 1980. In 1964 the party split between a pro-Soviet and a pro-Chinese faction. The latter has been led by a former philosophy professor, Abimael Guzman, known as "Chairman Gonzalo." After spending time in China, he led the party to declare itself in 1969 a "Marxist-Leninist-Maoist party of a new type." His followers proclaim that he represents the "fourth stage" of Marxism, "Marxist-Leninist-Maoist-Gonzalo" thought.

After 1980 Sendero Luminoso gained control of much of Peru, drawing on a base among poverty-stricken Quechua- and Aymara-speaking Indians in the Andes mountains, descendants of the proud but humbled Inca Empire. Gonzalo was arrested and imprisoned in 1992, making him a revolutionary martyr. His movement continues but has been greatly weakened, with the Marxist guerrillas in neighboring Colombia now much stronger. Gonzalo's thought is shown by the following quotation:

> If you're talking about exploitation and oppression, you're talking about the state; if you're talking about the state, you're talking about classes; if you're talking about classes you're talking about class struggle; if you're talking about class struggle, you're talking about mass struggle; and, as time has shown over and over again, if you're talking about mass struggle you're talking about rebellion, armed struggle, guerrilla warfare—as our own situation proves today. Our people, like all the peoples of the world, have their own proud history of struggle etched in their blood and heroism.[*]

[*]Central Committee of the Communist Party of Peru, 1982, "Develop Guerrilla Warfare," English translation, 1985 (Berkeley, Calif.: Committee to Support the Revolution in Peru), p. 17. A major influence on Gonzalo was the early Peruvian Marxist José Carlos Mariátegui, *"The Heroic and Creative Meaning of Socialism:" Selected Essays,* ed. and trans. by Michael Pearlman (Atlantic Highlands, N.J.: Humanities Press International, 1996).

again in the **Great Proletarian Cultural Revolution** at its height from 1966 to 1969, Mao emphasized industrial decentralization throughout the country, complete communalization of agriculture, total egalitarianism and moral incentives, and the complete obliteration of all vestiges of previous culture, as discussed in more detail in chapter 15.

This rival to the Soviet approach generated many subsidiary movements around the world.[17] In many Third World countries, they became powerful rural guerrilla movements opposing both capitalism and Soviet-supported leftist groups, notably in Angola, Cambodia, and Peru.

Two years after Mao's death in 1976, his philosophy was repudiated in China. This was largely, but not totally, followed by a decline of support for Maoism among its adherents, although many of these movements continue to follow the rural guerrilla strategy recommended by Mao. Despite this general decline, a new Maoist movement has gained strength recently in rural Nepal.

17. One government siding with China was Albania in 1961 under Enver Hoxha. After China's opening to the United States and its shift away from Maoism under Deng Xiaoping, Albania went into a Stalinist isolationism against the "imperialism" of the United States, the "social hegemonism" of the USSR, and the "revisionism" of China. In 1990 communism collapsed in Albania, then the poorest nation in Europe.

In Cambodia (also known as Kampuchea) the officially Maoist Khmer Rouge ruled from 1975 to 1979 under the brutal Pol Pot. Cities were emptied, and mass slaughter of anyone educated or connected with the former regime was carried out. In 1979 the Soviet-backed Vietnamese successfully invaded and installed a puppet regime. The Khmer Rouge retreated to the countryside to fight, backed for a long time by the Chinese, but were finally defeated at the end of the 1990s.

THE THEORY OF ECONOMIC SOCIALISM

The Socialist Planning Controversy

Pre-1917 discussions of the functioning of socialism tended to be either vague or unrealistic.[18] In *The State and Revolution* Lenin naively suggests that all that would be needed would be "the functions of 'foremen and accountants,' functions which are already fully within the ability of the average town dweller and can well be performed for 'workman's wages.'" Thus the first serious analysis of socialist planning followed neoclassical theory rather than Marxist theory.

The **socialist planning controversy** began in 1908 with Enrico Barone's "The Ministry of Production in the Collectivist State."[19] Barone applied Pareto's efficiency analysis of the Walrasian general equilibrium model. He posited a system with no money and the state determining *equivalences* (relative prices) between goods and distributing them through state stores in exchange for goods brought by people. The Ministry of Production would have to know all costs of production, all demand functions, and all capital stocks. From this a general equilibrium could be solved for a *collective maximum* that would correspond to an efficient competitive equilibrium in that the cost of production would be minimized and the price would equal the cost of production.

Barone foresaw most of the points elaborated by participants in the later controversy. He recognized that actually solving for the planning equilibrium would be very difficult: "But it is frankly *inconceivable* that the *economic* determination of the technical coefficients [prices] can be made a priori." Anticipating the arguments of later authors, Barone proposed this determination be carried out "in an *experimental* way," that is, by varying prices and seeing what happens in the markets. He anticipated critics by noting the bureaucratic implications: "Account must be taken of the necessary remuneration of the army of officials

18. Marx and Engels avoided such discussions because they did not want to be "utopian," although Engels argued for central planning in his *Anti-Duhring,* published in 1887 after Marx's death.

19. English translation in F. A. Hayek, ed., *Collectivist Economic Planning* (London: Routledge & Kegan Paul, 1935), pp. 247–290. The original version was in Italian.

whose services would be devoted not to production but to the laborious and colossal centralization work of the Ministry (assuming the practical possibility of such a system)."

In 1920 Ludwig von Mises critiqued the practicality of this proposal in his "Economic Calculation in Socialism."[20] Money is necessary to calculate prices.[21] The *artificial market* of the experimenting socialist central planner can never generate *rational* prices because of insufficient incentives. The profit motive based on the private ownership of capital is the fundamental driving force in this Austrian School view. In von Mises's words: "It is only the prospect of profit that directs production into those channels in which the demands of the consumer are best satisfied at the least cost. If the prospect of profit disappears, the mechanism of the market loses its mainspring."

Two responses to von Mises's argument emerged. One followed Barone by proposing a form of market socialism with some planning. The other arose in the Soviet Union during the debates over command versus market in the middle to late 1920s and denied the relevance of the static efficiency criterion. It criticized market socialism as well as market capitalism.

In 1936 Oskar Lange defended market socialism in "On the Economic Theory of Socialism."[22] He proposed a Central Planning Board (CPB) that sets producer goods prices and the level of overall investment and distributes the *social dividend*. Consumer goods prices are set by free-market forces, with supply coming from state-owned firms that set the price equal to the marginal cost, as in perfectly competitive markets. Setting producer goods prices in this plan proceeds along the trial-and-error lines proposed by Barone.

Lange ran through the list of sources of market failure discussed in the previous chapter and argued that in all cases this system resolves the problem and leads to an efficient outcome that is equitable and macroeconomically stable. Monopolists are eliminated, so competitive prices are set. Planners account for externalities. Public goods are adequately supplied. Distribution of the social dividend ensures reasonable income equality. Central control of investment eliminates macroeconomic fluctuations.

Friedrich Hayek, von Mises's follower, counterattacked in 1940.[23] He argued that Lange failed to answer von Mises's argument regarding motivation: Without private ownership

20. See Morris Bornstein, ed., *Comparative Economic Systems: Models and Cases,* 7th ed. (Burr Ridge, Ill.: Irwin, 1994), pp. 273–279.

21. At the time von Mises wrote, the new Soviet regime was allowing money to disappear through hyperinflation. But after a short time, it reintroduced money and never again seriously discussed its abolition. In the years immediately after the Bolshevik Revolution, during the War Communism period, many of the revolutionary leaders attempted to institute full communism directly and immediately.

22. See Bornstein, *Comparative Economic Systems,* pp. 280–288.

23. Friedrich Hayek, "Socialist Calculation: The 'Competitive' Solution," *Economica,* May 1940: 130–131.

and the profit motive, firm managers will lack the incentive to search out minimum cost or fulfill consumer demand. Secondly, Hayek echoed Barone in noting the extreme difficulty of gathering information to carry out the necessary calculations. The decentralized capitalist market is the best information transmission system available. Also, there will be no entrepreneurs in such a system and thus technological stagnation.

In a further twist, the Hungarian economist János Kornai argued that the decentralized market socialism in Hungary after the introduction of the post-1968 **New Economic Mechanism** (NEM) led to state-owned firms operating under a **soft budget constraint** because the government did not want to shut them down.[24] The managers of the firms knew they did not have to be efficient; if they lost money, they would be bailed out. In principle governments can impose hard budget constraints on firms they own, but in practice such cases seem to be rare.[25]

One response to Kornai's critique is an economy exactly like the U.S. one but with ownership by a Bureau of Public Ownership that enforces hard budget constraints and distributes profits as a proportion of wages as a social dividend. This has been labeled *pragmatic market socialism*.[26] Another response involves imitating the Japanese *keiretsu* system, in which groups of corporations are tightly linked to major banks that own large amounts of their stock and monitor their performance, imposing hard budget constraints, but with the banks state-owned and the social dividend distributed by democratic political processes.[27]

Yet another possibility is the **socialist market economy** of China with its rapidly expanding **town and village enterprises** (TVEs). These operate vigorously in free markets with hard budget constraints but are owned by local units of government.

The command planning critique came from E.V. Preobrazhensky in 1926 in the Soviet Union and from Maurice Dobb in 1939 in Britain. Preobrazhensky argued for maximizing capital accumulation in the mixed market socialist economy of the **New Economic Policy** (NEP) of the Soviet Union in the mid-1920s. He argued for command central planning to extract resources from the economy in order to engage in rapid capital accumulation to maximize the rate of industrial growth, the policy adopted by Stalin in 1928.

24. See János Kornai, *The Economics of Shortage* (Amsterdam: North-Holland, 1980).

25. One exception has been the Renault automobile company of France. It was hostilely nationalized after World War II because its owner had been a Nazi collaborator. The French government did not wish to do the company any favors and long treated it harshly, imposing a hard budget constraint on it. It is now being privatized.

26. See James A. Yunker, *Socialism Revised and Modernized: The Case for Pragmatic Market Socialism* (New York: Praeger, 1992).

27. See Pranab Bardhan and John E. Roemer, "Market Socialism: The Case for Rejuvenation," *Journal of Economic Perspectives* 6(3) (1992): 101–116.

Dobb critiqued Lange by noting that the CPB would fix investment by fixing interest rates that would be insufficient to guarantee stable investment if prices could vary. Command planning could not only stabilize investment but raise it to a higher level, thus ensuring a higher rate of economic growth. Dobb argued that this higher rate of growth would more than offset any microeconomic inefficiencies that might arise, although the long-run performance of the Soviet economy belies his argument.

A more recent argument for command central planning is that the plans must arise from within democratic political frameworks.[28] One approach suggests that modern computers can be linked together to overcome the Hayekian information problems and achieve rapid feedback that will maintain balances and lead to efficient planning, but with goods distributed in markets.[29] Another view involves more of a halfway house between market socialism and command socialism, with planning dominating rather than markets, but with the planning being carried out by decentralized councils of workers and consumers.[30] This is essentially a variation on the participatory economy discussed later in this chapter, but with planning rather than market forces dominating.

The Theory of Command Socialist Central Planning

Practice preceded theory in the development of command socialist central planning. Central planning first appeared in Soviet Russia with the 1920 electrification plan (Lenin sloganeered that "Communism equals Soviet dictatorship plus electrification."). With the de facto market socialist NEP in 1921, indicative planning was instituted for several heavy industrial sectors under state ownership such as electricity, steel, and cement. This was carried out using the **material balance method,** which became the main planning method used by the Soviet central planning authority, **Gosplan,** after the introduction of comprehensive command planning in 1928.

Discussed in more detail in chapter 10, the basic outline of Soviet central planning is as follows. Long-term planning was on a five-year time horizon. Five-year plans were broken down into one-year plans from which monthly quotas for individual firms were derived.

28. A recent symposium discussing these approaches, with papers by Michael Albert and Robin Hahnel, Al Campbell, Paul Cockshott and Allin Cottrell, Pat Devine, David Kotz, David Laibman, and John O'Neil, appears in a special issue of *Science and Society* 66 (2002), edited by Pat Devine.

29. See W. Paul Cockshott and Allin Cottrell, *Towards a New Socialism* (Nottingham, U.K.: Spokesman, 1993). For their more direct response to the Misesian and Hayekian arguments, see Allin Cottrell and W. Paul Cockshott, "Calculation, Complexity, and Planning: The Socialist Calculation Debate Once Again," *Review of Political Economy* 5 (1993): 73–112. Austrian responses reiterate the basic Misesian point that without private property even superefficient computers will fail to generate efficient prices (Peter J. Boettke, *Calculation and Coordination: Essays on Socialism and Transitional Political Economy* [London: Routledge, 2001], chap. 3).

30. See Michael Albert and Robin Hahnel, *The Political Economy of Participatory Economics* (Princeton, N.J.: Princeton University Press, 1991).

Each firm had a **techpromfinplan,** or technical-production-financial plan. It specified output quantities and prices; input quantities and prices, including wages; and also levels and kinds of capital investment for the firm, presumably consistent with those for other firms.

In practice, one year's overall plan generally involved minor modifications of the previous year's plan based on the outcome of that plan. This led to the **ratchet effect,** whereby firms avoided producing beyond the quota for fear of facing higher future quotas. Other perverse effects included hoarding of inputs and **storming** (*shturmovshchina*), in which firms dashed to meet a quota at the end of the month as inputs became available, often relying on a fixer (*tolkach*) to buy inputs on illegal markets, with some of these individuals later becoming entrepreneurs in the postsocialist economy. For the first five-year plan, the material balances were based on the inherited structure of production.

This involved figuring out how much of which final goods were to be produced. Then the amounts of all the inputs required to produce those outputs were estimated, and the inputs to produce those inputs, and so forth. If more tanks were to be produced, this required more steel, which requires more coal and more iron ore, as well as more steel to produce the machinery used in mining coal and iron ore, and so forth. Sources of inputs could be production, imports, or previously existing stocks.

If a commodity was in "deficit," then either one of the three previous mechanisms would be drawn on, or greater efficiency in its production would be induced, or demand for it had to be cut back. Ultimately material inputs must have been in balance to produce the planned outputs. If the plan represented a set of demands, then material balance implied that supply equaled demand in all sectors; the plan would theoretically have resulted in a general equilibrium.

In the 1930s mathematical approaches to implementing planning began to be promulgated, although never used in Soviet central planning. These approaches were developed outside the Soviet Union or were not often used by their creators because of a Stalinist ideological campaign against "bourgeois mathematical formalism" in economics that was not ended until Khrushchev's de-Stalinization speech in 1956.

The first of these mathematical approaches was **input-output analysis,** developed by Wassily Leontief, who had studied at Leningrad University in the 1920s but had subsequently emigrated to the United States. It is a precise analogue of the material balance method. It depicts the production structure of an economy using a rectangular input-output matrix, whose rows represent inputs and whose columns represent outputs. Some inputs may be primary in that they are not outputs, some outputs may be final in that they are not inputs, and other goods are intermediate, being both inputs and outputs, such as steel.

To solve for all the outputs as a function of the final demands requires one to solve a polynomial equation of order equal to the dimension of the input-output matrix, suggesting a trade-off between detail and solvability. The more detailed the equation, the more useful it is; but computability is more difficult, and gathering accurate data is even more difficult. Soviet economists estimated input-output matrices, But they *never* succeeded in estimating one at a level of detail that matched the level of detail at which planning was actually carried out, indicating the seriousness of Hayekian information problems.

Further limitations of this technique are that it assumes constant returns to scale, no technical change, and no substitutability between factors of production. These assumptions are all necessary to ensure constancy of the technical coefficients in the matrix. Thus this method is most applicable at points in time rather than over time. However, it brings out the reality of "everything being connected to everything else," and has been used for studying ecological-economic systems.[31] Optimization can be achieved by using a generalized version of input-output analysis known as **linear programming,** assuming that the planner can establish some kind of value weighting of the final desired goods so that they can be added up in a planner's objective function.

Linear programming was discovered by Leonid V. Kantorovich, the only Soviet economist to win the Nobel Prize in economics. A professional mathematician and engineer, Kantorovich was approached in 1939 by the Central Plywood Institute to figure out how to match cutting machines and logs in plywood factories. He discovered linear programming as a result but made little of it at first, given Stalin's antiformalism campaign, and he presented its full implications for planning only in 1959.

Kantorovich was careful to couch his formulation as consistent with the labor theory of value, since labor can be viewed as the only primary input, with all outputs being produced by direct and indirect amounts of it in such a system. But the obvious interpretation of linear programming suggests the neoclassical model in which the value of a primary input depends on its marginal productivity and on its scarcity, not on how much direct and indirect labor it took to produce it.

Linear programming, along with nonlinear and dynamic programming, is a common tool used by individual firms and government agencies in market capitalist economies. It also enjoyed some usage at firm levels in some socialist economies. But it has never been operationally used for overall central planning in any command socialist economy. Probably the closest any economywide planners have come to using it has been in the indicative planning exercises carried out in France.

31. Walter Isard, *Ecologic-Economic Analysis for Regional Development* (Glencoe, Ill.: Free Press, 1971).

The Participatory or Cooperative Alternative

Finally, we consider the theory of the **participatory or cooperative economy,** also known as the **labor-managed economy.** Because of the example of Yugoslavia, treated further in chapter 14, most of this discussion has dealt with a market socialist system in which the state owns the means of production. But such an economy may be characterized by workers' ownership as well as workers' management, with some of the criticisms of such a system reduced under this latter version.

The fundamental argument in favor of this organizational form is that it may eliminate worker alienation and the struggle between labor and management, thereby increasing worker motivation and productivity. Also, there may be a fairer distribution of income. When Tito first introduced this system into Yugoslavia, it was argued that it represented the true culmination of Marx's historical dialectic.

Jaroslav Vanek has proposed five characteristics distinguishing the participatory economy:[32]

1. Workers will manage the firms. In practice, this has usually involved management by professional managers hired by worker-controlled boards.
2. There will be income sharing, often thought by many theorists to be the same as wages equaling the average product of labor, although Vanek argues that it means a "democratic" determination of remuneration levels for specific types of jobs. In practice, such firms generally exhibit internal variations in wages.
3. Productive resources are not owned by the workers and therefore must be paid for by rentals, although workers enjoy **usufruct rights** to the fruits of the operation. This is not exemplified by firms following one of the capitalist variants of this form, as they may own the productive resources.
4. It will be a market economy. Any central planning will be of the indicative rather than of the command sort.
5. Workers can freely choose where to work.

In short, the labor-managed market socialist economy supposedly combines the best aspects of capitalism and socialism, constituting a virtuous **Third Way** between the two. Market efficiency abounds, but the alienating class struggle of standard capitalism is eliminated. Supporters of the capitalist workers' ownership type argue that in their version there

32. See Jaroslav Vanek, *The Participatory Economy* (Ithaca, N.Y.: Cornell University Press, 1971). For classic writings on the participatory economy see David L. Prychitko and Jaroslav Vanek, eds., *Producer Cooperatives and Labor-Managed Systems* (Cheltenham, U.K.: Edward Elgar, 1996).

will also be no Kornai-type soft budget constraint, as there might be in the socialist version. Worker-owners will be responsible and efficient worker-managers.

Criticism of this vision originally came from Benjamin Ward,[33] who argued that in cooperatively managed firms there will be a tendency for less labor to be hired as workers strive to maximize net income per head of existing workers. This tendency can result in a backward-bending supply curve by the firm when a standard market capitalist firm would have an upward-sloping supply curve. An increase in price could reduce output. Rather than encouraging efficiency, workers' management may do just the opposite.

Other criticisms of labor-managed economies argue that worker-managed firms may tend toward monopolization and may disregard externalities such as pollution. Rather than getting the best of both worlds, the cooperative economy may actually combine the worst of capitalism and socialism, resulting in a stagflationary economy like that of Yugoslavia in the 1980s.

A final critique is that such an economy may underinvest in capital in the long run because workers will drain firms of extra income in the short run, especially in the socialist version, where workers' lack of property rights in firm assets reduces their incentive to support long-time investment. Workers will take funds out and put them in savings accounts to earn interest.[34]

Vanek responded to Ward's argument and also to the monopolization argument by suggesting that entry by new firms would solve these problems. In Yugoslavia such free entry was discouraged, although there has never been any evidence of backward-bending supply curves there despite apparently very low labor mobility. Workers would not want to pollute their own work or living places[35] and would recognize in a competitive environment that their own jobs ultimately depended on the firm making timely and productive investments.

Despite the collapse of Yugoslavia, the capitalist version of the cooperative economy seems to be enjoying renewed attention. Its form ranges from straight workers' ownership in **cooperatives,** to **employee stock ownership plans** (ESOPs) in which workers' ownership operates through a trust fund usually based on pension benefits, to paying workers with stock options, to the weakest version involving merely profit sharing. Successful examples of each type in the United States include for cooperatives plywood producers in the Northwest, for ESOPs the Weirton Steel Company of West Virginia (although the prominent example, United Airlines, declared bankruptcy), and for profit sharing various

33. Benjamin Ward, "The Firm in Illyria," *American Economic Review* 48 (1958): 566–589.

34. See Eirik Furobotn and Svetozar Pejovich, "Property Rights, Economic Decentralization and the Evolution of the Yugoslav Firm, 1965–72," *Journal of Law and Economics* 16 (1973): 275–302.

35. If pollution is truly external, the workers may not care. Table 2-2 shows Yugoslavia to have had a better environmental record than most of its command or capitalist peers.

Silicon Valley high-technology companies. Cooperatives and ESOPs sometimes arise when a plant is threatened with closure and the workers buy it out, although between 1974 and 1986 ESOPs enjoyed special tax breaks in the United States, and some were formed to allow previous owners to escape pension liabilities while getting the tax break.[36]

To examine the debate over the cooperative economy, Craig and Pencavel[37] compared the Northwest Pacific plywood cooperatives with conventional plywood producers. In the cooperatives, employment tends to be more stable as workers adjust to demand shocks by adjusting wages, an argument with macroeconomic implications, as argued by Weitzman in his *The Share Economy* (1984). Supply elasticity is less than for conventional firms, but there are no backward-bending supply curves. Cooperatives exhibit high productivity and profitability, at least partly through the need for fewer foremen and supervisors as the workers monitor each other. However, cooperatives exhibit lower share prices relative to earnings, making it hard for them to raise capital and thus raising the long-run growth issue.[38] Craig and Pencavel hypothesize that this is due to the workers' bearing extra risk in regard to their wage income.

Thus the future of workable socialist forms that fulfill the goals of Karl Marx may be found in models emerging out of existing market capitalist economies in the form of worker-owned cooperatives. The ideological appeal of such a solution plays a role in the support for such ownership in the privatization programs in the former Soviet bloc.[39]

THE TRANSITION FROM SOCIALISM TO CAPITALISM: AN OVERVIEW

Most of the nations that adopted some form of Marxist-inspired socialism have moved away from it since 1989 toward some form of capitalism, even as some have slowed or even arguably reversed course, such as Uzbekistan. This process of transition has been a grand drama during the past decade and a half, as well as a source of much study and debate that continues with no definite resolution, reflecting the unresolved state of the various transitions themselves. In later chapters, we shall discuss the issues involved in more detail, but here we present a brief overview and summary.

36. The first U.S. ESOP founded under the 1974 tax law was ComSonics, an electronics firm in Harrisonburg, Virginia, begun by Warren L. Braun. A cofounder of the U.S. ESOP Association, Braun has since been involved in the establishment of groups advocating the "ESOPization" of the former Soviet economy.

37. Ben Craig and John Pencavel, "The Behavior of Worker Cooperatives: The Plywood Companies of the Pacific Northwest," *American Economic Review* 82 (1992): 1083–1105.

38. Some of the most successful have been bought out by large conventional firms like Georgia-Pacific. In some cases, the result has been increased hiring of supervisors.

39. For a discussion of how Marxism relates to producer cooperatives see David L. Prychitko, *Marxism and Workers' Self-Management: The Essential Tension* (New York: Greenwood Press, 1991).

If one begins in 1989, the year the Berlin Wall fell and many Eastern and Central European nations achieved political independence from the Soviet Union, most of these nations could be categorized as being in the command socialist category, with some in the market socialist category. Also, all these nations had one-party governments without Western-style democratic procedures. A few of these countries can still be categorized in this manner, the most extreme example being North Korea, a nation that can barely be said to have participated in a transition at all.

Thus, in moving from such a system toward some variation of market capitalism, it is generally argued that a nation will replace command with market mechanisms in decision making, will privatize state-owned enterprises to move from socialism to capitalism, and will liberalize its political system (although some countries have done the former two without doing the latter, such as China). Details of each of these become important, as well as such issues as speed and sequencing, because if they are not well managed, transition economies can become deeply depressed.

In adopting markets rather than command, freeing prices from central control was usually the easiest thing to do. More difficult to achieve was macroeconomic stabilization, as the sudden freeing of prices often led to inflationary outbursts, now mostly under some degree of control. In most countries, total output also declined sharply for various reasons, with unemployment rising in many countries, although not all. Still harder to achieve has been the establishment of the institutional framework that allows for the open and stable functioning of markets, such as developing banking, financial, and accounting systems, a proper competition policy, laws of corporate governance and bankruptcy, opening to trade and investment, and foreign currency convertibility.

The process of privatization has proven difficult, with a variety of methods being used. It has been frequently observed that restructuring of enterprise management may be more important than privatization per se, and countries that privatized quickly and carelessly, such as Russia and the Czech Republic, have run into serious problems compared with some that have privatized more gradually and carefully, such as Poland and Slovenia. Such issues as the continuance of state subsidies, known as the *soft budget constraint,* may be more important than the actual pattern of ownership, with countries propping up firms with subsidies in order to avoid increasing unemployment. Nevertheless there is strong evidence that privatized firms in transition countries exhibit greater productivity increases than state-owned ones on average.[40]

40. See Oleh Havrylyshyn and Donal McGettigan, "Privatization in Transition Countries," *Post-Soviet Affairs* 16 (2000): 257–286. They find that newly formed enterprises show the greatest productivity increases, followed by those bought out by foreign firms, with privatizations by insiders showing the least, both by management and by workers.

Another set of issues that arose as many countries fell into deep recessions with high inflation, and experienced political and institutional instability, involved the emergence of social problems. One sign of these problems has been the decay of the social safety nets in many of these countries that were associated with the old socialist regimes, with income inequalities and poverty rates soaring in many of these countries, although not all. For example, Slovakia still possesses the world's most equal income distribution. In many countries that have failed to establish a well-functioning new set of institutional arrangements, much economic activity has gone underground and problems of corruption and crime have become severe. These issues are clearly related to the quality of government and the level of democracy as well. Many of these problems appear to be deeply and complexly interrelated, with a relationship between income inequality and the size of the underground economy apparently emerging.[41]

Given the length of the transition process, the question arises regarding whether or when the transition will be over. This, in turn, raises the question of what the endpoint of the transition process is to be. It is easy to declare a situation of endless transition processes, much as the old Soviet Union officially considered itself to be always in a state of transition to the never-to-be-achieved state of communism.

In a symposium,[42] various observers of transition provided different answers. János Kornai, a Hungarian economist, declared it completed if a country is no longer a one-party state, most of its enterprises are privately owned, and the market is the dominant force in decision making. Based on that definition, Kornai declared that for many of the Central and Eastern European countries the transition is indeed over, especially in his native Hungary. Alan Gelb stated that the transition is over when the problems facing these countries are the same as those facing other countries at similar levels of development, and based on this definition, he declared that the transition was not over. Marie Lavigne declared the question unanswerable, but then posited that for the countries in Europe, it will be over when they join the European Union (EU), which some of them will probably do in 2004.[43] However, some people would argue that this last stage is more a matter of convergence than of systemic transition. On the other hand, it might be argued that the whole idea of transition

41. See J. Barkley Rosser, Jr., Marina V. Rosser, and Ehsan Ahmed, "Income Inequality and the Informal Economy in Transition Economies," *Journal of Comparative Economics* 28 (2000): 156–171; and J. Barkley Rosser, Jr., Marina V. Rosser, and Ehsan Ahmed, "Multiple Unofficial Economy Equilibria and Income Distribution Dynamics in Systemic Transition," *Journal of Post Keynesian Economics* 25 (2003): 425–447.

42. See Annette N. Brown, ed., *When Is Transition Over?* (Kalamazoo, Mich.: Upjohn Institute for Employment Research, 1999).

43. It has been reported that the EU considered the cutoff for completion of transition to be given by a score in table 3-2 on the general transition indicator of 2.00 or less. None of the countries have achieved that score, although Kornai's Hungary comes closest at 2.3. Nevertheless, at the Copenhagen summit in December 2002, the EU accepted Estonia, Latvia, Lithuania, Poland, the Czech Republic, Hungary, Slovakia, and Slovenia for likely entrance in 2004.

somehow implies a single endpoint model that will not be achieved, and that when countries reduce their rate of institutional changes, that will be the end of the transition, even if they are at some difficult-to-categorize Third Way middle state.

Broadly, the higher-income nations with more developed democratic traditions, located farthest to the West in Europe, have been the ones that appear to have gone the furthest along this path, with eight of them having been accepted for likely accession to the EU in 2004: Poland, Hungary, Slovenia (formerly a part of Yugoslavia), the Czech Republic and Slovakia (formerly the two parts of Czechoslovakia), and the Baltic states of Estonia, Latvia, and Lithuania (all formerly in the Soviet Union). Those in the next tier of EU accession include Romania and Bulgaria. The 12 members of the Commonwealth of Independent States (CIS), all former republics of the Soviet Union, are generally less far along, although there are great variations among them, which are discussed in chapters 10 and 11. Also, somewhat further back are Albania and the other republics of the former Yugoslavia besides Slovenia. The East Asian countries show even greater variations, with several of them having had no output declines at all, notably China. But within all these subgroups one finds many peculiar variations that defy any simple generalizations, including the fact that some of these countries have experienced warfare, which has greatly complicated everything for them.

Tables 3-1 and 3-2 provide summary data on the transition experiences of these countries, including even some for North Korea and Cuba, both of which oppose transition ideologically. Table 3-1 provides data on economic performance: the ratio of 1999 real per capita GDP to that in 1989, the maximum annual rate of inflation, the rate of inflation in 2000, the unemployment rate for 1995–1997, the most recent Gini coefficient, the Human Development Index (HDI) for 2000 (which can range from 0.0 to 1.0), and the ratio of the HDI in 2000 to that in 1990. Table 3-2 provides data on the status of the transition in each country: the share of GDP produced by the private sector, an index of the regulatory burden, an index of graft, an index of democratic rights, an economic freedom index (EFI), and a general transition indicator.

Obviously many of these last figures are quite subjective and are being assigned by international agencies or groups thought to be subject to the **Washington Consensus** that views the United States as the universal role model toward which all countries should be tending. Thus many would argue that these measures should be viewed with a certain amount of skepticism. In any case, although there are clearly positive correlations between the broad transition indicators and the performance indicators, there are many exceptions and complexities to this generalization.

However, one point that stands out strikingly is that if one looks at both the ratio of real per capita GDP in 1999/1989 and the ratio of the HDI for 2000/1990, only one country on this list for which both ratios are available is clearly better off in the later years on both

Table 3-1
Performance Indicators for Transition Countries

Country	Real GDP 1999/1989	Inflation Rate Max.	2000 Inflation	Unemployment Rate (1995–1997)	Gini Coeff.	HDI 2000	HDI 2000/1990
EU Accession Countries (Except Baltic States)							
Bulgaria	0.67	579	10.3	12.1	0.264	0.779	n.a.
Czech Republic	0.94	52	3.9	3.5	0.254	0.849	0.952
Hungary	0.99	35	9.8	11.4	0.244	0.835	0.941
Poland	1.28	640	10.1	13.0	0.311	0.833	1.002
Romania	0.74	295	45.7	8.4	0.282	0.775	1.093
Slovakia	1.01	46	12.0	13.1	0.195	0.835	0.936
Slovenia	1.05	247	10.8	14.1	0.284	0.879	n.a.
Baltic Countries							
Estonia	0.78	947	4.0	10.0	0.376	0.826	0.947
Latvia	0.56	1,162	2.7	6.9	0.324	0.800	0.921
Lithuania	0.70	1,162	1.0	6.4	0.324	0.808	0.916
Other Non-CIS European Countries							
Albania	0.93	237	24.8	13.5	n.a.	0.733	1.049
Bosnia and Herzegovina	0.93	13,118	3.0	n.a.	n.a.	n.a.	n.a.
Croatia	0.80	25,855	0.4	16.1	0.290	0.809	n.a.
Macedonia FYR	0.59	1,780	7.5	34.0	n.a.	0.772	n.a.
Serbia and Montenegro	n.a.	n.a.	51.4	n.a.	n.a.	n.a.	n.a.
Commonwealth of Independent States							
Armenia	0.48	10,896	−0.8	8.9	0.444	0.754	n.a.
Azerbaijan	0.47	1,787	1.8	12.2	0.360	0.741	n.a.
Belarus	0.81	1,997	168.6	3.1	0.217	0.788	0.915
Georgia	0.31	7,486	4.1	n.a.	0.371	0.748	n.a.
Kazakhstan	0.61	2,961	13.2	3.5	0.354	0.750	0.935
Krygyzstan	0.61	958	18.7	n.a.	0.346	0.712	1.034
Moldova	0.31	2,198	31.3	13.1	0.406	0.701	0.924

(Contd.)

measures than in the earlier years (Poland). Thus it is clear that the transition process has been very difficult for many people in these countries, and many are still waiting for the promised economic rewards that have yet to arrive.

SUMMARY AND CONCLUSIONS

Originating in ancient religious and philosophical ideas, socialism emerged in the European Renaissance as a millennarian movement and became secularized as a class struggle in the French Revolution. The nineteenth-century utopian socialists constructed scenarios for ideal societies.

Karl Marx codified a holistic socialist viewpoint by combining German dialectical philosophy with French political polemics on class struggle and the British labor theory of value to provide a vision of historical motion. He foresaw the development and eventual

Table 3-1 (continued)

Country	Real GDP 1999/1989	Inflation Rate Max.	2000 Inflation	Unemployment Rate (1995–1997)	Gini Coeff.	HDI 2000	HDI 2000/1990
Russia	0.55	2,510	20.8	9.2	0.487	0.781	0.907
Tajikistan	0.29	7,344	49.9	2.5	0.347	0.667	n.a.
Turkmenistan	0.61	9,743	13.5	n.a.	0.408	0.741	1.021
Ukraine	0.35	10,155	13.2	1.1	0.290	0.748	0.887
Uzbekistan	n.a.	1,281	27.8	0.4	0.446	0.727	1.046
East Asia and Caribbean							
Cambodia	1.62	n.a.	−0.8	n.a.	0.404	0.543	n.a.
China	2.52	3.0	0.3	n.a.	0.403	0.726	n.a.
Laos	1.84	n.a.	25.1	n.a.	0.370	0.485	n.a.
Mongolia	0.93	n.a.	11.5	n.a.	0.332	0.655	n.a.
Vietnam	1.97	n.a.	−1.7	n.a.	0.361	0.688	n.a.
N. Korea	0.55	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Cuba	n.a.	n.a.	−0.1	n.a.	n.a.	0.795	n.a.

Source: The ratios of real per capita GDP for 1999/1989 are from *World Economic Outlook October 2000: Focus on Transition Economies* (Washington, D.C.: International Monetary Fund, 2000), p. 89, except for North Korea, whose sources are listed in Table 19-4. The maximum annual inflation rates are from Stanley Fischer and Ratna Sahay, "The Transition Economies After Ten Years," NBER Working Paper No. 7664, Cambridge, Mass., April 2000, p. 35, except for Bosnia and Herzegovina, which is from *World Economic Outlook October 2000: Focus on Transition Economies,* p. 89. Inflation rates for 2000 are from *Human Development Report 2002* (New York: Oxford University Press for the United Nations, 2002), pp. 190–193, except for Bosnia and Herzegovina, which is an average of 1994–2000; Cuba, which is an average of 1996–2000; Macedonia, which is for 1993–2000; and Uzbekistan, which is for 1995–2000 from Gerald P. O'Driscoll, Jr., Kim R. Holmes, and Mary Anastasia O'Grady, *2002 Index of Economic Freedom* (Washington, D.C., and New York: Heritage Foundation and the *Wall Street Journal,* 2001), pp. 122, 168, 280, 410, and 420. Unemployment rates for 1995–1997 are from Fischer and Sahay, "The Transition Economies After Ten Years," pp. 37–38, except for China, which is from *World Development Indicators 2000* (Washington, D.C.: World Bank, 2000), p. 54. Gini coefficients can range from 0.0 (most equal) to 1.0 (most unequal) and are for the latest year available ranging from 1992 to 1998 from *Human Development Report 2002,* pp. 194–196. The HDI is constructed by the United Nations Development Program from life expectancy, adult literacy, school enrollment, and real per capita GDPs, and for 2000 is from *Human Development Report 2002,* pp. 150–153. HDIs for 1990 are from Marie Lavigne, "What Is Still Missing?" in Annette N. Brown, ed., *When Is Transition Over?* (Kalamazoo, Mich.: W.J. Upjohn Institute for Employment Research, 1999), pp. 30–31.

collapse of market capitalism from its internal class contradictions and its replacement by socialism and eventually communism.

The failure of capitalism to collapse by the end of the nineteenth century led to divisions within the socialist movement, with revisionists advocating gradualistic reforms. Lenin explained the noncollapse by the emergence of imperialism, and the anarcho-syndicalists called for the abolition of all states. Lenin called for revolutionary upheaval in poorer countries, and he led a socialist revolution in Russia.

More recent socialist developments include Trotskyism, developed in reaction to Soviet Stalinism, Titoism developed in Yugoslavia after World War II and promulgated a worker-managed market socialism, and Maoism in China, which advocated rural-based guerrilla movements and radical egalitarianism.

Table 3-2
Transition Indicators for Transition Countries

Country	% GDP Private	Regulatory Burden	Graft Index	Democratic Rights	EFI	General Transition
EU Accession Countries (Except Baltic States)						
Bulgaria	37.5	2.58	3.45	2.87	3.4	3.1
Czech Republic	72.5	2.54	2.70	1.25	2.4	2.6
Hungary	65.0	2.32	2.51	1.29	2.4	2.3
Poland	59.0	2.55	2.61	1.29	2.7	2.5
Romania	47.5	2.84	3.37	2.92	3.7	3.2
Slovakia	64.5	2.86	3.00	2.87	2.9	2.7
Slovenia	42.5	2.57	2.18	1.59	3.1	2.7
Baltic Countries						
Estonia	65.0	2.41	2.52	1.71	1.8	2.5
Latvia	61.0	2.59	3.21	1.71	2.5	2.9
Lithuania	60.0	2.93	3.00	1.71	2.35	2.9
Other Non-CIS European Countries						
Albania	67.5	3.56	3.79	3.33	3.3	3.5
Bosnia and Herzegovina	n.a.	4.00	3.28	n.a.	3.9	4.2
Croatia	49.5	2.81	3.36	3.17	3.4	3.0
Macedonia FYR	45.0	3.25	3.42	2.92	3.25	3.2
Serbia and Montenegro	n.a.	n.a.	n.a.	n.a.	4.05	n.a.
Commonwealth of Independent States						
Armenia	47.5	3.46	3.64	3.50	2.70	3.3
Azerbaijan	25.0	3.80	3.80	3.96	3.50	3.8
Belarus	15.0	4.18	3.52	4.25	4.35	4.5
Georgia	40.0	3.68	3.59	3.50	3.40	3.5
Kazakhstan	32.5	3.32	3.70	3.83	3.60	3.3
Krygyzstan	45.0	3.61	3.61	3.50	3.60	3.2
Moldova	35.0	3.22	3.31	2.87	3.35	3.2
Russia	59.0	3.24	3.50	2.83	3.70	3.5

(Contd.)

The theory of socialist planning derived initially from neoclassical origins in Barone's work based on the general equilibrium model of Walras and the efficiency analysis of Pareto. Von Mises and Hayek of the Austrian School denied the feasibility of planning on the grounds of incentive problems in the absence of the private ownership of capital and the accompanying profit motive, as well as inevitable information difficulties for the central planning bureaucracy. Kornai emphasized that the soft budget constraint arising from a government's unwillingness to shut down firms it owns removes any incentive for efficiency by state-owned firms, even in a market socialist context.

Lange responded by proposing a market-oriented form of socialist planning that uses trial-and-error techniques to find equilibrium prices. Such a scheme would cure the inefficiencies, inequities, and instabilities of market capitalism. This position was criticized by advocates of command central planning such as Dobb, who argued that only central

Table 3-2 (continued)

Country	% GDP Private	Regulatory Burden	Graft Index	Democratic Rights	EFI	General Transition
Tajikistan	17.5	4.14	4.06	4.33	3.85	4.0
Turkmenistan	17.5	4.00	4.03	4.56	4.40	4.6
Ukraine	39.3	3.71	3.71	2.92	3.85	3.6
Uzbekistan	35.0	4.04	3.83	4.62	4.35	3.9
East Asia and Caribbean						
Cambodia	n.a.	3.03	n.a.	n.a.	2.60	3.5
China	n.a.	3.06	3.23	n.a.	3.55	3.9
Laos	n.a.	4.46	n.a.	n.a.	4.55	4.2
Mongolia	n.a.	2.70	3.12	n.a.	2.90	3.2
Vietnam	n.a.	3.37	3.26	n.a.	3.85	4.1
N. Korea	n.a.	n.a.	n.a.	n.a.	5.00	n.a.
Cuba	n.a.	n.a.	n.a.	n.a.	4.75	n.a.

Source: The shares of GDP privately produced are for 1995–1997 from Fischer and Sahay, "The Transition Economies After Ten Years," pp. 37–38. Regulatory burden is an index for 1997–1998 that varies from 1 to 5, with the burden increasing as the number rises (the original scale was from −25 to +25, with the burden declining as the number rose) and is from *World Economic Outlook October 2000: Focus on Transition Economies,* p. 136. The graft index is for the same years, with the same scale and from the same source as the regulatory burden index (also changed similarly from the original). The democratic rights index is for 1997 and varies from most democratic at 1 to least democratic at 5 (1 to 7 in the original source), from *Freedom House, Nations in Transition, 1997,* as reported by David Kennet, *A New View of Comparative Economic Systems* (Orlando: Harcourt Brace Jovanovich, 2001), p. 489. The EFI is for 2001, varies from 1.0 (most free) to 5.0 (least free), and is constructed from indexes of trade policy, fiscal burden of government, government intervention in the economy, monetary policy, capital flows and foreign investment, wages and prices, property rights, regulation, and black market activity from *2002 Index of Economic Freedom,* pp. 22–26. The general transition indicator is for 1999, varies from 1.0 for the most transition to 5.0 for the least transition (the reverse of what appears in the original source), and is constructed from indexes for large-scale privatization, small-scale privatization, governance and restructuring, price liberalization, trade and foreign exchange rate system, competition policy, banking reform and interest rate liberalization, and securities markets and nonbank financial institutions from *World Economic Outlook October 2000: Focus on Transition Economies,* p. 134.

planning can stabilize the economy and provide a high rate of investment and growth. High growth renders efficiency issues irrelevant. This was the path taken by the Soviet Union under Stalin, with growth eventually bogging down under technological stagnation.

As Soviet central planners developed the material balance method in practice, theories of planning developed. Leontief developed input-output analysis that depicts the material balance problem in a mathematical model. Kantorovich developed linear programming that allows one to use input-output matrices to plan optimally. That optimal shadow prices on primary inputs like natural resources can be interpreted as reflecting their scarcity-related marginal productivities generated a great debate within the Soviet Union over the use of such techniques for socialist central planning.

Advocates of the cooperative or labor-managed economy, associated with Yugoslavia, argued that it reduced alienation and improved productivity, while critics argued that it generated monopolization, unemployment, and inflation. Current advocates point to capitalist versions that combine workers' ownership with workers' management, as in a number of companies in the United States.

The process of transition from Marxist-inspired command socialism toward some variety of market capitalism involves many elements. Fundamental are the liberation of prices from government commands and the privatization of state-owned assets, along with the end of rule by a single communist party. However, making markets function properly involves much more in terms of institutional arrangements and macroeconomic stabilization. Most countries have experienced declines in living standards and increases in inequality during the transition process.

The difficulty of achieving a successful transition to market capitalism in much of the former Soviet bloc has triggered backlashes and backpedalings in a number of countries. But on a positive note, the most rapidly growing economy in the world is the socialist market economy of China, with its locally but publicly owned TVEs as its largest sector. If socialism is to have a future as well as a past, other than being "the longest road from capitalism to capitalism," then it will probably be in some new form, perhaps combining local workers' ownership with market structures in a pattern as yet unforeseen.

QUESTIONS FOR DISCUSSION

1. Marx and Engels claimed that they advocated *scientific socialism* in contrast to *utopian socialism.* What was the basis of their criticism of the latter? Was it justified?
2. According to the Marxian labor theory of value, what is the value of a piece of capital equipment?
3. Is there any relationship between the debate over orthodox Marxism and revisionism and the current debate over gradualism versus sudden "shock therapy" in the transition from command socialism to market capitalism?
4. Maoists claim to be the true heirs of Marxism-Leninism. Evaluate.
5. How did Hayek respond to Lange's defense of market socialism?
6. Thoroughly evaluate the arguments for and against the possibility of rational economic calculation under socialism.
7. How can linear programming be viewed as both consistent and inconsistent with orthodox Marxism?
8. Critics of the cooperative economy suggest that it can lead to stagflation. Evaluate the pros and cons of this argument.
9. There are countries whose real per capita output rose between 1989 and 1999 while their HDI declined, and there are other countries for which the opposite is true. Which are these countries and what might explain such outcomes?

10. Although economic performance generally improves with the amount of transition and economic freedom, some countries are exceptions, with high rates of the former but low rates of the latter and vice versa. Which are these countries and what might explain such outcomes?

11. Of the countries listed in tables 3-1 and 3-2 that are also listed in tables 1-1 and 1-2, how do their various indexes and measures in this chapter's tables correspond with their categorization in the earlier tables? Were they accurately categorized? Why or why not?

12. If you were to advocate a "new socialist vision," what would you include in it? If you were debating against someone proposing your vision, how would you critique it?

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4 Islamic Economics and the Economics of Other Religions

You shall not covet your neighbor's house; you shall not covet your neighbor's wife, or his manservant, or his maidservant, or his ox, or his ass, or anything that is your neighbor's.
—Exodus 20: 17, Holy Bible

Now the company of those who believed were of one heart and soul, and no one said that any of the things which he possessed was his own, but they had everything in common.
—Acts of the Apostles 4: 32, Holy Bible

It is evident that, unlike both capitalism and socialism, the goals of Islam are absolute and a logical outcome of its underlying philosophy.
—M. Umer Chapra, *Islam and the Economic Challenge,* 1992, p. 213

INTRODUCTION: WHAT IS THE TRADITIONAL ECONOMY?

In his 1944 book *The Great Transformation,* Karl Polanyi argues that the essence of traditional economies is that they are embedded within larger social and cultural frameworks. Whereas in market and command economies production and distribution decisions are made largely on economic grounds, with sociocultural factors subordinated to the economic ones, in traditional economies people decide according to past practices that have coevolved slowly with the religious and family structures of their societies. Such economies are often characterized by **familistic groupism** that extends beyond family groups. This was the original economic system as the human species evolved.

This original economic system can be called the **Old Traditional Economy,** characterized by primitive technologies as viewed from our current perspective. Such Old Traditional economies took various forms: Polanyi identifies three of them as **household, reciprocal,** and **redistributive.**[1] In the household economy, the focus is on family groups and sharing among them.[2] In the reciprocal economy, exchange relations between groups take a ritualistic form of gift giving that is reciprocated. An example is the Trobriand Islanders, who were studied in the early 1920s by Bronisław Malinowski in

1. Much controversy has occurred within economic anthropology over these categories, with **formalists** arguing that all economies are market economies obeying universal laws, in contrast with **substantivists** associated with Polanyi, whose ideas are closely related to those of the institutionalist economists. Formalist ideas are explained in Edward E. LeClair, Jr., and Harold K. Schneider, eds., *Economic Anthropology: Readings in Theory and Analysis* (New York: Holt, Rinehart, & Winston, 1974). Substantivist arguments are upheld in Rhoda Halperin, *Economies Across Cultures* (New York: Macmillan, 1988). Yet another variation is the argument that all economies are embedded but that what matters is how they are embedded. See Bernard Barber, "All Economies Are Embedded: The Career of a Concept and Beyond," *Social Research* 62 (1995): 387–413. Further discussion is found in J. Barkley Rosser, Jr., and Marina V. Rosser, "A Comparison of Comparative Economic Anthropologies," *History of Economics Review* 23 (1995): 96–107.

2. Polanyi originally argued that the household form was historically the most primitive, but later came to accept that it was more closely associated with more technologically advanced peasant societies and that the most technologically primitive societies were of the reciprocal type. This is discussed in James P. Stodder, "The Evolution of Complexity in Primitive Exchange," *Journal of Comparative Economics* 23 (1995): 1–32, 190–210.

his *Argonauts of the Western Pacific*. In the redistributive system, a Big Man or another central authority redistributes goods. This form became the model for the despotic ancient empires.[3]

In all of the Old Traditional economies, a crucial part of the sociocultural matrix within which economic decision making is embedded is the traditional religion that dominates the society. In the **New Traditional Economy** there is an effort to re-embed economic decision making within such a religiously derived sociocultural matrix, but with modern technology instead.

THE APPEAL OF THE NEW TRADITIONAL ECONOMY

The New Traditional Economy seeks to be the best of all possible worlds, combining old with new, individual with collective, ethical with practical. It is supposed to be the true Third Way between capitalism and socialism, drawing upon the virtues of each while eliminating the sins of each.

On the one hand, the proponents of the New Traditional Economy look backward nostalgically to the lost world of the Old Traditional Economy through a haze of myth and memorialization. On the other, they seek to function in the modern world with modern technology, indeed to use such technology to further the spread of their religion[4] in the search for a humane socioeconomic order. The harmony of the family and the group will be preserved or renewed in the face of modern tendencies toward alienation, angst, crime, marital breakdown, and general social disintegration.[5]

3. Marx identified the ancient empires of China and India as exhibiting what he called the **Asiatic mode of production,** which he identified as standing outside the usual stream of history because the state suppressed class conflicts through control of crucial public infrastructure. Karl Wittfogel identified control of agrohydraulic infrastructure as the key to this system in his *Oriental Despotism: A Comparative Study of Total Power* (New Haven, Conn.: Yale University Press, 1957).

4. One such example is televangelism in the United States among Protestant fundamentalists. Another is the use of remote computer terminals for female students to access library materials in Saudi Arabian universities without having to come into contact with any men in the libraries themselves.

5. It can be argued that the New Traditionalism movement is an effort to develop *social capital,* generally defined as a set of mutually supporting social networks generating generalized trust. For definitions see James S. Coleman, *Foundations of Social Theory* (Cambridge, Mass.: Harvard University Press, 1990), and Robert D. Putnam, *Bowling Alone: The Collapse and Revival of the American Community* (New York: Simon & Schuster, 2000). For its possible role in economic development see Francis Fukuyama, *Trust: The Social Virtues and the Creation of Prosperity* (New York: Free Press, 1995); John F. Helliwell and Robert D. Putnam, "Economic Growth and Social Capital in Italy," *Eastern Economic Journal* 21 (1995): 295–307; Stephen Knack and Philip Keefer, "Does Social Capital Have an Economic Payoff? A Cross-Country Investigation," *Quarterly Journal of Economics* 112 (1997): 1251–1288; Michael Woolcock, "Social Capital and Economic Development: Toward a Theoretical Synthesis and Policy Framework," *Theory and Society* 27 (1998): 151–208; and Partha Dasgupta and J. Serageldin, eds., *Social Capital: A Multifaceted Perspective* (Washington, D.C.: World Bank, 1999).

Movements reflecting such ideas have sprung up among most major religions of the world. The one most clearly projecting a well-defined view of economics is Islam. This partly reflects the fact that its founder, the Prophet Muhammed, was a merchant, and thus was more knowledgeable about such matters than most other founders of world religions. Nevertheless, other religions also reflect certain views regarding appropriate economic conduct or structures. Fundamentalist variants urge their adoption as part of broader campaigns of moral and social transformation.[6]

A WHIRLWIND TOUR OF RELIGIONS AND ECONOMICS

We shall briefly review broad currents of major world religions in terms of their ideas about economic conduct. These will include Buddhism, Confucianism, Hinduism, Judaism, and Christianity. Then we shall consider the case of Islam in more detail, as this is the most prominent and most fully developed form of the new traditional economic system in the contemporary world.

Buddhist Economics

In a famous essay,[7] E. F. Schumacher extols the virtues of **Buddhist economics,** arguing that the goal of humanity should be spiritual liberation and that Buddhist economics offers a means to this end. He invokes a vision of a balanced attitude toward work, directed at achieving a level of consumption that is satisfying but not saturating. Schumacher exalts the harmony of humanity and nature, saying that trees should be worshipped, that non-renewable resources should not be wasted, and that local production should be favored over long-distance trade in order to reduce wasteful transportation activities and to encourage self-sufficiency. His essay has become popular with the environmental movement.

Is there such a thing as Buddhist economics, and does it correspond with the idealized image presented by Schumacher? The answer is not simple. In much of the Buddhist world, especially China and Japan, the religion has played a relatively passive role, supporting market or traditional forms often more deeply based on other religious traditions such as Confucianism. As a dominant ideology, Buddhism has been confined to South and

6. We note here a distinction between *religious economics* and the *economics of religion* that has been made by Timur Kuran, "Religious Economics and the Economics of Religion," *Journal of Institutional and Theoretical Economics* 150 (1994): 769–775. The former advocates as an ideology a particular religion's view of economics to be imposed on societies, whereas the latter is the scholarly study of the impact of different religions on economies.

7. See E. F. Schumacher, *Small Is Beautiful* (New York: Harper & Row, 1973), chap. 4.

Southeast Asian countries, where it is practiced in its southern form known as *Hinayana* ("Lesser Vehicle") or *Theravada* ("Way of the Elders").[8]

Nations where this form of Buddhism has flourished are Sri Lanka (formerly Ceylon), Burma (also known as Myanmar), Thailand, Laos, and Cambodia (also known as Kampuchea). Sri Lanka and Burma were part of British India prior to the late 1940s, while Laos and Cambodia were part of French Indochina, along with *Mahayana* ("Greater Vehicle") Buddhist Vietnam prior to 1954, the Mahayana form predominating in China, Korea, and Japan. Thailand, known as Siam before World War II, was a buffer between these two large British and French colonial entities and maintained its independence.

In Laos and Cambodia no such Buddhist movement exists openly because the official ideology is orthodox Marxism-Leninism, now gradually undergoing a transformation. But some observers[9] see Buddhist influences in local forms of that ideology.

Buddhism in Thailand evolved during the nineteenth century under powerful kings who emphasized a rationalistic and individualistic form of the religion, with each individual responsible for his or her own enlightenment. This attitude coincides well with market capitalism, and today Thailand is a rapidly growing example of such an economy, despite recent financial upheavals and the emergence of dissident antimaterialist Buddhist movements such as the *Santi Asoke* sect.

In Sri Lanka and Burma (now Myanmar), Buddhism became identified with nationalist and anticolonialist movements and developed a militant form[10] associated with socialist views of economics, labeled **Buddhist socialism** in Burma. The developer of this ideology was U Ba Swe, who in the late 1930s referred to Stalin as "builder of *Lokka Nibban*" or the Buddhist heaven on earth. U Ba Swe influenced Burma's first prime minister, U Nu, and was a government minister from 1948 to 1958. Their ideal was *pyidawatha,* or a welfare state in which each individual could pursue salvation. That government was overthrown in 1962 by General Ne Win, who established a brutal and xenophobic military dictatorship that is still in power. Although this regime proclaims itself Buddhist, among its most serious opponents are monks.

Schumacher emphasizes detachment from materialism and a deemphasis on mindless economic growth. Burma has had a very low economic growth rate since its independence, but the Burmese leadership no longer views this as a good thing. Part of this low growth is

8. One exception is Tibetan Buddhism, although since the exile of the Dalai Lama in 1959, Chinese Communism has dominated Tibet rather than Tibetan Buddhism, which has become an internationally influential religion with many Western followers while remaining dominant in tiny Bhutan. Like Schumacher, the Dalai Lama has prominently supported the world environmental movement.

9. See Charles F. Keyes, "Buddhism and Revolution in Cambodia," *Cultural Survival Quarterly* 14 (1990): 6–63.

10. In Sri Lanka this militance has coincided with serious military conflict between the Buddhist/Sinhalese majority and the Hindu/Tamil minority.

caused by Burma's removal from international trade and bungled socialist central planning under Ne Win. But part is a result of elements of Buddhism as expressed in Burmese practices.[11] A major focus of Burmese Buddhism has been the achievement of individual merit by sponsoring the building of temples. This focus leads to contradictory impulses. On the one hand, this serves as a Protestant ethic type of motivation for accumulating wealth. On the other, it leads to dissipation of that wealth in building temples rather than real capital investment and long-run economic growth. Along with building temples has gone substantial economic support for Buddhist priests.

Confucian Economics

Arguably Confucianism should not be included in this discussion, as it is more a philosophy and a cultural influence than a religion. Its current influence does not take the form of religious leaders advocating some fundamentalist adherence to holy scriptures or priestly hierarchies. Nevertheless among East Asian countries under Chinese cultural influence,[12] elements of Confucianism are seen to have an impact on the nature of the economic systems. In such countries as Singapore and Taiwan, as well as more recently in the communist People's Republic of China, advocacy of Confucian values has been actively encouraged by government leaders, often explicitly as a counterweight to liberal Western influences.

Confucius was a scholar/adviser of the sixth century B.C.E. to political leaders, and he wrote his ideas in the *Analects,* with many later discussions and additions by other Confucian scholars. Its five central concepts are benevolence (*jen*), righteousness (*i*), propriety (*li*), wisdom (*zhi*), and faithfulness (*xin*), the first of these being the most important. Benevolence implies a hierarchy in which benevolent elites (the emperor in China and his scholarly Mandarin bureaucrats) rule those who, in return, are loyally obedient to those elites as long as they truly practice benevolence. This idea extends to the family, where the son obeys the father and the wife obeys the husband. Thus there is strong emphasis upon order, hierarchy, education, and benevolence, all argued to be crucial elements of Confucian societies and their economies.

Confucian attitudes toward market forces have been mixed. There are passages in the *Analects* supporting a laissez-faire approach as long as the emperor is properly benevolent and reverent and celestial harmony is being maintained. But during the 1100s a form of **neo-Confucianism** developed that eventually became strongly opposed to commerce, industrialization, and foreign trade.

11. See Melford E. Spiro, *Buddhism and Society: A Great Tradition and Its Burmese Vicissitudes* (New York: Harper & Row, 1970).

12. Besides countries with largely ethnic Chinese populations, this group would certainly include Japan, Korea, and Vietnam.

Generally the current Confucian revival in East Asia tends to support reliance on market forces, although with authoritarian state structures and elements of state planning and control. This is true in both very capitalist Singapore as well as in the still socialist People's Republic of China. It has been widely argued that Confucianist values can be very conducive to the support of rapid economic growth and development,[13] although the financial crisis that erupted in East Asia in 1997 made many wary of the potential for **crony capitalism** and corruption that may go along with such a cultural environment.

Hindu Economics

Hinduism is the predominant religion of India, the world's second most populous nation. Central to the Hindu socioeconomic worldview is the caste system, the archetype of an old traditional economic system. The caste system, justified by the karmic doctrine of reincarnation, persists in the **jajmani system** of fairly self-sufficient groups of local villages trading with each other through the well-defined division of labor provided by the hereditary caste system. In past centuries various outside rulers, such as Muslim Moguls and Christian British, tried to penetrate and break this system. But it survived, partly as a result of the Hindu village tradition of paying a share of its output to the current ruler without question.

The foundation of **Hindu economics** was laid down by the father of Indian independence, Mohandas (Mahatma) Gandhi, in his 1909 book *Hind Swaraj*. *Swaraj* means self-rule and self-sufficiency, both nationally and at the village level, in a revitalized caste system purged of evil elements such as suppression of the Untouchables, the lowest caste, whom Gandhi renamed *Harijan* ("children of God"). The emphasis on economic nationalism and self-sufficiency continues in the Hindu nationalist Bharatiya Janata Party (BJP) today, although modified considerably since it has come to lead the government in a coalition with other parties, some of which do not support such ideas.

Despite his desire to reform the Hindu caste system, Gandhi was essentially an Old Traditionalist in his economic views, strongly opposing modern industrialization, railroads, and urbanization. He idealized homespun cloth and made the village spinning wheel the symbol of his movement, calling indigenous technology *swadeshi*. Gandhi also opposed excessive consumption, paralleling the views of the Buddhists. Gandhi was assassinated by a Hindu extremist in 1948 for his tolerance of other religions.

13. Among the first to emphasize the growth-encouraging elements of Confucianism was Herman Kahn, *World Development: 1979 and Beyond* (Boulder, Colo.: Westview Press, 1979). Further discussion appears in T. Hung-chao, ed., *Confucianism and Economic Development: An Oriental Alternative?* (Washington, D.C.: Washington Institute Press, 1989); G. Rozman, ed., *The East Asian Region: Confucian Heritage and Its Modern Adaptation* (Princeton, N.J.: Princeton University Press, 1991); and J. Barkley Rosser, Jr., and Marina V. Rosser, "Islamic and Neo-Confucian Perspectives on the New Traditional Economy," *Eastern Economic Journal* 24 (1998): 217–232.

In his 1965 book *Integral Humanism,* Deendayal Upadhyaya transformed this Gandhian inheritance into a New Traditional view for the Hindu nationalist political movement. Upadhyaya largely reiterates Gandhi's views, although with less emphasis on uplifting the Untouchables and more emphasis on adapting to modern technology. He advocates *swadeshi* but interprets it in the sense of **appropriate technology** as described by development economists. He still advocates a decentralized system of self-sufficient villages with caste systems, but with more modern and productive small-scale technologies. The theory and practice of Hindu economics in India is discussed more fully in chapter 16.

Judaic Economics

The Torah, especially Exodus, Leviticus, and Deuteronomy, contains a long list of specific rules and injunctions regarding economic behavior. Many are consistent with markets and private property, as exemplified by the Ninth Commandment, quoted at the beginning of this chapter. However, many of these strictures are irrelevant in the modern world, such as rules about the selling or treatment of slaves.[14] Some have drawn the attention of certain Orthodox Jews as perhaps being appropriate for Israeli society.[15] Among these are the use of tithes for redistributing income and the prohibition of charging interest among Jews, although this rule is not applied to non-Jews.[16]

The concept of the **Jubilee Year** is a dramatic example of a religious idea influencing current economic behavior. Put forward in Leviticus 25, it generalizes the prohibition against working on the Sabbath, a rule that has generated the most heated specific demands by fundamentalist groups in Israel, such as forbidding flights on the Sabbath by the national airline, El Al. The generalized version of the Sabbath argues for the fallowing of land every seventh year. After seven groups of seven years (49) will come a jubilee year. Property will be remitted to its original owner, recently acquired slaves will be freed, the poor sojourner will be cared for, and so forth. At the beginning of the twentieth century, the Chief Rabbi of Jaffa, Abraham Kook, argued that this implied the preemptive sale of Jewish lands to their earlier Muslim owners. This advice conflicted with the **Zionist movement** to build an Israeli nation and was not followed. The Jubilee Year idea has been picked up by certain

14. Jacob Neusner in *The Economics of the Mishnah* (Chicago: University of Chicago Press, 1990) argues that earlier laws and interpretations tend to reflect a traditional premarket economy, whereas later ones reflect more of a market capitalist one. An argument that Judaic laws support so many interventions in markets that they suggest a socialist perspective is expressed in Walter Block, "The Mishnah and Jewish Dirigisme," *International Journal of Social Economics* 23 (1996): 35–44.

15. See Meir Tamari, *"With All Your Possessions": Jewish Ethics and Economic Life* (New York: Free Press, 1987), for a presentation of these rules as a full economic system.

16. This differentiation between insiders and outsiders with respect to charging interest led to Jews filling a significant role as financiers in medieval Christian and Islamic societies when the latter two both forbade the charging of interest among their followers.

non-Jews, notably Pope John Paul II and Bono of U2, in arguing for debt relief for developing nations.

Modern Israel emphasizes building a functioning economy within a hostile environment. Some of the most distinctive institutions of the Israeli economy have not come from religious sources, notably the **kibbutz,** which was inspired by secular European utopian socialism, although the most successful kibbutzes today appear to be those that were founded by religiously oriented Orthodox Jews.[17] Indeed, the Israeli economy exhibits a fairly high level of state ownership reflecting the socialist nature of the founding Labor Party, despite more recent movements toward privatization and free markets, which have also undermined many of the kibbutzes. Although the fundamentalist movements are very strong in Israel, economic proposals that are perceived to be counter to national survival are strongly resisted.[18]

Christian Economics

In the Roman Catholic Church an important figure in developing economic doctrines was St. Thomas Aquinas, who in the thirteenth century reconciled Aristotelian philosophy with Christian theology. Among Aristotle's ideas that he imported into Catholicism were the idea of the **just price** and an abhorrence of charging interest.[19] Aquinas can be considered an ideologue of the Old Traditional Economy in its feudal European form.

This linkage between feudalism and Roman Catholicism led to a lack of enthusiasm for modern capitalism. However, despite the presence of certain Marxist-oriented *liberation theologists* among Latin American Catholic clergy, the Church has generally been antisocialist, especially under Pope John Paul II of Poland. He supports market capitalist economics more than any previous Pope, but is still critical of its excessive materialism and lack of compassion for the poor.[20] In Italy and Germany the Catholic Church–based

17. See A. Fishman, "Religious Socialism and Economic Success on the Orthodox Kibbutz," *Journal of Institutional and Theoretical Economics* 150 (1994): 763–768.

18. Besides some of the Sabbath issues, one other economic area where the fundamentalists have gotten their way is in forbidding the consumption of pork. The most extreme of the Jewish fundamentalist movements are explicitly anti-Zionist, arguing that a state of Israel can only be reestablished by the Messiah, who has not yet arrived.

19. Forbidding interest as **usury** dates back in Catholicism to the fourth and fifth centuries. The prohibition of interest was made absolute and total in 1311 by Pope Clement V but was relaxed to limit only "excessive" interest after 1600.

20. See United States Catholic Conference, *Economic Justice for All: Pastoral Letter on Catholic Social Teaching and the U.S. Economy* (Washington, D.C.: USCC Office of Publishing and Promotion Services 1986). The movement of the Catholic Church under Pope John Paul II away from support of leftist liberation theology in Latin America has been reinforced by the need to gain support from local elites and governments against competition from Protestant evangelizers, according to Anthony J. Gill, "The Institutional Limitations of Catholic Progressivism: An Economic Approach," *International Journal of Social Economics* 22 (1996): 135–148. See also Clive Beed and Cara Beed, "Work Ownership Implications of Recent Papal Social Thought," *Review of Social Economy* 60 (2002): 47–69.

political parties have been the Christian Democrats. More conservative than the Social Democrats in Germany or the former Communists and Socialists in Italy, these parties have supported fairly extensive social welfare programs and considerable state economic intervention in both countries, although in the 1990s the Christian Democratic Party in Italy disintegrated because of corruption problems.

In contrast, Christian Protestantism has been more closely linked to market capitalism both socially and ideologically. Max Weber argued that "the **Protestant ethic** is the spirit of capitalism."[21] Certainly the Protestant Reformation occurred in countries and at times that modern market capitalism was rapidly developing, the most supportive attitude coming from Calvinist churches in Northern Europe. Nevertheless, among the most radical of the Anabaptists, communal attitudes and approaches emerged, based on the scripture from Acts quoted at the beginning of this chapter. Some of these sects founded communities in the United States during the period of utopian socialist experimentation. But they were a small minority in generally pro-market capitalist Protestantism, although the Social Gospel movement of the late nineteenth century in the United States favored income redistribution and was linked to the rise of institutionalist economics.[22]

This fervor for market capitalism is exhibited prominently in the modern American Protestant fundamentalist movement that now attempts to formulate economic doctrines. However, this group is very diverse in its views (box 4-1).

Who speaks for the masses of U.S. fundamentalists is uncertain. The pro-laissez-faire New Christian Right has been vocal and has formed a successful alliance with the leaders of the New Christian Right social movements, especially the antiabortion movement. Nevertheless survey evidence suggests that many fundamentalists support income redistribution programs by the government, probably reflecting the tendency for these groups to be poorer than the average American.[23] This finding also reflects the populist tradition of American fundamentalism dating from the late nineteenth century.

Given the differing views among both fundamentalist and mainstream Protestants as well as Roman Catholics, the true nature of Christian economics remains unclear.[24]

21. See Max Weber, *The Protestant Ethic and the Spirit of Capitalism,* trans. by Talcott Parsons (New York: Charles Scribner's Sons, 1958) (originally published in German, 1904–1905).

22. See R. A. Gonce, "Social Gospel, Ely, and Commons," *Journal of Economic Issues* 30 (1996): 641–665.

23. Laurence R. Iannacone, "Heirs to the Protestant Ethic? The Economics of American Fundamentalists," in M. E. Marty and R. S. Appleby, eds., *Fundamentalisms and the State: Remaking Polities, Economies, and Militance* (Chicago: University of Chicago Press, 1993), pp. 342–366.

24. The position of Eastern Orthodoxy is especially unclear. Traditionally in Russia, the church was more anticapitalist than Roman Catholicism, although not necessarily antimarket. But the experience of Communist rule in Russia made the church somewhat more open to it, although not much so.

Box 4-1
Varieties of U.S. Protestant Fundamentalist Economic Views

At one extreme are the *strict fundamentalists,* who abjure discussions of economics or politics entirely, considering them to be a sinful distraction from the focus upon personal salvation. Although strongly anticommunist, they view the market as ultimately a sinkhole of sin and corruption, and they denounce their fundamentalist brethren who are involved in political and economic activities.

Somewhat more moderate, but also adhering to the doctrine of biblical *inerrancy,* are the New Christian Right fundamentalists, who have been very active in politics, with definite views on economics. Closely linked to former presidential candidate Pat Robertson, Jerry Falwell, and the Southern Baptist Convention, this group has been avidly pro-market capitalist. Economists at Jerry Falwell's Liberty University in Lynchburg, Virginia, strongly advocate Milton Friedman's Chicago School approach, albeit with a strong underpinning of Judeo-Christian morality.

More moderate theologically but more radical in their libertarian economics are the Christian Reconstructionists of the Calvinist Dutch Reformed Church. They believe that heaven must be created on earth before Christ will come again, an Austrian School heaven based on biblical quotations.* Thus the biblical tithe is cited as supporting a flat tax. God's ultimate authority rules out central planning, the latter being a form of idolatry. The Eighth Commandment ("Thou shalt not steal") is seen as forbidding any income redistribution by government. The use of metallic currencies in the Old Testament is seen as support for the gold standard, contrasting with the position of 1890s populist/fundamentalists such as William Jennings Bryan with his anti–big business "Cross of Gold" speech.

Despite this trend for U.S. fundamentalists to strongly favor laissez-faire economics, some do not. The *evangelical left* includes believers in biblical inerrancy who cite the already noted quotation from Acts and the Leviticus jubilee laws, as well as Jesus's concern for the poor. They support major government income redistribution, a national food policy, "just" international trade, and guaranteed wages.† Further to the left is *radical evangelicalism,* advocating full-blown socialism.

*See Gary North, *Inherit the Earth: Biblical Principles for Economics* (Fort Worth, Tex.: Dominion Press, 1987).
†See Ronald Sider, *Rich Christians in an Age of Hunger* (Downer's Grove: Intervarsity Press, 1977).

A BRIEF HISTORY OF ISLAM

The Prophet Muhammed and the Early Years

Islam was founded by the Prophet Muhammed (570–632 C.E.), a successful merchant in the west-central Arabian city of Mecca. This city lay at the intersection of major north-south and east-west trade routes and contained a shrine known as the *Ka'bah* that was the destination of annual pilgrimages by many Arabian tribes. Thirty-two different gods were worshipped there and had idols set up for the benefit of the pilgrims. The Prophet Muhammed belonged to the Hashemite clan; but Mecca was dominated by the Quraysh clan, which controlled the earnings obtained from the pilgrims coming to worship at the *Ka'bah*.

Around 610 the Prophet Muhammed began to receive revelations from Allah through the angel Gabriel. These revelations continued until his death and constitute the body of the

Qur'an,[25] which was not codified into *suras* (chapters) until after his death. He also made many pronouncements separate from the *Qur'an* that are collectively known as the *Hadith*. These two sources are the foundation of the Islamic law code, the *Shari'a*.[26]

Many early revelations deal with predictions of a Day of Judgment and the End of the World, not unlike in the Book of Revelations in the New Testament. These *suras* reflect wrath against the arrogant attitudes of the wealthy Quraysh and their lack of charity toward the poor. All persons are equal in the eyes of Allah.

A fundamental point is an absolute and uncompromising monotheism. There is no god but Allah, who is all powerful and utterly transcendent. The central concept of Islam is submission to the will of Allah; the word *Islam* means exactly that.

This assertion of monotheism threatened the livelihood of the Quraysh, who profited from the pilgrims worshipping the gods of the *Ka'bah*. In 613 the Prophet Muhammed went public and preached openly, drawing the strong opposition of the ruling Quraysh. Nevertheless he attracted a core of dedicated followers, especially among the poor and dispossessed.

In 622 the *Hijra* occurred—the migration of the Prophet Muhammed and his followers to Medina ("City of the Prophet"), an agricultural city north of Mecca, to which he was invited by conflicting tribes desiring a mediator.[27] This was year 1 of the Islamic calendar and is viewed as the beginning of the world Islamic community, the **umma.**[28] The umma is a religious/political/economic entity in which unity, or *tawhid,* is paramount. All things are unified in the Islamic religion.

Thus the Prophet Muhammed became a political leader as well as a religious prophet. The *Qur'anic suras* of this time establish rules for marriage, inheritance, and many other issues that arise in the functioning of a society. It is these *suras* that form the base of the *Shari'a,* along with the *Hadith*. During these ten years, the Prophet Muhammed succeeded in converting most of the tribes of the Arabian peninsula into the *umma,* including the Quraysh in Mecca.[29]

25. Also spelled *Koran* in many English language mass media.

26. The word *shari'a* in Arabic originally meant "path" or "way," especially the path to a water hole. Some argue that *Shari'a* refers to a general philosophy of behavior rather than a set of specific injunctions and rules. This argument has been popular with more liberal Muslims opposed to fundamentalist movements.

27. Some of these tribes were Jewish, and he initially made Islam very similar to Judaism. He always declared Allah to be the one God of the Jews and the Christians. Eventually a conflict broke out and he expelled the Jews, seized their property, and differentiated Islam more sharply from Judaism, for example by shifting the day of rest and worship from Saturday to Friday.

28. The familial/traditional aspect of this concept is highlighted by the fact that *umma* comes from *umm,* which is the Arabic word for *mother.*

29. After smashing the 32 idols in 630, the Prophet Muhammed established the principle of *Hajj,* or Islamic pilgrimage to Mecca.

After the Prophet Muhammed's death in 632, the inner circle of his companions selected a successor to him known as a **caliph,** who would lead the *umma* but would not be a prophet. Struggles over the caliphate would eventually divide Islam.

By 644 the caliphs had successfully conquered Syria, Palestine, Egypt, Iraq, Iran, and portions of Central Asia. Over the next 75 years North Africa and Spain would be conquered, ending 100 years after the Prophet Muhammed's death with a thrust into central France, which was thwarted at Tours.

Over this suddenly vast empire the caliphs imposed a reasonably benevolent rule, leaving intact local political and social structures. Believers in monotheism—Jews, Christians, and Zoroastrians—were allowed to practice their religion as long as they paid a special tax.

The fourth caliph was the Prophet Muhammed's son-in-law, Ali, whose caliphate was contested by Mu'awiya of the Quraysh clan. Ali's supporters came to be known as *Shi'is,*[30] while Mu'awiya's supporters came to be known as *Sunnis*.

In 680 Mu'awiya's son, Yazid I, defeated and killed Ali's son, Husayn, and his Shi'i followers at the battle of Karbala in Iraq, a martyrdom annually mourned by Shi'is on its anniversary. This formed the main split within Islam. Yazid's victory signaled the general dominance of Sunnis, who constitute about 85 percent of the world's Muslims. Shi'is are dominant in Iran. They are a majority and a plurality, respectively, in Iraq and Lebanon, but Sunnis have dominated both countries politically, socially, and economically. Small Shi'i sects dominated politically in Yemen and Syria.[31] East of Iran, Shi'is are frequently of the urban middle class, but generally they are a small minority.[32]

The Rise and Fall of Islamic Civilization

The apogee of Islamic civilization came during the Abbasid caliphate, based in Baghdad after 750. A high point was the rule of Harun al-Rashid (786–809). Baghdad was the world's largest city outside of China, and China was Baghdad's only rival in science and the arts. Muslim scholars studied the ancient Greek philosophers, who were banned in Christian Europe, and expanded upon their knowledge with such intellectual achievements as the development of algebra and Arabic numerals. Under Abbasid rule Islam became a

30. The term *Shi'ite* is frequently used in journalism but is considered by many believers in Shi'ism to be pejorative.

31. In Yemen it is the *Zaydis* who are numerically dominant and are often viewed as being the closest to the Sunnis of all the Shi'i groups. In Syria, the ruling El-Assad family are all from the *Alawite* sect of Shi'ism, which constitutes about 10 percent of Syria's population. However, the French favored them for positions in the officer corps during colonial rule, which allowed them to seize power later in a military coup. Officially Syria has a secular Arab socialist (*Ba'athist*) regime, like Iraq formerly had.

32. This is where the largest numbers of Muslims are found. The four countries with the largest Muslim populations are, in descending order, Indonesia, Bangladesh, India, and Pakistan.

truly multinational religion, transcending its Arabic origins even as Arabic became the lingua franca of the empire.

During this period the Sunni *Shari'a* underwent considerable development and broke into competing versions under the pressure of absorbing peoples with different cultures and traditions into the empire.[33] The foundation of the *Shari'a* was the *Qur'an* and the *Hadith*. But these works were not definitive because much of the *Qur'an* is written in a highly poetic language subject to many possible interpretations, and debate arose regarding the validity of certain *Hadith:* Were they actually said by the Prophet Muhammed or were they made up by someone later to justify a non-Islamic practice?[34]

After the death of Harun al-Rashid the caliphate began a long decline, breaking up into many small successor states by the mid-900s.[35] Despite this fracturing, the period 900–1700 actually saw the greatest expansion of Islam in terms of converts. In some areas this involved local populations adopting the long-established religion of the rulers, as in the Middle East. In other regions, conquest by Muslim successor states was crucial to converting the populace, as in Central and South Asia. Finally, in many areas the conversion was led by merchants[36] and missionaries, as in sub-Saharan Africa, Malaysia, and Indonesia. After 1700 the global expansion of Islam slowed as it encountered the expanding power of industrializing Christian Europe.

33. For a detailed account of the development of the Sunni *Shari'a* see Joseph Schacht, *An Introduction to Islamic Law* (Oxford: Oxford University Press, 1964). The four Sunni Shari'as are the *Hanafi,* the most liberal; the *Maliki,* popular in North Africa; the *Shafi,* popular in Southeast Asia; and the *Hanbali,* the strictest, enforced in Qatar and Saudi Arabia, where it has spread as the *Wah'habist* ideology of the Saudi royal family since 1740. Wah'habism has inspired some of the more militant Islamic movements in former Soviet Central Asia, including the former Taliban regime in Afghanistan and the al Qaeda movement of Osama bin Laden. The Shi'is have *Shari'as* but allow more leeway by current leaders in interpreting them.

34. A major source of controversy between the *Shari'as* was *ijtihad,* or interpretation, which was a method of allowing new practices in Islam. After the tenth century "the gate of *ijtihad*" was closed and no new interpretations were allowed. Some claim that this led to an ossification of Islam that contributed to its political and economic decline. See W. Montgomery Watt, *Islamic Fundamentalism and Modernity* (London: Routledge, 1988).

35. An early analyst of the decline of Islam was the great medieval Muslim philosopher and historian Ibn Khaldun, who argued that Islam rose through conquest by nomadic warriors who lost their vigor once in power. He also noted the decay of scientific inquiry in Muslim countries compared with some of the Christian states of his time and also discussed economic issues from an Islamic perspective. See his *The Muqaddinah: An Introduction to History,* trans. by F. Rosenthal, 3 vols. (New York: Pantheon Books, 1958 [originally in Arabic, 1379]); and Charles Issawi, trans. and arranger, *An Arab Philosophy of History: Selections from the "Prolegomena" of Ibn Khaldun of Tunis (1332–1406)* (Princeton, N.J.: Princeton University Press, 1987). See also Akbar Ahmed, "Ibn Khaldun's Understanding of Civilizations and the Dilemmas of Islam and the West Today," *Middle East Journal* 56 (2002): 20–45.

36. The role of merchants is tied to the lower transactions costs that may accrue from trust between coreligionists. See Jean Ensminger, *Making a Market: The Institutional Transformation of an African Society* (Cambridge: Cambridge University Press, 1992) and Jean Ensminger, "Transaction Costs and Islam: Explaining Conversion in Africa," *Journal of Institutional and Theoretical Economics* 153 (1997): 4–29.

The early twentieth century brought a low point for Islam as most Muslim states became colonies of Christian European powers; only Turkey, Saudi Arabia, Iran, and Afghanistan maintained formal independence throughout the twentieth century. The modern revival of Islam arose in the context of nationalist and anticolonialist struggles against this domination during the second half of the twentieth century.

The New Traditional Islamic Revival

At the start of the twenty-first century Islam is surging as a movement, strongly reviving throughout its traditional base and rapidly spreading beyond it. This is caused mostly by very high birth rates[37] in many Muslim countries and migration into other areas, including European countries. In France the Muslim influx has stimulated ultranationalist and antiforeigner political movements, symbolized by the second-place finish by the anti-immigrant Jean-Marie Le Pen in the 2002 French presidential election. But Muslim proselytization is occurring in many other parts of the world as well.

In core zone countries, either a self-styled Islamic fundamentalist government is in power or a significant opposition movement is Islamic fundamentalist. A universal demand of these movements is for imposing and enforcing a *Shari'a* law code. Since there are several different *Shari'as,* disputes can arise once implementation is actually attempted,[38] although in many countries one *Shari'a* is clearly preferred. This demand for the imposition of a *Shari'a* has extended to countries with significant non-Muslim populations, such as in certain states of Nigeria and in Sudan, where such demands have aggravated a long-running civil war.

The list of countries that have adopted a *Shari'a* code includes Sudan, Saudi Arabia, Qatar, Iran, Pakistan, and Afghanistan under the ultrafundamentalist Taliban (which was ruled by the Soviet Union for a while in the 1980s). In Algeria an Islamic fundamentalist party that promised to adopt a code won an election but was prevented from assuming power by the military; a civil war ensued as a result. Countries moving toward partial

37. Perhaps the most controversial element of Islamic fundamentalism is its view of the role of women. Without question the *Qur'an* gives women a lower status than men economically through unequal inheritance laws, the right of men but not women to multiple spouses, and the greater ease of divorce for men. However, women are allowed to own property, and except for prostitution there are no restrictions on labor market entry. In many Muslim countries women participate in skilled professions, although generally they have substantially less education than men. The Prophet Muhammed respected women, and some demands by Islamic fundamentalists are not to be found in the *Qur'an* or the *Hadith,* such as requiring the wearing of the veil, which reflects tribal practices and traditions. In many cases, the conversion to Islam of such tribes improved the status of women, who were previously not allowed to inherit property. In some places, men were previously allowed to have more wives than the four allowed by Islam.

38. One example is that since the official adoption of the *Shari'a* in Pakistan, no thief has had his hand chopped off because of a disagreement between different codes as to whether the hand should be chopped at the wrist or at the base of the thumb and fingers. Also, it must be proven that a thief did not steal out of need.

adoption of a *Shari'a* code include Nigeria, Egypt, and Malaysia. In Jordan and Morocco the monarchs stress their direct descent from the Prophet Muhammed and lavishly fund the *ulama* (Islamic clergy) and the mosques. In many Central Asian republics of the former Soviet Union, Islam is on the rise and Islamic fundamentalists were involved in a war with the government in Tajikistan, as they have been in the Russian republic of Chechnya. Uzbekistan helped overthrow the Taliban in Afghanistan after facing violence from its own Islamic Movement of Uzbekistan. Islamic fundamentalists have also played roles in the wars in Bosnia-Herzegovina and Kosovo in the former Yugoslavia, and a long-running Islamic guerrilla movement operates in the southern areas of the Philippines, whose population is about 90 percent Roman Catholic. In some mostly Muslim nations, such as Iraq and Syria, Islamic fundamentalists have been violently suppressed by secular socialist governments.

What lies behind this sweeping upheaval? Most of the Muslim world was subjected to colonial domination by European powers sometime during the twentieth century. Even those nations that retained formal independence were sometimes subjected to powerful outside influence, as when the U.S. Central Intelligence Agency organized the overthrow of the Iranian nationalist leader, Mohammed Mossadegh, in 1954 or when the Soviet military installed a puppet leader in Afghanistan in 1979. Such experiences established the possibility of Islam's becoming identified with national identity in anticolonialist struggles.

But generally Islam was not the vehicle of the anticolonialist movements that achieved national independence. In the Arab world many of these impulses were socialist, as in Algeria and South Yemen, or Arab nationalist, as in Egypt, seeking a transnational unity that never came to pass.[39] But profound disillusionment has set in with these initial post-independence solutions, and the general difficulties of world socialism have also shown up in many of these countries. Nevertheless, there remains fear of adopting Western-style market capitalism because it might lead to a renewed loss of national sovereignty. Hence Islam's appeal as a Third Way in the economic sphere becomes important.

In most of these countries, independence raised national identity issues because their borders were drawn by the colonial powers with little regard for cultural or ethnic considerations. This is true as well of the newly independent Central Asian republics, whose borders were drawn by Stalin during Soviet rule. This lack of solid national identity has led to the search for something else to unite them, and Islam has emerged as that something else.

Another factor was the success in the 1970s of the **Organization of Petroleum Exporting Countries (OPEC)** in raising oil prices and the enormous wealth this generated for some of its Muslim member states. This showed the possibility of Muslim countries

39. A similar case has been the displacement of the Arab nationalist Palestine Liberation Organization (PLO) by the Islamic fundamentalist Hamas as the most militant anti-Israeli movement among Palestinians.

asserting themselves economically against their former colonial powers. The first oil price shock in 1973 was preceded by the oil export embargo imposed by fundamentalist Saudi Arabia, OPEC's biggest oil exporter, to protest U.S. support for Israel during the Yom Kippur War.

Oil price increases triggered a surge of pride in the Muslim world, even as they also triggered envy of the wealthy Persian Gulf states. Inequalities of wealth became a problem and played a role in the rise to power by Shi'i fundamentalists in OPEC's second most powerful member nation, Iran. However, both Saudi Arabia and Iran have used their wealth to fund and encourage Islamic fundamentalist movements around the world.

Finally, there is the nostalgic appeal of Islam's glorious past. It offers a historical and cultural identity that has an international character, in which people can feel both independent and part of something greater and more glorious than themselves. The Saudi Arabians in particular have propagandized for the idea of Islamic economics as part of adopting of a *Shari'a*.[40] One's country can be modern, rich, and powerful, yet spiritually superior to the wealthy non-Muslim nations and in tune with an ancient and noble identity. The appeal of fundamentalist Islam is ultimately the appeal of the New Traditionalism.

THE PRINCIPLES OF ISLAMIC ECONOMICS

Fundamental Concepts

The principles of **Islamic economics** are derived from the *Shari'as*. Even within the accepted foundation of the *Qur'an* and the core *Hadith* there are varying interpretations of key passages regarding economic matters, even within particular *Shari'a* schools. As Islamic fundamentalism has increased in influence and become a serious contender for power in many societies, increasingly acrimonious debates have erupted among Islamic economists over these differences of interpretation and thus over what truly constitutes Islamic economics.

Three ideas underpin the Islamic economic system as a whole. The first is *tawhid,* or divine unity, the idea that all economic activity must be in accord with divine commands. The second is *khilafah,* or viceregency, the idea that humans are the partners of Allah in managing the world and its resources. This implies universal brotherhood, a concept stressed frequently in the *Qur'an* and the *Hadith* on its own. Finally there is *adalah,* or justice, which implies concern for the welfare of others and cooperation as the basic principle of

40. The importance of Saudi Arabia's role has been enhanced by Mecca and Medina's both being located there. Every year, over 2 million pilgrims from all over the Islamic world come to Saudi Arabia on the *Hajj* to visit those cities and are thus exposed to Saudi influence.

economic organization. Umer Chapra argues that ESOPs are a method whereby such cooperation can be achieved within an Islamic context.[41]

Zakat, or Almsgiving

Beyond these broad principles lie more specific injunctions, some positive commands, others negative prohibitions. The most important of the positive injunctions is **zakat,** or almsgiving. In theory almsgiving is supposed to be a voluntary activity by the devout, but in practice it became a religious tax used for income redistribution purposes by Islamic governments. In its original formulation it is a 2.5 percent tax on most forms of wealth, above a minimum necessity level, although higher rates, called the *tithe* (*'ushr*), are due for agricultural produce. The tithe seems more like an income tax than a wealth tax.

As with tax accounting in most economies, these simple rules have generated enormous discussion and the elaboration of numerous special cases and exceptions, with considerable differences between the different *Shari'a* codes that do not seem to follow any clear pattern.[42] Muhammed Siddiqi[43] presents debates of modern Islamic economists who have argued about whether or not higher rates can be charged for newer forms of wealth not specifically mentioned in the *Qur'an* or *Hadith*. Those specifically covered and thus subject to the *Qur'anic* fixed rates are flocks and herds, gold and silver, articles of trade, and agricultural produce, which pays the higher-rate tithe.

Countries that have introduced state-collected *zakat* include Pakistan, Saudi Arabia, Malaysia, and Sudan. A study of whether Pakistan's state-run *zakat* system introduced in 1980 will be able to eradicate poverty found in the negative.[44] Yet in Sudan *zakat* distribution to the poor is perceived politically as having a real impact.[45]

41. M. Umer Chapra, *Islam and the Economic Challenge* (Leicester, U.K.: Islamic Foundation, 1992), chap. 5. In addition, more general discussions can be found in Masadul Alam Choudhury, *Studies in Islamic Science and Polity* (New York: St. Martin's Press, 1998) and Masadul Alam Choudhury, *Studies in Islamic Social Sciences* (New York: St. Martin's Press, 1998).

42. In a classic account of economic laws in *Shari'a* codes, Aghnides spends nearly 150 pages describing these variations. See Nicholas P. Aghnides, *Mohammedan Theories of Finance* (New York: Columbia University Press, 1916), pp. 199–347.

43. Muhammed Nejatullah Siddiqi, "Muslim Economic Thinking: A Survey of Contemporary Literature," in K. Ahmad, ed., *Studies in Islamic Economics* (Leicester, U.K.: Islamic Foundation, 1980), pp. 191–315.

44. Faiz Mohammed, "Prospects of Poverty Eradication Through the Existing Zakat System in Pakistan," *Pakistan Development Review* 30 (1991): 1119–1129. A disproportionate number of Islamic economists have been from Pakistan, reflecting a combination of the British colonial educational system with Pakistan's establishment as the first modern Muslim state in 1947. The first self-declared work to present "Islamic economics" was by a Pakistani economist writing in Urdu in the same year (Sayyid Abdul A'la Maududi, *The Economic Problem of Man and Its Islamic Solution* [Lahore: Islamic Publications, 1947, English trans. English, 1975]). However, sophisticated economic analyses within a generally Islamic context were made much earlier by the medieval Muslim philospher and historian Ibn Khaldun (see Abdol Soofi, "Economics of Ibn Khaldun Revisited," *History of Political Economy* 27 [1995]: 387–404).

45. "Sudan's Islamic Rulers Split on Links with West," *Washington Post,* February 27, 1993, p. A18.

It can be argued that *zakat* is merely the basic ingredient of the fiscal policy of an Islamic state. Other kinds of taxes can be raised to cover state expenses, such as income taxes. Furthermore, the *Shari'a* codes allow for taxing non-Muslims at higher rates. In the early caliphates such practices played a role in pushing large masses of people toward conversion.

Hard Work and Fair Dealing

Another positive Islamic economic injunction involves working hard and dealing fairly with others. Sellers should use fair weights and measures. One should work hard at one's chosen profession, presuming it is an honorable one, and enjoy the fruits of one's labors. Rightly acquired wealth is approved of in this system. However, one should be modest in the enjoyment of wealth. Furthermore, one should pay one's workers a just wage, and one should charge just prices for one's output. One should be efficient and not wasteful ("Allah does not love people who waste what they have." *Qur'an* 6: 141). In short, Islam would not disapprove of the Better Business Bureau but would disapprove of conspicuous consumption.

Proper Consumption

Pork,[46] nonritually slaughtered animals, and alcoholic beverages are not to be consumed. Prostitution and gambling are forbidden.

Gharar, or the Avoidance of Chance

The prohibition against gambling led to a more general prohibition against **gharar,** translated variously as chance or uncertainty. One is not to make contracts when the outcome cannot be predicted. Thus, speculation, forward markets, and lotteries are all forbidden. This prohibition developed later and is not to be found in the *Qur'an*. Its basis is the specific forbidding of a particular game of chance in the *Qur'an*.

The forbidding of contracts involving *gharar* has led to controversy regarding two specific areas. One is insurance, where there are three schools of thought. The first view is that insurance is acceptable because it involves reducing risk for a group using the law of large numbers and is thus different from gambling, which involves an individual choosing to create additional personal risk. Another perspective holds that insurance is *gharar* and therefore unacceptable. A third view objects to life insurance but not to other forms of

46. That both Islam and Judaism forbid the consumption of pork while Christianity generally does not has occasioned much discussion. The **cultural materialist,** or cultural ecology, school of anthropology argues that this reflects ecological-economic imperatives, pigs being especially costly to raise in desert environments compared with other animals; see Marvin Harris, *Cows, Pigs, Wars, and Witches* (New York: Random House, 1974). However, other explanations have been proposed; see Paul Diener and Eugene E. Robkin, "Ecology, Evolution, and the Search for Cultural Origins: The Question of Islamic Pig Prohibition," *Current Anthropology* 19 (1978): 493–540.

insurance. A general outcome of this controversy has been suspicion of private provision of insurance and support for public provision instead.

The other area of controversy involves sharecropping rents, which some Islamic economists disapprove of because of the *gharar* element involved, though they approve of fixed rents. However, the discussion of land rent is somewhat complicated. Some approve of land rent in all forms. Some disapprove of rent in all forms. Others disapprove of fixed rents while approving of sharecropping (the most widespread form of rent in the Middle East). This last viewpoint arises from considering fixed rent to be a form of **riba,** or interest, and sharecropping to be a form of **qirad,** or profit sharing. Interest payments are strictly forbidden, while profit sharing is allowed. Those disapproving of all land rent say that fixed rents are *riba* and sharecropping is *gharar*.

Qirad, or Profit Sharing

A deep issue for Islamic economics that remains unresolved is the line between disapproved-of chance taking (*gharar*) and approved-of risk sharing through profit sharing, known as *qirad*. The answer may be that approved profit sharing involves no additionally sought-out risk and that profit-sharing agreements must be clearly spelled out to minimize uncertainty over the details of risk sharing.

The basis for accepting profit sharing comes from a tradition that the companions of the Prophet practiced it, as did the Prophet Muhammed himself in his early business activities. Nothing is specifically said of it in the *Qur'an,* and it is discussed only slightly in the *Hadith*. The different *Shari'as* display variations on accepted forms and structures.

A wide variety of specific profit-sharing arrangements have been allowed in the various codes.[47] A universally accepted one that has received much attention from current Islamic economists is called **mudarabah.** This is an Islamic form of venture capitalism in that there is a financial backer, which might be an Islamic bank, and an entrepreneur-manager. The first provides an agreed-upon sum of metallic money or possibly goods.[48] The first party then receives an agreed-upon share of subsequent net profits. A portion of the funds go to the second party as payment for services. If the enterprise fails, the first party loses all invested funds. The second party loses what was put in as labor time.

In practice, such arrangements have been undermined by fraud and dishonesty by entrepreneurs in reporting profits to investors. Thus, although such deals are supposed to be the ideal asset of a truly **interest-free bank,** during the late 1980s the share of Islamic

47. For discussion of these varieties, see Muhammed Anwar, *Modelling Interest-Free Economy: A Study in Macro-economics and Development* (Herndon, Va.: International Institute of Islamic Thought, 1987) and Paul S. Mills and John R. Presley, *Islamic Finance: Theory and Practice* (New York: St. Martin's Press, 1999).

48. The fixation on gold and silver as the only true forms of money has led the Saudi Arabians to put silver threads in their paper money.

bank assets that took this form in Iran and Pakistan, respectively, were only 38 percent and 14 percent,[49] with shares taking this form less than 10 percent in the late 1980s and early 1990s in Islamic banks in Egypt and Jordan.[50] Such arrangements reflect the ideal cooperative spirit of Islam. But the failure of many practitioners to fulfill the ideal and to cheat on their partners has been denounced by Islamic economists.

From the standpoint of non-Islamic economists these situations are classic examples of *principal-agent problems,* with the first party being the principal and the second party being the agent. There is *asymmetric information* between the parties, with the entrepreneur more aware of the actual situation of the enterprise and thus able to control the reporting of profits and the share that the financier receives. Most observers are unsurprised that financiers in such situations would seek more certainty regarding returns on their investments.

Riba, or the Forbidding of Interest

The core demand of Islamic economists is that interest be forbidden. This demand arises from condemnations in the *Qur'an* and the *Hadith* of *riba,* which literally means "increase or addition" but which is accepted as meaning interest in some form. Some argue that it only refers to an increase beyond some acceptable level, but this is a minority opinion among current Islamic economists, who mostly argue that all interest should be forbidden. It is forbidden both on money loaned over time and within barter transactions, where only goods are to be traded for each other at a supposedly equal rate.

Although there are several relevant passages, perhaps the most famous one, which also indicates a view of trade, is *Qur'an* (2: 275):

> Those who benefit from interest shall be raised like those who have been driven to madness by the touch of the devil; this is because they say: "Trade is like interest" while God has permitted trade and forbidden interest. Hence those who have received the admonition from their Lord and desist, may have what has already passed, their case being entrusted to God; but those who revert shall be the inhabitants of the fire and reside therein forever.

It can be argued that interest payments violate the fundamental Islamic requirements of brotherhood and justice because often interest is oppression and exploitation by the rich of the

49. Mohsin S. Khan and Abbas Mirakhor, "Islamic Banking: Experiences in the Islamic Republic of Iran and Pakistan," *Economic Development and Cultural Change* 38 (1990): 353–374. Details of the Pakistani Islamic banking system are discussed in Peter A. Cornelisse and Wouter Steffelaar, "Islamic Banking in Practice: The Case of Pakistan," *Development and Change* 26 (1995): 687–699.

50. Rajesh K. Aggarwal and Tarik Yousef, "Islamic Banks and Investment Financing," *Journal of Money, Credit, and Banking* 32 (2000): 93–120. Different sources provide contrasting data with regard to Malaysia, with Aggarwal and Yousef reporting low single-digit levels, whereas Muhammed Anwar, "The Role of Islamic Financial Institutions in the Socio-economic Development in Malaysia," *Pakistan Development Review* 30 (1991): 1131–1142, reports a level of 74 percent in 1989.

poor, especially when consumption loans for people in desperate circumstances are involved. The rich should take care of the needy, but interest income flows from the poor to the rich. Furthermore, this tends to make the interest-receiving rich idle and unproductive, a parasite class. Similar arguments played roles in discussions by Greek philosophers like Aristotle and also influenced medieval Roman Catholic Church discussions such as those of Thomas Aquinas.

It can also be argued that the redistribution of income leads to economic stagnation. In this scenario, consumption is reduced because of the lower average propensity to consume of the rich, who invest the income in expanded production, which leads to a surplus, as the market has diminished. This situation is aggravated as interest costs are passed on to consumers as higher prices. Mawdudi saw this stagnation leading to depression, monopoly, and imperialism.[51] Focusing on profit sharing rather than interest shifts the focus to the entrepreneur and thus stimulates genuine economic growth while removing a source of cyclical fluctuation.

Furthermore, forbidding interest eliminates the *Hayekian monetary trade cycle* of excessive investment responses to interest rate changes, leads to a closer link between savings and investment, and reduces destabilizing speculation. In this view, forbidding interest reduces inflation because there will be less overexpansion of credit and fewer people trying to live beyond their means. Cost pressures are reduced because producers can make profits at lower price levels, with the result that anticipated inflation will not affect investment. Finally, it may be efficient to forbid debt if there are sufficiently high costs associated with default and liquidation.

The most serious criticism of these arguments has been that forbidding interest will lead to insufficient savings and hence insufficient real capital investment and economic growth. Some have responded that zero interest rates mean that future generations will not have their preferences discounted and that there will be a greater orientation to the future. Also, *zakat* may serve as a motive for saving by devout Muslims.

Another problem with forbidding interest is how to allocate capital if there is no price for it. Socialist-oriented Islamic economists[52] argue that this can be done by central planners using mathematical programming techniques, although in chapter 3 we have seen that this is easier to advocate than to implement. The non-socialist Naqvi[53] has suggested setting the *zakat* rate equal to the opportunity cost of capital, which connects with the above theory about the motive for Islamic savings.

51. Sayyid Abdul A'la Mawdudi, *Interest* (Lahore: Islamic Publications, 1961) (in Urdu). Marx saw interest as arising from exploitive surplus value and thus thought it could lead to imperialism.

52. See Ausaf Ali, *Studies toward an Understanding of the Developmental Perspective* (Karachi: Royal Book, 1979).

53. Syed Nawab Haider Naqvi, *Ethics and Economics: An Islamic Synthesis* (London: Islamic Foundation, 1981).

The Practice of Islamic Banking

If proper Islamic banks are not allowed to charge interest, how can they make money? The answer is to finance and support the various allowed *qirad,* or profit-sharing, arrangements such as *mudarabah* described above. Such an approach effectively makes Islamic banks the equivalent of non-Islamic mutual funds. Someone depositing money in an Islamic bank de facto becomes part owner of the various enterprises to which the bank has lent money.

This is the idealistic view. However, there are many different allowable arrangements, some of which can be made to function almost exactly like standard interest. In most Islamic banks, probably the most widely used such arrangement is **murabaha.** This involves the financier purchasing goods for the producer and then selling them to him at an agreed-upon inflated price, which is to be paid back to the financier at an agreed-upon later date. This is viewed as legitimate by most Islamic economists because the financier bears risk during the period in which he owns the goods.

But this period can be reduced to an infinitesimal time span and most practicing Islamic banks do keep such periods very short, thereby sharply reducing their own risk. Islamic banks increasingly want to do this, as they face frustration in getting their partners to report properly to them on net profits, and such arrangements can largely resolve this principal-agent problem. That this approach may make a mockery of the whole business is the view of some Islamic economists, who argue that this method and similar ones should not be used widely.

In any case, self-identified Islamic banking is a dramatically growing phenomenon. The first successful such institution was a savings bank founded in 1963 in the Egyptian town of Mit Ghamr. It was shut down by the government in 1968 during a socialist binge, but a full-service Islamic bank was opened in 1972 as the Nasser Social Bank. In 1975 a full-service Islamic bank was opened in Dubai. At the same time the oldest son of then King Faisal of Saudi Arabia, Mohammed, founded the Islamic Development Bank (IDB), based in Jeddah, Saudi Arabia. This has been a major spearhead of the international movement toward Islamic banking and has been involved in much international trade and development lending. Islamic banks are now operating in over 60 countries, including the United States.[54] Iran, Pakistan, and Sudan allow only Islamic banks, although in the first two of these countries, the interest-like *murabaha* form has been most widely used.

Many of the complexities and issues surrounding Islamic banking have come to a head in Saudi Arabia, one of the most fundamentalist Islamic regimes. Despite this tradition,

54. In nations like the United States with relatively small Muslim minorities, using an Islamic bank is not only a way for a devout Muslim to feel virtuous, but can also facilitate meeting like-minded individuals whom one might be more inclined to trust and to do business with. See Timur Kuran, "Islamic Economics and the Islamic Subeconomy," *Journal of Economic Perspectives* 9(4) (1995): 155–173.

Western-style banking is allowed in Saudi Arabia, having developed from local money-changing operations, but is subject to severe restrictions regarding interest.[55]

But this existing system faces two major challenges. One is the demand by many *ulama* and also by some economists such as Umer Chapra,[56] who works for the Saudi Arabian Monetary Agency (SAMA), for the outright prohibition of interest and therefore of non-Islamic banks. This position has strong support from some factions within the ruling Saudi royal family, such as those allied to Prince Mohammed ibn Faisal, founder and head of the IDB.

The other challenge is that Saudi Arabia formally follows the very strict *Hanbali Shari'a* law code. This means that there is no legal support for the right to collect any interest, even though standard banking is technically allowed. As the country's economic growth slowed following the post–1981 decline in oil prices, many bank loans became nonperforming and debtors began going to the religious courts to have their debts declared invalid. The religious courts responded sympathetically to such appeals. By 1987 a crisis was declared, and SAMA formed a committee to resolve the situation. But its efforts failed as it again collided with the entrenched position of the religious courts, with the result that many Western banks are now pulling out of the country. Kuwait and the United Arab Emirates are also experiencing similar complications. In Saudi Arabia, the *ulama* have opposed the issuance of Saudi development bonds to finance the budget deficit of recent years.

Although a likely outcome of this situation is the establishment of full-blown Islamic banking, other difficulties are implied. In particular, there seem to have been recent problems regarding the profitability of Islamic banks. Some of this difficulty is caused by the overeager loans made during the oil-boom 1970s that have now gone bad. Some may be caused by lack of knowledge or experience on the part of the new Islamic bankers. Some may be a result of the fraud and misreporting of profits mentioned above.

The result has been increased caution on the part of Islamic banks and an increased trend toward the more interest-like lending arrangements like *murabaha* rather than the more profit-sharing ones like *mudarabah*. Symbolic of this trend has been the changing composition of the IDB's portfolio between 1975 and 1986, with the former increasing from nil to over 80 percent while the latter decreased from 55 percent to 1 percent.[57] (See box 4-2.)

55. See Peter W. Wilson, *A Question of Interest: The Paralysis of Saudi Banking* (Boulder, Colo.: Westview Press, 1991), chap. 2.

56. See M. Umer Chapra, *Towards a Just Monetary System: A Discussion of Money, Banking and Monetary Policy in the Light of Islamic Teachings* (Leicester, U.K.: Islamic Foundation, 1985).

57. Timur Kuran, "The Economic Impact of Islamic Fundamentalism," in M. E. Marty and R. S. Appleby, eds., *Fundamentalisms and the State: Remaking Polities, Economies, and Militance* (Chicago: University of Chicago Press, 1993), p. 311.

Box 4-2
Is Islam a Third Way between Capitalism and Socialism?

Does Islam approve of private ownership of the means of production, in short, of capitalism? Aside from approving of trade and profit, the *Qur'an* clearly approves of private property. Some of its most detailed legal discussions concern rules of inheritance, although these rules tend to favor the division of fortunes among many persons.* Thus, Islam is at least compatible with a moderate version of market capitalism appropriately modified to be consistent with *Shari'a* laws.

However, despite the decline of world socialism, a number of modern Islamic economists have argued for a socialist thrust or potential in the religion. This has been the case in Iran, where a wave of nationalizations occurred after the fundamentalists gained power in 1979. In Libya, the semisocialist regime of Moammar Gadahfi incorporates some Islamic ideas into its system.

The quasi-socialist tradition within Islamic economic thought was founded by Abu Dharr al-Ghifari, a Companion of the Prophet Muhammed. He believed that all wealth above a minimum subsistence level should be redistributed to the poor. For his troubles he is said to have been banished from Medina. The *Ismaili* sect of Shi'ism has a strong "tax the rich and redistribute" orientation, although its leader, the Aga Khan, is very wealthy. A subgroup of Ismailis, the *Qarmatians*, established a regime in Bahrain and eastern Arabia in the 900s that practiced cooperation among free men (they owned slaves) and placed very heavy taxes on the rich for redistribution to the poor.

But this is not state ownership of the means of production. To defend this position, modern Islamic economists have reinterpreted portions of the *Qur'an*. A point emphasized by the Islamic socialists is that the ultimate owner of everything is Allah. Thus it can be argued that His devout followers, perhaps a state-affiliated *ulama* such as in Iran, should be in charge of managing His property.

There are competing translations of *Qur'an* 51: 10. Mannon† translates it as follows:

> He [God] set on the earth mountains standing firm, high above it, and bestowed blessings on the earth, and determined its resources, in four Days, to be equally shared by all the needy persons.

However, other translations suggest that such equal sharing occurred early in historical time or make no reference at all to it. This is one of those areas where the highly poetic nature of the *Qur'an* leaves it open to a variety of interpretations.

*One loophole here is the establishment of a charitable religious trust, or *waqf,* that can be passed on without division.

†Mohammed Abdul Mannon, *Islamic Economics: Theory and Practice* (Lahore: Muhammed Ashraf, 1970), p. 104.

SUMMARY AND CONCLUSIONS

The New Traditional Economy presents itself as an ideal that combines the efficiency of markets with the humaneness of socialism. Alienation will be eliminated as economic motives are subordinated to religious ones in a higher moral universe. In the New Traditional Economy, all people will live in harmony with each other and with nature, or so its advocates argue.

Buddhist economics is seen as tending toward low-growth socialism in Burma (Myanmar) and a fairly straightforward market capitalism in Thailand, although some ecological economists support a variation of the Burmese version. Confucian economics emphasizes order and hierarchy in a system overseen by educated elites but open to market forces.

Hindu economics derives from the writings of Gandhi, with an emphasis on self-sufficient sets of villages, using simple technologies, and operating within a reformed caste system.

Judaic economics is largely promarket, although previously adjusted to the pressure to build up and maintain the Israeli state. Some Jewish theorists have focused on some biblical rules about tithes, as well as the redistribution called for in the jubilee year, as the basis for a new Jewish economics. Christian economics has ranged widely from pro-feudal medieval Roman Catholicism to the ultra-pro-market capitalism of the fundamentalist Protestant New Christian Right in the United States today. Despite the latter, leftist Protestant fundamentalists in the United States focus on different biblical passages or interpret those cited by the New Christian Right differently, with the result that there are a variety of Christian economic interpretations.

The history of Islam ranges from its founding by the Prophet Muhammed, through the early caliphates, the development of the various law codes (*Shari'a*), the decline of Islam as European power expanded, and the recent Islamic revival.

Principles of Islamic economics include the *zakat* tax for redistributing income to the poor, the approval of hard work and fair dealing, the forbidding of the consumption of pork, alcohol, and certain other items, the forbidding of dealing in chance (*gharar*), the approval of profit sharing (*qirad*), and the forbidding of interest (*riba*). The latter lead to the theory and operations of Islamic banks that do not charge interest. One conclusion is that there is a strong tendency to use approved-of financing mechanisms that closely resemble interest.

Islamic attitudes toward property, capitalism, and socialism have involved much debate. Although the *Qur'an* approves of both markets and property, a distinct tradition within Islamic economics has stressed more radical income redistribution and severe limits on private property, leading some Islamic economists to declare it a Third Way between capitalism and socialism.

This brings us to the final question: Can Islamic economies really function, and can they achieve their goals? At one level the answer is trivial since Saudi Arabia has never stopped being an Islamic economy and it is doing quite well, although prior to the discovery of oil there, it was isolated and poor, thus not proving the case one way or the other. Other would-be Islamic economies have been in power too short a time to give a definitive answer, although we shall consider the example of Iran more closely in chapter 17.

Let us conclude by citing two different authorities with strongly divergent viewpoints. For the positive one, we have Umer Chapra:[58]

> The institutions of zakat, inheritance, and the abolition of interest are not just values that every Muslim has to comply with faithfully for his personal well-being in this world and the Hereafter, they

58. M. Umer Chapra, *Islam and the Economic Challenge* (Leicester, U.K.: Islamic Foundation, 1992), p. 226.

also have an important role to play in economic restructuring. . . . However, all these are parts of a total socio-economic reorganization and their full potential cannot be realized if applied in an isolated manner. The Islamic program has to be accepted and enforced as a whole, and not just in parts, for total effectiveness.

For the negative one we have Timur Kuran,[59] who after forecasting takeovers by Islamic fundamentalists in many places declares:

Failures along the way could easily be taken to mean educational efforts need to be redoubled and non-Islamic influences curbed further. In this vain search for the Islamic utopia the political establishment would become increasingly repressive, making it treacherous to suggest that Islam does not offer clear and definitive answers to all economic problems. Meanwhile, the discipline of Islamic economics could feed on itself for decades, mistaking apologetics for serious reflection and cosmetics for genuine reform. The twenty-first century could thus become for Islam what the twentieth was for socialism: a period of infinite hope and promise, followed by disappointment, repression, disillusionment, and despair.

We shall not attempt to adjudicate between the shining optimism of Chapra and the dark pessimism of Kuran. However, we share with them the forecast that over the near future we shall see an increasing number of countries attempting the experiment of Islamic economics.

INTERNET SOURCES

www.omsakthi.org/religions.html

www.homestead.com/wysinger/religions.html

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QUESTIONS FOR DISCUSSION

1. In what sense can Buddhist and Hindu economics be said to be supportive of modern “green” movements?
2. Compare and contrast Buddhist, Confucian, and Hindu views of the role of the state in the economy.
3. Compare and contrast Judaic, Catholic, Protestant, and Islamic views of market capitalism.
4. Why does Islam seem to have a more fully developed economic system than other major world religions?

59. Timur Kuran, “The Economic Impact of Islamic Fundamentalism,” in Marty and Appleby, eds., *Fundamentalisms and the State,* p. 332.

5. Why in most modern economies is *zakat* unlikely to be able to resolve the problem of major income inequalities?

6. Distinguish four different attitudes to land rent among Islamic economists.

7. What are some economic arguments for and against the Islamic prohibition of *riba*?

8. Why do we see a trend in modern Islamic banks toward more interest-like kinds of loan arrangements?

9. What relevance, if any, does the experience of the former Taliban regime in Afghanistan have for the theory and practice of the New Tradiitional Economy?

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II VARIETIES OF ADVANCED MARKET CAPITALISM

Part II contains the first set of country case studies, those representing the varieties of advanced market capitalism.

Chapter 5 presents the case of the United States, the leading market capitalist economy and the world's largest economy. It is not only the archetype of this type of economy but is the technological leader of the world, with very high real per capita income. Its role in developing distinctive institutions of market capitalism, such as the modern corporation, is highlighted. From a nearly pure laissez-faire economy in the mid-nineteenth century it has become a mixed economy, but it is still strongly laissez-faire oriented. It also exhibits the darker side of market capitalism, with relatively high levels of income inequality and poverty.

Chapter 6 discusses Japan's, the world's second largest economy. It is one of the hardest economies in the world to understand and to classify, with much controversy existing about its true nature. Clearly it is market capitalist and very advanced. But it also combines significant elements of neo-Confucian tradition, making it somewhat of a New Traditional Economy. Japan also illustrates important elements of planning and bureaucratic coordination, even though the direct share of government in the Japanese economy is quite small. It has served as a role model for many of the other East Asian economies, despite stagnation of its economy since 1990.

Chapter 7 presents the case of France, notable as the advanced market capitalist economy that has most seriously used indicative planning. This chapter also contains an extensive discussion of the nature and prospects of the European Union.

Chapter 8 covers the Swedish economy, which has had the most extensive income redistribution of any market capitalist economy. Despite its socialist label, it has no central planning and little state ownership of firms. But it has government-run active labor programs to retrain workers and reduce unemployment, as well as a tradition of a corporatist centralized wage bargaining process that has long encouraged macroeconomic stability.

Chapter 9 looks at the social market economy of Germany. It is dominated by the problem of unifying two distinct economic systems into one national economy. This is symbolic of the larger global problem of integrating distinct economic systems into a functioning world economy.

With some exceptions, most of the country case studies have approximately parallel structures. After some general discussion, they begin by examining the historical and cultural foundations of the society and nation to reveal the tendencies manifested in its economic system. Then the microeconomic functioning of the system is studied to determine the essential nature of its decision-making processes. This is followed by a discussion of macroeconomic functioning and broader areas of performance such as living standards, distribution of income, and environmental problems. Finally, the economy's relationship with the rest of the world economy is considered.


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Philadelphia
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Washington DC
PA
OH
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San Francisco
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Oklahoma City
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Houston
FL
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MEXICO
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not to scale

5 The United States of America: The Market Capitalist Leader

We hold these truths to be self-evident: that all men are created equal; that they are endowed by their Creator with certain inalienable rights; that among these are life, liberty, and the pursuit of happiness; that to secure these rights, governments are instituted among men, deriving their just powers from the consent of the governed; that whenever any form of government becomes destructive of these ends, it is the right of the people to alter or abolish it, and to institute new government, laying its foundation on such principles, and organizing its powers in such form as to them shall seem most likely to effect their safety and happiness.
—Thomas Jefferson, *The Declaration of Independence,* 1776

Their taste for physical gratifications must be regarded as the original source of that secret disquietude which the actions of the Americans betray and of that inconstancy of which they daily afford fresh examples. He who has set his heart exclusively upon the pursuit of worldly welfare is always in a hurry, for he has but a limited time at his disposal to reach, to grasp, and to enjoy it.
—Alexis de Tocqueville, *Democracy in America*, *Vol. II,* 1840, p. 137

The business of America is business.
—Calvin Coolidge, U.S. President, 1923–1929

INTRODUCTION: THE WORLD'S LEADING ECONOMY

The United States of America has had the world's largest aggregate economy for more than a century and continues to lead the world at the beginning of the twenty-first century. Ranking third in population, the United States has been marked by a vigorous market capitalist system unencumbered by a history of feudalism and blessed with rich land and generally abundant resources. Largely open to immigration, it has a highly diverse and internally mobile population with generally high educational levels and skills and entrepreneurial traditions. A leading center of innovation since the mid-nineteenth century, it is the current technological leader of the world economy.

Even though the United States is a New World society with a relatively short history of continuous cultural development, it has the oldest continuously existing constitution of any nation on earth, written in 1787 and in effect two years later. This constitution established the eventually large area of the United States as a unified free trading area with well-established private property and individual rights and a functioning democratic political system, although in its earlier years these individual political rights were not fully extended to all members of the population. The establishment of an independent judiciary as a third branch of government, balancing the executive and the legislative, supported the functioning of the system of contracts and property that allowed the market capitalist economy to function flexibly and thrive dynamically.

Nevertheless, the history of the American economy and society has not been without difficulties and blemishes. Its greatest crisis and conflict was over the slavery system that divided the industrial North from the cotton-growing South. This culminated in the Civil War of 1861–1865, in which more Americans died than in all its other wars put together. Fought mostly in the South, where sometimes a bitter memory of it still lingers, the Civil War resulted in the end of slavery after the North's victory ensured the continuation of the union of the states. But the emancipation of the slaves did not lead to the economic or political uplift of the African American population, as an oppressive segregationist system was put in place after the immediate postwar Reconstruction period. The westward expansion of the United States was accompanied by the conquest and suppression of the Native Indian population, much of which was confined to reservations usually located on poor land; this ethnic group is still the poorest in the country. More generally, a high level of income inequality and of poverty relative to other advanced market capitalist economies characterizes the United States.

Besides leading in technology with the emergence of the **American system** of interchangeable parts and standardization during the early 1800s, the United States has innovated in both economic institutional structures and organizational forms. Institutions provide the broad framework, such as the legal system, within which the organizations that manage the economy can develop and evolve. The United States was the fountainhead of the key organization of the modern world economy, the industrial corporation, whose standard form, the managerial, line and staff hierarchy, initially emerged in the railroads that would span the continent in the latter part of the nineteenth century. Arising from the standardization of the American system, **"Fordist" assembly line production** first emerged in the U.S. automobile industry, the sector in which the modern multidivisional corporation would develop, with the rise of the General Motors Corporation and its multidivisional hierarchy. Although there had been multinational corporations previously, such as the Dutch and British East India companies, the American multidivisional corporation became the model for today's multinational and transnational corporations that are arguably the most important institutional actors in the contemporary world economy. The full Fordist standardization allowed for mass production with rapidly rising productivity and higher growth in the United States than in many other nations' economies. This production system can also be seen as a partial response to the chronic labor shortages that afflicted the U.S. economy in its earlier years.

The institutional foundation for modern American macroeconomic policy was established in 1913 (the same year that Ford started its first assembly line), with the simultaneous passage of a constitutional amendment to allow the levying of the federal income tax and the establishment of the Federal Reserve System. The latter would manage monetary policy and aided the more general development of a strong financial system in the United States that underpinned its economic growth. After World War I the United States displaced Great Britain as the world's leading financial power, although the nation largely continued to look inward and tried to avoid a global role. This isolationist attitude was symbolized by its refusal to join the League of Nations in 1920 and its passage of the trade-destroying Smoot-Hawley tariff in 1930. The Great Depression of the 1930s and the presidency of Franklin D. Roosevelt brought about a large expansion of the federal government's role in the U.S. economy, moving it away from the nearly pure laissez-faire system it had been previously.[1]

World War II brought a dramatic change in attitudes and policies regarding the rest of the world. After the United States took the lead at the **Bretton Woods conference** of 1944, its capital, Washington, D.C., became the headquarters for the new postwar global economic institutions of the International Monetary Fund (IMF) and the World Bank, and New York City became the site of the United Nations (UN), successor to the ill-fated League of Nations. The United States organized the General Agreement on Trade and Tariffs (GATT) in 1948 that oversaw successive rounds of tariff-reducing negotiations and other moves to expand international trade, eventually culminating in the 1990s with the establishment of the **World Trade Organization (WTO).** But even as the United States led the globalization of the world economy, a reaction against this hegemony set in during the late 1990s and the issue of protectionism has become controversial in the United States.

During the 1980s, a period of deregulation of the U.S. economy, American leadership of the world economy was challenged by other countries, especially Japan. However, the stagnation of the Japanese economy after the 1990 collapse of its financial bubble, followed by a surge of **New Economy** high-technology development in the United States in the late 1990s, led by the information technology sector, reasserted the primacy of the U.S. position. But this development was also accompanied by a speculative bubble in the U.S. stock market that peaked in early 2000. The high-tech sector has since been hit by a slowdown as the high-tech-dominated NASDAQ index declined by more than 60 percent from March 2000 to October 2001 after the terrorist attacks on New York City and Washington, D.C. Although the United States has come out of the recession of 2001, doubts remain about the future of its high-tech sector, where an overhang of excess capacity remains to be dealt with. The high-tech sector has also been supported by the high participation rates in higher education of Americans, although there are now increasing worries about the future of the American educational system. But its strong ongoing

1. Government was involved in the economy in many ways in the nineteenth century: establishing protectionist tariffs and developing transportation infrastructure through land grants to the railroads, as well as actual construction and ownership of the canals and highways, although much of this was done by state and local governments. Curiously, the federal government, through the military, played an important role in pushing for the development of interchangeable parts in the gun industry, from where this spread to sewing machines and other manufacturing sectors (David A. Hounshell, *From the American System to Mass Production, 1800–1932* [Baltimore: Johns Hopkins University Press, 1984]), although the earliest developments were probably in the private sector, notably in wooden moving-parts clocks and axes (Donald R. Hoke, *Ingenious Yankees: The Rise of the American System of Manufactures in the Private Sector* [New York: Columbia University Press, 1990]).

research and development activities, as well as its entrepreneurial vigor and flexibility, bode well for the future of the U.S. economy.

As noted at the end of chapter 2, the United States represents both the good and bad sides of the market capitalist system. Compared to other advanced economies, it has achieved high income levels and technological progressiveness, in 2000 ranking second (behind Luxembourg) in the world in real per capita income. Yet in the past, compared with other countries, the United States experienced greater macroeconomic instability and had a weaker social safety net, with accompanying higher levels of inequality and poverty. While the United States was in 6th position in the world on the UN Human Development Index in 2000, it was 25th in life expectancy. The U.S. economy offers dynamism and widespread prosperity, but this prosperity is not shared by all, with many seriously missing out on the benefits of America's economic success.

HISTORICAL DEVELOPMENT OF THE U.S. ECONOMY[2]

The Colonial Period and the Revolution

Human beings have inhabited the territory of what is now the United States of America for thousands of years, originally coming in various waves of migration from Northeast Asia. But in contrast to Mexico, no large-scale political entity based on a highly developed urban society existed in its territory prior to the arrival of the Europeans. Besides lacking immunity to European diseases, the Native American Indians were easily conquered and pushed back by the various European groups who arrived, despite initially aiding the new settlers in many cases.

The territory of the United States was contested by various European nations, including the British, French, Dutch, Spanish, and Russians. The struggle for control of the East Coast colonies was resolved in 1763 by the victory of the British over the French in the Seven Years War, known in the United States as the French and Indian War. What became the original 13 American colonies (and eventual states) had varied founding rationales, including havens for religious dissidents, commercial enterprises, and a penal colony (Georgia). Each colony initially had little economic or political relations with the others, penetrating its own hinterland gradually while developing overseas trade with Britain, the Caribbean, and other areas.

2. Overviews of U.S. economic history can be found in Robert Heilbroner and Aaron Singer, *The Economic Transformation of America: 1600 to the Present,* 4th ed. (Fort Worth, Tex.: Harcourt, Brace, 1999); Jeremy Atack and Peter Passell, *A New Economic View of American History,* 2nd ed. (New York: W. W. Norton, 1994); Jonathan Hughes and Louis P. Cain, *American Economic History,* 5th ed. (Reading, Mass.: Addison-Wesley, 1998); Gary M. Walton and Hugh Rockoff, *History of the American Economy,* 8th ed. (Forth Worth, Tex.: Dryden, 1998).

A portentous event was the initial 1619 arrival in Jamestown, Virginia, of the first African slaves, the beginning of a long and tragic pattern. During the first century of settlement, a majority of the English-speaking immigrants were indentured servants who had to work their way to freedom, also the condition initially of many of the Africans. The racial divide over who would be a slave and who would not developed over time, initially in Virginia.

As the 1700s proceeded, the British increasingly imposed laws and restrictions on trade related to a **mercantilist policy** that viewed the colonies' purpose as enriching Great Britain. Anger at these laws and at taxes imposed with no colonial representation in Parliament swelled in the years after 1763, along with anger at the British for taking the side of the Native Indians in the interior against further inland migration by the colonists. Independence was declared in 1776, the year Adam Smith published *The Wealth of Nations* and James Watt refined the steam engine. With the crucial support of the French, the American colonies won independence from Britain in 1781.

From Revolution to Civil War

The initial governmental system of the United States was the Articles of Confederation, in which the individual states were supreme over the federal government. After high inflation and interstate conflicts,[3] the Articles were replaced in 1789 by the Constitution when George Washington became president. While the states continued to have authority over many matters, the Constitution established the supremacy of the federal government in numerous areas, along with a balance between the executive, legislative, and judicial branches. The Bill of Rights guaranteed important civil liberties, although initially only for white males in practice. Trade protectionism between the states was forbidden. Nevertheless, disagreements over relations between the states and the federal government continued, providing the initial issue that divided the original political parties in the United States. This eventually culminated in the Civil War due to conflicts over states' rights versus federal supremacy regarding slavery.

During Washington's presidency (1789–1797), his first Secretary of the Treasury, Alexander Hamilton, developed the national economy by establishing the First National Bank that stabilized the currency.[4] In 1793 Hamilton invented the infant industry argument

3. Despite its problems, important issues were resolved under the Articles of Confederation, notably the establishment of the basic system for defining land ownership in the West in the Northwest Ordinances of 1785 and 1787, which allowed for the orderly settlement of the interior. These ordinances also outlawed slavery in the area north of the Ohio River.

4. The National Bank was controversial, and the First was not rechartered in 1811. Financial problems led to the chartering of a Second National Bank in 1816, but it would not be rechartered in 1836. There followed the period of free banking with no central bank in the United States until the establishment of the Federal Reserve in 1913.

for tariff protection to help the nascent textile industry in New England compete with the one in Britain. The issue of tariffs, also the major source of revenue for the federal government throughout most of the 1800s, would sharply divide the industrializing and import-competing North from the cotton-exporting South, where Eli Whitney's invention of the cotton gin in 1793 dramatically increased the profitability of slave-based cotton production.

During the early 1800s, the U.S. economy was led by the development of transportation infrastructure that linked the East Coast with interior regions west of the Appalachian Mountains, coinciding with migration and economic development westward. During the 1820–1840 period the focus was on canal building, most of it financed by state governments, the most important one being the Erie Canal in New York State, completed in 1825. From the 1840s on private railroad construction supplanted the canals, peaking in the 1880s after the federal government supported it through massive land grants. Development of this transportation infrastructure provided crucial support for the expansion of American agricultural production, which became a leading export sector and remains so today.

Another profoundly important development was the laying of the legal foundation for the modern **limited liability corporation** by rulings of the U.S. Supreme Court. This established the idea of a corporation as a juridical person (entity) separate from its owners, an idea that we now take for granted but that had not previously existed.[5] Connecticut was the first state to allow the relatively free establishment of limited liability corporations in 1837. Within 40 years, this fundamental legal-institutional innovation had spread to all the states. The later organizational evolution of the corporate form depended upon this critical institutional development.

The early 1800s also saw territorial expansion of the United States, with the Louisiana Purchase of 1803 from France doubling the country's size with land west of the Mississippi River. The 1848 Mexican War added most of the Southwest, including California. By 1853, all the territory of the current United States had been obtained by war, negotiation, or purchase, except for Alaska (purchased from Russia in 1867) and Hawaii (obtained from the Hawaiians by annexation in 1898). These territories gradually joined the Union as states, a process completed with the accession of Hawaii in 1959.

The question of whether or not slavery would be allowed in the new states of the Great Plains during the 1850s finally led to the Civil War. With the old Democratic Party split, in 1860 the new Republican Party succeeded in getting Abraham Lincoln elected president.

5. A somewhat related paradox is that while the United States reflects intense individualism, Americans have traditionally had a strong sense of community, reflected in its well-developed civic institutions and relatively high levels of social capital (see Robert D. Putnam, *Bowling Alone: The Collapse and Revival of American Community* [New York: Simon & Schuster, 2000]). The idea of the *legal personhood* of the corporation reflects this willingness to allow a group organizational identity while embedding it within a basically individualist system. Some resolve this paradox by referring to the simultaneous need for mutual support with strong individualism on the U.S. frontier.

Lincoln firmly opposed expanding slavery into the West. His election triggered secession by South Carolina and ten other southern states, a group that formed the Confederate States of America. Lincoln's decision to preserve the Union after the firing on federal forces in Charleston, South Carolina, in April 1861 led to the Civil War. Fortified by its rising industrial strength and increasing immigration from Europe, the North won the war, reunified the nation, and outlawed slavery in 1865.[6]

Growth and Reform on the Road to Global Dominance

At the end of the Civil War, American industry matched British industry in productivity and surpassed it over the next several decades. By the end of the nineteenth century, the United States had the world's largest aggregate economy and was near the top in real per capita income. The last decades of the century saw rapid growth and industrialization, with the expanding railroads unifying the nation and developing the new corporate industrial organizational form.[7] Major technological innovations included the invention of the light bulb by Thomas Edison, who founded what became the General Electric Corporation, and the (contested) invention of the telephone by Alexander Graham Bell, who founded what became AT&T. Along with widespread urbanization, electrification proceeded strongly by the end of the century. These and other inventions depended on the establishment of a strong patent system and the associated rise of market trade in technological assets, which was ultimately more important than any of the inventions individually for the long-term growth and development of the U.S. economy.

Massive immigration occurred in the late nineteenth and early twentieth centuries in a nearly pure laissez-faire economic environment. The few interventions by the federal government were tariff protection for American industries, land grants to the railroads, regulation of railroads by the Interstate Commerce Commission (ICC) after 1887, and the beginning of antitrust policy in 1890 with passage of the Sherman Act. Unions were unprotected and generally weak, and income became highly unequally distributed as a major

6. The economic nature of slavery is probably the single most controversial question in U.S. economic history, with some arguing that it was profitable and others that it was not. Part of this debate is whether or not it was necessary to fight the Civil War to eliminate slavery. Classic references include Eugene D. Genovese, *The Political Economy of Slavery: Studies in the Economy and Society of the Slave South* (New York: Vintage Books, 1967); Robert W. Fogel and Stanley L. Engerman, *Time on the Cross: The Economics of American Negro Slavery* (Boston: Little, Brown, 1974); Gavin Wright, *The Political Economy of the Cotton South: Households, Markets, and Wealth in the Nineteenth Century* (New York: W. W. Norton, 1978).

7. On of the role of railroad expansion in U.S. economic history, see Robert W. Fogel, *Railroads and American Economic Growth* (Baltimore: Johns Hopkins University Press, 1964), and Albert Fishlow, *The American Railroads and the Transformation of the Antebellum Economy* (Cambridge, Mass.: Harvard University Press, 1965). Discussion of the broader system of invention based on the patent system can be found in Naomi R. Lamoureaux and Kenneth L. Sokoloff, "Inventive Activity and the Market for Technology in the United States, 1840–1920," NBER Working Paper No. 7107, 1999.

merger wave restructured industry at the end of the century.[8] John D. Rockefeller, leader of the Standard Oil monopoly, became the first American billionaire, with Andrew Carnegie and J.P. Morgan also emerging as famous wealthy men of this period. Although growth predominated, the economy suffered depressions during the 1870s and 1890s, the latter triggering the rural populist movement against entrenched wealth. The end of the century also brought the first major attention by Americans to the outside world with the Spanish-American War of 1898, which led to U.S. involvement in many areas. The era from 1865 to 1900 was known as the *Gilded Age*.

The beginning of the twentieth century saw a backlash against these laissez-faire trends during the *Progressive Era* reforms under President Theodore Roosevelt (1901–1909), continued by president Woodrow Wilson (1913–1921). Roosevelt was known as the *Trust Buster,* as he used the Sherman Act to break up various trusts and monopolies. Roosevelt also expanded the national park system and conservation efforts, and signed laws to regulate food safety. Under President Wilson in 1913, the federal income tax was permanently allowed, the Federal Reserve System was established, tariffs were reformed, and in 1920 women won the right to vote. This era saw the highest rates of immigration to the United States until the 1990s, and participation in World War I resulted in efforts to plan the U.S. economy. The flow of immigration slowed sharply after restrictive legislation was passed in 1924.

The rapid economic growth of the Roaring Twenties moved back toward laissez-faire policies. In the 1920s the American economy and society were transformed by the automobile. By the end of the decade a majority of American families owned a car, made easier by the spread of inexpensive mass-produced automobiles such as the Model T Ford. The 1920s also saw radios spread throughout society, unifying America through mass communication. The 1920s ended with the stock market crash of October 1929, which was followed by the Great Depression that dominated the 1930s.

The American economy declined about 30 percent by 1933, when the unemployment rate crested at over 25 percent as Franklin D. Roosevelt assumed the presidency. Debate over the causes of the Great Depression continues today, with leading explanations including overly restrictive monetary policy in the wake of the stock market crash; a decline in consumption expenditures in the late 1920s; a collapse of business investment due to a collapse of business confidence after the stock market crash; a collapse of the banking sector after the stock market crash as real debts mounted with deflation; an international trade war that erupted after passage of the Smoot-Hawley tariff by the United States in 1930; and the effects of hapless global efforts to maintain the gold standard that culminated in a total

8. See Naomi R. Lamoureaux, *The Great Merger Movement in American Business: 1895–1904* (New York: Cambridge University Press, 1986).

collapse of the international financial system in 1931.[9] By late 1931, what had been a bad recession became the Great Depression. These explanations are not mutually exclusive. Despite gradual growth after 1933, the U.S. economy fully emerged from the Great Depression only with World War II in the early 1940s.

The Great Depression altered the American political landscape. President Roosevelt initiated the **New Deal,** an enormous increase in the federal government's role in the U.S. economy. The federal government's share of GDP jumped from just under 1 percent in 1930 to nearly 8 percent by the late 1930s and shot up to over 41 percent by the end of World War II in 1945.[10] Expanded federal government economic activities included the creation of the Social Security system, the Securities and Exchange Commission (SEC) to regulate the stock market, the Federal Deposit Insurance Corporation (FDIC) to insure bank deposits, and the creation of agricultural price support and subsidy programs. Also established was the federally owned Tennessee Valley Authority (TVA) that built dams in the Tennessee River Valley to provide electric power and aid industrial and agricultural development.[11] The federal government temporarily hired the unemployed to carry out projects of the Civilian Conservation Corps (CCC) and the Works Progress Administration (WPA). Both of these agencies were disbanded after the Depression ended. The government established the National Labor Relations Board (NLRB) to oversee elections for union representation as an outcome of the Wagner Act, which ushered in a wave of union organizing (see chapter 2).

9. For a detailed description of the stock market crash, see John Kenneth Galbraith, *The Great Crash* (Boston: Houghton Mifflin, 1972). On the role of an overly restrictive monetary policy in the wake of the stock market crash, see Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States: 1867–1960* (Princeton, N.J.: Princeton University Press, 1963), with the argument that too expansionary a monetary policy during the 1920s was the culprit in Murray Rothbard, *America's Great Depression* (Princeton, N.J.: Van Nostrand, 1972). On the role of a sudden decline in consumption expenditures in the late 1920s, see Peter Temin, *Did Monetary Forces Cause the Great Depression?* (New York: W. W. Norton, 1976). For an emphasis on the collapse of capital investment caused by a collapse of business confidence ("animal spirits"), see John Maynard Keynes, *The General Theory of Employment, Interest and Money* (London: Macmillan, 1936). For discussion that the declining stock market triggered a more general debt-deflation financial collapse, see Ben Bernanke, "Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression," *American Economic Review* 73 (1983): 257–276. For a focus on the role of the trade war that erupted, see Charles W. Kindleberger, *The World in Depression,* rev. ed. (Berkeley: University of California Press, 1986), with Kindleberger reporting a decline in aggregate imports by 75 nations from nearly $3 billion in 1929 to just under $1 billion in 1933 (p. 170). For the role of excessive adherence to the international gold standard, see Barry Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression: 1919–1939* (New York: Oxford University Press, 1992).

10. After the war this percentage declined to 15.6 percent in 1950, followed by a fairly steady increase to just over 23 percent in 1983 and then a gradual decline to 18 percent in 2001 (Walton and Rockoff, *History of the American Economy,* p. 595, and *Statistical Abstract of the United States: 2001* [Washington, D.C.: USGPO, 2002], Table 457).

11. Besides the TVA, the federal government owns only a few businesses, with the U.S. Government Printing Office being a rare example. The federal government is the residual owner of land west of the original 13 colonies; its share is 82 percent in Nevada, containing national parks and national forests, a source of unhappiness to some groups. State and local governments own more businesses, such as water supply utilities at the local level.

World War II saw a greater, albeit temporary, expansion of the federal government as the economy became a temporary command economy with full-blown wage and price controls. Output expanded rapidly, and with the United States suffering little damage while many other nations were not so fortunate, the United States ended the war producing half of the world's aggregate output. Overseeing the Bretton Woods international monetary conference in 1944 and funding the recovery-oriented **Marshall Plan** in Western Europe after the war, the United States had not only become the world's dominant economic power, but had become prepared to openly accept this position and to lead the world's economy.[12]

Evolution of the American Economy since World War II

After 1945 U.S. policymakers became caught up in the Cold War with the socialist world led by the Soviet Union. Concerns about Soviet influence underlay continuing relatively high American military spending, implementing the Marshall Plan to economically rebuild Western Europe, including West Germany, and the space race of the 1950s and 1960s.

The 1960s saw renewed increases in the role of government in the economy, with Keynesian fine-tuning of fiscal policies[13] under President John F. Kennedy and especially with the **Great Society** programs of President Lyndon Johnson (1963–1969). Besides his War on Poverty, Johnson established the medicare program, passed major civil rights legislation against racial segregation and voting rights legislation, and increased various social welfare programs for housing and welfare. Restrictions on immigration were relaxed, allowing for the greater diversity of immigrants, who substantially changed the nature of U.S. society in subsequent decades. But Johnson's economic policies ran into problems as inflation accelerated with the Vietnam War, protests against which forced him from office.

12. Part of this global leadership derives from possessing the world's most powerful military establishment. That predominance has increased since the end of the Cold War. When the U.S. Defense Department proposed a $48 billion increase in the U.S. defense budget in 2001, this amount exceeded the annual total defense budget of any nation on earth at the time (France had the second largest such budget at $42 billion).

13. For a critical review of postwar macroeconomic policies from a critical Keynesian perspective, see Lynn Turgeon, *Bastard Keynesianism: The Evolution of Economic Thinking and Policymaking since World War II* (Westport, Conn.: Greenwood Press, 1996). For a new Keynesian perspective on policies in the 1990s, see Jeffrey Frankel and Peter Orszag, eds., *American Economic Policy in the 1990s* (Cambridge, Mass.: MIT Press, 2002). For a new classical perspective see Thomas J. Sargent, *The Conquest of American Inflation* (Princeton, N.J.: Princeton University Press, 1998). Prior to the Fed-Treasury Accord of 1951, fiscal policy tended to dominate monetary policy. A strong shift to a monetarist policy occurred during 1979–1982, even as Ronald Reagan enacted his supply-side tax cuts in 1981. Since then the Federal Reserve has followed an interest rate–oriented monetary policy designed to reduce inflation without increasing unemployment, with a general cutback of efforts to fine tune the economy through fiscal policy, although President George W. Bush enacted tax cuts in 2001 to offset the recession of that year, eliminating the fiscal surpluses that arose after the tax increases of 1990 and 1993. The interest rate–oriented policy the Federal Reserve has recently followed is known as the Taylor Rule. See John B. Taylor, ed., *Monetary Policy Rules* (Chicago: University of Chicago Press, 1999).

Inflation in the 1960s was exacerbated by Johnson's rapid expansion of government spending on both the Great Society programs and the Vietnam War, without any increase in taxes to pay for them.

The 1970s was a period of economic turmoil, marked by oil price shocks and stagflation (a combination of stagnation and inflation), after the Bretton Woods system of fixed exchange rates was abandoned (along with the remnants of the international gold standard) in the early 1970s. Presidents Richard Nixon, Gerald Ford, and Jimmy Carter attempted to deal with these macroeconomic upheavals by a variety of ad hoc policies such as wage and price controls, and exhortations to restrain inflation that generally failed. The accelerating inflation finally brought on a strict monetarist anti-inflation policy by the Federal Reserve under Chairman Paul Volcker starting in 1979.

A decisive move to scale back Great Society programs and to deregulate the U.S. economy came with the presidency of Ronald Reagan (1981–1989) and his *supply-side* policies known as **Reaganomics.** This trend has continued, even through the presidency of Democrat Bill Clinton (1993–2001), during whose tenure the welfare system was reformed to end permanent welfare.

Rapid economic growth in the 1960s and early 1970s dramatically slowed after the first world oil price shock in 1973. The performance of the U.S. economy would not recover substantially until the high-technology boom of the late 1990s, which has run into some problems in the twenty-first century since the collapse of the bubble in high-tech stocks in early 2000. This renewal of growth also came after inflation was brought under control, which had begun to grow in the mid-1960s, jumped sharply after 1973, and peaked after the second oil price shock in 1979, gradually decelerating afterward, especially in response to the stricter Fed policy.

A trend that began during World War II toward greater income equality in the United States ceased by 1973. Since then, there has been an increasing trend toward greater inequality, despite some improvements in the relative positions of minority groups such as African Americans. This trend accelerated in the early 1980s and slowed somewhat in the late 1990s but continues today.

Although the U.S. share of global output is half that of its peak in 1945 (which was then half of world output), the United States continues to dominate the world economy, having grown throughout the second half of the twentieth century despite occasional recessions and more rapid growth in some other countries. The Soviet Union, America's greatest postwar ideological and military rival, ceased to exist in 1991, and Japan, its greatest economic rival, went into severe economic stagnation after 1990. Along with America's surging high-tech sector in the late 1990s, a sign of the continuing U.S. global economic dominance is that in 2001 the world's five largest corporations in terms of revenues were all U.S. based: Wal-Mart, Exxon-Mobil, General Motors, Ford, and Enron. However, Enron collapsed in

2002 in a spate of financial scandals. This event, together with the collapse of other prominent U.S. corporations as a result of accounting scandals, has resulted in calls for renewed regulatory oversight by such federal agencies as the SEC.

THE AMERICAN CORPORATION: PROSPECTS AND POLICIES

Nature of the American Corporate Form

Among America's most important contributions to the world economy has been its development of the organizational form of the modern corporation. Many observers speak of an **Anglo-American corporate form** that differs markedly from those found in Japan, Germany, and other nations. It is marked by distinct internal hierarchies and divisions, led by strong (and highly paid) chief executive officers (CEOs), with relatively little control by banks, other firms, workers, or government. Ownership is by stockholders, with a tendency in recent years to make CEOs and other top managers part owners by giving them stock options as part of their compensation. This movement supposedly reduces the principal-agent problem arising from the separation of ownership and control in large, mature joint-stock corporations, first identified by Adolph Berle and Gardiner Means in 1933. Managers tended to compensate themselves at the expense of the share price of the corporation's stock, and thus at the expense of the stockholder owners' interests, a classic example of the principal-agent problem.[14]

The crucial formative moment legally came in 1819 with a ruling by the U.S. Supreme Court in *Dartmouth College v. Woodward,* in which Chief Justice John Marshall clearly stated the doctrine of the juridical identity of the corporation as effectively a legal person distinct from its owners. Corporations had previously existed in Britain, the Netherlands, and other countries. But they had always existed solely at the discretion of governments and usually at the discretion of monarchs. It was this ultimate power that the State of New Hampshire attempted to assert, noting that it had granted a charter for Dartmouth College to exist on royal authority during the colonial period. This legal decision was the fundamental institutional innovation that paved the way for the emergence of the limited liability corporation, whose finances were legally distinct from those of the owners of the

14. See Adolph A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1933). Although supposedly CEOs are no longer working against the interests of owners, CEO compensation has dramatically surged, with median annual compensation rising from $2 million per year in 1992 to $5 million per year in 1998 (*OECD Economic Survey: United States,* November 2001 [Paris: Organization for Economic Cooperation and Development], p. 101). This escalation of CEO compensation, along with, escalating incomes for "stars" throughout the economy, is seen by some as manifestations of the United States becoming a winner-take-all society, a trend aggravating income inequality. See Robert H. Frank and Phillip J. Cook, *The Winner-Take-All Society* (New York: Free Press, 1995).

corporation, in contrast to firm partnerships and single proprietorships. This principle has now spread not only across the United States but throughout much of the world.

Starting with the rise of the railroads in the United States in the 1840s, these juridically innovative entities began to integrate forward into manufacturing and to evolve their peculiar hierarchies, notably the **U-form** identified by Alfred Chandler.[15] This form involved the first formal appearance of full-time salaried managers in a decentralized line and staff hierarchy. The basis of this hierarchy was the natural unit of a railroad of about 50 miles in length that would be operationally overseen by a single manager. Above this level would be higher-level managers dealing with support activities, with responsibility and authority ultimately residing in the CEO, who would handle the most important and long-range strategic and investment decisions. This U-form would lead to economies of scale in manufacturing industries by implementing forward integration into wholesale distribution activities as distribution costs fell with railroad expansion.

During the 1920s, Alfred P. Sloan and Pierre S. Du Pont created the multidivisional **M-form** structure in the General Motors Corporation, with each division being essentially a distinct U-form subentity within the larger corporation. Top management now compares profits across divisions, which effectively compete with each other within the framework of the corporation. The **New Institutionalist Economics** ideas of Ronald Coase and Oliver Williamson have emphasized that the way firms decide which activities to carry out themselves and which to outsource to other firms depends upon minimizing transactions costs.[16] As the M-form corporate form led to the emergence of industrial conglomerates in the 1960s, it was discovered that sometimes the transactions costs of managing disparate enterprises grew too great, and conglomerates have recently shed many divisions to focus on *core competencies*. One sign that economies of scale are exaggerated in many mergers is that usually the announcement of a forthcoming merger leads to a decline in the value of the stock of the acquiring company.

Despite these complications, and much turnover in the corporations considered to be on top, American-based M-form multinational corporations now dominate the world economy,

15. The concepts *U-form* and *M-form* were originally proposed by Alfred D. Chandler, Jr., *Strategy and Structure: Chapters in the History of Industrial Enterprise* (Cambridge, Mass.: MIT Press, 1962). See also Oliver E. Williamson, "The Modern Corporation: Origins, Evolution, and Attributes," *Journal of Economic Literature,* 19 (1985): 1537–1568. Regarding specifically the railroads, see Alfred D. Chandler, Jr., *The Visible Hand: The Managerial Revolution in American Business* (Cambridge, Mass.: Belknap Press of Harvard University, 1977). A contrast with the American form, labeled by some the *H-mode,* is the J-mode of Japanese management, discussed in the next chapter and in Masahiko Aoki, "Toward an Economic Model of the Japanese Firm," *Journal of Economic Literature,* 28 (1990): 1–27, which is supposedly more consensus oriented and less hierarchical than the Anglo-American H-mode. Managements in both the United States and Japan have adopted some of each other's practices in recent years.

16. Ronald H. Coase, "The Nature of the Firm," *Economica* 4 (1937): 386–405; Oliver E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications: A Study in the Economics of Internal Organization* (New York: Free Press, 1975).

engendering much resentment and criticism of their vast power[17] even as they spread modern technology around the world through their capital investments. As a sign of how vast and growing their reach is, in 1998 their revenues exceeded $2 trillion, with more than $500 billion of that amount coming from their foreign subsidiaries, with both of these numbers steadily growing.[18]

Two other aspects of the M-form that emerged in the 1920s must also be noted. One was the development of corporate financing of automobile purchases by the General Motors Corporation. This was an innovation that underlay the later emergence of the mass consumption society and mounting consumer debt as many other companies followed suit.

The other development was the establishment of permanent corporate research and development divisions within the larger corporations, the pioneer being the Du Pont Company with its Chemical Department. This organizational development further extended the foundation for technological change and economic growth that had arisen from the earlier establishment of the patent system.

Regulation and Deregulation of American Corporations

The rise of the great American corporations spawned a broad movement to restrain their power and perceived excesses. This began in 1887 with the establishment of the ICC to regulate rates charged by railroads. Antitrust regulation began after passage of the Sherman Act of 1890, as discussed in chapter 2. Antitrust enforcement has oscillated over time as the degree of monopoly power in the U.S. economy has waxed and waned. The Federal Reserve System regulated the banking system after 1913. During the 1930s the Civil Aeronautics Board (CAB) was established to regulate airfares and airline routes, and the Federal Communications Commission (FCC) was established to regulate allocation and use of the radio spectrum. During this period, monopolies were allowed in certain industries that were then be subject to rate regulation. AT&T was the allowed monopoly in the telephone industry, regulated at the federal level, and the electric utility industry was allowed to have local monopolies whose rates were regulated by state governments.

Following the establishment of the Federal Aviation Agency (FAA) in 1958, different sorts of regulation policies appeared during the 1960s, 1970s, and later that were more

17. Radical leftist critiques of corporate power in the United States include Paul A. Baran and Paul M. Sweezy, *Monopoly Capital* (New York: Monthly Review Press, 1966); G. William Domhoff, *Who Rules America Now?* (New York: Touchstone, 1986); Richard C. Edwards, Michael Reich, and Thomas E. Weisskopf, *The Capitalist System: A Radical Analysis of American Society,* 3rd ed. (Englewood Cliffs, N.J.: Prentice-Hall, 1986). Strongly opposing such views are neo-Austrian economists who see the vast size of these corporations as reflecting their entrepreneurial success in providing consumers with what they want, for example, Israel M. Kirzner, *Discovery, Capitalism, and Distributive Justice* (Oxford: Basil Blackwell, 1989) and “Entrepreneurial Discovery and the Competitive Market Process: An Austrian Approach,” *Journal of Economic Literature* 35 (1997): 60–85.

18. *Statistical Abstract of the United States: 2001* (Table 763).

focused on safety and environmental concerns. These included expanded powers for monitoring food and drug safety in 1962, civil rights laws in employment in 1964, laws to protect water and air quality between 1965 and 1972, with the Environmental Protection Agency (EPA) established in 1970, increased regulation of traffic safety in 1966 and of agricultural safety in 1967, establishment in 1970 of the Occupational Safety and Health Administration (OSHA),[19] increased regulation of consumer product safety in 1972, and laws to protect the disabled in 1990.

This wave of regulation triggered great controversy and debates about its cost, with some economists estimating consumer compliance costs in recent years as high as $700 billion per year.[20] As the 1970s proceeded, movements to reduce regulation arose, the first such effort appearing during the Carter administration (1977–1981) to deregulate airline fares and routes. This culminated with the elimination of the CAB in 1983 during the Reagan presidency, although the FAA continues to operate. President Reagan particularly encouraged such efforts after 1981, and the trend to deregulate the setting of prices and allocation of quantities has proceeded to the present day. The ICC was eliminated in 1996, in the early 1990s the FCC moved to auctioning of spectrum rights, and the EPA moved to the use of marketable pollution emission permits, notably for sulfur dioxide. These moves were inspired by Coase's argument that externalities can be resolved by defining property rights and establishing markets. The breakup of AT&T in 1982 following an antitrust suit eliminated its monopoly in the long-distance telephone industry, which then became deregulated.

A controversial policy has been the deregulation of the electricity supply industry, a state-by-state process, with the creation of a national market in electricity being the ultimate goal. This process is not complete and has become very controversial, with a badly managed effort in California that resulted in rolling blackouts and extreme price peaks during 2001.[21] Reports in 2002 that the Enron Corporation may have brought on blackouts and price peaks through market manipulation has raised serious questions about the entire

19. OSHA has been a special lightning rod for critics, with its book of regulations extending to 28,000 pages in 1980.

20. Gerald P. O'Driscoll, Jr., Kim R. Holmes, and Mary Anastasia O'Grady, 2002 *Index of Economic Freedom* (Washington, D.C., and New York: Heritage Foundation and the *Wall Street Journal*, 2002, p. 405), which also notes the power of states to impose costly regulations. Despite this, it rates only three countries in the world as more deregulated than the United States—the Bahamas, Hong Kong, and Singapore—although several others are rated at the same level as the United States.

21. According to *OECD Economic Surveys: United States 2001* (Paris: Organization for Economic Cooperation and Development, 2001), pp. 147–148, the average price per megawatt-hour in California was 11 times higher in December 2000 than in December 1999, with further price increases occurring in early 2001 before settling down somewhat. For more details, see Severin Borenstein, "The Trouble with Electricity Markets: Understanding California's Restructuring Disaster," *Journal of Economic Perspectives* 16(1) (2002): 191–211.

electricity deregulation effort. Clearly the details of such deregulatory efforts are very important in determining how effectively such schemes work.

Thus there have been major efforts to reduce or eliminate regulation of pricing and allocation in the U.S. economy, the old kind of regulation that first appeared in the 1800s. But there have been fewer efforts to reduce the newer kinds of regulation directed at health, safety, and environmental quality. The periodic efforts to attack these regulations invariably prove to be politically controversial. Generally cost-benefit analysis is used by those wishing to reduce such regulations, while those opposed question the relevance of efficiency arguments for issues of safety and social equity.

PROSPECTS AND PROBLEMS OF THE AMERICAN ECONOMY

The Problem of Poverty and Inequality

While the United States has achieved high incomes and a good quality of life for most of its citizens, an undeniable problem is the relatively large number of persons who do not share in this bounty. The United States has noticeably higher rates of income inequality and poverty than do other nations at its general level of development. This can be easily seen by looking at the quintile ratios in table 1-1, where that of the U.S. (9.0) is above that of any other high-income country shown in the table except for the even more market capitalist New Zealand. To make this point clearer, the *Human Development Report 2002* of the UN (table 13) provides recent quintile ratios for 36 nations in the "High Human Development" category. Of these, only two nations have higher quintile ratios than the United States: Chile and Costa Rica, both in traditionally unequal Latin America, with its substantially lower per capita income levels than the United States.

Measures of poverty also show the United States to have higher levels than other high-income nations. An especially difficult problem is poverty among children, where the United States stands out. Figure 5-1 shows relative poverty rates for a set of high-income countries during the mid-1980s to mid-1990s, the measure being the percentage of children in families with incomes less than half of the median income. The United States is in front at 24.9 percent, with the second-place United Kingdom at 18.5 percent and Finland and Sweden with the lowest rates—2.7 and 3.0 percent, respectively. This finding is less dramatic if one considers absolute measures of poverty for the population as a whole, with the UN *Human Development Report 2002* (table 4) showing both Australia and the United Kingdom as having higher rates than the United States at 17.6 and 15.7 percent, respectively, compared to 13.6 percent for the United States, for the percentage of people receiving less than $11 per day in real terms in 1994–1995. However, the U.S. percentage remains above the rest of the High Human Development group for which figures are

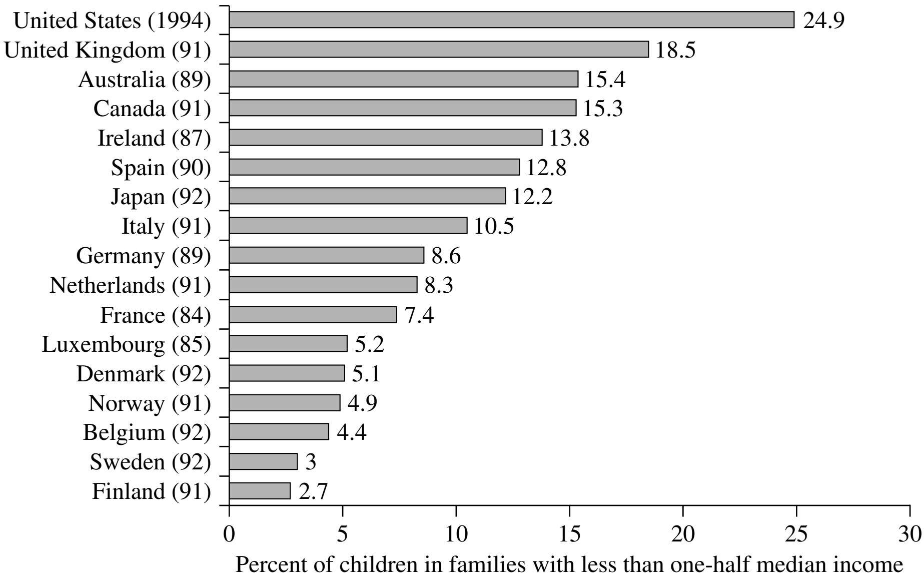

Figure 5-1
Relative poverty rates for children, mid-1980s to mid-1990s. Income is after taxes and includes near-cash transfers such as food stamps and housing assistance.

reported, with Norway the lowest at 4.3 percent, and the United States ranks lowest in this group for the overall HDI, which also takes into account life expectancy, literacy, and long-term unemployment measures.

In light of these facts, two further issues appear. One is the nature of the time trend of this inequality; the other is its distribution across different groups within American society. Both of these issues apply to the measures of income inequality and to the poverty rate. With regard to the overall time trend of inequality, it would appear that there was a gradual trend toward greater equality from the late 1920s, which increased dramatically during World War II, with its increase in the labor force participation of women and minorities, and continued until the mid-1970s. After this time the trend reversed and inequality has since tended to increase,[22] although it would appear that income is still more equally distributed

22. The distribution of wealth is more unequal than that of income, with the wealthiest 0.05 percent of the population owning about one-quarter of the wealth. Fewer data are available on this issue, but a recent study suggests an even greater increase in wealth inequality in the United States between 1992 and 2000 than has occurred for income (Dean M. Maki and Michael G. Palumbo, "Disentangling the Wealth Effect: A Cohort Analysis of Household Savings in the 1990s," Finance and Discussion Paper 2001–21, Board of Governors of the Federal Reserve System, Washington, D.C., 2001).

Table 5-1
U.S. Income Distribution over Time

Year	Bottom Fifth (%)	Top Fifth (%)
1970	5.4	40.9
1975	5.6	40.7
1980	5.3	41.1
1985	4.8	43.1
1990	4.6	44.6
1995	4.4	46.5
1999	4.3	47.2

Sources: For 1970 and 1975, *Statistical Abstract of the United States 1997,* table 725; for 1980–1999, *Statistical Abstract of the United States 2001,* table 670. (Washington, D.C.: USGPO, 1997.)

Table 5-2
U.S. Poverty Rates Overall and by Race/Ethnicity (in Percent)

Year	All Races	White	Black	Hispanic
1960	22.2	17.8	n.a.	n.a.
1970	12.6	9.9	33.5	n.a.
1978	11.4	8.7	30.6	21.6
1983	15.2	12.1	35.7	28.0
1989	12.8	10.0	30.7	26.2
1993	15.1	12.2	33.1	30.6
1995	13.8	11.2	29.3	30.3
1997	13.3	11.0	26.5	27.1
1999	11.8	9.8	23.6	22.8

Source: Statistical Abstract of the United States 2001, table 679. (Washington, D.C.: USGPO, 1997.)

than in 1929, and there is some evidence that the trend toward greater inequality may have slowed down or even stopped very recently. Table 5-1 shows the shares of national income going to the bottom fifth and the top fifth of the population for selected years from 1970 to 1999. For the top fifth the percentage in 1929 was 54 percent,[23] while for the period shown here it was lowest in 1975 at 40.7 percent and highest in 1999 at 47.2 percent.

Table 5-2 presents data on poverty rates, both overall and by racial/ethnic group, within the United States[24] from 1960 to 1999. Here a more complicated pattern emerges, both

23. Department of Commerce, *Historical Statistics of the United States,* Series G (Washington, D.C.: USGPO).

24. The poverty rates shown here reflect officially measured poverty rates, defined as money income being less than three times the estimated cost of a minimum food budget. This overstates poverty because it does not include in-kind transfers such as food stamps and Medicaid, which have increased substantially since the 1960s. On the other hand, food is not the only necessity. The price of housing has risen substantially relative to the price of food since the 1960s, with homelessness among the poor increasing during the 1980s. Thus, it is hard to find completely reliable data on levels of absolute poverty.

overall and for the groups, but with a more optimistic outcome than indicated by some of the data presented above. Overall there was a noticeable decline during the 1960s and into the 1970s, reaching an overall low of 11.4 percent in 1978. Then the rate moved up sharply during the succeeding recession, peaking at 15.2 percent in 1983. It declined gradually to 12.8 percent in 1989, but then during another recession rose again to 15.1 percent in 1993. It has steadily declined since reaching 11.8 percent in 1999, near its all-time low.

With respect to the racial pattern, it is not surprising to find that whites have consistently had substantially lower poverty rates than blacks or Hispanics. Although the overall time patterns for these groups have generally tracked the pattern for the overall rate, the optimistic part is that both minority groups saw substantially larger declines from 1993 to 1999. Blacks reached a new all-time low poverty rate in 1999 of 23.6 percent, and Hispanics did even better at 22.8 percent.

The improvement in the situation of African Americans is especially encouraging given the legacy of slavery and discrimination that has been arguably the worst blight on American history. There is evidence that some of this improvement reflects improved educational skills but that some also reflects genuine reductions in prejudice and in job discrimination, although the United States still has a long way to go to truly heal this old wound.[25] But with increasing diversity associated with greater immigration from many parts of the globe, the old black-white split is becoming less important in the highly mobile American economy.

The role of government in these trends is controversial. On the one hand, transfer payments have definitely been rising over time, despite the 1996 welfare reforms that seek to limit the time single mothers can receive welfare. While the biggest increases have been for social security for the elderly,[26] transfer payments to low-income groups have also risen.

25. One area where racial discrimination appears to persist substantially, although illegally, is in housing, as discussed in John Yinger, *Closed Doors, Opportunities Lost: The Continuing Costs of Housing Discrimination* (New York: Russell Sage Foundation, 1995). Housing discrimination subtly interacts with schooling quality and job locations to reinforce poverty among discriminated-against groups, which are generally funneled into poorer neighborhoods. Inequality of funding across school districts has been a fundamental contributor to income inequality in the United States, in contrast to school systems that are more centrally funded and directed, such as France's. The argument that inequalities in income at the state level in the United States are related to inequalities in political power, as measured by limits on who can vote, has been made by Stanley L. Engerman and Kenneth L. Sokoloff, "The Evolution of Suffrage Institutions in the New World," NBER Working Paper No. 8512, 2001.

26. The future viability of Social Security in the United States has been a hotly discussed issue, with many studies making various pessimistic projections and calling for various changes, such as the *Economic Report of the President 2002* (Washington, D.C.: USGPO, 2002). But the ratio of the elderly population to the working-age population in 2030 in the United States is likely to be similar to the ratio in Germany today, where pensions are substantially higher than in the United States and the government is not broke. Nations like Japan, with declining populations and longer life expectancies than the United States, are facing much more serious social security crises. However, the financial problems of medicare for the elderly in the United States are more serious, as discussed in Jeffrey Frankel and Peter Orszag, eds., *American Economic Policy in the 1990s* (Cambridge, Mass.: MIT Press, 2002).

Yet over the past several decades, the progressivity of the tax system has been reduced, despite a small reversal of this trend during the Clinton presidency. How these offsetting trends have played out is unclear, although the net effect of government activities has certainly been to make the distribution of income more equal than it would have been otherwise. But it is also clear that the United States tends to do much less redistribution than almost all of the European countries. Japan and some other East Asian countries more closely resemble the United States in this regard, but these nations tend to have much greater wage equality and thus end up with greater income equality than does the United States.

The Rise of the New Economy

Much of the decline in poverty rates for minority groups during the second half of the 1990s reflected a steady decline of the unemployment rate in an environment of stable and low inflation. The decline in unemployment, in turn, reflected an increase in employment that spread through lower-income and minority groups and that made it much easier to sharply reduce the number of people on welfare, as called for by the 1996 welfare reform. But this decline in poverty also reflected an acceleration in the economic growth rate in the United States above and beyond that caused by increasing employment, apparently as a result of an increase in the rate of productivity. Many observers identify the rise of the New Economy as being responsible for this, reflecting the accumulated impact of computerization and the spread of such new technologies as the internet.

While it is clear that the American economy grew at a more rapid rate during the late 1990s than since the 1960s, it has proven very difficult to identify the factors involved. The effort to study the sources of the New Economy has led to changes in the way such studies are done and in the revision of related databases. Suffice it to say that there are broad controversies and disagreements about exactly what has gone on and what the prospects are for it to continue. Table 5-3 summarizes a relatively optimistic set of findings from the *Economic Report of the President 2002,* which argues that the greater rate of productivity improvement is likely to continue and that indeed the New Economy is still here.

This table attempts to separate out various elements of the undisputed increase in **total factor productivity** (TFP) growth that occurred after 1995. It attributes about one quarter of this growth to improvements within the computer industry itself, although some other studies have found its share of this productivity increase to be substantially higher. This leaves about a 1 percent per year extra growth in TFP that was apparently occurring throughout the economy. This presumably reflects the general effect of the various new technologies, although the 2002 *Report* attributes part of this to increased competition and reorganization of the economy, a partial result of the deregulation trend discussed

Table 5-3
Accounting for U.S. Productivity Acceleration since 1995

Item	1973 to 1995	1995 to 2001	Change (%)
Labor productivity growth rate	1.39	2.6	1.21
Less: Business cycle effect	0.02	−0.46	−0.48
Equals: Structural labor productivity	1.37	3.07	1.7
Less: Capital services	0.72	1.29	0.57
Information capital services	0.41	1.01	0.6
Other capital services	0.31	0.28	−0.03
Labor quality	0.27	0.31	0.04
Equals: Structural TFP	0.37	1.44	1.07
Less: Computer sector TFP	0.18	0.35	0.16
Equals: Structural TFP excluding computer sector TFP	0.19	1.09	0.9

Source: Economic Report of the President 2002, Table 1-3 (Washington, USGPO, 2002). Data are for the private nonfarm business sector and are annual average rates.

previously. In fact, there is no further breakdown in this study of exactly what lies behind the more general phenomenon, although the *Report* argues that accounting for cyclical factors suggests that it should continue.

If this proves to be true, it augurs well for the future of the U.S. economy. But several conflicting elements enter the picture. Among the most important are the difficulties in the financial markets, especially the stock market, that have arisen partly because of an overreaction to these productivity improvements. The stock market responded to these improvements by sharply bidding up the values of stocks during the late 1990s, especially high-technology stocks. Even prior to the sharp decline in the values of these stocks in 2000, observers ranging from Federal Reserve Chairman Alan Greenspan to Robert Shiller had pointed to the record high price/earnings ratios in the markets as signaling an unsustainable "irrational exuberance."[27]

The problem for the high-technology sector appears to be twofold. First, there seems to have been considerable overinvestment in certain technologies and infrastructures, such as fiberoptic cables. In the long run, this may prove to be valuable to future economic growth and productivity improvement. But for now, this excess capacity of capital stock constitutes a drag on new investments in this sector.

Second, the prospects for financing further investment through the stock market do not look propitious in the near future. Not only did the high-tech NASDAQ index decline

27. Robert J. Shiller, *Irrational Exuberance* (Princeton, NJ: Princeton University Press, 1999). For a more radical view of U.S. financial markets see Doug Henwood, *Wall Street* (London: Verso, 1997).

67 percent between March 2000 and October 2001, but price/earnings ratios remain high as many companies reduce their earnings statements in light of the pressures to reform accounting procedures arising from the related collapses of the Enron Corporation and the once-mighty Arthur Andersen accounting partnership. It will take some time before these difficulties are worked out and appropriate adjustments are made. Indeed, 2002 was the third year in a row for all the stock market indexes in the United States to decline, the first time such an event has occurred since just prior to World War II.

Nevertheless, especially compared to the rest of the world, the fundamentals for maintaining technological progress and change in the United States look good. Spending on research and development has been steadily rising, and indeed appears to have accelerated somewhat since 1994, with the aggregate rising from about $169 billion in 1994 to about $265 billion in 2000.[28] One might argue that these figures prove nothing and that such spending can be wasted. But the number of patents issued has also continued to rise, and, perhaps more significantly, the number of citations of U.S.-issued patents in the scientific and technical literature has risen even more dramatically, from 19,422 in 1990 to 142,008 in 2000.[29]

Likewise, although this reflects past rather than current activity, the share of Nobel Prizes in the hard sciences awarded to U.S.-based scientists has grown. During the 1991–1999 period, U.S.-based researchers received 39 Nobel Prizes in either physics, chemistry, or physiology/medicine compared with 3 each in Germany and France, 2 in Great Britain, and 7 scattered among other countries.[30] Given the long-standing and increasing predominance of American higher education in the world, this predominance in basic research is unlikely to disappear soon.

However, doubts have arisen regarding the broader U.S. educational system below the university level. Ironically, part of the problem may have arisen from the improved status of women in the U.S. economy. Elementary and secondary school teaching was a traditionally female-dominated occupation during the earlier period of gender discrimination. Today the opening of other opportunities has led many highly intelligent women to seek higher-paying jobs in other sectors. This problem is exacerbated by funding problems for

28. *Statistical Abstract of the United States: 2001* (Washington, D.C.: USGPO, 2001), Table 767.

29. *Statistical Abstract of the United States: 2001,* Table 777.

30. *Statistical Abstract of the United States: 2001,* Table 795. For studies examining trends in the U.S. educational system, see Claudia Goldin, "The Human Capital Century and American Leadership: Virtues of the Past," *Journal of Economic History* 61 (2001): 263–292; Peter Temin, "Teacher Quality and the Future of America," *Eastern Economic Journal* 28 (2002): 285–300. The relative improvement in the economic status of women is documented in Claudia Goldin, *Understanding the Gender Gap: An Economic History of American Women* (New York: Oxford University Press, 1990); Francine D. Blau, "Trends in the Well-Being of American Women," *Journal of Economic Literature* 36 (1998): 112–165. However, there continues to be a substantial economic gender gap in the United States that is larger than that in some other countries, such as Sweden.

education, although the increasing divergence between the quality of education at the higher and lower levels in the United States is difficult to explain.

These funding problems for education are also appearing in many other high-income industrialized nations, partly driven by the labor-intensive nature of education. One notable difference between the United States and many of these other countries is the greater degree of centralized control in the latter countries. Among the countries belonging to the Organization for Economic Cooperation and Development (OECD) the mean percentage of central government funding is 53 percent, compared to only 7 percent in the United States, with only Belgium, Germany, and Switzerland having lower percentages than the United States in that group.[31] Such centralized control tends to reduce the inequalities in funding that exist between richer and poorer areas, an especially serious problem in the United States. President George W. Bush has increased federal funding and control in U.S. education, but its system remains far more decentralized than those of most other high-income countries.

Given the strong institutional foundation and traditions of entrepreneurship in the United States, it is likely that the ability to effectively transfer basic research to practical economic uses will remain high, especially compared to other nations. Whether or not the New Economy continues to fulfill the promise that it had in the late 1990s, it remains highly likely that the United States will remain the technological leader of the world economy for some time to come.

The Mass Consumption Society and Its Sustainability

One ultimate result of all this past economic growth and success in the U.S. economy has been its ability to generate high levels of consumption. Table 5-4 shows real per capita consumption levels and rates of certain goods, along with certain other quality-of-life measures for the group of nations with the highest real per capita consumption levels for 2000 (1999 for several individual consumer goods). The United States is not only well in front of second-place Luxembourg in real per capita consumption, it also is tops in per capita ownership of passenger cars and television sets and in the rate of internet subscribers. On the other hand, while the United States ranks in the mid-range in doctors per capita, it embarrassingly ranks last in the rate of infant mortality, probably reflecting its higher income inequality and lack of national health insurance.

Although generally an impressive achievement, a number of questions arise about both the significance and the sustainability of the United States's high level of per capita consumption. Substantial evidence suggests that Americans are working longer hours to

31. *OECD Economic Surveys: United States 2002* (Paris: Organization for Economic Cooperation and Development, 2002), p. 140, Table 27.

Table 5-4
Indicators of Living Standards for High-Consumption Countries

Country	Private Consumption (per Capita in PPP $)	Passenger Cars (per 1,000 Persons)	Internet Subscribers (per 100 Persons)	Television Sets (per 1,000 Persons)	Doctors (per 1,000 Persons)	Infant Mortality (per 1,000 Live Births)
United States	24,429	767	18.2	817	2.7	7.2
Luxembourg	17,877	586	4.9	385	3.1	4.7
Switzerland	17,513	485	12.6	467	3.4	4.6
Iceland	16,720	547	17.7	362	3.3	2.4
Australia	15,829	510	12.7	548	2.5	5.7
United Kingdom	15,382	385	12.4	517	4.3	2.6
Canada	15,254	490	20.2	717	2.1	5.3
Austria	14,910	496	6.0	331	3.0	4.4
Germany	14,620	516	11.0	415	3.5	4.5
Japan	14,225	404	8.4	686	1.9	3.4

Source: OECD Economic Surveys: United States 2002, Basic Statistics: International Comparisons. The per capita consumption figures are in 2000 purchasing power parity (PPP) U.S. dollars. Figures are for 1999 except for TV sets, which are for 1998; private consumption per capita, which are for 2000; and a few scattered other figures for various years.

achieve this level, are saving less to do so, and are enjoying their high consumption less.[32] Part of the problem appears to be a never-ending pursuit of more and more expensive luxury goods, with people feeling unhappy if they are unable to "keep up with the Joneses." Robert Frank labels this phenomenon **luxury fever** and sees it combining with the trend toward increased inequality, aggravated by the trend toward "winner-take-allism," as generating the observed higher rates of work, lower savings, and lessened happiness.[33]

The sustainability of this level of per capita consumption, or at least of its continued rise, is questionable. There are debates about whether or not the savings rate has really fallen, with some arguing that making proper adjustments for increased wealth from the late 1990s stock market boom means that savings have not fallen. But the stock market boom has come to an end. Furthermore, both the personal debt/income ratio and the rate of personal bankruptcies have been steadily rising since 1980, with both having gone up about 50 percent by 2000.[34] Yet consumer spending sustained the U.S. economy during 2001–2002 and arguably has been a major force in the global economy as well.

32. On working harder and saving less, see Juliet B. Schor, *The Overspent American* (New York: Basic Books, 1998). Regarding the failure of higher incomes to increase happiness, see Richard A. Easterlin, "Will Raising the Incomes of All Increase the Happiness of All?" *Journal of Economic Behavior and Organization* 27 (1995): 35–47.

33. For further discussion, see Robert H. Frank, *Luxury Fever: The New Middle Class Luxury Boom* (New York: Free Press, 1998).

34. *OECD Economic Surveys: United States 2001,* Figure 43, p. 168.

Table 5-5
Net Foreign Debt of High-Debt Countries

Country	1990 Net Foreign Debt (in Billions of U.S. Dollars)	1999 Net Foreign Debt (in Billions of U.S. Dollars)	1990 GNP (in Billions of U.S. Dollars)	1999 GNP (in Billions of U.S. Dollars)	Ratio of Net Foreign Debt to GNP 1990 (%)	Ratio of Net Foreign Debt to GNP 1999 (%)
Argentina	62.2	147.9	104	276	59.8	53.6
Brazil	119.9	244.7	394	730	30.4	33.5
Indonesia	69.9	150.1	111	125	63.0	120.8
Mexico	104.4	167.0	236	429	44.2	38.9
South Korea	35.0	129.8	247	849	14.2	15.0
Turkey	49.4	101.8	128	186	38.6	54.7
United States	452.3	2,187.4	6,318.9	9,873	7.2	22.2

Sources: Statistical Abstract of the United States 2001, table 1389 for Net Foreign Debt and table 1339 for GNP, except for the United States, for which the years are 1992 and 2000, and for which data are from *Economic Report of the President 2002,* table B-1 for GDP and table B-107 for Net Foreign Debt.

Furthermore, this low savings rate and high consumption rate relate to other countries. One macroeconomic result has been chronic annual trade and current account deficits numbering hundreds of billions of dollars that have persisted since the 1980s. Thus the United States has been borrowing heavily from abroad in order to sustain these high levels of consumption and the imports associated with them. The world's largest net creditor as late as the early 1980s, the United States became its largest net debtor by the mid-1990s. America's net foreign debt is now rapidly approaching $3 trillion and is about ten times greater than that of its nearest competitor, Brazil.

Given that it has the world's largest economy, the United States can sustain a much higher foreign debt than smaller and poorer economies. Indeed, to some extent this debt can be viewed as a sign of confidence that the rest of the world is willing to invest in the United States and lend it money. It also is a sign of the strength of the U.S. economy in that its trade deficit partly reflects the weakness of other economies that are unable to afford to import as many goods from the United States as the United States is able to import from them.

In summary, one argument is that the current levels of U.S. foreign indebtedness are not all that high viewed as a percentage of GDP when compared with many other countries. But an alternative view is that this ratio is rising rapidly. Table 5-5 shows the total foreign debt levels for the largest debtor nations and their respective ratios of debt to GDP, for 1992 and 2000 for the United States and for 1990 and 1999 for the other countries.[35]

35. The discrepancy between these two sets of years reflects a curious lacuna. We would have used the same source for the United States as for the other countries, except that the relevant table in the *Statistical Abstract of the United States 2001* does not have data for the United States. No explanation is provided, although data for the United States appear in other surrounding tables dealing with international economic data.

The U.S. ratio in 2000, 22.2 percent, is below that for 1999 of any other high-debt country except South Korea, at 15 percent. But this debt is currently growing at approximately the same rate it did between 1992 and 2000. If this continues, by 2016 this ratio will exceed 50 percent, will be well above those of either Brazil or Mexico, and will be in the same range as those of Argentina and Turkey, both of which have recently been experiencing severe financial crises because of their unmanageable levels of foreign indebtedness. This current pattern of foreign borrowing and import spending is not sustainable. Something will have to give, with a declining value of the dollar internationally being a likely result, even if the total factor productivity growth of the late 1990s continues in the United States.

The contradiction and problem for the world economy as a whole is that many nations depend substantially on exporting to the United States to maintain their own economic growth. Any substantial slowdown in such imports by the United States would have serious implications for much of the world economy. This may be another reason why the rest of the world continues to lend to the United States to sustain its import levels.

SUMMARY AND CONCLUSIONS

The United States is the leading world economy in aggregate and technological terms as well as the premier model of a market capitalist economy. Indeed, much of the international controversy over globalization involves widespread perceptions that the movement is really about pressuring other countries to imitate the U.S. model. Although many in the United States oppose its membership in various global organizations such as the IMF and the World Bank, for most other countries the location of the headquarters of these organizations in Washington, D.C., indicates that these entities are the enforcers of homogenizing policies based on the American model. But despite (or perhaps because of) its position of global economic leadership, mounting pressures in the United States for protectionism and unilateralism threaten the global economic system that has been in place since the end of World War II.

At once a new society and the oldest continuously existing constitutional republic in the world, the United States may have the world's most dynamic and flexible society and economy. Regularly altered by wave after wave of immigration from an increasingly diverse array of nations, with its established institutions of contract and property and evolving corporate forms, patterns of standardization and mass production, and a tradition of entrepreneurship, the U.S. economy is constantly renewed and transformed. Its technological leadership is firmly based upon strong basic science and solid research and development within a financial and institutional framework well suited to transforming new discoveries into implementation and application. Its higher educational system is among the world's best, with very high rates of participation, despite concerns about future elementary and secondary educational trends.

Although the United States was almost a purely laissez-faire economy during much of the nineteenth century, the role of the federal government increased in various stages, with the biggest increases occurring during the New Deal of the 1930s and the Great Society initiatives of the 1960s. Since then the U.S. economy has experienced deregulation and other moves back toward laissez-faire, although nearly a third of the economy remains directed by some level of government. Thus the United States definitely has a mixed economy despite its strong orientation to market capitalism.

Despite its advantages of solid growth and technological progress, the United States exhibits the darker side of market capitalism. It has higher levels of income and wealth inequality than other high-income countries and a higher poverty rate as well. These problems are exacerbated by its historical peculiarities, especially the legacy of slavery of African Americans and the conquest and suppression of Native American Indians. However, there are signs of some improvement in the relative status of minority groups and also of women in the U.S. economy as they take advantage of its dynamism within an increasingly ethnically diverse and open society.

The U.S. economy is also shadowed by certain longer-term problems. Its increasing level of foreign indebtedness is a barely noticed problem that arises as much from other countries' need for Americans to buy their goods as from Americans' own desire to do so. The necessary move to achieve a better global balance may yet trigger profound economic difficulties at the global level. But the U.S. economy's ability to move constantly in new directions, adapt to new situations, and create new institutional forms and technologies ultimately bodes well for its long-term future.

QUESTIONS FOR DISCUSSION

1. How did the United States play a fundamental role in the institutional development of market capitalism?
2. What led to the original movement toward regulation of the U.S. economy?
3. How did the regulation movement of the 1960s and 1970s differ from the original movement, and how did the modern deregulation movement relate to these different forms of regulation?
4. What are some of the reasons for U.S. leadership of global technological change?
5. What are some reasons that the U.S. New Economy might not continue?
6. What are some reasons that the United States has greater degrees of income and wealth inequality than other high-income market capitalist economies?

7. Some studies suggest that higher income inequality is more readily accepted by the U.S. population than it would be in other high-income countries. Why might this be true?

8. How has the legacy of slavery and the Civil War influenced the development and structure of the U.S. economy?

9. Why might economic growth and higher consumption levels not lead to greater happiness? Why might such arguments be relevant for the U.S. economy?

10. What lies behind the movement of the United States to become the world's largest net debtor? How might stabilization of this situation create threats to the world economy as a whole?

INTERNET SOURCE

www.census.gov./prod/www/statistical-abstract-us.html

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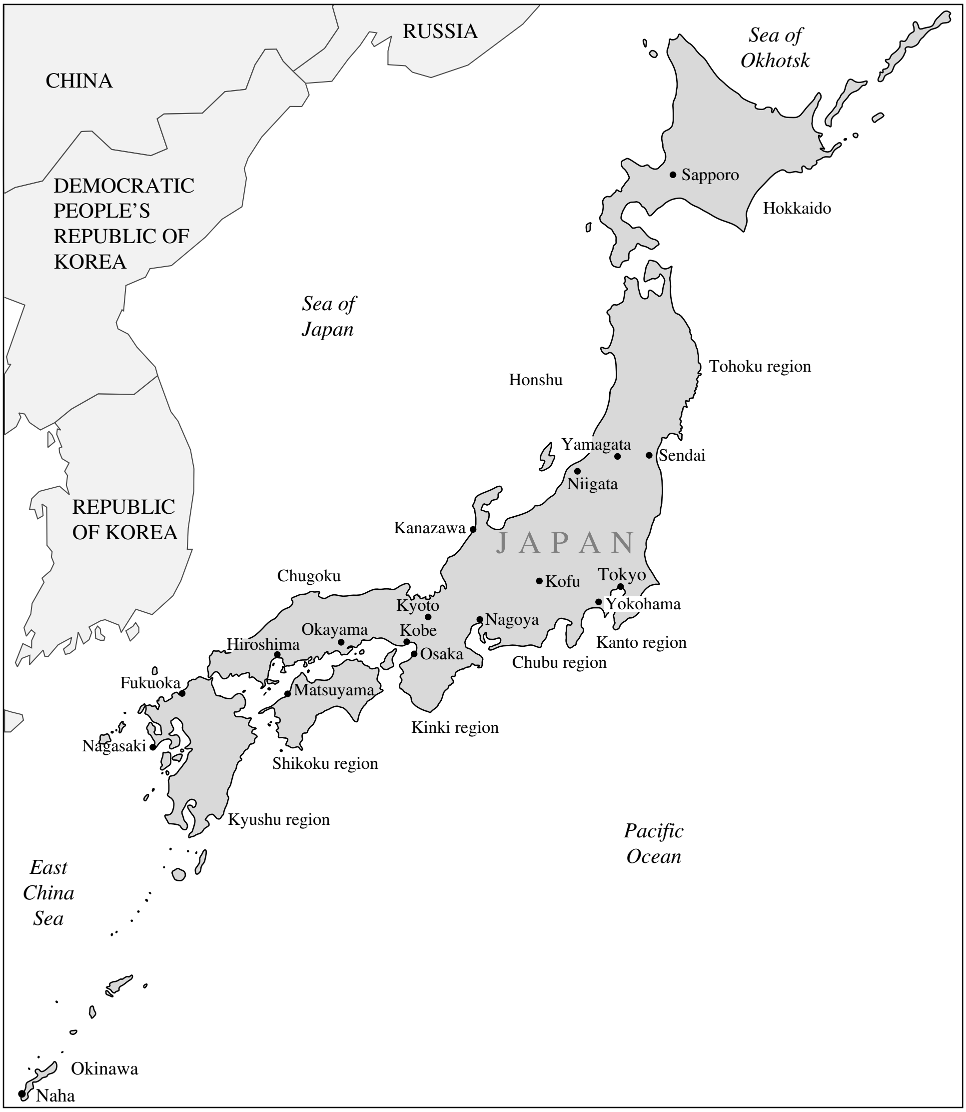
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KOREA
Sapporo
Hokkaido
Sea of
Japan
Tohoku region
Honshu
Yamagata
Sendai
Niigata
REPUBLIC
OF KOREA
Kanazawa
JAPAN
Chugoku
Kofu
Tokyo
Kyoto
Yokohama
Okayama
Kobe
Nagoya
Hiroshima
Osaka
Kanto region
Chubu region
Fukuoka
Matsuyama
Kinki region
Nagasaki
Shikoku region
Kyushu region
Pacific
Ocean
East
China
Sea
Okinawa
Naha

6 Japan: A Planned Market Economy with Traditional Elements

But to expect Americans, who are accustomed to thinking of their nation as number one, to acknowledge that in many areas its supremacy has been lost to an Asian nation and to learn from that nation is to ask a good deal. Americans are peculiarly receptive to any explanation of Japan's economic performance which avoids acknowledging Japan's superior competitiveness.
—Ezra F. Vogel, *Japan as Number One,* 1979, p. 225

The modern myth of Japan is assuredly the biggest hoax of the present age. . . . The economy has obviously slowed down, income distribution has become skewed, and while landowners have become rich, ordinary families can no longer afford their own home. There are now poor people as well as many old people who are scared about what will become of them.
—Jon Woronoff, *Japan as-anything but-Number One,* 1991, pp. 7–8

The industrialized capitalist countries are engaged in severe economic competition. Private companies square off toe to toe. Sometimes, in the heat of the contest, their cheering sections—government officials and politicians—vilify opponents, yell "unfair," and demand new rules. Japan has quietly endured this rhetorical crescendo from the United States for years. We cannot remain silent forever. It is time to speak out.
—Shintaro Ishihara, Governor of Tokyo, *The Japan That Can Say No,* 1989, pp. 40–41

INTRODUCTION: JAPAN AS A NEW TRADITIONAL ECONOMY?

Rising from the ashes of defeat and poverty at the end of World War II, Japan experienced the most rapid rate of sustained economic growth in the world to become its second largest economy. It achieved this while maintaining fairly low unemployment and inflation rates and a greater degree of income equality than most capitalist economies. Its people have the world's longest life expectancy. It leads in many areas of technology. It has large trade surpluses that do not decline, resulting in the largest accumulation of foreign reserves of any nation. These outcomes led many observers to declare that Japan had become, or was about to become, Number One, although this view has been modified because of the continuing stagnation of the Japanese economy in the 1990s and beyond, especially when Japan's tepid growth is compared with the more rapid growth of the U.S. economy in the late 1990s and beyond.

Despite the recent setbacks, however, Japan's economic achievements have inspired admiration and envy from other nations. Japan's conflicts with other nations over trade issues have threatened to plunge the world into a trade war and depression. Japan's very success (and failure) makes its every action important for the world economy.

There is little agreement about the nature of Japan's success, and many question whether it has succeeded, given its persistent economic malaise. A profound truth about Japan is that every supposed fact about it abounds in paradox and multiple interpretations.[1] For every interpretation by an admiring "Japanologist" there is a counterinterpretation by a critical "revisionist."

Where admirers see effective Japanese management bringing about harmonious labor-management relations, critics see oppression of labor movements by triumphant management. Where admirers see highly educated and technically innovative workers, critics see robotized rote learners who only know how to imitate, not create. Where admirers see ever-rising living standards, critics see workaholics living in rabbit hutches. Where admirers see innovative government-business relations, critics see a corrupt **Japan, Incorporated.** Where admirers see an open and cosmopolitan nation with lower tariffs and quotas than its trading partners, critics see an insular and arrogant nation cheating its trading partners through devious methods. Where admirers see a democratic and pacifistic nation, critics see a nation where dictatorial structures from its dark past persist and a potentially militaristic nationalism is rising.[2]

Even among admirers, there are debates about the basis of Japanese success. Advocates of different schools of economic thought and ideology seek to take credit for Japan's success by attempting to fit it into the straitjackets of their favored approaches, much like the different narrators in the famous Japanese movie *Rashomon,* who recount a single incident in very different ways. Thus advocates of government economic intervention argue that bureaucratic guidance through indicative planning and industrial policy has been key to Japanese success. Advocates of laissez-faire argue that these have been more a hindrance than a help, with the most dynamic sectors ignoring the government bureaucrats.

The Japanese economic system is a subtle mixture of structures and systems unique in the world, despite attempts by others to imitate it. Indubitably it is a market capitalist economy. Nevertheless, the government does engage in indicative planning and exerts significant influence. Japan was the first society of non-European origin to carry out industrialization and modern economic growth. It succeeded in adopting foreign technologies and practices without giving up its indigenous culture, symbolized by the late-nineteenth-century slogan "Japanese spirit and Western ability."

Japan may actually be the most successful example of a New Traditional Economy in the world. Many argue that the key to Japan's success is the **familistic groupism** of

1. This is a strong characteristic of Japanese culture, as illustrated by the Japanese film *Rashomon,* directed by Akira Kurosawa, in which an incident is recounted afterward differently by different participants. The Japanese distinguish between *tatemae,* a surface illusion, which is initially presented in a discussion or negotiation, and *honne,* which reflects the underlying reality.

2. The last paradox is an old one in Japanese culture, as described in the world's first novel, *The Tale of Genji,* by the eleventh-century writer Lady Murasaki. Samurai are supposed to be both sensitive poets and fierce warriors. This paradox is captured in the title of Ruth Benedict's 1946 classic work of Japanology, *The Chrysanthemum and the Sword*. Another example is that of Junichiro Koizumi, elected in 2001 as prime minister, who has been viewed both as a westernizing reformer and as an advocate of militaristic nationalism.

Japanese society, often labeled a "feudalistic holdover," that supposedly is responsible for both its harmonious labor-management relations and its harmonious government-business relations.

In chapter 4 it was argued that the household economy is the essence of the traditional economy. Japanese society is not dominated by a fundamentalist religious movement, but it is permeated by the idea that companies, bureaucracies, and society as a whole are families or households within which strong trust relations hold that enhance widespread social capital and thus productivity in the economy.[3] Thus the Japanese economy combines a traditional household orientation with advanced modern technologies and approaches. But given the clear dominance of modern market capitalism, a more accurate description is "planned market capitalism with strong traditional elements."

HISTORICAL AND CULTURAL BACKGROUND OF THE JAPANESE ECONOMY

The Absorption of Chinese Culture

The ability of the Japanese to absorb foreign influences and technologies while maintaining their cultural identity arose from having a strong sense of identity. That came from their high degree of homogeneity arising from their long isolation. Like Britain theirs is an island nation, but 100 miles removed from the nearest continent rather than just 20.

The original religion was **Shinto,** emphasizing worship of ancestral and nature spirits and of the emperor because of his claimed descent from Amaterasu, goddess of the rising sun, a status disavowed by Emperor Hirohito at Japan's surrender in 1945.

The model for Japan's integration of foreign influences into its society was its absorption of Chinese culture in the sixth and seventh centuries. Chinese writing was adopted but modified.[4] Buddhism and Confucianism were introduced but were also modified without displacing native Shintoism. Whereas in most societies an individual adopts one religion to the exclusion of others, most Japanese view themselves as simultaneously following

3. In Japanese before the modern era the word for house, *ie*, meant both family and business enterprise. Many Japanese argue that *ie* is the foundation of Japanese civilization, with Francis Fukuyama noting that family-like *iemoto* groups and high levels of trust are more common in Japan than in strongly family-oriented but low-trust China or southern Italy (*Trust: The Social Virtues and the Creation of Prosperity* [New York: Free Press, 1995]). Some argue that the familistic vision of Japan is incorrect, with this appearance arising from domination of society by hierarchical corporations (Hiroshi Okumura, *Corporate Capitalism in Japan,* trans. Douglas Anthony and Naomi Brown [New York: St. Martin's Press, 2000]), while others argue that the corporations themselves are feudalistic holdovers (Yasuo Takeuchi, "The End of Company-ism," *The Japanese Economy* 26 [2000]: 33–54). The Japanese system has also been labeled *socialism* (Yasuo Takeuchi, "Japan's Transition from Socialism to Capitalism," *Japanese Economy* 26 [2000]: 3–24).

4. Linguistically, Japanese is related to Korean but is very distinct from any variety of Chinese, despite the presence of many Chinese loan words in the language.

all three, an example of their ability to deal with *multiple realities*. Shintoism is followed for marriages (despite the recent fad of U.S.-style Protestant weddings in larger Japanese cities), Buddhism for funerals, and Confucianism for civil and political behavior. In 1890 the Diet, or parliament, was established, with voting for it reserved for top male landowners.

Shintoism and Buddhism[5] do not have much influence on Japanese economic thought or behavior, but the Japanese form of Confucianism does.[6] After 1600, Confucian values became deeply entrenched in the educational system, emphasizing loyalty to one's immediate superiors and respect for state authority. After 1868, influential businessmen emphasized Confucian values and the transfer of the **bushido code** of the samurai warriors to business management practices, symbolized by the modern phrase "from samurai to sarariman" (salaryman). Most important is **wa** (harmony), which, along with loyalty, cements the *familistic groupism* that dominates the Japanese economy.

The Tokugawa Shogunate and the Meiji Restoration

After 1185 Japanese rule was in the hands of military commanders known as **shoguns,** appointed by the emperor, to whom they were nominally subject.[7] During the 1500s, Portuguese traders and Jesuit priests penetrated Japan and almost dominated the country, but were expelled in 1603, after which the nation closed up under the Tokugawa shogunate. During this period of isolation, Japan experienced considerable development of business,[8] transportation infrastructure, and literacy, laying the foundation for later economic takeoff.

5. The best-known form of Japanese Buddhism is Zen, very popular with the samurai from the 1200s on. Some argue that Zen increases the ability of Japanese managers to deal with indirection and vagueness and that it enhances R&D creativity (see box 6-1).

6. A main difference between Chinese and Japanese Confucianism is that the former emphasizes benevolence as the supreme virtue, whereas the latter emphasizes loyalty. This, combined with state Shinto emperor worship to support the militaristic nationalism of World War II, helps to maintain status hierarchies in Japanese companies and bureaucracies (Michio Morishima, *Why Has Japan "Succeeded"? Western Technology and the Japanese Ethos* [Cambridge: Cambridge University Press, 1982] and Tessa Morris-Suzuki, *A History of Japanese Economic Thought* [London: Routledge, 1989]). Fukuyama sees this difference between Chinese and Japanese Confucianism as reflecting their different levels of generalized trust, with the Chinese less willing to sacrifice their families for the benefit of larger social groups than the Japanese (*Trust*). See also Wei-Bin Zhang, *Japan versus China in the Industrial Race* (New York: St. Martin's Press, 1998) and, for the development in Japan of the idea of "Japanese culture," see Tessa Morris-Suzuki, "The Invention and Reinvention of 'Japanese Culture,'" *Journal of Asian Studies* 54 (1995): 759–780.

7. Usually the real ruler would be an adviser to a prime minister to the shogun. This tradition of indirect rule persists today, with the greatest power being in the hands of party politicians with no official positions. This has led some foreigners to complain that "no one rules" and that negotiations with prime ministers or other officials about trade or other issues are pointless.

8. The ancestors of two of the six dominant modern *keiretsu,* Mitsui and Sumitomo, were founded in this period, the former as a dry goods business, the latter as a copper miner and smelter. Prior to the Meiji Restoration, merchants had low status in Japanese society. Their later rise paralleled that in the West as feudalism was replaced by capitalism.

After being forcibly opened to outsiders in 1853 by the arrival of Commodore Matthew Perry's "black ships" from the United States, Tokugawa society fell into crisis. Humiliated by military defeats, landless samurai under the slogan "Revere the emperor, expel the barbarians" overthrew the Tokugawa shogun in 1868. This was the Meiji Restoration, named for the emperor of the time.

Those who came to power both opened the country dramatically to foreign influences and technologies and removed all rights and powers of the samurai, thereby ending feudalism. The samurai were paid off with bonds in 1873, with which many of them started businesses. Farmers were given land. Students were sent abroad to study, especially to the United States and Germany.

The state started many industrial enterprises, pushing industrial development under the slogan "rich country, strong military," only to privatize them after a fiscal crisis in 1883. Industrial growth took off, with cotton spinning becoming the first internationally competitive industry by 1900. Iron and steel, railroads, mining, and machinery also expanded rapidly, aided by initial support from *infant industry* tariffs.

Japan also imitated the European penchant for imperializing neighbors.[9] In 1895 Taiwan was conquered after a war with China. This led to the 1905 Russo-Japanese War, culminating in the first victory of an Asian power over a European one in modern times,[10] with Japan taking control of Korea in 1910 as a result. The 1920s was a period of political democratization and liberalization, but it saw economic domination by four leading conglomerates, or **zaibatsus:** Mitsui, Mitsubishi, Sumitomo, and Yasuda, dominated in turn by leading family shareholders. During World War II these *zaibatsus* would each become associated with a bank that would be the key entity in the postwar **keiretsus** that succeeded them.

In 1931 the Japanese army seized the province of Manchuria and established the puppet state of Manchuko. In its New Economic System that many argue remained the model for Japan after World War II,[11] elements of economic central planning were tested in

9. Japan denied that it practiced imperialism, arguing that it was fighting against the racist imperialism of Europe and the United States, a view still held by some in Japan. During World War II, Japan claimed to be establishing the "Greater East Asia Co-Prosperity Sphere." Japanese soldiers were surprised when they were not welcomed in such European colonies as Vietnam or Malaya. Some argue that the Japanese dominate a neo-Co-Prosperity Sphere where Japanese investment ties economies closely to buying Japanese goods (Paul Burkett and Martin Hart-Landsberg, *Development, Crisis, and Class Struggle: Learning from Japan and East Asia* [New York: St. Martin's Press, 2000]).

10. The blow to Russia of this defeat was so great that it was a major trigger of the 1905 revolution in Russia. Russia and Japan have an ongoing dispute over islands taken by the Soviet Union at the end of World War II.

11. See Yukio Noguchi, "Leaving the '1940' System and Moving into a New System," in K. Sato, ed., *The Transformation of the Japanese Economy* (Armonk, N.Y.: M. E. Sharpe, 1999), pp. 392–402; Tetsuji Okazaki and Masahiro Okuno-Fujiwara, "Japan's Present-Day Economic System and Its Historical Origins," in T. Okazaki and M. Okuno-Fujiwara, eds., *The Japanese Economic System and Its Historical Origins* trans. by Susan Herbert (Oxford: Oxford University Press, 1999), pp. 1–37. Specifics regarding the changing role of the banks are described in Juro Teranishi, "The Main Bank System," in Okazaki and Okuno-Fujiwara, *The Japanese Economic System and Its Historical Origins,* pp. 63–96.

Manchuko that were used later. In 1937 Japan invaded China, later allying with Germany and Italy. Its 1941 bombing of Pearl Harbor brought the United States into World War II. On August 16, 1945, Japan surrendered after the United States dropped atomic bombs on Hiroshima and Nagasaki.

The American Occupation and Its Aftermath

On September 2, 1945, General Douglas MacArthur arrived to become the Supreme Commander of the Allied Powers and the virtual ruler of Japan until the American Occupation ended in 1952. This was the first time in Japanese history that it was ruled by a foreign power. After an initial period of radical purgings and reforms up to 1947, MacArthur encouraged continuity of rule by traditional elites,[12] as Japan was increasingly seen as a Cold War ally.

The United States imposed a constitution that formally demilitarized Japan, although the top managers of the wartime successor companies continued to meet secretly to coordinate decision making (Morishima, 2000, pp. 77–78). Much of the bureaucracy survived unscathed, except for a few name changes. Labor unions were legalized, as were the Communist and Socialist parties. The *zaibatsus* were broken up. Land was redistributed. Again the Japanese integrated foreign influences into their society and culture, this time from the United States.

Until around 1960 there was considerable labor militancy before harmonious relations with management finally emerged. In 1955 the two leading conservative parties united to form the Liberal Democratic Party (LDP), which has ruled Japan since then except for a brief period in 1993.[13] From the mid-1950s to the 1970s the old *zaibatsus* re-formed as loosely organized *keiretsus,* each centered on a bank and a trading company. Mitsui, Mitsubishi, and Sumitomo kept their names, but Yasuda became Fuyo and two other leading *keiretsus* emerged, Sanwa and Ikkan.

By 1955, real per capita income had reached its highest prewar levels. By the late 1960s, large, persistent trade surpluses emerged. By the mid-1970s, per capita income equaled those in many advanced economies and continued to grow more rapidly than any of them, despite a deceleration. In 1975, Japan became one of the G-7 (now G-8), the leading economic countries, whose leaders meet in economic summits each June. Japan had arrived as a world economic leader.

12. A supreme symbol of that continuity was his lack of a demand for Emperor Hirohito to step down. Hirohito reigned from 1926 until his death in 1989.

13. It is an old wisecrack that the LDP is neither liberal, democratic, nor even a party.

THE MICROECONOMIC FOUNDATIONS OF THE JAPANESE ECONOMY

The "Three Sacred Treasures" of Labor-Management Relations

The foundation of the Japanese economy is its highly educated and well-motivated labor force. Japan has few natural resources, and at the end of World War II, much of its capital stock was destroyed. Many quality- and productivity-improving innovations in the Japanese economy have been suggested by workers on site, often through **quality circles.** Such loyalty and commitment to the firms they work for is something that many other countries have sought to emulate.[14]

Basic to Japanese labor are the **three sacred treasures:** lifetime employment, seniority-based wages, and enterprise unions.[15] Conventional wisdom about Japanese labor is that there is frequent intraenterprise job rotation by multifunctional workers; that there is much on-the-job firm-specific training; that bonus payments are widespread and compensation schemes are flexible; that contracts are negotiated annually in a synchronized manner; that employment is stable; and that there are large severance payments at retirement but few pensions. This conventional wisdom has been questioned, notably because of the **dual economy (dualism).** Most of it does not apply to the 50 percent of the labor force in small firms or to most female workers in large firms.[16] Furthermore, these practices are apparently being increasingly abandoned in the areas where they formerly occurred as large Japanese firms restructure and imitate U.S. practices in response to the persistent stagnation of the Japanese economy.

Lifetime Employment

Lifetime employment is seen as the key to engendering loyalty and drawing forth innovative, productivity-improving suggestions. Critics suggest that it is limited to about 30 percent of the labor force, mostly educated men in large firms who must retire at age 55 with large severance payments, although they are often assisted in getting other jobs in smaller firms. However, comparisons of tenure patterns between Japan and the United States find

14. Jon Woronoff (*Japan as-anything but-Number One* [Armonk, N.Y.: M. E. Sharpe, 1991, chap. 2]) claims that this loyalty is a false *tatemae* phenomenon. Workers are forced to join quality circles and are pressured into exhibiting apparent loyalty to their firms, while the real *honne* is that they hate their bosses and their jobs just like workers everywhere. Burkett and Hart-Landsberg, in *Development, Crisis, and Class Struggle,* argue even more forcefully that the apparent harmony of Japanese labor-management relations reflects merely the crushing and domination of Japanese labor by capitalist management.

15. This term was invented by an American, James Abegglen (*The Japanese Factory* [Glencoe, Ill.: Free Press, 1958]).

16. Women are strongly discouraged from working if they get married and have children, although this attitude is changing.

Japanese workers more likely to stay with a single firm for a longer period of time, even in small companies.[17]

This system of lifetime employment depends on stability of employment, which was aided by rapid growth of the economy between 1945 and 1990. It is eased by the synchronized annual negotiating system and by the relatively docile enterprise unions. Also, the bonus system, amounting to up to 30 percent of compensation in some cases, may amount to a form of profit sharing that stabilizes the economy, as in the **share economy** theory, although this has been questioned.[18] The stagnation of the Japanese economy has led to permanently increased unemployment that is putting pressure on this system of stable employment. Evidence of this weakening is shown in the percentage of the labor force that got a new job during the previous year, which rose between 1992 and 1999 from 5.2 percent to 10.8 percent.[19]

One element of long-term employment is the development of firm-specific human capital by rotating workers from job to job within the firm. Workers know all about the firm but lack skills that are transferrable to other firms. This on-the-job training of blue-collar workers leads to their "white collarization" in larger firms and thus to their greater loyalty to the firm. But loyalty is a two-way street. Firms are more willing to engage in firm-specific training if they believe workers will remain for a long time.

Although some argue that lifetime employment reflects a deep Confucian code, it and many other distinctively Japanese practices are probably more recent developments. The real beginning of these practices may have been during World War II, when the government became concerned about worker morale issues for maintaining military production.[20]

Seniority Wages

Seniority wages go with lifetime employment as part of the general loyalty-to-the-firm-inducing package and also are consistent with the Confucian view of respect for elders. If one stays with the firm, one moves up in salary.

17. See Masanori Hashimoto and John Raisian, "Employment Tenure and Earnings Profiles in Japan and the United States," *American Economic Review* 75 (1985): 721–735. Fukuyama especially emphasizes the role of lifetime employment in enhancing the family-like (*iemoto*) and trusting relations within Japanese firms (*Trust*).

18. See Merton J. Peck, "Is Japan Really a Share Economy?" *Journal of Comparative Economics* 10 (1986): 427–432.

19. See *OECD Economic Surveys: Japan, December 2000* (Paris: Organization for Economic Cooperation and Development, 2000), p. 111. Whereas many observers applaud this weakening as a sign of westernizing reforms, Michio Morishima sees it as representing a weakening of Japanese Confucianism with the rise to power of a generation educated under Western influence, this being the main cause of the stagnation of the Japanese economy in the 1990s rather than a hope for revival (*Japan at a Deadlock,* New York: St. Martin's Press, 2000).

20. See Okazaki and Okuno-Fujiwara, "Japan's Present-Day Economic System and Its Historical Origins."

In Japan there is a steeper age-wage profile for blue-collar workers than in other countries, reflecting the white collarization of these workers, along with an across-the-board greater tendency for seniority wages in Japan than in the United States.[21] Nevertheless, there is a trend toward more emphasis on merit rather than seniority in wage setting, with strong expectations among both management and labor in Japan that the system will move in the direction of performance-based pay.[22]

Enterprise Unions

Enterprise unions go with the above package, with the proportion of unionized workers belonging to such unions holding steady at 91 percent since 1964.[23] If one is committed for life to a specific company and one has been working at several different jobs with the company, thus not being tied to a particular skill or craft, then it is logical to belong to a union that negotiates directly with that company and only that company. Stability of labor-management relations leads to the “happy family of the firm.” Such unions contain both white- and blue-collar workers and partly account for the smaller wage differentials between them. Enterprise unions are the pattern in Japan and are strongly supported by both management and labor. Nevertheless, some critics consider them to be ineffective tools for management interests, and they sharply contrast with the pattern of industrial or craft unions found in the United States and most nations.

Like the United States, Japan has had a steadily declining rate of unionization, from a maximum of 55.8 percent of the labor force in 1949 to 29.1 percent in 1984.[24] This decline may reflect the greater docility of the unions in contrast to earlier periods. In the 1940s and 1950s there was a higher strike rate in Japan than in Britain or France, and the Japanese unions were linked to radical left-wing politics, including some with ties to Japan’s Communist Party. The turning point toward moderation came with the breaking of a long steel strike in 1959 and a more bitter mining dispute in 1960.

The change in leadership of the steel unions after 1959 led to the synchronized system of annual spring negotiations. This avoids staggered wage contracts, minimizing inflationary momentum that can arise as one union imitates another, thus improving inflation-unemployment trade-offs and stabilizing employment. After the first oil price shock in 1973,

21. See Hashimoto and Raisian, “Employment Tenure and Earnings Profiles.” For the argument that seniority wages reinforce loyalty to the firm among lifetime employees, see Katsuhito Iwai, “The Japanese Firm as a Worker-Managed Enterprise,” *Japanese Economic Studies* 23 (1995): 77–95. Fukuyama also sees this as part of the familistic Confucianism in Japanese firms (*Trust,* p. 188).

22. See Ken Sakuma, “Changes in Japanese-Style Labor-Management Relations,” *Japanese Economic Studies* 16 (1988): 3–48.

23. See David Flath, *The Japanese Economy* (Oxford: Oxford University Press, 2000), p. 322.

24. Sakuma, “Changes in . . . Relations.”

the unions asked for high wage increases that triggered increases in both unemployment and inflation. After the second oil price shock in 1979 they avoided such conduct, having absorbed the lessons of the first shock, thereby maintaining greater macroeconomic stability.

The Japanese Firm and the Keiretsu System

The most distinctive element of Japanese industrial organization is the existence of interlocked associations of firms known as *keiretsu,* which are either **horizontal keiretsu** or **vertical keiretsu.** The former are essentially revivals of the prewar *zaibatsus,*[25] firms in different industries all linked to a common bank and trading company. The latter are a set of suppliers and distributors linked to a major industrial producer by long-term contracts. It is widely argued that the vertical *keiretsu* initially formed during World War II to ensure supply sources for military production. U.S. trade negotiators charge that they are anticompetitive and keep out U.S. suppliers.

The Toshiba Corporation, which makes computers, consumer electronics products, semiconductors, and heavy machinery, is at the center of a vertical *keiretsu* that includes 11,000 franchised distributors, about 200 direct suppliers, and about 600 suppliers of the direct suppliers. At the same time, Toshiba is a member in good standing of the Mitsui horizontal *keiretsu.* But some vertical *keiretsus* stand alone, such as those associated with Honda and Sony, both very independent companies. Members of horizontal *keiretsus* tend to be large companies that practice the three sacred treasures of labor-management relations, while peripheral firms in vertical *keiretsus* tend not to do so.

In all *keiretsus* there is much cross-holding of stocks. In the horizontal form there is much stock ownership by the bank and a large proportion of loans from the bank. In some horizontal *keiretsus* the CEOs of firms meet on a weekly basis to coordinate strategies and behaviors. These relations extend to their workers, who tend to buy from companies in their company's *keiretsu.*

Table 6-1 shows for the six largest horizontal *keiretsus* in 1987 the number of firms, the average percentage of interlocking shares, and the average percentage of intragroup loans. These Big Six together accounted for 4.14 percent of the employees, 12.96 percent of the assets, 15 percent of the capital, 14.35 percent of the sales, and 11.7 percent of the gross profits in the Japanese economy.[26] But this pattern of cross-shareholding is declining, having dropped from about 21 percent to about 16 percent for the economy as a whole.[27]

25. The difference is that *zaibatsus* were single holding companies, whereas the firms in *keiretsus* maintain their formal independence.

26. Takatoshi Ito, *The Japanese Economy* (Cambridge, Mass.: MIT Press, 1992), p. 188. Another aspect of close relations within *keiretsus* is that their top managements often come from certain universities (Morishima, *Japan at a Deadlock*, pp. 90–96).

27. See *OECD Economic Surveys: Japan, December 2000*, p. 1.

Table 6-1
Intra-*keiretsu* Relations

Keiretsu	Number of Firms	Percent of Interlocking Shares	Percent of Intragroup Loans
Mitsui	24	17.10	21.94
Mitsubishi	29	27.80	20.17
Sumitomo	20	24.22	24.53
Fuyo	29	15.61	18.2
Sanwa	44	16.47	18.51
Ikkan	47	12.49	11.18

Source: Takatoshi Ito, *The Japanese Economy* (Cambridge, Mass.: MIT Press, 1992), p. 181.

Table 6-2
Selected *Keiretsu* Members

Sector	Mitsui	Ikkan
Banking	Mitsui Bank	Dai-Ichi Kangyo Bank
Life insurance	Mitsui Life	Asahi life
		Fukoku Life
Trading	Mitsui Bussan	C. Itoh
		Kanematsu Gosho
Construction	Mitsui Construction	Shimizu Construction
	Sanki Kogyo	
Food and drink	Nihon Mills	
Textiles	Tohre	Chichibu cement
Steel	Nihon Seikojo	Kawasaki Steel
		Kobe Seiko
		Nihon Heavy Industries
Electronics	Toshiba	Hitachi
		Fujistu
		Yasukawa Electronics
		Nihon Columbia
Automobiles	Toyota	Isuzu
Shipbuilding	Mitsui Shipbuilding	Ishikawajima harima
		Kawasaki Heavy Industries
Optics		Asahi Kagaku
Department stores	Mitsukoshi	Seibu Department Store

Source: Takatoshi Ito, *The Japanese Economy* (Cambridge, Mass.: MIT Press, 1992), pp. 185–187.

Table 6-2 shows some major companies in certain leading sectors associated with two of the Big Six horizontal *keiretsus,* one from the more tightly controlled group (Mitsui) and one from the less tightly controlled group (Ikkan).

Some *keiretsus* have more than one firm per sector, and some firms belong to more than one *keiretsu,* notably Hitachi, which belongs to Fuyo, Sanwa, and Ikkan simultaneously. These are the three less loosely interconnected, and hence less *zaibatsu*-like, of the Big Six horizontal *keiretsus*. Many of these firms remain predominantly owned and controlled by the family of the founder-entrepreneur, Toyota being a prominent example.

It has been argued that these entities are able to enjoy **network externalities** of some sort. But there is evidence that group membership may have a negative impact on profitability relative to independents run by founder-entrepreneurs such as Akio Morita of Sony.[28] These firms make higher interest payments to their coordinating banks, which seem to be the big gainers in terms of profits, although the firms may be gaining security of financing.

Broadly, there was a trend toward banks and companies owning each other's stock beyond *keiretsu* relationships, with the share of Japanese stocks so held rising from 32.7 percent in 1955 to 67.1 percent in 1989 and steadily declining since then. In contrast, for the United States in 1988, the figure was 35.4 percent.[29] This has led some to joke that Japan is "capitalism without capitalists."

This pattern arose after Japan joined the **Organization for Economic Cooperation and Development (OECD)** in the 1960s and was pressured to open its stock market to foreign investors. This high level of cross-holdings prevents foreigners from taking over companies, and in 1989 they owned only 3.9 percent of Japanese stocks, although this percentage rose sharply in the 1990s to 18 percent in 1999.[30]

Vertical *keiretsus* may achieve efficiencies because their stable long-term contracts allow for *just-in-time* delivery **(kanban)** systems that minimize inventory costs and encourage superior quality controls. A large firm will generally have more than one supplier for a part, thus maintaining a degree of competitiveness that does not exist when parts suppliers are merely subsidiaries of the major firm, as is often the case among U.S. automobile producers. Often the major firms help the smaller firms with investment and marketing. But the smaller firms generally bear the brunt of unemployment in a slowdown, providing a buffer for the major firms that helps them maintain their lifetime employment systems.

Managerial Decision Making

For some time there has been a tendency in the United States, and to a lesser extent in Europe, to imitate aspects of Japanese management practices. An example of this is the General Motors (GM) Saturn subsidiary, consciously set up along such lines in contrast to the rest of GM, and long more successful than the rest of GM. Although some argue that

28. Richard Caves and Masu Uekasa, *Industrial Concentration in Japan* (Washington, D.C.: The Brookings Institution, 1976), pp. 72–83.

29. *OECD Economic Surveys: Japan, 1991/1992* (Paris: Organization for Economic Cooperation and Development, 1992), p. 75.

30. *OECD Economic Surveys: Japan, December 2000.*

these practices cannot be exported from Japan because of their cultural uniqueness, the success of Japanese automobile subsidiaries in the United States relative to U.S. producers suggests otherwise.[31]

Masahiko Aoki[32] argues that Japanese firms reflect a **J-mode** type of organization, in contrast to the **H-mode** found in most U.S. and European corporations. The H-mode includes both the U-form and the M-form discussed in chapter 5. The J-mode is characterized by "horizontal coordination among operating units based on the sharing of ex post on-site information (learned results)." This contrasts with the H-mode, characterized by "hierarchical separation between planning and implemental operation and the emphasis on the economies of specialization." The J-mode depends on both long-term relationships between workers and firms and long-term relationships between banks and firms, which tend to hold for *keiretsu* members with lifetime employment systems.

Small pay differentials between workers and top managers in Japanese firms and the fact that top managers have usually risen from within the firm increase the loyalty and links between the two, making management essentially the representative of the employees. Thus Japanese firms resemble labor-managed firms, although rank hierarchies are strongly maintained. Aoki maintains that horizontal coordination works only because of the existence of a rank incentive structure.

Horizontal coordination is carried out through elaborate processes of consensual decision making **(nemawashi).** This involves discussion of a decision with virtually everyone involved. Westerners sometimes complain that Japanese decision makers have too many meetings and are slow to come to decisions. But advocates of the system note that once a decision is reached, everyone is "on board" and knows what is involved. Thus, the decision is more likely to be carried out effectively than a typical H-mode, purely top-down decision.

Not only is there coordination across equal levels, but there is also encouragement of input from the bottom up. This leads to **ringi-sho,** or the writing of memos by underlings that are channeled upward to superiors. This is connected with the widespread use of quality circles and the dependence upon workers for suggestions for improving the firm's performance.[33] Maintenance of strict seniority-based rank hierarchies allows superiors to defer to underlings for their expertise when it is superior. Intracorporate solidarity and

31. A warning is that some U.S. companies touted as following Japanese practices like lifetime employment have fallen on hard times, such as, IBM.

32. Masahiko Aoki, "Toward an Economic Model of the Japanese Firm," *Journal of Economic Literature* 28 (1990): 1–27.

33. Another element is widespread use of statistical quality control methods, introduced after World War II by the U.S. quality control expert W. Edwards Deming, and ignored at the time in the United States. The Japanese established a prize for quality control in his name.

information sharing are further encouraged by such leveling devices, such as having only one cafeteria and parking lot for all employees rather than segregating top management from the rest of the workers in an overpaid ghetto.

Given the long-term nature of employee-firm relations and of bank-firm relations, Japanese managers use longer time horizons for strategic planning. A manifestation of this is a greater emphasis upon maximizing market share, subject to a minimum profit constraint, rather than maximizing short-run profits. However, as low profitability increasingly plagued many Japanese firms during the 1990s, this approach has come under pressure, especially as more outside and foreign investors have come to own Japanese stocks.

Long-term bank financing has allowed Japanese firms to resist pressures that come from stock markets for short-run profits through threats of takeover raids. Firms have been insulated by the high level of cross-holdings of stocks between firms and between banks and firms. This willingness of banks to take a long-term view depends on the high Japanese savings rate, which allows for low interest rates that stimulate capital investment and a longer time horizon for that investment. But this low cost of capital may have ended in Japan with the emergence of bank debt problems.

An example of the long-term view of Japanese managers versus the short-term view of U.S. ones is the development of the VCR, invented in the United States and initially produced there. Unlike the manufacture of some other products, where the United States lost out due to intensive Japanese competition (e.g., TVs), U.S. producers such as Westinghouse voluntarily gave up VCRs because of the initial slow growth of the market and the resulting low rate of return on investment. This occurred prior to Japanese entry into the market. During the 1980s this was the most rapidly growing consumer market in the United States, but no U.S. firms participated. This case shows the advantages of the Japanese financing and management system when it worked well. But such successes are now much less likely with the financial problems now facing the Japanese economy.

Industrial Policy by Government

A controversial aspect of the Japanese economy is the role of government, famous for the cooperative government-business relations labeled **industrial policy.** Controversy arises over how much such cooperation actually goes on; if it goes on, over how effective it is; and if it goes on and is effective, whether it is to be admired or condemned.

These disputes focus on the role of the **Ministry of International Trade and Industry (MITI),** the main implementer of Japan's industrial policy. A lesser role is played by the Ministry of Finance (MOF) through its control over tax subsidies and the banking system. The Ministry of Agriculture also attracts attention because of its protectionist policies.

Those who argue that the state is the driving force of the Japanese economy point to the apparent supremacy of government bureaucrats. A sign of this is that after retirement from government, high-level bureaucrats "descend from heaven" **(amakudari)** to high-level employment in top firms. Chalmers Johnson[34] has identified the 15 MITI vice ministers (top internal officials) from 1949 to 1978 and their *amakudari* positions. These include the president and chairman of Toshiba, the president of New Japan Steel, the chairman of Nippon Kokan Steel, the president of the Japan Petrochemical Corporation, the managing director of Mitsui Trading Company, the executive director of Toyota, and the president of Sumitomo Metals Corporation, among other equally impressive positions.

All of these men served in MITI and its predecessor ministries before or during World War II.[35] Thus Johnson sees substantial continuity between wartime planning practices carried out by the Ministry of Munitions and its postwar successor, MITI. These policies include sectoral financial targeting, encouragement of bank rather than equity financing, encouragement of better labor relations, and the use of selective cartelization.

The basic pattern of MITI intervention in markets relates to **product cycles.** MITI gets in at the early stage and at the end but gets out during the middle stage. At the beginning stage of an industry targeted for growth, favored policies include infant industry tariffs,[36] subsidies for special capital investments (often coordinated with the MOF), and **rationalization cartels** that seek to take advantage of economies of scale or carry out MITI-financed R&D projects. Rationalization cartels were used in the early 1950s for steel, coal, shipbuilding, electric power, synthetic fibers, and chemical fertilizers and in the late 1950s for petrochemicals, machine tools, and electronics. Currently these cartels focus upon computers, high-definition TV, superconductivity, and biotechnology.

At the end of the product cycle, MITI eases the closeout using **depression cartels.** These were used in both coal and shipbuilding in the 1970s. However, such cartels have been used less often lately because of increased antitrust enforcement in response to international pressure. The use of cartels for R&D has continued. More recently, MITI has shifted to aiding adjustment for reducing environmental pollution and in response to the results of trade disputes.

Those applauding the use of industrial policy in Japan point to the overall rapid growth of the Japanese economy and the export success of such favorably targeted industries as shipbuilding, steel, and computers. Those questioning the effectiveness of MITI's policies

34. Chalmers Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925–1975* (Stanford: Stanford University Press, 1982), p. 72.

35. Many of them were part of the promilitary *reform bureaucrat* movement of the 1930s who first experimented with economic planning in Manchuria. Some were initially influenced by the Soviet model of five-year plans for industrialization but later followed the **corporate state** approach of Nazi Germany.

36. Import restrictions were lifted on buses and trucks in 1961, on color TVs in 1964, on automobiles in 1965, on color film in 1971, on cash registers in 1973, on large memory integrated circuits in 1974, and on computers in 1975, all industries where Japan is now an export power.

note that several of the most successful export sectors were not targeted, including sewing machines, cameras, bicycles, motorcycles, pianos, radios, tape recorders, magnetic tapes, audio components, watches, pocket calculators, machine tools, textile machines, ceramics, and robotics.

MITI failed in the late 1950s to cartelize the automobile industry down to two firms. One firm very resistant to MITI's entreaties was Honda, perhaps the most technically innovative of the Japanese automobile companies and a great export success. Another firm resistant to MITI has been the technically innovative and export-successful Sony, which rejected MITI's advice not to produce transistor radios in the 1950s. Both companies were founded and led by strong-willed entrepreneurs operating outside of the planning and *keiretsu* systems, instead arguably functioning more according to the U.S. pattern.

Another criticism of MITI's effectiveness is that many of its subsidized research projects have not worked out as hoped, a noticeable recent trend, although sometimes they are successful. An example is the project for fifth-generation computer development, which followed successful earlier projects in the computer area. This effort to develop very-large-scale integrated systems seemed to exclude the parallel processing of many smaller computers. But in 2002, Japan announced that it had developed the world's fastest computer, albeit at a very high cost. It remains to be seen how commercially viable this will prove to be.

Thus Japan is generally moving away from government management of the economy. The heyday of MITI as the guiding light of the Japanese economy was in the 1940s, 1950s, and 1960s, when it was relatively easy to identify a sequence of industries the economy could successfully focus on in turn in a catchup development game. Now that Japan has caught up and competes at the cutting edge of world technology, MITI's effectiveness has been reduced.

WHY JAPAN FAILED TO BECOME NUMBER ONE

Macroeconomic Performance

From 1880 to 1940 Japan's average annual rate of growth in terms of real GDP was 3.41 percent, a rate exceeding that of any other country during that period. From the end of World War II to 1990, Japan also had the highest economic growth rate among the major advanced economies while maintaining unemployment rates in the 1 to 2.5 percent range. This high rate of growth was driven by a high capital investment rate backed by a high savings rate. But after the bursting of the Japanese stock market bubble in 1990, the growth rate of Japan fell below those of other leading market capitalist economies, with its unemployment rate exceeding 5 percent by early 2002.

Table 6-3 shows GDP growth rates for Japan, France, Germany, and the United States during the 1966–1999 period.

Table 6-3
Economic Growth Rates

Years	Japan	France	Germany	United States
1966–1973	10.1	5.8	4.3	3.6
1973–1980	4.3	2.9	2.6	2.5
1980–1990	3.8	1.1	1.4	1.9
1990–1999	1.4	1.7	1.5	3.4

Sources: Data for 1966–1980 from Bela Balassa and Marcus Noland, *Japan in the World Economy* (Washington, D.C.: Institute for International Economics, 1988), pp. 6–7, and for 1980–1999 from *World Development Report 2000/2001: Attacking Poverty* (New York: Oxford University Press for the World Bank, 2001), pp. 294–295.

Rates of growth in all of these leading economies have declined, and continue to do so, except for the increase in the United States during the 1990s. Table 6-3 offers a snapshot of the global growth crisis mentioned in chapter 1. Since World War II, Japan has had only 5 years of negative GDP growth: 1954; 1974, the first oil shock year; 1997 and 1998, when the Asian financial crisis triggered outright recession; and a small amount in 2001.

Underlying the high rate of capital investment is a high savings rate. Figure 6-1 shows gross savings rates as a percentage of GNP over time for several major economies. As the savings rate has remained high in Japan, so has the gross domestic investment rate at 30 percent of GDP in 1999, which means that the stagnation of Japanese economic growth has not been due to substantial declines in either savings or investment, despite widespread claims to the contrary.

Since World War II, Japan has had a very high savings rate. That this was not so prior to the war undermines the theory that the high savings rate reflects Confucian ideals or practices. Among competing explanations for this high rate of savings are the following: savings are caused by high growth rates as consumption increases lag behind income increases; individuals save to make down payments on homes, which are wildly overpriced; workers save for old age because of the combination of early retirement with low pensions and low social security payments; the lumpiness of large biannual bonuses encourages savings; there is no capital gains tax except on land; and throughout most of the postwar period, Japan had a relatively young population.

The last point raises serious concerns about the future. One sign of Japan's success is that it now has the longest life expectancy in the world. But this is leading to a rapidly aging population, which, when combined with early retirement and a falling birth rate, implies a rising dependency ratio that may well lead to a depressed savings rate. By 2005 Japan's dependency ratio will substantially exceed 60 percent, higher than that of any other leading industrial country.[37]

37. *OECD, Economic Surveys: Japan, 1991/1992,* p. 64.

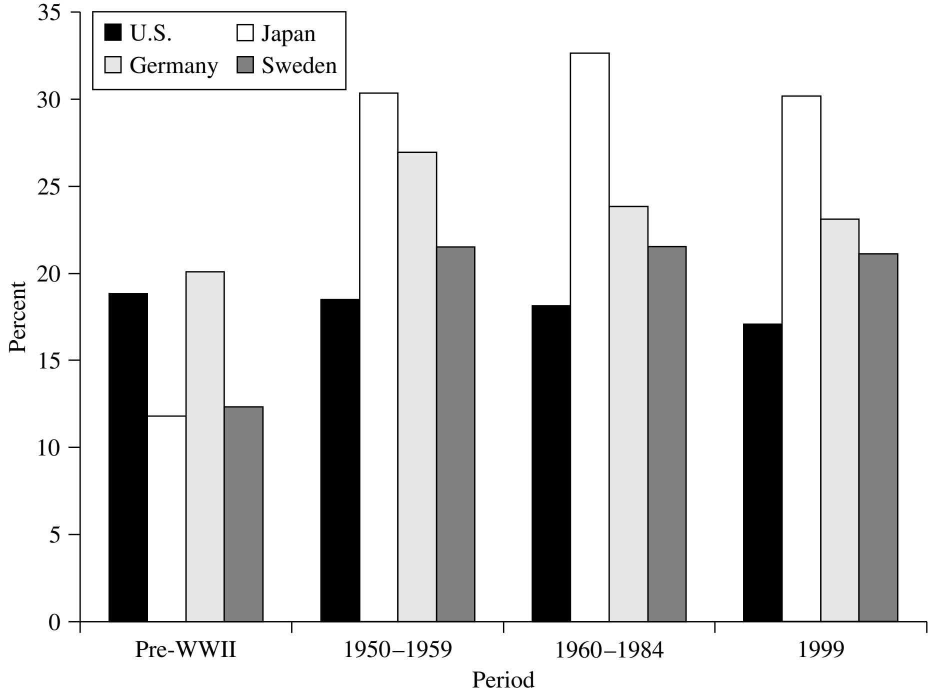

Figure 6-1
Gross Savings as a percentage of GNP.
Sources: Data for 1966–1980 from Bela Balassa and Marcus Noland, *Japan in the World Economy* (Washington, D.C.: Institute for International Economics, 1988), pp. 6–7, and for 1999 from *World Development Report 2000–2001: Attacking Poverty* (New York: Oxford University Press for the World Bank), pp. 29–99.

Macroeconomic Planning and Policy

Japan basically has a market capitalist economy with elements of a traditional economy and significant amounts of indicative planning and guidance. Beyond the sectoral and technological planning carried out by MITI, the Economic Planning Agency (EPA) regularly puts forth macroeconomic plans with associated sets of policy goals.

The indicative nature of these plans means that they are more forecasts than plans. For most of the plans up to the 1970s, the economy's actual growth exceeded the planned growth rate. From 1970 to 1983 the reverse was the case, with growth rates below targets by narrow amounts. The actual rates have been below the targets since then, with the EPA adopting a target band of growth rates rather than a specific rate for the 1996–2000 plan.[38]

38. See Kazuo Sato, "Japan at a Crossroads," in Sato, *The Transformation,* p. 60.

Although the EPA draws up the plans, it is the MOF that is the agent in charge of carrying them out and implementing macroeconomic policy. Not only is the MOF in charge of the government's budget and fiscal policy, but until recently it was in charge of the central bank, the Bank of Japan. Although inflation has been moderate, price stability is one macroeconomic variable where Japan has never been a world leader in economic performance.

The structure of the fiscal policy has attracted attention because of the relatively low levels of government spending and taxation in Japan. Supply-side economists in the United States emphasize the almost nonexistence of capital gains taxes as a possible source of Japanese economic success. But the highest marginal income tax rate is 50 percent, higher than in the United States, as is the highest corporate income tax rate. It is argued that Japan's relatively low level of social transfer payments encourages savings and hard work. Another reason for Japan's low government spending is low defense spending, stemming from the U.S.-mandated demilitarization.[39]

As the stagnation persisted during the 1990s, budget deficits were allowed to surge, reaching 7 percent of GDP by 1998, with the ratio of national debt to GDP reaching 150 percent by early 2002, an increasing concern within Japan. Japanese policymakers have been frustrated because this stimulative fiscal policy and a monetary policy featuring zero interbank overnight interest rates have failed to produce high economic growth rates.

Quality of Life

According to the 1993 UN *Human Development Report,* Japan had the highest quality of life of any country in the world and thus in a sense had succeeded in becoming Number One. But the same report for 2002 listed Japan as having declined to ninth place in the world on the Human Development Index (HDI). Japan was tops in life expectancy at 78.6 years for 1990 and at 81.0 for 2000. A measure accounting for gender empowerment puts Norway on top and Japan 31st for 1999.[40] In Japan women earn only 51 percent of what men do, compared to about 70 percent in the United States and over 85 percent in Sweden, Norway, and France.

Table 5-4 in the previous chapter shows some indicators of living standards for high-consumption countries in 1998. In nominal terms, Japan is ahead of these countries in per capita income and per capita consumption. But its standing is reduced when the purchasing power parity (PPP) adjustment is used because of the high cost of food and housing in Japan relative to other nations.

39. The Japanese Self Defense Forces were established with U.S. approval in 1954. The 1 percent of GDP spent on defense makes Japanese defense spending among the world's highest, given the large size of Japan's economy. The low level of defense spending relative to the United States has meant that more Japanese engineers have been available for making civilian industry more competitive.

40. *Human Development Report 2002* (New York: Oxford University Press for the United Nations Development Program, 2001), p. 149.

Table 6-4
Selected Gini Coefficients

Mid-1970s	Japan	Sweden	W. Germany	United States	OECD Avg.
Before taxes	0.335	0.346	0.396	0.404	0.366
After taxes	0.316	0.302	0.383	0.381	0.350
Mid-1990s, after taxes	0.249	0.250	0.300	0.408	n.a.

Sources: For the mid-1970s, Martin Bronfenbrenner and Yasukuchi Yasuba, "Economic Welfare," in Y. Kamamura and Y. Yasuba (eds.), *The Political Economy of Japan: The Domestic Transformation* (Stanford: Stanford University Press, 1987), p. 111; for the mid-1990s, *Human Development Report 2001,* p. 142.

Another area in which the quality of life in Japan is high relative to other nations is its low crime rate. In 1988, while the U.S. murder rate was 8.6 per 100,000, the Japanese rate was 1.4; the U.S. rape rate was 37.5 per 100,000, whereas the Japanese rate was 1.4; and the U.S. armed robbery rate was 225.1, whereas the Japanese rate was 1.6.[41] This mostly reflects cultural values, although gun policies in the United States play a role. However, these rates have been rising more recently in Japan while still remaining low compared to those of most other nations.

Japan has one of the more equal income distributions in the world. This equality is not due to government redistribution but reflects the egalitarian wage structure arising from the labor-management system. Income distribution is seen by looking at before- and after-tax distributions. Japan is more equal than Sweden before taxes, but is less so after taxes. Table 6-4 makes the two comparisons for Gini coefficients for selected countries for the mid-1970s. The longer-term pattern of Japanese income distribution was to become more unequal from 1890 until about 1940 and then more equal until about 1980; since then, a gradual trend toward greater inequality has set in.[42]

The dark side of the Japanese economic paradise is captured in the widely repeated phrase about "workaholics in rabbit hutches." The Japanese work much longer hours with fewer vacations than almost anybody anywhere. In large metropolitan areas, especially Tokyo, the Japanese spend long periods of time commuting under highly congested conditions.[43] They have cramped living quarters often lacking the sanitary facilities of most developed nations, and they pay very high prices for them. Housing and congestion questions are addressed in table 6-5.

41. *The Economist*, "Japan Compared," December 24, 1988, p. 50.

42. Toshiyuki Mizoguchi, "Long-Term Changes of Income Distribution in Japan, 1890–1995," *Journal of the Asia Pacific Economy* 5 (2000): 45–56.

43. Japan is one of the most congested countries in the world. It is slightly smaller than California but has about half the population of the United States. Much of Japan consists of uninhabitable mountains, further increasing the congestion.

Table 6-5
Housing and Infrastructure

	Japan	United States	United Kingdom	France
Floor space per resident				
Square meters	25.0	61.8	35.2	30.7
Year	1988	1987	1988	1984
	Tokyo	New York	London	Paris
Urban park space per resident				
Square meters	7.9	29.3	26.9	11.8
Year	1999	1997	1997	1994
Sewerage service coverage ratio				
Percentage	60.0	71.0	97.0	51.0
Year	1999	1992	1995	1994
Expressway extension per 10,000 vehicles				
Kilometers	1.07	4.32	1.31	3.19
Year	1999	1986	1996	1997

Sources: Floor space per resident data from *OECD Economic Surveys: Japan 1991/1992* (Paris: Organization for Economic Cooperation and Development), p. 60; other data from *OECD Economic Surveys Japan: December 2000* (Paris: Organization for Economic Cooperation and Development), p. 157.

Another problem is environmental pollution, although there has been improvement since the 1960s. In the late 1960s several major disasters occurred that triggered major cleanup efforts, most infamously the *Minamata disease* caused by mercury pollution in shellfish and the *itai itai* ("ouch ouch") disease caused by cadmium pollution. In 1973 a law was passed that taxed polluters according to emissions levels and allowed compensation for victims. From 1965 to 1980 sulfur dioxide emissions in parts per million declined from 0.057 to 0.016, while organic water pollutants in parts per million declined from 23.11 in 1970 to 9.20 in 1980.[44] These trends, plus the high life expectancy in Japan, suggest that this problem is being brought under control.

Finally, Japanese society suffers from serious problems of discrimination. Besides the low wages received by women, discrimination also exists against foreigners (*gai-jin*), the largest such group being Koreans. Most of these people are descendants of workers who were imported when Japan ruled Korea, but they are not allowed to become citizens and are restricted in their professional activities. There is also discrimination against the indigenous Ainu who live in the North and a group known as the Burakumin who are descended from people who held undesirable jobs in the feudal period.

44. Martin Bronfenbrenner and Yasukuchi Yasuda, "Economic Welfare," in Hugh T. Patrick and Henry Rosovsky, eds., *Future Prospects of the Japanese Economy* (Stanford: Stanford University Press, 1987), p. 111.

The End of the "Economic Miracle"

Japan's economic growth rate consistently exceeded that of its rivals, the United States, Germany, and the former Soviet Union, for the position of Number One during the postwar era until 1990. Since then Japan's growth rate has decelerated more dramatically than those of Germany and the United States, while the former Soviet Union has experienced even sharper declines. The enormous hype in the 1980s regarding Japan's long-term prospects has been succeeded more recently by the opposite claim: Japan has run out of steam, and its "economic miracle" is over. Whereas in the late 1980s it appeared to be only a matter of a few decades before Japan surpassed the United States in aggregate GDP, this outcome now seems very unlikely in the foreseeable future.

Many theories have been advanced to explain this altered situation. These include rising dependency ratios that reduce savings; opening of financial markets caused by deregulation, leading to outflows of capital; hollowing out of the industrial base as large corporations invest in other countries; technological stagnation owing to Japan's having caught up with the world leaders; weakness of the nontradeable goods sector in a dual economy; the failure of government spending to stimulate the economy as a result of declining multipliers; the unwillingness of consumers to spend tax cuts because of fear of job loss; the emergence of a liquidity trap in financial markets as incipient deflation makes even a zero interest rate too high to allow capital investment; a decline in the rate of return to capital investment owing to overinvestment in the past; a credit crunch caused by the accumulation of bad loans in the banking sector; a general disruption of the financial sector in the aftermath of the collapse of the stock market and land speculative bubbles; and deeper cultural arguments involving a breakdown of Confucian values or the decline of the work ethic among the younger generation.[45] Needless to say, these are not mutually exclusive theories but may be mutually reinforcing, with some studies suggesting that multiple causes are at work.

One fruitful focus of analysis is the central savings-investment nexus. Japan is a rapidly aging society that will experience rising dependency ratios, which tend to depress the savings rate. Thus Japan may become a victim of its own success as a society able to support long life. A solution to this savings shortfall might be delaying retirement. But this would clash with the Confucian value system that emphasizes respect for elders. In a typical large

45. Useful literature on the proximate causes of Japan's slow growth after 1990 includes Richard Katz, *Japan, The System That Soured: The Rise and Fall of the Japanese Economic Miracle* (Armonk, N.Y.: M. E. Sharpe, 1998); Tadahiro Uematsu, "Japan's Decade-Long Recession," *Kobe University Review* 45 (1999): 19–29; Taizo Motonishi and Hiroshi Yoshikawa, "Causes of the Long Stagnation of Japan during the 1990s: Financial or Real?" *Journal of the Japanese and International Economies* 13 (1999): 181–200; Keith Cowling and Philip R. Tomlinson, "The Japanese Crisis—A Case of Strategic Failure?" *Economic Journal* 110 (2000): F358–F381; Tamim Bayoumi, "The Morning After: Explaining the Slowdown in Japanese Growth in the 1990s," *Journal of International Economics* 53 (2001): 241–259.

Japanese corporation, when someone is appointed CEO, all persons who are his age or older retire, reinforcing the tendency toward early retirement in Japan.

Some argue that the factors involved in Japan's economic stagnation varied in importance throughout the 1990s. In the early 1990s, a low rate of return for large corporations resulting from overinvestment played a role, while smaller firms in the relatively unproductive nontradeable goods sector faced credit constraints. After the 1997 Asian financial crisis credit problems spread to the large corporations as well, with the accumulation of problems and bad loans in the banking sector owing to the continuing decline of real estate prices exacerbating these problems. Efforts at stimulative fiscal and monetary policies in the late 1990s were ineffective as public sector debt mounted and liquidity trap problems appeared in an increasingly deflationary environment. Despite continuing huge trade surpluses, capital continues to flow out of Japan. Prior to 1997 it was flowing to Asian countries, where subsidiaries of Japanese companies acted as suppliers of inputs to Japanese industry; after 1997 it increasingly went to Europe and elsewhere.[46]

Outside observers have tended to point to Japan's banking sector, calling for its deregulation and opening. This process of restructuring began in 1997 with the so-called **Big Bang Reforms,** which continue but so far have failed to resolve the problems. Many call for an end to the role of the banks as the keys to the *keiretsus,* and perhaps even an end to the *keiretsu* system itself. These advocates of "imitating America" in financial and corporate organization and management are opposed by others, who argue that Japan has strayed from its distinctive path by trying to do exactly that.

The Collapse of the Bubble Economy

A major source of the low cost of capital in the late 1980s was the high price/earnings ratios of the Japanese stock market relative to those of other countries. These high price/earnings ratios reflected high expectations regarding the future growth and earnings of Japanese corporations. But as the Japanese economy decelerated, it became clear that these expectations were exaggerated. The values of Japanese stocks fell sharply, ending the **bubble economy.** In this view, economic growth was a self-fulfilling prophecy. The expectation of high

46. On the shift of investment away from Asia toward Europe, see *OECD Economic Surveys: Japan December 2000,* p. 44. Burkett and Hart-Landsberg (*Development, Crisis, and Class Struggle*) emphasize the role of the interrelationship between Japan and the rest of Asia. They discuss the flying geese theory that has Japan leading the Asian countries as they all move up the technological ladder, with the others serving subsidiary roles as suppliers for Japanese corporations. But these other countries, most importantly China, begin to catch up, thereby undermining Japan's lead. The flying geese theory dates from the pre–World War II era as part of the Japanese theory of the Greater East Asia Co-Prosperity Sphere and was originally stated by Kaname Akamatsu, with his "A Theory of Unbalanced Growth in the World Economy," *Weltwirtschaftliches Archiv* 86 (1961): 196–217 presenting an English language version of his argument.

growth helped generate high growth by lowering the cost of capital. When that expectation disappeared, the cost of capital rose, thus making the economy harder to grow.

Many now regard the crash of asset values in the early 1990s as the watershed event of the Japanese economy, as it both symbolized and actualized the country's newly realized constraints. It is now widely accepted that the late 1980s runup in stock prices was a speculative bubble that burst. In the early 1970s, price/earnings ratios were about equal in the United States and Japan. By the end of 1989, when the Nikkei stock index peaked at over 38,000, Japanese ratios were about four times those in the United States. By late 1992 the Nikkei had fallen to around 14,000. It remained in that range for most of the 1990s but in 2002 slid below 10,000 and even below the U.S. Dow Jones average, which it had exceeded since the late 1950s.

Lying behind the speculative bubble in stocks, and such losing foreign investments as the Pebble Beach golf course in California, was an enormous runup in Japanese land and real estate prices. Owners of highly priced real estate could use it as collateral to borrow from Japanese banks in order to buy stocks or make foreign investments. At the peak of the runup, residential property in downtown Tokyo was worth 40 times more than equivalent properties in downtown London.[47] This led to wild estimates that the palace grounds of the emperor were worth more than the state of California and that metropolitan Tokyo was worth more than Britain, France, and Germany put together. In contrast to the 1990 collapse of the stock market, land prices continued to rise into 1991 before starting to decline. These prices continued to drop over the past decade, and given the importance of land in the assets of the banking system, this continued decline has been identified by many as a fundamental reason why the Japanese economy as a whole has been unable to turn around. Some have suggested that Japan adopt the U.S. strategy in the Savings and Loan crisis of the 1980s and pay for restructuring of banks and their bad loans. But as long as Japanese land prices continue to decline, even this policy does not seem to hold out much hope.

These high real estate prices aggravated Japan's housing shortage. Whereas the ratio of housing prices to annual income was about 1:1 in 1950 in both Tokyo and Japan as a whole, by 1983 it had risen to 7.9 for Tokyo and 6.7 for Japan as a whole.[48] Land prices nearly doubled after 1983 before peaking in 1991. Japan's land problem arises from a combination of low property taxation, especially of agricultural land in cities,[49] and high land capital gains taxation, along with a variety of land use restrictions. This leads to a "lock-in" effect causing a strong disincentive to sell land. But at least half of the peak land prices reflected a speculative increase that has now ended.

47. Yukio Noguchi, "Land Problem in Japan," *Hitotsubashi Journal of Economics* 31 (1990): 73–86.

48. Ito, *The Japanese Economy,* p. 412.

49. There are rice farms in Tokyo.

This collapse of asset values has coincided with a broader systemic crisis in Japan. The gains in wealth from the bubbles were very unevenly distributed, undermining the groupist solidarity of Japanese society. Scandals erupted regarding involvement of high politicians in the speculation. The Japanese public's disgust caused the ruling Liberal Democratic Party (LDP) to split and fall from power briefly in 1993. This same public unhappiness led to the rise to power within the LDP to the prime ministership in 2001 of the reformer Junichiro Koizumi, although he seems to have become frustrated in his efforts to reform the system since then.

Can Japan Achieve Technological Leadership?

The deceleration of growth in Japan could be a self-reinforcing process if it undermines the microeconomic foundations of the economy by causing layoffs in the large corporations and the end of the lifetime employment system. Breaking the loyalty of Japanese workers to their companies could be a fatal blow, leading Japan to fall even further behind as other economies surpass it.

But all of this may be just a course correction, an adjustment to a more realistic path after an overheated period in the late 1980s. The most fundamental question has to do with technological leadership. Will Japan take it from the United States across the board? If so, it will become the world's unequivocal economic leader. If not, it will at best remain Number Two. The ability of Japan at the turn of the millennium to be the first to produce popular hybrid cars and to gain a solid lead in many areas of consumer electronics, as exemplified by the success of its Play Station 2, is seen by some as signs of Japan's continuing potential.

Optimists about Japanese prospects stress that it has outcompeted the United States in industry after industry, moving up from low-technology ones like steel to higher ones such as automobiles; has a higher rate of capital investment; and produces higher-quality cameras, TVs, and a variety of consumer electronics goods. The role of MITI in industrial policy, including its funding of R&D, is often cited in Japan's long-term favor, as is the continuing emphasis on mathematics and science education relative to the United States. Finally, Japan's still harmonious intrafirm relations are also seen as favorable.

Skeptics about Japan's economic future abound. It is argued that Japanese companies achieved their greatest successes when they were able to license existing technologies from abroad and then perfect them. But when there is an outright contest to generate new technologies from scratch, the United States retains fundamental advantages, as discussed in the previous chapter. Cited is the ability of key elements of the U.S. computer and software industries to maintain their leads despite the massive focus of Japan's MITI on this sector. A central argument is that the groupthink mentality of the Japanese may be fine for imitating the success of others, but it does not encourage the individual creativity that underlies frontier research and major technological breakthroughs, as has been the case in the United States since the mid-nineteenth century.

The most basic problem may be illustrated at the highest level of academic scientific research. Japan has produced very few Nobel Prize winners compared to the United States. Whereas Japanese high schools may far outcompete their American counterparts in teaching mathematics and science, their learning method is largely rote and does not emphasize applications to new situations. At the university level, rigid seniority-driven vertical hierarchies stifle research, and the most creative Japanese researchers end up going abroad. The sources of Japan's success may also be the sources of its failure.

But this negative view is not universally accepted. That Japan is not currently the world's scientific leader does not mean it cannot be in the future. The United States was a leader in innovation and new product development in the mid-nineteenth century long before its emergence as the world's basic science leader at the end of World War II. Increasingly, Japan is not merely imitating but is inventing new products, the Sony Walkman being a notable example, albeit one differing from the usual Japanese approach. Furthermore, it is vociferously argued that the "rote imitators" argument is a racist insult that ignores the many creative and innovative Japanese citizens in many different areas, such as architecture, clothing design, literature, and film (box 6-1).

The enigma of Japanese creativity is rather like the paradox of Zen Buddhism. It can be viewed as both a source of ultimate creativity and as a source of mindless obeisance to superiors. The "annihilation of the ego" can be either a liberating enlightenment or the submission of the samurai to his master's commands. The most famous Zen *koan,* "What is the sound of one hand clapping?", can be seen as a mystical source of contemplation or as the trigger for a well-known rote response, the devotee swinging one of his hands through the air in a one-handed "clap." And all of the above may be true in an appropriately Japanese, Rashomon-like multiple-reality manner. Very likely the Japanese technological future will exhibit yet another synthesis of traditional Japanese culture with influences from outside of Japan, especially from the United States.

JAPAN AND THE WORLD ECONOMY

The question of technological competition between the United States and Japan comes to a head in the area of international trade. Among the most visible signs of Japanese economic success has been its ability to penetrate many export markets and to develop large trade surpluses. But these surpluses, along with the widespread perception that Japanese markets are unfairly protected from imports, has triggered enormous resentment and anti-Japanese sentiments around the world (box 6-2).

Box 6-1
The Cultural Foundations of Japanese Technological Innovation

Sheridan Tatsuno argues that the Zen Buddhist tradition of Japan particularly underpins a cultural tradition of technological innovativeness. He points out connections between Japanese traditional arts and areas where they have been successful in modern technologies.

Traditional Art Application	Aesthetic Principle	Business
Wood carving	Miniaturization	Pocket TV
	Animism	Video animation
Bonsai	Miniaturization	Electronic products
	Trained growth	Bioengineering
Flower arrangement	Creative forms	Robot design
	Naturalism	Commercial landscaping
	Asymmetry	Amorphous crystal growth
Rock gardens	Reductionism	Home construction
	Aesthetic asymmetry	Science city design
	Meditative space	Research lab design
Architecture	Multipurpose rooms	Apartment housing
	Open to nature	Office complexes
	Natural materials	Office interiors
Paper folding	Manual dexterity	“Transformer” toys
	Complex three-dimensional forms	Computer-aided design
Hand-sewn juggling balls	Aesthetic play	Educational toys
Abacus	Manual dexterity	Calculator keyboards
	Visualization	Computer simulation
Chopsticks	Manual dexterity	Robot fingers
Folding fans	Collapsible space	Laptop computer design
	Aesthetic function	Ergonomic furniture
Japanese characters	Visualization	Fifth-generation computers
	Image recognition	Visual scanners
Wrapping cloth	Multipurpose	Compact folding solar panels

This list may be fanciful, but it does emphasize that the image of the mindlessly imitative Japanese is incorrect. The rising generation of highly educated young Japanese is quite likely to be more creative than its predecessors.

Source: Sheridan Tatsuno, *Created in Japan: From Imitators to World-Class Innovators* (New York: Ballinger, 1990), p. 57.

Trade disputes between the United States and Japan have increased. At the heart of the arguments of the U.S. revisionists seems to be a resentment of Japanese trade surpluses. The case has been articulately made by the former Clinton administration trade negotiator Clyde Prestowitz,[50] who argues that Japan, viewing things in power terms, always gets the best of the United States in trade negotiations because its wily MITI bureaucrats take a long run view.

50. Clyde V. Prestowitz, Jr. *Trading Places: How We Allowed Japan to Take the Lead* (New York: Basic Books, 1988).

Box 6-2
Does Japan Follow a Long-Term Strategy?

In 1857, Masayoshi Hotta, an adviser to the shogun, declared:

> I am therefore convinced that our policy should be to stake everything on the present opportunity, to conclude friendly alliances, to send ships to foreign countries everywhere and conduct trade, to copy the foreigners where they are at their best and so repair our own shortcomings, to foster our national strength and complete our armaments, and so gradually subject the foreigners to our influence until in the end all the countries of the world know the blessings of perfect tranquillity and our hegemony is acknowledged throughout the globe.*

*Quoted in Clyde V. Prestowitz, Jr. *Trading Places: How We Allowed Japan to Take the Lead* (New York: Basic Books, 1988), p. 21.

Prestowitz had little patience for traditional trade negotiations and demanded results-oriented agreements such as the 20 percent market share for semiconductor chips deal, rather than agreements ratifying rules that he claimed were always cheated on by the Japanese. Such views found some sympathy in the Clinton administration, which initially had confrontational relations with Japan over trade issues, partly because Japan has its own analysts who reflect the same ideas as the U.S. revisionists but from the Japanese perspective.

An assertive and popular example is Shintaro Ishihara, quoted at the beginning of this chapter, who participated in trade negotiations with the United States as Transport Minister and who has since become governor of Tokyo. He charges that U.S.-Japan trade frictions arise from American racism and hypocrisy, and states that the United States must accept the "imminent demise" of the "modern era" in which the United States has dominated Japan. The title of his book, *The Japan That Can Say No,* became a popular slogan in Japan in the 1990s.

Are there any facts that are clear from this controversy? One is that Japan experiences and has experienced for some time significant trade surpluses. In 2000 this equaled \$111.5 billion, with a substantial portion of that figure coming from the United States.[51] Generally Japan exports manufactured goods and imports raw materials and agricultural goods. Japan feels driven to export finished goods because of its extreme dependence on imported raw materials.

But why does Japan have such large surpluses? It has the lowest tariffs and quotas of any major industrialized nation if one does not count agriculture.[52] With respect to the

51. OECD, op. cit., p. 27.

52. OECD, op. cit., p. 86. Japan had an absolute ban on importing rice until late 1993, leading its citizens to pay six times world prices for rice. But it imports large amounts of corn and soybeans from the United States. The United States protects many agricultural products, and the EU is even more protectionist with respect to agriculture.

United States, 90 percent of Japan's trade surplus is in four sectors: automobiles, computers, VCRs, and semiconductors. The Japanese position is that the surpluses reflect superior Japanese competitiveness in price and quality. Critics question this assertion, arguing that the Japanese have targeted these high-technology sectors through industrial policy that uses dumping and other unfair techniques to hollow out critical U.S. industries one after another.

Japan is alleged to use a variety of informal barriers to imports. These include "administrative guidance" by ministries including MITI, overly "fastidious" interpretations of customs procedures, ridiculous safety standards,[53] bureaucratically arbitrary testing and certification procedures, biased public procurement policies, MITI's rationalization and depression cartels and subsidizing of high-technology R&D,[54] unfair patent rules, and inefficient retail distribution channels.[55] Furthermore, it is charged that the vertical *keiretsu* system as well as the high savings rate constitute "structural impediments" to imports. The Japanese respond that their trading partners engage in similar practices.[56]

Despite these many difficulties, there are U.S. companies that have succeeded in penetrating the Japanese market. Some successes include IBM, Texas Instruments, Motorola, McDonald's, Coca-Cola, and Gillette, although executives from even some of these companies have complained of the trade barriers they have faced.

The formation of the World Trade Organization (WTO) in 1993 has provided a new forum for the discussion and adjudication of grievances between the countries. Also, the Asia Pacific Economic Cooperation (APEC) group has declared full free trade as a goal by 2020, although the financial crisis of 1997 complicated this timetable. Pro-free trade U.S. President George W. Bush, who succeeded Clinton, has also favored Japan as an ally against the rising power of China. But ongoing disputes in such sectors as auto parts and steel continue to bedevil trade relations between the United States and Japan.

SUMMARY AND CONCLUSIONS

The Japanese economy is the most successful in the world with significant New Traditional elements in its system. It has combined a family-oriented approach derived from its unique combination of Shintoism, Confucianism, and Buddhism with the successful adoption of

53. A notorious example of this was the restriction on importing U.S. baseball bats on alleged safety grounds.

54. The Japanese correctly respond that the United States does this too for computers, aircraft, and biotechnology.

55. This is in the secondary sector of the Japanese economy, labor-intensive mom-and-pop operations that foreign producers find it hard to deal with.

56. A much-touted case was France's routing of all Japanese VCRs for customs inspection through the city of Poitiers, where they piled up for a lack of customs inspectors there.

modern technology in a market capitalist context. After opening to outside trade in the 1850s and the subsequent Meiji Restoration, Japan embarked on an outwardly oriented path of rapid economic expansion that continued until the early 1990s, except for the disruption associated with World War II. The immediate postwar occupation by the United States brought changes, but Japan has preserved its national culture and identity while absorbing outside influences and technologies.

Japan's large corporations practice a form of management that emphasizes close relations with workers. They have lifetime employment, seniority wages, and enterprise unions. Japanese managers engage in widespread consultation and horizontal coordination in their decision making, as well as encouraging the input of those below in well-defined hierarchies. Because of long-term financing from banks, managers were able to use longer time horizons in their decision making than occurs in most economies until the financial problems of 1990s emerged. Most large corporations belong to either horizontal or vertical *keiretsus,* associated groups of companies that coordinate their activities to some degree.

The Japanese government works cooperatively with business through an indicative planning process. Industrial policy, targeting rising and declining sectors for assistance, is carried out by MITI, which also subsidizes R&D activities. But some of the most successful Japanese corporations have stayed outside of both the *keiretsus* and industrial policy structures.

Long-term macroeconomic performance has been very impressive. Japan now has the second highest aggregate GDP in the world and surpasses the United States in nominal per capita income. Despite creeping up in the 1990s, unemployment has remained relatively low and the distribution of income has been fairly equal.

By some measures, Japanese citizens may have had the highest quality of life in the world in the early 1990s, only to fall to a lower ranking by the end of the decade because of the appearance of relative economic stagnation. They enjoy the longest life expectancy, a high material standard of living, high levels of education, and low crime rates. However, housing shortages persist, as well as significant discrimination against women and minority groups.

Yet despite past success, Japanese economic growth has substantially slowed down and may not pick up again. The aging of the population bodes ill for its high savings and investment rates, hurt also by the bursting of the speculative bubbles in stocks and real estate. Japan's ability to generate cutting-edge technology rather than just borrow from others has been seriously questioned, although others are more optimistic. In many areas the Japanese economy is coming to resemble more that of the United States as reform efforts continue.

Japan faces serious questions about its trade relations with the rest of the world, especially the United States, its main rival for the role of Number One. Ultimately the role Japan plays will depend on its willingness and ability to deal successfully with the rest of the world, an effort complicated by its struggles to reform its economy and return to the path of rapid growth. It should be remembered from what happened after the Meiji Restoration in 1868 that Japan is capable of immense change within a short period of time when its people decide to act. Whatever the outcome, the decisions and directions that Japan takes will be of profound importance for the entire world.

QUESTIONS FOR DISCUSSION

1. In what sense can Japan be viewed as a New Traditional Economy? How might this also not be true?
2. How do the three sacred treasures of labor reinforce each other? What trends in the Japanese economy may be leading to their disappearance?
3. Distinguish between horizontal and vertical *keiretsus*. How do they both help and hinder the Japanese economy?
4. Distinguish the J-mode of management from the H-mode. What are the advantages and disadvantages of each?
5. Why has industrial policy become less effective in Japan recently?
6. What are the arguments for and against the possibility that Japan will surpass the United States in technological leadership?
7. Will real acceptance by Japan of free trade lead to a loss of Japanese economic identity and a convergence on the U.S. model?
8. What are some possible cultural factors in the slowdown of the Japanese economy?
9. What has been the role of the decline of land prices in the slowdown of Japanese economic growth?
10. Will imitating the United States be the best approach for Japan to revive economic growth? Why or why not?

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SPAIN
Gulf of Lyons

7 Whither Indicative Planning? The Case of France

The French suffer from a deep-seated sickness. They will not understand that the times demand of them a gigantic effort of adaptation. . . . They cannot do without the State and yet they detest it, except when there is danger. . . . They do not behave like adults.
—Charles de Gaulle, as quoted by Alain Peyrefitte, *The Trouble with France,* 1981, frontispiece[1]

Reviewing the spectacle of these powerful age-old divisions within France, by rights, France should not exist. That from such a heterogeneous collection of peoples and civilization, France had somehow to be "invented." And indeed France had somehow to overcome obstacles and divisions, dragging along with her a mass of stagnant, contradictory and weighty histories, as heavy as the earth.
—Fernand Braudel, *The Identity of France,* 1988, p. 199

INTRODUCTION

France is the advanced market capitalist economy that has most publicly and prominently engaged in **indicative planning.** As in Japan, the use of indicative planning has coincided with considerable economic success. But as in Japan, France has now downgraded indicative planning and is allowing greater laissez-faire in policy.

If Japan is a land of paradoxes, France is more so. Lying in the narrowing zone at the western end of the Eurasian land mass, France has received multiple waves of migration from many directions. Its national unity has been created by force out of a diverse population. There is no natural tendency to harmony; indeed, in France we see just the opposite.

The French drive to national unity led to a strong centralized state, one that intervenes in or "directs" the economy, a practice known as **dirigisme** in French. Simultaneously there has been vigorous resistance to this *dirigiste* tradition. The term *political economy* was first introduced in France in 1615 to argue for *dirigiste*/mercantilist policies of state intervention in the economy. But the term **laissez-faire**[2] was also first introduced in France in 1751 by the Marquis d'Argenson to oppose such entrenched interventionist policies.

These contrasting traditions of economic policy and thought have intersected complexly with other sharp conflicts. The Wars of Religion were especially hard fought in France, a fact seen by Peyrefitte as a central source of "the trouble with France." Hyperconservatism and resistance to change are deeply entrenched in France, especially in rural areas.[3] This tradition supports *dirigisme* as a protectionist device preserving old ways of doing things.

1. Translated by William R. Byron (New York: New York University Press, 1981).

2. *Laissez-faire* literally means "let [them] do [it]." This imperative appeal is addressed to the government officials. The implicit *them* are businesspeople who are to be allowed to do as they want without government interference.

3. An example of this hyperconservatism is resistance to introducing the potato. Brought from South America, it was on the king's plate in England in 1619, but not so in France until 1787. French fries were invented only in the nineteenth century.

Yet, as noted in chapter 3, France has been a fountainhead of world radicalism with a history of major revolutionary outbursts in 1789, 1830, 1848, 1870, and 1968.[4] Although some of these had laissez-faire orientations, the later movements were strongly socialist and supported *dirigisme*.

The revolutionary tradition in France also reflects its deeply rooted class conflict. Karl Marx conceived of the class struggle while thinking about France and the French Revolution. The term **communism** is of French origin. Although this split has moderated recently, France's strong class divisions show up in sharp differences among political parties traceable to the French Revolution. The French Communist Party is among the most orthodox Marxist political parties in the world and, despite considerable loss of electoral support,[5] remains deeply entrenched in certain neighborhoods of metropolitan Paris (the *Red Belt*) and in other major cities. Many of these neighborhoods were strong supporters of the revolution in 1789, and in them are streets named not only for Marx and Lenin but also for Robespierre, who led the Reign of Terror in 1793.

Despite these conflicts, French nationalism is a powerful force and a source of *dirigisme* in French policy. Indicative planning was introduced in 1946 after France's national humiliation in World War II, with the hope of rebuilding the French economy so that France could return to its glorious past when it was the most powerful nation in the world. This last goal was not achieved, but the postwar economic performance of France has been generally impressive, with a 12th place position globally in 2000 of its human development index (HDI; UN, *Human Development Report 2002*).

As in Japan, the heyday of indicative planning in France was the 1950s and 1960s, when its economy was rapidly rebuilt and then moved into high-technology development. Its credibility was permanently damaged by the first oil price shock of 1973, which knocked plans and projections awry. Since then indicative planning has been a politicized football, being taken less seriously when conservative parties are in power and more seriously when the Socialists are in power.

With the defeat of the Socialists in the Assemblée Nationale (National Assembly) elections in 1993 and the appointment of a Gaullist[6] premier, Éduard Balladur, the formulation of official multiyear indicative plans was halted, even though then-President François

4. Whereas most radical upheavels of the 1960s in advanced countries largely involved students, in France workers were also significantly involved.

5. Many former Communist voters have switched to the far-right, anti-immigrant National Front, a trend especially pronounced in the 2002 presidential race, in which the National Front's Jean-Marie Le Pen defeated Socialist Lionel Jospin for second place, thereby knocking him out of the race. Many immigrants live in working-class neighborhoods and are seen as threats to exisiting jobholders. Both of these parties oppose European unification and support protectionism in trade relations.

6. De Gaulle himself supported indicative planning. It was in the late 1970s that the Gaullist party shifted to a more pro-laissez-faire stance under Jacques Chirac's leadership, although a dirigiste faction remains within it.

Mitterand (1981–1995) was a Socialist.[7] This policy continued under Mitterand's successor, the Gaullist leader Jacques Chirac (1995–), although he modified his previous pro-laissez-faire position. However, indicative planning came back into partial favor after the Socialist Lionel Jospin became premier after the 1997 National Assembly election. Jospin's term as premier ended with his defeat for president in 2002, and formal multiyear indicative planning remained discontinued, although elements of it at the regional level are still in place.

Another reason indicative planning has lost influence in French policy making has been the drive for European unification and the increasing integration of the French economy into the economy of the **European Union (EU).**

Integration has led to a loss of control over policy by the French government, as it has had to coordinate its economic policies with those of other countries, especially Germany. This first began with the European exchange rate mechanism (ERM) in the early 1980s and then after 1999 as it merged the French franc into the EU's new single currency, the euro. Although the French strongly supported unification, presumably to keep Germany under control, fear of losing their autonomy led to a near defeat of the referendum on the Maastricht Treaty by the French electorate in September 1992. Some observers see indicative planning as having reemerged at the level of the EU just as it is becoming increasingly irrelevant for the French national economy.

HISTORICAL AND POLITICAL BACKGROUND

Before there was France, there was the Roman province of Gaul, conquered by Julius Caesar. Peyrefitte calls France "Caesar's granddaughter," her mother being the Roman Catholic Church,[8] which in 496 baptized and anointed as king the chieftain of the Germanic Franks, Clovis, who conquered Paris. It took 1,300 years for the nucleus of France in the rich agricultural basin[9] around Paris to expand to its modern limits, approximating the boundaries of ancient Gaul.

7. Since the formation of the Fifth Republic in 1958, France has had a strong president who serves a seven-year term and has the power to appoint the premier and to dissolve the Assembly. The president serves only five-year terms as of 2002, beginning with Chirac's second term. Until 1986 the president was of the same party that dominated the Assembly. But in 1986–1988, again in 1993–1995, and from 1997 to 2002, that was not the case and France experienced *cohabitation.* In these situations the premier controls domestic policy, including economic policy, while the president controls defense and foreign policy. After his massive victory over the National Front's Jean-Marie Le Pen in the 2002 presidential race, Chirac was able to place his party in charge of the Assembly as well.

8. The role of the Roman Catholic Church has long been controversial in France. Although the population is overwhelmingly Catholic, a substantial proportion of France's industrial and financial entrepreneurs came from the Protestant and Jewish minorities.

9. France is a major agricultural exporter, indeed the world's largest, famous for its cuisine. Its high agriculture subsidies are a source of conflict with many of its trading partners. It has a relatively high proportion of population in agriculture for a nation so well off, aggravating its hyperconservatism.

According to some estimates, around 1500 France surpassed China as the nation with the world's largest GDP, a position it held until about 1830, when Britain surpassed it. In the late 1600s this economic lead underlay the military and political preeminence of the centralizing regime of Louis XIV, the "Sun King." From 1661 to 1683 his Minister of Finance was Jean-Baptiste Colbert, father of *dirigisme,* also known as **Colbertisme.**

Colbert pushed industrialization through *dirigiste* policies. Entrepreneurs in favored firms or industries were given numerous gifts, pensions, interest-free loans, tax breaks, exemption from military obligations, grants of monopoly power, and protection from imports[10] and guilds. A few state enterprises were established, the most famous being the Gobelins textile producer in 1667, the longest running state-owned enterprise in France. Colbert also instituted detailed industry-specific regulations to improve the quality and international competitiveness of French products.

The **physiocrats,** French economists, notably François Quesnay and the Marquis d'Argenson, criticized Colbertisme. Under their influence, Jacques Turgot, Minister of Finance for Louis XVI, tried to deregulate internal agricultural trade and eliminate internal monopolies and guilds in 1774.[11] But Turgot was forced from office in 1776 after bad harvests and riots.

The French Revolution was the endlessly controversial watershed event that defined the modern French state, its subdivisions, its currency and its class conflicts.[12] When asked to assess its significance, the late Chinese Premier Zhou En-lai declared, "It's too soon to tell." In economics the Revolution began on a pro-laissez-faire note but then moved in a *dirigiste* direction, culminating in Napoleon Bonaparte's military dictatorship and attempted world conquest.

After Napoleon's defeat in 1815, France followed Britain and Belgium as one of the first countries to industrialize. But between 1830 and 1930 France went from having the world's largest GDP to being fourth behind the United States, Germany, and Britain.[13]

A leftist regime led by Léon Blum came to power in the depression year of 1936. It fell within a year, but first it nationalized military production and established a Ministry of

10. Despite his external protectionism, Colbert established a customs union in 1664 in most of the northern half of France, *les cinq grosses fermes* (the five big [tax] farms), which stimulated the economic unification of France. The north-south split in France is the deepest and most persistent, the more Germanic north being wealthier and more urban-industrial and the Mediterranean south being poorer and more rural, except in the Rhone valley and on the Riviera.

11. A motivation for Turgot's reforms was a budget deficit. This became worse during the Revolution as citizens refused to pay taxes. Full-blown hyperinflation developed by 1794.

12. It also gave us many political categories of the modern world. Thus *left* and *right* originated in the French Assembly in 1789 as designating, respectively, anti- and promonarchists. The term *nationalism* also came from France.

13. Later it would fall behind the Soviet Union and Japan, then return to fourth place by moving ahead of Britain and the now-dissolved Soviet Union. Recently, France has fallen behind China.

National Economy that attempted to dominate the conservative Ministry of Finance. The Ministry of National Economy was dismantled after Blum's fall, but it foreshadowed the French postwar planning apparatus.

In 1940 Germany easily defeated France. Part of the country was directly occupied, and part was ruled by the puppet Vichy regime of Marshall Pétain. This defeat inspired the introduction of indicative planning after the war when the leader of the anti-Nazi Resistance, General Charles de Gaulle, headed the government. The Communist Party was the largest in the country, riding a wave of popularity for its role in the Resistance, and it supported central planning. But the Vichy regime had already introduced bureaucratic changes and technocratic planning practices that were carried over into the postwar planning system.

THE THEORY OF INDICATIVE PLANNING

General Arguments

Although French openness to indicative planning came from its *dirigiste* tradition, indicative planning in its ideal form is not *dirigiste. Dirigisme,* or direction, implies some coercion or strong incentive. Ideal indicative planning is purely voluntary. It is successful because those affected have been involved in its formulation, view it as credible, and act on its projections, thereby making it into a self-fulfilling prophecy.

The fundamental argument for indicative planning involves providing information. This argument was first expressed by John Maynard Keynes, who argued that "Many of the greatest economic evils of our time are the fruits of risk, uncertainty and ignorance." He argued that "the cure lies outside the operation of the individuals" and called for "the collection and dissemination on a great scale of data relating to the business situation" and for the creation of "some appropriate organ of action" that would "exercise directive intelligence" but would "leave private initiative and enterprise unhindered."[14]

Information Pooling, Concertation, and Coherence

The French planner and theoretician Pierre Massé further developed Keynes's argument, drawing on experience with French indicative planning.[15] He introduced the concept of **information pooling.** Planners carry out "generalized market research" allowing a common view of the future. This research involves consulting with leading actors in the

14. J. M. Keynes, "The End of Laissez-Faire," in *Essays in Persuasion* (London: Macmillan, 1931), p. 317. Although the idea of indicative planning was of British origin, the one attempt at such planning in the United Kingdom in the mid-1970s was a total failure and was quickly abandoned.

15. Pierre Massé, "French Methods of Planning," *Journal of Industrial Economics* 11 (1962): 1–17; Massé, "French Planning and Economic Theory," *Econometrica* 33 (1965): 265–276.

economy for their input, a process called **concertation.** After this step, the elements of the plan are adjusted to ensure coherence and to guarantee policy coordination. The goal is **l'économie concertée,** or **concerted economy,** which operates like a symphony, somewhere between the extremes of command planning and laissez-faire.

Massé also stressed the **exhortive** aspect of indicative planning. Not only is information about investment possibilities made available to firms, but firms are encouraged to believe that the possibilities are really achievable. Thus a higher rate of investment might come about in a self-fulfilling prophetic manner. Exhortive planning may have worked in France in the 1950s after a long period of low growth, when the planners may have broken through the entrenched hyperconservative risk aversion of businesses.

Criticisms of concertation argue that planners are no better at predicting surprise exogenous shocks than businesses and that economies need a variety of investment strategies to balance the national portfolio of investments. If everyone is following the plan and the plan is based on incorrect forecasts of external trends, society may be worse off than if some investors are preparing for the true outcome.

The Austrian School argues the impossibility of *any* central planner being able to gather sufficient information in a complex and ever-changing environment to formulate a useful plan. If firms face risk, uncertainty, and ignorance, as Keynes argued, governments are even worse off. Firms have localized information and prices are the best information transmitters, as long as markets are allowed to operate freely.

Informational Externalities and Economies of Scale

Responses to the Austrian view argue that part of the necessary information set for agents to achieve efficient behavior includes the intended or likely behavior of other agents.[16] In a purely decentralized economy such information is costly to obtain, implying an informational externality problem potentially amenable to concertation. But concertation may work only if there are economies of scale in information gathering. One reason indicative planning may have become less influential is improved computing and information technology. In the United States, specialized firms perform the forecasting functions of would-be indicative planners.

A related argument is that the efficiency of a general equilibrium depends on the existence of complete futures markets, which do not exist. In principle, an information pooling process can perform the role of nonexistent futures markets and lead to an efficient equilibrium.[17] Critics of this approach note that participants in such a process, including the

16. Roy Radner, "Competitive Equilibrium under Uncertainty," *Econometrica* 36 (1968): 31–58.

17. James E. Meade, *The Theory of Indicative Planning* (Manchester, U.K.: University of Manchester Press, 1970).

government, might have incentives to cheat by misrepresenting information[18] and that participants may be so uncertain about the future that they may be unable even to formulate long-term contingencies.

Multiple Equilibria and Coordination Failure

An argument knitting together these strands of theory is that informational externalities combined with the existence of economies of scale imply multiple equilibria, some of which are more efficient than others.[19] In this view, coordination failure may occur in the absence of some sort of indicative planning and a suboptimal equilibrium may be selected.[20] Guidance toward a superior equilibrium may involve an exhortive element, as well as a strictly informational one.

Nevertheless, all these schemes depend upon the planners having high credibility. French planners have suffered from a credibility problem due to inaccurate forecasts since the mid-1960s.

THE PRACTICE OF FRENCH INDICATIVE PLANNING

The Institutions of French Indicative Planning

Three motives inspired de Gaulle's adoption of indicative planning in January 1946. One was to avoid another humiliating defeat such as the one that occurred in 1940, which was widely attributed to a "decadent" and weak economy. Military strength requires national economic strength.

Another motive was to offset the power of the three Communist members of the cabinet. They supported a Stalinist command type of planning and had supported a 1944 attempt to revive Léon Blum's all-powerful Ministry of National Economy. In May 1945, on the surrender of Germany, de Gaulle sided with the Ministry of Finance and eliminated the Ministry of National Economy. The Commission Général du Plan (CGP, General Commission of Planning), established in 1946, was made subordinate to the Ministry of Finance and given no command authority. But it coopted the Communists in their demand for a central planning apparatus.

18. It may be possible to institute revelation schemes that punish cheaters, but this would involve moving to coercion and away from ideal indicative planning.

19. Jeff Frank and Peter Holmes, "A Multiple Equilibrium Model of Indicative Planning," *Journal of Comparative Economics* 14 (1990): 791–806.

20. The issue of coordination extends to government agencies. Even without private sector cooperation, the public sector may coordinate. Development of an independent public nuclear power capability may be a success story of French planning, although it is now criticized by many environmentalists.

The third motive was to provide a mechanism for negotiating with the United States over Marshall Plan aid and offered assurance that such aid would be administered intelligently.[21] Indeed, the First Plan (1946–1952) had a more *dirigiste*/command character than later plans because the CGP played an important role in distributing Marshall Plan monies based upon it. The founder of the CGP, its first director, and the developer of the First Plan was Jean Monnet, who was also the father of the European Coal and Steel Community, the predecessor of the EU.

The staff of the CGP was kept small, and following Monnet's ideas, it relied on persuasion to achieve influence rather than authoritative control. Many planning activities were actually carried out by related entities. An important institution on the input side has been the Institut Nationale Statistique des Études Économiques (INSÉE), an arm of the Ministry of Finance that gathers the statistical data used in making forecasts and maintains and develops the econometric models used in making the forecasts.[22] Also on the input side has been the Ministry of Industry, though it is not as powerful as its Japanese counterpart, the Ministry of International Trade and Industry (MITI).

The concertation process has been carried out by the Economic and Social Council, which has been concerned more recently with social issues such as education, women's rights, and income distribution. Also involved in concertation are the Modernization Commissions. These are both vertical, concerned with specific industries, and horizontal, dealing with issues cutting across the economy and concerned with coherence. Another body involved has been the regional planning agency, Délégation a l'Aménagement du Territoire et a l'Action Régionale (DATAR).

The 1981 election of the leftist Mitterand government brought further changes in the planning apparatus. A Commission of Planning was established to carry out higher-level coordination. More groups were brought in representing women, environmentalists, unions,[23] and foreign entities, especially the EU, which provided forecasts that entered into the planning process. Industrial strategy groups were created. The first Mitterand government enacted a major administrative decentralization allowing planning at local levels that had to be concerted as well. Concerting parties were pressured to sign contracts agreeing to follow the plan, especially nationalized companies.

21. A measure of ideological change since then is that such a move by a country today seeking aid from the United States would be absurd. Ideology appeared then in the U.S. condition for granting Marshall Plan aid that the Communists be removed from the cabinet. They were.

22. The Ministry of Finance got rid of the old Ministry of National Economy partly by refusing to give it any data. Truly, knowledge is power.

23. In principle, the unions were always in. But after the First Plan they largely dropped out, especially the largest one, the pro-Communist CGT, charging that business interests were in control of the process. Their position reflected continuation of the deep class conflicts in French society. Unions are more willing to be involved under Socialist governments.

Some saw a conflict between widening and deepening of the planning process. The former brings in more parties, thus making the plan more democratic and more popular. But widening tends to lead to dissipation and a lack of focus.

A complicating institutional issue is the relationship between the CGP and the Ministry of Finance. As in Japan, the Ministry of Finance is the supreme bureaucratic body, controlling budgets and jealously guarding its power against the CGP and other entities.[24] Monnet understood this and worked to appease the Ministry and involve it in the planning process so that it would support the outcome.

His successors have had varying success at imitating his approach. An important break came in 1963, when an unexpected immigration wave from Algeria upset plan forecasts. The Ministry of Finance forced a change in the plan because of the resulting budgetary crisis. The Minister of Finance then and for most of the next decade was Valéry Giscard d'Estaing, who became increasingly hostile to the CGP. The influence of planning was very weak during his term as president (1974–1981). He is now chairing a constitutional convention for the EU.

Another issue is the nature of the French bureaucracy itself. As in Japan, the top bureaucrats *(hauts fonctionnaires)* are a supreme elite who come from a small number of top educational institutions[25] and who move easily between top government posts and top business positions, a process equivalent to the Japanese *amakudari.* This unity of bureaucratic and business elites in both countries partly accounts for the relative success of indicative planning in the two economies as it facilitates the consultative process.

While the 11th plan was being formulated in 1993, the Gaullists won control of the Assembly; Éduard Balladur, their new premier, halted the development of a formal plan while retaining the CGP and its related entities such as DATAR with its regional plans, even though the Socialist Mitterand was still president. When Socialists regained the premiership in 1997 under Lionel Jospin (in cohabitation with the Gaullist president, Jacques Chirac), the CGP was directly attached to his office. In 1998 Jospin directed it to focus on interministerial cooperation and coherence in aiding integration of the French economy into the EU, reinforcement of social cohesion and the social safety net, and modernization of institutions, including regulation of industry and the environment. However, with the loss of national economic autonomy within the EU, the role of the CGP as a formulater of multiyear official national level plans has come an end.

24. In early 1994, the central bank, the Bank of France, was made independent of the Ministry of Finance.

25. In France the top institution is l'École National d'Administration (ENA), whose graduates are *les énarques,* known for their apolitical technocratic views. ENA was founded in 1945 because the previous top institution, I'École Polytechnique, was tainted by having had many of its graduates participate in the Vichy regime.

Table 7-1
Plan Forecasting Performance

Plan: Years	Forecast Growth Rate (%)	Actual Growth Rate (%)
Second: 1953–1957	4.4	5.2
Third: 1957–1961	4.9	4.5
Interim: 1960–1961	4.3	6.3
Fourth: 1961–1965	5.5	6.3
Fifth: 1965–1970	5.0	5.8
Sixth: 1970–1975	5.9	3.8
Seventh: 1975–1980	5.2	3.8
	Favorable 3.2	
Eighth: 1980–1984	Unfavorable 2.7	1.2
	Favorable 2.2	
Ninth: 1984–1988	Unfavorable 1.6	1.1

Source: Saul Estrin and Peter Holmes, "Indicative Planning in Developed Economies," *Journal of Comparative Economics* 14 (1990): 542.

The Plans and Their Performance

Plans were initially more microeconomically focused, becoming macroeconomic later. Forecasting failures arose after 1970 due to exogenous shocks, and the plans became less influential. After 1980 the plans focused increasingly on problems associated with EU integration, still today the focus of the remnants of the national planning apparatus. (See table 7-1 for the performance of the first nine plans.)

The First Plan (1946–1952) sought industrial reconstruction from war damage, with 1944 industrial production at 44 percent of 1939 production.[26] The planning emphasized *dirigiste* investment targets from directing Marshall Plan funds that financed about one-third of investment from 1948 to 1950.[27] It included no macroeconomic or social components and came close to being fulfilled.

The Second Plan (1953–1957) introduced concertation and the Modernization Commissions. The Second Plan and the Third Plan (1957–1961) were the most successful of the plans. They introduced macroeconomic forecasting and produced growth close to their high targets (5.2 percent actual compared to the 4.4 percent target for the Second Plan, 4.5 percent actual compared to the 4.9 percent target for the Third Plan). These were the plans that fulfilled the exhortive function of convincing businesspeople that higher growth was possible, thus possibly helping to bring it about. The growth rates in this period were the highest ever seen up to then in French history. But sectoral forecasts were far off, a pattern consistently seen later.

26. Henry W. Ehrmann, *Organized Business in France* (Berkeley: University of California Press, 1977), p. 88.

27. Stephen S. Cohen, *Modern Capitalist Planning*: *The French Model* (Cambridge, Mass.: Harvard University Press, 1969), p. 88.

Under the direction of Pierre Massé, the Fourth Plan (1961–1965) included social goals such as expanded social infrastructure investment and emphasis on regional planning. Development of the French nuclear power industry was targeted. Despite disruption by the 1963 Algerian repatriation, growth exceeded forecasts (6.3 percent actual compared to 5.5 percent planned).

The Fifth Plan (1965–1970) contained detailed microeconomic elements but had a macroeconomic focus, particularly on international competitiveness and controlling inflation, which was not met.[28] Growth exceeded the target for the last time in a French plan (5.8 percent compared to 5.5 percent) but was disrupted by the 1968 student-worker uprisings that led a year later to the decision of Charles de Gaulle, an adamant pro-planner, to retire from the presidency.

The Sixth Plan (1970–1975) placed more of a supply-side emphasis on rapid industrial expansion. This plan fell far short of its goals after the first oil price shock hit in 1973 (3.8 percent compared to 5.9 percent).

Under anti-planning President Giscard, the Seventh Plan (1975–1980) ignored microeconomic aspects entirely and sought to achieve macroeconomic balance alone. It failed (3.8 percent actual compared to 5.2 percent planned).

The Eighth Plan (1980–1984) had a microeconomic emphasis, pushing high-technology development and coinciding with a wave of nationalizations in 1981 and 1982 early in Mitterand's presidency. His coalition government with the Communists carried out many social policies as well, including major income redistribution[29] and wage increases. These policies led to rising inflation and a falling franc. In 1983 Mitterand tied the franc to the German mark in the ERM and adopted an anti-inflationary policy,[30] driving the Communists from the government. This plan saw the first use of multiple scenarios, none met (1.2 percent actual growth compared to a planned range of 2.7 to 3.2 percent).

The Ninth Plan (1984–1988) expanded participation in the concertation process, with greater emphasis on regional planning because of Mitterand's administrative decentralization. This plan went into abeyance after 1986 during the cohabitation between the Socialist Mitterand and the Gaullist premier, Jacques Chirac. It failed to meet its target range (1.1 percent compared to 1.6 to 2.2 percent).

28. Saul Estrin and Peter Holmes, *French Planning in Theory and Practice* (London: George Allen & Unwin, 1983), p. 68. For an early sharp critique of French planning, see Vera C. Lutz, *Central Planning for the Market Economy: An Analysis of the French Theory and Experience* (London: Longmans Green, 1969).

29. Prior to 1981, France had one of the most unequal distributions of income among advanced economies.

30. This policy was eventually successful. By 1993 the French inflation rate was lower than the German one and has generally remained so since then. It has been argued that this was the crucial turning point of French policy away from nationalist dirigisme and toward the free market within European unity (Daniel Yergin and Joseph Stanislaw, *The Commanding Heights: The Battle Between Government and the Marketplace That Is Remaking the Modern World* [New York: Simon & Schuster, 1998], chap. 11).

The Tenth Plan (1989–1992) focused on European integration and preparing France for the complete removal of market barriers in the EU on January 1, 1993. Elements included upgrading education,[31] now somewhat decentralized.[32]

The never-completed Eleventh Plan was to emphasize accommodation to the Maastricht Treaty of 1991 with its plan for development of the euro, although regional-level planning managed by DATAR continued. After 1997 the CGP, now attached to the premier's office, resumed this focus, although without formal multiyear plans. By 2001, with Germany's economy faltering, France emerged as an economic growth leader of the EU, only to slow down somewhat the following year.

After 1970, actual growth fell below planned growth, thereby undermining the credibility of the planners. Microeconomic forecasts were further off. But in the face of failures because of unforecastable exogenous shocks, planners may still forecast better than private markets. Evidence that private markets do no better than the planners can be found from looking at interest rates as indicators of private market forecasts.[33]

Finally, the process of generating the Cecchini Report (1988)[34] for the European Commission, in which participants were asked to forecast the effects of the removal of market barriers in the EU, was classic French-style indicative planning. This process helped stimulate the investment boom that began after 1985 in an exhortive anticipatory manner. Somewhat similar processes emerged during the 1990s in the runup to the adoption of the euro in 1999 and the effort to converge macroeconomic policies and performance within the EU. Thus, although there are no formal plans at the EU-wide level, it has been argued that the locus of indicative planning has effectively moved there.

Industrial Policy

In comparing French and Japanese industrial policies, the French have more frequently nationalized industries than have the Japanese. Another difference is that French policy has been less consistent than Japanese policies, probably reflecting the greater power of MITI compared to the French Ministry of Industry.

31. As of 1989, only 7 percent of the adult French population had a university education compared to 23 percent in the United States, 15 percent in Canada, 13 percent in Japan, 12 percent in Sweden, 11 percent in Norway, 10 percent in Germany, 9 percent in Britain, and 8 percent for Europe as a whole (*OECD Economic Surveys: France 1992* [Paris: Organization for Economic Cooperation and Development, 1992], p. 93). College-educated youth have about one-third the unemployment rate of those who are not, a high unemployment rate being a severe problem in France.

32. French education was long among the most centralized in the world. Ministers of education used to brag that at any hour they knew exactly which page of which book every student of a certain grade would be reading.

33. Saul Estrin and Peter Holmes, "Indicative Planning in Developed Economies," *Journal of Comparative Economics* 14 (1990): 542.

34. P. Cecchini, ed., *1992 The European Challenge* (London: Gower, 1988).

Some state-owned firms in France date back to Colbert in the 1600s, including Sèvres porcelain and Gobelins textiles. But until Léon Blum nationalized parts of the military production industry in 1936, most French enterprises were privately owned by bourgeois *patrons.*[35] Many French firms were small and family owned, even in industries that tend to be dominated by large corporations in other countries.

After World War II a wave of nationalizations occurred, affecting the Bank of France, the four largest commercial banks, the four leading groups of insurance companies, all electric power and gas producers, the coal mining industry, Air France, and the Renault automobile company (the last specifically because of wartime collaboration with the Nazis by its owner). Until 1981 no other firms were nationalized, although occasionally new public enterprises were created from scratch or the government bought part ownership, as it did with Dassault Aircraft in 1978. Until 1986 none of these industries was denationalized.

In early 1982, under the Socialist/Communist government of Mitterand, another major wave of nationalizations occurred, the last such in any major world economy. Large enterprises across a wide range of sectors were nationalized, many of them the products of government-encouraged mergers in earlier years, including Honeywell-Bull in computers, Rhône-Poulenc in chemicals, Usinor and Sacilor in steel, Thomson in electronics, and the French telephone subsidiary of ITT. After this, state-owned enterprises (SOEs) constituted 30 percent of the value added in industrial production and 50 percent of R&D spending.

Sectors with especially large increases in state-owned shares during 1982 included ferrous ores, which went from zero to 68.3 percent, basic nonferrous metals from 16.3 to 60.7 percent, glass from zero to 34.7 percent, basic chemicals from 11.6 to 47.8 percent, pharmaceuticals from 6.6 to 24.3 percent, and aerospace from 53.8 to 84.3 percent.[36]

After 1986, the Gaullist Chirac government initiated a gradual privatization program involving sales of shares of some of these enterprises to the French public. A few, such as the commercial bank Société Générale, were fully privatized before the Socialists returned to power in 1988, when privatization was halted. But no further nationalizations occurred.

After defeating the Socialists in March 1993, the Gaullist government began privatizing 21 companies, including some of the largest nationalized in 1982 such as Rhône-Poulenc, Bull, and Thomson, and some dating back to the 1940s, such as Air France and Renault. Unlike the 1986–1989 program, foreign buyers have been allowed, although the government is retaining part ownership in companies in the defense, health, and security sectors and in Renault. Railways and telecommunications remain nationalized (box 7-1).

35. Other state-owned firms as of 1936 were railroads, the postal savings bank, and Crédit Agricole, which makes loans to farmers.

36. See Henri Aujac, "An Introduction to French Industrial Policy," in William James Adams and Chrisitan Stoffaes, eds., *French Industrial Policy* (Washington, D.C.: The Brookings Institution, 1986), p. 30.

Box 7-1
Profitable State-Owned Enterprises in France?

Most French SOEs have been profitable, in some cases more profitable than privately owned French firms competing with them—for example, for many years, state-owned Renault versus privately owned Peugeot. How could this be? The answer is that, by and large, these companies were not subsidized and were under orders to behave like profit-maximizing market capitalist firms. They faced hard budget constraints because they had no guarantee from the government that they would be bailed out if they failed.*

An extreme case was Renault, toward which the government actually took a hostile stance because of its owner's wartime collaboration with the Nazis. The company had to make it on its own, and it did. Indeed, both Renault and Air France sometimes found themselves at odds with the national plans or other directives of the government and actively fought them. Although the French are now privatizing, they showed how to develop a relatively efficient set of SOEs.

*There are exceptions, such as the scandal-ridden bank, Crédit Lyonnais (finally privatized in 2002), and the steel industry, where subsidies rose to keep firms afloat. But even there, firms have been allowed to fail. Air France has suffered losses recently, but then so have most privately owned airlines.

Much to the surprise of many, after 1997 the socialist government of Jospin continued the privatization program, although it slowed in 2000 to include only sell-offs required for international mergers. Table 7-2 shows the status of state-owned shares as of March 2000. Thus, despite some continuing reluctance, France has by and large joined the worldwide trend to capitalism, with Jospin's replacement by a center-right government after Chirac's reelection as president in 2002 reinforcing this shift.

During 1946–1963, industrial policy emphasized reconstruction and modernization through indicative planning. Starting in 1963, President de Gaulle decided to build up the French military, thereby encouraging specific high-technology industries through government purchases, particularly nuclear weapons, computers, aerospace, and conventional military equipment. In aerospace, France came to be highly competitive in world markets, especially for military aircraft, but not in computers, where the French have remained far behind several other nations in quality.

Between 1969 and 1974 under President Georges Pompidou, concern about international competition increased. French economic policy focused on developing "national champions," and a series of mergers in various sectors was encouraged. Some of the resulting firms became reasonably competitive, such as the Compagnie Générale d'Électricité. Others did not, such as those in the steel industry. This was the **Grand Industrial Policy,** and many mergers took a conglomerate form across sectoral lines.

Between 1974 and 1978, President Giscard pursued a more laissez-faire policy, although he attempted to save certain declining industries such as footwear and leather goods. From 1978 to 1981 his policy resembled Pompidou's, but without encouraging conglomerate mergers.

From 1981 to 1984, policy focused on SOEs. After that time, the focus was on preparing for European unification. In fact, the European Commission has played an important role

Table 7-2
Public Enterprises and Bodies as of March 2000

Enterprises	Main Activity	Percent of State Share	Value of State Share
Renault	Automaking	44	29,068
Bull	Computers	17	2,083
France Télécom	Telecommunications	63	720,481
Air France	Air transport	64	11,697
Aérospatiale-Matra	Aerospace	48	25,295
Crédit Lyonnais	Banking	13	7,860
Thomson CSF	Electronics	33	16,546
Thomson Multimedia	Electronics	52	58,535
Caisse national de prévoyance	Insurance	2	518
EDF	Electricity	100	
La Poste	Posts	100	
SNCF	Rail transport	100	
RATP	Rail transport	100	
Commissariat à L'énergie atomique	Research and development	100	
GIAT Industries	Machinery and equipment	100	
SNECMA	Transport equipment	100	
Aéroports de Paris	Airport services	100	
Cie financière Hervet	Banking	100	

Source: OECD Economic Surveys, France, July 2000 (Paris: Organization for Economic Cooperation and Development, 2000), p. 96. The value of the state share is in millions of French francs. There is no value figure for the enterprises with 100 percent, as they are not traded on the French stock exchange.

in pressuring the French to privatize, with some conflicts over specific cases occurring. The most notable case involved the much troubled Crédit Lyonnais bank, which was supposed to have been fully privatized by October 1999. Three years later it was, and was promptly purchased by Crédit Agricole to create Europe's second largest bank.

The tools of French industrial policy have included export subsidies, R&D funding, tax breaks, preferential lending by state-owned banks, and a relaxed antitrust policy. The last may have contributed especially to inefficiency and reduced productivity improvements in the French economy. Ironically, one outcome of shifting policy to the EU level has been a strengthening of antitrust policy, symbolized by the EU's 2001 blocking of the proposed GE-Honeywell merger that was approved by the U.S. authorities.

Labor and Management

Governments in France have long sought to bring about harmonious labor-management relations. But in contrast to Japan, harmony has proven to be difficult to achieve because class conflicts run deep in France. In the early 1830s, it was the striking silk workers of Lyon who inspired Karl Marx to assign to the industrial proletariat the role of world progressive hero class. The French union movement dates from that period and has been one of the world's most militant and politically revolutionary.[37]

One major effort to suppress the class struggle came during the Vichy regime in the early 1940s. Its official ideology was **corporatism,** based on the Roman Catholic Church's idea in the 1890s of solidarity between the classes.[38] The keystone of this effort was the Labor Charter of 1941, mandating the formation of combined labor-management committees that would resolve outstanding issues while forbidding strikes and lockouts. Both employers' associations and unions resisted joining these committees and the effort was generally a failure, although social committees were established that dealt with issues of health care and working conditions. Some of these evolved after the war into bases for labor-management cooperation. But unions have generally been suspicious of cooperation because of its association with the Vichy regime and the view that it merely suppresses the labor movement.

As can be seen in tables 2-3 and 2-4, in France union membership has not been high, but strike activity has been vigorous. However, a sharp drop in union membership occurred in the early and mid-1980s during the first Mitterand government when he ruled in tandem with the Communists. Large wage boosts and other pro-labor policies were implemented. Proposals for workers' management, called **autogestion,** also were put forth. These schemes foundered as the Communists left the government after Mitterand pledged to tie the franc to the European ERM, thereby restricting further wage increases.

Although French labor-management relations continue to be marked by many strikes and generalized strife relative to other countries reflecting historic class conflicts, recently there has been somewhat greater peace than in the past. However, a factor in this has been a persistently high unemployment rate (in double digits for many years). Only by 2001 did it finally dip below 10 percent, and the youth unemployment rate has remained about twice the level of the overall rate. High unemployment rates have also marked Germany, Italy, and Spain, the other large continental EU members. In France, one response by the Jospin government was to reduce the work week to 35 hours after 1997. Economists, especially in the United States, argue that these high unemployment rates reflect restrictive regulations in the labor market, such as rules making it difficult to lay off workers, which discourage firms from hiring them in the first place.

37. See Edward Shorter and Charles Tilly, *Strikes in France: 1830–1968* (London: Cambridge University Press, 1974).

38. See Frederic L. Pryor, "Corporatism as an Economic System: A Review Essay," *Journal of Comparative Economics* 12 (1988): 317–344, for a discussion of these ideological roots. Although the Roman Catholic Church formalized its position on corporatism in the 1890s, some of the earliest advocates of this approach in the church were French, notably Frédéric Ozanam, a participant in the 1848 revolution, who was beatified by the pope in 1997.

Regional Planning

An aspect of French planning not found in Japanese planning is an emphasis upon developing less developed regions. This extends the long process of nation building and absorption of peripheral zones in France. But it also arose from an anti-Paris sentiment outside of the capital, which is far ahead of the rest of the country in per capita income.[39]

Starting in 1954, policies were adopted to reduce regional inequalities, although at first, these policies were disconnected from the indicative planning run by the CGP. These policies included restrictions on industrial development in Paris,[40] investment grants and other subsidies including tax breaks for firms setting up in a Critical Zone (of which eventually there were two tiers), and the division of the country into 22 planning regions. In 1963, DATAR was established to implement these policies and to coordinate with the CGP in the indicative planning process. Unlike the CGP, DATAR had a budget and some executive authority, both of which it retains.

Regional development policies became linked with Pompidou's Grand Industrial Policy in the early 1970s. The conglomerate mergers encouraged then were to have regional bases so that the resulting national champions could function as **growth poles** and would support many suppliers and small firms within given regions.

Policies also emerged that were designed to halt the decline in industrialized regions where industries began to die, especially in the Lille region of the far north and in northeastern Lorraine, where the declining steel industry was concentrated. Again, these policies were linked with industrial policy as subsidies to the steel industry coincided with subsidies to these regions. More recently, under pressure from the EU, these firm subsidies have been reduced and some firms have failed.

Mitterand moved toward decentralizing planning and some other administrative functions as well. The basic regional planning units were the 22 established in 1956, which now gained expanded powers.[41] Decentralization led to a basic contradiction. The original goal was to equalize regional income differentials. But putting fiscal responsibility in the hands of local rather than national authorities may lead to increased inequalities. Richer regions can afford to support better schools and gain an edge that the highly centralized system did not give them over poorer regions.

39. In 1997, using the national average as the index of 100, the Ile-de-France region containing Paris was at 154.4, whereas no other region was as high as 100 (Peter Karl Kresl and Sylvain Gallais, *France Encounters Globalization* [Cheltenham, U.K.: Edward Elgar, 2002], p. 211). The poorest parts of France have traditionally been in the southwest and in Brittany in the far west, although the decline of industry in the north had put the Nord-Pas-de-Calais region as the lowest at 82.6 in 1997.

40. This contrasts with Japan, which has made no effort halt the implosion of labor and capital into Tokyo, now the world's largest metropolitan area.

41. There is a nostalgic correspondence between these planning regions and the prerevolutionary provinces that were eliminated in favor of departments, the official units of local government.

There is no consensus regarding the success or failure of this effort. Overall, the trend has been toward greater regional equality of income distribution, although the lead of Paris has increased somewhat recently. But equalizing trends are discernible in the United States, which has very little regional planning. Other countries, such as the United Kingdom, have seen increasing inequalities in regional income distributions despite having some regional policies.

Furthermore, despite French efforts, the problem of the declining industrial regions is getting worse. As with the broader planning effort, help for declining areas moved to the EU level, which provides subsidies to less developed regions throughout the EU, including some areas of France. Nevertheless, regional planning by DATAR is an element of French planning that is still operating.

FRANCE, EUROPE, AND THE WORLD ECONOMY

France and the European Union

Many important issues face the EU, including the addition of new members from Central and Eastern Europe; development of relations between the nations that have adopted the euro (*Euroland*) and those that have not; the future of regional aid and development policies; the future of the very expensive Common Agricultural Policy (CAP); and the balance of power between the various countries within the EU, with Germany trying to gain more power and France strongly resisting this move. More generally, there is the issue of whether or not the EU will move more in the direction of federalism, toward becoming a "United States of Europe," as envisioned by its father, the Frenchman Jean Monnet.

One major source of resistance to this more federated entity is the fact that the European Parliament in Strasbourg is quite weak and unable to initiate legislation. Instead laws must come from the European Commission in Brussels, whose members are appointed by the member national governments. It has been widely argued that for the EU to become more truly unified, greater power will have to be vested in democratically elected bodies such as the European Parliament.[42] A constitutional convention is underway to reform the EU governing structures, chaired by former French President Giscard.

Colbertism included a deep vein of protectionism within nationalist mercantilism. This tradition lived on strongly in French policy. France was among the most protectionist of major nations until after World War II, with the exception of a free trade interlude from 1860 to 1871. But just as the defeat in 1940 turned France toward indicative planning, it also

42. See Roland Vaubel, "The Constitutional Reform of the European Union," *European Economic Review* 41 (1997): 443–450. For further discussion of the structure and problems of the EU, see Willem Molle, *The Economics of European Integration: Theory, Practice, Policy*, 3rd ed. (Aldershot, U.K.: Ashgate, 1997; Larry Neal and Daniel Barbezat, *The Economics of the European Union and the Economies of Europe (*New York: Oxford University Press, 1998); and *The Economist,* "A Survey Europe: A Work in Progress," October 23, 1999.

turned France toward a more internationalist and free trade stance, especially with regard to Germany. Thus, as Luigi Barzini explains: "Three wars since 1870, all of them fought against Germany, cracked [France's] faith in its invincibility, and this is why France must now keep abreast of the Germans, keep them under surveillance, maintain the most intimate relations with them, and hold them in an embrace as close as a stranglehold. If France cannot dominate Europe alone, it hopes that maybe the two nations together might do so."[43]

To the extent that the desire to end the ancient Franco-German enmity was the political/diplomatic driving force for the creation of the EU, it has been a great success. But it has also been a smashing success economically, such that most nonmember nations in Europe now want to join.[44] The principal competing hypothesis to the alleged benefits of indicative planning for successful postwar French economic growth is the benefits of integration into the free-trading EU.

The argument that free trade in the EU has driven postwar French economic growth is strong. Exports have grown more rapidly than the economy as a whole, and they have increasingly gone to the EU. Exports have always been somewhat more volatile than GDP, but exports as a percentage of GDP rose from 8.9 percent in 1958 to 17.3 percent in 1979[45] and to 25.1 percent by 1990 in 1980 prices,[46] with this percentage drifting down slightly in more recent years.

Trade between France and its future EU partners declined from 35.5 percent in 1913 to a mere 17.9 percent in 1949.[47] Most of that decline was due to a shift to France's colonial empire. Colonial trade's share peaked in 1938 at 46 percent and still exceeded 40 percent in 1952.[48] From 17.9 percent in 1949, the EU's share of French exports soared to 64.8 percent in 1990.[49]

Although impressive, this increase does not resolve the issue of free trade because the major lowering of trade barriers occurred at the end of the 1950s and the beginning of

43. Luigi Barzini, *The Europeans* (New York: Simon & Schuster, 1983), p. 154.

44. A few naysayers are wealthy Switzerland, Iceland, and Norway, the latter two heavily dependent on the fishing industry, which they fear the EU will regulate. Even these three have largely free trade with the EU.

45. Jean Hough, *The French Economy* (London: CroomHelm, 1982), p. 200.

46. OECD, *Economic Surveys: France, 1992,* p. 145.

47. J. J. Carré, P. Dubois, and E. Malinvaud, *French Economic Growth,* John P. Hartfield trans. (Stanford: Stanford University Press, 1975), p. 405.

48. William James Adams, *Restructuring the French Economy: Government and the Rise of Market Competition since World War II* (Washington, D.C.: The Brookings Institution, 1989), p. 147. Although France gave up most of its formal colonial empire by 1962, it maintains close economic and diplomatic links with a group of former African colonies that traditionally tied their currencies to the French franc and now do so to the euro. Even Socialist governments have intervened militarily to support governments in these countries, as in Chad and the Ivory Coast.

49. OECD, *Economic Surveys: France, 1992,* p. 145. French opposition to agricultural imports into the EU and American film and TV show imports into France were major reasons it took until 1995 to create the World Trade Organization (WTO). Also, the French demanded that a Frenchman, Jean-Charles Trichet, be installed as chairman of the new European Central Bank partway through the term of the first chairman, the Dutchman Wim Duisenberg, apparently much to the annoyance of the other EU members.

the 1960s. Thus it may be that indicative planning was more important in the 1950s, when its information and exhortive roles may have influenced French business leaders. But once the lowering of trade barriers took effect, the expansion of exports to the EU probably became more important. Indeed, the highest growth rates ever recorded for the French economy came in the 1960s, when it also outperformed all other members of the EU, although this was also still a period when planning played an important role.

France's role in the EU has imitated the attitudes of French citizens toward their own government, as described by General de Gaulle in the first quote at the beginning of this chapter. The French have been among the most enthusiastic supporters of the EU and of European unification, despite barely supporting the Maastricht Treaty in a 1992 referendum. One thing that has encouraged their support is the perception that they have a lot of influence. The operative language among the **Eurocrats** at the European Commission in Brussels is French,[50] and the European Parliament meets on French soil in Strasbourg, albeit on the German border.

The Persistence of French Protectionist Tendencies

France continues to carry out protectionist policies by bureaucratic subterfuge and engages in mercantilist export promotion, which is linked to industrial policy[51] through an aggressive export bureaucracy and a system of insurance and interest subsidies. This protectionist tendency is directed less at other EU members, except when agriculture is involved, and more at making the EU itself a protectionist fortress against the outside world.

Protectionism has led France to prevent the EU from allowing easy entry of Eastern European commodities, much to the dismay of Germany and Britain. Also, France has expressed much skepticism regarding allowing new members into the EU, although it did go along with the December 2002 Copenhagen summit's decision to allow in 10 more members in 2004, mostly from Central and Eastern Europe. While it has called for deepening rather than widening of the EU, it has resisted further moves toward integration out of fear of German domination of the EU.

Protection of French agriculture has also been a cause of French reluctance to allow in new countries, with the expensive EU agricultural programs strongly under the influence of the French. In the negotiations prior to and at the Copenhagen summit, the most difficult problem was the level of agricultural subsidies the new members would receive, with Poland being especially unhappy with France's insistence that these be kept to only 40 percent of the level received by farmers in the older EU member nations.

50. This contributes to British uneasiness about European unification, along with the apparently socialist and bureaucratic tendencies of the Eurocrats, which upset pro-laissez-faire figures such as Margaret Thatcher. This unease was enhanced in the late 1980s by a French Socialist, Jacques Delors, serving as president of the European Commission.

51. France has transferred much industrial policy to the EU level. It closed down the nationalized Creusot-Loire steel company in response to EU pressure. Several joint EU ventures, notably Airbus, the Ariane space satellite program, and the CERN nuclear research facility, have had considerable success.

Box 7-2
The Emergence of the Euro

Among the most dramatic and important developments to come out of the formation of the EU has been the adoption of a common currency, the euro. Agreed to in the Maastricht Treaty of 1991, the euro was adopted by 11 of the 15 EU members on January 1, 1999, as a common unit of account and form of bank money, while each country continued to use its own national currency until mid-2002, with each currency in a fixed exchange rate with the euro. Although it was initially worth $1.17 at its introduction, the euro declined about 25 percent against the U.S. dollar until a coordinated intervention in the foreign exchange markets turned it around in October 2000. Since then it has risen, surpassing the dollar in value in late 2002 and reaching its initial value by May 2003.

On January 1, 2001, Greece also adopted the euro, with only the United Kingdom, Sweden, and Denmark remaining outside of the new **Euroland** by choice with their own currencies. Whereas the United Kingdom lets its pound float freely, both Sweden and Denmark peg their currencies to the euro. In September 2000, the Danes rejected joining the euro zone in a closely contested referendum. Sweden will decide whether or not to join in a September 2003 referendum. As of March 2002, the euro had successfully replaced all the national currencies in the 12 nations in Euroland.

The theory behind the adoption of the euro is the optimum currency area. It is argued that within an optimum currency area there should be much trade, great factor mobility, and a common macroeconomic fluctuation, as a common monetary policy will be carried out. The last is now under the control of the European Central Bank (ECB) in Frankfurt am Main, which began operation in 1999. It is widely believed that the EU is weakest in regard to labor mobility, which remains quite low, partly due to language and cultural differences between the nations. Also, there is some lack of common macroeconomic behavior, with Germany stagnating since 2000 while Ireland has boomed. The tendency of the United Kingdom's macroeconomy to fluctuate with that of the United States is a factor in that country's reluctance to join in.

The issue of macroeconomic convergence lay behind the criteria adopted at Maastricht that each country joining the euro zone was supposed to meet, although few actually fulfilled all of them in 1999. These criteria included achieving a rate of inflation within 1.5 percent of the three lowest rates in the EU, long-term interest rates within 2 percent of the three lowest rates in the EU, at least two years of "normal" exchange rate fluctuations, a budget deficit no greater than 3 percent of GDP, and a public debt to GDP ratio no greater than 60 percent. The last requirement was violated by many countries. It appears that the budget deficit criterion was the one most strictly enforced, with several Mediterranean countries engaging in rapid privatizations of SOEs in order to reduce their deficits.* Greece was kept from joining for two years because of its failure to meet the criteria. More recently, however, some of the largest members, notably France and Germany, have been violating this criterion.

Ultimately, the emergence of the euro is seen as a crucial step toward greater European unity, with the countries joining giving up independent national monetary policies. It is understood that Sweden and Denmark hold back because of the fear that they might have to reduce their large welfare states, and that the United Kingdom holds back because of a strong feeling of national independence and a sense of serving as a bridge between Europe and the United States. The question of whether or not to join the euro zone is one of the biggest issues confronting these three holdouts.

*See Robert A. Mundell, "A Theory of Optimum Currency Areas," *American Economic Review* 53 (1961): 657–664.

Thus France has gone a long way toward surrendering its national sovereignty in the EU. But part of its willingness to do so is connected with the willingness of the EU to accede to French ways of doing things, from indicative planning to industrial policy to mercantilist protectionism. Colbertism may have died in Paris only to have moved to Brussels.

The outcome of the relationship between the EU and the rest of the world economy is very important. If France succeeds in blocking an expansion of trade relations between the EU and the rest of the world, especially Eastern Europe or such potential EU members as Turkey, the results could be tragic.

SUMMARY AND CONCLUSIONS

France has engaged in public and influential indicative planning. In contrast to the indicative planning in Japan, France's concertation had strong informational and exhortive components. It also has been more macroeconomically oriented, with less stress on industrial policy than in Japan. In addition, France has had a strong component of regional planning, unlike Japan. Yet another difference from Japan is that France has had a much larger state-owned sector, one that functioned fairly efficiently but that is now being substantially privatized. In both Japan and France, indicative planning has declined in influence since the 1960s.

This indicative planning reflects a tradition of state intervention in the economy going back to the *dirigisme* practiced by Colbert under King Louis XIV, when France was the world's leading military and economic power. France's decline after that time has been attributed by supporters of laissez-faire to *dirigiste* policies. After World War II the French economy experienced remarkable growth, accompanied by both indicative planning and integration of the French economy into the European economy of the European Union (EU). France today has high unemployment that has led to major policy reassessments and the move to privatization.

The major current thrust of the French economy is to integrate further with the EU. But it also seeks to mold the EU in its own image, pushing for indicative planning as well as industrial and protectionist policies aimed at the rest of the world. Thus, whether the EU opens up further to the rest of the world economy or retreats behind a wall of protectionism depends importantly upon France, and the outcome has serious implications for the whole world economy.

QUESTIONS FOR DISCUSSION

1. How have the *dirigiste* and laissez-faire traditions conflicted in France?
2. What are the theoretical arguments for and against indicative planning?
3. How do French indicative planning and industrial policies compare with those of Japan?
4. Why have French state-owned enterprises (SOEs) been more efficient than those in most countries?
5. What was the link between France's Grand Industrial Policy and the regional planning effort, and how are both changing as France integrates further with the EU?

6. Why have French labor-management relations been so bad?

7. How has France's attitude toward the EU resembled that of French citizens toward their own government?

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FINLAND
Kiruna
Norwegian Sea
Norrbotten
Lulea
Vasterbotten
Jamtland
Umea
Vasternorrland
Ostersund
Harnosand
Gulf of Bothnia
FINLAND
NORWAY
SWEDEN
Kopparberg
Gavleborg
Aland
Falun
Gavle
Varmland
Uppsala
Vastmanland
Karlstad
Orebro
Stockholm
Nykoping
Linkoping
Skaraborg
Ostergotland
Alvsborg
Jonkoping
Visby
Gotland
LATVIA
North Sea
Halland
Vaxjo
Kronoberg
Kristianstad
Baltic Sea
LITHUANIA
DENMARK
Malmo

8 Sweden: Crisis and Reform of the Social Market Welfare State

Each time that I have gone back one thing that has impressed me more than anything else is the seeming wholeness of life. It is reflected in a calm, a poise, a certain health rare in our time. . . .

It may be merely that the Swedes have made haste slowly, with that deliberate tempo of speech and manner which the world has found a little funny. They have fought shy of the arbitrary advances by which humanity has sought to pull itself up by its bootstraps. Their progress has never been marked by dogma.

—Marquis W. Childs, *Sweden: The Middle Way,* 3rd ed., 1947, pp. xiv–xv

In the seventeenth century, Sweden was at the height of its military power, controlling the major part of Northern Europe. As befitted a major world power, Swedish leaders commissioned the construction of a great warship, known as the Vasa ship. Indeed, they sought to create the most heavily armed, technically advanced warship of the time. The planning was meticulous. The execution of design was at the highest technical levels of Swedish craftsmanship. On the day of the ship's launching, everyone from the royal family to the lowly shipbuilders looked on as their majestic creation slipped into the water, the ballast inside its hold shifted, and the great ship sank peacefully beneath the waters of Stockholm harbor.

—Hugh Heclo and Henrik Madsen, *Policy and Politics in Sweden: Principled Pragmatism,* 1987, pp. 40–41

INTRODUCTION

The world has watched with a mixture of fascination and dismay the evolution of the Swedish economic system—fascination by those who have admired its many virtues and achievements, dismay by advocates of laissez-faire, including many in Sweden itself. However, as the Swedish economy experienced increasing difficulties after the mid-1980s and a non–Social Democratic government between 1991 and 1994 moved the system toward less government intervention in the economy, the shoe shifted to the other foot. Advocates of laissez-faire applauded as Sweden joined the global trend, while admirers of its welfare state watched despondently.

Even after the recent changes, the Swedish economic system remains different from that in the United States and most of the rest of the market capitalist world. It may be converging more on the systems of its Scandinavian neighbors and less on those of northern European countries such as Germany. In chapter 1 we labeled these **social market economies,** a term originally applied to the West German economy in the 1950s. These economies avoid central planning and rely on market forces and private ownership of the means of production[1] while providing relatively high levels of government income redistribution and social welfare spending. Thus they take a middle way between laissez-faire

1. Austria has been an exception in having significant public ownership of the capital stock.

market capitalism and command socialism. They also have been characterized by parliamentary democratic political systems with high levels of personal civil liberties and periods of rule by social democratic or labor parties since World War II.

Sweden went much further in these directions than other countries, such as Germany, Austria, and the Benelux countries, or even its Nordic neighbors such as Norway, Denmark, Finland, and Iceland. While adhering to market forces in product markets, private ownership of land and capital, and a strict fiscal policy until the mid-1970s,[2] Sweden developed the most extensive income redistribution and social support system (often described as a system of "cradle-to-grave security"), along with the highest levels of taxation of any nonsocialist economy in the world. It also developed **centralized wage bargaining,** labeled **corporatism,** an equalizing **wage solidarism** approach, and active government intervention in labor markets for retraining.

As late as 1980, the Swedish economy was one of the top four non-oil-exporting nations in the world in real per capita income; however, in 2000 it was 17th, although this was an improvement from the late 1990s, when it was not even in the top 20. For decades the United Nations rated Swedish women as having the best living conditions in the world, although according to the *2002 UN Human Development Report,* Sweden has fallen to fourth place globally in that category while holding third place in gender empowerment behind Norway and Iceland, its fellow Scandinavian countries. It probably came as close to eliminating poverty as any nation ever has at the peak of its redistributionist policies, with only about 1% of its population belonging to an underclass.[3] Although it now reportedly has a slightly higher poverty rate than either Luxembourg, Finland, or Norway, the *2002 UN Human Development Report* still rates it as having the world's lowest Human Poverty Index (HPI), a measure that also takes into account education, life expectancy, and long-term unemployment measures. From the beginning of World War II to 1991, its unemployment rate never exceeded 4 percent and generally was in the 1–2 percent range, coinciding

2. It is non-Socialist governments that have tended to violate these strictures. Most of the few nationalizations were in the 1890–1920 period under Conservative governments to prevent foreign takeovers. Another wave occurred to prop up employment under the non-Socialist government of 1976–1982 when the budget deficit soared to 13 percent of GDP.

3. This group consists largely of jobless youths and a few elderly and disabled persons, despite the extensive social welfare safety net (James Angresano, *Comparative Economics* [Englewood Cliffs, N.J.: Prentice Hall, 1992], p. 282). The poverty rate has definitely risen since 1990 (Björn Gustafsson, "Poverty in Sweden: Changes 1975–1995, Profile and Dynamics," in Björn Gustafsson and Peder J. Pedersen, eds., *Poverty and Low Income in the Nordic Countries* [Aldershot, U.K.: Ashgate, 2000], pp. 169–206). Some of the newer poor are among recently arrived immigrants. As of the mid-1990s, only 0.3 percent of Luxembourg's population earned less than $11 per day, compared with 6.3 percent in Sweden (*UN Human Development Report, 2002* [New York: Oxford University Press, 2002]), even though Luxembourg was only seventh best at eliminating poverty according to the Human Poverty Index, behind Sweden, Norway, the Netherlands, Finland, Denmark, and Germany.

with very high labor force participation rates.[4] Despite this high level of employment, its inflation rates were in line with those in the rest of Europe until the late 1980s.

Sweden seemed to transcend the equity-efficiency trade-off. It had high real growth with high income equality and considerable macroeconomic stability, all within a highly democratic political structure marked by extensive individual liberties in social and cultural matters. Despite its current problems, this past record of achievement has led some to present the Swedish model as still an ideal for Eastern European economies in transition.[5]

But the critics have been having their day, most vociferously within Sweden itself. They have argued that most of its rapid growth occurred prior to 1950, when its income redistribution and social welfare system was still mostly undeveloped.[6] Whereas in the past the Protestant work ethic of Lutheran Sweden kept people working hard in gainful employment despite generous social welfare benefits and high taxation levels, a lazy new generation has supposedly appeared that is undermining the system by taking advantage of its benefits, especially generous sick and parental leaves.[7] After the mid-1970s (or, some would say, the mid-1960s), the performance of the Swedish model steadily worsened, with seriously decelerating growth and accelerating worker absenteeism, which continued into the early 1990s. Centralized wage bargaining partly broke down in 1983, with accelerating wage boosts, inflation, and budget and current account deficits resulting.

In 1991 Swedish voters replaced the long-ruling Social Democrats with a pro-laissez-faire coalition government led by Carl Bildt of the Moderate Party.[8] Supporting the then just-submitted application to join the EU, this government made noticeable cutbacks in the social welfare system and accompanying tax cuts. To break the wage-price spiral, the unemployment rate was allowed to soar to nearly 9 percent by the end of 1993. In September 1994, the

4. This contrasts with both Japan and Switzerland, which have had equally low unemployment rates but lower labor force participation rates because of substantial discrimination against women in their labor markets.

5. James Angresano, "A Mixed Economy in Hungary? Lessons from the Swedish Experience," *Comparative Economic Studies* 34 (1992): 41–57.

6. Assar Lindbeck, "The Swedish Experiment," *Journal of Economic Literature* 35 (1997): 1273–1319. This rapid pre-1950 growth was significantly aided by Sweden's neutrality in World Wars I and II, during which it exported significant raw materials and industrial goods to Germany. Its only rivals from 1950 to 1970 for top status in real living standards were Switzerland, which was similarly neutral and exporting to Germany, and the United States, on whose soil no fighting occurred except at Pearl Harbor and on a few Aleutian Islands in World War II.

7. Tightened government policies cut sick leave in half between the late 1980s and the late 1990s ("Survey: The Nordic Countries," *The Economist,* January 23–30, 1999).

8. Since 1932 the Social Democrats have been the largest party in the Riksdag (parliament). They ruled during 1932–1976, 1982–1991, and since 1994, usually in open or tacit coalitions with other parties, most recently with the Greens, founded in 1981, and the Party of the Left, the former Communists. The now pro-laissez-faire Moderates were formerly known as Conservatives, dating from a 1700s promercantilist party based on the upper aristocracy. Their coalition partners were the Center Party, formerly known as the Agrarian Party, a rural-based party with nineteenth-century roots that has often been a swing party between Left and Right, and the promarket but pro–welfare state Liberal Party, which frequently led governments between 1905 and 1930.

Social Democrats returned to power and currently rule in a coalition government led by Göran Persson. But they have been constrained by a high budget deficit and the entry into the EU in early 1995 after a positive referendum vote in November 1994. Sweden has remained outside of the euro zone but may enter it after a scheduled September 2003 referendum on the issue. Despite recent hopeful signs of stabilization and improvement, the **Swedish model** will never be the same again, even if it still remains more welfare-state-oriented and corporatist than most in the world.

HISTORICAL AND CULTURAL ROOTS OF THE SWEDISH MODEL

Foundational characteristics significant in explaining Sweden's history and its character include an independent peasantry that was never enserfed; a powerful Protestant state church;[9] a deeply rooted respect for law; ethnic homogeneity of the population; a long history of organized government; a tradition of honesty and effectiveness in the bureaucracy;[10] weakness of the middle class;[11] and an intellectual tradition of rationality and practicality.

If the Swedish middle way depends on a pragmatic balancing of individual and communal interests, this ethos was already present in Viking times (500–1100) before Sweden was Christianized. A rugged and democratic individualism was enforced by the wide-ranging travels of the Vikings and the rigorous climate of the country. Local parliaments whose laws were respected elected their regional kings.[12] But agricultural production took place in commonly held open fields, reflecting a communalism encouraged by the need to cooperate with each other against the harsh environment.[13]

After adopting Lutheranism in the 1500s, Sweden entered a period of royalism and national expansion, achieving such power that it led the Protestant cause in the Thirty Years'

9. This laid a base for the tradition of hard work. But the nineteenth-century revolt against the church played an important role in the formation of the socialist political and economic movements that can be argued to have displaced it. Thus Hugh Heclo and Henrik Madsen, *Policy and Politics in Sweden: Principled Pragmatism* (Philadelphia: Temple University Press, 1987), p. 5, declare, "An outsider is struck by the churchlike quality of the mammoth labor movement and its concern for proper public action and thinking. The power of this Social Democratic 'church' dominates Sweden's political landscape."

10. The modern bureaucracy was founded during the great power era of the early 1600s. It was staffed by aristocrats or talented laymen and acted as a brake on royal absolutism. As in France and Japan, it is prestigious and has traditionally attracted highly qualified individuals.

11. This was caused by the late development of Sweden's industrial revolution (after 1870), associated with a weak tradition of pro-laissez-faire views.

12. Although democracy was invented in ancient Greece, it has continuously existed for the longest time in Scandinavia, the oldest operating parliament in the world being the Althing of Iceland. The British Parliament was established by Viking invaders.

13. Modern Sweden has many consumer and agricultural cooperatives. A deeply entrenched communalist idea of sharing from the Viking period is *lagom,* from the drinking horn passed among Viking villagers, which has come to mean "just right" or "fairness" in modern times. One was expected to drink just the right amount from the horn, not too little and not too much.

War (1618–1648). This period established Sweden's efficient government bureaucracy and efficient financial system (including Europe's oldest continuously existing central bank) and the development of capitalist institutions in iron and copper mining, which became Sweden's leading export industries.

During the less expansionistic but more liberal 1700s, science, technology, and education developed vigorously in Sweden, which possesses a highly educated labor force today. The enclosure movement in agriculture also began then, which ended the traditional open field system by the 1860s as privately owned fields were separated from others by fences. This movement displaced rural workers who would form the base of an urban industrial working class, although many strongly independent farmers remained in the countryside.

After a related expansion of the iron and timber export industries, the Swedish economy took off in the 1870s, with expansion led by railroad investment, resulting in the world's fastest rate of growth until 1950 (exceeding even Japan's).[14] This economic performance was aided by Swedish entrepreneurs' technical innovations that became the bases of later industrial empires. These innovations include the invention of chemical pulp processing (Svenska Cellulosa is Sweden's 10th largest firm); significant improvements in telephones (L.M. Ericsson is Sweden's 6th largest firm); innovations in steam turbines (Asea is Sweden's largest firm); innovations in self-adjusting ball bearings (SKF is Sweden's 9th largest firm); and the invention of dynamite (Nobel Industries is Sweden's 8th largest firm and funder of the Nobel Prizes).[15]

Sweden's rapid industrialization led to the emergence of a working class movement. In 1889 the Social Democratic Party (SAP) was founded by union members, and in 1898 the general trade union federation *Landsorganisationen* (LO) was founded. The Swedish Employers Federation, *Svenska Arbetsgivareforening* (SAF), which would later be the LO's partner in centralized wage bargaining, was founded in 1902. A period of bitter economic, social, and political conflict followed, marked by many strikes and a near revolution in 1918. This ended with the achievement of universal suffrage and absolute parliamentary supremacy. After 1930 the economy fell. This recession led to the 1932 electoral victory by the Social Democrats, who would remain in power until 1976.[16]

14. Although British and French investors played a role, the existing Swedish banks were important. The wealthiest family in Sweden, the Wallenbergs, began as the founders of the Enskilda Bank in the 1840s. In 1966 the head of the family, Marcus Wallenberg, served on the boards of directors of 60 companies, and as of 1989, Wallenberg interests still possessed over 25 percent of the voting rights shares in 6 of Sweden's 10 largest companies. This tight control has led some companies to take a longer temporal perspective, much like Japanese corporations.

15. See Assar Lindbeck, *Swedish Economic Policy* (Berkeley: University of California Press, 1974), chap. 1; the *Economist,* "A Survey of the Swedish Economy," March 3, 1990.

16. Their hold on power would be solidified by a deal with the Agrarian Party. They supported agricultural price supports in exchange for support of Keynesian-style public works to end unemployment. The Stockholm School of economics, notably Ernst Wigforss and Gunnar Myrdal, developed theories of aggregate demand management independently of Keynes.

LABOR MARKET INSTITUTIONS

Corporatism

Most observers argue that key to Sweden's ability to maintain both low unemployment and low inflation from World War II to the mid-1980s was the nature of its labor market. The most important factor has been the centralized wage bargaining system widely called *corporatism.*

Corporatism has two versions: *authoritarian* and *liberal* (or voluntary). The former involves the state establishing and enforcing centralized wage bargaining, as in **fascist economies** such as Mussolini's Italy, Vichy France, and Nazi Germany, which called themselves **corporate states.**

Liberal corporatism is largely self-organized between labor and management, with only a supporting role for government. Leading examples of such systems are found in small, ethnically homogeneous countries with strong traditions of social democratic or labor party rule, such as Sweden's Nordic neighbors. Using a scale of 0.0 to 2.0 and subjectively assigning values based on six previous studies, Frederic Pryor in 1988 found Norway and Sweden the most corporatist at 2.0 each, followed by Austria at 1.8, the Netherlands at 1.5, Finland, Denmark, and Belgium at 1.3 each, and Switzerland and West Germany at 1.0 each. At the anti-corporatist end, with 0.0 each, were the United States and Canada.[17] Other studies have generated rankings with different measures, with several rating Austria as the most corporatist nation. Yet all studies agree that Sweden has one of the most corporatist of the current economic systems, although it is probably the case that several of its immediate neighbors are now more strongly corporatist than Sweden. At least in Europe, the relative size of the economy seems to be important, as one study indicates at least some corporatist elements in wage bargaining in most of the EU members except for the largest economies: Germany, France, and Great Britain.[18]

The lowest wage rigidity and the fewest changes in unemployment seem to occur at the two extremes, the most corporatist (Sweden, Norway, and Austria) and the least corporatist (the United States and Canada).[19] Sweden, Norway, and Austria have all had good unemployment/inflation performances, matched only by the Switzerland and Japan since

17. Frederic L. Pryor, "Corporatism as an Economic System: A Review Essay," *Journal of Comparative Economics* 12 (1988): 326.

18. See Philippe C. Schmitter and Jürgen R. Grote, "The Corporatists Sisyphus: Past, Present and Future," European University Institute, Working Paper No. 55.97 (Florence, 1997).

19. See L. Calmfors and J. Driffill, "Bargaining Structure, Corporatism and Macroeconomic Performance," *Economic Policy* 6 (1988): 14–61.

1945. However, some argue that this good performance is unstable over time,[20] an observation with considerable relevance to Sweden.

The Rise and Fall of Swedish Corporatism

Sweden's severe labor-management strife that had gone on for most of the nineteenth century ended in 1938, when the **Saltsjöbaden Agreement** between the LO (representing labor) and the SAF (representing management) was signed. This agreement had several important institutional innovations, the most important one establishing a centralized wage bargaining process that remained largely in place until 1983.[21] Although a central wage bargain was at the national level, there were always adjustments to this at the industry and local levels, the three-stage model.

This agreement and its implementation served as the basis for labeling Sweden corporatist. But it represents a balance of power between still-conflicting groups, not a cessation of struggle. Hence Sweden may be **conflict corporatist** rather than **consensus corporatist** like Austria, the former type achieving greater gender and other kinds of equality due to the greater assertiveness of labor in such systems. In Austria, centralized wage bargaining is much more directly controlled by the government rather than the negotiating parties, with some noting that its institutional setup is essentially a holdover from the previous fascist corporate state system of *chambers* for labor and management, albeit now in a democratic system.

Nevertheless, for a long time, considerable consensus operated within the Swedish bargaining system. During the Swedish economy's golden age of the 1950s and 1960s, consensus was based on shared concerns about macroeconomic stability and international competitiveness. Concern with trade competitiveness led to a further agreement between the the employers' federation (SAF), the union federation (LO), and a federation representing white collar workers, the TCO, that resulted in the EFO model, named for the economists representing each group: Edgren, Faxén, and Odhner.[22] The agreement stated that productivity improvements in the internationally competing (tradeable) goods sector would set the standard for wage increases in the whole economy.

Another factor in this harmonious consensus was personal. The chief negotiators involved had long been in office and maintained regular and friendly communications, as

20. See Matti Pohjola, "Corporatism and Wage Bargaining," in J. Pekkarinen, M. Pohjola, and B. Rowthorn, eds., *Social Corporatism: A Superior Economic System?* (Oxford: Clarendon Press, 1992), pp. 44–81.

21. The government was not formally part of this agreement, although it played a role in convincing the LO to go along. The minister of finance traditionally participated as a peripheral party to the negotiations.

22. See Gösta Edgren, Karl-Olof Faxén, and Clas-Erik Odhner, *Wage Formation and the Economy* (London: Allen & Unwin, 1973).

did their staffs. They included Minister of Finance Gunnar Strang, in office from 1955 to 1976, and Prime Minister Tage Erlander, in office from 1946 to 1969.[23] The favorable negotiating environment was also eased by good economic performance.

But after 1983, consensus disappeared and conflict reemerged, seriously weakening Swedish corporatism. The causes seem to involve a reversal and unraveling of the factors that made it work initially. The disrupting factors include heightened international competitive pressures after the first global oil price shock of 1973; a rise in public sector employment; a loss of restraint in wage demands by labor because of a lack of unemployment fears; and losses of power by the Social Democrats. This triggered distrust by the LO of the government, as well as unhappiness by the SAF from the 1970s on, with LO-supported policies pushed by Social Democrats. All these factors combined in 1983, when most engineering and many white-collar negotiations were decentralized to the industry and local levels, the two-stage model that lacked a first national level stage. This resulted in actual wage settlements exceeding wages centrally set, a phenomenon known as *wage drift,* that accelerated during the late 1980s.

A basic factor has been the long-term increase in public sector employment, with two results. These workers are in the nontradeable goods sector, and thus their increase implies an increase of that sector relative to the tradeable goods sector. This makes it harder to impose the EFO model, in which tradeable goods sector wages determine nontradeable goods sector wages. Furthermore, public sector workers are not restrained by firm profit constraints on their wage demands, resulting in soaring wage demands and settlements by public sector workers disconnected from the LO-SAF centralized bargaining outcomes. More generally, the blue-collar LO has come to represent a smaller proportion of the total unionized labor force, falling from 81 percent in 1950 to 58 percent in 1990.[24]

Emergence of the wage drift problem is shown in table 8-1. Beginning in the 1970s, it accelerated in the late 1980s. This increase coincided with an exceptionally low unemployment rate that, after 1982, encouraged excessive wage demands in the more decentralized bargaining context, although excessive wage demands apparently ended with increased unemployment after 1990.

Explosive wage increases in the late 1980s exceeded productivity gains and led to labor cost increases substantially in excess of those among Sweden's international trade competitors. Labor costs increases ran ahead of 11 main competitors by more than 3 percent annually in most of the late 1980s and more than 5 percent annually in 1989 and 1990. The crisis

23. He was succeeded by the more ideological and charismatic Olof Palme, who was mysteriously assassinated on a Stockholm street in 1986, an event some claim marked Sweden's "loss of innocence."

24. Christian Nilsson, "The Swedish Model: Labour Market Institutions and Contracts," Trade Union Institute for Economic Research, Working Paper No. 109 (Stockholm, 1992), p. 13.

Table 8-1
Wage Drift and Unemployment Rates

Year	Negotiated	Wage Drift (%)	Total (%)	Unemployment Rate (%)
1980	7.8	1.7	9.5	1.4
1982	4.6	1.7	6.3	2.5
1984	5.6	2.3	7.9	2.8
1986	6.0	2.6	8.6	2.5
1988	4.2	2.3	6.5	1.7
1990	6.1	3.9	10.0	1.5
1992	2.7	0.8	3.5	4.2
1994	1.5	1.0	2.5	8.0
1996	4.4	1.7	6.1	8.1
1998	2.8	0.8	3.6	6.5

Note: Negotiated means percentage increase in wages negotiated centrally for all workers. *Wage drift* is the extra percentage negotiated at the industrial or local level beyond that. *Total* is the sum of the two.
Sources: For 1980–1992 from NIER, *The Swedish Economy: Autumn 1992* (Stockholm: National Institute for Economic Research, 1992), pp. 78 and 82, and *OECD Economic Surveys: Sweden 1990/1991* (Paris: Organization for Economic Cooperation and Development, 1990), p. 127. For 1994–1998 wage data are from *OECD Economic Surveys 1998–1999: Sweden 1999* (Paris: Organization for Economic Cooperation and Development, 1999), p. 68, and unemployment rates for 1994–1998 are from ibid., p. 172.

generated by this hit in 1990 as a swelling current account deficit,[25] culminating in the late 1991 replacement of the Social Democratic government (which had ruled since 1982) by a Moderate-led coalition committed to breaking the wage-price spiral. The changed policy stance in 1992 shows up in table 8-1, as well as the lower labor cost increase by that time. By 1992, competitors' labor costs were rising more than 3 percent ahead of Sweden's labor cost,[26] and by late 1994 the current account had reached near balance.

However, an important element in this renewed wage restraint was an initial return of centralized wage bargaining. Although the SAF formally dismantled its wage-negotiating apparatus in 1990 and moved most bargaining to the industry level in accord with the two-stage model, Sweden's government imposed strong de facto centralization in 1991–1992 that helped rein in wage drift. The subsequent two years saw a major shift to the local level. But this trend was reversed in 1995–1997 as four different bargaining schemes emerged, with 42 percent of white collar workers and 62 percent of blue-collar workers covered solely by industry-level agreements, and only 10 and 15 percent, respectively, set solely

25. Sweden had a small current account surplus in 1986 (*OECD Economic Surveys* [Paris: Organization for Economic Cooperation and Development, 1990], p. 126); by 1990 this had become a deficit of about 3 percent of the GDP (NIER, *The Swedish Economy: Autumn 1992* [Stockholm: National Institute for Economic Research, 1992], pp. 9, 54).

26. NIER, *The Swedish Economy,* p. 140.

at the local level. There was a small shift toward the local level in 1998, but with most agreements still at least influenced by the industry level, with these patterns continuing to shift back and forth in the next several years.[27] Thus, although the old Saltsjöbaden mechanism of formal centralized bargaining between the SAF and the LO ended in 1990, high degrees of coordination and centralization in the Swedish wage bargaining system remain: a weakened corporatist system.

Wage Solidarism

Whereas corporatist wage bargaining exists in a number of economies, a characteristic of Sweden's labor market prior to 1983 that was unique was *solidaristic* wage bargaining. The goal of this type of bargaining is to equalize wages across firms and also across skill and seniority levels. This scheme was the brainchild of the LO economists Gösta Rehn and Rudolph Meidner and was accepted in 1962 by the LO.[28]

Most economists criticize such an approach, arguing that it reduces incentives and labor mobility. Rehn and Meidner argued just the opposite regarding labor mobility. They emphasized the need for sectoral restructuring within the Swedish economy to maintain Sweden's international competitiveness and saw the solidaristic wage policy as encouraging this goal. Such a wage policy would drive weak firms out of business more quickly while providing greater profits for stronger firms to invest more and grow more rapidly. With few wage differences, workers would be able to shift easily from the failing firms to the expanding ones. This approach may have worked as intended in the 1960s. One study suggests that the policy enhanced productivity as long as there was solidarism across firms but not so much across skill levels or occupations (the latter was more often the case in the 1970s).[29]

From the early 1960s to the early 1980s, wage solidarism tended to equalize wages across skill and seniority categories. But with increased decentralization of bargaining and wage drift, the trend has been reversed since then. This is demonstrated in the ratio of the wages of younger workers to those of older workers. For employees with nine years of

27. *OECD Economic Surveys: Sweden 1998–1999* (Paris: Organization for Economic Cooperation and Development, 1999), pp. 75–76.

28. Rudolph Meidner, *Coordination and Solidarity: An Approach to Wages Policy* (Stockholm: Prisma, 1974). See also Bertram Silverman, "The Rise and Fall of the Swedish Model: Interview with Rudolf Meidner," *Challenge* 41(1) (1998): 69–90.

29. Douglas A. Hibbs, Jr., and Håkan Locking, "Solidarity Wage Policies and Industrial Productivity in Sweden," *Nordic Journal of Political Economy* 22 (1995): 95–108. The same authors argue that as wages became more compressed in a way that did not enhance productivity, the centralized wage bargaining process increasingly generated wage inflation. See Douglas A. Hibbs, Jr., and Håkan Locking, "Wage Compression, Wage Drift and Wage Inflation in Sweden," *Labour Economics* 3 (1996): 109–141.

schooling, the ratio of wages of those aged 16–19 to those 20 and older rose from 0.43 in 1968 to 0.71 in 1981.[30]

This solidarism shows up in broader measures of income distribution. The Gini coefficient for wage incomes declined from 0.195 in 1975 to 0.169 in 1982 (approximately the year of greatest equality) but rose to 0.176 by 1987.[31]

Eventually undermining the efficiency of wage solidarism was the restructuring of the Swedish economy desired by Rehn and Meidner, away from a resource-based heavy industrial economy toward a more information-based high-technology one. In this type of economy, learning by doing on a specific job becomes more important for productivity increases than before. But such learning by doing responds to wage differentials that provide the incentives for acquiring the skills. Thus wage solidarism became a disincentive to economic growth.

Since 1970, Swedish workers have become less interested in changing jobs, preferring to stay where they are. This is because migration is often involved in job switches, as many of the dying industries (especially mining) have been located in the north, while many of the growing ones have been located in the south. Thus the LO began to push for job security policies that undermined the efficiency rationale for wage solidarism.

GOVERNMENT POLICIES AND THE LABOR MARKET

Active Government Labor Policies

The question of economic restructuring concerned Rehn and Meidner, two LO economists, who formulated the Rehn-Meidner Plan in 1951. Their plan urged active government programs for retraining and relocating workers from dying industrial sectors to growing ones. Sweden has had the most extensive and successful such programs in the world. Considerable sectoral restructuring has occurred while unemployment has remained relatively low. A great deal of money has been spent to implement these policies: about 2 percent of GDP in 1987, approximately twice the funding percentage of Denmark, its nearest rival in this regard.[32]

30. Robert J. Flanagan, "Efficiency and Equality in Swedish Labor Markets," in B. P. Bosworth and A. M. Rivlin, eds., *The Swedish Economy* (Washington, D.C.: The Brookings Institution, 1987), p. 142. See also Pers-Anders Edin and Robert Topel, "Wage Policy and Restructuring: The Swedish Labor Market since 1960," in R. B. Freeman, R. Topel, and B. Swedenborg, eds., *The Welfare State in Transition: Reforming the Swedish Model* (Chicago: University of Chicago Press, 1997), pp. 155–201.

31. Ministry of Finance of Sweden, *The 1990 Medium Term Survey of the Swedish Economy* (Stockholm, Ministry of Finance of Sweden, 1990), p. 339.

32. *The Economist,* "A Survey of the Swedish Economy," p. 5.

The Rehn-Meidner Plan's largest active policy is occupational retraining. Other programs include training to avoid being laid off, relief work, youth teams, and recruitment support. The attitude of the LO toward such programs shifted after 1970, with a greater desire to preserve existing jobs rather than to retrain for or move to new ones, leading to legislation in the 1970s making it harder to lay off workers. The nonsocialist government in power between 1976 and 1982 increased subsidies to businesses to keep them going and nationalized several firms for the same purpose, undermining the tight fiscal policy of the Social Democrats, who began to cut back public spending as a percentage of GDP after returning to power in 1982.

The Moderate-led government introduced two new programs in September 1992: a youth training scheme and a temporary development scheme for those receiving unemployment compensation. In 1991 1.9 percent of the labor force was involved in these programs, rising to 3.2 percent in 1992, 5.1 percent in 1993,[33] and 7 percent in 1998,[34] a trend that disturbs many observers even as the unemployment rate in Sweden has declined.

Another policy favored by LO economists was the wages fund. This was to be created by a payroll and excess profits tax and would buy up shares of corporations to be owned by the unions. This plan was bitterly opposed by the SAF. The Social Democratic government under Olof Palme instituted it in 1983, but the Moderate-led government abolished it in 1991. Some observers argue that this was a form of extreme syndicalist socialism that would have been profoundly radical if its goals had been truly fulfilled.

The Welfare State, Taxes, and Labor Supply

Probably the most famous feature of the Swedish economy is the scale of its cradle-to-grave welfare state programs, unmatched by any other market capitalist economy. A rudimentary public health system begun in 1874 became a universal health insurance system in 1955.[35] A public pension system was established in 1914 and made universal in 1959. Paid holidays were established in 1931 at four days a year and were gradually expanded to reach five

33. NIER, *The Swedish Economy,* pp. 79–80.

34. *OECD Economic Surveys: Sweden 1999,* p. 69. For analysis of the relative efficiency of the different parts of this program, see Susanne Ackum Agell, "Swedish Labor Market Programs: Efficiency and Timing," *Swedish Economic Policy Review* 2 (1995): 65–100; Anders Forslund and Alan B. Kreuger, "An Evaluation of the Swedish Active Labor Market Policy: New and Received Wisdom," in Freeman, Topel, and Swedenborg, *The Welfare State in Transition,* pp. 267–298. Agell found job replacement schemes to be more effective than job retraining ones. For links between the active labor market policies and the wage bargaining system see Johnny Zetterberg, "Unemployment, Labour Market Policy and the Wage Bargaining System," in J. Johannesson and E. Wadensjö, eds., *Labour Market Policy at the Crossroads* (Stockholm: EFA, Ministry of Labour, 1995), pp. 57–115.

35. The biggest current complaint about the Swedish health system is the long wait for certain kinds of elective surgery, up to two years for eye cataracts and hip replacements (*The Economist,* "A Survey of the Swedish Economy," p. 15).

Table 8-2
The Public Sector in Various Countries, 1988

Country	Spending	Transfers	Taxes	Employment
Sweden	59.9	31.6	55.3	31.8
Denmark	59.8	31.4	52.1	29.8
Norway	55.1	30.4	47.6	25.8
France	50.0	28.3	44.1	22.9
Italy	49.6	29.1	37.0	29.1
Germany	45.2	23.5	37.2	15.5
Canada	43.7	22.7	34.7	20.3
Finland	38.9	15.7	37.9	20.6
United Kingdom	38.4	17.4	37.0	20.7
United States	34.0	14.1	28.9	15.1
Japan	31.8	17.3	31.5	8.3

Note: Public sector spending, transfers, and taxes are given in percentage of GDP, and employment is given in percentage of the labor force in the public sector. Divergences between this table and table 1-2 reflect the fact that this table includes all levels of government, not just the national level.
Source: OECD Economic Surveys: Sweden 1990/1991 (Paris: Organization for Economic Cooperation and Development, 1990), pp. 61, 63.

weeks plus two days by 1989. Three-month maternity leave was introduced in 1945 and was gradually expanded to an 18-month general parental leave at 90 percent pay in 1991.

Beginning in 1974, the government paid 90 percent of salary for unlimited sick leave. Many observers claim that Swedish workers abused this policy, taking more sick leave than any others in the world, an average of 26 days per year in 1988, up from 18 in 1983.[36] As of 1990 daily absenteeism rates in Sweden averaged about 25 percent, 10 percent due to illness and 15 percent for watching children, taking vacation, or invoking 1 of the 101 reasons for which workers can be on leave, clearly an example of moral hazard.[37]

These benefit programs cost a lot of money. Among the market economies, Sweden has the highest percentage of GDP devoted to government spending, including transfer payments, of any market economy, even though these expenditures have been declining from a peak of 67 percent in 1982. Table 8-2 shows public sector spending, transfer payments, and taxes as percentages of GDP, and public sector employment as a percentage of total employment for several economies in 1988, with Sweden still easily holding its top position as recently as 1997. Some observers note that much of the more recent increase in

36. *The Economist,* "A Survey of the Swedish Economy," pp. 15–16. This was cut back in 1992. Employers are now responsible for paying for the first fourteen days, the percentage of pay covered has been reduced, and individuals must now make a contribution to the health insurance fund. Apparently by the late 1990s, workers were taking only about half as much sick leave as previously.

37. *The Economist,* "A Survey of the Swedish Economy," p. 15.

Box 8-1
Sweden: Feminist, Feminine, or Both?

The UN claims that Swedish women have one of the highest qualities of life of any women in the world. Besides being prime beneficiaries of the numerous social welfare programs such as parental and sick leave, full abortion rights, and an extensive public day-care system, they have the highest labor force participation rate of any industrialized market economy and some of the least wage discrimination. They work more but take more time off. Furthermore, they have been highly concentrated (until recently) in the rapidly expanding public sector. Thus, they have felt vulnerable to recent cutbacks and were notable among those concerned about Sweden joining the EU, fearing more pressure to weaken existing programs.

Sweden clearly qualifies as feminist, but some argue that it also qualifies as feminine, clashing with the macho Viking image but not with the communal sharing legacy of the Viking lagom drinking horn.* This may show up in Swedish management, which practices a familistic orientation with reduced hierarchies and apparent indecisiveness in the eyes of foreigners.† But these structures can be flexible and innovative, as shown by the use of work teams engaging in Japanese-style consultation rather than assembly lines at Volvo's newer car factories.‡

*G. Hofstede, *Culture's Consequences* (London: Sage, 1980). (See footnote 13.)
†Gunnar Hedlund, "Managing International Business: A Swedish Model," in M. Maccoby, ed., *Sweden at the Edge: Lessons for American and Swedish Managers* (Philadelphia: University of Pennsylvania Press, 1991), pp. 201–220.
‡Berth Jönsson, "Production at Volvo," in *Sweden at the Edge,* pp. 109–120.

public sector employment has resulted from local governments employing women in such services as day care that perhaps could be privately provided (for more discussion of Sweden's policies toward women, see box 8-1). This has led to the quip that Sweden's government hires half of its women to take care of the children of the other half who are working in the private sector. The cost of such high goverment spending accounts for Swedens's high tax rates and the inefficiencies involved in a large public sector.[38]

The rising trend of government transfers has been paid for by increased taxes or financed by cutbacks in other areas of government spending, notably infrastructure investment. The latter peaked in the late 1960s and declined by about 20 percent to about 3 percent of GDP by 1991, whereas transfers nearly quadrupled during the same period.[39] This led to a deterioration of Swedish infrastructure, but the Moderate-led government increased infrastructure investment substantially in the early 1990s.

Besides the association between generous sick leave and worker absenteeism, another labor supply issue is the effect of high tax rates, especially high marginal income tax rates. Prior to 1991 the top rate was 75 percent, which became effective for salaries equivalent

38. Sherwin Rosen, "Public Employment, Taxes, and the Welfare State in Sweden," in Freeman, Topel, and Swedenborg, *The Welfare State in Transition,* pp. 79–108.

39. Villy Bergstrom, "Aspects of the 'Swedish Model' and Its Breakdown" (Stockholm: Trade Union Institute for Economic Research, 1992), p. 14.

to 40,000 to 50,000 U.S. dollars per year, depending on exchange rates.[40] For this income level, the Swedish tax rate exceeded that of any other market economy. High tax rates may have reduced the labor supply by 6 to 10 percent among prime working-age adults relative to what would be the case with U.S. tax and spending levels.[41]

Such a supply-side effect raises the **Laffer Curve** issue of tax revenues and tax rates, and Sweden had marginal tax rates sufficiently high so that a cut almost increased revenues.[42] Such high tax rates have triggered considerable tax avoidance and use of the underground economy, with the scale of such activities possibly exceeding 25 percent of the official GDP.[43]

In 1991 the Social Democratic government initiated tax reforms, reducing the top marginal income tax rate to 50 percent and shifting to greater reliance on the value-added tax (VAT), which is more widely used in other European countries. The subsequent nonsocialist government made more adjustments, including reducing payroll charges and giving more financial control to local governments. These changes, combined with cuts in sick leave and other transfer payments, were designed to increase the supply of labor and to reduce the structural budget deficit. But the latter goal was frustrated by the recession of the early 1990s, which caused a shortfall in revenues as well as a surge of payments for unemployment compensation, leading to a deficit greater than 10 percent of GDP. The Swedish government's fiscal problems were aggravated by Swedish banks boycotting government bonds due to the high deficit, thus raising the cost of government borrowing, although by 1997 the deficit was reduced to a little more than 1 percent of GDP.[44]

Although the trend in Sweden is to cut back on benefits and reduce the progressivity of the tax system, Sweden has a higher degree of both income and wealth equality than any other market economy except for Finland. Table 8-3 shows the Gini coefficients for before taxes and transfers (factor income) and after taxes and transfers (disposable income), as well as the percentage of wealth held by the top 1 percent of the population in several countries.

40. *OECD Economic Surveys: Sweden 1990/1991,* p. 64.

41. Gary Burtless, "Taxes, Transfers, and Swedish Labor Supply," in Bosworth and Rivlin, *The Swedish Economy,* p. 241. See also Thomas Aronsson and James R. Walker, "The Effects of Sweden's Welfare State on Labor Supply Incentives," in Freeman, Topel, and Swedenborg, *The Welfare State in Transition,* pp. 203–265.

42. Charles E. Stuart, "Swedish Tax Rates, Labor Supply, and Tax Revenues," *Journal of Political Economy* 89 (1981): 1020–1038.

43. Edgar L. Feige, "The Swedish Payments System and the Underground Economy" (Stockholm: Industrial Institute for Economic and Social Research, 1985). Despite the widespread publicity surrounding this issue, more recent studies suggest that the scale of such activities in Sweden has been exaggerated by many and is not that high. See Friedrich Schneider and Dietrich H. Enste, "Shadow Economies: Size, Causes, and Consequences," *Journal of Economic Literature* 38 (2000): 77–114.

44. *OECD Economic Surveys: Sweden 1999,* p. 102.

Table 8-3
Income and Wealth Distributions

Country	Factor Income Gini Coeff.	Disposable Income Gini Coeff.	Top 1 Percent of Wealth
Sweden	0.487	0.230	17.0
Finland	0.420	0.217	n.a.
United States	0.455	0.344	25.0
Germany	0.436	0.282	28.0
Norway	n.a.	0.256	n.a.
France	0.392	0.231	19.0
Italy	0.510	0.345	n.a.
Japan	0.340	0.265	n.a.
Netherlands	0.421	0.253	n.a.
Belgium	n.a.	n.a.	28.0
Denmark	n.a.	0.284	28.0
United Kingdom	n.a.	n.a.	32.0
Canada	n.a.	n.a.	19.6

Sources: Gini coefficients are for 1995 from *OECD Economic Surveys: Sweden 1999* (Paris: Organization for Economic Cooperation and Development, 1999), p. 112. Wealth is the percentage owned by the top 1 percent and data from the mid-1980s are from Lars Bager-Sjögren and Anders Klevmarken, "The Distribution of Wealth in Sweden: 1984–1986," Working Paper No. 91 (Stockholm: Trade Union Institute for Economic Research, 1991), p. 7. (Note that by the mid-1990s this figure was about 40 percent for the United States.)

In Sweden the trend in income distribution has been toward greater inequality since the early 1980s. The share of wealth held by the top 1 percent remained fairly constant from 1975 to 1987, although the composition of the top group shifted from rural landowners to wealthy urbanites.[45] But for 1978 to 1987 the Gini coefficient of wealth distribution went from 0.783 to 0.841 because many poorer households went into debt.

The changes in the Swedish welfare state and tax systems, along with the heightened unemployment levels since 1990, have made it clear how tightly knit the Swedish economic system has been, with such factors as low unemployment, high taxes, wage compression, and subsidized day care reinforcing each other in a systemic way. In particular, many of the benefits of the welfare state have been tied to employment. Thus, as unemployment increased in the early 1990s, it seriously weakened this whole interrelated socioeconomic structure in unforeseen and disruptive ways that the Swedes have had to struggle to deal with. No single reform or policy can easily solve the problems of such a complex interrelated system.[46]

45. Ministry of Finance of Sweden, *The 1990 Medium Term Survey* (Stockholm: Ministry of Finance of Sweden, 1990), p. 344. Despite the general equality in Sweden, a small elite of very wealthy people remains who control the top level of the economy, the Wallenberg family being the leading example.

46. Richard B. Freeman, "The Large Welfare State as a System," *American Economic Review, Papers and Proceedings* 85 (1995): 16–21.

SWEDEN AND EUROPE: CAN REVIVED GROWTH CONTINUE?

Macroeconomic Policy and Performance

It has long been asserted that Sweden's macroeconomic policy has been Keynesian or even **ultra-Keynesian.** Although true to some extent, this statement is simplistic. Keynesianism has often been identified with the use of fiscal policy to maintain full employment, especially the government's willingness to run discretionary budget deficits during recessions. This was not part of the policy of the Social Democrats during their long tenure from 1932 to 1976; noticeable budget deficits appeared only during the 1976–1982 interregnum of nonsocialist rule, although they have been more common since. Strict fiscal policy, including regular surpluses, was long the norm in Sweden. The goal was to have low interest rates without stimulating inflation.

Swedish policy was Keynesian in its emphasis on maintaining full employment at all times. During the 1930s a public works program supported this goal. But the corporatist wage bargaining system that kept supply-side inflationary pressures at bay, and thus abetted the generally stimulative monetary policy, has been central to Swedish policy. Although corporatism is not usually identified with Keynesianism, Keynes once made statements interpretable as supporting something like it,[47] and many self-identified **Post Keynesians** support it.[48]

But one innovative policy Sweden has long practiced virtually alone in the world is in the spirit of Keynes's view that socialization of investment is "the only means of securing an approximation to full employment."[49] This is an investment fund filled by tax-deductible profits contributed by corporations to the Central Bank. The government then releases these funds to the corporations during recessions. This policy works to smooth out investment behavior over time, thus smoothing out business cycles.

As a final measure, the Swedish government has resorted to devaluing the krona to stimulate exports, which at nearly a third of GDP is the driving force of the Swedish economy. A successful devaluation occurred in the early 1930s during the Great Depression, when Sweden was one of the first countries to disconnect from the moribund gold standard. This devaluation, and the stimulus it gave to exports (especially to Hitler's rearming Germany), probably had more to do with Sweden's shallow depression and rapid recovery than any erstwhile Keynesian fiscal or monetary policy.

Unfortunately, this last-resort tool increasingly became the first-resort tool, with successive Swedish governments devaluing the krona more frequently since the early 1970s.

47. J. M. Keynes, *The End of Laissez-Faire* (London: Hogarth, 1927), pp. 41–42.

48. Philip Arestis, "Post-Keynesian Economic Policies: The Case of Sweden," *Journal of Economic Issues* 20 (1986): 709–723.

49. J. M. Keynes, *The General Theory of Employment, Interest and Money* (London: Macmillan, 1936), p. 378.

Workers indulged in wage drift, figuring they could get away with it because the government would simply devalue, thereby reinforcing the wage-price spiral. But the plunges into current account deficits became more sudden and disconcerting, leading to disgust on the part of the leading Swedish corporate leaders, who turned increasingly to investing abroad rather than in Sweden.[50]

Sweden's anticipated membership in the EU in the early 1990s led to pegging the krona to the German mark, which removed devaluation as a policy tool and completely altered the macroeconomic policy landscape. Most noticeable was the end of the use of low interest rates to stimulate investment, as monetary policy became focused on defending the krona in the ERM. The most dramatic result of this came in September 1992 during the currency crisis that resulted in the United Kingdom and Italy dropping out of the ERM and devaluing their currencies. In order to defend the krona, the Swedish Central Bank temporarily raised overnight interbank interest rates to 500 percent. Even though Sweden has stayed out of the euro zone since 1999, it continues the fixed exchange rate policy by pegging the krona to the euro, as does Denmark, but unlike the United Kingdom among the three EU members that have remained outside of the euro zone.

Swedish macroeconomic performance since 1960 is presented in figure 8-1. Averages of growth rates of GDP, unemployment rates, and inflation rates are shown for Sweden and for the European members of the Organization for Economic Cooperation and Development (OECD).

Keeping in mind that Sweden started out ahead of the other European members of the OECD in per capita income in 1960 and that OECD Europe is Sweden's main trading partner, figure 8-1 tells a simple story. From 1960 to the mid-1980s, Sweden's GDP growth and inflation performances were generally in line with those of the rest of Europe, and it did substantially better in keeping unemployment low. Then in 1990–1991 Sweden's growth slowed while its inflation rate increased and its unemployment rate moved closer to Europe's average, although it remained lower. Deep in recession at the end of 1993, Sweden saw its nearly 9 percent unemployment rate almost converging on the European average. But after Sweden moved out of recession in the mid-1990s, its economy came to resemble its earlier performance, with growth and inflation rates near the European averages and with a lower unemployment rate, although this measure does not take account of those in special jobs associated with the active labor management policies.

50. In 1981 Swedish investment in the EU was about 4 billion kroner (plural of krona) and EU investment in Sweden was about 1 billion kroner. In 1989 the former was in excess of 30 billion kroner, while the latter was about 2 billion kroner (*The Economist,* "A Survey of the Swedish Economy," p. 21). This trend has led to an employment shift; in 1978 the 17 largest multinational corporations in Sweden had 266,000 employees in Sweden and 261,000 abroad, whereas by 1988 they had only 213,000 employees in Sweden and up to 342,000 abroad (Ministry of Finance of Sweden, *The 1990 Medium Term Survey,* p. 236).

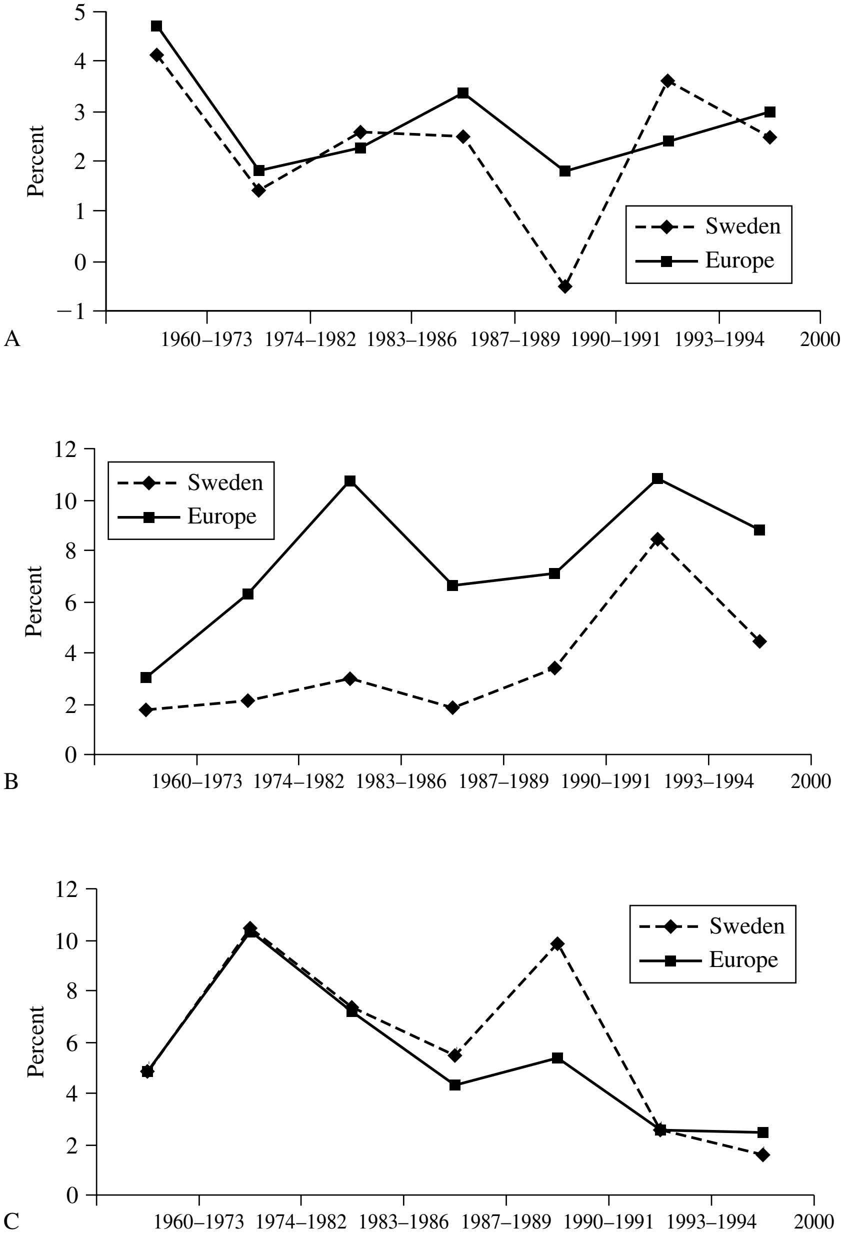

Figure 8-1
Swedish and European macroeconomic performances: a, GDP growth rates; b, unemployment rates; c, inflation rates.
Sources: Figures for 1960–1986 are from Alice M. Rivlin, "Overview," in B.P. Bosworth and A.M. Rivlin, eds., *The Swedish Economy* (Washington, D.C.: The Brookings Institution, 1987), p. 4; for 1987–1991, estimated from NIER, *The Swedish Economy: Autumn 1992* (Stockholm: National Institute for Economic Cooperation and Development, 1992), pp. 19, 138, 139; for 1993–1994 from *The Economist,* November 12–19, 1994, p. 122; and for 2000 from *The Economist,* March 17–23, 2001, p. 112.

Sweden and the European Union

During the summer of 1991 Sweden applied to join the EU, was accepted, voted in a referendum in November 1994 by 52 to 48 percent to join, and entered on January 1, 1995, along with Austria and Finland.[51] This move on Sweden's part was momentous and placed new constraints on Swedish policymakers.[52] Although, like Denmark, Sweden has stayed outside of the euro zone in order to be able to retain a more generous welfare system than other EU members, Sweden's macroeconomic policies are tied to those of the EU by its decision to peg the krona to the euro, with a referendum to join the euro to occur in September 2003. Sweden's long-standing low unemployment rate policy has probably ended permanently, even though its unemployment rate remains well below the EU average.

The driving force behind the 1991 decision to join the EU was the clear and inevitable reality that the Swedish economy was becoming increasingly integrated with that of Europe. The surge of investment by Swedish corporations in the EU, noted previously, was the clearest sign of this inevitability.[53] This trend was further strengthened by Swedish corporations' frustration with rapidly rising Swedish wage rates in the 1980s. From the late nineteenth century on, Sweden's economic growth has been driven by its technologically progressive export industries. Joining Europe so that these companies do not totally flee seems to have been an important motive. Furthermore, increased competitive pressures have aided Swedish consumers by lowering price-cost margins and have improved Sweden's overall growth and efficiency by encouraging large-scale, high-technology exporters, exactly those firms whose investments abroad had been a source of concern.[54]

Within Sweden, the opposition to joining the EU and the continuing opposition to joining the euro zone resembles the opposition to the EU in other countries such as France, a curious alliance of the Right and the Left. On the Right were protected industries that feared competition, notably farmers who have been heavily subsidized ever since the Agrarian (now Center) Party cut a deal with the Social Democrats in 1933. Opponents on the Left

51. Sweden, Austria, and Finland were all neutral in the Cold War, with only Ireland previously being a neutral member of the EU. But by the mid-1990s the concept of such neutrality had lost most of its significance.

52. Rudolf Meidner in particular blames globalization pressures more generally for the end of the system that he helped establish (Bertram Silverman, "The Rise and Fall of the Swedish Model: Interview with Rudolf Meidner," *Challenge* 41(1) [1998]: 69–90).

53. Several of Sweden's major corporations have merged outright with foreign firms, notably its largest, Asea, with Switzerland's Brown Boveri and its fourth largest, Saab-Scania, with the United States's General Motors, a major presence in the EU. Volvo attempted a merger with France's Renault that did not transpire, but it has since merged with Ford of the United States.

54. It has been noted that, compared with most other European economies, Sweden's is marked by firms that are either very large or very small, with high levels of concentration in many industries leading to concerns about excessive monopoly power and high prices. See Stefan Fölster and Sam Peltzman, "The Social Costs of Regulation and Lack of Competition in Sweden: A Summary," in Freeman, Topel, and Swedenborg, *The Welfare State in Transition,* pp. 315–352.

were the Green Party environmentalists[55] and those in the Party of the Left (formerly Communist) and left-wing Social Democrats, especially women, who opposed ending the full employment policy and feared further inroads into the welfare system.

The fears about the welfare system are not groundless, as seen by events in the former East Germany since unification with West Germany. As discussed in the next chapter, West Germany's social policies are much less favorable to women than were those in East Germany or those currently existing in Sweden. Unification meant cutting those programs in East Germany, and women have borne the brunt of rising unemployment there. However, the Swedish economy is more competitive than that of eastern Germany and retains more autonomy relative to Germany than does the no-longer-independent eastern Germany.

On the positive side, joining the EU appears to have enhanced efficiency and competitiveness sufficiently so that Sweden is better able to afford a reasonable facsimile of its former programs, a result in line with Denmark's performance. Although a member of the EU for some time, Denmark still has social welfare programs nearly as generous as Sweden's. What it has not been able to maintain has been full employment, and given Sweden's weakened centralized wage bargaining system, it seems unlikely that it will be able to return to that either, although the government has expanded its active labor market policies. As in most of the rest of the market capitalist world, competitive wages are likely to be maintained at least partly by the threat of unemployment. That Sweden's voters are torn by the costs and benefits of EU membership is shown by their voting in 1994 for the Social Democrats to protect social programs but shortly thereafter ratifying the EU referendum that threatened those programs (box 8-2). Their remaining outside the euro zone had symbolized Swedish ambivalence, but the improved performance of the Swedish economy in the late 1990s and after 2000 paved the way for the 2003 referendum to join it after all.

IS THE SWEDISH MODEL DEAD?

In an often cited 1985 paper,[56] Erik Lundberg presented eight reasons for the alleged death of the Swedish model. One was the collapse of support for the Social Democrats after 1976.[57] But even the Social Democrats agreed on the need for "stiff medicine" because of

55. The Center Party also has taken strong proenvironmentalist positions. Sweden has had a very strong environmental policy since the 1970s, generally stricter than that of the EU. An example is a stricter standard for automobile emissions. But Sweden has a *looser* policy for hunting regulations; the EU forbids bear hunting, while Sweden allows it.

56. Erik Lundberg, "The Rise and Fall of the Swedish Model," *Journal of Economic Literature* 23 (1985): 1–36.

57. It is difficult for outsiders to understand the pervasiveness of the SAP as a social institution in Sweden. Its intimate links with the LO have involved it in owning and directly operating cooperatives and many other institutions throughout Sweden.

Box 8-2
The Swedish Energy-Environment Trade-off

A growth conundrum for Sweden involves policies toward energy and the environment. Sweden's policies make it difficult to increase electricity output. This has resulted in rising electricity prices, further fueling the exodus of Swedish firms. Some of Sweden's important exporters, such as the pulp and paper industry, are very energy-intensive. Sweden faces a serious energy-environment trade-off.

After the 1973 oil price shock, the Social Democratic government accelerated an ongoing policy to rely on nuclear power to reduce oil imports. Sweden was a world leader in civilian nuclear technology.* Today it leads in megawatt hours per person of electricity produced by nuclear power and is third, behind France and Belgium, in the percentage of its electricity provided by nuclear power at just under half.

In 1976, the Center Party defeated the Social Democrats on an anti–nuclear power platform. A referendum on the issue in 1979, the year of the Three Mile Island nuclear accident in the United States, decided not to build any new reactors beyond the existing 12 and to shut them all down by 2010. More recent governments promised to close two by 1996 but put off doing so in the face of the energy-environment conundrum.

Since then Swedish governments, also for environmental reasons, have ruled out building more hydroelectric plants on remaining undammed rivers, the major nonnuclear source of electricity, and have unilaterally adopted the goal of not increasing carbon dioxide emissions above 1988 levels. That goal rules out using coal, oil, or natural gas to replace nuclear power. Prospects for such alternatives as solar, wind, or geothermal energy are not good.

Thus, if two nuclear power plants are shut down and these other restrictions remain, the price of electricity will nearly triple from its 1985 level.† Uncertainty over energy costs has already led one producer (Granges, a metals group) to build a smelter in Iceland rather than in Sweden. The Swedes face a difficult dilemma.

*Prior to 1969, Swedish nuclear development was oriented toward a potential bomb.
†*OECD Economic Surveys: Sweden 1990/1991* (Paris: Organization for Economic Cooperation and Development, 1990), p. 53.

massive budget deficits, and they supported entry into the EU despite internal splits on the issue.

Second was the expansion of the concept of full employment that occurred in the late 1960s. This led to reckless macroeconomic and wage-setting policies that ultimately undermined the goal of full employment. Support for this goal declined after 1991, however.

Third was stagnation of economic growth, which exacerbates all conflicts. Lundberg cites the debate over nuclear power and the alleged laziness of the younger generation as troubling trends. The future of these trends is uncertain, although the halving of sick leaves in the 1990s marked a shift to a more sustainable pattern.

Fourth was excessive wage solidarism combined with overly high tax rates that reduced work incentives and distorted investment in dying industries in the late 1970s. This trend has been decreasing since the early 1980s.

Fifth was the breakdown of the EFO model of wage setting, largely caused by the increased public sector employment, with the resulting explosion of wages beyond productivity increases and the concomitant loss of international competitiveness. This trend has since been reversed.

Sixth was misguided policies during 1975–1978 to prop up dying industries with various subsidies. This factor has largely disappeared.

Seventh was the increased use of inflationary stabilization policies. This, too, has significantly changed, with Sweden's inflation rate now in line with the EU average since it pegged the krona to the euro.

Eighth was the loss of policy autonomy due to the increasing internationalization of the economy. Joining the EU was the final guarantee of this process.

A ninth reason for the alleged fall of the Swedish model, not mentioned in Lundberg's paper, is that although Sweden continues to have a high rate of R&D spending, it remains concentrated in industries tied to Sweden's old natural resource base.[58] Sweden has largely failed to develop the newer microelectronics industries that are the wave of the future, although efforts by Ericsson to compete with Finland's Nokia in the cell phone business suggest that not all is lost. This may be tied to a deeper loss of entrepreneurship resulting from the conformist and cocoon-like welfare state, and resurrecting this Swedish entrepreneurship may be the ultimate key to reviving Swedish economic growth in the long run.

Lundberg argued that the Swedish economic model was not really dead but had merely experienced a "break in the trend," and that Sweden would continue to maintain its commitment to full employment and a generous social welfare policy. Now the former commitment appears to have been abandoned, despite the government's expansion of active labor market policies, and social welfare policies have come to face a continuing challenge.

What has probably happened is that Sweden is more closely imitating its Nordic neighbors. Although they have many historical and political differences among themselves, including those over membership in the North Atlantic Treaty Organization, the EU, and the euro zone, with the exception of Iceland all the Nordic countries have higher taxes, larger welfare states, and greater corporatist tendencies than most social market economies.[59] For decades, Sweden led Scandinavia and Finland both in terms of real per capita income and in terms of politics and ideology. But it seems that Sweden pushed unsustainable policies too far and fell behind its neighbors in real per capita income. That these countries continue to do well suggests that with proper adjustments, Sweden may also be able to continue with a modified version of its system.

58. See Charles Edquist and Bengt-Åke Lundvall, "Comparing the Danish and Swedish Systems of Innovation," in R. R. Nelson, ed., *National Innovation Systems: A Comparative Study* (Oxford: Oxford University Press, 1993).

59. Thus, Norway and Iceland both belong to NATO but not to the EU. Denmark, Sweden's longtime rival as an ancient monarchy with a still existing thin layer of aristocracy, belongs to both NATO and the EU but has stayed out of the euro zone, as has Sweden. Sweden's fellow neutral power, Finland, has joined both the EU and the euro zone and differs linguistically from the other two, being considered a Nordic but not a Scandinavian country. See *The Economist,* "The Nordic Countries: Happy Family?" January 23–30, 1999.

Thus the Swedish model is not dead, but it has suffered serious body blows since Lundberg's 1985 assessment and is struggling to survive. If one compares the Swedish model to a ship, it is being buffeted by powerful outside forces and its "ballast has shifted." It remains to be seen whether the recent and current course adjustments will be sufficient to keep it afloat, or whether it will sink "peacefully beneath the waters," as did the mighty Vasa ship of yore.[60] The most recent data regarding its future are encouraging.

SUMMARY AND CONCLUSIONS

By many measures, Sweden has been one of the most successful economies in the world and is probably the clearest example of a redistributionist social market economy. Swedish economic policy combines a rigorous respect for free markets in output and private ownership of the means of production with the most active government labor market intervention in the world for the purposes of retraining, informing, and relocating laid-off workers in new jobs. From 1938 until the 1990s, Sweden practiced a corporatist centralized wage bargaining system between the main labor federation (LO) and the main employer federation (SAF). The LO pursued a solidaristic wage policy, partly with the goal of restructuring the economy. Centralized wage bargains were set based on productivity improvements in the export sector, which has been the economy's main growth engine. Income redistribution programs have been more extensive than those of any other market economy. Sweden has had generous sick and parental leave policies, a system often described as providing cradle-to-grave security.

These policies have generated great successes over time. From 1870, when industrialization took off, to 1950, Sweden had the highest economic growth rate in the world, placing it in the global top three in real per capita income. At the same time, it has had greater income and wealth equality than any market capitalist economy and probably came closer to eliminating poverty than any other society. Until 1992 Sweden maintained low unemployment rates that never exceeded 4 percent while maintaining inflation rates comparable to those of the rest of Europe. It may have achieved the highest quality of life for women of any nation, even if it has slipped recently from that top position. At the core of these achievements has been a small group of technically and managerially innovative corporations that have maintained a strong competitive edge in a number of industries.

The Swedish model experienced increasing difficulties beginning in the 1970s and is now undergoing a process of change and adjustment. High tax rates and generous sick

60. The Vasa ship was discovered largely intact in Stockholm's harbor in 1961 and was later raised, at great risk to the life and limb of those who did so. It currently occupies a museum on the harbor entirely devoted to it.

leaves adversely affected the labor supply, especially among a less hard-working younger generation. Rising public sector employment and spreading wage drift broke down the centralized wage bargaining system. Accelerating wage increases caused accelerating inflation and led to current account deficits and currency devaluations. Because of these problems and rising electricity costs, leading Swedish corporations increasingly shifted their capital investment outside of Sweden to the rest of the EU. The Swedish economy fell into recession in 1992–1993, with unemployment rates not seen since the 1930s.

Recent government policies have included tax cuts, reductions in sick leave benefits and other social welfare policies, and a strictly anti-inflationary macroeconomic policy. The last policy involved pegging the Swedish krona to the euro as Sweden joined the EU but maintained its distance by remaining outside of the euro zone. The 2003 referendum on joining the euro zone represents a crucial moment for Swedish macroeconomic policy.

These policy changes alter the purist version of the Swedish model as it previously existed, moving it more in the direction of other European economies, especially those in the rest of Scandinavia, which originally followed Sweden in developing their systems. Certain distinctive characteristics such as the full employment policy may be permanently lost as Sweden integrates into the EU. Nevertheless, if the current reforms can restore the competitive thrust of the Swedish economy, there is reason to believe that a modified version of its unique system, one that still includes more income redistribution, an active labor retraining and adjustment policy, and a better treatment of women than in most countries, will survive and even thrive once again.

QUESTIONS FOR DISCUSSION

1. What are the different types of corporatism, and what are the advantages and disadvantages of each? What are the sources of wage drift, and how has it affected Sweden's future prospects as a corporatist economy?

2. What are the relationships between the EFO model, the Rehn-Meidner Plan, and wage solidarism? How do they reinforce or undermine each other, and what have been their economic impacts over time?

3. Many observers argue that Swedish taxes are too high. Evaluate this argument.

4. Is the equity-efficiency trade-off relevant for Sweden?

5. It has been argued that Swedish macroeconomic policy is ultra-Keynesian. Evaluate this argument.

6. What are the implications of Sweden's having joined the EU for the future of the Swedish model? Evaluate the arguments for and against Sweden joining the euro zone.

7. Evaluate the applicability of the various parts of the Swedish model to other economies in the world, such as those in Eastern and Western Europe, Japan, and the United States.

8. Compare and contrast the Swedish and American approaches to welfare and other income redistribution programs and policies.

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DENMARK
Baltic Sea
Schleswig-Holstein
Kiel
Rostock
Mecklenburg-Vorpommern
Schwerin
Emden
Bremerhaven
Hamburg
NETHERLANDS
Bremen
POLAND
Niedersachsen
Berlin
Potsdam
Hanover
Magdeburg
Brandenburg
Saxony-Anhalt
Northrhein-Westfalen
Halle
Leipzig
Düsseldorf
GERMANY
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Koln
Erfurt
Chemnitz
Bonn
Hesse
Thuringia
Suhl
B.
Frankfurt
CZECH REPUBLIC
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Mainz
L.
Nurnberg
Saarland
Regensburg
Stuttgart
Bayern
FRANCE
Augsburg
Baden-Wurttemberg
Munich
Freiburg
AUSTRIA
SWITZERLAND

9 The Unification of Germany and the Unification of Europe

The particularism of the stocks, dynasties, and cities, the dualisms of west and east, of Protestants and Catholics, of Lutherans and Reformed, of Prussia and Austria, of imperial patriotism and colonial expansion eastward, of mysticism and scholasticism, of rationalism and faith, of nobility and bourgeoisie, of civilian and military, of bureaucracy and public opinion, of capitalism and labor—all these tensions in German history needed to be resolved. The attempt would be made at first in a provisional way by [a] claim to supremacy put forward as a missionary concept; only after such an effort failed would compromise be tried.
—Veit Valentin, *The German People: Their History and Civilization from the Holy Roman Empire to the Third Reich,* 1946.

INTRODUCTION

The problem of Germany is the problem of Europe: Can unity be created from diversity while still respecting diversity? For over a thousand years the much-divided Germans have struggled to create unity, but each time they succeeded, they overreached by attempting to absorb their neighbors in a universal empire. For Europe then, does the 1990 reunification of West and East Germany show that Europe can also be united or remain fundamentally divided in reality?

An economic manifestation of this problem came in the early 1990s after Germany reunified, when the costs of subsidies to the former East Germany raised Germany's budget deficits. The German central bank, the *Bundesbank,* sharply raised interest rates then. Because of the dominant position of the German economy and the dominant role of its currency, the Deutschemark, in the European exchange rate mechanism (ERM), the system that predated the euro, interest rates rose throughout the EU and triggered a European recession. Italy and Great Britain then dropped out of the ERM and devalued their currencies. Although Italy rejoined the ERM later and joined the euro zone at its establishment in 1999, Great Britain did not. It remains outside of the euro zone and somewhat estranged from its fellow EU members.

Germany has the world's fourth largest economy and one of the highest per capita income levels. Drawing on a highly educated and hard-working population, Germany industrialized rapidly after its unification in 1871 by the Iron Chancellor, Otto von Bismarck. This fed ambitions underlying Germany's aggressive role in World Wars I and II.

With Germany's overwhelming defeat in World War II, its economy collapsed. It was divided into the Federal Republic of Germany (FRG) in the West, which adopted a market capitalist economic system, and the German Democratic Republic (GDR) in the East, which adopted a command socialist economic system.[1] The two German republics competed

1. There was more division because former German territories in the East were annexed by the USSR and Poland. The FRG gave up its demand for those territories only in 1990 under pressure from the international community to gain acceptance of its unifcation with the GDR.

vigorously during the Cold War, both growing more rapidly than most economies of their respective systems. Yet the FRG's growth outstripped the GDR's, and after the country freed prices and introduced a new currency in 1948, its economic performance was labeled the **West German economic miracle (Wirtschaftswunder).** In 1990 the GDR ceased to exist and joined the FRG as a broken-up set of *Länder* (states). Today Germany has the archetypal *social market economy,* a term invented in postwar West Germany. It respects private property and market forces, eschewing central planning.[2] But historically it has had an extensive social safety net and an income redistribution system. In the 1880s, Bismarck established the world's first government-run health insurance, social security, and worker's compensation systems.[3]

Compared to Sweden, also a social market economy, as described in the previous chapter, Germany's social welfare system is not as extensive, nor are its taxes as high or as progressive. Germany does not use active labor policies, but its apprenticeship system produces a highly skilled blue-collar labor force.[4] It does not have corporatist centralized wage bargaining, but it has **codetermination (Mitbestimmung),** in which **works councils** advise management and labor leaders sit on supervisory boards of corporations, a system that brings about considerable labor-management cooperation.

Compared to most countries, including Japan, Germany has a strong banking sector that dominates the economy and owns large portions of the stock of major corporations. During the late nineteenth century the banks encouraged protectionism and cartelization of industry, which lasted until the end of World War II. This bank domination has persisted in Germany's postwar free trade economy, even after decartelization.[5] Some now argue that this bank domination is a reason for the recent stagnation in Germany, much as in Japan.

2. Between 1967 and 1972 a halfhearted effort at "Concerted Action" occurred; major economic actors discussed trends and policies in imitation of French concertation with hints of Swedish corporatist bargaining. The French economist Michel Albert has described both the French and German economies as following the **Rhineland model.**

3. The main supporter of such legislation at the time, the German Social Democratic Party, was outlawed. Bismarck coopted its policies while suppressing it.

4. In contrast to Sweden's, Germany's apprenticeship system reduces labor mobility by its specialized training. It is a direct descendant of the medieval guild system with its masters, journeymen, and apprentices.

5. In 1974–1975 banks owned 9.1 percent of German equity capital and controlled 17.9 percent of supervisory board memberships and 50 percent of board chairmanships. Two-thirds of bank holdings were by the Big Three: Deutsche Bank, Dresdner Bank, and Commerzbank (Eric Owen Smith, *The German Economy* [London: Routledge, 1994], p. 357). The holdings of the Allianz insurance company, equal to 5 percent of the FRG's GDP in 1989 (Smith, *The Germany Economy,* p. 337), are so widespread that the company is known as "the spider in the web," a position strengthened recently by financial sector mergers. For discussion of the earlier history of German banking, see Timothy W. Guinnane, "Delegated Monitors, Large and Small: Germany's Banking System, 1800–1914," *Journal of Economic Literature* 40 (2002): 73–124.

Traditionally the *Bundesbank* was probably the most independent central bank in the world, and along with the Swiss central bank, it followed a rigorous monetarist policy that produced consistently low inflation.[6] Of all the nations that joined the euro zone, Germany was among the most skeptical, reluctant to give up its strong Deutschemark for a potentially weaker euro. The new **European Central Bank (ECB)** is located in Frankfurt, home of the *Bundesbank,* to placate the Germans, and the ECB has attempted to imitate the model of the *Bundesbank*. Ironically, by 2001 the German economy was the weakest in the EU, and Germany since then has most strongly advocated a more expansionary ECB monetary policy.

Despite its general long-term successes, Germany more recently has developed problems in sustaining growth. It led the EU into a recession in the early 1990s and has been the growth laggard of Euroland since the beginning of the new century. Besides its sluggish economy, two other elements with long-term implications haved led observers to discuss **Germany's fading miracle.**

One is a long-term slowdown of growth greater than the general global slowdown that has occurred. This German slowdown has been accompanied by a long-term increase in unemployment and outbreaks of neo-Nazi skinhead violence directed at foreigners. German growth has long been led by exports of technologically advanced engineering products, with Germany at times being the world's top overall exporter (and currently second only to the United States). But Germany faces increasingly stiff competition, especially from Asian producers, and many see it losing its edge.

The other problem is that reunification with the former GDR has been costlier and more difficult than anyone predicted. Just prior to the reunification, former FRG Chancellor Helmut Kohl had forecast that the outcome would resemble the *Wirtschaftswunder* in West Germany after 1948. But the 1990 East German economy was further from market capitalism than the 1948 West German one; there was private ownership of the means of production in the 1948 West but not in the 1990 East. Also, the productivity, quality, and environmental differences between the two economies were much greater than were originally anticipated.

Combined with the collapse of the entire European socialist bloc and the sharp contraction of markets for East German goods in the former **Council on Mutual Economic Assistance (CMEA)**[7] countries was a massive collapse of output in eastern Germany. This led to greater expenditures on unemployment compensation and privatization efforts by the

6. This policy reflects memories of the 1923 German hyperinflation, which undermined the interwar Weimar Republic and paved the way for Hitler. Anti-inflationary policy was aided until recently by modest union wage demands.

7. The CMEA, or COMECON, was the trade organization of the part of the socialist bloc dominated by the former Soviet Union.

FRG government than expected. The resulting budget deficits[8] led the *Bundesbank* to raise interest rates, which brought about a general European recession and currency crises that cracked the European ERM. Continued stagnation in Germany would lead in 1998 to replacement of Kohl and the Christian Democratic Union (CDU) by a coalition of the Social Democratic Party (SPD) and the Green Party, with Gerhard Schröder of the SPD as Chancellor. But this government, narrowly reelected in 2002, has not been able to return Germany to its position as the growth leader of Europe.

The process of privatizing and integrating the former GDR economy has been successfully completed on the surface. Growth in the former GDR exceeded that in the West through 1996, but since then it has fallen behind. Because it is apparently stuck behind the western part, many now speak of the eastern part as representing a **Mezzogiorno problem** in reference to the chronically depressed southern region of Italy. But deep differences remain, with strong resentments between **Ossis** (East Germans) and **Wessis** (West Germans), the Ossis complaining of domination by the Wessis and the Wessis complaining of excessive expenses to support the allegedly lazy Ossis. Eastern unhappiness is symbolized by the reappearance in the Reichstag (parliament) in 1994 of the former Communists, now the Party of Democratic Socialism.

HISTORICAL BACKGROUND OF THE GERMAN ECONOMY

The Origins of the "German Problem"

The Romans called them *Germani,* although their own identity then was tribal, and there were many tribes.[9] Blocking European unity in 9 C.E. by defeating an invading Roman army, they would conquer the Roman Empire four centuries later.

In 800 the Frankish leader Charlemagne attempted to create a universal unified European state, the Holy Roman Empire.[10] For the next thousand years, there would be a Holy Roman Emperor, a German pretending to rule a universal Christian state in Europe.

Here was the "German Problem" for Europe. There really was no Germany. It consisted of tribal entities with ill-defined borders. Germany sought to rule Europe,[11] but its own

8. Chancellor Kohl had promised that there would be no tax increases.

9. The most prominent core German tribes were the Saxons, Bavarians, Franks, Allemani (later called Swabians), Thuringians, and Frisians. Several of these provided the names for modern German *Länder* (Saxony, Bavaria, Thuringia).

10. In the 1700s Voltaire quipped that it was neither holy nor Roman nor an empire. For a discussion of its changing status from the late medieval period to the Renaissance and afterward, see Tom Scott, *Society and Economy in Germany, 1300–1600* (Houndsmills, U.K.: Palgrave, 2002).

11. This effort involved a conquest movement eastward into Slavic lands, creating Austria and later Prussia, whose militaristic and authoritarian Junker aristocracy brutally enserfed the Slavic peasants and would later unify Germany.

power was in the hands of local dukes, archbishops, princes, and the like. Only with Bismarck's 1871 unification would there be a *Deutschereich* (German Kingdom).[12]

Because Germany was a trade route in Central Europe and a center of innovation (symbolized by Gutenberg's invention of the printing press), the German economy experienced substantial growth in the 1400s and 1500s. But it was shattered by the disastrous Thirty Years' War (1618–1648), the ultimate European showdown between Protestantism and Catholicism. It left Germany divided religiously, a third of its population killed, and its economy ruined, a condition not overcome until 1871.

The Rise and Fall of Imperial Germany

In 1871 Prussia's Chancellor Bismarck overcame separatism to unify Germany[13] by getting the various regions to join in the successful Franco-Prussian War. Prussia led the unified German Empire, partly because it had experienced the most economic growth, including nascent industrialization.

The German economy expanded and industrialized rapidly after the 1871 unification. Between then and 1913, just before World War I, exports more than quadrupled and steel production surged past Great Britain's, leading to intense commercial competition with Britain that drove their diplomatic and military rivalry. The British overcame their ancient antipathy toward the French to ally with them against Germany. Their victory over Germany in World War I led to the replacement of the German Empire with a republic.

A feature of German growth was its lead in general science and technology prior to industrialization.[14] One area with an early economic payoff was the chemical industry, which Germany led after conducting organic chemistry studies of the scientific application of fertilizer in the 1840s. In the 1880s, Otto Benz invented the first true automobile and founded Daimler-Benz (now Daimler-Chrysler), the producer of high-quality Mercedes-Benz cars. High-technology manufactured exports remain a key feature of German economic success,

12. Modern Germany is an artificial creation out of still-disparate tribes. There are substantial differences between the German spoken in different regions, and the northern Germans from Hamburg are more physically similar to the southeastern English than to the Latinized southern or Slavicized eastern Germans.

13. Of the states joining the German Empire, the most reluctant was the Kingdom of Bavaria in southeastern Germany, which harbored serious separatist movements well into the twentieth century. It was one of the larger old German states and resented Prussian domination partly for religious reasons as a Catholic state, northeastern Prussia being Protestant. The Bavarians have their own political party, the Christian Social Union, which allies with the Christian Democrats but is more conservative. The unification did not solve the German Problem because there were many ethnic Germans outside the empire in Switzerland, Austria, and elsewhere and many non-Germans, especially Poles, within it. These issues stimulated the expansionism of Germany in the two world wars.

14. Germany lost its scientific leadership to the United States in the 1930s when Hitler's persecution of Jews and other groups caused a migration of top scientists to the United States. The most famous was Albert Einstein, who convinced President Roosevelt in 1939 to authorize the Manhattan Project that built the atomic bomb. Many of the Manhattan Project's participants were also refugees from Germany.

Box 9-1
The German Hyperinflation

Hyperinflation is shown in the following table, which shows the exchange rate of the mark to the U.S. dollar in 1914 and from 1919 to November 1923. Although the German economy stabilized after this time until the Great Depression struck in 1929, the hyperinflation deeply discredited the Weimar Republic. Many people saw their life savings quickly wiped out and became receptive to the idea of searching for a scapegoat. When hyperinflation peaked, wheelbarrows full of money were required to shop for groceries.

Marks per U.S. Dollar, 1914 and 1919–1923

Dates	Value
July 1, 1914	4.2
July 1, 1919	14.0
July 1, 1921	76.7
July 1, 1922	493.2
January 1, 1923	17,972.0
July 1, 1923	353,412.0
August 1, 1923	4,620,455.0
September 1, 1923	98,860,000.0
October 1, 1923	25,260,208,000.0
November 15, 1923	4,200,000,000,000.0

Note: The figures are monthly averages.
Source: Gustav Stolper, Karl Hauser, and Knut Borchardt, *The German Economy: 1870 to the Present* (New York: Harcourt, Brace & World, 1967), p. 83.

reinforced by the fact that more German managers possess an engineering background than do managers in other countries.

The Weimar Republic and the Nazi Command Capitalist Economy

In November 1918, the Social Democrats took control of the government and established the Weimar Republic. Signing the surrender and the 1919 Versailles Treaty, which took territory from Germany and imposed massive reparations payments, alienated nationalists. They would eventually follow the National Socialist (Nazi) leader, Adolf Hitler, who argued that these acts had resulted from an "international Jewish conspiracy."

Besides reducing military spending, removing agricultural tariffs, and introducing workers' councils to advise managements in the workplace,[15] the economic policies of the Social Democrats differed little from prewar ones.

Economic policymaking was overwhelmed by the reparations payments announced in 1921. Payment difficulties stimulated **hyperinflation** (box 9-1), which accelerated

15. These councils presaged the modern codetermination system, but they were largely ineffectual.

until a new currency and reform program (relying upon U.S. loans) was implemented in November 1923.

The Great Depression hit Germany harder than any other country. At the Depression's low point in 1932, the Nazis became the largest party in the *Reichstag* (German parliament). In January 1933 Hitler was appointed Chancellor. He soon outlawed all other parties, seized absolute power as *Fuhrer,* and established the Third Reich. In 1939 his invasion of Poland began World War II in Europe. Hitler oversaw the Holocaust, in which 6 million Jews and millions of other people were killed. In 1945, faced with imminent German defeat by the Allied forces, Hitler committed suicide.

Soon after achieving power, Hitler imposed a **command capitalist** economic system that achieved strong economic growth until it was distorted by war.[16] For Hitler, economic ideology and practice were subordinated to his anti-Semitic and militaristic nationalist politics. In the early 1920s the National Socialist German Workers' Party (the Nazi Party's full name) had an anticapitalist bias, opposing interest and land rent and calling for the nationalization of many businesses. But Hitler was anticommunist and appealed to small and big business for support.[17] In 1929 the official party line supported a **corporate state,** a position that the Nazi Party maintained until it lost power. In practice Hitler did not nationalize industries, and he purged the socialist wing of the Nazi Party shortly after his seizure of power.

Hitler's economic program focused on building up the military as rapidly as possible and as independently of other nations as possible. He imposed price controls and compulsory **cartelization** and outlawed independent labor unions. The government controlled foreign trade and foreign exchange transactions, made bilateral deals with countries southeast of Germany, and emphasized self-sufficiency. Economic sectors were organized in *chambers* that followed government orders. Early in Hitler's rule, he emphasized infrastructure investment, such as constructing highways (*Autobahnen*).

Prior to the war, Hitler's economic policies were quite successful. Germany came out of the Depression rapidly—its GDP doubled between 1932 and 1938—and the unemployment rate fell from 29.9 percent in 1932 to 0.5 percent in 1939, when the war began. But the economy had already hit bottom and had begun to grow in 1932 prior to Hitler's ascension to power.

16. Although Germany had a 0.5 percent unemployment rate in 1939, between then and 1944 armaments production nearly quadrupled. Slave labor from conquered territories was used.

17. Hitler's compulsory cartelization policy weakened small businesses. Most big businesses initially supported Hitler unenthusiastically. But it was a widespread postwar consensus that Hitler was put in power by the big cartels, some of which were then broken up.

A TALE OF TWO POSTWAR GERMAN ECONOMIES

The West German *Wirtschaftswunder* and Its Fading

Germany surrendered on May 9, 1945, and was partitioned into six zones. Two were annexed by Poland and the Soviet Union and experienced massive outmigration to western parts of Germany. What is Germany today was split into four zones of occupation: by France near its border in the southwest, by the United Kingdom in the north, by the United States in the south, and by the Soviet Union in the east. Berlin was a special area, which was also subdivided into four zones of occupation. In 1947 the U.S. and U.K. zones were united in *Bizonia,* to the initial opposition of the French and the Soviets. The deepening Cold War and Marshall Plan aid persuaded the French to let their zone join in the newly declared Federal Republic of Germany (FRG) in 1949, and the Soviet zone became the newly declared German Democratic Republic (GDR) that same year.

In 1946 the German economy experienced a massive collapse. Compared to 1939, national income was less than half, industrial production less than a quarter, rail freight a third, and food consumption barely above half.[18] This was a horrible situation but one that offered the possibility of future rapid growth through rebound. At first there was no interest in achieving it in the Soviet zone, but there was in the American and British zones from 1947 on.

The capital stock of West Germany was actually 16 percent higher in 1946 than it had been in 1938, and only limited reductions had occurred in the labor force.[19] But there were three main problems. First, destruction of transportation and communications infrastructure had created production bottlenecks. Second, huge portions of capital stock had been diverted to military production, which had ceased. Third, economic paralysis had resulted from fixed prices, rationing, and **monetary overhang**[20] left over from Hitler's economic system. The first problem was readily remedied by 1947 through sectorally concentrated capital investment.

In January 1948 Ludwig Erhard became Administrative Director of the Bizonal Economic Administration and sought to resolve the other two problems. He was associated with economists based at Freiburg University known as **Ordo-liberals.** They strongly supported free markets and private property. But they also wanted a state strong enough to

18. Gustav Stolper, Karl Hauser, and Knut Borchardt, *The German Economy: 1870 to the, Present,* trans. T. Stolder (New York: Harcourt, Brace & World, 1967), p. 205.

19. Holger C. Wolf, "Postwar Germany in the European Context: Domestic and External Determinants of Growth," ED–93–11 (New York: Stern Business School, New York University, 1993), pp. 3–4.

20. Monetary overhang arises in a goods economy when there is a great deal of money in circulation but goods are in short supply and prices are fixed.

break up cartels, which they blamed for the Nazi episode.[21] They also supported government provision of a social safety net, hence the term **social market economy (soziale marktwirtschaft).**[22]

Erhard's first move came in March 1948, when he established a central bank. It was built up out of state banks created in the *Länder* by the Allies, and its governing board was dominated by the presidents of the *Ländern* banks.[23] This governing board would be the basis of control of the *Bundesbank* and its policymaking independence.

On June 20, 1948, without prior notice, a new currency, the Deutschemark, replaced the old Reichsmark at a 1:1 ratio for current wages and prices but at a 1:10 ratio for all debts, thereby wiping out monetary overhang at one stroke. A few days later, Erhard removed price and rationing controls on all but a few essential foods plus coal, steel, and electric power while retaining foreign exchange controls that remained in place until 1958. The result was the immediate appearance of previously hoarded goods on shelves and an increase in industrial production of 50 percent in 1948 and 25 percent in 1949.[24] This began the *Wirtshaftswunder.* Its success made it the model for reform of the East German economy following reunification, and it was the prime inspiration for all *Big Bang* (everything-all-at-once) reform programs throughout Eastern Europe.[25]

After some initial stumbles,[26] the *Wirtschaftswunder* continued strongly during the 1950s, led by a tripling of exports between 1950 and 1958 and a growth rate of industrial production between 1950 and 1955 greater than that of any nation in Europe. The FRG's acceptance into various international economic bodies, especially the **European Coal and Steel Community (ECSC),** enhanced exports. Although West Germany received $4.5 billion worth of Marshall Plan aid, this aid was a lower percentage relative to the economy than that of many other European recipient countries. Possibly the Marshall Plan's real

21. Some firms were broken up, most prominently the chemical giant I. G. Farben, which became Bayer, Hoechst, and BASF.

22. This term was coined by Andreas Müller-Armack, *Wirtschaftslenkung und Marktwirtschaft,* Hamburg; Verlag für Wirtschaft und Sozialpolitik (1947), longtime permanent secretary in the Ministry of Trade and Commerce.

23. An important characteristic of the FRG was already manifest: its high degree of decentralization, with many social and economic policy-making powers in the hands of the *Länder*. In this way the FRG has attempted to resolve the long-running conflict between tribes and nation.

24. Stolper, Hauser, and Borchard, *The German Economy,* p. 231.

25. It played a role in finalizing the split between East and West Germany, formalized in 1949. The Soviets refused to allow such blatant market capitalism in the East.

26. Despite current fond memories, the public initially was slow to accept the idea that it was beneficial. Unemployment rates continued to rise through 1950. It was not until 1954 that more West Germans said they perceived an improvement rather than a worsening in living standards (Wolf, "Postwar Germany in the European context," p. 25).

significance for the FRG was its support for establishing the trading system in Western Europe and for integrating the FRG into that system.

Because the *Wirtschaftswunder* was so dramatic, the later slowdown of growth also seemed dramatic. The year 1955 was the last year the FRG had a double-digit real growth rate (12 percent). It surged to 9 percent in 1960 after the final currency decontrols and hit 8.2 percent in 1969, but it has not come close to such rates since.[27] Annual rates of increase in productivity have steadily declined from a 5.1 percent average over 1951–1964, to 4.4 percent over 1964–1973, to 2.9 percent over 1973–1979, to 1.5 percent over 1979–1987.[28] The rate of growth did not reaccelerate in a sustained way later and has fallen even lower since 2000. Why has the miracle faded?

One belief is that the slower growth rate was an unavoidable consequence of combining a generally declining world economic growth rate with the fact that the FRG had caught up. The latter reason is supported by the very strength of the rebound effect in the late 1940s and early 1950s.

An alternative response is a German variant of **Eurosclerosis,** a theory popular with the Ordo-liberals. The EU as a whole has slowed down. Since the 1970s, the EU has had persistently high unemployment rates compared with the United States and Japan. The Eurosclerosis view argues that this slowdown is caused by restrictive labor market practices and other regulations inhibiting the market economy that have grown up over time. These problems continue to persist and seem especially serious in Germany to many observers.

In the FRG, the unemployment rate averaged 0.9 percent over 1960–1964,[29] 1.2 percent over 1965–1969, 1.3 percent over 1970–1974, 4.4 percent over 1975–1979, 7.0 percent over 1980–1984, and 8.8 percent over 1985–1989. After a brief decline in 1990 and 1991, it rose again as the FRG went into recession, aggravated by the double-digit rate in eastern Germany, reaching a maximum in 1990. Since then it has declined very gradually, finally dropping to just below 10 percent in 2001 while remaining much higher in the East; however, it has since risen above 10 percent again. Whether these high unemployment rates are due to excessively high wages, restrictive firing rules (as charged by the Eurosclerosis group), the codetermination system, or the domination of the German economy by its banks,

27. V. R. Berghahn, *Modern Germany: Society, Economics and Politics in the Twentieth Century* (Cambridge: Cambridge University Press, 1982), p. 262.

28. W. R. Smyser, *The Economy of United Germany: Colossus at the Crossroads* (New York: St. Martin's Press, 1992), p. 28.

29. This lowest level of unemployment coincided with the cutoff of immigration from the GDR after the building of the Berlin Wall in 1961.

they aggravate the revival of neo-Nazi activities and skinhead attacks on foreigners.[30] The increasing divergence between Germany's stagnation and conditions in many other EU countries has led to sharp conflicts over monetary policy by the ECB.

Industrial Relations

Germany has a unique system of labor-management relations that the Eurosclerosis group blames partly for the fading of its economic miracle. *Mitbestimmung,* or codetermination, has two components. The first was introduced in 1952 and mandates the establishment of works councils in firms with more than five employees. Elected by workers at a given work site, the councils are supposed to advise management on day-to-day operations. They do not set prices or output levels or negotiate wages. They deal with working hours, hiring and firing rules (the complaint of the Eurosclerosis group), and technical aspects of production.

The other aspect of codetermination is election of workers to company supervisory boards, made compulsory in 1976 for firms with more than 500 employees. German corporations have two levels of oversight bodies: the supervisory board being above and appointing the more frequently meeting board of directors or management board. The law mandates that shareholders[31] elect two-thirds of the members of the supervisory board, while the remaining one-third is split between workers elected by their colleagues and union representatives. Workers themselves take the works councils more seriously than their representation on the supervisory boards.

Both of these systems were designed to bring about peace between labor and management, reducing output lost to strikes, and to moderate wage demands to keep inflation down. The first goal was largely met, and losses due to strikes declined to about one-tenth of their level in the interwar period,[32] a substantially lower figure than in most other European countries. But there has been a big increase in strikes since the FRG-GDR unification in 1990. Although German labor costs are now the world's highest, inflation had remained low until unification, and current account balances had remained in surplus until then as well. During the 1990s there was a small increase in inflation that has since declined to nearly a zero rate, with the current account moving essentially to a zero balance.

Ordo-liberal critics of these arrangements argue that together they have interfered with the workings of the market. An effort at quasi-corporatist, quasi-indicative planning, **Concerted Action (Globalsteureung),** by the government during the late 1960s and early 1970s symbolized this interference.

30. The skinhead problem has been worse in the former East Germany than in the former West Germany.

31. The supervisory boards are stacked with bankers. In 1985 for the 24 largest German firms, the portion of shares held by all banks was 82.67 percent and the portion held by major banks was 45.44 percent (Smyser, *The Economy of United Germany,* p. 86).

32. Berghahn, *Modern Germany,* pp. 286–287.

Labor unions left Concerted Action after becoming a minority on the supervisory boards, as determined by the 1976 law on codetermination, and they have become increasingly militant. Strike activity increased in 1978 after long being nearly nonexistent, and one strike was directed for the first time at preventing a new technology (in printing) from being adopted, a direct threat to the driving force of German economic growth. More aggressive labor has since pushed such ideas as shorter work weeks, now among the shortest in the world. Since reunification, all these issues have become more intense and labor-management relations have dissolved into general hostility, despite the persistence of the institutions of codetermination.

The Social Safety Net

Prior to reunification, social policies were less of an issue, although the share of GDP for social programs increased at the rate of about 10 percent per year during Social Democratic rule in the 1970s, a trend reversed after the party was removed from office in 1982. In the early postwar era the major effort was simply to restore the programs, many existing from Bismarck's time, that had existed before Hitler wrecked them. Only in the late 1960s was an effort to expand social programs initiated, starting with a direct child allowance. The FRG also made compensatory payments to victims of Nazi oppression. In recent decades, increasing cost pressure has occurred because of the rising percentage of old people receiving social security and because of rising medical costs. Unemployment compensation costs have risen as unemployment has increased.

The German social safety net is highly decentralized, organized either on industrial lines or locally. Medical coverage is provided by bodies funded by combined payroll-employer payments and is self-financing, although old-age insurance is not. This decentralization reflects the relatively decentralized nature of the FRG, in which the *Länder* have considerable power. The issue of the social safety net has become highly controversial since the FRG-GDR unification as costs for such programs have soared in the East and cuts have been made in the West.

The Development of the East German Command Socialist Economy

East Germany (the GDR) was one of only two areas in the world (the other being the Czech Republic) that came to have a Marxist-oriented regime after having achieved industrialization. In contrast to Marx's forecast about the internal contradictions of industrial capitalism, it was an external force, the Soviet military, that imposed the Marxist regime after the German surrender in 1945.

Led by Walter Ulbricht, the group of men who governed the GDR in its early years came from a minuscule fragment of the pre-Hitler Communist Party of Germany, which was proudly descended from the Spartacus League of 1919 and from Marx and Engels themselves.[33] After Hitler came to power, many Communist Party members were arrested and executed, others gave up and converted to National Socialism, and still others escaped westward, not to return. Among those who went to the Soviet Union, many died in the great purges of the late 1930s, some allegedly on Ulbricht's own orders. Thus only a remnant was left to take power after the Soviet army conquered Berlin.

Although the area of the GDR was slightly ahead of that of the FRG in per capita output in 1939, it fell behind immediately in the postwar period. The Soviet Union carted off entire factories, livestock, timber, machinery and equipment, and railroad rolling stock, both as war reparations and to help rebuild the Soviet economy. This policy continued until August 1953, when a major uprising by workers protesting their wages and living conditions brought an end to it in the immediate post-Stalin period. Thus, after 1947, while the United States was building up West Germany with Marshall Plan aid,[34] the Soviet Union was tearing East Germany down. The huge gap that opened up was never overcome, despite strenuous efforts by the East Germans.

Prior to its absorption by the FRG, the GDR had a reputation for being the highest-income command socialist economy, as well as being one of the most rigidly and tightly controlled and the most efficiently run. In reality, only some elements of these generalizations were true. One difficulty in discussing the GDR's economy is that its statistics were frequently falsified. For example, different sources that ranked GDR per capita output as a percentage of that in the FRG estimated it for the 1980s as ranging from below 40 percent to over 100 percent.[35]

After forming in 1949, the GDR only slowly adopted the command socialist system. Up to 1953, the Soviet leadership was uncertain whether it wanted to develop the GDR at all or just to plunder it and keep it down. The ease of getting to the West before construction of the Berlin Wall in 1961 also operated as a constraint on moving too quickly. Thus, although five-year plans were introduced in 1951, the process of nationalization in East Germany occurred slowly. The initial postwar wave focused on the property of refugees and war criminals and the very largest firms, especially banks and insurance companies.

33. Although born in Trier in the Rhineland, Marx as a young man studied at the University of Berlin and also at Jena, both in eastern Germany. The Spartacus League sprang from the German Social Democratic Party, and both Marx and Engels encouraged the latter's development. In East Germany the Communist Party and the Social Democrats were forcefully united in 1946 into the Socialist Unity Party, under the domination of the Communists, which would rule the GDR without democracy. The West German Social Democratic Party formally abjured Marxism at a conference in 1959 after a particularly poor electoral performance against the Christian Democrats, after decades of de facto revisionism.

34. The initial U.S. posture toward Germany was hostile, as expressed in the Morgenthau Plan, and there were some reparations deliveries. An early sign of the coming split was U.S. General Lucius Clay's order on May 27, 1946, to halt such deliveries, paving the way for differential treatment between East and West.

35. *The Economist,* "A Survey of Germany," May 23, 1992, p. 7.

As late as 1955, over a quarter of output was privately produced, and as late as 1959, a majority of agricultural acreage was still privately owned.[36]

By the early 1960s most of the GDR's economy had been nationalized, some of it in the form of partial state ownership. A small private sector did remain, even after another wave of nationalizations in 1972. In 1963 reforms brought prices in line with costs of production, instituted the use of profits as a principal criterion, and allowed managers some autonomy to retain some profits for discretionary usage. None of these policies accord with the usual image of the GDR's economy.[37]

The GDR was integrated into the Soviet bloc, becoming a member in good standing of both the CMEA and the **Warsaw Pact,** the defense group opposed to the North Atlantic Treaty Organization (NATO). Indeed, the GDR generally stood for hard-line positions in both foreign and domestic policies within those organizations and eventually exhibited a certain arrogance based on its alleged lead in productivity, as well as its ideological purity as the home of Marx and Engels. Over time it supplied the CMEA with high-technology goods, such as optical equipment and computer chips, thereby reinforcing its image of economic superiority within the Soviet bloc.

In 1979 the GDR introduced the most distinctive feature of its economic system, the **Kombinat.** It consisted of 126 centrally directed combines, employing an average of 25,000 workers in some 20 to 40 enterprises related either vertically or horizontally. These *Kombinaten* were subsequently subject to "perfected" steering mechanisms that avoided a focus on gross output, and in the late 1980s they carried out technological intensification, the GDR being one of the few command socialist economies to do so. Some observers have noted a superficial similarity between these *Kombinaten* and the sectoral chambers of the Nazi command economy, although the *Kombinaten* were state-owned in contrast with the Nazi sectoral chambers.

Shortly before German reunification came a resurgence of local pride regarding the Prussian past, but this was really an admission that the FRG was far ahead economically. GDR critics charged that the FRG had become an American colony and had lost its "Germanness" in a sea of international capitalist homogeneity. The political split between the two Germanys reflected traditional attitudes in the two regions, the Prussian East having a long authoritarian past and the West having long been a center of pro-democratic views.

36. Berghahn, *Modern Germany,* p. 277. Agricultural productivity in the FRG exceeded that in the GDR at unification. But because of economies of scale and high soil quality, the former collectivized farms of eastern Germany have the potential to be more productive than the small family farms of western Germany, which survive largely because of massive state subsidies.

37. That image was partly based on the political repressiveness of the regime, dramatically symbolized by its willingness to shoot people escaping over the Berlin Wall.

THE TWO ECONOMIES COMPARED

General Observations

Comparing the economies of the FRG and the GDR was long a favorite sport of comparative economists because the two Germanys had similar cultural and geographical backgrounds but different economic systems, thus allowing the possibility of some sort of controlled experimental comparison.[38] But this idea has complications. The two Germanys had very different immediate postwar experiences: The United States aided the FRG, whereas the Soviet Union suppressed the GDR economically. Also, being smaller, the GDR suffered more from the disruption of internal German trade than did the FRG. Furthermore, the GDR was integrated into the poorer CMEA trade bloc, in contrast with the FRG's integration into the EU trade bloc.[39]

Another problem is the GDR's seriously distorted economic data. Immediately after unification in 1990, even at the 1:1 currency exchange rate that was implemented, per capita income in the East was only slightly above one-third of that in the West. Nevertheless, almost all studies prior to unification found the GDR to have been growing consistently more rapidly than the FRG after the mid-1950s. The Central Intelligence Agency (CIA)[40] found 1981 per capita income in the GDR to be 87.6 percent of that in the FRG. Supposedly the GDR had higher growth rates throughout most of the 1980s.[41]

Despite these difficulties, generalizations can be made, most of them consistent with stock stories regarding the differences between market capitalism and command socialism. In particular, the FRG had greater efficiency, higher general living standards, and broadly superior environmental quality. The GDR had greater macroeconomic stability, including nearly continuous full employment, a greater degree of income equality, and a somewhat more extensive social safety net.

38. See Martin Schnitzer, *East and West Germany: A Comparative Analysis* (New York. Praeger, 1972); Paul Gregory and Gerd Leptin, "Similar Societies under Differing Economic Systems," *Journal of Comparative Economics* 1 (1977): 519–544.

39. This is partly misleading. Because it never recognized the separateness of the GDR, the FRG allowed imports from it duty free. Thus the GDR had a back door into the EU because its goods could be reexported from the FRG to the EU duty free. This led some to call the GDR the EU's "13th member" (between 1986 and 1995 the EU had 12 members). Previous access to the EU reduced the GDR's gains from unification because it gained little new access to previously unavailable export markets.

40. Central Intelligence Agency, *Handbook of Economic Statistics* (Washington, D.C.: USGP0, 1986), pp. 26–27.

41. After 1987, according to official statistics, West German growth exceeded East German growth as the entire EU experienced a boom, since ended, whereas the entire CMEA bloc went into a stagnationist crisis. The GDR resisted it better than most of its fellow CMEA members, a fact that the hardline GDR leader, Erich Honecker, annoyingly pointed out to his proreform Soviet colleague, Mikhail Gorbachev.

Relative Efficiency

After unification, when firms in the two Germanies faced each other in direct competition, those in the West boomed while those in the East collapsed. The discovery after reunification that per capita incomes in the East were only one-third of those in the West rather than nearly equal strongly supports the greater efficiency of the FRG economy, certainly in terms of dynamic, if not static, efficiency. Part of the FRG's superior efficiency is related to an element that was very hard to measure prior to unification but that was fundamental to its economic success, namely, product quality. Quality was much higher for most Western goods, which had been subject to consumer preferences and market competition, than for Eastern goods produced in response to planners' preferences for captive markets.

General Living Standards Compared

Although people in the FRG were better off in most categories, people in the GDR were better off in certain collectively provided goods, notably public transportation, housing and electricity (which cost less), and day care. However, no accounting for quality differences is made in tables 9-1 and 9-2, which tend to favor the FRG. Table 9-1 presents the endowments of various consumer durables in the two states, and table 9-2 shows the time an average person would need to work in order to obtain the good or service in the two states.

Price changes facing East Germans during the six months following currency unification with West Germany on July 1, 1990, moved in directions one would expect from the above

Table 9-1
Consumer Durables Endowments

Goods	East	West
Percentage of population owning:		
Private car	54.0	96.0
TV set	96.0	99.0
Color TV set	57.0	95.0
Telephone	17.0	99.0
Refrigerator (without freezer)	99.0	81.0
Freezer (with or without refrigerator)	43.0	75.0
Washing machine	99.0	97.0
Proportion of:		
Living space built after 1948	35.0	70.0
Units with bath/shower	82.0	96.0
Living space per capita (in square meters)	27.6	35.5

Note: Except for living space per capita, all figures are percentages and are for 1989.
Source: Hans-Werner Sinn, "Macroeconomic Aspects of German Unification," in P. J. J. Welfens, ed., *Economic Aspects of German Unification: National and International Perspectives* (Berlin: Springer Verlag, 1992), p. 126.

Table 9-2
Work Time (Hours and Minutes) Required to Purchase Selected Items

Type of Purchase	East	West
Men's shirt	7.19	1.22
Women's pantyhose	2.40	0.12
Children's shoes	7.21	2.35
Color TV	1,008.56	81.34
Washing machine	491.04	59.09
Car	4,375.00	694.33
Rail fare, 15 km	0.27	1.46
Dark bread	0.07	0.12
Milk, liter	0.07	0.05
Pork cutlets, 1 kg	1.47	1.01
Lemon, 1 kg	0.54	0.16
Coffee, 250 g	4.20	0.21
Month's rent, two-room apt., no bath	5.78	11.76
Consumer electricity, 75 kwh	1.31	1.82
Day nursery, monthly rate	1.22	8.68
Women's permanent	1.73	2.79

Source: Martin Schnitzer, *Comparative Economic Systems,* 5th ed. (Cincinnati: South-Western, 1991), pp. 230–232, for 1987 for some commodities and for 1989 for others.

tables except for rent and energy, which remained constant because they were still fixed by the government, for an overall price decline of 1 percent.[42]

Environmental Quality

Polls taken in 1988 and 1990 comparing levels of satisfaction of East and West Germans with various aspects of their lives showed the greatest disparity in this area, with Wessis about twice as satisfied as Ossis.[43] In 1985 sulfur dioxide emissions per capita were 7 1/2 times as great in the GDR as in the FRG and nitrogen oxide emissions were about 20 percent greater,[44] the former reflecting the use of dirty lignite coal in the East and the

42. George Akerlof, Andrew K. Rose, Janet L. Yellen, and Helga Hessenius, "East Germany in from the Cold: The Aftermath of Currency Union," *Brookings Papers on Economic Activity,* no. 1 (1991): 10.

43. Detlef Landua, "The Social Aspects of German Reunification," in A. G. Ghaussy and W. Schhfer, eds., *The Economics of German Unification* (London: Routledge, 1993), p. 202. Other areas where Wessis were more satisfied than Ossis were living standards, housing and income, and public safety. Areas where they were almost equally satisfied were home and family life, health care, and education. In no area were Ossis more satisfied than Wessis. It appears that there was less social capital in the East, where people tended to trust only a small group of very close friends, as reported by Beate Völker and Henk Flap, "Weak Ties as a Liability: The Case of East Germany," *Rationality and Society* 13 (2001): 397–428.

44. Günter Streibel, "Environmental Protection: Problems and Prospects in East and West Germany," in P. J. J. Welfens, ed., *Economic Aspects of German Unification: National and International Perspectives* (Berlin: Springer Verlag, 1992), p. 201.

latter the higher use of cars in the West. Per capita carbon dioxide emissions were almost twice as great in 1986 in the GDR as in the FRG.

It is difficult to obtain accurate data on water pollution because some water flowing through the GDR came from Czechoslovakia and was already polluted. But general trends are clear. In the West, pollution levels in the Rhine were cut to about 10 percent of previous levels for several major pollutants between 1971 and 1986, whereas they increased in the major rivers of the East.[45] Another serious problem in the East was abandoned toxic waste dump sites.

In 1988, per capita expenditures on environmental protection were 388 marks in the FRG and 107 marks in the GDR.[46] After reunification a crash environmental cleanup program in the East was begun, funded by the unified federal government.[47] Its priorities included discovery and cleanup of waste dump sites, major cleanup or restoration of sewage treatment plants and sewer lines, modernization of lignite-burning power and heating plants, and modernization of air pollution control equipment in 6,735 installations.[48] This program has been very successful, and the former GDR has experienced much greater environmental improvement than other former members of the Soviet bloc.

Macroeconomic Stability

The FRG has one of the better macroeconomic performance records in the market capitalist world, sharing the best postwar inflation record with Switzerland up to 1990. Its unemployment rate has varied. It avoided the double-digit range between the end of World War II and reunification, and its unemployment rate actually dropped below 1 percent during the early 1960s, although it has gone up substantially since then.

In the GDR, strict control over investment and prices by the central planners produced a superior record in these areas, with almost zero inflation until recently[49] and unemployment rates consistently below 1 percent. As of January 1990, the unemployment rate in the GDR was 0.1 percent. By early 1992, one out of three East German workers had lost their jobs. Despite recovery in some parts of the former GDR, the unemployment rate there still remains about twice as high as in the western zone.

45. Streibel, "Environmental Protection," p. 185.

46. Streibel, "Environmental Protection," p. 202.

47. In this regard, eastern Germany is lucky because in other East European countries economic difficulties have forced environmental cleanup to take a back seat, despite the prominent role played by environmentalists in the reform movements.

48. Klaus Zimmermann, "Ecological Transformation in Eastern Germany," in Landua, *The Economics of German Unification,* pp. 218–219.

49. This does not account for the black market, where there certainly was inflation, nor does it account for time spent standing in line for goods, which could be several hours per day.

Distribution of Income and the Social Safety Net

The distribution of income was more equal in the GDR than in the FRG, although the gap narrowed over time. Thus, in 1970 the top and bottom quintile shares of income were 31.1/9.7 in the GDR and 39.9/8.3 in the FRG, whereas in 1983 they were 30.2/10.9 in the GDR and 34.3/9.8 in the FRG, respectively.[50] These figures overstate the degree of actual equality in the GDR because they do not take into account special favors and goods available to the ruling elite but not most East Germans, which were scandalously lavish.

Social safety net policies were surprisingly similar in the East and the West, both having ultimately derived from the old Bismarckian programs. Nevertheless, differences can be noted. One was that administration in the East was centralized, there being no *Länder*. Individuals did not make payroll contributions for health care funds and health care coverage was wider, although the quality was lower and dropping. Doctors were state employees in the East but private practitioners in the West, resulting in those in the East leaving for higher incomes in the West. Social security pensions were higher in the West than in the East, an average of 1,018 marks per month versus 427, respectively,[51] one area where Ossis gained from reunification.

The East was substantially more generous than the West in providing day care. Day care facilities were heavily subsidized in the East but hardly at all in the West, a fact showing up in the relative prices for day care in table 9-2. This correlated with substantial differences in employment of married women with children in the two states. In 1988 62 percent of married women aged 18–40 with children aged 1–6 worked in the East, whereas only 28 percent worked in the West. For married women aged 25–65 with school-age children aged 7–18, 88 percent worked in the East whereas only 32 percent worked in the West.[52] Also, abortion was more readily available in the East than in the West. As the western system was imposed on the East, women were more likely to become unemployed than men. Along with increased restrictions on abortion availability, female unemployment has caused anger in the East among women.

THE COSTS AND OUTCOMES OF UNIFICATION

The Process of Unification and Its General Prospects

The process of reunification was modeled on what was done in the West in 1948. The results have been dissimilar so far, but the long-run outcome remains uncertain. Unification

50. Schnitzer, *Comparative Economic Systems,* p. 227.

51. Sinn, "Macroeconomic Aspects of German Unification," p. 12.

52. Landua, "Social Aspects," p. 98.

began with the fall of the Berlin Wall on November 9, 1989,[53] a date many identify as the effective beginning of the end of the **Cold War.**[54] In March 1990, elections were held in the East and Chancellor Kohl's Christian Democrats won a decisive victory, promising rapid and painless absorption into the FRG under its existing constitution. On July 1, 1990, the currencies were unified at a 1:1 exchange rate, although at a schedule of lower rates for *Ostmark* balances above certain levels, and most price and trade restrictions were removed. On October 3, 1990, came full legal and political unification. On January 1, 1991, the West German tax system was applied in the East.

This was the most rapid of all **Big Bang economic transformations** of a formerly command socialist economy into a market capitalist economy. It exhibits some of the costs and benefits of such an approach, although some of both probably apply strictly to this case alone. Following a catastrophic decline, the East grew much more rapidly than the West during 1992–1996, although the West has grown slightly more rapidly since then.

Although some of the problems facing the former GDR are common to all economies attempting to transform from command socialist to market capitalist systems, two are prominent relative to the others, one positive and one negative. The positive issue is that absorption of the East into the West's existing political, legal, and regulatory framework resolved the institutional problem. The East inherited a preexisting and generally successful set of laws and property rules, functioning stock and bond markets and banking system, and a largely stable and moderate democratic political framework. These factors lead many observers to be optimistic about the area's future prospects, given the crucial role of properly functioning institutions in a successful market capitalist economy.

Furthermore, the former GDR inherited the credibility of the West German macroeconomic managers. Unfortunately, one of the costs of unification has been damage to that credibility caused by the difficulties arising from the reunification itself, especially the apparent failure of the FRG leadership, particularly then Chancellor Kohl, to anticipate the scale of the problems that appeared.[55] The *Bundesbank* aggressively raised interest rates as budget deficits swelled from 1990 to 1992 because it was concerned about losing its hard-won credibility. Since 1999, the responsibility for this has moved to a higher level with the European Central Bank (ECB). Many in Germany are dissatisfied with its relatively

53. An unfortunate coincidence is that this was the 51st anniversary of *Kristallnacht,* a night when fanatic Nazis attacked stores and homes owned by Jews, smashing glass and crystal particularly and attacking Jews themselves, an outburst heralding an increase in the Nazi anti-Jewish campaign.

54. Soviet leader Mikhail Gorbachev played a crucial role in the fall of the Berlin Wall because he signaled an unwillingness to use force to keep the Wall up. He had been unhappy with the hardline GDR leadership. Prior to the fall of the Wall, there had been a surge of East Germans emigrating through Hungary after it opened its border with Austria, since closed by Austria.

55. Kohl and the *Bundesbank* split on this point. The latter opposed the 1:1 currency unification on grounds that have since been confirmed, namely, an anticipated collapse of output in the East.

tight monetary policies, given Germany's stagnation since then, even though it was Germany more than any other country that insisted on such an approach by the ECB in order to mimic the *Bundesbank*'s policies.

The great negative factor in the economic unification was the 1:1 currency unification, now known to have constituted a wild overvaluation of the Ostmark (the former GDR currency) with unofficial markets at the time trading 20 Ostmarks per Deutschemark. Combined with a drive for nominal wage equality between East and West, despite lower productivity in the East, overvaluation significantly deepened the collapse of output in the East. This was the source of the unexpected costs triggering the budget deficits that raised German interest rates.

In contrast, Poland, which has also mostly followed Big Bang policies, had a smaller decline in output, probably because it allowed a devaluation of the Polish currency (złoty) when it decontrolled prices. Given the political unwillingness in Germany to undo the high wages in the East, pessimists predict that this overvaluation will be a long-run drag on the former GDR economy, discouraging future investment; permanently draining it of its most skilled workers, who will move west; and creating a permanently depressed regional economy such as those in southern Italy or northern Britain, even though the German economy as a whole may do reasonably well. For most of the former GDR, these forecasts have proven largely true.

This has come to be known as the *Mezzogiorno problem,* with the most of the investment in the East concentrated in the major cities of Dresden, Leipzig, and especially the reestablished capital of Berlin, with other areas remaining very depressed, especially in the northern part.[56] Over time the West will outweigh the East, with a population in 1989 four times as great in the West as in the East and an aggregate GDP 10 times as great.

The output collapse in the East was one of the most dramatic ever seen. Taking average real 1989 GDP as an index of 100, the index stood at 54 in the second quarter of 1991.[57] In a single year, September 1989 to September 1990, net manufacturing output fell 51.1 percent.[58] The proximate cause of this collapse was a price-cost squeeze facing firms, driving them to bankruptcy or to output reductions and layoffs. There were six underlying causes, three on the cost (supply) side and three on the price (demand) side.

56. See A. Hughes Hallet and Y. Ma, "East Germany, West Germany and Their Mezzogiorno Problem: A Parable for European Economic Integration," *Economic Journal* 103 (1993): 416–428; Andrea Boltho, Wendy Carlin, and Pasquale Scaramazzion, "Will East Germany Become a New Mezzogiorno?" *Journal of Comparative Economics* 24 (1997): 241–264.

57. *1991/1992 OECD Economic Surveys: Germany* (Paris: Organization for Economic Cooperation and Development, 1992), p. 20.

58. Rolf Hasse, "German-German Monetary Union: Main Options, Costs and Repercussions," in Landua, *The Economics of German Unification,* p. 44.

Most important on the cost side were excessive wages in the East arising from the 1:1 currency unification rate[59] and the drive for equality of nominal wages with the West without equal productivity.[60] Some western Germans claim that the alleged laziness of eastern workers relative to western ones contributes to labor productivity differentials, a charge that aggravates Ossi-Wessi relations. If this is true, it reflects 45 years of a "we pretend to work and they pretend to pay us" mentality, although some perceive a different attitude among younger workers in the East.

A second factor was technologically outmoded capital stock, which raised costs directly and implied future higher costs for retooling. The third such cost was the heavy pollution produced by many of the eastern productive plants. No private party wanted to be held responsible for the cleanup. The government assumed responsibility in this area, with considerable success.

The immediate source of the collapse of internal demand resulted from the sudden availability of western goods at reasonably low prices,[61] also a result of the overvaluation of the Ostmark at currency unification. Important factors in the collapse of demand were both sheer novelty and fundamental quality. The first factor was overdone and somewhat temporary, with a nostalgic return to eastern goods in certain markets later. But the quality issue was real and decisive in many areas, and led to an ending of production of some East German products such as the notorious Trabant car.

The second round of the demand collapse was the negative multiplier effect of the first collapse. The initial decline in demand triggered a series of layoffs and income declines that further suppressed demand, although this second collapse was mitigated by infusions of assistance from the West.

The third source of demand decline came from the general collapse of the CMEA and the loss of former markets in Eastern Europe by the former GDR. Some of the shining stars of the former GDR economy had been high-technology goods it supplied to the rest of the CMEA, such as optical equipment and microchips. To the extent that the former buyers can still buy, they can now access other producers, such as the Japanese, who offer higher

59. An oddity of the currency unification that damaged existing small private enterprises in the East was that liquid assets were only exchanged at a 2:1 rate, whereas debts were exchanged at a 1:1 rate.

60. It may be that the rate of currency unification was irrelevant and that it was the demand for nominal wage equality that was the problem. It might have been better to impose increased wages at once through the currency rate rather than letting the increase drag on through disruptive strikes, with the accompanying uncertainty and social and political disruption.

61. Some of this collapse of demand stimulated the West German economy as it sold goods to the East, and output expanded in the West as it contracted in the East until the end of 1992, when the West went into recession as well. But the surge of imports to the East caused the overall current account balance to go into a rare deficit, thus triggering borrowing from abroad and adding to the pressure for higher interest rates.

quality at lower prices. But these economies all suffered output declines and reduced imports. Many of these former stars continue to struggle, although some have been revived by western investment.

Despite these gloomy prospects, there have been many gains in the East. Those workers who are employed are earning six to eight times what workers in Poland or Hungary do, putting them far ahead of all of their counterparts in the former Soviet bloc. Furthermore, the FRG has engaged in massive infrastructure investment, resulting in expanded and improved roads, railroads, ports, airports, and telecommunications networks, with the last more advanced than those in the West. Environmental quality has dramatically improved. The move of the capital from Bonn in the West to Berlin in the East in 1999 generated a massive construction boom, with Berlin now a glittering and fashionable metropolis.

The Rise of Unemployment in the East

The output collapse caused a surge of unemployment, with one out of three workers reportedly losing their jobs. However the official unemployment rate was only 16.5 percent in January 1992. What happened to the other half of the laid-off workers? Some retired early, some (especially women who lost their inexpensive day care) dropped out of the labor force, some became “short time” workers, some went into retraining programs, some migrated to the West or are commuting there for work, and some have found other employment in the East.

A rough measure of this pattern is given in figure 9-1. Of 4.1 million workers in state firms at the end of 1989, 2.4 million had been removed from that category at the end of 1991 by the **Treuhandstalt (THA)** privatization agency. Figure 9-1 shows what those 2.4 million workers were doing. These percentages continued to hold through the end of the *Treuhandstalt*’s activities at the end of 1994 and apparently were still reasonably accurate nearly a decade later.

The official unemployment rate in the East peaked at around 21 percent near the end of 1997. It has gradually declined since but continued to remain about twice as high as in the West well after 2000.

The Privatization Process

To fully reintroduce capitalism involves privatizing the existing set of state-owned assets, a complicated and controversial process. Some countries have privatized rapidly using vouchers to distribute state-owned assets to the population. Others have attempted more gradualistic approaches, often selling assets to outside interests with the hope of establishing a firm foundation for future economic development. Germany took the gradual approach, although it moved as rapidly as possible within its chosen framework.

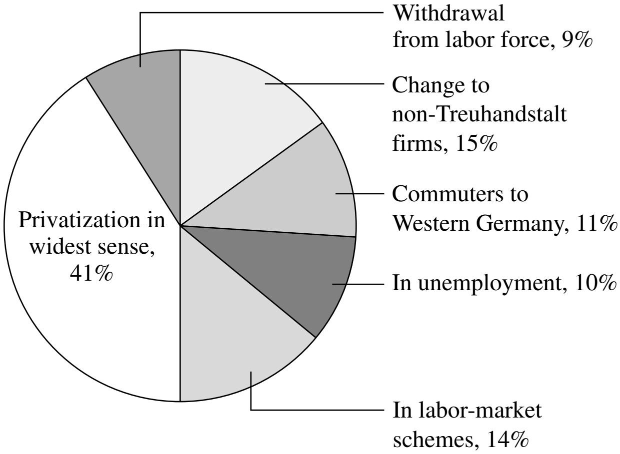

Figure 9-1
Labor adjustments in Treuhandstalt firms.
Source: 1991/1992 OECD Economic Surveys: Germany (Paris: Organization for Economic Cooperation and Development, 1992), p. 53.

The German approach involved establishing the THA to dispose of state-owned firms. The THA established a committee for each firm to be privatized that searched for a core business that could be saved. Rarely did the THA try to sell an entire firm, especially if it was a former *Kombinat* and thus was rather large. Instead firms were usually broken up into pieces that were then sold off by whatever mechanism could be agreed upon.[62]

As of the end of March 1992, 42 percent of THA firms remained to be privatized, 30 percent had been sold to Germans (overwhelmingly from the West), 10 percent had been liquidated (mostly firms that sold goods to dead former CMEA markets such as military goods), 7 percent had been sold to foreigners, 6 percent had been reprivatized (returned to previous owners or their heirs), and 5 percent had been transferred to municipalities.[63] The disposition of THA firms since then involved a higher rate of liquidations because the firms involved were among the least productive and hardest to sell of all the firms. The THA formally ceased to exist at the end of 1994.

Reprivatizations caused serious complications, with many assets being tied up in legal disputes over ownership among multiple previous owners, especially real estate. Former owners have been granted generous rights, and waves of property confiscations led to

62. In some cases the sale price was negative after grants, debt cancellations, unemployment payments, environmental cleanup costs, and other payments were counted (OECD, *Economic Surveys,* p. 52).

63. *OECD Economic Surveys,* pp. 51–54. See also Wendy Carlin and Colin Mayer, "Structure and Ownership of East German Enterprises," *Journal of the Japanese and International Economies* 9 (1995): 426–453.

Box 9-2
The "Colonization" of East Germany?

A subtle problem, but perhaps the most dangerous for the long-run prospects for German national unity, is the aggrieved feeling that exists in the East of having been "colonized" by the West.*

Given the scale of the unemployment increases, the increased child care burdens on women and restrictions on abortion, and the decline in income, this feeling is understandable. Also, many employers are now Wessis; the Wessis are on top and the Ossis are on the bottom. Of course, the Wessis have their own complaints: The Ossis are lazy, unification is costing too much in taxes, and interest rates are higher. A noneconomic component of this perception is the purge of various institutions in the East. Anyone who was a member of the former ruling Socialist Unity Party or who worked with the Stasi secret police was automatically fired from any public position. Whole categories of civil servants were fired, including the entire judiciary and whole university departments. A general "political correctness" investigation goes on in the East that is both adding to unemployment and exacerbating Ossi resentment. Many of those who have fallen victim to this campaign include dissidents who opposed the GDR regime and aided in its overthrow. Now they have become dissidents once again.[†]

The new unity of Germany will probably hold, simply because the West profoundly dominates the East. But if that is the only reason it does so, it will be an unstable unity, a development Germany's neighbors fear.

*See Dorothy Rosenberg, "The Colonization of East Germany," *Monthly Review* 43 (September 1991): 14–33.

[†]The murkiness of this situation is seen in the charge that he was a Stasi (the East German secret police) informer leveled against the 81-year-old novelist and former dissident Stefan Heym when he entered the *Reichstag* as a member of the post-Communist Party of Democratic Socialism in late 1994. [Being an informer is not the same as being "a member," who were full time employees. Nobody accused Heym of that.]

multiple claims, as many as 15 different parties in one case. Jewish-owned properties that had been seized by Nazis and Nazi-owned properties were redistributed to other individuals after the war before being nationalized. Most of these disputes were resolved by 2003.

East German Attitudes

Enormous changes have been wrought in the lives of the former East Germans, with many things improved while others are much worse (box 9-2). Prices for goods are now very similar in both parts of Germany, even if incomes are not. Women in particular have borne the brunt of many of the worst impacts. A particularly disturbing phenomenon was an apparent increase in the death rate by as much as 30 percent in certain age categories, with many observers[64] citing stress as the principal factor involved. Similar effects have been seen in some other transition countries, notably Russia.

The contrasting attitudes regarding the contradictory changes impinging on the former East Germans are shown in table 9-3. These are based on surveys taken in the mid-1990s

64. See Regina T. Riphahn and Klaus Zimmermann, "The Mortality Crisis in East Germany," IZA Discussion Paper No. 6, May 1998.

Table 9-3
Eastern Germans' Evaluation of Unification's Effects (Percentage of the Population)

Indicator	Better in United Germany	Better in GDR
Supply of goods	98	1
Newspaper choices	96	1
Travel	95	2
Expression of one's opinion	68	6
Leisure	52	26
Possibility of further education	46	23
Food prices	33	43
Health services	32	39
Security of pensions	29	43
Future prospects	24	57
Supply of interesting jobs	20	63
Child raising	8	49
Safety from crime	3	93
Sense of community	3	87
Rent	2	94

Source: William H. Berentsen, "Socioeconomic Development of Eastern Germany, 1989–1998: A Comparative Perspective," *Post-Soviet Geography and Economics* 40 (1999): 32.

in eastern Germany and show percentages of people saying that either the item is better now in the unified Germany or that it was better before under the GDR. The general results are not surprising. The major change since the mid-1990s has been an improved attitude among some young people, especially in the growing economies of the largest cities.

A Reunified Germany and a Unifying Europe

The reunification of Germany generated pressures both toward European unification and away from it. A major impetus for unification is fear. Although former President Mitterand of France supported German unification against British doubts, he did so recognizing its inevitability and hoping to keep the outcome under control. This meant pushing through the 1991 Maastricht Treaty and supporting the full unification of Europe to involve Germany and keep it under the control of the higher European entity, thus ensuring a European Germany rather than a German Europe, as some had feared.

The Maastricht Treaty was signed in December 1991 and was approved by all EU member states. But complications arose. Because of its reluctance to give up the Deutschemark, which had dominated the ERM, for the uncertainties and loss of power associated with adopting the euro, Germany insisted on the strict Maastricht criteria regarding limits on budget deficits that were used to keep Greece out of the euro zone between 1999 and 2001. Ironically, by 2002, Germany itself was on the verge of violating those limits. Furthermore, Germany insisted that the ECB be established in Frankfurt, where the *Bundesbank* is located, and the ECB's anti-inflationary monetary policy has restrained German economic growth recently.

Another major issue is Eastern Europe. Absorbing the former GDR automatically increased Germany's involvement there. Germany had to pay Russia to allow the unification. It has become Russia's largest creditor, thereby dragging Germany into the complex problems arising from the dissolution of the former Soviet Union and the struggles there over reform.

Also, before World War II, Germany had had extensive trade relations with the nations in the East, relations disrupted by the division of Europe in the Cold War. Now Germany seeks to revive those trade relations and has been ahead of all other countries outside of Eastern Europe in expanding trade and investment there. As a result, Germany has become the champion of those countries that have succeeded in joining the EU and those that still seek to join.[65]

Fears about a resurgent Germany appear to have become stronger, especially among the French since 1998, when the Social Democratic-Green coalition led by Gerhard Schröder came to power. This is the first German government to be led by people too young to remember World War II and thus more assertive of Germany's right to behave as a normal nation and not have to apologize constantly for its role in World War II. This attitude is especially upsetting the French, as they see Germany expanding its influence eastward.

Germany's relationships with Eastern Europe creates conflict with France and other EU members not wishing to expand the EU eastward. They would rather intensify the drive to unity among existing members. An underlying fear is that Germany is not just after economic gains but may be reviving its ancient drive for political domination of the East as well, despite having renounced its claims on territories lost in World War II. Will the emergence of German unity once again lead it to seek to establish a universal empire, however subtly?

A German response is that bringing Eastern European nations into the EU will further dilute its own role as the EU gets bigger. Furthermore, Germany is driven by its own fears, particularly that immigration from these countries might increase if their own economies are not developed. It is anti-immigrant sentiment that drives the most extreme neo-Nazi activists in Germany. Germany's opening to the East is an effort to protect both itself and its neighbors from its own historical demons.

The unification of Germany means that it will be the leader of Europe. Thus the fate of the German economy will determine the fate of the European economy. Will there be a German-led, Europewide *Wirtschaftswunder,* or will Eurosclerosis take over and drag all

65. See Stanley W. Black, ed., *Europe's Economy Looks East: Implications for Germany and the European Union* (Cambridge: Cambridge University Press, 1997).

nations down into ethnic and nationalistic conflict? With Germany suffering slower growth than its EU neighbors in the years right after 2000, the prospects are disturbing.

Whether Germany can match the competition in high technology from Japan and the United States may be important in answering that question. The signs for Europe on the high-technology front are troubling. Although Germany maintains a level of R&D spending equal to that of Japan and the United States in percentage of GDP, its slow GDP growth means that absolute R&D spending has not grown rapidly. Germany maintains a strong position in machine tool and automotive technologies (Siemens and Daimler-Benz were first and second in European R&D spending, respectively, in 1989), but it has fallen to second place behind the United States in biotechnology and is a distant third in computers and information technologies, areas likely to be critical in the future.[66] It fell even further behind the United States in this crucial area in the past decade.

An important reason Germany has failed to keep up in R&D has been weak support by the federal government for such expenditures. A deeply entrenched factor is abdication to the *Länder* of much responsibility for such financing and for encouraging economic development more broadly. Although granting power to the *Länder* solves the problem of reconciling the separatist tendencies of the German regions with the existence of a unified nation-state, the inability to grant greater powers to the central German government could doom the entire European enterprise to another German-centered disaster.

SUMMARY AND CONCLUSIONS

Germany has long struggled to achieve national unity out of diverse elements among its peoples, a struggle complicated by uncertainty as to who its peoples were and where the boundaries of their domains were located. Although Germany achieved moments of great unity under the inspiration of universal empires, it has also experienced catastrophes of national disintegration and economic collapse, as in the Thirty Years' War and at the end of World War II. But the German people always rise again, as they are doing with the unification of East and West Germany.

Germany's economic strength has depended upon the skills, genius for creation, and hard work of its people. A center of advanced education and scientific achievement, the German economy has long been a technological leader of the world economy. As the fourth largest economy in the world, it competes at the high end of technology with the two largest economies, the United States and Japan.

Germany's industrialization in the late nineteenth century was very rapid. Although Germany's unifier in 1871, Chancellor Otto von Bismarck, ruled despotically, he introduced

66. Smyser, *The Economy of United Germany,* pp. 108–110.

the first government-funded social security, health insurance, and worker's compensation systems in the world. This established the tradition known after World War II as the social market economy, a system characterized by market capitalism with an extensive social safety net. This system has been imitated by many nations since then.

During the Great Depression the Nazi dictator, Adolf Hitler, established a command capitalist economy. It grew successfully at first, but then Hitler started World War II, which led to total economic collapse as well as military and political defeat. Germany was divided into East and West by the victorious Allies. The East became part of the Soviet bloc, and a command socialist economy was established. In the West, a social market economy was established, and an economic miracle of rapid growth appeared after price and currency reforms in 1948. West Germany's economy has also been characterized by labor-management codetermination and substantial bank ownership and control of major corporations.

In the postwar era, the West German economy was integrated into the wider European economy through the institution of the European Union (EU). Eventually its success and the accelerating reform movement in the Soviet Union led it in 1990 to reabsorb what had been independent East Germany. The process of German unification has been more difficult and costly than expected, with the consequences further complicating European unification. The slowdown of the German economy after the introduction of the euro in 1999 has exacerbated tensions, with Germany now advocating a looser monetary policy by the ECB, in contrast with its earlier position that the ECB should emulate Germany's former monetary policy when the Deutschemark reigned supreme over the currencies of the old European exchange rate mechanism (ERM).

The vital questions concerning Germany today are, first, whether or not it can successfully complete its reunification, and second, whether or not it can return to leading Europe toward a peaceful and productive balance of unity and diversity on a path to a sustainable and fulfilling future.

QUESTIONS FOR DISCUSSION

1. What is the source of the "German Problem" in Europe, and how does it affect prospects for European unification?
2. Compare and contrast Hitler's command economy with that of the former East Germany.
3. Compare and contrast the 1948 West German reform policies with those applied in 1990 in eastern Germany during unification with the FRG.
4. What elements of the German economic system resemble those of Japan's economic system?

5. Compare and contrast German labor market policies with those of Sweden.
6. How does the German economic system compare with that of the United States?
7. Compare the social safety nets of the former East and West Germanies.
8. Evaluate the claim that West Germany has "colonized" the former East Germany.
9. Why has the unification of Germany cost more than expected, and what are the implications of this fact?
10. Explain and evaluate the claim that Germany is a fading miracle.
11. Evaluate the forecast that Germany might end up following Japan down a path of serious long-run economic stagnation. In what ways are their situations similar and in what ways do they differ?

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III VARIANTS OF TRANSITION AMONG FORMER SOCIALIST ECONOMIES

Part III consists of a set of case studies of economies that have been predominantly socialist in the past, again defined by reference to state ownership of the means of production. All of these economies are currently engaged in efforts to make a transition by various means to more market and capitalist economies than has been the case in the past.

However, the title of this part makes no reference to past command or planning practices, as some of the countries discussed have been market socialist for a long time, with few or no centrally planned command elements, notably Hungary and Yugoslavia. The title includes the word *former* rather than *post* or *ex,* as some of the economies are still predominantly socialist, despite some transitional movements, and remain officially committed to socialism, notably China and some of the former Soviet republics.

Chapter 10 presents the canonical example of centrally planned command socialism, the Soviet Union before its breakup in 1991. The general nature of such a system is discussed, as well as aspects specific to the Soviet Union. Reasons for the collapse of this system are elucidated. Post-Soviet Russia is also emphasized in this chapter.

Chapter 11 carries the story of chapter 10 forward to consider the now independent former republics of the Soviet Union and their alternative economic situations and scenarios for the future. Besides stressing the historical and cultural factors unique to each former republic, the chapter examines their interrelationships and prospects for continuing economic connections with each other, along with the progress of their respective reform paths.

Chapter 12 presents the case of Poland, prominent as the model of *shock therapy* reform. Poland has succeeded in moving toward a market economy and, after a period of severe economic decline in the early 1990s, has resumed general economic growth led by an exporting entrepreneur-based sector. However, Poland has experienced a political backlash, with former Communists coming to control the government and the privatization process remaining incomplete. Details of some other Central and Eastern European economies are also presented, especially that of the fairly successful Czech Republic.

Chapter 13 discusses Hungary, long famous as the most market-oriented of the Soviet bloc economies. Partly as a result of already being somewhat marketized, Hungary has followed a more gradualistic transition program. The result has been a less dramatic collapse of output but also a less dramatic macroeconomic performance, although it has done well recently. Hungary's approach to privatization followed a *full value* sale of state assets that guaranteed full funding of privatized firms.

Chapter 14 considers the tragic case of the now shattered Yugoslavia, home of worker-managed market socialism. Although it disintegrated into ethnic warfare after a period of hyperinflation and worsening regional economic inequality, Yugoslavia remains the most important example of what some still consider to be the most viable form of a possible socialist economy. The current success of Slovenia, a former Yugoslav republic, supports this contention. With the highest per capita income of any former socialist state, Slovenia suggests that Yugoslavia's economic model had considerable merit.

Chapter 15 analyzes the People's Republic of China (PRC), recently the world's most rapidly growing economy. Still politically Communist and officially committed to a socialist market economy, China represents yet another pattern of gradualistic reform and transition to a market economy. Different from the other Central and East European cases discussed, given its Asian/Confucian historical and cultural background, its lower level of economic development and greater rural population, and its sheer size as the world's most populous nation, China presents numerous contrasts to other socialist economies besides its far superior recent economic performance. One peculiarity of the Chinese economy is its decentralized town and village enterprises (TVEs), which can be viewed as a form of local market socialism. The PRC's economy is also compared with those of Hong Kong and Taiwan.

Out of this array of cases come few generalizations that hold without exception. One is that the more rapidly transforming economies fall faster but recover faster, although gradualistic China has not fallen at all. In general, transitions manifest the ills of market capitalism, such as greater income inequality and macroeconomic fluctuations, as well as the virtues, such as the elimination of long lines for consumer goods and improved availability and quality of goods and services. More generally, almost every case has led to outcomes that were unforeseen by any observers, thus providing a caution to all economic analysts about predicting the future.

S.S.R. Soviet Socialist Republic
Arctic Ocean
ESTONIAN S.S.R.
LATVIAN S.S.R.
LITHUANIAN S.S.R.
BELORUSSIAN S.S.R.
Leningrad
Moskva
Gorkii
UKRAINIAN S.S.R.
Pacific Ocean
FORMER SOVIET UNION
Kuybyshev
Sverdlovsk
MOLDOVAN S.S.R.
Novosibirsk
GEORGIAN S.S.R.
KAZAKH S.S.R.
ARMENIAN S.S.R.
AZERBAIJAN S.S.R.
MONGOLIA
TURKMENISTAN S.S.R.
KYRGYZ S.S.R.
UZBEK S.S.R.
CHINA
TAJIK S.S.R.

10 The Former Soviet Union: The Myth and Reality of the Command Economy and Russia's Economic Transition

We speak of an economy being "commanded" when the state uses the means of authority at its disposal to force the whole of the economy in the direction it desires.
—Adolf Weber, *Marktwirtschaft und Sovjet-wirtschaft.*

Command economy is one of the most notorious falsifications of the socialist economic system by anticommunists. It claims that economic decisions under socialism are made on the basis of arbitrary commands from the center bringing about inflexible and over-bureaucratized structure. In reality planned organization and management of socialist production is based on principles of democratic centralism, namely a combination of the centralized control and initiatives of workers, the virtual owners of the means of production.
—*The Dictionary of Political Economy*[1]

INTRODUCTION

The demise of the Union of Soviet Socialist Republics (USSR) raised numerous questions about its causes. Western observers pointed to the crisis of the socialist economic system of the former Soviet Union (FSU) and its variation, the centrally planned command economy. The dramatic disappearance of the hammer and sickle red banner symbolizing the Soviet Union prompted a theory about the historical inability of soviets (worker-elected bodies of governance) to perform socioeconomic functions beyond rubber-stamping the Communist Party's directives. The secessionist movements and the ultimate disintegration of the union of the republics posed as a third possible cause.

The demise of the FSU was brought about by the imperative need for an open economy and the slowdown in the arms race that imposed a heavy financial toll on the USSR. The historical inadequacy of the country's ossified economic structure with regard to volatile international markets was revealed. A series of reforms were devised to prop up the existing socialist system with legalized but controlled markets.

But complementing the socialist centrist structure with a decentralized market-driven microeconomic initiative proved short-lived and ultimately unfeasible. Real decentralization for working markets presumed a switch from state to private property, thus challenging the foundation of the socialist system. The time came to make the toughest choice: either to embrace market capitalism or to create a third way uniquely reflecting the entrenched duality of the Soviet economic system and the Russian economic tradition that came before it and remained the institutional and political trend setter, given Russia's political and economical weight as well as its historical pre-eminence to the Russian Empire. This dilemma remains unsolved.

1. *The Dictionary of Political Economy,* ed. M. Volkov (Politizdat: Moscow, 1979), p. 158.

HISTORICAL BACKGROUND OF THE SOVIET ECONOMY

The Setting

Until December 25, 1991, the USSR was the largest country in the world, occupying one-sixth of the earth's inhabited land and being almost 2.5 times the size of the United States. Its population of about 293 million, the third largest in the world, was composed of 128 ethnic groups. Some 72 percent of the total population were Eastern Slavs, of whom more than 70 percent (just over 50 percent of the total Soviet population) were ethnic Russians. Belorussians and Ukrainians constituted the remainder of the Eastern Slavs there. Other ethnic groups belonged to Turkic, Baltic, Finno-Ugric, Caucasian, Persian, Armenian, Caucasian, Latin, and other linguistic families. The predominant religion of the country was Russian Orthodox, along with Islam in Central Asia, Azerbaijan, and Tatarstan; Protestantism in Estonia and Latvia; Roman Catholicism in Lithuania and western Ukraine; Buddhism in Kalmykia and Buryatia; and Judaism scattered throughout and other religions present as well. Due to official communist atheism and the government's suppression of religious activities, only about one-third of the population actively practiced its faith.

The history of the Soviet state starts with the October 1917 revolution that empowered the soviets (councils) of workers and peasants to implement communism, as mapped by Karl Marx and Vladimir Lenin (see chapter 3). Although Marx had reservations about the likelihood of revolution in Russia because of its inadequate capitalist development, Lenin, the leader of the Russian Social Democratic Party, argued that the Russian working class was less corrupted as a result of the tardiness of Russian imperialism and thus more committed to the goal of the communist revolution.

Formed in December 1922, the Union of the Soviet Socialist Republics was made up of the Russian Soviet Federal Socialist Republic (RSFSR), the Ukraine, Belarussia, and the Transcaucasian Federation (Georgia, Armenia, and Azerbaijan).[2]

The Economy of the Russian Empire before 1917

Prior to 1917, the Russian Empire was an intermediate case compared to underdeveloped Asia and to industrially developed Western and Central Europe. It represented a duality between traditional agriculture and military-driven industrial development. The dual economy produced ambivalent attitudes toward change and reforms, which were viewed as favoring industry at the expense of agriculture. Russia's economic culture was mostly

2. Prior to that date the Russian Federation had already incorporated on a national autonomy basis the Bashkir (1919), Tatar (1920), Karelian (1920), Chuvash (1920), Kirgiz (later Kazakh) (1920), Udmurt (1920), Mari (1920), Kalmyk (1920), Gorskaya (1920), Daghestan (1921), Komi (1921), Kabardinian (1921), Crimea (1921), Buryat (1922), Chechen (1922), Yakut (1922), and Cherkess (1922) republics and regions.

shaped by this duality and the persistence of traditionalism, however varied in extent in the different regions.

The Peasant Emancipation Act of 1861 abolished serfdom and granted personal freedom to the peasants. However, this freedom was constrained by collective decision making in rural communes (*mir*). The Russian *mir,* with its collective land ownership formed in the late 1400s, survived into the nineteenth century in central Russia, impeding private farming in most of the European part of the Russian Empire (except for the Baltic states and Poland, which became part of the Russian Empire in the eighteenth century).[3] This persistence of communal agrarian practices fed the uniqueness of the Russian economic tradition. Russian Populists (*Narodniki*) believed that the agrarian commune could allow Russia to avoid industrial capitalism and leap into agrarian communism, given the Russian peasants' egalitarian and collectivist instincts, impulses foreign to the individualism of the German or French peasantry.

Inward-looking Slavophile traditionalists viewed industry as alien to Russian culture. Therefore, the initial foundation of heavy industry in the late 1600s under Tsar Peter the Great was associated with his pro-Western policy of seeking to break away from "barbaric traditionalism" and modernize Russia.[4] Aborted after Peter's death, the tsar's industrial initiative set in motion a sequence of waves of modernization without fully accomplished western-style industrialization.[5] In 1854, its belated implementation was driven by militarization in the aftermath of the Russian Army's defeat in the Crimean War with Turkey, Britain, and France. The majority of industries used serf labor before the emancipation of serfs came into effect in 1861. Historically, industrial spurts were forced upon the economy by the tsar's decisions, thus adding to absolutist paternalism in the economic tradition.

Prior to the centralization and the tsardom in Russia, over 200 years of Tatar-Mongol invasions and rule had introduced elements of the oriental tradition of subordination and passivity, as well as dislike of taxation, which was regarded as forced tribute. Russian egalitarian communalism was reasserted after the defeat of the Tatars by Tsar Ivan the Terrible in the mid-1500s. Traditionalism and Russian Orthodox Christianity, merged with tsarist paternalism, on the one hand, and progressive Occidentalism, on the other hand, were the blessing and the curse of the Russian Empire, reinforcing cultural, economic,

3. The effects of emancipation were far from uniform. The regions of Ural and the Don were settled by the Cossacks, largely self-governing communities of colonists who owed certain military service obligations to the crown.

4. Outward-looking Westernizers, including enlightened monarchs (Catherine the Great, Alexander II), and aristocrats (Decembrists), opposed the conservative Slavophiles. More recently, the outward-looking Gorbachev confronted the inward-looking Yeltsin. The ultimate Slavophile revival is associated with novelist Alexander Solzhenitsyn's return to Russia in 1994.

5. The latest of these waves took place after the dissolution of the USSR during the presidency of Boris Yeltsin.

and political dualism. These different impulses split the economy along agrarian versus industrial lines and, later, between introverted versus extroverted economic development. This dualism emerged during the Soviet period as the divide between the official political economy and the informal illegal market economy, a dualism that has extended into the post-Soviet period.

The Formative Years of the Soviet Economy

Except for the brief period of *War Communism* that was the ultimate wartime command economy, with rationing and no money, the socialist economy in Soviet Russia did not start until the First Five-Year Plan in 1928, when political power was consolidated by Joseph Stalin.

The launch of the *New Economic Policy* (*NEP*) in 1921 delayed the introduction of socialism because of the urgent need to repair a conflict between the workers and the peasantry, who had been alienated by wartime requisitioning. The NEP was a temporary strategic retreat from the socialist agenda, replacing wartime requisitioning with a turnover tax on liberalized trade between the cities and the countryside. It allowed limited restoration of markets and partial reprivatization of previously nationalized industries, and banks took responsibility for maintaining critical state control over the commanding heights (strategic key industries controlled by the state). As a result of NEP reforms, the recovery of war- and revolution-ravaged agriculture surpassed that of industry and was perceived by the leadership as a possible political threat to the goals of the proletarian revolution. The NEP was thus aborted, and the Soviet economy rejected the use of market forces and turned to command central planning.

COMMAND ECONOMY: THE ONLY CHOICE?

Launching the Model

The centrally planned command economy was introduced into the Soviet Union, where several economic subsystems coexisted. They ranged from self-sufficient communes with mostly **barter exchange** to individual small-scale proprietorships and medium-sized businesses that produced for markets with the use of hired labor. There were also publicly owned large-scale enterprises (mostly in extractive and heavy industries) that by nature were socialist prototypes using direct administrative allocation of resources and assigned labor.

This economic pluralism produced political splintering in the ruling Communist Party. Leon Trotsky advocated superindustrialization in the Soviet Union that would lead to a worldwide *permanent* communist revolution. The faction of “peasants, enrich yourselves” called for liberalization of domestic and international markets (Nikolai Bukharin). Decentralizers proposed a greater role for trade unions in existing state enterprises (A. Tomsky and N. Pyatakov).

Joseph Stalin supported an autarkic model of **socialism in one country.** He outmaneuvered and physically exterminated his opponents in the party and his program won, establishing the cult of Stalin, who played to the uniqueness of Russia and its mission to lead other nations. Assuming paternalism, Stalin reasserted economic traditionalism in the guise of revolutionary socialism.[6]

Implementing socialism in one country called for speedy industrialization for self-sufficiency, military buildup, and social transformation of the agro-industrial economy into an urban industrial one ordered by the political center. It disallowed market allocation of resources and was prone to underemployment. The state monopolized foreign relations, closed the economy through restrictions on foreign trade, *currency inconvertibility,* and limited trade specialization.

Accelerated industrialization, which heavily favored producer and military goods at the expense of agriculture, assumed *unbalanced economic growth.*[7] Pressure for superindustrialization was reinforced by the perceived hostility toward Communism by Britain, Japan, Poland,[8] and the Chinese Nationalists.

The possibility of foreign military invasion favored a push for rapid change instead of gradualism. The debate on industrialization between the **geneticists** and the **teleologists** focused on the feasibility of economic engineering. The geneticists argued that planning could guide the market, as with indicative planning (see chapter 7). They argued for the objectivity of economic laws (Kondratiev, Bazarov) and viewed planning as a navigating tool. The teleologists (Strumilin, Pyatakov) leaned toward social engineering, with resource allocation determined by planners and constrained by the physical limits of the economy. Geneticists assumed movement toward general market equilibrium, whereas teleologists pursued a biased economy with an imposed equilibrium reflecting the preferences of the ruling elite. Teleology sought to eliminate markets that bred capitalism.

6. The Russian philosopher Nikolai Berdyaev wrote that the Russian Revolution was fated to be totalitarian, given the Russian mentality of "all or nothing" (Nikolai Berdyaev, *Russian Thought in the 19th and 20th Centuries* [Amsterdam: Nijhoff, 1947]).

7. The idea of unbalanced growth was formulated by Preobrazhensky who advocated *primitive socialist accumulation* of capital through savings extracted from agriculture. Bukharin defended the balanced growth model avoiding discrimination against peasants and allowing for both state and private property in industry and agriculture. Shanin proposed unbalanced growth focused on agriculture operating in a market environment, with investment planned only in the short run.

8. Poland was given independence after the Russian Revolution. Between the world wars, the anti-Russian government of Piłsudski was in power in Poland (see chapter 11 for more detail).

Superindustrialization favored the teleologists, who asserted the need for long-run plans and opposed market forces. Central comprehensive planning—the *First Five-Year Plan,* inaugurated in 1928—ensured political control over the diverse republics, grouping them into economic regions to meet nationwide production needs.

Soviet taut planning prioritized industry over agriculture for sociopolitical reasons, emphasized regional specialization and deemphasized republic-level diversification, and established state monopolies in key industries. This model was intended to complete the socialist transition in the shortest possible time and to eliminate the entrepreneurial subsystems alien to socialism. To accomplish this, Stalin launched agricultural collectivization, which forced collective ownership on peasants as a stepping stone to comprehensive public ownership. This collectivization brought about tremendous hardship to the peasants, physically exterminated their most entrepreneurial contingents, and largely discouraged individual production. The success of Stalin's industrialization program turned out to be a disaster for agriculture. The Soviet Union became for the most part an overindustrialized and overurbanized economy with an inadequate and no longer self-sufficient agricultural sector.[9]

Soviet Central Planning: The Beginning

Central to Stalin's command economy was *central administrative planning* eliminating the "frivolity" and "waste" of market forces, thus pushing structural and social reorganization of the economy. Central planners steered individual sectors to assigned targets and instructed every enterprise, industry, and region about what steps to take, when, and how. In every economy, the issue of proportionate allocation of resources is crucial. Central planning established these proportions of production and exchange a priori, following the political and social decisions of the ruling party Politburo.

Soviet economists claimed that central socialist planning had superior foresight than the alleged myopia of short-run profit maximization of capitalist markets. The initial industry-biased growth was to be compensated for in the long run by future production increases in the deprioritized sectors of consumer and agricultural goods.

The first Soviet economic strategy consisted of pressure plans relying on mass enthusiasm with little use of material incentives. The plans played a dual role, allocating resources and setting targets for economic growth. This duality was reflected in the debate over whether the First Five-Year Plan would have a forecasting or command nature. The First Five-Year Plan actually conceived the *command economy*. The preparatory stages (1925–1926) used indicative planning to generate *control numbers* spelling out various economic possibilities. The Five-Year Plan aggregated adjustable annual plans.

9. In the well land-endowed republic of Ukraine (known then as "the Ukraine"), planned redistribution of agricultural output to meet national demands created persistent shortages. During collectivization there was massive killing of animals by peasants, and a horrible famine, centered on Ukraine, took the lives of millions of peasants.

The Central Planning Board **(Gosplan)** was responsible for plan feasibility studies and for research on the methodology of balancing nationwide proportions. But the need to obtain adequate information posed a critical challenge. With limited markets this information was incomplete, and thus 100 percent implementation of plans could not be guaranteed. This fact made planning intrinsically unstable, contrary to the commonly held belief about its superiority.[10] Target planning emphasized specific sectors and forced unbalanced growth; absolute numbers of output were deemphasized and relative indicators of economic dynamics were elevated. Ultimately, central planning marked the victory of political ideology over economic reality.

A goal of the First Five-Year Plan was to catch up with capitalist industrial countries. The average rate of growth during the planned period was claimed to be 21.6 percent.[11] The speed of industrialization was puzzling given that the rates of growth were targeted while the resource base was generally ignored. But this performance reinforced planning as a mobilizing device and contributed to the myth of the superior and sustainable growth of the Soviet economy.

The success of the initial industrialization push cannot be attributed solely to central planning. It was accomplished at the tremendous cost of forced collectivization and a major decline in living standards. The siphoning of consumer resources into investment dramatically lowered private consumption below the historical standards of other economies with the same per capita GDP. From 1928 to 1937 the share of private consumption declined from 64.7 to 52.5 percent, a decline that took 40 years in Germany, 50 years in England, 30 years in the United States, and over 50 years in Japan. This led to the shortage economy, with chronic plan underfulfillment in consumer and agricultural goods.

The pressure economy with taut planning mobilized resources for investment: The USSR invested a quarter of its GDP, higher than that of any other country. Concentrated investment in growth-supporting sectors was based on domestic savings, with virtually no borrowing from abroad.[12] Central planning emerged as a political instrument of superindustrialization and was effective in that respect during the initial period of extensive growth.

10. This instability came into the open with the breakup of the Soviet Union.

11. B. V. Zembatova, *Planirovanje: Prostyi i Slozhnyi Istiny (Planning: Simple and Complex Truths)* (Moscow: Nauka 1990), p. 75. The numbers supplied by Soviet scholars usually exaggerated the growth performance because of elevated industrial prices and generally distorted statistics. According to alternative estimates in the West, Soviet growth performance was still very high, averaging between 4.5 and 11.9 percent, between 1928 and 1937. Per capita rates of growth in Japan were higher between 1920 and 1930, and Germany matched them during the postwar period.

12. Purchases of Western machinery and equipment in the early 1930s, financed by agricultural exports, were phased out after 1931, coinciding with the closing of the economy, which was deemed self-sufficient.

Industrialization produced an extensive bureaucracy in planning and executive institutions interested in perpetuating their political and economic power and ultimately resulted in **rent-seeking** behaviors. Command industrialization formed the basis for the merger between the party, the planners, and the ministerial and local government bureaucracies, resulting in the formation of a new class, the **nomenklatura,**[13] which presided over this vertical hierarchy and engaged in rent-seeking behaviors. The pre–World War II Five-Year Plans asserted the administrative, command, taut, and priority nature of Soviet planning. Its modifications commenced with Stalin's death in 1953 and started the cycle of reforms.

SOVIET CENTRAL PLANNING AND ITS IMPLEMENTATION

The counterposition of planning and the market as allocative mechanisms has a long history in economics. However, planning and the market are not perfect allocative substitutes. Planning is concerned with expanded reproduction and particular investment, with consumption deemphasized. In contrast, the market seeks to satisfy individual consumer preferences. Soviet planning prioritized investment to catch up with the West industrially and militarily. Therefore, planning ignored static efficiency in favor of high rates of economic growth.

Planning was implemented in the Soviet Union through a system of annual, medium-term (5 years), and perspective (15 years or more) plans. The latter two were highly aggregated to enable planners to cope with their task of translating party policy into a coherent developmental strategy. Annual plans were drafted by individual enterprises and disaggregated in order to balance resources with projected product needs. Central planning fostered the building of overly large production facilities that would employ up to 10,000 people; this was formally known as **gigantomania.** Over time this led to industrial and regional monopolization, which later impeded market reforms and privatization.

Constant *informal bargaining* by enterprises to lower their quotas plagued the implementation of plans and caused the infamous **ratchet effect.** This effect arose from an increase in the planned assignment if the previous plan's target was achieved. Such achievement was viewed as evidence of hidden resources and insufficiently taut targets. This environment made managers bargain to lower quotas and to lie about available resources, and produced managerial disincentives to be more efficient and technologically advanced.

Another practice, **storming,** arose from holding off production followed by strenuous last-minute attempts to meet production quotas. This practice reflected anticipated shortages in resources caused by informal bargaining and plan adjustments, with subsequent hoarding of inputs for the final push. In this environment, plentiful resources coexisted with constant paranoia about their scarcity. Under storming, plan implementation resulted in massive

13. The *nomenklatura* consisted of party members appointed to particular government jobs.

Box 10-1
The Puzzle of the Soviet Economy

Here are several conundrums of the Soviet economy:

- There was no unemployment; however, nobody worked.
- Nobody worked; however, the plan was always fulfilled.
- The plan was always fulfilled; however, there were always shortages.
- There were always shortages; however, the country was creating the land of plenty.
- The country was creating the land of plenty; however, there were always lines.
- Everybody knew how to avoid queuing; however, everybody was unhappy.
- Everybody was unhappy; however, political decisions were approved of unanimously.

—Old Soviet parable

production of substandard goods, further aggravating shortages. Between episodes of storming, officially employed labor did little work; this situation effectively constituted hidden unemployment. The problems of plan implementation in the USSR raised the question of whether the Soviet economy was centrally planned or merely centrally managed.

The retail surface of the Soviet economy used markets with commodities bought and sold at various prices using money. However, the origin and roles of prices were different from those of a market economy.

Prices were used by planners to ensure compliance with plans and continuous control over plan implementation. Although resources were allocated mostly in physical terms, prices permitted their comparative valuation. Soviet domestic prices were distorted because they reflected planners' priorities in distribution and production rather than relative scarcities. This feature of Soviet pricing disabled rational decision making by producers.

Wholesale prices were distorted the most. The planners used these prices to balance intersectoral outputs and to provide for comparison of alternative production mixes based on different technologies.

In agriculture, government procurement prices for designated quotas promoted specific crops, individual regions, and financially controlled collective farms. Artificially low procurement prices deepened farmers' indebtedness and their dependence on state credits.

Retail prices offset the consequences of the socialist principle of distribution, "from each according to his ability to each according to his work," and produced inequality in income distribution.[14] The government sought to diminish this inequality through two policies: free provision of public goods (health care and education) and low prices for mass consumption

14. Ideological views on income distribution were quite ambivalent: Official socialist thought opposed inequality, but it recognized the need to reward different work differently.

goods (food, housing, transportation) while raising prices for luxury goods.[15] Official data on income distribution during the Soviet era showed Gini coefficients of .23–.26, which were slightly above those of egalitarian Nordic countries.[16] Fixed low prices for staples allowed entrepreneurial individuals to engage in arbitrage selling to higher bidders in the shadow economy.[17] Thus retail pricing ultimately aggravated inequality. Furthermore, provision of public goods was segregated by location, social stratum, and workplace, thus violating the socialist principle of equity.

Soviet prices were very sticky. Thus the gap between prices and scarcity values increased over time and lowered the effectiveness of planning. The idea of the planned creation of a *socialist market*[18] where efficiency of production rose with diminishing inequality in income distribution failed miserably. But it succeeded in producing a **second economy** where market forces partially corrected artificial shortages.[19] Prices in second economy markets reflected relative and absolute scarcities.

Soviet Agriculture: The Peculiarity of the Soviet Model[20]

Once, Russia was the breadbasket of Europe. From 1909 to 1913, Russian grain exports amounted to around 30 percent of world grain exports. But after the Communist Revolution, agricultural performance dwindled.

Three categories of agricultural producers survived: state, collective, and private farms. This sector had a special history of its own with regard to prices, incentives, planning, and party policies. Stalin's industrialization was contingent on the mass collectivization of peasants and the elimination of the well-off peasants **(kulaks).**

The first category was the collective farm, or **kolkhoz,** a pseudocooperative, with elected[21] management ensuring a supply of agricultural goods to the state at minimum cost. This goal was reached by keeping the income of peasants at subsistence levels maintained by

15. Individual cars were regarded as violating collectivism and thus were classified as luxury goods, prohibitively priced.

16. Branko Milanovic, *Income Inequality and Poverty during the Transition from Planned to Market Economy* (Washington, D.C.: World Bank, 1997), p. 15.

17. Friedrich Schneider and Dominick H. Ernste, "Shadow Economies: Size, Causes and Consequences," *Journal of Economic Literature* 38 (2000): 77–114.

18. The socialist market was not the same as market socialism: It assumed the duality (again?) of the market appearance of prices and goods for sale and was socialist in the intent to create economic equity.

19. Statistically evasive, the second economy in Russia was estimated to account for 13.6 percent of GDP in 1989. Maria Lackó, "Hidden Economy—An Unknown Quantity? Comparative Analysis of Hidden Economies in Transition Countries in 1989–1995," *Economics of Transition* 8 (2000): 117–149.

20. For a discussion of Soviet agriculture see chapter 3 in Marshall Goldman, *USSR in Crisis: The Failure of an Economic System* (New York and London: W. W. Norton, 1983.).

21. Elections were generally perfunctory because *nomenklatura* candidates ran unopposed.

household plots and individually owned livestock.[22] Collective farms were exploited by paying low procurement prices and by overcharging for state-owned tractors and machinery. Consumer goods and utilities were sold to kolkhozes at high prices or made unavailable at any price (supplying electrical energy denied to collective farmers was a low priority). Until 1966 collective farmers did not have guaranteed wages and were paid in **labor days** calculated according to the time needed to accomplish specific tasks. Labor days payment was arbitrary and variable, depending on regions, seasons, and specific farms. Generally, payment was in agro-products and remained uncertain before actual disbursement.

The second category was the **sovkhoz** or state farm. These were set up as "factories in the fields" and were run under more favorable policies. When underpaid in delivery prices, these farms were compensated by subsidies. The farmers were state employees and got a guaranteed wage. They were given access to better inputs at wholesale prices. The asymmetric coexistence of the two forms of property and institutional arrangements in agriculture, the kolkhoz and sovkhoz, served the sociopolitical goal of crowding out entrepreneurship in this traditional sector, which tended to persist on the collective farms. Economically it led to a dramatic decline in productivity and in absolute production, on collective farms because of price discrimination and compulsory deliveries and on state farms because of subsidization. The failure of Soviet agriculture necessitated the first economic reforms initiated after Stalin's death.

The third category of agricultural producers consisted of the individual farmer and family. Economically, individual farmers are generally found in the private sector; however, in the Soviet reality, they occupied a unique segment of economic activity. Land in **auxiliary household plots** was not privately owned; it was cultivated only by peasants and state employees in rural and suburban areas. Livestock was privately owned but usually pastured on collective or state land. Individuals worked on these plots for themselves and owned their produce. But they also worked for the collective or state enterprises, creating tension in dividing time between their private and collective enterprises. Even though private plots in the USSR at their height in the 1970s occupied at most only 4 percent of the arable land, they accounted for 40 percent of its fruits, berries, and eggs, over 60 percent of its potatoes, and about 30 percent of its milk, meat, and vegetables.[23] These private plots would later become better prospects for market-oriented agriculture.

22. Urban people came to believe that peasants had an advantage in living off the land. The city joke went that a peasant came to the city to exchange his money, bringing a bag of it. On counting it, the bank clerk found that it was 1 ruble short of 100,000 rubles. "What a pity, says the peasant, I took the wrong bag. The other one was exactly 100,000."

23. Goldman, *USSR in Crisis,* p. 83. Private plots were spread unevenly among regions. Liberalization in the late 1940s was followed by a crackdown in 1959. More plots were present in Transcaucasia and in the Baltics. There, individual plots accounted for almost 50 percent of agricultural output, 43.6 percent in Lithuania specifically (Lev Timofeev, *Cherny Rynok kak Politicheskaya Systema (Black Market as a Political System)* [Vilnuis: VIMO, 1993], p. 24).

Individual plots were a legal element of the second economy, and their products were traded for money. Generally second economy activity encompassed personal/private economic activity outside of the state-owned first economy and was constitutionally outlawed, with a few minor exceptions. Therefore the majority of the second economy was viewed as an economic crime.[24] Nevertheless, individual agricultural plots were declared legal economically because they relieved some of the deprivation of the peasants who were not provided for by the state-owned network. The difference between lawful and unlawful economic practices in agriculture was murky, allowing for dual use of state or collective-owned property and outright pilfering. **Shadow economy** would be a better characterization because it did not circumvent the official economy; rather, it alleviated the peasants' underconsumption and compensated for the deficiencies of the planned economy, which failed to fully integrate agriculture into the socialized sector.

The Russian observer Timofeev maintained that the "black market [was] the art of survival in the circle of restrictions and prohibitions: the state enforce[d] kolkhoz, the peasants sneak[ed] in the individual plot, . . . the authorities want[ed] one meat-free day a week, the people start[ed] breeding rabbits in their apartments, the state provide[d] for an incompetent doctor for free, the people [brought] a hefty gift and [saw] a good doctor . . . without any wait."[25] The symbiosis between socialized property and pursuit of individual gain produced a Soviet economic mentality of disregarding the law that corrupted efforts at market reforms. This mentality led to "a pursuit of gain without reckoning the responsibility of a proprietor and the acceptance of kleptocracy."

Agriculture in the classical Soviet command model was deprioritized, resulting in dependence on grain imports. This dependence questioned the ability of the USSR to maintain itself as a closed economy since it was unable to feed itself. The increasing role of imports of agricultural products and other goods inspired reforms in the export sector and the overall economy.

Closed Economy: Command Trade Isolationism

One reason the Soviet Union lasted as long as it did was that Stalin's initial model was the closed economy, enforced much longer than most features of the system. Its ideological underpinning was Stalin's idea of an autarkic socialist country encircled by hostile imperialist countries. The anarchy of the world markets could undermine the effectiveness of central

24. In 1963 the death penalty was applied to economic crimes. The description of different forms of the unofficial economy is provided in E. L. Feige and K. Ott, eds., *Underground Economy in Transition: Unrecorded Activity, Tax Evasion, Corruption and Organized Crime* (Aldershot, U.K.: Ashgate, 1999), pp. 101–117.

25. Timofeev, *Cherny Rynok kak Politicheskaya Systema,* p. 13.

planning. Therefore domestic firms were "protected" from foreign competition and world prices.[26]

The state assumed authority over foreign trade and foreign currency transactions through state monopolies, the all-union Ministry of Foreign Trade and the *Vneshtorgbank* (Bank for Foreign Trade), respectively. The state monopoly of foreign trade was as old as the Soviet Union. Even during the NEP liberalization, this monopoly was maintained. Moreover, this state monopoly restated the overall authority of the Russia-based/Moscow Center over dealings abroad by individual republics. If a factory in Minsk (Belarus) could not buy from a factory in Kiev (Ukraine) without planners' consent, it could not possibly buy from Warsaw or Lyon either. The policy of self-sufficiency set a minimal role for imports only of goods not procurable domestically.

Planners determined imports and exports by balancing domestic inputs with projected outputs and making up for potential discrepancies. Export production derived from the need to pay for imports. Producers of exportable goods did not have direct relationships with foreign buyers but dealt exclusively with foreign trade bureaucracies organized at the industrial level. Domestic producers did not understand export revenues because official statistics showed them in ruble values, while actual exports were in foreign currencies converted into rubles at the official rate, which was notorious for its arbitrariness.[27]

Foreign trade relations were mostly bilateral and highly politicized. In 1948 Yugoslavia had its Soviet oil imports cut by 50 percent when the country broke away from the Soviet bloc. China, the largest purchaser of Soviet petroleum from 1955 to 1961, found its imports curtailed sharply during the Sino-Soviet split. In late 1958, oil deliveries to Finland were halted until the country came up with a president more acceptable to Moscow.[28] In 1968, oil shipments to Cuba were held back when the country became too independent.

The use of trade for greater integration with the socialist satellites came through the Council of Mutual Economic Assistance (CMEA), also known in the West as Comecon, founded in 1949.[29] Briefly after World War II, the East European countries pursued diverse economic models. But by the late 1940s the USSR had asserted its dominance over the region and established the CMEA as a multilateral body to coerce these countries to adopt a uniform strategy of communist industrialization with the USSR. This strategy incorporated

26. The oil shock of 1973–1974 caused world prices to quadruple but had no effect on Soviet domestic prices, which were revised only in 1982.

27. The USSR was a founding member of the IMF as a participant of the Bretton Woods Conference. However, it soon withdrew and returned to the abandoned gold standard in foreign currency transactions as a result of the deep mistrust of market-determined exchange rates.

28. Goldman, *USSR in Crisis,* p. 138. It has been revealed that Finland's longtime president, Urho Kekkonen, was a KGB agent.

29. CMEA membership comprised the USSR, Czechoslovakia, Hungary, Poland, East Germany, Romania, Bulgaria, and Albania (which withdrew in 1961). Mongolia, Cuba and Vietnam joined later. Yugoslavia was an associate member.

two principles: (1) extensive development that prioritized capital goods at the expense of consumer goods and (2) an autarkic focus on import substitution and minimal dependence on western markets.

Industries in CMEA countries became dependent on Soviet energy resources and raw materials. The idea of a socialist international division of labor suggested intraindustrial rather than interindustrial specialization. This led to a *collective isolationism* from world markets and a tendency to create a socialist alternative to international capitalist trade.

On the positive side, intra-CMEA specialization acknowledged the benefits of trade for economic development. On the negative side, the international socialist division of labor was shaped by concerted planning rather than markets. Plan coordination sought tighter integration of individual economies and explored supranational plans.[30]

The problems of inefficiency and noncompetitiveness of individual national industries escalated in the mid-1960s, leading to declining intrabloc trade. These problems called for changes in mutual trade and increased trade with the West. However, for the Soviet Union, intra-CMEA trade had become critically important: In 1966–1989 almost half of the USSR's imports came from East European countries: 85 percent of ships, boats, and marine equipment, 60 percent of railway equipment, and over 50 percent of machinery for light industries.[31]

Soviet trade with the West was also highly politicized and was instrumental in systemic confrontation. Liberalization of trade with the West was brought about by technological backwardness in the course of the arms race. In the early 1970s, Soviet foreign trade was a means of relaxing Cold War tensions. But the decade of trade promotion ended in 1979 with the Soviet invasion of Afghanistan and the U.S. boycott of the Moscow Olympic Games in 1980.

The benefits of trade during that decade made the Soviet Union addicted to readily operational turnkey plants and consumer goods purchased at the height of world oil prices through the expansion of Soviet oil exports. Adventurist foreign policy in developing countries contradicted the economic gains from trade. This divided Soviet pro-western technocratic cosmopolites, who advocated the economic and technological benefits of further trade, from pro-socialist hardliners, who put the politics of global expansionism above the economics of international commerce.

The goals of the Soviet command model declared the creation of a nonclass egalitarian society. However, the nonfeasibility of this social reengineering in the Soviet command

30. Khrushchev proposed to make the CMEA supranational in the early 1960s. In 1971 it adopted a "Comprehensive Program for the Extension and Improvement of Collaboration and the Development of Socialist Economic Integration of the CMEA Countries," which moved toward Lenin's vision of a single world economy with one plan.

31. Marie Lavigne, *The Economics of Transition: From Socialist* Economy *to Market Economy* (New York: St. Martin's Press, 1999), p. 74.

economy revealed itself from the beginning during the planning debate of the late 1920s. It was staunch ideology and its political enforcement by all means, including massive purges of dissenters—the totalitarian nature of the Soviet rule—that kept the model alive. However, expansion of the post–Stalin Soviet model and greater interaction with the outside world made the political economy of command socialism vulnerable and nonsustainable, and ultimately discredited it when its inherent dualism came into the open.

THE REFORM CYCLE: CAN A COMMAND ECONOMY BE REFORMED FROM WITHIN?

Reluctant Reform Thinking

The Soviet command economy epitomized pervasive *protectionism* and paternalism. Enterprises were shielded against insolvency and bankruptcy through centralized subsidies. They were not subject to financial discipline, and their managers' performance was assessed on the basis of their compliance with the government's plans. The interregional government transfers propped up underproducing regions and individual republics. The people were protected against economic fluctuations and the possibility of unemployment through coordinated public education and mandatory assignment of guaranteed jobs. The state monopoly of foreign trade protected domestic firms from external shocks and from competition with foreign goods. The network of interrepublican commodity flows with preset prices and quotas created a sense of certainty in domestic trade and increasing interdependence. A similar arrangement was fostered in intra-CMEA trade, where prices were determined in concerted fashion and fixed for five years. This economic stability lacked any impetus to change.

The terms *reform* and *reformism* in the Soviet Union's parlance were ideologically unacceptable in the not so distant past. They were interpreted as dangerous Western imports.[32] Ideological fervor called for perfecting the Soviet *most advanced model.* With the death of Stalin, a rethinking of Soviet economic accomplishments and their costs took place. The process of political destalinization gradually spilled into economics, especially after Khrushchev's 1956 speech to the 20th Party Congress, in which he denounced the weaknesses and excesses of Stalin's totalitarian rule.

The strengths of Stalin's economic model were the mobilization of resources for industrial catchup, the development of a military-industrial complex, and the postwar recovery through extensive growth. However, its weaknesses became more pronounced in the more complex postwar economy as resources for extensive growth approached exhaustion. This

32. Lenin vilified Kautsky and Bernstein (chapter 3) as "traitors" and "renegades" for their reformist "revisionism."

shortage arose from the undervaluation of the opportunity costs of planned priorities absent appropriate criteria to assess economic performance. Ubiquitous protectionism downplayed economic incentives and prevented economic subordinates from making well-substantiated decisions. The vertical institutional structure produced compartmentalized responsibilities, shortsighted ministerial bureaucracies, and parochial economic behavior.

As a result, a chain reaction followed when a substandard component of one enterprise diminished the quality of the finished commodity, with no parties bearing responsibility. **Ministerial compartmentalism**[33] also triggered destruction of the resource base due to improper exploitation, collateral damage to agriculture from irrigation and water management projects, and so on.[34]

With greater complexity of the economy, goals became more varied, coordination became more challenging, and control over subordinate activities and information verification became more difficult. With greater production possibilities and emerging resource constraints, efficient use emerged as a necessary goal.

First Attempts at Economic Reforms

Nikita Khrushchev, Communist Party General Secretary during 1953–1964, initiated destalinization in domestic politics and economics. In foreign policy he embraced the idea of peaceful coexistence and competition between socialism and capitalism, despite his dangerous bluff that led to the Cuban missile crisis in 1962. Khrushchev revoked Stalin's idea of a bipolar world of two irreconcilable hostile camps and introduced "limited sovereignty of socialist states," recognizing possible separate roads in Eastern Europe.

These new concepts imposed higher standards of well-being and consumption without cutting back on military control over the Soviet bloc. The Soviet economy was to deliver increasing amounts of both guns and butter.[35] The USSR was to deliver a model for the Third World experiencing decolonization. These circumstances prompted the first round of reforms in three areas: agriculture, which had failed to recover from the losses of the war as fast as industry; administrative decentralization through delegating authority of decision making to regions and away from ministries; and an aggressive use of foreign trade and military and industrial assistance to aid regimes sympathetic to the USSR.

33. Industry-based ministries overseeing production of a specific industry nationwide made executive decisions. Organizationally, these ministries were vertically subordinate to Gosplan and the Council of Ministers and ultimately to the Central Committee of the Communist Party and its ruling Politburo.

34. Massive marsh drainage projects in Belarus (known then as Byelorussia) increased the acreage of arable land but caused bad floods due to the elevation of underground waters.

35. Riots in Poland in 1956 were suppressed with the threat of using Soviet troops. Soviet armed forces were used the same year in Hungary, where an uprising got out of control.

This first round of reforms demonstrated the inherent flaws typical of the reform cycle prior to the Soviet Union's collapse, namely, attempts to change the systemic mechanism without altering its principle. This trait of Soviet reforms and their inconsistent implementation were molded into an institutional legacy that the post-Soviet transition struggled to undo.

Khrushchev sought to increase his political stature in the political succession after Stalin's death through agricultural reforms,[36] including switching from levies in kind on privately owned cattle and other animals to reduced monetary taxes, with the state raising procurement prices and canceling old debts. These moves promoted marketization of agricultural products and increased economic incentives. As a result, the income of the average peasant family rose almost 400 percent between 1953 and 1954.[37] Simultaneously Khrushchev initiated the virgin (previously nonarable) lands campaign in the classic Stalinist style of extensive growth, bringing 2.3 million hectares in Kazakhstan under cultivation and arbitrarily sowing it in wheat and corn, disregarding climate and soil conditions.[38] Khrushchev's penchant for favoring agriculture spending was disliked by the heavy industrial and military complexes.

To alleviate the burden of comprehensive control by central bureaucratic authorities, Khrushchev replaced nearly all central ministries (save defense and nuclear power ones) in 1957 with regional economic councils (sovnarkhozy) that gave those regions and individual republics their first taste of partial economic autonomy. This decentralization gave individual regions certain decision-making freedom. However, the center's mistrust of the regional elites caused the federal government to reemphasize central planning and discourage horizontal linkages among the regions. In 1961, 105 initially created regional councils were reorganized into 17, attesting to creeping recentralization. The 1963 creation of the Supreme Council of National Economy as the supercoordinator of regional councils under the Gosplan aegis was another indicator.

After the failure of administrative decentralization and in the face of declining productivity, a marginal move toward economic decentralization was conceived through an *experimental* use of the profit motive. In 1962, the Communist Party newspaper *Pravda* published an article by Evsei Liberman proposing to make individual enterprises efficient, giving labor and management a share in profits, and requiring self-accounting and awareness of

36. Khrushchev faced opposition after Stalin' death from Beria, Malenkov, and Kaganovich, members of the Politburo, and needed quick economic success.

37. Woodford McClellan, *Russia: A History of the Soviet Period* (Engelwood Cliffs, N.J.: Prentice Hall, 1986), p. 234.

38. The plowing of vast territories unprotected by forests led to windstorms that blew fertile topsoil away and, subsequently, major crop declines in 1961 and 1963, undermining Khrushchev's support. He was later labeled a "harebrained schemer."

costs. Ironically, 40 years later, this situation resurfaced in the guise of privatization that sought similar ends with different means. Readiness to experiment was forced by budgetary problems and the resulting threat of hidden inflation coming into the open.[39]

Use of profit incentives was intended to improve central planning instead of causing the state to abandon it, to raise its scientific level, and to optimize plan implementation. The principle of planning was to remain, with implementation to be monitored and controlled through monetary levers such as profits, credits, and bonuses with planned prices. This reform considered the monetary valuation of economic performance rather than physical amounts of output and allowed possible feedback from sales to output decisions. Enterprises experienced greater freedom in day-to-day operations. But these reforms were undermined by the rigidity of state-determined prices and the inflexibility of wages still tied to output per worker or gross output. This situation caused the enterprises to pursue profit incentives in the shadow (largely illegal elements of the second economy) sector by using hoarded resources to produce marketable goods that were sold informally through unreported networks.

Reforms and Economic Stagnation

Following the fall of Khrushchev, regional decentralization was abandoned and in 1965[40] the reconversion to the branch principle of industrial management took place during the early years of Leonid Brezhnev's tenure (1964–1982). Newly created bureaucracies exercised tutelage over enterprises and limited management leeway. Officials claimed that economic methods of management should not decrease the role of administrative methods. To reassert administrative authority, a larger role for five-year and long-range plans targeting new scientific technologies was imposed.

Accelerating reforms in Hungary and Czechoslovakia in the late 1960s tested the limits of Soviet reform tolerance. The Soviet military invasion and destruction of the "Prague Spring" movement in Czechoslovakia in 1968 reemphasized the limited sovereignty of Soviet East European satellites. Under the threat of radical deviations from the Soviet model, including withdrawals from the Warsaw Pact, the USSR reinforced socialist internationalism and socialist economic integration through more extensive coordination of national plans. This reversed the reform movement and, during the 1970s, led to recentralization of enterprises into large associations to facilitate central control.

39. Monetary reform in 1961 exchanged 10 old rubles for 1 new one, disguising a price hike of up to 50 percent on consumer goods, and food in particular, that produced serious unrest in a number of industrial cities, with open violence in Novocherkassk.

40. The Kosygin reforms of 1965 recentralized the economic bureaucracy and reorganized industry into superassociations of enterprises and research institutes for scientific planning.

The ambivalence of reform practices led to entrenchment of the traditional features of the Soviet model and grass-roots distrust of reform proposals. A public opinion poll taken in Russia in 1993 demonstrated that in the past, people had favored economic reforms over political ones (which became reversed for their view of present and future reforms[41]). The monopoly of the Communist Party over political and economic decisions and state ownership were systemic obstacles to reforms. Reform initiatives remained in the hands of the party and government leaders, thus making them more politically than economically driven.

Gorbachev's "Revolution"

When Mikhail Gorbachev took over the Communist Party and the Soviet state in 1985 after a brief interregnum of inept successors to Brezhnev, many people inside and outside the USSR pictured him as a radical reformer, even a revolutionary. But after assuming power, Gorbachev initially demonstrated continuity with his predecessors on all but a few issues.[42] The Soviet growth rate had been declining steadily. Soviet official statistics reported annual growth rates of 10.3 percent during the 1950s, declining to 4.2 percent during the 1960s, further decreasing to 2.1 percent in the 1970s, and a 0.6 percent rate of growth in the 1980s.[43]

With plummeting Soviet economic performance and a widening technological gap with the West, Gorbachev's initial strategy was to forge greater political and economic unity with Warsaw Pact countries and proceed with concerted reforms. To secure controlled progress, Gorbachev made new overtures to the West to relax tensions and achieve a new detente. To justify these moves, the *new thinking* emphasized the interdependence of nations and the challenge of global problems like the burden of the arms race, environmental problems, and issues of the less developed countries. However, this new thinking did not affect Soviet ideology, which adhered to the then fashionable idea of *socialism with a human face.* Nevertheless, Gorbachev's promotion of East European reform demonstrated a pragmatic foreign policy, one which concluded that economic goals could be achieved by political and ideological concessions. He foresaw reducing the USSR's cost of supporting loyal regimes and a refocus on urgent internal needs of **perestroika** (economic restructuring).

41. World Bank, *From Plan to Market, World Development Report 1996* (Washington, D.C.: World Bank, 1996), p. 12.

42. Gertrude Schroeder, "Soviet Economic Reform Decrees: More Steps on the Treadmill." In *Soviet Economy in a Time of Change: A Compendium of Papers Submitted to the Joint Economic Committee.* U.S. Congress, 96th Congress, 1st Session (Washington, D.C.: USGPO, 1982), pp. 219–241.

43. Daniel Gros and A. Steinherr, *Economic Reform in the Soviet Union: Pas de Deux between Disintegration and Macroeconomic Destabilization,"* Princeton Studies in International Finance, no. 71 (Princeton, N.J.: Princeton University, 1991), p. 1.

During Gorbachev's first years, there were innovations that foreshadowed the radical reforms of the 1990s. First, he raised the issue of *real* socialism, contrary to the *ideal* pictured by official social science theories and statistics. He demystified the Soviet economy and opened debate over the divergence between existing practices and theoretical socialism in his policy of openness **(glasnost).** Secondly, Gorbachev opened the economy, hoping that international competition would provide incentives to change. He eliminated the state monopoly on foreign trade to end Soviet enterprises' insulation from international competition. In part, he wanted to duplicate the success of China's gradual opening to foreign trade, which had spurred its economic growth.

Greater openness about the Soviet economy's deficiencies was forced on Gorbachev by the 1986 Chernobyl disaster, which demonstrated the failure of the Soviet model to provide energy without jeopardizing the environment and endangering human lives. The leadership's initial reaction to the nuclear plant explosion was to keep it secret and to pronounce all attempts to publicize it "an imperialist plot to discredit the Soviet Union."[44] The international externalities of the disaster and the public uproar prompted the Soviet leadership to admit the magnitude of the accident and to invite foreign specialists to aid its containment and help deal with the consequences. The subsequent investigation resulted in the exposure of numerous other environmental disasters and economic mismanagement, leading to questions about the ability of the Soviet system to provide economic development without ecocide.[45]

Radicalization of reform accelerated with a widespread realization of the debilities of the Soviet system, which varied in different republics as a result of different economic experiences prior to imposition of the Soviet model. The Baltic republics' secession in 1989 marked a turning point in the historical integrity of the Soviet Union, which ultimately broke up in 1991.

Radical reform started in 1990 with open debate over transition to a market economy by dismantling central planning and introducing different kinds of property relations to promote individual entrepreneurship. The goal was to replace the vertical planning hierarchy by horizontal market linkages and direct interaction between demand and supply, thus introducing economic decentralization. With the removal of central authority and the distancing of the Communist Party from economic matters, many plans for introducing markets appeared, echoing the debate of the 1920s. Inside reformers proposed various scenarios: partial destatization of industrial property or forced emphasis on privatization

44. Ironically, the leadership later explained its silence about the accident by stating its decision "not to spoil May Day celebration for the Soviet people."

45. Murray Feshbach and Alfred Friendly, Jr., *Ecocide in the USSR: Health and Nature under Siege* (New York: Basic Books, 1992).

first, or decontrol of prices and self-adjusting institutional reconfiguration to transform monopolistic firms into self-accounting and autonomous competitive decision makers. Some proposals (Shatalin's Plan of "500 days" of transformation, for example) reflected the frustration with previous gradual reforms and advocated a sweeping move to free markets.

The decentralization of economic decision making stimulated the nationalist sentiment of individual republics and sped up secessionist movements. The centrifugal trends in the CMEA brought about its ultimate demise in 1990. The disintegration of the Soviet Union in 1991 and the rise of economic nationalism fragmented the reform movement by diverting it into the individual political realms.

MOVING AWAY FROM THE CENTRALLY PLANNED ECONOMY

The Legacies of the Soviet Economy

The Soviet economic system was based on the following principles:

- State planning for state-owned industries, demand structuring by the state budget, and a state-determined monetary policy with a one-tier banking system.
- Production in a state-run system of mostly monopolistic firms, producing a narrow range of goods at state-administered prices and facing monopolistic suppliers.
- *Risk aversion* by managers/administrators who were reluctant to innovate or introduce quality improvements and engaged in hoarding material factor inputs to easily fulfill quantitatively specified state plans.
- A full employment guarantee and, as a consequence, the systemic impossibility of firms going bankrupt—a **soft budget constraint** policy.
- A state monopoly in foreign trade, administered prices, and exchange rates reflecting the inconvertibility of the domestic currency.
- Fiscal revenues generated mainly by turnover taxes and mandatory transfers of profits used to subsidize insolvent firms and prices for mass staple goods, as well as providing public goods.[46]

Command central planning was justified by its alleged ability to achieve sustained rates of growth and to catch up with advanced industrial countries. The slowdown in growth

46. Paul J. Welfens, "The Socialist Shadow Economy: Causes, Characteristics, and Role for Systemic Reforms," *Comparative Economic Systems* 16 (1992): 116.

rates from the mid-1970s to economic stagnation in the 1980s, along with environmental abuse, attested to central planners' inability to deal with a complex, overindustrialized economy's need for constant adjustments.

Monopolistic producers and risk-averse managers lacked the impetus to innovate, which led to technological backwardness. Full employment guarantees disguised hidden unemployment and favored labor-intensive production processes. The **soft budget constraint** policy resulted in wasteful resource use when the costs of nonprofitable production were borne solely by the state. Domestic production had limited exposure to international trade and became noncompetitive, except for raw materials and some military goods. State provision of public goods and subsidized staples masked consumer goods shortages and the poor quality of public goods used by the population compared to the goods available to the ruling elite.

A succession of reforms failed to improve central planning, was unsuccessful in questioning state ownership, and died out completely at the end of the 1980s after reenactment of the 1965 self-accounting enterprise reforms (the Law on Enterprise adopted in the summer of 1987), the last of the command reforms. The late 1980s produced legal recognition of a variety of proprietary arrangements ranging from cautious introduction of **cooperatives** to individual proprietorships. The recognition of private property in Russia clearly broke with a long history of denying private economic activity. The Law on Individual Labor Activity, adopted in 1986, articulated rules for operating private enterprises but did not encourage entrepreneurship. Subsequent legislation on cooperatives subjected them to extensive control by central and local governments. The legalization of private enterprise came only in 1991 with the Law on Enterprise and Entrepreneurship, followed by the Law on Principles of Entrepreneurship and the Law of the Destatization and Privatization of Enterprises, where target dates for state decontrol of enterprises were tentatively set. These reforms did not fully apply in agriculture, where a compromise with long-term leases of land still owned by the state was introduced.

During the late 1980s, the legal groundwork for reforms was put in place and opposition to reforms lost political clout. After the August 1991 coup d'ėtat, there was an attempt to shift the reform focus from debate to implementation. With the monopoly of the Communist Party gone and in the absence of truly democratic political institutions to express popular interests, a variety of opinions and strategies led to a stalemate. Reform decisions were made at the top of the post-coup government, which pursued the political goals of establishing President Boris Yeltsin's reform reputation and the leading role of Russia in implementing reforms. In order to expediently resolve this situation, aggravated by the disintegration of the Soviet Union, the reformers administered **shock therapy** (see chapters 3 and 12) that involved *price decontrol* in January 1992, coupled with dramatic privatization schemes.

Transition in Post-Soviet Russia

After the collapse of the USSR in December 1991, the Russian Federation faced the demanding reality of politically assuming a limited role with respect to its internal administrative regions and making a resolute break with its economic legacies. Russia was where the socialist transformation of the tsarist empire had started and where it ended. Of all the 15 former Soviet constituent republics, Russia remained longest on the track of the Soviet economic model and fully experienced the affinity of its established economic system, which showed a remarkable ability to absorb and dissipate reforms.

The reform cycle in the FSU, and before that in imperial Russia, showed a pattern of surging waves of five liberalization movements that were largely overridden by the pressure of the political elites asserting their vested interests.[47] This pattern was characterized mockingly as "One step forward, two steps backward" after the title of one of Lenin's articles.

Boris Yeltsin, the first democratically elected president of Russia, launched the sixth reform wave in an attempt to undo the legacies of the Soviet model. He endorsed reform radicalism to resolve long overdue economic problems and sought to make Russia an economic equal of the West, as had Tsar Peter the Great, Catherine the Great, Alexander II, Piotr Stolypin, and Mikhail Gorbachev, who spearheaded the five waves before him. However, Yeltsin's efforts were far from successful, and his biggest historical accomplishment was to destroy the Communist Party's monopoly politically and economically. However, he did not succeed in building a new pluralistic society, becoming mired in battles with the opposition and generally doubting the loyalty of his allies.

Yeltsin rid the country of the Communist Party's rule, the step that Gorbachev shied away from, and finished off the remnants of the command economic system. Yeltsin was also the first Russian leader to constitutionally relinquish power in 1999 to a successor, Vladimir Putin, whose reform agenda has a strong commitment to centralism. Under Putin, 89 administrative regions were regrouped into 7 megaregions, with the president securing the right to have a significant say in appointing their governors. This power earned Putin the nickname of "Ivan Kalita," the centralizing tsar of the 1300s. Recently, Putin's emphasis has shifted to the promotion of small business through tax incentives and legalization of nonfarm land ownership and respective development (the New Land Code of 2001 permitted ownership and transactions with nonagricultural land). This is an obvious political effort to raise economic opposition to the entrenched oligarchy and gain political support for his initiatives.

47. *The Economist,* "Russia, the Sixth Wave" (December 5, 1992).

The Russian Federation resembles the FSU in that it encompasses numerous distinctive ethnic and religious groups[48] and divergent regions. Its constituent republics and regions, however, are autonomous in their daily administrative matters, although with no right to independence. Nevertheless, quite a few of these areas have voiced strong independence sentiments, and many are increasingly prone to local autocracy and corruption. The balancing act between achieving a radical economic transition and maintaining the political integrity of the Russian Federation remains a tremendous challenge.

Eleven years of transition from a command to a market economy have seen distinctive periods marked by constant ad hoc shifts of economic strategies and a dramatic deterioration in economic performance. Real output in 2001 was 72.5 percent that of 1991. This result put Russia into the group of laggards in economic transformation. The economic transition and the political transition proceeded at different rates, producing inevitable clashes and conflicts and inconsistent reform implementation. Russia has built a quasi-capitalist economy that is neither fully market-driven nor obviously capitalist. It became largely a **virtual economy** because almost all of its parameters, such as prices, wages, taxes, and budgets, were illusory and mostly disguised the persistence of the soft budget constraint, as well as informal transfers to insolvent underrestructured enterprises that effectively wasted resources and destroyed value in the name of protecting employment.[49]

Transition Initiation: A Victory of Circumstances and Legacies over Choice

Russia started its economic transition with shock therapy, as did Poland, which has produced the most successful of the Soviet bloc economic transitions. However, Russia's initial economic conditions and implementation of reforms were very different from Poland's. In Russia, the urgency of shock therapy came from the pressing need to reverse economic collapse by introducing market forces and to consolidate the political power of then President Yeltsin. The Russian Federation did not have the choice to adopt gradualism because of the institutional legacy of bogged-down piecemeal reforms in the past. The divergence of the transition in the FSU region is discussed in full in chapter 11.

During the 1992–1994 period of price liberalization, mass privatization, foreign trade liberalization, and the introduction of full convertibility of the ruble, Russia abolished the last vestiges of a planned economy. These adjustments also set in motion forces that ultimately corrupted Russia's transition to a functional market economy.

48. There are 20 million Muslims in Russia, for example.

49. The virtual economy is a model that explains the resistance of loss-making enterprises to restructure and to assume market behavior. This model combines the worst of planned and market allocation but is politically stable and change resilient. For more detail see Clifford G. Gaddy and Barry W. Ickes, "Russia's Virtual Economy," *Foreign Affairs* 5 (1998): 54.

Soviet state-controlled prices were severely distorted among the various sectors of the economy and in comparison with the outside world, which urged resolute price decontrol and correction. When the government of the acting prime minister, Yegor Gaidar, moved in 1992 to liberalize retail prices and deregulate foreign trade, repressed inflation[50] came into the open. This set up the scene for **arbitrage** of goods purchased from the still-subsidized wholesale networks to be resold at inflated retail prices, with the earnings promptly being sent abroad. The continuing inflationary spiral caused the budget to run huge deficits that swelled to 28 percent of GDP. The Central Bank of Russia (CBR) proceeded to monetize the debt, thereby refueling inflation, but at the same time it generated **seigniorage** revenue for those in charge that amounted to 11 percent of GDP in 1993.[51]

Mass privatization was ill conceived and was accompanied mostly by political rhetoric based on claims of its irreversible nature and social justice, contrary to the West's economic emphasis on the fundamental importance of private property for the institution of a market economy. Between October 1992 and June 1994, 70 percent of Russia's large and medium-sized enterprises, and 80 percent of firms employing fewer than 200 people, were sold to citizens, employees, and managers during the stage of **voucher privatization.**[52] The use of vouchers denominated in currency had the appearance of a government gift to the public and was played up by the populists. Yet, despite its populist appearance, voucher privatization was actually an instrument for the redivision of wealth among the old and new power elites. The initial distribution of vouchers among the citizens who had no experience with or knowledge of investment options soon produced a secondary market where discounted vouchers, worthless in the eyes of lay people, were consolidated by the insiders, who later used them to purchase the most promising properties.[53]

The institutional weakness of Yeltsin's government during the initial period of privatization and the lack of an adequate communication infrastructure disallowed truly nationwide voucher auctions and forced compromises in the regional implementation of privatization. As a result, several local elites succeeded in seizing lucrative formerly state-owned enterprises, and became defiant in asserting their authority and denying the fiscal power of the

50. Gorbachev's reforms granted autonomy to enterprises that immediately jacked up wages above rigid controlled prices, resulting in money overhang and chronic shortages. The money overhang was partly diverted into the second economy and black markets, where goods officially in short supply were available at astronomic prices.

51. World Bank, *From Plan to Market,* pp. 36–37.

52. A voucher was a privatization cheque, issued to every citizen and denominated in the amount of 10,000 rubles, which at the time was roughly equal to $14.

53. The Czech Republic, Lithuania, and Mongolia issued nontradable vouchers and effectively avoided such a situation. M. Boycko, A. Shleifer, and R. Vishny, *Privatizing Russia* (Cambridge, Mass.: MIT Press, 1995), pp. 86–87.

center.[54] Other regions followed the good old Soviet practice of negotiating a temporary exemption from privatization in the tradition of *tolkachi* (informal pushers-negotiators), an exception already granted to the oil and gas industry.[55]

For the vast majority of Russia's regions, the end of the USSR did not mean the end of local established elites, which continued to exercise the power of the *nomenklatura.* The industrial and managerial *nomenklatura* pursued control over economically strategic resources in their aggressive discrimination against outsiders. In 1994, 81 percent of those who received vouchers ended up with only 15 percent of the divested assets.[56] Administrative *nomenklatura* used municipal privatization, of housing in particular, as cash income. The overall price of municipal property sold by mid-1993 came to about 68 billion rubles, of which 45 percent went into local coffers.[57]

The effects of shock reforms from the center and the increasing authority of the regional elites generated a wide range of behaviors. At one extreme, there were regions that declared themselves special economic zones with economic sovereignty (such as Kaliningrad) and engaged in barter transactions among themselves to avoid federal taxes. At the other extreme, some regions (along the Volga River, in particular[58]) remain unprivatized and essentially untouched by the transition, and are mostly dependent on subsidies from the center. Yeltsin responded to this growing decentralization with discretionary bilateral manipulation of individual regions and displayed remarkable political craftiness, especially during his reelection campaign in 1996. His willingness to compromise and tolerate independence-minded regions, however, was tested by rebellious Chechnya's bid to achieve its full independence. The confrontation with Chechnya also contributed to Yeltsin's downfall.

Transition Uniqueness

By the end of 1995, Russia had completed the privatization of over 120,000 enterprises that accounted for 80 percent of employment in that year. Compared to other countries, Russia's

54. Fiscal decentralization, if properly administered, can efficiently deliver public services if the rules of subordination and shared responsibilities are clearly defined. In Russia, fiscal decentralization became the arena of informal bargains and tax competition with the center. Tatarstan and Bashkortostan won exemption from statutory sharing. Various other regions resorted to barter to avoid tax responsibilities. *World Economic Outlook, October 2000* (Washington, D.C.: International Monetary Fund, 2000), p. 128.

55. For autonomous republics like Tatarstan and Bashkortostan that are well endowed with gas and oil, these exemptions were instrumental in generating economic rents.

56. World Bank, *From Plan to Market,* p. 55.

57. Darrell Slider, "Privatization in Russia's Regions," *Post-Soviet Affairs* 10 (1994): 378.

58. The variance among the Volga regions is striking: The city of Samara retained almost all traits of the FSU economy, whereas the governor of Saratov Ayatskov is an ardent defender of the hard budget constraint. M. de Melo, G. Ofer, and P. Yossifov, "Transition in Regional Capitals along the Volga," *Post-Soviet Geography and Economics* 40 (1999): 555.

privatization was unique. The World Bank estimated that 55 percent of the large and medium-sized enterprises sold could be classified as noncompetitive worker-management buyouts. In other economies in transition, this indicator would have averaged 14 percent.[59] This fact earned Russian privatization the label of *destatization* officially and *grabitization* informally. Mass privatization, impressive in its sheer volume and its emphasis on large-scale enterprises, failed to improve economic efficiency and induce normal market behavior. Instead it generated the perverse effects of persistent arrears (nonpayment of outstanding liabilities) and sliding into a *barter (*nonmoney) economy. The emergence of arrears was a direct result of the enterprises' failure to keep pace with the collapse of demand in the short run and to continue to produce out of inertia. The underdevelopment of the banking system played an additional role. The enterprises' later resistance to restructuring and their failure to address liquidity shortages led to the emergence of risk-free tax arrears and to a reliance on state subsidies. In 1997, 78.1 percent of enterprises were in arrears. The state went along with subsidies because of the fear that the accepted failure of one enterprise would trigger a domino effect and total economic collapse. The tax arrears increased from 15.1 to 181.8 trillion rubles during 1994–1997.[60]

The resurfacing of barter in Russia (and in Ukraine) is a logical extension of previous Soviet experiences. During the period of central planning from 1960 to the mid-1980s, barter took place because of the all-encompassing and inevitably inefficient planned distribution. In the late 1980s and early 1990s, because of general shortages, barter increased to 35 percent from previous levels of 2–6 percent. In 1992–1994, enterprises' financial deficits increased barter even further, to 40 percent and later to 75 percent. Starting in 1997, barter was institutionally built into the system and accounted for 90 percent of industrial output.[61]

The proliferation of barter and enterprise arrears imposed high costs and impeded reforms; they locked regions into local transactions and hindered competition. The barter economy and persistent arrears reinforced cronyism and corrupted the effectiveness of property rights.[62]

The simultaneous implementation of privatization and price liberalization substantially affected income distribution, which became much more unequal. Some estimates put Gini coefficients at .48, twice as high as those observed in the FSU.[63] By 1999, 54 percent of Russian income earners were below the subsistence level, and the gap between the top and

59. World Bank, *From Plan to Market,* p. 53.

60. *Finansy Rossii* [Russian Finance] (Moskva: Goskomizdat, 1999), p. 54.

61. Victor Makarov and Georgy Kleiner "Barter in Russia," *Problems of Economic Transition* 11 (2000): 54–55.

62. Since 1998 barter has diminished in volume, but it still remains widespread.

63. World Bank, *From Plan to Market,* p. 69.

Box 10-2
Cashless Society in Russia

Barter transactions became quite extensive and complex. A textile factory in need of utility poles and having no cash to spare came up with a very crafty chain of transactions. The textile factory sent fabric to the sewing outfit that sewed shirts for security guards at an automobile plant that in turn provided a car and truck to a cement factory that delivered cement utility poles to the textile factory. In one of the villages crop-dusting pilots were paid in old fuselages of disposed planes that were de-winged and sold to owners of summer cottages.

Source: The Washington Post (September 3, 1998), p. A44.

bottom was 40-fold. Of Russia's 89 regions, 42 had average incomes below the poverty line.[64] By 1998, 47.4 percent of income was concentrated in the highest quintile, while only 6.2 percent was in the lowest quintile. The increased polarization of income narrowed the savings base for investment and aggravated social and political tensions.[65]

State revenues, which consisted mostly of profits from state-owned enterprises during the Soviet era, plummeted as a result of the recession and mass privatization. To compensate for this loss, tax rates were sharply raised, driving most solvent enterprises into the shadow economy. There the options were limited to either bankruptcy under the burden of exorbitant taxes or collusion with organized crime and mafias. Under the circumstances, the budget crisis resulted in pressure on the CBR to cover budget deficits by printing money or circulating debt instruments. The CBR stopped issuing money to support the budget after the enactment of the Federal Law of the Central Bank of Russia, which declared that defending the stability of the ruble was its first responsibility.[66] To this end, the CBR introduced a currency corridor mechanism to impose external financial discipline.

In 1995, the urgent problems of mounting budget debt and multiple arrears prompted the issuance of *short-term state bonds* (GKOs in the Russian abbreviation) that offered very high interest rates and effectively crowded out private investment.[67] The combination of the GKOs and the currency corridor contributed to a dramatic drop in inflation from 26 percent in 1995 to 6 percent in mid-1998. Attracted by the high returns on GKOs, speculative inflows of capital strengthened the ruble but eroded Russian exports: The rate of export growth dropped from 20 to 8 percent between 1995 and 1996 and turned negative in 1997

64. *Argumenty i Facty* 10 (2000). See also T. Iu. Bogomolova, and V. S. Tapilina. "The Economic Inequality of the Population of Russia in the 1990s." *Problems of Economic Transition* 44 (2001): 3–18.

65. *Argumenty i Facty* 23 (2000): 4.

66. The CBR was put under the control of the State Duma, which would nominate a chairman and two board members.

67. Real investment deflated by CPI fell in 1998 compared to 1995 from 267.0 to 161.4 trillion rubles. D. Treisman, "Inter-enterprise Arrears and Barter in Russian Economy," *Post-Soviet Affairs* 16 (2000), p. 241.

for the first time since 1992. The fall in world oil prices magnified the current account deficit, ultimately causing a financial crisis, which resulted in the devaluation of the Russian ruble in August 1998. Because Russia continued to be very dependent on oil revenues for foreign currency earnings,[68] it also defaulted on its foreign debt obligations. Public opinion polls revealed that 48.7 percent of Russia's population considered the inflicted loss substantial and 32.4 percent catastrophic.[69]

The Opportunity and Challenge of the New Openness

Liberalization of foreign trade during the start of the economic transition abolished most of the quotas and licenses in 1992, and by 1995 less than 3 percent of imports were subject to licensing and certification.[70] At the same time, in the course of this liberalization, *special exporters* in the form of export intermediaries with special entry rights were created. This practice was abolished in 1995 but soon reappeared under the guise of coordinators for exporting oil,[71] who manipulated trade liberalization to their advantage. The convertibility of the ruble provided additional opportunities for economic rent seeking, especially in the industries that remained subsidized and exempt from wholesale price decontrol; they could sell abroad at much higher prices.

The Russian economy's exposure to foreign imports contributed to the further decline of domestic production, which took a nosedive after the collapse of CMEA and the disintegration of Soviet interrepublican trade (discussed in chapter 11) and shrank under the pressure of import competition. Severe economic instability and hyperinflation triggered massive capital flight, which ranged from $10 to $40 billion in 1992, according to various estimates,[72] reached $80 billion by 1998,[73] and continued at the rate of $20 billion per year through 2001. In the long run, Russia is likely to resist deindustrialization and a greater reorientation of its comparative advantage in extractive industries, raw material, and lumber.

68. Vladimir Popov, "Uroki valutnogo krizisa v Rossii I drugkhyh stranakh" ("The Lessons of the Currency Crisis"), *Voprosy ekonomiki* 6 (1999): 112.

69. *Osenny krizis 1998 goda: rossiskoye obstestvo do I posle (Autumn 1998 Crisis: Russian Society Before and After)* (Moskva: RNISiNP, 1998), p. 188. See also O. V. Dynnikova. "Capital Flight." *Problems of Economic Transition* (6) 45 (2002): 69–82.

70. Natalia Tabatchnaia-Tamirisa, "Trade Liberalization and Industry Protection in Russia during 1992–1995," *Hitotsubashi Journal of Economics* 38 (1997): 84. See also Simeon Djankov and Caroline Freund. "New Borders: Evidence from the Former Soviet Union." *Weltwirtschaftiches Archiv* 138 (2002): 493–508.

71. Trading companies would need to buy the right from export coordinators to access the pipelines.

72. Vladimir Tikhomirov, *The Political Economy of Post-Soviet Russia* (New York: St. Martin's Press, 2000), p. 141.

73. Evgeny Gavrilenkov, "Permanent Crisis in Russia: Selected Problems of Macroeconomic Performance," *Hitotsubashi Journal of Economics* 40 (1999): 53.

Russia increased its trade in armaments and now ranks third behind the United States and Britain, displacing France, with $4.4 billion in arms exports in 2001.[74]

Russia's greater openness to trade produced incentives to pursue areas in which it had a competitive advantage, capitalizing on the state-sponsored emphasis on oil exports and traditional exports of armaments. The financial crash of 1998 and the subsequent devaluation of the ruble assisted import substitution in agriculture and made Russian industrial products more competitive in world markets. This prompted some complaints about dumping of Russian exports and induced a wariness about Russia's joining the World Trade Organization.[75]

Transition Scorecard

Russian shock therapy,[76] though mostly politically motivated, was intended to put the economy on a rebound growth track. After the disintegration of CMEA and the collapse of the Soviet Union, a deep recession set in: Between 1990 and 1995, Russian industrial production fell by 55 percent, exceeding the decline experienced by the United States during the Great Depression. The combination of the perverse effects of price decontrol, privatization gone awry, an incomplete land reform, and a massive outflow of capital deepened the recession. In 1993, this provoked a violent confrontation between Yeltsin and the State Duma (Russian Parliament), which continued to have a sizable number of Communists and ultranationalists who recommended a strategic economic retreat. Yeltsin won this confrontation and used the momentum to expand his presidential powers, turning Russia into a presidential republic and taking a step backward in political democratization.[77]

The deepening of the economic recession in the following years and the escalation of the war in Chechnya dictated new strategies. Shock therapy failed to produce viable entrepreneurs and was pronounced to be harmful because of the spiraling inflation. Russia experienced *demonetization* of the economy and a spread of barter operations.

Russian privatization was successful in introducing new owners of plants and equipment, but it failed to create effective corporate governance. The combination of mostly unrestructured enterprises and revenue-starved government budgets, compounded by capital flight, severely undercut investment. This situation prolonged Russia's transformational recession and ultimately resulted in the proliferation of the virtual economy. In 2000–2001,

74. *Moscow Times,* April 12, 2002.

75. Russia is scheduled to join the WTO in 2004.

76. Owing to its mostly political nature, it was labeled *market bolshevism.* See Peter Reddaway and Dmitry Glinsky, *The Tragedy of Russia's Market Reforms: Market Bolshevism against Democracy* (Washington, D.C.: United States Institute of Peace Press, 2001).

77. This political change came into effect with the December 1993 approval of the new constitution.

increasing oil prices had a stimulating effect on the economy, which started showing signs of better growth rates and a decline in the virtual economy. However, at the beginning of 2002, it was found that growth had slowed from 8.2 percent in 1999 to around 3.3 percent in 2001, raising concerns about the sustainability of a successful transition. The acceleration of the rate of economic growth became a top priority for Putin's policy in 2003.

The economic transition in Russia revealed significant perversities in its implementation and escalated ethnic and regional tensions. It is still in the process of making a break with the institutional legacies of the Soviet economy, which demonstrated remarkable resilience and the ability to adapt to new realities. The Russian transition turned out to be a *nomenklatura* revolution when the power elites successfully consolidated their political dominance with economic wealth. The *nomenklatura,*[78] a class produced by the Soviet economy, succeeded in carrying its influence into the post-Soviet economy and reasserted its dominance. The burden of the transition was borne largely by the majority of the population, who felt disillusioned, cheated, and, paradoxically, nostalgic for Soviet times.

The persistent problems of lagging restructuring and soft budget constraints, coupled with escalation of the Chechnyan conflict, spurred inflation, which remains a serious problem. Currently, Russia is at the crossroads, mired in numerous economic, political, social, and ethnic conflicts. President Putin faces the tremendous challenge of completing Russia's transition to a law-abiding market economy. He is determined to see Russia's GDP grow at the rate of 8 percent per annum over the next 15 years, which would move to close the gaps with the Chinese and American GDPs, which are, respectively, 5 and 50 times bigger. He is encountering strong economic opposition from the new economic oligarchy and the Soviet-era *nomenklatura.*

SUMMARY AND CONCLUSIONS

The Soviet model of a command economy was created by a combination of internal economic underdevelopment and international political discontinuity in the aftermath of World War I, when workers' revolutions threatened many nations. It was designed to produce a speedy transition from a relatively backward nation to a modern industrial society. It persisted well beyond the attainment of industrialization, serving as an economic basis for the Communist Party's totalitarian regime. This regime produced a false mythology about the system's performance. Central planning was supposedly a superior tool for balancing economic proportions and maximizing the use of resources, but in reality, it

78. See an extensive study of the background history of Russian oligarchy at http://www.cdi.org/russia/johnson/6057-6.cfm.

Table 10-1
Public Opinion about the Characteristics of Different Periods in the USSR and Russia

Characteristics Typical Of	Russia before 1917	USSR under Stalin	USSR under Brezhnev	Present-Day Russia	Do Not Know
Grave economic situation	13.1	9.2	4.0	77.2	1.0
Fear of repression	2.6	67.8	1.9	30.9	0.9
Social security	6.2	6.4	78.0	7.5	3.2
Order	6.4	80.7	11.7	1.3	1.8
Speedy economic growth	21.1	42.5	27.8	7.3	2.9
Progress in agriculture	29.2	27.3	39.5	2.1	3.9
Crime	2.6	3.5	2.8	93.5	0.9
Patriotism	28.9	51.6	22.4	5.2	1.6
Bureaucracy	5.8	6.3	57.2	35.3	2.4
Overall crisis	6.3	3.4	10.4	82.2	1.6
Civil and political liberties	10.0	1.7	15.5	71.7	3.2
Respect for the Orthodox Church	65.0	1.9	3.5	32.4	1.7
Corruption	2.9	2.0	23.2	77.7	1.0

Source: *Osenny krizis 1998 goda: rossiskoye obstestvo do i posle (Autumn 1998 Crisis: Russian Society Before and After)* (Moscow: RNISiNP, 1998), p. 23.

produced disproportionate and inflexible economic outcomes, in the process abusing human and natural resources.

The model produced many problems, Soviet agriculture being a prominent example. Problems were not acknowledged or were labeled temporary difficulties[79] and attributed to the aggressive designs of world capitalists and spy-inspired "wreckers" rather than to the malfunctioning of the system itself. The mythology deemed the model a fountainhead of human accomplishment and supposedly required no more than further perfecting. With the population's isolation from the outside world, this mythology took deep root, and when it encountered resistance, the model was forcefully imposed with threats of physical repression. The system's reality was revealed when the economy opened and a comparison with economic outcomes in other countries did not favor the Soviet Union.

The opinions of the Russian people, who were polled after the 1998 crisis about the typical characteristics of different periods of the FSU and Russia before and after the end of the Soviet era once again demonstrated the survival of myths and the challenge of actual reality (table 10-1).

After the disintegration of the Soviet Union, Russia made an ambitious move to end the legacies of the Soviet model by opting for shock therapy and launching a functional market economy. The reality of the Russian transition was a balancing act between maintaining the administrative integrity of Russia as a country and implementing a viable market economy

79. A Soviet joke noted that temporary problems were constant.

with democratic institutions, an outcome still delayed by the advent and persistence of the virtual economy. Currently, Russia is searching for a compatible market economy model that will combine high rates of growth and greater participation in world trade with a continuous and strong presence of political authority, similar to the experience of South Korea. This agenda, however, is somewhat affected by the country's superpower nostalgia and yearning for regional leadership.

QUESTIONS FOR DISCUSSION

1. How did Russian agricultural traditions lay a foundation for socialism?
2. What was the relationship between the geneticist/teleologist debate and the debate over industrialization and agriculture in the late 1920s in the USSR?
3. What were the successes and failures of Soviet command planning in the 1930s?
4. What was the role of agriculture in the Soviet reform movements?
5. How were Soviet trade relations managed, and how did these eventually influence the movement for reform?
6. What was the pattern of Soviet reforms up to the time of Gorbachev?
7. Why and how did Gorbachev's reforms bring about the dissolution of the USSR and the collapse of its economic system?
8. What factors contributed to the continuation of Russia's transformational recession?
9. What are the unresolved problems of Russian privatization?
10. Why did Russia experience demonetization and the expansion of barter transactions?

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Arctic Ocean
SWEDEN
FINLAND
Latvia
Lithuania
Estonia
Belarus
Russia
Pacific Ocean
Ukraine
FORMER SOVIET REPUBLICS
Moldova
Georgia
Armenia
Kazakhstan
Azerbaijan
Uzbekistan
MONGOLIA
Turkmenistan
Kyrgyzstan
IRAN
CHINA
Tajikistan

11 Alternative Paths of Transition in the Former Soviet Union

Unbreakable Union of freeborn Republics, Great Russia has welded forever to stand.
—First line of the former Soviet national anthem

Do the Republics want to be free? They can take as much independence as they can swallow!
Boris Yeltsin, former president of the Russian Federation, 1992

Be Glorious, our free Fatherland,
Eternal Union of fraternal people,
Common wisdom given by our forbears, Be Glorious. . . .
—The refrain of the new Russian anthem, December 2000 (The new lyrics were written for the old melody)

INTRODUCTION

The disintegration of the Soviet Union was brought about by a systemic crisis in the Soviet economy and by the partial nature of reforms within it. The escalation of nationalist sentiment during *perestroika* and respective **secessionist movements** in the late 1980s also contributed significantly to the demise of the USSR. Fifteen new independent states (NIS) emerged in place of the Soviet republics. Several of them originally joined together as the **Commonwealth of Independent States (CIS),** presently a loose economic and political association designed to address issues of common interest.[1]

Russia initially viewed the CIS as an economic and security successor to the Soviet Union and as an existing structure of the established economic ties. Originally signed by 12 post-Soviet states (the Baltic states opted out, and Georgia joined later), the CIS was in continuing decline throughout most of the 1990s despite various attempts by Russia to make it more influential politically and economically. Marking its 10th anniversary in 2001, many observers noted its mostly declarative nature and a tribute to those with nostalgia for the Soviet Union. More recent developments in Belarus, Moldova, and Ukraine, which have sought greater economic unity with Russia, have renewed interest in this arrangement.

Currently, Russia's position is to end subsidized transfers of energy resources to the CIS members that drain 3 to 4 percent of Russia's GDP and turn it into a market-oriented economic association.[2] In January 2003, President Putin announced Russia's interest in signing a Free Trade Area agreement with the CIS countries in October 2003. The **CIS customs union** of 1996, which included Russia, Kazakhstan, Kyrgyzstan, Tajikistan, and Belarus, was transformed into the **Eurasian Economic Community (EEC)** in October 2000 (effectively modeled on the EU), signifying a further movement from bilateralism to

1. The 15 NISs (an abbreviation that denotes the former 15 Soviet Union republics) include the 3 Baltic countries along with the other 12 former Soviet republics, although not participating in the CIS.

2. Russia is also one of the Shanghai five, along with China, Kazakhstan, Kyrgyzstan, and Tajikistan, joined by Uzbekistan in 2001 and becoming the Shanghai Cooperation Organization.

Table 11-1
Ethnic Mix of the Former Soviet Union before 1989

Republic	Titular Nationality (%)	Growth Rate (%)	Minorities per 1,000 Inhabitants (%)
Russia	82	6.91	Tatars (4)
Ukraine	73	3.84	Russians (22)
Uzbekistan	71	25.72	Russians (8)
Kazakhstan	40	11.89	Russians (39), Ukrainians (5)
Belarus	78	6.48	Russians (13), Poles (5)
Azerbaijan	83	15.36	Russians (6), Armenians (6)
Georgia	70	8.30	Armenians (8), Russians (6)
Tajikistan	62	25.63	Uzbeks (23), Russians (7)
Moldova	65	29.63	Ukrainians (14), Russians (13)
Lithuania	80	8.24	Russians (9), Poles (7)
Turkmenistan	72	24.76	Russians (9), Uzbeks (9)
Armenia	93	7.99	Azeri (2)
Latvia	52	6.15	Russians (35)
Estonia	62	7.04	Russians (30)
Kyrgyzstan	52	19.50	Russians (22), Uzbeks (12)

Source: The Economist, August 31, 1991, p. 38, and W. Ward Kingkade, "Demographic Prospects of the Former Soviet Union," in Richard F. Kaufman and John. P. Hardt, eds., *The Former Soviet Union in Transition* (Armonk, N.Y.: M. E. Sharpe, 1993), p. 796.

multilateralism. In early 2003, there was also a move to pursue a currency union based on the Russian ruble. The convergence of reform paths in the European and Asian parts of the FSU may contribute to the implementation of this trend and further maintenance of the Euro-Asian economic community.

Historically, the Soviet republics were compelled to conform to the economic philosophy and policy produced by the center located in Moscow and staffed mostly by the *nomenklatura,* largely of Russian ethnic origin. Stalin's original idea of self-isolated socialism and a centralized command economy strived to consolidate economically region with diverse economic, political, cultural, and religious backgrounds that Soviet Russia had inherited from the tsarist Russian colonial empire (table 11-1). After Stalin's death, the Soviet leadership pursued a policy of forced assimilation, language uniformity, and tight economic association among divergent nationalities and ethnic groups to produce a single Soviet nationality and unity. This goal has never been fully achieved. However, the Russian language requirement for higher education and joining the ranks of the administrative elite has established Russian as the language of interrepublican communication.

During Gorbachev's tenure as president of the USSR, the *union republics* (the republics formally having the right to secede) challenged their association with Russia, which was based on the principle of centralized asymmetry in Russia's favor, as well as overreliance on Russia and vertical administrative subordination in defiance of their national priorities and traditional trade links with foreign countries. That period saw reform movements in the individual republics become more nationalistic and politically oriented. The resulting secessionist efforts led to the collapse of the Soviet Union in 1991.[3]

The paths of economic transition in the former Soviet republics were contingent on a number of factors. At the outset, ethnic heritage and national self-determination took priority over political and economic goals. Second, the individual republics' experience within the Soviet Union and the duration of their union republic status played important roles in the selection of their economic strategies. Third, integration with the world economy required a reevaluation of their available resources, a market test of the competitiveness of domestic goods, and geographic redirection of their trade. The degree of economic reform, macroeconomic stabilization, and microeconomic restructuring contributed to national confidence and international recognition. Finally, a new international balance of political and economic forces and the war on terrorism have produced new geopolitics that have radically redefined political and economic security. The republics are reconsidering their alliances and external relations to accommodate this new reality.

Economic transition in the NISs involves populations of different age and gender compositions that are increasing at different rates, directly affecting the progress and scope of the transition. Urban-rural population splits divide priorities between industrial and agrarian reforms. The legacies of their respective experiences with the Soviet Union mark the speed and the direction of the economic transition. Integration with the world economy dictates the scope and sequence of economic restructuring. The profiles and personalities of individual leaders play a crucial role in the republics where presidential powers are substantial and have long-term consequences. A decade of economic transition proved that the expectations of extreme divergence were valid and has also defined common economic problems.

INDEPENDENCE OR INTERDEPENDENCE

Economic Background of the Former Soviet Republics

The diverse relative weights of area and population of the NIS demonstrate the territorial and economic preeminence of Russia[4] and the disparities in economic performance (tables 11-2 and 11-3).[5]

3. Many previously republican Communist leaders assumed nationalist positions to assert themselves as the reform leaders and maintain their ruling positions.

4. The Russian Federation incorporated on a national autonomy basis the Bashkir (1919), Tatar (1920), Karelian (1920), Chuvash (1920), Kyrgyz (later Kazakh) (1920), Udmurt (1920), Mari (1920), Kalmyk (1920), Gorskaya (1920), Daghestan (1921), Komi (1921), Kabardinian (1921), Crimea (1921), Buryat (1922), Chechen (1922), Yakut (1922), and Cherkess (1922) republics and regions.

5. The Baltic states seceded from the USSR before it became defunct and expressed no interest in joining the agreement of the CIS.

Table 11-2
The Former Soviet Union: Territory and Population (1990 and Projections of Population in 2015)

	Territory		Population		
Region	%	Million	2015	%	% Urban
FSU	100.0	288.6		100.0	66
Russia	76.2	148.0	142.9	51.3	74
Ukraine	2.7	51.8	47.9	18.0	67
Belarus	0.9	10.3	9.8	3.6	66
Estonia	0.2	1.6	1.2	0.5	72
Latvia	0.3	2.7	2.1	0.9	71
Lithuania	0.3	3.7	3.5	1.3	68
Moldova	0.2	4.4	4.5	1.5	47
Georgia	0.3	5.5	5.1	1.9	56
Armenia	0.1	3.2	3.8	1.1	68
Azerbaijan	0.4	7.1	8.8	2.5	54
Kazakhstan	12.1	16.7	16.9	5.8	57
Turkmenistan	2.2	3.6	5.6	1.3	45
Uzbekistan	2.0	20.3	29.9	7.0	41
Tajikistan	0.6	5.2	7.8	1.8	32
Kyrgyzstan	0.9	4.3	5.5	1.5	38

Sources: Stanley Fischer, "Economic Reform in the USSR and the Role of Aid," *Brookings Papers on Economic Activity* 2 (1991): 291. Projections for 2015 are from *Human Development Report 2000,* United Nations Development Program (New York: United Nations, 2000), pp. 184–185.

Table 11-3
Economic Development Level of Different Soviet Republics in 1990 (% of the USSR Average)

		Productivity	
Republic	National Income per Capita	Industry	Agriculture
Russia	117	110	108
Ukraine	93	80	108
Belarus	103	103	128
Estonia	140	115	152
Latvia	122	105	131
Lithuania	108	103	152
Moldova	80	73	83
Georgia	84	90	62
Armenia	82	75	76
Azerbaijan	64	60	68
Kazakhstan	91	90	100
Uzbekistan	50	60	56
Kyrgyzstan	53	65	74
Turkmenistan	67	100	66
Tajikistan	40	75	60

Source: Vneshniaia torgovlja (Foreign Trade) 11 (1991): 36.

The record of overall economic development (see table 11-3) shows that the Baltic republics outperformed Russia and Russia outperformed the remainder of the republics. The edge in overall economic achievement provided a head start for independent economic transition for the front runners. In 1998, per capita GDP (in 1994 US$) in Estonia, Latvia, and Lithuania was 184, 108 and 102 percent, respectively, of that of Russia.[6]

The differences in economic development and political consciousness, demographic composition by gender and age, and resource endowments underlie the various NIS models of economic and political independence in the world of market economies. Varying degrees of successful economic change and numerous problems encountered during a decade of rocky transition to independence raise issues involving the economic alliances and concerted actions of the NIS.

Divergent Economic Cultures in the Former Union Republics

Historically, in most of the USSR, the established economic culture was superimposed on entrenched traditional communalism, reliance on a paternalist state, and obedient conformity to the Orthodox Church carried over from the time of the Russian Empire.[7] However, there were also distinctive regional variations, which can be grouped into the following categories. The first includes Russia,[8] Belarus, Ukraine, northern Kazakhstan, and Moldova. In this group, the population is more educated and responsive to innovations and change, especially in urban areas.[9] In rural areas of these states, spontaneous collectivism and shared responsibility are strong despite a climate of major change. The population has a high percentage of retirees (retirement age is 60 for men, and 55 for women). In Russia, retirees constitute 18.5 percent of the population, in Ukraine 21.2 percent, in Belarus 19.5 percent, and in Moldova 15.3 percent compared to less than 10 percent in Central Asia.[10] The older population, concentrated in the countryside, has imposed a heavy toll on social safety nets during the economic restructuring and has exhibited a bias toward reform conservatism.

6. *Human Development Report 2000,* United Nations Development Programme (New York: Oxford University Press, 2000), pp. 184–185.

7. Other Christian churches and dissident sects within the Orthodox Church, as well as non-Christian churches, except within certain designated zones, were marginalized.

8. Russia proper is far from being uniform in this regard. There are Sunni Muslim autonomous republics within Russia (Tatarstan and Chechnya, among others) and Buddhist areas (Kalmykia) that have distinctive economic cultures.

9. Moldova is not as urbanized as the rest of the group: The rural population constitutes 52 percent of the country, but its urban population profile fits the criteria.

10. John Dunlop, Marc Rubin, Lee Schwartz, and David Zaslow, "Profiles of the Newly Independent States: Economic, Social, and Demographic Conditions," in Richard F. Kaufman and John P. Hardt, eds., *The Former Soviet Union in Transition,* Joint Economic Committee, Congress of the United States (Armonk, N.Y.: M. E. Sharpe, 1993), pp. 1038–1040.

The Transcaucasus republics of Georgia, Armenia, and Azerbaijan represent another group aggregated on the basis of geographic proximity and geopolitics. This region could have become an advantageous transit route between east and west and between north and south, but instead it has become a hotbed of civil wars and ethnic strife. The three republics occupy less than 1 percent of the territory of the FSU, and 60 percent of their land is mountainous. Historically influenced by the Persian, Russian, and Ottoman empires, these republics share a legacy of alliance with Russia against Persian and Turkish assaults.[11] Prior to 1917 these republics were virtual colonies of the Russian Empire, providing raw materials (manganese, copper, and oil) as well as products of subtropical agriculture such as fruits, cotton, silk, and tobacco. These countries' experience of having been objects of aggression and colonization produced strong nationalism in the region. All three states are extremely distinctive in their ethnic composition, religious beliefs, and economic practices. Ethnically diverse Georgia borders ethnically homogeneous Armenia. Distinctive varieties of Gregorian Georgian Orthodox and Monophysite Armenian Christianity are in conflict with Shi'i Azeri Muslims in Azerbaijan and Abkhazian Muslims in Georgia. At the end of the 1980s, income inequality gaps and territorial disputes plagued the relationship between Armenia and Azerbaijan: 29.7 percent of the Azeri population were below the lowest income level of 75 rubles per month compared to 5.4 percent of Armenians.[12] (See table 11-4 for income data.)

Georgia and Armenia share two commonalities with the first group: an urban population with high levels of education and professionalism and higher incomes than the Azerbaijan population, a fundamental source of Azeri-Armenian ethnic strife. Income inequality in the region resulted mostly from the illegal elements of the second economy (see chapter 10) in all three republics, which became even more influential as reforms progressed. In 1990, the share of the shadow economy in Azerbaijan and Georgia was 21.9 and 24.9 percent, respectively, but by 1995 it had increased to 60.6 and 62.6 percent, respectively.[13] Corruption reinforced by the Soviet economic system became a political force when the system started falling apart.[14]

Economically these republics are mostly agrarian. Oil resources in Azerbaijan make it a special case (reserves are estimated at 18–35 billion barrels). Since large-scale exploitation

11. Before 1917 the majority of the population of Armenia was Muslim. The alliance with Russia contributed to Armenian self-determination and national homogenization.

12. Michael Alexeev, "Income Distribution in the U.S.S.R. in the 1980s," *Review of Income and Wealth* 39 (1993): 25. In the late 1990s, Azerbaijan surpassed Armenia in income per capita owing to its outward oil trade at world prices.

13. Simon Johnson, Daniel Kaufman, and Andrei Shleifer, "The Unofficial Economy in Transition," *Brookings Papers on Economic Activity* (2) (1997): 188.

14. Economic mafias in Georgia and Azerbaijan were the initial force behind demands of derussification and introduction of native languages into schools in the 1970s.

Table 11-4
Income Parameters in the Former Soviet Union (1989–1990)

	Population in Millions	GNP per Capita*	Gini Coefficient	Poverty (%)†
USSR	289.3	2,870	0.289	11.1
Kazakhstan	16.9	2,600	0.189	15.5
Kyrgyzstan	4.4	1,570	0.287	32.9
Tajikistan	5.3	1,130	0.308	51.2
Turkmenistan	3.7	1,690	0.307	35.0
Uzbekistan	20.5	1,340	0.304	43.6
Armenia	3.3	2,380	0.259	14.3
Azerbaijan	7.2	1,640	0.328	33.6
Georgia	5.5	2,120	0.292	14.3
Belarus	10.3	3,110	0.238	3.3
Moldova	4.4	2,390	0.258	11.8
Russia	148.3	3,430	0.278	5.0
Ukraine	51.9	2,500	0.235	6.0
Estonia	1.6	4,170	0.299	1.9
Latvia	2.7	3,590	0.274	2.4
Lithuania	3.7	3,110	0.278	2.3

*GNP per capita in U.S. dollars computed by the World Bank.
†Poverty line was defined as income below 75 rubles per capita.
Source: Richard Pomfret, *Poverty in the Kyrgyz Republic,* Working Paper 5 (The University of Adelaide, 1998).

of oil began in the 1870s, Azerbaijan has experienced accelerated growth and urbanization. At the turn of the twentieth century, Baku, the capital of Azerbaijan, produced more oil than all of the United States, and wages there were the highest in the Russian Empire. After a brief episode of independence in 1918–1920, Azerbaijan became part of the Trans-Caucasian Republic of the USSR in 1922 and a union republic in 1936. Beginning in the early 1940s, Azerbaijan's oil production declined when the Soviet leadership refocused on Siberia as a source of gas and oil.[15]

The Baltic group[16] has a greater orientation toward individualism[17] and respect for private property, as well as longer exposure to market economies resulting from historical relations with the West and political independence from 1920 to 1940. With access to warm-water seaports, the Baltic republics served as a gateway for Russia's trade with the West. High educational standards and professional competence have eased integration with Western market economies and boosted acceptance of the Western market economy model. But a substantial Russian population in the Baltic countries (30 percent in Estonia, 34 percent

15. Richard Pomfret, *Asian Economies in Transition* (Cheltelham, U.K.: Edgar Elgar, 1996), pp. 13–107.

16. Estonia and Latvia were integrated into the Russian Empire after the Northern War with Sweden (1700–1721). Lithuania was partitioned between Poland and Belarus. Its different parts were integrated into the Russian Empire during the eighteenth century.

17. The abolition of serfdom in the Baltic lands preceded that of Russia proper by almost 30 years.

in Latvia, and 9.4 percent in Lithuania), in combination with low rates of indigenous population growth, has complicated the social agenda of economic reforms.

Archaic forms of economic culture, greater acceptance of authoritarian rule, and the presence of gender inequality prevail in the mostly Sunni Muslim Central Asian group of countries, namely, Uzbekistan, Kazakhstan, Turkmenistan, Kyrgyzstan, and Tajikistan. A large rural population[18] and relatively low levels of education make this group of nations favor a slower pace of transition and clan-like governance. The majority of Central Asia has never had private ownership of land because of the largely nomadic nature of its populations. Collectivization produced very strong resistance in Kazakhstan, where about 1 million people perished in the confrontation that ensued. In addition, privatized cattle production or large farms for grain and cotton production would not be beneficial because of the region's dependence on irrigation installations in its climate of desert or semideserts.

Kyrgyzstan, a notable exception here, is mountainous and endowed with water resources and fertile valleys. Ferghana valley (shared by Kyrgyzstan and Uzbekistan) is another exception to the inhospitable climate of Central Asia and an example of an environmental disaster: the shrinking Aral Sea. Land was traditionally allotted to extended nomadic families within the boundaries of the area owned by their tribe. The communal tradition and the revival of Islam make these states responsive to the redistributive practices found in theocratic New Traditional Economies, such as Iran.

The Central Asian region was colonized by Russia in the late 1880s and turned into cotton-growing vassal states; it served as a source of raw materials during the Soviet period. The integrative measures also included central control over the river routes and construction of a strategically important railroad from the Caspian Sea to Samarkand. Russia consolidated its control over Central Asia by asserting its boundaries in successive border agreements with China's Xinjiang province (permanently dividing the ethnic groups of the Kazakhs, Kyrgyzs, Uighurs, and others), with Persia, and with a British-negotiated pact with Afghanistan.

Immediately after the Russian Revolution of 1917, Central Asia hoped that Russia would grant the region independence or greater autonomy in the spirit of self-determination promised by Lenin. Lenin's party supported settlers in the region who were mostly of Russain ethnic origin, established the first soviet (self-governing council—see chapter 10) in Tashkent (Uzbekistan), and deliberately excluding Muslims, who promptly organized a resistance *Basmachi* (rebel fighters) movement actively opposing the Soviet regime.

18. Compared to Iran and Turkey, the Central Asian republics are behind in urbanization and industrialization. Urban population in the region accounted for 41 percent of the total compared to 54 percent in Iran and 53 percent in Turkey at the end of the 1980s. See Alastair McAuley, in Michael Ellman and Vladimir Kontorovich, eds., *The Disintegration of the Soviet Economic System* (London and New York: Routledge, 1992), p. 138.

Ironically, it was the Soviet regime that reinforced the Islamic movement as a unifying force in the land of ethnic diversity.

The Central Asian republics were initially incorporated into the Soviet Union as autonomous regions of the Russian Federation and were granted union republic status as late as mid-1930s. According to the USSR's Constitution, a union republic had a right to secede. However, the economics of central planning and social strategies of assimilation were designed to prevent such an eventuality. The uniform language policy was used to the same end. The Arabic script used as a means of common communication before 1917 was replaced by the Latin script in 1922, and by the Cyrillic alphabet after 1935 to increase the pace of integration with Russia and cut links with the Muslim world and beyond.

The Legacies of Collective Autarky

All of the 15 NIS share a legacy of forced economic isolationism, strong economic integration, and limited access to world markets. Interrepublican trade as a share of GNP in 1990 was on average 29 percent compared to the EU average of 13.7 percent for intraregional trade.[19] This collective autarky was reinforced by the state monopoly on trade relations, insulation of individual enterprises from foreign competition, and nonconvertibility of the ruble. Interrepublican trade, though overcentralized, had the benefit of channeling implicit transfers to worse-off republics through subsidized prices, especially for oil, to aid more equal income distribution. However, in many cases, these transfers were a partial compensation for distorted prices and turnover taxes. Republics other than Russia were heavily involved in interrepublican trade marked by intraindustrial specialization that produced an asymmetric overdependence on raw materials and components from Russia. In 1990, average exports to Russia represented around 25 percent of the income of the other 14 republics and more than 30 percent for 5 of them. A comparison with the EU and the similar gravitation to trade with Germany reveals export shares of 12–15 percent. At the same time, regions of Russia proper traded about 60 percent more with each other than with the other republics before the disintegration of the Soviet Union.

The interrepublican dependence on trade with Russia and each other is shown in table 11-5. The degree of dependence was highest for the Baltic republics. As a trading partner, Russia in 1987 was responsible for 69.1 percent of trade with Latvia, 80.1 percent with Lithuania, and 84.8 percent with Estonia.[20] Ironically, it was this Baltic region that made a 180-degree trade refocus on the West shortly after achieving their independence (table 11-6).

19. Renzo Daviddi and Efisio Espa, "Regional Trade and Foreign Currency Regimes among the Former Soviet Republics," *Economics of Planning* 28 (1995): 32.

20. Daviddi and Espa, "Regional Trade and Foreign Currency Regimes," p. 35.

Table 11-5
Loss from Disruption of Bilateral Trade (% of Net Material Product)

Republic	Interrepublican Trade
Russia	11.5
Kazakhstan	12.5
Ukraine	24.2
Uzbekistan	26.6
Turkmenistan	28.2
Tajikistan	31.7
Georgia	35.9
Azerbaijan	36.4
Kyrgyz Republic	38.3
Moldova	45.0
Lithuania	46.2
Armenia	50.3
Estonia	51.1
Latvia	52.1
Belarus	52.9

Source: Holger C. Wolf, *The Economics of Disintegration in the Former Soviet Union* (New York University, Department of Economics and International Business, 1993), p. 13.

Table 11-6
Share of New Independent States in the Gross Volume of Exports and Imports (%)

	Exports				Imports			
	1994	1995	1996	2001*	1994	1995	1996	2001*
Azerbaijan	43	40	54	10	62	34	34	31
Armenia	73	62	41	26	52	50	34	25
Belarus	59	62	66	60	68	66	66	70
Georgia	75	63	65	45	82	41	39	37
Kazakhstan	58	53	56	30	60	69	71	52
Kyrgyzstan	66	66	80	35	66	68	56	55
Moldova	72	63	68	61	72	68	61	38
Russia	21	18	18	15	27	29	31	27
Tajikistan	23	34	44	33	42	60	59	78
Turkmenistan	77	49	69	52	47	55	28	38
Uzbekistan	62	39	23	34	54	41	32	36
Ukraine	55	52	44	29	73	63	43	56
Estonia	25	20	23	—	19	14	14	—
Latvia	38	19	23	—	28	16	15	—
Lithuania	42	35	41	—	42	28	26	—

*Data for 2001 show the share of the CIS in individual countries' exports and imports. The numbers for Uzbekistan and Turkmenistan are derived from the data on their trading partners.
Source: Vladimir Tikhomirov, *The Political Economy of Post-Soviet Russia* (London: Macmillan, 2000), p. 125. Data on the Baltic countries are from *Baltic States: A Regional Economic Assessment* (Paris: Organization for Economic Cooperation and Development, February, 2000), p. 186, and Interstate Committee of the CIS. (Moscow: Commonwealth of Independent States, 2002).

The republics relied excessively on Russian oil: Russia accounted for 89.5 percent of USSR oil production in 1991 and about 80 percent of CIS oil production in 2001.[21] The exceptions were oil-endowed Kazakhstan and Azerbaijan, which enjoyed a certain independence in this regard and therefore had better prospects for independent regional reforms.[22] Net energy imports (energy use less domestic production) in 1997 were −57 percent in Russia, −69 percent in Kazakhstan, and −17 percent in Azerbaijan, while in Belarus they constituted +87 percent and in Ukraine +46 percent.[23]

Another factor in interdependence within the FSU was the monopoly of certain republics on the production of specific goods. Russia produced 58 percent of Soviet automobiles, 97 percent of streetcars, and 100 percent of sewing machines. Ukraine provided 100 percent of corn-harvesting machines and 96 percent of diesel locomotives. Thus the collapse of interrepublican trade triggered a considerable contraction in production. The NIS encountered an acute dilemma: Its economic interdependence necessitated the continuation of trade; however, the new borders and border duties, deteriorating terms of trade caused by the switch to world prices, and priorities of national independence dictated otherwise and urged trade reorientation. The introduction of national currencies and individual currency regimes created barriers to trade among the republics and caused trade flows to shift to alternative trading partners. The proximity factor was seriously undermined by the threat of imported inflation through trade channels from the republics experiencing major economic destabilization.

Currently, countries such as Russia, Kazakhstan, and Turkmenistan could pursue self-subsistent policies of economic development based on available raw materials. Before the disintegration of the USSR in 1991, Kazakhstan accounted for 5.2 percent of the oil and 20.7 percent of the coal produced in the FSU. For natural gas production, Turkmenistan accounted for 10.4 percent and Russia for 79.3 percent. For the rest of the former Soviet republics, autarkic reforms are rather unlikely. Their options are to refocus external trade and economic relations from the nearby republics to the West, the Middle East, or the Far East. The most resolute refocusing has happened in the Baltic states (particularly Estonia), where "divorce" from the USSR meant the return to a natural association with nearby Scandinavia and anticipated accession to the EU.

21. "Ekonomika sodruzestva nezavisimikh gosudarstv," *FIN* (Moscow, 1992), p. 12; Paul Mathieu and Clinton R. Shiells, "The Commonwealth of Independent States' Troubled Energy Sectors," *Finance and Development* 39 (3) (2002): 34.

22. Azerbaijan is dependent on Russia for oil transit. The new Caspian Consortium pipeline gives Kazakhstan better access to non-CIS markets and improves its bargaining position. The latter was attested to by Russia's new decision to renegotiate the terms of transit for Kasakh oil through the Transneft networks.

23. *World Development Indicators 2000* (Washington, D.C.: World Bank, 2000), pp. 139–140.

Box 11-1
Baltic Free Trade Agreement (BAFTA)

Signed in 1992 in Tallinn, this agreement went into effect in 1994 with substantial abolition of all customs duties and quotas. In 1997 a second agreement was added to it that stipulated a rare tariff free movement of agricultural products in the inter-regional trade. Despite the radical nature of the BAFTA, the intra-regional trade has not changed very much with the highest share of exports of the member countries only slightly above 12 percent on the average.

In 1998–1999 the BAFTA saw mounting tension due to the trade deflection of pork transit through Estonia that does not have an external tariff on agricultural products, into Latvia and Lithuania that respectively have 50 percent and 17 percent external tariffs. Latvia imposed a countervailing duty of 70 percent and accused Estonia of violating the BAFTA.

Source: Baltic States: A Regional Economic Assessment (Paris: Organization for Economic Cooperation and Development, February 2000), p. 186.

Up to 1994, the Central Asian countries were mainly concerned with adjustments to the shock of the collapse of interrepublican trade. Since 1995 there have appeared to be attempts to balance trade between the traditional partners with the expansion of trade with the rest of the world. In 1998, however, all of the Central Asian republics except Uzbekistan experienced the highest trade deficits in relation to GDP: In Turkmenistan it was 18.4 percent, in Tajikistan 9.9 percent, in Kyrgyzstan 9.2 percent, and in Kazakhstan 4.5 percent (although relatively smaller in percentage terms, this trade deficit was the highest in absolute volume in the region, reaching $1 billion).[24] Overall during 1991–1998, official trade with traditional partners fell almost 7 times and the total trade decline less than 3.5 times. Because of the post-September 2001 antiterrorist alliance with the United States, Uzbekistan might have better prospects for improving its economic standing, with U.S. assistance in a number of military and infrastructure projects.

Table 11-7 shows that the attitudes toward intraregional trade versus extraregional trade are far from uniform. Kyrgyzstan and Tajikistan favored intraregional trade; Kazakhstan demonstrated the lowest drop in trade with Russia; and Uzbekistan radically reduced its traditional trade ties with Russia, the NIS, and Central Asia. The declaration of a customs union between Russia, Belarus, Kazakhstan, and Kyrgyzstan in 1995 provided short-term momentum to mutual trade that was wiped out by the financial crash in Russia in August 1998. In 1998 Kyrgyzstan became a member of the World Trade Organization and began to reexport consumer goods into the region. This forced Kazakhstan and Uzbekistan to impose countervailing duties, in conflict with the provisions of the Central Asian customs union agreement signed in 1994.

24. Bakhtior Islamov, "Central Asian States: On the Way from Autarkic Dependence to Regional and Global Interdependence," *Hitotsubashi Journal of Economics* 40 (1999): 77.

Table 11-7
Share of Trade with the Commonwealth of Independent States, Russia, and Mutual Trade in Central Asia (%)

		Kazakhstan		Kyrgyzstan		Tajikistan		Turkmenistan		Uzbekistan	
		Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
CIS											
	1991	90.7	85.9	97.2	80.0	76.7	81.8	94.7	78.7	84.1	82.3
	1998	39.3	47.2	44.9	52.4	34.6	65.7	60.1*	56.8*	24.3*	28.2
	2001	54.9	69.6	65.0	67.6	33.6	59.0	49.4	54.6	39.3	40.6
Russia											
	1991	53.4	70.4	42.9	39.0	44.7	34.1	46.1	38.7	55.7	54.7
	1998	30.6	41.5	16.8	20.9	8.5*	15.3*	7.5*	13.4*	11.6	18.8†
Central Asia											
	1991	12.6	10.5	30.7	29.6	13.1	30.4	29.9	7.9	10.4	19.5
	1997	5.0	3.7	33.2	31.7	28.4	45.0	12.9	15.2	7.5	8.9†

*Data are for 1997.
†Data are for 1996.
Sources: Bakhtior Islamov, "Central Asian States: On the Way from Autarkic Dependence to Regional and Global Interdependence," *Hitotsubashi Journal of Economics* 40 (1999): 81; and www.cisstat.com/eng.mac-08.htm.

Over the past decade, the former Soviet republics have tried various arrangements to sustain regional integration. Russia has made some attempts to secure its position as a gravity center for regional trade. Since 1991, when the CIS was formed, numerous declarations of intent have taken place, including an Interstate Bank to be set up to manage settlement in the ruble zone in 1992 and a charter of a common economic space to be adopted in 1993 in preparation for a customs union. In 1996, this union became effective between Russia, Belarus, Kazakhstan and Kyrgyzstan, with Tajikistan joining in 1998. Russia and Ukraine signed a treaty for economic cooperation for 1998–2000 in an effort to unify tax and tariff procedures. The evolving trade structure has been markedly bilateral, with the beginnings of subregional integration reflecting the differences among the countries in the pace of economic transition.

For the majority of the NIS, foreign trade and the ability to attract foreign investment are critical to the success of their economic transition. At the end of the 1990s, the majority of the NIS had accumulated external debt owing to current account deficits and the inability to attract sufficient inflow of capital. By the end of 1999, Transcaucasia and Central Asia had an external debt of $20.5 billion.[25]

Among the Central Asian states, the concerted effort to create new transportation and pipeline infrastructure could dramatically increase trade flows and reduce respective costs. Since 1992 all five Central Asian states plus Azerbaijan have joined Turkey, Afghanistan,

25. *World Economic Outlook* (Washington, D.C.: International Monetary Fund, 2000), p. 256.

and Pakistan as members of the Economic Cooperation Organization (ECO). In 1999 Uzbekistan formally joined Georgia, Ukraine, Azerbaijan, and Moldova (GUUAM) in an initiative to restore the route between Asia and Europe without Russia. This organization, mostly driven by geopolitical motives, has had a shaky experience caused by individual members' weak commitment (Uzbekistan, for example) and conflicts of national agendas concerning external economic relations.

The NIS choice of extraregional and interregional trade partners and their ability to maintain the solvency of their respective currencies are key to their economic and political independence. The transition of this group still remains in the preliminary stage.

Monetary Disunion

The collapse of interrepublican trade reduced production and led to supply-push inflation. Price liberalization also unleashed repressed demand-pull inflation. Additional inflationary pressure came from persistent subsidies to enterprises in efforts to avoid mass unemployment. Individual republics feared the impact of inflation and monetary crisis in Russia after it undertook resolute price decontrol at the beginning of 1992. The Kyrgyz Republic was the first among the CIS to introduce its individual currency, the som, without consulting other members. The other countries chose to abandon the ruble for domestic circulation. The IMF initially supported the idea of the *ruble zone* but shifted in 1993 to support for a *payments union* that did not materialize. The 15 NIS were to get credits from the IMF only if independent currencies were instituted. Therefore, all former republics have instituted national currencies. Some of these were initially in parallel use with the ruble, which continued to service interrepublican trade up to 1994 (table 11-8).

The ruble zone started breaking up in December 1991, when the ruble's circulation became paralleled by some republics' new currencies or money surrogates for internal circulation. The disintegration of the USSR prevented the Central Bank of Russia (CBR) from exercising control of monetary emission, leading to regionalization of money expansion.

Russia lacked the willingness and the ability to sustain the ruble financial zone, even though it was viewed politically as a unifying instrument. Until 1994 the CBR remained the main currency-issuing institution. The NIS could not issue rubles but extensively used ruble-denominated credits to fund their internal enterprises' soft budget constraints. The ruble continued to be the medium for bilateral trade accounts settlements. Introducing national currencies did not solve the problem of financing the republics' trade with Russia because of their previous trade deficits, massive deterioration of terms of trade caused by the shift to world prices, and their lack of convertible currency reserves for settling payments.

Credit expansion by national banks in surrogate rubles (locally known as *talonas, coupons,* etc.) sought to subsidize domestic producers and became a potential channel of imported inflation into Russia. Initiated in early 1992, Russia's price liberalization exceeded the pace of similar reforms in most other CIS countries. It resulted in differences

Table 11-8
Rates of Inflation and Currency Depreciation in the Republics

Republic	Implicit GDP Deflator to the U.S.$ (1992–1995)	Exchange Rate Depreciation to the U.S.$ (1992–1995)	
Latvia	42.0	Lat:	0.1
Estonia	45.4	Kroon:	1.2
Lithuania	63.3	Lit:	4.3
Kyrgyz Republic	95.2	Som:	14.0
Uzbekistan	211.6	Sum:	210.0
Moldova	103.1	Lei:	29.1
Russia	139.6	Rrub:	29.0
Tajikistan	202.3	Trub:	178.0
Azerbaijan	59.1	Manat:	336.0
Kazakhstan	168.6	Tenge:	291.0
Ukraine*	220.9	Karbovanetz:	1,126.8
Belarus	318.1	Rubel:	721.9
Armenia	171.5	Dram:	450.8
Turkmenistan	328.0	Manat:	1,724.4
Georgia	279.0	Lari:	7,385.4

*Ukraine used the karbovanets (Ukrainian for ruble) as money before the hryvnya (Ukrainian currency) was introduced in 1996.
Sources: A. Illarionov, "Financial Stabilization in the Republics of the FSU," *Voprosy Economiki* 2 (1996): 64–66; and World Development Report 2003 (Washington, D.C.: The World Bank, 2003), pp. 238–240.

between republics in price and wage levels, leading to arbitrage that further destabilized interrepublican relations. The periphery of the ruble zone realized that independent reforms required national authority over macroeconomic policy during the transition, and these former republics began to consider withdrawal from the zone. This process accelerated after the CBR's decision to raise the interest rate from 50 to 80 percent, causing angry protests by Ukraine, Belarus, and Kazakhstan.

Ukraine was one of the first republics to hasten currency "divorce." Russia responded favorably to this development, believing that ruble stabilization would arrest the increasing dollarization of domestic circulation and overall demonetization of its internal market operations. Ukraine was determined to introduce its currency, the hryvnya, in 1995. The two countries signed a protocol whereby rubles issued by the former republic to cover budget needs (subsidies and wage indexation) were to be credits with the CBR, with a favorable interest rate of 22 percent. However, President Leonid Kuchma engaged in slack fiscal policy, issuing a credit to the government to pay for the harvest, and showed an inconsistent attitude toward fighting inflation, declining to peg the hryvnya to foreign reserves via a **currency board** arrangement. Failure to commit to the stabilization policy and fiscal discipline in Ukraine caused the introduction of the hryvnya to be postponed. (See table 11-9 for inflation dynamics data.)

Box 11-2
Convoluted Paths of the Belarus Rubel

The monetary situation in Belarus turned very complex. Instituting a separate currency in May 1992 responded to the shortage of FSU ruble bank notes because of continuing subsidies to enterprises. It also served as a rationing device to prevent arbitrage of state-subsidized food products outside of the country. The currency notes had pictures of animals instead of people. A one-rubel note had a picture of a white hare (*zaichik* in Belorussian) that became the name of the Belorussian currency in general.

By May 1994, Belarus had exhausted its credit limits with Russia, causing the Belarus rubel to float. Belarus needed an extension of its bilateral monetary agreement with Russia that formally exchanged Russian and Belarus currencies at a 1:1 exchange rate, while the actual market rate was seven Belorussian rubel to one Russian ruble. Implementation of the April 1994 monetary unification agreement has been stalled because of Russia's unwillingness to finance slower budget reforms in Belarus.

In 1996 Yeltsin used the idea of the economic union with Belarus as a reelection political card that would cost Russia almost $470 million in written-off state credits owed by Belarus. Russia and Belarus reached an agreement on a single currency by the end of 1997, a major step toward full economic union. The treaty of April 2, 1997, was ratified unanimously in Russia and by a vote of 166 in favor to 3 against in Belarus. Currently, Russia and Belarus continue their commitment to an economic and monetary union even though they do not have the same enthusiasm about the transition to a market economy.

Table 11-9
GNP Decline of the Commonwealth of Independent States in 1992–1997 (1990 = 100)

	1992	1993	1994	1995	1996	1997	1991–1997
Armenia	47	41	43	46	49	50	324
Azerbaijan	78	60	49	44	44	46	279
Belarus	90	83	73	65	67	74	147
Estonia	78	72	71	74	77	80	148
Georgia	55	41	36	37	41	45	343
Kazakhstan	95	85	74	68	68	70	141
Kyrgyzstan	86	73	58	55	58	62	208
Latvia	65	54	56	56	57	61	252
Lithuania	80	67	59	61	64	67	202
Moldova	71	72	49	49	45	46	269
Russia	85	78	68	65	64	64	175
Tajikistan	71	63	43	43	31	32	310
Turkmenistan	95	85	64	64	62	47	179
Ukraine	90	77	52	52	47	45	228
Uzbekistan	89	87	82	82	84	86	89

Source: Jeromin Zettelmeyer, "The Uzbek Puzzle," IMF Staff Papers 46 (1999): 2.

In mid-1992 the chairmen of the central banks of most of the former republics negotiated an agreement on an Interbank Union. This agreement was supposed to provide equal representation, coordinated monetary policy, effective control over national credit expansion and intervention by national banks, and acceptable national currencies with concerted determination of their exchange rates relative to third-country currencies. This Interbank Union agreement was doomed from the start because equal representation did not reflect the different responsibilities of the countries. Russia proposed to set vote quotas depending on relative weights of the banks in the ruble zone, a proposal that assumed the other republics' recognition of the critical authority of Russia.

The former Soviet republics use various exchange rate regimes based on their economic agendas. The countries that are laggards in the economic transition have chosen multiple exchange rates and limited convertibility as a protectionist method to fight current account deficits and internal destabilization (Turkmenistan and Uzbekistan, for example). Countries more advanced in their transition have used currency boards to assist integration into world trade and to stabilize their economies externally (such as Estonia and Lithuania).[26] Export-oriented countries (Armenia and Georgia are recent examples) use managed floats and full convertibility for their current account transactions in an attempt to increase the competitiveness of their exportable goods.

The collapse of the ruble zone showed a widening gulf between the NIS drive for self-determination and their ability to pursue independent reforms. Their dependence on inter-republican trade cuts two ways. First, reliance on the continuing intraregional trade is an impediment to the transition to a genuine market economy with freely fluctuating prices. Second, a further reduction of intraregional trade without replacement by other export and import outlets risks a slump in production and increasing unemployment, thereby constituting a social deterrent to market reforms.

Pace of Economic Transition: Divergence or Convergence

The speed of the economic transition in the former Soviet republics is influenced by their initial economic and social conditions, persistent legacies of the Soviet economic system, and the nature of their respective leadership's determination to continue market reforms.

The economic slide that set in before the dissolution of the USSR was dramatically accelerated by the disintegration of the CMEA (see chapter 10). As a result, in 1992 the CMEA's GNP was 82 percent of its 1970 level.[27] The distribution of this decline shows divergences among the countries. Macroeconomic performance in the NIS, measured by GDP growth rates during the 1990s, divided them into two broad categories, recovering and lagging economies. The first group includes the Baltic republics and Armenia. These coun-

26. The currency board institutes an association of the domestic money supply with foreign currency reserves through a fixed exchange rate peg that enforces monetary discipline and the credibility of the currency. Latvia has had its currency pegged to SDR since 1995 (which has been maintained informally ever since). Estonia's peg to the German mark and later to the euro was remarkably successful in providing macroeconomic stabilization and controlling inflation, which qualified Estonia for accession to the EU. Lithuania's currency board peg to the U.S. dollar was not as successful because of the country's inability to promote radical reforms and increase export competitiveness.

27. Andrei Sizov, "Ekonomika Rossii i drugikh stran SNG v nachale 90h godov [The Economy of Russia and other CIS countries in numbers at the beginning of the 1990s]," *Mirovaia Ekonomika i Mezdunarodnyie Otnoshenya* 7 (1993): 21.

tries passed through a severe *transformational recession,* but shortly afterward they succeeded in returning to positive growth at accelerating rates. Their economic growth is mostly driven by foreign trade and increasingly by foreign direct investment (FDI). In Estonia, FDI accounted for 31 percent of the activity of the Estonian Privatization Agency between 1993 and 1998. In Latvia FDI was slower to take hold: It peaked in 1997 and showed a shift toward debt takeovers, as in the Gasprom (Russia) and Ruhrgas (Germany) acquisition of Latvia Gas. The position of Lithuania is more moderate, with selective access to privatization on behalf of foreigners.[28] The group of laggards (Belarus, Azerbaijan, Turkmenistan, Ukraine, Uzbekistan, and Tajikistan) experienced a very substantial decline since 1989 and failed to stabilize their economies by 1994–1995.[29] In some cases (Armenia, Georgia, Tajikistan, and Russia's involvement in Chechnya), regional tensions and armed conflicts strongly hampered progress in the transition.

There were distinctive variations within the recovering and lagging countries. Within the Baltic triangle, Estonia maintains a leading position, taking advantage of its traditional trade links with Finland, its small population, and its decisive privatization plans that were completed by 1998. Latvia and Lithuania have exhibited a slower recovery, especially after the banking crisis of 1995. Both countries were also affected by Russia's 1998 financial crash.

In Central Asia the decline of output continued into the late 1990s: In 2001 the volume indices of the GDP as percentage of 1991 were 88.3 in Kazakhstan, 76.1 in Kyrgyzstan, 45.0 in Tajikistan, and 98.8 in Uzbekistan.[30] Uzbekistan stands as an exception, with its fall in output having been relatively smaller throughout the 1991–1997 period: The average rate of decline of Uzbek production was 85 percent, whereas in the Baltic countries and Russia it was 60 percent.[31] This fact can be explained by Uzbekistan's initial low degree of industrialization and almost complete self-sufficiency in energy, as well as the country's natural endowment of land for cotton production and its large-scale cultivation, inherited from the Soviet system. Among the Slavic republics, Ukraine and Belarus lag behind, owing to a combination of energy dependence on imports by their heavily industrialized economies and increasingly because of political power struggles. Ukraine was highly integrated into the Soviet economy and failed to reorient its trade; therefore, it experienced deteriorating terms of trade after Russia switched to world prices for energy resources.

28. *Baltic States: A Regional Economic Assessment* (World Economy and International Relations [Paris: Organization for Economic Cooperation and Development, 2000]), pp. 131–132.

29. Martha de Melo and Alan Gelb, "A Comparative Analysis of Twenty-Eight Transition Economies in Europe and Asia," *Post-Soviet Geography and Economics* 5 (1996): 265–267.

30. 2002 cisstat.com.

31. Zeromin Zettelmeyer, "The Uzbek Puzzle," IMF Staff Papers 46 (1999): 2.

In 1996 its exports to the former Soviet republics were 57 percent, and imports constituted 65 percent of its trade total.[32] President Leonid Kuchma is said to be exploring the possibility of an economic union with Russia and Belarus.

Belarus is similarly dependent on Russia because of its industrialized profile and lack of energy resources. As in Ukraine, the eastern part of Belarus is populated with mostly ethnic Russians who strongly support economic union with Russia. President Alexander Lukashenka shows little tolerance for his political opponents and prefers the economic status quo of stagnation to the volatility of a speedy economic transition. His response to the economic crisis of 1995 was mostly a lip service proposal of "market socialism" and a "multistructural pluralist economy" with continued state administrative control.

The respective republics' different rates of declining production have changed their relative economic rankings within the CIS. In per capita GDP Russia has yielded leadership to Belarus, as shown in table 11-10. During the 1991–1997 period, Belarus's GDP fell cumulatively by 147 percent, compared to 175 percent in Russia and 228 percent in Ukraine. The better economic performance of Belarus is related to its slower reforms, the persistence of centralized allocation of energy resources, and preferential credit to priority sectors.

Various factors have affected the speed of the economic transition: The reform in Uzbekistan[33] was gradual by intent, rather than being resisted (as in Turkmenistan or Belarus) or disrupted by armed conflict (as in the Caucasus or Tajikistan). Political factors in many cases override economic priorities. Armenia provides a stark example of a political agenda interfering with a remarkable achievement in economic stabilization that reduced inflation from 5,000 percent in the mid-1990s to the single digits and returned the economy to positive performance, with growth of 7.8 percent in 1998.[34] However, the impasse between Armenia and Azerbaijan over Nagorno-Karabakh, which seemed to be close to resolution in early 2001 during the talks mediated by the United States in Florida, continued.

During the initial stages of the economic transition, the uneven pace of reform in the NIS aggravated social and national tensions by producing definite winners and losers, which contributed to growing disunity and a radical redirection of external economic ties outside of the former Soviet economic space. However, in the late 1990s new reintegrative trends

32. Saul Estrin and Adam Rosevear, "Enterprise Performance and Corporate Governance in Ukraine," *Journal of Comparative Economics* 27 (1999): 445.

33. The new alliance in the antiterrorist effort with the United States might produce a reentrenchment of the current leadership and a consolidation of its political authority that might be in conflict with economic democratization.

34. David L. Bartlett, "Stabilization Policy in Post-Soviet Armenia," *Post-Soviet Geography and Economics* 41 (2000): 30–32.

Table 11-10
GDP in New Independent Countries: Total in 2000 US$ Billions (Purchasing Power Parity) and per Capita

Republic	PPP GNP	GNP per Capita	HDI Rank
Armenia	9.7	2,559	76
Azerbaijan	23.6	2,936	88
Belarus	75.5	7,554	56
Estonia	13.8	10,066	42
Georgia	13.4	2,664	81
Kazakhstan	87.3	5,871	79
Kyrgyzstan	13.3	2,711	102
Latvia	16.7	7,045	53
Lithuania	26.3	7,106	49
Moldova	9	2,109	105
Russia	1,219.4	8,377	60
Tajikistan	7.1	1,152	112
Turkmenistan	20.6	3,956	87
Ukraine	188.9	3,816	80
Uzbekistan	60.4	2,441	95

Source: Calculated from "World Development Report 2003" (Washington, D.C.: The World Bank, 2003), pp. 190–192.

appeared, generated by the realization of the exorbitant costs of independence and the slow development of new transportation infrastructure.

Overall, the former Soviet republics' progress in the transition can be summarized by the achieved level of economic liberalization. The indicators provided below show several subgroups of economies in transition based on their cumulative liberalization indicators. The Baltic countries are the first distinctive group, with higher scores for privatization and subsequent restructuring of the privatized enterprises (an average score of 2.9 for restructuring compared to the average of 2.0 for the CIS). The two-pronged strategy of (1) macroeconomic stabilization and (2) resolute enterprise restructuring proved to be more successful in this region because of the size of the respective economies and their reconnecting to the traditional trade ties forged 600 years earlier in the era of the Hansa League. The Baltic countries also had the highest rank in external trade liberalization and efficient ERMs (4.2 on average compared to 3.1 for the CIS.) The laggards in economic liberalization are Belarus, Azerbaijan, Turkmenistan, Ukraine, Uzbekistan, and Tajikistan. These countries have very diverse economic and structural profiles, but they share ambivalence toward privatization and financial reforms. This group is not sure how more conservative or more liberal economic models will affect their national cultural identities. (See tables 11-11 and 11-12 and figure 11-1 for details by country.)

Readiness for market reforms differed tremendously across the FSU. Industrial republics with higher exposure to foreign economic relations were the first to reform and faster to embark on the path of transition. However, the nature of the agricultural sector, its extent, entrenched institutions, and the economic culture may be in conflict with speedy reforms

Table 11-11
Transition Indicators (1999)

Republic	Privatization* Large Scale	Privatization* Small Scale	Price Decontrol	Financial Reforms	Cumulative Liberalization Index (1997)
Estonia	4.0	4.3	3.0	3.7	5.72
Latvia	3.0	4.0	3.0	3.0	5.00
Lithuania	3.0	4.3	3.0	3.0	5.39
Armenia	3.0	3.3	3.0	2.3	3.37
Azerbaijan	1.7	3.0	3.0	2.0	2.64
Belarus	1.0	2.0	1.7	1.0	2.54
Georgia	3.3	4.0	3.0	2.3	3.26
Kazakhstan	3.0	4.0	3.0	2.3	4.35
Kyrgyzstan	3.0	4.0	3.0	2.3	3.39
Moldova	3.0	3.3	3.0	2.3	3.80
Russia	3.3	4.0	2.7	1.7	4.32
Tajikistan	2.3	3.0	3.0	1.0	2.21
Turkmenistan	1.7	2.0	2.0	1.0	1.53
Ukraine	2.3	3.3	3.0	2.0	2.55
Uzbekistan	2.7	3.0	2.0	1.7	2.83

*The indicators in this table range from 1 to 4+, where 4+ indicates approaching the level of an average prevailing in the advanced economies.
Sources: European Bank for Reconstruction and Development, Transition Report 1999 (London: European Bank for Reconstruction and Development, 1999); and Martha de Melo, Cedvet Denizer, and Alan Gelb, "Patterns of Transition from Plan to Market," *The World Bank Economic Review* 10 (Washington, D.C.: World Bank, 1996) and the authors' more recent updates.

Table 11-12
Share of Agriculture in Overall Employment and GDP in the Former Soviet Republics

Republic	Employment in Agriculture (%)	Value Added in Agriculture as % of GDP in 2001
Azerbaijan	34.8 (1994)	20
Armenia	33.9 (1994)	26
Belarus	19.5 (1994)	16
Estonia		6
Georgia	25.6 (1990)	21
Kazakhstan	21.6 (1994)	9
Kyrgyzstan	42.0 (1994)	38
Latvia	20.0 (1992)	5
Lithuania	23.4 (1994)	8
Moldova	33.0 (1990)	28
Russia	15.6 (1995)	7
Tajikistan	51.4 (1993)	19
Turkmenistan	43.9 (1994)	27
Ukraine	21.0 (1994)	15
Uzbekistan	44.3 (1994)	36

Sources: "Russia and the Countries of the World," *Goskomstat* (1996): 34–36, 70–77; and "World Development Report 2003" (Washington, D.C.: The World Bank, 2003), pp. 238–239.

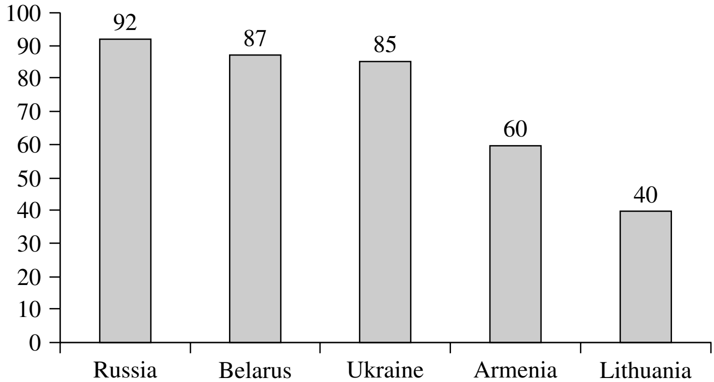

Figure 11-1
Decline in agricultural production in selected countries, 1992–1993.
Sources: "Reformirovanije ekonomiki stran SNG: Belarus (Reforms of the CIS countries economies: Belarus)." *Rossiisky ekonomichesky zhurnal* 4 (1993): 31; and Andrei Sizov. "Ekonomika Rossiji i drugikh stran SNG v nachale 1990h godov (The Economy of Russia and other CIS countries at the beginning of the 1990s)." *Mirovaia Economika i Mezdunarodnye Otnoshenija* 7 (1993): 22.

in the more industrialized NIS. The share of agriculture in domestic employment and overall GDP in the former Soviet republics is generally far above the average for the developed market economies. Therefore, the progress of agrarian change is very important. For republics with major rural populations, market reforms were dominated by the importance of agrarian reforms (the Kyrgyz Republic being an exception to this generalization).[35]

Historically, the Soviet economic system was in constant conflict with agriculture, the sector least suited for command administration because of the diversity of climate and natural endowments of various regions and regionally established economic traditions. The centrally planned economy succeeded in industrialization but mostly failed in agriculture. Having evolved from the forced collectivization of the Stalinist model to a moderately reformed one in the 1960s and 1970s, agriculture has not performed satisfactorily relative to its potential (see chapter 10).

In the 1950s, state-owned machine tractor stations were liquidated and the collective farms received their equipment. The reforms of 1960s granted wage guarantees to peasants and in the 1970s closed the wage gap between industrial and agricultural workers. In those

35. Hasty attempts at decollectivization in Russia have led to uninterest in marketing agricultural products. In addition, a new "scissors crisis," with agricultural prices held at artificially low levels and manufactured goods and agricultural equipment prices decontrolled, has produced devastating reductions in production and withdrawals from market operations. Humanitarian food aid from the West in major cities (Moscow, St. Petersburg, Ekaterinburg) has undercut agricultural producers in adjacent rural areas who had higher costs and could not compete with free products from the West.

same years, agriculture enjoyed increased investment and government subsidies. A number of regions and republics were granted relatively autonomous decision making. This regionalization of management allowed the Baltic republics, Georgia, and Armenia to reshape their agricultural practices to reflect more closely those of traditional family farms. But with persistent planned output levels and controlled prices, these reforms did not lead to improved overall productivity, and they contributed to suppressed inflation and regional corruption. In the infamous cotton scandal in Uzbekistan, local authorities took advantage of government investment by reporting fraudulent numbers about dramatically increased productivity in areas that never saw a plough.[36]

With land remaining state property and in the absence of market-determined differential rents, the Soviet Union suffered from land misallocation and immense waste of land resources, causing environmental damage.[37] A 50 percent increase in Kazakhstan's cultivated land area during Khrushchev's Virgin Lands campaign was achieved at the cost of creating dust bowls in the more marginal areas of Kazakhstan and western Siberia.[38] Poorly executed irrigation led to secondary salination. Although yields of specific crops were not bad compared to European averages, Soviet agriculture was extremely cost and investment inefficient. In terms of grain yields, Estonia, Lithuania, Belarus, Ukraine, Moldova, and Kazakhstan ranked behind such countries as Bulgaria and Hungary. Moreover, the policy of stable food prices in tandem with increasing wages produced food lines and burdened the state budget.

Agricultural prices were fixed in relation to the costs of production that in theory enabled the farms to cover their expenses but in practice suppressed specialization. Breeding livestock was less well rewarded than raising crops and was therefore discouraged as a comparative advantage specialization. Similar failures in specialization were produced by regional price zones, where the priority zone's prices were raised to cover higher costs, which discouraged a more efficient pattern of spatial specialization.

The agricultural sector could have been a source of radical economic reform if the changes of the 1960s had been complemented by reform of land ownership and freeing of prices. Instead, Soviet agriculture did not undergo radical reforms. During the 1980s, adjustments in financial and price policies increased the irrationalities in prices and softened the budget constraint.[39]

36. The fraud was unveiled under Brezhnev's successor, Yuri Andropov, with the aid of space satellites.

37. A comprehensive program of marsh drainage in Belarus has caused underground waters to rise and flood very fertile lands.

38. The virgin lands campaign was an example of an ill-conceived initiative to increase productivity by extensive expansion of arable land, including marginal areas of the Kazakh steppe.

39. Edward C. Cook, "Agriculture's Role in the Economic Crisis" in Ellman and Kontorovich, *The Disintegration of the Soviet Economic System,* pp. 228–243.

Other factors contributed to lack of interest in decollectivization. First, the reforms of the 1960s and 1970s reversed the urban-rural distribution of income, producing a higher noncash living standard on successful collective farms. In this regard, Belarus was a notable example. The symbiosis of individual plots with collective farm equipment provided a favorable subsidized environment for additional income as well as guaranteed wages. This development also produced a new professional farm worker with a taste for urban amenities in the countryside.[40] This result undermined the naive belief of urban intellectuals that the source of the national communal tradition was the conventional peasant. On the other hand, less successful collective farms and less fortunate peasants produced a depressing picture of primitive subsistence agriculture that led to overexploitation of land and labor.[41] The coexistence of entrepreneurial peasants and risk-averse collective farmers produced social tensions and divisions with respect to reforms.

Second, the survival and revival of religious communes (Baptist, Mennonite, Pentecostal), combined with a strong work ethic and environment-friendly agrarian practices, kept the communal tradition alive.[42] However, this situation varied in different republics, depending on their individual experience with collectivization, their degree of urbanization, and their agrarian culture.

Third, agrarian reform was restarted under unfavorable political and economic conditions. In Russia the collapse of administrative control and the resulting institutional chaos coincided with hyperinflation and price-escalating disparities. In 1991 agricultural output price index was 160 compared to input ones at 193 (1990 = 100), whereas in 1996 respective price scissors (the gulf between the purchasing power of agricultural goods and their industrial inputs) were 174,094 and 793,327.[43] As a result, peasants stopped buying machinery, fertilizers, and pesticides.[44] The subsequent reduction in agricultural production created a tense economic and social situation. The 1998 financial crash in Russia caused the Russian ruble to be devalued. In the next three years, this aided the **import substitution** effect in agriculture; however, the remaining hurdles in land ownership continued to obstruct further development of this trend.

40. Robert McIntyre, "Collective Agriculture in Eastern Europe and the Former Soviet Union," *Monthly Review* 45 (December 1993): 2–4.

41. See Lev Timofeev, *Tekhnologiya chernogo rynka ili krestyanskoye iskustvo golodat (Technology of Black Markets or Peasants' Art of Starvation)* (Vilnius: VIMO, 1993), pp. 41–44.

42. E. Rashkovsky, "Opyit totalitarnoi modernizatsyi Rossyi (1917–1991) v svete sotsiologyii razvitiya [The experience of totalitarian modernization in Russia (1917–1991) in the light of development sociology]," *Mirovaja ekonomika i mezdunarodnyii otnoshenya* 3 Nauka (1993): 112.

43. *Review of Agricultural Policies: Russian Federation* (Paris: Organization for Economic Cooperation and Development, 1998), p.

44. Alexander Nikonov, "Agricultural Transition in Russia and the Other Former States of the U.S.S.R.," *American Journal of Agricultural Economics* 74 (1992): 1159.

The Progress of Agrarian Reforms in the Individual States

The course of agrarian reform in the NIS followed divergent patterns but was marked by several commonalities. Although all of the NIS committed to introducing market elements into agriculture, the market environment in agriculture is weak relative to the industrial sector. The successor states have sought to reduce their dependence on agricultural products from the former republics, diversify their production, and secure alternative sources of food imports. This has resulted in an increase in grain cultivation in Central Asia, Georgia, and Armenia. The president of Turkmenistan resolved to make his state self-sufficient in grain production. At the same time, the overall cultivated areas of most NIS declined to minimize areas of high-cost production and provided for the shift into the marginal areas of Russia, Ukraine, Kazakhstan, Latvia, Georgia, and Tajikistan.

The majority of the NIS are aware that the long-term solution to increasing efficiency in agriculture lies in encouraging private ownership. This path to land reform has proceeded furthest in the Baltic countries, Armenia, and some Russian regions. Russia's 1990 Law on Land Reform abolished the state monopoly on land ownership, providing for subsequent land repartitioning and lifetime leases. However, the overseeing of repartitioning was delegated to local authorities, conditioned on secession of families from collective or state farms. The conditions also included limits to the size of plots and a land sale moratorium for the first 10 years. Even though the Russian government later decreed the right to sell land, local authorities continued to resist the peasants' use of this nominal right.[45] By the beginning of 1997 there were about 786,000 private farms across the CIS, renting or owning 35 million hectares of land. However, their contribution to overall agricultural production remained low: In 1998, across 12 countries, it ranged from 1.5 to 10 percent of total agricultural production.[46]

In 1992, 24,000 Russian collective and state farms (93 percent of all farms) were reregistered, of which 8,100 farm collectives decided to maintain their previous status and 11,300 farms became corporations or partnerships. The initial stage of agrarian reforms thus produced denationalization without decollectivization.

By November 1, 1993, 268,000 individual family startups comprising a total area of 11.2 million hectares (42 hectares per farm on average) were formed, a jump from 191,000 in 1991. However, this process slowed visibly, and over 9,000 farms ceased to operate by the end of the year.[47] This development reflected increasing interest by urban dwellers in

45. Don Van Atta, "Agrarian Reform in Post-Soviet Russia," *Post-Soviet Affairs* 10 (1994): 172.

46. Heenan, Patrick, and Monique Lamontagne. *The CIS Handbook: Prospects into the 21st Century* (London: Fitzroy Dearborn, 1999), p. 31. For coverage of agricultural reforms in the Baltic states, Russia, Ukraine, Belarus, and some Central European states, see Stephan Goetz, Tanja Jaksch, and Rosemarie Siebert, eds., *Agricultural Transformation and Land Use in Central and Eastern Europe* (Burlington, Vt.: Ashgate, 2001).

47. *Ekonomika i zizn* 49 (1993): 24.

getting land—urban flight—that accounted for three-quarters of new subsidiary farming.[48] Their output between 1990 and 1998 increased 18 percent compared to the drop in socialized farm production of 41 percent over the same period.[49] Russia has instituted the Land Fund to allot land to new agrarian units, drawn from nonutilized but arable land of collective and state farms, about 10 percent of their total acreage. Individual subsidiary farm holdings for orchards, vegetable gardens, and animal production were set up on these lands.

Opinion about Russian agriculture reflected pluralistic views at earlier stages of reform. A survey of farmers' attitudes toward private enterprise showed that only 12 percent of peasants wanted to be private farmers, 63 percent did not, and the other were undecided.[50] The comments mentioned the higher risk of private entrepreneurs compared to wage employees, a lack of markets for credit and insurance, and the unavailability of machine rentals.

Private ownership of land is now legally recognized in all FSU states except for Kazakhstan, Uzbekistan, the Kyrgyz Republic, Tajikistan, and Turkmenistan. The latter countries have had little experience with private ownership of land because of their nomadic economic heritage and the late arrival of extended families. In the Kyrgyz Republic, President Asker Akaev has been pushing for private ownership since 1995, but he has encountered resistance from traditionalists who believe that land can be privately used but should be publicly owned. Resistance was reinforced by the fear that private ownership of land would lead to economic invasion by the Russians and the Uzbeks.

Agrarian reforms in Central Asia are conditioned by the availability of arable (irrigated) lands.[51] Uzbekistan, the most advanced in irrigation, is expanding individual peasants' subsidiary plots for vegetable gardening while maintaining large collective farms for cotton and cereal production. Unprofitable state farms were reorganized into cooperatives and leased enterprises. In Kazakhstan, individual farm holdings began to pick up, but specialized and breeding units are still owned by the state. In Uzbekistan, with more arable land, agrarian reforms date back to the late 1970s, when a Chinese-like system of private user rights coexisted with formal state ownership. A dual price system allowed market-determined prices for over-the-quota output to operate with planned prices. Contrary to the stimulating impact of this system in China, the experiment in Uzbekistan resulted in declining output. Since 1992 the decline in agricultural production, though smaller than that of other NIS, has continued because of the parallel operation of independent farms

48. After the late 1980s, Gorbachev placed major emphasis on agriculture, introducing land statutes that permitted urban dwellers to acquire land and housing in rural areas. Previously this was not permitted, and nonviable farms were left to die out.

49. Gregory Ioffe and Tatyana Nefedova, "Areas of Crisis in Russian Agriculture: A Geographic Perspective," *Post-Soviet Geography and Economics* 4 (2000): 289.

50. Nikonov, "Agricultural Transition," p. 1160.

51. The diversion of river water for irrigation of the Ferghana Valley in Uzbekistan caused the disaster of the Aral Sea, which is disappearing, risking the extinction of its natural habitat.

(*dekhkan*) and still collectivized ones, as during the two previous decades. In 1995 collective farms still accounted for 46.6 percent of cultivated area, with leased and independent *dekhkan* farms making up 12 percent.[52] The main inhibitors of agrarian restructuring remain a heavy hand from above and a persistent grip of the power elite on economic resources that impedes Uzbekistan's overall progress in economic transition.

The Baltic countries had an extensive history of peasant holdings between 1870 and 1940. Agricultural reform in this region encompassed small family farms, large-scale shareholding companies, and partnerships. The pace of reforms varied among the Baltic states. Before being annexed by the Soviet Union, Lithuania was mostly an agrarian economy where industry and construction accounted for only about 10 percent of employment. During the Soviet period a dual economy sprang up, with agriculture remaining important and labor-intensive industrialization becoming vital. Soviet efforts at collectivization met fierce resistance in Lithuania; it eagerly welcomed the opportunity to decollectivize in the early years of national independence. Formal dissolution of all collective and state farms in 1991 led to spontaneous and chaotic redivision and privatization of land, with a high incidence of graft concerning formerly state-owned machinery and equipment. Numerous claimants for land decreased the size of individual allotments, making them frequently economically unviable; average plot size in 1993 was 8.8 hectares.[53]

Legislative acts established land tradability in all of the Baltic countries by 1994. Land privatization proceeded by voucher through restitution to former owners. *Agricultural privatization* in Latvia and Estonia developed more slowly, new private farms coexisting with collective farms reorganized into agrarian cooperatives. By 1998, 28 percent of Estonia's land was privatized compared to 55 percent in Lithuania; privatization was completed in Latvia in 1999.[54] Estonia's newly organized farms are large, but medium-sized and small farms are the norm in Latvia and Lithuania. Land markets are firmly established in all three countries, but demand for land is fairly low because of food market setbacks in the late 1990s and diminishing imports by the NIS, which account for about 58 percent of the Baltic countries' agricultural exports. Development of the land market is contingent on the expansion of government subsidies and support, especially because of the likely accession to the EU.

After the Baltic countries, Armenia's farm privatization was the most advanced; the reversal of collectivization took the sharpest turn there. Armenia is encouraging small parcel farming, which has gained very strong momentum. In Georgia both private and state possession of land are legally recognized, and sale and purchase of land are permitted. However,

52. R. Pomfret, "Agrarian Reform in Uzbekistan: Why Has the Chinese Model Failed to Deliver?" Working Paper 98–16 (University of Adelaide, Department of Economics, October 1998), p. 5.

53. S. Girnius, "Ekonomika gosudarstv Baltii v 1993 godu [Economies of the Baltic countries in 1993]," *Voprosy ekonomiki* 8 (1994): 112.

54. OECD, "*Baltic States,*" p. 31.

privatization of land proceeded slowly, with only 25 percent of the total agricultural land privatized by mid-1997. Almost 1 million hectares out of 2.9 million hectares of agricultural land in the mountainous areas are seriously compromised by erosion, diminishing the demand for these areas.[55]

While the principle of private land ownership is formally established by law in most of the NIS, its implementation remains a matter of heated debate. Belarus's June 1993 land code act allowed privately owned and operated household plots, but land for commercial agricultural production was reserved for the state-owned farms or available for limited leases. Belarus, where an overall economic strategy is mostly absent, exhibits a reserved approach to agricultural reforms, and the republic's authorities are focused on stabilization and reintegrative trade relations with the CIS. The rights of private land owners are still circumscribed in the areas of transfer, land use, and size of the holdings. In Belarus, private land holdings are limited to 1 hectare, whereas in Russia, Ukraine, and Moldova, the limits are 50–100 hectares, compared to 50 hectares in Lithuania and 300 hectares in Hungary. These restrictions are intended to encourage producer associations and prevent absentee ownership.

Fearful of following the example of Russia's ill-conceived reforms, Ukraine's nationalist agenda and legislation on land reform and independent family farming allowed private ownership, subject to restrictions on size, resale, and employment of hired labor. In 1992 about 5,000 private farms occupied about 1 percent of the agricultural land, with household plots of collective and state farmers and garden plots assigned to city workers taking up an additional 9 percent of the private farms' area. Private plots employed over 90,000, compared with 4.6 million employed on state and collective farms.[56] Private farmers operate in an overbureaucratized environment, working for three years under draconian taxation before they get title to the land. Duties (starting from 80 percent of the purchase price and reduced proportionately every year) were imposed on land sold during the first six years of ownership. The sale of land was permitted at the end of 1992 but was restricted to small farm enterprises. Hired seasonal labor was forbidden, and private farmland allotments were limited to 10 percent of arable land.[57] President Kuchma's address to the Rada (the Ukrainian parliament) emphasized radicalization of agrarian reforms but conceded to the deputies (who banned land privatization) that the policy would support all forms of ownership—state, collective, and private. By the end of 1994, the four-month land privatization moratorium was lifted, opening a window of opportunity for family farms that

55. Emir Djugeli and David Chantladze, "Georgia on Its Way to the Market-Oriented Economy," *Russian and East European Finance and Trade* 35 (1999): 67.

56. "Ukraine," *International Monetary Fund Survey* 10 (Washington, D.C.: International Monetary Fund, 1993), pp. 58–59.

57. *Finvest* 21 (1992): 2.

produced about 4,000 new ones in only six months.[58] In 1995 Ukraine declared its determination to radicalize agrarian reforms and to promote privatization; however, these policies remain only partially implemented.

A paradoxical picture emerges from the republics' different approaches and policies in agriculture: The states that achieved the most decollectivization have experienced the strongest shock in reduced agricultural production, as seen in figure 11-1 based on the initial stages of transition.

Agrarian reforms in the NIS range from resolute enforcement of private property rights to gradual and selective implementation of a property rights mix, depending on the quantity and quality of land and domestic policies. The persistence of Soviet-era economic institutions in agriculture impedes market specialization and increases import dependence on foreign-produced food. The rural areas demonstrate some bias toward government special treatment of agriculture, the continuation of subsidies, and support of economic reforms from above. Successful agrarian reforms are contingent on the success of overall market reforms and the implementation of consistent property laws. However, at present, with a few exceptions, the situation in agriculture has slowed the transition to a market economy.

The Verdict on Privatization

The transition from command socialism established privatization as a cornerstone of successful economic reform. However, implementing privatization has proven to be highly complex, raising fundamental questions about the desirable economic system model. Before the collapse of the USSR, state-led economic reforms tried to introduce market incentives to complement economic planning at different stages of the Soviet economy. The failure of partial market socialism reforms pointed to the need for speedy and unconditional privatization. The state would become the legal guardian of individual, cooperative, and corporate forms of property.

The transition to a postsocialist economy can be implemented in different ways. The genetic philosophy[59] takes into account the persistence of the institutional legacies of the socialist economy and their hysteretic effects.[60] The genetic-inspired transition strategy shows a preference for gradualism and allowing time for the new institutions to develop.

The normative philosophy is the opposite of the genetic one. It defines the desirable outcome of an economic transition and embarks on concrete steps to achieve it. Rooted in

58. Ihor Stebelsky, "The Promise Unfulfilled: Ukrainian Agriculture in Kuchma's First Year," *Ukrainian Economic Review* 3 (1996): 132.

59. See the discussion of geneticists versus teleologists in chapter 9.

60. A hysteresis effect is an institutional memory of preexisting economic practices underlying resistance to change.

market fundamentalism, this philosophy sometimes leaves very little room for considering individual cultural, ethnic, and economic environments. The transition process in the NIS initially favored the normative approach to privatization, which increasingly became a hot political and social issue. Privatization was charged with multiple tasks ranging from (1) producing incentives for greater efficiency of production to (2) technological progress and (3) satisfying the demand for economic equity in the distribution of previously state-owned assets and sustaining social welfare standards. The agreement on the fundamental need to introduce private property was combined with divergent views regarding how to implement it. The progress of macroeconomic stabilization and price liberalization in relation to the speed of privatization produced heated debates. Privatization for launching a market economy has not delivered equal results in all cases.

Eight FSU states signed the October 1991 agreement committing themselves to privatization and market reforms. Enjoying the limited economic autonomy granted the Baltic republics in November 1989, Estonia pioneered partial price liberalization in 1989 and introduced private enterprise legislation in 1990. The pace of private property recognition in Latvia and Lithuania was more consonant with Russia's reforms that took off with price liberalization at the beginning of 1992.[61] In Ukraine, where price liberalization was introduced simultaneously with Russia, privatization was initially sabotaged by the *nomenklatura,* which feared foreign takeover.

The progress of the economic transition in Russia, Ukraine, Belarus, and Moldova is directly correlated with the implementation of privatization. Russia embarked on ambitious shock therapy to break the vicious circle of piecemeal reforms and to resolve a financial crisis. Mass privatization through the use of vouchers was devised for these purposes.

A decade of economic transition suggests that privatization does not yield equal results in all cases for the Comecon as well as among the NIS. A massive transfer of property rights from the state to private owners (destatization in the former Soviet republics) produced a large number of dysfunctional private enterprises still operating under soft budget constraints and resisting restructuring and financial discipline. Table 11-13 demonstrates a positive correlation between the degree of enterprise restructuring and the overall index of government effectiveness and the rule of law, which is quite pronounced in the Baltic countries. With varying degrees of large- and small-scale privatization, the NIS almost uniformly exhibit an insufficient degree of enterprise restructuring. The inability of the respective governments to impose fiscal discipline and discontinue soft budget constraints reduces their resources for sustaining social safety nets, throwing large groups of people into poverty. In many cases, privatization has promoted vested interests and the pursuit of

61. Roman Frydman, Andrzej Rapaczynski, and John S. Earle. *The Privatization Process in Russia, Ukraine and the Baltic States (*Budapest: Central European University Press, 1993), pp. 5, 132, 196, 235.

Table 11-13
Privatization and Enterprise Restructuring in the New Independent States

Country	Enterprise Restructuring	Government Effectiveness	Rule of Law
Estonia	3.0	2.6	5.1
Latvia	2.7	0.7	1.5
Lithuania	2.7	1.3	1.8
Armenia	2.0	−6.5	−1.5
Azerbaijan	2.0	−8.3	−5.6
Belarus	1.0	−6.6	−8.6
Georgia	2.0	−5.1	−4.9
Kazakhstan	2.0	−8.2	−5.9
Kyrgyzstan	2.0	−5.8	−4.7
Moldova	2.0	−4.6	−0.2
Russia	1.7	−5.9	−7.2
Tajikistan	1.7	−14.2	−13.3
Turkmenistan	1.7	−12.5	−9.7
Ukraine	2.0	−8.9	−7.1
Uzbekistan	2.0	−13.0	−8.7

The maximum index for enterprise restructuring is 4; the average of this index for countries that are on the accession track is above 3. The index for government effectiveness and rule of law ranges from −25 to +25, with the average for advanced countries at +12.6.
Source: World Economic Outlook (Washington, D.C.: International Monetary Fund, October 2000), pp. 134, 136.

economic rent. This effectively led to oligarchic or clan abuse of economic power, as in Russia, Uzbekistan, and Ukraine. In these nations, several proposals have been made for potential renationalization to prevent oligarchic abuse and corruption and to maintain safety nets.

The Baltic countries have achieved the most visible success in their privatization, with Estonia showing the most substantial progress in economic restructuring, followed by Latvia. Lithuania is somewhat lagging behind them. During the early stages of privatization, ownership priority was given to insiders and small-scale enterprises, except in Estonia, which turned against **employee ownership** as early as in 1992. Independence privatization peaked in 1994 in Estonia and in 1997 in Latvia, and was nearly complete by the end of 1998 in both countries. After its peak in 1992, Lithuanian privatization followed the speedy Czech voucher scheme (mass sale of state-owned assets using privatization checks distributed among the public) but later took a slower and more selective turn. Foreign capital played a crucial role in privatization in the Baltic countries, with Estonia accepting foreign ownership as a payment for its current balance deficit. This has accounted for 12 percent of Estonia's foreign direct investment; the respective numbers for Latvia and Lithuania were 10 and 18 percent in 1998.[62]

62. OECD, *Baltic States,* p. 130.

At the opposite end of the spectrum, the countries of Central Asia have demonstrated much slower progress in privatization. Kyrgyzstan was the fastest in privatizing housing and using a voucher scheme for large enterprises. Other Central Asian republics showed little movement on large enterprise privatization, with Kazakhstan being a notable exception. FDI is largely limited to oil and gas, and a few joint ventures were set up in Uzbekistan. The lack of an economic entrepreneurial tradition, and the concentration in agriculture and processing industries, dictate the need to accelerate privatization in the rural areas, which have not progressed to a sufficient degree for the reasons discussed in the preceding section.

In Ukraine, where price liberalization was introduced simultaneously with Russia, privatization was initially torpedoed by the Rada and the *nomenklatura,* which feared foreign (Russian?) takeovers and favored worker-management buyouts, particularly for enterprises desired by clans. With 83 percent of the labor force employed by the state, *large-scale privatization* stalled. Small-scale privatization occurred mostly locally and predominantly in the western part of Ukraine; however, its extent was nowhere near that of the other republics. At the end of 1998, 55 percent of SOEs operated at a loss, produced noncompetitive goods, and relied on barter and arrears to finance their operations, as did similar ones in Russia.[63]

The progress of the economic transition in Russia, Ukraine, Belarus, and Moldova was directly correlated with the implementation of privatization. Russia, as noted earlier, used shock therapy to end piecemeal reforms, make the economic transition irreversible, resolve budget crises, and avoid political turmoil. Mass privatization involved the use of vouchers. In Ukraine privatization met resistance from labor and industrial and collective farm managers reinforced by the fear of Russian takeover. In Belarus, the Communists did not yield to the nationalists after the August 1991 coup and remained in most positions of power. Privatization in Belarus was resisted by the Communists and by President Lukashenka's strong, obstructive dictatorial position, which is often likened to the sultanism of Central Asia.[64] Moldova has made major strides toward privatization since 1995, with the World Bank providing economic support.[65] However, the newly privatized enterprises are strongly dependent on Russian energy, which led them to consent to increasing Russian ownership of their stock as payment for energy, an option that has also been used in Ukraine since 1999.

Privatization in Russia clearly broke with a long history of treating private economic activity as a crime and public resentment of entrepreneurs. The implementation of Russian

63. King Banaian, *The Ukrainian Economy since Independence* (Cheltenham, U.K.: Edward Elgar, 1999), p. 168.

64. According to sultanism views, the patrimonial role of the state is closely linked to the leader, who has unchecked discretion over politics and economics. Private and public domains are fused, and cronyism flourishes. S. Eke and T. Kuzio, "Sultanism in Eastern Europe: The Socio-Political Roots of Authoritarian Populism in Belarus," *Europe-Asia Studies* 3 (2000): 531–532.

65. The recent change of leadership in Moldova in favor of the Communists and a pro-Russian group might render questionable the further progress of privatization.

privatization (fully discussed in chapter 10) still has not resulted in the creation of financially solvent and productively efficient enterprises. Privatization in 89 different regions (before they were consolidated into 7 by President Putin) reflected substantial economic and political variation, depending on the resource base, the size of enterprises, association with the defense sector, and the reform agendas of local ruling elites. Resource-rich and profit-promising enterprises appeared to be primary targets for oligarchic takeovers and rent-seeking behaviors. Small-scale private enterprises, if profitable, became the prey of the shadow economy and the mafia. Insufficient enforcement of antimonopoly laws and property rights hindered the development of genuine entrepreneurship. Fiscal arbitrariness forced legitimate private businesses into the shadow economy.

The assessment of Russian privatization remains controversial. Regionalization and decentralization of management and control as a result of privatization contributed to political decentralization and disintegration and to the collapse of *fiscal federalism,* all of which contributed to macroeconomic destabilization. President Putin's government sought to offset these recent trends by reaggregating the economy administratively into seven megaregions and by passing a law on nonagricultural land ownership.

Privatization in the NIS has varied in its scale and effectiveness in creating a functional market economy. In many cases it has been incomplete and inconsistent, and has been taken advantage of by political and economic interest groups. Privatization created numerous opportunities for rent creation and rent seeking, including granting property rights to a monopolist, delaying privatization and setting up an environment for price arbitrage, maintaining **asymmetric information** during the process of privatization, and merging with local political elites. Its implementation was conditioned by the prevalent economic cultures and the persistence of soft budget constraints. The inadequacy of the legal enforcement of property rights caused expansion of the shadow economy.

SUMMARY AND CONCLUSIONS

The economic transition of the former Soviet republics took many divergent paths and led to varying degrees of success. Reforms were initiated in response to increasing internationalization of market economies that demonstrated the ability to operate efficiently in ever-changing economic and technological environments. The attempt to integrate with the world economy questioned the systemic compatibility and economic competitiveness of socialism. Reforms were undertaken to make socialism work in the open economic environment, but it became increasingly clear that the centrally planned economy would not yield to market forces. Systemic transformation became imperative.

In the NIS, systemic economic transformation was complicated by the political disintegration of the varied regions and cultures. The dissolution of the Soviet Union challenged the NIS to identify their national goals for reform and to take responsibility for their respective policies. The legacies of the Soviet economy make this identification and independent decision making problematic, given the high degree of economic interdependence with and resource reliance on Russia. New regional associations and economic alliances based on geographic proximity and shared infrastructure were formed to address common problems of economic transition.

Russia itself has largely stopped sponsoring other republics' reforms, given its preoccupation with political strife and intrafederation ethnic conflicts such as that in Chechnya. After its 1998 financial meltdown, Russia reevaluated its economic alliances with Belarus, Ukraine, and Moldova, as well as further economic cooperation with Central Asia and Transcaucasus, especially with regard to the resources of the Caspian Sea (see chapter 10).

Land reform remains the road block of the transition and has not been given adequate attention because industrial privatization has received priority. This policy pleases international monetary institutions (the IMF and the World Bank) providing economic assistance.

Most of the NIS that had a slower economic transition have experienced a major increase in income inequality and escalating political pressure to slow the transition. The costs and benefits of economic independence are often perceived as socially unfair, a belief that contributes to nationalist sentiments and the popularity of policy extremism.

The various transition tracks in the former republics of the Soviet Union have demonstrated convincingly that the economic transformation from centralized, planned interdependence to market-driven specialization and overall liberalization is neither an easy nor a speedy undertaking.

QUESTIONS FOR DISCUSSION

1. What proved to be an obstacle in the republics' integration with Western trade?
2. What factors contributed to the strong interdependence of the NIS?
3. Explain the divergence of the economic cultures of the Baltic states and the Central Asian republics.
4. Why are reforms in agriculture progressing more slowly than other types of reform?
5. Why didn't Russian denationalization of land lead to decollectivization?
6. What are the differences in agrarian reforms in Lithuania and Estonia?
7. Which republics have had the most success in privatization and why?
8. What are the factors determining the choice of economic system by the various post-Soviet republics?

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RUSSIA
LITHUANIA
Baltic Sea
Slupsk
Gdansk
Koszalin
Suwalki
Olsztyn
Szczecin
Pila
Torun
Lomza
Bialystok
Gorzow
Ciechanow
Gorzow Wielkopolski
GERMANY
Plock
BELARUS
Poznan
Warsaw
Siedlce
P O L A N D
Brest
Zielona Gora
Leszno
Kalisz
Radom
Lublin
Legnica
Piotrkow
Wroclaw
Czestochowa
Kielce
Zamosc
Opole
Tarnobrzeg
Katowice
Rzeszow
CZECH REPUBLIC
Bielsko
Krosno
Nowy Sacz
UKRAINE
SLOVAKIA

12 Poland: The Peril and Promise of Shock Therapy

What has decided me definitely for Poland, on the basis of my latest studies of Polish history, is the historical fact that the intensity and vitality of all revolutions since 1789 can be gauged pretty accurately by their attitude to Poland. Poland is their "external" thermometer.
—Karl Marx, *Letter to Friedrich Engels*, December 1856[1]

Communism does not fit the Poles. They are too individualistic, too nationalistic. Poland's future economy should be based on private enterprise. Poland will be a capitalistic state.
—Joseph Stalin[2]

INTRODUCTION

Poland's geographical and historical misfortune has been to be located between Germany and Russia. It was conquered and ruled by each of them in the twentieth century, as well as in earlier centuries, with Nazi Germany conquering it in World War II, only to become a Soviet satellite after the war, although officially independent. Thus Poland has a strong western orientation in its culture, politics, and economics and seeks alliances with western powers such as France. This longing for western-oriented national independence underscored the 1989 decision of the first post-Communist Polish government to undertake an economic transition rapidly through big bang or shock therapy policy.

Known as the **Balcerowicz Plan,** after then Finance Minister Leszek Balcerowicz, Poland's market transition was implemented in January 1990. This plan called for immediate decontrol of most prices; devaluation and then pegging of the Polish currency (złoty) to the U.S. dollar; removal of all foreign exchange controls; and legalization of all forms of private enterprise. The plan also called for privatization of SOEs, but privatization was not fully implemented before a political backlash emerged that slowed the program down.

Poland's transition experience shows both the peril and the promise of a shock therapy approach. Output declined sharply and a significant rise in unemployment followed, leveling off in late 1993 at around 16 percent. A sharp spike in prices following triple-digit inflation also occurred. But inflation rapidly declined to a much lower level. Although it was still running at double digit rates as late as 1998, it was down to about 1 percent by the beginning of 2003. Sharper income inequalities also emerged initially. These unpleasant economic facts led to the election in September 1993 of a parliament (*Sejm*) dominated by former Communists, now the pro-reform Democratic Left Alliance. They followed a more gradualistic approach without abandoning reform efforts.

1. Quoted in Terry R. Kandal, "Marx and Engels on International Relations, Revolution and Counterrevolution," in M. T. Martin and T. R. Kandal, eds., *Studies of Development and Change in the Modern World* (New York: Oxford University Press, 1989), p. 45.

2. To Stanislaw Mikoxajczyk, October 1944, quoted in Stanislaw Mikoxajczyk, *The Rape of Poland. The Pattern of Soviet Aggression* (New York: Whittlesey House, 1948), p. 100.

In 1995 one of their members, Alexander Kwasńiecki, a former Communist, replaced the anticommunist **Solidarity (Solidarność)** leader, Lech Wałęsa, as Poland's president and was reelected in 2000. Although rightist coalitions took power later in the *Sejm,* policies since the mid-1990s have taken a more gradualist path as a result of ongoing divisions within the coalitions, and have continued since the Democratic Left Alliance regained power in late 2001.

Poland was the first former Soviet bloc economy to bottom out and begin growing again and the first to surpass its 1989 prereform level of real per capita income after the breakup of the Soviet bloc. It was the only postsocialist European economy to have growth of industrial production in 1992, indeed for any year from 1990 to 1992. Poland also had the highest economic growth rate in all of Europe for 1993 at around 4 percent, a performance repeated later in the 1990s with even higher growth rates. While impressive, Poland's growth began from a very low base after the economy's initial decline and slowed substantially after 2000, down to a little less than 1 percent at the beginning of 2003.

Poland's growth in the 1990s was led by strong export performance tied to complete currency convertibility at a credible rate. Much of its growth occurred in a rapidly expanding private sector based on native Polish entrepreneurship, despite the slowness of privatizing existing SOEs. By late 1993, a majority of Poland's labor force and about 45 percent of its economic activity were in the private sector. By 1999 the GDP share of private sector activity had risen to around 70 percent, with about 50 percent coming from new firms started by entrepreneurs since 1989.

Following the premise of peril or promise, the outcome of economic shock therapy in Poland can be viewed as both a failure and a success. The failure is that the original goal was to achieve full market capitalism, which has not happened because not all the SOEs have been privatized. Privatization was not fully implemented immediately because of political divisions in the *Sejm,* where there have been many parties and changes in government, reflecting the Polish political tradition of vigorous democracy and intense individualism, which led to fragmentation and indecisiveness. Full privatization was also hampered by fear of more unemployment, the shock part of the therapy.

But the promise is also there in the success that has been achieved. The initial outcome corresponded with Balcerowicz's earlier (1981) proposals[3] that called for enterprise autonomy with major structural reforms, but privatization of only small and medium-sized SOEs.

3. Leszek Balcerowicz, *Reforma Gospodardarcza. Propzycje, tendencie, kierunki dyskusji* (Government Reforms: Proposals, Tendencies, and Brief Discussion) (Warsaw: PWE, 1981), pp. 279–373. In advocating shock therapy, Balcerowicz drew on cognitive dissonance theory from psychology, declaring that "people are more likely to change their attitudes and their behavior if they are faced with radical changes in their environment, which they consider irreversible, than if those changes are only gradual" (Leszek Balcerowicz, *Socialism, Capitalism, Transformation* [Budapest: Central European University Press, 1995], p. 342). Balcerowicz again served as finance minister during the late 1990s, but was unable to push through the completion of privatization and has more recently served as chairman of the Polish central bank.

His 1989–1990 plan achieved the more modest goal of his 1981 plan. It may have been necessary to push a more radical plan to achieve significant changes before the politicians could slow things down. Although the rapidity of the transition probably triggered the reaction that slowed it down, the sustained growth of the Polish economy since the early 1990s shows the sustained success of the plan.

POLAND'S HISTORICAL BACKGROUND PRIOR TO 1947[4]

Occupying the original homeland of the Slavic peoples, Poland in 1024 crowned its first king after he swore special fealty to Rome and the pope, initiating a tradition of strong adherence to Roman Catholicism.[5] The Polish kingdom achieved great power under Casimir (Kazimierz) the Great (1330–1370), who established traditions of democracy and tolerance long associated with Poland. Democracy came with the election of kings by a group of nobles who constituted the *Sejm*. Tolerance was symbolized by Casimir's invitation to Western European Jews to settle in Poland when they were persecuted during the Black Plague of the mid-1300s. Poland would become the most important center of Jewish life in the world for hundreds of years.[6]

Poland was a major center of the Renaissance, experiencing a flowering of science, art, literature, and economic growth during the 1500s.[7] The Thirty Years' War in the early 1600s initiated a long economic and political decline. This decline was exacerbated by the *liberum veto,* which allowed a single member of the *Sejm* to dissolve it by a veto, the ultimate in Polish democratic indecisiveness. Little was accomplished during the 1700s, and the Polish military decayed. The result was partition of Poland by its three absolutist neighbors, Russia, Prussia, and Austria, culminating in 1795, when Poland ceased to exist as an independent nation.

Poland's desire for independence surfaced repeatedly in revolutionary upheavals in 1830, 1846, 1848, 1863, and 1905. Although there was some industrialization in Russian

4. For more detail see W. F. Reddaway, J. H. Penson, O. Halecki, and R. Dyboski, eds., *The Cambridge History of Poland,* Vols. 1 and 2 (Cambridge: Cambridge University Press, 1941 and 1950, respectively).

5. This is exemplified by the Polish pope, John Paul II. Adherence to Catholicism as part of Polish national identity was enhanced when Poland was ruled by Lutheran Germans from the West or by Orthodox Russians from the East (and more recently by the officially atheist Soviets).

6. See Chmien Abramsky, Maciej Jachimczyk, and Antony Polonsky, *The Jews in Poland* (Oxford: Basil Blackwell, 1986). Today there are only a few thousand Jews left in Poland, most of them elderly. Hitler killed most of those who did not successfully flee. His deadliest camps were in Poland, notably Auschwitz. Jewish emigration from Poland began in the 1880s, when anti-Semitic pogroms began in the Russian-ruled zone after the assassination of Tsar Alexander II by anarchists. Further emigration occurred after World War II, especially in 1968 during anti-Semitic purges under the Communist regime.

7. The contrast with Russia to the east was especially sharp then, with Tsar Ivan the Terrible resisting such influences.

Poland, the country's economy remained primarily agricultural. Austrian Poland was extremely poor and totally agricultural. The most significant economic development, including expanded mining, occurred in Prussian Poland. Polish independence was won militarily against the Germans and the post-1917 Soviets when Marshall Józef Piłsudski, Poland's military leader and first head of state, defeated the Soviet siege of Warsaw in 1920.

The parliamentary government succeeding Piłsudski's initial government allowed hyperinflation related to large budget deficits, a situation that also affected Poland's neighbors. The economic situation led Piłsudski to carry out a coup in 1926, and he ruled as dictator until his death in 1935, when he was succeeded by a group of army colonels. The economic policies of Piłsudski and his successors involved state intervention along authoritarian corporatist lines. Industrial output tripled between 1922 and 1939, although it was only about 5 percent higher than the prewar 1913 level.[8] Poland's economy was still predominantly agricultural when World War II began.

Germany invaded Poland on September 1, 1939, starting World War II in Europe. This invasion immediately followed signing of the Molotov–von Ribbentrop nonaggression pact between the USSR and Germany in which they agreed on a division of Central and Eastern Europe. The USSR soon invaded from the east, taking areas that would be annexed after the war when Poland was given former German territory westward. Poland had the highest percentage of fatalities of any nation[9] during the war.

After Germany invaded the USSR in 1941, Stalin set up the Polish Workers' Party, which dominated a multiparty government that took power after the Red Army removed the Germans in early 1945. The United States and Britain supported a Polish government-in-exile in London, but they let Stalin have his way at the Yalta Conference in 1945, given his assurances that the USSR would respect Polish independence and that free elections would be held soon.[10]

In early 1947, elections were held but were manipulated by the Polish Workers' Party. After this, opposition leaders fled. Parties such as the Social Democrats were

8. See J. Taylor, *The Economic Development of Poland, 1919–1950* (Westport, Conn.: Greenwood Press, 1952), p. 91; Ivan T. Berend and György Ránki, *Economic Development in East Central Europe in the 19th and 20th Centuries* (New York: Columbia University Press, 1974), p. 299.

9. See George Kolankiewicz and Paul G. Lewis, *Poland: Politics, Economics and Society* (London: Pinter, 1986), p. 11. More Soviets and, by some accounts, Germans were killed, but out of larger population bases. A larger percentage of the global Jewish and Belarusian populations were killed compared to the Polish population, but at that time there were no formal nations for these peoples. Anger at these neighbors persists in Poland, with a poll in 1997 showing that the least popular nationalities in Poland are, in order, Germans, Lithuanians, and Russians, with the most popular being, in order, Americans, French, and Italians (George Sanford, *Poland: The Conquest of History* [Amsterdam: Harwood, 1999], p. 110).

10. This decision, and the failure to support the government-in-exile earlier, when Stalin might have been more agreeable, was widely criticized. By the time of the Yalta Conference in 1945, the Red Army was already in Poland and not much could be done.

"amalgamated" with the Polish Workers' Party, many members being purged; "national Communists" such as Władysław Gomułka were purged from the ruling party, and the leadership was taken over by hardline Stalinists. Poland had gone from the grip of Adolf Hitler to that of Joseph Stalin.

ECONOMIC POLICIES OF THE COMMUNIST REGIME

The Periods of Communist Rule

The 1947–1989 period of Communist rule had four subperiods: 1947–1956, 1957–1970, 1971–1981, and 1982–1989. The 1947–1956 period was characterized by standard Stalinism, emphasizing heavy industrialization under command socialist central planning, deviating only in a failed effort to collectivize agriculture.

After Khrushchev's destalinization speech at the 1956 20th Soviet Party Congress, violent riots erupted in Poznań that triggered a party-government upheaval, and Władysław Gomułka was brought back from disgrace to lead the party and the nation. A "thaw" period ensued, marked by the halting of efforts to collectivize agriculture[11] and reduced persecution of the Roman Catholic Church. But then came more repressive policies, culminating in an anti-Semitic purge of the leadership in 1968,[12] shortly before Polish troops participated in crushing the reformist Czechoslovak regime.[13]

An effort to raise food prices in 1970 led to strikes and riots that resulted in Gomułka's replacement by Edward Gierek. Gierek pushed rapid growth, and the early 1970s saw the fastest growth of the Polish economy ever, though it was unbalanced and unsustainable. Gierek encouraged the formation of large enterprise units similar to the East German *Kombinat*. These enterprises engaged in wasteful gigantomaniac investment projects financed by foreign borrowing, which created bottlenecks in the economy. The debt-service ratio (interest payments on foreign debt as a percentage of hard currency export

11. Later the government seized land for unpaid debts. This gradually led to an increase in state farmlands to nearly 30 percent in 1989 (Krystyna Daniel, "Private Farm Ownership in a Changing Poland: Myth and Reality," in G. S. Alexander and G. Skąpska, eds., *A Fourth Way? Privatization, Property, and the Emergence of New Market Economies* [New York: Routledge, 1994], pp. 140–141). In 1956 about 23 percent of the land was in collective farms, a figure that went to nearly zero shortly thereafter (Frederic L. Pryor, *The Red and the Green: The Rise and Fall of Collectivized Agriculture in Marxist Regimes* [Princeton, N.J.: Princeton University Press, 1992], p. 110).

12. After that it was joked that "Poland is a country that has traffic jams without cars and anti-Semitism without Jews."

13. Poland's willingness to support Soviet foreign policy after World War II was caused by fear of Germany, especially after Stalin gave Poland former German territory, an acquisition not recognized by Germany until 1990, when it sought reunification.

earnings) rose from 16 percent in 1973 to 42.2 percent in 1976.[14] Attempting to stabilize the economy, Gierek tried to raise food prices in 1976, but this triggered another round of strikes and riots that forced him to back off. This was followed by more foreign borrowing, and the debt-service ratio soared to 101.2 percent in 1980. Growth ceased and was sharply negative for 1979–1982.

Another effort to raise food prices in 1980 led to the formation of the Solidarity (*Solidarność*) trade union, initially based in the Lenin Shipyard in Gdanśk and led by Lech Wałęsa. The very idea of a workers' movement rising up against the state in a "workers' paradise" was a major contradiction. The union was tolerated until the end of 1981, when a military coup was carried out by General Wojciech Jaruzelski, who declared martial law and outlawed Solidarity.[15]

In 1982 the Jaruzelski regime introduced the Reformed Economic System (RES), characterized by the "three Ss": self-management (*samorzadny*), self-financing (*samofinansujacy*), and independent enterprise (*samodzielny*). In imitation of the market socialism of Hungary and even of Yugoslavia (discussed in chapters 13 and 14, respectively), command central planning was scaled back and given a more long-term and consultative character. Workers' councils, which were supposed to have authority over the management of enterprises, were given increased power. Established in 1945, they had little actual authority after 1958 until these changes occurred in the 1980s.

Briefly in the mid-1980s, the economy stabilized somewhat and grew. But then subsidies for maintaining low food prices inflated budget deficits. Foreign borrowing resumed, and Poland's debt rose from \$26.8 billion in 1984 to \$40.8 billion in 1989.[16] Growth stalled, and without central command controls on prices, inflation reached 251 percent in 1989.

Strikes broke out again in 1988, and in early 1989 a round table conference with Jaruzelski and Wałęsa as the main negotiators established a coalition government in August, in which the Communists participated but non-Communists were in charge, with Leszek Balcerowicz as finance minister. At the end of 1990, Jaruzelski was replaced as president by Lech Wałęsa after a democratic election. Poland was the first East European country to shrug off Communism, and it did so peacefully.

14. Urszula Plowiec, "Economic Reform and Foreign Trade in Poland," in J. C. Brada, E. A. Hewett, and T. A. Wolf, eds., *Economic Adjustment and Reform in Eastern Europe and the Soviet Union: Essays in Honor of Franklyn D. Holzman* (Durham, N.C.: Duke University Press, 1988), pp. 348–351.

15. This was the only military coup carried out in a Communist country, reflecting a long tradition of disliking "Bonapartism" and maintaining civilian party control of the state. The Soviets supported Jaruzelski's coup. What remains debated is whether he was just a dictator beholden to a foreign power or partly a national savior who forestalled a Soviet army invasion by his coup.

16. Dariusz Olszewski, Grazyna Pruban, Monika Pawilica, Piotr Nojszewski, and Miroslawa Sibilska, "The Polish Economy and Politics Since the Solidarity Take-Over; Chronology of Events and Major Statistical Indicators," PPRG Discussion Paper No. 6, Warsaw University (1991), Table 7.

Overall Economic Performance of the Communist Regime

From 1947 to 1989 Poland's economic performance resembled that of other East European Communist states. The virtues included substantial real economic growth until the late 1970s, a shift from a rural-agricultural society to an urban-industrial one, low unemployment, a more equal income distribution than in most market capitalist economies, available public goods, and a generous social safety net, although the quality of medical care deteriorated in the 1980s.

But the usual difficulties also existed: gigantomania, inefficiency culminating in stagnant growth, shortages and poor-quality consumer goods, and severe environmental damage. Peculiar to Poland was a severe disjuncture between agriculture and the rest of the economy, which aggravated Polish inflation. Agriculture was largely market capitalist, but inefficient nonetheless for reasons discussed below. Larger than average foreign debt burdens also emerged.

Figure 12-1 shows average annual growth rates of Polish real GNP and industrial production for five-year periods from 1950 to 1989. Industrial production grew fastest during the Stalinist era of the early 1950s, whereas overall GNP grew fastest during the early 1970s.

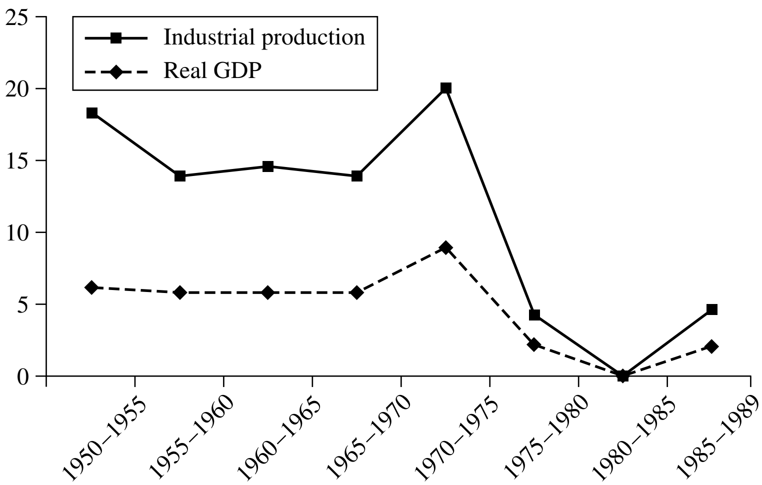

Figure 12-1
Economic Growth Rates in Poland.
Source: Stanislaw, Gomuka. *Growth, Innovation and Reform in Eastern Europe.* Madison: University of Wisconsin Press (1986), p. 191 for 1950 to 1980 and Dariusz, Olsewski, Grazyna Pruban, Monika Pawilica, Piotr Nojszewski, and Miroslawa Sibilska. "The Polish Economy and Politics since the Solidarity Take-Over: Chronology of Events and Major Statistical Indicators." PPRG Discussion Paper No. 6, Warsaw University (1991), Tables 3A and 6 for 1980–1989.

Table 12-1
Social and Consumption Characteristics

Year	Population Urbanized	Persons per Room	Consumption per Capita
1950	26.60%	1.53	14.44
1980	59.10%	1.05	49.50

Source: Stanislaw Gomulka, *Growth, Innovation and Reform in Eastern Europe* (Madison: University of Wisconsin Press, 1986), pp. 174, 175, 180.

Table 12-1 shows figures for the percentage of population urbanized, number of persons per room in housing, and consumption per capita in thousands of 1977 złotys for 1950 and 1980. These figures show substantial positive changes over this period.

The Distribution of Income

Poland was approximately mid-ranked among Soviet bloc countries with respect to income distribution. Decile ratios for per household income (the ratio of the share of the top 10 percent of the population to the share of the bottom 10 percent of population) for 1982–1985 show Czechoslovakia at 2.4, Hungary at 2.6, Poland at 3.0, the USSR at 3.3, and the United Kingdom at 3.9.[17] These findings generalize to other measures such as Gini coefficients and measures of earnings.

During the Solidarity period in 1981, there were some fluctuations and a significant increase in equality both in earnings and in income, but these were reversed afterward.[18] Earnings also had been more equal during the late 1950s and became so again in the late 1980s, although this equalization did not show up in income data.

Most estimates suggest that income inequalities have increased during the post-Communist period. The Gini coefficient rose from .28 in 1989 to .34 in 1998, although nearly two-thirds of that increase supposedly occurred between 1992 and 1993, according to one study.[19] However, this is a relatively small increase in inequality compared with what has happened in many other transition economies, especially many of the CIS states.

17. Anthony B. Atkinson and John Mickelwright, *Economic Transformation in Eastern Europe and the Distribution of Income* (Cambridge: Cambridge University Press, 1992), p. 114.

18. Atkinson and Micklewright, *Economic Transformation in Eastern Europe,* pp. 90, 129.

19. John Flemming and John Micklewright, *Income Distribution, Economic Systems and Transition* (Florence: UNICEF, 1999), p. 64. One source argues that such findings reflect technical problems in sampling used by the Polish government and that, over time, increases in wage inequality have been offset by social safety net income transfers (Michael P. Keane and Eswar Prasad, "Inequality, Transfers and Growth: New Evidence from the Economic Transition in Poland," *Review of Economics and Statistics* 84 [2002]: pp. 324–341). One difficulty in measuring income distribution in transition economies is their large underground economies, which is less of a problem in Poland (Małgorzata Kalaska and Janusz Witkoufski, "Hidden Labor in Poland," in E. L. Feige and K. Ott, eds., *Underground Economies in Transition: Unrecorded Activity, Tax Evasion, Corruption, and Organized Crime* [Aldershot, U.K.: Ashgate, 1999], pp. 245–274).

Table 12-2
Environmental Conditions in Poland in the 1980s

Category	Poland	EE-6	EU
Energy intensity of GDP	890	770	230
Water intensity of GDP	116	153	82
Wastewater per GDP	97	83	24
Gases per GDP	47	51	24
Dust per GDP	13	13	1
Solid waste per GDP	1,300	1,000	400

Note: Energy per GDP is in "tons of oil equivalent" per U.S. dollar, water intensity per GDP in cubic meters per $1,000, wastewater in cubic meters per $1,000, gases per GDP in cubic meters per $1,000, and gases in kilograms per U.S. dollar, as are dust and solid waste.
Source: Figures are from Tomasz Zylicz, "Environmental Policy in Poland." PPRG Discussion Paper No. 12 (Warsaw: Warsaw University, 1991), p. 17.

ENVIRONMENTAL DEGRADATION IN POLAND

Paradoxically, Poland contains some of the most environmentally pristine land in all of Europe, mostly in its northeastern corner, and some of the most polluted, mostly in its southwestern corner. Of Polish land, 8.5 percent is virtually in its natural condition and another 19 percent contains "biological complexes operating on sustainable and ecologically sound principles."[20] At the other extreme, the southwestern 11 percent of the land area, home to one-third of the population, is among the most polluted and hazardous to health on earth. This area contains many steel, cement, and chemical plants.[21]

Table 12-2 presents various average aggregate environmental measures for Poland relative to the East European 6 (EE-6: Bulgaria, Czechoslovakia, the GDR, Hungary, Poland, and Romania) and the EU for the 1980s. Poland was substantially worse than the EU on all measures and worse than the EE-6 on a majority of the measures. Poland's performance was especially bad in the areas of energy intensity per GDP, wastewater per GDP, and solid waste per GDP.

During the later years of the Communist regime, environmental enforcement was based on a system of rarely collected and not very high fines. With soft budget constraints, such fines made little difference to decision making. But during the transition period, environmental policy has been a success story for Poland, with generally steady improvement in most of the categories listed in table 12-2, some quite dramatic. Between 1989 and 1998

20. Tomasz Żylicz, *Costing Nature in a Transition Economy: Case Studies in Poland* (Cheltenham, U.K.: Edward Elgar, 2000), p. 34.

21. This area, along with neighboring sections of southeastern former East Germany and the northern Czech Republic, is known as the Dirty Triangle, with very high sulfur emissions from widespread burning of lignite coal.

there were declines of energy use per GDP by 19 percent, water use per GDP by 25 percent, wastewater by 36 percent, gaseous emissions by 56 percent, dust by 83 percent, and solid waste by 22 percent.[22] Policy efforts have used funds from privatized industries that faced environmental liabilities at the national level, and decentralized water and solid waste management to local governments.[23] Despite these improvements, the Poles understand that their environmental record still looks bad by EU standards and that they need to clean up further in order to join that organization.

The Curious Case of Polish Agriculture

Conflicts between the interests of the rural and urban sectors of the Polish economy aggravated the difficulties and imbalances that doomed the Communist regime. A rural branch of Solidarity was started, but it has gone its separate way since 1990, showing that these conflicts persist in the post-Communist period.

Poland differed from the rest of the Soviet bloc in that its farms were not collectivized, although a state farm sector with about 30 percent of the land eventually developed. Part of the problem for the central planners was that Polish agriculture was not very successful in spite of being largely privatized, even relative to the inefficient collectivized agricultural systems in the rest of the Soviet bloc.

Table 12-3 provides average annual rates of increase in gross agricultural output and total factor productivity (TFP) in agriculture for 1970–1987 for a set of countries and for the Soviet bloc subset, the percentage of the labor force in agriculture for 1980, and agriculture as a percentage of exports and imports.

Poland had the lowest rates of output growth and of TFP growth. It was a close second to Yugoslavia in the percentage of its labor force employed in agriculture and second to the USSR in its percentage of agricultural imports.

Both Poland and Yugoslavia had mostly private farms during the Communist period, although Yugoslavia's nonprivate sector was in collectives rather than state farms. Both suffered from the problem of too many inefficient small farms. This is a major reason for Poland's poor agricultural performance relative to that of the collectivized Soviet bloc systems that achieved economies of scale. But Yugoslavia showed the highest rate of TFP growth on the list, a sharp contrast with Poland. Why?

22. Żylicz, *Costing Nature in a Transition Economy,* p. 7.

23. For further discussion, see Piotr Jasinski and Helen Lawton Smith, eds., *Environmental Regulation in Transforming Economies: The Case of Poland* (Aldershot, U.K.: Ashgate, 1999); John W. Sutherlin, *The Greening of Central Europe: Sustainable Development and Environmental Policy in Poland and the Czech Republic* (Lanham, Md.: University Press of America, 1999); Jerzy Śleszyński, "Privatization and Environmental Policy: Environmental Liability in Transition Period, the Experience of Poland and Former GDR," Economic Discussion Papers No. 50 (Warsaw: University of Warsaw, 1999).

Table 12-3
Agricultural Performance in Various Countries, 1970–1987

Country	Output Growth	TFP Growth	Percent Labor (1980)	Percent Exports	Percent Imports
Bulgaria	1.41	1.39	22.7	0.0	0.0
Czechoslovakia	2.32	1.93	12.9	4.4	13.5
East Germany	2.09	1.11	10.0	0.0	0.0
Hungary	2.24	1.10	19.9	23.4	11.4
Poland	1.02	0.02	29.8	6.3	16.8
USSR	1.16	0.25	20.0	3.9	26.5
Yugoslavia	1.94	2.77	32.2	11.8	10.4
West Germany	1.46	2.55	n.a.	n.a.	n.a.
Italy	1.38	1.44	n.a.	n.a.	n.a.
Spain	2.71	3.21	n.a.	n.a.	n.a.
United States	1.62	1.76	n.a.	n.a.	n.a.

Source: Figures are from Fredric L. Pryor, *The Red and the Green: The Rise and Fall of Collectivized Agriculture in Marxist Regimes* (Princeton, N.J.: Princeton University Press, 1992), pp. 29, 250.

Poland's private farmers worked within a generally centrally planned system that was hostile to their interests and diverted inputs to their state-owned rivals, who were no different from them in technical efficiency.[24] In the more decentralized market socialism of Yugoslavia (discussed in chapter 14), farmers were not discriminated against in this manner and could obtain necessary inputs more easily. Thus their growth and productivity gains resembled those of the market capitalist economies. Polish farmers had the worst of both worlds: inefficient scale and inefficient input markets.

However, the move to free markets after 1989 has not improved Poland's situation in agriculture. Although exports rose after 1990, gross agricultural production has mostly declined since then, and most farms remain too small. Privatization of state farms was almost complete by 1994, with leasing as the main method but with restrictions on foreign purchases of real estate still in place.[25] The problems of Polish agriculture were the most serious issue in negotiating Polish entry into the EU. The Polish Peasants' Party has tended to favor the ruling ex-Communist, Democratic Left Alliance but exhibits increasing opposition to the EU. Polish farmers are unhappy that they are not to receive the levels of subsidies and support given to French and other farmers in the older member nations of the EU.

24. Joseph C. Brada and Arthur E. King, "Is Private Farming More Efficient Than Socialized Agriculture?" *Economica* 60 (1993): 41–56.

25. Ben Slay, "The Polish Economic Transition: Outcome and Lessons," *Communist and Post-Communist Studies* 33 (2000): 65; *OECD Economic Surveys: Poland, January 2000* (Paris: Organization for Economic Cooperation and Development, 2000), pp. 50, 176; Darla Munroe, "Economic Efficiency in Polish Peasant Farming," *Regional Studies* 35 (2001): 461–480. The Poles remained afraid of foreigners taking over their land, especially descendants of former German owners.

THE POLISH ECONOMIC REFORMS AND THEIR CONSEQUENCES

The Balcerowicz Plan

In August 1989, a government led by Solidarity activists came to power with vigorously pro-laissez-faire Leszek Balcerowicz as finance minister. Balcerowicz developed a plan for the rapid transformation of the Polish economy with input from foreign advisers, especially the IMF. Poland had accelerating hyperinflation, so macroeconomic stabilization was the highest priority. The resulting plan resembled those recommended by the IMF to combat hyperinflation in Latin American economies.

The key parts of the plan, which were implemented on January 1, 1990, were the following:

1. Elimination of remaining price controls coinciding with 300 to 600 percent increases in still state-controlled energy prices.[26]
2. Sharp devaluation of the złoty to a fixed exchange rate with the U.S. dollar while making it completely convertible both internally and internationally.
3. Tripling the discount rate of the National Bank of Poland, which signaled a tight monetary policy.
4. Reduction of subsidies for SOEs as a share of government expenditures from 36 to 10 percent to reduce the budget deficit.
5. Reduction of the rate of wage indexation to inflation from 80 to 30 percent, with a confiscatory (500 percent) tax placed on any enterprises that exceeded this goal by more than 5 percent.

These policies garnered an IMF-organized stabilization fund, but it did not have to be used because Poland rapidly began to run a trade surplus with its competitive exchange rate. In the next several months came the introduction of a value-added tax, an income tax, a stock exchange, and moves to allow privatization of small-scale enterprises. The last occurred rapidly, generally as employee buyouts. Not implemented because of political opposition in the *Sejm* was privatization of large-scale enterprises, despite being a high priority on Balcerowicz's agenda.

26. Overall prices increased more than 70 percent that month, the highest monthly rate of increase ever. By the end of 1991, energy prices had increased the most relatively, whereas clothing and textiles had decreased the most relatively (*OECD Economic Surveys: Poland* [Paris: Organization for Economic Cooperation and Development, 1992], p. 86).

The Shock and the Therapy

As a result of the Balcerowicz Plan, output plunged about 25 percent from December 1989 to January 1990, and a gradual increase in unemployment followed.[27] This immediate decline in output, it has been argued, resulted principally from three shocks: reduced consumer demand because of falling real wages; rising costs due to higher taxes; and higher costs of credit, with further declines resulting from a general reduction in the availability of credit.

But Poland's rate of inflation was substantially reduced. Furthermore, a portion of the lost output was essentially nonexistent, for it reflected either goods unwanted by anybody or was an artifact of the regular falsification of data under the centrally planned economy that ceased to function in January 1990. Official data overstated the initial output decline because many officially unemployed persons entered the private sector, where activities were not yet being recorded. Although real wages fell sharply, this decline followed exorbitant increases in 1989, resulting in little net change. Furthermore, there appears to have been no decline in average consumption flows, and indeed, a surge of consumer durables purchases occurred.

The general performance of the Polish economy from 1989 on relative to those of the other Višegrad economies (Poland, Hungary, the Czech Republic, and Slovakia) is portrayed in table 12-4. During this period of intense change, many of these numbers are suspect, although not necessarily more so than previous estimates.[28] In most categories since 1989, the four Višegrad economies have outperformed the other Central, East European, and former Soviet transition economies. The only other such nation that has arguably done better than them is the former Yugoslav republic of Slovenia, their colleague as a front-wave EU accession state along with the three former Soviet Baltic republics.

Through 1997 Poland clearly outperformed all of the European post-Soviet transition economies in output and continues to hold a solid lead in cumulative output. Poland was the only former CMEA country whose real per capita output was substantially above its 1989 level that soon. Despite this early turnaround, however, Poland's performance on unemployment and inflation has been less spectacular, although it has clearly brought a very high inflation rate into the single-digit range. Unemployment continues to be a problem, having crept back up above 10 percent after briefly dropping below that level in 1998, and remains higher than in Hungary or the Czech Republic (for more discussion of the

27. Mark E. Schaffer, "The Polish State-Owned Enterprise Sector and the Recession in 1990," *Comparative Economic Studies* 34 (1992): 58–87.

28. Communist governments were replaced or significantly altered in all of the countries in this table by the end of 1989.

Table 12-4
Macroeconomic Performance of Viśegrad Economies

Category/Year	Poland	Hungary	Slovakia	Czech Republic
Output				
1989	0.2	−0.2	1.4	1.4
1990	−11.6	−3.3	−2.5	−1.2
1991	−7.6	−11.9	−14.5	−14.2
1992	1.5	−3.0	−6.1	−6.6
1993	4.5	−0.8	−4.7	−0.9
1994	5.2	2.9	4.8	2.6
1995	7.0	1.5	7.3	5.9
1996	6.1	1.3	6.9	4.1
1997	6.8	4.6	6.5	−1.0
1998	4.8	4.9	4.4	−2.2
1999	4.1	4.5	1.9	−0.2
2000	2.4	4.2	n.a.	3.9
Unemployment				
1989	0.2	0.5	0.0	0.0
1990	6.5	1.7	1.5	0.7
1991	11.5	7.4	11.8	4.1
1992	13.6	12.3	10.4	2.6
1993	16.4	12.1	14.4	3.5
1994	16.0	10.9	14.8	3.2
1995	14.9	10.4	13.1	2.9
1996	13.2	10.5	12.8	3.5
1997	10.3	9.0	13.0	5.2
1998	9.5	8.5	15.6	6.5
1999	11.6	n.a.	19.2	9.0
Inflation				
1989	640.0	17.0	1.4	1.4
1990	289.0	33.4	18.4	18.4
1991	60.4	32.2	58.3	52.0
1992	44.3	21.6	9.1	12.7
1993	37.6	21.1	25.1	18.2
1994	29.4	21.2	11.7	9.7
1995	21.6	28.3	7.2	7.9
1996	18.5	19.8	5.4	8.6
1997	14.9	18.3	6.4	8.5
1998	11.8	14.3	5.6	10.6
1999	7.3	10.0	14.2	2.1
2000	6.6	10.4	n.a.	4.0

Sources: Data for all categories and countries for 1989–1996 from Marie Lavigne, *The Economics of Transition: From Socialist Economy to Market Economy,* 2nd ed. (New York: St. Martin's Press, 1999), pp. 284–286; for output and inflation in all countries for 1997–1999 from *World Economic Outlook 2000: Focus on Transition Economies* (Washington, D.C.: International Monetary Fund, 2000), pp. 203, 215; for unemployment in Poland for 1997–1999 from *OECD Economic Surveys: Poland January 2000* (Paris: Organization for Economic Cooperation and Development, 2000), p. 31; for unemployment in Hungary for 1997–1998 from *OECD Economic Surveys: Hungary* (Paris: Organization for Economic Cooperation and Development, 1999), p. 22; for unemployment in Slovakia for 1997–1999 from Joaquim Oliveira Martins and Tristan Price, "Policy Interdependence during Economic Transition: The Case of Slovakia 1999–2000," OECD Economics Department Working Paper No. 253 (Paris: Organization for Economic Cooperation and Development, 2000); for unemployment in the Czech Republic for 1997–1999 from *OECD Economic Surveys: Czech Republic February 2000* (Paris: Organization for Economic Cooperation and Development, 2000), p. 22; and for output and inflation for Poland, Hungary, and the Czech Republic for 2000 from *The Economist,* March 24, 2001, p. 124.

Box 12-1
The Czech Republic: Transition Fairy Tale or Failure?

Prior to 1997, the Czech Republic was widely admired as the most successful of the transition economies, with a relatively small output decline coinciding with relatively low unemployment and inflation. The Czech Republic liberalized prices almost as rapidly as, if somewhat later, than other Central and East European Countries. It had a successful and fairly rapid privatization based on mass distribution of nontradeable vouchers, which tended to be used to buy stocks of holding companies. Ten holding companies own around 50 percent of all privatized assets;* however, these holding companies are managed by state-owned banks, which have been accused of propping up inefficient firms through a de facto soft budget constraint policy that was responsible for the Czech Republic's good macroeconomic performance.†

Compared to the Polish currency, the Czech currency (koruna) is not freely convertible internationally and the Czechs generally have a higher standard of living, more internationally competitive industries, a more equal income distribution, and a greater commitment to rapid economic reform.‡ Relative to Poland and Hungary, the former Czechoslovakia had a very strict command economy with stable prices, no unemployment, and few foreign debts. Thus the Czechs started from a position of greater macroeconomic stability. They also had a higher income base and past experience with industrial market capitalism, the only nation besides the former GDR to have extensively industrialized prior to becoming socialist. Finally, they have greater access to the German market because of greater geographic proximity. The Czech Republic actually borders the former West Germany, unlike any other former CMEA state except the former GDR.

Then in May 1997, the Czech Republic experienced a severe financial crisis that led to a general economic slowdown. It is now one of the few transition economies that succeeded in starting on the upslope of the transition *j-curve* of output, only to stall and go into a recession, with declining output during 1997–1999. A new effort to privatize the banks and restructure corporate governance may have succeeded, with the Czech Republic returning to growth in 2000. But many believe that the rapid voucher privatization was mismanaged compared to the more careful Polish and Hungarian privatizations.

*OECD, *Trends and Policies in Privatization* 1, No. 2 (Paris: Organization for Economic Cooperation and Development, 1993), p. 18.

†See Richard Portes, "Transformation Traps," *Economic Journal* 104 (1994): 1178–1189; Raj M. Desai, "Reformed Banks and Corporate Governance in the Czech Republic, 1991–1996," *Post-Soviet Geography and Economics* 37 (1996): 463–494; and Clemens Shutte, *Privatization and Corporate Control in the Czech Republic* (Cheltenham, U.K.: Edward Elgar, 2000).

‡Divisions over the pace of reform were a factor in the separation. From 1994 to 1999, Slovakia was ruled by a somewhat authoritarian and nationalist government that moved more slowly on transition policies. But Slovakia avoided the recession of the Czech Republic and now appears to have the world's most equal distribution of income.

Czech Republic's transition, see box 12-1), although lower than in Slovakia. Polish unemployment tends to be worse in rural areas located in the north and east.

The Political and Policy Reactions to Shock Therapy

The severe 1990–1991 decline triggered a political backlash that began early in 1990, when Solidarity began to fragment over disputes between Lech Wałęsa and the government and between Solidarity's urban and rural branches as farmers demanded protection and subsidies. Resigning as Solidarity leader in November 1990, Wałęsa defeated Solidarity Prime

Minister Tadeusz Mazowiecki in the presidential election. Wałęsa's government retained Balcerowicz as finance minister in order to keep the IMF and foreign bankers happy.

In the October 1991 elections for the *Sejm,* candidates backed by remnants of the fragmented Solidarity Party did poorly. In a classic manifestation of Polish democracy, 67 parties contested the race and 28 of them obtained seats. But no party had more than 13 percent of the seats, and a period of instability emerged during which revolving governments and decision-making gridlock were reminiscent of the days of the *liberum veto*. Balcerowicz did not run again in 1991 and thus left office. Further movement on economic reform substantially slowed, but Balcerowicz's basic handiwork was not reversed.

In September 1993 a leftist coalition won control of the *Sejm,* and the number of parties in it was sharply reduced. This victory was later reinforced by the election as president of ex-Communist Alexander Kwasńiecki, who supported essentially social democratic policies and opposed domination by the Roman Catholic Church in social policy. More important than the various prime ministers who would serve until a rightist coalition took power in the *Sejm* in 1997 was the finance minister, Grzegorz Kołodko, who served from 1994 to 1997, viewed by many as on a par with Balcerowicz. He continued privatization and a strict monetary policy to combat inflation, but emphasized that reform of the state sector had to be balanced by private sector reforms while Poland's fairly generous social safety net was maintained. Kołodko also promoted a semicorporatist "social pact" to restrain wage-push pressures on inflation.[29] After 1997 Poland was ruled by a split government, with a rightist coalition in the *Sejm* cohabiting with the leftist president, Kwasńiecki, a combination that it maintained at the beginning of the new century. In late 2001, the Democratic Left Alliance won a majority in the *Sejm,* with Leszek Miller as prime minister and Solidarity completely out. Throughout these various changes, the basic outlines of economic policy have not fundamentally changed.

The Problem of Privatization in Poland

In July 1990 Poland established the Ministry of Privatization (MOP). Several mechanisms for privatizing enterprises were established, including (1) management or employee buyouts (also called **direct privatization**), (2) liquidation of assets, (3) trade sales to specific buyers, and (4) offering stock on public capital markets.

In 1993 a law was passed allowing for mass privatization through the establishment of **National Investment Funds (NIFs),** of which 15 were established that would be owned

29. Grzegorz Kołodko and D. Mario Nuti, "The Polish Alternative: Old Myths, Hard Facts and New Strategies in the Successful Transformation of the Polish Economy," *Research for Action 33* (Helsinki: UNU/WIDER, 1997).

by the public through vouchers, although in conjunction with a foreign investor. Each NIF would focus on about 30 firms and would emphasize restructuring of their management teams, taking over 512 firms by 1996.[30] In 1995 a new law was passed that modified this basic system. This multipath approach to privatization means that in Poland all the methods of privatization are used that have been used in transition economies (except for restitution to previous owners).[31]

Although Leszek Balcerowicz wanted rapid privatization as part of his shock therapy approach, it has not happened, in contrast to such countries as Russia and the Czech Republic. But by now, many observers agree that this has turned out to be fortunate, as avoidance of corruption and the greater degree of restructuring associated with the Polish approach have led to a generally superior outcome, although some of this is due to the especially great success of Poland's many new enterprises started since 1989. Table 12-5 shows the time pattern of the multipath Polish approach to privatizing the 8,200 SOEs that existed in 1990.

The capital privatization path is also known as **indirect privatization** and is the common path for larger firms, with the state often retaining some ownership shares. The public offerings often involve strategic sales to especially selected investors. Although the NIF mass privatizations were resisted for a long time, they were completed reasonably quickly once they started. But this method was far from the predominant form of privatization in Poland despite the attention it received. Direct privatizations, worker or management buyouts or leases, are limited to smaller enterprises. Liquidations are generated by the works council of an enterprise and sometimes involve bankruptcy, usually with the firm's assets sold at public auction. The total value of the three broad categories was about equal as of 1998.

Even though the overwhelming majority of Polish enterprises have been privatized, the state-owned sector still produces about 40 percent of GDP. This government sector

30. For descriptions of each of the NIFs and their foreign partners, see Marshall I. Goldman, "Privatization, Property Rights and Development Potential: Lessons from Poland and Russia," *Eastern Economic Journal* 25 (1999): 389–398. For more detailed discussion of legal and institutional details, see Władysław Sztyber, "The Programme of National Investment Funds in Poland," Economic Discussion Paper No. 37 (Warsaw: University of Warsaw, 1997).

31. For more general discussion of legal, institutional, and governance issues, see Christine A. Bogdanowicz-Bindert and Jan Czekaj, "Poland: A Privatisation Model That Works," in S. Faulkner, J. McLoughin, and S. Owsiak, eds., *Polish Transition Ten Years On—Processes and Perspectives* (Aldershot, U.K.: Ashgate, 1999), pp. 78–118. For corporate governance issues, see Marek Belka, Anna Krajewska, and Stefan Krajewski, "Corporate Governance and Economic Performance in Poland," *Eastern European Economies* 37 (1999): 5–38; Oleh Havrylyshyn and Donal McGettigan, "Privatization in Transition Countries," *Post-Soviet Affairs* 16 (2000): 257–286. For specifics regarding bank privatizations and restructuring, see Ben Slay, "Polish Banks on the Road to Recovery," *Post-Soviet Geography and Economics* 37 (1996): 511–522.

Table 12-5
The Many Tracks of Polish Ownership Transfer

Number of Enterprises (Cumulative)	1990	1991	1992	1993	1994	1995	1996	1997	1998
Commercialization									
Capital Privatization	6	27	51	96	132	159	183	227	244
Public Offerings	5	11	12	15	22	27	28	37	42
Trade sales	1	16	39	81	110	132	154	165	169
Written tender (sealed bids)	0	0	0	0	0	0	3	25	33
NIF Mass Privatizations	0	0	0	0	0	321	512	512	512
Debt-equity Swaps	0	0	0	0	60	90	115	130	n.a.
Direct Privatization									
Total	31	449	719	917	1,042	1,149	1,319	1,486	1,698
Through leasing	24	339	557	672	736	788	869	968	1,121
Liquidations	18	540	857	1,082	1,245	1,385	1,405	1,420	1,584
Agricultural enterprises	0	0	720	1,338	1,645	1,645	1,645	1,645	1,645

Source: OECD Economic Surveys: Poland January 2000 (Paris: Organization for Economic Cooperation and Development, 2000), p. 175.

increasingly consists of very large and not very productive enterprises, especially in certain troubled sectors such as coal mining and steel production. Polish policy toward its SOEs has been marked by relatively hard budget constraints, although some of the firms in these industries, especially politically sensitive coal mining, have been exceptions to this rule. The process of privatization has faced persistent opposition that has slowed it down in Poland, despite the numerous strong voices pushing a faster process.

Why has there been so much opposition? One reason is fear of unemployment. In 1982 workers' councils were established in the SOEs as part of Jaruzelski's attempts to reform the economy and satisfy the workers. Those councils have actually been functional and fairly influential in running Polish SOEs. However, the first step in privatizing a company is to "commercialize" it, which involves eliminating the workers' council and putting the enterprise under the control of professional management. In the increasingly common case of outright liquidation, managers often sell off assets, obtaining rewards for themselves, while the workers are laid off. This is a variation on *nomenklatura* privatization, which has aroused much anger in former Soviet bloc countries.

Another source of opposition is fear of foreign buyers, especially Germans, obtaining control of the holding companies and thus of the assets of the economy as a whole on the cheap. Foreign participation has occurred in some privatizations, but there has been much less FDI in Poland than in either Hungary or the Czech Republic. Generally, both workers and managers have resisted buyouts by outsiders, whether foreigners or not, leading to very few trade sales or stock offerings.

Although the majority of foreign advisers urge the Poles to resume the push for rapid privatization, the question is whether this is really necessary. Some[32] argue that such a push may not be wise and that a gradualistic approach to the privatization of the large-scale SOEs may be better in the long run. One successful example is China (discussed in chapter 15). Despite differences in levels of industrialization and per capita income, China and Poland are similar in having both agriculture and small enterprises largely outside the control of the central government while still having many large-scale enterprises under central state ownership and control. In 1993 China had the world's highest economic growth rate and Poland had Europe's highest.

Those advocating slower privatization argue that it should proceed, but that caution and gradualism are desirable for the large-scale sector. More important tasks are building up markets and establishing the appropriate institutional structures to support markets. Poland's functioning markets in agriculture and small-scale enterprises provide this foundation and the positive environment in which suitable enterprises eventually may be privatized and operate optimally. The current difficulties occurring in some rapidly privatized countries, such as Russia, suggest that mass privatization without the appropriate market and institutional framework may be problematic and may hinder the long-term completion of the transition process.

Polish privatization has mostly been fairly gradual and varied. Reductions of subsidies have led to more productive SOEs than in many other countries, although some have argued that the expectation of future privatization induces more efficient behavior. Increasingly it is the halt, the lame, and the infirm firms that remain state-owned.

But perhaps the most crucial reason for Poland's economic success during the transition has been its great success in starting new enterprises, a development that reflects a well-structured institutional environment and entrepreneurial vigor among the Poles. Examples of successful new firms include Computerland S.A., founded in 1991, which provides information networks to businesses; Softbank S.A., founded in 1989, which provides software services to the financial sector; and Veri Service, founded in 1991, which provides modern food processing services throughout Central and East Europe. (In this success, Poland has also resembled China.) Poland, the initial prophet of drastic change and shock therapy, has become the model of evolutionary gradualism in privatization.

WHITHER POLAND IN THE WORLD ECONOMY?

Following the 1990 reforms, significant changes occurred in Poland's economic and diplomatic relationships with the rest of the world. An immediate outcome in 1990 was a surge

32. Peter Murrell and Yijang Wang, "When Privatization Should Be Delayed: The Effect of Communist Legacies on Organizational and Institutional Reforms," *Journal of Comparative Economics* 17 (1993): 385–406.

of exports to the EU, led by manufactured goods such as chemicals, steel, and transportation equipment, which continued into 1991.[33] In December 1991 this was followed by an Association Agreement with the EU that established Poland as one of the leading front-wave candidates to join the EU.[34] Between 1989 and 1998 the share of exports going to the EU approximately doubled, from about one-third to about two-thirds.

This export surge followed the shift of the CMEA to hard currency dealings on January 1, 1991, and the dissolution of the Warsaw Pact in mid-1991. The year 1991 saw a sharp decline in Polish trade with its former CMEA partners after an increase in 1990, although trade continued to increase with the former USSR, contrary to widespread impressions in the West.

Although the EU accepted Poland for membership as of 2004, considerable opposition has existed within the EU to accepting Poland and its neighbors. Five reasons were put forward by EU governments.[35] One was fear of migration. Wages in Poznań are a tenth of those in Berlin, a mere 200 miles west. Germany already suffers from anti-immigrant sentiments. Another is fear of competition from low-cost producers in Poland. The EU had some trade restrictions on steel and coal imports and very serious limits on low-cost agricultural commodities from Poland. Another complaint was that Poland is not ready to meet the Maastricht conditions for full European unification.

Other areas of concern center on Polish agricultural problems; bad environmental conditions; general regulations on capital movements, property rights, and antitrust; and anticorruption measures perceived to be insufficient. Finally, the EU members feared the cost of subsidies and other supports that may be called for if Poland and its neighbors join, although the agreement that was signed in December 2002 is now widely viewed as insufficiently generous to Poland and the other new members.

One other possible problem between Poland and the West centers on borrowing and investing. Despite Poland's reform success, it has received less FDI than Hungary and, in percentage terms, less than many of its neighbors (see table 13-3). Some of this reticence

33. Bartlomeij Kamiński, Andrzej Kwieciński, and Jan J. Michalek, "Competitiveness of the Polish Economy in Transition," PPRG Discussion Paper No. 20 (Warsaw: Warsaw University, 1993). Although a rising proportion of Polish exports are from its private sector, the worker-managed SOEs proved surprisingly agile and were responsible for much of this surge, maintaining a substantially higher share of exports than of GDP for some time. More recently, as privatization has proceeded further, the remaining SOEs have been less and less successful.

34. For implications of the likely accession for Poland, see Maryla Maliszewska, Jan J. Michalek, and Alasdair Smith, "EU Accession and Poland's External Trade Policy," Economic. Discussion Papers No. 45 (Warsaw: University of Warsaw, 1999); Michat Dobroczyfiski, "Poland and the Socio-Economic Civilisation of the European Union," Economic Discussion Papers No. 53 (Warsaw: University of Warsaw, 2000).

35. "Rejoined: A Survey of Eastern Europe," *The Economist,* March 13, 1993.

Box 12-2
Polish Fears of European Union Accession?

Although the policy of Poland and those of most of its neighbors are strongly directed to joining the EU, as in many Western countries popular opinion has been drifting toward a more fearful and negative, even jaundiced, view of what this might entail. A study of Polish opinion published in 2000 by the Institute of Public Affairs in Warsaw and reported by *The Economist* on January 13, 2001, p. 51, reports the following findings:

1. Whereas in 1996 80 percent favored joining the EU and only 4 percent were opposed, in late 2000 only 56 percent favored joining and 27 percent were opposed.
2. When asked why the EU wants Poland to join, the two main reasons given by the Poles were "to get a bigger market" (60 percent) and "to get cheap labor" (46 percent).
3. When asked who in Poland will gain most from joining, "the educated" and "the politicians" were both listed by over 70 percent; "big companies" by 60 percent; and workers, small businessmen, and priests by about 20 percent.
4. The poles favor having the EU enact laws on crime, the environment, and defense but not on foreign policy, education, or laws regarding moral policies such as that concerning homosexuality.
5. The group most pessimistic about joining are farmers, with many Poles bemoaning the quality of food from the West that would likely replace their "wholesome" locally produced foodstuffs.

Despite these doubts and fears, on June 7–8, 2003, 59 percent of eligible Polish voters turned out to vote on the referendum, which was supported by 77 percent of those voting. Poland will join the European Union.

reflects historical Polish fears of foreign control, especially by Germany.[36] Some of it also reflects the fear of running up excessively large foreign debts, as happened under the Communist governments. Despite maintaining full convertibility of the złoty, Poland maintains restrictions on FDI in real estate, insurance, air and shipping transport, broadcasting, certain forms of telecommunications, and gaming, as well as on certain short-term capital movements.[37]

Some of the relatively modest FDI in Poland also reflects the trepidation of potential foreign investors. Whereas strict command socialist Czechoslovakia ran up few debts before 1989, market socialist–oriented Poland and Hungary both did so with abandon. As of 1990, the debt service ratios of the three countries were, respectively, 25, 71, and 65 percent.[38]

36. As of the end of 1998, Germany indeed had the largest share of total FDI in Poland at 22.8 percent, followed by the United States at 15.7 percent, Italy at 9.0 percent, France at 8.4 percent, and the Netherlands at 5.9 percent. The largest foreign companies investing directly in Poland were the auto producers Fiat of Italy and Daewoo of South Korea, followed by RAO Gazprom of Russia and Bayerische Hypo und Vereinsbank AG of Germany (*OECD Economic Surveys: Poland, January 2000,* pp. 195, 197).

37. *OECD Economic Surveys: Poland, January 2000,* p. 50.

38. *Reforming the Economies of Eastern and Central Europe* (Paris: Organization for Economic Cooperation and Development, 1992), p. 65. The debt service ratio is the ratio of interest payments on foreign debt to export earnings.

Whereas the post-1989 Hungarian government reacted by accepting the debt burden incurred by its predecessors and is paying its obligations in full, the Polish government reacted by complaining about its situation and requesting a reduction of its burden. Lech Wałęsa made the request in an emotional speech[39] to the U.S. Congress, which responded by cutting Poland's formal debts to the United States in half. The result of this action has been a perception of Poland as a land of debt defaulters, in contrast to its neighbors, thereby reducing substantially the enthusiasm of potential foreign investors. However, despite receiving less FDI than many of its neighbors relative to its size, Poland's record of economic success has continued and the fears of foreign investors have gradually receded.

SUMMARY AND CONCLUSIONS

Poland has had a difficult and at times tragic history. After a glorious period in the late Middle Ages and the Renaissance, Catholic and Slavic Poland suffered in the Thirty Years' War and eventually was partitioned by its powerful neighbors in 1795. Regaining independence after World War I, Poland experienced economic difficulties and was partitioned once again by Germany and the USSR in 1939. In World War II it was completely conquered by the Germans. At the end of the war it was conquered yet again by the Soviets and lived under their domination until 1989.

Under Soviet rule, a Stalinist command socialist system was imposed on Poland. The Soviets promoted heavy industrialization, although the deeply religious and anti-Russian Polish peasantry successfully resisted agricultural collectivization that characterized most of the Soviet-bloc countries. After uprisings in 1956 the system was relaxed. Poland compiled a standard record for an East European system, achieving substantial growth prior to the late 1970s while maintaining reasonable income equality and low unemployment. But mounting economic tensions led to the formation of the Solidarity trade union in 1980, which was suppressed in 1981 by martial law imposed by Jaruzelski. The martial law government attempted more marketization, decentralization, and workers' management, but accelerating inflation and foreign indebtedness were the main results. As internal tensions mounted in 1989, a Solidarity-led government came to power in Poland.

A shock therapy (or big bang) plan to transform the Polish economy into a market capitalist system was implemented in 1990, freeing prices, devaluing the złoty and making it freely convertible, and moving toward strict monetary and fiscal policies to combat inflation. The shock therapy plan succeeded largely in controlling inflation. However, a

39. For the gist of his argument, see Lech Wałęsa, *The Struggle and the Triumph: An Autobiography* (New York: Arcade, 1992), pp. 11–12. He invoked a strong sense of guilt for the United States over its role at the Yalta Conference.

dramatic fall in output was followed by a substantial increase in unemployment. Even though Poland later became the most rapidly growing economy in Europe, there was a political backlash against shock therapy and the movement toward market capitalism slowed down.

The Polish economy has not been completely privatized. Agriculture and almost all small enterprises are private, producing nearly 40 percent of GDP, but many large-scale enterprises remain state-owned. Privatization has been roughly equally divided between various commercialization schemes that include capital privatization of large firms and a well-managed voucher scheme through National Investment Funds (NIFs), direct privatization of small enterprises largely through worker or management buyouts, and liquidations and public auctions of unprofitable enterprises. Remaining SOEs are mostly large firms in troubled sectors.

Poland has been accepted for membership in the EU after being granted associate status, despite various disagreements, especially involving agricultural policy. Trade broke down with its former CMEA trading partners but may be revived. Partly because it succeeded in getting its foreign debts reduced, Poland remains somewhat unattractive to foreign investors compared with some of its neighbors.

Taking all factors into consideration, Poland has been one of the most successful of the transition economies. It was the first of the former Soviet bloc nations to regain its 1989 level of real per capita income. Shock therapy ultimately brought inflation under control, although unemployment remains a problem. More gradualist privatization combined with strong encouragement of new enterprises has worked well. While undergoing the transition, Poland has retained most of its social safety net and income inequality has not increased as much as in most other transition countries. Increasingly, the problems of Poland resemble those of a normal Western European economy. Thus, ironically, as Marx forecast, Poland is an external thermometer for its neighbors.

QUESTIONS FOR DISCUSSION

1. How has Poland's history affected its approach to economic reform?
2. What are the implications of the problems in Polish agriculture for reform of agriculture in the republics of the FSU?
3. What have been the greatest successes and failures of the shock therapy approach in Poland?
4. How has Poland's approach to the economic transition differed from that of the Czech Republic?

5. How did the introduction of limited workers' management under martial law affect the later privatization program?

6. How can one explain a former Communist serving as Poland's president?

7. How did Poland's mass privatization differ from those in Russia and the Czech Republic, and what were the consequences?

8. Why did the EU appear to be reluctant to allow Poland and its neighbors to join?

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SLOVAKIA
UKRAINE
AUSTRIA
Ózd
Miskolc
Tokaj
Salgótarján
Eger
Máriapócs
Gyor
Szentendre
Sopron
Pannonhalma
Budapest
Debrecen
Szombathely
Székesfehérvár
Veszprém
Szolnok
Slóiok
Zalaogerszeg
H U N G A R Y
Kiskunhalas
ROMANIA
Kaposvár
Szeged
Pécs
Mohács
CROATIA
FED. OF SERBIA
AND
MONTENEGRO

13 Hungary: Gradualism and the First Successful Completed Transition?

"Now, Comrade Kádár,[1] perhaps you could tell us your opinion."

"Thank you, Comrade Chairman. Well, Marx once wrote . . ."

"Yes, Comrade Kádár, we know what Marx wrote. It's your opinion we want."

"Of course, of course, Comrade Chairman. Well, according to Lenin . . ."

"Please, Comrade Kádár, please; your own thoughts, please."

"Oh, very well, Comrade Chairman, of course comrade, but before I state my own opinion I should like to make very clear in advance that I do not agree with it."

—Old Budapest joke[2]

Despite the State socialism and the presence of Soviet troops, phrases like "the country of revolt," "reform-country," and "the country of goulash-socialism" strengthened the national identity of Hungarians. Now Hungary and the Hungarians struggling with the transformation are faced with signs of pity, contempt and abandonment.

—Éva Ehrlich and Gábor Révész, *Hungary and its prospects 1985–2005,* 1995, p. 120

INTRODUCTION

If Poland is the former Soviet satellite that has fairly successfully engaged in shock therapy, Hungary is the one that has engaged fairly successfully in **gradual transformation.** It was poised to do so because Hungary began a gradual movement toward a market economy after introducing its **New Economic Mechanism (NEM)** in 1968. This market socialist foundation allowed it to move gradually to a reasonably complete market economy without taking a sudden leap across a vast unknown abyss. Hungary shows both the advantages and the disadvantages of a gradual approach to systemic transformation as opposed to a shock therapy approach.

Hungary has many similarities with Poland. Both are Central European nations that were caught between Germany and Russia during the twentieth century, although in earlier centuries Hungary was caught between Germanic Austria and Ottoman Turkey. Both are proudly nationalistic, with a Western orientation. Hungary and Poland were the two most rebellious members of the Soviet bloc in Europe, and both experimented with market-oriented reforms prior to the general loosening introduced during Gorbachev's *perestroika.* In 1989 both slipped away from communism peacefully.

But they have notable differences. Whereas Poland contains a Slavic population and borders on other Slavic nations, Hungary stands alone linguistically and culturally. Its language is not Indo-European,[3] and it is surrounded by Slavs, Germanic Austrians, and

1. János Kádár, Hungary's Communist leader, 1956–1988.

2. William Shawcross, *Crime and Compromise: János Kádár and the Politics of Hungary Since Revolution* (New York: E. P. Dutton, 1974), frontispiece.

3. The languages closest to Magyar, the Hungarian language, are Finnish and Estonian, which are not spoken nearby.

Latinic Romanians, which gives an acute impetus to its nationalism. Hungary spent more time under foreign rule than did Poland, which may explain Hungary's more authoritarian tradition.[4] As in Poland, there have been periodic outbursts of nationalist revolt, such as Hungary's failed anti-Soviet uprising in 1956. But the Hungarians also learned to resist their conquerors pragmatically and passively. After 1956 Hungary trod a careful middle ground, going further toward a market economy than any other Soviet bloc country while staying within bounds acceptable to the Soviets.

Hungary contains some of the most fertile soil in Europe and became the breadbasket of the Soviet bloc. It had the most successful collective farms in the Soviet bloc, in contrast to Poland's unproductive small family farms. An unfortunate outcome of the efforts to privatize Hungary's collective farms was a period of turmoil and sharp decline in agricultural production during much of the 1990s.

Compared to Poland and the rest of the FSU, Hungary's gradualist approach to transition resulted in a less sharp decline in output. Hungary's economy hit bottom later and bounced back more slowly, although it also has suffered negative effects from the wars in the neighboring former Yugoslavia.[5]

Hungary may have a more solid foundation for future growth than Poland, given Hungary's longer experience with markets. It makes interest payments on its foreign debts despite having the highest per capita burden in Europe. The resulting confidence of foreign investors has Hungary far outpacing its neighbors in receiving foreign direct investment despite some slowing after 2001. It adopted a *full-value* privatization process for industry that, while gradual, is now nearly complete and ensures that new owners have sufficient financing to make needed improvements and long-run investments.

Indeed, despite the gradual nature of its transition, many consider Hungary to have gone further along the transition path than any other of the formerly socialist economies; some even declare that, at least in Hungary's case, the transition is over. With a still fairly generous social safety net, Hungary may have gone from being a market socialist economy to being a social market economy.

There are two major remaining problems. Like Poland, Hungary suffers from the relatively ungenerous financial agreement with the EU for joining that body. Given the collapse of the former CMEA trade bloc, the need for full integration in the EU is great. However, like Poland, Hungary will be admitted to the EU in 2004, given that their

4. Another possible explanation is the extreme inequalities in landholdings in Hungary, which persisted to the end of World War II.

5. Besides receiving many refugees, the embargo against Yugoslavia reduced Hungarian exports, with losses in the first half of 1993 equaling about $1 billion. Éva Ehrlich and Gábor Révész, *Hungary and Its Prospects 1985–2005* (Budapest: Akadémiai Kiadó, 1995), p. 40.

respective populations have agreed. Achieving this admission has been the overwhelming focus of current policy and of ongoing reform efforts in Hungary.

The other problem is that, unlike Poland but like Russia and Serbia, Hungary is a nation with many of its ethnic cohorts living in neighboring countries, where they experience discrimination. This fuels an irredentist nationalism that periodically threatens to drag Hungary into conflicts with these neighbors that could yet sabotage economic reform.

HISTORICAL BACKGROUND

Originally from Central Asia, the nomadic Magyars migrated west and settled in Hungary in 896, where they intermarried with the preexisting population and imposed their distinctive language.[6] On Christmas Day, 1000, the pope granted St. Stephen (István) a crown, which remains the mystical symbol of Hungarian nationhood.[7] Hungary's power peaked during the Renaissance in the late 1400s. In 1526 the Hungarians lost their independence to the Ottoman Turks. The Austrian Hapsburgs drove out the Turks and took control in 1687.

After 1830 movements for Hungarian autonomy spread, culminating in 1848–1849 with a nationalist uprising put down by the Hapsburgs, who vigorously suppressed the Hungarians.[8] After being defeated by Prussia, the Hapsburgs decided to ally with the second largest group in their empire, and in 1867 the Dual Monarchy was created in which Hungary shared power with the Austrians.

The Austro-Hungarian Empire

Whereas Austria industrialized and democratized, Hungary remained determinedly feudalistic. In 1848 the serfs were legally freed, but they remained dominated by the nobility. About four-fifths of the rural population owned too little land to be self-sufficient in food, while about one-fifth of the land was held by only 324 estates.[9]

6. A sign of the earlier Slavic farming population is that most farming words in Magyar are of Slavic origin. The term *Magyar* refers to the ethnic group, whereas the term *Hungarian* refers to a citizen of the country. Out of a current population of about 10 million, about 90 percent are Magyar, with the major minority groups being Gypsies, Germans, Jews, and Slovaks.

7. The U.S. government kept this crown from 1945 to 1978. Most Hungarians are Roman Catholic but lack the Polish fervor.

8. This policy was summed up as being implemented by "a standing army of soldiers, a sitting army of officials, a kneeling army of priests, and a creeping army of denunciators" (Oscar Jászi, *The Dissolution of the Hapsburg Monarchy* [Chicago: University of Chicago Press, 1929], p. 102).

9. Jászi, *The Dissolution of the Hapsburg Monarchy,* pp. 222–223.

The Magyars, at best, constituted a bare majority of the population in their zone, while Magyar landlords ruled over Croatian, Serbian, Romanian, Ruthenian, and Slovak peasants. When World War I came,[10] Hungary was on the losing side and was hated by the emerging nationalists among these other ethnic groups.

On Austro-Hungarian surrender in October 1918, Count Mihály Károlyi declared Hungarian independence and called for the creation of an "eastern Switzerland," but the formerly oppressed nationalities withdrew, supported by the victorious allies. The Károlyi government resigned in March 1919 and was replaced by a revolutionary Bolshevik regime led by Béla Kun, who promised to resist the allies and defend Hungarian territory. He was forced to back down and was out of power by August.

Admiral Miklos Horthy took power as regent. He signed the 1920 Treaty of Trianon, which reduced Hungary to about a third of its previous size. Substantial Hungarian minorities ended up in the Vojvodina section of the new state of Yugoslavia, in the Slovakia and Ruthenia portions of the new state of Czechoslovakia, and in Transylvania under Romanian rule. Anger over the treaty fed revisionism, which sought changes in the treaty and led Horthy and Hungary to ally with Italy and Germany in World War II after being granted or seizing chunks of these territories between 1938 and 1941.

The interwar period was characterized by economic stagnation. In 1920 about 15 percent of the rural land was redistributed to the peasants, but severe inequality continued. By 1941 the portion of the agricultural workforce was still 49 percent, while the portion in mining or industry was only 25 percent.[11] In the early 1920s, inflation was followed by a period of stability and trade with Hungary's immediate neighbors. The Great Depression brought a trade war and a shift to trade with Austria, Italy, and Germany.

In 1944 as the Soviets entered from the east, Admiral Horthy attempted to surrender but was imprisoned by the Germans and replaced by a fascist regime that began killing Jews. In April 1945, after much damage and death, the Nazis were defeated in Hungary, which lost its ill-gotten territories.

A multiparty government came to power in 1945, officially led by the peasant-based Smallholder Party.[12] Led by the Stalinist Mátyás Rákosi, the Communists held key ministries, but they came in fourth in elections in late 1945 after land redistribution was carried

10. During the war, Hungary undermined Austria while trying to dominate the groups in its zone. The result was the final dissolution of the Hapsburg Empire. Ironically, many people in these formerly subject areas are nostalgic for it now.

11. Ivan T. Berend and György Ránki, *The Hungarian Economy in the Twentieth Century* (New York: St. Martin's Press, 1985), p. 95.

12. This party reemerged in the 1990 elections to place third in parliamentary seats, but it has since fragmented.

out.[13] Rákosi used *salami tactics* to slice off and reduce the opposition. In 1946 Hungary's hyperinflation, the worst in the world, strengthened the Communists.[14] In 1947 they staged a rigged election in which, despite obtaining only 22 percent of the vote, they came out with the largest number of seats in the parliament and clear control. By 1949 the salami was fully sliced and Rákosi declared a one-party "dictatorship of the proletariat."

HUNGARIAN ECONOMIC POLICIES UNDER COMMUNISM

From Stalinism to Revolution, 1945–1956

At the end of World War II about one-fourth of Hungary's industrial capacity had been destroyed, and the country faced reparations payments to the USSR. The Communists gradually achieved command socialism by the end of the decade. By December 1949 only about 20 percent of the nonagricultural workforce was still in the private sector, all in firms with fewer than 10 employees. By 1960 this figure was zero. Aware of the popularity of the 1945 land reform, Rákosi moved slowly in agriculture, pressing for collectivization after 1948; however, only one-fifth of the agricultural workforce and one-third of the arable land were collectivized by 1952.

A five-year plan began in 1950, emphasizing heavy industrialization within the CMEA framework. Hungary specialized in exporting transportation equipment and vehicles, especially buses, to its socialist trading partners. Electronics was also a specialty and much of Hungary's output was produced by Tungsram, now owned by General Electric. Only in the early 1960s did the industrial workforce exceed the agricultural one. Fertile Hungary became an important food supplier of the Soviet bloc.

The 1950–1953 period saw economic growth exceeding 8 percent per year, increases in income equality, and reductions in economic discrimination against women and ethnic minorities such as Gypsies.[15] But this period also saw intense repression, massive purges,

13. Landless peasants declined from 46.8 percent of the peasant population to only 17 percent, while those holding more than 14 hectares declined from 7 percent to 2.8 percent (Berend and Ránki, *The Hungarian Economy,* p. 184).

14. At its peak in July 1946, the inflation rate was 10 to 12 percent *per hour.* Starvation was prevented by imposing a "calorie-standard" of payment. When the pengo was replaced by the forint, it traded at 4 trillion pengos per forint (Berend and Ránki, *The Hungarian Economy,* pp. 189–191).

15. See E. Lynn Turgeon, *State and Discrimination: The Other Side of the Cold War* (Armonk, N.Y.: M. E. Sharpe, 1989), chap. 7, who argues that the economic position of women and Gypsies relative to non-Gypsy men was best during the Rákosi regime and deteriorated after the 1968 adoption of the NEM. The position of women has remained better in Hungary than in most of East-Central Europe since 1989, at least regarding wage discrimination (Ariane Pailhé, "Gender Discrimination in Central Europe during the Systemic Transition," *Economics of Transition* 8 [2000]: 505–535, although their overall position relative to men has declined (Yudit, Kiss, "System Changes, Export-Oriented Growth and Women in Hungary," *Europe-Asia Studies* 55 [2003]: 3–37).

and jailings. Rákosi filled concentration camps with large numbers of people, many in the USSR.

After Stalin's death in 1953, the Soviets replaced Rákosi as premier, but not as party secretary, with the moderate national Communist Imre Nagy. He established the *New Course,* which involved ending collectivizing agriculture and redistributing investment funds from heavy to light industry. He also closed the prison camps and rehabilitated purged Communist Party members.

In 1955, power returned to Rákosi. But the New Course had set off an intellectual process that would culminate in the New Economic Mechanism of 1968. In 1954 György Péter published influential papers[16] calling for decentralized decision making. These influenced such reformers as János Kornai, the most important economist to emerge from the Soviet bloc and a crucial analyst of systemic transition.

Rákosi's efforts to censor intellectuals associated with Nagy generated popular opposition after February 1956, when Khrushchev denounced Stalin. Conflict and tension accelerated after the Polish riots in June, and Rákosi was removed in July. On October 23, Nagy was reinstated. Mass street uprisings occurred, and on November 1, Nagy announced Hungary's withdrawal from the Warsaw Pact and adoption of political neutrality. Soviet troops entered the country, and on November 4 the revolt was bloodily put down. Nagy was replaced by János Kádár, who remained in power until 1988.[17]

The Move to the "Soft Dictatorship," 1957–1967

Intense repression immediately followed the **Hungarian Revolution.** Economic policy became mostly orthodox. Kádár imposed full collectivization of agriculture. But in contrast to other Soviet bloc countries, peasants were partially paid off and the process proceeded in a fairly voluntary manner, aiding the later success of Hungarian agriculture. Industrialization was implemented more gradually. Annual GDP growth rates averaged 5.7 percent for 1957–1967.

In 1963 Kádár relaxed the repression by issuing a general political amnesty followed by general civil liberalization, including allowing Hungarians limited rights to travel abroad, something forbidden in other Soviet bloc countries except for selected individuals. The economic reformers resurfaced.

16. Originally in Hungarian, an English version of one is György Péter, "On the Planned Central Control and Management of the Economy," *Acta Oeconomica* 2 (1967): 23–45.

17. Nagy was arrested and secretly executed. A crucial actor in these events was the Soviet ambassador, later the longtime KGB director and eventual Soviet leader, Yuri Andropov. The role of Kádár shocked many because he had publicly expressed anti-Soviet views during the uprising. This reversal is behind the "Old Budapest joke" at the beginning of this chapter.

Kádár greatly increased internal civil and economic reforms while observing certain limits. He avoided **workers' management** (at least before 1985), which the Soviets regarded as smacking of **Titoism.** He maintained the one-party state and resisted moves to serious privatization. Kádár slavishly supported Soviet foreign policy, including providing troops for the 1968 Czechoslovak repression. He followed the line of internal Soviet policy. The NEM coincided with the **Kosygin reforms** in Moscow; the backlash in late 1972 coincided with a backlash in Moscow; the return to reform in 1979 with its Western trade focus coincided with a peak of United States–USSR detente; and the acceleration of reforms after 1985 coincided with Gorbachev's *perestroika.*[18]

The New Economic Mechanism, 1968–1989

In 1968 Hungary ended its short-term central command economy. Command planning was then limited to infrastructure investments in high-priority sectors, administrative regulation of defense industries, supervision of domestic supply responsibilities for certain key products, and fulfillment of CMEA obligations. Decentralization included firm-specific profitability rewards such as managerial bonuses and profit sharing for employees, allowing approximately one-quarter of the prices to be set by market forces. This allowed contracting for production of producer goods by producer and user firms in many industries, allowed some firm-level autonomy over investment out of retained profits, and allowed some managerial discretion in setting wages and in hiring and firing.

This decentralization went further toward market mechanisms than the mechanisms in any other avowedly socialist economy except for Yugoslavia, which had mostly eliminated command central planning in the 1950s and had adopted workers' management. The initial reception of the plan in Hungary was favorable, and the economy grew at an annual rate of 6.1 percent between 1968 and 1972. This **goulash communism** made Kádár a semipopular leader.

After 1972, portions of the NEM involving firm-level control over the distribution of profits and the setting of wages and investment were weakened by pressure from the largest firms[19] and the trade unions, the major beneficiaries of the NEM being small and

18. Kornai recalls that from 1963 until the late 1980s there were four taboos for an economist in Hungary: "First, you couldn't question Hungary's belonging to the Warsaw Pact and its relationship with the Soviet Union; second, you couldn't question the Communist Party's monopoly of power; third, you could not reject the predominant role of state ownership; and fourth, you couldn't directly attack Marx, or even voice a serious critical view of him" (Olivier Blanchard, "An Interview with Janos Kornai," *Macroeconomic Dynamics* 3 [1999]: 437).

19. Hungary suffers from an especially top-heavy distribution of firm sizes (Éva Ehrlich, "The Size Structure of Manufacturing Establishments and Enterprises: An International Comparison," *Journal of Comparative Economics* 9 [1985]: 267–295.) This continues to be a problem; increased monopoly power emerged as marketization and privatization proceeded.

medium-sized firms. Subsidies increased to large, unprofitable firms, ushering in the soft budget constraint, first identified by János Kornai and discussed in chapter 3 as the principal systemic Achilles heel of market socialism. To review this concept, firms have the freedom but not the incentive to behave efficiently because the government will always bail them out. Annual growth rates averaged 5.2 percent in 1972–1978, but then slowed down, with a worsening trade deficit after the first oil price shock in 1973 and a rising foreign debt burden, as the government borrowed recklessly from abroad to finance its soft-budget-constrained enterprises.

By 1979, Hungary had achieved the highest per capita level of foreign debt of any CMEA nation, triggering a return to reform. Hungary became the first Soviet bloc nation to join the IMF and the World Bank since the late 1940s. Following IMF policies, Hungary adopted tight monetary policy and restrictions on imports while trying to stimulate exports, temporarily halting increases in foreign indebtedness. Hungary also eased restrictions on partnerships with foreign firms.

During this period, efforts were made to streamline the government bureaucracy, to remove central control from about 50 percent of prices, to break up some of the larger enterprises into smaller units, and to relax restrictions on some small-scale private enterprises, especially cooperatives, subsidiaries, and domestic joint ventures. A significant private nonagricultural sector reemerged and many citizens worked extra jobs in the **second economy,** an increasing source of income. Given austerity, overall growth was an anemic 1.1 percent per year during 1979–1984.

In 1985 Mikhail Gorbachev[20] came to power in the USSR. His *glasnost* and *perestroika* allowed the Hungarians to lay the basic groundwork for outright market capitalism. Leasing of land, certain equipment, and structures for private use by members of collective farms was allowed. Agriculture had been the first sector freed from central orders in 1965 and had experienced solid output growth, with a much larger share of exports being agricultural than in any other European CMEA country (see table 12-3). Other changes were election of enterprise managers by workers, limited workers' management, a move toward cooperatives, loosening of restrictions on foreign trade, and further loosening of controls on prices.

In 1987 commercial banking was separated from the Central Bank and a decentralized system of financial intermediaries was established with bond and, eventually, stock markets. In these areas Hungary preceded its neighbors and established the basis for its later gradualistic path. The annual growth rate rose slightly to 1.3 percent, accompanied

20. In 1985 he took part in a policy debate over whether to follow the East German model of tightened central planning or the looser Hungarian model. His favoring the Hungarian model reflected the influence of his mentor, Yuri Andropov, who became a great fan of the country and its system, despite his role in crushing the 1956 uprising.

by renewed accumulation of foreign debts and accelerating inflation that would reach double-digit rates in 1988,[21] the last year of positive output growth until 1994.

Intensified policy debates culminated in a party conference in May 1988. Kádár was replaced as party secretary by Károly Grósz, and all of Kádár's close associates were removed from the Politburo. Two years later, the Communists were voted out of power after allowing other parties to operate starting in 1989. But the 1988 party leadership was already committed to moving toward market capitalism. The 1988 Act on Enterprises triggered a wave of spontaneous privatizations. Market socialism was ending.

AN EVALUATION OF MARKET SOCIALISM IN HUNGARY

Was It Really Market Socialism?

As discussed in chapter 3, market socialism's most influential theorist was Oskar Lange, who argued that state-owned firms would operate in competitive markets adjusted by the central planner to correct for market failures such as externalities. Lange did not posit workers' management, but that developed in Yugoslavia, the first self-proclaimed market socialist economy, discussed in the next chapter. The goal was to seek a **middle way** different from those of the social market economies like Sweden or West Germany, in which the virtues of both markets and socialism would be manifested, the efficiency and flexibility of the former with the egalitarianism and macrostability of the latter.

During the 1968–1988 period Hungarian leaders claimed to be following a market socialist model. But were they? In important ways they were. Ownership of the means of production remained overwhelmingly in state hands, many prices were decontrolled, and most short-term command central planning was inoperative. Nevertheless, many prices remained controlled, and the central government used many methods to coordinate enterprise behavior bureaucratically.

The one way Hungary deviated from the Lange model was in its high degree of monopolization. There have been two market socialist traditions: **Manchesterian,** which emphasizes reliance on reasonably competitive markets and is the Langean version, and **anti-Manchesterian,** which came out of late-nineteenth and early twentieth-century German Social Democratic Party mainstream theory.[22] The anti-Manchesterian school

21. It can be argued that Hungary experienced endogenous monetary expansion after the legalization of commercial banking in 1987 (Shirley J. Gedeon, "Failure of Monetary Restriction in Hungary and Yugoslavia: A Post Keynesian Interpretation," in M. Knell and C. Rider, eds., *Socialist Economies in Transition: Appraisals of the Market Mechanism* [Aldershot, U.K.: Edward Elgar, 1994], pp. 154–169).

22. See Alberto Chilosi, "Market Socialism: A Historical View and a Retrospective Assessment," *Economic Systems* 16 (1992): 171–185, for a discussion of the roots of these schools.

Box 13-1
The Soft Budget Constraint and the Instability of Market Socialism

János Kornai argues that the middle way is fundamentally an unstable system that tends ultimately to revert to a system of state control or to move the other way toward market capitalism.* Central to his argument is the soft budget constraint and its role as the main mechanism of continued state interference and control of the economy. Ultimately, the soft budget constraint involves subsidies that allow firms to ignore market signals.

But the soft budget constraint can take a multitude of forms, and it did in Hungary: individualization of rules emphasized by continuing bureaucratic control over managerial promotions, tax breaks, uncertainty and negotiation with the appropriate government ministries using political connections, manipulation of prices, low-interest loans with no deadlines for repayment, generous central allocations of investment funds, and outright monetary transfers. "The naive reformer does not recognize the conflicts between indirect bureaucratic control and the market," Kornai wrote.†

*János Kornai, *The Socialist System: The Political Economy of Communism* (Princeton, N.J.: Princeton University Press, 1992), chap. 24.
†János Kornai, "The Hungarian Reform Process: Visions, Hopes, and Reality," *Journal of Economic Literature* 24 (1986): 1, 728.

argues that economies of scale should be taken advantage of and that competition is no guarantee of optimality. Given the high concentration of industries in the Hungarian economy, Hungary followed the second rather than the first approach.

Among Hungarian reformers and theorists a distinct evolution of thought developed, a transition from being *naive reformers,* as in the early writings of Péter and Kornai, to being either *radical reformers* (Manchesterians) or **Galbraithian socialists** (anti-Manchesterians). Eventually the radical reformers, including Kornai, supported full market capitalism.

Macroeconomic Performance

By the late 1980s Hungary was ahead of most of the socialist world in living standards. Only those countries that had industrialized prior to becoming socialist, the GDR and Czechoslovakia, were clearly ahead of it.

One problem with market socialism, when wracked by soft budget constraints, is a tendency toward inflation. Inflation became very serious in Poland after its move to market socialism in the early 1980s and also in Yugoslavia in the 1980s. But inflation was less serious in Hungary, which did not experience double-digit rates until 1988 and passed a peak rate of 38 percent in 1991. Annual comparative macro data for Czechoslovakia, Hungary, and Poland for the early transition period are shown in table 12-4, while more overall numbers are provided for a broader set of transition economies in table 3-1. Although Hungary was in recession in 1989, its unemployment rate was then a mere 0.5 percent. Table 13-1

Table 13-1
Inflation Rates in Market Socialist Economies

Year	Hungary	China	Poland	Yugoslavia
1980	9.1	6.0	9.1	n.a.
1981	4.6	2.4	24.4	46.0
1982	6.9	1.9	101.5	30.0
1983	7.3	1.5	23.0	39.0
1984	8.3	2.8	15.7	57.0
1985	7.0	8.8	14.4	76.0
1986	5.3	6.0	18.0	88.0
1987	8.6	7.3	25.3	118.0
1988	15.5	18.5	61.3	199.0
1989	17.0	17.8	244.1	1,256.0

Source: Data from János Kornai, *The Socialist System: The Political Economy of Communism* (Princeton, N.J.: Princeton University Press, 1992), p. 550.

shows inflation rates for Hungary, China, Poland, and Yugoslavia for 1980–1989. Thus, until the end of Hungary's market socialist period, it experienced fairly steady growth with single-digit inflation and very low unemployment.

The system also exhibited microeconomic virtues for consumers compared with command socialism. There were few lines in Hungary to obtain reasonably available consumer goods, in sharp contrast with the situation in the USSR, where the average consumer spent several hours per day in lines and many goods were chronically in short supply. This favorable situation for Hungarians coincided with generally greater civil liberties than in the other Soviet bloc countries throughout this period.[23]

The Distribution of Income and Broader Social Indicators

Movement toward a market economy often leads to increased income inequality. But Hungary's income distribution not only was more equal than those of most of its cohorts, it also peaked around 1982, well within the market socialist period.

The 1986 decile earnings ratio data for a broad set of countries, including the Soviet republics, show that Hungary had more income equality than Poland, the USSR, the United Kingdom, and the rest of the Soviet bloc except for Czechoslovakia.[24] However, Hungary had not eliminated poverty. Between 1977 and 1987 the proportion of the population below

23. This is relative only to the Soviet bloc. There were still restrictions on political and other activities unseen in the West, and the ability to buy the available goods increasingly depended on working in the second economy because of poor first-economy wages. Hoarding and a shortage mentality persisted.

24. Anthony B. Atkinson and John Micklewright, *Economic Transformation in Eastern Europe and the Distribution of Income* (Cambridge: Cambridge University Press, 1992), p. 103.

the minimum subsistence level was between 11 and 17 percent, depending on the estimation method, a range lower than Poland's. The lowest poverty rates in Hungary were achieved around 1982.[25] Much of the poverty was concentrated among the Gypsies, especially in the eastern parts of Hungary, still the poorest region of the country. Hungary had a very generous social safety net, with the highest family benefits of any European country at 25 percent of average earnings, compared to 20 percent in second-place Czechoslovakia in 1989.[26]

Another measure of inequality, the ratio of the average income earned by those above the overall average income level to the average income of those below the overall average income level, correlates with the decile ratios results. This measure of inequality increased after the prereform year of 1967 from 1.92 to 1.96 in 1972, but then declined to 1.84 in 1977 and to 1.82 in 1982.[27]

Despite generally favorable economic results, Hungary experienced some unfavorable social trends. Although life expectancy for females steadily increased until 1991, reaching 73.8 years, it declined to 73.7 years in 1992. Life expectancy for men peaked in 1970 at 66.3 years but steadily declined to 64.6 years in 1992.[28] This trend may reflect the near quintupling of per capita beer consumption and the near tripling of per capita wine and brandy consumption between 1960 and 1984.[29]

It may also reflect the mystery of why Hungary possesses the world's highest suicide rate, which rose sharply from a low of 17.7 per 100,000 population in 1954 to a high of 45.6 in 1981.[30] There has been much speculation about this, including a cultural-linguistic theory based on Finland's having the world's second highest rate and the two countries speaking related languages. It is unlikely that this high suicide rate or the lowered male life expectancy was caused solely by the economic system, but they stand as a warning that one cannot infer social happiness from apparently favorable economic data.

25. Atkinson and Micklewright, *Economic Transformation,* pp. 231, 234.

26. Atkinson and Micklewright, *Economic Transformation,* p. 217.

27. Kornai, "The Hungarian Reform Process," *Journal of Economic Literature* 24 (1986): p. 1725. Unreported second economy income was increasing as a proportion of the total throughout this period, possibly nullifying these results. Also, *nomenklatura* perks are not counted, making the numbers overstate the degree of equality, although not over time or relative to the rest of the Soviet bloc.

28. Ehrlich and Révész, *Hungary and Its Prospects,* p. 107. Male life expectancy has remained low and for 40-year-old men is easily the lowest in the OECD, which Hungary has joined (*OECD Economic Surveys: Hungary 1999* [Paris: Organization for Economic Cooperation and Development, 1999], pp. 98–103).

29. Hans-Georg Heinrich, *Hungary: Politics, Economics and Society* (Boulder, Colo.: Lynne Rienner, 1986), p. 135.

30. Heinrich, *Politics, Economics and Society,* p. 137.

THE POST-1989 TRANSITION

General Political and Policy Changes

When a democratically elected non-Communist government came to power under József Antall in May 1990, most of the framework for the subsequent economic transition policies was already in place. The Antall regime actually slowed down the by-then highly accelerated process of reform and reinforced Hungarian gradualism without reversing or halting the reforms.

The post-Kádár Communist governments engaged in dramatic policies, including allowing East Germans to emigrate through Austria to West Germany in September 1989.[31] This set in motion the process that two months later culminated in the fall of the Berlin Wall and the subsequent political upheavals throughout Eastern Europe. During elections in March 1990, the government established the State Property Agency (SPA) to oversee privatization and agreed with the USSR on troop withdrawals.

The leading party in the 1990 election was Antall's Democratic Forum, a rural-based conservative party with a nationalist bent.[32] Second was the urban-based Free Democrats, who supported Polish-style shock therapy. Third was the revived Smallholder Party, which supported restitution of agricultural land to former owners or their heirs. Fourth was the successor to the Communists, the Socialist Party of Hungary. The Democratic Forum, the Smallholders, and the fifth-place Christian Democrats formed the government. The Smallholder Party splintered, and Antall died in 1993. After an election in the summer of 1994, the Socialists under Gyula Horn won and formed a government with the Free Democrats. Power has oscillated to the right and then back to the left again since then.

The crucial economic policymaker in the Horn government was Lajos Bokros, who introduced a fiscal austerity program in March 1995 along with an incomes policy. Hungary's current account deficit and budget deficit had both surged in 1994; after the Mexican debt crisis of 1994, there was fear that it might spread to Hungary. This fiscal austerity program substantially cut the previously generous social safety net, with the share of GDP going to

31. The barbed wire along the border was taken down in May 1989. Now it is Austria and other Western nations that are trying to keep immigrants from the East out, rather than the Eastern nations trying to keep their citizens in.

32. Antall upset his immediate neighbors by declaring, after becoming prime minister, that he was the "protector" of their Hungarian minorities: 2 million in Romania, 600,000 in Slovakia, and 400,000 in Yugoslavia. Relations with Romania have at times been especially tense because of serious anti-Hungarian discrimination in Transylvania. Relations worsened with Slovakia after it became independent in 1993 and began to mistreat its Hungarian minority. The Serbians became upset at reports of Hungary arming Croatia, long a province of Hungary. The Horn government was less bellicose in dealing with its neighbors but tensions continue, with this issue splitting the Right and the Left in Hungary.

social security and welfare declining from 20 percent in 1994 to 14.7 percent in 1997.[33] Bokros left the government the following year, and political control of Hungary has oscillated among the various political parties since then. But the basic pattern of policy he established has remained in place, with some declaring that after this time, Hungary was no longer on a gradualist path.

Antall formally moved in June 1990 to dissolve the Warsaw Pact, which happened a year later, along with the dissolution of the CMEA. Hungary joined the Višegrad Group, initially with Poland and Czechoslovakia and now including the Czech Republic and Slovakia as separate members. Hungary is one of the front-wave counties among the first eight of the transition countries to join the EU in 2004, and in 1997 it joined NATO, its bases being used during the war in Kosovo in 1999. It was one of the first nations to recognize the independence of the former Soviet republics, including its neighbor, Ukraine. It has sought good relations with Germany and its immediate neighbor, Austria,[34] the two nations that lead FDI in Hungary.

The Hungarian Approach to Privatization

Whereas Poland emphasized worker-management buyouts,[35] the Czech Republic emphasized voucher distribution schemes, and Russia used both, Hungary followed a more deliberate policy somewhat resembling the cautious British privatizations under Margaret Thatcher. The Antall government insisted on this approach, undoing a series of spontaneous *nomenklatura* privatizations that occurred after 1988 by initially renationalizing those firms.

The SPA sells firms at full value to cash-paying buyers, many of them foreign firms, either on the stock market, in open auctions, or after negotiations with the SPA. Although not encouraged, worker-management buyouts have not been prevented, and some have occurred. Also, as in Poland, many new enterprises have been formed by domestic entrepreneurs, many surfacing from the hidden second economy. Despite gradualism, Hungary

33. *OECD Economic Surveys: Hungary 1999,* p. 49. For more detailed discussions of the policies of Bokros, the runup to them, and their aftermath, see János Kornai, "Adjustment without Recession: A Case Study of Hungarian Stabilization," in S. Zecchini, ed., *Lessons from the Economic Transition: Central and Eastern Europe in the 1990s* (Dordrecht: Kluwer Academic for the OECD, 1997), pp. 123–151; László Csaba, "A Decade of Transformation in Hungarian Economic Policy: Dynamics, Constraints and Prospects," *Europe-Asia Studies* 50 (1998): 1381–1391.

34. Hungarians have some nostalgia for the Austro-Hungarian Empire. When Zita, the last empress, died at age 96 in 1989, her Vienna funeral was broadcast live on Hungarian TV and 100,000 Hungarians crossed the border to witness the event live.

35. For a comparison of Polish and Hungarian privatization schemes see Kálman Miszei, "Privatization in Eastern Europe: A Comparative Study of Poland and Hungary," *Soviet Studies* 44 (1992): 283–296.

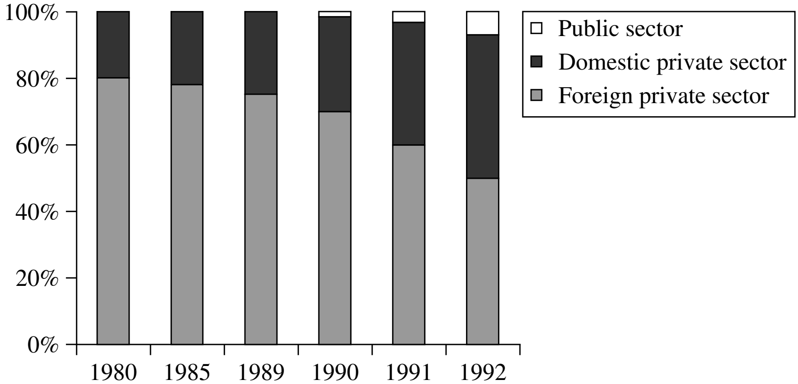

Figure 13-1
Public-Private Balance of GDP in Hungary.
Source: Data from Ehrlich and Révész, *Hungary and Its Prospects 1985–2005* (Budapest: Akadémiai Kiadó, 1995), p. 32, shows percentages of GDP for the given years in the public, domestic private, and foreign private sectors, including an estimate of the portion due to the hidden economy as well. Data includes agriculture, where much of the initial private activity occurred.

has accomplished substantial privatization to the point where a solid majority of the economy is now in private hands. Data on the early stages pace of Hungary's privatization process are presented in figure 13-1. By the end of 1997, the share of business capital owned by the state was down to 21 percent and the share of output by the state sector was down to 15 percent. While the government continues to retain shares in companies in crucial sectors, its ownership pattern now closely resembles that of many countries in western Europe.[36]

Whereas the voucher schemes of the Czech Republic, Russia, and Mongolia resulted in more rapid shifts to official private ownership than in Hungary, the Hungarian approach has had its advantages, including lack of the state bureaucratic interference and control in those countries through soft budget constraint devices such as subsidies. Subsidies to Hungarian enterprises from the state declined from 12.3 percent of GDP in 1987 to 2.3 percent of GDP in 1992[37] and to zero under the Bokros reforms in 1995. In addition, Hungary passed a strict bankruptcy law in 1992, which, combined with a nearly complete privatization of banking, has led Hungary to have by far the hardest budget constraint of any of the formerly socialist

36. Data on the share of business capital are from Éva Ehrlich and Gábor Révész, "Coming in from the Cold: The Hungarian Economy in the 20th Century," Institute of World Economics Working Paper No. 109 (Budapest: Hungarian Academy of Sciences, 2000), and data on the share of output are from *OECD Economic Surveys: Hungary 1999,* pp. 76–80.

37. János Kornai, "The Evolution of Financial Discipline under the Postsocialist System," *Kyklos* 46 (1993): 317.

economies—indeed, harder than those of most OECD countries. Arguably this reflects the immense policy influence of János Kornai in his native country.

Having cash-paying buyers has meant that the privatized firms are able to make capital investments and productivity improvements through management restructuring. Hungarians were disappointed that many foreign buyers did not always act as expected and have in some cases downgraded their Hungarian facilities. However, since tariffs on imported inputs were removed in 1995, more recent foreign investment appears to have moved more toward higher-technology and higher-skilled-labor export sectors.

Despite considerable success in reducing the state sector in Hungary, Kornai describes limits to this process.[38] Although the bureaucracy of the Communist Party has been disbanded, the new political parties have created professional staffs to work with the new legislative bodies. Although the planning bureaucracy no longer exists, new agencies for regulating the market economy have been created, such as for banking, insurance, and antitrust activities. Although the former secret police have been dismissed, soaring crime has caused a greater need for regular police. Although formerly disputes were settled by party secretaries, now a court and legal system has appeared and expanded to resolve such matters.

Post-1989 Macroeconomic Performance

Hungary's output declined from 1988 to 1993, but less than in most other former Soviet bloc countries, and inflation was more moderate and improving, although unemployment was at uncomfortable double-digit levels. The high unemployment rates reflect the hardened budget constraint combined with a clearer and stricter bankruptcy law than in most other former CMEA countries. The 1992 overall GDP was 81.2 percent of the 1989 level, although industrial production declined to 71 percent, agriculture and forestry to 75.5 percent, and services to 96.9 percent.[39] Overall macroeconomic performance data are presented in tables 3-1 and 12-4.

The years 1994 and 1995 saw the macroeconomy threatening to get out of control, which prompted the Bokros reforms in 1995. In that year, growth was slow but steady, with unemployment declining to 10 percent while inflation surged to 30 percent. Whereas the current account deficit was nearly 10 percent in 1994 and the budget deficit was about 7 percent of GDP, these numbers improved noticeably in 1995 and 1996, only to worsen somewhat in 1997 while stabilizing afterward.

38. János Kornai, "The Postsocialist Transition and the State: Reflections in the Light of Hungarian Fiscal Problems," *American Economic Review, Papers and Proceedings* 82 (1992): 1–21.

39. Ehrlich and Révész, *Hungary and Its Prospects,* p. 148.

However, Hungary avoided sliding into recession, even after the 1998 Russian financial crisis. With steady growth, real per capita income moved above the 1989 level by 2001, with unemployment steadily declining, dropping below 10 percent in 1996, despite continuing problems in the eastern part of the country. Hungary's inflation rate was still 4.8 percent in late 2002, higher than those of its immediate Višegrad neighbors. In conjunction with this continuing higher inflation, Hungary had a gliding band policy for its currency, the forint, with a fairly steady pattern of depreciation occurring, declining in value by nearly one-half against the dollar between the end of 1998 and mid-2001.[40] Finally, depreciation ended in May 2002, with the forint pegged to the euro.

The Collapse of Agriculture

A great shock has been Hungary's declining agricultural production, which in turn hit animal production hard. The number of cattle and pigs produced in 1992 dropped to about two-thirds of their 1985 level.[41]

Hungarian agriculture was a major export earner and was dominated by cooperatives that controlled well over 50 percent of production.[42] Cooperatives exhibit more control by farmers over management than do simple collectives. Properly managed collective farms in East Europe were generally more productive than small-scale family farms, although family plots associated with cooperatives were the most productive of all because the collective farms provided many public goods and achieved economies of scale through shared machinery.[43] After 1965, marketization allowed great flexibility and eventually allowed individual farmers to lease cooperative property, an arrangement somewhat resembling the family responsibility system in China described in chapter 15.

Part of the decline in agriculture resulted from bad weather and part from the breakup of the CMEA and the resulting loss of foreign markets that were not replaced by Western ones because of the protectionist stance of the EU. But more devastating was the emergence of severe uncertainty regarding property rights in agriculture, described in box 13-2. However, despite its transition problems in agriculture, Hungary has remained a net exporter of agricultural products. As of 1998, about 25 percent of agricultural land was still owned

40. *OECD Economic Surveys: Hungary 1999; The Economist,* May 12–18, 2001, p. 110. *Gliding band* policies have a range within which the currency freely fluctuates, with that range gradually adjusting.

41. Ehrlich and Révész, *Hungary and Its Prospects,* p. 150.

42. Frederic L. Pryor, *The Red and the Green: The Rise and Fall of Collectivized Agriculture in Marxist Regimes* (Princeton, N.J.: Princeton University Press, 1992), p. 417.

43. On this point see Robert McIntyre, "The Phantom of Transition: Privatization of Agriculture in the Former Soviet Union and Eastern Europe," *Comparative Economic Studies* 34 (1992): 81–95. For the general productivity issue see E. Lynn Turgeon, "A Quarter Century of Non-Soviet East European Agriculture," *ACES Bulletin* 15 (1983): 27–41.

Box 13-2
Privatization Pitfalls: Hungarian Agriculture

Many consider uncertainty about property rights to be the main culprit in the collapse of Hungarian agricultural output. The main source of this uncertainty is the demand for restitution to previous owners by the Smallholder Party, a demand that apparently would largely benefit urbanites who would suddenly become absentee landlords. Cooperative lands were assigned to individual owners, and compensation vouchers were distributed to previous owners or their heirs. This led to abandonment or destruction of commonly held equipment such as machinery and storage facilities, as well as killing of livestock in a reverse parallel of the Soviet agricultural collectivization of the 1930s. Recipients of vouchers include current farmers wanting higher wages, pensioners wanting higher rents, and urban heirs wanting to be able to sell their plots. The voucher system has led to conflict, confusion, and general paralysis that has been very damaging, despite a gradual stabilization of the situation, with about a third of the land being returned to its owners,* a third distributed in vouchers, and a third distributed to farm workers.

*Restitution has been widely used for distribution of former collective farm lands in much of Central and Eastern Europe.
Source: Johan F. M Swinnen, "The Political Economy of Land Reform Choices in Central and Eastern Europe," *Economics of Transition* 7 (1999): 637–664.

by cooperatives.[44] Today its more serious problem is integrating into the EU's Common Agricultural Policy on terms that are arguably unequal with those of older members.

The Distribution of Income

As in other postsocialist economies, the distribution of income in Hungary has become substantially more unequal. The percentage of the population below the official poverty line approximately doubled between 1989 and 1992 and approximately doubled again by 1996.[45]

Table 13-2 shows the shares of household income going to the bottom and top 10 percent of the population and decile ratios at 10-year intervals from 1962 to 1992, along with the decile ratios for 1989 and 1996, with Gini coefficients for 1989, 1992, and 1996. The increased inequality from 1982 to 1992 is sharp, although partially mitigated by the elimination of unreported *nomenklatura* perks.

However, although not as good as that of neighboring Slovakia, the record in Hungary is much better than that of most of the FSU. Evidence suggests that since 1995 the trend may have slightly improved, and despite the fiscal cutbacks under Bokros, Hungary continues to have a relatively generous social safety net, with the highest social security tax rates in

44. Mieke Meurs, *The Evolution of Agrarian Institutions: A Comparative Study of Post-Socialist Hungary and Bulgaria* (Ann Arbor: University of Michigan Press, 2001), p. 1.

45. Ehrlich and Révész, *Hungary and Its Prospects,* p. 99; Zsolt Spéder, "Poverty Dynamics in Hungary during the Transformation," *Economics of Transition* 5 (1998): p. 4.

Table 13-2
Hungarian Distribution of Household Income

Year	Share to Top 10%	Share to Bottom 10%	Decile Ratio	Gini Coefficient
1962	3.9	20.2	5.2	n.a.
1972	4.0	19.7	4.9	n.a.
1982	4.9	18.6	3.8	n.a.
1989	n.a.	n.a.	n.a.	0.237
1992	3.9	24.3	6.2	0.295
1996	n.a.	n.a.	7.6	0.308

Sources: Data for 1962–1982 and for decile shares and the ratio for 1992 from Éva Ehrlich and Gabor Révész, *Hungary and Its Prospects 1985–2005* (Budapest: Akadémai Kiadó, 1995), p. 157; for Gini coefficients for 1989 and 1992 from Barabara Boyle Terry, Timothy M. Smeeding, and Debra Bailey, "Income Transitions in Central European Households," *Economic Development and Cultural Change* 47 (1999): 251; and for the decile ratio and Gini coefficient for 1996 from Zsolt Spéder, "Poverty Dynamics in Hungary during the Transformation," *Economics of Transition* 6 (1998): 12.

the region.[46] The most difficult problems are the widening regional gap between the western and eastern areas and the continuing deep poverty of the Gypsy minority.

Foreign Trade and Investment

Hungary's situation has similarities to Poland's. Both are joining the EU after the dissolution of the CMEA and the collapse of their former markets. Both had high foreign debt burdens, but whereas Poland demanded debt reductions, Hungary did not. Hungary has begun to reduce its indebtedness gradually, in both absolute and net terms, while attracting the largest amount of FDI of any former CMEA country. Hungarian exports in 1992 were 93 percent of those in 1989, an increase from 1991 after previous declines.[47]

The redirection of trade has been dramatic. Whereas in 1988 45.5 percent of exports and 44.3 percent of imports were with CMEA countries, by 1991 those proportions had declined to 18.9 and 21.2 percent, respectively.[48] This shift had major implications for

46. Spéder, "Poverty Dynamics"; Mark Kramer, "Social Protection Policies and Safety Nets in East-Central Europe: Dilemmas of the Postcommunist Transformation," in E. B. Kapstein and M. Mandelbaum, eds., *Sustaining the Transition: The Social Safety Net in Postcommunist Europe* (New York: Council on Foreign Relations, 1997), p. 60. For further discussion see Michael F. Förster and István György Tóth, "Poverty, Inequalities, and Social Policies in the Visegrad Countries," *Economics of Transition* 5 (1997): 505–510; Branko Milanovic, "The Role of Social Assistance in Addressing Poverty," in J. Braithwaite, C. Grootaert, and B. Milanovic, eds., *Poverty and Social Assistance in Transition Countries* (New York: St. Martin's Press, 1999), pp. 99–156; World Bank, *Making Transition Work for Everyone: Poverty and Inequality in Europe and Central Asia* (Washington, D.C.: World Bank, 2000).

47. Ehrlich and Révész, *Hungary and Its Prospects,* p. 150.

48. Sándor Richter, "Hungary's Changed Patterns of Trade and Their Effects," *Soviet Studies* 44 (1992): 973.

Table 13-3
Cumulative Foreign Direct Investment Inflows

Country	FDI in Millions of US$, 1989–1995	As a Percentage of GDP in 1994
Hungary	10,634	31
Poland	6,459	7
Czech Republic	3,996	13
Russia	3,900	1
Romania	1,101	3
Ukraine	950	1
Kazakhstan	719	3
Estonia	646	14
Latvia	323	5
Albania	186	12

Source: World Development Report 1996: From Plan to Market (New York: Oxford University Press for the World Bank, 1996), p. 64. The nations listed are those for which either the cumulative flow exceeded $500 million or the percentage of 1994 GDP was at least 5 percent. China is not listed here, but from the same table, its cumulative total was $121,704 million, with a percentage of GDP about the same as Hungary's.

the sectoral structure of Hungarian exports, as quite different goods were exported to the socialist countries than to the nonsocialist countries. The main emphasis of Hungary's trade policy is to increase exports to the EU as it joins that organization.[49]

The biggest shift has been in the machinery and transport equipment sector, long dominated by Hungary's famous buses produced by Ikarus. Bus production and exports sharply declined because of protected markets in the West and the collapse of markets in the East. However, during the late 1990s, foreign auto producers built new parts and assembly plants in northern and western Hungary for the export market, including Audi, Ford, GM Opel, and Suzuki.

Among the most striking aspects of the Hungarian transition has been the enormous amount of FDI that Hungary has received, well ahead of any other former CMEA countries both in total and compared to its GDP, as shown in table 13-3. This reflects the very investment-friendly Hungarian policies and the perception by many foreigners that Hungary has a more established market institutional environment and a more stable economy than other transition economies. Approximately half of this FDI has been for new plant construction and the other half has been for the takeover of existing firms, the latter being a major part of the privatization process in Hungary. Even though Hungary now has

49. For a discussion of Hungary's status in terms of accession to the EU, see Éva Ehrlich, *Infrastructure Services* (Budapest: Strategic Task Force for European Integration, 1998). Curiously, as part of its drive to join the EU as a fully developed market economy, it instituted the six-year Szechenyi Plan to direct government cofunding of many development activities (*The Hungarian Economy* 30[1] [2001]: 3–18).

virtually no restrictions on such long-term direct investment,[50] it continued to maintain certain restrictions on short-term capital flows as late as 1999.

Hungary's industrial sectors can be divided into four groups for analyzing foreign investment.[51] One is heavily tied to ongoing trade with the former CMEA, such as the professional electronics, petrochemicals, and oil and gas equipment industries. Initially these industries attracted investors interested in gaining access to the former Soviet market, but in the later 1990s the relatively highly skilled machinery sector became the most rapidly growing export sector, selling to the EU.[52]

The second group consists of the genuinely high-tech sectors led by politically well connected individuals, such as pharmaceuticals and plastics. These industries tended to be privatized early and have attracted substantial foreign investment designed to acquire access to their R&D.

The third group had markets in the former CMEA that have largely disappeared, including steel, textiles, and consumer electronics. There has been some investment in this area in the hope of creating EU-competitive exports based on low wages or protected domestic industries.

The final group is dominated by cultural areas such as food, furniture, and the building industry. This group has attracted less investment except in selected firms, such as the Nagykanizsa Furniture Factory, which was bought out by IKEA of Sweden.

For the future of the Hungarian economy, the second group is especially important. Hungary has had a strong tradition of education, research, and high-technology development in several areas. Besides pharmaceuticals and plastics, Hungarians have long been at world-class levels in mathematics and physics, and have the possibility of expanding into computer software development.[53]

But during the 1990s there were cutbacks in funding for the Academy of Sciences and various research institutes. The crucial question is whether or not foreign investors will

50. Although Hungary does not have a much larger underground economy than its neighbors, its relative liberalism regarding foreign investment has reputedly made it a base for underground economy operators (Endre Sik, "The Spatial Distribution of Informal Marketplaces and Informal Foreign Traders in Contemporary Hungary," in E. L. Feige and K. Ott, eds., *Underground Economies in Transition: Unrecorded Activity, Tax Evasion, Corruption, and Organized Crime* [Hants, U.K.: Ashgate, 1999], pp. 275–306).

51. See Adám Török, "Trends and Motives of Organizational Change in Hungarian Industry—A Synchronic View," *Journal of Comparative Economics* 17 (1993): 366–384.

52. Bartlomiej Kamiński, "Industrial Restructuring as Revealed in Hungary's Pattern of Integration into European Union Markets," *Europe-Asia Studies* 52 (2000): 457–487.

53. Two of the twentieth century's leading mathematicians were born and educated in Hungary: John (János) von Neumann and Paul Erdós. The "father of the H-bomb" in the United States, Edward Teller, was born in Hungary. A recent Hungarian mathematician-entrepreneur is Rubik, inventor of the popular cube. In economics Hungary produced the Nobel Prize–winning game theorist John Harsanyi and the frequently cited János Kornai.

support continued development of Hungarian R&D or whether they will just milk recently purchased high-tech firms for existing technologies and then leave them to die. A disturbing trend in the latter direction has been a brain drain out of Hungary to Western countries. Whether Hungary eventually achieves high-income status or stagnates as a marginal EU state may hinge on this issue.

SUMMARY AND CONCLUSIONS

Hungary is a nation with a distinctive language and culture that has been surrounded by hostile neighbors throughout most of its history and has experienced long periods of foreign domination that have fostered intense nationalism. Poised between eastern and western Europe, Hungary declared its independence at the end of the Austro-Hungarian Empire in 1918. It was ruled by a conservative authoritarian government that allied with Hitler in World War II in order to reacquire territories lost at the end of World War I. After 1945 it fell under Soviet domination.

After following the Stalinist economic model for only a few years, Hungary moved toward more decentralized, market-oriented forms in 1953. This movement was cut short by the failed anti-Soviet uprising in 1956, but it resumed with the NEM in 1968. The NEM ended command central planning and granted considerable decision-making autonomy to individual enterprises while keeping ownership in state hands. After a period of backsliding to centralized control in the 1970s, the movement toward a market economy accelerated in the 1980s, laying the groundwork for the later gradualist transformation to market capitalism.

Until its abandonment in the late 1980s, the market socialist system of Hungary compiled a fair record of political and economic performance. It had a less politically repressive atmosphere than other Soviet bloc states and avoided consumer goods shortages with their attendant lines. Agricultural production, based on cooperatives with flexible leasing and marketing arrangements for both inputs and outputs, made Hungary the breadbasket of the CMEA. Hungary had low unemployment and a fairly equal income distribution.

Nevertheless, large foreign debts accumulated as a result of the soft budget constraint, as firms still owned by the state were propped up by a variety of devices. Bureaucratic coordination still dominated the economy, and as time wore on, growth stagnated and inflation began to accelerate.

With prior market experience and a financial system already in place, Hungary after 1989 was able to approach the economic transition in a gradualist manner not based on shock therapy. This led to smaller declines in output than in most other former CMEA countries, although it also meant a slower turnaround. However, a confused and misguided approach to land redistribution seriously damaged the previously successful agricultural sector.

Taking a disciplined approach to paying its existing foreign debts and adopting a rigorous bankruptcy law, Hungary has attracted more FDI than any other former CMEA country. Some of this funding has gone into high-technology sectors, where Hungary has considerable potential based on its highly educated population. It has joined NATO and is part of the first group of countries in central Europe joining the EU in 2004. However, it continues to have difficulties with some of its neighbors over their treatment of Hungarian minorities. Nevertheless, Hungary's experience with markets bodes well for its eventual adjustment and future prospects.

Indeed, with generally well-established market institutions, reasonable macroeconomic stability despite a still somewhat high inflation rate, and western European levels of privatization, Hungary is perhaps the first of the former socialist nations to have completed the transition process. With its still substantial social safety net, Hungary may have gone from being a market socialist economy to a social market economy.

QUESTIONS FOR DISCUSSION

1. Evaluate the successes and failures of Hungarian market socialism before 1989, especially in comparison with the command socialisms of the GDR and the USSR.
2. Why did the soft budget constraint lead to large foreign indebtedness in Hungary?
3. How did Hungarian market socialism compare with the model of Oskar Lange?
4. Evaluate János Kornai's argument that market socialism is unstable.
5. What are the lessons to be learned from the privatization of Hungarian agriculture?
6. Evaluate the effects of the strict bankruptcy laws in Hungary.
7. Evaluate the gradualistic transition policies of Hungary in comparison with those of the former GDR, Russia, Poland, and the Czech Republic.
8. Evaluate the hypothesis that Hungary has completed the transition process.

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AUSTRIA
HUNGARY
ROMANIA
BULGARIA
ALBANIA
MACEDONIA
SLOVENIA
CROATIA
BOSNIA AND HERZEGOVINA
FEDERATION OF SERBIA AND MONTENEGRO
Vojvodina
Serbia
Montenegro
Kosovo
Adriatic Sea
Kobarid
Bled
Velenje
Ptuj
Celje
Zagreb
Ljubljana
Postojna
Kocevje
Koper
Subotica
Kikinda
Vrbas
Backa Palanka
Vrsac
Ruma
Belgrade
Sabac
Smederevo
Sarajevo
Uzice
Cuprija
Bor
Zajecar
Knjaževac
Pljevlja
Novi Pazar
Prokuplje
Pirot
Leskovac
Dubrovnik
Peć
Vranje
Podgorica
Dakovica
Bar
Skopje

14 Worker-Managed Market Socialism: The Collapse of Yugoslavia and the Success of Slovenia

One day—it must have been in the spring of 1950—it occurred to me that we Yugoslav Communists were now in a position to start creating Marx's free association of producers. . . . I soon explained my idea to Kardelj and Kidrić while we sat in a car parked in front of the villa where I lived. . . . Tito paced up and down, as though completely wrapped up in his own thoughts. Suddenly he stopped and exclaimed: "Factories to the workers—something that has never been achieved!" With these words, the theories worked out by Kardelj and myself seemed to shed their complications, and seemed to find better prospects of being workable.
—Milovan Djilas, *The Unperfect Society: Beyond the New Class,* 1969, p. 221.

So in the . . . battle of Kosovo [Polje] the Serbs learned the meaning of defeat, not such defeat as forms a necessary proportion of all effort, for in that they had often been instructed during the course of their history, but of total defeat, annihilation of their corporate will and all their individual wills. . . . The night fell for four centuries, limbo became Hell, and manifested the anarchy that is Hell's essential character.
—Rebecca West, *Black Lamb and Grey Falcon: A Journey Through Yugoslavia,* 1941, p. 840.

INTRODUCTION

On June 28, 1914, in Sarajevo, the capital of Bosnia-Herzegovina, a Bosnian Serb named Gavrilo Princip assassinated Archduke Franz Ferdinand, heir to the throne of the Austro-Hungarian Empire. This date was the bitter anniversary of the Serb defeat by the Turks in 1389 at Kosovo Polje. Austria-Hungary had taken Bosnia-Herzegovina from the Turks in 1878 and annexed it in 1908 against Serbian opposition. The assassination led Austria-Hungary to declare war against Serbia, thus beginning World War I. Out of this war would emerge the new nation of Yugoslavia, Land of the South Slavs. In the early 1990s this nation would fragment, and Sarajevo would be at the center of the most violent warfare in Europe since World War II, warfare marked by horrors such as ethnic cleansing and concentration camps. The nation ceased to exist on February 5, 2003, when its remnant officially became the Federation of Serbia and Montenegro.

Prior to this tragedy, Yugoslavia had undergone a fascinating economic experiment. After 1950 under the leadership of Josip Broz, better known as Marshal Tito, it became the only nation to implement a **worker-managed market socialist system** according to the theories discussed in chapter 3. This system achieved successes in its early years. But it also suffered serious difficulties, notably a tendency toward inflation, which accelerated after Tito's death in 1980.

At first, Yugoslavia's unique system seemed to combine the best of capitalism and socialism. But after 1980 it increasingly seemed to combine the worst of both worlds. As inefficiencies mounted, output fell, unemployment and foreign indebtedness rose, inflation became hyperinflation, and severe regional economic inequalities grew worse. The last trend fed the ethnic and religious tensions seething beneath the surface of Yugoslav society, which had been held in check by Tito's charismatic leadership. Following a late 1980s upsurge of nationalism among the Serbs, the most numerous ethnic group, which still remained less than a majority, these tensions led to secessions by various republics and finally to the outbreak of war.

Variations on Yugoslavia's hybrid economic model have appealed to other postsocialist economies undergoing systemic transformations, especially the idea of workers' management, albeit in conjunction with workers' rather than state ownership. Some of its elements seem to be salvageable for use elsewhere, even though the system as a whole ultimately failed.

The relationship between Yugoslavia's worker-managed market socialism and its regional conflicts was complex. The existence of these conflicts stimulated adoption of the system because its emphasis on markets rather than command central planning fit with the individual republics' desire for local autonomy. But the conflicts undermined the economic system, particularly as decentralization included decentralization of control over monetary policy, which aggravated the inflationary tendency. It is an open question whether the inflation of the late 1980s was inherent in labor-managed market socialism, was an artifact of regionalized macroeconomic control, or arose for combined reasons as local governments pumped money into local worker-managed firms to prop them up, a Yugoslav variation on the soft budget constraint problem discussed in the previous chapter.

The trend toward regional inequality accelerated as central control over the Yugoslav economy weakened. The central government long maintained control over investment and reallocated resources from the richer republics in the northwest to the poorer ones in the southeast. In 1991 the secessions began with the richest republics, which resented these regional reallocations.[1] But the poorer republics increasingly demanded reallocations as Yugoslavia's overall economy deteriorated. It is unclear whether the country collapsed because the economy collapsed, the economy collapsed because the country collapsed, or both collapsed at the same time for different reasons.

Yugoslavia's regional inequality was caused largely by the rapid growth of the richer republics. In particular, Slovenia has the highest per capita income of any post-Communist country in the world. As of 2003, it had largely stabilized its macroeconomy while still possessing a largely worker-managed and now substantially worker-owned economy that continues to have a large state-owned sector. Slovenia's recent economic success may argue for the positive aspects of the system that failed in Yugoslavia as a whole.

1. That ethnic politics was probably the most important factor in the secessions is seen in that wealthy Vojvodina, an autonomous region of Serbia, did not secede.

HISTORICAL AND CULTURAL BACKGROUND

Overview of the Yugoslav Republics and Their History to 1918

Within the former Yugoslavia[2] are at least 26 identifiable ethnic groups speaking as many as 18 languages. But it is religion, not language, that lies at the base of the intergroup conflicts in Yugoslavia. The two largest groups, the Serbs and the Croats, share the Serbo-Croatian language[3] but write it with different alphabets: The Roman Catholic Croats use the Latin alphabet, and the Eastern Orthodox Serbs use the Cyrillic alphabet.

This deep division dates to 285 C.E., when the Roman Emperor Diocletian split the empire into East and West along a line running through modern Bosnia-Herzegovina, down the middle of the former Yugoslavia. Diocletian's line essentially divided the Greek-influenced Byzantine world to the East from the Latin-influenced Roman world to the West. After the Great Schism of 1054, this line largely marked the religious division between the Orthodox East and the Catholic West. Beginning in the fifth century, Slavs immigrated into both zones.

In what was northwestern Yugoslavia, bordering Italy and Austria, is mountainous Slovenia, best off economically of the former republics and the first to secede in 1991. It is populated mainly by Roman Catholic Slovenes, who speak a Slavic language distinct from Serbo-Croatian. Heavily industrialized Slovenia is a successful exporter and was a disproportionately large source of the former Yugoslavia's foreign exchange earnings. After being an independent kingdom in the seventh and eighth centuries, it was conquered and Christianized by Catholic Charlemagne, emperor of the Holy Roman Empire. Slovenia was ruled for centuries by Austria and Germany, and its culture bears a strong Germanic influence.

Croatia lies southeast of Slovenia, second in per capita income and also strongly Western in its cultural orientation. Roman Catholic as a result of Charlemagne's conquest in 803, Croatia was independent in the tenth and eleventh centuries but was ruled by Hungary thereafter. Croatia had significant subregions, Slavonia and Krajina, where Serbs outnumbered the Croats until they were driven out during the wars of the 1990s.

2. Until it ceased to exist on February 5, 2003, Yugoslavia consisted of the republics of Serbia and Montenegro, the former including the autonomous regions of Vojvodina and Kosovo. The other four republics—Slovenia, Croatia, Bosnia-Herzegovina, and Macedonia—became independent nations during 1991 and 1992.

3. Nationalistic Serbs and Croats agree that there are distinct Serbian and Croatian languages. Linguists disagree. The boundaries between areas where the subdialects of Serbo-Croatian are spoken do not correspond with the boundaries between the zones dominated respectively by the Serbs, Croats, and Bosnian Muslims, who also speak Serbo-Croatian (George Rapall Noyes, "The Serbo-Croatian Language," in R. J. Kerner, ed., *Yugoslavia,* [Berkeley: University of California Press, 1949], p. 288).

Flat in the north and mountainous in its center, Croatia possesses the former Yugoslavia's major coastline on the Adriatic Sea. This coastal region, Dalmatia, has a distinctive history marked by Italian influence. Most of its inhabitants are Roman Catholics who speak Serbo-Croatian and consider themselves to be Dalmatian Croats. Dalmatia contains Yugoslavia's most famous tourist attraction, the former city-state of Dubrovnik, which was damaged by Serbian shelling during the 1990s wars.

In the center of old Yugoslavia lies poor and tragic Bosnia-Herzegovina, the mountainous location of the worst fighting and ethnic cleansing in the wars of the 1990s and beyond. No ethnic group has a majority in this nation, although Bosnian Muslims (also known as *Bosniaks*) are the most numerous and comprise about 40 percent of the population. About 30 percent are Serbs and over 10 percent are Croats, and both groups have declared independent republics within Bosnia-Herzegovina. The Croat republic formed a federation with the Bosniak zone following the Dayton Peace Accord of 1995, which led to the introduction of outside peacekeeping forces into Bosnia-Herzegovina. A higher percentage of this republic's population identified itself as Yugoslavs than any other, and pictures of Tito, symbol of Yugoslav national unity, were long prominent there.[4]

Although briefly independent in the fourteenth and fifteenth centuries,[5] Bosnia-Herzegovina was hard fought over militarily and religiously by powers east and west of it. Caught between the Catholics to the west and the Orthodox to the east, the landed aristocracy of Bosnia and much of the rest of the population joined the heretical Bogomil sect,[6] for which they were persecuted. After falling under Ottoman Turkish control in 1521, which lasted until 1878, many Bogomils converted to Islam and were allowed to keep their lands. Their friendliness with the Turks fired the Serbs' hatred of them.

Southeast of Bosnia-Herzegovina lies poor and even more mountainous Montenegro, smallest in land area and population of any of the republics. Containing fierce fighters, Montenegro was the first Yugoslav republic to achieve independence in the modern era, as recognized by the Ottoman Turks in 1799. The Orthodox Montenegrins are very close to the Serbs and remained with their northeastern neighbor, Serbia, in the remnant of Yugoslavia until it became the Federation of the Republics of Serbia and Montenegro. Even with this loosening, the Montenegrins seriously contemplate seceding and even have their own currency.

4. Bosnia was the home base of Tito's partisan guerrillas during World War II.

5. Ironically, this kingdom was the only entity before 1918 to ever approximate the territory of modern Yugoslavia.

6. Bogomil means "mercy of God" in Old Church Slavonic. The dualistic Bogomils believed that the visible world was created by Satan, for which they were denounced as "devil worshippers." Certain of their views were compatible with Islam.

Located east of Croatia, Bosnia-Herzegovina, and Montenegro is Serbia, the most populous republic, which contains two autonomous regions. North of the Danube River and bordering on Hungary and Romania is economically well-off Vojvodina, where a Roman Catholic Hungarian minority is almost as numerous as the Eastern Orthodox Serbs. This region was under Hungarian rule until World War I. Tito allowed Hungarian local domination, but Serb domination was asserted by the nationalistic Serbian leader, Slobodan Milošević. Its capital, Novi Sad, located on the Danube River, was seriously damaged by NATO bombing during the 1998 Kosovo War. Milošević was removed from power in October 2000 after being defeated in a presidential election by Vojislav Kostunica, although the position of president of Yugoslavia ceased to exist at the beginning of 2003. Milošević has been on trial for war crimes in The Hague after being removed from the Yugoslav presidency, along with some others who ruled with him.

In the center is Serbia proper, solidly populated by the most numerous Yugoslav ethnic group, the Orthodox Serbs, and midrange in per capita income prior to 1990. Its capital, Belgrade, is the largest city of the former Yugoslavia and served as the Yugoslav national capital. Independent between 1169 and 1459, when it fell under Turkish control, Serbia ruled a large and powerful kingdom in the 1300s. It achieved autonomy in 1831 and full independence in 1878 with the support of Russia. The Serbs' position in the former Yugoslavia resembles that of the Russians in the FSU in that they contributed disproportionately large numbers to the ruling Communist Party and the upper ranks of the military and have a significant presence outside of their home republic. During the ethnic warfare, as other republics seceded, the Serbians demanded rights and protection for their fellow Serbs in those republics.

Under Turkish rule, rural Serbia developed institutions that some[7] think foreshadowed the later Yugoslav economic system, notably the **zadruga,** or farm communally held by an extended family group led by a strong headman. There was no class structure among the Serbian peasantry, given that their rulers were foreigners. To the extent that these elements affected the formation of the mixed Yugoslav economic system, we might consider this system as partly a New Traditional Economy.

South of Serbia proper and bordering Albania and Montenegro is the autonomous region of Kosovo, the poorest of any republic or region of the former Yugoslavia. Its population is now around 90 percent non-Slavic and Muslim Albanian, with the rest being mostly Serbs and some Gypsies. But Kosovo is the location of Old Serbia, the center of the Serbs' powerful medieval kingdom, the site of Pec, headquarters of the autonomous Serbian Orthodox Church, and the location of the battlefield of Kosovo Polje. Under Tito the local

7. Joel M. Halpern and Barbara Kerewsky Halpern, *A Serbian Village in Historical Perspective* (New York: Holt, Rinehart & Winston, 1972).

government was run by ethnic Albanians, but in 1987, following Serbian complaints of discrimination, Milošević, the Serbian Communist Party chief, replaced them with Serbs. This action began his nationalistic assertions that eventually triggered the disintegration of the entire country. War broke out in 1998 when Milošević attempted to suppress local Albanian separatists, ultimately leading to a NATO bombing campaign and ground intervention. NATO peacekeepers are now trying to prevent violence between the Albanian majority and the Serb minority.

In the southeast is Macedonia, poorest of the republics prior to 1991, although richer than the autonomous region of Kosovo. Macedonia was long under Byzantine control and later came under Ottoman Turk control. Although Slavs are the majority, Macedonia is possibly the most ethnically diverse of all the republics, with a large Albanian minority that is the majority in northwestern Macedonia and the largest Gypsy population in the world in percentage terms of any nation. In 2001 separatist Albanians initiated a guerrilla conflict that generally quieted down after negotiations and changes of government, although the situation remains tense.

The Orthodox Macedonian Slavs were the main object of fighting several times during the 1900s, and great controversies surround their identity, which was first recognized on a 1907 map as "Macedo-Slav." Their language is distinct, being somewhere between Serbo-Croatian and Bulgarian.[8] The Bulgarians eastward long claimed Macedonian territory and fought with Serbia, Greece, and Albania in the Balkan Wars of 1912–1913. Serbia won that war, and Macedonia was South Serbia until Tito made it into a separate Yugoslav republic after World War II, during which time it was ruled by Bulgaria. Because the northern province of Greece is also named Macedonia and was the ancient home of Alexander the Great, Greece refuses to recognize Macedonian independence, has placed it under an economic embargo, and attempts to block its recognition by the rest of the world.

Table 14-1 and figure 14-1 present summary data on the population, population growth rate, per capita income, and unemployment rate for each of the former Yugoslav republics and autonomous regions. The gap in per capita income between Slovenia and Kosovo was

8. Both Serbs and Bulgarians have often denied the separate existence of the Macedonian language. Thus, a man named Stojanovski (Macedonian) was forced to change his name to Stojanović (Serbian) during periods of Serbian domination and to Stojanov (Bulgarian) during periods of Bulgarian domination. Noyes ("The Serbo-Croatian Language," p. 281), states, "So today a man may walk from Varna on the Black Sea [east end of Bulgaria] west to Sofia, then down to Bitolj in Southern Macedonia, northward to Belgrade, thence west through Slavonia and Croatia to Zagreb, still further west to Ljubljana and into Slovenian districts annexed by Italy after the First World War; and, if he pay heed to the speech of the peasantry rather than that of the postmasters and the schoolmasters, he will never cross a definite linguistic boundary dividing Bulgarian from Serbo-Croatian or Serbo-Croatian from Slovenian."

Table 14-1
Data on Former Yugoslav Republics and Regions

Area	Population	Population Growth Rate	Per Capita Product	Unemployment Rate 1967–1975	Unemployment Rate 1976–1987
Slovenia	1,948	0.71	5,918	2.5	1.7
Croatia	4,683	0.41	3,230	5.2	6.4
Vojvodina	2,051	0.46	3,061	7.4	12.7
Serbia Proper	5,840	0.64	2,238	9.2	15.1
Montenegro	639	0.87	1,754	8.3	19.8
Bosnia-Herzegovina	4,479	0.84	1,573	7.4	15.7
Macedonia	2,111	1.43	1,499	18.9	21.3
Kosovo	1,939	2.34	662	20.5	29.6
Former Yugoslavia	23,690	0.80	2,480	8.1	12.6

Note: Population and per capita social product are for 1988, the former in thousands and the latter in U.S. dollars. Unemployment rates as percentages are shown for both the 1967–1975 and 1976–1987 periods, emphasizing the increasing disparity between richer and poorer areas, and are from Evan Kraft, "Evaluating Regional Policy in Yugoslavia," *Comparative Economic Studies* 34 (1992): 11–33.
Sources: Figures are from Evan Kraft, "Evaluating Regional Policy in Yugoslavia," *Comparative Economic Studies* 34 (1992): 13, except for population growth rates, which are from Martin Schrenk, Cyrus Ardaland, and Nawal El Tatawy, *Yugoslavia: Self-Management Socialism and the Challenge of Development* (Baltimore: Johns Hopkins University Press, 1979), p. 360. The latter are annual averages for 1975–1980.

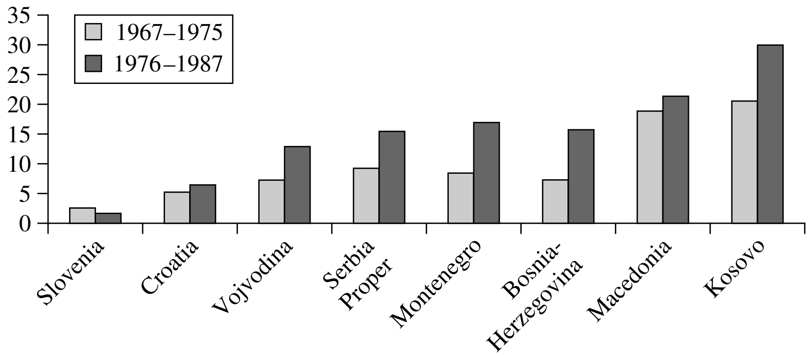

Figure 14-1
Unemployment Rates in Former Yugoslav Republics and Regions.
Source: Figures from Evan Kraft. "Evaluating Regional Policy in Yugoslavia." *Comparative Economic Studies* 34 (1992): 13.

about 9:1 in 1988, a within-nation gap greater than that existing almost anywhere in the world and an increase from 3.3 to 1 in 1947.[9] Generally the poorer republics had higher population growth rates, so that while their overall economic growth rates were often higher, their per capita incomes fell behind those of the richer republics. The high population growth rate in predominantly Muslim Kosovo contributed to the panic of the Serbs and their implementation of oppressive policies there in the 1990s. In both Kosovo and Macedonia warfare has erupted among the ethnic Albanians, who have sought reunion with Albania[10] since the fall of its ultra-Stalinist regime; this goal exists despite Albania's being Europe's poorest state until very recently.

Yugoslavia from 1918 to 1950

On November 24, 1918, right after World War I ended, the Kingdom of Serbs, Croats, and Slovenes was formally declared, with Serbian King Peter I serving as monarch. This culminated more than a century's drive for a South Slav nation, a goal inspired by intellectuals studying folklore and the Serbo-Croatian language. Initially an ethnically balanced parliamentary democracy, the new state rapidly became dominated by the Serbs. In 1929 King Alexander declared a dictatorship, renamed the nation Yugoslavia, and suppressed other ethnic groups. He was assassinated by a Croatian nationalist in 1934.

Yugoslavia's economic policy emphasized autarky with high tariffs and state regulation of industries. As the 1930s progressed, Yugoslavia engaged in bilateral trade deals engineered by Nazi Germany and its allies. By 1939, 48 percent of Yugoslav imports came from Germany and 70 percent from all the European Axis powers.[11]

In April 1941 the Axis powers invaded and dismembered Yugoslavia. Northern Slovenia was annexed by Germany, which had absorbed neighboring Austria. Southern Slovenia, Dalmatia, Montenegro, and Kosovo were taken by Italy, along with Albania. Hungary retook Vojvodina. Bulgaria took Macedonia. In Croatia and Serbia, separate puppet regimes divided Bosnia-Herzegovina.

The Ustashi regime in Croatia in World War II, led by Ante Pavelić, was among the most brutal of the mid-twentieth century's fascist regimes.[12] It established concentration camps in which hundreds of thousands of Jews, Gypsies, and Serbs perished. The feeling that the Croat Tito insufficiently punished the Ustashis and the bitter memory of these atrocities

9. Fred Singleton and Bernard Carter, *The Economy of Yugoslavia* (London: Croom Helm, 1982), p. 117.

10. Kosovo was combined with Albania under Italian rule during World War II.

11. Singleton and Carter, *The Economy of Yugoslavia,* p. 70.

12. Among other gruesome practices, Pavelić kept a jar full of eyeballs of his regime's victims in his office.

have figured in recent Serbian nationalism.[13] Marshal Tito led Communist partisan guerrillas against these fascist regimes and liberated Yugoslavia with only minimal outside assistance.

An enthusiastic supporter of Stalin before and during the war, Tito initiated Stalinist policies immediately afterward but held a National Assembly election that he and his party won. Among these policies were rapid nationalization of industry during 1946 and introduction of a very detailed Five-Year Plan in 1947 that stressed industrialization. Collectivization of agriculture was initiated in 1949, but it was halted and mostly reversed after 1951.[14]

Tito's status as "another Stalin" was based on the Yugoslav Partisans' defeat of Hitler's forces with little assistance from the Soviet Red Army. Ironically, it was this status that made Stalin jealous and led to his desire to remove Tito and place Yugoslavia firmly under his personal control.[15] After a series of increasingly hostile letters and discussions over a range of issues, the **Cominform**[16] formally expelled the Yugoslav Communist Party on June 28, 1948,[17] and called for the overthrow of Tito and his top aides, Edvard Kardelj, Milovan Djilas, and Alexsandr Ranković.[18] A pro-Stalin group tried to carry out this plan, but Tito purged them and asserted his control over the party and the nation.

Despite this political break with Stalin and the resulting economic boycott by East European states, Tito followed a Stalinist economic model for two more years, with poor

13. Fears of new atrocities were aggravated by the newly independent Croatian government in 1991. Croatian President Franjo Tudjman was an anti-Ustashi partisan during World War II, but he renamed major squares and streets in Croatia's capital, Zagreb, after Ustashi heroes and adopted uniforms for the Croatian military that the Serbs claimed resembled those of the Ustashi. Tudjman died in 1999, and his successor modified many of these policies.

14. A small state sector in Yugoslav agriculture remained, although the large majority of farms were privately owned and often uneconomically small. An upper limit for private farms of 10 hectares was imposed in 1951 and removed in 1990.

15. For detailed accounts of the events surrounding the Stalin-Tito rift of 1948, see Milovan Djilas, *Conversations with Stalin* (New York: Harcourt, Brace and World, 1962); Vladimir Dedijer, *The Battle Stalin Lost: Memoirs of Yugoslavia 1948–1953* (New York: Viking Press, 1970).

16. The Communist Information Bureau was formed in 1947 as the successor to the Third Communist International **(Comintern),** which Stalin formally dissolved in 1943. It would be replaced later by the Warsaw Pact.

17. Ironically, it was the same date as the 1389 Turkish victory over the Serbs and the 1914 assassination of Archduke Franz Ferdinand.

18. Tito eventually purged two of his three famous aides. The Montenegrin Djilas was out in 1952 for excessive liberalism, and would be in and out of jail over the next three decades, a weather vane of Tito's attitudes. His most famous work is *The New Class* (New York: Harcourt, Brace and World, 1957), which attacked *nomenklatura* perks and powers. The Serbian Ranković was purged in 1966 for supporting excessive central planning and power when Tito decided to decentralize. His removal rankled Serbian nationalists. The Slovenian Kardelj remained in power as Tito's Number Two.

results. Only in 1950, as described in the first quote at the beginning of this chapter, did Djilas, Kardelj, and Economic Planning Chief Boris Kidrić convince Tito to move toward worker-managed market socialism.

WORKER-MANAGED MARKET SOCIALISM IN YUGOSLAVIA

Theoretical Issues

Many of the theoretical issues regarding **workers' management** were presented in chapter 3. In Yugoslavia these debates came after the initial implementation of the system there. Much like the development of central planning in the USSR, it was carried out in an ad hoc, pragmatic manner.

The main criticism of workers' management is the possibility of backward-bending supply curves or at least perverse demands for labor by firms. This can lead to an unstable general equilibrium or to a gap between goods' market prices and wages, both of which can cause inflation,[19] although actual reductions in output in response to price increases were not observed in the Yugoslav economy until the late 1980s.

Jaroslav Vanek[20] argues that the **worker-managed economy** can achieve **Pareto optimality** because factors will be paid their marginal revenue products, and there will be greater stability of employment,[21] high rates of capital accumulation, smaller firms with less monopoly power,[22] no systematic tendency toward inflation,[23] and a greater tendency toward improved productivity. Vanek also says that general social harmony will result because of reduced alienation and enhanced democracy. Free riders might reduce productivity, although this can be offset by a greater incentive for workers to monitor each other.[24]

19. See Gerd Weinrich, "Instability of General Equilibrium in a Labor-Managed Economy," *Journal of Comparative Economics* 17 (1993): 43–69, for the first argument, and Zeljko Bogetid and Dennis Hefley, "Market Syndicalism and Market Imbalances," *Journal of Comparative Economics* 16 (1992): 670–687, for the second.

20. Jaroslav Vanek, *The General Theory of Labor-Managed Market Economies* (Ithaca, N.Y.: Cornell University Press, 1970).

21. Surveys of producer cooperatives around the world in capitalist settings support this generalization empirically, based on greater wage flexibility (John P. Bonin, Derek C. Jones, and Louis Putterman, "Theoretical and Empirical Studies of Producer Cooperative: Will Ever the Twain Meet?" *Journal of Economic Literature* 31 [1991]: 1290–1320).

22. This did not hold in Yugoslavia, where the economy was characterized by large firms and considerable monopoly power, a situation that worsened over time.

23. Certainly the Yugoslav economy was very inflationary. But this may have been caused by aspects of the Yugoslav economy that deviated from the theoretical ideal of a worker-managed economy rather than demonstrating its necessary outcome. If so, this would imply that positive aspects of the Yugoslav economic experience do not disprove general arguments against market socialism.

24. See Samuel Bowles and Herbert Gintis, "A Political and Economic Case for the Democratic Enterprise," *Economics and Philosophy* 9 (1993): 75–100, for elaboration.

As discussed in chapter 3, Vanek presents five characteristics of the ideal labor-managed or **participatory economy:** equal participation in management, income sharing, payment for use of capital, free markets, and freedom of employment. Yugoslavia may have exhibited only three of these attributes, failing to have free markets or payment for the use of capital,[25] and adherence to the three displayed by the Yugoslav economy varied over time.

The above arguments apply to a labor-managed economy that is capitalist, in which workers are owners as well as managers, as in **producer cooperatives** or **employee stock option plans (ESOPs).** This may be where some transforming postsocialist economies are heading. But beyond these issues are the problems associated with market socialism, including the problem of technological stagnation caused by worker myopia without property rights[26] and the problem of inefficiency arising from the soft budget constraint.

The soft budget constraint took a peculiar form in Yugoslavia because of the extreme regional decentralization. Unlike Hungary, Yugoslavia had no explicit firm subsidies. But loans were made by republic-level or lower banks, often under the control of the firms themselves,[27] at negative real interest rates, especially during the accelerating inflation of the 1980s. Repayment of these loans led to regional redistributions of income from richer to poorer republics and included strong cross-firm subsidizations within republics.[28] This fed inflation, and the decentralized nature of the process made it more difficult to control the situation.

Stages of Implementation of the Yugoslav System

In 1950 the original **Workers' Council Law** was passed, requiring the supreme controlling body of an enterprise to be a workers' council elected by the workers themselves. The council would appoint a management board including workers and the enterprise director, who would jointly determine the organization of production, purchase of inputs, shop-floor conditions, marketing, financing, and wage and salary policies. Control over pricing and investment devolved to these worker-managed enterprises later. Starting in 1952, enterprises elected workers' councils and management boards and moved to the new system,

25. John P. Burkett, "Self-Managed Market Socialism and the Yugoslav Economy, 1950–91," in Morris Bornstein, ed., *Comparative Economic Systems: Models and Cases,* 7th ed. (Burr Ridge, Ill.: Irwin, 1994), p. 347.

26. Eirik G. Furobotn and Svetozar Pejovich, *The Economics of Property Rights,* 2nd ed. (Cambridge, Mass.: Ballinger, 1990).

27. An extreme example was the Agrokomerc Affair of 1987, in which the Bosnian enterprise sold large volumes of unbacked promissory notes approved by a local bank under the effective control of the managers of Agrokomerc.

28. Evan Kraft and Milan Vodopivec, "How Soft Is the Budget Constraint for Yugoslav Firms?" *Journal of Comparative Economics* 16 (1992): 432–455.

Box 14-1
Ideological Foundations of the Yugoslav System

Tito and his associates were true-believing Marxists and sought to justify their approach ideologically against Stalin's charge that they were anti-Marxist, revisionist deviationists. To avoid being utopian, Marx and Engels rarely discussed what socialism ought to look like. In fact, the Yugoslav model drew significantly from utopian socialist ideas, as well as from those of the anarcho-syndicalists, more so than from Marx or Engels. So Stalin may have been right.

The problem for Tito and his associates was that although Marx occasionally said something good about producer cooperatives and associations, as in Volume III of *Capital* and in his writings on the Paris Commune, many more of his writings argued that they were a transitional form on the way to socialism and were imbued with the problems of capitalism. He especially criticized them when attacking some of their advocates, such as the anarchist Proudhon. Marx did not write about central planning, but Engels strongly advocated it in his 1887 *Anti-Duhring*. Thus, the Yugoslavs had to rely on selected quotations from Marx and Engels and on other socialist literature to provide an ideological justification for their model.*

*For details of this debate see Milovan Djilas, *The Unperfect Society: Beyond the New Class* (New York: Harcourt, Brace & World, 1969); and Deborah D. Milenkovitch, *Plan and Market in Yugoslav Economic Thought* (New Haven, Conn.: Yale University Press, 1971).

although the fundamental issue of whether these bodies could really control a strong director who disagreed with them remained.

From 1952 to the early to mid-1960s, Yugoslavia's economy was worker-managed, with continuing strong central control. It was not yet market socialist. Many prices and most investments were controlled by the central planners. One-year plans directed the economy during the transition to worker management up to 1957. Then, from 1957 to 1961, the Second Five-Year Plan involved much input from the republic level and was viewed as a success, as the economy grew rapidly.

A Third Five-Year Plan began in 1961, but it was abandoned the following year as inflation and foreign trade imbalances resulted from the high economic growth. One-year plans operated as debate ensued, and a series of reforms were passed between 1963 and 1966 that resulted in a full shift to market socialism and the reduction of planning to a purely indicative function for the Fourth Five-Year Plan (1966–1970). Price setting was now in the hands of the individual enterprises. Control of investment was divided between the firms, the banks, and the local governments. This system continued with the Fifth Five-Year Plan (1971–1975). The period of the Fourth and Fifth Five-Year Plans was considered by most to be the high-water mark of worker-managed market socialism in Yugoslavia.

During the early 1970s, debate arose that culminated in the Constitution of 1974 and the Law of Associated Labor in 1976, which shifted the system yet again to one of **integrally planned worker management.** Behind this shift was a merger wave that reduced the ability of workers to control their managers. In large firms, it is difficult for workers to have meaningful input into management decisions. Mergers occurred as an alternative to bankruptcies and soft budget subsidies in an environment of fierce competition.

Part of that competition came from abroad as Yugoslavia strove to integrate with the world economy. Firms had possessed the right to engage in foreign trade contracts since 1953. In 1961 Yugoslavia unified the exchange rate of the dinar, which became partially convertible. Yugoslav citizens were allowed to travel abroad, and many became **gastarbeiters** (guest workers) in Germany, Switzerland, and Scandinavia and sent home their foreign earnings. By 1965 Yugoslavia had joined the IMF and the General Agreement on Tariffs and Trade (GATT), predecessor to the World Trade Organization (WTO), and had become an associate member of OECD and the CMEA.

Emerging regional differences in economic growth rates as control of investment was decentralized became entangled in broader political issues of democratization versus central control. Although a one-party state, Yugoslavia was the most liberal of all Communist states in human rights policies. Nevertheless, Tito sometimes felt his control threatened and cracked down on dissent. One such period occurred beginning in 1971 after major separatist uprisings in Kosovo and Croatia. The revolts in Croatia were especially violent, involving terrorist bombings and skyjackings.

The 1974 constitution reasserted the leading role of the Communist Party in Yugoslav society. The 1976 Law on Associated Labor went in two directions. On the one hand, it reintroduced planning at the local level that was to be consistent with national-level planning, although not on a command basis. On the other hand, it introduced planning at the level of newly created entities known as **Basic Organizations of Associated Labor (BOALs).** These were groups of related workers within an enterprise who performed the same type of work—spinners in a textile mill, for example. In some cases, BOALs coincided with previously existing firms that had been merged into larger units. Thus this was an effort to revive worker management in the face of emerging technocratic managerial hierarchies during the high market socialism period. The BOALs could form into **Working Organizations of Associated Labor (WOALs),** which corresponded to existing enterprises, and into **Composite Organizations of Associated Labor (COALs),** which constituted vertically integrated structures across firms.

The Breakdown of Yugoslav Worker-Managed Market Socialism

Economic performance improved during the Sixth Five-Year Plan (1976–1980). But then Tito died in 1980, and national political control went to a rotating collective presidency with little power. Political and economic authority rapidly devolved to the republics. Economic performance deteriorated steadily on all measures, and interregional tensions escalated.

After 1986, output declined while inflation wildly accelerated. Inflation led to a wave of strikes in 1987 as workers attempted to make wages keep up with prices.[29]

The year 1989 marked the beginning of Yugoslavia's move toward standard market capitalism. New laws allowed privatization and foreign investment. Four types of enterprises were to be allowed: socially owned, cooperatives, private firms (owned by individuals, foreigners, or civil legal entities), and mixed (any combination of asset ownership of the previous three types). In 1990 efforts were made to increase control by the National Bank over the money supply from authorities in the republics, unify tax systems and regulate fiscal policy from the center, eliminate ceilings on land holdings, and remove remaining restrictions on prices and foreign exchange transactions. A major anti-inflation drive was implemented, involving wage-price freezes, credit limits, and a strict linking of the dinar, now fully convertible, to the West German *Deutschemark,* which succeeded in reducing the record 1,256 percent inflation rate of 1989 to 121.7 percent in 1990.[30]

Then came June 1991. After months of failed interrepublic negotiations following threats by Serbian leader Milošević to impose controls on the rest of the country, as he had done in Kosovo in 1987 and in Vojvodina in 1989, Slovenia seceded. It was attacked by the Yugoslav air force. Croatia seceded in quick succession, and the Yugoslav army invaded. The war had begun, and it would only worsen with the subsequent secessions of Bosnia-Herzegovina and Macedonia. Tragedy descended, and the Yugoslav economy ceased to exist as a unified entity.

PERFORMANCE AND EVALUATION OF THE FORMER YUGOSLAV ECONOMY

Was It Really Worker-Managed Market Socialism?

The demise of the Yugoslav economic system has stimulated the debate over its nature, functioning, and consequences. Those who argue that such a system is inherently flawed point to the Yugoslav collapse as the ultimate proof. The critics of this interpretation argue that Yugoslavia's economy was not worker managed; rather, it was Yugoslavia's market socialism that fundamentally undermined its efforts to achieve workers' management. This implies that the ultimate disbelievers' argument against the Yugoslav system is correct: True worker-managed market socialism may be impossible in a complex world.

29. It might seem that strikes in such a system would be impossible, but they had occurred since the late 1950s. The divisions between BOALs within a firm and between BOALs and WOALs, along with the increase in the power of managers within ever larger firms in a highly oligopolistic environment, made strikes more likely as rising inflation seriously eroded real wages.

30. Egon Žižmond, "The Collapse of the Yugoslav Economy," *Soviet Studies* 44 (1992): 108.

Casting doubt on the idea that the Yugoslav economy was worker managed[31] is evidence that for a long time enterprise directors were really in control, followed by decision makers in technical units. Following behind these in order were supervisors of economic units, management boards, and only then the workers' councils. Semiskilled and unskilled workers had almost no power. If workers' management ever existed, it was in the "glorious" early period of the 1950s, when the state retained substantial control over prices and investment. But that era was industrially primitive, and skeptics can argue that by their very nature, large-scale, technologically advanced firms cannot be managed by a group of low-level workers.

Another argument against the Yugoslav system is that enterprise decision making was heavily influenced by outsiders, including the Communist Party, trade unions, and local government authorities. Local government influence became especially problematic as the individual republics strove to establish autarky and duplicated facilities existing in other republics, such as electricity production facilities, out of fear of being cut off by a neighbor. But then it can be argued that it is precisely when an economy tries to combine workers' management with market socialism that such interference inevitably occurs.[32]

Output Growth and Inflation

Table 14-2 shows annual average output growth rates, inflation rates, and real per capita growth for the Yugoslav economy for major subperiods from 1947 through 1990. Prior to its stagnation in the 1980s, Yugoslavia's growth record was reasonably impressive in Europe during the postwar era, not declining in any year prior to 1980.[33] In 1945 Yugoslavia was a poverty-stricken, largely preindustrial, war-damaged economy with a per capita income of only U.S.$100 per year. At its collapse it had achieved a respectable middle-income status.

If one compares these data for the same three periods (1965–1973, 1974–1980, 1981–1989) with the OECD as a whole, and with Turkey, Spain, and Portugal, which were fairly comparable in income and general development with Yugoslavia, one finds that Yugoslavia ran ahead of the OECD as a whole but behind the other three countries during 1965–1973 and outperformed all of them except on inflation during 1974–1980 but lagged behind all of them during 1981–1989 in all categories.[34]

31. See Janez Prasnikar and Jan Svejnar, "Workers' Participation in Management vs. Social Ownership and Government Policies: Yugoslav Lessons for Transforming Socialist Economies," *Comparative Economic Studies* 34 (1991): 32.

32. A further limit on workers' management was restrictions on entry of new firms, especially those started (and owned) by unemployed workers. This further exacerbated the oligopoly and unemployment problems in the Yugoslav economy.

33. High growth in the 1950s and 1960s was aided by substantial amounts of foreign aid from Western countries.

34. *OECD Economic Surveys: Yugoslavia, 1989/1990* (Paris: Organization for Economic Cooperation and Development, 1990), p. 34.

Table 14-2
Yugoslav Macroeconomic Performance, 1947–1990

Year	Real Output Growth	Inflation Rate	Real per Capita Growth
1947–1952	11.8	n.a.	n.a.
1953–1964	8.6	n.a.	n.a.
1965–1973	6.2	11.7	5.2
1974–1980	6.4	17.9	5.3
1981–1989	0.6	138.7	−0.2
1985	0.5	77.0	n.a.
1986	3.6	91.0	n.a.
1987	−1.0	118.0	n.a.
1988	−1.6	199.0	n.a.
1989	−0.8	1,256.0	n.a.
1990	n.a.	121.7	n.a.

Sources: Data for 1947–1952 are from Fred Singleton and Bernard Carter, *The Economy of Yugoslavia* (London: Croom Helm, 1982), p. 116. Data for 1953–1964 are from Egon Žižmond, "The Collapse of the Yugoslav Economy," *Soviet Studies* 44 (1992): 106. Data for 1965–1973, 1974–1980, and 1981–1989 are from *OECD Economic Surveys: Yugoslavia, 1989/1990* (Paris: Organization for Economic Cooperation and Development, 1990), p. 34. Data for individual years 1985–1989 are from Janez Prasnikar and Zivko Pregl, "Economic Development in Yugoslavia in 1990 and Prospects for the Future," *American Economic Review Papers and Proceedings* 81 (1991): 192; and the inflation rate for 1990 is from Žižmond, "The Collapse of the Yugoslav Economy," p. 108.

Capital Investment and Labor Employment

A central argument regarding worker-managed economies has been that worker-managers will seek to stabilize employment as well as to maximize their income per capita. These goals lead to contradictory impulses regarding capital investment. On the one hand, worker-managers should want capital investment in order to increase labor productivity and thus income per worker. On the other hand, if worker-managers lack a long time horizon, they may prefer immediate wages, thus suppressing capital investment.[35] Concern over this conflict enhanced the reluctance of the Yugoslav government to give up control over capital investment during the 1960s. Furthermore, the desire to stabilize employment does not mean that employment opportunities will expand for those who are unemployed; only those who are employed will get job security.

The Yugoslav economy long exhibited high rates of capital investment and stable levels of employment. However, after the mid-1960s, it also exhibited the socialist tendency toward a rising capital-output ratio, which is indicative of inefficient patterns of capital investment. The unemployment rate gradually rose, as shown in table 14-1. During the 1980s, capital investment fell sharply and inflation accelerated as workers shifted

35. Lack of worker ownership contributes to this problem.

Table 14-3
Capital-Output and Labor-Output Ratios

Year	Capital-Output Ratio	Labor-Output Ratio
1953	2.36	0.41
1964	2.00	0.28
1974	2.37	0.19
1979	2.52	0.17
1988	3.23	0.19

Source: Data are from Egon Žižmond, "The Collapse of the Yugoslav Economy," *Soviet Studies* 44 (1992): 106.

toward an "I want my wages now" attitude. Along with this came falling output and rising unemployment.

From 1953 to 1977 capital investment constituted an average of 32.5 percent of total output, about the same as for Japan.[36] However, by 1988, this ratio had fallen to 18.3 percent for Yugoslavia.[37] Table 14-3 shows the behavior of the capital-output and labor-output ratios over time. The former declined up to 1964 but steadily increased afterward. The labor-output ratio declined up to 1974 but remained fairly constant afterward. Inefficiency in the capital market was probably due to the longtime existence of negative real interest rates and the arbitrary allocation of capital by local authorities.[38] The relatively greater efficiency of the labor market reflected its relatively free operation.

Distribution of Income

Although payment of productivity-related differential wages within enterprises was accepted, worker-managed Yugoslav firms tended to have greater equality of wages than those in other economies.[39] This led to a high degree of equality of overall income distribution. In 1978 the quintile ratio for income in Yugoslavia was 5.86, whereas it was 5.6 for Sweden and 9.5 for the United States in 1972.[40] This high equality, comparable to that of Sweden, is all the more striking given the great regional inequality, as shown in table 14-1. By 1987 the quintile ratio in Yugoslavia had risen to 7.0.[41] Yet Yugoslavia's

36. Dragomir Vojnić, "Investment Policy," in R. Stojanović, ed., *The Functioning of the Yugoslav Economy* (Armonk, N.Y.: M. E. Sharpe, 1982), pp. 65–66.

37. *OECD Economic Surveys: Yugoslavia, 1989/1990,* p. 90.

38. Kraft and Vodopivec, "How Soft Is the Budget Constraint for Yugoslav Firms?"

39. See Howard Wachtel, *Workers' Management and Workers' Wages in Yugoslavia* (Ithaca, N.Y.: Cornell University Press, 1973).

40. World Bank, *World Development Report* (Oxford: Oxford University Press, 1981), pp. 182–183.

41. World Bank, *World Development Report* (Oxford: Oxford University Press, 1992).

income was never as equally distributed as that in the other socialist economies of Central and Eastern Europe.

Nevertheless, there was considerable equality within some of the Yugoslav republics, notably Slovenia. As table 3-1 shows, Slovenia had the fourth most equal income distribution of all the transition economies for which data were available in 1998, behind only Slovakia, Belarus, and the Czech Republic. As in these countries, its income distribution was relatively unchanged from the time of its secession from Yugoslavia, despite a gradual trend toward greater inequality in recent years.

Foreign Economic Relations

Yugoslavia maintained friendly economic relations with a wide variety of nations, in keeping with its position as a founder of the **Nonaligned Nations Movement.** It maintained a semiconvertible currency and joined all the major multilateral economic bodies, both in the East and in the West, either fully or as an associate member. It traded with both blocs, although generally more with the West than with the East.

Yugoslavia ran chronic trade deficits and accumulated large foreign debts as a result, like its market socialist neighbor, Hungary. During the 1980s, however, Yugoslavia's current account was in surplus as often as it was in deficit, despite constant trade deficits,[42] largely because of substantial flows from Yugoslav guest workers in other countries. For Yugoslavia these foreign earnings were a double-edged sword: When economic times were bad, not only did exports decline, but the repatriated earnings from these workers fell off sharply as they got laid off in disproportionate numbers.

Yugoslavia's economic relations with foreign countries were relatively insular and autarkic, despite its membership in many international organizations. This tendency also extended to the republic level. Each republic wanted to be self-sufficient, which led to wasteful and duplicative patterns of capital investment often carried out at the behest of local authorities.

These patterns are apparent in table 14-4, where interrepublic trade flows as a percentage of republic output are presented for 1988. Exports outside of Yugoslavia are also shown. Not surprisingly, the least autarkic republic was Slovenia, which exported 14.9 percent of its output outside Yugoslavia and 22.2 percent to other republics. The most autarkic was Serbia, exporting only 9.0 percent of its output outside of Yugoslavia and 14.8 percent to the other republics. The strongest republic-to-republic flow was from Montenegro to Serbia, reflecting their close link.

42. *OECD Economic Surveys: Yugoslavia, 1989/1990,* p. 102.

Table 14-4
Interrepublic Trade Flows in 1988

FROM:	Bosnia-Herzegovina	Montenegro	Croatia	Macedonia	Slovenia	Serbia
TO:						
Bosnia-Herzegovina	69.5	5.1	4.3	2.5	3.1	3.7
Montenegro	0.9	65.6	0.7	1.1	0.4	1.2
Croatia	6.0	2.8	68.7	4.4	9.4	4.7
Macedonia	1.1	1.9	1.1	66.5	1.1	2.1
Slovenia	3.3	1.7	6.1	3.2	62.9	3.1
Serbia	8.5	14.5	7.0	12.2	8.1	76.2
Exports outside of Yugoslavia	10.7	8.4	12.1	10.1	14.9	9.0
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0
Trade with other republics	19.8	26.0	19.2	23.4	22.2	14.8

Source: Data from Wei Ding, "Yugoslavia: Costs and Benefits of Union and Interdependence of Regional Economies," *Comparative Economic Studies* 33 (1991): 22, represent percentages of output levels in 1988. In this table, Serbia includes the autonomous regions of Vojvodina and Kosovo.

WAR, BLOCKADE, AND COLLAPSE

In June 1991 the Serb-dominated Yugoslav military attacked Slovenia from the air. After Croatia's later secession, war spread there, and much fighting was carried out by unofficial local militias encouraged by the Serbs. In 1992 the UN declared a cease-fire, leaving Serbian forces in control of about 20 percent of the country but with no permanent settlement, a situation that briefly led to renewed fighting in 1995, with thousands of Serb refugees ultimately fleeing from Croatia to Serbia.

In 1992 warfare in Bosnia-Herzegovina started, which resulted in hundreds of thousands dead and millions driven into refugee status and scattered across neighboring republics and throughout Europe. The 1995 Dayton Peace Accord promised that all these refugees would be able to return to their homes, but few have been able to do so.

With blame placed largely on Serbia,[43] the UN in 1992 placed an economic embargo on Yugoslavia (Serbia and Montenegro), exempting only certain humanitarian goods.

43. Although Slobodan Milošević was widely blamed for most of the bad things that happened in the former Yugoslavia, the continuation of warfare between Albanians, Macedonians, and Serbs after his removal somewhat weakened that argument. One argument is that the breakup of Yugoslavia was caused by outside pressures and conniving by leading Western powers and organizations (Sean Gervasi, "Germany, U.S., and the Yugoslav Crisis," *Covert Action* 43 [Winter 1992–1993]: 41–45, 64–66). The intervention and bombing by NATO in the 1998 Kosovo War led to a serious worsening of relations between the United States and Russia, as the latter strongly supported the Serbian leader. This reflected a more general tendency for European nations to support the republics of the former Yugoslavia that they supported in World War I: Germany and Hungary behind Croatia; France, Greece, and Russia behind Serbia; Turkey and other Muslim nations behind the Bosnian Muslims and the Muslim Albanian Kosovars, and Bulgaria behind Macedonia. The fear that warfare in this region could yet trigger a more internationalized conflict has not completely disappeared.

Although it would be relaxed after 1995, this embargo was strengthened again during the war in Kosovo in 1998 and was not fully removed until after Milošević was removed from power in late 2000. The combination of war-induced destruction, death, and flight, along with a collapse of interrepublic and foreign trade arising from the economic blockade, led to a general economic collapse on a scale difficult to measure. With the renewed fighting in 1998, Montenegro effectively seceded economically, if not officially, even to the extent of adopting its own currency, now pegged to the euro.

Croatia's economy was effectively destroyed. From 1990 to 1993 output declined around 60 percent, a catastrophic amount, and food shortages emerged.[44] Because of the threat of renewed fighting, 40 percent of Croatia's budget was spent on defense. Tourism collapsed. The monthly inflation rate in November 1993 was well over 35 percent (over 2000 percent annualized). This high rate was brought down sharply by a strict monetary policy that was followed by several years of stagnation, with real output at about 45 percent of its 1990 level by 1995.[45]

During the early 1990s there was a wave of spontaneous *nomenklatura* privatizations, with previous managers gaining control of firms at cut-rate prices and with allegations of corruption and spreading gangsterism. This led to a movement of partial renationalizations, followed by renewed privatization. By 1997, about 53 percent of Croatia's assets were still state-owned.[46]

The declines in Macedonia have not been as bad, but they have been aggravated by Greece's embargo. Economic declines have been much worse in war-torn Bosnia-Herzegovina, with one report placing per capita output in 1997 at only US$815.[47]

In Serbia itself the embargo took an enormous toll, with average wages reaching a miserable US$38 per month by the time Kostunica came to power in late 2000. Most people relied on the underground (shadow) economy to survive.[48] In January 1994 the rate of inflation culminated in a monthly rate of 313 million percent, in the quadrillions of percents on an annualized basis. This was the highest inflation rate seen anywhere in the world since the late 1940s, although it was sharply reduced during 1994.[49] As part of its economic stabilization and also to enhance its war footing, Yugoslavia reversed course on privatization and went from 43.5 percent of capital being state-owned in 1993 up to 81.9 percent in

44. "Croatia's War-Ravaged Economy Near Collapse," *Washington Post,* November 11, 1993, p. A46.

45. Vojmir Franicevi and Evan Kraft, "Croatia's Economy after Stabilisation," *Europe-Asia Studies* 49 (1997): 669–691.

46. Vojmir Franicevi, "Privatization in Croatia," *Eastern European Economies* 37 (1999): 5–54.

47. "Survey: The Balkans, Europe's Roughest Neighborhood," *The Economist* (January 24, 1998).

48. "Serbia: When the Party's Over," *The Economist* (October 14, 2000), p. 27.

49. Steven H. Hanke, "Yugoslavia Destroyed Its Own Economy," *Wall Street Journal,* April 28, 1999, editorial page.

1994,[50] with new command elements also introduced into the economy that had not been present prior to 1990. By the time Milošević lost power in late 2000, this remnant of the Yugoslav economy had become a bizarre and pathetic caricature of its former self. On February 5, 2003, Yugoslavia formally ceased to exist, being replaced by the Federation of Serbia and Montenegro.

How unnecessary and tragic this situation is can be seen by contemplating Sarajevo, capital of Bosnia-Herzegovina. Long under siege and almost constant bombardment, it is divided into neighborhoods along mutually hateful ethnic lines. Yet prior to the war Sarajevo was a cosmopolitan multicultural city, site of the 1984 Winter Olympics, where the various ethnic groups lived together in integrated peace, even intermarrying at a significant rate to produce the many self-identified Yugoslavs in Bosnia-Herzegovina. But groups that did not hate each other before do so now and will probably continue to do so for a long time, though peace was supposedly declared there in 1995. The tragedy of Sarajevo encapsulates the tragedy of Yugoslavia as a whole.[51]

SLOVENIA: THE SUCCESS STORY THAT GOT AWAY

Slovenia is the one republic that got away, despite being bombed in 1991. Once Croatia declared its independence, Slovenia's lack of a common border with Serbia and its relative lack of Serbs drew Milošević's attention away from it. Slovenia's superior status is symbolized by the decision in December 2002 of the EU to accept Slovenia for membership in 2004, while none of the other former Yugoslav republics have even long-term accession status.

Slovenia suffered economic consequences from the war, including a 20 percent decline in output between 1989 and 1992 and an increase in unemployment to 13 percent from less than 2 percent, largely caused by the collapse of trade with the other former republics. But its decline hit bottom and the rate of inflation had fallen to a monthly rate of 1 percent as of April 1993, with exports rising and the tolar, the Slovenian currency, stabilizing internationally.[52]

Slovenia is in the best shape of all the transition economies, although it was arguably in that state in 1990. Table 3-1 shows that it has the highest real per capita income, even ahead

50. Mladen Lazić and Laslo Sekelj, "Privatisation in Yugoslavia (Serbia and Montenegro)," *Europe-Asia Studies* 49 (1997): 1064.

51. The embarrassment of the international community with this situation is shown in a joke circulating Europe in late 1992: "A TV salesman brags that the set he is offering automatically switches channels whenever Bosnia is mentioned."

52. "Slovenia: The Yugoslav Success," *The Economist* (July 26, 1993), p. 55.

of the Czech Republic, which was ahead of it in 1945, as well as ahead of Poland and Hungary. It has experienced solid, steady output and export growth since 1992. It has the highest human development index among all the transition economies. It has the lowest level of graft, in sharp contrast with the other former Yugoslav republics by most accounts. It has the fourth most equal income distribution among the transition economies. Its inflation rate is in single digits, if not yet quite fulfilling the Maastricht criterion for joining the euro zone. Although its unofficially reported unemployment rate for 1998 was unpleasantly over 14 percent, its internationally comparable rate, according to surveys, was a much better 7.7 percent in 1998.[53]

In comparison with the other front-wave accession countries joining the EU in 2004, Slovenia stands out in at least three ways that do not greatly impress policymakers in either Washington, D.C., or Brussels. First, it still has a relatively low level of privatization—less than half of output, according to table 3-2. Second, of the privatization that has occurred, a great deal has taken the form of **insider buyouts,** specifically by workers. Third, there has been a relatively low level of foreign direct investment (FDI), especially for privatization, in Slovenia.

Regarding the degree of privatization overall, it must be noted that during 1991 and 1992 there was a great debate in Slovenia about how this should be done. Some advocated an instant mass privatization approach. But Joze Mencinger, the most influential figure, held out for a more gradualistic and decentralized approach.[54] At least one source suggests that in 1997, between 50 and 55 percent of output was privately produced.[55] But the nonprofit share was divided between two different kinds, enterprises that were simply operating as before and those that were specifically taken over by the state. Under the old Yugoslav system, firms were viewed as *socially owned,* which meant in practice that nobody owned them. As part of the privatization process, it was possible for the state to take over the ownership of an enterprise, which gave the firm a definite owner, unlike those that remained socially owned.

In fact, there are several different ways in which privatization can occur: foreign purchase, insider buyouts (usually by workers), domestic outsider purchases, as well as the formation of firms that did not exist before, and the firms that the state takes over specifically.

53. World Bank. *Slovenia: Economic Transformation and EU Accession,* Vol. II: Main Report (Washington, D.C.: World Bank, 1999), p. 5.

54. Joze Mencinger, "Privatization Experiences in Slovenia," *Annals of Public and Cooperative Economics 67* (1996): 415–428. Some observers argue that it was trade union support that was key to the outcome (Paul Phillips and Bogomil Ferfila, "The Legacy of Socialist Self-Management in Slovenia," mimeo [Winnipeg: University of Manitoba, 1999]). The banking sector has also been gradually privatized, with about 50 percent ownership by the state in 1996 (Maria Minniti and Lidija Polutnik, "Financial Development and Small Firm Financing in Slovenia," *Comparative Economic Studies* 41 [1999]: 111–133).

55. World Bank, *Slovenia,* p. 86.

Table 14-5
Slovenian Ownership Forms and Indicators (1995)

Ownership Category	No. of Firms	Equity	Assets	No. of Employees	Sales	Exports	Net Profits
New private	27.4	3.4	6.4	8.3	11.1	8.4	5,109
Foreign	7.6	5.0	5.6	5.4	11.8	18.2	6,110
Internal	30.5	17.3	17.2	32.9	25.1	22.1	−5,992
External	19.2	28.9	27.0	27.9	29.3	29.7	−122
Social	10.7	9.0	12.8	13.4	17.8	17.8	−20,802
State	4.6	36.4	31.1	12.0	3.8	3.8	3,204

Source: World Bank. *Slovenia: Economic Transformation and EU Accession,* Vol. II: *Main Report* (Washington, D.C.: World Bank, 1999), p. 95. All data are in percentages of the totals except for net profits, which are in millions of Slovenian tolars.

Table 14-5 shows the breakdown as of 1995 of the various types of enterprises and their roles in the Slovenian economy.

The new private and foreign-owned sectors were relatively small, although they were highly profitable, and the foreign-owned sector was heavily involved in exporting. The state-owned sector consists of very large, profitable firms. The worker-managed firms, both worker owned and socially owned, were losing money, as were the externally (domestic) owned. Nearly a third of workers were in the internally owned firms, and assuming that these as well as the socially owned firms were worker managed, almost half of workers were in worker-managed firms.

This pattern made policymakers in Washington and Brussels unhappy. They argued that workers' ownership leads to excessive wage boosts and insufficient governance restructuring. FDI is seen as the best way to achieve such restructuring. But Slovenia has had little of the latter, so little that it was not even listed in table 13-3, with cumulative FDI at less than 3 percent of GDP. The EU has demanded that there be greater openness to FDI, and it considers the high level of workers' ownership as a deliberate scheme to keep out foreign ownership. The argument has been further emphasized as policymakers have cited a study by Smith, Cin, and Vodopivec that finds that a 1 percent increase in foreign ownership increases value added by 3.9 percent, while a 1 percent increase in worker ownership increases value added by only 1.4 percent.[56] But, as the authors note, this suggests that there is still a positive return to more worker ownership, even when there is far less foreign

56. Stephen C. Smith, Beom-Cheol Cin, and Milan Vodopivec, "Privatization Incidence, Ownership Forms, and Firm Performance: Evidence from Slovenia," *Journal of Comparative Economics* 25 (1997): 158–179. At the end of 1994, the leading sources of FDI in Slovenia were Croatia, Austria, Germany, France, Italy, and Switzerland (Marjan Svetli and Matija Rojec, "Short Overview of the Slovenian Economy and Foreign Investment in Slovenia," *Eastern European Economies* 36 [1998]: 60–72).

ownership, and there are presumably diminishing returns to any kind of ownership structure. Although Slovenia might achieve greater gains from more FDI, it is doing very well on its own path of worker management augmented by worker ownership.

A little remarked element of the relatively successful Slovenian model is that in 1993 a law regarding employee participation was passed that mandated German-style codetermination in labor-management relations in all firms, irrespective of their ownership forms. This involves both a works council for oversight at the workplace level and a supervisory board at the management level. Clearly, these bodies are successors to the former system of workers' management. Furthermore, in 1994, under pressure from the trade unions, a tripartite Economic and Social Council was established that has negotiated economywide annual agreements regarding employment, wages, social security, pensions, prices (many of which are controlled), and elements of macroeconomic policy. In short, Slovenian macroeconomic policy now contains substantial corporatist elements.[57]

Thus, whereas worker-managed market socialism ultimately self-destructed in the former Yugoslavia as a whole, in Slovenia it was quite successful. Slovenia's success argues that the self-destruction of Yugoslavia was fundamentally caused by its ethnic conflicts and not by inevitable failure of the economic system itself. Slovenia's example shows that important elements of the worker-managed market socialist system may still be viable and relevant in the modern world economy, especially in the transition economies.

SUMMARY AND CONCLUSIONS

What once was Yugoslavia was destroyed in a tragic ethnic war that began in 1991 and still sputters in some of its former republics. This former nation officially ceased to exist as of early 2003. Prior to 1991, Yugoslavia possessed the only worker-managed market socialist economy ever seen. The system was introduced in the early 1950s under the leadership of the World War II Communist partisan leader, Marshal Josip Broz Tito.

This economic system involved elected workers' councils that functioned like capitalist boards of directors, appointing a management board and a director of the enterprise, while the state retained ultimate ownership. During the 1950s and early 1960s central planners retained considerable authority over prices and capital investment, the latter partly to achieve regional equality of growth rates and partly out of fear that the workers would allocate all retained earnings to wages rather than capital investment.

57. Paul Phillips and Bogomil Ferfila, "Slovenia in Transition: Plus ça Change, Plus la Même Chose?" in B. Ferfila, J. Holm, P. Phillips, R. Heinisch, L. Leloup, M. Kos, V. Kos, B. Donnorummo, S. Rascan, and A. Saito, eds., *Drzave in Svet: The States and the World* (Ljubljana: Fakulteta za Druzbene Vede, 2001), pp. 259–287.

In the mid-1960s, control by central planners was removed and the system largely followed market forces. As this policy stimulated a merger wave and increasing regional inequalities, the system was revised again in the mid-1970s to allow for integrated planning by organizations of associated labor within enterprises. Starting in 1989, outright privatization was allowed, thus setting the economy on the road to capitalism, although not necessarily on a path away from worker management.

Yugoslavia's economy grew at a rapid pace, with high rates of capital investment and a fairly equal overall distribution of income from 1950 to 1980. However, growth and capital investment fell in the 1980s, unemployment rose to double-digit levels, and inflation accelerated wildly. Regional income disparities increased, as did tensions over religion, power, and ethnicity. Eventually these tensions exploded into war, and now there are five nations where previously there was just one.

The breakup of Yugoslavia was ultimately caused by its ethnic conflicts. But many argue that the combination of soft budget constraints, lack of centralized macroeconomic control, inefficient capital investment, ongoing interference by Communist Party bureaucrats and local authorities in decision making, rising monopoly power, and the frustration of workers no longer able to affect management in ever-larger firms and going on strike were inherent in the economic system and led to its inevitable collapse into rising unemployment and hyperinflation.

A response to this critical view may be the post-1991 experience of now-independent Slovenia. Although still possessing a largely worker-managed market socialist economy, Slovenia has the highest per capita income of any former Communist state and has achieved reasonable economic stability. Nevertheless, Slovenia is privatizing ownership. Thus the slogan for those who like worker management but accept shedding of the socialist aspect might be "Worker-managed market socialism is dead! Long live worker-managed market capitalism!"

QUESTIONS FOR DISCUSSION

1. Compare the functioning of market socialism in Yugoslavia with that in Hungary.
2. Compare and contrast the Yugoslav system with USSR-style command socialism. What were the relative advantages and disadvantages of each?
3. How did the regional issue affect the operation of the soft budget constraint and the emergence of hyperinflation in Yugoslavia?
4. If workers' management leads to stability of employment, why did unemployment rise steadily in Yugoslavia?

5. How can it be argued that Yugoslavia did not really have a system of workers' management, and what would this imply?

6. What is the evidence for capital market inefficiency but labor market efficiency in Yugoslavia, and why might these have occurred?

7. How can one explain the simultaneous existence of general income equality and extreme regional inequality in Yugoslavia?

8. Was the Yugoslav economic system Marxist?

9. What are the future prospects for workers' management in the world economy and why? What forms might this take?

10. Compare the transition path of Slovenia to those of Poland and Hungary.

11. Does Slovenia's success have implications for the world economy or is it simply a special case?

12. How does Slovenia face a conflict between its unique transition path and its joining the EU?

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RUSSIA
Lake Baikal
KAZAKHSTAN
Lake Balkhash
MONGOLIA
Hailar
Heilongjiang
Harbin
Jilin
Changchun
Karamay
Kulja
Urumqi
Kashgar
Xinjiang
Liaoning
Hebei
Inner Mongolia
Beijing
N. K.
S. K.
Yumen
PAK.
Golmud
Ningxia
Taiyuan
Shandong
Yellow Sea
C H I N A
Zhengzhou
Shaanxi
Qinghai
Shanghai
Anhui
Tibet
Sichuan
Hubei
Wuhan
NEPAL
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Changsha
Jiangxi
Guizhou
Hunan
Fujian
TAIWAN
BANG.
Kunming
Guangxi
INDIA
Guangzhou
Nanning
Yunnan
Hong Kong
MYANMAR
VIET.
Hainan
South China Sea
Bay of Bengal
THAILAND
PHILIPPINES

15 China's Socialist Market Economy: The Sleeping Giant Wakes

The mountains are high; the emperor is far away.
—Ancient Chinese Proverb

Our celestial empire possesses all things in prolific abundance and lacks no product within its own borders. There is therefore no need to import the manufactures of outside barbarians.
—Emperor Qianlong (Ch'ien-lung)[1] to the special emissary of King George III of Great Britain, 1793

China is a sleeping giant. When China wakes she will shake the world.
—Napoleon Bonaparte, circa 1800

INTRODUCTION

With the world's largest population and one of its most rapidly growing economies,[2] the People's Republic of China (PRC) is an important case of economic transformation. It continues to be ruled by an authoritarian and entrenched Communist Party, whereas other nations experienced economic collapse following the political abandonment of communism. What is China's[3] secret?

There is no simple answer. China occupies a central position geographically, historically, and culturally in East Asia, where many countries have experienced rapid industrial growth. Many of these countries have followed the model of Japan, which has led this group, whereas China long lagged behind them economically. But China has awakened, is asserting its central position, and is emerging as a regional leader. Its economy may have become the second largest in the world.[4] Given its growing military might, China reckons to become a full international superpower.

1. In 1979 China officially switched from the Wade-Giles system of Latin alphabet transliterations of Chinese words to the Pinyin system. Following current scholarly and journalistic usage, we use the Pinyin system except for deeply entrenched cases such as the name of the country itself, *Zhongguo* in Pinyin. The first time a name appears in Pinyin, it is followed by the often more familiar Wade-Giles form in parentheses, as with Qianlong (Ch'ien-lung). The Wade-Giles system is still generally used in Hong Kong and Taiwan.

2. During 1980–1992 China was third in aggregate GDP growth rate behind Botswana and South Korea and second in per capita GDP growth rate behind South Korea (World Bank: *World Development Report 1994* [New York: Oxford University Press, 1994], Tables 1 and 2) but was first in aggregate growth rate in 1994 (*The Economist,* January 28, 1995, p. 102). China's growth rate has slowed somewhat since then and is no longer the world's highest, although it continues to be one of the highest.

3. The name *China* refers to the People's Republic of China (PRC) and the name *Taiwan* refers to the Republic of China (ROC), each claiming to be the legitimate government of all of China, including Hong Kong, although Taiwan ceased forecasting a reconquest of the mainland after the early 1990s.

4. There is a wide range of estimates of Chinese per capita income. In Table 1.1 of the World Bank's *World Development Indicators 2000* (Washington, D.C.: World Bank, 2000), China is listed as having a GNP in 1998 adjusted for the cost of living (PPP) of $3.779 trillion, putting it second behind the United States's $7.904 trillion and ahead of Japan's $2.982 trillion. But its unadjusted GNP was only $928.6 billion, putting it in seventh place behind the United States, Japan, Germany, France, the United Kingdom, and Italy. Estimates of the PPP per capita income in 1990 range from $1,135 to $4,264 (Harry X. Wu, "China's GDP Level and Growth Performance: Alternative Estimates and the Implications," *Review of Income and Wealth* 46 [2000]: 485).

Under Chairman Mao Zedong (Tse-tung) the PRC pursued egalitarianism and regional self-sufficiency, the latter for defense reasons from fear of attack by the USSR or the United States. The countryside was organized into large **communes** corresponding to former town and village clusters, and traditional culture and social values were assaulted during the **Great Proletarian Cultural Revolution** (**GPCR,** 1966–1969).

Although the communes have been disbanded, a remnant of them persists as **town and village enterprises (TVEs),** rural industrial enterprises owned by local units of government, the towns and villages that formerly comprised the communes, and lower-level **brigades.** These entities are free from central planning and operate in a competitive market context, many exporting goods abroad through laissez-faire Hong Kong or via specific foreign capitalist firms. China's export sector has been growing rapidly in recent years, outperforming the stagnant centrally planned state-owned sector as well as, until the mid-1990s, the strictly privately owned sector, the latter mostly located in **Special Enterprise Zones (SEZs).**[5] This dynamic TVE form is the unique innovation of the PRC's self-proclaimed **socialist market economy.**

Since the late 1970s, post-Mao China has seen a revival of Confucianism, which emphasizes filial loyalty within families and toward state authorities, hard work, and morality. Confucius was Chinese, and Confucianism was long the established official state religion of China before the twentieth century. **Neo-Confucianism's** New Traditional Economy emphasis on familism and groupism may be the common characteristic shared by the rapidly growing East Asian economies, as noted in chapters 4 and 6 and discussed further in chapter 19 on Korea.

The post-Mao renewed emphasis on family units led to the **household responsibility system** in agriculture after 1978, when Deng Xiaoping (Teng Hsiao-p'ing, 1904–1997) came to power, to be succeeded by Jiang Zemin and, more recently, Hu Jintao. This system resulted in dramatic improvements in food output and increases in rural incomes, which is important given that a majority of China's more than 1.2 billion people still live in the countryside. Despite slowing growth in the agricultural sector since 1984, China has achieved the ability to feed itself, a historic milestone for a society whose past was characterized by regular famines. During the **Great Leap Forward** (**GLF,** 1959–1961), starvation deaths of up to 30 million people occurred when the communes were first established.

Despite recent economic successes, China faces severe problems, including:

1. The threat of separatism in poor western provinces populated by minorities, such as Tibet and Xinjiang.

5. In 1994 the private sector growth rate exceeded that of the TVE sector. A substantial trend toward privatization of TVEs in various forms has emerged since 1994.

2. Continuing political conflicts over democratization and dissent such as the violently suppressed 1989 student uprising in Tiananmen Square in the capital, Beijing (Peking).

3. The threat of continuing extreme oscillations between inflation and deflation combined with a slower economic growth rate.

4. Rising regional income inequalities as the reforming coastal areas surge ahead. Income inequality is also widening between urban and rural areas, as the latter fall behind and are prevented from adjusting by continuing restrictions on labor migration. Income inequity within both urban and rural local areas is increasing as those with education earn more while many others remain in poverty.

5. The problem of managing laissez-faire Hong Kong since its absorption by China in 1997 and the attempt to absorb market capitalist Taiwan later, both of which are far ahead of the PRC in real per capita income.

6. The threat of a major energy/environmental crisis in the not too distant future if China's rapid growth path continues.

7. Dealing with the accumulating bad debts in the state-owned banks accruing from the losses of increasingly inefficient SOEs.

8. Finally, absorbing the increasing numbers of migrants and unemployed persons from the countryside by China's already overcrowded cities in a gradually slowing economy.

Nevertheless, China continues to move in the direction of markets and capitalism. It formally accepted the private sector in its constitution in 1999 and accepted new capitalists into the higher ranks of the Communist Party in 2002, as well as joining the World Trade Organization (WTO) in 2001. Some see a loosening on information flow in China since the 2003 outbreak of SARS, perhaps reminiscent of the appearance of the glasnost policy in the USSR after the Chernobyl nuclear accident in 1986. Thus China is a land of great hopes but also possesses some genuine fears as it faces potential pitfalls in its attempt to achieve a more market-oriented socialist economy.

HISTORICAL AND CULTURAL BACKGROUND

Culture and Religion

China has exhibited strong cultural continuity over thousands of years, despite episodes of revolutionary violence and disorder. This reflects the Taoist conception of universal harmony resting on a balance of conflicting and interpenetrating forces of yin (female) and yang (male), ideas that have pervaded Chinese culture. As in Japan, three major religions have coexisted even among individual adherents,[6] and the balance of their views has produced the synthesis that is Chinese culture. Two of these religions, **Taoism** and **Confucianism,** are Chinese in origin; the third, **Buddhism,** came originally from India mainly via the Silk Road out of Central Asia.[7]

The founders of the two native Chinese religions—Lao-Tzu (604–? B.C.E.),[8] who founded Taoism, and Confucius (551–479 B.C.E.)—are reported to have met. Their philosophies form the complementary and contrasting foundations of Chinese culture, set forth respectively in Lao-tzu's *Tao Te Ching* and in the *Analects* of Confucius.

Followers of the Tao, "the Way," seek harmony with nature and immortality. The key to this search is **wu-wei,** "no action," a Chinese term used to describe nirvana when Buddhism came to China and was Sinified.[9] The *Tao Te Ching* is famous for paradoxical formulations such as "Do nothing and all will be done." It has been associated with a laissez-faire orientation and was so used at the beginning of the Han dynasty (206 B.C.E.). Further examples are the following quotes from the *Tao Te Ching:*

> Administer the empire by engaging in no activity. . . . The more taboos and prohibitions there are in the world, the poorer the people will be. . . . Therefore the sage says: I engage in no activity and the people of themselves become prosperous.

Taoism became formally organized in the second century C.E. It was declared the state religion in 440 and again in 574 and 591. It peaked in official favor in tandem with Buddhism during the early Tang dynasty in the 600s and early 700s, but was officially suppressed along with Buddhism in 854 by Confucianism. It became a mass religion with numerous gods and priestly hierarchies, emphasizing divination, alchemy, astrology, and other such practices.[10] But by the time of the Communist revolution in 1949, Taoism had mostly disappeared as an organized religion.

6. It is said that the Chinese have "worn a Confucian crown, a Taoist robe, and a pair of Buddhist sandals" (William Theodore de Bary, Wing-tsit Chan, and Burton Watson, *Sources of Chinese Tradition* [New York: Columbia University Press, 1960], p. 631).

7. Hinayana missionaries entered in the first century C.E. from Southeast Asia, and Mahayana missionaries entered from Central Asia, the latter gaining dominance and fragmenting into numerous schools. In Tibet and Inner Mongolia, Vajrayana (Lamaist) Buddhism prevails. Islam dominates among Turkic minorities in the northwestern Xinjiang (Sinkiang) Uygur (Uighur) Autonomous Republic and in parts of southern China.

8. The date of Lao-tzu's death is unknown. There is debate regarding his existence and authorship of the *Tao Te Ching.* B.C.E. stands for Before Common Era, formerly known as B.C.

9. Other Sinifications of Buddhism in China include eliminating the doctrine of reincarnation and downplaying gender equality because Confucianism asserted patriarchal male supremacy. Buddhism said little about politics or economics and became less influential after its suppression in 854, but it underlaid politically active nineteenth-century sects, notably the Boxers, who led a 1900 antiforeigner rebellion.

10. It is analogous to Shintoism in Japan and Sinkyo in Korea. Taoism shares ancestor worship with Confucianism, a practice predating both religions in China. On the laissez-faire nature of Taoism in China, see James A. Dorn, "China's Future: Market Socialism or Market Taoism?" *Cato Journal* 18 (1998): 131–146.

If Taoism, with its anarchistic hermit sages escaping to the wilderness to seek harmony and immortality, is the yin of Chinese culture, then Confucianism is the yang, given its moralistic scholar-mandarin-bureaucrats administering the empire from great imperial cities. Confucianism has been the favorite doctrine of the scholar in power, whereas Taoism has been that of the scholar out of power.

Chinese Confucianism centers on **ren,** usually translated as "benevolence" or "humaneness," which society's leaders, from the emperor down through his mandarin gentry, should practice. The emperor is the "Son of Heaven," who should rule benevolently and is owed loyal obedience if he does so. This loyal obedience extends to family relations: The son obeys the father and the wife obeys the husband. Benevolent imperial conduct is key to celestial harmony and order.[11] If an emperor behaves badly, he loses the "Mandate of Heaven" and can be legitimately overthrown.

Although Confucianism would develop into an authoritarian state-centered doctrine in later dynasties, it advocates a "light touch" by the ruler with almost Taoist, laissez-faire overtones. The *Analects* frequently declare that if the emperor is benevolent and reverent (including carrying out rites necessary for maintaining celestial harmony), then he can practice *wu-wei* and the state will be well governed.

The truly authoritarian Chinese philosophy was **Legalism,** developed during the reign of the initial unifier of China in the third century B.C.E., Qin Shi Huang (Ch'in[12] Shi Huang-ti). The Legalists supported absolute power by the state, and the Qin dynasty was harsh and oppressive. It was overthrown in 206 B.C.E. shortly after Qin Shi Huang's death by the Han, who initially followed laissez-faire Taoism. During the first century B.C. when the Han Emperor Wu nationalized the salt industry, a debate occurred between Legalists, who supported nationalization, and Confucianists, who opposed it. But Legalism's official influence faded, and its only remnants are found in some of its elements that were incorporated into the **neo-Confucian synthesis** of the 1100s.

After 854 Confucianism became the official Chinese state religion, absorbing elements of other religions in a synthesis codified in the 1100s. It became ossified and reactionary by the nineteenth century. Official Confucianism opposed commerce, industrialization, and relations with the outside world and supported the ideal of China as the self-sufficient Middle Kingdom to whose emperor foreign barbarians should kowtow and pay tribute.

11. Confucianism is less theistic than Taoism or Buddhism. Its supreme deity is a remote heaven. The Confucianist model of a nontheistic benevolent ruler influenced anticlerical European Enlightenment thinkers in the 1700s, notably Leibniz, Voltaire, and the physiocratic economist, François Quesnay, sometimes called "the Confucius of the West." For its relation to economic modernization and Western thought, see Wei-Bin Zhang, *Confucianism and Modernization: Industrialization and Democratization of the Confucian Regions* (New York: St. Martin's Press, 1999).

12. It is from his name that the name *China* comes. Generally a reviled figure in Chinese history, Qin was admired as a strong national leader by Mao Zedong.

Social Structure and Land Tenure in Traditional China

Confucius supported equal division of land among patriarchal families. During the Han period, family land ownership with division among all male heirs predominated. The basic social pattern emerged of a town with a group of villages functioning as an essentially self-sufficient unit. In China this pattern still exists. The towns became the communes during Mao's GLF, the villages became brigades, and subvillage or smaller village groups became **production teams.** Individual households were at the bottom of this economic division.

The Confucian ruling class was the scholar-gentry, following the praise of education by Confucius. Starting in the Han dynasty, civil service examinations for the state bureaucracy appeared, the world's first, although these did not become fully standardized until the Song dynasty. The fairness of these exams and the fluidity of the class structure varied over time. Fairness was a sign of lack of corruption, and testing was usually fairer early in a dynasty's rule.

The lower levels of the bureaucratic elite ruled the countryside in the small towns as the emperor's agents. Class mobility was reduced because, to pass the exam, one had to spend much time studying numerous classical writings and the thousands of ideographs in the Chinese alphabet. The son of a scholar-bureaucrat was better positioned for such study than the son of an uneducated peasant.

The Dynasty Cycle

A Chinese interpretation of their history consists of a series of cycles associated with the rise and fall of ruling dynasties. In this view, the Communists are seen as just the latest dynasty. The most important dynasties have been the Han (206 B.C.E. to 220 C.E.), the Tang (T'ang, 618 to 906), the Song (Sung, 960 to 1275), the Yuan (1276 to 1367), the Ming (1368 to 1644), and the Qing (Ch'ing, 1645 to 1911).

A recurring pattern characterizes all dynasties. A major dynasty initially attacks corruption, builds up the economy, follows Confucian virtues, and strengthens the country. Gradually corruption increases and imperial attention to government decreases. Taxation levels, famines, rebellions, and local warlord activity increase until the dynasty falls. Sometimes new dynasties are foreign, notably the Mongol Yuan[13] and the Manchu Qing.[14]

13. The Mongol Yuan, Khubilai Khan, was emperor in the late 1200s when Marco Polo visited China and then told Europe of its splendors. The gap between China and Europe is seen in the fact that Marco Polo left Europe's largest city, Venice, with a population of 160,000 and visited the former Song capital, Hangzhou (Hangchow), the world's largest city, with around 6 million people.

14. The foreignness of the Manchus stimulated the anti-imperial nationalist movement in 1912, embittering Pu'yi, the last emperor, who was convinced by the Japanese to lead their puppet state of Manchu'ko in conquered Manchuria in the 1930s. Manchuria has since been divided into the provinces of Heilongjiang, Jilin, Liaoning, and northereastern Nei Mongol.

This dynasty cycle supposedly proved that China was an unchanging society, an idea popular in nineteenth-century Europe when China fell behind technologically and economically. Karl Marx explained the Chinese lag by the **Asiatic mode of production,** an economic system that existed outside of his historical materialist categories. For example, in the Asiatic mode, a monarch controls the hydraulic infrastructure that, in turn, controls flooding and irrigation on great river systems in monsoon zones. Yet Marx's idea pertained more accurately to India because China generally had private rather than state ownership of land. But China did have a bureaucracy that managed an agrohydraulic infrastructure of dams and irrigation systems, the basis of Wittfogel's extension of Marx's idea to **hydraulic (oriental) despotism.** Marx and Wittfogel both saw state bureaucracy suppressing capitalism and class struggle dynamics, thus leading to the stagnant economy and society that characterized much of Asia.[15]

Wittfogel's theory characterizes late Qing China when, after the **Opium Wars** (1839–1842), Great Britain imposed humiliating port treaties, took over Hong Kong,[16] and gained the right to import opium into China.[17] Yet this theory does not hold over the longer term. For hundreds of years China was the world's technological leader, peaking as such in the early Tang Dynasty,[18] but gradually lost its technological edge by the 1400s. When Emperor Qianlong dismissed the British envoy in 1793, China's riches were still close to Europe's wealth prior to the Industrial Revolution.

Periods of expansion and outward orientation alternated with ones of contraction and inward orientation. The Han empire ruled parts of Central Asia, established the Silk Road trade link with Europe, and opened itself to outside influences like Buddhism. During the seventh century the early Tang Dynasty expanded, reconquering portions of Central Asia and allowing Christianity, Manichaeism, and Islam. Expansion halted after the Arabs defeated a Chinese army in 751 in Central Asia. Then China withdrew and disintegrated, despite economic and cultural advances in the Song dynasty, until the Mongol conquest in 1276. During the 1400s, the Ming dynasty expanded Chinas's reach; its ships visited the

15. Karl August Wittfogel, *Oriental Despotism: A Comparative Study of Total Power* (New Haven, Conn.: Yale University Press, 1957).

16. Portugal ruled tiny Macau, near Hong Kong, from the 1500s, but sought no further entry and turned it over to Chinese control in 1999, just as Britain did with Hong Kong in 1997.

17. As late as 1867, a majority of China's export earnings came from silk and silk products. Increasingly, the British exported Chinese tea to Britain in exchange for opium from India.

18. Some Chinese discoveries and inventions include paper, gunpowder, the compass, row cultivation crops, the iron plow, efficient horse harnesses, the crank handle, steel, water power, the chain pump, the suspension bridge, the use of petroleum as a fuel, the mechanical clock, the circulation of blood, inoculation against smallpox, the decimal system, negative numbers, the contour transport canal, manned flight with kites, the parachute, the rudder, multiple masts on ships, the crossbow, and the rocket. The Chinese origin of most of these discoveries was long unknown in Europe. See Joseph Needham, *Science and Civilization in China* (Cambridge: Cambridge University Press, 1954).

east coast of Africa and colonized Taiwan. In the 1500s, the Chinese allowed Jesuits in and studied their scientific knowledge, only to expel them later.[19]

From Empire's End to Communism's Victory

After the Opium Wars, China experienced one defeat after another. France, Germany, Russia, the United States,[20] and Japan,[21] in addition to Britain, established treaty ports where their national merchants operated free of Chinese jurisdiction. All nations operated in Shanghai, where a park under British control bore the infamous sign "No Chinese or dogs allowed." Antiforeign, anti-imperialist movements and Westernizing upheavals against the Qing dynasty erupted.[22]

In 1911 the Qing dynasty was overthrown by followers of Sun Yat-sen, who was a Westernizer soon put out of power. A period of **warlordism** ended when Chiang Kai-Shek led the Nationalist Guomindang (Kuomintang) to power in 1928. Chiang had Soviet and Communist support, but he turned on the Communists, which caused them to follow Mao Zedong in 1935–1936 on the **Long March** to Yan'an (Yenan) in the northwest. From there they fought a peasant-based guerrilla war.[23]

Chiang was eclectic in his ideology, borrowing from the Soviets, the Americans, and the fascists. During World War II he published a book forecasting a great future for China if it followed Confucian virtues. This is still the official ideology of the Guomindang party, which ruled Taiwan until 2000 and was one reason Mao was anti-Confucian.[24]

After the war, despite U.S. aid and advice, Chiang did not carry out land reform. He allowed hyperinflation to develop, undermining his support among the urban middle

19. They entered through the southern port of Guangzhou (Canton) from Macau, sponsored by the Portuguese. In the late 1600s their influence peaked. They fell in the 1700s, caught between inward-looking Chinese nationalism and Vatican attitudes opposing their participation in imperial Confucian rituals.

20. The United States flooded China with Protestant missionaries, whose impact was less than that of the Jesuits expelled in the 1700s. The Chinese Christian population of a few million is small.

21. Japan got treaty port rights after defeating China in 1895, when it took Taiwan. It took semi-industrialized Manchuria in 1931 and invaded China outright in 1937. Japan never conquered China during World War II, despite committing major atrocities.

22. The first major upheaval after the Opium Wars was the 1850s Taiping rebellion against the government. Its leaders led a syncretic sect with Christian elements that supported collective ownership of land and other semicommunist ideas. This was followed by the Boxer Rebellion in 1900.

23. For Mao's activities in Yan'an, see Edgar Snow, *Red Star Over China* (New York: Grove Press, 1968). For policies toward peasants then, see William Hinton, *Fanshen* (New York: Monthly Review Press, 1966).

24. Referring to Mao's regime, John King Fairbank (*The United States and China,* 4th ed. [Cambridge, Mass.: Harvard University Press, 1983], p. 465) notes, "Dynastic absolutism has been replaced by party dictatorship, the Son of Heaven by the party chairman, the imperial family-clan by the central executive committee, the scholar elite by a party elite, tax-gatherers by cadres in the countryside, Confucian classics by Communist classics, written examination by group discussion, scholarly self-cultivation by guilt-ridden self-criticism."

class.[25] With a solid rural base, the Communists defeated the Nationalist forces in Manchuria and swept down out of the northeast. On October 1, 1949, Chiang's forces retreated to Taiwan where they ruled until 2000, while Mao's Communists established the People's Republic in Tiananmen Square in Beijing.[26]

MAOIST ECONOMIC POLICIES

The Ideology of Maoism

Initially discussed in chapter 3, **Maoism** was the main Communist rival to the Soviet-style model during the twentieth century. Its ultimate origin was the *May Fourth Movement* of 1919, which protested turning Chinese territory over to Japan in the Versailles Treaty. From that movement came the Chinese Communist Party (CCP), founded in 1921. Mao Zedong of the southern province of Hunan was a founding delegate.[27] Initial links with the Soviet-based **Comintern** led the CCP to follow a Soviet-led line until the disaster of 1928, when they retreated from Shanghai to the countryside.

Mao became the effective leader of the party during the Long March and formulated his doctrine of relying on a mass peasant base, which differed from Stalin's position. Initially this doctrine emphasized land distribution in the Confucian manner, but in the early 1940s Mao stressed land distribution as a bridge to full collectivization. The Soviets supported the CCP in 1949, and the USSR and the PRC were allied during the Korean War of 1950–1953, although Mao resented Stalin's reluctance to actively commit troops.

Mao's views evolved over time, as did Chinese policy. Nevertheless, by the end of his life, a Maoist dogma had emerged that can be compared with Soviet views. When Tito split from Stalin in 1948 and when Khrushchev denounced Stalin in 1956, Mao supported Stalin against their *revisionism,* and the ideological split with Khrushchev developed into the **Sino-Soviet split.**

25. The Shanghai cost-of-living index rose from 100 in January 1947 to 897,458 in November 1948 (Frank H. H. King, *A Concise Economic History of Modern China [1840–1961]* [New York: Praeger, 1969], p. 161).

26. Coinciding with the Soviet explosion of a nuclear bomb, this Communist victory in China triggered an outburst of McCarthyite Cold War hysteria in the United States, including a major purge of State Department "Old China Hands" who were blamed for this outcome, in many cases for having accurately forecast it.

27. Several May Fourth Movement-CCP activists from Hunan and Sichuan operated in France, including Deng Xiaoping. Deng was a military commander in the Long March and the civil war, giving him a military base. His last official position was chairman of the Supreme Military Commission. Although he would become de factor supreme leader after 1978 despite having been purged twice by Mao, Deng would not hold any of the official top positions of CCP general secretary, president, or premier.

But Maoism differed from Stalinism in at least five ways: (1) its emphasis on developing the rural economic base and maintaining population in the countryside (although actual Maoist policy increased the urban-rural income gap); (2) its emphasis on egalitarianism and use of moral incentives rather than material incentives; (3) its antibureaucratic attitude, which peaked during the GPCR when **Red Guards** denounced bureaucrats[28] and sent them to the countryside for "reeducation"; (4) its greater opposition to traditional culture—whereas Stalin supported the maintenance of important elements of nineteenth-century Russian art and culture, Mao sought to extirpate the past by campaigning against the *Four Olds* (old customs, old habits, old culture, and old thinking); and (5) its emphasis on regional decentralization of economic control, more like the ideas of Khrushchev than those of Stalin.

Implanting Socialism and the Stalinist Model, 1949–1957

Inheriting a devastated economy and initially relying on support from centrist and liberal groups, the new Communist regime moved slowly, emphasizing ending hyperinflation and redistributing land to individual peasants. Collectivization of agriculture proceeded gradually, as did nationalization of industry and trade.

In agriculture, after granting land to all peasants individually, Mao's regime began to establish localized mutual aid teams in 1950. The higher level, village-based brigade cooperatives, began to be organized in 1955 and had completely displaced the lower organizational forms by April 1958, when the town-level communes began to be formed. Starting from a base of 34.7 percent of industrial enterprises that were fully nationalized in 1949, the economy included no purely private industry by 1956, although a joint state-private sector still controlled 32.5 percent of industrial enterprises.[29]

Between 1953 and 1957 the First Five-Year Plan followed Stalinist lines, reflecting Sino-Soviet friendship and Chinese reliance on Soviet economic advisers. Command central planning in China emphasized a heavy industrial buildup, especially in northeastern Manchuria, where Russia traditionally had interests and a preexisting industrial base had been expanded by the Japanese. Steel production soared at an annual rate of 31.8 percent, pig iron at 27.7 percent, and cement at 29.3 percent, whereas grain output expanded at a

28. Chinese bureaucracy shows up in the CCP structure. Whereas most Communist parties have a Central Committee with a Politburo above it, China has had two higher layers above that. Officially, there is the Standing Committee of the Politburo. But above it was a group of Long March veterans unofficially known as the Sitting Committee because they were so old that they rarely stood up, the most prominent member of this group having been Deng Xiaoping. Only one member of this last group is now left, and it lost its effective power with the deaths of Deng in 1997 and of his chief rival, the more Maoist Chen Yun, a few months earlier. However, with the official retirement of the leading officials in 2002, there now appears to be a new unofficial Sitting Committee at the top.

29. Carl Riskin, *China's Political Economy: The Quest for Development since 1949* (Oxford: Oxford University Press, 1987), p. 96.

rate of only 4.0 percent.[30] Per capita kilocalorie availability rose from 2,048 in 1953 to 2,217 in 1957 as rural per capita pork consumption fell from 5.5 kilograms to 4.4 over the same time period.[31]

The Great Leap Forward, 1958–1961

A cutoff of Soviet aid[32] and a poor harvest in 1957 triggered the Great Leap Forward (GLF) in 1958. A goal was to develop rural-based industrialization using traditional technology to produce inputs and mechanization for agricultural production in decentralized communes, a policy labeled "walking on two legs." The outcome of this approach was not as disastrous for industry as many observers then claimed, but the agricultural outcome was much worse than was reported at the time.

Communes were established at the level of the traditional market towns, which became the accounting units for income determination and distribution. This communalization included establishing dormitories for men and common dining halls. Although potentially liberating women from housework, this move attacked traditional Confucian notions of the family and was resisted in many areas. By late 1959 a retreat from this type of communalization began with the elimination of the male dormitories, and in 1960 the accounting unit was transferred back to the brigade (village) level.

Rural industry developed in backyard production facilities, and pig iron and other basic industrial goods output increased in 1958–1959, although the quality was generally very poor. Industrial output growth decelerated in 1960 and fell sharply in 1961 as disorganization and catastrophe overwhelmed the economy.

The catastrophe in agriculture caused the worst famine in China's recorded history, with 15 to 30 million deaths occurring during 1959–1961. The overall death rate in China was twice as high in 1960 as in 1958.[33] Rural food grain consumption per capita fell from 201 kilograms per capita in 1958 to 156 in 1960, and per capita pork consumption fell from 4.6 kilograms per capita in 1958 to 1.2 in 1960. Given poor transportation and local self-sufficiency, certain areas experienced much sharper declines than these overall figures indicate, and many more people died in these areas.

30. James T. H. Tsao, *China's Development Strategies and Foreign Trade* (Lexington, Mass.: Lexington Books, 1987), p. 17.

31. Mark Selden, *The Political Economy of Chinese Development* (Armonk, N.Y.: M. E. Sharpe, 1993), p. 26.

32. This aid was in the form of loans with short payback periods. Arguments over aid coincided with ideological splits over revisionism, cancellation of the joint nuclear agreement in 1959, and the abrupt removal of all Soviet advisers in 1960. By 1965 Sino-Soviet trade was one-fifth of its late 1950s level and occurred only in Swiss francs after 1970. In 1969 armed border clashes occurred in the northeast. Relations finally eased in the late 1980s and have become quite friendly again more recently.

33. Vaclav Smil, *China's Environmental Crisis: An Inquiry into the Limits of National Development* (Armonk, N.Y.: M. E. Sharpe, 1993), p. 17.

The Period of Adjustment, 1962–1965

In 1962 Mao accepted blame for the GLF in a "self-criticism" extracted under pressure from a coalition that included Party General Secretary Deng Xiaoping. Central planning was reinstituted. The unit of rural income accounting was lowered from the brigade to the production team, where it remained until 1978. Development priority reversed from heavy industry to agriculture, with light industry favored over heavy industry.

Both agriculture and industry grew solidly. Between 1961 and 1965 overall agricultural output rose at an annual rate of 9.4 percent and industrial production rose at an annual rate of 7.8 percent.[34] Famine disappeared. Deng was a crucial figure in this policy shift. During a 1962 policy debate while advocating expanded use of private family plots, Deng coined his famous aphorism, "It does not matter whether the cat is black or white as long as it catches mice." This saying was used against him during the GPCR (1966–1978), when he was purged as a **capitalist roader.** He was rehabilitated in 1973 but purged again before Mao died in 1976. This saying can be seen as indicating his fundamental pragmatism, which would lie behind the policies he would institute after Mao's death.

The Great Proletarian Cultural Revolution and the Late Maoist Period, 1966–1978

In 1966 Mao threw the country into turmoil again. Youthful Red Guards, waving copies of *Quotations of Chairman Mao* (the "Little Red Book"), attacked the party hierarchy, led by figures such as Deng. Intellectuals and bureaucrats were sent to the countryside or prison for reeducation. Mao sought to establish pure communism.

A crisis occurred in 1967, when virtual anarchy reigned throughout the country. Mao then sent in the People's Liberation Army (PLA) to restore order, although the political campaign against Mao's enemies continued through 1969 and political conflicts and switches continued to his death, including the purge and mysterious death in 1971 of then number two, Lin Biao (Lin Piao), in an airplane reportedly flying to the USSR.[35] Mao's economic policies continued for two years after his death until Deng established his power and began to implement the Four Modernizations: (1) agriculture, (2) industry, (3) science and technology, and (4) national defense.

A policy emphasis of the GPCR era was national and regional self-reliance. Nationally this led to a decline in foreign trade from $4.245 billion in 1966 to $3.785 billion in 1968,[36]

34. Alvin Rabushka, *The New China: Comparative Economic Development in Mainland China, Taiwan, and Hong Kong* (Boulder, Colo.: Westview Press, 1987), p. 208.

35. He opposed the anti-USSR opening to the United States then under secret negotiation, which occurred in 1972. After his death, Lin Biao was identified with Confucius and the most extreme anti-Confucius campaign of the Maoist period occurred.

36. Riskin, *China's Political Economy,* p. 208.

paralleling the declines in agricultural output by 1 percent and in industrial output by a whopping 20 percent.[37] Then all three areas began experiencing steady growth, foreign trade reaching $US 20.64 billion by 1978,[38] agricultural output increasing annually at a rate of 4.4 percent, and industrial production rising annually at a rate of 12.7 percent between 1968 and 1978.[39]

The regional element of self-reliance involved substantial decentralization to local government units of planning administration. Fear of a Soviet invasion led to the **Third Front policy,** which emphasized major industrial expansion in southwestern provinces like Sichuan, away from both the Soviet border and the coastal regions vulnerable to U.S. attack. Local areas built input supply systems for industrial production, building on foundations laid out during the GLF and later used for TVE development. The framework established in this period of multiple hierarchical levels of responsibility, with restraint by higher levels, allowed for planning flexibility and slackness of planning crucial for the later period of very rapid growth.[40]

DENGISM AND THE MOVE TO A MARKET ECONOMY, 1979 TO THE PRESENT

The Oscillations of the Reform Process

Mao died in 1976, and in 1977 Deng Xiaoping reentered the leadership with the backing of influential military figures. In 1978 the CCP leadership confirmed his leading role and committed the nation to gradualist market-oriented reforms. Crucial to this change was Deng's base of support in the military, which was attracted by his emphasis on pragmatic policies that would bring more rapid growth and modernization. Initial changes affected agriculture and laid the foundation for establishment of the SEZs, which opened China to outside economic influences.

Just as the Mao era saw sudden shifts of sentiment and policy, the post-Mao period has seen ongoing conflict and policy oscillations, albeit trending toward marketization and opening up the economy to the outside world. Most backward shifts had the support of Deng, although he may have been forced to go along in some cases.

37. Rabushka, *The New China,* p. 208.

38. Nicholas R. Lardy, *Foreign Trade and Reform in China, 1978–1990* (Cambridge: Cambridge University Press, 1992), p. 12.

39. Rabushka, *The New China,* p. 208.

40. See David Granick, *Chinese State Enterprises: A Regional Property Rights Analysis* (Chicago: University of Chicago Press, 1990).

The first backlash came in 1981, when ideologues attacked intellectual liberalization. But in 1982 the CCP committed itself to eliminating corruption[41] and reforming itself. In 1983 came the "anti–spiritual pollution" campaign against foreign influences. Then in 1984 came major enterprise reforms, followed in 1985 by the removal of many military hardliners from party positions. In late 1986 student prodemocracy demonstrations triggered the removal of Deng's heir apparent, the relatively liberal Hu Yaobang, as general secretary and the initiation of an "anti–bourgeois liberalization" campaign. But in 1987 another reformer, Zhao Ziyang, replaced Hu. Then in 1988 tighter central planning controls were imposed in an anti-inflation effort led by Li Peng, the hardline premier.

In 1989 came the dramatic events televised to the whole world when, after Hu Yaobang's death, thousands of students occupied Tiananmen Square to demand democracy. This movement was brutally crushed by the military, and many Chinese were killed. Zhao Ziyang was replaced by Jiang Zemin because of Zhao's friendliness toward the students. Deng supported the crackdown, seeing the uprising as too disruptive of the system.

After a period of international disapproval, China resumed economic reforms in 1992, signaled by Deng's visit to Shenzhen, the prominent SEZ adjacent to Hong Kong. Reforms spread to many provinces, and rules on private enterprise were loosened. In 1993 the CCP officially declared its desire to achieve a *socialist market economy.*[42]

In 1994 farmer demonstrations and resurgent inflation to 20 percent again increased pressure for scaling back reforms. With Deng increasingly ill in early 1995, President and General Secretary Jiang Zemin began wearing Mao jackets rather than business suits and engaging in trade disputes with the United States over pirated software and other matters.

Before Deng died in 1997, the movement for more reform again asserted itself, and at the 15th Communist Party Congress in 1997, hardline Premier Li Peng was replaced by the reformist Zhu Rongji, who promised to cut loose state-owned enterprises. Jiang Zemin had already assumed Deng's old post as chairman of the Military Commission, as well as being president and party general secretary, thereby cementing his supreme power. In 1999 the private sector was recognized as legitimate in the constitution, and in 2000 an agreement was reached for China to join the WTO, which it did in 2001. At the 16th Party Congress in 2002, Hu Jintao replaced Jiang Zemin as party general secretary (also becoming president soon after) and capitalists were allowed into upper party ranks, although Jiang Zemin remained chairman of the Supreme Military Commission, thus imitating Deng Xiaoping.

41. The major form of corruption has been nepotism that places children of party leaders in charge of private or semiprivate businesses favored by the government. Nepotism reflects traditional attitudes of doing business through **guangxi,** patron-client connections, especially family links.

42. In the early and mid-1980s the Chinese admired Hungary's market socialism as a model. But now they assert the uniqueness of their own path, the socialist market economy, although what is unique about it may be the TVEs.

Reforms in Agriculture

Deng had supported more pragmatic, market-oriented policies since the GLF period. Thus, the agricultural reforms introduced in 1978 included recognition of property rights and of production teams' adherence to the principle of "to each according to his work"; restoration of the right to private plots and respect for household boundaries; allowance of free-market rural bazaars; and increases in state purchases of agricultural commodities along with price increases for these commodities. In 1979 came the **household responsibility system,** by which households became the principal unit of account, the elimination of the communes, and the introduction of a two-tier price system under which households could freely sell anything they produced above their quota. The quota sales would be at a centrally fixed (and lower) price, while the surplus would be sold at free-market prices.

This household responsibility system allows households to lease equipment from higher units and to engage in long-term transferable leases for the right to use land, although land remains formally owned by villages, now juridical entities again since the dissolution of the communes, brigades, and teams.[43] The response to these increased incentives was a dramatic increase in output, greater between 1978 and 1984 than in the previous 21 years, which provides a base of support for further reforms. However, the rate of increase slowed after that, including some actual declines in grain production.[44] By 1994 strikes and protests by farmers had occurred in some areas.

Figures for agricultural output during this period are presented in table 15-1. The acceleration of output between 1978 and 1984 reflected improved incentives provided by changed pricing policies, loosened restrictions on crop specialization, greater interregional trade caused by relaxation of the self-reliance doctrine, elimination of political meddling in team management, a full shift to material rather than moral incentives, and reduction of monitoring costs within teams.[45] But ultimately, why these reforms engendered such

43. Four different systems now exist, all presuming ultimate land ownership by the villages. Most widespread is the dual-field system, with equal distribution of land for self-provision plots to families and the majority leased out for market production by auction. Another is capitalization of contract rights, in which monetized shares are bought in farms, a system popular in the more capitalist-oriented southeast. A third involves direct transfers among farmers of contract rights to a farm. The fourth is the collective farm system, popular in well-off areas, where income is based on a farmer's output relative to a normal target and the collective provides many services (Erik Fahlbeck and Huang Zuhui, "The Property Right Structure of Farmland and Family Farming in China—An Analysis of Developing Options," in *Agricultural Policies in China* [Paris: Organization for Economic Cooperation and Development, 1997], pp. 78–87).

44. This reflected market forces as production shifted to higher-value nongrain commodities. Grain continues to be subject to some central planning and quotas.

45. Estimates of the effect of monitoring costs range from zero (Justin Yifu Lin, "Collectivization and China's Agricultural Crisis in 1959–1961," *Journal of Political Economy* 98 [1990]: 1228–1252) through 10 percent (Xiao-yuan Dong and Gregory K. Dow, "Monitoring Costs in Chinese Agricultural Teams," *Journal of Political Economy* 101 [1993]: 539–553) to 50 percent (John McMillan, John Whalley, and Lijang Zhu, "The Impact of China's Economic Reforms on Agricultural Productivity Growth," *Journal of Political Economy* 97 [1989]: 781–807).

TABLE 15-1
Urban and Rural per Capita Food Consumption

	Food Grain		Edible Oil		Pork	
Year	Urban	Rural	Urban	Rural	Urban	Rural
1957	196	205	5.2	1.9	9.0	4.4
1978	205	193	4.1	1.1	13.7	6.4
1984	239	254	11.1	3.2	18.7	11.7
1988	233	253	13.6	4.0	21.2	13.3
Annual Percentage Rate of Increase						
1957–1978	0.2	−0.3	−0.3	−2.6	2.0	2.1
1978–1984	2.6	4.6	16.6	17.8	5.2	10.0
1984–1988	−0.6	0.0	5.1	5.6	3.2	3.2

Note: The base is 1957 because it was a good year just prior to the GLF disaster. Annual percentage growth rates for each subperiod are also shown. The main food grains are wheat and millet in the north and rice in the south.
Source: Figures are from Mark Selden, *The Political Economy of Chinese Development* (Armonk, N.Y.: M. E. Sharpe, 1993), p. 21, in kilograms per person.

productivity improvements in China, whereas similar ones have frequently failed in Eastern Europe, is a mystery.

After 1984, agricultural output growth has decelerated as short-run decollectivization gains were achieved and the limits of Chinese agriculture appeared. These limits include the small size of farms, which became even smaller as the rural birth rate increased;[46] disinvestment in infrastructure built and maintained by teams and brigades; unfavorable terms of trade as prices were freed in other sectors and growth began to focus there, whereas some price controls on grain continued; and a long-term decline in the amount of cultivated land.[47]

China's agricultural improvements were substantial, and food consumption patterns in China now resemble those of middle-income countries more than those of poor countries. Ending famine in the world's most populous nation is an outcome of historic proportions. A major policy issue facing Chinese agriculture will be to adjust to lowered import protection as a result of China's joining the WTO in 2001.

46. The Chinese birth rate peaked when Mao advocated large families in the 1960s. China vigorously pushes the policy of one child per family, but rural Confucianist families want a son because of the household responsibility system. Reports suggest that a serious gender imbalance is emerging in rural areas, with a shortage of girls.

47. Cultivated land reached a maximum of 112 million hectares in 1956. It was down to 93 million hectares by 1988. See Frederick W. Crook, "Primary Issues in China's Grain Economy in the 1990 Decade," in Joint Economic Committee, ed., *China's Economic Dilemmas in the 1990s* (Armonk, N.Y.: M. E. Sharpe, 1992), p. 406. For further discussions of Chinese agricultural prospects and policy alternatives see OECD, *Agricultural Policies in China* (Paris: Organization for Economic Cooperation and Development, 1997); Y. Yang and W. Tian, eds., *China's Agriculture at the Crossroads* (New York: St. Martin's Press, 2000).

Enterprise Reforms

After initial moves in 1980, major enterprise reforms came in 1984, when most firms were allowed to replace plan targets with **responsibility contracts** that enabled them to retain and freely dispose of any surplus beyond a generally small contracted production and financial obligation. The dual price system from agriculture was extended to most of the rest of the economy, creating a market economy beyond the contracted portion with a steadily declining share in central SOEs.

The emerging significance of the uniquely Chinese TVEs has been striking. They are technically known as *rural collectives* and are owned by town or village governments. Their managers usually are appointed by the next higher unit of government, usually at the county level.[48] Many of these entities existed in the Mao era as commune or brigade enterprises, but they have greatly expanded their operations. More than the centralized SOEs, the TVEs face hard budget constraints and operate in vigorously competitive markets. In 1989 3 million TVEs either went bankrupt or were taken over by others.[49]

Figure 15-1 shows the percentages of manufacturing output attributable to each type of enterprise. By 1992 the pure SOE was in the minority. Although the strictly private sector has expanded, primarily in the SEZs, the biggest increase in absolute terms has been in the collective sector, especially the rural TVE sector, although the private sector has begun to grow more rapidly since the 1993 reforms, with an apparent acceleration after 1997.

Many economists believe that the TVE form should be at a disadvantage because property rights are vague. But this has not been a problem given the often strict oversight by higher-level units of government that hire the managers. The earnings of the TVEs go not only to enterprise wages and reinvestment, but also to local public services. Compared to

48. The system of interaction between the county level, town level, and village level of government with the local enterprises has been described as constituting **local state corporatism** (Jean C. Oi, *Rural China Takes Off: Institutional Foundations of Economic Reform* [Berkeley: University of California Press, 1999], chap. 4). The "four wheels of rural enterprise" are the township-owned, the village-owned, the jointly owned (or collective shareholding cooperative), and the individually owned.

49. Yingyi Qian and Chenggang Xu, "The M-Form Hierarchy and China's Economic Reform," *European Economic Review* 37 (1993): 547. Further evidence on reasons for the success of TVEs relative to SOEs is presented in Paul Bowles and Xiao-Yuan Dong, "Enterprise Ownership, Enterprise Organisation, and Worker Attitudes in Chinese Rural Industry: Some New Evidence," *Cambridge Journal of Economics* 23 (1999): 1–20. It appears that the share of output in TVEs exceeded that in the SOEs as of 1994.

Although mostly dismissed as backward and inefficient, the SOEs have been subject to restructuring efforts through corporatization (Cyril Lin, "Corporatisation and Corporate Governance in China's Economic Transition," *Economics of Planning* 34 [2001]: 5–35) and having their ownership shares traded on stock markets (Rajen Mookerjee and Qiao Yu, "Capital Market Reform on the Road to a Market Economy," *Journal of Developing Areas* 30 [1995]: 23–40), which have been extremely volatile. Also, SOEs in strongly market-oriented areas such as Guangdong province adjacent to Hong Kong have shown greater flexibility and productivity improvements (Huagang Li, "State Factories in Transition—Openness, Competition, and Productivity," *Journal of Development Economics* 58 [1999]: 429–462), although in the older industrial northeast, many of them lose a great deal of money, generating serious debt problems for many Chinese banks (Nicholas R. Lardy, *China's Unfinished Economic Revolution* [Washington, D.C.: The Brookings Institution Press, 1998]).

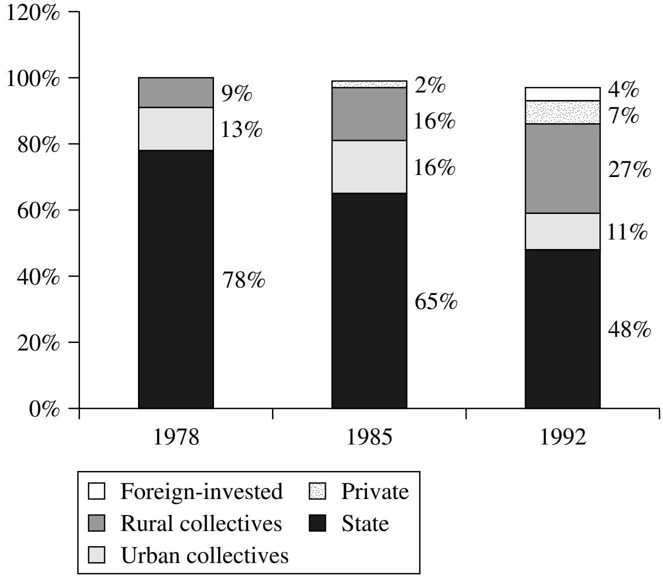

Figure 15-1
Forms of Enterprise Ownership in China.
Note: Figures are precentages of industrial production from each category.
Source: Data from Barry Naughton, "Chinese Institutional Innovation and Privatization from Below." *American Economic Review Papers and Proceedings* 84 (1994), p. 267.

regular SOEs, TVEs have greater flexibility and freedom from central control, allowing them to fill niches where SOEs were limited, such as light industry. TVEs allow local communities to turn control of assets into income, even without access to asset markets. This applies to labor as well in an environment where labor mobility continues to be limited, despite some recent loosening of restrictions.

TVEs have had an edge over strictly private firms as well because of their lower tax rates, and they have an advantage in negotiating with a still-dominant government. Until 1993, privatization outside of the SEZs continued to be limited. Hence TVEs provided an alternative to privatization where it was unavailable.

TVEs vary greatly in terms of what they do and how they behave. Many operate as subcontractors for foreign private firms in coastal SEZs or are located near urban areas. Others are the direct extensions of the former suppliers of regionally self-sufficient Maoist rural industrial complexes.

However, there has been considerable expansion since 1993, when TVEs were hit by a wave of privatization, which accelerated after 1997 (although the supporting data are somewhat limited). One study of 50 firms in three provinces, two of them adjacent to booming

Shanghai, showed that the percentage of privately owned firms increased from 12 to 38 percent between 1994 and 1998. Another study for a somewhat larger sample confined to Zhejiang and Jiangsu provinces, adjacent to Shanghai, showed 1999 privatization levels of 55.3 and 59.5 percent of firms, respectively, with much of the privatization occurring in 1998.[50] Although these provinces are especially rapidly growing and market-oriented, China may be on the verge of making the transition to a predominantly market capitalist economy.

Special Economic Zones and Foreign Trade

In the days of the emperors, it was traditional to restrict foreign traders to specific ports, where they kowtowed and paid tribute to the emperor and remained separate from most of Chinese society. The current strategy of establishing selected ports as SEZs with relaxed rules where foreigners are allowed to operate fits with this traditional Chinese approach. A law establishing ground rules for joint ventures was passed in 1979. In 1980 four cities were selected to be SEZs, all along the southeastern coast,[51] including Shenzhen adjacent to Hong Kong. Restrictive rules on economic activities were relaxed. In 1984 14 more coastal cities, some in the north, were declared to be "open cities" and allowed to have **Economic and Technological Development Zones (ETDZs).** Foreign investment in these areas was encouraged.

Foreign investment has poured in, exports have poured out, and these cities have boomed. SEZ-rich Guangdong Province, for example, grew at the rate of about 25 percent per year during the 1980s and early 1990s, although more slowly later as investment and growth shifted toward Shanghai. If it were an independent nation, it would easily have had the world's most rapid growth rate. Much of the foreign investment is from overseas Chinese, often families originally from the southern provinces and operating through Hong Kong.[52]

As of 1989, 61.6 percent of cumulative FDI was from Hong Kong, much of it in the SEZs of Guangdong, 11.2 percent from the United States and 8.7 percent from Japan.

50. The 1994–1998 data are from Hongyi Chen, *The Institutional Transition of China's Township and Village Enterprises: Market Liberalization, Contractual Form Innovation and Privatization* (Aldershot, U.K.: Ashgate, 2000), p. 243, and the 1999 data are from Loren Brandt, Hongbin Li, and Joanne Roberts, "Why Do Governments Privatize?" mimeo (University of Toronto and Stanford University, 2001). Jiangsu province, especially its Sunan zone, closest to Shanghai, has long been strongly oriented to reform and change, being the first major area in China where the TVEs initially developed out of the communes and brigades in the mid-1970s, prior to the general initiation of market reforms (J. Bruce Jacobs, "Uneven Development: Prosperity and Poverty in Jiangsu," in H. Hendrischke and F. Chongyi, eds. *The Political Economy of China's Provinces: Comparative and Competitive Advantage* [London: Routledge, 1999], pp. 109–150).

51. There was little industrialization in the southeast then. The northeast was industrialized before the 1950s and the southwest during the Maoist Third Front period. The heavy industries of the northeast remain the stronghold of the state-owned sector in China.

52. Throughout the rapidly growing southeast Asian economies, ethnic Chinese play an important role as merchants, including in Singapore, Malaysia, Thailand, Indonesia, and the Philippines, and previously in Vietnam.

Box 15-1
The Success of the Shenzhen Special Economic Zone

Spectacularly growing Shenzhen increasingly resembles its neighbor, wildly successful laissez-faire Hong Kong, to the point where proposals have been floated to tie Shenzhen monetarily to Hong Kong. Its industrial production in 1979 was 60.61 million yuan, whereas in 1987 it was 5,762.89 million yuan.* In 1987, 45.15 percent of production was electronics, whereas only 10.30 percent was textiles and clothing.† Between 1985 and 1988, telephone ownership per 100 inhabitants rose from 4.8 to 22.1, whereas in Shanghai, China's largest city and an open city to boot, the number rose from only 3.9 to 5.0.‡ Thus, rising living standards increasingly separate Shenzhen from the rest of China, and regional inequalities of income are increasing.

*Kwan-yu Wong, Yu-you Deng, and Han-xin Chen, "Shenzhen: Special Experience in Development," in Y. Yeung and X. Hu, eds., *China's Coastal Cities* (Honolulu: University of Hawaii Press, 1992), p. 280.
†Wong, Deng, and Chen, "Shenzhen," p. 285.
‡Wong, Deng, and Chen, "Shenzhen," p. 310.

A significant portion of Hong Kong's investment was of Taiwanese origin, enough to put it ahead of both the United States and Japan.[53]

While total PRC trade rose from $20.64 billion in 1978 to $84.05 billion in 1990,[54] exports from Guangdong rose from $1.388 billion in 1978 to $10.370 billion in 1990, and the share of exports from foreign-invested enterprises went from zero to nearly one-third.[55] Thus the SEZs are engines of growth and expansion, and they probably have liberalized beyond the point at which the central government could rein them in even if it wanted to. SEZs have become an illustrative case of the ancient Chinese proverb that "the mountains are high, the emperor is far away."

A major new development has been China's joining the WTO in 2001. The struggle over joining brought conflicts between pro- and antireform groups to a head in China. Curiously, even as China has increasingly opened to foreign trade, trade barriers between provinces have proliferated, partly reflecting each province's broader tendency to go its own way.[56]

53. Kerry Dumbaugh, "Hong Kong and China in the 1990s," in Joint Economic Committee, *China's Economic Dilemmas in the 1990s,* p. 881.

54. Nicholas R. Lardy, *Foreign Trade and Reform in China, 1978–1990* (Cambridge: Cambridge University Press, 1992), p. 12. One reason for export growth has been yuan devaluation from 1.50 per U.S. dollar in 1980 to 8.44 in early 1995. This devaluation enters the controversy over measurements of per capita income in the PRC, because the low official numbers reflect this lowered value of the yuan. The surge of exports to the United States has led to a bilateral surplus in China's favor, which exacerbates trade tensions.

55. Lardy, *Foreign Trade and Reform in China,* p. 126.

56. Alwyn Young, "The Razor's Edge: Distortions and Incremental Reforms in the People's Republic of China," *Quarterly Journal of Economics* 115 (2000): 1091–1135. For discussion of the proliferation of province-level policies see H. Hendrischke and F. Chongyi, eds., *The Political Economy of China's Provinces: Comparative and Competitive Advantage* (London: Routledge, 1999).

The Distribution of Income and the Standard of Living

With Dengist marketization came greater income inequality, although with some countertrends. This issue attracts attention in the PRC because in some ways under Mao it had one of the most equal income distributions ever observed anywhere.[57]

The PRC had great class equality within local units in both villages and urban areas. Gini coefficients within eight small rural Chinese communities between 1955 and 1978 ranged from a highly equal 0.16 to 0.31 compared with an estimate for India of 0.46 in 1981.[58] The overall Gini coefficient for urban income in 1981 was a highly egalitarian 0.16 compared with a range in South and Southeast Asia from 0.36 in Pakistan to 0.52 in Malaysia.[59]

Offsetting this local class equality were urban-rural and broader coast-interior regional inequalities. Overall Gini coefficients on household incomes of 0.33 in 1979[60] and of rural households of 0.37 in 1979[61] are less equal than in several East Asian nations, including Taiwan's 0.29 in 1972. But accounting for social services increases the rural PRC equality measure. The Gini coefficient drops to 0.26 for 1979,[62] reflecting the widespread provision of education and medical care in rural areas, a success of Maoist policy.

Stalinist industrialization policies increased urban-rural inequality during the Maoist period, despite rhetoric about developing the rural base.[63] This inequality decreased during 1979–1984 when rural incomes rose sharply, but the former trend toward inequality has emerged again, with farmers recently engaging in strikes and demonstrations, despite absolutely increasing incomes.[64]

Prerevolutionary China exhibited long-entrenched inequality between the better-off coastal provinces and the poorer interior provinces, which reflected different soil endowments and climate conditions.[65] Maoist policy left more state revenues in poorer provinces

57. Samir Amin, *The Future of Maoism* (New York: Monthly Review Press, 1987).

58. Selden, *The Political Economy of Chinese Development,* pp. 146–147.

59. Riskin, *China's Political Economy,* p. 249.

60. Riskin, *China's Political Economy,* p. 250.

61. Selden, *The Political Economy of Chinese Development,* p. 155.

62. Selden, *The Political Economy of Chinese Development,* p. 157.

63. Kai-yuen Tsui, "Decomposition of China's Regional Inequalities," *Journal of Comparative Economics* 17 (1993): 600–627. An important factor was severe restriction on rural-urban migration, partially relaxed in the early 1990s.

64. The ratio of per capita urban to rural incomes fell from 2.36 in 1978 to 1.72 in 1985 and then rose to 2.60 in 1994, only to decline again to 2.27 in 1996 (Shujie Yao, "Economic Development and Poverty Reduction in China over 20 Years of Reform," *Economic Development and Cultural Change* 48 [2000]: 451).

65. Poorer interior provinces of the north and west contain minority ethnic groups such as Tibetans in Xizang (Tibet), Mongols in Inner Mongolia, and Turkic Muslims in Xuar (Xinjiang). About 95 percent of the PRC population is Han Chinese, who in these provinces want more aid from the central government, whereas the local minorities often want independence.

and directed investment toward them, especially during the Third Front investment campaign. Regional inequality at the county, provincial, and broader levels has increased since 1978 as investment has been directed more at the coastal provinces, especially the rapidly growing SEZs; this trend continued strongly throughout the 1990s.[66]

Despite broadly increased regional inequality, the shift to the household responsibility system raised peasant incomes across the board, even with some recent declines in provision of public services and an apparently regressive fiscal system in rural areas.

Despite increased interprovincial inequality between 1980 and 1988, in 1980 17 provinces had per capita incomes below 200 yuan per year, whereas by 1988 none were below that figure.[67] In China the rising tide has lifted most ships, although absolute poverty still exists, with deep and extreme poverty between 1988 and 1995 increasing sharply in four interior provinces, including Sichuan, China's largest province, with a population of over 110 million, even as poverty declined overall nationally in all its forms.[68]

The striking development of the 1990s in China was that income inequality increased sharply in almost all categories, between the coast and the interior, between urban and rural areas at least until 1994, and in urban areas as the Gini coefficient rose from 0.23 in 1988 to 0.28 in 1995, in rural areas as it rose from 0.301 in 1988 to 0.340 in 1995, and overall nationally as it rose from 0.338 in 1988 to 0.429 in 1995.[69]

The causes of this widespread increase have been much debated, although this has been a well-entrenched trend ever since the reform process began seriously in 1978. Factors that have been identified include the relative decline of the more egalitarian state-owned sector; inflation; impacts of foreign trade; regressive rural fiscal transfer policies; commercialization of urban housing; increases in rent-seeking activities and in insider control and monopoly power and corruption; reduction of urban subsidies; and transfers of benefits to private property.[70] Without question, this sharply rising income inequality is a serious problem facing China and there has been much discussion of reducing it since Hu Jintao took power.

66. By 1995, the gap between the highest- and lowest-income provinces was approaching 10 to 1, with a per capita income of 10,938 yuan in Guangdong compared with 1,138 yuan in Gansu (Aizur Rahman Khan and Carl Riskin, *Inequality and Poverty in China in the Age of Globalization* [New York: Oxford University Press, 2001], p. 48). See also Long Gen Ying, "China's Changing Regional Disparities during the Reform period," *Economic Geography* 75 (1999): 59–70.

67. John Knight and Lina Song, "The Spatial Contribution to Income Inequality in Rural China," *Cambridge Journal of Economics* 17 (1993): 211.

68. Khan and Riskin, *Inequality and Poverty in China in the Age of Globalization,* pp. 65–67.

69. Zhao Renwei, "Increasing Income Inequality and its Causes in China," *The Chinese Economy* 33(4) (2000): 11.

70. See Lixin Colin Xu and Heng-fu Zou, "Explaining the Changes of Income Distribution in China," *China Economic Review* 11 (2000): 149–170; Zhao Renwei, "Increasing Income Inequality and Its Cause in China," *The Chinese Economy* 33(4) (2000): 8–27; Khan and Riskin, *Inequality and Poverty in China in the Age of Globalization,* pp. 65–67.

Box 15-2
China Compared with Populous South Asian Economies

Country	Per Capita GNP	Life Expectancy (Female)	Adult Illiteracy (Female)	Malnutrition in Children	Birth Rate	Gini Coeff. Overall
China	780	72	25	16	1.9	.403
India	450	64	57	n.a.	3.2	.378
Indonesia	580	67	20	34	2.7	.365
Bangladesh	370	59	71	56	3.1	.336
Pakistan	470	63	71	38	4.9	.312

China's general living standard has improved, especially compared with the standards of other populous Asian nations that had similar poverty levels half a century ago. This improvement reflects both more rapid growth in the post-Mao era and the legacy of the redistributionist and public services provision policies of the Maoist era. Summary comparative data for China, India, Indonesia, Bangladesh, and Pakistan are shown in the table for per capita income, female life expectancy, adult female illiteracy, child malnutrition, birth rate,* and overall income distribution. Although official income statistics suggest that China is still part of this group of nations, its material quality-of-life indicators suggest that China is now in the middle-income group of nations worldwide.

*The lower Chinese birth rate has been achieved through draconian policies, a one-child-per-family policy at times enforced by forced sterilizations and abortions, but it has risen somewhat recently (see footnote 46).

Note: All data are from *World Development Report 2000/2001: Attacking World Poverty* (New York: Oxford University Press for the World Bank, 2000). Per capita GNP is in U.S. dollars for 1999 from pp. 274–275. Female life expectancy at birth is for 1998 from pp. 276–277. Adult female illiteracy is the percentage of the population for 1998 from pp. 276–277. Malnutrition of children is the percentage of children under 5 years old for 1992–1998 from pp. 276–277. Birth rate is births per woman for 1998 from pp. 286–287. The overall Gini coefficient is for 1998 for China, for 1997 for India, for 1996 for Indonesia, for 1995–1996 for Bangladesh, and for 1996–1997 for Pakistan from pp. 282–283.

A Chinese Energy/Environmental Crisis?

Because at just over 1.3 billion the PRC has the world's largest population and the world's most rapidly growing industrial economy, severe environmental problems have emerged. In the long run, with a deceleration of population growth and time to implement recently enacted environmental protection laws, the problems may be brought under control. In the short run, problems ranging from deforestation to declining urban water supplies have became acute.

A primary concern has been energy supplies. China is well endowed with potential energy sources including substantial coal, oil, and hydropower reserves.[71] However, each of these poses environmental problems. Most coal has a high sulfur content, and newer coal

71. China also has a very limited nuclear power program.

sources are available only through strip mining, which severely damages the land. Most available onshore oil sources have been utilized already, and China's former oil export surplus has become an import deficit. China has a serious ongoing conflict with neighboring countries over control of the Spratley Islands in the South China Sea, where new oil reserves may be discovered. China's major new hydropower project in the Three Gorges area of the Yangzi (Yangtze) River is destroying farmland and scenic areas.

With greater economic development, rising electricity demand led the PRC to rely on China's massive coal reserves; the country became the world's largest producer by 1990. Nevertheless, coal consumption increased at an annual rate of 6.5 percent, whereas production increased by only 4.5 percent during the late 1980s.[72] In the countryside, stalks of crops have been burned for fuel rather than plowed under for natural fertilization, threatening to create long-term food and energy crises.[73]

Burning high-sulfur coal with inefficient small burners has led to severe air pollution in industrialized urban areas. Sulfur dioxide levels range from 100 to 2,000 milligrams per cubic meter compared with U.S. urban wintertime levels of 20 to 100, and suspended particulate levels exceed official Chinese safety standards by 3 to 10 times.[74] Compared to the worst pollution periods in Tokyo in the 1960s, Beijing has four times the nitrogen oxide emissions, five times the carbon monoxide emissions, and six times the sulfur dioxide emissions.[75] Given its huge population and projected increasing use of refrigerants that deplete stratospheric ozone, how the PRC deals with its environmental problems has global significance.

HONG KONG, TAIWAN, AND MAINLAND CHINA

Hong Kong's Economic Development

As discussed in chapter 2, the former British crown colony of Hong Kong may have the world's most laissez-faire market capitalist economy. Hong Kong has dramatically succeeded during the past half century as a leading **newly industrializing country (NIC)** and achieved a per capita income of $23,520 in 1999, putting it in 20th place globally.[76]

72. Crook, "Primary Issues in China's Grain Economy," p. 499.

73. Vaclav Smil, *China's Environmental Crisis: An Inquiry into the Limits of National Development* (Armonk, N.Y.: M. E. Sharpe, 1993), p. 101. Since 1985, erosion and salinization have negatively affected crop production (Jikun Huang and Scott Rozelle, "Environmental Stress and Grain Yields in China," *American Journal of Agricultural Economics* 77 [1995]: 853–864). Another environmental issue has been the enormous Three Gorges dam project on the Yangzi River.

74. Smil, *China's Environmental Crisis,* p. 117.

75. Smil, *China's Environmental Crisis,* p. 234.

76. *World Development Report 2000/2001: Attacking Poverty* (New York: Oxford University Press, 2001), p. 274.

Its laissez-faire policy includes absolute free trade, no regulation of capital flows or labor markets, few regulations on enterprise formation or activity, no government ownership of business, and a low (15 percent) flat income tax rate. Exceptions to the free-market emphasis include major government involvement in infrastructure building and maintenance, some provision of social services, and involvement in housing and real estate because the government owns all land.[77]

After the Opium Wars the island of Hong Kong was ceded in perpetuity to Britain in 1842. In 1860 Kowloon Island was also ceded to Britain in perpetuity after another war, and in 1898 the larger New Territories on the mainland were granted for a 99-year lease. Anticipating the impending expiration of this lease, Britain and China in 1984 agreed that the entire crown colony would revert to PRC sovereignty and control in 1997, which happened peacefully on schedule.

In this joint 1984 declaration China promised **one country, two systems,** a formula the PRC hopes eventually to apply to Taiwan as well. For 50 years Hong Kong is to have practical autonomy over local politics and its economic system, but defense and foreign policy are to be controlled by the PRC. This dual system created skepticism and anxiety in Hong Kong and its stock market became highly volatile, responding sharply to every policy wiggle in Beijing. The 1989 Tiananmen Square massacre was especially shocking, and it was followed by an emigration wave of capital and people from Hong Kong.

Hong Kong is small, with about 5 million people, and highly urbanized. It long served as an international trade entrepot between China and the rest of the world, and British-owned banks and trading houses dominated its economy. After 1949 many industrialists and skilled workers came from Shanghai, and industrialization took off.[78] China ceased to use Hong Kong as an entrepot but did not try to retake it.

After the Sino-Soviet split in the late 1950s, the PRC used Hong Kong again. This relationship has expanded so that now Hong Kong is China's major trading partner and its major source of foreign capital investment. Between 1963 and 1988 China's share of exports to Hong Kong rose from 1.4 to 27 percent.[79] Hong Kong serves four vital functions for the PRC economy: It is China's main (1) trading partner, (2) financier, (3) middleman, and (4) facilitator, although Shanghai is increasingly competing with it for some of these roles. The last role is important for introducing market capitalist practices and advanced technologies into the PRC.

77. One reason it has low taxes has been its receipt of income from land leaseholder payments.

78. A shift from a laissez-faire policy since 1987 has been encouraging investment in high-tech electronics industries from fear of falling behind other, more dirigiste NICs in this area (Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization* [Princeton, N.J.: Princeton University Press, 1990], p. 333).

79. Marcus Noland, *Pacific Basin Developing Countries: Prospects for the Future* (Washington, D.C.: Institute for International Economics, 1990), p. 21.

Despite future uncertainties, the PRC promised to preserve the Hong Kong economic system because it sees many benefits for itself from doing so. Companies under the control of family members of the PRC's political elite are engaging in direct investment in Hong Kong, and their total share of market capitalization reached 7 percent as of May 1994.[80]

So far, the mainland government has mostly kept its word regarding Hong Kong, engaging in some repression of political and religious dissidents (the Falun Gong religious movement in particular) but mostly leaving the economy alone except for some financial market interventions and manipulations, especially during the Asian financial crisis of 1997, which left China relatively unaffected. However, the very high interest rates imposed in Hong Kong to maintain both the Hong Kong dollar and the Chinese yuan led to massive declines in real estate values that hurt the Hong Kong elites. In the spring of 2001, the mainland government invited a group of wealthy Hong Kongers to tour the poor western provinces of China, hoping to get them to invest there and aid development in those troubled regions.

For China, Hong Kong is a role model. Its enormous success has influenced post-Mao policymakers in their moves toward liberalization, although they fear the virus of political liberalism that it potentially represents. Thus Hong Kong acts both as a lure and as a threat that must be controlled "without killing the goose that lays the golden egg."

Taiwan's Economic Development

Compared with Hong Kong, Taiwan's economy more closely resembles those of Japan and South Korea[81] because of its considerable indicative planning and government ownership of enterprises. But Taiwan actually has a largely market capitalist economy with a Confucian tradition that has performed successfully, reaching a per capita income of $13,235 in 1999.[82]

The population of this tropical island was Malayo-Polynesian in the 1500s, when the Portuguese established a trading port and named it Formosa. The Dutch East India Company took over in 1633. Han Chinese from Fujian province directly across the Straits of Taiwan began to move in, especially after the Manchu Qing victory over the Ming dynasty in 1644. In 1662 a Ming loyalist seized control and threw the Dutch out, only to have his grandson defeated in 1682 by the Qing, who annexed it to China. It became a separate province under the Qing after the native population became a minority confined to the interior mountains.

80. "The Chinese Takeover of Hong Kong Inc.," *The Economist,* May 7, 1994, pp. 35–36.

81. Both Taiwan and South Korea are NICs with significant agricultural sectors and a history of colonial rule by Japan. See chapter 19 for more detailed comparisons of these countries.

82. *Monthly Bulletin of Statistics of the Republic of China,* 26 (January 2001), p. 22.

After defeating China in a war in 1895, Japan took control of Taiwan and turned it into a source of agricultural output, building transportation infrastructure and some food processing plants. During World War II the Japanese built some light industrial plants, but three-fourths of this capital stock was destroyed by Allied bombing. Per capita income in Taiwan was slightly ahead of that on the mainland in 1945, although well behind that in Hong Kong.

China regained control in 1945, which led to tension between the Fujianese-speaking Taiwanese and the Mandarin-speaking ruling Guomindang, who eventually constituted about 15 percent of the approximately 20 million Taiwanese population after the defeated Chiang Kai-Shek retreated there in 1949.[83] Protected from invasion by the U.S. Seventh Fleet and supported by U.S. economic aid, Chiang Kai-Shek learned from his mistakes in mainland China and implemented vigorous anti-inflation and land reform programs.

Radical land reform policy was eased because many landlords had been Japanese or their collaborators. Reform proceeded in three stages, the first being rent reduction from pre-1949 levels, which had exceeded 50 percent of total output. Then came a sale of public lands seized from Japanese owners. Finally in 1953 came the **land-to-the-tiller program,** in which all landlords were forced to sell their land to tenants in exchange for government bonds, a plan in accord with ideas of Sun Yat-sen, the leader of the movement to replace the emperor with a republic in China in the early twentieth century. Agricultural output expanded rapidly, although the government remained heavily involved during the 1950s. The egalitarian nature of this land reform is a major reason why Taiwan has an extremely equal income distribution.

Up to 1958, when a military confrontation with the PRC occurred, indicative plans emphasized import substitution. But starting in 1966, **Export Processing Zones (EPZs)** were established; these are thought by some to be the models for the PRC's SEZs. Taiwan's exporting success is such that it has the second largest foreign exchange reserves in the world after Japan.

Foreign investment was encouraged and its indicative plans emphasized transportation infrastructure development, although a state-owned industrial sector persists. By 1970 full employment was achieved and Taiwan has had low-inflationary growth, with a more equal income distribution than that of any other NIC. A Six-Year Plan started in 1990 successfully emphasized small-firm development of electronics and high-technology exports,[84] especially to Japan, Taiwan's leading trade partner. Although it did experience recessions in 1997

83. Mandarin is the official dialect of the Chinese language, spoken in Beijing.

84. The Taiwanese have been accused by other nations, especially the United States, of pirating technologies and violating patents. Signing the 1993 GATT agreement committed them to eliminating this practice, and some of the companies that were engaged in it have shifted their activities to the PRC since then.

and 1998, Taiwan was less affected by the 1997 Asian financial crisis than most of its neighbors, however, the PRC was even less affected due to its strict controls on cross-border capital flows.

Taiwan faces the large question of its relations with the PRC. Unlike Hong Kong, Taiwan calls itself the Republic of China (ROC) and claims to be the legitimate government of all China, a claim relaxed somewhat recently. After the United States–PRC rapprochement of the 1970s, Taiwan was expelled from the UN and lost recognition by the United States and most other nations that chose to recognize the PRC.

Chiang Kai-Shek died in 1975 and was succeeded by his son, who died in 1988 after initiating a liberalization and democratization process. He was succeeded by a native Taiwanese, Lee Teng-hui, although the leadership continued to be dominated by old mainlanders. His election partially pacified the locals, some of whom support an independent Taiwan, an idea opposed by both the Chiang Kai-Shek's old party, the Guomindang, and the Communists. The PRC has announced that a Taiwanese declaration of independence would cause an invasion.

Yet in 1999 the Taiwanese brought the pro-independence People's Democratic Party (PDD) to power, although this party did not control all the government and had to back off from pushing independence openly. Relations with the Chinese mainland have been quite tense since then, and the mainland has begun to sharply build up its military, apparently with the main goal of ultimately enforcing reunification. This effort has been opposed by the United States, leading to considerable tension at times between China and the United States. However, they appear to have set this conflict aside somewhat after September 11, 2001, in common opposition to radical Islamic movements, which have appeared in China's separatist-minded western province of Xinjiang.

PRC leaders would rather absorb Taiwan in the same way as they did Hong Kong. Such proposals have been made, and they have been resisted. Since 1988, a working relationship has developed between the ROC and the PRC. Groups of Taiwanese businessmen negotiate in Beijing and substantial trade and investment now occur between the two countries, mostly via Hong Kong, but increasingly through SEZs in neighboring Fujian province.

The Taiwanese wait to see how Chinese rule of Hong Kong proceeds and the nature of the regime in the PRC before they do anything official. However, the increasingly close economic links between the three Chinas suggest that some day they may be one again.

The Three Chinas Compared

A comparison of the PRC, Taiwan, and Hong Kong indicates that the PRC and Hong Kong are the most different geographically, demographically, systemically, and in performance and that Taiwan is between them on most indicators.

Hong Kong is small and urbanized, market capitalist, laissez-faire, and high in income but has a less equal distribution of income. The PRC is huge and rural, still largely socialist despite widespread marketization and increasing privatization, and poorer but more egalitarian despite recent inequality increases. Taiwan is closer in size to Hong Kong but with a substantial rural agricultural sector, and lies between the PRC and Hong Kong in degree of economic state guidance. It is closer to Hong Kong in income level but even more equal than the PRC in income distribution, although this reflects Taiwan's relative regional homogeneity. Behind Hong Kong in per capita income, Taiwan is ahead of it in educational levels and in the technological level of its exports.

All three share a common Chinese culture, especially Confucianism, but only the PRC has had a Communist revolution. Hong Kong and Taiwan have been ruled by foreigners for extended periods of time. They all have had authoritarian political systems, although there has been a recent trend toward democratization, most markedly in Taiwan. Unemployment rates are currently low in all three countries, although the PRC has substantial disguised unemployment.

Table 15-2 compares GDP growth and inflation performances of the three countries over time, as well as their income distributions as measured by the ratio of the top 10 percent of

Table 15-2
The PRC, ROC, and Hong Kong Economies Compared

Category	PRC	ROC	Hong Kong
Per capita GDP, 1966	88.00	236.00	658.00
GDP growth, 1970–1980	7.90	9.30	9.30
GDP growth, 1980–1990	10.10	8.50	7.10
GDP growth, 1990–1998	11.10	6.50	4.40
Inflation, 1970–1980	1.10	11.10	8.70
Inflation, 1980–1990	10.10	8.50	7.10
Inflation, 1990–2000	8.60	2.10	5.80
Ratio of top 10%/bottom 40%	1.22	1.03	1.93

Sources: Per capita GDP levels in 1966 are in U.S. dollars from Alvin Rabushka, *The New China: Comparative Economic Development in Mainland China, Taiwan, and Hong Kong* (Boulder, Colo.: Westview Press, 1987), pp. 206, 217, and 226. GDP growth rates and CPI inflation rates for 1970–1980 and 1980–1990 are from Asian Development Bank, *Asian Development Outlook* (Hong Kong: Oxford University Press, 1992), pp. 288 and 296. GDP growth rates for 1990–1998 are from John Wong and Lee Ding, *China's Economy into the New Century: Structural Issues and Problems* (Singapore: World Scientific, 2002), p. 275. Inflation rates for 1990–2000 are from *The U.N. Human Development Report, 2002* (New York: Oxford University Press, 2002), pp. 190–191, except for Taiwan, which are for 1990–1999 from *Monthly Bulletin of Statistics of the Republic of China,* 26 (January 2001), pp. 22–23. The ratio of the top 10 percent of the income distribution to the bottom 40 percent for the PRC for 1979 is from Carl Riskin, *China's Political Economy: The Quest for Development since 1949* (Oxford: Oxford University Press, 1987), p. 250; for the rural areas of the ROC, data are from Mark Selden, *The Political Economy of Chinese Development* (Armonk, N.Y.: M. E. Sharpe, 1993), p. 155; and for Hong Kong for 1980 data are from World Bank, *World Development Report 1994* (New York: Oxford University Press, 1994), Table 30. Many of these numbers have competing estimates, and their true values are controversial.

population to the bottom 40 percent. Per capita incomes from 1966 show that their respective rankings are unchanged, although their relative distances from each other have changed somewhat. Hong Kong and Taiwan did relatively better during the Maoist period, but more recently the PRC has led in growth.

SUMMARY AND CONCLUSIONS

China, the world's most populous nation, has the longest continuously existing civilization. Home of the counterbalancing religions of Taoism and Confucianism, reflecting respectively a laissez-faire spontaneity and a contrasting respect for hierarchy and order, China, not Japan, is the cultural fountainhead of the dynamic East Asian regional economy. It has experienced long dynastic cycles of expansion and contraction, innovation and stagnation, cosmopolitan openness and hermit-like isolation. Today it is opening and expanding as one of the world's most rapidly growing economies.

After more than a century of foreign domination, the Communists led by Mao Zedong came to power on the mainland in 1949, while the nationalist Guomindang under Chiang Kai-Shek retreated to Taiwan. The British continued to rule Hong Kong. After initially imitating the Stalinist model, Mao's policies went through many changes as he disagreed with Stalin's successors. In the Great Leap Forward (GLF) and the Great Proletarian Cultural Revolution (GPCR), Maoism exhibited radical egalitarianism in large rural communes, regional decentralization, opposition to traditional culture, and a search for economic self-sufficiency. But income differentials between urban and rural areas widened during his rule.

After Mao's death in 1976, the more pragmatic Deng Xiaoping came to power and instituted market-oriented reforms prior to his 1997 death, when he was succeeded by Jiang Zemin, who was succeeded partially in 2002 by Hu Jintao. Communes were disbanded and households took responsibility for agriculture. Economic growth focused on local government-owned TVEs and on coastal SEZs where direct foreign investment was encouraged through loosened rules. Generally successful, the post-Mao PRC has experienced increasing income inequalities, oscillating inflationary tendencies, environmental problems, an increasingly weak state-owned sector with bad debts dragging down the banks, and political dissidence and democracy movements, which some see being encouraged by President Hu Jintao. The future of the Chinese socialist market economy is unclear.

The PRC has been outperformed since 1949 by both Hong Kong and Taiwan, which have had largely market capitalist economies, Hong Kong's highly laissez-faire and Taiwan's with more indicative planning in a consciously Confucianist system. Both have had strong export-led growth, a path now pursued by the PRC as well.

Long the PRC's main link to the world economy, Hong Kong was peacefully taken over by the PRC in 1997, but its economic system is to continue for 50 years. However, with China joining the WTO and generally opening up, Hong Kong is gradually losing its special international linking role to rivals such as Shanghai. Relations between Taiwan (the ROC) and the PRC are hostile, because both claim to be the legitimate government of China, and with the coming to power of a pro-independence party in Taiwan, the threat of military hostilities has increased. But economic relations have expanded since 1988, and eventually some sort of political accommodation will probably create a united China. Such a united China, an awakened giant, could return to its old role as the Middle Kingdom, axis of world history.

INTERNET SOURCES

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QUESTIONS FOR DISCUSSION

1. How does the contrast between Taoism and Confucianism show up in modern discussions of economic policy in China?
2. How did the traditional organization of the rural Chinese economy become transformed in the Maoist period?
3. How did the dynasty cycle fit in with the idea of the Asiatic mode of production? Is the dynasty cycle of any relevance today, and if so, how?
4. How did Maoism resemble and differ from Stalinism?
5. How did the Maoist regional decentralization policy both damage and aid economic development? What has been the pattern of regional development since the Maoist period?
6. What were the changes in agricultural policy in the Dengist period, and why are they reaching their limits?
7. What are the special characteristics of the TVEs and what are their future prospects?
8. Assess the role of the SEZs in the Chinese economic reform process.
9. How have Dengist reforms changed China's income distribution?
10. What are the limits to continued Chinese economic growth?
11. What is the role of the state in the Hong Kong economy?

12. How does the socialist market economy differ from market socialism?

13. Compare Taiwanese economic policy and performance with those of the PRC and Hong Kong.

14. What are the prospects for the application of the PRC's "one country, two systems" approach in Hong Kong and Taiwan?

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IV ALTERNATIVE PATHS AMONG DEVELOPING ECONOMIES

The final part presents diverse cases of developing economies and concludes with a summarizing chapter that ties together some general themes and trends discussed throughout the book. This part's case studies include New Traditional Economies, reforming state-dominated economies, indicatively planned market capitalist economies, and the purest remaining command socialist economy in the world. The final chapter also presents detailed material on privatization in Great Britain as well as on the sub-Saharan success story of Botswana.

Chapter 16 examines the case of India, home of the world's second largest population and of a complexly mixed developing economy that has begun to grow more rapidly in recent years as it undergoes a transformation process. It possesses probably the world's largest remaining traditional economy and also one of its largest state-owned sectors connected with a still-functioning central planning apparatus. At the same time, it has a deeply entrenched market capitalist sector. Home to the Gandhian tradition and long averse to globalization as a result of painful memories of British colonialism, it is now opening to the world economy as it tries to find a reasonable balance among its many elements and systems.

Chapter 17 presents the case of Iran, the world's leading example of an Islamic fundamentalist economy both practically and ideologically. While Iran fits the broader category of a New Traditional Economy, it is shown to have only partly fulfilled the criteria for such an economy. Iran is experiencing many problems, some caused by its continuing excessive dependence on oil exports and their volatile world prices and others resulting from Iran's self-imposed isolation. This chapter also presents material on some other Islamic economies, notably Saudi Arabia and Pakistan.

Chapter 18 discusses the Mexican economy, which is broadly representative of the state-dominated technocratic populist corporatisms found in Latin America; other economies from the region are also discussed. Mexico's turbulent history of revolution and reform is recounted, as it is important to note that the Mexican and other Latin American reforms have become a model for those in the former Soviet bloc. Mexico has moved forcefully to marketize, to privatize, and to open to the United States by signing the North American Free Trade Agreement. But uprisings in the countryside and currency crises have weakened Mexico's efforts.

Chapter 19 studies the case of Korea, both South and North, and concludes our case studies with a final direct comparison of capitalism and socialism. One of the most dynamic of the East Asian NICs, South Korea has a strong export-led growth record, despite having experienced a sharp recession during the 1997 Asian financial crisis. Characterized by large industrial groupings somewhat like those in Japan, South Korea has had a strongly market capitalist orientation, albeit with considerable government intervention through indicative planning. It is now struggling to reform its corporate and financial sectors.

North Korea remains the purest example of a command socialist economy in the world, a virtual fossil of the classic Stalinist model, with only a minimal reform movement underway. It has fallen far behind South Korea in overall economic performance, although the living standards of its people are not as far behind as might be expected, especially given the severe famine it experienced starting in the mid-1990s. Prospects for unification of the Koreas are considered in comparison with the experience of German unification.

Chapter 20 ties up various loose ends and expands further on four main themes woven throughout the book. The first is the global trend toward privatization, which is considered more fully by examining in detail the case of Great Britain, which began the modern global privatization movement under Margaret Thatcher. Great Britain, the original center of the Industrial Revolution, has long been in a state of relative decline. The privatization wave has helped partly to revive its economy, although it now appears to be reaching the limits of this movement.

The second theme is the clash of civilizations, the idea that Western market capitalism, Islam, and neo-Confucianism are now in a global conflict. This idea is studied by considering the situation in Central Asia, where the former Soviet republics are moving out of a command socialist system but face virtually all three alternative economic models as possible paths to follow.

The third theme is integration versus disintegration. Examples include the drive toward integration in the EU and free trade in the WTO, the North American Free Trade Agreement, and recent initiatives in the Asia Pacific Economic Council. Disintegration is most dramatically manifested by the collapse of the FSU and of some of the nations allied with it. The cultural conflicts inherent in this process interact with the issues arising from the economic clash of civilizations.

The fourth and final theme is the prospects for economic growth at the global level in light of the deceleration of such growth since the early 1970s. Broader social and institutional elements in the growth process are discussed, such as the increase in global income inequality, the importance of institutions, the rise of corruption and shadow economies, and the role of social capital. The sub-Saharan success story of Botswana is discussed. The final chapter concludes with a discussion of the role of the environment in this theme and the prospects for global cooperation, particularly in light of continuing disagreements between nations over such issues as the Kyoto Accords on global warming.


AFG.
Srinagar
Jammu & Kashmir
CHINA
Simla
Chandigarh
PAKISTAN
New Delhi
Arunachal Pradesh
NEPAL
Itanagar
Uttar Pradesh
Jaisalmer
BHUTAN
Agra
Lucknow
Dispur
Assam
Jaipur
Nagaland
Kanpur
Rajasthan
Varanasi
Patna
Meghalaya
Manipur
BANG.
I N D I A
Bihar
Agartala
Gandhinagar
Kandla
Mizoram
Bhopal
Jabalpur
Kolkata
Gujarat
Baroda
Madhya Pradesh
Veraval
MYANMAR
Raipur
Nagpur
Bhubaneswar
Maharashtra
Orissa
Mumbai
Poona
Hyderabad
Bay of Bengal
Andhra Pradesh
Arabian Sea
Goa
Guntakal
Karnataka
Andaman and Nicobar Islands
Bangalore
Chennai
Port Blair
Tamil Nadu
Calicut
Kerala
Lakshadweep
Madurai
Cochin
Trivandrum
SRI LANKA
INDIAN OCEAN

16 India: The Elephant Walks

On entering Murshidabad, the old capital of Bengal in 1757, Clive wrote: "The city is extensive, populous and rich as the city of London, with this difference that there were individuals in the first possessing infinitely greater property than in the last city." Similar words were used of Agra, Fatechpore, Lahore and many other Indian towns.
—Jack Goody, *The East in the West,* p. 113

Indian Muslims and Christians did not come from outside. Their ancestors were Hindus. Culture does not change with the religion. Culture is associated with land and nationality is related with commitments.
—Atal Bihari Vajpayee, presidential speech to the Bharatiya Jana Sangh (BJS) party, Indore, September 7, 1968[1]

INTRODUCTION

With the world's second largest population of about 1 billion, India, like China, is one of the world's great historical centers of civilization. Like China, its huge rural population is a testament to its past economic successes in irrigated agriculture. But unlike China, India has yet to succeed in pulling the great mass of its rural population out of poverty. Nevertheless, India's population has moved beyond the threat of periodic famine, and the Indian economy is now growing at a steady and substantial rate, if not quite as rapidly as China's.

India possesses what is arguably the most complexly mixed economic system in the world. Allowing for the possible exception of rural sub-Saharan Africa, it is the world's largest repository of the Old Traditional Economy. India has a system of nearly self-sufficient villages operating within the socioeconomic context of the caste system associated with India's predominantly Hindu religion. Within these villages the **jajmani system** of reciprocal labor exchanges partially persists, and most people continue to work in the professions assigned to them according to their birth caste.

After its independence in 1947 from British rule (a system known as the **British Raj**[2]), India adopted a Soviet-inspired model of heavy industrial growth in its cities based on substantial state ownership that continues to be directed by an indicative planning system. This policy was accompanied by strong protectionism and extensive, detailed regulation of the private sector, although this regulation has been relaxed somewhat since 1991.

India also has a considerable history of long-distance trade relations and markets with vigorous entrepreneurship. In tandem with its large state-owned sector and extensive regulations and planning, there is a large and rapidly growing market capitalist sector,

1. Quoted in D. D. Pattanaik, *Hindu Nationalism in India 1: Conceptual Foundations* (New Delhi: Deep & Deep, 1998), p. 72. Vajpayee first became prime minister of India in 1996.

2. *Raj* means "rule" and is derived from the same Indo-European root as the English word *royal.* A maharaja is a "great ruler."

including a successful computer software industry based in Bangalore in the southern state of Karnataka. As in most of the rest of the world, policy in India has shifted toward encouraging the growth of this private sector and reducing the regulations it faces. Although this policy began in the mid-1970s and expanded gradually in the 1980s, it leaped forward when an economic emergency in 1991 inspired major reforms. The economic growth rate in India then accelerated considerably, although it decelerated somewhat after 1998.

India's postindependence economic policies have all been carried out by democratically elected governments. Indians are proud of possessing the world's largest functioning political democracy despite their continuing high illiteracy rates. During most of this period India was led by the **Congress Party,** a secular group that led the independence movement and is now seeking to represent all sectors of the nation. For much of this time the Congress Party and the nation were led by members of a single family, initially Jawaharlal Nehru, followed by his daughter, Indira Gandhi, followed in turn by her son, Rajiv Gandhi, the last two killed by assassins.[3]

Since 1996 India's political leadership has shifted to coalition governments, most of them dominated by a party based on Hindu nationalism, the **Bharatiya Janata Party (BJP),**[4] with its leader, Atal Bihari Vajpayee, retaining the post of Prime Minister after an election in late 1999 in which he defeated Rajiv Gandhi's widow. The BJP's ideology is arguably that of New Traditionalism, as described in chapter 4, although the party has been restrained by its coalition members, many of them regionally based political parties, from pursuing such policies with any vigor. Indeed, the BJP has increasingly appeared to support continuing *gradual* moves to more opening and market deregulation, even as it holds back from substantially privatizing the state-owned sector or dismantling the system of indicative planning and certain of the regulations on the private sector. Thus, India will almost certainly continue to possess a highly mixed economy in the near future.

India faces numerous profound difficulties in achieving economic growth and development. These include severe internal conflicts over religion, language, regional identity, and caste. Home not only to more people than is Europe, India is also home to more religious and language groups. Several states of India contain militant separatist movements, some of them engaging in violence.

The most serious of these movements are in Jammu and Kashmir, the most northern state of India and the only one in India with a majority Muslim population. India has fought three wars with its Muslim-dominated northwestern neighbor, Pakistan, over Jammu and Kashmir, with a truce line dividing the state into zones of control while each country claims

3. Indira and Rajiv Gandhi shared this fate with Mohandas K. (Mahatma) Gandhi, the father of Indian independence. They were unrelated.

4. The BJP was founded in 1980 and succeeded the earlier Bharatiya Janata Sangh (BJS), which Vajpayee also led at times.

the whole state. The latest war was in 1999, with India's victory contributing to the electoral margin of the incumbent government. Prime Minister Vajpayee has moved to make peace with Pakistan, but the situation has become more tense and conflict continues. Both India and Pakistan have openly tested nuclear weapons, which makes this a dangerous conflict of considerable global significance.[5]

The difficulties India continues to face in overcoming poverty and underdevelopment include widespread illiteracy, high birth rates, and inadequate or malfunctioning public infrastructure, especially in rural areas, where caste conflicts and unequal land holdings aggravate these problems. However, a pattern has emerged, with the worst of these problems being concentrated in certain states, especially in parts of northern India. Several states in the south and the west have begun to show substantial improvement in living standards, with rising literacy, falling birth rates, and rising per capita incomes. That these improvements have appeared even with numerous ongoing inefficiencies and excessive bureaucratic regulations suggests that there are much greater possibilities for India's growth and development in the future if effective reforms can be adopted. The enormous success of expatriate Indians in other countries also suggests the country's potential. Although India has profound and complex difficulties, both in its external relations and in its numerous internal conflicts and contradictions, the likelihood that India will significantly raise the living standards of most of its citizens seems much greater now than ever before.

HISTORICAL AND CULTURAL BACKGROUND

The Religions and Languages of India

India may be the birthplace of more religions than any other nation on earth, with **Hinduism, Buddhism,**[6] **Jainism,** and **Sikhism** claiming it as their original homeland. Of these, Hinduism is the oldest and the most numerous on the Indian subcontinent;[7] over 80 percent of the nation's current population is Hindu.[8] Although the Buddha lived most of his life in

5. See "Not Cricket: A Survey of India and Pakistan," *The Economist* (May 22, 1999), for further discussion. More recent reports suggest that the countries came quite close to nuclear war in 1999.

6. For discussion of the economic ideas of Hinduism and Buddhism, see chapter 4.

7. The Indian subcontinent contains the nations once ruled by the British Raj, along with several small nations in the Himalaya mountains such as Nepal and Bhutan. Besides these and India, there are largely Muslim Pakistan and Bangladesh and largely Buddhist Sri Lanka (Ceylon) and Myanmar (Burma).

8. This 85 percent figure is one officially listed by the government of India. However, excluding Untouchables, who are rejected by upper-caste Hindus as not being proper Hindus and who are prevented from entering temples along with the at best marginally Hindu tribal populations, would reduce that figure by about 20 percent. Also, strict Hindus view their coreligionists as only being those who are "twice born," only about 20 percent of the population. See Robert Eric Frykenberg, "Constructions of Hinduism at the Nexus of History and Religion," *Journal of Interdisciplinary History* 23 (1993): 523–550.

India, his religion has only a small number of adherents in India today. Most of the several million adherents of Jainism and Sikhism now live in India.

India also contains millions of members of religions not founded in India. Islam is the second most important religion there and Christianity has several million adherents, with Mother Teresa being a recent well-known example. There also are important settlements of other outside religious groups such as the Zoroastrian Parsis from Iran, found mostly in Mumbai (Bombay), the financial center of India, and even a small Jewish population in Cochin in the south. With the exception of Sikhism, which is only about 500 years old, these other religious groups have been in India for at least 1,000 years.

Hinduism has no identifiable founder, and in some form it has been present in India from prehistoric times. It amalgamates many localized sects and deities, with a self-conscious unity clearly established only in the 1800s under the British Raj.[9] Hinduism has numerous sacred texts, among which are the *Rig Veda,* the *Upanishads,* and the *Bhagavad Gita,* all written in Sanskrit, the language of the Aryans who invaded the subcontinent around 1500 B.C.E. The Aryans, from whose language the languages of northern India are descended, brought many gods with them and also are thought to have imposed the caste system, initially as a method of distinguishing themselves from the already present Dravidian and tribal groups whom they conquered. However, some of the gods and beliefs of Hinduism probably predate the arrival of the Aryans, and probably elements of the caste system were already in place, with the Aryan priestly caste of Brahmins providing a rationalization of the system in northern India. Hinduism has also absorbed many practices of other religious groups in India, especially the Muslims, from whom the Hindus adopted restrictive attitudes toward women.

Hinduism's most important socioeconomic legacy in India is the **caste system.** One's caste is determined by birth, and each caste has a given economic function and social status. There is strong social pressure to marry within one's caste. According to the Hindu doctrines of reincarnation and karma, one is born into a given caste because of one's behavior in previous lives. Traditional relations between castes are determined by a set of reciprocal relationships known as the *jajmani system.* The number of castes and subcastes is enormous; the census of 1901 counted 2,378 distinct groups, including tribes.[10] Among the castes, five broad groups stand out: the *Brahmins,* the socially elite priestly caste; the *Kshatriyas,* the warrior caste, from whom many rulers and landlords came; the *Vaisyas,* the commercial caste, including

9. The British categorized as *Hindu* in their 1871 census anyone who was not Buddhist, Jain, Jewish, Christian, Muslim, Parsi, or Sikh, the term having previously simply meant "Indian." It was only at the 1893 Parliament of World Religions in Chicago that Hinduism was generally recognized as a great world religion. See Robert Eric Frykenberg, "Hindu Fundamentalism and the Structural Stability of India," in Martin E. Marty and E. Scott Appleby, eds., *Fundamentalisms and the State: Remaking Polities, Economies, and Militance* (Chicago: University of Chicago Press, 1993), pp. 233–255.

10. Michael Edwardes, *A History of India: From the Earliest Times to the Present Day* (New York: Farrar, Straus, and Cudahy, 1961), p. 27.

merchants, craftspeople, and cultivators; the *Sudras,* a peasant group; and the *Untouchables,* who technically are outside the system and are subordinate to the other castes. Slightly less than 20 percent of the population belong to the first three castes, a bit more than 40 percent to the Sudras, and about 20 percent are Untouchable or outcast tribals.[11]

Inspired by the leader of the independence movement, Mohandas K. Gandhi, a Hindu also known as Mahatma ("Great Soul"), the caste system was legally abolished after independence from Britain in 1947. Indeed, there are now affirmative action policies favoring Untouchables. But these policies have triggered resentment by the upper castes and have been opposed by Hindu nationalists. The caste system persists in practice in most rural areas. Gandhi preached tolerance of all religious groups, along with nonviolence **(satyagraha),** and was assassinated by a Hindu nationalist extremist in 1948 for his efforts.

Opposition to the caste system has been important to the emergence of new religions in India, both those arising internally as well as those coming from outside. However, the eventual assimilation of these groups into Indian society has caused them to become de facto castes within India's broader caste system. Proclamations of universal equality accompanied Jainism and Buddhism, both founded around 500 B.C.E. in India.

Jainism, founded by Mahavira at about the same time as Buddhism, around 500 B.C.E., never had followers who dominated politically or ruled anywhere in India, although this religion experienced periods of widespread influence in the south. But Jains, who oppose the killing of any living thing, became an important urban-dwelling merchant group, some of whom led early industrialization efforts in India despite the fear that industrial machinery could kill insects.

In contrast, Buddhist leaders ruled portions of northern India for several hundred years, including perhaps the most revered of all of India's pre-Raj kings, Asoka, who ruled during 273–232 B.C.E. His symbol of the Buddhist wheel of the law is incorporated into the flag of modern India. However, by the fifth century C.E., Buddhism was disappearing from India in the face of a village-based Hindu revival. Few Buddhists were left in India after the Muslims invaded and came to rule most of northern India after 1000 C.E. Yet Buddhists continued to dominate in Sri Lanka on the island of Ceylon to the southeast and in Myanmar (Burma) to the east of modern India, both formerly parts of the British Raj.

Founded by Guru Nanak about 500 years ago as an attempted egalitarian unification of Hinduism and Islam, Sikhism[12] arose and remains concentrated in the northwestern state of

11. There are serious disagreements about these figures. Some official sources have listed totals for these Hindu-connected groups that add up to as much as 92 percent. But about 12 percent of the population are Muslim, and at least another 5 percent or so are either Sikh or Christian. Census takers often classify Buddhists, Jains, and Sikhs as Hindus, much to the unhappiness of members of these groups. (We thank Robert Eric Frykenberg for this observation.)

12. For a discussion of the economic ideas and political movements of modern Sikhism, see Harjot Oberori, "Sikh Fundamentalism: Translating History into Theory," in Marty and Appleby, *Fundamentalisms and the State,* pp. 256–285.

Punjab,[13] now the highest per capita income state of India. The economically successful Sikhs also developed a strong warrior tradition and ruled Punjab immediately prior to the British conquest in the early 1800s. There is a strong separatist movement among the Sikhs that led to the assassination of former Prime Minister Indira Gandhi by her Sikh bodyguards in 1984. This happened after she attempted to suppress the movement by ordering an attack on the Sikhs' most sacred site, the Golden Temple in Amritsar.

Most of the religious groups from outside India initially arrived as merchants engaged in long-distance trade. Syrian (Nestorian) Christians probably arrived in the fourth century, although their traditions claim that the Apostle Thomas initially brought Christianity to India in the first century. Their descendants in southern India are the largest Christian group in that country. Later the Portuguese introduced Roman Catholicism into their colony of Goa on the western coast, which they ruled from 1510 to 1961, when India conquered it and made it a state. Evangelical Protestant missionaries from various countries brought other forms of Christianity. Groups from Britain introduced some Anglican structures during their Raj, but with surprisingly little support from high colonial officials.

Initially arriving as merchants not long after the founding of their religion in the seventh century, Muslims came to rule most of northern India after 1000 until the British conquest in the mid-1700s. They periodically engaged in vigorous efforts at conversion and sometimes active suppression of the Hindus and eventually became the second most numerous religious group on the subcontinent. Today the conflict between Muslims and Hindus is one of the most difficult political issues within India and underlies the most serious military conflict on the subcontinent in the India-Pakistan confrontation over Jammu and Kashmir.

The Hindu nationalist view of all these groups is summarized in Prime Minister Vajpayee's statement at the beginning of this chapter. These nationalists argue that the adherents of all these religions were originally converts from Hinduism and thus are culturally Hindu in the final analysis. The idea of the supremacy of Hinduism as a culture is embodied in the term **Hindutva,** the imposition of which is the goal of the modern Hindu nationalists.

Finally, we note the great diversity of languages in India—around 100. Most of the states of modern India are based on distinct languages spoken predominantly within their borders. The most widely spoken language is Hindi,[14] the language of Uttar Pradesh in the north, India's largest state, with over 150 million people. The sharpest linguistic and cultural divide is between the north, where most of the languages are of Indo-European origin descended from Sanskrit, and the south, where they are mostly of Dravidian origin. Prior

13. Punjab was partitioned in 1947, with the majority of its population ending up in Muslim-dominated Pakistan. The Sikhs mostly live in the smaller part that is now a state of India.

14. Its most widely spoken form is known as Hindustani, with proper Hindi being more a classical language of priests, although now the official language of India.

to the British Raj, there was never a political entity that ruled all of northern and southern India.

However, there is little connection between language and religion in India, with most groups speaking the language of the region in which they are located, regardless of their religion. Of course, devout members of some religions learn specific languages to read their sacred texts, such as Sanskrit for Hindus and Arabic for Muslims, although many Muslims also know Hindi-related Urdu, now the official language of Pakistan. In any case, distinct from religion, language itself has been a source of conflict in modern India, with many in the south opposing the adoption of Hindi as India's official language. Despite this official adoption, English continues to be widely used throughout India to communicate between groups speaking different languages.

Political and Economic History to the British Conquest

Excavations at the city of Mohenjodaro on the Indus River in what is now Pakistan reveal that around 2500 B.C.E. that city had the first fully developed sewer system known in world history, an achievement crucial to the complete development of urban civilization. This city, probably populated by Dravidian speakers worshipping proto-Hindu gods, traded with the Mesopotamian kingdoms of that time, exporting various jewels. From this beginning, the Indian subcontinent became one of the wealthiest areas of the world and long played a central role in the system of world trade that arose in the ancient world.

The political history of India prior to the British conquest in the mid-1700s is at least as complicated as that of the European continent, with little continuity and countless kingdoms and entities of various sizes endlessly struggling and displacing one another. This history was marked by periodic invasions, usually out of the northwest. Occasionally a strong state arose and ruled large areas, sometimes extending well beyond modern India's borders in the north, although no state prior to the British Raj ever ruled all of modern India. Among the important successive invaders from the northwest were the Aryans, Persians, Greeks under Alexander the Great, White Huns, and Arabs. Waves of Turkic Muslims invaded after 1000 C.E., including eventually Timur Ling (Tamerlane), a descendant of the Mongol conqueror, Chingiss (Genghis) Khan, and Timur Ling's descendants, the Mughals (Moguls) after 1500.

Among the empires that controlled large areas in the north were the Buddhist Mauryas, whose most famous king was Asoka (273–232 B.C.E.); the Guptas, whose power peaked around 400 C.E. and under whose rule the revival of Hinduism began; and the Mughals, who ruled from soon after 1500 until the British conquest, with their power peaking at the 1605 death of Akbar, a religiously tolerant and respected patron of philosophy and the arts. Later Mughals imposed taxes on non-Muslims and fought with important Hindu groups. Their empire's disintegration after 1700 opened the door to the British conquest.

In the south there were few empires of great extent, with coastal towns often under the control of foreign merchants, given the crucial importance of the southern tip of India to the maritime trade of the Indian Ocean. After the Muslim conquest of northern India, southern India became a stronghold of Hindu resistance.[15]

From prehistory India has played a central role in world trade, with its southern tip serving as "a hinge"[16] for trade in the Indian Ocean between those coming from the west and from the east. Direct trade with the Roman Empire operated out of Arikamedu in the southeast from at least the time of the Emperor Tiberius in the first century C.E., with reports of an outflow of precious metals from Rome to pay for imports of cotton muslin cloth and precious jewels. Routes to the Mediterranean ran through Egypt from the Red Sea and also from the head of the Persian Gulf. From this early time, cotton textiles were a leading export from several Indian states and remained so until after the British conquest. Indians were important in this shipping, especially those from the northwestern state of Gujarat, whose citizens are successful merchants in many countries today. Eventually Arabs, and later various European groups, controlled this shipping.

To the east, Tamil traders from southeast India "Indianized" much of Southeast Asia. They reexported spices to Europe from the Spice Islands of Indonesia and traded directly with China from at least 400 C.E. These merchants played an important role at the crucial Malacca Strait as late as 1900.

From an early time, banking and accounting were highly developed in India. One of India's major intellectual contributions to the world was the discovery of the number zero. Although this may have originated from the Hindu concept of the void, its widespread adoption and spread via the Arabs to Europe had more to do with its usefulness in arithmetic, with the demands of accounting playing an important role.

From the time of the landing by the Portuguese explorer Vasco da Gama in 1498, Europeans began to control various trading ports in India, usually with the agreement of a local ruler. The Dutch were next to arrive, although they became more focused on controlling

15. Despite this history, the southern states are not strongholds of the Hindu nationalist BJP, which is strong in northern states where Muslims ruled Hindus for hundreds of years. The southern states have more regional political parties based on local languages that oppose northern domination.

16. Janet Abu-Lughod, *Before European Hegemony: The World System A.D. 1250–1350* (New York: Oxford University Press, 1989), p. 261. A view has developed that the Asian economies were more advanced than the European ones to a late date and that European growth simply piggybacked on the already existing Asian economic system, aided by precious metals obtained from the Americas. Some arguing this view include Abu-Lughod; K.-N. Chaudhuri, *Asia Before Europe: Economy and Civilisation in the Indian Ocean from the Rise of Islam* (Cambridge: Cambridge University Press, 1990); James M. Blaut, *The Colonizer's Model of the World: Geographical Diffusionism and Eurocentric History* (New York: Guilford Press, 1993); Jack Goody, *The East in the West* (Cambridge: Cambridge University Press, 1996); and Andre Gunder Frank, *ReOrient: Global Economy in the Asian Age* (Berkeley: University of California Press, 1998), although the last emphasizes dominance by China. For a critique of these arguments, see David S. Landes, *The Wealth and Poverty of Nations: Why Some Are So Rich and Some Are So Poor* (New York: W. W. Norton, 1998).

the Spice Islands in Indonesia. The French, the British, and even the Danish also were active from an early time. The English East India Company established its first trading post in Surat in the northwest in 1612, followed by several other posts, including one at Calcutta (Kolkata) in Bengal in the northeast in 1699. Today the British-founded cities of Mumbai (Bombay) in the western state of Maharashtra and Calcutta are India's two largest, with the modern capital, New Dehli, the third largest. From their major base at Pondicherry in Tamil Nadu, the French made a failed effort to control much of India by setting one local ruler against another during the 1740s. In the 1750s, the British outcompeted the French, using the French strategy to gain control of India.

The British Raj

Victory in a 1757 battle at Plassey in Bengal by a small force under the command of Robert Clive over a much larger force commanded by a local ruler was the crucial moment when the British achieved control of India, or at least of Greater Bengal. But the British conquest of India was a drawn-out process taking place over a long time. It was another victory in 1764 that led the weak but still reigning Mughal emperor to grant the British the right of administration and taxation over the states of Bengal, Orissa, and Bihar in the northeast. This was the clear beginning of British political rule, although the East India Company had been working to gain political power since at least the late 1600s.

From 1765 the British gradually extended their direct control over more and more areas of India. They imposed their judicial system from the late 1700s, elements of their economic system from that time into the early 1800s, and their higher educational system in the 1830s.[17] In 1857–1858, anger at the overthrow of many local leaders, at the extremely high taxes imposed on peasants, and other resentments boiled over in a revolt against British rule by the *sepoys,* Indian troops commanded by the British.[18] This revolt was put down with great difficulty and led to the removal of the last Mughal emperor and the imposition of direct rule by the British government rather than by the East India Company. Queen Victoria assumed the title "Empress of India" and her local representative took the title "Viceroy." This was the imperialist British Raj at its zenith.

Up to its end in 1947 the Raj remained a peculiar hodgepodge of entities, with over half of the Indian subcontinent under direct British rule and the rest under local rulers bearing various titles and powers who recognized the feudal supremacy of the British monarch to

17. During the 1830s and 1840s liberal reformers in England influenced India policy, leading to efforts to overthrow traditional Indian elites through high rents, equal treatment before the law, and the new educational system. In the long run these reforms would lay the foundation for the modern Indian state, but in the short run they laid the foundation for the revolt of 1857–1858.

18. The immediate trigger of the revolt was the introduction of a new cartridge covered with animal grease the soldiers had to bite. The Hindus thought it was from forbidden cows and the Muslims thought it was from forbidden pigs, thereby uniting the sepoys in revolt.

varying degrees, usually by financial payment. However, some regions long asserted great independence, and incorporating these *princely states* was a major problem confronting India at independence.[19]

After the **Sepoy Rebellion** the British built railroads and allowed some development of local Indian industry. However, unhappiness of local industrialists at continuing restrictions in the 1880s led to the formation of the Congress movement, which became the modern Congress Party. In 1905, trying to divide the politically active Bengalis, Viceroy Lord Curzon partitioned Bengal into a mostly Hindu western part, now the Indian state of West Bengal, and a mostly Muslim eastern part, now the nation of Bangladesh. This division triggered the formation of the Muslim League, which would successfully call for partition between India and Pakistan in 1947, leading to the migration of millions of people as well as the deaths of at least a million in communal riots. The **Curzon Partition** also stimulated pro-independence sentiment in the Congress movement, which came to be controlled by Hindu nationalists at that time.

After 1919 the Congress movement was led by the religiously tolerant advocate of *satyagraha* (nonviolence), Mohandas (Mahatma) Gandhi, who led widespread protests against many British policies and maneuvered his ally, Jawaharlal Nehru, into official leadership of the Congress Party. The British attempted to appease the independence movement with increasing devolutions of power such as "Indianizing" the bureaucracy. But in 1947 independence was achieved, with Nehru becoming the first Prime Minister. In 1948 Gandhi was assassinated by a Hindu nationalist during the partition upheavals.

The impact of the British Raj on India's economy and standard of living is controversial. Much of the data from the era before the Raj and the early period of British rule are unreliable and in dispute, with sharply conflicting numbers being put forward by disagreeing parties.

The economy of India probably grew during the first half of the 1600s and perhaps throughout that century when the Mughals maintained unified control of northern India. But economic conditions probably deteriorated during the early 1700s and perhaps throughout that century. At least one estimate shows the population doubling, from 100 million to 200 million, between 1600 and 1700 but then declining to 190 million by 1800.[20] Another source states that real wages rose between 1600 and 1650 but were substantially lower by 1729 than they had been in 1600. Further declines in real wages occurred under British rule; the wages of unskilled workers reached a minimum in 1890, and those of skilled workers reached a minimum in 1916.[21]

19. One local ruler who resisted absorption was the Hindu maharaja of Muslim-majority Jammu and Kashmir. His eventual decision to give it to India after Pakistani tribesmen invaded began the conflict there.

20. Colin Clark, *Population Growth and Land Use* (London: Macmillan, 1977), table 3.1.

21. Radhakamal Mukerjee, *A History of Indian Civilization: Volume II, Medieval and Modern Synthesis* (Bombay: Hind Kitabs Limited, 1966), pp. 326–327.

Assuming that these data are approximately accurate, it is an open question whether these negative changes resulted from internal chaos arising from disintegration of Mughal control or from the increasing interventions by outsiders. The Dutch and the British were granted extraordinary trading privileges internally in the 1650s and began to displace Indian merchants. In 1700 the British imposed modest import tariffs on Indian calico cloth, the beginning of a long policy of discrimination against Indian manufactures in favor of British ones.

Although there is debate about the ultimate impact on Indian living standards, strong evidence suggests that in the early 1800s there was substantial deindustrialization in India under British rule. Imports of manufactured cotton cloth from Lancashire in England displaced much local production, while India's export pattern changed from manufactured cloth to raw cotton. The crucial period was between 1814 and 1828, when British exports of cotton cloth to India rose from 818,208 to 42,822,077 yards, while similar Indian exports to Britain declined from 1,266,608 to 422,504 pieces.[22] Those who defend British policy argue that British cloth was cheaper than handcrafted Indian cloth because of the lower cost of American cotton after the invention of the cotton gin and the Industrial Revolution's advantages of steam engine–based mass production in the mills of Manchester. This argument holds that cheaper British cloth aided Indian consumers, with a price in 1850 only 20 percent of what it was in 1800,[23] even if producers were hurt. Yet the powerful historical memory of this sharp decline in production, and the perception that it was aggravated by British manipulation and control of markets in both Britain and India, has influenced the **protectionism** that has characterized much of India's post-independence economic policy.[24]

Despite the surge of British textile imports during the early 1800s, some estimates suggest that half of the handspun cotton cloth industry survived to supply the domestic market. It would be cut back further by the appearance of a domestic machine-based textile industry based in Mumbai (Bombay) and Ahmedabad in Gujarat after the 1850s. By the late 1920s India had once again become a net exporter of cotton yarn, if not of cloth.[25]

22. J. Goody, *The East in the West,* p. 131, table 4.1. For further discussion, see Amiya Kumar Bagchi, *The Political Economy of Underdevelopment* (Cambridge: Cambridge University Press, 1982).

23. Tirthankar Roy, "Economic History and Modern India: Redefining the Link," *Journal of Economic Perspectives* 16(3) (2002): 112.

24. Intense debate remains about the data involved here, with some doubting this tale of deindustrialization. There is no doubt about the change in trade patterns with Britain. But there may have been an increase in exports to Central Asia, especially in the 1830s, with a possible maintenance of the industry. (We thank Robert Eric Frykenberg for this observation, which is based on unpublished data in India.)

25. B. R. Tomlinson, *The New Cambridge History of India, III.3: The Economy of Modern India, 1860–1970* (Cambridge: Cambridge University Press, 1993), pp. 106–107. Tomlinson (p. 5), shows that Indian per capita income probably grew during 1900–1913, declined during 1914–1920, grew during 1920–1929, and then declined during 1930–1939 and 1940–1946.

Since over 70 percent of Indians were engaged in agriculture throughout the Raj period, the economic impact on that sector was more important for living standards than anything else. The data are fragmentary, but it is unlikely that there was any noticeable increase in per capita production, and possibly the opposite in terms of consumption. But there was at least enough improvement to support a somewhat steady increase in population from 190 million in 1800 to about 250 million by 1870, about 280 million by 1900, and about 360 million by 1950.[26]

The nature of the Indian land tenure system has long been debated, with British reformers and their critics, such as Karl Marx, agreeing that in rural India there was no private ownership of land prior to British rule. Although much land was held communally by villages or owned by local rulers, there is evidence of some private ownership and limited land sales in some regions from the distant past.[27]

The main British policies included supporting a new tax-gathering landlord class in some regions,[28] sharply raising rural taxes to encourage efficiency, and substantially expanding capitalist property relations in land with the sale of real estate to merchants and moneylenders, as landowners could not pay off debts with sharply increased rural indebtedness. In some regions, notably Punjab in the northwest, the British financed expansion of irrigation systems. British policies served to shake up, if not to displace, what has been called the **Hindu equilibrium** of rural Indian social and economic life.[29]

India began to export food grains in the late 1800s, although some criticize this development as a pattern of underdeveloped dependence arising from British policies. Evidence suggesting that these exports may have hurt the Indian population shows that as many as 26 million people died in famines between 1875 and 1900, in contrast to "only" 5 million between 1850 and 1875 and 1.4 million between 1800 and 1850. In 1943, between 3 and 4 million would die in the great Bengal famine.[30]

Another area of sharp controversy is the balance of payments, with Indian nationalists claiming that British policies induced a financial drain. Although overall India had a trade surplus, with Britain it had a large bilateral current account deficit in the 1800s. This may have resulted from the main goals of the Raj: to provide markets for British exports, to have

26. Tomlinson, *The New Cambridge History of India,* p. 4.

27. Atindranath Bose, *Social and Rural Economy of Northern India* (Calcutta: Firma K. L. Mukhopadhyay, 1961), chap. 2.

28. These regions were mostly in the northeast, where conflicts between tenants and landlords continue to be a major problem (Tomlinson, *The New Cambridge History of India,* pp. 42–50). It may be only a coincidence that these areas are among the poorest in India today.

29. Deepak Lal, *The Hindu Equilibrium: Cultural Stability and Economic Stagnation: India 1500–1980 AD, Volume 1* (Oxford: Oxford University Press, 1984).

30. Mukerjee, *A History of Indian Civilization,* pp. 417–418.

India service its debt payments to Britain, and to have India provide manpower for the British imperial armies.[31]

Despite this account of the negative effects of British rule on India, Britain's defenders note several advantages that India received. These include an extensive railroad system,[32] a judicial system that treats all persons as equal before the law, a reasonably competent civil service,[33] political democracy, a fairly high-quality higher education system, and, above all, a degree of national unity achieved both by the spread of the English language and by the effort to overcome British rule.

Critics note that the railroad system was built to serve British military needs; that there is much corruption in the legal system; that the civil servants have overbureaucratized the economy; that because of widespread illiteracy democracy has led to a worship of "great leaders" and ignorant tolerance of political corruption; that primary education was neglected and illiteracy rates were very high at independence; that the prevalence of the English language is a culturally degrading legacy despite the advantages it may confer in the modern high-tech global economy; and that the partition of the Raj between Hindu, Muslim, and Buddhist-dominated nations and the ongoing conflicts between some of these groups shows that there was a failure to achieve true national unity. Some of these critics contend that the British encouraged the divisions that led to the ultimately horribly bloody partition. Clearly, the final judgment on British rule in India remains to be made.

ECONOMIC POLICY SINCE INDEPENDENCE

The Move Toward Central Planning and Socialism

On gaining independence in 1947, it was unclear what economic policy India would pursue. The ruling Congress Party tried to represent most interests in society and contained within itself deep division between a pro–free market group centered on leading industrialists and large landlords, and a more prosocialist group based on labor unions, intellectuals,

31. Tomlinson, *The New Cambridge History of India,* p. 16, table 1.3, and p. 149.

32. Relative to the Mughal era, the ratio of investment expenditures to public expenditures was much higher during the colonial period, allowing an expansion of various kinds of infrastructure (Roy, "Economic History and Modern India," p. 111).

33. The Indian Administrative Service (IAS) still reflects strong British influence. "The informal training at the academy includes instruction on the 'appropriate' attire for formal and casual occasions (formal for men means suits, and for women, Indian clothes), English table manners ('remember to use the correct silverware'), gender relations, and the 'proper' way of addressing senior IAS officials (always as 'sir')." Vibha Pinglé, *Rethinking the Developmental State: India's Industry in Comparative Perspective* (New York: St. Martin's Press, 1999), p. 30. Although this training seems a bit dated, the IAS has long had a reputation for competence.

and peasants. Although India was always mostly a market capitalist society with a substantial traditionalist element, a decisive turn toward indicatively planned socialism was made in 1950, when Jawaharlal Nehru consolidated his control over the Congress Party.

It was Nehru, the first Prime Minister, who led India along the socialist path against those in the Congress Party who opposed it. Arguably Nehru had four main motivations, which at times conflicted with each other: a firm secular nationalism, a strong belief in political democracy, an attachment to Gandhian ideals of nonviolence and egalitarianism, and support for the Soviet model of socialist planning to achieve heavy industrial growth and self-sufficiency.[34] The last three can be seen as supporting his secular nationalism (except when democracy leads to Hindu nationalist sectarianism), but these three clash in various ways with each other.

Nehru's support for parliamentary democracy kept him from implementing full egalitarianism due to opposition from well-organized landlord groups opposed to land reform; it also kept him from adopting all aspects of the Soviet model, such as full nationalization or command planning. Thus, India's quasi-socialism resembles the moderate **Fabian socialism** favored by British thinkers early in the twentieth century, whom Nehru encountered while studying at Cambridge University, more than the Soviet model he came to admire after meeting Soviets at conferences in the late 1920s.

There was also a severe clash between elements of the Gandhian approach (see box 16-1) and the Soviet model. Gandhi opposed the development of heavy industry, supported small enterprises and decentralized labor-intensive activities, and generally supported private ownership rather than state ownership of enterprises. However, Nehru and Gandhi were in agreement on the need for **import substitution policies** and national self-sufficiency **(swaraj),** and on opposing sectarianism.

Although the Indian Planning Commission was established in 1951 with the First Five-Year Plan, Indian planning originated in the imposition of controls on Indian industry in 1939 at the beginning of World War II.[35] Many elements of the early plans reflected ideas in the Bombay Plan of 1943, put together by a group that included Nehru and various leading industrialists.[36]

34. Baldev Raj Nayar, *India's Mixed Economy: The Role of Ideology and Interest in Its Development* (Bombay: Popular Prakashan, 1989), p. 144.

35. Rakesh Mohan and Vandana Aggarwal, "Commands and Control: Planning for Indian Industrial Development, 1951–1990," *Journal of Comparative Economics* 14 (1990): 683. For further discussion of the historical and political circumstances of the plans and their performance, see Nayar, *India's Mixed Economy;* Tomlinson, *The New Cambridge History of India;* and Pinglé, *Rethinking the Developmental State.*

36. A leader of this group was the head of the Tata family of Bombay Parsis, who supported financially and politically both Gandhi and Nehru and the Congress movement in opposition to perceived mistreatment by the British. In response, Nehru opposed nationalization of TISCO, then and now India's largest steel company, which has remained privately owned and operated since independence, along with many other companies owned by the Tata family.

Box 16-1
Gandhian Economics: A Model for India or the World?

"Father of Indian independence," apostle of the nonviolent strategy of *satyagraha* that influenced Martin Luther King, Jr., and the American civil rights movement, and martyred for his religious tolerance by a Hindu fanatic in 1948, Mohandas K. (Mahatma ["Great Soul"]) Gandhi is the most revered figure in India's history by modern Indians. Indeed, he is one of the world's most revered figures of the twentieth century, coming in third on *Time* magazine's list of "Persons of the Century" after Albert Einstein and Franklin D. Roosevelt. Every modern political and social movement in India invokes his name and influence, if only hypocritically, including free marketeers, socialists, and Hindu nationalists.

He is often identified with a peculiarly utopian economic model for India that supports protectionism for local village industries using backward technologies, opposes the killing of cows and other animals, and tolerates the Hindu caste system while opposing discrimination against women or Untouchables. Such a view appeared in his most famous work, the *Hind Swaraj* of 1909, and has attracted the praise of some Western environmentalists. However, over time in numerous articles, interviews, letters, and speeches in Hindi, Gujarati, and English, he evolved a more nuanced view of economics (see Ajit K. Dasgupta, *Gandhi's Economic Thought,* London: Routledge, 1996). Viewed as a moral absolutist, elevating ethics over utilitarian economics, Gandhi came to recognize that moral values can be in conflict and argued that ethical rules that imply impractical economics may be invalid.

Although the poorest should be materially uplifted, welfare is bad because it destroys work incentives and the rich should not be dispossessed. Although villages should be self-sufficient, they may import certain necessary items such as surgical equipment. Machinery may be allowed to produce certain necessary items, such as Singer sewing machines to be used in conjunction with spinning wheels. While supporting the rights of the oppressed (to be asserted nonviolently), Gandhi saw rights as tied to duties and opposed the UN Declaration of Human Rights. While opposing the killing of cows, he discussed ways to improve productivity in the leather goods and other animal parts industries. While supporting cooperation between workers and capitalists and between tenants and landlords through his theory of *trusteeship,* he supported nonviolent removal by tenants of landlords receiving special privileges from the British. While opposing contraceptive use, he supported slowing population growth through the rhythm method of birth control. He proclaimed equality of the sexes and supported equal pay for equal work while declaring it a woman's place to raise children. While the individual was the foundation of society, the good of the individual was the good of all. He called the law of supply and demand a "devilish" concept, yet he supported the use of the market and the ideas of efficiency and entrepreneurship.

Thus, it is not surprising that most political groups in India can find arguments to support their ideas in the writings or sayings of Mahatma Gandhi.

Also in 1951, a law was passed to establish the system of licenses and permits for private industries that would expand to an enormous set of detailed regulations and controls, collectively and derisively known as the **License-Permit Raj,** although elements of it dated to World War II controls. This system expanded under Indira Gandhi with a 1969 law that allowed controls on the size of firms in various industries and a 1973 law that controlled access to foreign exchange by firms for importing inputs. Although gradually relaxed, both of these laws came to be associated with extreme inefficiencies and distortions in the economy. For example, access to imported raw materials was negatively tied to a firm's capital stock utilization rate, leading to excess capital accumulation while restraining production.[37]

37. The most notorious case arising from such regulations was that of the Haldia fertilizer plant, built by the government in 1980 and employing around 3,000 employees, but that had produced no fertilizer as of 1992.

The First Five-Year Plan, for 1951–1956, used a highly aggregated Keynesian-style model with an emphasis on basic infrastructure and agriculture. The Second Five-Year Plan, for 1956–1961, turned toward the Soviet approach by tracking investment in the capital goods sector and pushing for heavy industrial expansion, especially in the steel industry. Growth of the state-owned sector also began to accelerate, although largely through the establishment of new SOEs such as Hindustan Steel Limited. The Third Five-Year Plan, for 1961–1966, continued the thrust of the previous plan, with more detailed modeling of foreign exchange flows and consumption sectors. This was the high water mark of planning. Political support for it declined after Nehru's death in 1964, especially given the serious shortfalls in actual performance against planned targets. In the early 1960s, because of his prestige as a founder of the **Nonaligned Nations Movement,** Nehru attracted much foreign aid, which was reduced by some sources after his death, with many aid providers in this period supporting central planning, including the United States.[38]

Nehru's immediate successor started a Fourth Five-Year Plan in 1966 that was abandoned the following year for a "plan holiday" until 1969. This was triggered by fiscal problems associated with border wars with China in 1962 and with Pakistan in 1965, along with a drought-induced food crisis that led to famine and, in 1966, to the largest decline in GDP of any postindependence year except for the oil price shock year of 1980. Indira Gandhi, Nehru's daughter, became Prime Minister in 1966 and expanded the emphasis on production of inputs to agriculture that had already been initiated. This emphasis continued with the reintroduced Fourth Five-Year Plan for 1969–1974, which also saw the first use of a 77-sector input-output model for planning. But this period was more significant for its major wave of nationalizations and increased regulation of the private sector.

The Fifth Five-Year Plan, for 1974–1979, saw an effort to reduce poverty by targeting consumption levels of the poor. This period saw considerable political upheaval, with Indira Gandhi declaring dictatorial emergency rule in 1975, partly to deal with oil price shock–induced inflation. Reaction against abuses of power during the emergency rule[39] led to her ouster and that of the Congress Party in 1977 by a Janata Party–led coalition, which in turn was replaced again by Indira Gandhi and the Congress Party in 1980. The Sixth Five-Year Plan, for 1980–1985, introduced a detailed investment allocation matrix, with numerous

38. The early 1960s saw friendship between India and the United States, especially between Nehru and President John Kennedy, whose ambassador to India, economist John Kenneth Galbraith, oversaw much food aid from the United States. President Lyndon Johnson restricted such aid to Nehru's successors, who criticized the U.S. role in Vietnam, notably during the food crisis of 1966. After 1969, President Richard Nixon tilted the United States toward China and Pakistan, while India tilted toward the Soviet Union. In 1971 the United States supported Pakistan against India's support for Bangladesh in its war for independence from Pakistan. U.S.–India relations have warmed considerably since the mid-1990s.

39. Besides suppression of dissent and corruption by some of Indira Gandhi's family members and associates, an abuse that triggered intense opposition was a population control measure of widespread sterilization of men that focused on Muslims and other minority groups. Indira Gandhi's refusal to accept a court ruling against voting irregularities immediately triggered the emergency rule.

submodels tied to the core input-output model, and focused on increasing exports with relaxed import restrictions on high-technology inputs for export industries.

In 1984 Rajiv Gandhi replaced his mother as prime minister on her assassination by Sikh separatists. He was turned out of power by another Janata-led coalition in 1989 after corruption scandals erupted, and was assassinated by Tamil extremists in 1991 during a campaign that saw the Congress Party return to power. The Seventh Five-Year Plan, for 1985–1990, followed the thrust of the Sixth, but with further relaxation of market regulations and heavy foreign borrowing to increase exports. This led to a noticeably higher growth rate, with industrial production growth exceeding its target for the first time ever in a five-year plan period, but it also led to a substantial increase in foreign indebtedness that provoked the 1991 economic crisis.

There was a hiatus without plans between 1990 and 1992, as major reforms were introduced in 1991. But the Eighth Five-Year Plan began in 1992, followed by the Ninth beginning in 1997, the latter in an era of coalition governments eventually dominated by the Bharatia Janata Party (BJP). These plans deemphasized quantitative sectoral planning targets and focused more on fiscal and monetary policy with major market deregulation.

All of the plans have been indicative rather than command. Details of the performance of these plans through 1990 are shown in table 16-1.

The pattern of socialist state ownership of enterprises went through several stages. The initial period in the 1950s and 1960s involved mostly the government acting as entrepreneur and establishing new enterprises but not nationalizing existing ones, except some owned by the British. The crucial moment came in 1969 during Indira Gandhi's rule. The ruling Congress Party split, with its pro–free-market minority walking out of the government as she moved sharply left.

Table 16-1
Performance of Indian Five-Year Plans: 1951–1990 Growth Rates

	GDP		Industrial Production		Agriculture	
Plan Period	Target	Actual	Target	Actual	Target	Actual
1951–1956	2.1	3.3	n.a.	7.3	n.a.	n.a.
1956–1961	4.6	4.1	8.3	6.6	3.4	2.0
1961–1966	5.6	2.6	11.1	9.0	4.6	−1.0
1969–1974	5.7	3.4	8.1	4.7	4.9	2.9
1974–1979	4.4	5.3	7.0	5.9	3.3	3.7
1979–1984	5.2	5.2	8.0	6.4	3.8	4.3
1985–1990	n.a.	6.0	8.0	8.5	n.a.	n.a.

Sources: Rakesh Mohan and Vandana Aggarwal, "Command Controls: Planning for Indian Industrial Development, 1951–1990," *Journal of Comparative Economics* 14 (1990): 681–712; William A. Byrd, "Planning in India: Lessons from Four Decades of Development Experience," *Journal of Comparative Economics* 14 (1990): 713–735, with evaluation by Arvind Panagariya; and "Indicative Planning in India: Discussion," *Journal of Comparative Economics* 14 (1990): 736–742.

There is debate regarding whether Indira Gandhi was a socialist on principle or out of political expediency. But in 1969 there was no conflict, as her strong pro-socialism agreed with the political atmosphere in India, which tended in that direction. She attracted a number of former Communist Party members[40] and other leftists to her government to make up for the departure of the Congress pro–free-market minority and began nationalizing existing firms in many sectors. She also sharply increased the regulations of the private sector, expanding control by the rent-seeking License-Permit Raj.

The wave of nationalizations swept through industry after industry, starting with banks in 1969, the year that the monopoly control act was passed limiting the sizes of private firms in many sectors. This was the **reservation system,** which eventually extended to over 800 commodities. Indira Gandhi was strongly reelected in 1971 on a pro-nationalization platform that coincided with a strong pro-Soviet tilt in foreign policy as well. She nationalized the coal industry and general insurance that year (life insurance had been nationalized in 1956). The year 1972 saw nationalization of the second largest steel company in India, although the Tata-owned TISCO remained privately owned. There were already several state-owned steel mills dating from the Second Five-Year Plan period. The year 1972 also saw nationalization of copper extraction and refining through management takeovers that were completed in 1976. Finally, between 1972 and 1976, nationalization of cotton textile mills occurred, although some had been nationalized in the late 1960s to prevent them from closing. Most of these nationalizations were made to protect employment and the interests of organized labor. The remaining private cotton textile sector was placed under strict regulatory controls.

The end of the ideologically driven wave of nationalizations came at the beginning of 1974 after the major act to control foreign exchange dealings and imports by firms was passed in 1973. Food prices worldwide rose sharply in 1972 and 1973, and in 1973 Indira Gandhi set in motion an effort to nationalize wholesale trade in wheat. However, this encountered severe resistance as food shortages mounted, and in January 1974 the effort was abandoned. There would be more nationalizations, and the state-owned sector would continue to expand for another decade. But these later nationalizations were related to specific crises or interest groups rather than as part of a broad push to socialism.

Curiously, some have seen the declaration of emergency rule in 1975 as a move to suppress dissent against Gandhi's policy shift to the right. Inflation had accelerated in the face

40. The Communist Party has long been influential in India, ruling for decades in the states of Kerala and West Bengal. After 1964 it split into three parties over the Sino-Soviet conflict and issues of reformism versus revolution, with revolutionary Maoist Naxalite guerrillas fighting against the pro-Soviet Communist Party government in West Bengal and also active in Bihar. Nayar (*India's Mixed Economy,* p. 386) notes that by the 1980s the Indian economy looked much like what had been called for in a Communist Party platform in 1964, except that large plantations and foreign trade remained privately owned. Otherwise, most of the leading industrial companies were state-owned and the remaining private sector was heavily regulated, as called for in that platform.

Table 16-2
Growth of the State-Owned Sector in India

Year	Number of Enterprises	Investment (billions rupees)	Percent Non-Ag Labor		Percent GDP
			State-Owned	Private	
1951	5	0.29	n.a.	n.a.	n.a.
1956	21	0.81	n.a.	n.a.	n.a.
1961	48	9.53	27.5	41.7	8.0
1969	74	24.15	28.7	39.3	n.a.
1974	122	62.37	32.5	35.2	14.0
1979	176	156.02	34.8	32.9	n.a.
1984	214	354.11	36.7	30.3	20.0
1991	245	n.a.	n.a.	n.a.	24.0

Sources: For 1951–1984, Baldev, Raj Nayar, *India's Mixed Economy: The Role of Ideology and Interest in Its Development* (Bombay: Popular Prakashan, 1989), pp. 364–366. For 1991, Vijay, Joshi, and I. M. D. Little, *India's Economic Reforms, 1991–2001* (Oxford: Clarendon Press, 1996), p. 38.

of food and oil price shocks and huge increases in government spending, and policies of liberalized investment and relaxation of some regulatory controls were implemented. The oil industry was nationalized during the emergency rule, as were some engineering firms that were in danger of closing. The trend toward nationalizing failing firms would eventually lead to an inefficient state-owned sector propped up by soft budget constraints.[41]

Nationalizations and the establishment of new SOEs continued sporadically up to Indira Gandhi's death in 1984. In the later stages, some of the newer SOEs were granted special privileges and allowed to form joint ventures with foreign corporations, with the auto producer Maruti Udhyog Limited's (MUL) deal with Japanese-owned Suzuki in 1983 being a sign of the times. Some of the SOEs, such as MUL, that were granted exemptions from controls have thrived. In some cases these exemptions have reflected bureaucratic or political interests in the firms. However, after Rajiv Gandhi became prime minister in 1984 he loosened controls on the state-owned computer and software industries, which he highly favored, and also allowed private firms to operate in a less controlled manner in that sector. This provided the foundation for the takeoff of India's information technology industry, which is now based in Bangalore in the southern state of Karnataka and is a rapidly growing export industry of India.[42]

Table 16-2 shows the number of SOEs, the amount of investment in rupees in the SOEs, and the respective percentages of the nonagricultural labor force in private versus public

41. For details of the nationalizations through the mid-1970s, see Nayar, *India's Mixed Economy.*

42. For accounts of government policies toward the automobile and computer industries in the 1980s and 1990s, see Pinglé, *Rethinking the Developmental State.* Pinglé states that there is wide variation in the quality of regulation and management by the bureaucrats of different state-owned sectors, with the steel industry being badly managed, while the computer industry and some of the auto industry firms are better managed.

firms. This table shows public firm employment surpassing private firm employment only after the ideological turnaround of 1974. There was a strong momentum for expansion of the SOE sector.

Although nationalizations slowed significantly after 1984, investment in the SOEs as a percentage of GDP continued to rise even in the late 1980s, reaching 10.5 percent of GDP for 1985–1990 compared to 10.2 percent for 1980–1985, with the private sector investment shares of GDP being 4.5 percent in 1985–1990 and 4.3 percent in 1980–1985. In 1990–1995 the share of GDP going to SOE investment fell to 9.1 percent, but it was still ahead of the private sector share at 6.0 percent.[43] But by 1995–1998 the private sector share had moved ahead of the SOE share, the former at 8.3 percent and the latter at 7.0 percent.[44]

Economic Reforms in India

On the assassination of Rajiv Gandhi in May 1991, he was succeeded as Congress Party leader by P. V. Narasimha Rao, who led the party to electoral victory and became prime minister. In June, his government faced a severe balance-of-payments crisis, triggered partly by a shortfall in income transfers from Indians working in the Persian Gulf following the war there. But the payments crisis also reflected deeper problems of rising foreign debt, a fiscal deficit of over 8 percent of GDP, and inflation of over 13 percent.[45]

Under the prodding of his finance and commerce ministers, Narasimha Rao announced substantial reforms in conjunction with a devaluation of the rupee, an emergency loan from the IMF, and more conventional efforts to reduce the budget deficit and inflation. Those urging these reforms cited the superior economic performance of the East Asian tigers, such as Hong Kong, Singapore, South Korea, and Taiwan, and their greater integration into the world economy and lack of regulation of firms.[46]

Among the most striking reforms was the effort to reduce tariffs and import restrictions more broadly. It has been widely claimed that India had the most highly protected economy (or at least one of them) in the world against imports, as of 1991. Between 1991 and 1998, the average unweighted tariff rate fell from 125 to 35 percent, while the average weighted

43. For 1990–1996 the SOEs generated value-added of 13.4 percent of GDP, second only to Bolivia out of 132 nations listed in World Bank, *World Development Report: Entering the 21st Century, 1999/2000* (Oxford: Oxford University Press, 2000), table 17. This number, high relative to those of other countries, shows that at least some of the SOEs of India are somewhat efficient. As of 1991, about half of the nearly 250 SOEs were profitable (Vijay Joshi and I. M. D. Little, *India's Economic Reforms, 1991–2001* [Oxford: Clarendon Press, 1996], p. 38).

44. T. N. Srinavasan, "Performance and Prospects of the Indian Economy," lecture presented at the annual meeting of Allied Social Sciences Association, Boston, January 2000.

45. Joshi and Little, *India's Economic Reforms,* p. 17.

46. Daniel Yergin and Joseph Stanislaw, *The Commanding Heights: The Battle Between Government and the Marketplace that Is Remaking the Modern World* (New York: Touchstone, 1998), p. 225.

tariff rate fell from 87 to 20 percent, although rates were also declining in neighboring countries and trade partners.[47] Furthermore, the WTO has ordered its member, India, to remove its remaining quantitative restrictions on trade such as quotas, many of which have been quite extreme. In some industries, the appearance of import competition has brought about noticeable improvements in the quality of goods produced by domestic firms, including some SOEs, the automobile industry being a notable example.[48] This opening to imports is the most ideologically dramatic reform for the Indian government, given the experience with British colonial trade policy and the Gandhian legacy of self-sufficiency (*swaraj*).

An unpleasant side effect of the tariff reductions was a reduction in revenue for the government at a time when it was attempting to reduce its budget deficits. This was partly offset by a new policy of disinvestment in SOEs, with the Indian government selling off shares of these firms to private investors. Critics note that this policy has not been one of full privatization of SOEs. But the present government is fully privatizing about a quarter of the nationalized insurance industry. Some state governments have also been fully privatizing their SOEs and bringing FDI into those sectors, including the Communist government in West Bengal.

India's fiscal situation has not been stabilized, with interest payments rising as a percentage of the federal budget once again and with many state governments being in much worse shape fiscally than the central government. Indeed, as of 2001, the aggregate of federal and state deficits had returned to its level in the crisis year of 1991 as a percentage of GDP, a source of considerable concern to many observers.[49] A major spending problem at both the federal and state levels is large subsidies for money-losing SOEs and even for weak private firms that have not been allowed to shut down in order to maintain employment. A sector attracting special attention is electricity, with frequent power shortages crippling the economy. Meanwhile, the losses of the heavily subsidized state electricity boards amount to 0.7 percent of the GDP.[50] The scale of these subsidies for money-losing SOEs has made it hard to fund basic education, basic social infrastructure, and services in many of India's states.

Another major form of opening to the outside world has been a substantial relaxation of limits on FDI. Many new joint ventures have started as a result. However, the results have

47. Srinavasan, "Performance and Prospects."

48. "India's Economy: Survey," *Economist* (February 22, 1997), p. 6. For many years the dominant car in India was the Hindustan Ambassador, which resembled a British Morris Oxford from the 1950s. Even this vehicle, produced by an SOE, has recently improved in quality.

49. Montek S. Ahluwalia, "Economic Reforms in India since 1991: Has Gradualism Worked?" *Journal of Economic Perspectives* 16(3) (2002): 70.

50. Joshi and Little, *India's Economic Reforms,* p. 17.

been mixed, with opposition sometimes arising in state governments to deals approved of by the federal government, often involving prominent U.S. corporations. Thus, Kentucky Fried Chicken was forced out of Karnataka as a result of religious complaints. Both Coca-Cola and Pepsi-Cola encountered difficulties completing planned investments. Most dramatic was the 1995 cancellation in Maharashtra of a planned, and much-needed, investment in electricity capacity in Mumbai (Bombay) by U.S.-based Enron and Bechtel. This cancellation was later overturned by higher courts, but it scared off many foreign investors throughout India. The government of Maharashtra was run by the Hindu nationalist BJP, and the cancellation showed its tendencies toward protectionism and nationalism. However, the BJP, now in charge at the national level, has moved away from that policy.

Despite these moves toward reform, many seemingly irrational restrictions on trade and investment remain. There are export restrictions on some raw materials to keep their prices low for domestic customers. Restrictions on interstate trade in some agricultural commodities remain, and even on such trade between districts within some states.

Tied to the general lowering of restrictions on imports has been a general reduction for firms of import license restrictions, which were eliminated outright for 80 percent of industries in 1991 alone. Private firms have been allowed to enter sectors previously mostly nationalized. Banking is an important example, the latter reform coinciding with a decontrol of interest rates. There also has been a substantial reduction of the reservation system that restricts the size or expansion of firms in many sectors. However, this system has not been completely eliminated and was only reduced somewhat for cotton textiles by the end of 2000. The reluctance reflects the Gandhian tradition, although this is a potential export industry.

Despite these reforms, other areas remain little changed,[51] with labor policy being an especially significant example. A series of laws are in place to protect nonagricultural labor from unemployment. Workers can be fired only with government permission. Unsurprisingly, this policy makes firms reluctant to hire workers. The lack of bankruptcy laws and the restrictions on firm closures sometimes lead owners to simply abandon plants. There continue to be many other restrictions with similarly counterproductive effects, leading many to conclude that India has experienced the worst effects of both socialism and capitalism. The rent-seeking License-Permit Raj may be reduced, but it is far from dead.

Despite their limited nature, the 1991 reforms resulted in a noticeable increase in the economic growth rate, which rose to 7 percent annually by the mid-1990s. It was reduced

51. Despite the publicity surrounding the 1991 reforms, one econometric study examining the responsiveness of India's economy to external shocks suggests that it has had gradually increasing integration into the world economy since the mid-1970s rather than any sudden change since then (Mohammed I. Ansari and Ira N. Gang, "Liberalization Policy: 'Fits and Starts' or Gradual Change in India," *Comparative Economic Studies* 16 [1999]: 23–46).

to 4.8 percent during the Asian financial crisis in 1997, which did not severely affect India, but returned to nearly 7 percent in 1998. Since 2000 the growth rate has been in the 5 percent range, with some concern arising about rising budget deficits that, by 2001, were almost as large as in the crisis year of 1991.[52] Nevertheless, growth rates have remained above the **Hindu rate of growth** of 3–4 percent that many thought India was permanently condemned to, and they have been achieved without the rising levels of foreign indebtedness of the late 1980s. These outcomes have tended to keep the BJP-dominated government on the reform path, albeit gradually, despite its inclination toward protectionism.

However, the benefits of these reforms have not been universally shared, with many gains going to upper-income groups. Although there is no clear evidence of any sectors of Indian society poorer, some regions and groups have not gained much. Generally, the rural population seems to have gained the least, with no reduction of its approximately 45 percent poverty rate between 1990 and 1998. During the same period, urban areas saw their poverty rate decline from 35 to 30 percent.[53] This failure of the reforms to aid rural populations significantly may reflect the failure to reform such badly performing SOEs as those controlling fertilizers and irrigation, as well as electricity, all of which are important for farmers.

THE REMAINING DEVELOPMENT CHALLENGE

Population and the Social Problem

Compared to its largely static preindependence performance, India has come a long way, more than doubling its real per capita output, doubling its life expectancy, and tripling its adult literacy rate since 1947.[54] Compared to many of its neighbors in Asia, India lags on most basic aspects of economic development. Yet, compared to many other areas of the world, India has seen substantial improvement in recent years. Even prior to the 1991 reforms, its annual GDP growth rate of 5.5 percent during the 1980s was among the world's top ten, with almost all of the nations ahead of India being among its Asian neighbors. However, India's growth rate in the 1980s came with unsustainable foreign borrowing that prompted the 1991 balance of payments crisis. Nevertheless, India overall remains in the bottom category of the world's nations as a poor, less developed nation, in contrast to its

52. Ahluwalia, "Economic Reforms in India," pp. 68, 70.

53. Srinavasan, "Performance and Prospects." See also Gaurav Datt and Martin Ravallion, "Is India's Economic Growth Leaving the Poor Behind?" *Journal of Economic Perspectives* 16(3) (2002): 89–108.

54. Srinavasan, "Performance and Prospects."

Table 16-3
Social Development Indicators for Asian Countries

Country/ State	Birth Rate	Infant Mortality	Adult Female Literacy	Percent Urban	Sanitation Access
India	29	71	39	28	16
Kerala	18	17	86	n.a.	n.a.
Uttar Pradesh	36	98	25	n.a.	n.a.
Pakistan	40	95	25	36	39
Bangladesh	31	75	27	20	35
Sri Lanka	21	14	88	23	75
China	19	32	75	33	68
South Korea	16	9	96	84	100

Sources: Birth rates per 1,000 population for 1992 from Jean Drèze and Amartya Sen, *India: Economic Development and Social Opportunity* (Oxford: Clarendon Press, 1995), tables A.1 and A.3. Infant mortality rates per 1,000 live births for 1997 from World Bank, *Entering the 21st Century: World Development Report, 1999/2000* (Oxford: Oxford University Press, 2000), table 7, except for Kerala and Uttar Pradesh, which are from Drèze and Sen, *India,* table A.2. Adult female literacy rates are percentages above age 15 for 1997 from World Bank, *Entering the 21st Century,* table 2, except for Kerala and Uttar Pradesh, which are percentages above age 7 for 1991 from which are from Drèze and Sen, *India,* table A.3. Percent urban population for 1998 from World Bank, *Entering the 21st Century,* table 2. Sanitation access is percent of population for 1995 from World Bank, *Entering the 21st Century,* table 7.

large neighbor and rival, China, which has probably broken into the lower-middle-income stratum.

Fundamentally, India has only begun to deal with the basic demographic and social prerequisites for true economic development. These include achieving a substantially lower birth rate, attaining widespread literacy, experiencing a substantial transition of population to urban areas, and providing sufficient infrastructure for growth and development. The first two of these factors are closely linked with each other through another important social characteristic, the status and treatment of women. It is now clear that one of the most important factors in lowering birth rates to escape low-level **Malthusian traps** is to educate women, especially those in rural areas.[55] In much of India, this has not yet been successfully done.

Table 16-3 shows various social and developmental indicators for India and several other Asian countries. Also included are data for two states of India, Kerala in the southwest and Uttar Pradesh in the north, the latter India's largest state. These figures indicate the degree of regional variation within India on these measures, with some states making progress while others remain in much worse shape. Box 16-2 discusses the special political, social, and economic characteristics of Kerala.

55. Partha Dasgupta, "The Population Problems: Theory and Evidence," *Journal of Economic Literature* 33 (1995): 1879–1902.

Box 16-2
Kerala: India's Socialist Success Story?

The performance on social indicators such as birth rate, infant mortality, female literacy, and other quality-of-life measures in the state of Kerala, located at the southwestern tip of India, is strikingly superior to that of all other states of India. India's Nobel Prize–winning economist, Amartya Sen, has widely publicized this performance, even noting that Keralans are better off on many of these measures than many disadvantaged groups in high-income countries, such as African Americans (Amartya K. Sen. "From Income Inequality to Economic Inequality," *Southern Economic Journal* 64 [1997]: 384–401).

The policies responsible for these outcomes were installed by the Communist Party, which was elected in Kerala in the 1950s, and have been generally maintained since, even when the Congress Party displaced the Communists. They reflect an egalitarianism manifested in an affirmative action program that reserves more than half of the government jobs for members of lower castes, significant in a state with a large public sector. Indeed, the political base of the Keralan Communist Party has been well-organized lower castes against upper-caste Hindus and Christians (Jitendra Singh, *Communist Rule in Kerala* [New Dehli: Diwand Chand, 1959]). Kerala has one of the largest Christian populations in India and much of its Jewish population.

These policies may reflect historical patterns prevailing before independence. Kerala was previously three states, two of which were independent of the British Raj and had pro-education policies dating from the early 1800s, as well as various social groups with more positive attitudes toward women than existed elsewhere in India. But recent policies have been effective, as the third part of Kerala, Malabar, has converged on the other two in its performance on these social indicators (Jean Drèze and Amartya Sen, eds., *India: Economic Development and Social Opportunity* [Oxford and Delhi: Oxford University Press, 1995], p. 200).

The big negative is that Kerala has had very low economic growth, with its real per capita income equaling only 4.6 percent that of the United States in 1992 compared to 5.1 percent for India as a whole. Its annual per capita growth rate between 1980 and 1992 was only 0.3 percent, despite its low birth rate, compared with 3.1 percent for India as a whole and even 2.2 percent for Uttar Pradesh for the same period (Drèze and Sen, *India,* table A.2).

Probably more than its egalitarian redistribution policies, extremely vigorous enforcement of License-Permit Raj regulatory policies has limited economic growth in Kerala. One advantage it has gained from its investment in education has been a high remittance of income earned by educated Keralans abroad in recent years, especially from the Persian Gulf. Clearly, the challenge for Kerala is to achieve real economic growth by providing opportunities for its educated citizens at home without sacrificing their high quality of life.

Table 16-3 reveals expected patterns but also some odd cases. South Korea, now an upper-middle-income country, discussed in chapter 19, is converging on the pattern of high-income developed economies, although at the end of the Korean War in 1953 its per capita income was comparable to that of India. It has a low birth rate, a low infant mortality, high female literacy,[56] a large urban population, and access to sanitation (an indicator of general availability of social infrastructure). India as a whole generally shows the opposite pattern

56. The importance of education and literacy is seen in that in 1960, South Korea had an adult literacy rate (71 percent) greater than India's in 1992 (50 percent) (Drèze and Sen, *India: Economic Development and Social Opportunity,* p. 38). Their per capita incomes have since diverged sharply from each other.

on all of these indicators.[57] The state of Uttar Pradesh is generally worse off than India as a whole, closely resembling Pakistan on many indicators, even though Pakistan has a higher per capita income than India (see table 15-2).

Kerala, discussed in box 16-2, sharply contrasts with India as a whole and especially with Uttar Pradesh. Both Kerala and Sri Lanka more closely resemble South Korea in birth rate, infant mortality, and female literacy. Although China also tends to resemble South Korea on these indicators more than it does India as a whole, Kerala and Sri Lanka have even lower infant mortality and higher female literacy than does China. Only on birth rate does China resemble them, being slightly lower than Sri Lanka but slightly higher than Kerala. However, none of these match South Korea, although Kerala comes close on birth rate. But these positive social indicators are not accompanied by high per capita income, and Kerala's per capita income is only modestly above Uttar Pradesh's, with both somewhat below the overall Indian level.[58] In general, China has clearly progressed further than India on most of these social developmental indicators, as well as having a noticeably higher per capita income (see table 15-2).

In order to fully develop, India must invest more in infrastructure and education and improve the status of women to bring down the birth rate. Helpful would be fiscal reforms reducing wasteful subsidies to inefficient SOEs in order to provide funds for such investments, especially for primary education. The poorest states also have the worst records with regard to education. The poorest state, Bihar, in the northeast, has the lowest rate of primary school attendance: less than 20 percent for girls aged 5–9.[59]

A regional divide is opening in India, with states in the west and the south performing better on many indicators and growing more rapidly than several states in the northeast. There is now a more than 3:1 ratio in per capita income between the highest-income state (Punjab in the northwest) and the poorest (Bihar). But even some states in the northeast have begun to grow rapidly after engaging in reforms to improve infrastructure availability and functioning, notably Orissa and Madhya Pradesh.

In contrast, Bihar seems frozen by inefficient policies and also suffers more than other states from extreme caste and class conflicts in rural areas.[60] These conflicts affect education.

57. In contrast to many news stories, India may have actually urbanized less than would be predicted by relevant economic variables (Charles M. Becker, Jeffrey G. Williamson, and Edwin S. Mills, *Indian Urbanization and Economic Growth since 1960* [Baltimore: Johns Hopkins University Press, 1992]).

58. Drèze and Sen, *India: Economic Development and Social Opportunity,* table A.3.

59. Drèze and Sen, *India: Economic Development and Social Opportunity,* table A.3.

60. Despite these conflicts and inequalities, overall inequality in India is not too high (Drèze and Sen, table 1.1). This probably reflects India's general poverty, not yet on the Kuznets curve of increasing inequality in the early stages of growth. This situation may be changing, with reforms and rising growth rates concentrated in urban areas.

By law, all children are supposed to attend primary school. But, as noted above, less than 20 percent of girls do so in Bihar. One reason for this has been the intransigence of local ruling village landlords, who have actively prevented the construction of schools or have blocked pay for teachers where schools have been built. It is not surprising that families put their children to work when there are no functioning schools for them to attend. Thus, in an increasingly decentralized India, what may be needed are social and political upheavals in the poorest states to overturn the entrenched power of upper-caste groups who control land and resources.

Hindu Nationalism and the New Traditionalist Alternative

With the effective end of the Nehru-Gandhi dynasty in the Congress Party and the eclipse of its former unifying role as the bringer of independence, India may have seen a fundamental long-term shift in its political balance in favor of the Hindu nationalist BJP that dominates the current ruling coalition. If this trend continues, the internal ideological and political struggles of the BJP will be of increasing importance for India as a whole and for its future development. In particular, the core of the BJP has long been committed to a radical Hindu nationalism that will try to influence policy against competing tendencies that ally with the BJP's coalition partners, most of them regionally based parties not sympathetic to the BJP's core ideology.

Hindu nationalism developed in the late nineteenth century[61] and became the cutting edge of the independence movement at the time of the Curzon Partition of Bengal in 1905. As Mohandas (Mahatma) Gandhi took control of the Congress Party around 1919, the movement began to develop its own organizations. The 1920s saw publication of works advocating *Hindutva,* the idea that all Indians are culturally Hindu, even if they formally belong to other religions, and the formation of various cultural and political organizations, the most important being the Rashtriya Swayamsevak Sangh (RSS).[62] This group exists today and forms the activist core of the BJP, as it did of the predecessor (BJS), with most of the BJP's leaders coming out of the RSS, including Prime Minister Vajpayee. It has been banned three times, most recently in 1992–1993 after it destroyed a mosque on a sacred Hindu site in Ayodha, triggering Hindu-Muslim riots. Unlike Gandhi and his nonviolent *satyagraha,* the RSS has at times advocated violence, manifested in 2002 in anti-Muslim actions in Gujarat, where a radically nationalist local government was reelected.

61. Some initial supporters were Europeans fascinated by the Hindu religion, such as members of the spiritualist Theosophical Society like Annie Besant, who moved to India and aided early Hindu nationalists.

62. For a history of the RSS and related organizations, see Frykenberg, "Hindu Fundamentalism and the Structural Stability of India"; D. D. Pattanaik, *Hindu Nationalism in India 2: Modern Trends* (New Delhi: Deep & Deep, 1998).

Dealing with the Gandhian legacy has been difficult for the RSS and Hindu nationalists more generally. On the one hand, Gandhi is reviled for his religious tolerance, nonviolence, and uplifting of the Untouchables. On the other, his idealistic and utopian vision of a self-sufficient, village-based system with *jajmani* caste relations lies at the heart of their vision as well. The leader of the BJS, Deendayal Upadhyaya, in his influential 1965 book *Integral Humanism,* openly and respectfully drew on many of Gandhi's ideas while modifying them. Notably, Upadhyaya allows for more modern technology while still advocating that it should be native **(swadeshi)** and appropriate to factor conditions.[63] Thus, Upadhyaya's approach is New Traditionalist rather than Old Traditionalist. The modern BJP officially describes itself as secular and in favor of equality, citing Gandhi, although the call for equality involves dismantling affirmative action programs favoring the Untouchables.

Some efforts have been made to construct an explicit **Hindu economics,** usually drawing on various ancient texts such as the *Rig Veda,* and trying to bring an idealized Indian past into the modern world with references to modern economic writings, thus fitting the New Traditionalist mold. The parallel to the development of modern Islamic economics is obvious and unsurprising. One effort is the book *Hindu Economics: Eternal Economic Order,* by M. G. Bokare, who claims that this work subsumes all previous economic thought. Bokare proposes a decentralized (Gandhian) order of "exploitationless" self-employment (socialism), with no taxes and no interest (Islamic economics), appropriate technology (Upadhyaya), and a general market context.

In practice, economic nationalism of *swaraj* self-sufficiency, along with such specific Hindu practices as forbidding the killing of cows, is advocated. The most important recent manifestation of economic nationalism, as previously mentioned, was the cancellation of a contract with U.S.-based Enron in the state of Maharashtra in 1995 by a BJP-dominated government. With the BJP in power at the national level, the struggle over such issues is now fully joined. But recent indications suggest that, under pressure from its coalition partners, the BJP is trying to show its ability to rule nationally and has not pushed extreme nationalist policies too forcefully. Indeed, it has adopted the policy of opening Indian financial markets to foreigners and listing Indian corporations on foreign stock markets. Although military victory against Pakistan in 1999 gave Prime Minister Vajpayee the power to pursue a more internationalist approach that deviated from the core BJP ideology without incurring much criticism, continuing conflict with Pakistan disturbs the hard-core BJP ideologues who oppose such internationalism. Thus, a cautious implementation of the existing reform movement seems the most likely outcome for the near future.

63. See also Deepak Lal, "The Economic Impact of Hindu Revivalism," in Marty and Appleby, *Fundamentalisms and the State,* pp. 410–426.

SUMMARY AND CONCLUSIONS

India may possess the most complexly mixed economy in the world, with traditionalism, both old and new, based on the Hindu caste system, market capitalism dating from India's ancient history of long-distance trade, and socialism and indicative planning dating from the era of Jawaharlal Nehru, India's first prime minister after the country gained independence in 1947. Like most countries, India is carrying out market-oriented reforms. These have focused on reducing the tariffs and quotas that had made India perhaps the most protectionist economy in the world, as well as reducing the various restrictions on business activities collectively labeled the License-Permit Raj. Indicative planning continues, although with reduced influence, and little privatization of SOEs has taken place, although shares of these companies have been sold to the public to reduce the fiscal deficits that have plagued India's governments. A major impetus to reform came with the foreign exchange crisis of 1991, which coincided with a surge in the budget deficit and the final collapse of the Soviet Union, India's de facto ally and partial role model.

India's efforts to develop economically involve overcoming numerous difficult legacies. Colonial rule by Britain led to a deindustrialization of India, long one of the world's leading economies. Profound conflicts over religion, caste, language, and regional identities plague India both internally and in relation to its neighbors, most importantly Pakistan, a former part of the British Raj. India's political leadership has moved from the secular Congress Party, once led by Mohandas Gandhi, the father of Indian independence, to the Hindu nationalist BJP currently in power. Yet in leading the nation, the BJP may be moving away from its radical New Traditionalist positions to imitate the more secular Congress Party approach as it tries to carry out the internationalizing and deregulating reforms initiated earlier. Very important will be whether or not a government based on asserting Hinduism can make peace with its Muslim neighbor, Pakistan, with which it has been in serious conflict since independence, a conflict now more dangerous because of the nuclear weapons possessed by both countries.

With over a third of its population still in deep poverty, India has a long way to go to achieve serious development. Many observers have castigated India as the "sick man of Asia," comparing it unfavorably to its "tiger" neighbors to the east and even to its immediate neighbors, who enjoy a higher quality of life, Buddhist-dominated Sri Lanka and Muslim-dominated Pakistan and Bangladesh. These three countries now have higher per capita incomes than India and lack its caste system. Sri Lanka appears to have a substantially higher quality of life, although it suffers from an internal separatist conflict. The negative comparison has most frequently been made with India's largest and most important neighbor and rival, China, which has moved well ahead of India in per capita income and many measures of living standards.

But these negative characterizations may be overdrawn. Even in the 1980s, although its growth lagged behind that of most of the East Asian tigers, such as South Korea and Taiwan, it was among the top ten in the world. During the financial and economic crisis of 1997–1998 that rocked the most spectacular of the tigers, especially Thailand and South Korea, India was only modestly affected. China's growth rate slowed during that crisis and had trouble recovering. India's growth rate declined from 7.8 percent in 1996 to 4.8 percent in 1997 but jumped back to 6.5 percent in 1998, although it has been below 6 percent since 2000.[64] India may be gaining from its democratic political tradition that many had viewed as a drag, in contrast to China's authoritarianism. There is a well-established system of laws and transparent relations in the Indian economy, even with its continuing bureaucracy and restrictions, that contrasts favorably with China's situation. This will become more important as India opens and seeks foreign investment, while China seems increasingly difficult for foreign investors.

Fulfilling partly the Hindu nationalist ideal of decentralization, the states and regions of India are increasingly asserting themselves to implement reforms to improve the quality of life, such as the improvements in education and the status of women in the state of Kerala. Many states are growing rapidly, such as Karnataka, with its world-class software industry based in Bangalore. While some states, such as Bihar, are mired in deep poverty, social conflicts, and slow growth, more states are overcoming the obstacles holding India back. It is hoped that the states will extend the benefits of reform to the rural population as well as to the urban sector. India has long been viewed as a country of vast potential. That potential is now beginning to be seriously realized.

The elephant[65] has not only awakened; it has stood up and begun to walk resolutely. It is unlikely that it will sit down again.

QUESTIONS FOR DISCUSSION

1. What legacy did the British leave in India? Evaluate the benefits and costs of their Raj.

2. How has the indicative planning system in India compared with that in other countries?

3. To what extent is the Traditionalist element in India's economy more of the old or the new variety and why?

4. Evaluate the success or failure of India's policy of import substitution in its effort to industrialize after independence. Why was it so committed to such an approach?

64. Ahluwalia, "Economic Reforms in India," p. 68. For a comparison of India and China, see *The Economist* "Two Systems, One Grand Rivalry," June 21, 2003, pp. 21–23.

65. Appropriately enough, the Hindu god of fortune, Ganesha, is depicted as an elephant.

5. Evaluate the legacy and influence of the economic thought of Mohandas (Mahatma) Gandhi in India today.

6. How is the state of Kerala a model for the rest of India? How is it an example to avoid? Can these conflicting tendencies be reconciled, and if so, how?

7. Evaluate the role of rent-seeking in the establishment of the License-Permit Raj.

8. Can the Hindu nationalists successfully lead the movement for economic reform in India without compromising their principles?

9. Evaluate the pros and cons for economic policy and performance of political democracy in India.

10. What are the benefits and dangers of the drive toward regional decentralization of economic policy in India?

11. What is the status of women in India, and how does it affect the prospects for India's development? Can this status be changed, and if so, how?

12. Evaluate the role of the caste system in India's society and economy. Does it have any benefits?

13. Compare and contrast the economic policies and performance of China and India.

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TURKMENISTAN
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Caspian Sea
Tabriz
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Tehran
Mashhad
Qom
Bakhtaran
Esfahan
Birjand
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Yazd
Dezful
IRAQ
I R A N
Zabul
Ahvaz
Kerman
Zahedan
PAKISTAN
Shiraz
Bushehr
Bam
Bandar Abbas
SAUDI ARABIA
Persian Gulf

17 Iran: The Struggle for a New Traditional Islamic Economy

Islam provides for a balanced regime. My advice . . . is . . . do not be influenced either by the empty propaganda of the pillaging and oppressor pole of capitalism or by the atheistic and communist pole.
—Ayatollah Sayyed Ruhollah Mousavi Khomeini, *Imam Khomeini's Last Will and Testament,* 1990, p. 56

INTRODUCTION

The Islamic Republic of Iran is to Islam what the Soviet Union was to communism: the fountainhead of the international revolutionary movement.[1] The 1979 **Islamic Revolution** in Iran was the first overthrow of a modern secular leadership by a popular movement to establish a fundamentalist Islamic system. The Iranian Revolution's claim to universality has inspired similar movements throughout the Muslim world, despite theological differences between Islam in Iran and in most other countries. Furthermore, despite moves toward moderation in recent years, some of Iran's organizations fund fundamentalist movements, including groups that have engaged in terrorist acts such as the Hezbollah in Lebanon.

Thus Iran stands out as the most important example of practical Islamic economics, with intense internal debates resulting in policy shifts by the revolutionary regime. Despite many controversies, core elements of **Islamic economics** have been adopted in Iran, such as **interest-free banking.** While poor economic performance has weakened the appeal of the Iranian model for many observers, supporters of the revolution point to external shocks, from invasion by Iraq, to an economic embargo by the United States, to lower world oil prices, as contributing to Iran's economic difficulties over the past quarter of a century.

Despite its image as a role model and a revolutionary Islamic fountainhead, Iran is not typical of most Islamic nations. It is dominated by the **Shi'i** (also known as *Shi'ite,* a term considered to be insulting) branch of Islam, which differs from the more widespread Sunni branch. Shi'ism has traditionally been more revolutionary precisely because of its underdog position in the Islamic world relative to **Sunnism.** Some Sunni-dominated societies that are Islamizing their economies, such as Pakistan, have adopted more gradual and less radical approaches. Nevertheless, the Iranian Revolution influences radical Sunni movements in Algeria, Egypt, Palestine, Central Asia, and the fundamentalist Sunni government in Sudan, as well as Shi'i movements in Lebanon, Iraq, Saudi Arabia, the Persian Gulf emirates, Pakistan, and Afghanistan.

1. To compare the 1917 Bolshevik Revolution with the 1979 Islamic Revolution in Iran see Richard W. Cottam, "The Iranian Revolution," in N. R. Keddie and J. R. I. Cole, eds., *Shi'ism and Social Protest* (New York: St. Martin's Press, 1986), pp. 121–158. Some might argue that this position was filled for several years by Afghanistan under the rule of the *Taliban,* while it housed the *al Qaeda* movement led by Osama bin Laden. But that regime has been overthrown and never managed to develop a viable economic system. These movements are more properly labeled **neo-Old Traditional,** despite their desire to obtain modern weaponry, although al Qaeda has arguably taken the ideological lead as the most radical Islamic fundamentalist movement.

Iran is a major oil producer and a member of OPEC, which engineered the oil price shock of 1973.[2] At the time, Iran was second to Saudi Arabia as a producer in OPEC and had accumulated vast wealth. Yet this economic growth triggered inflation and increased income inequalities that helped fuel the 1979 revolutionary movement. Iran's importance in OPEC is illustrated by the fact that the second oil price shock in 1979 was not engineered by OPEC, but resulted from the collapse of Iranian oil production during the revolution.

THE REVOLUTIONARY TRADITION IN SHI'I ISLAM[3]

As recounted in chapter 4, the Sunnis and Shi'is split over the succession to the Prophet Muhammed as leader **(caliph)** of the Islamic community **(umma).** The Shi'is supported members of the Prophet's family, such as his son-in-law, Ali, and his grandson, Husayn, whereas the Sunnis supported nonfamily members for the political position of caliph. After the Shi'i defeat at the Battle of Karbala, they developed the notion of a spiritual leader, the **Imam,**[4] as a direct descendant of the Prophet Muhammed. The Imam *should* be caliph but might not be. The Prophet's son-in-law, Ali, was both the fourth caliph and the first Imam. Husayn was the third Imam, succeeding his older brother.

The branch of Shi'ism dominant in Iran and most numerous worldwide recognizes a line of 12 such Imams, thus known as the Twelver Shi'is.[5] The Shi'i Imams could extend the prophecy of Muhammed, thus making Shi'i law codes subject to ongoing revision by religious authorities, in contrast with Sunni ones.

When the eleventh Imam died in 874, his infant son, Mehdi, went into hiding. For 70 years his proclamations were issued by four successive messengers. Then Mehdi was declared to have gone into a state of supernatural suspension (*Occultation*) in which he is hidden from the world until the Day of Judgment, when he will return and bring about heaven on earth.

2. Within OPEC, predominantly Muslim members are Algeria, Nigeria, Libya, Saudi Arabia, Iraq, Iran, Bahrain, Qatar, the United Arab Emirates, and Indonesia, with Venezuela the leading non-Muslim member. Non-oil-producing nations with a large Muslim population (there are oil-producing Muslim nations not in OPEC, such as Oman, Egypt, Yemen, Azerbaijan, and Kazakhstan) include Bangladesh, India, Pakistan, Turkey, Uzbekistan, Malaysia, and Afghanistan.

3. For a history of Shi'i Islam see Moojan Momen, *An Introduction to Shi'i Islam: The History and Doctrines of Twelver Shi'ism* (New Haven, Conn.: Yale University Press, 1985).

4. In Sunni Islam an **imam** (not capitalized) leads Friday prayers at a mosque. This is distinct from the Shi'i **Imam** (capitalized), who is a supreme religious leader.

5. The *Zaydi* Shi'is of Yemen agree on only the first four Imams. The *Isma'ili* Shi'is recognize the first seven and thus are known as Sevener Shi'is. The Seveners historically generated the most economically redistributionist Muslim movements and societies, such as the *Qarmatians* of eastern Arabia in the 900s.

This doctrine underpins a messianic tradition in Twelver Shi'ism in which individuals periodically appear claiming to be either the **Hidden Imam** himself or his special messenger. The latter claim was the position of Ayatollah Ruhollah Khomeini, leader of Iran's Islamic revolution, although he was called *Imam* after the revolution.[6] As supreme lawgiver Khomeini created and took the title *Vilayat al-faqih,* Mandate of the Jurist, a position held by Ayatollah Sayed Ali Khamene'i since Khomeini's death in 1989. No one is now called *Imam* in Iran, with Khamene'i being known as *Rahbar* (leader).

Shi'i Islam has a more fully developed religious hierarchy that possesses greater influence over society than does Sunni Islam. The **zakat** (tithe to charity) goes to the **ulama** (religious authorities) for redistribution. Furthermore, the Shi'is collect an additional 20 percent income tax, the **khums,** that also goes to the ulama. In the ulama hierarchy under Imam or *Vilayat al-faqih,* the next rank is *Grand Ayatollah* and then *Lesser Ayatollah.* Below that is *Hojjat-el-Islam,* the rank held by former president Ali Akbar Hashemi Rafsanjani. His successor as president, Mohammed Khatami, is a member of the ulama but belongs to a still lower rank.

Another factor in Shi'ism's revolutionary attitude is its history of oppression by the Sunnis. In Iraq, Bahrain, and Lebanon, Shi'is outnumber Sunnis, but the latter are better off economically and politically dominant. This relatively inferior status dates from the defeat at Karbala; the Shi'is intense focus on martyrdom in memory of that defeat and Husayn's martyrdom of Husayn infuses their revolutionary fervor. Thus, on *Ashura,* the tenth day of the Islamic month of *Muharram* and the anniversary of Karbala, Shi'is publicly march, cursing the first three caliphs and sometimes flagellating themselves. On Ashura in December 1978, 25 percent of Iran's population was in the streets calling for the overthrow of the shah and the return of Imam Khomeini, the final blow to the shah's regime.

However, it must be noted that this revolutionary tradition leads to a paradox when Shi'ism comes to power, as it has in Iran. Because it is a religion of protest, Shi'ism tends to fail when in power. In the words of one observer, "As soon as it succeeds politically, it negates itself metaphysically. Its material success is its moral failure."[7]

In Iran, the official view on economic laws is still Khomeini's, as stated in his *A Clarification of Questions* (1984), even since his death. He agreed with the Sunnis on forbidding interest and supporting *zakat,* although the latter is voluntary and distributed by the ulama. Khomeini also supported the 20 percent income tax, or *khums,* for the ulama. He accepted land rent, sharecropping, and insurance, which made him more moderate than some Sunni Islamic economists. In general, he accepted private property.

6. Khomeini's sending cassette tapes from exile gave him an aura of the Hidden Imam. He exhorted the masses to martyrdom like those at Karbala, and demonstrating crowds called for the return of "Imam Khomeini."

7. Hamid Dabashi, "The End of Islamic Ideology," *Social Research* 67 (2000): 484.

Nevertheless, in 1979 Khomeini ordered the confiscation of properties owned by the former royal family and their associates. This signaled the ascension of **Islamic socialist** policies in line with those advocated by Ayatollah Taliqani,[8] and it accorded with Khomeini's call for redistributive justice and his denunciations of corruption in the shah's regime. Khomeini opposed economic domination by foreigners or non-Muslims, especially Americans and Israelis, a development that he saw as happening under the shah. Thus the confiscations ostensibly aided the poor in a just manner, and they asserted Muslim Iranian independence from imperialist domination by foreign non-Muslims. However, this confiscatory policy conflicted with the more pro-market capitalist views in many of Khomeini's writings, a conflict played out ever since, with a tilt away from the radical approach emerging later.

HISTORICAL OVERVIEW TO THE REVOLUTION

Iran's current territory largely coincides with that of the ancient seat of culture and civilization known as Persia.[9] Just over 2,500 years ago, Cyrus founded the Persian Empire, later the core of Alexander the Great's realm. After Alexander's death, successor states ruled from Persia until the Muslim conquest in 640, after which there was rule from outside for centuries by multinational Muslim empires.

In 1501, Isma'il, founder of the Safavid dynasty, proclaimed himself shah and established an empire with the modern borders of Iran. Isma'il was a Shi'i who claimed to be the Hidden Imam. He forced the previously Sunni Persians to convert to Shi'ism, thus establishing the still existing Shi'i ulama hierarchy.

The Qajar dynasty came to power in 1785. Soon afterward, control of Persia was contested by Great Britain and Russia. The ulama opposed cooperation with these powers, provoking a war with Russia in 1828 that Persia lost. In 1872 the British gained the Reuter

8. See Ayatollah Mahmud Taliqani, *Ownership in Islam,* trans. R. Campbell (Berkeley: Mizan Press, 1982). Taliqani's Islamic socialist positions reflect a well-developed vein of thought in Iran that draws on radical Shi'i views (Sohrab Behdad, "A Disputed Utopia: Islamic Economics in Revolutionary Iran," *Comparative Studies in Society and History* 36 [1994]: 775–813). Despite these traditions and efforts after 1979 to Islamicize, economic education in Iranian universities still largely follows American models (Sohrab Behdad, "Islamization of Economics in Iranian Universities," *International Journal of Middle East Studies* 27 [1995]: 193–217).

9. *Persia* became *Iran* in 1935 to emphasize the Aryan, or Indo-European, origins of the Persians. Its leader at that time, Reza Shah, was fascinated with the Nazi ideology of the *Aryan master race* and looked to Germany to offset British and Soviet domination. Shi'i Persians are about 60 percent of the population, and Shi'i Turkic Azeris are about 30 percent. Religious minorities include Sunnis; Baha'is, a group founded in Persia in the 1800s and greatly persecuted today; Christians; Jews; and Zoroastrians, adherents of the ancient Persian religion whose New Year at the vernal equinox is still celebrated in Iran, Kurdistan, and Afghanistan as *Nowruz,* although the Taliban regime attempted to suppress its celebration in Afghanistan.

concession, which granted them control over mines, the national bank, and railroad construction in Persia. It was cancelled a year later after agitation by the ulama. But there was no opposition to the **d'Arcy oil concession** in 1901, the first in the Middle East, out of which came the Anglo-Persian Oil Company, now British Petroleum, after oil was discovered there in 1908.

In 1906 some ulama combined with Western-oriented intellectuals to remove the Qajar shah in the Constitutionalist revolt, which developed a constitution modeled on Belgium's. Russian troops reinstated the Qajars in 1911. During World War I, both Britain and Russia occupied portions of Persia. This humiliation led to removal of the Qajars in 1925 by the military commander Reza Shah Pahlavi (born Reza Khan), who established the Pahlavi dynasty after becoming the new shah, which lasted until 1979.

Inspired by Kemal Ataturk's reforms in post-Ottoman Turkey, Reza Shah followed a secularizing and nationalist course. He forbade women to wear traditional Islamic garb in 1928, stripped the ulama of control of the courts in 1932, and reduced their control over the wealthy religious endowments **(waqfs)** in 1934. He built up a strong military and a strong centralized state that suppressed ethnic minorities.

Reza Shah also brought in German advisers to offset the influence of Britain and the Soviet Union. In 1941 the British and Soviets deposed him in favor of his son, Mohammed Reza Pahlavi, and occupied Iran's south and north, respectively. In 1946 the United States pressured the Soviets to withdraw from Iran.

Decades of British control of Iran's oil industry stimulated the reemergence of a nationalist democratic coalition led by Mohammed Mossadegh, a participant in the 1906 Constitutionalist revolt. Mossadegh became prime minister in 1951, nationalized the oil industry, and deposed the shah. In addition to liberal nationalists, his supporters included prominent ulama such as Ayatollah Taliqani, later dubbed the "Islamic socialist." In 1953 the American CIA and the British MI6 deposed Mossadegh, restored the shah, and put Iran's oil industry under the control of British Petroleum and several American companies.[10]

The shah followed U.S. foreign policy, joined the anti-Soviet Baghdad Pact of 1955, and maintained friendly, if covert, relations with Israel. Internally he established tight dictatorial control enforced by his secret police, SAVAK. The shah opened the country to foreign investment and angered the ulama by elevating to wealth and power members of religious minorities such as the Baha'is.

10. Known as Project Ajax, this coup remains controversial, with the British government refusing to release documents relating to it (Kermit Roosevelt, *Countercoup: The Bloody Struggle for Control of Iran* [New York: McGraw-Hill, 1979] and Daniel Yergin, *The Prize: The Epic Quest for Oil, Money and Power* [New York: Simon & Schuster, 1991], chap. 23). Recently declassified documents from the CIA indicate some differences from earlier accounts, accessible at http://cryptome.org.

In 1963 the shah initiated the **White Revolution** to modernize and Westernize the Iranian economy and society. A crucial element was land reform involving distributions to peasants from major landowners, including the religious endowments (*waqfs*). This triggered protests led by Ayatollah Khomeini, who was exiled to Iraq and then to Paris, from where he became the main opposition leader against the shah.

In 1973 the shah supported the first OPEC oil price shock, which enormously increased revenues and income for Iran. Much of the money went to state-sponsored industrial development, but much was also siphoned off by the shah's cronies. Inflation soared, resulting in the impoverishment of many Iranians, while a few became very rich. As broad-based opposition to the Pahlavi regime spread, the government's secret police intensified repression, which in turn triggered more opposition.

Opposition to the shah was broad-based, extending from the relatively disempowered landless peasants and the ulama through the bazaar merchants to government workers and the middle class. In January 1978, police fired on a pro-Khomeini demonstration by students in Qom, the religious center of Iran, and 70 people died. This event triggered a cycle of demonstrations and strikes every 40 days to memorialize those martyred. Civil unrest steadily escalated even after martial law was declared in September 1978. During Ashura demonstrations in December, millions were in the streets.

The shah left the country on January 16, 1979. On February 1, Khomeini returned to Tehran in triumph, welcomed by a crowd estimated at 2 million. The Islamic Revolution had achieved victory over the secular and corrupt monarchy.

IRAN'S ECONOMY BEFORE AND AFTER THE REVOLUTION

The Revolution after the Revolution

The victory of Iran's Islamic Revolution initiated a period of two and half years of intense power struggles, with serious violence erupting on all sides. Many of those arrested for opposing the new regime were then charged with being "Corrupters of the Earth" and were executed. Justification for such extreme measures heightened after Iraq, then led by Saddam Hussein, invaded Iran in September 1980, beginning a war that lasted until 1988, with about 1 million people killed on both sides.

During 1979, in the immediate aftermath of the shah's overthrow, the Revolutionary Council issued many radical economic proposals. Its members included the Islamic socialist Ayatollah Taliqani and his ally, Abolhassan Bani-Sadr, who became prime minister two days after Revolutionary Guards seized the American embassy in Tehran and took those inside hostage in early November 1979. U.S. President Jimmy Carter's failure to free the hostages became a factor in his defeat by Ronald Reagan in the 1980 presidential election.

A month later, in December 1979, the Islamic constitution was adopted that established the *Vilayat-al-faqih* (Supreme Jurist) concept. A legislative assembly (*Majlis*) was established, which was dominated by Islamic fundamentalists. The new constitution also called for a prime minister and a president, with Bani-Sadr elected to the latter post in January 1980. After more violence, he was replaced in 1981 by Ayatollah Ali Khamene'i, who remained president until Khomeini's death in June 1989, when Khamene'i succeeded Khomeini as *Vilayat-al-faqih.* Hojjat-el-Islam Ali Akbar Hashemi Rafsanjani was then elected president, and the position of prime minister was eliminated. In May 1997, a supporter of a more moderate version of **Islamism,** Mohammed Khatami, was elected president,[11] and in February 2000 a *Majlis* was elected with supporters of Khatami in control.

The Islamic constitution also mandates a body of 12 ulama, the **Council of Guardians,** who pass on the "Islamicness" of any legislation. In the struggle over economic policy this body became the bastion of pro–market capitalist forces, blocking a bill to nationalize foreign trade in 1982 and a land reform bill in 1983. It represented the interests of the urban bazaar merchants and of large landlords, including some ulama.[12] As of Khomeini's death, the Council of Guardians had vetoed approximately 48 percent of the bills passed by the assembly.[13]

We have identified five periods in economic policy since the revolution. First is the **First Radical Phase,** lasting from 1979 to 1981, that dates through the main postrevolutionary power struggle. This period saw a wave of nationalizations and confiscations, as well as proposals such as foreign trade nationalization and land reform, later blocked by the Council of Guardians.

The **Second Radical Phase** lasted from 1982 to 1984 and was marked by more emphasis on strictly Islamic policies, such as implementing interest-free banking rather than maintaining the more socialist-oriented policies of the previous phase. The role of the Council of Guardians, supported by Khomeini, was crucial. The indicative central planning inherited from the shah's regime was dismantled.

The period 1985–1989 was the **First Pragmatic Phase.** There were no major innovations in economic policy, but instead an opening to the outside world. A softening of the

11. An irony of the 1997 election is that Khamene'i prevented Rafsanjani from running for a third term as president out of fear of his perceived relative liberalism and was supporting the hardline speaker of the Majlis, Nateq-Nadoori, only to have the much more socially liberal Khatami win. In the 2000 Majlis election, Rafsanjani was viewed as the leader of the more conservative forces and refused to sit in the Majlis when his allies did poorly.

12. See Mansoor Moaddel, "Class Struggle in Post-Revolutionary Iran," *International Journal of Middle East Studies* 23 (1991): 317–343. A source of confusion for American commentators has been that the most anti-American groups in Iran have been the most promarket. Thus the American terms *radicals* and *moderates* have been confused.

13. Nader Entessar, "The Challenge of Political Reconstruction in Iran," in C. Bina and H. Zangeneh, eds., *Modern Capitalism and Islamic Ideology in Iran* (New York: St. Martin's Press, 1992), p. 229.

attitude toward the United States occurred under the pressure of the Iran-Iraq war. (Secret arms purchases from the United States led to the Iran-contra scandal in the United States.) During this period, real incomes declined and economic crisis set in.

The **Second Pragmatic Phase,** from 1989 to 1997, coincided with Rafsanjani's presidency. This phase was marked by some privatization of state enterprises and moves toward integrating into the world economy, including obtaining a loan from the World Bank in 1993, while maintaining Islamic economics internally and active support for fundamentalist Islamic movements abroad. However, Rafsanjani reintroduced a five-year indicative planning process that remains in place today.

The **Social Reform Phase** began with the ascension of Mohammed Khatami to the presidency in 1997. His policies have emphasized the rule of law and a relaxation of control of political discussion and social customs by the ulama and the security forces[14] while remaining broadly within an Islamic framework, although the conservative ulama have strongly resisted his policies. Economically, Khatami has continued Rafsanjani's efforts to open Iran to the world economy, and with more success. Internally there has been a consolidation of state control where it exists and few changes in Islamic economic institutions or practices. Arguably Khatami is seeking to truly establish the New Traditional Economy in Iran, given his attempts to combine modernization and globalization with continued adherence to Islamic law codes and economic practices.

The Economy of Iran Under the Pahlavis

In a sense, the Islamic Revolution did not fundamentally alter Iran's economy, which was dominated by the state sector, especially after the oil industry was nationalized in the early 1970s. Iran's economy ran on oil then and runs on oil now. Economically, the "revolution" was that a different group came to control this state-run oil machine.

State-led development dated from the 1920s with Reza Shah's nationalist drive for autonomous development. Using modest oil revenues, public enterprises were established in textiles, sugar, cement, iron, and steel; infrastructure was built up, and the state loaned money to tariff-protected private sector development in an import substitution industrialization strategy. In 1944 Mohammed Reza Pahlavi established comprehensive indicative central planning. From the late 1950s through the early 1970s, capital investment was almost evenly split between the public and private sectors, with the former concentrating on iron, steel, copper, machine tools, aluminum, and petrochemicals and the latter concentrating on finished metals, specialty steels, synthetic fibers, paper, automobile assembly, and sugar, some of these in joint ventures with foreign capital.

14. Khatami has been vigorously opposed by the judiciary and the secret police, with his political allies facing arrest, including elected Majlis members, despite his reelection as president by a larger margin. See "Human Rights Watch Report 2002: Middle East and North Africa: Iran" at hrw.org.

The 1973 oil price shock generated a surge of revenues into state coffers, and investment shifted toward the state sector. Whereas in the Fourth Development Plan (1968–1972) there were 141 billion rials of private investment and 146 billion rials of public investment, during the Fifth Development Plan (1973–1977) the respective figures were 319 billion and 734 billion rials.[15] By 1978 government spending was 43 percent of GNP, military spending was 10 percent of GNP, and 25 percent of the nonagricultural labor force was on the government payroll.[16]

Despite this industrialization, much of Iran's labor force remained in agriculture, dominated by sharecropping relationships between landless workers and absentee landlords, often ulama or religious organizations (*waqfs*).[17] After the shah's 1963 land reform a major rural-urban migration occurred, with the population becoming an urban majority by the 1980s.

The dominant feature of Iran's foreign trade has long been overwhelming dependence on oil exports. Even in the 1960s, the percentage of export earnings due to oil never fell below 85 percent. After the oil price increase of 1973 this percentage soared to 97 percent and stayed above 94 percent until oil prices dropped in 1986 (see table 17-2). That the percentage remains high after 1979 contradicts one of the goals of the revolution, which was to reduce this dependence on oil exports. But the 1980–1988 war with Iraq forced continued reliance on this source of hard currency. Table 17-1 shows Iranian oil production in relation to OPEC and world production over time, and table 17-2 shows oil exports, their percentage of total exports over time, and the average price of Iranian light crude oil. Although table 17-2 shows no figures after 1993, published reports note that petroleum exports continue to be well above 80 percent of Iran's exports.[18]

The surge in oil revenues after 1973 triggered double-digit real growth rates of GDP but also double-digit inflation rates. These combined with increasing income inequality to fuel the fires of revolutionary fervor that exploded in 1978. With strikes, the exodus of foreign technicians, and general upheaval, both oil production and GDP fell in the immediate aftermath of the revolution. Both grew again after 1981, only to decline in 1986, with GDP declining again in 1987 because of lower oil prices and under the pressure of the war, whose end saw a return to the growth of both. Inflation has remained at double-digit levels

15. See H. Razavi and F. Vakil, *The Political Environment of Economic Planning in Iran, 1971–1983* (Boulder, Colo.: Westview Press, 1984), p. 66.

16. Alan Richards and John Waterbury, *A Political Economy of the Middle East: State, Class, and Development* (Boulder, Colo.: Westview Press, 1990), p. 207.

17. There was a tradition dating from the Mongol invasions of insecure land tenure in Iran even among the wealthiest families. This led many to donate land to the *waqfs,* the charitable organizations controlled by the ulama, to avoid seizures by governments.

18. "Survey of Iran: Children of the Islamic Revolution," *The Economist* (January 18, 1997).

Table 17-1
Iran and OPEC, Shares of World Production

Year	World Total	OPEC Total	Iran Total	OPEC, % World	Iran, % World	Iran, % OPEC
1973	55.7	31.0	5.9	55.6	10.6	19.0
1975	52.8	27.2	5.3	51.5	10.0	19.5
1979	62.5	31.0	3.2	49.6	5.1	10.3
1980	59.4	27.0	1.7	45.4	2.9	6.3
1981	56.0	22.8	1.4	40.7	2.5	6.1
1982	53.2	19.0	2.2	35.7	4.1	11.6
1983	53.0	17.9	2.4	33.8	4.5	13.4
1984	54.2	17.9	2.2	33.0	4.0	12.3
1985	53.6	16.6	2.2	31.0	4.1	13.2
1986	55.9	18.7	2.0	33.4	3.6	10.7
1987	56.3	18.8	2.3	33.4	4.1	12.2
1988	58.5	21.0	2.2	35.9	3.8	10.5
1989	59.5	22.6	2.8	38.0	4.7	12.4
1990	61.2	24.3	3.1	39.7	5.1	12.8
1991	60.1	23.6	3.3	39.3	5.5	14.0
1992	60.2	24.9	3.4	41.4	5.6	13.6
1993	60.1	25.7	3.6	42.8	6.0	14.0
1994	61.0	25.5	3.6	41.8	5.9	14.1
1995	62.3	26.0	3.6	41.2	5.8	14.0
1996	63.7	26.5	3.7	41.5	5.8	13.9
1997	66.4	28.3	3.7	42.6	5.5	12.9
1998	66.9	28.8	3.6	43.0	5.4	12.6
1999	65.6	27.6	3.6	42.1	5.3	12.9

Source: U.S. Department of Energy, *Monthly Energy Review,* March 2000, tables 10.1a,b, pp. 136–137. Volume figures are in millions of barrels per day.

except in 1985 and 1990. The first Gulf War period saw a surge of oil exports and economic growth with a slowdown since then, although both surged again with the oil price increases in 2000 and afterward. Statistics on real GDP growth rates and CPI inflation rates are shown in table 17-3.

The Nationalization Question After the Revolution

Iran's state sector gained in the immediate aftermath of the revolution as the nationalizations and confiscations ordered by Khomeini took place. This ended with the removal of Bani-Sadr from office at the end of the First Radical Phase as the Council of Guardians asserted the right to private property. The policy trend in the Second Pragmatic Phase under Rafsanjani saw some privatizing of this state sector and even the opening of a stock exchange in 1990. However, this trend has largely ceased since Rafsanjani was replaced by Khatami, despite some rhetoric regarding economic reform.

Confiscations from the Pahlavi family and their retainers began in March 1979. These confiscations went to a body controlled by the ulama and some bazaar merchants known as

Table 17-2
Iranian Petroleum Exports

Year	Value of Petroleum Exports	Oil as % of Total Exports	Price in $ per Barrel of Iranian Light-34 API
1967	1.75	90.6	n.a.
1970	2.36	98.1	1.36
1973	5.62	90.5	2.11
1974	20.90	97.0	10.63
1975	19.63	97.3	10.67
1976	22.92	97.4	n.a.
1977	23.60	97.3	n.a.
1978	21.68	96.5	n.a.
1979	19.19	96.9	13.45
1980	13.29	94.2	30.00
1981	12.05	95.7	37.00
1982	19.23	99.0	34.20
1983	19.22	99.2	31.20
1984	12.26	98.7	28.00
1985	13.11	98.4	28.00
1986	7.20	88.9	28.05
1987	10.00	90.2	16.15
1988	6.04	88.0	13.26
1989	9.02	87.0	16.04
1990	13.42	94.0	20.64
1991	13.64	95.0	17.37
1992	13.26	n.a.	17.73
1993	11.98	n.a.	14.34
1994	n.a.	n.a.	14.18
1995	n.a.	n.a.	15.69
1996	n.a.	n.a.	19.32
1997	n.a.	n.a.	16.94
1998	n.a.	n.a.	10.76
1999	n.a.	n.a.	16.43

Sources: Value of oil exports, percentages of exports, and the price of crude oil through 1987 from Cyrus Bina, "Global Oil and the Oil Policies of the Islamic Republic," in C. Bina and H. Zangeneh, eds., *Modern Capitalism and Islamic Ideology in Iran* (New York: St. Martin's Press, 1992), p. 129. Exports for 1988–1993 are obtained by multiplying prices from Cyrus Bina, "Oil, Japan, and Globalization," *Challenge* 37 (1994): 47, by export volume figures from International Financial Statistics of the IMF. Percentage of exports for 1988–1991 from Hamid Zangeneh, "The Post-Revolutionary Iranian Economy: A Policy Appraisal," *Middle East Policy* 6 (1988): 127. Figures for 1991–1999 are constructed from International Financial Statistics and *Monthly Energy Review* tables.

the Mustaz'afan Foundation **(banyad),** or "Foundation of the Oppressed."[19] The proceeds were to aid the poor, especially in developing low-income housing projects. By 1981 the Mustaz'afan was managing 149 industrial units, 64 mining units, 472 agricultural units, 101 construction units, 25 cultural units, 238 commercial units, and 2,786 real estate

19. Scandals involving management of this foundation's funds led Khomeini to joke that "the foundation for the needy has turned into the foundation for the greedy."

Table 17-3
Iranian Real GDP Growth and Inflation Rates

Year	Real GDP Growth Rate	CPI Inflation Rate
1974–1975	6.9	14.7
1975–1976	2.6	12.8
1976–1977	12.1	10.9
1977–1978	11.1	27.6
1978–1979	−16.7	11.7
1979–1980	−6.0	10.5
1980–1981	−20.8	26.0
1981–1982	8.9	22.4
1982–1983	14.0	19.2
1983–1984	8.8	17.7
1984–1985	2.8	10.5
1985–1986	4.2	4.1
1986–1987	−8.1	20.8
1987–1988	−0.1	27.8
1988–1989	2.2	28.9
1989	3.3	22.4
1990	11.7	7.6
1991	11.4	28.2
1992	5.7	31.0
1993	0.2	35.8
1994	0.7	36.4
1995	4.3	49.7
1996	6.7	28.9
1997	3.6	17.1
1998	1.8	19.4
1999	n.a.	21.0

Source: Data through 1988–1989 from Adnan Mazarei, Jr., "The Iranian Economy under the Islamic Republic: Institutional Change and Macroeconomic Performance (1979–1990)," Working Paper 616s, Department of Economics, UCLA, 1991, table 4, constructed from data from the Central Bank of the Islamic Republic of Iran. The years are according to the Iranian calendar, for which years begin on March 21. For 1989–1999 data are constructed from International Financial Statistics of the IMF.

units.[20] In 1985 the Council of Guardians ordered the return of 180 of these to their original owners. Arguably the large role of the *banyads* resembles that of the monasteries and other church-controlled economic institutions in medieval Europe.

In June 1979 all banks and insurance companies were nationalized. In July a comprehensive nationalization law was passed that established the Organization of Nationalized

20. Mehrdad Valibeigi, "Islamization of the Economy: The Post Revolutionary Iranian Experience," Ph.D. thesis, 1991, Department of Economics, American University. Although Mustaz'afan is the largest and wealthiest, there are other such foundations, or *banyads.* Some aid the international Islamic revolutionary movement by offering a bounty of several million dollars for the assassination of the novelist Salman Rushdie and funneling millions of dollars to Muslim opposition groups in Algeria and other countries (Gary Sick, "The Two Faces of Iran: Rafsanjani's Moderation, the Mullahs' Holy Terror," *Washington Post,* April 4, 1993, pp. C1–C2). This has apparently continued even since the accession of Khatami to the presidency.

Industries (ONI), which was to run the nationalized firms. A total of 580 firms in nine categories were affected: food, electricity and appliances, construction equipment, textiles, pharmaceuticals, shoes and leather, paper and wood, chemicals, and cement. Besides firms viewed as crucial to the economy, those nationalized were either set up by families connected to the shah or had liabilities to the banking system exceeding their assets. In 1990 the government offered minority shares for sale in 400 state-owned firms.[21]

The Islamic constitution, passed in December 1979, mandated public control of all major industries, foreign trade, major mines, banking, insurance, power, dams, major irrigation systems, air, sea, land, and railroad transport. In 1980 the government attempted to nationalize control of foreign trade, of which it already controlled about 40 percent. Legislation mandating such control was passed, but was declared to be in nonconformity with Islam by the Council of Guardians because it would take away the rights of merchants and establish a state monopoly. Eventually, in 1984, compromise legislation was passed in which the state would import necessary goods, while the remainder would be privately controlled.

The Land Question since the Revolution

In late 1979 the Revolutionary Council decreed that confiscated, unclaimed, uncultivated public lands possessed by private agencies, as well as certain scattered woodlands and pastures, would be available for redistribution. In 1980 a bill to eliminate leasing and sharecropping passed that limited private farm sizes to three times necessary to support a family and that turned large-scale mechanized farms into cooperatives. A committee of seven members was to redistribute land. Between April and November 1980, they redistributed slightly over 1 million hectares of land out of 14 million arable hectares in Iran. Then Khomeini suspended the law and the committee under pressure from the grand ayatollahs and large landlords. A more moderate bill was passed in December 1982, but it was rejected by the Council of Guardians in January 1983.

An urban land law was passed in 1982 that was upheld by the Council of Guardians. It nationalized uncultivated land, land with unknown ownership, and portions of parcels more than 3,000 square meters in size. The goal was to develop housing for the poor, and the amount of investment in construction doubled between 1978 and 1983, whereas investment in mining and industry fell sharply during the same period.[22] But this program has not led to expanded housing and has become bogged down in bureaucracy and corruption.[23]

21. Valibeigi, "Islamization of the Economy," pp. 76–79.

22. Valibeigi, "Islamization of the Economy," p. 157.

23. Ali A. Kiafar, "Urban Land Policies in Post-Revolutionary Iran," in C. Bina and H. Zangeneh, *Modern Capitalism and Islamic Ideology,* pp. 235–256.

Postrevolutionary Labor-Management Relations

Many Islamic economists argue (see chapter 4) that cooperative workplace relationships are preferable to the standard hierarchical boss-worker pattern. During the revolution, workers' councils spontaneously appeared in some industries. Many called for nationalizing their particular industries, and when this occurred, the councils were often disbanded. In some industries, notably oil, the councils supported Marxist opponents of the government and were violently suppressed.

Provisions for **Islamic workers' councils (*Shourahs*)** were promulgated in 1980. But when more restricted legislation was passed in December 1982, it was rejected by the Council of Guardians. A temporary labor law was passed in 1991, but it leaves even less scope for workers' councils. Thus this aspect of Islamic economics has been replaced by a more standard approach after an attempted beginning.

Interest-Free Banking in Iran

As noted in chapter 4, eliminating interest **(riba)** is probably the most distinctive feature of Islamic economics. Iran became the first modern Islamic state to implement nationwide interest-free banking, since followed by Pakistan and Sudan. This was carried out in two stages.

First, in February 1980, the Supreme Council of Money and Credit was formed, and it passed a resolution calling for eventual abolition of all interest. As a preliminary step, it replaced interest in banking transactions with "service charges" and set service charge rates for particular kinds of loans and accounts. This was criticized by radical Islamic elements as superficial.

But fears of complete Islamization led to a panic among depositors in late 1980, when Iraq invaded Iran, and long-term savings accounts dropped by about 15 percent from 1980 to 1981.[24] This forced Khomeini to declare that banks' giving monetary so-called prizes to depositors was Islamically legitimate. This implies a varying return, as the prizes contain an element of randomness, not unlike many Western bond funds.

The second stage was implemented in 1983 with a comprehensive Law of Interest-Free Banking. Interest on short-term deposits was eliminated. Long-term accounts could share in profits from loans. This led to a dramatic shift from short-term to long-term accounts after 1983, as shown in figure 17-1.

The 1983 law also granted the Central Bank of Iran the right to determine the overall volume of credit expansion, possible rates of return for certain kinds of partnerships and lease arrangements, service charge levels, and ranges for credit in the various allowed forms of profit-sharing arrangements. In July 1990 the Central Bank used an increase in the

24. Valibeigi, "Islamization of the Economy," p. 143.

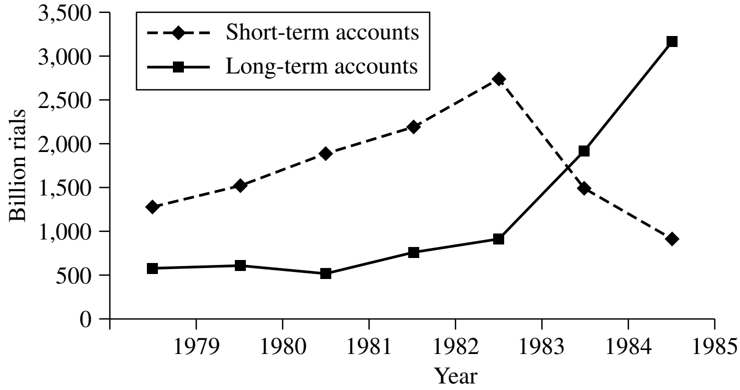

Figure 17-1
Short-term and long-term bank accounts in Iran.

allowed rates of return as a contractionary monetary policy to sop up excess liquidity and combat accelerating inflation.

As noted in chapter 4, the majority of loans by Iranian banks look more like interest arrangements than profit-sharing arrangements. Many argue this is essentially a semantic issue, whereby the term *interest* is replaced by the term *profit.* However, the banks are essentially business partners with their customers rather than lenders under this system, especially given the lack of deposit insurance. Furthermore, also as noted in chapter 4, Iran has managed to maintain a noticeably higher percentage of the loans in its Islamic banks that follow the more properly Islamic profit-sharing **mudarabah** form than have other countries with extensive Islamic banking systems.[25]

Certainly, an important change in Iranian banking was the nationalization of the banks in 1979 and the state direction of investment that resulted, although a privately owned bank was allowed to open in 2002. This state direction cut investment in industry and mining and increased it in construction. This shift might have occurred anyway, but it reflects the social emphasis on housing construction and reconstruction as war damage by Iraq escalated. This may mean that not only the issue of Islamic banking but more broadly that of Islamic economics is secondary to the conflict between capitalism and socialism (private versus nationalized banking). This continuing conflict is just what some Islamic economists point to in disputing that Islamic economics represents a superior Third Way between capitalism and socialism.

25. See Rajesh K. Aggarwal and Tarik Yousef, "Islamic Banks and Investment Banking," *Journal of Money, Credit, and Banking* 32 (2000): 102. In the late 1990s, de facto real interest rates were negative, leading to a fall in capital investment (Jahangir Amuzegar, "Iran's Post-Revolution Planning: The Second Try," *Middle East Policy* 8 [2001]: 25–42).

Box 17-1
Policies Toward Women and Family Planning

The shah's 1963 White Revolution granted women the right to vote, their family law rights were strengthened in 1967, and they were not subject to Islamic dress codes from the 1920s. Women were allowed to enter a variety of professions, and many did so. Educational opportunities expanded as female adult literacy rose from 17 percent in 1970 to 30 percent in 1980, compared to that of men at 55 percent in 1980.*

With the Islamic Revolution, sexual segregation in education, employment, and public activity was decreed. Birth control and abortion were forbidden. A strict dress code was imposed, violation of which was punishable by up to 74 lashes of a whip.[†] These restrictions continue with some relaxation since 1990 in employment, where women may now work in several previously forbidden areas, and in family planning and birth control. However, unhappiness of women was a major factor in the election of Khatami in 1997, and he has allowed expansion of political and feminist expression in the media.[‡]

Between 1965 and 1980 the population growth rate of Iran was 3.1 percent per year, a high rate implying population doubling every 23 years. Between 1980 and 1990 this rate accelerated to 3.6 percent per year, one of the highest in the world, implying a doubling time of less than 20 years.[§] This reflects the impact of Islamization on women and the pressure on them to stay home and have children.

This made it harder to raise real per capita incomes as the dependency ratio increased. Although real GDP rose in most years since the revolution, real per capita income steadily fell in U.S. 1988 dollars from 7,988 in 1980 to 7,252 in 1985 to 6,132 in 1988[″] to 5,280 in purchasing power parity (PPP) terms in 1992.[¶]

After some initial hesitation and a period of study,** Iranian policymakers, backed by a late decision by Ayatollah Khomeini, moved to implement a vigorous birth control policy, which has sharply lowered the population growth rate to 1.4 percent per year. The contraceptive prevalence rate for 1990–1998 was 73 percent compared with only 15 percent for Pakistan, a sharp contrast with the policy of the 1980s.[††]

*Alan Richards and John Waterbury, *A Political Economy of the Middle East: State, Class, and Development* (Boulder, Colo.: Westview Press, 1990), pp. 88, 113.

[†]Ann Elizabeth Mayer, "The Fundamentalist Impact on Law, Politics, and Constitutions in Iran, Pakistan, and the Sudan," in M. E. Marty and R. S. Appleby, eds., *Fundamentalisms and the State: Remaking Polities, Economies, and Militance* (Chicago: University of Chicago Press, 1993), pp. 115–116. Traditional Iranian Shi'i clothing for women is the *chador,* a black garment that completely covers the body except for the eyes, which is also worn in Afghanistan in zones following strict Islamic rules.

[‡]Afsaneh Najmabadi, "Feminism in an Islamic Republic: 'Years of Hardship, Years of Growth'," in Yvonne Yazbeck Haddad and John L. Esposito, eds., *Islam, Gender, and Social Change* (Oxford: Oxford University Press, 1988), pp. 59–84; Azadeh Kian-Thiébaut, "Political and Social Transformations in Post-Islamist Iran," *Middle East Report* 212 (1999): 12–16; and Maryam Poya, *Women, Work and Islamism: Ideology and Resistance in Iran* (London: Zed Books, 1999).

[§]World Bank, *World Development Report 1992* (New York: Oxford University Press, 1992), table 26, p. 269.

[″]*Statistical Abstract of the United States 1991* (Washington, D.C.: USGPO, 1991), table 1446, p. 841.

[¶]World Bank, *World Development Indicators Report 1994* (New York: Oxford University Press, 1994), table 30, p. 221. This figure may not be comparable with the others.

**A 1992 personal communication from Ralph Andreano, who represented the World Health Organization on a mission to Iran. This policy has been reinforced by worsening environmental conditions in Iran, as noted in N. Patrick Peritore, "Iran: From Revolution to Ecological Collapse," in *Third World Environmentalism: Case Studies from the Global South* (Gainesville: University of Florida Press, 1999), p. 209.

[††]United Nations Development Program, *Human Development Report 1999* (New York: Oxford University Press, 1999), Table 16, p. 199. This UNDP report also shows evidence that the economic status of women relative to men is about the same as the global average, according to the gender-related development index (GDI) compared to the human development index (HDI), with improved adult female literacy rates (65.8 percent compared to 80.7 percent for men in 1997) being an important factor. However, the social and political status of women in Iran is still relatively low, as measured by the gender-empowerment index (GEM).

Table 17-4
Measures of Household Expenditure Inequalities

Year	Quintile Ratio (Urban)	Gini Index (Urban)	Quintile Ratio (Rural)	Gini Index (Rural)
1977	14.7	0.4998	9.4	0.4375
1979	12.9	0.4702	11.7	0.4789
1980	9.1	0.4040	n.a.	n.a.
1982	10.6	0.4168	8.5	0.4051
1983	12.2	0.4282	10.7	0.4161
1984	11.4	0.4205	11.3	0.4293
1995	n.a.	0.4300	n.a.	0.4300
1999	n.a.	0.4500	n.a.	0.4500

Sources: For 1977–1984 from Sohrab Behdad, "Winners and Losers of the Iranian Revolution: A Study in Income Distribution," *International Journal of Middle East Studies* 21 (1989): 327–358, tables 5 and 8; for 1995 and 1999 from Jahangir Amuzegar, "Iran's Post-Revolution Planning: The Second Try," *Middle East Policy* 8 (2001): 36. Only a nationwide figure is available for each of the latter two years.

THE DISTRIBUTION OF INCOME

A driving force of Iran's revolution was resentment of the increasing income and wealth inequalities in the 1970s. This fed the Islamic demand for social justice and supported the "Islamic socialist" trend in power in the immediate aftermath of the revolution. Despite the disruptions and economic decline after the revolution, increased equality of income was one initial success. But inequalities have since reemerged, possibly to a greater level than before the revolution.

Table 17-4 presents measures of inequality of household expenditures, as accurate data on incomes are unavailable.[26] For both urban and rural households, quintile ratios and Gini indexes are presented for selected years. These quintile ratios are the ratios of household expenditures by the richest 20 percent of the population to that by the poorest 20 percent. For the Gini index, a higher value indicates greater inequality.

Most reductions in inequality occurred early after the revolution, although in rural areas there was initially an increase in inequality before a reduction. In urban areas, the main factors were sharp reductions in the incomes of wealthy individuals because of the confiscations and nationalizations of 1979–1981 and an increase in income for the working class from an increased minimum wage. Also, the income tax code became more progressive. Since the end of the First Radical Phase, a trend toward greater inequality has reemerged, which was continuing in the late 1990s.

The initial increase in inequality in rural areas coincided with agricultural price hikes in 1978 and 1979 that were taken advantage of by large-scale farmers. These higher relative

26. Since such data do not account for savings, they tend to overstate any degree of equality.

prices persist, causing an improvement in rural incomes relative to urban incomes, although the latter are still about twice rural incomes in per household terms. Less dramatic than in urban areas, the movement toward equality was probably due to the 1980 land reform redistributions before Khomeini and the Council of Guardians halted them. There has been a drift back toward greater inequality, as in the urban areas.[27]

Since the 1979 revolution the college educated have been relative losers, whereas the illiterate have been relative gainers in the income distribution. An obvious, if unproven, hypothesis is that the highly educated are less religiously devout than the illiterate. However, a positive correlation remains between educational level and income in Iran.[28]

Macroeconomic Imbalance, Rent-Seeking, and Economic Reform

Given the fall in oil prices in 1986, pressures of the war with Iraq, the largest inflow of refugees of any nation in the world during the 1980s (especially from Afghanistan), and trade sanctions and investment restrictions by the United States, added to the general revolutionary upheaval, serious macroeconomic imbalances emerged in Iran. In the late 1980s inflation accelerated (see table 17-3), the current account balance went into deficit, and the budget deficit sharply increased. Nevertheless, until April 1993, the government refused to devalue the rial against foreign currencies (it was pegged to the IMF's Special Drawing Right [SDR]) and tried to deal with the external imbalance by *import compression* through very strict tariffs and quotas. The outcome of this policy was summarized by Hashem Pesaran:[29]

> The result has been rising domestic inflation, a surge in rent-seeking activities at the expense of production, promotion of corruption, misallocation of resources from manufacturing to trade and distribution, and a significant policy bias against investment.

It is inaccurate to blame these disorders on the Islamization of Iran's economy. Rather, these problems arose from stubborn pride regarding the value of the rial in the face of shocks and disruptions and hostility from much of the outside world, which beyond a

27. This trend continued in both areas at least up to 1989. Mehrdad Valibeigi ("Distributive Justice under the Islamic Republic of Iran," paper presented at the Eastern Economic Association meetings, Boston, 1994, tables 1 and 2) finds the percent share of household expenditures in the richest fifth to have been 69.74 in 1977, 54.43 in 1984, and 60.43 in 1989 in urban areas and 49.83 in 1977, 47.96 in 1984, and 55.17 in rural areas. It is striking and curious that, in contrast to most of the world's governments, that of Iran has not made publicly available to such bodies as the United Nations or the World Bank any studies of income distribution. The figures reported by Amuzegar for 1995 and 1999 in table 16.4 are from a report by the Iran Plan Organization. This report also shows that 20 percent of the people own 80 percent of the wealth and that the decile ratio in 1999 was 31:1.5 (Amuzegar, "Iran's Post-Revolution Planning," p. 36).

28. Sohrab Behdad, "Winners and Losers of the Iranian Revolution." *International Journal of Middle East Studies* 21 (1989): 327–358.

29. M. Hashem Pesaran, "The Iranian Foreign Exchange Policy and the Black Market for Dollars," *International Journal of Middle East Studies* 24 (1992): 119. Further discussion of the foreign exchange problems of Iran in this period is found in Adnan Mazarei, Jr., "The Iranian Economy under the Islamic Republic: Institutional Change and Macroeconomic Performance (1979–1990)," *Cambridge Journal of Economics* 20 (1996): 289–314.

certain point introduced distortions that became self-feeding. Ultimately the problem originates with Iran's history as a major oil exporter and its inability to adjust to lower oil prices and reduced oil markets. Nevertheless, there has been a substantial sectoral reallocation of resources toward trade (especially that trade controlled by the bazaar merchants) and away from industry.[30]

A measure of the overvaluation of the rial is the ratio of the black market price for U.S. dollars compared to the official price. The gap steadily increased to about 5:1 around 1982 and then fell back a bit but took off again in 1984. In November 1989 it reached a level of almost 20:1.[31]

Overvaluation made it difficult for any industry to compete with foreign producers despite extensive protectionism. This reinforced the dependence of the economy on oil exports for hard currency earnings, even as the market for oil continued to lack strength, although this situation changed at least in 2000 and the next few years. Access to imports depended on obtaining appropriate licenses from government officials, allowing a classic setup for corruption and rent-seeking.

The extreme difficulties of 1989 led the Rafsanjani government to introduce multiple exchange rates as the Second Pragmatic Phase began. This meant that different kinds of international transactions occurred at different exchange rates to stabilize the balance of payments. Combined with the world embargo against Iraq after the 1990–1991 Gulf War, which increased Iran's oil export market, economic conditions improved for a while in Iran, with inflation falling, per capita income rising, and capital investment rising. This improvement ended in 1993 with a renewed outburst of inflation and continued weakness in oil prices. The government loosened import restrictions and let the rial float, which led to a fall by more than half against the U.S. dollar. But conditions simply worsened, and in 1994 restrictions were reimposed on imports, multiple exchange rates were reintroduced, and plans to remove subsidies to various groups and to sell off assets owned by religious foundations (*banyads*) were shelved. Despite Rafsanjani's rhetoric of privatization and reduced government, the share of GDP in government expenditures actually rose from 17 to 24 percent between 1990 and 1993.[32]

The Five-Year Plan of 1995–2000 promised the privatization of money-losing SOEs, the removal of monopoly power by the economically powerful *banyads* and the more general liberalization of trade, streamlining of the bloated bureaucracy, and the unification of the

30. Nations that export large quantities of a primary resource find it difficult to develop or maintain industry because their export earnings drive up the value of their currency, making it difficult for industry to compete and survive. This phenomenon is called the *Dutch disease,* following events in the Netherlands when major natural gas reserves were discovered.

31. Pesaran, "The Iranian Foreign Exchange Policy and the Black Market for Dollars," p. 116.

32. Hamid Zangeneh, "The Post-Revolutionary Iranian Economy: A Policy Appraisal," *Middle East Policy* 6 (1998), table 7, p. 119.

foreign exchange rates. Similar goals were promised for the next Five-Year Plan as well.[33] However, neither Rafsanjani nor his successor, Khatami, achieved any of these goals in any significant way. Indeed, rather than reducing the number of foreign exchange rates, Khatami was forced to increase them from three to four in 1997, which increased the scope for rent-seeking activities by those able to arbitrage across the transactions allowed under the different exchange rates.[34] However in 2002 the Central Bank, with Khatami's support, was able to reunify the exchange rates into a single one. Also, a single privately owned bank was allowed to open, which reportedly offers lower effective interest rates, while still being officially Islamically acceptable, than the state-owned banks.[35]

Ultimately the policy flip-flops of the Rafsanjani regime reflected an ongoing conflict between the radical fundamentalist ulama, who seek world revolution and isolation from the world economy, and a more pragmatic group seeking renewed economic growth through market-oriented reintegration into the world economy. In addition to this conflict over the distribution of income is the fear that privatizations and market-oriented reforms will simply worsen an already highly unequal income distribution. This latter fear has played a major role in the reluctance of Khatami to carry out such policies.[36]

The one area where Khatami has followed through more than Rafsanjani is that of opening Iran's economy to the rest of the world. Probably his most dramatic single economic endeavor was to allow foreign investment in the oil industry. It was a major diplomatic coup for Khatami that the United States relaxed its embargo enough to permit subsidiaries of U.S. oil companies located in other countries to participate in these deals, even as the general U.S. economic embargo against Iran remained in place.[37] However, in early 2000 the United States also relaxed some trade restrictions, allowing imports of caviar and pistachios

33. Bijan Khajehpour, "Domestic Political Reforms and Private Sector Activity in Iran," *Social Research* 67 (2000): 577–598.

34. Jahangir Amuzegar, "Khatami's Iran, One Year Later," *Middle East Policy* 6 (1998): 90. The Second Development Plan (1995–2000) also promised various liberalizing moves that did not take place. Observers argue that this plan was a failure, as output targets were not met, with actual GDP growing at an annual rate of 3.8 percent compared to a target growth rate of 5.1 percent for the period (Amuzegar, "Iran's Post-Revolution Planning: The Second Try," p. 30).

35. "A Survey of Iran: God's Rule or Man's?" *The Economist* (January 18, 2003).

36. It has been argued that during the Khatami presidency there has been a conflict within the economic decision-making bureaucracy between statist and populist-oriented "control freaks" from the wartime cabinet of Prime Minister Mussavi and then-President Khamene'i and technocratic market-oriented "IMF-World Bank disciples" inherited from the Rafsanjani regime. It may be that Khatami has favored the former in some areas partly to retain the support of Khamene'i for some of his political and socio-cultural liberalizations (Amuzegar, "Khatami's Iran, One Year later"). However, the 2000–2005 Five-Year Plan calls for more privatization and deregulation, as well as an increase in the rule of law and development of non-oil industries ("God's Rule or Man's?" *The Economist,* p. 12).

37. Relations became especially warm during the height of the war against the Taliban in Afghanistan, when Iran supported American efforts. But with the defeat of the Taliban, more traditional hostility resurfaced, with the United States labeling Iran part of an "axis of evil" because of its pursuit of nuclear weapons and the continued support of terrorist groups by its *banyads.* This hostility has worsened since the fall of Saddam Hussein in Iraq.

from Iran. This reflected the improved relationship between Iran and the rest of the world as Khatami emphasized a policy of "discussion between civilizations," an obvious reference to Samuel P. Huntington's famous forecast of a "clash of civilizations."[38]

The one thing that Khatami has not proposed is any change in core Islamic economic institutions such as *zakat,* or interest-free banking. Iran's economy may be opened up and possibly even reformed and modernized in various ways. But for the time being it will remain a traditional Islamic economy and, perhaps even more emphatically, a New Traditional Islamic one.

IS IRAN THE MODEL FOR THE NEW TRADITIONAL ISLAMIC ECONOMY?

Is a New Traditional Islamic economy really possible, and is Iran the model for it? There is no simple answer to this question, as the discussion above should indicate. Yet, for better or for worse, Iran *is* the fountainhead of the international movement for Islamic society and economy, a significant material and spiritual supporter of radical factions of this movement, with the one exception being Afghanistan during the Taliban period. But in the longer run, Iran may not be the role model it is now for those societies that attempt this particular experiment in the future.

A major reason is the Shi'i character of Iran's revolution, which is responsible for at least two peculiar aspects. One is that Iran is ulama-dominated; it is a theocratic state ruled by the *Vilayat-al-faqih,* supported by ulama control of the *zakat* and of the economy more directly through the *banyads.* The Sunni tradition emphasizes more "separation of church and state."[39] Rather than arbitrary promulgations of law codes by Supreme Jurists, the Sunnis accept existing *Shari'a* (Islamic) law codes and demand that nonclerical heads of state, whether hereditary monarchs, usurping military dictators, or democratically elected presidents, adhere to and enforce those codes. If they do not, then they can be overthrown by the Islamic movement. But the Sunni hierarchies, less wealthy and powerful than the Iranian Shi'i one, do not demand direct power *for themselves.* Clearly, much of the popularity of Khatami has had to do with his efforts to make Iran more like the Sunni states in this regard, emphasizing a strong adherence to the rule of law rather than to arbitrary rule by out-of-control religious and security entities, although his inability to do much against these groups has undermined his popularity.

Second, within Islam the history of oppression and grievance of the Shi'is has led them to more of a redistributionist radicalism, as expressed in the Islamic socialism of the First Radical Phase immediately after Iran's revolution. Given the general discrediting of world socialism and the less aggrieved position of the traditionally dominant Sunnis, they are less inclined to Iranian-style radicalism.

38. Samuel P. Huntington, "The Clash of Civilizations," *Foreign Affairs* 72 (Fall 1993): 22–49.

39. It is argued that this aspect reduces Iran's appeal as a model even among Shi'i populations in Arab nations. See Graham E. Fuller and Rend Rahim Francke, "Is Shi'ism Radical?" *Middle East Quarterly* 7 (2000): 11–20.

However, the anti-Western and antineocolonialist sentiments in much of the Islamic world give credence to the strong position taken by Iran and account for its increasing influence on many Sunni fundamentalist movements. The Shi'is sense of oppression allows them to articulate more clearly the frustrations and anger of many throughout the Islamic *umma.*

But more moderate role models exist, some arguably more Islamic, that may eventually be more influential than Iran on Islamic economic experiments in the future. Among these are the predominantly Sunni nations of Saudi Arabia and Pakistan (box 17-2). The former is highly influential because of its vast oil wealth, its position as the site of the Muslim holy cities of Mecca and Medina, and its long adherence to the strict *Hanbali* law code. It practices state-gathered *zakat* but not does not enforce interest-free banking.

But Saudi Arabia's wealth and its long dependence on the United States for protection against Iraq and other enemies have made it suspect among Islamic radicals. The Saudi monarchy is antirevolutionary and among the most reactionary regimes in the world. Thus, while it inspires a certain respect, it also inspires contempt among global Islamic

Box 17-2
Pakistan: The Most Authentic Islamic Economy?

A serious, if less dramatic, model is Pakistan. As noted in chapter 4, many Islamic economists have been of Pakistani origin. In the modern world, Pakistan was the first state specifically established as an Islamic state, although its founders sought a secular system of governance. Its approach to Islamization has been quieter and more gradual than Iran's, but it may have a more truly Islamic economy. Given its Sunni orientation, these achievements may make it more influential in the long run with the majority of Islamic nations.

Since gaining independence in 1947, Pakistan has alternated between democratically elected governments and military dictatorships. It has experienced wars with neighboring India, the loss of its former province of East Pakistan in 1971 (now Bangladesh), and considerable internal ethnic and religious strife, much of the latter between majority Sunnis and minority Shi'is. Not being an oil producer, Pakistan has remained at a lower level of per capita income and economic development than has either Iran or Saudi Arabia, but it has avoided the wide fluctuations in growth rates that those countries have experienced. Its record has been one of real but slow and steady economic growth, albeit marred by reportedly high levels of corruption.*

In 1980, influenced by Iran's revolution, the military dictator, Zia al-Huq, declared Islamization the official policy of the country. Despite backsliding under the rule of Benazir Bhutto, it remains so. Its implementation has been more gradual than in Iran, not socialist but arguably more complete. In 1999, a military coup reinforced the Islamic trend and the kinds of subterfuges and superficialities seen in other countries.† It has not engaged in widespread nationalizations; it has introduced an anticorruption campaign, along with a more vigorous confrontation with India over the province of Kashmir and in their nuclear weapons competition.

In contrast to Iran, Pakistan has a state-managed zakat system. In contrast to Saudi Arabia, it has a full-blown Islamic banking system, although subject to the sa, or confiscations. Aside from supporting the Taliban in neighboring Afghanistan prior to the September 11, 2001, terror attacks and Muslim separatists in neighboring Kashmir, Pakistan has largely avoided proselytizing its system abroad. Unfortunately, its conflict with India over Jammu and Kashmir could lead to a nuclear war between the two nations.

*See William Easterly. "The Political Economy of Growth without Development: A Case Study of Pakistan," in Dani Rodrik, ed., *In Search of Prosperity: Analytic Narratives on Economic Growth* (Princeton, N.J.: Princeton University Press, 2003), pp. 439–472.
†See Peter A. Cornelisse and Wouter Steffelaar, "Islamic Banking in Practice: the Case of Pakistan," *Development and Change* 26 (1995), pp. 687–699 for details of Pakistan's Islamic banking system.

revolutionaries, and it faces an internal ultrafundamentalist opposition movement that produced Osama bin Laden and many of his followers in the al Qaeda movement. Among al Qaeda's central demands has been removal of the U.S. military presence from Saudi Arabia. This presence was enormously increased after the first Persian Gulf War, in which Saddam Hussein's Iraqi invasion of Kuwait threatened the Saudi regime, but most of those troops have been removed since the overthrow of Saddam Hussein.

Thus Iran is the most prominent global role model for would-be Islamic economies, despite its peculiarities and idiosyncracies. Ultimately, the current regime must deal with its own contradictions. It has been pulled in the direction of the global market economy, especially in recent years, being partially released from international ignominy by Saddam Hussein's actions in Iraq and the extremism of al Qaeda and the Taliban in Afghanistan, coupled with the more moderate rhetoric of Khatami. However, since Saddam Hussein's fall Iran has faced increased hostility from the United States, especially over its reported nuclear weapons program. Iran's vast oil resources, its base of industry, and its educated entrepreneurs offer great potential for economic growth.

Despite political gains by reformers at the ballot box, Iran's pragmatists are in conflict with the firmly entrenched ulama, who adhere to Khomeini's vision of Iran as the fountainhead of the general Islamic Revolution. Any move to seriously reintegrate Iran with the world economy will draw forth opposition from these conservative figures, who remain powerful in the security and judicial apparatus, just as the ulama opposed such policies when they were attempted by the Qajars and the Pahlavis. Furthermore, the ongoing effort to support radical and even terrorist Islamic movements around the world maintains Iran's position as a pariah in much of the world, including among many Islamic regimes. However, the release from house arrest in early 2003 of the moderate grand ayatollah, Montazeri, suggests the possibility of some further evolution of thinking among the ulama.

Iran's current military buildup and apparent drive for nuclear weapons terrifies its Arab neighbors in the Persian Gulf. This is especially true of Saudi Arabia, whose opposition to the overthrow of Saddam Hussein at the end of the first Persian Gulf War in 1991 was predicated on the fear that he was all that stood between them and an aggressive and expansionistic Iran, driven by its imperial dreams of glory, made all the more excessive by its aggrieved and impassioned sense of Shi'i martyrdom. However, Khatami has reduced the fears of Iran's Arab neighbors somewhat with an outreach policy to Saudi Arabia in particular, a policy that gained credibility when Iran successfully chaired the meeting of the Organization of Islamic Countries (OIC) during the first year of Khatami's presidency.

What will eventually develop out of the political movements initiated during the Khatami presidency? Will he end up like Mikhail Gorbachev in the former USSR, a figure who, by attempting to reform a system, ultimately unleashed the forces that undermined it and led to its unraveling? Will Iran simply abandon its Islamic economic and political systems and ultimately converge on the U.S. model in a globalizing economy, as so many other countries appear to be doing? Or will the social and political reforms succeed in reinvigorating support for the Islamic system? It is notable that calls for removing the core Islamic institutions such as the banking system have not been heard among the calls for separating the religious and political systems, although a renewed assault on the powers of the economic foundations (*banyads*) could easily emerge. Thus, there is a real possibility that Khatami will avoid Gorbachev's fate and achieve his goals, although the future is always difficult to predict, especially given ongoing demonstrations by students and reactions to them by the clerical and security establishments.

In the end, the more Iran stands out as the anti-imperialist, anti-Western, antihegemonist voice of the Islamic world, and as an economic Third Way, the more it will thrust itself forward as the definitive role model that all Islamic revolutions must emulate. At the same time, such a stance will undermine Iran's appeal as a model by undermining its ability to grow economically. Thus, in the competition for influence in newly independent Central Asia, Iran may well ultimately falter and fail as the great alternative to capitalism and socialism.[40] On the other hand, if the regime can achieve a greater opening to the world, reduce corruption and monopoly power by the *banyads,* reinvigorate economic growth, and establish a democratic and somewhat more tolerant rule of law while still maintaining the structures of an Islamic economic system, it may well succeed in becoming the model of the New Traditional Islamic economy.

SUMMARY AND CONCLUSIONS

Iran is not a typical Muslim state because it is dominated by Shi'ism, the main minority branch of Islam, and because it is a major oil producer and exporter. However, its Shi'i traditions significantly contributed to the emergence of the Islamic Revolution in Iran. In turn, Iran's example has made it the leading role model for Islamic revolutions even among predominantly Sunni nations. Iran's revolutionary traditions include a sense of aggrieved martyrdom because of long domination by the Sunni majority; the particular strength of the Shi'i ulama based on their independent sources of funding from the *zakat* and their ability to order the behavior of followers; and the messianic thrust associated with the idea of the mystical twelfth and Hidden Imam who is to return to save the world. Ayatollah Ruhollah Khomeini's claim to being the special messenger of the Hidden Imam allowed him to become supreme leader and jurist, the *Vilayat-al-faqih,* of the theocratic revolutionary state in Iran.

40. The Iranian Revolution's self-image as the Third Way between the two "Great Satans," the United States and the then USSR, is symbolized by a chant heard on the streets during the revolution. "Cheerleader: Who took our oil? Crowd: America. Cheerleader: Who took our gas? Crowd: Russia [The Shah sold natural gas to the USSR]. Cheerleader: Who took our money? Crowd: Pahlavi." From Michael M. J. Fischer, *Iran: From Religious Dispute to Revolution* (Cambridge, Mass.: Harvard University Press, 1980), p. 190.

After a glorious past as the center of ancient empires, Iran was conquered by the original Islamic empire and ruled by outsiders for centuries. After 1501 it largely converted to Shi'ism under the reign of Shah Isma'il. During the nineteenth century, Russia and Great Britain fought over Iran but the Shi'i ulama opposed accommodation with either of them, diplomatically or economically. In the twentieth century, democratic movements such as the Constitutionalist revolt of 1906 and the secular nationalist movements under the Pahlavi dynasty forced some change. After the 1973 OPEC oil price shock, inflation, corruption, and increasing inequalities of income and wealth fed discontent and support for an Islamic revolution. In 1979 the Pahlavi regime was replaced by the Islamic regime under Khomeini.

The postrevolutionary period has gone through five phases. The First Radical Phase, 1979–1981, saw an Islamic socialist approach with widespread confiscations and nationalizations. The Second Radical Phase, 1982–1984, was marked by more traditional Islamic innovations such as the adoption of interest-free banking, with the Council of Guardians blocking or overturning more socialist policies. Also, this period and the First Pragmatic Phase, 1985–1988, were dominated by the war with neighboring Iraq. The Second Pragmatic Phase emerged after the end of the war and the death of Khomeini in 1989 and coincided with the presidency of Rafsanjani, from 1989 to 1997, with moves toward marketization, privatization, and increased involvement in the world economy.

The phase of social reform has coincided with the presidency of Mohammed Khatami, who has emphasized the rule of law and a relaxation of controls over political and cultural expression. While Rafsanjani's efforts to open Iran to the world economy and present a friendlier diplomatic face to the rest of the world have continued, privatization efforts have largely halted and Islamic economic institutions have been preserved.

Economic policies have included nationalization of much of industry, as well as of banking and insurance. Interest-free banking is practiced nationwide, although in actual practice it differs only somewhat from standard banking, with the differences consisting largely of semantic reshufflings. The Islamic taxes, the *zakat* (wealth tax for the poor), the *'ushr* (tithe), and the *khums (*income tax) are not collected by the state but are voluntarily given to the ulama, thereby reinforcing their power and independence. Furthermore, many confiscated enterprises are owned and run by ulama-managed foundations, the *banyads.* Land reform was carried out in the cities for the purpose of providing housing for the urban poor and homeless. The distribution of income became more equal after the revolution, but a trend toward greater inequality reemerged. Rural incomes have improved relative to urban incomes. But the economy has continued to remain crucially dependent on oil exports and suffers from rent-seeking and corruption, in contrast to the original goals of the revolution.

After the revolution, restrictions were placed on the behavior of women, including dress, labor force participation, and birth control. But in the 1990s there was a major shift toward encouraging birth control in response to a very high birth rate, and women have been allowed back into many professions. The issue of women's rights has been a central one facing the regime, especially during the period of social reform.

Iran is the most prominent model in the world for revolutionary New Traditionalism, the attempted combination of a traditional fundamentalist religion with modern high technology in an economy independent of the patterns of either the old capitalist or socialist economies. It stands in contrast to more moderate models such as those of Saudi Arabia and Pakistan. But Iran faces a choice between pragmatically reintegrating into the world's economy and polity at large, thus probably achieving a greater rate of growth, or pursuing its role as the leading supporter of Islamic revolutions around the world, thus probably achieving continuing political isolation and economic stagnation. The struggle between these competing tendencies will probably go on for a long time.

QUESTIONS FOR DISCUSSION

1. Why is the revolutionary tradition stronger in Shi'i Islam than in Sunni Islam?
2. What have been the characteristics of the five phases of economic policy since the 1979 revolution?
3. What was the role of the oil industry in the economy both before and after the revolution in Iran?
4. What is the role of the religious foundations in the Iranian economy?
5. Has Iran succeeded in eliminating interest from its banking system? What have been the results of its efforts to do so?
6. How does the Shi'i view of *zakat* differ from the Sunni view, and what are the implications of this for Iran?
7. How have economic policies regarding women changed since the revolution?
8. To what extent does the Iranian economy represent a New Traditional Third Way between capitalism and socialism?
9. Compare the Pakistani model of Islamic economics with that of Iran.
10. In its effort to be a role model for Islamic economies throughout the world, what fundamental contradiction does Iran face?

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UNITED STATES OF AMERICA
Ensenada
San Quintin
Nogales
Ciudad Juarez
Sonora
Hermosillo
Ojinaga
Guaymas
Chihuahua
Coahuila
Santa Rosalia
Gulf of California
Delicias
Nuevo Leon
Loreto
Los Mochis
Durango
Monterrey
Gulf of Mexico
North Pacific Ocean
M E X I C O
Zacatecas
Cuidad Victoria
San Lucas
San Luis Potosi
Islas Marias
Nayarit
Yucatan
Leon
Poza Rica
Guadalajara
Bahia de Campeche
Quintana Roo
Jalisco
Mexico City
Morelia
Xalapa
Campeche
Puebla
Guerrero
Veracruz
BELIZE
Acapulco
Oaxaca
Chiapas
Comitan
Salina Cruz
GUATE.
Tapachula

18 Revolution and Reform in the Mexican Economy

In Mexico, the Spaniards encountered history as well as geography. That history is still alive: it is a present rather than a past. The temples and gods of pre-Columbian Mexico are a pile of ruins, but the spirit that breathed life into that world has not disappeared; it speaks to us in the hermetic language of myth, legend, forms of social coexistence, popular art, customs. Being a Mexican writer means listening to the voice of that present, that presence.
—Octavio Paz, Nobel Prize for Literature Address (translated by Anthony Stanton), 1990

He of the voice confesses that, since having been born, he has conspired against the shadows which cover the Mexican sky . . . that, before being born, being able to possess everything in order to have nothing, he decided to possess nothing in order to have everything . . . that Mexico is something more than six letters and an underpriced product on the international market.
—Subcommandante Marcos, February 16, 1995 (translated by Cindy Arnold and transmitted via the Internet on March 7, 1995)

INTRODUCTION

On January 1, 1994, two events occurred that captured the ongoing conflicts and contradictions of the Mexican economy. One was that the **North American Free Trade Agreement (NAFTA)** went into effect, freeing trade and investment relations among Mexico, the United States, and Canada after a long process of marketizing and privatizing reforms in the insular Mexican economy.

The other event was the outbreak of an armed rebellion in Chiapas, the poorest and southernmost state of Mexico, in the far south, by the **Zapatista National Liberation Army (EZLN).**[1] Named after the early-twentieth-century Mexican revolutionary Emiliano Zapata, this revolt was led by non-Indians, including Subcommandante Marcos, quoted above (a charismatic pipe smoker who always wears a ski mask in public and is reputed to be a former professor); most soldiers in this group were Tzeltals or other Mayan-related Indians. EZLN leaders declared opposition to NAFTA and timed the uprising to coincide with its implementation. But the Indian soldiers were more concerned with how ancient conflicts over land control would be made worse for them by 1992 reforms led by then-President Carlos Salinas de Gortari and the long ruling Revolutionary Institutional Party (PRI, or *Partido Revolucionario Institucional*). These conflicts over land reflect the underlying divisions of class, race, and power that have plagued Mexico since the 1521 Spanish conquest.

In 1996 a parallel revolt erupted in the neighboring states of Guerrero and Oaxaca led by the Popular Revolutionary Army (EPR, or *Ejercito Popular Revolucionario*). They and the EZLN played a major role in the PRI's fall from power in 2000 with the presidential election of Vicente Fox of the National Action Party (PAN, or *Partido Acción Nacional*), who promised to help the Indians and negotiated an end to the revolts in 2001. Fox's victory saw

1. The full name in Spanish is Ejercito Zapatista de Liberacion Nacional.

the end of a more than 70-year period of domination of Mexican politics and society by the PRI.

In Mexico City at the Plaza of Three Cultures there is a group of Aztec pyramids, behind which stands a Spanish church, behind which in turn stands a group of American-style 1960s apartment buildings. This conjunction of culture and history encapsulates the essential tensions and contradictions of Mexico's economy and society.[2] It is a rapidly industrializing and urbanizing middle-income economy that is integrating itself into the world economy. At the same time, it contains large pockets of poverty in traditionalist sectors that are as contemporaneous with the fifteenth and eighteenth centuries as they are with the twenty-first century.

At the top of the Mexican economy is a mostly Spanish-descended elite who operate successfully within the modern market capitalist economy emerging in Mexico. At the bottom is a somewhat larger poor minority, mostly pure Indians, many living in a traditional Mexican economic form in village agricultural units known as *ejidos,* many speaking native Indian languages.[3] In the middle are the majority mixed-race *mestizos*.[4] Similar to the Plaza of the Three Cultures, in Mexico a modern U.S.-related economy sits on top of a colonial Spanish-derived system that in turn sits on top of the remnant of a precolonial traditional economy.

The Mexican economy is difficult to categorize, a characteristic it shares with many other Latin American economies. Since the late nineteenth century it has had strong market capitalist elements, even during its most inward-looking and socialist phases. But it has long had a highly centralized state sector. This tradition was enhanced by the revolution of 1910–1920 and the populist 1930s presidency of Lázáro Cárdenas, who nationalized the oil industry. It reflects patterns from the Spanish colonial period and even from the Aztec empire. Furthermore the economy includes the traditional remnant of the rural *ejidos,* reconstructed by revolutionary populism in the twentieth century.

This curious system has drawn many labels: **Bonapartist populist corporatism** (*Bonapartist* after Napoleon III of France),[5] which "activates strategic class groups and

2. This plaza is in Tlatelolco, site of the main market of the Aztec city of Tenochtitlán. It survived the destruction of that city to become the main Aztec neighborhood of Mexico City. In 1968, a massive student protest there was suppressed and hundreds were killed. It was also the site of the final defeat of the Aztecs in 1521.

3. Around 50 Indian languages are spoken in Mexico. In the Yucatan in the southeast, around 80 percent of the people speak Mayan languages. In the southern state of Oaxaca, more than 10 percent of the population do not speak Spanish.

4. Until 1921, 16 different racial categories were identified in the census. A *mestizo* was defined as someone with one pure Spanish parent and one pure Indian parent (Nathan L. Whetten, *Rural Mexico* [Chicago: University of Chicago Press, 1948], pp. 51–52). Racial categories have not been recorded since then, but officially at that time, about 10 percent of the population were white, about 30 percent were Indians, and about 60 percent were *mestizos.* During the Spanish rule, a small number of Africans were brought into certain areas to cut sugar cane.

5. Martin C. Needler, *Mexican Politics: The Containment of Conflict,* 2nd ed. (New York: Praeger, 1990), p. 130. He confesses that this is no better than labeling it "miscellaneous."

incorporates them into the state apparatus, controlling and 'de-radicalizing' their demands,"[6] and **state capitalism** manifested as technocratic populism, dominated by a politicized and technocratic bureaucracy.[7] Putting these together, we might label the Mexican system **technocratic populist corporatism** while recognizing its recent movement toward a more market capitalist model.

Mexico's movement toward market capitalism began after a macroeconomic crisis in 1982, triggered by mounting foreign debt and rising interest rates on that debt, combined with falling oil prices. Mexico exports oil, and by 1982 it received over 74 percent of its export earnings from oil.[8] Based on these earnings, the government borrowed massively from abroad, largely to finance rising social expenditures and subsidies for state-owned firms.

By August 1982 the government could not meet its interest obligations, and negotiated with the United States and the IMF a program of fiscal austerity and import reductions that led to declining output for several years after decades of rapid growth. After 1989 came major efforts to reduce government ownership and control in the economy,[9] as well as opening the economy to free trade and reducing endemic corruption.[10] The economy grew rapidly again, especially its export manufacturing sector, but it later returned to recession. Macroeconomic stabilization marked by substantial disinflation was enhanced by the **Pacto,** a **corporatist incomes policy** established in 1987.

Shortly after President Zedillo took office in 1994, a new financial crisis erupted with a sharp devaluation of the peso. Zedillo allowed the peso to float, and engaged in an austerity policy as the Pacto ended and organized labor rejected the new plan. A deep recession ensued in 1995 followed by export-led growth. During the crisis, the U.S. government provided an emergency $40 billion loan that was strongly criticized but that the Mexican government was able to repay after several years. In 1997 Zedillo instituted the antipoverty PROGRESA program directed at isolated communities.

Arresting the brother of former President Salinas (who then fled the country), Zedillo supported democratic outcomes in elections, thus paving the way for Vicente Fox's and PAN's victory in 2000. This ended the established practice in the PRI of powerful presidents

6. José Luis Reyna, "Redefining the Authoritarian Regime," in J. L. Reyna and R. S. Weinert, eds., *Authoritarianism in Mexico* (Philadelphia: Institute for the Study of Human Issues, 1977), p. 161.

7. Roger Bartra, "Capitalism and the Peasantry," in N. Hamilton and T. F. Harding, eds., *Modern Mexico: State, Economy and Social Conflict* (Beverly Hills, Calif., Sage, 1986), p. 286.

8. *OECD Economic Surveys: Mexico, 1991–1992.* (Paris: Organization for Economic Cooperation and Development, 1992), p. 261.

9. Exceptions to this are in the oil industry, where state-owned Petróleos Mexicanos (PEMEX) remains nationalized, although NAFTA allows foreign investment in peripheral parts of the energy industry, and in railroads and electricity production.

10. It has been asserted that the dominant force of the Mexican economy is bribery, *La Mordida* ("the bite"). Charges of complicity with drug dealers and assassinations of high-ranking figures in the Salinas administration suggest that the effort to reduce corruption was less than successful.

hand picking their successors at the end of their six-year terms. Zedillo and his predecessor, Salinas, had both risen through the bureaucracy, and both possessed a Ph.D. in economics from U.S. universities (Yale and Harvard, respectively). Fox had served as governor of Guanajuato province before leading PAN and winning the presidency democratically.

Although quality-of-life measures in Mexico have shown improvement, not all of its citizens have gained. From 1983 to 1988, real wages per worker declined by 41.5 percent and income inequality increased.[11] Signing NAFTA opened President Salinas to charges of putting Mexico under U.S. economic domination similar to that during the Porfirio Díaz dictatorship (1876–1911). Salinas also reformed the *ejidos* by allowing the farmers involved (*ejiditarios*) to privatize and sell their plots, and he reduced subsidies for corn (maize) production, the principal crop of the *ejidos* and the mainstay of poor Mexicans' diet. The result has been rising inequality and poverty in Mexico since the mid-1980s, providing a serious challenge for the post-PRI leadership. Thus, after the end of the armed revolts in late 2001,[12] Mexico confronted a dramatic question: Will economic reform lead to revolution or to the end of reform?

HISTORICAL BACKGROUND

From Origins to Independence

Mexico is the original site of cultivated agriculture in the Western Hemisphere, starting 6,000 years ago with the domestication of corn (maize). The country contains several independent centers of culture and economic development, with the Mayans in the Yucatán peninsula in the south and a succession of peoples in the temperate and fertile Valley of Mexico in the center being most prominent.

In 1325 the Aztecs[13] conquered the Valley of Mexico and established Tenochtitlán. They practiced mass human sacrifice, making them despised by neighboring tribes. Some of these tribes helped the Spanish defeat the Aztecs in 1521.

Although they possessed horses, guns, and smallpox, the 1521 conquest of Mexico by a few hundred Spaniards remains a dramatic event in world history.[14] When Hernando

11. Nora Lustig, *Mexico: The Remaking of an Economy* (Washington, D.C.: The Brookings Institution, 1998), pp. 69, 92.

12. Although the Zapatista revolt in Chiapas formally ended in 2001, by early 2003 the local people in Chiapas were engaging in seizures of land, especially that owned by wealthy Americans.

13. The Aztecs are also known as the "Mexica," which is the origin of the country's name. There was great interest in them at the time Mexico gained its independence from Spain.

14. A classic account is William H. Prescott, *History of the Conquest of Mexico* (Boston: Phillips, Sampson & Co., 1843).

Cortés arrived, Tenochtitlán was not only the largest city in the Western Hemisphere, with 300,000 people, but one of the largest in the world and bigger than any city in Europe.[15] After achieving victory, Cortés offered friendship and favors to tribes that surrendered to or allied with him but was brutal to those that resisted him. Cortés adopted the centralized Aztec tax collection and land tenure systems.

Mexico became the main part of New Spain, ruled by viceroys appointed by the kings of Spain. In the center of the country the Spanish controlled vast estates **(encomiendas)** on which Indians were forced to work, initially as slaves and later as **debt peons** when the *encomiendas* became *haciendas.*[16] Political and economic domination coincided with a mass, if partially superficial, conversion to Roman Catholicism of most Indians.[17] As long as they accepted Catholicism and paid their taxes, Indian villages were generally left to the rule of their own leaders and were allowed to control their traditional communal lands, although subject to encroachment pressure from neighboring *haciendas.*[18] Principally agricultural, New Spain's main export (and Mexico's throughout most of the nineteenth century) was silver.

From Independence to the Revolution

After Napoleon conquered Spain in 1810,[19] a priest named Miguel Hidalgo led a revolt for Mexican independence, which was initially crushed because it consisted mostly of Indians demanding the distribution of *hacienda* lands. But independence from Spain was finally achieved in 1821, followed by several decades of economic stagnation, large budget deficits,[20] political instability, severe foreign indebtedness, and, in the 1830s and 1840s,

15. After its rebuilding by Cortés as Mexico City, it would again be the largest city in the Western Hemisphere until surpassed by New York City in the mid-nineteenth century. Today it is second only to Toyko as the world's largest metropolitan area.

16. The North contained mostly smaller *ranchos* owned by *mestizos*. Spanish control in the Mayan Yucatan was less solid, with less intermarriage and more native uprisings. The Zapatista upheaval in Chiapas was the latest in a long line of such rebellions.

17. The vision of an Indian in 1531 that called for a church to be built honoring the Virgin Mary on the site of a temple of the Aztec mother of gods was crucial in extending Catholicism. This became the Shrine of Guadalupe, containing an image of the Virgin as an Indian. The Virgin of Guadalupe became a symbol of Indian Catholicism and a national symbol of Mexico, with the independence fighters and even the followers of Zapata in the early twentieth century marching under a banner with her image.

18. Generally the viceroys protected native land holdings against encroachments, recognizing that this eased tax collections. This protection disappeared after independence.

19. French revolutionary ideas influenced the Mexican revolutionaries. Mexico has a tradition of French intellectual influence, which has shown up in recent economic practices such as the Pacto, with its elements of concertation.

20. Mexico achieved its first balanced budget in 1894.

losses of about half of the nation's land area to the United States in wars. The latter coincided with the U.S. drive for continental control of land from coast to coast.[21]

In 1857 a group of liberals led by a Zapotec Indian named Benito Juárez wrote a constitution that forced the sale of all lands owned by the Roman Catholic Church,[22] eliminated special privileges for military officers, and allowed the sale of village *ejido* lands.[23] This was **La Reforma** (the Reform). After defeating an attempt in the 1860s by the French to install Maximilian, the brother of Austrian Emperor Franz Josef, as emperor in Mexico, Juárez remained president until he died in office in 1872.

In 1876 a Juárez supporter, Porfirio Díaz, became president. After stepping aside in 1880, he returned to office in 1884 and forbade opposition thereafter, remaining in office until 1911. His tenure resembled the Salinas presidency in economic policy, with openness to foreign trade and investment, overseen by technocratic advisers known as *cientificos*. They balanced the budget and oversaw the beginnings of industrialization, mostly in the north, and the development of Mexico's oil industry by U.S. and British investors. The economy grew substantially, but so did landlessness,[24] debt peonage in the countryside, and general inequality and poverty.

From the Revolution to the Present

In 1910 Díaz jailed an opposition candidate in the north whose supporters in Chihuahua, including former bandolero Francisco (Pancho) Villa,[25] rose up in revolt. They were soon supported by a force of mostly Indian peons from Morelos in the south, led by Emiliano Zapata.[26] Díaz resigned in 1911, and Mexico experienced periodic civil war until 1920.

The political party that ruled Mexico until 2000, the PRI, was victorious in the revolution. Out of the revolution came the constitution of 1917. Article 27 denied the absolute

21. The drive to obtain what are now the southwestern U.S. states of California, Arizona, Nevada, New Mexico, Utah, Colorado, and Texas from Mexico was pushed especially by the slave-owning southern states, which saw this region as a zone in which to expand the slavery system.

22. The Roman Catholic Church was a force for extreme conservatism, supporting reestablishment of monarchy. Anticlericalism is deeply rooted in Mexican politics, although Catholic liberation theologians including the local bishop supported the Chiapas Zapatista revolt. The church's position in Mexico has been enhanced since the election of President Fox and the pro-Catholic PAN party in 2000.

23. Juárez was a strong supporter of state-run education for Indians and supported assimilation into a market capitalist economy. Many traditional Indian *ejido* lands were obtained by *mestizos* after this constitution was adopted.

24. In 1910 well over 90 percent of the population in some states such as Oaxaca were landless, the most extreme such inequality in Mexico's history (George McCutcheon McBridge, *Land Systems in Mexico* [New York: American Geographical Society, 1923], p. 154).

25. In 1914 Villa attacked New Mexico, causing U.S. President Woodrow Wilson to send General George Pershing after him. Pershing failed to catch him and withdrew to lead U.S. forces in World War I. Villa laid down his arms in 1920 in return for a *hacienda* and was assassinated in 1923 by a government fearful that he might renew his revolt. Despite allying with Zapata, his views on land reform were less radically redistributionist than Zapata's.

26. Zapata's army mostly worked on sugar-growing *haciendas.* He was killed in 1919 by government troops after being tricked into coming in for a peace negotiation.

right to private property, thus laying the groundwork for both nationalizing the oil industry and redistributing *hacienda* lands to **peons** and villages as reconstructed *ejidos*. Article 123 guaranteed a variety of labor rights, including the right to organize unions, the eight-hour day, the abolition of child labor and peonage, and compensation for injuries on the job.

Despite radical and even socialist rhetoric, Mexican policy in the 1920s and early 1930s was moderate, although some land redistribution occurred and unions were allowed. But in 1934 Lázáro Cárdenas, the most populist of all of Mexico's presidents, came to power. He accelerated land redistribution to the *ejidos,* emphasizing communalism, and organized a ruling party–related peasant interest group. He also organized a party-related national union federation (CTM, or *Confederación de Trabajadores de México*),[27] still the main union federation in Mexico. These became the essential institutions of Mexican corporatism.[28] Most dramatically, Cárdenas nationalized the oil industry in 1938, establishing Petróleos Mexicanos (PEMEX).

Cárdenas's radicalism triggered a political backlash. PAN, the conservative opposition party that came to power in 2000,[29] was founded in 1938. Cárdenas's land policies were halted after he left office in 1940. After Miguel Alemán became president in 1946, economic policy encouraged privately owned and irrigated farms to adopt Green Revolution technologies developed in the United States that use hybrid seeds and require mechanization. Alemán began an industrial growth policy led by import substitution that continued until 1982. Despite restrictions for some industries, foreign investment was allowed and encouraged. In the 1960s, foreign investment took the form of special incentives for investments on the Mexican–U.S. border in **maquiladora plants.**

The 1940–1970 period was marked by strong growth and reasonable macroeconomic stability. Land redistribution resumed after 1958. The student uprising of 1968 triggered a shift to populism and a leftist international stance after 1970.[30] Expanded social spending undermined macroeconomic stability and foreign indebtedness rose.

27. In 1948 its leader, Lombardo Toledano, organized the Socialist Party. The descendant of that party is the main leftist opposition party, the Party of Democratic Revolution (PRD, or *Partido de la Revolucion Democratica*), now led by Cuauhtémoc Cárdenas, son of Lázáro Cárdenas. Many believe that Cárdenas outpolled Salinas in the 1988 presidential election but that the corrupt PRI prevented an accurate vote count. He ran a weak third in the presidential elections of 1994 and 2000, despite being elected mayor of Mexico City in 1997.

28. The macrostabilization Pacto of 1987 was negotiated between the government, these two bodies, and business leaders.

29. After 1988, the ruling PRI allowed the victorious PAN candidates to assume the governorships they won, including in Gaunajuato, where the eventual president, Vicente Fox, came to power.

30. Mexico maintains an international stance independent of that of the United States, symbolized by its being the only Latin American nation to maintain diplomatic relations with Cuba throughout Castro's rule. Although Fox initially moved much closer to the United States, he became more distant again after the United States began its war on terrorism and monitored more tightly its border with Mexico. The 1968 uprising coincided with New Left uprisings in many countries, including the United States and France. Many in Mexico consider its suppression to mark the beginning of the end of the period of PRI dominance.

Table 18-1
Population and GDP Growth Rates, 1900–1993

	1900–10	1910–25	1925–40	1940–54	1954–70	1970–82	1982–89	1989–93	1994–2000
Population	1.1	0.1	1.6	3.0	3.4	3.3	2.3	2.0	2.1
GDP	3.3	2.5	1.6	5.8	6.8	6.2	0.6	3.0	3.2
Per capita GDP	2.2	2.4	0.0	2.8	3.4	2.9	−1.7	1.0	1.1

Sources: Figures for before 1940 are from Clark W. Reynolds, *The Mexican Economy: Twentieth Century Structure and Growth* (New Haven, Conn.: Yale University Press, 1970), p. 22; for 1940–1991 from *OECD Economic Surveys: Mexico* 1991–1992 (Paris: Organization for Economic Cooperation and Development, 1992), pp. 9, 14, 19; and for 1992–1993 from "Mexico: The Revolution Continues," *The Economist,* January 22, 1994, p. 20. Figures for 1994–1999 are from *OECD Economic Surveys:* Mexico, July 2000 (Paris: Organization for Economic Cooperation and Development, 2000), pp. 7, 27, and for 2000 from *The Economist,* March 31, 2001, p. 106. All numbers are average annual percentage growth rates.

These problems culminated in the crisis of 1982 and the shift to austerity. After Salinas's election in 1989 came NAFTA, privatizations, and sales of *ejido* lands, thereby undoing much of Lázáro Cárdenas's legacy.

Table 18-1 shows twentieth-century economic and population growth in Mexico. Population growth has been high for a long time until recently.

THE LAND QUESTION

Types of Land Tenure

No issue looms larger over Mexican history than land. Even today, when agriculture accounts for only 8 percent of GDP and 25 percent of employment,[31] the issue remains controversial, as its role in the Zapatista uprising showed. Mexico's most serious poverty is rural.

Traditionally, three types of farms existed in Mexico: the **hacienda,** the **rancho,** and the **ejido.** The *haciendas* derive mostly from royal *encomienda* land grants to the *conquistadores*.[32] Many were enormous, containing thousands of people and functioning as self-contained communities. Some *haciendas* derived directly from estates of the Aztec nobility,[33] others from purchases from Indians in tribes allied with Cortés. Many still exist,

31. *OECD Economic Surverys* (1992), p. 18. A majority of employment was agricultural as recently as the 1960s.

32. The *encomiendas* were abolished in 1720. In the shift to the *hacienda* form, the Indians assumed debts to the owner that passed from one generation to the next, thus tying them to the land. This debt peonage was abolished in 1917.

33. Sometimes Aztec nobility and Spanish married, coinciding with these land transfers, and a strand of today's Mexican elite descended from this group. During the Aztec period there were six different forms of land tenure (Gary D. Thompson and Paul N. Wilson, "Ejido Reforms in Mexico: Conceptual Issues and Potential Outcomes," *Land Economics* 70 [1994]: 448–465).

but they have lost their special powers over rural labor. Today there is no legal difference between them and the *ranchos* regarding land tenure.

The *ranchos,* owned by *mestizos,* tend to be smaller and were favored by the 1857 Reform of Juárez. Derived from land grants given to foot soldiers or small farmer immigrants who tended to marry local Indian women, *ranchos* differed from the *encomiendas* because they did not have vassal laborers attached to them. They were often sited on poor soil, the *haciendas* and the Indian villages having the better lands. More numerous in the north, the *ranchos* became the favored base for adopting Green Revolution techniques, especially as they were aided by government investment in road and irrigation systems.

The *ejidos* derived from communal lands held in Indian villages before the Spanish conquest. Landholding was based on extended kinship groups identified with certain areas. Although held in common, most of the land was divided and assigned to individual families for their use. A portion known as the **atlepetalli** was held for strictly common use, and this was the basis of the later communal parts of the *ejidos*.[34]

Prior to 1910, *haciendas* and *ranchos* encroached on *ejido* lands. Since the 1940s, the *ejidos* have been largely ignored by government infrastructure investment and thus left behind technologically. *Ejido* areas contain the poorest Mexicans. The 1992 move to allow the sale of *ejido* lands follows the Juárez policy of trying to turn them into full-blown *rancho*-style, capitalist farms with rising productivity and income.

Reestablishment of the *Ejidos*

Land reform drove the 1910–1920 revolution. Article 27 of the 1917 constitution allowed *haciendas* to be broken up and distributed as *ejidos* to the former *peons*. As in the ancient Indian villages, this involved both individual use of collectively owned land and communal farming, the latter encouraged under Cárdenas. Thus there are now three types of land tenure: private farms, **individual-use ejido farms,** and **communal ejido farms.**

Prior to Cárdenas's presidency, land distribution to *ejidos* occurred slowly, and no president distributed much more than 3 million hectares.[35] In 1930 no region of the country had more than 20 percent of cultivated land in *ejidos*.[36] Cárdenas distributed more than 20 million hectares, more than all the presidents before him combined, resulting in 47.4 percent of Mexico's total cultivated land in *ejidos* by 1940. Yet state averages ranged

34. The term *ejido* is Spanish, from the same root as the word *exit.* In Spain, *ejidos* were originally external lands owned by towns, hence the element of *exit.*

35. John B. Ross, *The Economic System of Mexico* (Stanford: California Institute of International Studies, 1971), p. 3.

36. Clark W. Reynolds, *The Mexican Economy: Twentieth Century Structure and Growth* (New Haven, Conn.: Yale University Press, 1970), p. 139.

from 22.7 percent in southern Baja California to 84.4 percent in Emiliano Zapata's sugar-growing Morelos.[37]

Although Cárdenas's immediate successors focused on helping private farms (the legal distinction between *haciendas* and *ranchos* having disappeared in 1917), redistributions resumed between 1958 and 1970 to "cover their left flank," given the otherwise conservative thrust of PRI policies. Although *ejido* holdings increased, successive presidents continued to focus infrastructure investment on the increasingly more productive private farms. As of 1988, national shares of agricultural land were 43 percent in private farms, 52 percent in individual-use *ejidos,* and 5 percent in communal *ejido* farms.[38]

The Emergence of Dual Agricultural Development

Since the presidency of Cárdenas, a sharp dualism has emerged between private and *ejido* farms, which triggered the changes in Article 27 passed in 1992. But it is unclear to what extent this dualism reflects the inherent incentive structures of the two kinds of farms and to what extent it reflects population density and government policies favoring private farms. The *ejidos* are more common in densely populated areas, such as the central Bajio Valley. Over half of individual *ejido* units consisted of less than 4 hectares in 1960, too small to be efficient under any tenure or technology system, especially for the crop production they engaged in.[39]

Whereas *ejidos* concentrate on traditional corn and beans production, private farms have branched out into such commercial crops as soybeans and sorghum, and more recently fresh fruits and vegetables, which were not produced in Mexico in 1940. These crops, as well as wheat, have experienced larger increases in yields than corn because of the introduction of hybrid Green Revolution varieties and expanded irrigation supporting them.[40]

From 1940 to 1958, the percentage of federal government irrigation investment rose from 4 to 53 percent in the North Pacific region, which contains the lowest percentage of land in *ejidos*. In the *ejido*-laden Center it rose from 3 to 9 percent, whereas in the poverty-stricken

37. Whetten, *Rural Mexico,* p. 595.

38. *OECD Economic Surveys* (1992), p. 166.

39. Rodolfo Stavenhagen, "Collective Agriculture and Capitalism in Mexico: A Way Out or a Dead End?" in Hamilton and Harding, *Modern Mexico,* p. 264. He argues (pp. 268–273) that communally farmed *ejidos* have outperformed individually farmed ones because of economies of scale. Another study finds *ejido* farms to be as productive as private ones among Chiapas coffee farmers, after accounting for the size of farms, attributing this to extensive individual use rights in the communal lands (Malcolm H. Dunn, "Privatization, Land Reform, and Property Rights: The Mexican Experience," *Constitutional Political Economy* 11 [2000]: 215–230).

40. David Barkin, *Distorted Development: Mexico in the World Economy* (Boulder, Colo.: Westview Press, 1990), pp. 18–25.

South Pacific region it rose from zero to 1.2 percent.[41] Regional shares of crop production between 1939 and 1959 rose in the North Pacific region from 11 to 18 percent, whereas they declined in the Center from 35 to 28 percent. Favoritism toward private farms also extended to government credits and financing.

Whatever caused the problems of the *ejidos,* in 1992 the Salinas government gave up on them. NAFTA removed protection of corn from competition with low-cost U.S. producers, and although the removal is being phased in gradually, observers expect substantial outmigration from current corn-producing *ejidos*. This follows major reductions of general government subsidies to agriculture during the 1980s austerity period.[42] This is a policy of attacking rural poverty by forcing the poorest farmers off the farms. The response in the poorest state of all was the Zapatista rebellion. Although President Fox made peace with the Zapatistas and has promised to aid the rural poor, he has made no major changes in agricultural or land ownership policies.

THE OIL QUESTION AND THE EXTERNAL DEBT CRISIS OF 1982

Development of the Mexican Oil Industry

Mexico's first modern[43] oil discovery was made in 1901 by Edward L. Doheny of the United States. By 1916 his Mexican oil holdings made him the second wealthiest oil magnate after John D. Rockefeller. Doheny sold out to Standard Oil of Indiana (Amoco) in 1925. Weekman Pearson, a British citizen, was building rail lines when he formed an oil company and made a strike in 1906. He sold out to Royal Dutch Shell in 1917, just prior to implementation of the new constitution that granted authority over mineral rights to the government, leading foreign investors to view the Mexican environment as unstable.

Nevertheless, many other petroleum companies did invest,[44] especially Standard Oil of New Jersey (Exxon), and Mexico became the second largest oil-producing nation in the world during the 1910s, with production peaking in 1921 at 193,398 barrels per day (bpd). Overexploitation combined with a perceived friendlier investment climate in Venezuela led

41. Reynolds, *The Mexican Economy,* p. 156. This reflects the fact that the North is drier than the Center and the South Pacific, but the North Pacific also received substantially more road construction than did the Center or the South Pacific.

42. *OECD Economic Surveys* (1992), p. 166. One study finds six distinct regions in terms of the response to these reductions (James J. Biles and Bruce W. Pigozzi, "The Interaction of Economic Reforms, Socio-economic Structure and Agriculture in Mexico," *Growth and Change* 31 [2000]: 3–22).

43. The Aztecs burned oil to their gods and used it to caulk boats.

44. The 1938 nationalization affected 17 American and European companies, some of which were small independents. Two companies were not nationalized then because they granted major concessions to their workers.

to a decline in production to 32,895 bpd in 1932, after which it increased slightly until 1938 because of the discovery of a major new field.[45]

The 1982 Crisis

After the early 1940s, Mexico's oil production increased moderately and steadily to 897,000 bpd in 1976,[46] the year López Portillo was elected president. His predecessor had followed a populist policy after the 1968 student uprisings and had sharply increased social spending, resulting in a budget deficit at 9.9 percent of GDP and a foreign debt level of $27.5 billion. The 1970s were characterized by oil price shocks, and Lopez Portillo decided to have PEMEX borrow massively from abroad to expand production, which more than doubled by 1980.[47] Combined with the 1979 price increases, as a share of Mexican GDP oil exports rose from 15.4 percent in 1976 to 74.6 percent in 1982, after which it declined to 33.2 percent by 1990.[48]

Mexico's budget deficit as a percentage of GDP fell to 6.7 percent for 1977 and 1978.[49] But taken in by overoptimistic forecasts about future oil price increases after 1979, the government went on a borrowing binge. Despite surging exports, imports more than quadrupled between 1977 and 1981, and Mexico's current account was in deficit throughout this period.[50]

From 1976 to 1981 Mexico's foreign debt tripled to $74.9 billion and exceeded $100 billion by the mid-1980s. The budget deficit soared to 16.9 percent of GDP by 1982.[51] With oil prices declining and inflation accelerating along with foreign and public sector indebtedness, capital flight from Mexico exceeded $10 billion in both 1981 and 1982.[52] Double-digit dollar interest rates triggered a crisis in August 1982 after the debt service ratio jumped from 42.4 percent in 1980 to 62.2 percent in 1982,[53] and domestic financial capital fled after a bank nationalization carried out by López Portillo.

In August 1982, incoming President Miguel de la Madrid Hurtado sent his incoming finance minister to Washington to negotiate with the IMF and the U.S. government. A

45. George W. Grayson, *The Politics of Mexican Oil* (Pittsburgh: University of Pittsburgh Press, 1980), p. 13.

46. Grayson, *The Politics of Mexican Oil,* p. 241.

47. Grayson, *The Politics of Mexican Oil.*

48. Lustig, *Mexico,* pp. 23, 32–33.

49. Lustig, *Mexico,* p. 23.

50. Judith A. Teichman, *Policymaking in Mexico: From Boom to Crisis* (Boston: Allen & Unwin, 1988), p. 153. A similar scenario underlaid the crisis of late 1994, although in that case the optimism about exports came from implementation of NAFTA, but imports grew more rapidly than exports, caused partly by a creeping overvaluation of the peso.

51. Lustig, *Mexico,* pp. 22, 30.

52. Teichman, *Policymaking in Mexico.*

53. Lustig, *Mexico,* p. 32.

Box 18-1
The Nationalization of Oil

Nationalization by Lázaro Cárdenas in 1938 resulted from labor disputes. A **syndicalist**-oriented national oil workers' union, the Sindicato de Trabajadores Peróleros de la República Mexicana (STPRM), was founded in 1935. The union wished to control the industry directly, as workers had in the recently nationalized railroads. But because of poor performance of the railroads, Cárdenas did not take this route and instead established Petróleos Mexicanos (PEMEX) to run the oil industry.

The establishment of PEMEX set off a deep conflict that lasted until President Alemán enforced a settlement in 1946. Most of the demands of the STPRM were rejected, but the oil workers gained generous wage and benefit boosts and the union obtained a closed-shop situation, which gave it power over hiring. In later years, this right became a source of massive power and corruption for the union's leadership.*

Although President Zedillo denied it, Mexico's oil reserves constituted the collateral for the $40 billion provided by the United States in early 1995 to support its balance of payments during the peso crash.† Clearly, the issue of oil as Mexico's national patrimony is extremely sensitive.

*The union leader after 1962, known as "La Quina," was viewed as the most corrupt man in Mexico—he even had his own private army. President Salinas's most dramatic anticorruption move after taking office in 1989 was to arrest La Quina, which required the use of the regular army.

†Nora Lustig, *Mexico: The Remaking of an Economy,* 2nd ed. (Washington, D.C.: The Brookings Institution, 1998), p. 183.

potential Mexican default was viewed fearfully by large U.S. banks holding much of the debt. The result was a shift in U.S. macroeconomic policy to lower interest rates and a deal with the IMF imposing strict fiscal austerity on Mexico.

Despite another crisis after oil prices plunged in 1986, this austerity, combined with later moves to privatization, marketization, tariff reduction, and the corporatist Pacto, led to a sustained reduction of inflation after 1987. The current account balance went into surplus, the budget deficit declined to 1.5 percent of GDP by 1991, and the debt service ratio declined to 29.4 percent by 1990.[54] After 1989, Mexico again attracted financial capital.

However, the oil industry remained nationalized, perhaps because Salinas's leading opponent in the 1988 election was the son of the man who originally nationalized the industry.[55] Salinas tightened budgetary controls; imposed more rational internal pricing; internally restructured PEMEX; arrested La Quina, the oil workers' union's corrupt boss; and allowed foreign investment in peripheral parts of the industry.

During the 1994–1995 peso crisis, President Zedillo suggested selling off PEMEX's petrochemicals division but was forced to retreat from this stance. President Fox encountered a similar response when he suggested privatizing parts of PEMEX in 2000. National ownership of PEMEX remains a sacred cow of Mexican politics as a symbol of Mexico's independence from foreign economic domination, especially by the United States.

54. Lustig, *Mexico,* pp. 30, 33.

55. Also, PEMEX makes money for the government, unlike many of the parastatal companies closed, merged, or privatized under de la Madrid and Salinas. Although Mexico has never joined OPEC, its 1938 nationalization was a role model for OPEC nationalizations in the early 1970s.

TRANSFORMATION OF THE MEXICAN ECONOMY

Macroeconomic Performance Since 1982

The 1982–1985 period saw the introduction of the Program for Immediate Economic Reordering (PIRE) under President de la Madrid. Besides rescheduling foreign debts through the IMF, this plan involved massive peso devaluation and sharp cuts in government spending accompanied by tax increases. But by 1985 the economy was nowhere near projected goals for inflation and current deficit reduction, and Mexico fell out of plan compliance.

A major earthquake hit Mexico City in December 1985, followed by plunging oil prices in 1986. These twin events triggered a reacceleration of inflation and a run on the peso in 1987. This peso crisis led to the adoption of the Pacto in December 1987, with its French-style concertation between labor, farmers, business, and the government. The Pacto set wage and price targets in key sectors, tightened monetary and fiscal policies with tax simplification, and liberalized trade, cutting the maximum tariff rate from 45 to 20 percent. The Pacto reduced the rate of inflation substantially.

In 1989, after Salinas became president, he extended and renewed this plan six times through the end of his term in September 1994 but increasingly focused on microeconomic reforms such as privatization and trade liberalization. By 1993 inflation had fallen to a 7.1 percent annual rate and the Mexican economy was in recession. Although the budget was finally in surplus, the current account had fallen into a deep deficit, setting the stage for the crisis at the end of 1994.[56]

The 1995 crisis saw the steepest decline of output since the Great Depression, with a reversion to a fiscal austerity policy somewhat resembling the PIRE of 1982–1985, although with an independent central bank, a much smaller budget deficit, and a floating peso. Recovery of exports was sufficient to allow the emergency loan by the United States to be paid off by early 1997. Although exports grew rapidly in conjunction with the boom in the United States, the nontradable goods sector remained stagnant, partly reflecting ongoing problems in the banking sector and a rising level of nonperforming loans.[57]

After the 1998 international financial crisis a tighter monetary policy was implemented, along with a major reform of bank insurance and oversight in 1999 that led to a reduction of nonperforming loans and greater financial stability,[58] with inflation finally dropping out of the double-digit range in 2000. However, after falling sharply in 1995, real wages continued to decline for two more years, and they have increased only slightly since then.

56. See Rudiger Dornbusch and Alejandro Werner, "Mexico: Stabilization, Reform, and No Growth," *Brookings Papers on Economic Activity* 1 (1994): 253–315.

57. Anne Krueger and Aaron Tornell, "The Role of Bank Restructuring in Recovering from Crises: Mexico 1995–98," Cambridge, Mass.: National Bureau of Economics Research Working Paper no. 7042, 1999.

58. *OECD Economic Surveys: Mexico, July 2000* (Paris: Organization for Economic Cooperation and Development, 2000), pp. 107–112.

Table 18-2
Selected Macroeconomic Indicators for Mexico, 1981–2000

Category	1981	1982	1983–88	1988–90	1991–93	1994	1995	1996	1997	1998	1999	2000
GDP	8.8	−0.6	0.2	3.0	3.3	4.4	−6.2	5.2	6.8	4.8	3.7	5.1
Inflation	27.9	58.9	92.9	53.6	16.0	7.0	35.0	34.4	20.6	15.9	16.6	7.1
Current account	−16.1	−6.2	1.8	n.a.	−20.8	−29.7	−1.6	−2.3	−7.4	−15.7	−14.0	−17.7
Budget surplus	−8.0	−2.5	4.9	8.2	0.6	−0.1	0.0	0.0	−0.7	−1.2	−1.1	−1.0
Real wage	4.8	−5.1	−8.6	n.a.	7.6	7.6	−13.5	−11.1	−0.6	2.2	1.4	n.a.

Sources: Figures for 1981–1990 are from Nora Lustig, *Mexico: The Remaking of an Economy,* 2nd ed. (Washington, D.C.: The Brookings Institution, 1998), pp. 22, 23, 30, 40, 41, 68, 69; for 1991–1999 from Nora Lustig, "Life Is Not Easy: Mexico's Quest for Stability and Growth," *Journal of Economic Perspectives* 15(1) (2001): 89; and for 2000 from *The Economist,* April 7–13, 2001, p. 122, except for the budget surplus, which is an estimate from *OECD Economic Surveys: Mexico July 2000* (Paris: Organization for Economic Cooperation and Development, 2000), p. 53. GDP inflation and real wage are average percentage changes per year, current account is in average billions of U.S. dollars per year, and budget surplus is average percentage of GDP per year.

Slower growth in the United States after 2000 hurt Mexican growth, with GDP growth barely above zero in the following two years. Table 18-2 presents several macroeconomic indicators for selected years for the period 1980–2000.

Privatization

Privatization was a major feature of the Mexican reform process from 1982 to 1995, focusing mostly on liquidating or merging small or unviable enterprises. During the 1986–1988 period there was a shift to selling small to medium-sized enterprises. Later came sales of larger enterprises following a detailed 12-step process.[59]

The **parastatal sector** expanded from 15 firms in 1934 to 36 in 1940 to 272 in 1970 to a high of 1,155 in 1982. Spending on it peaked in 1975 at 18.2 percent of GDP, whereas revenues from it peaked in 1984 at 22.33 percent of GDP. As of 1991, parastatal sector spending was down to 9.4 percent of GDP and revenues were down to 14.0 percent, both due largely to PEMEX.[60]

From a maximum of 1,155 in 1982, the number of parastatals was reduced to 223 by mid-1992.[61] These privatizations took place as cash sales. During 1989–1992 the government accumulated proceeds equal to 6.8 percent of GDP, which compares with Great Britain's 11.9 percent of GDP over the much longer 1979–1991 period.[62]

59. *OECD Economic Surveys* (1992), p. 88; Pedro Aspe, *Economic Transformation: The Mexican Way* (Cambridge, Mass.: MIT Press, 1993), chap. 4. Aspe served as Salinas's finance minister for most of his presidency.

60. Aspe, *Economic Transformation,* pp. 181–183.

61. *OECD Economic Surveys* (1992), p. 89. Parastatals have taken four forms in Mexico: decentralized organizations, of which 77 were left in 1992; majority state-owned enterprises, of which 106 were left in 1992; public trusts, of which 40 were left in 1992; and minority participation companies, of which none were left in 1992, down from 78 in 1982.

62. *OECD Economic Surveys,* 1992.

The largest privatization, in terms of revenues earned for the government and number of employees involved, was that of the telecommunications company, Téléfonos de México, which was sold in December 1990.[63] Firms selling for more than $50 million included a copper mining company, two airline companies, two sugar refineries, a pasta and vegetable oil company, and a motor vehicles company, most of which went to Mexican buyers. Besides Téléfonos de México, other companies with more than 10,000 employees include two banks[64] and one of the airline companies.[65]

The 1994–1995 peso crisis prompted the renationalization of some banks, highways, and some airlines. But privatizations have since restarted with railroads in 1997 and ports in 1998,[66] although utilities and PEMEX remain state owned.

Maquiladoras, NAFTA, and the Opening of the Mexican Economy

Since the nineteenth century, fear of domination by the United States has been an overriding theme in Mexican political and economic life. Even Porfirio Díaz (ruled, 1876–1911), who was relatively pro–United States and pro-capitalist, said, "Poor country, so far from God and so close to the United States."[67] After World War II, President Alemán enacted import restrictions for industrial development led by import substitution with minimal reliance on the United States. The most dramatic anti-U.S. moves for economic independence were Cárdenas's oil and railroad nationalizations during the 1930s.

Policy relaxation came in 1965 after U.S. President Lyndon Johnson, a Texan, settled a long-standing border dispute on terms favorable to Mexico. This policy, known formally as the U.S.–Mexico Border Industrialization Program, was known more generally as the **maquiladora program.** U.S. plants could easily invest on the border and sell output in the United States freely.

This program grew rapidly, drawing investment in numerous industries, so that by 1981, 1.5 percent of the Mexican labor force was employed in such plants.[68] Rules covering them in Mexico were further liberalized in the mid-1980s, triggering a great expansion of

63. Lustig, *Mexico,* p. 106; Aspe, *Economic Transformation,* p. 218.

64. The largest bank sold was Bancomer of Monterrey, Mexico's third largest city. Located in the northeast near Texas but not on the border, and thus able to gain from NAFTA, Monterrey contains powerful entrepreneurial families dating back to the Díaz period known as the Monterrey Group, who have been relatively independent of control by Mexico City elites (Roderic A. Camp, *Entrepreneurs and Politics in Twentieth Century Mexico* [New York: Oxford University Press 1989]).

65. Aspe, *Economic Transformation.*

66. *OECD Economic Surveys* (2000), pp. 113–114.

67. Reynolds, *The Mexican Economy,* p. 197. It should be noted that Mexicans do not like referring to people from the United States as "Americans," as they see that term applying to themselves as well. They call citizens of the United States *Norteamericanos* (North Americans).

68. Barkin, *Distorted Development,* p. 90.

manufacturing output and exports. Controversy over conditions in these plants and border towns erupted during the 1993 NAFTA confirmation fight in the United States. But some investigators found that the lack of potable water, indoor plumbing, and electricity was associated with people in the border towns not working in the *maquiladoras,* and that those working in them were generally substantially better off.[69]

Controversies over conditions in the *maquiladoras* have increased since the adoption of NAFTA as expansion of this sector has surged. Between 1995 and 2000 the number of *maquiladora* plants rose from 2,138 to 3,486 and the number of employees rose from 497,000 to 1,216,819,[70] with their share of exports rising from 4.9 percent in 1995 to 13.3 percent in 1999.[71] Charges have been made that wages are lower than those in other Mexican plants and that labor unions have been suppressed, with the rate of unionization dropping sharply in the auto industry.[72] In connection with both of these arguments is the claim that a disproportionately large number of *maquiladora* workers are female, who are especially badly treated and exploited in various ways.[73]

After 1982, Mexico decided to join the world economy, even if mostly as an adjunct to the U.S. economy. Given that in 1982 two-thirds of Mexico's trade was with the United States, that approach seemed inevitable.[74] Although attention has focused on NAFTA and the coincidence of its implementation with the Zapatista uprising, most major moves toward trade liberalization occurred prior to NAFTA. The process began in 1984, when the percentage of goods requiring import permits fell below 100 percent, a figure that was down to 9.1 percent by 1991.[75] Whereas the maximum possible tariff was 100 percent as late as 1986, when Mexico joined GATT (now the WTO), it was 20 percent by 1989. Tariffs continued to decline as well as nontariff barriers and remaining restrictions on foreign investment.

Along with the initiation of NAFTA negotiations in 1990, free trade zones were established with Guatemala in 1989 and with Chile in 1991. NAFTA opened all of Mexico to equal rules for foreign investment, although investment has continued to focus on the

69. Mitchell A. Seligson and Edward J. Williams, *Maquiladoras and Migration Workers in the Mexico–United States Border Industrialization Program* (Austin: University of Texas Press, 1981), pp. 50–51.

70. www.nafta-mexico.org/export.htm as reported in R. Scott Frey, "The Migration of Hazardous Industries to the Maquiladora Centers of Northern Mexico," Department of Sociology, Anthropology, and Criminal Justice, University of North Florida, Jacksonville, 2001.

71. *OECD Economic Surveys* (2000), p. 36.

72. Dan La Botz, *The Mask of Democracy: Labor Suppression in Mexico Today* (Boston: South End Press, 1992), p. 182.

73. Altha J. Cravey, *Women and Work in Mexico's Maquiladoras* (Lanham, Md.: Rowman and Littlesfield, 1998).

74. *OECD Economic Surveys* (1992), p. 262.

75. Aspe, *Economic Transformation,* p. 157.

Box 18-2
NAFTA and the Mexican Financial Crisis

Although most estimates suggest major net gains to Mexico from NAFTA (and minor ones to the United States), certain sectors are being adversely affected in each country. In the United States vulnerable industries include textiles, sugar, and citrus fruits. In Mexico the most vulnerable industry is corn farming, which has also been affected by the abandonment of the *ejidos* by the Salinas administration and the outbreak of the Zapatista revolt in Chiapas, even though this sector was granted a 15-year transition period for the removal of all import restrictions.

One result of trade and investment liberalization has been surging manufacturing output and exports, with a major restructuring of Mexico's commodity export profile. Oil's export share peaked in 1982 at 74.6 percent and then declined to 26.1 percent in 1991, whereas manufacturing's share rose from 13.7 percent in 1982 to become the majority export sector at 51.3 percent in 1991,* with these trends continuing since then.

Despite escaping dependence on raw materials exports, Mexico is now dependent on U.S. intermediate goods imports. From 1982 to 1993 exports surged from $24 billion to $52 billion. But imports rose from $17 billion to $65 billion, of which only $8 billion were consumer goods.[†] This soaring trade deficit triggered the peso crisis at the end of 1994 and the subsequent austerity program, thus bringing into question NAFTA's benefits for Mexico, although the crisis was aggravated by internal banking problems, and exports and GDP growth rose sharply after the crisis ended in 1995.

Another issue in the U.S. NAFTA debate involved the high rate of migration from Mexico, driven by Mexico's high population growth rate and lower per capita income. If NAFTA succeeds in creating jobs in Mexico, this will lower migration to the United States.[‡] Rising incomes and urbanization are lowering the population growth rate (see table 18-1). Massive migration from the *ejidos* could alter the migration scenario, however.

*OECD *Economic Surveys* (1992), p. 261.
†Rudiger Dornbusch and Alejandra Werner, "Mexico: Stabilization, Reform and No Growth," *Brookings Papers on Economic Activity* 1 (1994): 296. For further discussion of the peso crisis see Nora Lustig, *Mexico: The Remaking of an Economy,* 2nd ed. (Washington, D.C.: The Brookings Institution, 1998), and Timothy Kessler, "The Mexican Peso Crash: Causes, Consequences, and Comeback," in Carol Wise and Riordan Roett, eds., *Exchange Rate Politics in Latin America* (Washington, D.C.: The Brookings Institution, 2000), pp. 43–69.
‡President Vicente Fox asked President George W. Bush to relax U.S. rules on immigration, but immigration restrictions have been tightened since the war on terrorism began after September 11, 2001.

border zone. Foreign investment surged, mostly from the United States.[76] From $626.5 million in 1982, foreign investment rose to $3.877 billion in 1987, $9.414 billion in 1990, and over $12 billion in 1993.[77] After dropping to $9.6 and $9.2 billion in 1995 and 1996, respectively, it rose to $12.8 billion in 1997 and held at $11.3 and $11.6 billion in 1998 and 1999, respectively.[78]

76. Fear of such investment flows concerned labor union critics of NAFTA in the United States. Constraining such investment is the inadequacy of Mexican infrastructure, especially for transportation, and continuing problems with corruption and bureaucratic red tape.

77. Aspe, *Economic Transformation,* p. 165.

78. *OECD Economic Surveys* (2000), p. 37.

The Environment

Mexican environmental policy and Mexico's environment were issues in the U.S. NAFTA debate. Mexico suffers from severe pollution problems, but they tend to be concentrated in two main areas: Mexico City and the U.S.–Mexico border area, with the latter upsetting people in the United States. Considered in the aggregate, Mexico has fairly low levels of carbon dioxide emissions compared to most OECD countries.[79]

Mexico City has very severe air pollution, as can be seen by comparing the volumes of various pollutant emissions for the metropolitan area with the aggregate amounts for different countries. At the end of the 1980s, Mexico City's particulate emissions equaled those for all of Italy, sulfur dioxide emissions were about the same as for all of Denmark, hydrocarbons emissions somewhat exceeded those of all of Austria, as did carbon monoxide emissions, and nitrogen oxide emissions were slightly less than those in all of Switzerland.[80] These emissions aggravate health concerns because of the city's high elevation (over 7,000 feet) and thermal inversions (like those of Los Angeles), which trap and concentrate pollutants in a colder layer of air at the bottom of the Valley of Mexico.

The major sources of pollutants have been motor vehicles, along with some stationary sources. The Salinas government imposed quantitative controls on motor vehicles in the metropolitan area starting in late 1989 and in 1991 shut down a large polluting oil refinery in the area.[81] There has been some improvement in Mexico City's air quality since then, although the rising number of automobiles continues to provide a serious challenge.

The U.S.–Mexican border problem is due to toxic emissions from *maquiladora* plants. NAFTA provides U.S. funding for cleaning up these plants, and the Salinas administration passed new laws and promised stricter enforcement of existing laws. Skeptics abound who doubt that these promises will be carried out. The 1994 financial crisis caused reductions in U.S.–Mexico border cleanup spending. The majority of hazardous waste from *maquiliadora* plants is unaccounted for, with only about 11 percent of toxic wastes being properly treated according to one estimate.[82]

Generally a nation's polluting pattern varies with its income level. Very poor countries have serious problems with wastewater and solid waste, which are still problems in Mexico

79. *OECD Economic Surveys* (1992), p. 119.

80. Mexico City figures are from *OECD Economic Surveys* (1992); the rest are from World Resources Institute, *World Resources 1992–93* (New York: Oxford University Press, 1992), p. 351.

81. *OECD Economic Surveys* (1992), p. 244.

82. Stephen Mumme, "NAFTA's Environmental Side Agreement: Almost Green?" *Borderlines,* 7, no. 9, October 1999. There have also been charges of *maquiladora* plants dumping toxic wastes in clandestine sites in Mexico (La Botz, *The Mask of Democracy,* p. 167).

City's slums; middle-income countries are peak generators of sulfur dioxide emissions; higher-income countries generate more carbon dioxide and nitrogen oxide emissions. Mexico is following this pattern while facing a special challenge in controlling pollution in the world's second largest metropolitan area.

The Distribution of Income and the Quality of Life

Mexico's real standard of living has improved for most of the population. Between 1970 and 1990, life expectancy rose from 61 to 70 years, the infant mortality rate declined from 68.5 per thousand births to 23.9, the percentage of the population with access to safe water rose from 61 to 79.4 percent, the percentage with access to electricity rose from 58.8 to 87.5 percent, and the percentage with access to sewerage rose from 41.5 to 63.6 percent.[83] By 2000, life expectancy had increased further to 72.2 years, although infant mortality increased slightly to 25.[84]

Despite these general improvements, many people have been left behind. Apart from those in the desperate slums of Mexico City, most of those not sharing in these gains live in the rural areas. Rates of poverty and inequality rose in the early stages of the 1980s reforms, with some improvements since then. Extreme poverty (less than $1 per day) rose from 13.9 percent in 1984 to 17.1 percent in 1989 and then declined to 15.5 percent in 1994, while moderate poverty (less than $2 per day) rose from 21.5 percent in 1984 to 28.4 percent in 1989 and then declined to 19.7 percent in 1994. Most of this improvement was in urban areas, while poverty rates continued to rise in the rural parts of the southernmost states of Mexico, exactly those areas that saw rebellious uprisings in the 1990s.[85] The trend of overall inequality follows a somewhat similar pattern, with increasing equality up to 1984, more inequality to 1989, and possibly a similar trend to 1994 and afterward. Figure 18-1 shows data for 1963 to 1989. As of early 2003, the overall rate of poverty was about the same as in the early 1980s, and 40 percent of those in rural areas earned less than $1.40 per day.[86]

The Salinas administration was aware of this trend toward greater income inequality, especially given the strong showing in the 1988 presidential election by the leftist PRD. The response was the National Solidarity Program, directed mostly at rural infrastructure development, especially roads, health clinics, electricity, and drinking water provision. Social spending rose from a low in 1985 of 5 percent of GDP and 22.6 percent of programmable

83. *OECD Economic Surveys* (1992), p. 112.

84. *UN Human Development Report 2002,* p. 175.

85. Nora Lustig, "Life Is Not Easy: Mexico's Quest for Stability and Growth," *Journal of Economic Perspectives* 15(1) (2000), pp. 100–101.

86. Mary Jordan and Kevin Sullivan, "Trade Brings Riches, But Not to Mexico's Poor: NAFTA's Critics Say Pact Has Failed to Improve Lives of Impoverished Majority," *Washington Post,* March 22, 2003, pp. A10–A11.

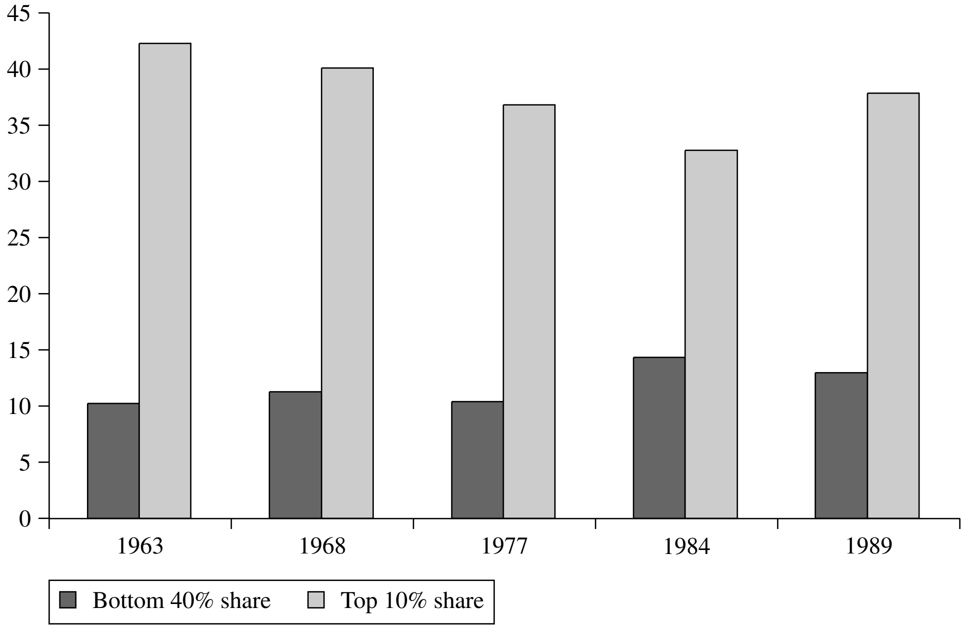

Figure 18-1
Income distribution in Mexico, 1958–1989.
Note: "Bottom 40% share" shows the percent of income going to the poorest 40 percent of households, "Top 10% share" shows the percent of income going to the richest 10 percent of households.
Source: Figures are from Nora Lustig, *Mexico: The Remaking of an Economy,* 2nd ed. (Washington: Brookings Institution, 1998), p. 92.

public sector spending to 7.6 percent of GDP and 43.7 percent of programmable public sector spending in 1991.[87]

In the face of the post-1994 guerrilla uprisings and the aftermath of the peso crisis, in 1997 President Zedillo introduced a new antipoverty program, the PROGRESA, which targeted children in poor households in poor communities for in-kind educational, health, and nutritional assistance. This program was 4.4 percent of the overall budget in 2000, and overall social spending as a percentage of the budget rose from 52.0 percent in 1997 to 61.5 percent in 2000. But this effort was insufficient to assuage those unhappy with the distributional implications of reform.

President Fox's main antipoverty program has consisted of encouraging private micro-credit institutions and to try to build more child-care centers in urban areas. However, the

87. Aspe, *Economic Transformation,* pp. 119–121.

former program has reached only a small percentage of the poor, and the latter program has been hampered by the severe budget limitations Mexico has faced with its near-zero GDP growth since Fox took office, largely due to the slowdown of the U.S. economy.[88] It is no solace to the government that it is often when things are getting better that uprisings occur, although Chiapas has been left behind more than any other state and troubles began to erupt there again in 2003. Revolutions of rising expectations can cause reforms to become general revolutions.

THE MEXICAN ECONOMY IN LATIN AMERICAN PERSPECTIVE

Mexico reflects common patterns in the Latin American nations once ruled by Spain or Portugal. Mexico was the site of the proudest and most economically advanced indigenous civilization of the Western Hemisphere. Tenochtitlán was the hemisphere's largest city when Columbus arrived. These advanced civilizations provided a base for the colonial regime both organizationally and in labor quality.

The Spanish colonial legacy in most of these countries left very unequal income distributions associated with the **latifundia** (hacienda) system in which Spaniards owned large estates worked by indigenous peoples.[89] In later political-economic developments the United States became identified as the resented neocolonial power. Many populist corporatist governments arose out of unstable conditions broken by periods of military dictatorship. Mexico's proximity to the United States caused it to have a more intense anticolonial and revolutionary ideological tradition, even as the country benefited from greater exports to the United States relative to other Latin American nations.

Ultimately, intermarriage in Mexico led to a predominantly *mestizo* population that was proud of its nation. The success of Mexico's economic development, despite its problems, has disproved the standard racist view of Latin American economic development at the end of World War II, which held that only nations such as Argentina and Chile, with largely European populations, were suitable for industrial development. The success of the East Asian NICs also undermines this notion, but many of those nations revel in their own racial purity. Mexico and Brazil have given the lie to the idea that interracial marriage is inherently inimical to economic development.

Table 18-3 presents summary snapshots of some Latin American economies. Mexico stands up pretty well, lying between the extremes for most indicators. With the exception of command socialist Cuba, which has suffered severe stagnation since the cutoff of Soviet subsidies while still being subject to the U.S. economic embargo, Mexico resembles most

88. Jordan and Sullivan, "Trade Brings Riches."

89. In some, the native populations were wiped out by disease, slavery, warfare, or some combination of these, only to be replaced by African slaves, East Indians, or European immigrants.

Table 18-3
Indicators for Latin American Economies

Country	Per Capita GDP	Inflation Rates	Quintile Ratio	Life Expectancy	Female Literacy	Health and Ed. Budget	EFI
Guatemala	3,821	10.1	15.8	64.8	61.2	3.8	2.80
Cuba	3,967	−0.1	n.a.	76.0	96.6	11.6	4.75
Peru	4,799	27.3	11.7	68.8	85.3	5.3	2.75
Costa Rica	7,625	199.5	29.7	67.7	85.4	8.0	3.10
Brazil	8,650	15.6	11.5	76.4	95.7	10.6	2.65
Mexico	9,023	19.4	16.5	72.6	89.5	7.5	2.90
Uruguay	9,035	33.9	8.9	74.4	98.1	5.2	2.55
Chile	9,417	25.3	18.6	75.3	95.6	6.3	1.85
Argentina	12,377	8.9	n.a.	73.4	96.8	5.9	2.50

Sources: Per capita GDP figures are in U.S. dollars adjusted for purchasing power parity in 2000 from *UN Human Development Report 2002* (New York: Oxford University Press, 2002), pp. 190–192, except for Cuba, which is for 1998 from *UN Human Development Report 2000,* p. 158. Inflation rates are annual averages for 1990–2000 from *UN Human Development Report 2002,* pp. 190–192, except for Cuba, which is for 1996–2000 from Gerald P. O'Driscoll, Jr., Kim R. Holmes, and Mary Anastasia O'Grady, *2002 Index of Economic Freedom* (Washington, D.C., and New York: Heritage Foundation and Wall Street Journal, 2002), p. 168. The quintile ratio is for the latest year available during 1991–2000 from *UN Human Development Report 2002,* pp. 194–196. Life expectancy from birth is for 2000 from *UN Human Development Report 2002,* pp. 149–151. Adult female literacy rates are in percentages for 2000 from *UN Human Development Report 2002,* pp. 222–224. Health and education budgets are in percentages of GNP for 1998 for health and between 1995 and 1997 for education from *UN Human Development Report 2002,* pp. 207–209. EFI is Economic Freedom Index for which ranges from 1.00 (most free) to 5.00 (least free) for 2001 are from O'Driscoll, Holmes, and O'Grady, 2002, *2002 Index of Economic Freedom,* pp. 22–26.

other Latin American countries in that their reform processes have been similar, except that Chile marketized and privatized sooner than the rest.

But Mexico has had one of the more consistent and vigorous economic reform programs with its move to full trade liberalization under NAFTA.[90] It has been a vanguard reformer, but one with a strong revolutionary tradition because of its proximity to the United States and its proud cultural heritage. Thus it has had more dramatic internal conflict than most of its Latin American neighbors.[91]

Bordering on troubled Chiapas, Guatemala is Mexico's immediate neighbor to the southeast in Central America and the site of repressive governments that have warred against a Mayan-descended population. Because it has implemented few economic reforms, Guatemala suffers from greater extremes of inequality and poverty than the other nations profiled in table 18-3.

90. See John Williamson, ed., *Latin American Adjustment: How Much Has Happened?* (Washington, D.C.: The Brookings Institution, 1990), for discussion of reform programs in most Latin American economies.

91. In many of these countries the shift to economic reform came with the reinstitution of political democracy after periods of military dictatorship, whereas technically, democratic and civilian rule prevailed in Mexico throughout, if de facto authoritarian and dominated by the PRI.

Cuba, located in the Caribbean 90 miles south of Key West, Florida, has had a command socialist economy since soon after Fidel Castro came to dictatorial power in 1959. Like Mexico, Cuba lies in close proximity to the United States, which has affected it intensely since Cuba achieved its rather late independence from Spain in 1898 during the Spanish-American War. Still facing an embargo by the United States, although it was slightly relaxed in the 1990s, and having lost subsidized support from the Soviet Union, Cuba has struggled to maintain its once high-quality medical and educational systems as it has economically stagnated.

Home of the ancient Inca empire in northwestern South America, Peru has suffered deep conflicts between a ruling, mostly Spanish-descended, urban elite and the mostly pure Indians of the rural areas that has involved the now mostly defeated Maoist **Sendero Luminoso** ("Shining Path"; see chapter 3). Economic reforms have been inconsistent but were accelerated somewhat after 1995.

Long a continuous political democracy in Central America, Costa Rica is famous for having no standing military, a fact many see as connected to its democracy. It is the first country in the world to have engaged in a **debt-for-nature swap** with the World Bank to preserve some of its rain forests. Such arrangements allow a less developed country to have its foreign debt reduced in exchange for environmental preservation agreements.

Brazil is the largest and most multiethnic Latin American nation. This former Portuguese colony, occupying eastern South America, has the largest foreign debt of any nation except the United States, along with high rates of economic growth and income inequality. After ending a military dictatorship it had trouble bringing hyperinflation under control and in 2002 elected a leftist government led by Lula da Silva.

Except for a period of dictatorship in the 1970s and early 1980s, Uruguay, nestled between Brazil and Argentina, has been fairly quiet and stable, with policies imitating those of some social democracies of Western Europe, as shown by its higher degree of income equality. Its growth has recently stagnated, dragged down especially by neighboring Argentina's deep recession.

Long a stable parliamentary democracy in the "Southern Cone" of South America, Chile became a military dictatorship under Augusto Pinochet during the 1970s after a brief elected leftist rule. Economic liberalization began under Pinochet prior to the restoration of political democracy and has been more thorough than in any other Latin American country, although with some limits such as controls on short-term capital flows.

Argentina, located in the Southern Cone, had by far the highest income of any Latin American country in 1945, only to fall under the populist corporatist rule of Juan Péron, whose policies engendered severe stagnation. Saddled with large foreign debts and entrenched hyperinflation, Argentina replaced a military dictatorship with democratic rule in the late 1980s and has followed economic reform policies similar to Mexico's since then. After bringing inflation under control in the 1990s as it adopted a **currency board** tied to the U.S. dollar, it fell into a long recession starting in 1997. This culminated in a major financial crisis in late 2001, when it unhitched from the currency board and steeply devalued its currency, with rising poverty.[92] The figure for per capita income in table 18-3 is now highly overstated, although it appears that the severe decline in Argentina's income may have halted by the end of 2002, with some signs of improvement since then.

SUMMARY AND CONCLUSIONS

Mexico is opening, marketizing, and privatizing an economy long characterized by a state-dominated, inward-looking policy designed to protect it from U.S. domination. With a long history of centralized state authority dating from the Aztec period, Mexico was ruled for most of the twentieth century by the Institutional Revolutionary Party, which finally lost power in 2000. The party's name indicates its effort to simultaneously include conflicting socioeconomic forces within a corporatist structure, to remain revolutionary in its populist appeal to peasants through land redistribution and to workers through party-related unions, and to protect business through its institutionalized, technocratic bureaucracy. It remains the largest party in the Mexican parliament, despite having lost the powerful presidency to reformer Vicente Fox of the National Action Party.

Mexico's technocratic populist corporatism began to change with reform policies developed since the foreign debt crisis of 1982, triggered after oil price declines rendered massive borrowings predicated on rising oil prices unsustainable. Mexico has since escaped from its dependence on raw materials exports and has engaged in an industrialization drive fueled by foreign investment, further encouraged by trade liberalization culminating in the NAFTA with the United States and Canada. But these gains were challenged as rising imports of intermediate goods triggered a peso devaluation and an austerity program at the end of 1994. After a deep recession in 1995 and some policy readjustments, export-led growth resumed later in the decade.

The development and reform policies of Mexico have been mostly successful and influential. Living standards have improved for most citizens, and urbanization proceeds as Mexico City competes with Tokyo to be the world's largest city. Mexico has even joined the OECD, the "rich man's club" of countries that was founded in Western Europe after World War II.

But as in many other parts of the world, economic reform has also brought increased income inequality and opposition, especially from rural peasants still living in traditional *ejidos*. These grievances exploded at the beginning of 1994 in the armed Zapatista uprising

92. The case of Argentina has engendered fierce debate over IMF adjustment policies, with some arguing that Argentina has become impoverished by following IMF advice rather than the other way around; see, for example, Joseph Stiglitz, "Argentina Shortchanged," *Washington Post,* May 12, 2002, p. B1.

in the poor state of Chiapas. As in Eastern Europe, a possible political backlash might halt or reverse some of the reforms. The recessionary aftermath of the peso crisis of 1994–1995 and the problems of corruption and inequality finally led to victory for the opposition PAN party in 2000, which faces the challenge of solving all these problems. Mexico's path of development continues to be fraught with grand drama.

INTERNET SOURCES

www.pemex.com

www.mexico.com

www.geoinvestor.com/statistics/mexico/economicdata.htm

www.latin-focus.com/countries/mexico/mexico.htm

QUESTIONS FOR DISCUSSION

1. What elements of the modern Mexican economy can be traced to the Spanish colonial and Aztec periods?
2. How are the economic policies of Juárez, Díaz, Cárdenas, Alemán, and Salinas similar and different?
3. To what extent are the *ejidos* a New Traditional Economy element in Mexico? What is their current status and outlook?
4. Why did President Zedillo deny to the Mexican people that he pledged the oil reserves of PEMEX as collateral for the foreign exchange support loan from the United States in 1995?
5. How has NAFTA affected the development of the *maquiladora* industries, and what has been its broader impact on the Mexican economy?
6. How does the Mexican reform program compare with those in Central and Eastern Europe? In what ways has it been more and less successful?
7. How does Mexico compare with other Latin American economies in terms of economic performance?
8. Why did the Zapatista revolt occur?
9. To what extent is the label of the Mexican economy as technocratic populist corporatism accurate?
10. How has the U.S. war on terrorism affected Mexico's economy and society?

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RUSSIA
Onsong
Hoeryong
CHINA
Chongjin
Hyesan
Manpo
Kilju
Kanggye
Pukchong
NORTH KOREA
Sinuiju
Hyangsan
Wonsan
Gulf of
West Korea
P'yongyang
East Sea
(Sea of Japan)
Nampo
Kumgang
Haeju
Kaesong
Janggok
Gangneung
Seoul
Samcheok
Beaches
SOUTH KOREA
Buyeo
West Sea
(Yellow Sea)
Pohang
Gunsan
Daegu
Gyeongju
Masan
Gwangju
Pusan
Mokpo
South Sea
(East China Sea)
JAPAN

19 North and South Korea: The Lingering Shadow of the Cold War

Pine and bamboo trees seem to symbolize Koreans. The trees retain green leaves throughout all four seasons, resisting cold temperatures in the winter and hot temperatures in the summer. Similarly, the Korean people have managed to survive periods of suffering and humiliation inflicted upon them by foreign invasions on over 900 occasions.
—Sung Moon Pae, *Korea Leading Developing Nations,* 1992, p. 19

In the past foreign observers have gone wrong, in my view, by underestimating North Korea in nearly every way possible. In the meantime, predictions based on the idea that this regime draws deeply from the well of Korean tradition and anticolonial nationalism, and will therefore have staying power in the post–Cold War world, have so far been correct.
—Bruce Cumings, *Korea's Place in the Sun,* 1997, p. 433

Korean pride assumed many forms . . . it grew into what can only be called a Korean worldview. The scenario goes as follows. For every people there comes a time to rise. The Europeans and Americans became lazy and were replaced by the Japanese. Japan has also become soft. Now it is Korea's turn!
—Jon Woronoff, *Korea's Economy,* 1983, pp. 75–76

INTRODUCTION

The shadow of the Cold War lingers over the Korean peninsula. Although homogeneous in culture and ethnicity, the Korean people were divided at the end of World War II between a Communist North and a capitalist South. They fought a bloody war during 1950–1953 that involved outsiders, most significantly the United States and China. The **Korean War** ended in a stalemate with little change in the division between North and South, today the most heavily armed border on earth.

As South Korea outstripped North Korea economically and diplomatically, North Korea's secretive leadership sought to develop nuclear weapons despite international opposition. After the July 1994 death of longtime leader Kim Il Sung,[1] his son and successor, Kim Jong Il, agreed to give up North Korea's nuclear program in return for foreign energy aid, although this agreement fell apart in late 2002 with North Korea's admission that it was still developing nuclear weapons. Still facing 37,000 U.S. troops in the South, North Korea can no longer count on the support of China and Russia, as it could in the early 1950s.

Korea has been a cultural bridge between China and Japan and was invaded frequently by both. This led Korea to adopt extreme isolationism; it was called the **Hermit Kingdom** during the nineteenth century. The last Asian nation opened to outside influence, it fell under Japanese control that ended in 1945 when the USSR and the United States militarily occupied the North and South, respectively. Each established competing regimes that went to war in 1950.

1. At his death, Kim Il Sung was the world's longest-lasting national ruler.

After the war North Korea, officially called the Democratic People's Republic of Korea (DPRK), developed an economy that still follows an extreme Stalinist command socialist model despite some reform moves. Caught between China and the USSR during the Sino-Soviet conflict, Kim Il Sung developed a self-reliance ideology called **juche** that led to a modern Hermit Kingdom. Stressing heavy industrialization, North Korea for over a decade after 1953 grew more rapidly than South Korea while developing a wide social safety net and greater income equality. But since South Korea surpassed North Korea in per capita income in the mid-1970s, the North has stagnated economically. After 1988 North Korea declined so dramatically that it has acknowledged experiencing outright famine, which has caused the deaths of thousands, possibly even millions, and went against its *juche* doctrine to request international food assistance. In 1997–1998 it was estimated that the average South Korean seven-year-old boy weighed roughly two-thirds more than his North Korean counterpart.[2] Since then the famine has eased somewhat as food production has partly recovered, although it was not ended as tensions rose with the United States after late 2002, with many refugees still trying to cross into China.

When Korea was divided the South, officially called the Republic of Korea (ROK), had more agriculture and light industry than the heavily industrialized North. After corruption and stagnation in the 1950s, a military dictatorship came to power in 1961 under Park Chung-hee that instituted indicatively planned market capitalist growth. The South integrated with the world economy, following an export-led growth policy like that of Japan, and its comparative advantage evolved technologically from textiles through heavy industry to consumer electronics and automobiles. South Korea did this in tandem with the three other "tigers," or NICs of East Asia: Taiwan, Hong Kong, and Singapore.[3]

From 1980 to 1992 South Korea had the highest real per capita income growth rate in the world. South Korean per capita income reached $11,380 in 1996, putting it well in the category of developed economies, before it plunged to a low of $6,723 in 1998 as a result of the 1997 Asian financial crisis. North Korea's per capita income fell from a high in 1988 of $1,260 to a low of $573 in 1998.[4] Both countries have since experienced growth, North Korea aided by newly improved relations with South Korea under its reforming president, Kim Dae Jung.

2. Nicholas Eberstadt, "Disparities in Socioeconomic Development in Divided Korea," *Asian Survey* 40 (2000): 876.

3. These are increasingly labeled the **newly industrializing economies (NIEs),** presumably to defer to the idea that Hong Kong (and perhaps Taiwan) is not a country.

4. Data come from Byoung-Lo Kim, *Two Koreas in Development: A Comparative Study of Principles and Strategies of Capitalist and Communist Third World Development* (New Brunswick, N.J.: Transaction, 1992), p. 67; "Leading Korean Economic Indicators," in *Korea's Economy 2001,* Vol. 17 (Washington, D.C.: Korea Economic Institute, 2001); and Hwang Eui-gak, "Beyond the Summit: Deepening Linkages on the Korean Peninsula," in *The Korean Peninsula in the 21st Century: Prospects for Stability and Cooperation. Joint U.S.–Korea Academic Studies* 11 (2001): 71–72.

As South Korea's income rose, so did pressures within it to democratize. The military dictator, President Park, was assassinated in 1979. In 1988 his successor voluntarily gave up power to a democratically elected successor when the Olympic games were held in Seoul, South Korea's capital. In 1993 an opponent of the previous military regimes, Kim Young Sam, was elected president. He engaged in an anticorruption drive that affected the top ranks of both the military and business communities.[5] South Korean business has been dominated by large conglomerates known as **chaebol,** somewhat similar to the Japanese *zaibatsu* and *keiretsu*. During the 1997 Asian financial crisis, former dissident Kim Dae Jung became president, and accelerated the anticorruption drive by instituting a more far-reaching set of reforms to reduce the power of the *chaebol*. He was succeeded in early 2003 by a fellow member of his party, Roh Moo Hyun.

Yet the South Koreans cannot reduce the military's share of their economy given the threat of the world's fourth largest army on their northern border. The long-run solution, supported by both Northerners and Southerners, is reunification. Negotiations between the North and South experienced a dramatic breakthrough when Kim Dae Jung visited the North Korean capital of Pyongyang for a summit meeting with Kim Jong Il in mid-June 2000, just before the fiftieth anniversary of the outbreak of the Korean War. Yet the North Koreans continue to be reluctant to open up fully out of fear of domination by the capitalist South Koreans.

The problems of the German reunification have made the South Koreans reluctant to unify rapidly. But eventually unification will probably happen, and despite a difficult transition, a unified Korea could be a major world economic power. Koreans work longer hours than any other people in the world and have achieved high levels of education following the claim of some that theirs is the world's most **Confucianist society.**[6] This combination has already shown its potential in the substantial achievements of South Korea.

HISTORICAL AND CULTURAL BACKGROUND TO 1953

Premodern Korea

Koreans have a distinct cultural and ethnic identity. They are related linguistically to the Japanese and Manchurians but are closer culturally to China. Their myths declare that they

5. Mark L. Clifford, *Troubled Tiger: Businessmen, Bureaucrats, and Generals in South Korea* (Armonk, N.Y.: M. E. Sharpe, 1994).

6. Besides Confucianism, another factor in the intensely competitive drive for education by Koreans is an attitude known as *Hahn,* "a sense of rancor, regret, remorse, revenge, grievance, grudge, and grief," possibly caused by long, passive suffering under foreign, especially Japanese, domination. "Once released *Hahn* has turned into an enormous force inciting and motivating people to find ways to gratify their suppressed needs" (Hong Dong Kim, "Koreans: Who Are They?" in A. M. Whitehall, ed., *Doing Business in Korea* (London: Croom Helm, 1987), pp. 9–11.

are descended from Tangun, son of a bear and a god, founder of the first Korean kingdom in 2333 B.C.E. There is still a cult that worships him, and the North Koreans claim to have found his tomb.[7]

The first historical dynasty, founded in 1122 B.C.E., lasted nearly 1,000 years, during which time Chinese Confucianism penetrated Korea. In 668 C.E., after more inroads by Chinese culture including *Buddhism,* the Silla Kingdom conquered two rivals and united Korea for the first time.[8] The Silla kingdom transmitted Chinese cultural influences to Japan. The Silla rulers were replaced in 936 by the Koryo kingdom,[9] dominated by increasingly corrupt Buddhist monks and marked by many foreign invasions.

In 1392 the Choson kingdom established its capital at Seoul; this kingdom lasted until Japan annexed Korea in 1910. Initially progressive, under Choson rulers Korea was possibly the world's technological leader in the early 1400s.[10] With a new aristocratic class, the scholarly bureaucratic *yangban,* the Choson kingdom was Confucianized. After a series of invasions at the end of the 1500s, it withdrew into itself to become the ossified Hermit Kingdom.

The Opening Up of Korea and the Japanese Occupation

After various Western nations failed to open up Korea, post-Meiji Japan obtained a commercial treaty in 1876. During the 1880s Korea signed trade treaties with other outside powers, and U.S. Protestant missionaries poured in.[11] An uprising against foreigners in Korea in 1894 triggered a Chinese-Japanese war, won decisively by Japan. In 1905 Russia

7. This attempts to legitimize their claim to rule all of Korea. The oldest Korean religion is a disorganized shamanism known as **Sinkyo,** with similarities to Japanese Shintoism and Chinese Taoism. Unlike them it has no priestly hierarchy and is centered on female shamans. The predominance of women in Sinkyo reflects a reaction to the dominant male-oriented Confucianism. See Cornelius Osgood, *The Koreans and Their Culture* (New York: Ronald Press, 1951).

8. The conflict between the southeastern Silla and the southwestern Paekche continues today in regional dislike between the southeastern Kyongsang provinces and the southwestern Cholla provinces. The 1961–1988 military regimes were dominated by officers from Kyongsang, and opposition to them centered in Cholla. A 1980 uprising was suppressed with a massacre of hundreds of students in Kwangju, capital of South Cholla and home of former President Kim Dae Jung.

9. Origin of *Korea,* meaning "land of the morning calm."

10. One example was the invention of printing prior to Germany's Gutenberg, who is often given credit as being the first.

11. By the late 1980s about 24 percent of the South Korean population were Christian, more than in any East Asian country except the Philippines, and 27 percent were Buddhist. Although a few Christian churches and Buddhist temples have recently reopened in North Korea, the main "religion" there remains Kim Il Sung worship. The influence of Americans before 1910 led Seoul to be the first city in Asia to have electricity, trolley cars, a water system, telephones, and telegraphs, all at the same time (Bruce Cumings, *Korea's Place in the Sun: A Modern History* (New York: W. W. Norton, 1997), p. 132.

and Japan fought over Korea and Japan was victorious. In 1910 Japan annexed Korea, resulting in the bitter hostility between Koreans and Japanese that persists today.

Under Japanese rule, Korea's economic growth accelerated and modernizing reforms were carried out to integrate Korea into the Japanese empire, albeit in a subordinate position. Among these were the abolition of slavery, the institution of a civil code, introduction of a modern financial system,[12] expansion of the school system, the building of infrastructure in transportation and hydroelectric power, and the initial development of Korea's textile industry.

Koreans revolted against Japanese domination in a nonviolent independence movement in 1919, which was suppressed by the Japanese after thousands of Koreans were killed. Koreans opposed Japan's attempt to suppress their language and culture, the takeover of a majority of the most fertile land by Japanese landlords, and the increasing export of food and natural resources to Japan, especially after Japan invaded China in the 1930s.[13] To illustrate this diversion, per capita rice consumption in Korea declined by nearly 50 percent between 1915 and 1938.[14]

In 1919 a provisional Korean government in exile was established in Shanghai with a Christian, Syngman Rhee, as president. He was removed in 1925 for embezzlement and relocated to the United States. In 1948, after Japan's defeat in World War II, the United States installed Syngman Rhee as the first president of the ROK after returning him to the country in October 1945.

In 1929 Kim Il Sung joined the Korean Communist Party, and in 1932 he joined a group of anti-Japanese guerrillas operating in Manchuko (Japanese-occupied Manchuria). He led a famous cross-border raid in 1937 but retreated to the Soviet Union in 1941 after his Chinese commander died. Kim Il Sung's official biographies have him almost singlehandedly defeating the Japanese in 1945. The Soviet military brought him back in October 1945 and installed him as leader of a provisional government in the North in February 1946.[15]

12. Before 1876 there was no formal money in Korea. Rent and taxes were generally paid in grain (rice in the south, wheat or millet in the north).

13. Many Koreans cooperated with the Japanese, and North Koreans charged that the United States elevated many such individuals in the South after 1945. Park Chung-hee, ROK dictator from 1961 to 1979, had been an officer in the Japanese army.

14. Andrew J. Grajdanzev, *Modern Korea: Her Economic and Social Development Under the Japanese* (New York: Institute of Pacific Relations, 1944), p. 118. In contrast, some recent research suggests that Korea actually grew more rapidly economically than did Japan during 1911–1938, at an annual rate of 3.57 percent compared to 3.36 percent for Japan (Cumings, *Korea's Place in the Sun,* p. 148).

15. There are wildly varying stories about Kim Il Sung's activities prior to 1945. Some South Koreans claim that he was not the same Kim Il Sung as the anti-Japanese guerrilla commander in the 1930s, that man having been killed in 1939 (Dae-Sook Suh, *Kim Il Sung: The North Korean Leader* [New York: Columbia University Press, 1988], chap. 3).

Japanese occupation of Korea ended with the Japanese surrender at the end of World War II in August 1945.

The Division of Korea and the Korean War

During World War II, the 1943 Cairo Conference among the United States, Great Britain, and China declared that "The aforesaid three great powers, mindful of the enslavement of the people of Korea, are determined that in due course Korea shall become free and independent."[16] Korean nationalists interpreted "in due course" to mean "immediately upon liberation from the Japanese," but President Franklin D. Roosevelt intended an extended postwar trusteeship. Scholars disagree about Stalin's position at Yalta and Potsdam. He did not declare an official position because the USSR was not formally at war with Japan, although at Yalta in February 1945, he agreed to declare war against Japan three months after the German surrender in response to a request from Roosevelt.

On August 8, 1945, the USSR did so and fought the large Japanese army in Manchuria. Soviet troops landed in northeastern Korean ports on August 10. On August 15, Japan surrendered and the United States, without troops in Korea, proposed the 38th parallel as a military demarcation line, which was accepted by the Soviets.

Immediately upon surrendering, Japanese government officials in Seoul turned over power to a local Korean group that established the People's Republic of Korea and set up political action committees throughout the countryside. U.S. troops arrived in September and disbanded this nascent government, establishing a military regime that lasted until 1948. In the North, the Soviets allowed the local committees of this government to operate but increasingly controlled them.

The next three years saw intense and complicated negotiations, disagreements, political maneuverings, assassinations, and a deepening of the Cold War, which prevented the United States and the USSR from agreeing on Korean unification.[17] In August 1948 the ROK was formally established in the South, with Syngman Rhee as president, and was recognized by the UN as the legitimate government of Korea. In September the DPRK was established in the North, with Kim Il Sung as its leader. Each leader demanded the overthrow of the other to unify Korea under his own leadership. Cross-border fighting became constant and a guerrilla war began in the South. The USSR and the United States removed their own troops except for some advisers by mid-1949.

16. Osgood, *The Koreans,* p. 297.

17. Scholars dispute the details of this period when up to 450 different political groups were active at some time. For a variety of accounts see Osgood, *The Koreans;* Ellen Brun and Jacques Hersh, *Socialist Korea: A Case Study in the Strategy of Economic Development* (New York: Monthly Review Press, 1976); Bruce Cumings, *The Origins of the Korean War,* Vols. I and II (Princeton, N.J.: Princeton University Press, 1981 and 1989); Erik Van Ree, *Socialism in One Zone: Stalin's Policy in Korea* (Oxford: Berg, 1989).

Deep disagreements exist regarding the Korean War. Disputed issues include (1) Who was really responsible for starting it? (2) Could it have been stopped sooner than it was, and why was it not? (3) What kinds of weapons were used or almost used by each side, and what atrocities were committed by each side? and (4) Was Kim Il Sung or Joseph Stalin really in charge on the Communist side (or was Mao Zedong after the Chinese entry into the conflict)?[18] The question of Stalin's role is central and is related to the origins of the Cold War. Most analysts see him as the prime aggressor, though some see him acting essentially defensively.

The North Korean army invaded South Korea in June 1950, quickly taking Seoul and all but the southeastern corner of the country around Pusan. During a Soviet walkout, the UN condemned the invasion and was formally the combatant on the Southern side, although most troops were from the United States and South Korea. In September UN forces under U.S. General Douglas MacArthur landed at Inchon, Seoul's port, far behind North Korean lines. Within two weeks these forces invaded the North across the 38th parallel, going clear to the Chinese border. In November Chinese troops attacked, pushing UN forces south of Seoul to nearly the 37th parallel by January 1951. The war seesawed until an armistice was signed in July 1953, with the final military line, and the new border, approximating the 38th parallel.

The war devastated both North and South Korea. More than 10 percent of the Korean population—3 to 4 million people—were killed.[19] Severe damage to cities and infrastructure resulted. GDP in the South declined by 15 percent and in the North by 30 percent, leaving per capita incomes nearly identical at around $55 per year.[20]

THE NORTH KOREAN ECONOMY

The Ideology of Kim Il Sungism and *Juche*

The North Korean economy and its relations with the rest of the world have developed according to the ideology of **Kim Il Sungism.** This ideology arose from struggling against the United States and competing with South Korea while trying to remain independent of

18. For varying discussions of the war see I. F. Stone, *The Hidden History of the Korean War* (New York: Monthly Review Press, 1952); Clay Blair, *The Forgotten War: America in Korea 1950–1953* (New York: Random House, 1987); John Halliday and Bruce Cumings, *Korea: The Unknown War* (London: Penguin Books, 1988); and Van Ree, *Socialism in One Zone.*

19. U.S. deaths were 54,246, similar to those in Vietnam. Chinese deaths were somewhere between 500,000 and 1 million (Halliday and Cumings, *Korea: The Unknown War,* p. 200).

20. Byoung-Lo Philo Kim, *Two Koreas in Development: A Comparative Study of Principles and Strategies of Capitalist and Communist Third World Development* (New Brunswick, N.J.: Transaction, 1992), p. 67.

the competing USSR and China. These efforts led Kim Il Sung to advocate the doctrine of *juche*[21] or self-reliance.

Kim Il Sungism is Stalinism with elements of Maoism and Korean Confucianism. Kim Il Sung admired Stalin, who put him in power, but tilted toward China when Khrushchev began destalinization in 1956.[22] Classical Stalinist elements include (1) strong central planning without free markets or privatization, (2) emphasis on heavy industry and militarization, (3) de facto socialism in one country implied by *juche,* and (4) a massive **Cult of Personality** devoted to Kim Il Sung.

The *Cult of Personality* began after Kim Il Sung enunciated *juche* in 1955 and accelerated after the Chinese criticized him in 1967. The extremity of this cult emerged in 1972, when a 66-foot statue of him was erected in Pyongyang and a museum with 92 rooms opened for his sixtieth birthday. In 1982 an Arch of Triumph larger than that in Paris and a Juche Tower taller than the Washington Monument were built.

Maoist elements showed up in moral incentives campaigns to encourage production. Kim Il Sung began the "flying horse" (*Chollima*) campaign in 1956, calling for a superhuman drive to rebuild industry without outside assistance.[23] Other drives in the 1960s emphasized collective management in industry and direct administration by party leaders in agriculture. Agricultural communalization reached levels seen only in China during Mao's GLF.

Confucianist elements emphasized filial piety as Kim Il Sung created a cult of his parents and himself while grooming his son, Kim Jong Il, as his successor. Kim Jong Il waited four years after his father's death in July 1994 before formally assuming his leadership positions in the Communist Party and the military and left the presidency open, implicitly still occupied by his revered father. Further Confucian elements include disdain of commerce, similar to the Choson period *yangban* view, and an emphasis on hard work, respect for education, and isolationism similar to that of the nineteenth-century Korean Hermit Kingdom.[24]

21. Frequently transliterated as *chuch'e,* it comes from two words: *ju,* meaning "ruler" or "master," and *che,* meaning "body" or "essence" (Byung Chul Koh, "Ideology and North Korean Foreign Policy," in R. A. Scalapino and H. Lee, eds., *North Korea in a Regional and Global Context* [Berkeley: University of California Press, 1986], pp. 20–36). After analyzing its various meanings, Bruce Cumings declares, "The term is really untranslatable; the closer one gets to its meaning, the more the meaning slips away. For a foreigner its meaning recedes into a pool of everything that makes Koreans Korean, and therefore is ultimately inaccessible to the non-Korean. [It] is the opaque core of North Korean national solipsism" (Cumings, *Korea's Place in the Sun,* p. 404).

22. This anti-Soviet tilt peaked in 1963–1964, when the Soviets sharply reduced their economic and military assistance. But relations were normalized after Khrushchev's ouster. Periods of anti-Chinese tilt followed in 1967–1969, when Chinese Red Guards denounced Kim Il Sung as a "fat revisionist," and in 1978–1980 at the beginning of China's pro-market economic reforms.

23. Stalin had Stakhanovite drives in the 1930s, but he also used wage differentials as material incentives much more than either the Chinese under Mao or the North Koreans.

24. South Korea shares respect for family, hard work, and education but not isolationism or disdain for commerce. Thus, Confucianism can be associated with either economic dynamism or stagnation.

Specific elements of *juche* include political independence (*chaju*), economic self-sustenance (*charip*), and military self-defense (*chawi*). Ironically, the search for these elements led to the undermining of their goals. To achieve independence from the USSR and China, North Korea reached out to the rest of the world, politically and economically. It became an observer at the UN in 1973, joined the Nonaligned Nations Movement in 1975, and sharply increased its trade and borrowing from capitalist countries during this period.[25]

Yet the upshot of these actions was a repudiation of its debts to capitalist countries in 1976, throwing North Korea back on its old comrades,[26] especially the USSR, which dominated its trade from that year to 1991, despite the DPRK's refusal to join the Soviet trade bloc, the CMEA.[27] With the collapse of the USSR and the recognition of South Korea by both Russia and China,[28] North Korea lacks any external supporters and faces the full implications of *juche*. It must reach out again to a skeptical capitalist world while trying to maintain its isolated and fossilized system, which has been in economic free fall.[29]

It has begun to do so somewhat, starting with its repudiated 1994 agreement not to produce nuclear weapons that increased foreign aid and led to the ending of the economic embargo by the United States. It went further with its admission of famine and receipt of international relief aid. New trade and investment agreements were signed with South Korea as relations warmed in the runup to the historic summit in June 2000 between the two Kims. During 2001, North Korea worked on various economic agreements with Russia, Germany, Australia, the Netherlands, and Italy. These moves to open North Korea's economy to the outside world appear to have accelerated after the implementation of a more decentralized and market-oriented approach began in mid-2002, although the immediate effect of these reforms appears to have been economic turmoil.

25. Between 1971 and 1975, its imports from OECD countries increased 10-fold, while its exports to them tripled (Sungwoo Kim, "Foreign Trade of North Korea: Analysis and Recommendations," Department of Economics Working Paper No. 73, Northeastern University [1991], p. 14).

26. A Joint Venture Law was passed in 1984. The main response for a decade was by North Koreans living in Japan, a hotel project with a French company, and a few minor deals with the Chinese and the Russians (Eui-Gak Hwang, *The Korean Economies: A Comparison of North and South* [Oxford: Clarendon Press, 1993], pp. 212–214). Since the warming of relations between North and South Korea, the South Korean Hyundai *chaebol* has started several projects, although it has been accused of bribing North Korean officials, and President Kim Dae-Jung was investigated in connection with these accusations after he left the presidency of South Korea.

27. Although the DPRK never joined the CMEA, it was a founding member of the three main CMEA suborganizations.

28. In Moscow one sees large billboard ads for South Korean companies. China has spoken of a "five-way strategic relationship in northeast Asia" that is to involve China, Russia, Japan, the United States, and South Korea (Economist Intelligence Unit, *Country Report: North Korea,* No. 1, 1993, p. 33). This emphasizes how truly isolated the DPRK has become.

29. North Korea shields its citizens from outside information and influences to an astounding extent. All North Korean students were pulled back from Eastern Europe once the democratization movements took hold there in 1989.

Stages of the North Korean Economy

Given how far the DPRK has fallen behind the ROK economically, it is hard to imagine that the reverse was true for a period following the Korean War.[30] This is generally accepted despite the inevitable problems with barely available or believable North Korean economic data.[31] If East German data were distorted, North Korean data are far worse given their secretive Hermit Kingdom attitudes.[32]

Early economic success for North Korea arose from political consolidation, early equalization through the socialization of all industries and agriculture, mass mobilization strategies, and moral incentives policies. But these measures did not work in the long run because of the lack of material incentives to improve productivity and the extreme emphasis on self-reliance.

After taking power in 1946, Kim Il Sung "Sovietized" the North Korean economy.[33] Land was distributed to the peasants and heavy industry was nationalized, with most small commodity production remaining private until after the Korean War.[34] During 1953–1958 agriculture was completely collectivized as cooperatives, although private plots and small private farmers' markets would continue to be tolerated. All remaining private industry was nationalized. Two short-term plans between 1946 and 1949 led to a more than tripling of industrial output and to a 40 percent increase in agricultural production.

Postwar plan targets and actual performance are presented in table 19-1. The plan for 1953–1956 emphasized reconstruction and was successful, beginning North Korea's rapid growth stage. A Five-Year Plan came next that was completed in three years, with 1960 serving as a buffer year afterward. This plan continued rapid growth, completed the socialization drive, and began the mass mobilization drives.

30. At the peak of this gap, Joan Robinson visited and praised the rebuilding of the DPRK capital, Pyongyang, from a city with "not one stone standing upon another" to "a modern city . . . a city without slums" ("Korea, 1964: Economic Miracle," in *Collected Economic Papers,* Vol. 3 [Oxford: Basil Blackwell, 1973], pp. 207–215, originally published in *Monthly Review,* January 1965).

31. At least 10 different agencies have estimated DPRK economic data. DPRK official data report total output two to four times greater than do the other sources (Hwang, *The Korean Economics,* p. 106).

32. North Korea contemplated joining the Asian Development Bank to obtain financing for a special economic zone around Najin-Sonbong, but it was "troubled by the ADB requirement of exact economic data," since it was "used to releasing only figures favorable to itself" (Economist Intelligence Unit, *North Korea,* p. 38).

33. For accounts of DPRK economic policies before 1970, see Brun and Hersh, *Socialist Korea,* and Joseph San-hoon Chung, *The North Korean Economy: Structure and Development* (Stanford: Hoover Institution, 1974). It has been argued that there was continuity both in personnel and in method between the Japanese system of planning industrial development in Manchuria and northern Korea and the early North Korean system (Mitsuhiko Kimura, "From Fascism to Communism: Continuity and Development of Collectivist Economic Policy in North Korea," *Economic History Review* 52 [1999]: 69–86).

34. One reason for this contrast was that heavy industry had been largely in the hands of Japanese owners who were expelled, whereas small commodity production was largely Korean-owned.

Table 19-1
Performance of the Post-1953 North Korean Plans

Plans	National Income		Industrial Production		Grain Production	
Years	Target	Actual	Target	Actual	Target	Actual
1953–1956	20.5	30.1	37.5	41.8	10.8	7.1
1957–1960	17.1	20.9	21.1	36.6	5.6	7.2
1961–1970	15.2	7.5	18.1	12.8	8.2	2.7
1971–1976	10.3	n.a.	14.0	16.3	5.8–7.0	8.2
1978–1984	9.6	8.8	12.1	12.2	2.3	2.3
1987–1993	7.9	−1.8*	n.a.	n.a.	n.a.	−4.5

Note: All figures are average annual percentage rates of change. These numbers are certainly positively exaggerated.
*This figure masks the severity of the recent decline. Growth averaged 3 percent through 1989 but has fallen more than 5 percent per year since then (Economist Intelligence Unit, *Country Report: North Korea, No. 1* (1993): London: *The Economist,* 5). The last plan's targets were extended to 1996 but were abandoned in the famine year of 1995, when agricultural output collapsed because of massive flooding. No formal central planning targets have been set since then.
Sources: Data from Joseph Sang-hoon Chung, "Economic Planning in North Korea," in R. A. Scalapino and J. Y. Kim, eds., *North Korea Today: Strategic and Domestic Issues* (Berkeley: University of California Press, 1983), p. 17; "North Korea's Economic Development and Capabilities" in J. K. Park and B. C. Koh, eds., *The Foreign Relations of North Korea: New Perspectives* (Seoul: Kyungnam University Press, 1987), p. 112; Byoung-Lo Philo Kim, *Two Koreas in Development* (New Brunswick, N.J.: Transaction, 1992), p. 207; and Economist Intelligence Unit, p. 5.

In 1961 the First Seven-Year Plan was introduced. It was extended to 1970 because of difficulties arising from expanding the *juche* policy after the Soviets reduced aid as North Korea tilted toward China in the Sino-Soviet dispute. It emphasized heavy industrial development and mechanization of agriculture. Military spending sharply increased from a low of 3.7 percent of the state budget in 1959 to 19 percent in 1960 and to 30.4 percent in 1967, a level it maintained until 1972, after which it gradually declined.[35]

The Six-Year Plan of 1971–1976 emphasized technical improvement through imported foreign technologies because the North Koreans realized that South Korea was outstripping them economically. Official statistics claim that this plan's targets were fulfilled, but making 1977 a buffer year to delay announcing a new plan suggests otherwise. The 1976 foreign debt crisis implied this underachievement, as the DPRK would be cut off from easy access to Western technology.

The Second Seven-Year Plan (1978–1984) emphasized modernization and "scientification" by North Korean engineers and scientists. This was the first attempt to increase light rather than heavy industry and to increase material incentives for workers. The plan also

35. Chung, *The North Korean Economy,* p. 180.

involved major efforts in energy extraction (especially coal) and large-scale "nature-remaking" projects such as massive land reclamation. This plan fell somewhat short. Its failures prefigured later problems, as energy shortages have been a major bottleneck, as have soil erosion and other difficulties affecting agriculture that arose partly from some of the large-scale nature-making projects.

A three-year interim without a plan followed, with efforts to reform and decentralize. In 1984 North Korea's Joint Venture Law passed as a result of Chinese influence. So far it has generated minimal interest, but it has somewhat increased control over accounting and funds by enterprise managers.

Opponents of reform gained in 1987 when the Third Seven-Year Plan (1987–1993) began. This plan was to emphasize modernization and light industry, but its abject failure and the collapse of socialism in the former USSR, formerly North Korea's leading trading partner (40 percent of trade in 1991)[36] and aid supplier, created a crisis. The response during a "period of adjustment" projected to 1996 reemphasized heavy industry.[37]

Output in most sectors continued to decline into the late 1990s, although agricultural output hit a low point in 1995, when torrential floods struck and the famine period started. With the accession to full power in September 1998 of Kim Jong Il, a second *chollima* "Flying Horse all-out mobilization" campaign was launched. Output grew by 6.2 percent in 1999, increasing the regime's confidence in dealing more directly with the reforming South Korean regime.[38] The plan's emphasis was on heavy industry, but it was directed more toward consumer goods production. An effort to develop a computer software industry was also launched.[39] External factors probably helped as greater openness to foreign investment and trade, especially with South Korea, was encouraged.

On July 1, 2002, the North Koreans made a significant move toward economic reforms more along Chinese lines. Although prices are still set by the central planners, they are now set close to external market prices. Electricity prices were immediately raised 60-fold and housing rents rose 10-fold. Even rice prices rose more than 50-fold, although rationing of food continues in a majority of North Korean cities and counties, as well as for the elderly

36. Economist Intelligence Unit, *North Korea,* p. 5.

37. Economist Intelligence Unit, *Country Report: Korea, Second Quarter,* 1994, p. 40.

38. Hwang Eui-jak, "Beyond the Summit," pp. 68–71. Although accepting that the North Korean economy probably grew in 1999 and into 2000, Nicholas Eberstadt argues that the damage to human capital from the "Arduous Period" famine is so great that growth cannot be sustained without much more profound changes ("Prospects for Economic Recovery in the DPRK: Perceptions and Evidence," in *The Korean Peninsula in the 21st Century: Prospects for Stability and Cooperation, Joint U.S.–Korea Academic Studies* 11 (2001): 1–23.

39. Lee Ho-chul, "North Korea's Information Technology Revolution," in *The Korean Peninsula in the 21st Century,* pp. 25–60.

and needy. At the same time, wages rose 15- to 20-fold and the North Korean won was devalued to near its black market rate.[40]

Arguably more significant has been a substantial loosening of controls over enterprises. Enterprises are now allowed to engage in commercial transactions with each other as a complement to centrally planned output activities, although they remain state-owned. Production facilities may establish plans in line with their capabilities. How far this independence of firms will go remains to be seen. The last and purest command socialist economy appears to be seriously moving toward a more market-oriented approach to its economic policy and system.

THE SOUTH KOREAN ECONOMY

The Stages of Development and Indicative Planning

The South Korean economy has been a global superstar, having experienced the highest rate of real per capita economic growth in the world during 1980–1992. Growth slowed somewhat but was still very impressive during 1993–1997, but then it fell into a sharp recession in 1998 as South Korea suffered severely from the Asian financial crisis. It recovered quickly the following year but has slowed down somewhat since. In conjunction with the crisis, President Kim Dae Jung instituted a wide-ranging reform effort that followed IMF recommendations to privatize the banks, reduce the size and power of the *chaebol,* and open the economy to greater capital mobility. Some critics suggest that it was the effort to do this when the ROK joined the OECD a few years earlier that made South Korea vulnerable to the international financial speculative attacks that came from outside after the Asian financial crisis started in Thailand and spread to Indonesia and the Philippines.[41]

The East Asian NICs have much in common: a strong emphasis on education and a tradition of hard work associated with the Confucian heritage,[42] significant state infrastructure development, and a strong market orientation. Nevertheless, these economies exhibit major

40. Korea Economic Institute, *Korea Insight* (Washington, D.C., August 2002). Subsequent reports suggest that the initial results of these reforms have been to disrupt the economy and cause a new round of economic decline. Some have even speculated that the decision by the North Koreans to announce to the United States that they had been secretly developing a nuclear weapons program and to withdraw from the 1994 agreement was driven by a need for more generous external economic assistance, as well as a need to restart the closed Yongbyon nuclear reactor to provide desperately needed electricity.

41. Irma Adelman, "Lessons from Korea," in L. R. Klein and M. Pomer, eds., *The New Russia Transition Gone Awry* (Stanford: Stanford University Press, 2001), pp. 117–135.

42. Now a truism, this argument was first made in 1979 (Herman Kahn, *World Economic Development: 1979 and Beyond* [Boulder, Colo.: Westview Press, 1979]). Before then, the antibusiness aspects of Confucianism were noted more often.

differences, South Korea having more state involvement in its economy and higher levels of corporate concentration in the *chaebol* than the others. South Korea has had one of the most indicatively planned market capitalist economies, sharply contrasting with the laissez-faire system of Hong Kong. Whereas the *chaebol* dominate the South Korean economy more than do the *keiretsu* in Japan, Taiwan's economy has a competitive small-business market structure in most industries.

The ROK had a pathetic start after 1945. The period of U.S. military rule from 1945 to 1948 was a complete loss in terms of economic growth, and production in most sectors declined. The main achievement of the Syngman Rhee regime (1948–1960) was land reform, which laid the groundwork for later increases in agricultural productivity.[43] Whereas GDP grew at an annual rate of about 3 to 4 percent during 1953–1960[44] per capita income barely rose because of rapid population growth[45] and remained under $100 per year. The Rhee regime was corrupt, mismanaged macroeconomic policy, was excessively protectionist with a strong import substitution policy, and began some of the *chaebol* through political links.

Student demonstrations in 1960 brought down the government, and elections were held. But in 1961 Park Chung-hee took power in a military coup and ruled until his assassination in 1979. His authoritarian regime instituted indicative planning and initiated the takeoff of rapid growth. Some argue that the growth occurred in spite of planning, and that it was currency and exchange rate unification, budget deficit reductions, and the shift from import substitution to export promotion that caused the expansion.[46] Others argue that the Park regime's manipulation of market prices and investment significantly stimulated the high growth rate.[47] In contrast to both Japan and France, the Economic Planning Board (EPB) in South Korea could force government budgets to be in accord with its plans.

Table 19-2 summarizes the performance of the plans. In general, actual performance outstripped planned targets. Initially came the Nathan Plan, developed in 1954 by a U.S.

43. Yeong-Dok Jeon and Young-Yong Kim, "Land Reform, Income Redistribution, and Agricultural Production in Korea," *Economic Development and Cultural Change* 48 (2000): 253–268.

44. Kim, *Two Koreas in Development,* p. 67.

45. In mid-1991 the ROK population was over 43 million, about twice that of the DPRK. The ROK is the fifth most densely populated country in the world after Singapore, Hong Kong, Taiwan, and Bangladesh. Seoul may now be the fourth most populous metropolitan area in the world (*Statistical Abstract of the United States* [Washington, D.C.: USGPO, 1991], p. 835), although some other sources do not even put it among the world's 10 largest metropolitan areas.

46. Marcus Noland, *Pacific Basin Developing Countries* (Washington, D.C.: Institute for International Economics, 1990), p. 41.

47. Alice H. Amsden, *Asia's Next Giant: South Korea and Late Industrialization* (New York: Oxford University Press, 1989.)

Table 19-2
Performance of the South Korean Plans

Plans	Years					
	1962	**1963**	**1964**	**1965**	**1966**	**Average**
First FYP	5.7	6.4	7.3	7.8	8.3	7.1
Revised FYP	2.8	4.4	5.0	5.0	5.0	4.8
Actual	2.2	9.1	9.6	5.8	12.7	9.3
	1967	**1968**	**1969**	**1970**	**1971**	**Average**
Second FYP	7.0	7.0	7.0	7.0	7.0	7.0
Actual	6.6	11.3	13.8	7.6	9.4	10.5
	1972	**1973**	**1974**	**1975**	**1976**	**Average**
Third FYP	9.0	8.5	8.5	8.5	8.5	8.6
Actual	5.8	14.9	8.0	7.1	13.6	11.2
	1977	**1978**	**1979**	**1980**	**1981**	**Average**
Fourth FYP	10.0	9.0	9.0	9.0	9.0	9.2
Actual	10.3	11.6	6.4	−6.2	6.6	4.3
	1982	**1983**	**1984**	**1985**	**1986**	**Average**
Fifth FYP	8.0	7.5	7.5	7.5	7.5	7.6
Revised FYP	5.6	9.3	7.5	7.5	7.5	8.0
Actual	7.2	12.6	9.3	7.0	12.9	10.4
	1987	**1988**	**1989**	**1990**	**1991**	**Average**
Sixth FYP	7.1	7.1	7.1	7.1	7.1	7.1
Actual	9.1	11.5	6.2	9.2	8.4	8.9
	1992	**1993**	**1994**	**1995**	**1996**	**Average**
Seventh FYP	7.5	7.5	7.5	7.5	7.5	7.5
Actual	5.0	8.3	8.9	6.8	5.0	7.9

Note: Numbers are annual real GDP growth rates in percent.
FYP = Five-Year Plan.
Sources: Data for the first five plans are from Paul W. Kuznets, "Indicative Planning in Korea," *Journal of Comparative Economics* 14 (1990): 670, and for the remaining two are constructed from the same source, p. 662; Asian Development Bank, *Asian Development Outlook 1992* (Hong Kong: Oxford University Press, 1992), p. 84; Economist Intelligence Unit, *Country Report: South Korea, No. 1* (1993): London: *The Economist* 3; and Dilip K. Das, *Korean Economic Dynamism* (New York: St. Martin's Press, 1992), p. 3. Actual growth figures are from "Leading Economic Indicators," *Korea's Economy 2001,* Vol. 17 (Washington, D.C.: Korea Economic Institute, 2001), front table.

consulting firm. Not implemented, it underlaid Park's First Five-Year Plan beginning in 1962.[48] This first plan of guided capitalism had little detail and was revised in 1964 to emphasize industrial growth rather than food self-sufficiency at the time of the macroeconomic stabilization. Its goals were to increase energy production, grain production, and import substitution industries. Government provided one-third of investment funds.

The Second Five-Year Plan (1967–1971) resembled the original version of the First Five-Year Plan, but it emphasized textile exports as a leading sector and increasing the public sector for social overhead capital investment.[49] This plan was more detailed, having been developed from an input-output model of the economy. Actual performance easily exceeded targets for the first two plans.

The Third Five-Year Plan (1972–1976) emphasized balanced regional development and improved quality of life for workers,[50] focusing on rural development through the *new village movement* to utilize excess rural labor for rural revitalization. It had a **prescriptive** rather than an indicative drive to build up heavy and chemical industries, which was implemented partly by the government taking over the banks and directly controlling investment, a policy many thought was overdone. Plan performance exceeded targets, despite the first oil price shock, but foreign borrowing left the ROK with a large foreign debt burden that remains today.

The Fourth Five-Year Plan (1977–1981) was the only one to fall short of its targets. Industrial policy shifted toward electronics, machinery, and shipbuilding, with lower foreign borrowing. The second oil price shock combined with the political upheavals following President Park's assassination by the Korean CIA director in 1979 to thwart this plan. The year 1980 was the only one since the Korean War in which the ROK had negative economic growth except for 1998. General Chun Doo-hwan seized power in 1980 and ruled until he retired voluntarily in 1988.

After Park's death, planning shifted back toward the looser indicative style from the more command-like prescriptive style.[51] The Fifth Five-Year Plan (1982–1987) had sectoral

48. For detailed discussions of South Korean planning see Paul W. Kuznets, *Economic Growth and Structure in the Republic of Korea* (New Haven, Conn.: Yale University Press, 1977), and "Indicative Planning in Korea," *Journal of Comparative Economics* 14 (1990): 657–676.

49. Sectors completely owned by the state include the postal service and telecommunications, and those partly owned by the state include railways, airlines, electricity, and banks.

50. The latter was Park's follow-up to his banning independent labor unions in 1971 after a series of strikes. In 1972 he declared himself President for Life. The lack of peaceful and equitable labor market dispute resolution mechanisms is a continuing problem, despite substantial relaxation of restrictions on labor unions beginning in the late 1980s.

51. Atsuko Ueda ("Growth Model of 'Miracle' in Korea: An Application of Numerical Analysis," mimeo, Department of Economics, University of Wisconsin–Madison, 1993) supports this conclusion, finding that during the 1970s the growth path deviated substantially from that of a competitive equilibrium, but that since then it has been much closer to a competitive equilibrium.

goals similar to those of the previous plan, adding price stabilization, regional equality and social welfare, and the encouragement of competitive market forces, the last directed at the powerful *chaebol,* which had sharply increased their share of output during the previous decade. This plan exceeded its targets with the aid of declining oil prices, declining world interest rates, and the appreciation of the yen. Japan is the ROK's largest trading partner after the United States and has been its leading source of licensed technology.[52]

The Sixth Five-Year Plan (1987–1991) expanded state welfare programs and emphasized domestic research and development. It also called for liberalization of the financial system, which had been strictly controlled,[53] including partial reprivatization of the banks, while curbing ongoing real estate speculation. This plan also exceeded its targets.

The Seventh Five-Year Plan (1992–1996) moved further toward high technology and greater free marketization under the new democratic regime of Kim Young Sam. During 1992 and 1993 this plan was below its target, but was above it again in 1994 and 1995.

Debates over the role of indicative planning in South Korea resemble debates in other countries with such planning. Critics charge that sectoral targets have been wildly off and that outperforming planned targets proves the uselessness of plans rather than their effectiveness. They also point out that when planning had a strong element of command in the 1970s, inefficiencies arose as investment became overly focused on heavy industry and chemicals.[54] Defenders of South Korean planning claim beneficial effects of the information-sharing mechanism arising from the planning process similar to that in French-style concertation, as discussed in chapter 7.[55] But the recent trend has been toward looser indicative planning, especially under Kim Dae Jung and the influence of the IMF after the 1997 crisis.

South Korea's high degree of state intervention relative to the other NICs reflects its higher levels of industrial concentration due to the *chaebol*.[56] Domination of the ROK economy by a small number of large firms simplifies information gathering and coordination

52. Amsden, *Asia's Next Giant,* p. 233.

53. Changes include partial opening of South Korean financial markets to foreigners while delinking the won from the U.S. dollar. The won and ROK interest rates appear to be increasingly influenced by the Japanese yen and Japanese financial markets, although the United States still has greater influence in the ROK than in any of the other NICs, where Japan is apparently now more influential (Jeffrey A. Frankel, "Foreign Exchange Policy, Monetary Policy and Capital Market Liberalization in Korea," Center for International and Development Economics Research Working Paper No. C93–008, University of California at Berkeley, 1993).

54. Paul W. Kuznets, "Indicative Planning in Korea."

55. Il KaSong, "Indicative Planning in South Korea: Discussion," *Journal of Comparative Economics* 14 (1990): 677–680.

56. The average market share in an industry held by the three largest firms in the ROK in 1981 was 62 percent, in Japan in 1980 it was 56.3 percent, and in Taiwan in 1981 it was 49.2 percent (Amsden, *Asia's Next Giant,* p. 122.) Aggregate concentration rose until the financial crisis in 1997, with some reduction since then in South Korea. It is holding steady in Taiwan and declining slightly in Japan.

between planners and decision-making managers. The *chaebol* have benefited from this planning, particularly its industrial policy aspect.

Industrial Policy and the *Chaebol*[57]

South Korea has followed Japan with respect to industrial policy, viewing imitation as key to competing with the former colonial master. In both countries, the pattern of exports and imports evolved as each country climbed a developmental ladder from exporting primary commodities and low-skill, labor-intensive products to higher-skill, high-technology ones. In both countries infant industry protectionism was used, often backed by state-directed investment, until the next targeted industry achieved a certain level of development and exports.

The Korean pattern of development has involved decade-long spurts. During 1946–1953 the country generally produced simple commodities and imported many goods. For 1954–1962 the import substitution strategy was top priority. In 1963–1972 labor-intensive light industries led export expansion. During 1973–1982 the emphasis was on capital-intensive heavy industries. The period 1983–1992 saw the shift to technology-intensive industries based on the strong technical education of the South Korean population—between 1953 and 1986, the number of scientists and engineers rose from 4,157 to 361,330—and exploding R&D spending, which rose between 1971 and 1986 from 10.67 billion to 1,523.28 billion won.[58]

From 1963 to 1987 the percentage food and live animal exports fell from 21.6 to 4.3 and that of industrial raw materials exports fell from 28.4 to 1.6, while the percentage of engineering products exports rose from 5.7 to 41.9.[59] The driving engines of this expansion were the *chaebol*.

The *chaebol* are more like Japan's prewar *zaibatsu* than the modern *keiretsu*. Like the *keiretsu* they are technically groups of companies[60] rather than a single conglomerate. But all the companies in the group are entirely owned by a single family, thus making them more like the *zaibatsu*. The major difference between the *chaebol* and both Japanese forms of enterprise is that the latter had or have a bank at their base, whereas the *chaebol* do not. For an extended period of time all the banks in South Korea were state-owned, making the

57. Sometimes transliterated as *jaibul,* which more accurately indicates its pronunciation.

58. E. Willmot and M. Thorpe, "Korean Economic Development: Export Composition and Performance," Curtin School of Economics and Finance Paper 92.16, University of Technology, Perth, Australia, 1992, p. 6. High-technology goods that South Korea now produces include supercomputers, fingerprint recognition devices, double video machines, high-volume workstations, high-definition TV, and satellites.

59. Noland, *Pacific Basin Developing Countries,* p. 50.

60. In 1988 the largest *chaebol,* Hyundai, consisted of 33 technically independent companies.

Box 19-1
The Evolution of a *Chaebol:* Lucky-Goldstar

How the growth of the ROK economy has intersected with that of the *chaebol* can be seen by considering Lucky-Goldstar.* Founded as a cosmetic cream company in the late 1940s, it branched out into plastics to provide the plastic caps for its cream jars. Plastics led it to produce combs, toothbrushes, and soap boxes, and later to produce electrical and electronic and telecommunications equipment. To supply inputs, it moved into oil refining and then tanker shipping. The high insurance costs of oil refining led it to start an insurance company. Energy, chemicals, and electronics will be Lucky-Goldstar's future growth areas, with emphasis on fine chemicals, genetic engineering, semiconductor manufacturing, fiberoptic communications, and satellite telecommunications. Thus the group has evolved through a step-by-step evolution of related businesses.

*Alice H. Amsden, *Asia's Next Giant* (New York: Oxford University Press, 1989), p. 126.

chaebol dependent on state credit institutions.[61] Privatizing the banks has been a major aspect of recent reform efforts in South Korea.

The major *chaebol* developed in two generations. Samsung and Lucky-Goldstar are the largest of the first generation, which began during the Syngman Rhee regime in the 1950s. The second generation began in the 1960s under the Park regime, and Hyundai and Daewoo were its largest members. A few *chaebol* developed out of old firms founded by Japanese capitalists, Sunkyong being the largest of these. In 1997 these five were the largest *chaebol* in the ROK by sales, their rank order being Hyundai, Daewoo, Samsung, Lucky-Goldstar, and Sunkyong. By 2001 this had changed, with Daewoo's bankruptcy and the partial breakup of Hyundai, with a clear top five in order: Samsung, Hyundai "MH" Group, Lucky-Goldstar, Sunkyong, and Hyundai Motor.

The share of all exports from the nine largest *chaebol* trading companies rose from 13 percent in 1975 to 54.2 percent in 1984.[62] The share of GDP attributable to the 10 largest *chaebol* rose from 15.1 percent in 1974 to 67.4 percent in 1984, the three largest alone being responsible for 35.8 percent of 1984 GDP,[63] an almost unheard-of degree of concentration in a market economy. The *chaebol* were encouraged under Rhee and Park, especially under Park if they went along with government plans. But concern about concentration led Chun

61. Part of Kim Young Sam's anticorruption drive was to outlaw the use of false names in bank accounts and other financial dealings. Ironically, this has eliminated the major source of funds for curbside moneylenders who have financed small businesses, thus slowing economic growth. The major state-controlled banks focus their lending on the *chaebol.*

62. Dong Sung Cho, "Government, Entrepreneurs and Competition," in A. M. Whitehall, ed., *Doing Business in Korea* (London: Croom Helm, 1987), pp. 80–93.

63. Amsden, *Asia's Next Giant,* p. 116. It is somewhat unclear how many enterprises should be labeled *chaebol.* The Korea Economic Institute, *Korea's Economy 2002,* Vol. 18, Washington, D.C. (2002) report lists the "top 30" in one table. But, even with Hyundai in parts, there are still five definitely much larger than the rest.

to pressure the *chaebol* to open up ownership to the public and to sell some less related subsidiaries. Pressure on the *chaebol* intensified under Kim Young Sam because of links between them and the previous military regimes, especially on Hyundai, then the largest.[64]

Despite these efforts, domination of South Korea's economy by the *chaebol* is likely to continue. The most likely mechanism for ending *chaebol* domination would be their failure to grow while new firms grow faster. This has been the pattern in the United States and other mature industrialized economies, where older and larger firms have often lost their dynamism. This pattern represents a possible threat to South Korea's dream of continued rapid growth, especially relative to other NICs, such as Taiwan, with comparable levels of education but much lower levels of industrial concentration.

The most intense efforts to reform and restructure the *chaebol* came under Kim Dae Jung in the aftermath of the 1997 Asian financial crisis and in response to pressure from the IMF when it provided a financial bailout for the ROK. The high indebtedness of the *chaebol,* which reflected their de facto soft budget constraints produced by the state-owned banks, were denounced as examples of Asian crony capitalism. Reforms involved privatizing the banks, reducing the debt levels of the *chaebol,* increasing the transparency of their affiliations and governance structures, and reducing their size by pressuring them to spin off related companies.

The most dramatic development in connection with the *chaebol* came in 1999, when the second largest one, Daewoo, experienced a financial crisis and was forced into official bankruptcy and extensive restructuring. Daewoo's problems arose because it went against the government's request to downsize and had gone on a binge of debt accumulation to buy up troubled companies during the broader financial crisis. However, despite breaking up Daewoo, the government established a bond stabilization fund that has continued to prop up its remnants, although Daewoo's founder was forced out of the firm's management.

South Korea among the NICs

Among the rapidly growing East Asian economies are four subgroups based on relative per capita incomes. These subgroups exhibit a Gerschenkronian[65] relationship with each other: Growth rates tend to decelerate for the highest-income East Asian economies and to be higher for the lowest income ones. At the top is Japan, the regional leader, which since the

64. Hyundai compounds in countries outside of South Korea are run like military camps. Hyundai has experienced bitter strikes in recent years and has been the leader in investing in North Korea.

65. This refers to the ideas of Alexander Gerschenkron, *Economic Backwardness in Historical Perspective* (Cambridge, Mass.: Harvard University Press, 1962), discussed more fully in chapter 20. He argued that the later a country began to experience sustained growth, and the further behind the global leaders it was when it did so, the more rapidly it would grow after its initial takeoff.

early 1990s has been in a state of stagnation or even recession (as described in chapter 6 in terms of the flying geese theory). At the bottom and growing rapidly is the People's Republic of China (PRC), as discussed in chapter 15. The second highest group is the upper tier of NICs: Hong Kong, Singapore, Taiwan, and the ROK. The lower tier of NICs, lying below them but above China, includes Thailand, Malaysia, and Indonesia, although China may be surpassing some of them, much as Singapore and Hong Kong have surpassed Japan in some ways.

Table 19-3 presents data on the characteristics and performance of the seven upper- and lower-tier NICs. Generally, the ROK compares well with its fellow upper-tier NICs except for its foreign indebtedness.

Within the upper-tier NICs, Taiwan and South Korea are closer to each other than to the others in many ways. Hong Kong and Singapore are both almost completely urban, with virtually upper-income status, whereas Taiwan and South Korea are still middle-income countries with substantial rural sectors, though close to becoming upper income. Taiwan and South Korea have in common experience as Japanese colonies prior to 1945, being the capitalist portions of systemically divided nations, and having recently moved toward democratization of their political systems.

Important differences between them include that, relative to Taiwan, South Korea has fewer small businesses, a lower savings rate, a less equal income distribution, less agricultural production, less FDI, more borrowing from abroad, more state ownership of

Table 19-3
Comparative Economic Data for East Asian NICs

Country	Population	GDP per Capita	GDP Growth	Inflation Rate	Export Growth Rate	Government Share	Debt Service
ROK	47	8,490	5.7	5.8	15.6	13.7	6.5
Hong Kong	7	23,520	3.9	5.2	8.4	10.0	0.0
Singapore	3	29,610	8.0	1.6	n.a.	11.8	0.0
Taiwan	22	13,235	6.4	2.1	8.2	13.5	0.0
Indonesia	207	580	4.7	14.4	9.2	12.2	22.2
Malaysia	23	3,400	6.3	5.0	11.0	15.2	9.1
Thailand	62	1,960	4.7	4.6	9.4	11.7	11.8

Source: ROK, Hong Kong, Singapore, Indonesia, Malaysia, and Thailand for population in millions for 1999 and per capita GDP in 1999 U.S. dollars from *World Development Report 2000/2001: Attacking Poverty* (New York: Oxford University Press for the World Bank, 2000), pp. 274–275; for annual average GDP growth rate 1990–1999 and annual average growth rate of implicit GDP deflator (inflation) for 1990–1999, and for annual average growth rate of exports for 1990–1999 from *World Development Report,* pp. 294–295; for government expenditure as a percentage of GDP for 1998 from *World Development Report,* pp. 300–301. Foreign debt service as a age of GDP in 1998 from *World Development Indicators 2000* (Washington, D.C.: World Bank, 2000), pp. 252–254. All data for Taiwan from *Monthly Bulletin of Statistics of the Republic of China* 26 (January 2001): 3, 22, 23, 57.

enterprises, more regulation of industry, a more overvalued exchange rate, a more closed and restricted credit market, more controlled markets, and more real estate speculation.[66]

Many of the NICs experienced sharp recessions and currency devaluations during 1997, along with capital flight and stock market crashes. The countries worst hit were Indonesia and Thailand, while the least affected were those dominated by ethnic Han Chinese: Singapore, Hong Kong, and Taiwan. South Korea experienced sharp negative impacts but rebounded more swiftly than the other countries that were hit hard. However, South Korea's unemployment rate remained substantially higher than it had been in the past—over 6 percent even in 1999 compared to around 2 percent prior to the crisis. The distribution of income became noticeably more unequal; the Gini coefficient remained about .283 between 1990 and 1997 but then jumped to .316 in 1998 and to .321 in 1999.[67] This crisis provided a permanent dent in the reputation of the Asian tigers that will not disappear soon.

THE ECONOMIES OF NORTH AND SOUTH KOREA COMPARED

General Observations

Direct comparison of the two Korean economies is very close to a controlled experiment given the common cultural heritage and fairly similar geographic conditions of the two countries.[68] The major differences are their respective economic and political systems. However, this comparison is hampered by the unreliability of data on the secretive North.

Despite a few surprises, the generalizations about the two systems apply well to North Korea and South Korea. Current real per capita incomes and growth rates are much higher in South Korea, as is its volume of exports and general integration into the world economy. This is unsurprising given the *juche* isolationism of North Korea. South Korea has a more diversified economy, with a greater variety of consumer goods, high-technology goods, and services, whereas North Korea retains a greater focus on heavy industry and military production.

North Korea has a more equal distribution of income and greater gender equality. Until the early 1990s, the material index of living standards in North Korea compared well with

66. Sung Moon Pae, *Korea Leading Developing Nations: Economy, Democracy, and Welfare* (Lanham, Md.: University Press of America, 1992), p. 106.

67. Florence Lowe-Lee, "Where Is Korea's Middle Class?" *Korea Insight* 11(2) (2000): 1.

68. There are greater geographical differences between these two countries than between eastern and western Germany, the former favorite subjects of comparative economists for such studies. North Korea is more richly endowed with mineral and hydroelectric resources. Because of its colder climate it grows more wheat, whereas South Korea grows more rice. Hence the South has had a much denser population than the North, reaching a rural peak in the long-rebellious southwestern Cholla provinces. Also, the South has Seoul, which is far larger than any city in the North.

that in South Korea, despite the growing disparity in real per capita income and the severe deterioration in the North as famine took hold.

Despite these contrasts, the two Koreas have much in common economically, a fact that may yet be important if they unify. They share a strong Confucian tradition and the competitive spirit of *Hahn,* the latter stimulated by the decades-long competition between them as well as their shared resentment of Japan. They possess the two hardest-working labor forces in the world, as measured by the average length of the work week.[69] They also share a respect for education that has led to nearly universal literacy, as well as very rapid growth rates of high-tech education among their populations. South Korea has a higher percentage of its student-age population in college (36 percent in 1988, 23 percent in North Korea) than any country except the United States and Canada.[70]

Growth of per Capita GDP

Figure 19-1 shows per capita GDP for the North and the South for various years from 1945 to 1992. North and South Korea use different measures because, in traditional socialist fashion, North Korea does not count services in GDP. Correcting South Korea's numbers for this would reduce them by about a third. But this would still leave a very large gap between the two in 1992, even presuming that these estimates of North Korean GDP are accurate, which is highly questionable. The two countries started out fairly equal and were about equal at the end of the Korean War. The North surged ahead for a decade, but then the South moved ahead after 1975, leaving the North far behind. Given that South Korea has about twice the population of North Korea, the gap between them in aggregate GDPs is even more pronounced.

Composition of Output

The two economies contrast sharply in the composition of their respective outputs between industry, agriculture, and services. In North Korea services declined sharply from 33.3 percent of GDP in 1956 to 5 percent in 1982 and industry increased from 40.1 percent to 70 percent of GDP, with agriculture holding steady. In South Korea services rose from 40.3 to 53.1 percent and industry increased from 12.5 to 30.7 percent for the same years, with agriculture declining from 47.2 to 16.2 percent.[71]

A surprise in the available data is the strong performance in agriculture by North Korea relative to South Korea, at least until the 1990s, when food production collapsed in the

69. Amsden, *Asia's Next Giant,* p. 205. This long work week was introduced by the Japanese, who had imitated Europe when it first began industrializing. Work weeks have shortened both in Europe and in Japan, but not in either Korea.

70. Kim, *Two Koreas in Development,* p. 91.

71. Kim, *Two Koreas in Development,* p. 75.

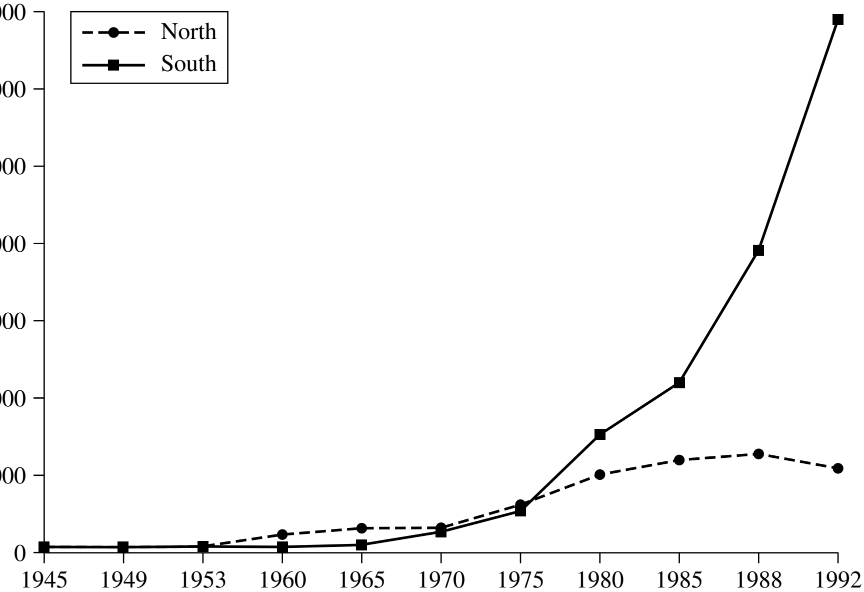

Figure 19-1
Per capita GDP (in current U.S. dollars) for North and South Korea.
Sources: Figures through 1988 are from Byoung-Lo Kim, *Two Koreas in Development* (New Brunswick, N.J.: Transaction, 1992), p. 67, and for 1992 are estimated from Economist Intelligence Unit, *Country Report: North Korea,* No. 1 (1993), p. 5, and *Country Report: South Korea,* No. 1 (1993), p. 3, in current U.S. dollars.

North. The UN Food and Agriculture Organization (FAO) reports an average annual overall rate of growth of agricultural output from 1970 to 1987 of 4.53 percent for North Korea compared with 2.39 percent for South Korea.[72] Even if North Korea's number is exaggerated, as is likely, collectivized agriculture held its own in the North relative to the free-market farming in the South, at least up to 1987. The Marx-Stalin vision of the economies of scale available to collectivized agriculture may have worked there for a while. Another explanation involves respective policy choices: The *juche* policy in the North stimulated food self-sufficiency, whereas the South emphasized exporting manufactures and importing food after 1964.

Comparison of the two in 1987 shows North Korea outproducing South Korea in wheat, rye, and potatoes (much favored by Kim Jong Il during the 1990s' famine), the two countries about even in rice production and sweet potatoes, and South Korea far ahead in beef and

72. Federic L. Pryor, *The Red and the Green: The Rise and Fall of Collective Agriculture in Marxist Regimes* (Princeton, N.J.: Princeton University Press, 1992), p. 251.

veal, pork, poultry, and fish. Thus, although the North had a higher per capita calorie supply than the South,[73] the opposite is almost certainly true with respect to per capita protein supply in 1987. But this was probably the year of the North's best relative performance.

Production gradually declined in the North, with oscillations up to 1991, and then collapsed dramatically up to the beginning of the famine in 1995, only to recover gradually afterward. Thus, grain production was 443 metric tons in 1991, 345 in 1995, and 422 in 1999, while rice production went from 164 metric tons in 1991 to 121 in 1995 to 163 in 1999.[74] Flooding triggered the especially low agricultural output in 1995, but even so, it had been declining steadily. Some observers tie the disaster to ecological destruction from deforestation to provide energy, as well as to a decline in synthetic fertilizer imports in the 1990s, on which North Korea's agricultural production had become dependent.[75] The sharp decline in fertilizer imports came partly from the collapse of the former Soviet Union, which had previously subsidized such exports to North Korea. The crisis led to emergency food imports from South Korea, Japan, and the United States and strongly influenced the future path of relations with South Korea.

Social Indicators and the Distribution of Income

Internationally published data suggested few differences in basic social indicators until the onset of famine in 1995 in North Korea. There are the expected consumption differences: South Koreans have far more automobiles and TV sets and better clothing, while North Koreans have more public transportation, pay less for housing, and have more doctors per capita.[76] Life expectancy in 1988 in the South of 70 years slightly exceeded that in the North of 69 years.[77] Overall, the Physical Quality of Life Indexes estimated by the Overseas Development Council for the World Bank for the two countries in 1985 were identical at 86 out of a possible 100.[78]

However, a gap opened up with North Korea's famine as life expectancy in the DPRK plunged to 63.1 for 1995–2000, while that of the ROK held at 74.7 for 1999. Also, during this same period, the mortality rate for children under five years of age climbed to 30 per

73. Kim, *Two Koreas in Development,* p. 90.

74. Hwang Eui-gak, "Beyond the Summit," p. 71. (We note that Hwang Eui-gak and Eui-Gak Hwang are one and the same, the different listing reflecting a recent move in South Korea to assert the traditionally Asian last-name-first order rather than following the standard Western convention.)

75. Peter Drysdale, "North Korea's Economy: Challenge and Opportunity," *The Korean Peninsula in the 21st Century: Prospects for Stability and Cooperation. Joint U.S.–Korea Academic Studies* 11 (2001): 203–210.

76. Kim, *Two Koreas in Development,* chap. 5.

77. Hwang, *The Korean Economies,* p. 126.

78. Pae, *Korea Leading Developing Nations,* Appendix A. Japan received 100. Countries receiving 99 were Sweden, Iceland, France, and Australia. Scores ranged as low as 6 for Sierra Leone.

1,000 born in North Korea compared to only 5 per 1,000 born in South Korea, this gap almost certainly reflecting the impact of the famine.[79]

The distribution of income is reported as more equal in North Korea than in South Korea. In 1988 the decile ratio for the North was 5.83 compared to 13.73 for the South.[80] Inequality in the South increased; the Gini coefficient rose from 0.332 in 1970 to 0.389 in 1980.[81] It declined somewhat until 1997, despite apparent continuing increases in property income inequality.[82]

Even in the absence of definitive data, there is almost certainly greater gender equality in the North than in the South. In 1980 South Korea had the lowest female/male wage ratio of any country in the world: 44.5 percent.[83] This reflects large educational and work experience differentials between the sexes in South Korea, given the strong paternalistic/sexist element in traditional Korean Confucianist society, where husbands have dominated wives to an extreme degree.[84] Although gender inequality persists in the North, there has long been a movement to remove it. The women's labor force participation rate rose from 20 percent in 1956 to 48 percent in 1976.[85]

International Trade

One reason for the growing income gap between the two Koreas is the contrast between the export orientation of the South and the *juche*-based self-reliance of the North. This difference encourages the technological dynamism of the South compared with the increasing stagnation of the North. Table 19-4 tracks the time path of exports and imports in the two Koreas.

79. *Human Development Report 2001* (New York: Oxford University Press for UNDP, 2001), pp. 141, 238, for life expectancies, and *Human Development Report 2000* (New York: Oxford University Press for UNDP, 2000), pp. 158, 186, and 268, for data on infant mortality.

80. Kim, *Two Koreas in Development,* p. 95. DPRK numbers do not capture nomenklatura perks and income in kind. "Fat revisionist" Kim Il Sung and his son, Kim Jong Il, had lavish lifestyles, and the upper levels of the party and government are packed with their relatives; Kim Jong Il's rivals for power include his stepmother and half brother. He is reputed to hand out expensive French cognac to allies. The inequalities between the starving masses and the elites, including the military, reportedly grew very large during the famine (Kongdan Oh and Ralph C. Hassig, *North Korea Through the Looking Glass* [Washington, D.C.: The Brookings Institution, 2000], p. 66). But the false name bank accounts in the ROK mean that the incomes of the most wealthy have not been fully identified there either.

81. Dilip K. Das, *Korean Economic Dynamism* (New York: St. Martin's Press, 1992), p. 104.

82. Hwang, *The Korean Economies,* p. 136.

83. Amsden, *Asia's Next Giant,* p. 204.

84. Osgood, *The Koreans,* p. 47.

85. Changsoo Lee, "Social Policy and Development in North Korea," in C.-S. Lee and S.-H. Yoo, eds., *North Korea in Transition* (Berkeley: University of California, Institute of East Asian Studies, 1991), p. 124.

Table 19-4
Foreign Trade of North and South Korea

	North Korea		South Korea	
Year	Exports	Imports	Exports	Imports
1970	365	396	835	1,984
1975	814	1,093	5,081	7,274
1979	1,150	1,160	15,056	20,339
1985	1,380	1,720	30,283	31,136
1989	1,690	2,900	62,400	61,500
1991	1,400	2,310	71,900	81,500
1996	730	1,250	85,300	88,000
1999	520	960	145,500	116,800

Sources: Figures through 1985 are from Byoung-Lo Philo Kim, *Two Koreas in Development* (New Brunswick, N.J.: Transaction, 1992), p. 81, and for 1989 and 1991 from Economist Intelligence Unit, *Country Report: North Korea, No. 1* (1993): 5 and *Country Report: South Korea, No. 1* (1993): 3 in millions of U.S. dollars. Figures for North Korea for 1996–1999 are from Hwang, Eui-Gak, "Beyond the Summit: Deepening Linkages on the Korean Peninsula," *The Korean Peninsula in the 21st Century: Prospects for Stability and Cooperation. Joint U.S.–Korea Academic Studies* 11 (2000), p. 71, and for South Korea for 1996–1999 are from *OECD Economic Surveys, September 2000* (Paris: Organization for Economic Cooperation and Development, 2000), p. 44.

A crucial element in North Korea's stagnation has been the very low level of capital goods imports into North Korea compared to South Korea and even other socialist states since the DPRK repudiated its debts in 1976. Thus, in the 1970s, capital goods were 28.8 percent of the South's imports, 21.8 percent of China's imports, and 27.7 percent of the North's imports, whereas in the 1990s, they were 35.1 percent of the South's imports, 37.8 percent of China's imports, but only 16.4 percent of the North's imports. This policy reflected concern about hard currency and *juche* ideological fears about becoming dependent on foreign supplies for replacement parts.[86]

Particularly serious for North Korea is that Russia and China, its top two trading partners, were formerly letting it run up debts in trade but have ceased to do so. The North must now earn its hard currency. That will be difficult to do, as seen by looking at its exports, which in 1985 to its main capitalist market, Japan, were, in order, gold, zinc, fresh vegetables simply preserved, iron and simple steel coils, anthracite coal, and shellfish. These are not rapid growth industries in contrast to the high-technology engineering and consumer industries in South Korea's export mix.[87] But since the 1998 revival, the North Koreans have been trying to develop a computer software industry. They also have relied on military exports, some of them controversial.

86. Nicholas Eberstadt, "Disparties in Socioeconomic Development in Divided Korea," p. 886.

87. Economist Intelligence Unit, *South Korea,* Appendix 2.

Box 19-2
The South Korean Plan for Unification and Postsummit Agreements

The ROK's Ministry of Finance has studied what it should do if there would have been a peaceful unification on the South's terms around the year 2000, drawing on the German experience.*

First, as the ROK won is much stronger than the DPRK won, the currencies would not be unified on a one-to-one basis, as the German currencies were. Second, migration from the North to the South would be restricted. Third, land in the North would be renationalized and then reprivatized. Fourth, the costs of unification would be met by borrowing, and in 1993 those costs were estimated to be about $980 billion, enough to make the South Koreans hesitate.

Both sides are moving cautiously after the historic summit, which was followed by ministerial talks on July 31, 2000. Among the items agreed on at that meeting were that the Liaison Office at Panmunjon, on the border, would be reopened, that both sides would jointly celebrate the National Liberation Day of August 15, that they would ensure that Korean residents of Japan would be allowed to visit their hometowns, and that the rail line across the border would be rehabilitated. The last has been achieved, providing a land transportation link from South Korea to the western edge of Europe.

The two sides have a long way to go to achieve unification. But they have made an important start on reducing the threat of armed conflict on the Korean peninsula.

*Economist Intelligence Unit, *Country Report: North Korea, No. 1* (1993): 28–29.

The Threat of War and the Hope for Unification

Although South Korea has surged ahead of North Korea economically, North Korea retains a clear lead in one important area: accumulated military hardware and armed forces. The only hope it has of unifying Korea under its control is through military conquest. Compared to the South, the North has nearly twice the number of men under arms (1,132,000 to 633,000), nearly twice as many tanks and combat aircraft, and far more armed helicopters and submarines. Their forces are deployed in an offensive stance near the border.[88] This disjuncture is the main source of the threat of a possible outbreak of war on the Korean peninsula.

But peaceful unification is possible, as both Koreas are deeply nationalistic.[89] Their economies are broadly complementary and could fit together if the political and economic difficulties of transition could be handled. That the latter would be serious is seen by the high costs of reuniting East and West Germany, where the income gap was not as great as it is between the two Koreas.

There is also the problem of the profound isolation of the North Korean people and their continuing absorption in the Cult of Personality of Kim Il Sung. Even though he is dead, it will take time for their fixation to end. But with the dramatic and historic summit between

88. Figures from the International Institute of Strategic Studies as reported in "North Korea's Nuclear Stand-Off," *The Economist,* April 3, 1993, pp. 38–39. The South has a slight edge in warships, a general and increasing technological and qualitative edge, and the support of 37,000 U.S. troops.

89. They were simultaneously admitted to the UN in 1991.

Kim Jong Il and Kim Dae Jung in June 2000, relations were improving dramatically and the threat of war receding substantially. However, in his 2002 State of the Union speech, American President George W. Bush voiced his distrust of North Korea, labeling it part of a global "axis of evil," along with Iraq and Iran. The unification process seems to have stalled since then, especially with the subsequent revelations of North Korea's continuing pursuit of nuclear weapons.

SUMMARY AND CONCLUSIONS

The two Koreas represent the sharpest continuing contrast between a command socialist economy and a largely market capitalist one. This contrast coincides with the extreme political and military tension that exists between the two, a lingering shadow of the Cold War.

Korea was divided at the end of World War II after being ruled by Japan from 1910 to 1945. Japan had displaced an isolationist Confucianist regime. The division led to war from 1950 to 1953, in which the United States and China significantly participated. The war left both Koreas economically devastated.

Initially after the war the North's economy grew more rapidly than that of the South. The North was ruled during 1946–1994 by Kim Il Sung, who instituted Stalinist command socialism, modified by the self-reliance doctrine of *juche* and Maoist moral incentives campaigns. The South was ruled during 1948–1960 by Syngman Rhee, whose postwar regime was marked by corruption and mismanagement.

South Korean growth took off after the introduction of indicative planning combined with general macroeconomic stabilization under the military dictatorship of Park Chung-hee from 1961 to 1979. Except for the tumultuous postassassination year of 1980 and the post–financial crisis year of 1998 (when both economies declined), the South Korean growth rate has probably exceeded that of the North since around 1963.

Whereas North Korea has pursued an inward-looking isolationist strategy reminiscent of that of the nineteenth-century Hermit Kingdom, South Korea has pursued an outward-looking, export-led strategy of growth similar to that of Japan and its fellow East Asian NICs. Whereas the North had fair agricultural performance until famine struck in 1995 and strong heavy industrial output, the South has evolved from exporting simple light manufactured goods to high-technology electronics and consumer products, largely produced by the giant *chaebol.* Whereas the North appears to have greater income and gender equality, the South has recently moved toward significant political democratization and is carrying out a program to reform and restructure the *chaebol* and the financial system.

Despite their obvious differences, North and South Korea share many characteristics, including a strong nationalism partly rooted in a shared resentment of Japan for its past colonial rule. Both Koreas manifest their deep Confucian heritage in their hard work and great respect for education, which both have intensely pursued. Thus, despite their intense competition and the threat of a new Korean War, they have embarked on a serious path of negotiation and reconciliation marked by the summit between their leaders in 2000. Although the United States has not supported this movement since 2001, increasing anti-Americanism in South Korea suggests that it will continue for the near future.

Unless the unification is achieved by a northern military conquest, it will be carried out on the South's terms, given its overwhelming economic and diplomatic predominance. The South hesitates, observing the difficulties experienced in Germany. Nevertheless, the economic potential of a unified Korea is considerable, although it will remain a smaller nation caught between the Chinese and Japanese giants. Eventual unification, or at least a definite peace between the two countries, would finally end the chapter in human history known as the Cold War.

QUESTIONS FOR DISCUSSION

1. Compare and contrast the Confucian elements in the North and South Korean economies.
2. Compare and contrast North Korean *juche* with the Stalinist and Maoist economic models.
3. Compare and contrast South Korean indicative planning with indicative planning in Japan and France.
4. Compare and contrast the South Korean *chaebol* with the Japanese *zaibatsu* and *keiretsu*.
5. How and why is South Korean industrial policy changing?
6. Compare and contrast the South Korean economy with that of Taiwan. What are their positions relative to the other East Asian NICs?
7. How might the democratization movement in South Korea both slow and stimulate economic growth?
8. Why did North Korea surpass South Korea economically in the 1950s and 1960s? Why has it lost that lead and fallen far behind since then?
9. After doing reasonably well in agriculture, what factors led to the famine in North Korea in the mid-1990s? How were these factors related to the general nature of its economic system?
10. How does a comparison of the North and South Korean economies resemble and differ from the comparison between the former East and West German economies?
11. How have the South Korean plans for possible unification with North Korea been influenced by the German example?

12. What are the prospects for a unified Korea to become a major world economic power? Why or why not is this possible?
13. How did South Korea become a victim of the Asian financial crisis?
14. Some analysts argue that South Korea should not have followed the IMF-inspired reform plan. Evaluate this argument.

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20 Evolving Trends of the Transforming World Economy

Henceforth books on comparative economic systems will be found on the shelves dealing with economic development.
—Yegor Gaidar, address to the International Economic Association, Moscow, August 1992

It is better to hang together than to hang separately.
—Benjamin Franklin, during the debate on the Declaration of Independence, U.S. Continental Congress, Philadelphia, 1776

INTRODUCTION

This concluding chapter attempts neither to summarize what has been presented in the rest of the book nor to draw definitive conclusions. Rather, it deals with certain general trends and ties up loose ends without offering a definitive concluding section. The transformation process of the world economy is far too complex and profound for simplistic summaries or statements.

Despite Fukuyama's claim discussed in chapter 1, it should be clear that history is not at an end. When Yegor Gaidar made the remarks quoted above, he was acting premier of Russia, in charge of a radical program of moving toward market capitalism in Russia, the former fountainhead of world communism. Gaidar is now out of power, and his successors are stumbling rather than rushing toward his former goal. In much of the reforming socialist world, successors to the former Communist parties have been democratically elected, with mandates to slow, if not reverse, the marketization process. Although China continues to move toward marketization, its largest sector is the local market socialist one of TVEs. In East Asia, indicatively planned neo-Confucianist economies thrive, and in the Islamic world, fundamentalist movements with uncertain state-market balances continue to spread. The future is less certain than it seemed when Fukuyama wrote in 1992.

No one would have predicted the September 11, 2001, attacks on New York and Washington. Since then, a war in Iraq has again reshuffled alliances and led to unpredicted reverberations and developments. Undoubtedly, by the time you read this book, the ongoing shocks and evolution of history will make the world even more different in ways that we cannot foresee. However, even though the future is always fundamentally uncertain, certain trends may be discerned that promise to influence the world economy in future years.

THE TREND TOWARD PRIVATIZATION AND ITS LIMITS: THE CASE OF GREAT BRITAIN

Despite hesitation and confusion, the trend toward market capitalism is indisputably entrenched and ongoing in most of the world, including the mixed market capitalist economies.

Transformation toward market-oriented economies has been the easier part and there are now only a few nations, such as North Korea, where markets effectively do not exist.

But in nations ranging from Poland to China, the process of privatization has proceeded slowly, with a variety of problems and difficulties. A few formerly socialist nations succeeded in implementing rapid, mass privatizations, notably the former East Germany, the Czech Republic, Mongolia, and Russia. Except for Germany, the other nations used mass voucher schemes resulting in arrangements of uncertain long-run stability or arrangements that involve large amounts of insider ownership, notably in Russia and Mongolia.[1]

In discussing Poland's economy in chapter 12, a variety of privatization methods, from mass voucher schemes to selling shares of state-owned firms in open stock markets, were presented. Selling shares is the standard approach in market capitalist economies with functioning stock markets. Motives for privatizing and limits to this process will be seen by examining the process in Great Britain, officially called the United Kingdom. This privatization drive was part of a broader movement known as **Thatcherism,** named after Margaret Thatcher, the British prime minister from 1979 to 1990, who launched this global trend.[2]

The purpose of Thatcherism was to reform and revive an apparently moribund and stagnant economy. Although it had generally positive long-term real per capita economic growth after World War II, the United Kingdom's performance lagged behind that of other major market capitalist economies, leading to relative decline. Whereas the United Kingdom had led the world economy in the nineteenth century as the source of the Industrial Revolution, and had maintained a lead in both aggregate and per capita GDP as late as the 1870s (when the United States and Germany surpassed it), its relative position has declined as of 2001 to fifth or sixth place in aggregate GDP globally[3] and to nineteenth place in real per capita terms, with even its former colonies of Hong Kong and Singapore pulling ahead of it.[4]

1. Although the Russian scheme was designed to achieve such an outcome, the one in Mongolia was not. Vouchers were distributed to members of the public, who were allowed to buy shares of firms directly. But most Mongolians bought shares of firms in which they or their close relatives worked.

2. Thatcherism preceded and inspired Reaganomics in the United States under President Ronald Reagan (1981–1989), despite differences in approaches. Reagan's program had less emphasis on privatization because there was little state ownership of enterprises in the United States in 1981, in contrast to the United Kingdom in 1979.

3. Ahead of it are the United States, Japan, Germany, France, and, if one allows PPP accounting, China, which is second in PPP terms. Italy was ahead of it both nominally and by PPP in the mid-1990s, but a surge of growth in the United Kingdom in the late 1990s, along with an appreciating British pound, put Britain back ahead of it slightly. Except for China, these nations are part of the G-7, which also includes Canada, recently expanded to the G-8, with Russia also a member.

4. World Bank, *World Development Report* 2003 (New York: Oxford University Press, 2003), table 1, pp. 234–235. Ahead of it were Luxembourg, the United States, Switzerland, Norway, Iceland, Belgium, Denmark, Canada, Ireland, Japan, Austria, the Netherlands, Hong Kong, Australia, Germany, France, Finland, Singapore, and Sweden.

The sources of this relative decline are numerous. Hypothesized causes include a failure of entrepreneurship with accompanying technological slowdown;[5] excessive class conflicts resulting in too many strikes;[6] too much regulation and socialism after World War II; excessive slowness in joining the EU because of nostalgia for the lost British Empire and a special relationship with the United States; and the costs of past **imperial overreach.**[7] However, given the better growth records of the United States and Great Britain in the late 1990s compared to most of Europe, some argue that the link between the United States and the United Kingdom is desirable, as they represent the **Anglo-Saxon economic model,** which others should strive to emulate.

A theory compatible with the Thatcherite position is that of Mancur Olson,[8] discussed in chapter 2. Olson argues that the longer a nation goes without a major revolution, defeat, or general shakeup, the stronger will become rent-seeking special interest groups who generate laws and institutions to satisfy their rent seeking, which eventually drains away economic vitality. In Olson's view, the United Kingdom has not had a serious shakeup since the 1066 invasion by William the Conqueror, although the English Revolution and Oliver Cromwell's rule in the mid-1600s created a flurry despite the subsequent Restoration. This entrenchment of rent-seeking groups culminated with the Labor Party government of the late 1940s, which nationalized a great deal of industry and introduced welfare state elements such as socialized medicine. It was this legacy that Thatcher sought to overthrow after 1979.

Central to this effort was her privatization drive. The most popular part of this program was privatizing public housing for its inhabitants.[9] Industrial firms were privatized by

5. This is despite generating the second largest number of Nobel Prize science winners after the United States. A break has developed in the United Kingdom between pure and applied science. Some attribute this to cultural trends and social disdain, and Thatcher is thought to have represented a new entrepreneurial class not associated with older aristocratic Tory elites.

6. Thatcher blamed this on unions possessing too much power, which she moved to reduce.

7. Paul Kennedy (*The Rise and Decline of the Great Powers: Economic Change and Military Conflict from 1500 to 2000* [New York: Random House, 1987]) sees this related to Britain's fall from its past "world hegemonic position," militarily and politically as well as economically. He argues that there is a "hegemony cycle" and that once a nation begins its relative decline, powerful forces are set in motion that reinforce it (see J. Barkley Rosser, Jr., *From Catastrophe to Chaos: A General Theory of Economic Discontinuities* [Boston: Kluwer, 1991]), chap. 16, for further discussion).

8. Mancur Olson, *The Rise and Decline of Nations: Economic Growth, Stagnation, and Social Rigidities* (New Haven, Conn.: Yale University Press, 1982). An argument that combines Olson's argument with the technological stagnation argument involves the idea that because Britain was the first to industrialize, it became locked in to an inefficient technological and institutional pattern that held it back (Mark Setterfield, *Rapid Growth and Relative Decline: Modelling Macroeconomic Dynamics with Hysteresis* [London: Macmillan, 1997]).

9. Despite the publicity surrounding this program, the share of owner-occupied housing rose only from 54.7 to 66.5 percent between 1979 and 1989 (Christopher Johnson, *The Grand Experiment: Mrs. Thatcher's Economy and How It Spread* [Boulder, Colo.: Westview Press, 1991], p. 298). But it was a popular success and a political triumph, attracting working class voters to the Conservative Party on the premise of "popular capitalism."

selling shares in the existing stock market, often with vigorous publicity campaigns designed to attract many buyers in the spirit of **popular capitalism.** This included some encouragement of workers to buy into their own firms, although with little effort at formal ESOPs until the late 1980s. The largest enterprises sold in this manner were British Telecom, British Gas, Rolls Royce, the British Airports Authority, large portions of British Petroleum, Britoil, British Airways, and Cable and Wireless.[10] Overall, the share of the United Kingdom's public sector in the capital stock declined from 44.1 to 30.6 percent between 1979 and 1989 and its share of GDP declined from 27.2 percent to 20.3 percent during the same period,[11] a rather undramatic decline compared to that of some other countries engaging in privatization programs.

The goals of Thatcher's privatization program included (1) efficiency improvements[12] arising from greater competition, reduced interference in managerial decisions by government ministers,[13] freeing up of prices, and reduced wage pressures with weakened government sector unions; (2) equity improvements as ownership spread widely (*popular capitalism*);[14] and (3) macroeconomic policy gains as the government received revenues from "selling off the family silver,"[15] along with greater anti-inflationary pressure[16] as firm debts were privatized and wage pressures were reduced. Many of these goals were achieved to some degree, and during 1983 and 1985–1988 the British economy grew more rapidly than either the EU or OECD averages, although it went into recession thereafter, as it did in the early 1990s.

The major criticism of the United Kingdom's program is that many of the major firms privatized were and continue to be natural monopolies. The upshot has been government

10. Johnson, *The Grand Experiment,* p. 300.

11. Johnson, *The Grand Experiment,* p. 302.

12. Evidence is strong that during the 1970s public sector firms had declined in performance relative to private sector ones, despite efforts to emphasize a commercial approach during that period relative to earlier ones. Some argue that the problem with the British nationalized firms was low profitability tied to socially imposed conflicting goals, whereas their productivity records were as good as those of private firms (James Foreman-Peck and Robert Millward, *Public and Private Ownership of British Industry 1820–1990* [Oxford: Clarendon Press, 1994]).

13. An example of this was frequent orders to buy higher-cost British-made inputs rather than imported ones.

14. The share of the adult population owning some stock rose from 7 to 20 percent between 1979 and 1988 (Colin Harbury, "Privatization: British Style," in Morris Bornstein, ed., *Comparative Economic Systems: Models and Cases,* 7th ed. [Burr Ridge, Ill.: Irwin, 1994], p. 133).

15. This phrase is due to former Prime Minister Harold Macmillan, a Tory. Proceeds from privatization peaked in 1988 at 4.0 percent of government expenditure. Such proceeds in the late 1990s globally were about $600 billion annually ("Privatisation," *The Economist,* July 22, 2000, p. 99). A good overview of privatization throughout Western Europe and the United States is Pier Angelo Toninelli, ed., *The Rise and Fall of State-Owned Enterprises in the Western World* (Cambridge: Cambridge University Press, 2000).

16. The rate of inflation fell from an annual average of 12.5 percent in the 1970s to 7.4 percent in the 1980s (Johnson, *The Grand Experiment,* p. 72), although global inflation declined during this period, and the Thatcher program also included a vigorous monetarist policy. Except for a few brief upsurges, the inflation rate has since generally declined in line with the global trend.

regulation of these enterprises.[17] Also, Thatcher eventually began to push privatization of parts of the medical care system and local water supply systems, and some of the latter actually occurred. These were unpopular positions that, combined with Thatcher's attack on local public finance and opposition to the Maastricht Treaty,[18] led to her downfall in late 1990. Thatcher's departure as prime minister slowed, but did not end, the British privatization campaign.

Thus, as discussed in chapter 2, privatization has limits despite its apparent global acceleration. This global privatization drive has often emphasized worker ownership in a variety of forms, an approach not supported by Thatcher. Nevertheless, it was Thatcher's program that initiated the global agenda in this area, and it succeeded in somewhat reviving the British lion's economic growth.

A CLASH OF CIVILIZATIONS?

A theme of this book has been the emergence of the New Traditional Economic system. This form has no single model, despite the focus on the Islamic economic system in chapters 4 and 17. Less clear is whether the East Asian zone of neo-Confucian, partially state-directed economies with their familistic groupism, may also fit this mold, although it contrasts substantially with the Islamic form.[19]

Samuel Huntington argues[20] that the revival of more traditional economic systems raises the issue of a possible global "clash of civilizations," centered on economic blocs defined as Western liberal (market capitalist Western Europe and North America), Islamic (largely Middle Eastern and South Asian), and neo-Confucian (centered on Japan, Korea, and China). The last group appeared to make the greatest relative gains prior to the Asian financial crisis of 1997 but has since exhibited a more complicated pattern, with China maintaining a rapid growth rate while Japan has sunk even deeper into the stagnation it has experienced since the collapse of its stock market and real estate bubbles at the beginning of the 1990s. This emerging clash coincides complexly with the remnant of the capitalism/socialism clash, largely in abeyance with the apparent victory of capitalism.

17. John Vickers and George Yarrow, in *Privatization: An Economic Analysis,* 6th ed. (Cambridge, Mass.: MIT Press, 1995), discuss these problems with privatizing state monopolies in Britain. They also note the difficulties in privatizing such industries as the water supply, in which environmental and safety issues arise as well as those of natural monopoly.

18. This treaty led the EU to adopt the euro as its common currency, a move that Great Britain has not followed.

19. One major difference is that neo-Confucianism is not a radical fundamentalist movement, but is more subtle in its cultural pervasiveness and influence.

20. Samuel P. Huntington, "A Clash of Civilizations?" *Foreign Affairs* 72(3) (1993): 22–49. Huntington presents eight different potentially clashing civilizations, with the conflict between Orthodox and Catholic Christianity in the Balkans fitting into this perspective. See also Samuel P. Huntington, *A Clash of Civilizations* (New York: Simon and Schuster, 1996).

In Central Asia, all of these economic forces—market capitalist, command socialist, and the two major New Traditional forms—come together. Some argue that Central Asia is an incubator of world history as both a generator and a transmitter of technology and culture between East and West.[21] Recently it was dominated by the command socialist system, whether in the Soviet Central Asian republics, in Afghanistan dominated by the Soviets, or in Chinese Inner Asia (Xinjiang). Now that system has loosened in Central Asia, although the former Soviet republics there are reluctant to change, and the command socialist mode persists in them more than in most of the former Soviet Union.

Religiously, Central Asia is Muslim, and linguistically most of it is Turkic or Persian. Islamic fundamentalist movements are on the rise, despite the defeat of the Taliban in Afghanistan by an international force led by the United States. Simultaneously, systemic market forces are penetrating, spearheaded by Turkey[22] (which seeks to join the EU) and by U.S. multinational corporations. Although the region is not culturally Confucian, the rapid growth of the Chinese economy offers the allure of Chinese influence through possible close relations between Xinjiang and the former Soviet republics.[23] Reports suggest that in such places as Kyrgyzstan, the Chinese have taken effective economic control.

World leadership in technological innovation and economic growth has shifted back and forth between Europe and East Asia over the past several thousand years. Some have argued that this leadership is shifting again from West back to East, despite the reassertion of technological leadership by the United States in the late 1990s. But this is an uncertain outcome given that, although China and Korea are growing very rapidly, the leading candidate for Asian-based leadership, Japan, suffers serious economic problems, as discussed in chapter 6. That the outcome of the clash of these competing systems in Central Asia will have global significance now seems much clearer than it did before the 1990s.

INTEGRATION, DISINTEGRATION, AND GLOBALIZATION

Another major theme of this book has been how individual nations relate to the larger world economy as it exhibits powerful trends toward expanded international trade and investment. Offsetting trends have been integrative and disintegrative. Integration is exemplified by the EC becoming the EU after the 1991 Maastricht Treaty; the final surrendering

21. S. A. M. Adshead, *China in World History* (London: Macmillan, 1988); Andre Gunder Frank, *The Centrality of Central Asia* (Amsterdam: VU Press, 1992).

22. A manifestation of this conflict is the question of alphabets, with traditional pro-Soviets supporting continued use of the Cyrillic alphabet, in which Russian is written; pro-free-market Westernizers supporting the Latin alphabet as used in Turkey; and Islamic fundamentalists supporting the Arabic alphabet.

23. Gaye Christoffersen, "Xinjiang and the Great Islamic Circle: The Impact of Transnational Forces on Chinese Regional Economic Planning," *China Quarterly* (133) (1993): 130–151.

of national currencies and the adoption of the euro by 12 members of the EU between 1999 and 2002; the NAFTA among the United States, Canada, and Mexico; the formation of the new Asian-Pacific Economic Community (APEC);[24] and the successful conclusion in December 1993 of the Uruguay Round of GATT negotiations on world trade, with over 100 nations signing the agreement in 1994 to establish the WTO. The most dramatic counterexample has been the disintegration of the former Soviet Union, the collapse of its CMEA trade bloc, and the splitting up of several other Eastern European states, most bloodily the former Yugoslavia.

But even within the integrative tendencies, powerful counterforces can be seen. Nationalism is rearing its head in Europe in various nations and ways, in some as neofascist anti-immigrant movements. The drive to expand the EU has run into resistance in some would-be members, such as Norway, and also from existing members, such as France, especially toward Turkey, although the Copenhagen summit of December 2002 saw the approval of 10 more nations.

Passed by the U.S. Congress in late 1993, NAFTA has been associated with upheavals in Mexico, as described in chapter 18. Furthermore, it has been undermined by a series of petty trade disputes between the United States and Canada, which have the world's largest bilateral trade flows. These disputes have covered a range of products, with lumber and wood products triggering an especially heated debate with considerable bitterness.

Regarding the GATT agreement that established the WTO to adjudicate global trade disputes, many nations claim various exemptions and demand special treatment and authority over various matters. A dramatic sign of this was the United States's bypassing of the WTO in its auto parts trade dispute with Japan in 1995 and its unilateral imposition of steel tariffs in 2002. If this effort at global free trade fails, it will recall the 1870s and 1930s, when world economic slowdowns led to abrogation of free trade agreements that had been gradually arrived at among the major trading nations.[25]

On the other hand, within the WTO mechanisms, the subordination of such concerns as labor standards, environmental protection, and human rights to trade has created protests in many parts of the world, beginning with dramatic demonstrations in Seattle in 1999. These protests have been directed more broadly at globalization as a whole, not just at trade itself. Thus, such entities as the World Bank and the IMF have also become objects of protest as the conflicts over globalization have escalated and remain unresolved.

It must be recognized that the issue of globalization ultimately goes beyond economics, even if it is primarily driven economically. Throughout much of the world, there is fear and

24. In late 1994 this fairly informal group dedicated itself to the long-term goal of complete free trade.

25. The most dramatic such example was the U.S. Smoot-Hawley Tariff of 1930, enacted to "preserve American jobs," which was followed by the job-destroying Great Depression after a global round of protectionist retaliation.

resentment of increasing U.S. dominance and alleged **hegemonism** of the United States as effectively the world's only military superpower as well as its unquestioned economic leader, fears heightened by the U.S. invasion of Iraq against the majority of world opinion. There is fear that the United States will not only impose economic systemic homogeneity through such bodies as the World Bank and IMF, but that it will impose its culture as well, the "cocacolonization" of the world. The actions of Osama bin Laden and the al Qaeda movement can be seen in this context, the assertion of radical Islam against the immense pull of American society and culture. French film makers and producers of indigenous crops around the world may feel sympathy with such groups even while disapproving of their methods. In effect, this issue brings to a head the implicit debate between Fukuyama and Huntington: Will the world converge on the U.S. model or will it remain split into different cultural camps that ultimately clash?

CAN THE TRANSFORMING WORLD ECONOMY SUSTAIN ITS GROWTH?

Among the striking developments of the past quarter century has been the dramatic slowdown in the growth rate of the global economy since the first oil price shock in 1973.[26] This slowdown occurred for most of the nations discussed in this book. It happened for the United States and virtually all of Western Europe, irrespective of systemic variations, although the United States saw a pickup in growth in the late 1990s with the explosion of information technology. It happened in Mexico and throughout Latin America after 1980, although Mexico as an oil exporter did very well in the 1970s, as did Iran. It happened in sub-Saharan Africa, where many countries slipped into negative per capita GDP growth.[27] It happened dramatically for the entire Soviet bloc, with declines like the Great Depression or worse for many nations, although most of these countries returned to economic growth after the middle to late 1990s.

The main exceptions to this dismal scenario have been the East Asian NICs: China, Thailand, Malaysia, Indonesia, South Korea, Taiwan, Hong Kong, and Singapore, although the Asian financial crisis of 1997 hit many of them hard. The upper-income members of this group, the last four, had declining growth rates in the 1990s, and the leader of the neo-Confucian group, Japan, experienced the dramatic slowdown described earlier. Japan went from double-digit growth rates in the 1950s and 1960s to growth slower than that of the

26. Although slow growth in the 1970s could be attributed to high oil prices, this explanation is no longer valid, as the real price of oil in 1993–1994 had fallen to the 1970 level that preceded the oil price shock, and dropped even lower in 1998 and 1999 in the wake of the Asian and Russian financial crises. It has risen since then.

27. Data are presented on some of these countries in the tables in chapter 1. This group includes parts of South Asia, most of sub-Saharan Africa, and several countries elsewhere. Detailed discussion of their problems can be found in books on economic development.

United States since 1990. This is the Gerschenkron **relative backwardness hypothesis** at work. Nations that are far behind the global leaders can grow rapidly, but slow down as they catch up to those leaders. Furthermore, most of these countries have relied on export-led growth. If protectionism erupts in the EU and NAFTA blocs against outsiders, this could crimp even the most robust NIC economies. On the other hand, China and India have room for expansion, given the enormous size of their potential markets. They provide potential alternative engines for continued regional expansion and even eventually for global expansion as they become more important in the world economy.

Box 20-1
Botswana: A Sub-Saharan African Success Story

Located in poor sub-Saharan Africa, Botswana was the world's most rapidly growing economy in 1980–1992.* Although its growth rate was only half as great during the 1990s, it still did much better than its neighbors.

Botswana's high growth has been accompanied by low inflation, budget surpluses, and current account surpluses. How has Botswana succeeded?

Some of it is sheer luck. Diamonds were discovered after Botswana gained independence in 1965 from Britain, and their export has been the main source of the nation's rising income. But other nations in the region also have valuable natural resources, such as the Congo (formerly Zaire), but have fared poorly.

However, Botswana has also had some bad luck, most tragically in having one of the world's highest rates of HIV/AIDS infections in the world during the 1990s, which has negatively impacted its economy as well as its society more broadly.

In Botswana an important positive factor is the absence of corruption reflecting democratic government. Diamond earnings have been used to expand infrastructure, education, and other underpinnings of growth and development rather than to line the pockets of a rent-seeking elite.† Another factor is ethnic homogeneity; most of the population belongs to the Tswana tribe, averting the tribal wars dragging down many African countries.‡ A crucial role was played by the first prime minister and president, Sir Seretse Khamaw, who voluntarily stepped aside as the leading tribal chief and who strongly supported democracy and honest government.

Botswana's economy has been market oriented since independence, and capitalist enterprises have been encouraged. However, a substantial state-owned sector faces little pressure for privatization because of its profitability and accountability. This sector is marked by joint ventures between the state and foreign corporations, the most important being with the De Beers diamond company, Debswana, which generates half of government revenues.§ That this sector continues to be efficient reflects Botswana's honest and democratic government.

*This conclusion is based on aggregate GDP (World Bank: *World Development Report 1994* [New York: Oxford University Press, 1994], Table 2). Because of its rapidly growing population, it was fourth in real per capita growth rate at 6.1 percent (see table 1-1), after South Korea, China, and Bhutan.

†Botswana stands out globally for both its high rate of infrastructure investment and its high growth rate (J. Bradford De Long and Lawrence H. Summers, "Equipment Investment and Economic Growth," *Quarterly Journal of Economics* 106 [1991]: 445–502). Botswana has avoided the wasteful gigantomaniac projects favored by many other African nations.

‡An important minority group is the traditionalist Khoi-San. Botswana contains a larger Khoi-San population than any other country.

§Keith Jeffries, "Public Enterprise and Privatization in Botswana," in T. Clarke, ed., *International Privatization: Strategies and Practices* (Berlin: Walter de Gruyter, 1994), p. 386.

One important trend is that many of the very poorest nations have become even poorer. They have not only low per capita incomes, but also low life expectancies and literacy rates. To this dismal list can be added high infant mortality rates and high birth rates, high rural populations, little infrastructure, and especially low education of women. Their falling behind has increased the overall global level of income inequality. In 1960 the top 20 percent of the world's people received 70.2 percent of the income while the bottom 20 percent received 2.3 percent, whereas in 1989 these figures had become 82.7 percent and 1.4 percent, respectively.[28] The global Gini coefficient for national per capita incomes rose from 0.69 to 0.87 over the same period.[29]

There is no single reason for these growing inequities and the more general recent slowdown. One theory is the **long-wave Kondratiev cycle,** a hypothesized macroeconomic fluctuation of about half a century in length.[30] A problem with this argument is that a clear cause for the cycle is not provided, although the most common explanation depends on alternating waves of technological innovation. But whether we are soon about to experience a round of global growth-inducing innovation is impossible to forecast. Some see the boom in information technologies in the United States in the late 1990s as the beginning of such a new long-wave upswing, although the crash of that sector in 2000 and afterward, along with the broader crash of the stock market bubble, renders this view questionable.

Another argument involves the trend toward postindustrial service-oriented economies. It is harder to increase productivity in service sectors than in industrial sectors, the most rapidly growing economies being those undergoing industrialization. The service-oriented nature of most public sectors underlies the **cost disease of the public sector,**[31] which explains the tendency toward an increasing share of public sector activities in high-income market capitalist economies **(Wagner's Law),** even those trying to avoid such an increase.

Other factors that have been identified involve a general weakening of the social and political institutions that support economic growth. Some of these are the informal links

28. United Nations Development Program, *Human Development Report* 1992 (New York: Oxford University Press, 1992), p. 36.

29. United Nations Development Program, *Human Development Report 1992,* p. 36. Direct measurement of inequality at the global level shows the global Gini coefficient rising from .625 in 1988 to .660 in 1993 (Branko Milanovic, "True World Income Distribution, 1988 and 1993: First Calculation Based on Household Surveys Alone," *Economic Journal* 112 (2002): 51–92. For a general discussion of marketization and globalization as increasing global inequality, see Frances Steward and Albert Berry, "Globalization, Liberalization, and Inequality: Real Causes," *Challenge* 43(1) (2000): 44–92.

30. For an application of this concept to the rise and fall of the Soviet bloc economies, see J. B. Rosser and M. V. Rosser, "Schumpeterian Evolutionary Dynamics and the Collapse of Soviet-Bloc Socialism," *Review of Political Economy* 9 (1997): 211–223. Joshua Goldstein (*Long Cycles: War and Prosperity in the Modern Age* [New Haven, Conn.: Yale University Press, 1988]) uses this to explain the hegemony cycle.

31. See William J. Baumol and Alan S. Blinder, *Macroeconomics: Principles and Policy,* 6th ed. (Fort Worth, Tex.: Dryden, 1994), chap. 17.

between people that have come to be called **social capital.**[32] Others may be the more official institutions that allow markets to function, such as legal systems and property rights, with the failure of these institutions to even develop in poor countries or in transition countries being especially identified as culprits.[33] Societies with weak institutions, inefficient governments, or low social capital become subject to rent seeking, to corruption, and more broadly to an apparent global increase in underground or shadow economies.[34] This may be related to rising global inequality in a variety of ways.[35]

GLOBAL ENVIRONMENTAL ISSUES IN THE TWENTY-FIRST CENTURY

Another argument is that a global environmental and resource crisis is slowing growth. Its extreme doomsday version was publicized by the neo-Malthusian Club of Rome,[36] a study widely criticized on many grounds. But the explosion of environmental concern around the world since the early 1970s has resulted in many nations diverting resources to pollution cleanup or avoidance activities. This alone explains part of the economic slowdown.

A number of global environmental threats have been identified, the most serious one being atmospheric pollution affecting global climate. Despite criticism of the **global warming hypothesis,**[37] it and the threat to the ozone layer from chlorofluorocarbon (CFC) emissions symbolize what humanity faces. Table 20-1 presents data on atmospheric greenhouse gas pollutants emitted by the world's 10 largest aggregate air polluters, as measured

32. Robert D. Putnam (*Making Democracy Work: Civic Traditions in Modern Italy* [Princeton, N.J.: Princeton University Press, 1993]) discusses how social capital can affect both political and economic functioning of societies. For evidence that social capital is related to economic growth, see Stephen Knack and Philip Keefer, "Does Social Capital Have an Economic Payoff? A Cross-Country Examination," *Quarterly Journal of Economics* 112 (1997): 1251–1288.

33. Olivier Blanchard and Michael Kremer, "Disorganization," *Quarterly Journal of Economics* 112 (1997): 1091–1126; J. Barkley Rosser, Jr., and Marina V. Rosser, "Complex Dynamics and Systemic Change: How Things Can Go Very Wrong," *Journal of Post Keynesian Economics* 20 (1997): 102–122.

34. Friedrich Schneider and Dominik H. Enste, "Shadow Economies: Size, Causes, and Consequences," *Journal of Economic Literature* 38 (2000): 77–114; Andrei Shleifer and Robert W. Vishny, *The Grabbing Hand: Government Pathologies and Their Cures* (Cambridge, Mass.: Harvard University Press, 1998). It is ironic that Shleifer was accused of involvement in questionable monetary transactions while advising the Russian government on transition policies.

35. J. Barkley Rosser, Jr., and Marina V. Rosser, "Another Failure of the Washington Consensus on Transition Countries: Inequality and Underground Economies," *Challenge* 44(2) (2001): 39–50; and J. Barkley Rosser, Jr., Marina V. Rosser, and Ehsan Ahmed, "Multiple Unofficial Economy Equilibria and Income Distribution Dynamics in Systemic Transition," *Journal of Post Keynesian Economics* 23 (2003): 435–447.

36. Donella H. Meadows, Dennis L. Meadows, Jorgen Randers, and William W. Behrens III, *The Limits to Growth* (New York: Universe, 1972).

37. Patrick J. Michaels and Robert C. Balling, Jr., *The Satanic Gases: Clearing the Air about Global Warming* (Washington, D.C.: Cato Institute, 2000). For a detailed analysis of the economic implications of the consensus forecast that warming will happen, see William D. Nordhaus and Joseph Boyer, *Warming the World: Economic Models of Global Warming* (Cambridge, Mass.: MIT Press, 2000).

Table 20-1
Greenhouse Gas Emissions by the Top 10 Nations

Country	CO_2	Methane	CFCs	CO_2 per Capita	Percent CO_2 of World Total
United States	5,309	28	350	19.2	19.7
China	3,369	34	32	2.8	14.1
Russia	1,582	37	n.a.	10.7	6.6
Japan	1,170	1	100	9.3	4.9
India	999	n.a.	0.7	1.1	4.2
Germany	863	5	75	10.5	3.6
United Kingdom	558	4	71	9.5	2.3
Canada	410	8	n.a.	13.8	1.7
South Korea	409	n.a.	n.a.	9.0	1.7
Italy	403	4	n.a.	7.1	1.7

Sources and Note: CO_2 is in 1996 emissions in millions of metric tons and is from *Human Development Report 2000* (New York: Oxford University Press for UNDP, 2000), pp. 231–233, with per capita emissions in the same unit and from the same source and percentage of world total from the same source. Methane emissions are in average annual million metric tons for 1989–1994 from *World Resources: A Guide to the Global Environment, 1998–99* (New York: Oxford University Press for the World Resources Institute, 1998), p. 346. CFCs are in annual million metric tons for 1987 from Paul Kennedy, *Preparing for the Twenty-First Century* (New York: Random House, 1993), p. 117. CFCs are not greenhouse gases. CO_2 is the main greenhouse gas, responsible for more than half the anthropogenic input to global warming.

by carbon dioxide (CO_2) emissions. CO_2 comes substantially from burning fossil fuels, generally an activity of high-income countries, and from deforestation, an activity of poorer tropical countries. Methane generally comes from cattle and certain crops like rice, and thus from both rich and poor countries. The CFCs are used by richer countries and are of strictly industrial, anthropogenic origin.

Consideration of this problem leads to a final note of optimism regarding a possible wave of innovations that could place the world economy on a sustainable growth path that does not rely on polluting fossil fuels. The most serious transformation of the world economy comes from the relationship between humanity and the environment, the search for an economic system that is ecologically sustainable in the long run. Arguably we have entered a higher stage of evolution of the interacting human-environment system.[38] This is symbolized by the global association between environmental movements and political democratization movements, evident in the breakdown of the former Soviet bloc.

Continued global cooperation is crucial. The 1989 Montreal Accords on CFC emissions offer grounds for optimism. But the world has been unable to agree about implementing agreements on carbon dioxide (CO_2) emissions that were agreed to in the Kyoto Accords

38. Vladimir I. Vernadsky, "The Biosphere and the Noösphere," *American Science* 33 (1945): 1–12; J. Barkley Rosser, Jr., "Complex Ecologic-Economic Dynamics and Environmental Policy," *Ecological Economics* 37 (2001): 23–37.

in 1997.[39] However, progress on crucial technologies might improve the possibility of long-run sustainable growth. These include solar batteries competitive with fossil fuels in cost and electric and hybrid cars competitive with fossil fuel–driven cars. Breakthroughs in these and related areas could trigger a globally sustainable, real capital investment boom as the world economy adopts the new technologies and truly transforms itself into a higher stage of evolution within a framework of international peace, democracy, and cooperation. Thus, rather than bringing the end of history, the transforming world economy may transform world history.

QUESTIONS FOR DISCUSSION

1. Compare and contrast the British privatization program under Thatcher with those of other countries presented in this book.
2. Evaluate the success or failure of the popular capitalism program in halting the relative decline of the British economy.
3. Why is Central Asia a focal point of a potential global clash of civilizations, including a clash of economic systems?
4. What are the sources of the competing pressures for global economic integration and disintegration?
5. Why has Botswana been an exception to the dismal record of sub-Saharan African economic development?
6. What are some explanations for the global deceleration of economic growth since the early 1970s, and what are the prospects for reversing this trend?
7. What do you see as the predominant trends in the evolution of economic systems in the twenty-first century and why?
8. The war on terrorism has apparently brought about an alliance between the United States and Russia against Islamic fundamentalists. Will this alliance endure, and what are its connections with the analysis of economic systems presented in this book?
9. If the United States continues to follow a more unilateralist path in the world, will this exacerbate global environmental and developmental problems or will it allow the United States to lead the world more effectively to a better long-run form of economic evolution?

39. The main reason for the failure to implement the Kyoto Accords was the refusal of the United States to agree to do so at the Hague summit in 2000. Given that the United States is the world's largest source of greenhouse gas emissions and has continued to expand its emissions, this refusal angered many other nations in the world and contributed to a perception that the United States prefers a unilateral approach to world affairs. This widespread perception has made it more difficult for the United States to persuade other nations to support some of its diplomatic and military policies.

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Glossary

A

Alienation According to Marx, the experience of not owning the means of production one works with; separation from the means of one's survival and thus under the control of the owner of those means. Modern usages focus on psychological feelings of distance, that is, of not identifying with those nearby.

Amakudari Japanese for "descend from heaven," referring to former government bureaucrats taking corporate jobs after retiring from their government positions.

Amana Farms Villages and farms in Iowa established in the early 1880s by egalitarian German Pietists who owned the property communally until the 1940s, when their technological innovations, including Amana microwave ovens, were bought out by U.S. corporations. The most successful U.S. utopian socialist community, now a tourist attraction in Iowa.

American System Manufacturing system using standardized interchangeable parts, first developed by the U.S. wooden clock industry and the U.S. gun industry in the early nineteenth century; the latter derived from an idea of a Frenchman, de Grébauville, in 1765. The basis for the later Fordist assembly-line mass production.

Anarchism From a Greek term meaning "no ruler," that is, that there should be no government. Advocated in the late 1700s by William Godwin, a view advocated by some on both the extreme Left and Right.

Anglo-American Corporate Form Usually strongly hierarchical, with a strong, highly paid CEO who is answerable to the board of directors and the shareholders, with little control by banks, workers, or other corporations.

Anglo-Saxon Economic Model Idea of a common economic system in the United States and the United Kingdom, with Anglo-American corporate form part of this, along with support for a laissez-faire economic system.

Anti-Manchesterian See **Market Socialism.**

Antithesis The opposite of a *thesis,* a primary reality. In Hegel's dialectical theory, these oppose each other in a dynamic unity that drives history. The conflict of thesis and antithesis generates a synthesis.

Apparatchik A Russian term from the Soviet era for a bureaucrat who obtained power by following the ideas and orders of the Communist Party. Now applied to any bureaucrat who mindlessly follows the orders of the ruling elite.

Appropriate Technology View in development economics that technology should adapt to local conditions and factor proportions rather than just be the most advanced possible technology. From Mohandas (Mahatma) Gandhi's ideas for development in India.

Arbitrage Process of agents buying things at low price in one market to sell at higher price in another market, which tends to equalize the prices in competitive markets. Common in economic transition when some prices remain controlled by the state in one country but are not in a neighboring country.

Asian Tigers Rapidly growing East Asian economies, originally comprising Singapore, Hong Kong, Taiwan, and South Korea, later extended to include Thailand, Malaysia, and Indonesia, and possibly China.

Asiatic Mode of Production Social-economic-political system found in agricultural Asian countries with strong government control over hydraulic systems and little private ownership of land. Marx argued that these were stagnant economies, especially those of China and India in the past.

Asymmetric Information A situation in which one of two parties in a transaction knows more than the other. A source of inefficiency in centrally planned economies between planners and enterprise managers, as well as in many financial and insurance markets in capitalist economies. Source of the principal-agent problem.

Atlepetalli Communally held portions of traditional Indian lands in Mexico, later the basis for the communally held parts of *ejido* farms.

Austrian School Generally strongly pro-laissez-faire, anticommunist, and antisocialist school of economics that also believes in the subjective theory of value and questions equilibrium analysis. Founded in Vienna by Carl Menger in the 1870s, with the most important twentieth century members being Ludwig von Mises and Friedrich Hayek.

Autogestion French version of workers' management of enterprises, proposed in the early 1980s but never implemented.

Auxiliary Household Plots Plots of land farmed by individual families belonging to collective farms, with the produce sold in free markets. A very common practice in socialist agricultural systems, sometimes the only legal markets in strict command socialist economies.

B

Balcerowicz Plan Plan proposed and largely implemented in 1989 in Poland to end central control of prices and economic decision making. Named for its proposer, Leszek Balcerowicz, who was then the finance minister.

Banyad Economic entity owned by a religious body in Iran. Much of Iran's economy is controlled by *banyads,* many of which are independent of the government. The term is often translated into English as "foundation."

Barter Exchange Direct exchange of goods and services without the use of money. Such exchange has become prevalent in some transition economies, notably Russia in the late 1990s.

Basic Organizations of Associated Labor (BOALs) Labor organizations created in Yugoslavia in 1976 to carry out local-level planning by groups of workers in related enterprises.

Bharatiya Janata Party (BJP) The leading Hindu nationalist political party in India. Main leader of the Indian national government after the mid-1990s.

Big Bang Economic Transformations Sudden change of economic systems from socialism to capitalism in the 1990s in Central and Eastern Europe.

Big Bang Reforms Policies leading to a big bang economic transformation, with the Balcerowicz Plan in Poland being the main example, although sometimes applied to large-scale deregulatory reforms in market capitalist economies, especially in banking and financial sectors.

Bolshevik Revolution (Russian Revolution) Actually, two revolutions took place in Russia in 1917. The first, in February, overthrew the tsar and was democratic. The Bolshevik Revolution came in October, led by Vladimir Lenin, leading to socialist economic policies and the dissolution of the democratic Duma (parliament). Also known as the *Great October Socialist Revolution*.

Bolsheviks Russian for "majority," historically identified as a group in the early 1900s in the Russian Social Democratic Labor Party led by Vladimir Lenin that advocated control by a vanguard group and eventually led the Russian Revolution of 1917.

Bourgeoisie French, originally meaning "wealthy living in cities." According to Marx, the ruling class of capitalism that owns the means of production and oppresses and exploits the working class, the proletariat.

Bretton Woods Conference Held in Bretton Woods, New Hampshire, in 1944, this conference established the International Monetary Fund (IMF) and the World Bank.

Brigades Units of rural production control in China under Mao Zedong corresponding to the village level. Unit of accounting after the Great Leap Forward and the eventual basis for the later town and village enterprises (TVEs). Hierarchically below communes but above production teams.

British Raj The system of British rule in South Asia from the mid-1700s to 1947, including at its height modern India, Pakistan, Bangladesh, Myanmar (Burma), and Sri Lanka (Ceylon).

Bubble Economy Growth economy based on speculation in stocks and land that then collapses into stagnation. Originally used to describe Japan in the 1980s but now applied to other countries as well.

Buddhism Religion founded by Siddhartha Gautama in South Asia between 600 and 500 B.C.E., that is widespread in East Asia. It emphasizes liberation from material concerns.

Buddhist Economics According to E. F. Schumacher, a system of slow, locally focused growth that encourages spiritual liberation ("small is beautiful"). Not followed by many actual Buddhist economies in Asia but influential among ecological economists.

Buddhist Socialism Doctrine proclaimed by U Ba Swe in Burma in the 1930s advocating *pyidawatha,* a welfare state in which the individual pursues salvation. Influential with the first leaders of independent Burma (now Myanmar).

Bushido Code Japanese code of the samurai warriors, stated to have been transferred to businessmen after the Meiji Restoration of 1868 ("from samurai to sarariman" [salaryman]).

Business Unionism Labor union activity focused on immediate economic gains from businesses within the existing capitalist system rather than revolution. It may seek reforms within the system, with the U.S. American Federation of Labor–Council of Industrial Organizations (AFL–CIO) being a main example.

C

Caliph Successor to the Prophet Muhammed as the political leader of the Islamic community. A source of controversy and war in the Muslim world. This official position was eliminated when Kemal Ataturk overthrew the last Ottoman sultan in 1923 in Turkey.

Capitalism Economic system with predominantly private ownership of the means of production.

Capitalist Roader Term applied by Maoists in China to opponents of the 1950s Great Leap Forward and the 1960s Great Proletarian Cultural Revolution, with the eventual leader, Deng Xiaoping, among those so labeled.

Cartelization Process of agglomerating companies into monopolistic groupings under the influence of government, especially in Japan, Germany, and other countries, to protect industries and preserve employment.

Caste System Hindu socioeconomic system wherein people work at the jobs that their parents held. Although officially illegal, still largely dominant in rural India and based on ideas of reincarnation and karma. People deserve their social status because of their behavior in past lives and can only marry someone from their caste.

Centralized Wage Bargaining Key idea of corporatism that wages will be determined largely by negotiations between labor and management at the national level. Especially influential in Scandinavia and Austria.

Chaebol Korean corporate form combining many subsidiary firms from many sectors into a single firm. Resembles the earlier Japanese *zaibatsu,* but without a bank as part of it.

Chicago School Strongly pro-laissez-faire view of economics advocated by many associated with the University of Chicago, such as Milton Friedman. Accepts neoclassical equilibrium theory.

CIS Commonwealth of Independent States, a political economic group consisting of 12 former republics of the Soviet Union: Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan. The Baltic Republics of Estonia, Latvia, and Lithuania are not members. Seen by some as an attempted revival of the Russian-dominated Soviet Union.

CIS Customs Union Idea proposed but not adopted for the CIS. In a customs union there is free trade between members and a common set of tariffs and quotas for the rest of the world.

Clash of Civilizations Argument made by Samuel Huntington that world politics is now driven by conflicts between cultures such as Islam and Western liberalism.

Classical School School of economics that believes that the macroeconomy is self-stabilizing, that a steady policy minimizing inflation should be in place with free markets and all will go well, in contrast to the Keynesian school. However, Marxists also consider themselves to be classical. More generally, an approach to economics prior to the neoclassical revolution of the 1870s.

Coase Theorem Idea of Ronald Coase of the University of Chicago that if property rights are well defined and enforced and transactions costs are minimal, then the free market can internalize externalities efficiently.

Codetermination (Mitbestimmung) Placement of labor union leaders on boards of directors of corporations, originally pursued in Germany.

Colbertisme From Jean-Baptiste Colbert, minister of finance for King Louis XIV of France in the late 1600s, a doctrine of state intervention and direction of economy. The original version of *dirigisme*.

Cold War Conflict after the end of World War II between the United States and the Soviet Union and ideologically between capitalism and socialism. Largely ended in 1991 with the dissolution of the Soviet Union.

Collective Consumption Goods Goods that no one can be excluded from consuming. Subject to the free rider problem when privately provided. Usually called *public goods.*

Cominform Communist Information Bureau, formed by Stalin in 1947 as the successor to the Comintern. Expelled Tito-led Yugoslavia in 1948. Replaced by the Warsaw Pact of Soviet allies in 1949.

Comintern The Third Communist International, a body led by the Soviet Union from the early 1920s until 1947, that controlled most Communist parties.

Command capitalism Economic system characterized by state control of crucial economic decision making, with private ownership of the means of production. Nazi Germany is a prominent example. It characterized the U.S. economy during World War II.

Command economy State direction of allocative decision making in the economy through commands.

Command socialism Economic system with both a command allocation system and state ownership of the means of production. The former Soviet Union was the most prominent example, and North Korea is the purest current example.

Communes Collective units of ownership and production with group living in China during the 1950s Great Leap Forward. At that time, units of accounting and control as well. Coincided with town-level entities. Hierarchically above brigades, production teams, and households in the rural economy.

Communism (Pure) Originally a French concept, taken up by Marx and Engels in the *Communist Manifesto* as the ultimate idea of collectivism. In its pure version, the state will wither away and distribution will be “from each according to his abilities, to each according to his needs.”

Competition Attempts of firms to maximize profits by expanding market shares through marketing activities and lowering their costs of production, supposedly generating efficiency. Pure competition implies many buyers and sellers, free entry and exit, homogeneous products, and full information.

Competitive Describes markets that fulfill conditions for pure competition: many buyers and sellers, free entry and exit, homogeneous products, and perfect information, or at least equally available information.

Complete A market economy that has functioning markets for all things that provide utility to people. A condition for an economy in general equilibrium to be Pareto Optimal (efficient).

Composite Organizations of Associated Labor (COALs) Yugoslav organizations founded in the 1970s that were groups of Basic Organizations of Associated Labor corresponding to vertically integrated industrial structures.

Concertation Process in indicative planning, especially in France, in which the goals of different sectors and groups are harmonized, through consultation, just as the different instruments in an orchestra are aligned by the conductor.

Concerted Action (Globalsteureung) German indicative planning, or "global steering," practiced briefly during the 1970s.

Conflict Corporatism Scandinavian centralized wage bargaining with minimal government direction, with management granting women's and social rights to satisfy labor demands, in contrast to the government-controlled consensus corporatism of Austria, resembling the corporate state of the fascist era.

Confucianism Chinese religious philosophy founded by Confucius emphasizing benevolence and respect for hierarchies, the emperor, and education. Once thought to be antimercantile but now seen as often aiding economic growth.

Confucianist Society Society dominated by Confucianist religion and philosophy, usually ethnically Chinese, Japanese, or Korean.

Congress Party Dominant political party of India from the late 1800s to the 1990s. Secular and the leader of the independence movement.

Consensus Corporatism Centralized wage bargaining dominated by government but within a democratic society, notably Austria after World War II. Argued to give fewer rights to the labor movement than conflict corporatism.

Consumer Surplus Net benefit to the consumer, amount desired and gained without being paid for, measured by the area under the demand curve and above the price line in standard supply-and-demand analysis.

Consumers' Sovereignty Rule by the consumers, argued to be a fundamental characteristic of competitive market economies.

Contestable Markets Oligopolistic markets characterized by ultra free entry and exit. Argued to mimic the price and output of competitive markets.

Cooperative Economy Economy dominated by worker-owned firms.

Cooperatives Enterprises owned by workers. There are also cooperatives of consumers and other parties.

Corporate State Society where government enforces harmony between management and labor without democracy. Fascism is the classic example.

Corporatism Society with centralized wage bargaining.

authoritarian Outcomes enforced by the government of a corporate state.

democratic Outcomes not enforced by the state, including less controlled conflict and more controlled consensus forms.

Corporatist Incomes Policy Incomes policies involve government intervention in markets to influence the distribution of income between wages and profits, usually done for macroeconomic stabilization. This is often labeled *corporatist.* It can take various forms, of which centralized wage bargaining is one.

Cost Disease of the Public Sector Tendency for costs of public services to rise with wages in high-income countries because most services are labor intensive.

Council of Guardians Body of religious leaders in Iran with authority to veto legislation deemed to be insufficiently Islamic.

Council on Mutual Economic Assistance (CMEA) Soviet-led group of countries committed to economic cooperation and trade under socialism. Dissolved in 1990, also known as COMECON.

Creative Destruction Process whereby technological progress causes backward firms to go out of business. Initially described by Joseph Schumpeter.

Crony Capitalism System of decision making by closely aligned groups of friends (cronies) in business and government. Prevalent in much of Asia and argued to be susceptible to corruption.

Cult of Personality Hero worship of a strong leader, usually in a socialist society. Stalin in the Soviet Union, Mao Zedong in China, and Kim Il Sung in North Korea are examples.

Cultural Materialist Argument by anthropologist Marvin Harris that culture and religion reflect underlying ecological conditions. Prohibition of eating pork by Jews and Muslims in desert societies is a leading example.

Currency Board System whereby a country both pegs the value of its currency to that of another country and limits its domestic money supply to its supply of that country's currency obtained as foreign exchange. Used by several transition economies including Estonia and Lithuania.

Curzon Partition Division of Bengal in 1907 by Lord Curzon between the mostly Hindu and mostly Muslim parts that foreshadowed the later partition of India and Pakistan (and Bangladesh) at independence from Britain in 1947.

D

D'Arcy Oil Concession First concession for oil production granted in the Middle East in 1901 by Persia (now Iran) to Great Britain. Led to formation of the Anglo-Persian Oil Company, now British Petroleum, whose Iranian holdings were nationalized in 1951, leading to a 1953 coup to regain them.

Debt-for-Nature Swaps Arrangements in which a developing country has part of its foreign debt canceled in exchange for preserving endangered ecosystems, often rain forests.

Debt Peonage System of tying peasants to land through indebtedness in Latin American countries, usually in connection with the latifundia estate system.

Depression Cartels Mergers organized by the Ministry of International Trade and Industry (MITI) in Japan within declining industries to prevent shutdowns and layoffs.

Destalinization Movement in the Soviet Union and its bloc to end the cult of personality hero worship of Joseph Stalin after his death and to increase civil and economic liberties, initiated by Nikita Khrushchev in a secret speech to the Twentieth Soviet Communist Party Congress in 1956.

Dialectic Idea that conflicts of unified opposites drive dynamic processes. Applied to history by the nineteenth-century German philosopher Hegel and later by Marx, who saw conflicting classes as the opposites.

Dialectical Materialism Extension of historical materialism and dialectical analysis to all fields of knowledge, including science, with controversial results in studies of genetics in the USSR by Lysenko. Term originally due to Plekhanov.

Dictatorship of the Proletariat Argument by Marx that, after the socialist revolution, the working class will be the rulers, although he saw this as ultimately democratic, as they would be the majority of society. Lenin used the idea to justify having a vanguard of the Bolshevik Party lead the society without elections.

Direct Privatization (Management or Employee Buyouts) Method of privatizing state-owned enterprises during the transition from socialism to capitalism by having existing management or workers taking over their ownership.

Dirigisme French view that government should direct the economy.

Dual Economy (or Dualism) Pattern usually seen in developing countries whereby part of the economy is technologically advanced, high in income, and trading with the world economy, while the rest is more backward, poorer, and isolated from the world economy.

Dynamic Efficiency See **Efficiency.**

E

Economic and Technological Development Zones (ETDZs) Initially located mostly in coastal cities in China in 1984, these zones have relaxed rules for foreign investment and foreign trade, although not as relaxed as those in the Special Economic Zones (SEZs).

Economic Freedom Index (EFI) Number estimated annually by the Heritage Foundation based on a variety of factors to measure economic freedom. Ranges from 1.0 (totally free) to 5.0 (totally unfree).

Efficiency According to Lionel Robbins, the allocation of scarce resources among competing ends that best achieves those ends.

dynamic Maximizing the growth rate of an economy over time.

static Corresponds to Pareto optimality, the idea that no one can be made better off without making someone else worse off.

Ejido Commonly held farms in Mexico, derived from commonly held lands of the Indian period. Revived after 1930s and in the process of being privatized since 1992.

communal-use ejido Communally used as well as owned parts of *ejidos.*

individual-use ejido Although officially commonly held, usually by extended family groups, most *ejido* lands are farmed by individual families who have primary use of them.

Employee Stock Ownership Plans (ESOPs) Method of worker ownership popular in the United States, with stock owned by workers' pension plans.

Encomienda Large estates controlled by the Spanish during the colonial era in Mexico and the basis of later *haciendas.* Indians worked as slaves on *encomiendas.*

Equilibrium Quantity supplied equals quantity demanded in a market where the price is positive.

general All markets are in equilibrium.

partial One market or a subset of markets are in equilibrium.

Equity-Efficiency Trade-off Idea of Arthur Okun that too much equality can reduce incentives for growth in an economy.

Eurasian Economic Community Subgroup of the CIS more strongly allied to Russia than others and seeking closer economic ties.

Eurocrats Nickname for bureaucrats working for the European Commission in Brussels, the administrative capital of the European Union.

Euroland Unofficial nickname for members of the European Union that have adopted the euro as their currency, including as of 2002 Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain.

European Central Bank (ECB) The central bank of the European Union, established to manage the euro as it was introduced starting in 1999. Headquartered in Frankfurt-am-Main, Germany.

European Coal and Steel Community (ECSC) Founded in 1951 to remove tariffs on coal, iron ore, and steel among its members: Belgium, France, West Germany, Italy, Luxembourg, and the Netherlands. The forerunner of the European Economic Community and then the European Union. Formally ceased to exist in 2002.

European Union (EU) Developed since 1951 out of the European Coal and Steel Community and the European Economic Community, now a free trade zone and common market with a common currency, the euro (not used by all members), it is evolving gradually toward greater unity. Currently has 15 members, those in Euroland plus Denmark, Sweden, and the United Kingdom. Ten more countries have been allowed to enter in 2004, eight of them transition economies in Central and Eastern Europe.

Eurosclerosis Idea that Western European growth is relatively stagnating because of excessive regulatory and tax burdens; widely held in the 1980s.

Excess Capacity Theorem The theorem that the long-run equilibrium for monopolistic competition implies firm production levels lower than those that would generate minimum short-run average costs and therefore are inefficient.

Exhortive Element in indicative planning whereby businesspeople are encouraged to be optimistic and carry out growth-generating investments in a self-fulfilling, prophetic manner. Thought to have happened in France in the 1950s.

Exploitation In Marxian analysis the extraction of surplus value from workers, who do not own the means of production, by capitalists, who do.

Export Processing Zones (EPZs) Special zones established in 1966 in Taiwan to emphasize exporting rather than import substitution. Thought to have inspired the Special Economic Zones established later in China.

Externality An effect that one party generates on other parties but does not experience personally.

negative An externality that generates net costs for the affected parties but not for the generator.

positive An externality that generates net benefits for the affected parties but not for the generator.

F

Fabian Socialism Moderate British socialist movement led by Sidney and Beatrice Webb in the late 1800s and early 1900s urging gradual socialist reforms. Similar to revisionism and the basis for European social democratic parties and the Labour Party in Great Britain, at least into the late 1900s.

Familistic Groupism Practice in New Traditional economies whereby firms and even society as a whole behave like a family. Thought to be especially widespread in the Japanese economy and society.

Fascist Economies Economic systems found in antidemocratic Italy and Germany in the 1930s and 1940s. Characterized by command capitalism, with the government directing privately owned firms and the corporate state idea dominating labor-management relations.

First International International Communist group founded and led by Karl Marx in the 1860s. Dissolved by him in 1872 after the anarchist Mikhail Bakunin appeared to be on the verge of taking control.

First Pragmatic Phase Economic policymaking period from 1985 to 1989 in Iran during the latter part of the Iran-Iraq War, marked by the move away from socialist and radical Islamic policies to markets and greater openness.

First Radical Phase Economic policymaking period from 1979 to 1981 in Iran immediately after the Islamic Revolution, marked by strongly Islamic socialist-oriented policies with a wave of nationalizations.

Flying Geese Theory Idea that East Asian economies advance in a formation of leading and following countries like flying geese, with Japan in the lead followed by Singapore and Hong Kong, followed by Taiwan and

South Korea, followed by Thailand, Malaysia, Indonesia, and then finally by China. Originally developed in the 1930s by the Japanese economist Akamatsu.

Forces of Production In Marxian analysis, the technological substructure of the economy that combines with the relations of production (relations between classes) to determine the mode of production. Conflicts between the forces and relations can change the mode of production.

Fordist Assembly Line Production Mass production method initiated by Henry Ford for automobile production in 1913 involving a moving assembly line. Derived from earlier developments in standardization of interchangeable parts.

Formalism School of economic anthropology that argues that all societies can be analyzed using standard market models of neoclassical economics.

Fourth International International Communist organization founded by Leon Trotsky after his exile from the Soviet Union in 1929. Competed with the dominant Third International, the Comintern, led by Stalin.

Free Rider Problem Inability to exclude individuals from consuming collective consumption goods (public goods) means that it is hard to privately provide these goods as people can consume them without paying for them, becoming free riders.

G

Galbraithian Socialists Followers of "anti-Manchesterian" school of market socialism that favors large firms. Inspired by John Kenneth Galbraith's *The New Industrial State* that saw convergence between central planning and corporate planning in large firms by the "technostructure."

Gastarbeiters German term for "guest workers," originally brought into Germany temporarily from Turkey and Yugoslavia but many staying permanently. Now a general phenomenon in high-income Northern Europe.

General Equilibrium See **Equilibrium.**

Geneticists Group of Soviet economic planners in 1920s led by Nikolai Bukharin advocating more use of markets and balance between industry and agriculture, so that "genetic structure" of economy can be developed.

Germany's Fading Miracle Slowdown of West German economic growth in the 1970s, 1980s, and 1990s, in contrast with the economic miracle (*Wirtschaftswunder*) of rapid growth in the 1950s and 1960s. Seen by many as part of Eurosclerosis.

Gharar Arabic word meaning "chance" or "uncertainty." In Islamic economics, contracts based on *gharar* are forbidden. Seen as forbidding gambling and some forms of insurance.

Gigantomaniac Investment Pattern under socialist command planning, especially in the Soviet Union, of carrying out inefficiently large investment projects.

Gini Coefficient The ratio of the area above the Lorenz curve to the area below the diagonal line. Varies from 0.0 (equal) to 1.0 (unequal). Used to measure income inequality.

Glasnost Russian word meaning "openness" (literally, "glassy"). Policy of the last Soviet leader, Mikhail Gorbachev, during the mid-1980s to allow free discussion of economic, social, and political problems, as well as of past Soviet history.

Global Warming Hypothesis View that global temperatures are rising because of emissions of greenhouse gases that trap solar radiation near the earth's surface, with carbon dioxide the most important such gas. The Kyoto Accords were to limit their emission, but disagreements between the United States and other countries have slowed action.

Gosplan The central planning agency of the Soviet Union, disbanded in 1991.

Goulash Communism Label for the system in Hungary after the market socialist New Economic Mechanism (NEM) was introduced in 1968, leading to greater availability of consumer goods. Goulash is a native Hungarian dish.

Gradual Transformation Idea that in moving from socialism to capitalism, it is better to do so gradually, as in Hungary. Contrasts with shock therapy or big bang reforms.

Grand Industrial Policy Effort in France under Pompidou in the early 1970s to identify "national champions" among corporations and help them to compete with foreigners.

Grand National Consolidated Trades Union First major trade union in Britain. Led initially by the utopian socialist Robert Owen, it covered all workers in the 1830s.

Great Leap Forward (GLF) Intensive effort from 1958 to 1961 in China under Mao Zedong to develop rural-based industry and full communalization of agriculture. Led to massive famine, with up to 30 million dead.

Great Proletarian Cultural Revolution (GPCR) Chinese movement under Mao Zedong from 1966 to 1969, although not formally ended until 1978, to purge society of culture from the pre-Communist period and to attack entrenched bureaucrats and "capitalist roaders." Carried out mostly by youthful Red Guards.

Great Society Programs initiated by U.S. President Lyndon Johnson during the mid-1960s to expand social programs, the War on Poverty, Medicare, Model Cities, civil rights legislation, and voting rights for all.

Growth Poles Centers of development for economic regions. The idea of François Perroux in France was that regional planners should focus on encouraging such poles.

Guangxi Chinese word for "connections" or clout in patron-client relations, usually obtained through family relations and insider reciprocal dealings. Important in much of East Asian business; seen as part of crony capitalism.

H

Hacienda Large Mexican estates of the latifundia type on which peasants were forced to work through debt peonage. Eliminated after the 1910 revolution.

Hegemonism Domination by a single country, now thought to be the United States.

Hermit Kingdom Nickname for the Korean kingdom of Choson from the late 1500s to the late 1800s when the outside world was kept out. Some argue that the *juche* policy of North Korea imitates that of the Hermit Kingdom.

Hidden Imam In 874 the twelfth spiritual leader of most Shi'i Muslims went into hiding and is believed to have gone into a permanent state of suspension known as *Occultation,* from which he sends messages through special individuals and will eventually emerge to save the world. Inspired Islamic revolutionaries in Iran, who saw the Ayatollah Khomeini as the messenger of the Hidden Imam.

Hindu Economics Movement to make the Indian economy conform to doctrines of Hinduism such as the caste system and the prohibition of killing cows. Often associated with the ideas of self-sufficiency and protectionism (*swaraj*) espoused by Mohandas (Mahatma) Gandhi.

Hindu Equilibrium Traditional balance in rural India between castes, thought to have been initially disturbed by British irrigation and transportation investments.

Hinduism Polytheistic religion with a belief in reincarnation and the caste system, followed by the majority of the population of India.

Hindu Rate of Growth Thought to be about 3–4 percent per year, a rate that India was limited to by its social and political systems for many decades. Since the reforms of the early 1990s, India's growth rate has exceeded this level.

Hindutva Idea advocated by Hindu nationalists in India that all Indians are culturally Hindu, whatever religion they claim to be, and that therefore India should be governed according to Hindu doctrines.

Historical Materialism Doctrine of the *Communist Manifesto,* by Karl Marx and Friedrich Engels, that history is driven by class struggles over control of the means of production, with slavery followed by feudalism followed by capitalism, which was to be followed by socialism and eventually communism.

H-Mode *Hierarchy mode,* a term coined by Masahiko Aoki to describe American and European corporate management hierarchies, which he contrasted with supposedly more consensual and egalitarian J-mode of Japanese management.

Holistic System Analyzing systems or processes as wholes rather than examining their individual parts. Dialectical approach considered to be holistic. Argued by some to lead to authoritarian and totalitarian political views.

Household Economy Idea advocated by Karl Polanyi that most primitive economies consist of self-sufficient households.

Household Responsibility System After 1984 in Chinese agriculture, households gained great responsibility and control over lands they farmed while promising some production of certain commodities. A crucial part of post-Mao Dengist market reforms in China, followed by a surge of agricultural output.

Human Development Index (HDI) A number estimated annually by the United Nations for each country, ranging from 0 (bad) to 100 (good). Items entering the index include real per capita income, life expectancy, and educational attainment.

Hungarian Revolution Effort in 1956 to make Hungary a neutral nation no longer dominated by Soviet Union, was violently suppressed by Soviets.

Hydraulic (Oriental) Despotism A system in ancient societies with great river systems subject to monsoon rains, with infrastructure on rivers for flood control and irrigation controlled by despotic states increasing output. Identified with the Asiatic mode of production by Marx.

Hyperinflation Very high and accelerating rate of inflation; in recent years identified by the International Monetary Fund as more than 50 percent per month. Usually leads to major social and political turmoil and instability.

I

imam Leader of a local Sunni Muslim congregation.

Imam In principle, leader of all Shi'i Muslims, thought to have special links to Allah. After the Islamic Revolution in Iran, the Ayatollah Khomeini was called "Imam."

Imperial Overreach Argument that the leading world country (hegemon) tends to expand its power too much, overstraining its economy and leading to relative decline. The United Kingdom in the early twentieth century is an example.

Imperialism Thesis Idea among Marxists that capitalism did not collapse by the end of the 1800s, as forecast by Marx, because of European imperialism, which allowed European workers to be bought off. Thus, the socialist revolution would occur in the hinterland rather than in capitalism's core. Strongly advocated by Lenin and a key part of the Marxism-Leninism doctrine.

Import Substitution Policies Development policy directed at building up industrialization by replacing imported manufactures with domestically produced ones, often using infant industry tariffs or other protectionist policies.

Incompleteness of Markets Failure of private markets to provide public goods or resolve some externalities, which can make a general equilibrium be inefficient (not Pareto Optimal).

Indicative Planning Central planning directed at guiding and coordinating a mostly market economy on a strictly voluntary basis, in contrast with command planning. Widely used in France, Japan, South Korea, and India.

Indirect Privatization Also known as the *capital privatization path,* this is a method of privatizing formerly state-owned firms in transition economies that involves selective sales of stock to chosen individuals or groups, with the state retaining some shares. Favored by larger firms in Poland.

Industrial Policy Effort to direct investment at targeted industries that are seen as the next wave of growth in an economy and also to ease the decline of older industries. Used especially in Japan, with the Ministry of International Trade and Industry seen as the main director of this policy.

Industrial Revolution Rise of machine-driven capital goods using steam power that appeared initially in Britain near the end of the 1700s. Led to sharply higher rates of economic growth as it spread from country to country.

Information Knowledge needed to carry out market transactions.

asymmetric One party in a transaction knows more than another, leading to a variety of inefficiencies.

full When information is full, the market may be efficient.

incomplete In general, may lead to inefficiency, although this is less likely if parties to a transaction are equally ignorant, thus avoiding asymmetry problems.

Information Pooling Major economic agents pool information with each other, thereby aiding the concertation process in indicative planning, at least in principle.

Input-Output Analysis Modeling the economy by estimating the quantities of particular inputs that are needed to produce particular outputs, as summarized in an input-output matrix. Used by central planners and in linear programming optimization.

Insider Buyouts Purchase of a firm by its managers, workers, or both.

Integrally Planned Worker Management System introduced in Yugoslavia after 1976 to offset the impact of the merger wave that had reduced worker input in management. Led to the establishment of the Basic, Composite, and Working Organizations of Associated Labor.

Interest-Free Banking Advocated by Islamic economists, interest (*riba*) being explicitly forbidden by the sacred book, the *Qur'an*. Interest-free banks now exist in many countries and are the only ones allowed in Iran and Sudan.

Invisible Hand Phrase used metaphorically by Adam Smith to describe the allocative workings of market forces.

Islamic Economics Idea that economic behavior should conform to Islamic law codes (*Shari'a*), especially the prohibition of interest.

Islamic Revolution In Iran the revolution in 1979 that replaced the shah with a government run by Shi'i Muslim leaders who imposed the *Shari'a.*

Islamic Socialism Branch of Islamic economics that advocates socialist ideas such as nationalization of enterprises. This view was dominant in the immediate aftermath of Iran's Islamic Revolution during the First Radical Phase.

Islamic Workers' Council (*Shourah*) Idea of worker management within the Islamic context advocated by some Islamic socialists. Proposed but not fully implemented in Iran during the First Radical Phase.

Islamism Political movement to impose Islamic law codes, the *Shari'a.*

J

Jainism Religion founded in India by Mahavira around 500 B.C.E. Emphasizes nonviolence, implying very strict dietary restrictions.

Jajmani System System of reciprocal relations between castes in rural India that determines labor allocation and most economic activity. A remnant of the Old Traditional Economy in India.

Japan, Incorporated Phrase used to indicate the intimate relationship between business and government in Japan, with its familistic groupism at the level of the economy, as if the entire economy were a single company.

Jen Chinese word usually translated as "benevolence" or "humanness." Considered to be a central ideal of Confucianism. See also "ren."

J-Mode Term used by Masahiko Aoki to describe the Japanese management system, which supposedly favors egalitarian approaches involving consensus. Contrasts with the hierarchical H-mode of American and European managements.

Jubilee Year Generalized Sabbath concept in Judaism that every 49 years there should be a major restructuring of economic relations, with property remitted to its original owners, recently acquired slaves to be freed, the poor to be taken care of, and other features. Resisted in modern Israel because of the implication that land should be returned to its former Arab owners.

Juche Korean word meaning "self-sufficiency," a central concept of Kim Il Sungism in North Korea and its policies, now under pressure because of economic problems in North Korea. Sometimes transliterated as "chu'che."

Just Price Concept of Saint Thomas Aquinas that in each transaction there is a morally correct price equivalent to an Aristotelian golden mean. Often thought to prefigure the equilibrium concept, except that it would vary from transaction to transaction because of the different relative incomes of the agents.

K

Kanban Just-in-time inventory system used in Japanese business, now widely imitated in the rest of the world because of improved computer information systems.

Keiretsu Group of allied companies in Japan, usually linked through a bank. Major *keiretsus* contain both vertical and horizontal elements. Considered to be the central structure of Japanese industrial organization.

horizontal Firms in different industries in the same *keiretsu.*

vertical Companies in a supply chain in a single industry linked through long-term contracts.

Keynesian School Named for the British economist John Maynard Keynes. Believes that the macroeconomy is not automatically self-stabilizing and may need government intervention to stabilize it, in contrast with the Classical School.

Khums A 20 percent income tax paid by Shi'i Muslims to the ulama; not paid by Sunnis. Leads to a more elaborate clerical hierarchy among Shi'is than among Sunnis.

Kibbutz Communal production units, usually farms, in Israel. Founded in the early days of Zionist immigration by Eastern European Jews influenced by utopian socialist ideals. Now gradually becoming more market oriented.

Kim Il Sungism Doctrines of the longtime leader of North Korea, Kim Il Sung, who ruled from 1948 until his death in 1994. Emphasizes self-reliance, or *juche,* within a Stalinist-style strong command socialist framework, along with Maoist elements involving moral incentives.

Kolkhoz Russian word for “collective farm.” Income from farm output shared among members of the Kolkhoz. Most common type of agricultural production unit in the former Soviet Union.

Kombinat East German industrial unit introduced in 1979 involving aggregation of related enterprises. Thought to resemble the sectoral chambers of the Nazi economy.

Korean War Fought between North and South Korea from 1950 to 1953, with significant interventions by the United States and China, ending largely in a draw, with 3 to 4 million dead.

Kosygin Reforms Reforms introduced by Soviet Premier Alexei Kosygin in 1965, involving greater autonomy of enterprises from central planners and greater use of profit measures and financial accounting in guiding economic decision making.

Kulaks Russian word for richer landowning peasants who hired landless peasants. Denounced as “class enemies” by Joseph Stalin in the late 1920s at time of collectivization of Soviet agriculture.

L

Labor Days Accounting unit used to assign income according to amount of work in socialist economies. Based on Marxian labor theory of value.

Labor-Managed Economy Economy in which workers have authority over management, argued to have existed in Yugoslavia. The term was favored by Jaroslav Vanek, but was also known as a *participatory economy* or a *worker-managed economy.*

Laffer Curve Relation between tax rates and tax revenues that first rises as tax rates rise but then declines as overly high tax rates reduce tax revenues. The relation behind the supply-side idea that tax cuts might increase tax revenues.

Laissez-Faire View that there should be minimal government intervention in the economy, from the French term literally meaning “let them do it.”

Land-to-the-Tiller Program Taiwanese program in 1953 to force landlords to sell land to peasants.

La Reforma Reforms implemented by Mexican President Benito Juárez after 1857 that removed privileges of church and military officers, increased the powers of small *rancho* owners, and allowed the sale of village *ejido* lands.

Latifundia General form of large estates holding peasants in debt peonage throughout most of Latin America. The *hacienda* was the form used in Mexico.

L’Économie Concertée (Concerted Economy) Goal of French indicative planners, a well-coordinated economy, like an orchestra playing together.

Legalism Doctrine of strong state control of the economy in ancient China. Legalists conflicted with more free-market Confucianists and Taoists.

Liberal Corporatism Corporatism in a democratic environment self-organized by labor and management with minimal government direction, also known as *conflict corporatism*. The predominant form in Scandinavian countries.

License-Permit Raj Sarcastic label for the system in India of extreme regulation of business, symbolized by the need for many licenses and permits to operate. Sharply increased in the 1970s under Indira Gandhi and now being gradually reduced.

Limited Liability Corporation Firm whose debts are separated from those of the firm's owners. Associated with legal rulings in the United States establishing the idea of a corporation as a juridical entity. The foundation of the modern corporate form.

Linear Programming Mathematical method for optimizing the allocation of inputs to maximize an objective function subject to constraints, with crucial relations given by an input-output matrix.

Local State Corporatism Emerging system in rural China involving a balance of the relations between county, town, and village governments and the town and village enterprises (TVEs).

Long March A 6,000-mile march from the south to the north of China in the 1930s by leading Communist Chinese cadres at the low point of their power. Mao Zedong came to be the party leader then, and veterans of the Long March were top leaders of China for many years after 1949, including Mao's successor, Deng Xiaoping.

Long Wave Kondratiev Cycle Theory that there are forty- to fifty-year cycles or fluctuations of economies, probably driven by technology waves.

Lorenz Curve Depicts the income distribution of a society with the percentage of households on the horizontal axis in order of their incomes and the percentage of national income on the vertical axis. The curve is closer to the diagonal if incomes are more equal.

Luxury Fever Pursuit in the United States of increasingly elaborate and expensive luxury consumer goods, leading to working long hours and saving little, studied by Robert Frank and seen as the modern version of conspicuous consumption studied in the early 1900s by Thorstein Veblen.

M

Macroeconomic Stability Avoidance of fluctuations of aggregate output, employment levels, or price levels in an economy. Widely considered to be a major goal of policymakers in most countries.

Malthusian Low-Level Equilibrium Trap Named for Thomas Malthus, author of *Essay on the Principle of Population*. A country is in a low-level equilibrium poverty trap if it has a high birth rate that prevents capital investment and growth, with entrenched poverty reinforcing its high birth rate.

Manchesterian Market Socialism See **Market Socialism.**

Maoism Doctrine advocated by the Chinese Communist leader Mao Zedong. Compared to Soviet Stalinism, it places greater emphasis on rural development, egalitarianism, moral incentives, and decentralization of industry. It defended Stalin against destalinizing Soviet critics after 1956.

Maquiladora Plants Factories built on the Mexican side of the U.S.–Mexican border, long allowed special privileges but accused of violating labor and environmental laws.

Maquiladora Program Policy established in 1965 to allow easy investment in *maquiladora* plants on the Mexican side of the U.S.–Mexican border, whose output could be freely exported to the United States. Most of these privileges were extended throughout Mexico with adoption of the North American Free Trade Agreement in 1993.

Market Locus of buying and selling transactions.

failure Idea that a market might be inefficient, usually because of the presence of monopoly power, externalities, public goods, or incomplete information.

incompleteness Idea that there are important economic phenomena for which there is no market. Incompleteness of markets implies inefficiency.

Market Capitalism Economic system with a market allocation system and private ownership of the means of production.

Market Economy Economy whose allocation decisions are determined by market forces of supply and demand.

Market Socialism Economic system with a market allocation system and state ownership of the means of production.

anti-Manchesterian German-supported approach emphasizing large firms owned by the state, sometimes called *Galbraithian socialism* and derived from the prediction of Joseph Schumpeter that large firms would be nationalized.

Manchesterian Market socialism consisting of small state-owned enterprises competing with each other.

Marshall Plan Provided large funds from the United States to rebuild countries in Western Europe after World War II.

Marxian Ideas stated by Karl Marx.

Marxism-Leninism Marxism as modified by Lenin, the leading ideology of the Soviet Union. Replaced Marx's prediction that capitalism would fall in the most advanced countries with the view that it would happen on the imperial periphery. Also rejected democratic ideas of Marx in favor of leadership by a vanguard of the Communist Party.

Marxist Ideas influenced by Marx's thinking, even if not exactly in agreement with what he actually said; thus contrasts with *Marxian.*

Material Balance Method Method of central planning based on keeping track of quantities of materials being used in the economy and making sure that supplies are in balance with demands.

Material Incentives Getting people to work and otherwise do as desired by rewarding them materially, usually with money. Contrasts with *moral incentives.*

Maximin Criterion Idea of John Rawls that just societies should seek to maximize the quality of life of the worst-off person.

Mensheviks Russian term for "minority," the name for the faction of the Russian Social Democratic Party ousted by the Bolsheviks. Supported a more democratic approach than the Bolsheviks, who would lead the Russian Revolution.

Mercantilist Policy Designed to expand national economic power through import protectionism and by forcing colonies to trade only with the ruling country. Prevalent in the 1600s and 1700s and criticized by Adam Smith in *The Wealth of Nations*.

Methodological Individualism View that the appropriate unit of economic analysis is the individual, with the strong version arguing that social aggregates are unreal.

Mezzogiorno Problem Generic term for a persistent poverty problem in a region of a nation, such as the former East Germany. The Mezzogiorno is located in southern Italy, traditionally much poorer than northern Italy.

M-Form Multidivisional corporate form, initially appearing in the 1920s in the General Motors Corporation. Now the dominant form of large corporations in most of the world.

Middle Way Similar to the Third Way concept, a system midway between capitalism and socialism designed to achieve the best of both worlds. A term used to describe Sweden.

Millennarian Tradition Christian ideas of the Second Coming of Christ and apocalyptic end of the world as described in the Book of Revelations of the Bible. Millennarians see this happening soon and may call for revolutionary political, social, or economic changes, as with the Münster uprising in Germany in the early 1500s. Seen as an origin of socialist ideas in Europe.

Ministerial Compartmentalism Direction of economy through vertical control within sectoral-based ministries in command socialist economies.

Ministry of International Trade and Industry (MITI) Japanese ministry that oversees regulation of industry. Seen as the manager of industrial policy that directs investment to favored sectors and supports declining sectors.

Mode of Production Marxian term for the nature of the economic system, characterized by its technological base (forces of production) and its class relations (relations of production). Intense class conflict changes the mode, as in the change from feudalism to capitalism.

Monetary Overhang Situation in planned economies that have experienced chronic shortages of goods in the presence of large amounts of money. In economic transitions, this overhang can trigger inflation when price controls are removed.

Monopolistic Competition Market structure with many firms, free entry and exit, but product heterogeneity or differentiation allowing monopoly power for firms.

Monopoly A single seller in a market. Monopoly power arises when firms are able to raise prices and not lose all their customers, a source of inefficiency.

Monopoly Rent Extra income a monopolist gains from consumers as a result of charging higher prices for smaller supplies compared with a competitive market.

Moral Hazard Problem arising from asymmetric information in insurance markets when those who are insured behave recklessly because they are insured, a problem in financial markets as well.

Moral Incentives Maoist idea that individuals should work "for the people," without necessarily being paid much money, for moral reasons. Appealed to in some socialist countries and even market capitalist economies during wartime.

Mudarabah Form of Islamic finance approved of by all clerics that involves profit sharing. The lender provides funds and receives a share of the profits. Considered to be vulnerable to principal-agent problems when debtors understate profits.

Murabaha Form of Islamic finance involving an upfront fixed payment for lenders. Considered by some clerics to resemble interest arrangements too closely but increasingly widespread among Islamic banks because of principal-agent problems associated with more acceptable *mudarabah* arrangements.

N

National Investment Funds (NIFs) Fund pools used occasionally in Poland for instant mass privatizations of formerly state-owned firms. Similar schemes used more often in the Czech Republic and Russia, often funded by vouchers distributed to the population.

Natural Monopoly Situation where only one firm in an industry survives because of economies of scale or control of a scarce resource.

Negative Externalities See **Externalities.**

Nemawashi Process of horizontal coordination through consensus decsion making in Japanese corporations. A key part of the J-mode system.

Neo-Confucian Synthesis During the 1100s, when it was the official state religion of China, Confucianism absorbed elements of Taoism and Buddhism in this synthesis. This version was hostile to commercial activity.

Neo-Confucianism Revival of Confucian doctrines and attitudes in China after suppression by the Communist regime. Seen as respecting hierarchy and authority while supporting commercial activities.

Neo-Old Traditional Movements advocating complete rejection of the modern world and return to an idealized version of a pure traditional society and religion. The Taliban regime in Afghanistan is a leading example.

Network Externalities Positive externalities arising from relations between firms, often within a region, especially in high-tech industries.

New Deal Policies introduced by U.S. President Franklin D. Roosevelt during the Great Depression that expanded the role of government in the economy, including Social Security, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the National Labor Relations Board regularizing labor unions.

New Economic Mechanism (NEM) Market socialist policy introduced in Hungary after 1968 that ended central command planning. Led to foreign indebtedness as soft budget constraint problems emerged.

New Economic Policy (NEP) Market-oriented policy for agriculture and small enterprises in the Soviet Union during 1921–1928. Established after famines occurred at the end of War Communism, then displaced by Stalinist command central planning.

New Economy High-tech economy based on the internet, argued in the late 1990s in the United States to produce much higher growth rates, but facing doubts after collapse of the hi-tech stock market bubble in early 2000.

New Left Political movement in advanced capitalist countries during the 1960s. In the United States it focused on opposing the war in Vietnam using alternative Marxist views.

New Institutional Economics School of economic thought arguing that organizational forms reflect the process of minimizing transactions costs, developed by Ronald Coase and Oliver Williamson.

New Traditional Economy Economy seeking to use modern technology and relate to the modern world economy while attempting to reembed the economy in a traditional social structure, usually determined by a religion. Iran an example.

New Traditionalism Movement to pursue a New Traditional Economy. Islamic economics is an example.

New Traditionalist An advocate of New Traditionalism as an economic system.

Newly Industrialized Countries (NICs) Rapidly growing economies, mostly in East Asia, that began to industrialize relatively recently. A term often associated with the *Asian tigers.*

Newly Industrializing Economies (NIEs) Term increasingly used to replace *newly industrialized countries,* partly because some important ones are not recognized as independent countries, especially Hong Kong since its absorption by China in 1997.

Nomenklatura Russian term for "nomenclature." In Communist countries, positions assigned by the Communist party, usually to high-level members of the party, effectively the ruling elite of such societies. Term usually applied to persons in these positions.

Nomenklatura Perks Favors available to members of the *nomenklatura* such as access to special food stores, medical facilities, or housing, not recorded as income.

Nomenklatura Privatization Takeover of firms during the economic transition by *nomenklatura* members, usually the controlling management. Sometimes this takes the form of *stripping,* selling off the assets of the firm before it is officially privatized, after which it is worthless.

Nonaligned Nations Movement Movement of developing countries trying to maintain their independence of both the United States and the USSR during the Cold War. Organized initially in 1955 by India's Nehru, Indonesia's Sukarno, and Yugoslavia's Tito.

North American Free Trade Agreement (NAFTA) Agreement between Canada, the United States, and Mexico allowing free trade and investment between them, effective at the beginning of 1994.

O

Old Traditional Economy Economy embedded within a traditional social structure, using nonmodern technologies, derived from ideas of Karl Polanyi.

household Simple traditional economy focused on communalistic family units. See also "household economy."

reciprocal Traditional economy based on ritualistic reciprocal exchanges. Seen by some as precursors of market relations, now viewed by economic anthropologists as historically the most primitive economic system.

redistributive System in which a "Big Man" or leaders collect goods and then redistibute them. Seen by some as a precursor of a command economy.

Old Traditionalist Follower and advocate of an Old Traditional economy.

Oligopoly Market structure in which there is a small number of firms, each able to follow and respond to what the others are doing individually.

One Country, Two Systems Formula used by China to absorb Hong Kong politically while allowing it to maintain its laissez-faire economic system. The same formula has been proposed to Taiwan, but to no avail so far.

Opium Wars Fought between China and Great Britain in 1839–1842 over Britain's insistence on importing opium from India into China. Britain's victory gave it Hong Kong. The defeat was resented by many in China as a symbol of national humiliation.

Ordo-Liberals German economists after World War II who influenced West German economic policy. Advocated the idea of social market economy, and opposed nationalization and monopoly power while supporting social welfare spending.

Organic Composition of Capital In Marxian analysis, the ratio of constant capital to the sum of constant capital and variable capital. The rise of this ratio causes the rate of profit to fall.

Organization for Economic Cooperation and Development (OECD) Created out of the Marshall Plan in the late 1940s, a body created by higher-income market capitalist countries that produces studies and advises their governments.

Organization of Petroleum Exporting Countries (OPEC) Group of oil-exporting countries organized in 1960 by Saudi Arabia and Venezuela to control the price of oil. It currently has 12 members, most of them Middle Eastern and Muslim. OPEC enforced a quadrupling of the price of oil in 1973, which triggered a global recession. Its leading member is Saudi Arabia, with Iran and Iraq following in importance.

Ossis German slang term meaning "Easterners." Refers to residents of the former East Germany. Seen as lazy and ungrateful by Western Germans (Wessis).

P

Pacto Corporatist incomes policy that existed in Mexico from 1987 to 1994.

Parastatal Sector Firms in which there is partial government ownership or control.

Pareto Optimality Named for the Italian sociologist and economist Vilfredo Pareto. An economy is Pareto optimal if no one can be made better off without making someone else worse off. Now used as the standard definition of static efficiency.

Partial Equilibrium See **Equilibrium.**

Paris Commune Revolutionary government in Paris during 1870–1871 and violently suppressed at the end of the Franco-Prussian War. Served as inspiration for later socialist and communist movements.

Participatory or Cooperative Economy Same as a labor- or worker-managed economy, although sometimes argued to involve other parties, such as consumers, in consultations.

Peons Latin American peasants tied to the land through high indebtedness. Peonage was a widespread practice in large estates of the *latifundia* type.

Perestroika Russian for "restructuring." Economic reform policy of the last Soviet leader, Mikhail Gorbachev, to move from command socialism to a market economy.

Perfect Collusion Oligopolistic firms acting together as if they were a single monopolist, leading to a cartel. Unstable system because of the prisoner's dilemma of game theory, in which an agent can gain more by not cooperating with others.

Permanent Revolution Idea of Leon Trotsky that for the socialist revolution to succeed, it must occur throughout the world simultaneously. Caused part of the split with Stalin, who advocated "socialism in one country," the Soviet Union.

Phalansteries Utopian socialist communities in which there would be complete sharing, including sexual sharing, as envisioned by Charles Fourier in the 1830s. Also called *phalanxes.*

Physiocrats Economic school of thought in France in the mid-1700s led by Francois Quesnay that advocated limited laissez-faire and critiqued mercantilism. Argued that land was the source of value.

Planification In former Soviet Union this meant "planning how to plan," and especially how to aggregate microeconomic plans to be consistent with a macroeconomic plan. In France simply means "planning."

Planned Market Economy Goal of indicative planners in a market economy.

Planners' Preferences Driving force of economic decision making in a centrally planned command economy.

Popular Capitalism Goal of British Prime Minister Margaret Thatcher, in the 1980s, pursued particularly by selling public housing to its occupants.

Populist Corporatism Term used to describe the Mexican political economic system, emphasizing efforts to create harmony among many sectors by appealing to the population at large against former entrenched interests.

Bonapartist Populist corporatism led by a military strong man.

technocratic Populist corporatism led by well-educated bureaucrats, sometimes labeled *cientificos* in Mexico.

Positive Externalities See **Externalities.**

Post Keynesian School of economic thought strongly advocating Keynesian ideas and tending to favor incomes policies such as corporatism as solutions to macroeconomic problems of unemployment and inflation.

Prescriptive Directing what should be done rather than merely describing alternatives.

Principal-Agent Problem Crucial problem arising from asymmetric information involving relations between someone (principal) hiring someone else (agent) who knows more than the principal about how to do something, seen as a widespread problem in many economic situations. In planned economies, enterprise managers are the agents, who do not always do what the planner principals tell them to do.

Producer Cooperatives A subcategory of cooperatives consisting of worker-owned enterprises. Sometimes cooperatives are owned by consumers rather than producers.

Producer Surplus Part of the net benefit to producers, consisting of earnings that did not have to be paid in order to create output. In the usual supply-and-demand case, the area between the price line and the marginal cost curve.

Product Cycles Life cycles from invention through innovation to mass production and eventual abandonment.

Production Possibilities Frontier (ppf) Maximum set of a combinations of goods that a society can produce at a specific time, given its resources and technology.

Production Teams Unit between household and brigade levels in agricultural production in rural China under Mao Zedong, often managing equipment and simple infrastructure. The unit of control immediately before the household responsibility system was established in 1984 under Deng Xiaoping.

Proletariat Marxian term for the industrial working class, taken from earlier French discussions such as those of Pierre Joseph Proudhon. Posited by Marx to rule under socialism.

Protectionism Policy of restricting imports through tariffs, quotas, or regulatory restrictions.

Protestant Ethic Presumed hard work and saving behavior found among Protestants, especially Calvinists, who were argued by Max Weber to have been the main developers of industrial capitalism.

Public Choice School of economic thought associated with James Buchanan and Gordon Tullock, also known as the *Virginia School.* Studies the behavior of government agencies, assuming that they maximize their own power and budgets and please the special interests supporting them. Generally pro-laissez-faire and allied with the Chicago School ideologically.

Pure Communism See **Communism.**

Q

Qirad Arabic term for "profit sharing," the basic principle behind financial arrangements approved of by Islamic economists, such as the *mudarabah* system.

Quality Circles Part of the Japanese management system, in which workers are encouraged to meet and discuss how to improve productivity and output quality. More successful in an environment of lifetime employment.

R

Rancho Small privately owned farms in Mexico, originally owned by mixed-race *mestizos* and now the dominant form in Mexican agriculture.

Ratchet Effect Phenomenon in command planned economies where an enterprise's production quota rises with its production, thereby discouraging firms from exceeding their production quotas.

Rate of Exploitation Marxian concept measured by the ratio of surplus value to variable capital, usually interpreted as the percentage of a worker's time spent producing profit for the capitalist. Marx argued that the rate of exploitation would rise as the profit rate fell, thereby intensifying class conflict.

Rate of Profit In Marxian analysis, the ratio of surplus value to constant plus variable capital. In more standard economic analysis, the amount of profit divided by the amount of capital.

Rationalization Cartels Mergers encouraged to focus on developing a new sector, especially encouraged by the Ministry of International Trade and Industry (MITI) in Japan.

Reaganomics Economic policies implemented during the presidency of Ronald Reagan (1981–1989), emphasizing large tax cuts and major deregulation of the economy, drawing substantially from the supply-side school of economics. Related in time and ideology to Thatcherism.

Real per Capita Income Income per person divided by the price level, considered to be the best available measure of the material standard of living.

Reciprocal Economy See **Old Traditional Economy.**

Red Guards Youthful followers of Chairman Mao Zedong in China during the Great Proletarian Cultural Revolution of the late 1960s. They publicly attacked and humiliated those accused of *capitalist roading.*

Redistributive Economy See **Old Traditional Economy.**

Relations of Production In Marxian analysis, the relations between classes in terms of production. Combined with forces of production, it determines the mode of production.

Relative Backwardness Hypothesis Idea of Alexander Gerschenkron that the further behind a nation is from the global leaders in income level when it begins to experience industrial growth, the more rapidly it will grow, at least initially, while it is able to adopt more advanced technologies of leading economies.

Ren Central Confucian concept of benevolence or humanness. See also **jen.**

Rent-Seeking Idea associated with the Public Choice school that government bureaucrats generate artificial monopolies creating monopoly rents that can then be captured by special interests. More precisely, the pursuit of such possibilities by special interests is rent-seeking activity.

Reservation System Part of the License-Permit Raj system of strict regulation of enterprises in India in which there are size limits on firms in particular industries. It is now being relaxed somewhat.

Responsibility Contracts Contracts for firms in China after 1984 allowing them to dispose of surpluses as they wish beyond certain amounts. Essentially an extension to the economy as a whole of the household responsibility system in agriculture.

Revisionism Doctrine originally stated by the German Social Democrat Eduard Bernstein at the end of the 1800s that capitalism would not collapse and that therefore a reformist approach within parliamentary democracy should be pursued by the working class. Was strongly criticized by Marxist-Leninists and became a term of opprobrium in later Communist regimes.

Rhineland Model Controversial notion that France and Germany share a common economic system with similar forms of government intervention.

Riba Literally means "increase" in Arabic, but interpreted by most Muslims to refer to interest. Passages condemning *riba* in the Islamic sacred book, the *Qur'an,* are seen as the basis for opposing interest by Islamic economists.

Ringi-sho Writing of memos to superiors by underlings in Japanese management hierarchies, seen as part of the J-mode system.

S

Saltsjöbaden Agreement Agreement made in 1938 at Saltsjöbaden in Sweden between the main management organization (*Svenska Arbetsgivareforening*) and the labor federation (*Landsorganisationen*) that established the corporatist centralized wage-bargaining system in Sweden.

Satyagraha Nonviolent assertion, advocated strongly by Mohandas (Mahatma) Gandhi during the Indian independence movement and more generally.

Second Economy Unreported market activities initially in market socialist economies, often involving moonlighting, spreading to command economies as adjuncts to their marketized areas. Seen by some as the origin of shadow or informal economies in later transition economies.

Second Pragmatic Phase Economic policymaking period in Iran during the 1989–1997 presidency of Hashemi Rafsanjani after the end of Iran-Iraq War. Placed relatively strong emphasis on marketization reforms and greater international openness.

Second Radical Phase Economic policymaking period in Iran from 1981 to 1984. Dominated by radical Islamic approaches but ended many Islamic socialist policies from the First Radical Phase that were vetoed by the conservative Council of Guardians. In this period, Islamic banking was imposed in Iran.

Seignorage Revenues to a government through controlling the issuing of currency.

Sendero Luminoso Spanish for "Shining Path," name for the Communist Party of Peru–backed guerrilla group led by Abimael Guzman ("Gonzalo"), who took a radically Maoist approach. Since Guzman's arrest in 1993, the group has sharply declined in influence and power, although it is still not completely eliminated.

Sepoy Rebellion Uprising by native troops in India, both Hindu and Muslim, in 1857 against British rule. Led the British to replace rule by the East India Company with direct rule by the British government, with Queen Victoria as Empress of India. Early harbinger of the Indian independence movement.

Shadow Economy Also called *informal, underground, black, occult, hidden,* and other terms. Its crucial aspect is that it is unreported to government authorities, usually to avoid paying taxes but also to avoid onerous regulations or demands for bribes from officials, or simply because the activities being engaged in are seriously illegal. It has sharply increased in transition economies.

Share Economy Idea of Martin Weitzman about profit sharing in modern economies. Some argue that Japan is a share economy.

Shari'a Islamic law code, based fundamentally on the *Qur'an* and on sayings of the Prophet Muhammed in the *Hadith*. Based on different views of logical analysis and consensus judgments, four different Sunni *Shari'as* have arisen, as well as several Shi'i ones.

Sherman Act of 1890 Fundamental antitrust law of the United States, which forbids "combinations in restraint of trade" and "efforts to monopolize markets."

Shi'i Branch of Islam In early succession struggles over who would be caliph, Shi'is advocated members of the family of the prophet Muhammed. Now the second most numerous branch of Islam, with a more fully developed clerical hierarchy than the majority Sunnis. Dominant in Iran.

Shinto Traditional religion native to Japan, involving emperor worship until the end of World War II.

Shock Therapy Idea advocated in Poland by Leszek Balcerowicz that an economic transition should occur suddenly and totally in all areas. See also **Big Bang Reforms.**

Shoguns Military dictators of Japan for centuries who ruled in the name of the emperor. Lost their power with the Meiji Restoration in 1868, which led to Westernizing modernization of Japan.

Sikhism Religion founded in India around 1500 by Guru Nanak, with most adherents living in the Punjab province. Attempted to combine elements of Hinduism and Islam. Many of its followers are successful in the military and in business.

Sinkyo Traditional religion native to Korea in which women serve as shamans. Somewhat similar to Shinto in Japan, although not as well organized.

Sino-Soviet Split Conflict that emerged between the Soviet Union and China at the end of the 1950s, partly over destalinization in the Soviet Union, partly over nuclear weapons, and partly over control of Communist parties globally. Eventually culminated in a military conflict on the Amur River in 1969.

Social Capital An intangible form of capital derived from relations with other people, usually as a result of established reciprocal relationships, often in organized groups, leading to high levels of trust and reduced transactions costs in economic activities.

Social Democracy Political movement in western Europe, especially northwestern Europe, that advocates combining market forces with substantial income redistribution, generally not involving nationalization of the means of production. The goal is essentially to establish the social market economy.

Social Engineering Idea that social planners can plan society rationally, originally a French concept proposed by the utopian socialist Clande Henri de Saint-Simon. Severely criticized by Friedrich Hayek as the “fatal conceit.”

Social Market Economy (Soziale Marktwirtschaft) German concept developed after World War II by Ordo-liberals that combines mostly free market capitalism with generous social welfare payments and redistribution.

Social Reform Phase Policymaking phase in Iran since 1997 during the presidency of Mohammed Khatami. Places less emphasis on market reforms and more on relaxing restrictions on social practices while remaining within the Islamic *Shari’a.*

Social Safety Net Provisions made by a society for those who experience poverty, illness, or various disasters.

Socialism State ownership of the means of production, although political socialism has evolved that does not call for this (e.g., social democracy).

Socialism in One Country Argument by Joseph Stalin in the late 1920s that the USSR should not work strongly for revolutions in other countries, the view of Trotsky, but should focus on building up socialism within the USSR alone.

Socialist Market Economy Label used by Chinese Communists to describe their particular version of market socialism.

Socialist Planning Controversy Debate over the possibility of using central planning to manage an economy rationally and efficiently. Advocates of central planning in the controversy included Enrico Barone and Oskar Lange. The main critics were leading Austrian economists, Ludwig von Mises and Friedrich Hayek, who argued that incentive and information problems were insurmountable except by using capitalist markets.

Soft Budget Constraint Concept stated by the Hungarian economist János Kornai, said to be especially serious for market socialist economies, where uncontrolled state-owned enterprises waste money and run up large debts on the expectation that the state will support them. The opposite of a hard budget constraint, in which firms that waste money will go out of business.

Solidarity Known in Polish as Solidarność, the labor union based in the Lenin shipyard in Gdansk and led by Lech Wałęsa, whose strike in 1981 triggered a military coup. A major leader of the anti-Communist movement in Poland.

Sovkhoz Russian word for “state farm.” In contrast to a *kolkhoz* (collective farm), farmers are paid a set wage by the state in a sovkhoz.

Sovnarkhozy Russian word meaning “regional planning entity.” Very powerful during the Krushchev decentralization period in the Soviet Union in the late 1950s and early 1960s.

Special Enterprise Zones (SEZs) Areas mostly in coastal cities in southern China in which foreign capitalists are allowed to invest and operate freely. Market capitalist, rapidly growing areas such as Shenzhen near Hong Kong, operating within the broader socialist economy.

Stakhanovite A very-hard-working worker, named for a coal miner in the USSR in the 1930s whom Stalin held up for widespread praise. Stakhanovite movements used moral incentives to inspire people to work hard for the glory of socialism but for no additional pay.

Stalinist Command Socialism Very centralized and strictly controlled economic system with state ownership of the means of production and economic activity directed by commands from central planners.

State Capitalism In principle, the same as market socialism, with state-owned enterprises operating in a market framework, but with the implication that they are acting strongly to maximize profits. Some Marxist critics of the Soviet Union used this term to describe it, arguing that the *nomenklatura* exploited workers in the same manner that capitalist owners exploited workers.

Static Efficiency See **Efficiency.**

Storming From Russian word "shturmovshchina." A practice in command planned economies wherein enterprises engage in frenzied last-minute efforts to meet a monthly production quota, often resulting in poor quality of output.

Substantivists School of economic anthropology associated with Karl Polanyi that argued that each society has its own individuality and opposed the formalist view that all societies can be analyzed using standard economics models.

Sunnism Majority branch of Islam. In succession struggles over the caliphate after the Prophet Muhammed's death, they supported having a group of leaders choose a caliph who did not need to come from the family of the prophet.

Surplus Value Marx's concept of value produced by the worker beyond that needed to reproduce the worker's labor power. Seen as the origin of profit extracted by capitalists from workers.

Swadeshi Mohandas (Mahatma) Gandhi's idea of appropriate technology in India, arguing that capital-intensive high technology was not appropriate. Gandhi adopted the spinning wheel as the symbol of this idea.

Swaraj Mohandas (Mahatma) Gandhi's idea of self-sufficiency as an economic goal, for villages first and for India as a whole as well. Has been used to justify protectionist policies in India, which are among the strictest in the world despite recent relaxations.

Swedish Model Variation on the social market economy system that more strongly emphasizes income redistribution and centralized corporate wage bargaining.

Syndicalism Anarchist movement advocating rule by labor unions. Very influential in France and in several Latin and Latin American countries.

Synthesis In dialectical theory, the new form that results eventually from the conflict of the opposed thesis and antithesis. For Marx, a new mode of production arising out of class conflict in the previous mode of production.

T

Taoism Religion founded in China around 600 B.C.E. by Lao-Tzu at about the same time as Confucianism. More antihierarchical and freewheeling than Confucianism, it can be seen in economic terms as pro-market and as advocacy of letting things flow spontaneously in harmony with nature. *Tao* means "the Way."

Techpromfinplan (Technical-Production-Financial Plan) The plan formulated for an enterprise in the Soviet Union, specifying technical, output, and financial aspects, including investment and output levels as well as employment, wages, and prices.

Teleologists Opponents of geneticists in debates over economic planning in the USSR in the 1920s. Led by E. V. Preobrazhensky, the teleologists argued that planning was to direct economy towards a goal, especially rapid industrialization.

Thatcherism Pro-laissez-faire policy approach of British Prime Minister Margaret Thatcher (1979–1990). Key elements included deregulation and privatization of formerly state-owned enterprises, the beginning of this global movement.

Thesis Primary argument in dialectical analysis, opposed dynamically by its antithesis.

Third Front Policy Maoist policy in the 1960s to decentralize industry for national security purposes in case of invasion by the United States or the USSR. Laid the foundation for the later growth of town and village enterprises.

Third Way Search for an alternative to capitalism and socialism. Fascism claimed to be a Third Way, as do the social market economies and New Traditional Islamic economies.

Three Sacred Treasures Characteristics of the labor market in major Japanese *keiretsu* firms, argued to have been introduced during World War II to maintain worker morale and productivity, but now under severe stress and weakening.

enterprise unions Unions organized by firms, argued to be more cooperative with firms, although critics charge them with being sellouts.

lifetime employment Workers are hired for life, or at least to age fifty-five, presumably increasing worker loyalty to the firm and willingness to help it.

seniority-based wages Wages tied to seniority, argued to maintain internal harmony in firms.

Total Factor Productivity Output per total amount of factor input, considered to be the most accurate measure of overall productivity.

Town and Village Enterprises (TVEs) Important form of firms in the current Chinese economy, owned by local units of government but operating in a free-market context—the Chinese version of market socialism. Many of these enterprises are undergoing reorganization and restructuring, with some becoming cooperatives and others increasingly resembling standard capitalist firms.

Tradable Pollution Permits Market-based solution to pollution problems used in the United States to reduce sulfur dioxide emissions. Government sets the total amount of pollution allowed and then lets firms trade rights to pollute up to that amount. Properly structured, is the lowest-cost way to attain a given cleanup level.

Traditional Economy An economy whose practices derive from being embedded within a sociocultural context, usually a traditional religion. Old and New varieties have different approaches to modern technology, education, and global economic integration.

Treuhandstalt (THA) German government agency that handled privatization of East German enterprises. Disbanded in 1994 after the process was completed.

U

U-Form Line and staff corporate hierarchical form with salaried managers. First appeared in U.S. railroad companies in the nineteenth century. Differs from the M-form in that the latter has multiple divisions, each of which resembles a U-form corporation.

Ulama Islamic clerics.

Ultra-Keynesian An extreme form of using Keynesian fiscal and other interventionist policies to stabilize a macroeconomy. Sometimes used to describe Swedish macroeconomic policies.

Umma The Islamic community, a term derived from the Arabic word for “mother,” suggesting familistic groupism.

Usufruct Rights Rights to use land or other property, even without necessarily owning it, as with the Chinese household responsibility system.

Usury Roman Catholic term for interest, especially very high interest rates, considered to be a venial sin from the 1300s to the 1600s. Now used only to refer to interest rates considered to be unfairly high.

Utopian Socialism Label used by Karl Marx and Friedrich Engels to denigrate their socialist predecessors such as Claude Henri de Saint-Simon, Robert Owen, and Charles Fourier. Argued that the focus of utopians on small communities did not deal with the problems of all of society.

V

Virtual Economy An economy dominated by large arrears between firms and widespread barter exchange, characterized by Russia in the late 1990s.

Voucher Privatization Method of mass privatization of state-owned enterprises where populace receive ownership shares in enterprises in form of vouchers. Method used in Russia, Czech Republic, and Mongolia.

W

Wa Japanese term for "harmony," considered to be the Japanese substitute for *jen* in its version of Confucianism.

Wage Solidarism Labor union policy of trying to equalize wages across workers and sectors. Led eventually to the demise of centralized wage bargaining in Sweden caused by wage drift that contradicted solidarism.

Wagner's Law Empirical tendency for the government share of the economy to rise as the income level rises.

Waqfs Charitable bodies in Muslim countries to which persons sometimes will their land. Can become quite wealthy and powerful, especially in Iran, where they compete with the *banyads.*

War Communism Period in Soviet history from 1918 to 1921, immediately after the Bolshevik Revolution, when White Russian and foreign armies tried to overthrow the Bolshevik regime. Economic policy was command without planning and with scattered nationalizations in an effort to achieve pure communism immediately. Grain seizures from peasants led to a severe famine in 1921–1922.

Warlordism Pattern in China, especially between World Wars I and II, of local areas being ruled by a warlord, or military strongman.

Warsaw Pact Soviet bloc military alliance equivalent to the North Atlantic Treaty Organization (NATO). Used for interventions in Hungary in 1956 and in Czechoslovakia in 1968. Dissolved in mid-1991.

Washington Consensus View of transition and adjustment to financial crises held by policymakers at the International Monetary Fund, the World Bank, and related U.S. government entities in Washington, D.C., such as the Treasury Department and the Federal Reserve. Critics accuse followers of the Consensus of applying a "one size fits all" approach to all crises, encouraging restrictive macroeconomic policies and U.S.-style markets.

Wessis German nickname for residents of the former West Germany, used in comparing westerners and easterners (Ossis). Wessis are thought to resent the subsidies paid to Ossis, whom they accuse of laziness and ingratitude.

West German Economic Miracle (Wirtschaftswunder) Label applied to West Germany from the late 1940s through the 1960s as its economy recovered from World War II and grew extremely rapidly.

White Revolution Major secularizing reforms imposed in Iran by the shah in 1963. Led to exile and opposition by Ayatollah Khomeini, leader of the eventual Islamic Revolution in Iran in 1979.

Worker-Managed Economy Same as a labor-managed economy and a participatory economy, with workers as managers.

Worker-Managed Market Socialism System in Yugoslavia from 1950 to 1990 to some degree. Workers supposedly managed state-owned enterprises.

Workers' Council Law Law in Yugoslavia passed in 1950 that mandated the beginning of the workers' management system.

Workers' Management Workers managing firms.

Working Organizations of Associated Labor (WOALs) Aggregations of Basic Organizations of Associated Labor in Yugoslavia after 1976 that corresponded to firms, in contrast to Composite Organizations of Associated Labor, which corresponded to vertically integrated structures across firms.

Works Councils German bodies used by labor to advise management, part of *Mitbestimmung* or the codetermination policy.

World Trade Organization (WTO) Body established in the mid-1990s as the successor to the General Agreement on Trade and Tariffs (GATT), designed to implement and enforce global free trade agreements. Has become the focus of demonstrations by those opposed to globalization and the Washington Consensus.

Wu-wei Chinese Taoist concept meaning “no action,” which allows harmony with nature. Thought to imply support for a laissez-faire economic policy, in which the government should take no action and let the market work freely.

Z

Zadruga Traditional Serbian farm unit held communally by extended family units. Seen as a source of communalistic and workers’ management traditions in Yugoslavia.

Zaibatsu Large conglomerate firms in Japan before 1945 that operated in many different economic sectors. Broken up at the end of World War II. The *keiretsu* appear to be modeled on them, except that firms retain formal independence. Very similar to the *chaebol* in Korea, except that *chaebol* are not bank related.

Zakat Arabic term for alms for the poor to be given according to the laws of Islam, one of the Five Pillars of Islam. The *Qur’an* specifies an annual amount of 2 percent of wealth, collected as a tax in some Muslim countries by the state.

Zapatista National Liberation Army (EZLN) Guerrilla movement based in the poor southern Mexican state of Chiapas, opposed to privatization of *ejidos* and to the North American Free Trade Agreement. Named for Emiliano Zapata, the peasant leader of the 1910 revolution. Active between 1994 and 2001 and led by Subcommandante Marcos.

Zionist Movement Movement to establish a Jewish homeland, modern Israel, in what had been the Ottoman and later the British province of Palestine. Many early Zionists followed socialist ideals in establishing communalistic kibbutzes.

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