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SOCIAL POLICY AFTER SOCIALISM

by

Deepak Lal*

UCLA Dept. of Economics
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Address for correspondence:
Dept.of Economics
University of California, Los Angeles
405 Hilgard Avenue,
Los Angeles, CA 90024-1477

*Professor of Political Economy, University College London, and James Coleman Professor of International Development Studies, University of California at Los Angeles.

ABSTRACT

This paper examines the difficulties in the transition from socialism. It argues that an essential element in devising a social policy after socialism must be a repudiation of the failed creed of egalitarianism. It sets out the principles from the viewpoint of classical liberalism which should govern social policy for alleviating poverty in a sustainable post-socialist economy, and speculates on the likelihood of such reforms being adopted in diverse socialist economies.

> Few documents in the history of mankind have stood up so remarkably to the test of verification by the future as the Communist Manifesto. A century after its publication no one has been able seriously to controvert any of its major positions. All over the world the crises of capitalism have grown both more frequent and more profound ... For unmistakably, ... the central problem is the sheer misery of the masses; and our experience makes it clear that, within a capitalist framework, there is little likelihood of its effective mitigation.
>
> (Laski (1948) pp. 97-8).

> "Socialism" in its Soviet and East European version is in an advanced state of disintegration written off as a failure not only by the bulk of Western observers but also by the bulk of their own "eastern" citizens. For some on both sides of what was once an iron curtain, this means the end of socialism as such. "Capitalism" has won. Socialism must now be relegated to the dustbin of history, ... Well, not so, or not quite so.
>
> (Nove (1991) p. xi)

> ... the point has to be made unequivocally that socialism is dead, and that none of its variants can be revived for a world awakening from the double nightmare of Stalinism and Brezhnevism.
>
> (Dahrendorf (1990) p. 38)..

> It will be well to contrast two kinds of security ... the security of a minimum income and the security of the particular income a person is thought to deserve ... this distinction largely coincides with the distinction between the security which can be provided for all outside of and supplementary to the market system, and the security which can be provided only for some and only by controlling or abolishing the market.
>
> (Hayek (1944) p. 89)

INTRODUCTION

It is now apparent that the road from socialism is as rocky as the road to socialism. There are two broadly symmetrical reasons for the difficulties in the transition to and from socialism. These can be cryptically termed: (a) the divergences in views about the ultimate destination and (b) the problems of political economy in implementing constructivist designs. Both are of importance for the subject that has been assigned to me at this conference.[1] They are dealt with somewhat discursively in Section I. This allows us to set out (in Section II) the principles (from the viewpoint of a classical liberal) which should govern the formulation of social policy in a sustainable (post-socialist) market order. Section III distinguishes "existing" socialist economies, by (a) their stage of economic development; (b) by the pervasiveness and possible acceptance of the socialist Weltanschaung amongst their populace; (c) by differences in their labor markets and (d) by the agencies undertaking reform. This allows some speculations about the likelihood of the principles for social reform outlined in previous sections being adopted in these diverse socialist economies.

I. THE POLITICAL ECONOMY OF SOCIALISM AND THE WELFARE STATE IN HISTORICAL PERSPECTIVE

The starting point for any discussion of the reform of social policy in current or ex-socialist countries must be a recognition that their existing social systems (and the economies on which they are based) represent an attempt to enforce egalitarianism -- a creed which they share with many proponents of Western welfare states. In practice, most socialist countries eschewed Marx's dictum of "from each according to his abilities, to each according to his needs", consigning it to a distant communist Utopia. They nevertheless sought, and to a substantial extent succeeded in enforcing (chiefly amongst the non-nomenclature) an equality of outcomes (summarized for instance in indices of the distribution of income). This has been a common objective of all the feuding creeds which have formed part of Socialism's broad church over the ages.[2]

The major theoretical difference (if one may call it that), between the advocates of the welfare state (who seek to socialize the results of production) and full-blooded socialist economies (which seek to socialize the means of production) in subserving egalitarianism, goes back to an essential difference in assumption (between classical and neoclassical economists) about the relationships between the allocative and distributive mechanisms in any economy. J.S. Mill's Principles of Political Economy marks the divide between these two different visions of the economic process.

The classics, including Marx, believed that questions concerning allocation and distribution in any economic system were inseparable. Mill demurred. He wrote:

> The laws and conditions of the production of wealth, partake of the characters of physical truth. There is nothing optional, or arbitrary in them ... It is not so with the distribution of wealth. This is a matter of human institution solely. The things once there, mankind, individually or collectively, can do with them as they like. They can place them at the disposal of whomsoever they please and on whatever terms.
>
> (Mill, Bk.II, Ch.I, pp. 349-50)

This view is at odds with that of the classical thinkers, including Marx. Hayek has always emphasized the importance of Mill in beginning what he calls the "manna from heaven" presumption of contemporary distributivist theories. As Gray notes:

> what distinguishes Mill from Hayek -- and for that matter from Marx -- is Mill's lack of any clear view of production and distribution as inseparable parts of a single economic system. We may have a choice between economic systems (though it is the burden of the Mises-Hayek-Polanyi argument about resource allocation under socialism that our freedom is far more restricted than we suppose); we do not have the freedom to mix the productive arrangements of one system with the distributive arrangements of another. This is the truth understood by all classical economists, including Marx, which Mill's influence has helped to obscure. (Gray (1984) p. 102)

The death of socialism in its communist version, what Dahrendorf (1990) terms "really existing socialism", should discredit the economic system based on socializing the means of production to subserve egalitarianism -- at least in the minds of those who invoked the god of History to their cause! If they recognize their classical lineage, Marxists may thus have to accept that historical experience has shown egalitarianism to be infeasible.[3]

The new institutional economics (including the economics of organization, transactions costs, and of imperfect information), has, moreover, provided theoretical support for the classical position. A major implication of these new theories is that:

> one of the main pillars of Walrasian neo-classical economics -- the separability of equity and efficiency -- breaks down when transactions costs and imperfect information are important; the terms and conditions of contracts in various transactions, which directly affect the efficiency of resource allocation, now crucially depend on ownership structures and property relations. (Bardhan (1989), p. 1389)

The new institutional economics therefore sharpens the classical insight that the growth and productivity outcomes of particular institutional forms cannot be separated from their system of property rights (and the distribution of income streams flowing from them). We cannot devise a Pareto efficient productive structure and then implement the social welfare maximizing distribution of national income to yield a Pareto-optimum -- even if this were done through lump sum taxes and subsidies.

Parallel developments in public economics (applied welfare economics) were also undermining the implicit belief of the early supporters of the welfare state that there were few effects on efficiency of the elaborate systems of subsidization and regulation that were set up under the welfare ideology. This implied, at least in Scandinavia that, the State sought "to provide job and residence insurance in addition to income insurance" (Sandmo, op cit., p. 223).

Beginning with an important contribution by Mirrlees (1971), it was demonstrated that in the absence of lump-sum taxation, there were limits to the amount of redistribution which could be financed through distortionary taxation.[4] Econometric attempts to provide quantitative evidence of the effects on labor supply, consumption and savings of the unavoidable "tax-cum-subsidy" distortions associated with various programs of the welfare state have been inconclusive (see Atkinson (1987)). But this is probably just another example of the emerging law that "all econometric evidence is equivocal"! Where does this leave the social democratic case for the welfare state?

The locus classicus of this case is probably Abba Lerner's "The Economics of Control". The section headings of its first chapter give a succinct summary of the form of argument:

> The fundamental aim of socialism is not the abolition of private property but the extension of democracy ... This is obscured by dogmas of the right and of the left ... The benefits of both the capitalist economy and the collectivist economy can be reaped in the controlled economy.. Control must be distinguished from regulation ... The three principal problems to be faced in a controlled economy are employment, monopoly, and the distribution of income ... liberalism and socialism can be reconciled in welfare economics. (Lerner (1944) pp. 1-6)

In Scandinavia which was to see the fullest development of the welfare state, as Sandmo notes: "Scandinavian economists ... saw the construction of the welfare state as a rather massive intervention in the operation of market forces." (Sandmo (1991) p. 221)

The inevitable productive inefficiency of a controlled economy (of the command variety) due to the ubiquitous problems of incentives and information was the burden of the case made by Hayek and Mises against Lange and Lerner (see Hayek (1935)). The Austrians have been vindicated both by theory (see for instance Dasgupta (1980)), and in practice -- by the near universal collapse of command economies.

Yet there are many socialists (see for instance Nove (1991) and Brus and Laski (1989)) who still believe that a controlled mixed economy which subserves the twin ends of efficiency and equity is feasible. It would use indirect controls (taxes and subsidies) and state enterprises in a predominantly private enterprise economy, to deal with various forms of market failure, and maintain a welfare state to achieve distributivist ends. A path the Hungarian reformers have sought to follow since 1968 (see Kornai (1986)). Though less well known, this has also been the intellectually favored development model in India (see Lal (1980), (1988)). Kornai's critique of this "naive socialism" is devastating. As he argues, in the context of the Hungarian attempt to substitute indirect for direct bureaucratic control, this enterprise falters on the inadmissibility of its central assumption about the character of the "planners", namely that:

> they are reincarnations of Plato's philosophers, embodiments of unity, unselfishness and wisdom ... Such an unworldly bureaucracy never existed in the past and will never exist in the future. Political bureaucracies have inner conflicts reflecting the divisions of society and the diverse pressures of various social groups. They pursue their own individual and group interests, including the interests of the particular specialized agency to which they belong ... What is now happening in Hungary with respect to detailed micro-regulation is no accident. It is rather the predictable, self-evident result of the mere existence of a huge and powerful bureaucracy. (Kornai (1986), p. 1727)

A clear vindication of the theories of the Virginia public choice school! This also points to another of Mill's poisoned legacies to modern economics, particularly in its discussions of the welfare state -- a naive view of the polity, based upon an implicit separation of politics and economics. The classical economists, including Marx, were quite happy to apply their methods to both politics and economics. But James Mill's "Essay on Government" had no successor till the modern writings of the "new" political economists (Buchanan and Tullock (1962), Olson (1965), Stigler (1988)), largely because his son John Stuart Mill insisted that Bentham's and his father's utilitarian techniques were only applicable to economics (see Barry (1978))

The polity was subsumed, largely for technical reasons, into a committee of Platonic Guardians charged with maximizing a social welfare function subject to the usual constraints. As part of this exercise the optimal tradeoff between equity and efficiency would emerge. This way of thinking reached its apotheosis in what is currently touted as providing the "grammar for arguments" about public policy, namely public economics. As two distinguished purveyors of its methods stated in an introduction to a book commending the application of "optimal tax" theory to developing countries, the theory assumes that:

> the government has coherent, unified and largely benevolent objectives, captured in the social welfare function, and we search for ways in which the tools available to it can be used to improve the measure of welfare" (Stern and Newberry (1987) p. 653)

After the revolutions of 1989 (and from even casual observation of the polities in the rest of the world), it is apparent that the theory is irrelevant as most polities do not even come close to these assumptions about their character. Ex-socialist reformist governments should beware of its panaceas. Yet, as Dahrendorf has emphasized, the longing in ex-socialist countries for a "middle way" which combines the efficiency of capitalism with the caring of socialism -- a "Sweden" -- is based on the same political illusion. He writes:

> "Sweden" is not Sweden; it is a dream with no base anywhere on the map of Europe. What is more, we must thank our lucky stars there is no "Sweden" in the real world, for if it existed, it would be located somewhere between Lee Kuan Yew's Singapore, which finds it difficult to accept even one opposition member in its "parliament" and charges a penalty of two hundred dollars for dropping litter in the street, and Plato's republic, in which philosopher-kings see to it that dissidence cannot arise because they alone are in possession of the truth. (Dahrendorf (1990) p. 3)

Moreover, the welfare state in Western democracies is also in trouble, even in Sweden where it seemed for so long to be unassailable (see Lindbeck (1990)). The causes are complex, and it is beyond the scope of this paper to trace them. But one important sequence is linked to the long run dynamic effects of the political economy pressures associated with the evolution of Western welfare states. These have led to actual or incipient fiscal crises for the State, and to a hardening of the economic arteries which was in part responsible for the stagflation of the 1970s (see O'Connor (1973), Lal and Wolf (1986)). Another cause of discontent, as noted by Dahrendorf was that:

> social democracy became increasingly associated with bureaucracy, to the point where, in some countries such as Sweden, it turned into the party of public servants ... One aspect of the 1980s in the OECD world is the protest not only against the economic stagflation of the 1970s but also against the political dependence on bureaucracy. (Dahrendorf, op.cit., p.52)

Some insights from the new political economy are useful in understanding these processes. These concern the political economy of redistribution in majoritarian democracies.

In a majoritarian two party democracy, politicians will bid for votes by offering transfers of income from some sections of the populace at the expense of others. Models of this political process (Stigler (1970), Meltzer and Richard (1981), Peltzman (1980)) show that there will be a tendency for income to be transferred from both the rich and the poor to the middle income groups. This "middle class capture" of the welfare state has been documented for a number of Western democracies (see Goodin and Le Grand (1987)).

As the quotation from Hayek (in the epigraph) shows, economic liberals since Adam Smith have supported programs to relieve hardship. In democracies, such programs have inevitably been "universalized" through the political process, leading to the creation of what are properly called transfer rather than welfare states, which primarily benefit the middle classes. As Le Grand and Goodin conclude:

> Given the apparent inevitability of the beneficial involvement of the non-poor in the welfare state, there is little scope for egalitarian-redistributivists who are thus offended by it to eliminate it through any simple reforms of the welfare state.
> (Goodin and Le Grand (1987) p. 226).

The poverty alleviation which occurs as a byproduct of the expansion of the transfer state is moreover bought at a rising dynamic cost. With the universalization of various welfare schemes, political entitlement are created whose fiscal burden is governed more by demography than the conjunctural state of the economy. Moreover, the increased tax burden required to finance the transfers over time creates well known distortions which damage productivity and growth (see Lindbeck, op.cit., for a discussion of the Swedish case, and Mesa-Lago (1983, 1989) for Latin America). Furthermore, with the inevitable rise in marginal tax rates that accompanies the churning involved in the transfer state, overt or covert tax resistance develops, with tax revolts, and the growth of tax evasion ultimately putting a ceiling on the revenues the State can garner. With the costs of entitlement rising faster (because of politically determined expansions in their coverage, and in many OECD countries because of demography) than the revenues needed to finance them, the transfer state finds itself in a fiscal crisis. This usually leads to the cutting back of those entitlement of importance to the poor while maintaining those for the middle classes. The U.S. failure to touch middle class social security entitlement while cutting back on various programs targeted to the poor in the 1980s is a case in point.

This same dynamic process is even more clearly discernible in those developing countries which under the factional pressures of majoritarian democracies have created and expanded welfare states. Uruguay, Costa Rica, Sri Lanka and Jamaica are examples. (They are included in a recently completed study of the political economy of poverty equity and growth in 21 developing countries (see Lal and Myint (1991).) All four created welfare states financed by taxing the rents from their major primary products. With the expansion of revenues during upturns in the primary product price cycle, political pressures led to their commitment to entitlement, which could not be repudiated when revenues fell during the downturn in the price cycle. The ensuing increase in the tax burden on the productive primary product sector (to close the fiscal gap), led to a retardation of its growth and productivity, and in some cases to the "killing of the goose that laid the golden egg". Thus, while there was undoubtedly some poverty redressal as a result of the expansion of these welfare states, over the long run the entitlement created damaged economic growth on which they were predicated, and hence eventually became unsustainable. By contrast those countries which relied for poverty alleviation on promoting rapid efficient labor intensive growth (for instance the NICs of Southeast Asia) saw sustained and dramatic poverty alleviation.

II. PRINCIPLES OF SOCIAL POLICY FOR A MARKET ECONOMY

What principles emerge from the above discussion for the design of social policy in a sustainable post- socialist market order?

The first principle, is that policy should be concerned with alleviating real hardship and not with equalizing people. The socialist distributivist end must be forsworn. State help should be concentrated on the minority in absolute need, whose numbers will hopefully decline as growth resumes and accelerates. The categories of prospective beneficiaries should not be allowed to multiply as "'need' assumes an elastic dimension in the name of 'relative poverty'" (Harris (1988) p. 18).

Second, universal provision of welfare and social security benefits should be eschewed. For in majoritarian democracies such "universalization" will corrupt the polity with competing politicians showing their compassion by indiscriminately buying votes with other people's money. This in turn will lead to the likely "middle class" capture of the transfer state, and could lead to endemic growth and fiscal crises.

Third, for so-called merit goods -- education and health -- State action should be confined to financing the poor (ideally through vouchers earmarked for purchasing the merit goods) and those suffering from catastrophic or chronic illnesses and possibly to setting standards. As Mill knew over 100 years ago, and Hayek reiterated in "The Constitution of Liberty", the case for monopolized State production of these services is at best weak, and in the case of higher education non-existent (see Lal (1989)).

We can apply these principles to the usual package of social assistance and social insurance (but not redistributive) programs which form the usual social policy package.

Social insurance may be required to deal with two types of contingencies. First, the stochastic shocks to a person's livelihood due to health related falls in labor supply or to exogenous changes in labor demand. The second is related to the necessary variability in incomes over the life cycle of most individuals, where because of either ignorance, fecklessness or more importantly the unavoidable imperfections of capital markets, individuals cannot smooth their incomes over their life cycle to match desired expenditures. Problems of moral hazard, adverse selection and monitoring make it difficult for private insurance and capital markets to function efficiently, but before one jumps to the conclusion that public action will necessarily improve matters it must be remembered that public insurance or credit schemes face the same problems. Thus for instance, research on developing countries has shown that, in capital markets, private agents with local knowledge may have an informational advantage and a better record on recovery of debts than centralized public agencies (see Binswanger et al. (1985), Braverman and Gausch (1989), von Pischke et al. (1983)). The evolution and success, in the 19th century in the U.K., of mutual aid friendly societies which provided insurance for those deemed uninsurable by commercial insurance companies, shows the possibilities of overcoming problems of moral hazard and monitoring, through localized control. There may be serious voluntary welfare alternatives to the centralized collectivist social insurance model which is currently the only one in the domain of public discussion (see Hanson (1974), Green (1982), Seldon (1981)).

By contrast, in the absence of private charity, social assistance is required to raise the income and thence the consumption of households whose incomes even in the absence of stochastic or life-cycle risks would be far too low (or non-existent in the case of the handicapped or mentally ill) to provide them a basic minimum standard of living. As most of this group is likely to consist of people who for identifiable reasons are incapable of earning a living, public assistance to meet their basic needs would be fully warranted. As they are not able to participate (or only marginally) in the labor force, and their inability to finance their basic needs is genuinely involuntary, the problems of perverse incentives which bedevils so many social insurance type programs is not likely to arise. This is the category of those the Victorians labelled the "deserving poor".

The problem of disincentives and the creation of a dependency culture is particularly acute for the able bodied poor (see Murray (1984)). No completely satisfactory scheme is available on the basis of Western experience to alleviate their poverty without the perversion of incentives. Negative income, or basic income schemes, which integrate the social assistance and tax system, involve unacceptable tax burdens (see Brittan and Webb (1990) for a recent re-examination of their costs in the U.K.) Also an unnoticed implication of Director's Law (Stigler (op cit.) and Meltzer and Richard (op cit.) for a negative income tax scheme is that it might lead to a greater expansion of the transfer state than is implied by a system of targeted benefits.[5] Moreover, Meltzer and Richard have shown that in a political economy model of a majoritarian democracy, with the median voter's interests being decisive, there will be pressures to expand the transfer state if the mean income rises relative to the median. One effect of the movement from a socialist to a market economy is likely to be an increase in this ratio. As this movement is also from a system where the existing transfers are determined dictatorially, and hence are often less generous than those determined through the democratic political process in Western welfare states (see IMF et al. (1991); Lapidus and Swanson (1988)), the movement to a majoritarian democracy in ex-socialist countries will accentuate pressures for an expansion of transfers, and the accompanying tax burdens.

However, the alternative of targeted means tested benefits, which are withdrawn when the unemployed find work or the poor move up the income ladder, lead to the well known disincentives associated with the unemployment and poverty traps. There is no obvious remedy. Decentralization to local communities of the administration and monitoring of these programs to help the able bodied poor, as is done in Sweden and Switzerland may be part of the answer (see Lindbeck, op cit., and Segalman (1986)).

An income maintenance scheme which distinguishes between the able-bodied poor and the deserving poor has recently been proposed for Eastern Europe by an IMF economist (Paull (1991)). It has much to commend it . The deserving poor are means tested and publicly assisted to bring them up to a minimum income level. The able-bodied poor are assisted through a series of training, job-search and workfare programs to enter or renter employment. The proposals are costed for Poland, and do not seem to imply unreasonable shares of GNP on these income maintenance measures either compared with planned Polish social expenditures for 1990, or similar expenditures in developed economies. If the programs can be decentralized so that they are administered and monitored locally, they might provide the best that can be done to deal with an intractable problem.

This leaves pensions. This is the major part of the current social expenditure budgets in many socialist countries. In the Soviet Union they were estimated to take up over 70% of the social security/social insurance budget (see R. Madison in Lapidus and Swanson, op cit., p. 174). As in most Western welfare states, they are pay as you go schemes. In the light of demographic trends (the ageing of populations) they are an economic time bomb (see Lal and Wolf (1985), Boskin (1986) for discussions about developed countries). The gradual privatization of pensions,with some public compulsion in the form of earmarked taxes which have to be put into private pension funds (as has recently been done in Chile) is the obvious and desirable remedy, once the capital markets essential for the smooth functioning of a market economy have been established. The Friedmans' recommendations for the transitional arrangements towards such an actuarily based, fully funded and privatized system for the U.S. social security system are worth emulating and hence worth quoting, except for one amendment:

1. Instead of repealing a payroll tax which funds pay as you go pension schemes, as the Friedmans' suggest, revenues from such a tax should be earmarked to be paid back to taxpayers to be used specifically to purchase or contribute to private pension schemes. This would ensure that all those in employment made provision for their old age and did not become charges on the income maintenance system (which would continue to support the deserving poor -- but only them -- from the cradle to the grave), because of fecklessness or myopia.

2. Continue to pay all existing beneficiaries [under existing state pension schemes] the amounts they are entitled to under current law.

3. Give every worker who has already earned coverage a claim to those ... benefits ... that would entitle him to under current law, reduced by the present value of the reduction in his future [net] taxes as a result of [privatisation of the proceeds from] ... the payroll tax. The worker could choose to take his benefits in the form of a future annuity or government bonds equal to the present value of the benefits to which he would be entitled.

4. Give every worker who has not yet earned coverage a capital sum (again in the form of bonds) equal to the accumulated value of the [implicit or explicit] taxes he or his employer has paid on his behalf.

5. Terminate any further accumulation of benefits, allowing individuals to provide for their own retirement as they wish. (Friedman and Friedman (1980) pp. 123-4).

III. SOCIALIST DIVERSITY AND THE FEASIBILITY OF SOCIAL REFORM

Is it likely that these principles of social policy based on classical economic liberalism will be adopted by ex-socialist countries? In answering this question it is useful to distinguish between different socialist economies in a number of ways. The first is based on different stages of development of the respective economies. The major difference is between those East European economies where Communism was imposed after the war when they were at a comparable stage of development as other European economies -- East with West Germany, Czechoslovakia with Austria, Poland and Hungary with Spain, Bulgaria, Romania and Yugoslavia with Greece (Brus and Laski (1989) p.28) -- and the two communist giants the Soviet Union and China -- backward developing countries which adopted socialism.

Though this is denied by some socialist intellectuals (see in particular Dreze and Sen (1989), and some of the articles in Ahmad et al. (1991), but see Bhagwati (1988) for counterarguments), social security systems which do not damage long term growth and poverty alleviation are much more difficult to devise, administer and finance in developing than developed countries.[6] This is in part linked to the preponderance of self rather than wage employment in these countries,and their less widespread, weaker and more venal fiscal systems. This suggests that the principles set out in Section 2 are more likely to be applicable in reformed East European economies, than in the two communist giants when (and if) they become genuine market economies.

But there is also an important difference in the labor markets (chiefly for industrial labor) between China and the other socialist countries. In China through its unique form of urban job allocation based on central command, workers are in effect tied to their enterprises -- which are also responsible for all their basic needs. By contrast in other communist countries there is substantial labor mobility and some form of labor market (see Byrd and Tidrick (1987)). In an earlier paper (Lal (1990)) I had suggested that this unique feature of the Chinese labor market allowed industrial reforms, which could combine the gains from a market economy with the maintenance of the egalitarianism and social control embodied in the job assignment system, so cherished by socialists! Applying the theory of trade and welfare, which assumes that labor is immobile between the respective trading economies, I had argued that China could achieve a unique form of market socialism by liberalizing its capital and product markets (including those for foreign trade and payments) while maintaining its rigid socialist job allocation system. This, of course, assumed that political reform involving the euthanasia of the Communist party was impossible. While this separation of political from economic liberalization might have been feasible before 1989, clearly after Tiananmen Square, this dichotomous development is now foreclosed as both the State and many of its citizens see political and economic freedom as being intertwined. So it is likely that only when the Mandate of Heaven is finally withdrawn from the current imperial dynasty, will a full fledged market economy be established, and it is unlikely that in any new political dispensation the current Chinese job allocation system will be retained. The principles outlined in Section 2, for social policy in the industrial-urban sector of a liberal economy may then commend themselves to a post-Communist polity.

In the rural sector of China, however, where the socialist communes have given way to an essentially privatized agriculture, we have a test of the best way of alleviating poverty in a primarily agrarian developing economy. The old collective system was aimed at fulfilling the communist notion of distribution according to needs. Under the new Responsibility system social security type needs are met through a local welfare tax. As Ahmad and Hussain (1991) note:

> the Responsibility system has undone many of the [social security] features associated with collectivization ... This is intentional, since the aim has been to "smash the iron rice bowl" ... the responsibility system has increased incentives, but it has also increased the risks to be borne individually by rural households. (p.267)

Though these authors seem (implicitly) to lament this substitution of personal for collective responsibility (except in the case of the "deserving poor"), an economic liberal can only laud the change, particularly as it has led to a phenomenal increase in rural incomes. As these authors concede:

> When assessing the impact of the responsibility system on rural social security, one should bear in mind that rural incomes have risen at a record pace since the introduction of the system.

> Between 1978 and 1987, rural income per capita at current prices grew by 13 per cent annually ... Given that the rate of inflation over the period has averaged around 6 per cent per annum, the rate of growth of real income still comes to a high 7 per cent.
>
> (ibid. p. 268)

Evidence from a myriad of developing countries assembled as part of the Lal-Myint project shows that growth invariably alleviates poverty (see Fields (1991)). The reported growth in rural incomes in China must have had a marked effect on poverty alleviation, well beyond what could have been achieved by redistributing poverty in a stagnant collectivized agriculture. It would also provide the means for alleviating the hardship of that small minority of nature's victims, to be found in every country.

The third source of difference lies between the Soviet Union and the other Communist countries in the length of the period their populations have lived under socialism. It is unlikely that even after three generations, the Marxist ideal of "Homo oeconomicus ... being replaced by Homo socialis" (Brus and Laski, op cit., p. 5) has been attained in the Soviet Union. However, there is likely to be a greater degree of amnesia about the personal attitudes and culture which underlie a market economy -- risk taking, entrepreneurship, acceptance of change as a way of life -- and a greater attachment to egalitarianism (based as much on envy as attachment to an altruistic moral code -- see Smith (1990) for some anecdotal examples). This attitudinal difference is likely to make it harder for the Soviet Union to make a full fledged move to the market and the acceptance of that economic liberalism which is increasingly realized to be its essential foundation.

One of the ways in which this difference could manifest itself is in popular reactions to the unemployment which must inevitably accompany the restructuring of productive relations in the move to the market. "The prospect of full employment of human and material resources constitutes the backbone of socialism's claim to economic superiority over capitalism" (Brus and Laski, op cit., p. 6). By contrast, frictional unemployment is unavoidable in a market economy, though its extent can be reduced by supply side measures such as training, and efficient information systems which match job-seekers with vacancies. Moreover, in moving to a new production structure there is likely to be an unavoidable short run rise in unemployment, as privatization makes the existing hidden unemployment in many State enterprises overt. For China, for instance, Ahmad and Hussain (1991) cite an estimate that "as much as 20 per cent of the labor force in the State sector may be unemployed in disguise" (p. 300). For the Soviet Union the joint IMF-IBRD-OECD-EBRD team estimates that on the radical scenario of a rapid move to a market economy (which from the experience of liberalization programs in developing countries is the only sustainable one (see Michaely et al. 1991): "unemployment would rise [from current rates of 1.8 per cent] to around 12 per cent in the first year of the transition period. The steady state value would be around 10 per cent" (IMF et al. (1991), vol. 2, p. 149).

The speed with which the initial "disemployment" is reduced by increased employment in newly productive sectors depends crucially upon the flexibility of the country's labor market. This flexibility is governed in part by the "reserves" available to economic agents to avoid adjustments to changes in their economic environment. If the reserves offered to workers in the form of welfare entitlement are too large they could postpone the required adjustments and hence accentuate unemployment levels in liberalizing economies. This obvious point has been amply borne out by the experience of GEMU (see Siebert (1991)).

The most detailed study of the effects of economic liberalization on unemployment is for developing countries. In these countries, because of poverty (and hence lower reserves from past savings), as well as the limited availability of welfare entitlement, economic agents have to adjust fairly swiftly to changes in their economic environment -- by altering the terms on which they are willing to exchange commodities (including their labor). It is not surprising therefore, that Michaely et al. (1991) found that trade liberalization, in particular, was "unlikely to do much harm to employment" (p. 81), and that "an emergence of unemployment, for whatever reason, has not determined the fate of the liberalization policy" (p. 84). Whether liberalization, particularly in the Soviet Union, with emerging pressures to expand entitlement and hence the "reserves" which postpone adjustment, will conform to these past patterns found in developing countries must remain an open question.

The differences in support for egalitarianism in various socialist countries could also place differing obstacles to the establishment of a market economy. Inequality of rewards following the removal of the socialist straitjacket is unavoidable and desirable -- because of the incentives required to achieve allocative efficiency. Egalitarian workers may resist this change. Winiecki (1989), citing Polish survey data, argues that workers are more concerned with absolute than relative gains. As long as the move to the market leads to increased efficiency and higher living standards they will not care about relative gains and losses. But some of the evidence cited in Smith (1990) suggests that this may not be true of Soviet workers.

The final and probably most important difference between the various socialist economies concerns the agents of the reforms. In both the Soviet

Union and China it has, to date, been a "top down" process, whereas in Eastern Europe it has been part of a "bottom up" process of "throwing out the rascals". This difference is important for the sustainability of reform. For, an essential element in establishing a market economy must involve the extinction of the nomenclature. The Soviets and Chinese are asking for their voluntary euthanasia, whereas the popular revolutions of 1989 in Eastern Europe are leading (however imperfectly) to their enforced demise. It would be surprising if a revolution from the top can be engineered by those who perceive themselves as its principal losers. That is why the proposals in this paper are likely to be irrelevant for the Soviet Union and China, until the parties of "real socialism" are overthrown. The dynamics of that process and its outcome are as unpredictable as the results of the most notable past attempt at a "top down" liberalization of a bankrupt mercantilist "ancien regime". I refer, of course, to the French Revolution, which began in 1788 with the calling of the Estates General by Louis XVI (see Doyle (1989)). Hence, the discussion in this paper is probably most relevant for the post-revolutionary East European countries. For the Soviet Union and China, still in the midst of, or awaiting their revolutions, this paper, like all the other paper plans floating around for demolishing their "ancien regimes", is not likely to be even a paper tiger!

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NOTES

[1]The actual topic assigned to me was social policy in the transition. However, as a moment's reflection will show, there is nothing special about the transition requiring policies to deal with problems of low or fluctuating household incomes which are different from those required once a market economy is established. In addition to the references mentioned in the text, I have also found the following recent works dealing with reform in socialist economies useful in thinking about the issues discussed in this paper: Aslund (1989), Charap and Dyba (1991), Collier and Siebert (1991), Crane (1991), Desai (1989) Dyba and Svejnar (1991), Ericson (1990), Johnson (1990), Klaus (1990), Lipton and Sachs (1990), Micklewright (1991), Nordhaus (1990), Ofer (1987, 1990), Winiecki (1986).

[2]See Alexander Gray (1946) for a lucid and entertaining account and critique of socialist ideas from Moses to Lenin. There has been a recent attempt to develop a theory of market socialism based on creating so called "starting gate" equality in a market economy (see Le Grand and Estrin (1989), and Hoover and Plant (1989)). For trenchant critiques from the viewpoint of classical liberalism see de Jasy (1990), Green (1990). For the dubious ethical foundations of the belief in egalitarianism see the essays in Letwin (1983).

[3]Hirschman(1991),a self-confessed liberal (in the American sense, that is socialist in European terms), has recently dissected the rhetoric of reaction. He finds three types of arguments based on perversity, futility and jeopardy have been used against the progressive agendas and reforms of the past two

hundred years. Though entertaining, the practical significance of his argument is unclear, particularly as he repeatedly says: "it is not my purpose to discuss the substance of the various arguments against social welfare policies in the United States and elsewhere" (p. 35). Surely, because an argument has been used before and often, does not make it wrong, and surely one of the lessons of 1989 must be that the constructivist progressive agenda begun in 1789 has, in practice, run into the sands. To "deconstruct" this truth through the currently fashionable study of rhetoric in literature and the law on U.S. campuses,is to descend into a world of nihilism, or fantasy.

[4] In Sweden, Lindbeck (1990) notes, welfare state policies have provided economic security and equalized the distribution of income, but

> there is a snake in every paradise. In this case the snake is the total marginal tax schedule. In the 1980s, when total tax revenues amounted to 50-55% of GNP, marginal tax rates were in the interval 70-80% for most income earners if all types of explicit and implicit taxes are included ... one important reason for these very high rates of tax is that the dominating ideology of social policies has been to avoid selective support of people ... [But] the negative substitution effects of higher marginal tax rates on aggregate labor supply in the open market have been mitigated by public sector provision of services to households. This counteracting effect is reflected largely in the high labor force participation of married women ... other types of public spending programs have accentuated the negative substitution effect on labor supply. One example is the health insurance system, which has given strong incentives for absenteeism from work. (pp. 17-8)

After listing the other distortions created- "on the job leisure", tax avoidance and cheating, distortions in returns to savings and investments -- he concludes: "it is extremely difficult, perhaps impossible, to quantify the effects of these distortions on the level and growth of GNP. However, it is a rather common opinion ... among both economists and politicians in Sweden today that the rather weak performance of productivity growth in Sweden during the last decades is related to these distortions". (p. 19)

[5]This can be seen as follows. Suppose we ignore the distinction between individuals and households. Assume the population is "n", and everyone is in the labor force. The mean individual income is "y", and the median "ym". Suppose there is a proportional income tax at the rate "t". All tax revenues = (t•y•p) are paid back as an equal per capita subsidy of "s" to the whole population (this is the negative income tax feature). Each individual will then receive a subsidy of s = typ/p = ty. The disposal income of the median individual is then ymd =(ym-t•ym+ty) = ym + t(y-ym). If the median income in a majoritarian democracy is less than the mean, the median voter's interest (which will be decisive) is served by maximizing his disposable income which will rise with the tax rate "t", until the usual disincentive effects on overall productivity set in (so t will always be less than one). It is likely that the tax rate t0 required to finance targeted benefits to say the lowest decile will be lower than the tax rate t which maximizes the median voters disposable income under the negative income tax. Moreover, as he does not receive any subsidies under the targeted program, his disposable income declines with "t" and hence his pressure to expand the transfer state. It should also be noted that from the viewpoint of political economy, the design of the tax-transfer system is best looked upon as the choice of a fiscal constitution where the citizens know the rules they choose must prevent the natural predatoriness of public agents (see Brennan and Buchanan (1980); Lal (1990a)).

[6]As Bhagwati (1988) emphasizes, the important difference between the socialists who want to adopt the direct welfare state route to poverty alleviation in the Third World, and those who argue that more can be done through the indirect route of efficient labor intensive growth, "is not

whether [the direct] route produces results but rather its productivity relative to that of the indirect route" (p. 548). With the slower growth in welfare state oriented economies relative to growth promoting comparators (Kerala versus Punjab in India, Sri Lanka versus Malaysia, for instance) it must be asked whether welfare states harm growth. To say that low income (and low growth) welfare states have better poverty alleviation outcomes than low income non-welfare states (the common comparison made) tells us nothing about the relative productivity in terms of alleviating poverty of the two approaches.