The Bank's Analytical Approach to Socialist Countries and Economic Reform

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I. INTRODUCTION

1. This is a first attempt at advancing some generalizations about the Bank's analytical work on socialist economies. It is based on a very selective review of Bank work on socialist member countries, and of the literature in the field of comparative economic systems. Section II introduces some basic analytical concepts which are useful in discussing the mode of operation of socialist economies and some problems arising from the lack of a universal economic model which would describe it. The socio-economic model of secular evolution of socialist systems in Section III is a summary of the outline given in Professor Janos Kornai's paper on World Bank reports on socialist countries. 1/ Section IV makes an attempt to set out the appropriate role of the Bank which follows from this scheme. Kornai's observations, including some of our own conclusions from country economic and sector work on the dilemmas of system reform are presented in Sections V and VI. In Section VII some topics are identified for an agenda of further work on the state-of-the-art relevant for the relationship between the Bank and socialist countries.

2. Socialist member countries of the Bank fall into three groups, distinct from each other by state of development, size, institutional framework, and ideological outlook. First, the East European countries (Hungary, Romania, and Yugoslavia). They are medium-sized middle-income countries with an economic system rooted firmly in Marxist principles, although with a distinctly different set of institutions in each. Second, a number of mostly small to medium-sized low-income countries, such as Ethiopia, PDRY (South Yemen), and Mozambique. They have structurally little in common

with one another which they do not also have in common with comparable other LDCs, except a larger role for the public sector, and a commitment to Marxist socialist principles, although somewhat more vaguely than the countries in the first group. China is somewhere between these two groups. It shares a variety of institutional features and the ideological orientation with the first group, its stage of development puts it closer to the second group, but its size sets it apart from either.

3. These countries share two principal features which define them as "socialist" for the purpose of this note. First, social or state ownership and control of the means of production is dominant, primarily because these countries consider a society organized along these lines as both more conducive to modernization and as a more legitimate expression of the prevailing social-political preferences than one dominated by the institution of private ownership and control. And second, a party proclaiming a Marxist ideological outlook considers itself the leading political force. This working definition excludes mixed economies with a commitment to the creation of a broad welfare state, such as India. The two main reasons for their exclusion are: (a) they justify their choice of a large public sector primarily on pragmatic considerations rather than ideological preference; and (b) at least in principle, the public sector is to operate under similar rules as the private enterprise sector.

II. THE ANALYTICAL PERSPECTIVE

4. For Morris Bornstein, an economic system involves the "interactions of organizations and participants (individuals or groups of individuals), according to rules and orders, in the production, distribution and use of goods and services." The forces determining an economic system are: (1) the
level of development; (2) social and cultural factors; and (3) the environment. "The nature of an economic system may be analyzed in terms of its social preference function, its institutions and instruments, and its pattern of resource allocation and income distribution." 1/

5. Prominent among the social and cultural factors determining an economic system is its underlying economic ideology. Bornstein defines it as "a set of ideas related to economic actions. It influences both the ends and means of the system. What its goals are, including the priorities among them; the institutions and instruments of the system and the pattern of their use; and attitudes about the changes in goals, institutions, and instruments." In this concept, ideology is inherent in every economic system.

6. Economic policies are notionally quite different from economic systems, although the dividing line may not always be clear in practice. Policies are for Bornstein the set of "tools chosen by the state when it intervenes to achieve social goals in the economic sphere", such as fiscal and monetary measures, exchange rates, direct controls (e.g. of prices, wages, trade flows), and changes in the institutional framework. The implication is that many sets of policies may be consistent within a given system. Koopmans and Montias point to an important practical distinction between systems and policies: Systems are relatively stable and only change under the influence of the forces mentioned in para. 4 above, whereas policies are changed with greater ease and in shorter time spans. 2/


7. The distinction between systems and policies has major practical consequences for the relation between the Bank and socialist member countries. The obvious meeting ground for a productive dialogue is the realm of policies. System changes involve forces outside the scope of economic reasoning and are subject to a productive dialogue only if the principal choices have been made by the country, and when the technocratic problems are being addressed in choosing among acceptable system changes or of implementing changes effectively.

8. Socialist economies, even using the restrictive definition introduced above, exhibit a diversity of institutional features which -- apart from the centrally planned economy of the textbook -- cannot be captured by a single model, derived from an exhaustive and universally accepted set of a priori assumptions and comparable in rigor and formal elegance to the models for capitalist market economies originating from the neo-classical paradigm. Nor can they be viewed through an uncritically modified model of neo-classical origin. In fact, quite different models derived from stylized facts concerning individual socialist economies are necessary to catch their distinct institutional frameworks and sets of rules.

9. In this sense, the study of socialist economies is not a mature discipline. There is no set of universally held behavioral and institutional assumptions, there are no rigorous microeconomic and macroeconomic theorems, no body of well-tested and widely accepted policy prescriptions. Our knowledge today of socialist economies is based largely on conjectures and hypotheses and a large collection of empirical cases. Thus, conventional diagnoses of economic development problems, and common sense notions regarding the means, ends and effects of policy measures designed for economies with a different underlying model are in many instances inappropriate. An effective
policy dialogue and the design of operationally meaningful conditionalities require that the systemic features of particular socialist economies be considered.

10. In the absence of a universal model of socialist economies, generalizations are difficult. This limitation of the state-of-the-art is the cause of many misplaced conclusions and recommendations. The reality of particular socialist economies with all their inherent defects is frequently contrasted to the pure model of the perfect market economy of neoclassical origin... Montias 1/ rejects this approach as "invidious comparison", and Nove 2/ considers "comparing model with muddle" as "plainly illegitimate".

III. THE PHASES OF DEVELOPMENT OF SOCIALIST ECONOMIES

11. As Kornai has pointed out, the evolution of the system of socialist countries has its own dynamics which, at an abstract level can be reduced to three "phases" through which they pass, with a unique set of institutions and an underlying ideological thrust each. Kornai stresses that these three phases do not necessarily have to follow each other chronologically; they are as much Weberian "ideal types".

12. Phase 1 is the "heroic-enthusiastic" period which follows the ascent to power. It is characterized by sweeping nationalization and radical redistribution of wealth and political/economic power. The underlying ideology tends to be "radical," "Maoist" or "new left" in outlook. Rapid transformation is driven essentially by moral incentives. Cuba up until the 1970s and

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China - between the Great Leap Forward and the end of the Cultural Revolution - are recent historical prototypes. Phase 2 is the "bureaucratic-hierarchical command economy," the classic centrally planned economy. The ideology is expressed in the official textbooks. The economy, through a mixture of instructions and material incentives, is centrally guided in considerable detail. The USSR and Romania are prototype cases of Phase 2 socialist economies. Phase 3 is sometimes referred to as "market socialism." It was first introduced theoretically by Lange 1/ in the 1930s, and variants are now widely advocated by East European and Chinese writers on "economic reform." Decentralization, devolution of the role of the State and reliance upon market-determined incentives are hallmarks of Phase 3 socialist economies, although no consistent model has yet been devised. Examples of economies in transition between Phase 2 and Phase 3 are Yugoslavia and Hungary; China seems to be moving in the same direction.

13. In all historical cases, Phase 1 was transitional and, after the initial revolutionary momentum was spent, led to Phase 2. In contrast, Phase 2 socialist economies are inherently stable systems with no automatic transition to Phase 3. A transition rather requires an explicit political choice and is not irreversible; reversion to Phase 2 is possible as a consequence of political pressure, and may be induced by a severe economic crisis which demands strong central leadership for resolution.

14. The location of a specific country in this framework, and the momentum of movement from one phase to another delimits the thrust and the contents of an effective country dialogue. Therefore, the determination of the place of the country in this scheme of evolution of socialist economies should be an

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essential part of country analysis. To assess the position of a country in the transition from phase 2 to phase 3 -- when a host of new system and policy problems arise -- several "litmus tests" can be employed which refer to key features prevalent in all centrally planned economies of the Phase 2 type.

15. **Structural Shortages.** Widespread and chronic excess demand and the prevalence of sellers' markets are common for most goods and services. This results in a variety of peculiar phenomena, such as forced substitution, rationing of one kind or another (including queueing), grey and black markets of various degrees of legality, involuntary household savings, and hoarding and unbalanced and/or excess stocks. **Chronic shortages and surpluses can exist side by side.** Given the chronic sellers' market situation, producers have little interest in fine-tuning output to buyers' requirements and needs, since all output can be disposed of.

16. **Weak Price Responsiveness and Soft Budget Constraints.** The signals guiding firms' output decisions are predominantly instructions in the dimension of quantities, with the effect that prices tend to be largely ignored. The shortage syndrome, in fact, is largely the manifestation of this weak price responsiveness of the agents. Underlying this seemingly irrational behavior is the fact that firms (in contrast to households) face a "soft budget constraint. /* If a firm gets into financial trouble - lack of liquidity or persistent losses - the paternalistic state is standing by to support it and to avert failure through provision of subsidies, reduction of taxes, permission to raise prices, or additional credits or relief from existing debtors. A special case of the soft budget constraint is the lack of

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financial discipline i.e., permissive with respect to arrears in the absence of financial penalties or of effective legal recourse if payment obligations are violated. The firm's budget constraint, therefore, is neither firm nor a matter of life and death, but is expandable. Under conditions of a soft budget constraint, demand constraints tend to be absent (leading to chronic shortages), financial risks tend to be ignored and, given the dominance of quantitative targets and quotas, profitability is a weak positive incentive.

17. Forced Growth. Growth of physical output is typically stressed by the political leadership and the planners as the major medium-term objective. As a consequence, priority is attached to the so-called "productive" versus "non-productive" activities (such as housing, services, etc.), manufacturing versus other productive sectors, basic versus processing industries, and large-versus small-scale firms. Frictions from excessive investment in priority activities may cause a temporary change in the investment pattern, but the system tends to gravitate back to the pattern of forced growth.

18. Expansion Drive and Investment Hunger. Phase 2 economies tend to develop an "almost unsatiable hunger for expansion and investment". The emphasis of the Center on forced growth explains this only in part. Not less important is the motivation of firms. Pervasive shortages create the impression that demand for output is not a constraint, the soft budget constraint of firms largely removes the risk of failure, and the impersonality and anonymity of the client.

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1/ This distinction, going back to Adam Smith, determines the National Accounts conventions of socialist countries, causing serious problems of cross-country comparability of aggregate measures of output.
of the processes leading to investment decisions largely eliminate accountability for mistakes.

19. Weak Foreign Trade Performance. In the absence of a profit motive and a hard budget constraint, firms tend to indulge their desire for imports. Forced growth raises import requirements for intermediate goods, physical shortages or shortages of foreign exchange encourage a build-up of precautionary stocks, and the expansion drive spills over into demand for imported equipment. And, given domestic supply shortages, producers prefer distributing output in the domestic sellers' market to active marketing in foreign buyers' markets. To maintain a sufficient level of exports, central authorities have to substitute mandatory export targets for lack of motivation for voluntary export. But in the absence of a price system based on opportunity costs, they lack the capacity to consider domestic resource costs of exports. In addition, the conflicts between the internal and the external system of relative prices require separating the two by an institutional arrangement commonly referred to as "price equalization" mechanism. It implies either setting up a special agency which taxes away profits or reimbursing losses originating in differences between the two price systems, or having diversified state trading agencies which deal with domestic and foreign clients at the respective prices, balancing aggregate transaction profits and losses internally.

IV. THE BANK'S ROLE

20. The position of a particular socialist country in this evolutionary scheme is critical for determining the most effective role for the Bank beyond
the provision of financial resources. For the three pure phases, the conclusion is fairly straightforward. During Phase 1, where revolutionary transformation of the economic system and political campaigns rather than policies and evolutionary institutional changes affect economic events, the scope for an effective role for the Bank is likely to be limited to areas outside the mainstream of development, such as technical and social infrastructure for which the need is independent of the economic system. For Phase 2, the Bank has little to contribute beyond financial resources since in the main problem area—improvement of planning techniques and plan implementation and control procedures—the Bank has limited expertise. Areas of collaboration are the same as for Phase 1 and, in addition, activities which promote the development or absorption of new technologies in areas where receptiveness is assured institutionally. In Phase 3 presumably similar institutions and policies would be appropriate in many instances as in pure non-socialist market economies. It is the transition from Phase 2 to Phase 3, commonly equated with "economic reforms", for which the determination of the Bank's proper role causes severe problems of approach to an effective collaboration.

21. The transition through economic reforms poses both formidable analytical challenges and unique opportunities to the Bank. The range of opportunities are those which the Bank always saw its major contribution: the design of effective sub-systems under decentralization, institution-building, and the development of policies. What is unique in the case of socialist economies is the lack of appropriate—positive and negative—experience in these areas and the limited scope for Bank support based on its cross-country experience.

22. A case in point is macroeconomic management. In a pure centrally planned economy of the Phase 2 type, macro- and micro-management are fully
integrated, and the country neither has nor needs macro-management in the conventional sense. Specific output, input, price, investment, and foreign trade decisions for all activities are determined centrally in a consistent planning framework. It assures that all markets are cleared and all internal and external macrobalances are maintained. The actual problems the country is facing arise essentially in the information sphere.

23. The moment the country takes steps away from strict central management, one of two methods, or any combination of them has to fill the void left by central ex ante regulation. Either it has to resort to ad hoc intervention once it is recognized that balances are not being met, or it has to introduce macroeconomic policies of the kind used in market economies. The Bank has traditionally strongly favored the latter approach, and most reformers in socialist countries prefer the same approach. The record of fine-tuning of the economy through macroeconomic instruments is mixed even in countries where the underlying microeconomic and institutional conditions are largely met by reality, and where experience of decades in using these tools has accumulated. Both conditions are absent in socialist countries.

Experience and introspection has taught socialist countries that this is their greatest vulnerability, and that the fate of any economic reform towards increased decentralization will depend on the ability to cope effectively with the problems of macroeconomic management; they are particularly sensitive to the need to maintain reasonable stability of the price level and approximate full employment of all resources. Socialist countries in this position can be expected to be particularly receptive to Bank advice, provided it focuses on the real frictions of the economy and admissible options for system changes or
24. The analytical challenges refer both to diagnosis of problems and prescriptions for the transition of Phase 2 to Phase 3. Kornai identifies two common errors of analysis. The first is the tendency to overlook or to underestimate the continuing relevance of many of the features associated with Phase 2. Different behavioral traits are inherent in certain features of the system; for example, the response of a socialist firm will normally differ from that of an owner-managed private firm given identical incentives and risks, since those taking the decisions are subject to a different sector rewards and penalties. But in part, the behavioral traits have developed as rational responses to system features and are difficult to change, at least in the short run. For example, managers of socialist firms, who learned their trade under the rules as circumscribed in the features outlined from the "litmus tests", discussed in paras 16-21, are unlikely to respond instantaneously to new types of signals.

25. A second and related common error of analysis is the uncritical adoption of prescriptions which are valid for a mature capitalist market economy. One such error is the belief in exclusive, instantaneous, and predictable responsiveness of decision-makers to input and output prices. Kornai calls this "the wishful theory of prices" in his review of Bank reports. Another misapplication of market economy experience is the approach of a piecemeal correction as a substitute for reform, for example by changing specific prices and rules in isolation. Two major reasons make this approach a dubious one: (a) interdependencies create second-round effects whose economic costs could overwhelm the gains from the first round changes; and (b) system and policies cannot be freely synthesized from isolated building-blocks.
practical conditions. This reform problem will be taken up again in Section VI below under the "second reform dilemma". There is not, however, universal agreement on these points and indeed the Chinese reform is moving along a quite different path from the one Kornai would stipulate.

V. FIRST REFORM DILEMMA: MACRO-ADJUSTMENT VS. INSTITUTIONAL CHANGE

26. Most socialist countries exhibit serious macro-imbalances. Some of them are specific to socialist economies individually or as a group; others, notably external imbalances, are shared with other countries. Reformers tend to expect the elimination of the causes for these problems from programs that would move the system from Phase 2 toward Phase 3, that is, from moving to increased decentralization, deregulation and competition. Often this is the reformers' main rationale. But few expect quick and dramatic results, because economic agents, who have internalized the Phase 2 rules of the game, must go through a drawn out and sometimes traumatic period of learning to live with a changing and more demanding environment. In contrast, conservative-orthodox advocates of Phase 2 socialism give highest priority to solving short-term macro-imbalances, without attempting to correct their causes. Some "conditional" reformers consider solving such imbalances as a necessary condition for reforms to succeed subsequently.

27. The strong government in Phase 2 socialism can correct these imbalances through forceful, direct intervention. Investment can be cut back by administrative order. Imports can be restricted by tightening quotas and licences. Exports can be boosted through instruction and disregarding resource costs. Inventories can be run down by reducing allocation quotas.
while maintaining output targets. And a severe austerity program can be enforced. As recent experience demonstrates, these centralized short-term adjustment programs can be highly effective, which poses a dilemma for reformers. On the one hand, they point to the imbalances as proof that the Phase 2 approach has exhausted its usefulness, and that new rules and institutions are necessary. On the other hand, severe imbalances deter reform.

28. For example, deregulation of deliveries and prices would immediately reveal the imbalances between supply and demand, and could result in inflation before additional investment - normally reduced at the same time - results in a more desirable equilibrium. Exposing producers to full foreign competition can depress domestic industry before it is able to adjust to the new conditions, worsening the external imbalance. Creating a domestic buyers' market and greater direct incentives to firms for exports will eventually translate into improved product quality, assortment and marketing, but only after considerable lead time. Switching output to exports to meet the external imbalance has inflationary effects which weaken the significance of price signals and financial discipline. Hardening the budget constraint is accompanied by bankruptcies and results in temporary unemployment and loss of socially-owned productive assets. Austerity measures in parallel with a reform program tend to be perceived as the result of, rather than the cause for, reform, and can destroy public and political support for reform.

29. Although these problems are common to all countries that go through an adjustment phases, socialist economies in the process of reform are particularly vulnerable for two reasons. First, these problems coincide with the need to learn how to operate under a new set of rules, that is, to respond
to price signals and hardened budget constraints. Second, opposition to reforms by proponents of Phase 2 socialism tends to be strong in a time of crisis. In contrast to the reformers who cannot point to an efficient model of a Phase 3 socialist economy, they have the advantage of being able to offer a model of macroeconomic management that seems to cope effectively with the symptoms of imbalances.

30. Outside analysts have to be aware of this peculiar dilemma of socialist economies that are in "delicate transition" toward Phase 3. Analysts must consider carefully their position before intervening in the process. The same advice that may be acceptable and can be implemented in non-socialist countries can cause more harm than good in a socialist economy that has begun transition. In this respect, Kornai points out that Bank reports on socialist economies are not always consistent. Although they strongly approve of or urge reform and decentralization, they also urge macro-measures that imply strong government action; this may, in consequence, lead to retrogression to centralization.

VI. THE SECOND REFORM DILEMMA:
PARTIAL OR OVERALL, ONE-STROKE OR SUCCESSIVE REFORM

31. The speed and scope of reforms are particularly controversial issues among reformers. Reform is an experiment, requiring continual adjustment through trial and error. Experiments within a socialist country in pilot firms - firms operating under an artificial set of rules in an otherwise unchanged environment - tend to be inconclusive. The positive and negative experiences of other socialist economies who went through a similar process at an earlier stage, can be more helpful in designing the appropriate approach.
32. An all-embracing reform, trying to cover all policy and institutional
issues in one single stroke and according to an elaborate ex ante model, is
analytically utopian and overloaded with politically unacceptable risks. But
a piecemeal approach of isolated actions can create such severe inconsisten-
cies that it may be aborted before reaching its objectives. Kornai argues
that the only viable approach is reform in stages, through "packages" of
mutually supporting changes. This remains, however, an open question on which
the comparative experience of China and Hungary can be expected to shed some
light.

33. Before turning to the question of the elements of viable reform
program, a brief review of the major classes of issues to be addressed in
system reform is in order. First, there is the question of ownership. In
addition to state or social ownership, a broad range of other ownership forms
is compatible with socialism: from private ownership of small firms, a
variety of cooperative and collective ownership of small firms, to mixed
ownership and control. Second, for the state-controlled sector, annual
planning — with short-term output targets and input quotas — should be
abolished. The experience of the socialist economies that took this step
provides strong evidence that it does not lead to economic collapse or chaos,
but merely shifts state control to more subtle, indirect means. In isolation,
abolishing annual planning probably will not decisively improve allocative
efficiency, but it introduces its precondition: room for initiative by firms
in trying to adjust to demand. Third, institutional reforms that transform
state-owned firms into efficient market-oriented units are necessary. This is
perhaps the most difficult task for which many approaches have been tried, but
no model has emerged as clearly successful.
34. Kornai advocates the following feasible minimum package of reform measures:

- autonomy and full responsibility of the firm for output and input choices and investment decisions;
- hard budget constraint for firms, enforced by legal procedures for rehabilitation, take-over or bankruptcy;
- deregulation of most prices;
- correct interest and exchange rates;
- import liberalization;
- significant profit retention by profitable firms; and
- creation of financial intermediaries for efficient voluntary reallocation of profitable firms' savings.

This is an illustration of the concept of a minimum package, not an exhaustive list for practical application, and not all its elements would have to be introduced at the same date. The actual reform package for a particular country would have to be designed according to the specific conditions and according to some wider vision of subsequent steps.

35. A related question is the choice between simultaneous and sequential approach. Reformers in Eastern Europe tend to stress, similar to Kornai, the need for simultaneous action on a package of mutually reinforcing system changes. Recent experience in China, however, could be viewed as new empirical evidence which suggests greater adaptability of the economic system than implied in the argument for a package approach. China is - like Yugoslavia and Hungary in the past - phasing out central output targets, input allocations, and output pricing over some period of time according to a ranking of commodities or industries according to their "strategic" importance and the
perceived imbalance of supply capacity and demand. But in addition, China has also opted for a parallel gradual transition for each given commodity and enterprise, parallel with the former transition. Firms' shares of both output subject to targets and of inputs subject to allocations are gradually reduced from full employment levels, and for the exempt portions the rules for contracting and price setting are relaxed. This creates a legalized parallel market where market transactions, starting from an initial marginal coverage, gradually assume domination. Price adjustment and balance between supply and demand are thus gradually brought about through trial-and-error on the parallel market.

VII. AN AGENDA FOR THE FUTURE

34. The review of a variety of Bank documents and the discussion of this note permits the identification of a number of issues where conventional economic wisdom, which evolved for a different economic system, is unlikely to lead to relevant conclusions or reliable guides for actions or policy advise for socialist countries. Without any claim to completeness, the following issues seem to require more analysis:

(a) **Macroeconomic management**: Reformers are searching for a set of macroeconomic policy instruments which permit a decentralized socialist economy to maintain a sustainable and stable path and of major macroeconomic aggregates without the need for corrective ad hoc interventions. These instruments may include those applicable in non-socialist market economies. Key questions pertain to the institutional requirements necessary to generate microeconomic responses
to defined instruments in the desired direction, and to the required modifications of instruments and/or institutions to make instruments more effective in the desired direction.

(b) **Hardening of the Budget Constraint:** Budget constraints of socialist firms can be soft because of the lack of determination to implement existing legal rules, but this is a political problem to be resolved politically. In the economic realm, budget constraints tend to be soft if there is no threat of a tangible financial penalty for imprudent action. In a capitalist system the threat to the decision-maker of losing his financial assets serves as a powerful deterrent. The same event has no perceptible deterrent effect in a socialist system where ownership and control are completely separated. Nevertheless, improvements are possible by changing the rules of decision-making through linking financial penalties to those empowered to make decisions - administrators, managers or workers, depending on the system's decision-making structure - for failures, balanced by financial rewards for success.

(c) **Financial Intermediation:** No socialist country has as yet managed to lay foundations for an efficient "socialist capital market". In the absence of private financial assets, certain institutional characteristics of an efficient capitalist capital market - such as valuation of physical assets according to returns, the potential for high profits and capital gains in the event of success, and the risk of large financial and capital losses in the event of failure - can obviously not be replicated in a socialist framework. Thus socialist organizations, as the main players in a hypothetical socialist
capital market - investors and borrowers as well as intermediators - will inevitably have less at stake in the financial successes and failures of intermediation decisions. Nevertheless, it seems essential to explore options for emulating the effects of private property relations, and their implications for autonomy, regulation, and internal procedures of socialist financial investors and intermediators, as well as for the coordination of capital market intermediations with national planning.

(d) Sequencing Economic Reforms: Much of the discussion about economic reforms in socialist countries is less concerned with the question whether Phase 3-type market socialism is preferable on efficiency grounds than with the process of getting there, i.e. with the search for a feasible way to reach that stage without destroying important social structures in the process. While a dynamic theory of system reform is beyond reach, a dynamic framework for designing a reform program is a necessity. It is worth noting that the time dimension of the change of important subsystems - such as phase-out of central annual output targets and input allocations for firms, or phase-out of centrally set or controlled prices - is no less an uncharted area than overall system reform. The design of minimum packages of mutually supporting changes is a closely related issue which cannot sensibly be separated from the sequencing question. The phasing-in of macro-policies as substitutes for phased-out central coordination is another area which cannot be separated. It seems that there is very little analytical literature on these issues.

(e) The Role of Incentives: Incentives - rewards and penalties set by a higher layer of the hierarchy for taking or abstaining from certain
allocative actions \(1\) - are an integral part of all the four issues sketched above; in fact hardening of the budget constraint can be considered as a special problem in the area of incentives. In a capitalist market economy, incentives establish the transmission between macro-policies and desired micro-responses. In this case the customary identification of the firm, the manager, and the owner is an acceptable and helpful simplification, as it permits the collapsing of the former two into the third, arriving at a handy objective function of the firm based on general utility theory. The same identification - as implied in recommendations that firms should be given a stronger profit incentive - makes little sense for a socialist system without further specification. In a Phase 2-type centrally planned economy the firm has no objective function of its own. And in a decentralized socialist system, incentives to the firm are effective only to the extent that they affect the utility of those who control the firm's decisions. Employing the concepts set out in Section II, the effectiveness of the incentive structure can only be analyzed with a view to its interaction with the information structure, the decision-making structure and the coordination structure of the system. Since this context, together with certain institutional features, invariably-differs between capitalist and a socialist economic systems, the role of incentives in economic reform requires a fresh look.

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1 Incentives affecting informational actions or effort (Ueffort).