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The Transition from Command Socialism

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The Transition from Command Socialism.

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The collapse of the Leninist political regimes and the moving toward political democracy in the Soviet Union and Eastern Europe does nothing to resolve the economic conditions that triggered the political collapse. The basic economic and financial institutions that are needed if these economies are to get moving again are not in place and no perceptible progress has been made to creating such institutions. Furthermore there is no indication that there is any real understanding, in either the leadership or the populace and in the east and in the west of what institutions are needed, what they do and how they can be brought into being.

What has to be done is 1. Divide the industrial structure into firms that are managerial units. 2. Appoint boards of directors who will choose the managements for these firms. 3. Direct the management to aim at earning profits. 4. Create markets that will serve to coordinate

*from Soviet style
central bank
for financial
as the
Liberal Market*



decisions. 5. Create financial organizations. 5. Vest the "ownership" of these firms in these financial organizations. 6. Create a system of financial institutions such as local banks, savings banks, pension funds, life insurance companies and mutual funds which are vehicles for financing firms and the accumulation of private wealth. 7. Privatize on a pragmatic basis as private wealth is created and the information necessary for market oriented investment decisions is generated.

In principle the division of the productive structure into decentralized profit seeking firms and the appointment of directors and management can be done quickly. A balance sheet of these firms can be drawn up. The values attached to assets will be quite arbitrary. Initially 100% of the liabilities can be equity. The entities that will have these liabilities as assets have to be created.

The directive to seek profits

Initially the equity shares in these managerial firms would be owned by the state. Borrowing from Italy and the United States's experience with the depression era's Reconstruction Finance Corporation a system of Public Holding Companies needs to be created. The Public Holding Companies can be local, regional or national; they can be



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specialized to industrial sectors. In principle there can be many.

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The assets of these holding companies will be the equity shares of the firms, their liabilities will be equity shares owned by the state. These holding companies will receive dividends as the operating units make profits. They will be the conduit for subsidies to those operating units that make initial losses. As the state and the public holding companies finance the entities that make losses they will acquire additional equity shares in return. Organizationally these holding companies will mimic private financial institutions: their management will aim at profits. These easy steps in reform will create a market socialist economy. Ever since the 1930's, when Oscar Lange and Abba Lerner published their seminal works on the economic theory of Socialism, economists have known that Socialist economies are best organized if markets determine the use of resources, the compensation of labor and the prices of outputs. The essential differences between a market socialist economy in the Lange-Lerner formulation and a capitalist economy is that in market socialism the liabilities of the holding companies are owned by state entities whereas in a capitalist economy the liabilities of the firms and the financial institutions are directly or indirectly privately owned.



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As long as the flow of profits is to firms owned by these holding companies and to the holding companies, investment will be financed by firms and holding companies. The total of investment - the macroeconomic contours of the economy - will be determined by what these organizations finance and by the state's transfer of funds in exchange for new equity shares to the holding companies.

The first step in the evolution of the eastern economies leaves the system with a predominant state involvement. This is so because the initial conditions for the evolution of these states is a population without any significant mass of private wealth. The institutions that can lead to the accumulation of private wealth need to be created. These institutions are those that facilitate private saving and private industries that can lead to private capital gains.

held at investment decisions are left to market forces in a capitalist economy

management of the holding companies with particular the creation of the financial institutions and and relations , as well as the information needed for rational financial decisions will take years if not decades.



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Meaningful economic reform can take place only as it is understood that a modern market economy is an integrated production and financial system. The economies of the east have production systems that were built up over the past 7 or 4 decades. If the population is to be fed and clothed this productive system has to be used even as they are managed so as to be responsive to emerging market forces. Such management will lead to the generation of profits data that a market economy requires.

If the object is to create a European style capitalist economy then the first item on the agenda for reform is to transform Stalin's command socialist economy into a market socialist economy.

In a market socialist economy the productive resources of the economy are assigned to firms which have a management that is ordered to maximize profits. A structure of constraints or regulations will be needed to prevent the abuse of monopoly positions which undoubtedly will exist because of the structure of much of industry. Furthermore the central authorities - the planning authority will need to guarantee that total demand will be large enough so that a close approximation to full employment is sustained. If things are to get better it will be necessary to first put



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at least part of the inefficient humpty dumpty back together.

This assignment of the productive capacity of the economy to firms that are instructed to make profits has not addressed the question of ownership - the liability side of the balance sheet has to be constructed. It is nonsense to talk about privatization. There is nothing like a capital market in the Soviet Bloc. There is no way of pricing the assets that the market oriented socialist economies inherit from the planned past until there is a history of profits that can be used to form profit expectations.

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In market economies decisions are decentralized to households and firms.

Capitalism is a special form of market economy in which the material means of production are privately owned. This means that individuals receive incomes in the form of interest, dividends and rents from owning property and from financing the ownership of property. In a continuing capitalist economy such incomes were received in the past, are being received now and are expected to be received in the future: the past and the present provide data for what is expected in the future.



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In the economies of the east there is no record of profits and there is no experience upon which to base expectations of future incomes from property. As the market value of property is determined by expectations of future incomes, there is no firm basis in these economies for determining the value of firms or of individual items of capital.

Furthermore in a capitalist economy the claims to future incomes can be bought and sold and pledged as collateral for loans. As a result assets, such as the material means of production, collections of material means organized into production units, and the instruments that reflect claims to incomes that arise from financing have prices. Assets owned multiplied by these prices leads to the wealth of individuals.

In the socialist countries because there is no historical record of profit incomes there is no basis on which to form expectations of profits. Therefore there is no price system of physical and financial assets. Furthermore the assets and the debts are not privately owned. No one owns wealth.

Before a capitalist economy can be brought into being a history of earned profits needs to be created and individuals need to acquire wealth. Wealth is acquired by



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saving. Instruments which individuals can use save need to be introduced. Individuals have to accept that it is good to give up consumption now in order to have consumption in the future.

The use of markets and valuations derived from markets is not a defining characteristic of Capitalism.

Charles Steinmetz, the great General Electric scientist of the beginning of this century, was a Socialist. He rationalized working for a firm that sought to monopolize the developing electrical industry by arguing that a trustified economy made the transition to Socialism easier: all that had to be done to transform a capitalist economy into a Socialist economy was to replace the Board of Directors elected by the stockholders with a Board that represents the interests of workers and the society.

Steinmetz's insight points out that to change a Stalinist economy into a market economy every productive asset has to be assigned to an operating firm. This operating body has to be organized as if it were a capitalist firm.

As yet there are no owners - the material assets of the economy are distributed to firms but these newly born firms do not have any debts or equity share owners. As a first



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step the liabilities of the firm will be equities that will be owned by public holding companies. The board of directors of the operating firms will be appointed by the public holding companies and perhaps sectoral interests. The board of will hire a chief operating officer who will be instructed to make profits within the guide lines imposed by the attenuating remnants of the planning system. The resulting structure of industry and trade will have private management and public ownership although their formal structure is consistent with a fully private economy.

Finance, Net worths, who has the wealth to run the firms: distribute existing firms to workers

Need institutions to make it attractive to save.
Pension funds savings banks

Only after there is a history of profits can a rational valuation of the going firm be made. Only after profit flows are generated can the debt carrying capacity of firms be determined, can it be determined whether it is desirable to pay for new equipment etc. Capitalism has two sets of prices, but these price sets are linked.

The way to go from where the economies of eastern Europe are to some other type of economic organization is to start by setting up the independent Socialist firms



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envisaged by Lange and Lerner. As these socialized firms achieve records of profits a decision whether to privatize or to remain public has to be made. The pace of privatization will be limited by the ability of the capital market to absorb the equities that will have to be sold.

Foreign ownership .- a monopoly of capital income by foreigners is not the way to build a successful capitalism that in the longer run will have the support of the populace.

Before reform can proceed an understanding of the institutions and information needed to make a market economy work, how such institutions can be created and how the information needed for decisions can be generated has not begun. It is likely to take years, if not decades, to develop the financial and economic relations, institutions, and information that a market economy needs. Meanwhile there are people to be fed, housed, clothed and raised and there investments need to be made which look forward to an economy where market forces lead to inputs to decisions.

Programs that abstract from the constraints imposed by existing conditions and ignore the institutional structure needed for a market economy are likely to make things worse



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without offering prospects for improvement in the relevant future. The building of a market economy must start from the way production and claims to incomes are now organized and be enlightened by an understanding of the institutional structures that make for successful market economies.

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NOTES

1. The path to recovery runs through market socialism

2. Public Holding Companies as the first step towards establishing value:

the private management of publically owned enterprizes.

The need to establish a tradition of honest and efficient management of public enterprizes. this is very difficult.

3. Need to start from the industrial structure you have. Cannot blanket assert that the plants are inefficient and must be abandoned. Even as the aim is to establish a record that can be used to value plants and equipment a close approximation to full employment must be maintained.

December 31, 1993 12



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