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SHOULD THERE BE A MARSHALL PLAN FOR EASTERN EUROP

W. ARTHUR LEWIS DISTINGUISHED ADDRESS
NATIONAL ECONOMIC ASSOCIATION
ATLANTA, GEORGIA
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The case for massive economic assistance by the United States to Eastern European countries in support of their political liberalization rests on the following propositions: (1) it is in our self-interest to support the political liberalization sweeping Eastern Europe, both in order to win the ideological contest between the two political and economic systems and to reap the dividends of peace through changes in the level and structure of our government expenditures; (2) political liberalization without better economic performance will invite a political backlash in Eastern Europe; and (3) economic assistance is necessary to enable the restructuring to take place. I shall take the first proposition for granted and concentrate on what the experience of economic development in developing countries has to teach us about the other two propositions.

1. The Complex Relationships between Economic and Political Development

Two very different definitions of political development are found in the political science literature. One definition focusses on the degree of responsiveness and accountability of political systems to individuals, classes, ethnic and religious groups, and to economic interest-group pressures. This definition of political development equates political development with the development of Western-style parliamentarian systems. It accords with popular notions concerning political development in the West, as well as with the history

[1]*I am indebted to Peter Berck, Edward Taylor, Dusan Vujovic and Pinhas Zusman for their insightful comments.*

of political development in developed capitalist countries of the last 150 years or so.

The second meaning of political development equates political development with the efficacy of a political system, in the sense of the ability of the state apparatus to carry out effectively the programs it wishes to carry out. This notion has become equated in the literature with the concept of "the degree of autonomy of the state". Some development economists (Ranis and Fei 1988) have argued that political development in the second sense is essential to economic development. In practice, these two notions of political development have not gone hand in hand, even in market-oriented developing countries. The systematic relationships between economic and political development have differed depending on which notion of political development is used. More importantly for the subject at hand, recent political developments in Eastern Europe are increasing the political development of Eastern Europe in the first sense and reducing its political development in the second sense, at least in the short run. This, in part, is the economic and political dilemma posed by recent political events in Eastern Europe.

What can we learn from the experience of developing countries about the prospects for continued political liberalization of Eastern Europe and about how economic development and economic performance impinge on these prospects?

Economic Development and Political Participation in Developing Countries

Every political system represents a specific relationship between two kinds of elements: political and social norms, on the one hand, and political and economic institutions, on the other. Political norms translate the socio-cultural and ideological attitudes of various groups into political views concerning legitimate methods and outputs of government. Satisfaction of these *norms constitutes the basis for the government's legitimacy. Political norms relate to such matters as equity, participation and due process. Since the 1950s, political norms in developing countries have come to include economic development as an ideology as well. At the normative level, economic development as an ideology has changed the nature of what the citizenry of a country expects of its government. Once development becomes an explicit goal of government, the normative bases of government are implicitly transmuted into those of a welfare state. Governments are expected to deliver not only national security, a modicum of personal and group-security and a modicum of group-justice but also national prosperity and growth in personal and group-living standards for the different strata of society. The developmental ideology has been particularly strong in developing countries and, somewhat paradoxically, in communist countries. Marxism has a developmental ideology as its foundation.*

Political and economic institutions represent a patterning of roles and structures in society. "Political institutions" describe characteristics of political systems such as the structure of authority, the nature and distribution of access to power, and the nature and distribution of access to influence over the outcomes of the political process, and the degree of autonomy of the state. "Economic institutions" describe characteristics of economies such as the significance and scope of the economic marketplace, the role and scope for economic calculus at the micro and macro level, the system of incentives, the conditions for access to factor markets, the distribution of income and assets, and the extent of economic and social stratification and its transmission across generations.

Stable government by consent is based upon a measure of correspondence between political norms, including developmental ones, on the one hand, and political and economic institutions and their outcomes, on the other. Such *correspondence confers legitimacy upon the government and enables non-coercive maintenance of order and of a structure of authority. By contrast, political change which is not imposed from the outside is the consequence of large and continuing noncorrespondences among normative and structural elements. Noncorrespendences generate political tensions whose resolution requires political, economic and social adaptations. These adaptations can be postponed for a while either by appeal to unifying symbols (e.g. external threat, such as the cold war, or nationalist or religious values), or by the use of force (e.g. Iran under the Shah, and the Philippines under Marcos). But eventually they must take place, either because otherwise further economic development is blocked or because the extent of force required to suppress the political tensions becomes unacceptable to the political and military elites themselves.*

By its very essence, the process of economic development changes not only the economy and its institutions but also both the normative and the structural bases of the polity. At the normative level, economic development as an ideology expands the nature of expectations from government to include economic performance. At the structural level, economic development increases the degree of differentiation of the economy and the complexity and diversity of society. (Parsons 1951, Smelser 1963, and Adelman and Morris 1967). In addition, at least initially, different groups and sectors benefit unevenly from development (Kuznets 1955 and Adelman and Morris 1973). The national and political elites, the middle income groups, the bureaucracies, and import-substitute-producing manufacturers and workers benefit at the expense of the rest. The groups that benefit have a direct stake in the stability of the government, its structure, and in the continuation of its policies. They therefore come into overt political conflict with the groups that lose, to the extent that the latter succeed in articulating their demands upon the government.

Thus, economic development gives rise to a complex process in which the normative changes that accompany development greatly increase the demands for system-deliveries placed upon the polity and in which both the normative changes and the process of economic development make the management task of the government more complex. Integrative mechanisms do develop in the course of economic development, but only with a lag, and only in response to perceived failures in the existing structures. The effects of these integrative mechanisms are also unevenly distributed, with some "modern" integrative mechanisms which are primarily growth-oriented replacing traditional mechanisms which are often more safety-net oriented (North 1973 and Adelman 1972). Initially, the institutions for integration of individuals and groups themselves serve to increase overt tensions by permitting overt articulation of group-demands and therefore making tensions more explicit. In mid-level developing countries, political conflicts, political tensions and political instability are generally higher (Adelman and Morris, 1967). Mass communication and literacy make these tensions more visible, raise individual and group expectations, and increase awareness of inter-group inequities. The process of economic development can be represented by a dome-shaped curve depicting the systematic variations of both economic inequality and political tensions with levels of economic development. At middle levels of development, the share of income accruing to the poor is least and therefore inequality and political tensions are greatest.

Conflicts arise between groups whose economic interests differ, groups that benefit and groups that lose, age sets, and social, ethnic, and religious groups whose values differ. Tensions within individuals rise as well, since their rates of modernization in different spheres of activity are uneven, and they experience larger discrepancies between their "just expectations" and the economic and political systems "actual deliveries". In addition, the unevenness of economic change and the dissolving of traditional social safety nets generate increased uncertainty and greater perceived insecurity, even when mean per capita incomes are rising. The more rapid the change, the higher the potential for tensions (Adelman and Morris 1967). As long as these tensions and insecurities are not resolved, they need to be managed and contained. The combination of economic development with political development of the first type increases the need for political development of the second kind.

Political systems must perform the tension-management function, both in the actual-delivery sphere and in the value/symbol-sphere. They can do so either by consent or by decree, and can operate either on the actual outputs of the system or in the symbolic sphere. All governments employ mixtures of these methods. Some governments, such as those of post-Shah Iran and of the communist countries have operated primarily in the symbolic/ideological spheres. Others, such as those of South Korea and Taiwan, have used their authority to increase actual deliveries and widen economic participation, while suppressing political participation. The particular mix of techniques of tension-management chosen has depended not only on the political culture but also on the perceived options for change. But in developing countries at middle levels of economic development, political development of the second type has generally been achieved at the expense of increased political participation, that is, at the expense of political development of the first kind.

There exists in popular perceptions a theory that economic development and democratization tend to go hand in hand, and that as one increases so does the other. Unfortunately, this "democratization" theory is not anchored in fact. Only once quite high levels of economic and social modernization have been reached in developing countries is a harmonic evolution of political development of the first type (democracy) and economic development possible; and, even at *high levels of economic development, the harmonious marriage of increases in economic development with increases in democracy requires perceived "good" economic and political performance by governments leading to reductions in discrepancies between "just aspirations" and the "actual deliveries" of the system.*

The political science theories (Apter 1965 and 1973; and Huntington and Nelson (1976)) and the empirical studies of the seventies (Adelman and Morris 1973) have concluded that there is no unique relationship between democratization and economic development. The process of economic development typically expands some channels and types of participation while contracting others. But the very lack of uniqueness in the relationship between economic development and political participation provides an opportunity for choice. The wise exercise of that choice poses the major challenge for the design of development in developing countries and for Eastern Europe currently.

Adelman and Morris (1973) and Huntington and Nelson (1976) see the major choices as consisting of the tradeoffs between expanding two dimensions of equity: economic participation, as reflected in the equity of distribution of income, assets and opportunities, versus political participation, as reflected in enlarging the base of political participation, increasing the channels of participation, and developing methods of participation at lower levels of government. Empirically, the scope for tradeoffs among the two types of equity has tended to vary with the levels of socio-economic development. In the early stages of development, typical of sub-Saharan Africa, the system is low in political development of the second kind. There, a political elite that is strongly committed to radical egalitarian ideology and nation-building tends to oppose increases in political participation by all groups in order to reduce probabilities of effective opposition to its modernization, nation-building, and *reform agenda. At subsequent, but still early stages of development, expansion of political participation to a nascent economic and bureaucratic middle class tends to actually delay expansion of both economic and political participation by the lower class. Also, increases in middle-class political participation (embourgeoisement) at early stages of economic development tend to lead to the subsequent establishment of technocratic states that (as in South Korea and Taiwan) suppress working-class political participation in the interest of rapid, labor-intensive, export-oriented economic growth. A similar process occurred in East European socialist countries. There expansion of participation took the form of sharing power within the party by moving from the Leninist concept of "cadre party" to a broad based communist party membership.*

At later stages of socio-economic development, typical of many contemporary Latin American countries, elites have tended to expand political participation to peasants and workers in order to quell revolts (Central America) or put pressure on the middle class (Argentina under Peron, Brazil after 1964) and continue import-substitution policies. Briefly, economic and political participation tend to go hand in hand. However, since increases in both forms of participation occur at least partly at the expense of the middle class, the alienation of the middle class and the polarization of society are the likely consequences. (Adelman and Hihn 1984) Upper and middle class sponsored military coups, right wing backlash, government death squads, centralization and oppression become likely. If they take place, both economic and political participation decrease drastically and the focus is shifted to increasing the rate of economic growth. This was the phase of the political-economic cycle in Latin America of the 1970s and in Central America today. The tradeoff became one between economic growth, on the one hand, and greater economic and political participation, on the other. If the suppression of greater economic and political participation does not deliver improvements in living standards, then there is a return to civilian regimes with greater political participation but not necessarily with either greater economic participation or higher rates of economic growth. This has been the phase of the political-participation economic-development cycle in most Latin American countries since the beginning of the 1980s.

The parallel political process in East European socialist countries consists of the decentralization-recentralization waves. Expansion of participation to the socialist establishment (bureaucrats, military, police, upper echelons of management, and "honest" intellectuals) gives rise to struggles within the elite to capture the state apparatus. The socialist establishment then, in effect, opposes broader popular economic and political participation by workers, peasants, and dissident intellectuals.

In the 1980's, the pressures of debt repayment, mounting inflation, escalating unemployment, and fiscal stringency, have lowered the real standards of living of urban workers and of the urban middle class very substantially and increased the economic uncertainty of all groups. The prospects for near term improvements in standards of living in all heavily indebted countries are low. The gap between "just aspirations" and "actual deliveries" is again increasing, with a lowering of both economic and political participation being the most likely outcome.

The experience of developing countries suggests that the path to democratization is oscillatory, alternating between various degrees of participation and oppression, even at relatively high levels of development for developing countries. The ability of the polity to deliver on the "just economic aspirations" of the politically articulate and mobilized members of society is a critical element in determining whether political participation in *the first sense survives or is replaced by increases in political development in the second sense, at the expense of both economic and political participation. The experience of developing countries, especially those at higher levels of development, thus validates the proposition that quick improvements in living standards in Eastern Europe are necessary if democracy and political liberalization in Eastern Europe are to survive.*

Economic Development and the Autonomy of the State

Greater autonomy of the state, that is, political development of the second type, is needed to manage the development process. Economic development consists of a combination of changes in the structure of production with institutional change (Kuznets 1955). Both types of change require government action to initiate, even when the institutional change is in the direction of greater reliance on markets, greater liberalization of international and domestic trade, and privatization. It is a mistake to think that liberalization and privatization can take place autonomously. Indeed, World Bank and IMF reports urging privatization and liberalization are littered with recommendations for government actions to achieve these goals. The instances of successful shifts from import-substitution development to export-led growth have entailed strong government guidance, in at least three of the four little Tigers (South Korea, Singapore and Taiwan). More fundamentally, change requires ignoring the desires of those who would benefit from the status quo *and of those who would be injured by change. It therefore requires greater autonomy of the state.*

Greater autonomy of the state entails both more effective public administration and greater authority of the state. More effective administration increases monotonically with economic development, (Adelman and Morris 1967) since it requires greater education, more literacy, better communication, etc.

On the other hand, greater authority by the state does not increase automatically with development. It necessitates better tension management, and can be achieved in three major ways. First, better tension-management can be achieved by gaining legitimacy through performance which lessens the gap between "just aspirations" and system deliveries for the majority of the population that participates in some manner in the political process. Since development increases inter-group tensions, proceeds unevenly, and is unequalizing, this route to greater state authority is quite hard to follow, especially at middle levels of development. Second, legitimacy can also be increased through symbol-manipulation; this is an especially effective approach in newly independent (or newly reformed?) countries relying on a nationalist ideology; theocratic governments (Apter 1973), like Iran and the communist countries up till very recently, derive their primary legitimacy from this source and depend on the integrative force of a system of widely shared ethical beliefs, secular or religious, to lower tensions. But this route to government authority does not produce lasting effects unless accompanied by either increased system-deliveries or by suppression of opposition and suppression of information. Neither will "free market symbols" in Eastern Europe, USSR, and China unless accompanied by genuine improvements in standards of living. Finally, greater authority can be achieved by reducing participation, through outlawing or intimidating opposition parties, individuals and groups, and by centralizing decision-making. Often this is achieved through a technocratic / military alliance, as in bureaucratic authoritarianism (Brazil under the generals and East European countries while the communist party was consolidating its position).

Multi-party political systems, labeled "reconciliation systems" in Apter's terminology, that are based on high participation (Chile under Frei and India), are generally characterized by at best moderate degrees of government authority.

Central control in reconciliation systems tends to be weak and bureaucratic, and is characterized by corruption and uneven access to power. Developing countries with reconciliation systems usually have shifting developmental priorities, that are specified mainly by politicians, with technocrats playing marginal roles. The polity consists of competing coalitions based on caste-ethnic interests and on differentiated class relationships. Political development of the first type is acquired at the expense of political development of the second kind.

Liberalization in Eastern Europe consists of a shift from a theocratic political system, with high government authority, towards a reconciliation system, with low to moderate government efficacy. It occurs at a time in which economic restructuring to achieve higher standards of living (i.e., developmental priorities) is a high priority for the survival of the newly adopted reconciliation systems. But the experience of developing countries suggests that reconciliation systems, with their changing economic priorities and shifting coalitions, are ill-suited to the tasks of economic modernization and institutional change.

Economic Development, Political Development and Welfare

Both real incomes and political participation in the first sense are arguments in the individual's utility function. Individual political freedoms from arbitrary exercise of state power, and the provision of lawful channels for exerting a measure of control over one's own destiny through participation in decision-making are important to individuals. Individuals care not only about their economic well-being but also about their personal security and personal freedoms. Furthermore, political restrictions have their counterpart in economic restrictions upon the use of income (availability of goods, freedom of movement and travel, security of property rights). The extent to which these are *important to individuals is made clear by events in Eastern Europe during the last few months.*

But this review of the relationships between economic and political participation indicates that, up to reasonably advanced levels of development, individuals must, unfortunately, trade off among economic and political elements of their welfare function. Traditionally in non-communist countries participation expresses itself through either "voice" or "exit" (Hirschman 1974). In Eastern Europe, where "voice" has been blocked and official "exit" has been denied, the tradeoff between economic growth and political and economic participation has taken a different form: "exit on the job" in the form of downward adjustment of individual productivity and shift of resources towards black market and moonlighting activities; or "exit as a consumer" through the accumulation of liquidity as a form of economic non-participation; or "voice" through informal channels ("samizdat" - self-publication, political jokes, rumors, dissident movements) the exercise of which is subject to state reprisals.

The tradeoff occurs not only between economic and political participation, but also between the two forms of political development. The latter tradeoff is all the more pronounced when, as in Eastern Europe, institutional reforms are required in order for the system to be able to deliver higher standards of consumption. These tradeoffs constitute one of the basic dilemmas of the process of development.

Political Events in Eastern Europe

The winds of political change in Eastern Europe have been occasioned by the coincidence of several different processes: (1) pervasive dissatisfaction with the limited ability of the planned Eastern economies to deliver consumer goods and economic-lifestyle prospects equivalent to those in Western Europe and the United States, despite growth rates of gross material product that, up to the late seventies, exceeded those of market-oriented economies; (2) pervasive dissatisfaction with the suppression of individual freedoms, and suppression of nationalist, ethnic and religious aspirations; (3) a loss of legitimacy of the political leadership through the transition from a generation of World War II communist leaders to a generation of communist party and government apparatchiks with no charisma, no historical achievement, and of limited competence; (4) political perestroika and glasnost in the Soviet Union, which have lessened fears of Soviet military suppression of popular participation and nationalist movements; and (5) the lessened ability of local communist parties to suppress domestic popular-participation explosions by using the military and the not-so-secret police consequent upon the increased political liberalization of the Soviet Union.

The economic consequences of these political events, however, have been to lessen the economic efficacy of the governments of Eastern Europe in exercising control over the direction and pace of economic development. This loss of government authority has not yet been accompanied by the substitution of the mechanisms required for indirect guidance of the economy by market signals. The institutional reforms undertaken to date in most East European countries (Hungary may be a partial exception) have been insufficient to enable enterprises and individuals to be responsive to economic calculus based on correct economic signals. Currently, the economies of Eastern Europe have the worst of all possible worlds: central planning as a guidance mechanism has been discredited, while still in force in varying degrees, but the structures and policies to place the economies of Eastern Europe on automatic pilot via the invisible hand are not in place. Political development in the first sense has led to a retrogression in political development in the second sense. At the same time, *political liberalization is enabling overt expression of heightened economic aspirations, while generating greater impatience with the inability of the economic and institutional system to deliver improvements in standards of living. In the absence of quick improvements in living levels, there is a genuine possibility of economic and political chaos followed by political backlash and large scale violations of human rights. As indicated above, this is a process familiar to observers of Latin American development. Herein lies the case for economic assistance to Eastern Europe by the West, in view of the West's vested interest in the establishment and survival of multiparty systems in Eastern Europe.*

2. History of Economic Reforms in Eastern Europe

The interplay between economic and political development is well illustrated by the history of economic reforms in Eastern Europe. Eastern Europe has not been a stranger to economic reform. Indeed, most East European countries have gone through three waves of reform, the most recent of which started in the early 1980s. The actual reforms introduced varied country by country. Nevertheless, they shared common goals and timing (Nyers 1983).

The early industrialization programs of all East European countries were modelled on Soviet industrialization: stress on heavy industry; on production characterized by high resource-output coefficients and leading to resource-and-consumption constrained growth; centralization and planning; administered prices coupled with both input and output-target allocations; large scale vertically-integrated enterprises; and inward trade-orientation.

The period between 1954 and 1960 was marked by a wave of institutional reforms aimed at correcting some of the adverse effects of Stalinist economic policies. Comprehensive institutional reforms were introduced in Yugoslavia, shifting its institutional structure from the standard Soviet model to the worker-management model with a substantial decentralization of decision making. Partial reforms, aimed at better satisfaction of consumer demand and at increasing total-factor productivity (that is, shifting the economy from resource-extensive to resource-intensive growth, in the Ricardian sense), were adopted in the Soviet Union, Hungary, Poland, and East Germany. In the Soviet Union, emphasis was placed on agricultural production and a system of partial decentralization through regionalized economic controls. In Hungary, the reforms started in 1957 introduced free trade in agricultural products, amalgamated small technologically obsolete farms into producer cooperatives, and introduced incentive-pricing and decentralization measures into agriculture. Concentration of industrial and commercial enterprises was increased in the early 1960s, with a (mistaken) view that this would increase the efficiency of resource-use. The Hungarian agricultural reforms were successful while the industrial reforms undertaken in the early 1960s were largely unsuccessful.

The second wave of reform in Eastern Europe occurred during 1964-1970. The emphasis was on raising living standards, accelerating economic growth, and increasing the efficiency and flexibility of enterprises. In all East European countries this period was marked by a shift in industrial policy aimed at increasing technology-based industries (Brada and Montias 1984). In some East European countries (Hungary and Poland, but not Czechoslovakia), there was an intent to shift from inward-orientation to export-orientation and greater trade with the West by fostering industrial exports, as mechanisms for increasing economic efficiency. The extent to which this shift occurred and the degree to which it was accompanied by institutional reforms varied among East European countries.

East Germany was the first to propose fostering technology-intensive industries (electronics, precision instruments, and optical industries) so as to diffuse technical change in industry more generally. Czechoslovakia identified about 60 technology-intensive sectors and subsectors for priority development (Brada and Montias 1984). But, as a result of the death of the Prague Spring movement, it aborted earlier reform attempts and recentralized decision making. Targets applying to the gross value of output rather than profits were reintroduced as measures of enterprise-performance and investment-autonomy was curbed.

In Poland, Gomulka stated in 1968 that planning should aim at " the maximum growth of the most profitable export" -- that is, growth should become export-led. But the food-riots that took place in December of 1970 forced the resignation of Gomulka. Gierek, who followed him, continued the outward-orientation, viewing it as an instrument to enable a simultaneous increase in wages and investment, both of which were to act as mechanisms for raising labor-productivity. The outward-orientation was implemented by increasing investment, credit and input-access and accompanied by partial reforms in the price system and in the legislation governing joint ventures with foreign enterprises. Reforms to tie domestic prices in raw materials and semi-finished products more closely to world prices were introduced. Incentives to export were introduced tying wage increases and foreign-exchange retention for imports by firms to their enterprise's value-added in exports. But there was no decentralization of either price-setting or investment. The Gierek reforms met with initial success (1972-74), but then led to a spectacular build-up of foreign debt and economic crisis.

In 1968-69, Romania extended some material incentives to enterprises, granted some measure of enterprise independence, introduced greater flexibility in banking and credit, and decentralized foreign trade. Bulgaria undertook *comprehensive price reforms in 1968. Yugoslavia embarked on a very comprehensive program of economic reforms as early as 1965 aimed at more enterprise autonomy in investment financing from commercial sources, production and marketing decisions, income distribution and price setting.*

The most far-reaching institutional reforms were contained in the New Economic Mechanism (NEM) introduced in Hungary in 1968. The NEM introduced decentralized decision making in industry by permitting market relations among firms, by limiting the scope of administered prices through linking the prices of tradeables to world prices, and by decentralizing about half of investment. (Balassa 1973).

In most East European countries, the reforms of the 1960s were either partially or completely reversed in the seventies. The reasons were mixed: some of the reforms were abandoned for socio-political reasons; others, because the expected benefits in productivity-increase did not materialize; others, for administrative reasons relating to management and coordination problems; and still others, because in the absence of binding constraints and obvious benefits, conservative and ideological pressures could prevail. The particular mix of reasons was country-specific. Retreat from reforms was also influenced by political considerations. The relevant political considerations for Eastern Europe were: the student movements of 1968 opposing the government and, with it, the government sponsored reforms of the late sixties; the start of the Brezhnev era that accorded greater influence to a stronger state; and the coincidence of the wars in Vietnam and Middle East that gave an impetus to growing military spending and stronger states. All these strands led to partial recentralization of enterprises and of decision making.

The counter-reforms were facilitated by the ample availability of foreign finance due to the recycling of the petro-dollars through Western banks and *financial markets. The seventies were marked by import-intensive, debt-led growth in Hungary, Poland, Yugoslavia, and East Germany, especially after 1974. Some East European specialists call this process "import-led growth". The imports served to mask the failure of the domestic producers to supply goods at competitive prices, and the systemic failures of the partially reformed economic systems. In Hungary, the dollar value of imports tripled between 1970 and 1975, and again doubled between 1975 and 1980. In Yugoslavia imports quadrupled between 1970 and 1975, and more than doubled between 1975 and 1980. Investment continued to increase, and so did total absorption. As in developing countries, the seventies were marked by adverse external shocks. The terms of trade of East European countries deteriorated, due, first to world inflation and drought and, then, to OPEC. After 1975, East European countries also experienced a reduction in their export volume, due to a worldwide recession. Of these, the decline in export volume was the more significant, though its relative role varied from country to country (Bekker 1987). Even though some East European countries narrowed their trade deficits towards the end of the seventies, foreign debt mounted very rapidly because of debt servicing. By 1980, the combined net convertible currency debt of Eastern Europe (excluding Yugoslavia, the USSR and debt to the two CMEA banks) stood at $68 billion. This debt amounted to almost $500 per capita and the debt service excluding amortization stood at 30% of export earnings for Bulgaria and Poland, 10-25% for the East Germany and Hungary, and at 11-14% in Czechoslovakia and Romania. (United Nations 1981).*

The debt crisis in Eastern Europe started with the inability of Poland to meet its foreign obligations and a rescheduling of Polish debt in 1981. As a result, there was less willingness to lend to East European countries. During the eighties, all Eastern European economies experienced sharp drops in their rates of growth of real output compared to the seventies. After 1981, Eastern

Europe achieved a current account surplus; but, except for Romania, Eastern Europe continued to borrow on international credit markets for debt servicing, increasing its hard currency international debt by 24 billion between 1980 and 1988. At the end of 1988, the total indebtedness of Eastern Europe (excluding the USSR and Yugoslavia) to market economies stood at 85 billion, of which Poland accounted for 45%, East Germany for 23% and Hungary for about 20%. Polish debt was about 450% of its convertible currency exports and Hungarian debt was almost 350%. In 1988, both Poland's and Hungary's net resource transfer to market economies was about 3% of their GDP. In 1987, Hungary's net resource transfer was 6% of GNP!

The debt-adjustment problem and popular dissatisfaction with the supply of consumer goods ushered in a new wave of economic reforms during the eighties in all Eastern European countries other than East Germany and Romania. The Soviet Union introduced perestroika, with the aim of improving the quality of products, and the mechanisms for accomplishing this being decentralization of decision making by firms, including investment autonomy, and a realignment of trade relations both with the West and CMEA countries. Hungary introduced a set of comprehensive price reforms in 1980-81 aimed at linking most industrial prices to world prices, and at reducing the average size of industrial enterprises. But the path of Hungarian reform in the eighties has not been a smooth one, with 1983 marking the introduction of some administrative controls aimed at curbing enterprise autonomy. In 1983, Poland increased the role of prices in the management of enterprises and is currently introducing new far reaching legislation intended to transform it into a market economy.

Several points emerge from this abbreviated economic history of East European reforms. First, there are vast differences among East European countries, in development levels, industrial and agricultural policies, degrees *of decentralization and use of market prices. Romania is both the least developed and the most Stalinist in structure. Yugoslavia and Hungary have undertaken the most extensive institutional reforms, but are at middle levels of industrial development. East Germany and Czechoslovakia have the most developed industrial sectors. The economies of Romania and Poland are both in shambles.*

Second, crises are favorable to reforms. The debt crisis of eighties and the food riots in Poland in 1970 led to significant institutional reforms. So are the current political-cum-economic crises.

Third, success of reforms is necessary to ensure their survival. The recentralization wave of the seventies in Eastern Europe suggests that disappointment with the economic outcome of reforms leads to retreat from reform.

Fourth, while the state has had a great deal of autonomy in Eastern European countries, it has not been immune to pressures from the bureaucracy and from enterprise managers nor is it invulnerable to popular revolt. The waves of decentralization and recentralization evident in the history of East European reform reflect the interplay of these pressures. Policy makers have difficulty in prevailing over those administrative layers in the bureaucracy, ministries, and enterprise management that have a vested interest in the preservation of the status quo. The result is the socialist equivalent of populist policies: a lavish use of resources, a generous allocation of investment funds and soft budget constraints leading to "extensive growth", X-inefficiency at the enterprise level, overambitious investment plans, substantial consumption subsidies, and open and hidden budget deficits. Pressures from those echelons of the central administration who lose power as a result of reform, lead to a cyclical character in the reform process. When decisions are decentralized and incentives to shift production patterns (e.g. towards exports) are granted, specialization strategies are difficult to carry out due to pressures from enterprise managers and ministries to be included among the priority sectors. For example, the priority sectors identified in Poland in 1968 included over 60% of the output of heavy industry and machinery and encompassed over 70% of all industrial enterprises (Brada and Montias 1984). On the other hand, when decisions are centralized, there is conflict between bureaucrats and managers over norms concerning gross output, material inputs, the wage fund, the distribution of profit, exports, and prices. These conflicts tend to be resolved at the cost of enterprise productivity. The cyclical character of institutional reform processes is, incidentally, familiar to students of land reform in Latin America.

Fifth, the planned economy is not without some advantages. It offers a great deal of security to both managers and workers. Both the bureaucracy and enterprise managers have evolved styles of behavior which result in less uncertainty than is prevalent in market economies. Central planners base their norms on small changes from the previous year. Enterprises are guaranteed survival through soft budget constraints that absorb their losses. Workers are guaranteed employment through the same soft budget constraints and through the tight labor market that low worker productivity and lavish investment generate. Prices of basic consumption goods are subsidized and therefore below world market, and prices of services such as housing, education, and health are extremely low. Under non-crisis circumstances, real wages are sufficient to guarantee a basic standard of living which is well below the European average but extends to the overwhelming majority of the population. Inequalities are small. By contrast, reform towards market socialism promises higher average standards of living at the cost of increased uncertainty, unemployment, inequality and, at least during the transition, even higher inflation. Eastern

Europe appears to want the advantages of market socialism. But is it willing to pay the price?

Sixth, decentralization does not necessarily increase efficiency in resource use when enterprises operate under targets and allocations, have employment constraints and face administered prices which bear little relationship to underlying scarcities and opportunity costs. At a minimum, for administrative decentralization to lead to greater efficiency in resource-use, it needs to be accompanied by price reform, investment-decision and investment-financing decentralization, and changes in norms for enterprise performance from quantitative norms to profit norms. More substantial incentives must also be granted to managers, tying their remuneration to the profitability of their enterprises, with profitability valued at world-market prices. In short, the economic success of decentralization in socialist countries depends on being able to simulate the behavior of a market economy within the socialist framework of ownership. In all Eastern European economies reforms to date have been partial, and have not successfully simulated the operations of a market economy. Disappointment with their success has therefore been inevitable.

Seventh, the cyclical character of reform patterns in Eastern Europe is inherent in the economic character of the partial reforms, and in the political-bureaucratic interplay of reform-minded and reform-resistant interests. Partial reforms have not yielded hoped for benefits. Exposure to foreign competition and imports of foreign technology have not generated the increases in total factor productivity that had been anticipated. And, despite deflationary measures with a large cost in lost economic growth undertaken in some East European countries, efforts to tie domestic prices to world prices have led to rapidly escalating inflation. This situation gives fuel to both conservative and reform minded elements. Both the argument that "a return to the old ways *of doing business is preferable" and the argument that "reform has not gone far enough" can be supported by appeal to past performance under partial reforms. At the moment, because of popular identification of political participation with market-oriented economies, the reformers appear to be in the ascendancy. But how long will the honeymoon last? Can greater political participation survive disappointment with yet another set of reforms? It is the doubts implicit in these nagging questions which make the affirmative case for a Marshall Plan aimed at Eastern Europe.*

3. Should there be a Marshall Plan for Eastern Europe?

There are two different economic problems faced by most Eastern European countries. The first, and most urgent, is the problem of transition between two different guidance and management systems; the second, is the longer run problem of structural change in the economy to achieve more efficient use of resources. The aim of structural change is to provide a sufficient supply of wage-goods at competitive prices, particularly non-tradeables. Both types of reforms are necessary for the success of the current political reforms in Eastern Europe.

The Transition Problems

In economies characterized by substantial rigidities, any change in system, even a change from an inherently lower-productivity system to an inherently higher-productivity system, creates severe adjustment problems in the short run. These manifest themselves in bottlenecks, inflationary pressures, slowdown in gross production in the short run, and balance of trade problems. Foreign capital inflows can, in part, substitute for the short-run lack of flexibility of the economy and facilitate adjustment. But the temptation to use foreign capital inflows to postpone adjustment rather than facilitate it is great.

These phenomena are familiar to development economists that have watched attempts to switch from import-substitution to export-orientation in economies with prolonged histories of import substitution and without institutional change. Indeed, the literature on bureaucratic authoritarianism, which argued that political development in the second sense at the cost of political development in the first sense was necessary to support a switch to export orientation in Latin America, was spawned in partial recognition of this phenomenon. (The other strand of support for bureaucratic authoritarianism was that the political influence of entrenched import-substitute interests needed to be curbed to effect the necessary changes).

These phenomena are also familiar to students of the adjustment history of Latin America, which highlight the dual role of foreign assistance in this regard. During the seventies, Latin American countries used foreign debt to postpone structural adjustment, maintaining their rates of growth of absorption and imports through increases in debt. This led to more severe adjustment problems in the eighties.

The same sort of postponement of adjustment through foreign debt was also evident in Eastern Europe during the latter part of the seventies. Eastern European countries other than Hungary reacted to the external shock mostly by increasing their foreign borrowing. But the specific adjustment patterns varied: Poland increased both imports and exports, borrowed massively, and experienced a very substantial decrease in growth rate (the growth rate of the net material product between 1975-80 fell to one eighth of that between 1970-75). Bulgaria's growth dropped very little, and the increase in exports accounted for almost 45% of its total adjustment (Bekker 1987). Hungary adjusted by cutting the rate of growth in its real GNP in half, increased exports and imports equally, and decreased its reliance on additional foreign debt, in part by using up foreign reserves.

This postponement of adjustment through debt-led growth in the seventies led to severe debt problems in the eighties in both Latin America and Eastern Europe. The debt problem of Eastern European countries, like that of heavily indebted developing countries, became critical in the eighties. All heavily indebted countries are now facing a similar adjustment problem-- the need to restructure their economies to achieve positive trade balances while confronting very stringent foreign exchange constraints arising from debt service problems. In principle, this can be achieved by either cutting imports, in a new round of import substitution, or by increasing exports. As in LDCs, the responses varied, with some countries turning more inward (Romania, and Czechoslovakia) and others (Yugoslavia, and Hungary) becoming more outward oriented in their policies. As in LDCs, adjustment was easier in economies that adopted an outward oriented approach (Balassa 1984), though painful even in those countries (Adelman and Vujovic 1989).

In the early 1980s, Eastern European countries other than Bulgaria adjusted to the debt crisis primarily by cutting the rate of growth of hard currency imports. By 1982, all except Bulgaria and Czechoslovakia had achieved a balance of trade surplus in convertible currency trade. Deflationary measures were adopted in Hungary, Poland and Yugoslavia under the impetus of the IMF, leading to sharp declines in domestic absorption. Fixed investment fell sharply between 1980 and 1985. In Yugoslavia real household incomes fell by almost 40% between 1980 and 1987. Hungary and Yugoslavia cushioned real private consumption, but Poland experienced a 6% real decline over the period, most of it in 1982. In an effort to service their debts, all East European countries transferred part of their growth abroad. As indicated by the difference in the growth of GMP and domestic absorption, the fraction of growth transferred abroad between 1981 and

1985 averaged[2] 109% and ranged from 170% in Hungary to 3% in Bulgaria.

The current system-restructuring problems in Eastern Europe are even more severe than their debt-adjustment problems were up to now. The system reforms must be undertaken starting with a heavy debt overhang[3]; in economies that are import-starved; whose standards of living have declined to varying degrees[4]; and that are plagued by rigidities, lack of experience with production under market institutions, and are experiencing galloping inflation rates[5]. They also have very substantial excess liquidity[6] in the hands of consumers (reputed to be 80% of GDP in Poland) ready to fuel increases in inflation once subsidies to basic goods are removed, domestic market prices are freed, and domestic prices are brought in line with world prices. At the same time, delivering improvements in living standards is a political imperative for democracy to survive. But the control of inflation requires reductions in government subsidies to both consumers and producers and tighter credit conditions for enterprises. Enterprise bankruptcy will then become a genuine possibility. Unemployment can then mushroom leading to severe socio-political problems in economies whose expectations and institutions are adjusted to full employment.

Experience with developing country adjustment programs of the eighties suggest that they rarely succeed without additional external resources. There were numerous instances of postponed adjustment programs in less developed countries in the eighties due to foreign resource unavailability, often due to

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[2] *Excludes Romania.*

[3] *Romania is an exception.*

[4] *Bulgaria is an exception.*

[5] *In some East European countries the inflation is suppressed.*

[6]. *Excess liquidity is defined as the ratio of nominal financial assets held by households to GDP at current prices.*

disagreements with the IMF. But how does one follow IMF-conditionality and, at the same time, succeed in delivering immediate improvements in living standards? Will countries that have already undergone about 40 years of austerity with the promise of improvements in living standards around the corner agree to further austerity under similar promises? Will the ideology of market-economies be more credible to Eastern Europe than the ideology of communism?

Clearly, some stabilization and restructuring loans are needed. But how much, of what kind, and under what conditions, should vary country by country. On the whole, the response should be timely but modest, so as not to obviate the need for domestic restructuring. Countries whose economies are in shambles, such as Poland and Romania, will require Western support of substantial commodity-import programs to enable them to rapidly deliver wage-goods. I would limit these commodity-import programs to food, especially perishables, in order to limit the possibilities for speculation, hoarding and abuse. A Polish program of this nature is already under way.

Support of Restructuring

There are two important points that we have learned from the experience of developing and Eastern European countries in the in the last two decades.

The first is that the productivity of borrowed-resource use is critical in determining whether foreign loans generate or do not generate a "debt problem". If the productivity of borrowed resources exceeds the rate of interest on borrowed funds , as it did in South Korea, then borrowing now and repaying out of growth later is a rational economic policy. (The analyses undertaken in the early sixties, under the auspices of the Agency of International Development, to explore the period of transition to self-supporting economic growth, which indicated that between 20 and 25 years of foreign assistance would be required in most middle-income developing countries, were all based on this assumption). If the productivity of investment of borrowed resources in developing countries is lower than the rate of interest, as has been the case in the majority of heavy borrowers in Latin America, then a "debt problem" will surely arise.

Past experience with international loans to Eastern European economies indicates that they have low productivity of borrowed resources, and therefore are more like Latin American countries than like East Asian economies in this regard. The economic growth of communist countries has been more resource and more capital intensive than that of market oriented developing countries (Chenery et al 1986). This indicates not only low average productivity of material-input use in East European economies but also low marginal productivity of resource-use. Indeed, as we saw above, the desire to increase total factor productivity has been a major motivating force in virtually all waves of Eastern European system-reforms. High growth rates in Eastern European countries up to 1980 were supported by very high rates of savings and investment, enforced by shortages of consumer goods and either suppressed or open inflations. This is precisely the type of economic growth that has led to the current disillusionment with the communist countries' economic performance. But this growth pattern also bodes ill for the probability of Eastern European economies being able to handle the "debt problem".

Foreign borrowing also gives rise to "transfer problems", so that not only must the productivity of investment exceed the rate of interest; the investment must also enable the economy to, either directly or indirectly, generate sufficient foreign exchange for debt-servicing and debt repayment. If foreign exchange earnings are not sufficient, and the economies cannot grow their way out of debt (as is the case when the productivity of resource-use is lower than the rate of interest) then achieving the transfer of resources into foreign *currency requires reductions in domestic absorption and expenditure switching between domestic consumption and tradeables and gives rise to high rates of domestic inflation. Declines in domestic absorption imply declines in household incomes and, in less developed countries, have usually led to even larger relative declines in the incomes of the poor.*

The second lesson we have learned from the experience of both types of countries is that reforms tend to be slowed down when increases in debt allow for ample increased imports. This is what happened during the seventies in the overwhelming majority of countries. It was only under the impetus of the debt-crisis of 1981-82, which led to a sharply reduced willingness by banks to lend to both developing and socialist countries, that a new wave of reforms was introduced in Eastern Europe.

In Eastern Europe debt-supported restructuring is a two-edged sword. Expansion of output and investment in Eastern Europe has not been liquidity constrained: on the contrary, enterprises have tended to operate with soft budget constraints (Kornai 1980). The availability of state credit has enabled enterprises to produce to inventory, rather than to satisfy final demands, and thus enabled them to be less responsive to consumer demand. To generate incentives for restructuring at the enterprise level, one wants a tauter rather than a more lavish credit regime. This tautness is compatible with aid-financed restructuring only if foreign-aid is accompanied by IMF-type constraints on credit expansion. Also, while economic expansion in East European countries is resource-constrained, it is less foreign exchange constrained than in the typical developing country. In the more developed East European economies (e.g. East Germany and Czechoslovakia), import-substitute industrialization has produced machinery and technology-intensive intermediates which need to be imported in the typical Latin American less developed country. Finally, while *increased imports make restructuring easier, state debt offers a disincentive to restructuring. Divestiture of state assets is inherently incompatible with increased state foreign liabilities.*

These considerations, which have been validated by the experience with debt-led growth in Eastern Europe, all suggest the need for great caution on the side of both borrower and lender in using further foreign debt to support the economic restructuring of Eastern Europe.

Trade versus Aid

Experience with aid to developing countries has indicated that trade is considerably more potent than aid in supporting growth and structural adjustment. The total foreign assistance budget of the World Bank is about the same size as the welfare budget in New York city. This consideration alone suggests that the inflow of resources by itself cannot make a perceptible difference when spread over 3 billion people and over 100 countries. What matters is the leverage which the aid flows can confer on the lender for negotiating the restructuring of domestic institutional arrangements and policies within LDCs.

Trade, on the other hand, has been found to be potent in raising the growth rates of export-oriented, open, economies; increasing the efficiency of resource use in the economy; generating international competitiveness; restructuring production patterns towards higher value-added goods in the product cycle; facilitating adjustment to external shocks; and increasing the market responsiveness of domestic institutions. All of these effects have been documented by Balassa (for example,1989).

Foreign Investment

Foreign investment in the form of joint ventures is also an attractive alternative to debt for restructuring. To the foreign investor, joint ventures offer low wages, a work force that is better educated than that in the United States, and a large domestic market that is starved for goods. In Eastern Europe, wage rates including fringe benefits are between 10 - 15% of the United States. East Germany, Hungary and Czechoslovakia offer a combined market with a GNP that exceeds that of China. To East European countries, joint ventures provide access to risk bearing foreign exchange without borrowing, access to foreign markets and marketing services, and access to more advanced technologies, know-how and management skills without paying for them. Foreign ventures thus look attractive to both parties. There are, however, potential conflicts of interest among the host-country and the foreign investors which could affect the way the foreign ventures are managed. Also, to date, the transfer of technology from the newly established joint ventures to other enterprises has been disappointing. Nevertheless, increased trade and foreign investment offer superior alternatives to foreign aid.

4.Conclusion

My gut reaction to recent developments in Eastern Europe was to urge the initiation of a Marshall plan by the OECD countries in support of the economic restructuring of East European countries. However, once I started thinking about the subject, I talked myself out of this. It became clear to me that, if the aim is economic restructuring, lavish foreign assistance was likely to be counterproductive for Eastern European economies. Substantial commodity assistance programs, along with modest adjustment loans, and some debt forgiveness in the short run should be structured on a case by case basis. The proper reform environment would necessitate opening up trade possibilities for Eastern European countries, insurance of foreign investment, and technical assistance with technology, training and management. Thus the long run response should consist mostly of measures to facilitate trade and investment (including technology transfer). The current programs structured for Poland and Hungary appear about right.

Ultimately, in all countries, it is internal policies and institutions that matter. The international environment can either facilitate or hamper the adoption of appropriate domestic development strategies. Foreign aid is, at best, the tail that can be used to generate incentives for wagging the dog. Attempts to do much more than provide a receptive international environment for East European restructuring are likely to do more harm to the cause of restructuring and generate more problems for Eastern European countries in the medium run than they would solve in the immediate run.

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