Transposable and Non Transposable Lessons from the Transition Experience

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In this paper we ask what are the transposable and non transposable experiences from the transition from socialism to capitalism. We ask these questions with special reference to the future transition in North Korea. We discuss transposability for three important dimensions of transition: price liberalization, privatization and institutional reform.

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I. Introduction

The transition experiences from socialism to capitalism across the world have been very diverse in terms of strategy, policies and outcomes. In terms of strategy, some countries like Poland and Russia chose the big bang approach to transition whereas other countries like China or Hungary chose a gradualist approach to transition. Different countries have also had diverse experiences in terms of reform sequencing. For example some countries chose to liberalize their capital account early on while other countries did this later on. We have also seen diversity in terms of the specific transition policies. China for example liberalized its prices via dual-track liberalization

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keeping a plan track with planned prices and planned deliveries while countries in Central and Eastern Europe did not. Large differences have been observed in privatization policies. Some countries chose mass privatization giving away state assets to the population like in the Czech Republic or to managers and workers like in Russia. Other countries chose to sell their state assets like Hungary or Estonia. Here, also diverse methods were used like direct sales or auctions. Important differences were observed also in terms of institution-building. Different countries opted for different political systems, different legal or fiscal arrangements. The quality of institutions in difference countries has also been very variable (see Johnson *et al.*, 2000, 2002a, 2002b). Not surprisingly, transition outcomes have also been very diverse. They have been very diverse in terms of growth. China's transition has led to one of history's biggest growth miracles with 30 years of uninterrupted economic growth. Central European countries all experienced an important output fall but started recovering within a couple of years after the beginning of transition. Their subsequent growth path has been normal. Russia by contrast has had continuous decline during most of the nineties and has found a path of solid growth only after the 1998 crisis and the boost in oil prices. Countries also have had a diverse experience in many other aspects. While inequality has been rising everywhere, it has been growing much more in the countries of the Former Soviet Union. Welfare outcomes have also been diverse as well as people's perception of welfare and happiness (EBRD, 2008). Some countries have thus done better than others in terms of growth, inequality or welfare.

When comparing the diverse experiences of transition, many discussions have turned around whether strategies or policies that delivered better outcomes were transposable or not. Would countries which did less well have fared better if they had adopted some of the policies that did better? Different opinions exist on that problem ranging from views about complete transposability of policies and institutions to views that are generally skeptical. Beyond transition, the general question is raised about the transposability of policies and institutions. This discussion has been most important in recent years with the comparative analysis of institutions. If certain legal or political institutions or even cultural values and norms lead to better outcomes than others, can these better outcomes be expected if institutions are transplanted (see *e.g.* Berkowitz *et al.*, 2003)? At an even more general level, this is the question of "external validity." In develop-

ment economics, there has been a wave of randomized policy evaluations to measure the effect and the cost-effectiveness of diverse health interventions like deworming, proper water infrastructure, or education interventions (reduction in school costs, provision of school breakfasts or school books, *etc.*). While the results of these studies are generally very precise and unbiased, the question is raised of whether the same interventions would work in the same way in other places.

The question of the transposability of transition experiences has direct policy relevance in the context of the future transition in North Korea. Nobody know as of now when and under which conditions the transition to capitalism will take place in North Korea. Nevertheless the question is raised of the specific transposability of the diverse transition experiences to the North Korean situation. The question of transposability has a double dimension here. The first is whether some successful transition experiences can be transposed or not or whether they worked only in a very specific context. The second dimension is that of the specific transposability to North Korea. Some transition experiences might be transposable in general but might not be, or only with important adaptations, in the context of the future North Korean transition.

In this lecture, I will focus on three policy areas: price liberalization, privatization (in a broad sense meaning the creation of the private sector) and institution-building. I will discuss arguments in favor and against transposability of the policies that worked best. I will also discuss more specifically the question of the transposability to the North Korean situation.

II. Price Liberalization

Price liberalization is an important component of any transition strategy as it concerns the change in the system for the allocation of resources. Prices did not play any real allocative role in the socialist economy. Free prices are the precondition to markets playing their allocative role.

Two main polices have been observed with regard to price liberalization: big bang or standard price liberalization and dual-track price liberalization. Under dual-track liberalization, all prices are liberalized at the margin but planned prices and plan contracts remain in place and are gradually phased out. In some countries like former Yugoslavia or Hungary, price liberalization has been gradual but I will not discuss that policy here.

One of the main arguments in favor of gradual price liberalization is to protect poorer consumers against the real income effect of price shocks, especially for basic foodstuff like bread, rice or cereals. This protection of consumers can be obtained with dual-track price liberalization if consumers have the right to buy certain quantities of goods at planned prices (usually far below market prices). One can thus conclude that any of the advantages obtained under gradual price liberalization can be obtained under dual-track liberalization. So, dual-track liberalization can be said to be pareto-superior to gradual price liberalization. In China, consumers could buy goods at planned prices in state-owned shops (whether those goods were rationed or not) and had to go on the market and pay market prices to buy additional quantities. The general principle of dual-track liberalization is that households and firms have the right to buy certain quantities of certain goods at planned prices. Firms also have the obligation to sell a certain quantity of goods at planned prices to other firms or to households.

We have observed that standard price liberalization has universally led to initial output falls (usually more than 10% though precise estimates are hard to make) while dual-track price liberalization did not lead to output falls but led on the contrary to output growth. The output fall observed in Central and Eastern Europe (but also to a certain degree in Vietnam where SOE output fell following price liberalization) has been one of the biggest puzzles of the whole transition experience. It was certainly unexpected and when it happened it took many years before economists could really understand what was taking place. The models by Blanchard and Kremer (1997) and Roland and Verdier (1999) gave explanations based on contract theory and institutional analysis. The former explained the output fall by inefficient bargaining due to deficient judicial institutions while the latter explained it by search frictions related to the absence of market institutions and Williamsonian investment specificy. More generally, price liberalization relieved enterprises from their planned obligations. This led to major production disruptions while the lack of preexisting market infrastructure or market institutions did not allow the nascent private activity to compensate for the production disruptions. While new explanations may still challenge existing theories of the output fall, it is uncontroversial that dual-track price liberalization (see Lau, Qian and Roland, 1997, 2000) did not lead to a fall in output. This is so by construction. Indeed, since existing planned obligations must be

met under the dual-track system, production disruption cannot take place by definition, that is if the plan track is enforced. Output can only increase as new profitable opportunities for trade and production are made on the market track.

Dual-track liberalization was implemented only in China, not in Central and Eastern Europe. Attempts to introduce forms of dual-track price liberalization were rejected politically. Russian economist and academician Valerii Makarov had proposed in 1989 a form of dual-track price liberalization as was implemented in China from 1984 onward. His views were not followed and standard price liberalization was implemented in 1992. A form of dual-track price liberalization was envisaged between former CMEA countries in 1990 and between former Soviet Union countries in 1992 under the initiative of the European Union. The idea was to organize a form of payments union (as had existed in Western Europe in the Fifties, before current account liberalization) making it possible to maintain existing international contracts for exports and imports that were stemming from CMEA relationships. The concern was indeed to avoid a major trade and production disruption following liberalization of foreign trade prices in transition countries and the introduction of hard currency (US dollars and Deutsche Mark at the time) as payment in foreign trade contracts. The main fear was that firms might not have access to hard currency and therefore would not be able to fulfill their payment obligations which would lead to production disruption. Also, there was not really the idea of keeping planned prices for these foreign trade transactions. Nevertheless, the goal was to create a framework to allow a smooth continuation of existing import and export links between firms while they were looking for better outside options to replace those that had been established by CMEA, the organization for planning imports and exports between the Soviet Union and its satellite countries. It is this last aspect that has a flavor of dual-track. We will never know how close to the dual-track those arrangements would have been since they never saw the light of the day. They were rejected for political reasons. In the case of Central European countries, the new democrative governments wanted to definitively cut their economic dependence towards the Soviet Union which still existed in 1990 when the CMEA collapsed. Trade disruption was seen as a cost to be paid to cut the "umbilical cord" to the Soviet Union which had occupied those countries militarily and kept them in a state of political dependence.

Given the important output fall and trade disruption that occurred

following price liberalization, should one conclude that Central and Eastern European countries made a mistake not to introduce dual-track liberalization? This is a controversial proposition that has met with a lot of skepticism. The main argument that has been used in that context is that the Chinese dual-track system was not transposable to Central and Eastern Europe. The argument is quite simple. Since the planning system was collapsing or had collapsed in the beginning of transition, it would have been impossible to implement the dual-track system. Production plans were less and less obeyed in the countries where central planning still existed but in many countries such as Hungary, Yugoslavia or Poland, the system of mandatory planning did not exist any more by the time price liberalization occurred.

The argument against transposability is however not as straightforward as it seems. While it is uncontroversial that mandatory planning (the obligation of enterprises to fulfill the plan targets they were assigned) had been abolished in various countries and was collapsing in the Soviet Union, implementation of the dual-track does not require a fully fledged planning system or even the system of mandatory planning. All it requires is the enforcement of existing plan contracts. If SOEs were producing and selling goods to each other, all the dual-track system requires is the continued enforcement of those contracts. Hungarian or Yugoslav SOEs which were routinely making deliveries to each other at non market prices could be asked to continue to do so without having to reestablish mandatory planning. The way the dual-track system was implemented in China, it had the nice property of maintaining existing planned deliveries at planned priced. This preserved existing rents agents derived from the planning system (and possibly also allowed to increase rents by using secondary markets — to resell goods traded in the plan track on the market track or to subcontract planned obligations to more efficient market produceds). However, one can conceive of a milder form of dual-track that would not preserve existing rents but might still prevent output disruption, a worthy objective in itself. For example, one might ask firms to prolong existing sales contracts albeit at liberalized or renegociated prices, and provide credit or even subsidies to cover financial losses from existing arrangements (via soft budget constraints). This is a way of preventing output disruption while not necessarily preserving rents. This is in essence the philosophy of the various proposals of the European Union for an East European payments Union that were made at the beginning of transition. Seen

this way, the argument against transposability of the dual-track seems less convincing since it does not require any real form of planning but merely the ability of the government to enforce contracts, a much milder institutional requirement. Nevertheless, the argument against transposability still holds if institutions are weakened to such a point where the government is not even able any more to impose forms of contract enforcement between firms. This argument must be however qualified. We are not talking of any form of contract enforcement but of enforcement of contracts established under the socialist economy. These were typically not free contracts between firms but imposed from above by the government. Imposing contract enforcement of this type is arguably somewhat harder than enforcement of freely established contracts. The difference is however not that huge since contracts usually protect firms from their business partners wanting to renegotiate deals to their disadvantage. Contract enforcement thus always tends to impose constraints on firms whether these were previously agreed to or imposed from above. The argument against transposability thus hinges on the inability of the government to enforce contracts. There are good reasons to believe this was the case in Russia and in other countries of the Former Soviet Union, at least in the very early transition. In that case, we would have to conclude that the output fall that occurred in those countries was likely to be inevitable since it is related to their institutional weaknesses. Note that the same institutional weaknesses that make the dual-track non transposable also magnify the extent of the output fall since they increase the extent of inefficient bargaining.

What conclusions should we draw from this discussion for North Korea? The conditions of transition are more likely to be of severe internal institutional weakness and thus to resemble more, or likely be worse, than the situation in the Former Soviet Union. The central planning system of North Korea has not really been functioning any more in the last decades and most people survive from activities in the informal economy. Whatever the actual conditions of transition will be, they will happen after a sufficiently important political and institutional shock and meltdown of the repressive government apparatus. The conclusion would thus be that dual-track price liberalization is in all likelihood not implementable. This conclusion is worrying because it means that the output fall observed in other countries after price liberalization will also be inevitable. This might be less dramatic than in other transition countries given the bad shape of central planning

in North Korea. However, given the dramatic economic situation of North Korea, a further output fall from the existing situation may have catastrophic consequences for the population, possibly generating situations of widespread famine.

It thus seems appropriate in the North Korean situation to think of ways to buffer the consequences of the output fall for the population. The best policy recommendation would seem to be to establish a system of rationing tickets for basic foodstuff to avoid famine and the extreme consequences of the inevitable increase in income inequality following market introduction. This form of rationing has been implemented in many countries after a very damaging war. The U.K. for example under the government of Clement Attlee organized a large rationing system after World War II. Given our above discussion, this can be seen as a form of dual-track liberalization with a "minimum plan" protecting minimum consumption of the population. Obviously, it is important to encourage the fastest development of the free market at the same time. In order to avoid an output fall, it would also be desirable to establish rationing within the production sector but that may be close to impossible and one should not count too much on it, apart maybe from some key sectors but even that is not certain and will depend on the institutional situation at the beginning of transition. In that case, it seems reasonable to prepare for emergency imports and emergency aid to buffer the effects of the output fall after liberalization.

III. Privatization

In what follows, we take a broad view of privatization. By privatization, we understand the establishment of a private sector via the transfer of state-owned enterprises (SOEs) in private hands but also policies to encourage development of small private sector. Usually, privatization is understood only as the transfer of state assets into private hands. However, the organic development of a *sui generis* private sector should be seen as an integral part of the privatization process. There are several reasons for this. First of all, under socialism there was a bias towards heavy industry and the service sector was completely underdeveloped. The private sector in services thus needs to develop mainly via entry and expansion. Second, there was a bias towards large firms. Small and medium enterprises which form a large part of the private

sector, in poor and rich countries alike, were totally absent under socialism. A dense network of small and medium enterprises thus needs to be developed from scratch. Third, since people were not allowed to set up private firms under socialism, there is an inevitable learning process. One does not become overnight able to manage large private assets. Learning to develop management skills by starting from small enterprises is thus a natural path to become a successful entrepreneur. This learning process can be relatively fast but it is useful and less risky to develop one's skills by starting at a small scale. There are thus important learning externalities associated to the development of a small private sector.

Two important policy questions are raised in that context: 1) What priority to give to the privatization of SOEs versus encouraging entry? 2) What type of policy to adopt in the privatization of state-owned assets?

The general lesson from the transition experience is that it is better to give priority to entry policies. It is useful from that point of view to contrast the Russian experience on one hand, where priority was given to the privatization of state assets, and the Polish and Chinese experience on the other hand where the opposite happened: priority was given to the development of the small private sector and the transfer of state assets was either delayed or occurred in a gradual way. There is a general consensus around this lesson for many reasons.

First of all, the development of the small private sector does not require large investments. Street vendors who emerge overnight at the beginning of transition to buy goods in some places and sell them in others can quickly become shopkeepers and the more successful ones can grow by using retained earnings.

Second, the small private sector fulfills many useful allocative roles. The government has necessarily limited attention and can only focus on the most urgent allocative tasks but it cannot and never could perform well the thousands of small allocative decisions that can improve the welfare of consumers in so many different ways. The small entrepreneurs thrive on all the small arbitrages that they can make and the opportunities they can seize to make allocative decisions that yield profit and at the same time higher consumer satisfaction.

Third, because of the efficiency of the millions of allocative decisions taken by the new entrepreneurs, the development of the small private sector increases many incomes and consumer welfare relatively rapidly.

Fourth, as stated above there are extremely useful learning externalities for the new entrepreneurs. These externalities are there not only for the

entrepreneurs but also for their family and friends who can benefit from this experience and possibly become entrepreneurs themselves.[1]

Fifth, the development of the small private sector does not require sophisticated government oversight. One of course needs basic legal institutions to enforce contracts and protect property rights but this is different from sophisticated oversight needed by regulatory agencies for larger firms and firms with publicly traded shares. This element should not be neglected in the transition context. Government capabilities are necessarily very weak. Moreover, the needed regulatory oversight of larger firms to avoid monopoly formation, to protect shareholders, *etc.* cannot be taken for granted. Regulatory capture is an even bigger danger than in normal economies. Given the limited capacity of government, it is useful to focus on the relatively simpler task of encouraging the development of the private sector.

Sixth, the opposite priority creates strong pressures for a fast transfer of ownership of SOEs in the private sector which brings various disadvantages we discuss below. For now, it should be clear that a fast transfer of ownership of SOEs under limited government capability entails many dangers of rent-seeking and capture.

Seventh, the development of the small private sector creates strong constituencies for market economy. This allows to create momentum for further reform and to stabilize the existing gains from reform.

There is no reason that the lesson that it is better to give priority to entry should not be transposable, especially in the case of North Korea. The quick development of small and medium enterprises should be a cornerstone of early transition in North Korea. It can help lead to faster growth of the private sector after price liberalization than the fastest type of privatization. It would be tragic to repeat mistakes from Central and Eastern Europe. The development of the small private sector requires minimal institutional reform (easing enterprise entry, protection of property rights of entrepreneurs and simple contract enforcement) that can be focused on easily by new authorities.

Let us now come to the issue of which methods are best to transfer ownership from the government to the private sector. Two main types of privatization policy have been implemented in Central and

[1] Research by Djankov *et al.* (2005, 2006a, 2006b, 2007) shows that having family and friends as entrepreneurs is one of the most important determinants for becoming oneself an entrepreneur. Besides the learning aspects there are also other reasons why family and friends matter: to provide finance, network and psychological encouragement among others.

Eastern Europe: mass privatization like in Russia and Czech republic and gradual sales like in most other countries (for example Hungary or Poland). Mass privatization is usually a form of fast giveaway of state assets. In the Czech Republic, the giveaway was organized via a system of vouchers enabling citizens to acquire for a very low prices shares of enterprises. In Russia, enterprises were given away to the managers and workers.

Mass privatization has usually led to less satisfactory outcomes in terms of enterprise governance and economic performance. It has also tended to increase rent-seeking or government capture by firms. The reasons are rather simple and intuitive. First of all, mass privatization does not solve satisfactorily the question of how to allocate assets to those who would be able to manage them the most efficiently. Assets are allocated for example to the firm's manager as was the case in Russia and it is hoped that competitive bidding will put them in better hands later on through some kind of Coasian process of efficient bargaining. This hope generally did not materialize because institutions were too weak to make such Coasian bargaining possible. Another reason for the worse performance of mass privatized firms is that no mechanism was put in place to finance the restructuring investments necessary to improve a firm's performance. When assets are sold, the buyer automatically has such investment plans. Otherwise, the buyer would not be buying the assets in the first place. The reason that mass privatization increases rent-seeking is that since mass privatization is a politically decided method of allocating assets, the incentives to engage in rent-seeking to influence the decisions on how to allocate assets becomes stronger. Also, since no investment plan is provided to restructure the firm, the new owners will have incentives to engage in influence activities to receive subsidies and protection from competition. These disadvantages of mass privatization are not controversial.

The main and overarching argument in favor of mass privatization was a concern for speed of reform and a will to create irreversibility. Some arguments were also made in favor of the idea that mass privatization, by redistributing massively wealth to the population, would quickly create constituencies for the market economy. With hindsight, the arguments for speed appear to have been exaggerated. Indeed, the need for speed was usually motivated by the danger of a return of communists to power and by the expectation that managers of SOEs would engage in asset-stripping because they were expected to lose their job and

would behave like in an "endgame" situation. In 1989, communist conservative forces appeared still quite powerful in the former Soviet Union. This was used as a justification for a policy of burning bridges in Poland in 1990 and by Russian reformers in 1992. In hindsight, fears of a communist backlash were exaggerated. The communist systems imploded and there was never a very serious threat of communist backlash. Moreover, the predictions about "endgame" behavior by enterprise managers proved to be wrong. Many managers engaged in active enterprise restructuring even though there were clear examples of asset-stripping. Moreover, the arguments in favor of irreversibility of mass privatization proved to be less watertight as appeared initially. Indeed, since Putin came to power, privatization reversals have been taking place in Russia. Arguments for the quick creation of market constituencies via mass privatization neglected the rent-seeking and asset diversion effects that were observed in the countries where it was implemented. The scandals surrounding mass privatization have actually created constituencies against reform.

In the North Korean situation, arguments for speed of privatization are even less valid than in Central and Eastern Europe. There are no international communist conservative forces like in the Soviet Union in 1989 that would justify the need for speed to create irreversibility. On the other hand, the dangers of rent-seeking and "oligarch-type" behavior are very likely given the strong oppression of civil society in North Korea. Indeed, one has seen in Russia, where the transition happened following the collapse of communism rather than from a push from below, that entrepreneurial elements inside and outside the *nomenklatura* were able to appropriate state assets in a remarkably quick way without much protest from below.

To conclude, privatization should address efficiency considerations first and foremost. This lesson should clearly be valid in the case of North Korea. It would be dangerous to use privatization as tool of redistribution since it may trigger forms of rent-seeking that lead to forms of regressive redistribution. A different matter is the privatization of land for which creative thinking will be needed.

IV. Institutional Reform

There is a strange paradox in the transition literature. On one hand, there is a consensus around the idea that the transition experience has revealed the importance of institutions for successful development. This

idea is so influential that it can be considered one of the main lessons from the transition experience. On the other hand, the issue of how institutional reform happens and how to do institutional reform in the context of transition is still poorly understood.

It is not the case that economists have only discovered the importance of institutions after some of the major failures of transition in the Former Soviet Union in particular. Many economists have emphasized the importance of a proper institutional framework already before the beginning of transition. This thinking was based on institutional economics but also on mainstream contract theory. The "Big bang" reformers who were in the majority in the early transition period tended to mock ideas of institutional reform in transition by arguing that it is inappropriate to wait for perfect institutional reform to start key economic reforms. Besides polemics, how can we understand the fact that institutional reform proceeded better in Central Europe compared to Eastern Europe, a fact that has been documented quite clearly by Johnson *et al.* (2000, 2002a, 2002b)? What is the role of the EU accession effect in understanding this effect? Is it simply the case that the prospect of accession to the EU forced Central European countries to establish better institutions than in the Former Soviet Union? What is the role of civil society development? How important have pressures from below been in forcing institutional change? What is the role of culture? Does the fact that Central European countries belonged to the Austro-Hungarian empire play a role in explaining institutional differences? Or the fact that Russia missed the Renaissance and the enlightenment period?

Understanding the better institutional outcomes in Central Europe compared to Eastern Europe is however not the only question when thinking about the role of institutions in transition. Why was imperfect institutional reform in China associated to growth miracle? China ranks nowhere close to the top countries in any international institutional ranking. Why has its growth been so miraculous given the now rather well-established causal effect of institutions on growth (Acemoglu *et al.* 2001)? Why on the other hand was "perfect" institutional reform in East Germany, where the institutions of West Germany were imported via unification, associated to disappointing economic performance? Before asking what lessons from institutional reform are transposable, we need to understand better what are the lessons we have learned. There are some partial lessons that we can probably already draw today.

A first lesson is that the transition experience clearly showed that it was wrong to neglect institutional reform in favor of speed, relying on the Coase theorem. This was a clear mistake. Even though it is not possible to introduce perfect institutions from the start, it is very important to make sure that a minimal set of institutions are in place. What exactly that set is is not clear and also depends on specific country situations. Nevertheless, this is a first minimal lesson we can draw from institutional reform in transition.

A second lesson which nicely complements the first one is related to the Chinese experience. It shows that it is not necessary to have top-ranked institutions to achieve growth. The Chinese experience is an empirical fact. One possible conclusion we can draw from this is that countries only need to have "adequate" institutions at different stages of their development. We however do not understand well yet what it means to have "adequate" institutions. One way to understand adequacy is that institutions come in different shades of quality and that one needs higher quality institutions the more sophisticated the economic transactions in the economy. Another way of understanding "adequacy" is that institutions develop on the basis of a country's existing institutions and evolve from that basis. These are two different understandings of the concept of adequacy. Under the former interpretation, there is one set of first best institutions and the direction towards higher quality institutions is well known and based on best practice experience. One cannot necessary "afford" the first best and it is not necessary to. Everything depends on the stage of development. Under the latter interpretation, there is not necessarily a "first best" and adequate institutions are much more specific to local conditions. In the former case, the recommendation is that one should move towards first best practices and transplant them whenever necessary, albeit at a pace that depends on the functional requirements of the economy for the quality of institutions. In the latter case, institutional change should mostly be country-specific. Transplanting institutions from some countries to others (I am talking here about voluntary transplantation like that done by Japan in the late nineteenth century) requires examining the institutional complementarities, in particular the complex complementarities between fast-moving and slow-moving institutions. I personally am more in favor of the latter interpretation. One important complementarity is the one between culture and political and legal institutions. Culture (values, beliefs and norms of behavior) moves more slowly than political

and legal institutions. A change in formal institutions will work only if it can be understood and operated from within the existing culture. If not, cultural change is necessary but it takes a lot of time and persuasion. Change in political institutions may accelerate cultural change. However, on the whole it is unproductive to transplant legal or political institutions that are in opposition to the existing culture.

These are very general considerations. Are there specific lessons about "minimal" institutions or "adequate" institutions that one can draw in a useful way? My view, based on the experience both from China and Central and Eastern Europe is that the most important basic institutional reform in transition is to ensure that government bureaucrats have incentives to support reform. These incentives do not need to be first best. What counts is that they work in the right direction. Two lessons from China are important here: yardstick competition and fiscal decentralization.

Yardstick competition is probably the most important incentive system used to align the incentives of bureaucrats with that of reform (see Maskin, Qian and Xu, 1999). Regional leaders were given the objective to maximize the growth in their province or locality and those who showed the best performance received faster promotion. As a result, local leaders everywhere have been pro-growth. The same logic of yardstick competition can in principle be applied for other policy objectives such as environmental or social objectives. Obviously, if the party leadership had not been committed to growth and reform, it would not have happened. However, once the political will for reform was there, yardstick competition created pro-growth incentives and we know the results. In Russia, under Yeltsin, the top leadership simply gave orders to the administration, in the typical Russian tradition of bullying recalcitrant subordinate bureaucrats.

In a sense, one could argue that the logic of yardstick competition is not easily transposed since it works best in the specific environment of the Chinese bureaucracy where a career inside the party apparatus is still seen as extremely prestigious and attracts some of the best elements of the elite. This is certainly true. However, it does not mean that forms of yardstick competition will not work in other forms of government administration. They might not work as well but the incentive properties of yardstick competition are the same everywhere. The exact rewards and costs might vary, but that is another story. The important thing is that bureaucrats compete in a tournament-like situation rather than competing in rent-seeking.

Fiscal decentralization has worked well in the case of China and has also served as a system to create competition between various levels of government (see *e.g.* Qian and Roland, 1998). It has given the incentive to local governments to compete to attract factors of production, mostly capital in order to enhance their tax base. This competition has worked at the same time to keep the overall tax level down. The most important aspect of fiscal decentralization however is not that. It is the fact that local governments became residual claimants of their tax revenues (Jin *et al.* 2005). This means that the local authorities had a direct incentive to maximize the tax base and therefore to maximize local GDP. This stands in contrast with the Russian situation under Yeltsin where local governments were not residual claimants of their tax base (see Zhuravskaya, 2000).

These two institutional features, yardstick competition and fiscal decentralization, certainly account to a great extent for why the incentives of the Chinese bureaucracy were aligned with that of reforms. This is however certainly not the whole picture and we still need to understand better what are the main institutional features that have made China's growth miracle possible.

Even if we do not have the answers to all the questions about institutional reform, we may still use our very imperfect knowledge to formulate propositions on institutional reform in North Korea.

I would claim that simple legal reform introducing the titling of property, easy entry, contract enforcement, basic protection of property rights, minimum of law enforcement and judicial protection should have priority. These will be difficult enough to introduce (especially if the North Korean transition occurs in a situation of acute crisis) but they cannot be ignored. It would be useful to study the existing informal methods of contract enforcement in North Korea so as to design the legal system in a way that is close enough to the more efficient enforcement practices of the informal economy, or at least to derive some inspiration from the efficient informal practices so that the new laws have some roots in existing practices. Copying inefficient practices of course does not make sense.

North Korea has a better institutional anchor than the countries from Central Europe had: South Korea. Korea was separated for many decades but there is a keen desire in South Korea to help North Koreans to develop as fast as possible once a serious transition process starts there. The institutional anchor is stronger in many dimensions. The countries share a common history and culture as well as a

common language. There will be a will in North Korea to develop an economy that is as successful as the South Korean one. However, the East German experience should remind us that it is no panacea. The existence of South Korea is not at all a guarantee for a successful transition in North Korea. The most important negative lesson from East German experience is that it is necessary to avoid costly transfers that reduce incentives to relocate jobs. In the North Korean case, it will be important to put forward the importance of self-reliance of individuals and to limit transfers to emergency help in the beginning of transition.

Note that contrary to the East German experience, there are no large benefits to early unification but only important potential costs. I see two important potential costs: transfers and international instability. As the East German experience has shown, a rapid unification would force to give North Koreans the same rights to welfare and transfers than the South Koreans. This would entail a very large fiscal shock that might burden growth for years and would potentially have adverse effects on the transition process itself. Given the income gap between North and South, giving immediately access to the South Korean social safety would represent a large positive income shock and would reduce the incentives of North Koreans to engage in productive activity. The danger of international instability is very serious. We do not know what the Chinese reaction would be to a quick Korean unification but we cannot exclude the possibility that it might lead to serious military tensions in North East Asia as the Chinese might see this as an aggressive move orchestrated by the U.S. Given the very low level of multilateral institutions in North East Asia, this might lead to a dangerous international escalation that nobody might control. Unification of Korea will eventually take place but a slow and cautious approach is certainly recommended.

V. Conclusion

I have raised in this lecture the question of the transposability of the best transition experiences. I examined three important dimensions of transition from that point of view: price liberalization, privatization and institutional reform.

The experience of price liberalization in transition has shown the benefits of dual-track liberalization in order to prevent the output fall and also to avoid creating losers. A successful dual-track liberalization

is not easily transposed and the reasons for its success in China were not necessarily present in all transition countries. They are not likely to be present in North Korea. However, the positive experience from the dual-track system suggests that the establishment of forms of emergency rationing of outside aid to prevent famines in the beginning of the transition process may be a good substitute in North Korea for a full-fledged dual-track liberalization.

The experience of privatization in transition has led to a consensus view that entry of new private firms should have priority over the transfer of ownership of SOEs as a way to jumpstart the private sector. This lesson is certainly transposable to North Korea. Coming to the question of the privatization methods, gradual sales are preferable to mass privatization from the point of view of economic efficiency. The main advantage of mass privatization is that it gives the benefit of speed. There were some valid arguments for speed in the case of Central and Eastern Europe but there are few benefits of speedy privatization in the North Korean context and certainly few reasons to sacrifice efficiency in privatization for speed.

Institutional reform is a complex subject on which there has been too little research. The only consensus is that institutional reform is of paramount importance in the beginning of transition. In the case of North Korea, there is a need for basic reform to establish the protection of property rights, titling, easy entry and facilitate contract enforcement. The costs of an early unification of the two Koreas appear larger than the benefits but there is no doubt that unification will happen eventually.

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