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European or Post-Communist  
Capitalism?

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## **Economic Transition to European or Post-Communist Capitalism?**

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**Abstract:** Transitional period in the post-Communist countries is ended. Acceptance to the EU of the majority of countries in Eastern Europe and the Baltics (Latvia, Lithuania, and Estonia) has in essence already been decided. Unfortunately the economic (and not only economic) system of CIS countries is far from European style of capitalism. It is better to qualified as "post-communist capitalism", a society that can not be squeezed into the classic understanding of the word "capitalism" or any other theoretically generalized model of capitalism. The key reason for this phenomenon is what can be termed the "necroeconomy". The collapse of the Communist regime and the breakdown of command economy "stripped off" the post-Communist economies vis-à-vis the international market: it turned out that with rare exceptions (partially hydroelectric power, mining, and primary processing of extracted raw materials) all goods produced in these countries were incompatible with international standards and could not compete with the Western products due to low quality and/or high prices. The economy of that type can only be referred to as "dead" economy, or "necroeconomy" (in the old Greek language nekros meant "dead"). Only the efficient bankruptcy law must be an effective tool against necroeconomy.

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The collapse of the communist regimes in the countries of Eastern Europe and the USSR, along with the breakup of the latter, constitutes a fundamental historical event at the end of the twentieth century (Stiglitz, 1992, p. 137). All this can be regarded as a global process of transition to a market economy (Berend, 1994), and in terms of magnitude it can be compared with the Great Depression of the 1930s (Avtonomov, 1996, p. 11), or with the reconstruction of Europe after World War II (for example, Sachs, 1992).

At the present time, scholarly literature and international practice have come to employ the terms "transition economy" and "transition period". With the goal of avoiding different interpretations (for example, the "transition" from a capitalist economy to a socialist economy in the 1920s in the USSR (Bukharin, 1990), or the transition from a market to a plan at the end of the 1990s and beginning of the XXI century (Antachak, Guzhin'ski and Kozarzhevski (2001)), here the term will refer to the transition from an economy with a communist orientation to a market economy.

With the passing of more than a decade since the beginning of this historic process, by generalizing on the accumulated experience (for example, Åslund, 2002, Mitra, Selowsky and et al. 2002, Papava, 2005a, UNICEF, 2001), it is possible to draw a number of very important conclusions about the path already traversed in transforming a communist economy into a market economy.

Notwithstanding the plethora of scholarly publications on the subject of the transition period, there are no generally accepted criteria for determining its completion. But the simplest formal (and indeed external) resolution of this question seemingly suggests itself: if the European Union (EU) recognizes this or that country with a transition economy, as ready to enter its ranks, then in all probability one should concede that the transition period in this country has been completed, and that its functioning economic system for all practical purposes has become European type market-based.

As is well known, acceptance of the majority of countries in Eastern Europe and the Baltics (Latvia, Lithuania, and Estonia) has in essence already been decided. On the whole, one can interpret this to mean the completion of the transition period, that is, the period of transition to the European type market economy. In other words, these countries are "leaders" in passing through the transition period with success. Henceforth the discussion here will use the term "leaders" to designate these countries.

What about other post-Communist countries, and above all Commonwealth of Independent States (CIS) countries? Are they still in transitional period?

It is obvious, that these countries, that were "outsiders", are still far from emerging European capitalism (for example, Schmitter, 1997).

Capitalism by its nature is not homogenous (for example, Coates, 2000, Crouch and Streeck (eds.), 1997, Gwynne, Klak and Shaw, 2003, Hall and Soskice (eds.), 2001, Hollingsworth and Boyer (eds.), 1997). Transitional period in "outsider" post-Communist countries is ended, but unfortunately the economic (and not only economic) system of some of them is far from European style of capitalism. It is better to qualified as "Post-Communist Capitalism", a society that can not be squeezed into the classic understanding of the word "capitalism" (for example, Gwynne, Klak and Shaw, 2003) or any other theoretically generalized model of capitalism (for example, Brown, 1995, pp. 15-177, Coates, 2000, Crouch and Streeck (eds.), 1997).

The logic of this problem appears to be rather simple: if the collapse of the communist system was essentially simultaneous in the countries of Eastern Europe and the former USSR, it follows that initially all were basically in the same situation and, consequently, the dragging out of the transition period to European capitalism is an artificial delay in making reforms in the economy (and society more broadly). This all-inclusive answer itself contains many questions about the causes of the artificial slowdown in the process of reform, resulted post-Communist capitalism.

As the key to understanding the principal problems of post-Communist transformation in the countries of the "outsiders", it is expedient to conduct a comparative analysis of these countries with the "leaders" described above.

### **1. Institutions of Statehood**

The collapse of communist regimes in the countries of Eastern Europe and the Soviet Union, together with the nearly simultaneous emergence of fifteen independent states in lieu of the USSR, placed new problems on the agenda. The resolution of these problems transcended the framework of those schemas that had already become classic and that had occupied the science of economics in the course of all its prior history. Hence economic scholarship proved virtually powerless to provide a theoretically grounded answer to such questions as: how should one make the transition from a planned to a market economy? (Becker and Becker, 1997, p. 259, Stiglitz, 1996, p. 3). It is not surprising that this process of transition, especially in its initial phase, proceeded under the well-known method of "trial and error".

Against this background of the impotence of economic science to deal with the transformation processes, from the very incipience of the transition period one special circumstance of great importance was not taken into account: the presence of

institutions of statehood. In particular, the states that were formed as a result of the collapse of the federal formations (above all, the Soviet Union and the Socialist Federal Republic of Yugoslavia) and that were not the direct legal successors of these federal states lacked the institutions of statehood. As a result, from the very beginning their process of transition was compounded by the need to construct these institutions (Balcerowicz, 1995, p. 146, Papava, 1996a, p. 252, 1996b, p. 306-307, Milanovic, 1998, p. 3). It bears noting that the process of transition to a market economy and the construction of institutions of statehood in the former German Democratic Republic was considerably more simplified, since it had been preceded by union with the Federal Republic of Germany (for example, Barfus, 1995, pp. 58-66, Derlien, 1999).

Under these conditions, the implementation of economic reforms according to schemas that had counted on the utilization of the corresponding institutions of the state (which were lacking in these countries) was foreordained to failure. In all probability, the most graphic example of this point was the fiasco of the "shock therapy" that Georgia initiated from 1992, but did so in the absence of its own national currency (Papava, 1996a, 1999, 2005b, pp. 125-129).

The advantage of the "leader" countries, compared with the "outsider" countries, was the presence of institutions of statehood. That significantly simplified and, thereby, accelerated the resolution of tasks associated with the transition to a market. Nevertheless, this factor cannot be deemed decisive in delaying the transition to a market in the "outsider" countries, for there are the examples of Slovakia, Slovenia, and the Baltic countries, as EU member states, or Croatia, as EU membership candidate country. The latter were also as "outsider" countries after acquiring independence and lacked their own institutions of statehood; their example refutes the thesis about the fundamental impossibility of a rapid transition to a market amidst the process of creating these state institutions. As for the success of Croatia (for example, Anusic, Rohatinski and Sonje (eds.), 1995), Slovakia (for example, Jakoby, Kováč, Morvay and Gajdzica 2005) or the Baltic countries (for example, Valdivieso, 1998) in the matter of reforming their economies and, simultaneously, constructing the institutions of statehood, this is above all explained by the targeted thrust of measures adopted by the reformist governments in these countries (for example, Sachs, 1995). This, in turn, is explained by the human factor, about which more will be said below.

## **2. The Human Factor**

The human factor, as a rule, has a decisive significance in practically any economic process. The character and possible success of economic reform in countries with a transition economy depend, to a large degree, on the behavior of the person who finds himself in a transition process from *homo soveticus* (i.e., someone who was formed under the conditions of a command economy and hence someone who was suppressed by the state and totally dependent on it) (for example, Buzgalin, 1994, pp. 250-253) to the type of person characteristic of a market economy, *homo economicus* (i.e., someone whose driving motivation is to receive the maximum utility in his household and the maximum profit in his firm). The latter type takes into account all the changes that have overtaken this category in the post-Smithian era (for example, Avtonomov, 1998, pp. 57-201, Bunkina and Semenov 2000).

The type of person who carries out the process of post-Communist transformation is characterized here by the term, *homo transformations*. That is someone who cannot completely emancipate himself from fear of the state and from the habit of living at the latter's expense; such is the case even though he is gradually beginning to act on the basis of his own private interests to achieve maximum utility and profit (Papava, 1996a, 2005b, pp. 34-35).

Because of the fact that the communist regimes in "leader" countries ruled almost half as long as in the "outsider" countries, the type of person called *homo soveticus* did not have time to develop fully. At the same time, *homo economicus* was not totally eradicated, as happened in the "outsider" countries at the end of the 1930s. Consequently, in the "outsider" countries *homo transformaticus* was dominated by the characteristic features of *homo soveticus*; by contrast, in the "leader" countries, it was the features of *homo economicus* that prevailed. It is precisely this difference that explains the greater readiness of *homo transformaticus* in the "leader" countries to undertake the transition to a market-in contrast to the situation in the "outsider" countries.

In economic activities, *homo transformaticus* acquires a special form, the roots of which go back to the economic system with a communist orientation (that is, a command economy).

Even under the conditions of a command economy, market mechanisms (more precisely, its individual components) all the same cannot be 100 percent excluded. It was so repressed by the state that it existed only in the "shadow" sector (for example, Shokhin, 1989, pp- 57-83, Papava, 2005b, pp. 45-51, Papava and

Khaduri, 1997). Under the conditions prevailing in a command economy, not one director with rare exceptions in principle could run his enterprise without violating the laws that the regime had promulgated (for example, Andreff, 2005, p. 2). Hence, in individual cases, this activity was linked to the "shadow" sector. Despite all this, under the conditions of a command economy, such directors did not become (and, in principle, could not become) entrepreneurs of a market type, for their behavior was bound by the political press of the existing communist regime. It is precisely this that can explain the fact that those enterprise directors who made use of elements of the market type in their behavior were called a *Delets* ("slick operator") not "*predprinimatel*" ("entrepreneur").

After the collapse of the command economy, in the majority of cases the former *Delets* knew how to preserve his position as a director in the state sector. And during the process of privatization, he exploited the so-called "rights of labor collectives" and became the owner of his enterprise (Åslund, 1996). And, regardless whether he hired managers or not, especially in the initial phase of the post-privatization period, he endeavored to direct the activity of his enterprise by relying on the mentality of a *Delets*.

Just as *homo transformativus* is not yet *homo economicus*, nor could the former *Delets* – in the wake of the collapse of the command economy – be transformed into an entrepreneur. *Homo transformativus* in the entrepreneurial sphere acquires the title of "post-slick operator". Because of the exclusively Soviet origin of this phenomenon, in English it is expedient to retain the Russian sound and use the phrase "*post-Delets*" (Papava, 2005b, pp. 35-36, Papava and Khaduri 1997). In terms of the orientation of their values, the *post-Delets* differs little from the values orientation of his "predecessor" – that is, the *Delets* of the Soviet era (Sulaberidze, 1998).

### **3. Necroeconomics**

The overthrow of the communist regime and the collapse of the command economy (against the background of the world market) stripped bare the economy of the post-Communist countries. With some exceptions (in particular, some enterprises that produce hydroelectric power, oil and natural gas extraction, and the primary processing of raw materials), the goods produced in these countries proved unable to compete with world standards. That is either because of their low quality or high cost. The market for such goods does not exist and, in principle, cannot exist. An economy of this type, in our opinion, can be called a "dead econ-

omy", or "necroeconomy" (from the Greek word *nekros*, meaning "dead") (Papava, 2001, 2002, 2005b).

It should be noted that a "necroeconomy" would be similar to the Gaddy-Ickes "Virtual Economy" (Gaddy, Ickes, 1998, 2002, Woodruff, 1999a, 1999b, pp. 174-175), although the term – "Virtual Economy" has a much broader sense (e.g. Carrier and Miller (eds.), 1998, Potemkin, 2000).

The process of exposing the command economy can be characterized as an antonym to the term "investment" – that is, "divestment" (Drucker, 1986, Taylor, 1988). The latter term signifies the removal from the post-Communist economy the pathology of a "misdeveloped" economy (Lipowski, 1998). The result, in my opinion, is the formation of a necroeconomy.

Naturally, when some part of an economy is moribund, the remaining part is viable. Provisionally, one can term the latter the "vital economy", or "vitaconomy" (from the Latin word *vita*, or "living"). Vitaconomy is the same as market economy in traditional understanding of this term.

The main question that needs to be answered is this: what do the necroeconomy and vitaconomy have in common, and in what respects do they differ?

The necroeconomy, like the vitaconomy, can produce goods. That is, in practical terms, there can be "supply" (for example, Sánchez-Andrés and March-Poquet 2002, p. 10). However, in contrast to the goods produced by a vitaconomy, there is no "demand" for the goods produced by the necroeconomy (because of their inferior quality or high cost). Consequently, the necroeconomy excludes any transaction of buying and selling. In essence, this precludes an equilibrium price.

If a certain segment of the economy is moribund (that is, its survival is impossible), then in principle there should not be any problem. According to common sense, a moribund economy cannot have any influence on its "vital" part.

Under the conditions of a market economy, this is precisely the way things are. Uncompetitive goods just "disappear", and in fact this does not create any problems for the remaining part of the economy. This can explain the limited nature of the research on economic theory in dealing with the problems of a market economy, for the latter simply does not have, in principle, a necroeconomy.

The countries now undergoing the process of post-Communist transformation find themselves in a fundamentally different position. In these countries, the necroeconomy was formed on the basis of the material and technical foundations of the former command economy.



For purposes of revealing the mechanisms of interaction, the necroeconomy and the vitaeconomy of the post-Communist economies can be understood in the following way.

It would be helpful to break the entire organism of post-Communist economy into the following groups:

- The necroeconomy in the state sector
- The vitaeconomy in the state sector;
- The privatized necroeconomy;
- The privatized vitaeconomy;
- The vitaeconomy, created by new private investments.

The first group, as a rule, includes primarily the large and medium-sized industrial enterprises. Based on the use for which their goods are intended, these are regarded as strategic. However, because their production is not competitive under market conditions, they are "dead".

The main vitaeconomy in the state sector consists of enterprises that mainly produce energy (above all, the production and transmission of electric power and the extraction and delivery of natural gas and petroleum) or that are involved in transportation and communications. In the event of privatization, these shift to category four in the above list (i.e., as part of the privatized vitaeconomy). This group can also include certain medium-sized and primarily small industrial plants (prior to their privatization).

Category three includes enterprises from the first group after their privatization. The change in the form of ownership, by itself, has absolutely no effect on these dysfunctional enterprises, for the condition of the "corpse" does not change, whether it has form of state-owned enterprise or that of a private firm. To ignore this fact is the basic cause of the relative discrediting of the process of privatization. That occurred when, in its initial state, in isolation from the process of investment, the function of putting moribund enterprises to work was undertaken. This was done without regard to whether each concrete enterprise was really "vital" or "dead".

The final, fifth category consists of the healthiest part of the post-Communist economy. It has been newly created under the principles of a market economy and on the basis of private investment. Despite this fact, the fifth category also has certain problems that demand corresponding consideration. In particular, this concerns certain foreign investments. On the basis of such investments, post-Communist countries do not attract the most modern technologies, but rather technologies that were in use earlier and, by

world standards, can be regarded as obsolescent. The appropriate terms for such technology and investments, in my opinion, are the terms "*second-hand*" technologies and "*second-hand*" investments; in Russian terminology, the corresponding term would be the stores that sell used goods, the "*komissionka*": technologies from *komissionka*. The products produced with these goods are competitive only within the framework of emerging markets, and for a limited period of time (that is, until goods competitive by world standards are able to penetrate these markets).

The following question that arises for discussion is this: what causes the durability of the necroeconomy in post-Communist countries?

One can find the answer to this question by drawing on the evolutionary theory of economic change (Nelson and Winter 1982).

The basic "instrument" of this theory is the concept of "routines". The latter refers to the rules and methods of conduct of firms that regulate their behavior and production (Murrell, 1992a, 1992b). It should be pointed out that, in the Russian language translation, the term "routines" is often replaced that the word "stereotypes" (for example, Sadygov, 1999, pp. 12-15).

It is precisely the "routines" (formed in the course of many decades within the core of the command economy) are the main factor in causing the "dead" enterprises to work even though the command economy itself no longer exists. As a result, their warehouses are filled with uncompetitive goods. But, because in principle it is impossible to sell these goods, such enterprises pile up hopeless debts to the state budget, to the social sector, to the energy sector, and other enterprises. The result is the creation of a tangled web of mutual indebtedness of enterprises (Åslund, 1995, Ch. 6).

According to the traditions established in a command economy, when an enterprise amassed debts (sometimes deliberately so), its director appealed to superior state organs (in the leading organs of the Communist Party, Gosplan, and Ministry of Finances) to write the debts off. As a rule, they achieved their goal. Given this situation (namely, the existence of a virtually unlimited, indeed guaranteed, possibility of writing off debts), the leaders of enterprises did not regard the accumulation of debts as something dangerous. This mechanism of writing off debts is the basic underlying "routine" that, unfortunately, periodically manifests itself in post-Communist countries in different varieties of a "tax amnesty" (Nikolaev, 2002, Shul'ga, 2002).

Of fundamental importance is the fact that precisely the *post-Delets* stands behind the necroeconomy – both in the state and in the private sectors. It is exactly people of this type who appear to be the initiators of behavior that corresponds to the

routines of a command economy. The *post-Delets*, by making use of his connections, penetrates the state structures (both the parliament and the government), and with his influence endeavors to justify himself politically and to prolong the existence of the necroeconomy.

Without qualification one can say that the necroeconomy serves the interests of the *post-Delets*. And until such people are "replaced" (on the basis of the corresponding institutional reforms) by real entrepreneurs, the necroeconomy will always have a solid base under it.

The obviously negative influence of the necroeconomy on the development of the "outsider" countries is beyond doubt. Consequently, it is necessary to expose and put into play that mechanism that is characteristic of a market economy and that will automatically resolve the problem of "dead" enterprises. In other words, this mechanism must ensure the universal application of market principles in the economic order. The key to solving these problems lies in the evolutionary theory of economic change cited above.

The government should devote special attention to the fifth form of the post-Communist economy: the private sector created exclusively on the basis of private investments. The state should promote its consolidation and expansion; it should take steps to create a stable political and macroeconomic environment when new firms are created through private investments. It is necessary to bear in mind that the formation of "routines" in this group of firms continues to pose a great danger.

The main priority of the economic policy of the post-Communist state should be to reduce the natural habitat of groups one and three by encouraging, at every level, the expansion of group five. In spite of the natural "unattractiveness" of those firms in group five that were created on the basis of "second-hand" investments, under the conditions of the existence of the requisite legal basis, it is practically impossible for these to become the source of a necroeconomy. That is because the formation of these firms derives from the principles of a market economy. As a result, if these lose their competitiveness, and if they are subordinate to market mechanisms, the corresponding "routines" of such firms ensure that they will simply disappear from the landscape.

As for the second and fourth groups, regardless whether the concrete firm still belongs entirely to the state or has already been privatized, it urgently needs to attract new investments by selling a corresponding share of its property or, at the very least, by transferring the rights of control for a long-term period to a strategic investor. In the contrary case, the probability will significantly increase for the vitaeeconomy that the

second and fourth categories will degenerate into the necroeconomy (corresponding thus to the first and third categories).

As noted above, privatization by itself does not lead to the eradication of the necroeconomy. Consequently, to ensure the viability of those enterprises in the first category that are deemed strategic in their purpose, the state has only one option: it must conduct an open international tender. The purpose here is to discover a strategic investor, who will be given the specific "dead" enterprise with the right to control it on a long-term basis. More precisely, that investor will not be "given" the enterprise, but rather the right to begin the corresponding production (whatever is deemed to be strategic for the given country) within the walls of the "dead" enterprise. One cannot exclude the possibility that this step may prove insufficient for the strategic investor. In that case, the state must proceed to the privatization of the given enterprise, even if sold at a nominal price, for the "dead" enterprise cannot be expensive.

As for the third group, the privatized necroeconomy, there are absolutely no favorable prospects whatsoever.

#### **4. Final Remarks**

The sole correct assessment for the overwhelming majority of the material and machinery base of the necroeconomy is that this is nothing more than metal. Consequently, the eradication (in the direct sense) of the necroeconomy is possible by the direct sale of scrap metal (including export sales), for this export of scrap metal will give the owner a return in hard currency. In principle, this can be used to create the vitaeeconomy.

The "routines" that correspond to a command economy are preserved, for there is resistance to recognizing the fact that "dead" machines and equipment are nothing more than metal. The lack of such a recognition prevents (and at times encourages a ban) on selling these, especially for export. As a result, the necroeconomy continues to exist.

Theoretically, it is clear that an efficacious mechanism for destroying the necroeconomy is directly associated with the law on bankruptcy. The examples of the "outsider" countries show that, although the law on bankruptcy (the draft of which was prepared by foreign experts on the basis of world experience) was confirmed by the parliaments in mid 90<sup>th</sup> ago, it unfortunately proved stillborn (Sánchez-Andrés and March-Poquet 2002, pp. 10-11). In other words, it was a "*necrolaw*": nor a single enterprise that is in fact bankrupt has been juridically recognized as such. This is explained by the fact that this law was not "inscribed" into the existing institutions in the country.

What happened with the laws on bankruptcy in "outsider" countries is a graphic confirmation of the fact that new institutions in post-Communist countries, which were created under the pressure of international financial organizations (according to Western models through the conscious, direct imitation of Western originals) often, prove unviable. And in the worst case, they can also precipitate negative effects. Here it is appropriate to recall that the International Monetary Fund is often subjected to well-grounded criticism because of its forced (and, simultaneously, simplistic) approach to institutional reforms. As a result of this, the process of establishing a market economy suffers (Stiglitz, 1999).

Destruction of the necroeconomy is possible solely by creating the appropriate to a market economy institutions (Polanyi, 2001) that can promote the process of post-Communist transformation (Hare and Davis, 2006).

The fact that the "leader" countries have been recognized by the European Union as practically ready for admission to its ranks attests, in principle, to the fact that the necroeconomy does not exist in these countries. As for the "outsider" countries, the main cause of the delay in the transition to an European market, European style of capitalism is the necroeconomy. That creates the economic basis for post-Communist capitalism.

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