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# The Evolutionary Transition to Capitalism

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EDITED BY

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## Reform's Rhetoric-Realization Relationship: The Experience of Mongolia

*Peter Murrell*

Despite its over-alliteration, the title of this chapter is a serious one. These reforms are occurring in the former socialist countries, from Budapest to Beijing. The rhetoric of reform refers to the tenor and the level of ambition embodied in the government's initial comprehensive statements of its approach to reform. Thus, the rhetoric of reform is primarily its philosophy at the outset together with the character of the set of policy measures that the government initially aims to implement. Realization connotes the nature and effectiveness of the measures that are actually implemented. In this chapter I examine the relationship between rhetoric and realization, arguing that it is not a simple monotonic one. At some point, advances in rhetoric can be counterproductive for realization.

Although the argument of this chapter is purely positive, it does have normative implications. A basic tenet of the radical approach to reform is that the implementation of reforms will be more effective the more ambitious their rhetoric.<sup>1</sup> If this is the case, little is to be gained from considering society's existing institutional structure and its knowledge base when formulating overall reform strategy. But if this tenet does not hold, the

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existing state of society becomes central in guiding the overall philosophy of reform. The design of reforms will not be a simple matter of picking complete, ready-made programs off the shelf. Rather, although lessons from the experiences of other countries will be helpful, even the broad agenda of reform has to be carefully calibrated to the existing features of society.<sup>2</sup>

The argument is conducted in two modes. The first section proceeds on an a priori basis, making connections between rhetoric and realization on the basis of simple theoretical arguments. The separate elements of that section contain a common component arising from the view that society's stock of knowledge is an important determinant of the effects of reforms. This stock of knowledge is a critical ingredient of the informal structures of society that must support the institutional and logistical arrangements necessary for the productive progress of reforms. Because political leaders can change only the formal structures in the short run, whereas the informal elements are historically derived and change slowly, there arises the problem of a possible mismatch between these two.

The second section establishes a data point supporting the a priori argument by examining the progress of reforms in Mongolia. Until the end of 1990, Mongolia was under the hegemony of the Soviet Union and the economies of the two countries were integrated. Hence, there are strong parallels between the case of Mongolia and those of the successor states of the Soviet Union, with events in Mongolia ahead by one year. In 1991, Mongolia aimed to implement extremely ambitious reforms, but in a very unfavorable economic environment. This section focuses on the realization of these reforms in four important areas: price liberalization, privatization, the legal system, and the development of the nascent private sector.

#### Can More Haste Mean Less Speed?

The following arguments are suggestive rather than conclusive. The purpose is simply to show the theoretical possibility that rhetoric and realization can be inversely related. Ultimately, whether this possibility comes to fruition is an empirical question, which is addressed for one country in the section on Mongolia.

#### *Personal Knowledge*

Society's stock of knowledge is a crucial input into reform—the knowledge held by policy-makers deciding on major goals, by officials implementing economic measures, and by the populace at large. The relevant knowledge stock includes a broad range of phenomena.<sup>3</sup> There are the judgments of policymakers on the trade-offs available to society, for

example, between inflation and efficiency when using price controls. There are the implicit models that officials use when interpreting the results of policies, for example, in deciding whether a perceived increase in the money supply is a reflection of statistical inadequacies or of important problems in monetary control. There are society's general attitudes on the nature of economic activities, for example, on the role of speculation and speculators in a market economy.<sup>4</sup>

It would not be so important to focus on the role of knowledge in reforms if all knowledge were acquired through straightforward technical learning. But this is not the case. Knowledge is a product of history as much as of formal lessons. An important component of intellectual capacity is "personal knowledge," acquired in practical situations, in learning by doing, in apprenticeship (Polanyi 1962). Such knowledge cannot be transferred simply in a formal process; it is learned in, and applicable to, a specific context.

Politics, policymaking, and policy implementation are as much skills as techniques and as such they employ the application of personal knowledge.<sup>5</sup> These activities require personal knowledge in the very framing of questions, the diagnosis of problems, and the interpretation of the activity of others. Thus, the whole process of reform uses this historically derived knowledge.

To see the implications of the forgoing points for reforms, let us take a simple example. Suppose that the architects of a radical reform have sufficiently escaped the historical specificities of their own country's knowledge base, that they are able to design a workable market system *de novo*.<sup>6</sup> In contrast, the implementers of reform have a knowledge stock that is more reflective of the history of their own society. There will thus be more error in interpretation, and less accurate implementation of the reforms, the farther the rhetoric of reform from the scenario in which the personal knowledge of the implementers was acquired. Hence, it is plausible that the effectiveness of implementation will decrease as the level of rhetoric increases above some level. In an extreme case, a policy measure might seem so theoretical to its interpreters that implementation is simply impossible.

The argument here is simply stated as the possibility that there can be mismatches between the rhetoric of reform and the extant personal knowledge. Some reforms simply cannot be implemented given the knowledge base of society. A rhetoric with too much ambition might immobilize implementers from looking for reasonable alternative reforms. The severity of these problems will increase the greater the gap between the programs envisioned in the reform rhetoric and the historical experiences that have provided the greatest inputs into the personal knowledge of society.

### Customs, Habits, Routines

Consider an activity such as the generation of revenues for the budget (that is, tax collecting in market economies). This activity is invariably conducted by large, complex organizations. Here I emphasize three elements of the behavior of such organizations noted by Nelson and Winter (1982, especially ch. 5). First, these organizations function by carrying out a fairly constant set of activities, or routines. Second, organizational memory, and therefore organizational productivity, are retained by the use of the routines: Organizations remember by doing (Nelson and Winter 1992, p. 99). Third, routines are used as control and monitoring devices within the organizations—they are instruments of organization, as well as instruments of production.

Reforms inevitably imply a change in the functioning and behavior of a large number of such organizations. For example, the authorities charged with generating budgetary revenues in former socialist countries will have to turn to the collection of explicit sales and income taxes, rather than the implicit trade and turnover taxes of the old regime. Thus, there is the question of how much of an advance, and how quick a move, one should ask of such organizations.

Asking an organization to adopt a wholly new mode of behavior might lead to such a deterioration in organizational memory and organizational controls that the advantages of a potentially more efficient mode of operation are outweighed. The rhetoric of a radical advance brings the existing routines into immediate disrepute, which leads to a deterioration in the instruments of organizational control. The rhetoric's stigmatizing of existing modes of behavior means that potentially productive elements of present routines cannot be salvaged. Innovation in the neighborhood of the present structure, perhaps the only innovation possible for a large complex organization, is disdained. Therefore, routines are rejected rather than invested with a new content that might well produce significant reforms because some reforms might not measure up to the rhetoric.<sup>7</sup>

There are obvious parallels between the arguments here and that of the subsection pertaining to personal knowledge. Indeed, both arguments might be cast in a wider framework, in which customs, habits, routines, and inherited personal knowledge are alternative means of describing related phenomena (North 1990). Each of these phenomena rely on different underpinnings, but the terminology and theoretical background are not as important here as the general conclusion. Rather, the general result relies upon noting that when there is a large component to knowledge and behavior that is historically derived, the attempt to impose change becomes vastly less productive the farther the theory and philosophy guiding change from the domain of experience.

### Pressure from Society

Almost by definition, radical reforms are implemented in a top-down process by an elite, whose knowledge base and concerns are very different from those of the rest of society. Given its revealed preference for the radical model, the leadership will almost certainly have a much more favorable view of the benefit-cost ratio of the new arrangements than does the rest of society. The preference for and the understanding of the new arrangements will diminish the further one moves from the governing elite.<sup>8</sup>

Reforms generate rather large up-front costs. In fact, this might be the very essence of radical reforms.<sup>9</sup> Hence, public protests are most likely to arise early on in the reform process. Given the informational asymmetries previously postulated, it is quite possible that these protests might come to focus on the ambitious but as yet not implemented rhetoric of the leadership. The progress of reforms might be halted before the genuinely constructive elements can be implemented.

The dynamics of rhetoric, protest, and retreat arises if the populace cannot adequately distinguish the rhetoric of reforms from the extent of the implementation of reforms. Such discernment is unlikely. The public at large faces a rather difficult signal-extraction problem. It is in the process of observing attempts to implement a new system. Only observations of the early effects of reform are available as data. The rhetoric of reform offered by the leadership simply complicates the signal-extraction problem. By attempting to persuade the public that a new economic system can be put in place quickly, the leadership might diminish the public's ability to differentiate between the costs of change and the benefits of the new system that is the goal of reforms. As a result, public pressure might cause a rejection of the new system even before its main elements have been put into place.

In Mongolia, protests against the effects of reforms focused on the supposed behavior of the private sector even before it had risen to any level of significance. Top political leaders viewed the public as believing that the emergence of the private sector was a cause of inflation and that the decline of living standards was a result of the exploitative behavior of the new private sector. Independent of the veracity of this belief, politicians had to react because of popular pressures. They introduced anti-reform measures.<sup>10</sup> The popular reaction against the reforms culminated in Mongolia's second parliamentary election of June 1992, when seventy-one out of seventy-six seats went to members of the old Mongolian People's Revolutionary Party (MPRP), whose substantial conservative wing was advocating a slower reform than were other elements of the political spectrum. A common interpretation of that result was offered by the *Economist*: "The coalition [of Democratic parties] offered accelerated

economic reform to an electorate that associates two years of free-market reforms with hunger and unemployment."<sup>11</sup>

### An Example: Mongolia

An examination of developments in Mongolia provides some modest empirical support for the proposition that there can be an inverse relationship between rhetoric and realization. I begin by positioning the Mongolian reforms on the rhetoric scale. I turn to the realization of reforms in four key areas.<sup>12</sup>

For the seven decades preceding its democratic revolution of 1990, Mongolia was the de facto sixteenth republic of the Soviet Union. Mongolia's industrial base was created by the Soviet Union and its international trade was carried out almost wholly within the Council for Mutual Economic Assistance (CMEA). The Mongolian elite was educated primarily in the Soviet Union; Mongolian educational institutions and their economics curricula were based on the standard Soviet model. The reformist government, formed after the country's first free elections in 1990, therefore faced all the problems of reform that are typical of the other countries of the old Soviet bloc.

The new reform government was a coalition, numerically dominated by the former communist party, the MPRP. However, in the first years of reform, political parties had little cohesion and personal relationships among the elite were as important as party loyalties. Therefore, it was possible in late 1990 for the prime minister, a member of the MPRP, to hand over the reins of overall reform strategy to a group of ambitious young economists, most of whom were no longer members of the MPRP. One year later, it was possible for the MPRP to disclaim responsibility for economic matters and for the new democratic parties to claim the reform policies as their own.<sup>13</sup>

In the months following the prime minister's announcement of reforms, enthusiasm over the pace of reforms almost reached euphoria. The common interpretation of events was provided by *Far Eastern Economic Review*: "The vigour with which Mongolia's landscape is being transformed derives from a group of young, forceful economists, who occupy key positions in the new government ... and who embrace the views of prominent Western economists such as Harvard's Jeffrey Sachs, who has helped to devise fast-track reforms in Eastern Europe. With the help of the IMF and the World Bank, they hope to establish a market economy in two years of what is certain to be a wrenching transition."<sup>14</sup> The enthusiasm spread from the chief architect of the reforms ("The change in Mongolia is not as rapid as we would like, but comparatively on an international basis it is phenomenal"), to the Western press ("a

lightning programme to introduce capitalism"), to experts lending technical help ("the speed and competence with which Mongolia is striving towards a free-market economy"), and to aid donors.<sup>15</sup>

This then was the rhetoric. Realization proved to be different, even at the time of greatest euphoria concerning the events in Mongolia. I now turn to some of the policy developments. There is no attempt to provide a systematic overview of the Mongolian reforms but rather an attempt to provide synopses of developments in four crucial functional areas of reform.

### The Progress of Price Liberalization

Price reform—and other serious reform—began in January 1991 with the enactment of a resolution that officially freed the prices of a reported 60 percent of goods and listed a number of products and services whose prices were to remain controlled "at the initial stage of the economic transition."<sup>16</sup> Even before this measure, the government had announced a commitment to move to a free-price system, with only temporary controls on some goods aiming at protecting the poorest segments of the population.<sup>17</sup> The spirit with which this measure was introduced was captured in the statement that the resolution would "leave its traces in the history of Mongolian society."<sup>18</sup>

As reforms proceeded, the government reaffirmed its intention to continue a program of rapid price liberalization. It announced that farmgate prices of all agricultural products would be freed following the fulfillment of the 1991 state orders. A measure passed in September 1991 was said to have halved the number of prices subject to government control.<sup>19</sup> The head of the Ministry of Trade and Industry's Price Policy Office claimed in November 1991 that the prices of more than 90 percent of Mongolia's goods and services had been freed and that the prices of fuel, power, and agricultural products had almost reached world-market levels.<sup>20</sup> In early 1992, more steps toward decontrol were announced, culminating in a March resolution that left only flour products, transportation, utilities, fuels, and medicines formally subject to controls.<sup>21</sup> The rhetoric of official announcements therefore tells a story of a transformation from almost total price control to almost total decontrol within fourteen months.

The actual implementation of price control was somewhat different from the official picture. In fact, each of the arguments of the previous section of this chapter seems relevant for price policy. The basic instruments of fiscal and monetary control were not in place and the top personnel in the relevant departments had none of the practical experience necessary to implement new systems of control in a rapidly changing market environment. Those in control of policy, even the radical reform-

ers themselves, were willing to use the familiar old techniques that were thoroughly inconsistent with the new policy.<sup>22</sup> The populace had little understanding of the sources of inflation in a market economy. As a consequence of each of these factors, the developments in price policy deviated a great deal from the ambitious announcements.

Despite the successive central government resolutions on price liberalization, measures that interfered in price setting abounded. For example, in a reflection of the argument that personal knowledge is important in the implementation of policy, the implementing order issued in connection with the initial price-decontrol measure required all economic entities, public and private, to comply with rigid procedures in pricing all products and services whether or not these prices officially remained under government control. These procedures included registering prices with "price-setting bodies" and the establishment of price committees within economic units, which would include representatives of buyers and of central or local agencies.<sup>23</sup>

In response to the political pressures arising from the perception that economic problems were caused by price decontrols, new forms of controls were issued. Some important measures gave local governments new authority over prices. In a reflection of the old practice of using enterprise surpluses as revenue sources, a measure introduced in October 1991 ordered the confiscation of all profits resulting from price increases that were deemed excessive.<sup>24</sup> The government commission responsible for implementing this measure interpreted it as applying to all producing entities, whatever their legal status, and to all prices.

Before reforms began, Mongolia had a fairly consistent and integrated set of price controls administered by a single hierarchy. After eighteen months of reform, a host of organizations and individuals had become involved in matters of price policy. Individual politicians at the highest levels intervened to control specific prices.<sup>25</sup> In companion with tax collection activities, the Ministry of Finance assumed responsibility for the collection of profits deemed to result from excessive price increases. The Ministry of Agriculture and the Ministry of Trade and Industry ran the old agricultural procurement system using fixed prices, in apparent contradiction with official government policy. Even new organizations, set up to aid in the transition, participated. Commodity exchanges, instituted to replace the old distribution system, provide an example: Flows of goods were forced through them and they were used to influence the prices of goods produced by supposed monopolies.

Hence, although the Mongolians have abandoned their old system of price control, prices are certainly far from being free. There are more individuals in the government directly influencing prices than ever before. The prices of the private sector, which had not been previously

controlled, are now subject to controls. Thus, it is plausible that the Mongolians might have greater intervention now into market pricing than if the top leaders had advocated a less precipitate route. But even more important is that there has been the creation of new price-controlling institutions that might attain some degree of permanence given their embeddedness in the new power structures.

#### *Privatization and the Security of Property Rights*

The central objective of privatization is to create a group of actors in society whose power, goals, and decisions are fundamentally separate from those of the state. There are two interrelated reasons why such separation is desirable. First, efficiency and growth are enhanced by the autonomy of economic units. Second, the independent power base of the autonomous units leads to pressure on the government for the further pursuit of reforms and for the maintenance of efficient market-oriented policies. The goal is not privatization per se but rather an economy and polity propelled by autonomous private property rights.

In pursuing these objectives, privatization must satisfy two necessary conditions. First, there must be formal transfer of clear ownership title from the government to individuals. Second, the recipient of the title must have a clear understanding of the nature of the property rights received and should feel that these rights are secure, especially against arbitrary government intervention. If the nominal transfer has been accomplished but the second condition has not been satisfied, then little might distinguish the "privatized" economy from the old one. This second aspect of privatization is then a matter of the functioning of the institutions of society and the character of the informal aspects of society on which these institutions rest. The formal transfer of property rights is, in some senses, a simple extension of the rhetoric. The recognition of those property rights by society and the use of them by their owners are the realization of reforms.

Acknowledging the importance of the second aspect of privatization leads to an emphasis on the detailed arrangements of society, for example, social and political predispositions on the protection of property rights rather than on the higher-level operation of the formal transfer of title. There is no question that privatization can go very fast in its formal aspects. But there is a question of whether speed on that dimension can retard society's acceptance and defense of a private property rights regime, which is so necessary for property holders to use their rights efficiently.

Privatization was at the center of Mongolian reform efforts: The Privatization Commission was designated as the vanguard of reforms and charged with overall coordination of reform efforts. Privatization

was considered by the leading reformists to be the sine qua non of a successful transition. Leading members of the new democratic parties planned to carry out privatization within a matter of two years.

Privatization in the first sense—the nominal transfer of title—has proceeded as fast in Mongolia as in any reforming country. By mid-1992, just eighteen months after the beginnings of reforms, the reformers were well on their way to their two-year goal. Approximately 90 percent (3,500) of small and medium enterprises were already privatized. Five hundred large entities—200 industrial and 300 agricultural—had been through the privatization process. Seventy percent of all livestock was owned by individuals in an agricultural sector that had been completely privatized. Most manufacturing industries were now more than half privatized, as was the overwhelming proportion of the service sector.<sup>26</sup>

But privatization in the second sense has only just begun in Mongolia. A single story, but one that is hardly unique, captures the present situation. After the decontrol of the price of an important food, there were demonstrations in Ulaan Baatar. A top government official was dispatched by the highest political leaders to the major producer of this food, a company that had been privatized six months previously. The government official audited the accounts of this company. On the basis of this audit and a reworking of the cost-accounting data, the company was ordered to lower its price (even though this price was one that had been officially freed by the government). The reason given by government officials was that the cost of production did not warrant the price that was being charged by the entity.

This incident highlights several elements of the general discussion of the first section of this chapter. There were demonstrations, causing the government to react immediately. In their reactions, officials used a policy that derived its essentials from the old system. The government officials believed that detailed intervention into the affairs of the privatized company was appropriate. Cost-based pricing was invoked as the rule to follow. Old habits and a historically derived understanding of the nature of economic processes combined to produce behavior that was at odds with the operation of the economy as envisaged in the rhetoric of reform. Given that this move by the government drew few objections and accomplished its immediate objectives, there is every possibility that such behavior will be accepted as part of the new order of business. To the extent that institutions are secured by society itself, locked in by the beliefs and habits arising out of events, the development of private property rights might well have been significantly retarded.

The preceding example is typical of the extent to which privatization in Mongolia has been only nominal. The old system of materials allocation still exists and is still supported by the compulsory requisition of

output by state bodies. Within this system, privatized companies are treated symmetrically with their erstwhile partners in the old state system rather than with new private companies, which are not given official allocations. Intervention in the production decisions of privatized concerns is rife.<sup>27</sup> As the preceding subsection makes clear, interventions into pricing decisions are still pervasive: The nominal privatization of enterprises does not give them access to a due process mechanism that allows them to challenge presumed violations of "price discipline" that can be followed by immediate confiscation of goods. If the legal dictum is correct that there are no rights without remedies, private property rights do not yet exist in Mongolia.

As a result of the attempt to implement the rhetoric but not the substances of privatization, the status of private property rights is absolutely unclear. Many of the old structures of state intervention are still functioning while the new legal titles are in existence. No formal tax collection mechanisms existed, which forced the authorities to use the old methods of tax collection in a way inconsistent with private-sector activity. The absence of a system of monetary and credit control meant that price intervention was almost inevitable. The focus on swift privatization occurred at a time when there were few voices in the country pressuring for the creation of the standard legal instruments necessary for the protection of property rights.

The privatization process in Mongolia has not yet created a group of autonomous actors whose power, goals, and decisions are fundamentally separate from those of the state. The process of swift formal privatization precluded any attempts at addressing the second aspect of privatization—developments within society and in its institutions that would secure the separation between the state and the new owners. Indeed, as the following statement from the Government Privatization Commission attests, there was probably little recognition of the necessity for such separation within society: "From the very beginning, it is necessary to pay special attention to setting control over the contracts of privatized shops, caterings, utility services and other enterprises on issues relating to maintenance of the types and size of services, the supply and price regimes, and the number of employees, and supervision over the implementation of these contracts."<sup>28</sup> (As this statement reveals, some of the inconsistencies that resulted in the attempts to implement the rhetoric might have indeed resulted from the mismatch between the personal knowledge of the framers of the reform program and the rhetoric itself. In the long run, the success of privatization will depend upon whether the present ad hoc government intervention into the privatized sector that is a result of such mismatches is established as a norm in society, locked in by the habits and understandings gained in these first years of reform.)



### *Laws and the Legal System*

An essential element of the transition is the establishment of "the Rule of Law, [which] means that government in all its actions is bound by rules which make it possible to foresee with fair certainty how the authority will use its coercive power in given circumstances and to plan one's affairs on the basis of this knowledge" (Hayek 1944, p. 72). To Hayek, the rule of law is so much the essence of a liberal society that "it may even be said that for the Rule of Law to be effective, it is more important that there should be a rule applied always without exceptions than what this rule is" (Hayek, 1944, p. 80). The creation of the rule of law gives us another yardstick with which to judge the effect of rhetoric on the realization of reforms.

That the pursuit of speed in reform can conflict with the rule of law was obvious from the beginning in Mongolia. Two examples provide some of the flavor of the situation. In the very first privatization, land was sold in violation of the constitution of the country.<sup>29</sup> This act was justified by the leading reformers as a way to secure fast privatization.

The second example is the passage of a new tax law at the very beginnings of reform. A central aim of this law was to create a code that would be appropriate for the market economy. As a consequence, the framers of the law brooked no accommodation for the realities of Mongolia, the status of its bureaucracy, and the ability of the implementers to understand and use the law. The law was a fine piece of rhetoric concerning the aims of the reform process.

The result was a law described, by even one of the leading reformers, as "too theoretical" and by an implementer of the law in a rural district as "impossible to interpret for the case of private herders."<sup>30</sup> Given the budgetary catastrophe that was occurring at the time that the new tax law was to take effect, tax collection was conducted outside the framework of the law, using many of the old methods of confiscation. With privatization proceeding apace, these actions violated Article 5 of the new constitution, which instructed the state to protect the rights of all owners and dictated that these rights be limited only through due process of law. Applying the rhetoric of radical reform to the tax law and privatization simultaneously was incompatible with the establishment of a law-governed state under a new democratic constitution.

These two examples were consistent with the overall spirit with which the reform program was pursued. Legislation had virtually no role in governing economic life, which was regulated by the unconstrained day-to-day decisions of the government.<sup>31</sup> This was a result of a conscious decision made early in the reform process to move fast and to sidestep the procedural and political constraints of parliament. Parliament itself handed over the task of reform to the government and agreed

that government resolutions would have the force of law. Even though the government's actions were therefore lawful, they did not produce a rule-of-law state: "[The] belief that, so long as all the actions of the state are duly authorized by legislation, the Rule of Law will be preserved [is] completely to misconceive the meaning of the Rule of Law. The fact that someone has full legal authority to act in the way that he does gives no answer to the question of whether the law gives him power to act arbitrarily or whether the law prescribes unequivocally how he has to act" (Hayek 1944, p. 82).

If, following Hayek, it is the establishment of the rule of law that is the hallmark of a successful realization of market-oriented reforms, then the ambition embodied in the government's program might have slowed the transition. Perhaps, given the lack of the rule of law under the old system, it is not the present place of law in society that is most troubling. Rather, the danger is that present behavior will be interpreted as consistent with the new system and locked into the informal structures of society. As Aristotle recognized, early behavior is all important: "Legislators make their citizens good by habituation; this is the intention of every legislator, and those who do not carry it out fail in their object. ... So it is a matter of no little importance what sort of habits we form from the earliest age—it makes a vast difference, or rather all the difference in the world."<sup>32</sup>

### **The Development of the Nascent Private Sector**

One can view a reforming socialist economy as comprising two sectors—(1) the newly created private sector and (2) the old state enterprises, or their privatized successors. There is a trade-off between the development of the reforms that are particularly useful to each of these two sectors: An increase in attention to one sector will lead to less progress on reform in the other (Murrell and Wang 1993). Therefore, the relative importance attached to developments in these two sectors is an important ingredient in the evaluation of the progress of reforms. For some, the rise of the new private sector will be crucial (Kornai 1990). In this case, an overly ambitious attempt to transform the old state sector can easily slow the progress of reforms as a whole through its detrimental effects on the nascent private sector.

In Mongolia in 1990, a tiny private sector was showing signs of rapid growth. Paradoxically, given the centralized nature of the rest of the economic system, this private sector was relatively free of state intervention. At the beginning of 1991, with the state sector still under administrative control, the private sector was able to set its own prices and engage in foreign trade, retaining its own foreign exchange earnings. In 1991, 10

percent of the resources in the state distribution system had been set aside to be sold to the new private sector, to encourage its growth. A program of loans to new small businesses began at the same time.

When reforms in the state sector took high priority, the nascent private sector became entangled in the consequences. As the state sector became decentralized and market interventions were used to solve perceived problems, there was a paradoxical increase in the influence of the state on the new private sector. When the state foreign trade system was decentralized, the nascent private sector had to apply for foreign trade licenses. When the shortage of foreign exchange became chronic, new private-sector firms were forced to surrender all their foreign currency earnings. By the beginning of 1992, the nascent private sector had lost the allocation of raw materials that it had previously received from the state distribution system.

The nascent private sector became a focus of the popular protests aimed at the reforms. The old attitudes to the private sector began to be more significant to politicians, and policy toward the new private sector became more punitive. The government even made the distinction between the nascent private sector and the privatized sector, treating the latter more favorably to save the privatized firms from collapse.<sup>33</sup> The ambition embodied in the initial reform program locked politicians into a program of securing the success of the privatized sector at the expense of the nascent private sector.

As reforms proceeded, the old habits and routines of politicians affected the nascent private sector to an increasing degree. One resolution required governmental agencies at both the central and local levels "to control prices for goods set by private shops so that these prices do not exceed the average market level" and "to define procedures for operating ... private shops."<sup>34</sup> Another resolution dictated that "the profit gained solely as a result of a price increase without using the practical possibility of the economic entity and reducing the volume of production should be completely transferred into the state budget."<sup>35</sup> Thus, this measure brought the nascent private sector into the ambit of the revenue-generation mechanism that had always existed in the state sector during the era of centralized socialism. In fact, the Ministry of Finance, under great pressure to increase its revenues, participated eagerly in this program to control prices, which had as its by-product the generation of extra revenues.

Hence, as reform measures brought significant change into the old state sector, the development of the nascent private sector was slowed. This slowing contains many of the elements outlined in the first section of this chapter. Public protest led to a perceived need to react to the economic distress that was befalling the country. That economic distress was

interpreted by the populace at large through the prism of the attitudes to the private sector generated under the old system. In reacting, politicians relied upon the stock of knowledge inherited from history. The only measures that were available to mollify the population were those that were familiar from the years of socialism. But they were applied in situations and in sectors to which they had not been applicable under the previous regime.

### Conclusion

Mongolia's reforms were characterized initially, and are sometimes still, as the most radical in the reforming socialist world—quick price and trade liberalization and an ambitious scheme for privatization. These characterizations were based on the stated intentions of the top leadership and on the formal measures passed early in the reform process rather than reflecting the reality of policy implementation. Instead, rapid price liberalization came to mean the proliferation of decentralized ad hoc controls, not free market pricing. The establishment of a set of autonomous private actors has not occurred despite the shotgun formal privatization. In trying to pursue these ambitious goals, policymakers were willing to make choices that slowed the establishment of the rule of law and the development of the nascent private sector.

Using the methodology made notorious in the generation of the Laffer curve, one can employ the Mongolian data point to picture reform's rhetoric-realization relationship. I have argued that the reforms of Mongolia, with a rhetoric higher than anywhere in the world, did not advance far. In contrast, many countries in the early 1990s have had much lower levels of ambition and are much more advanced in matters such as the development of the new private sector, the establishment of secure property rights, and the establishment of the rule of law. Any of these countries would provide a second data point. As a third, at the point of origin of our graph, we might place the Kosygin reforms, with little rhetoric and no accomplishments. With these three data points, it is obvious that reform's rhetoric-realization relationship does have a backward-bending portion.

### Notes

1. See, for example, Lipton and Sachs 1990.
2. Of course, there is concession to the existing situation in all reform programs. However, the argument here is that reform design must begin with the existing institutional structure, not simply make concession to it.

Wilson, W. 1887. "The Study of Administration," *Political Science Quarterly* 2, no. 2 (June), pp. 197-222.

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