THE TRANSFORMATION OF
THE SOCIALIST GOVERNANCE SYSTEM

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This paper discusses the mechanisms of corporate governance in centrally planned economies in Eastern Europe. A critical analysis of the five co-ordination mechanisms proposed by Kornai (1992) (bureaucratic, market, self-governing, ethical and family co-ordination) reveals a number of well established institutions in Central and East European societies and the failure of these institutions to facilitate efficient economic transactions.

A model of the corporate governance in the socialist economies is proposed. An examination of the administrative links reveals the dynamic system of negotiation and bargaining between firms and government agencies in the past. The uncertainty of outcomes of these former negotiation practices is compared with the uncertainty of the business environment during the current transition period.

A thorough discussion of the elements of the institutional framework in transition economies is based on the work of Chavance (1992) and Frydman and Rapaczynski (1994), and highlights the contradictions in the efforts of governments to design markets.
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I. Introduction

One of the authorities on the Socialist System of central planning is Janos Kornai. His detailed knowledge of the governing mechanisms in the socialist economies has met only few challenges. One of the aims of this paper is to look at Kornai’s typology of co-ordination mechanisms applied by the Communist governments in Eastern Europe. Our critical analysis of his work suggests a new concept - ‘political co-ordination’ - as more appropriate to describe the governing relations and mechanisms for management of the economic transactions within the central planning economies.

A new model of the administrative co-ordination in Central and Eastern Europe is discussed in the paper and presented in Fig. 1. The model describes the administrative links between the enterprise and the other economic agents in the past. Our analysis highlights some of the reasons for administrative failure during the reform period before 1989. Discussion of the resent changes after the collapse of the Central Plan asserts the negative effect which transition policies had on the enterprise management and the failure of the new system to establish incentives for restructuring of the economy.

II. The co-ordination mechanisms in the socialist system

Janos Kornai (1992) provides one of the most comprehensive analysis of the socialist system, discussing the construction of power relations and the ‘cohesion’
between political leadership (through ideology), administrative governance (through state apparatus and enterprise administration) and mass public organisations. The ‘interweaving’ between the state and the ruling Party had a significant impact on the mechanisms for allocation of economic and political responsibilities. The amalgamation of ideology, power, privileges and coercion had produced a unique decision making pattern applied across the whole system. Political decisions from the top are transmitted as executive decisions at enterprise level. The entire system of economic relations was managed through political platforms and political aims and objectives. Flexible targets for economic performance were set in non-monetary terms (Hirschhausen & Hui, 1995).

The power for decision making and allocation of resources was concentrated within a vigorously selected elite, formed by political and managerial apparatus. The resolve to retain power by these individuals was determined by the high prestige and the range of material privileges in their hands. The coercion used by the Party organs to maintain Party and state discipline produced a specific pattern of conformity among the members. In spite of the intensive monitoring of personal conduct, the lack of transparency within the authority relations allowed abuse of power at all levels.

In this context, the notion of economic rationality becomes an alien concept, or a second rate objective, the first one being political discipline. A director of a state enterprise, for example, would have a Party task to manage the firm in accordance with the State Plan, and with the political instructions descended from the higher political organisation. Strategic management at enterprise level would mean primarily obeying orders and following contradictory rules.
The contradictions usually derive from different organisations and state administrative departments - all ‘sharing’ responsibilities for supervision of the firm. The co-ordination of the activities of all agents managing the socialist economy is described here as the governance system in the socialist countries.

Kornai (1992) looks at a number of co-ordination mechanisms used by the socialist system: (1) bureaucratic co-ordination, (2) market co-ordination, (3) self-governing co-ordination, (4) ethical co-ordination, and (5) family co-ordination. The focus in his analysis is on the main actors, participating in the co-ordinated activities, their motives, and the relationships between them. The author argues that under the socialist system, bureaucratic co-ordination is the widest mechanism applied, while all the others are repressed and atrophied.

Kornai defines bureaucracy as the interweaving apparatus consisting of all political, state and administrative agents. He also distinguishes, between bureaucracy and bureaucratic co-ordination referring to the distinction between an organisational hierarchy and a co-ordination mechanism. It is not clear from his analysis whether the mechanism applies with equal strength in co-ordinating specific organisational process, vs. societal relations as a whole. If we accept his proposition, this would mean that the ‘organisation’ of the society would be subordinate to the co-ordination ‘mechanism’. The question is, where the co-ordination mechanism originated from in the first instance.

The separation between bureaucracy as a social structure and the bureaucratic co-ordination as a form of social relations hides the way economic agents are interlinked in the society. Our understanding, on the contrary, is that an
‘organisation’ and a ‘co-ordination mechanism’ are dialectically congruous, and by bureaucracy we understand organisational structures, agents, processes and co-ordination mechanisms as a unified entity (much more in Weberian sense). The co-ordination mechanism is indispensable from the institutional structure that facilitates its wider application.

Before we discuss in details the five co-ordination mechanisms suggested by Kornai, we have to introduce the distinction between political bureaucracy and state bureaucracy. It is true that the two are very much interlinked in the socialist system. However, political apparatus supervises the work of the state apparatus, and co-ordinates elections and appointments of state officials and functionaries.

* bureaucratic / ‘political’ co-ordination

As one of the most significant features of bureaucratic co-ordination Kornai points out the overlap of activities of the Party, the state and the mass organisations. All three types of institutions have established both functional and regional linkages for communication and supervision. Kornai also adds the political police as a network of control which guards the general public on a residential or occupational basis.

In practical terms this means that a director of a company will have to comply not only with the indicators of the Plan, with the decisions of the higher economic organisation (or relevant Branch Ministry) which appoints him, with the regional branch of the Communist Party which raises his candidature, with the regional authorities and mass organisations (involved also in policy & investment decisions), but also to ‘watch his/her back’ from the hidden policing structures that monitor the public opinion. The hidden police utilised both low and high status informants for
the purpose of state and political control. In this complexity of relations and information exchange one could never be sure how his /her performance is judged.

All these layers of social engineering raise the question - to what extend we may call this system of co-ordination ‘bureaucratic’. With the duality of rules, the parallel regulations, the mixture of vertical, horizontal and overt dependencies between individuals, we may conclude only that each individual in a ‘prestigious’ position within the hierarchy has to conform with a multiple set of personal and political dependencies.

In this context strategic management takes the shape of lobbying and negotiations with multiple agents - i.e. the regional/district Party Committee, the Branch Ministry, the Central Planning Office, the relevant professional association, the local and central Trade Union authorities, the enterprise Party Committee with its Chairman. The content of the strategic management is still focused on allocation of resources. However, the rationale for it is based not on efficiency and economic rationality (even though economic rationality is used in the argument), but on the principles of political acceptability, influence, prestige and mutual exchange of material and other privileges by the individuals involved.

What is assumed to be a bureaucratic co-ordination in reality could be associated much more with a concept of ‘political co-ordination’ which resembles the interests of all parties involved. Political co-ordination in the former socialist economies was achieved through two parallel processes: a) the setting up of the rules and the regulations for management of all economic transactions, and b) the monitoring and assessment of the enterprise performance. The rules and procedures were designed
by political agents in accordance with the ‘party line’. The assessment of the managerial performance and the production results were also conducted by Party officials.

The assessment criteria used in the economies in Central and Eastern Europe were of the type of ‘achieved objectives’ and ‘successfully performed activities’, rather than specific profitability and efficiency indicators. Therefore, the political and administrative co-ordination of economic activities could not provide incentives for improvement of efficiency.

* market co-ordination

In relation to market co-ordination in the socialist system, there are fundamental questions still without satisfactory answers. A question of this kind is, for example, was there a labour market, when there was no labour mobility? The restrictions on labour mobility were many, including the so called ‘township rights’, restricting employment within the area of the town of residence. Kornai doesn’t give a definite answer to the question of the existence of markets in the socialist system. He assumes that the supply with centrally allocated materials and products resembles a market in a sense that it requires additional ‘payments’, or for example ‘bribes’, to representatives of firm suppliers (Kornai, 1992). The ‘value’ of this additional ‘pay’ would be determined by the size of the deficit, the monopoly of the suppliers, and the objectives of the buyer.

However, usually firms did not have a choice of their suppliers. Bribes were used to assure that the prescribed transactions happen according to the Plan, rather than to purchase resources from alternative suppliers.
It is difficult to accept the argument of ‘distorted’ market co-ordination, because it assumes a dynamic relationship between demand & supply. When you have a condition of continuous and chronic deficit (as in the deficit economy of the socialism), the link between demand and deficit requires much more vigorous analysis. The opportunistic behaviour of the firm in this example can not be associated with a form of market behaviour, particularly when there is a complete monopoly on the supplied product.

Another example of a peculiar combination of bureaucratic and market co-ordination, which Kornai gives, is the households selling labour to the state owned firms and co-operatives. The author concludes that “bureaucratic public property attracts bureaucratic co-ordination while private property attracts market co-ordination” (Kornai, 1992, pp. 103).

It is not clear at all how Kornai interprets the fact that the labour market is highly regulated. When an enterprise is given a quota for the number of employees and their salary grade, the so called ‘demand’ is neither determined by the economic conditions of the firm, nor by the managerial decisions for a potential ‘purchase’ of labour. Individual labour is treated by the Central Plan as a resource that has to be developed by education and training institutions, and allocated to different sectors of the economy.

The assumed ‘supply’ of labour for most of the professional categories is determined by indicators from the central planning office regarding the number of specialists to be trained for specific industries and firms. This suggests that it is not
the public property of the firms, but the central planning mechanism, that distorts the market relations. To consider the households as suppliers of labour ignores the fact that they are not at all buyers of education. The education is ‘provided’ for them by the state, and their labour after graduation is allocated again by the state usually through the Branch Ministry. The principle of planned allocation of resources excludes any form of market co-ordination through demand and supply at macro level. The public ownership facilitates the smooth operation of the planned co-ordination of labour resources, rather than generating, or ‘attracting’ it, as Kornai suggests.

In any case, we support Kornai’s view of some coherence of the system. However, we see that this coherence lies between the public ownership of assets and the planned allocation of resources (or Kornai’s blocks 2 and 3), rather than the inevitability of political supervision of economic activities.

* **self-governing co-ordination**

With regard to the mechanism for self-governing co-ordination, Kornai presents extremely contradictory analysis. He starts with the thesis that “nominally, the mechanism of self-governing co-ordination exists in numerous spheres of the classical socialist system” (Kornai, 1992, p.103). The author finishes his argument with the statement that “the power structure of the classical system is fundamentally incompatible with the mechanism of self-government” (p.105).

From his analysis it is evident that formally both the structure of the Communist Party and the structure of the state are build upon the basic ideas of democratic elections and self-governance. However, in practice, the high level of coercion, or
we may call it ‘political engineering’ (i.e. manipulation of public decision making), suggests complete lack of autonomy and independence. Therefore, it is not clear why Kornai suggests the mechanism of self co-ordination as relevant to the classical socialist system.

With the high level of control in the society, any democratic form of decision making will mean merely a situation where a control agency allocates a limited amount of trust to a particular organisation - co-operative, mass organisation, or professional alliance. The metaphor that could express this trust is ‘a fish in a pond’, or the decisions are autonomous as long as they comply with already established rules and lead to the achievement of externally set objectives. This analysis suggests that within the socialist system there were fundamental barriers to self-governing co-ordination in the form of politically set objectives and targets for all economic agents.

* *ethical co-ordination*

Under ethical co-ordination Kornai suggests some very insightful examples of a donor / recipient relationship. These examples include highly ethical personal sacrifices, mutual assistance practices, or favours between firms (Kornai, 1992). Kornai does not pay much attention to this co-ordination mechanism. However, we believe that in the socialist system it is a fundamental one, and it influences a range of recent practices observed during the transition period. It is worth mentioning three examples given by Kornai himself: a) “voluntary work to provide a local kindergarten, school, or hospital, or to rehabilitate a playground; b) friends will help build somebody’s house, each one knowing that he can count on similar assistance when he needs it; c) the manager of one firm will help the manager of another by
supplying a component, hoping that he can expect similar support next time” (Kornai, 1992, p. 105-106).

If we look more carefully at these examples, we could see a distinctive pattern of relationships in the society - one of reciprocity, mutual interest and social cohesion. It is speculative to judge whether the need in a deficit economy had forced people to behave in this manner, or whether these communitarian attitudes of reciprocity are rooted in specific cultural values that derive from the Orthodox religion, or from other institutions. What seems apparent, is that after the collapse of the central planning system, these private networks were re-evoked to support the survival strategies of the transition period after 1989.

* **family co-ordination**

It is not clear why Kornai discusses family co-ordination mechanism only as part of the private life. He asserts the decline in the role of the family through the following examples: a) elimination of the family undertaking by the socialist enterprise form of production; b) traditional family activities being taken over by institutions (including holiday camps, vacations, nurseries, hospitals, extensive use of canteens); c) the expansion of female labour; and d) collectivised, institutionalised and organised activities for all members of the family.

These examples demonstrate the penetration of systemic features into the family institution. The fact that the socialist society is taking care of a number of traditional family duties does not suggest weakening of the family relations and their influence on individual behaviour. On the contrary, the vigorous selection of personnel for a political career, conducted by the Party organs, was based on the principle of
‘political trust’ and this meant first of all a detailed review of the family background of each individual. The mechanism of selection of administrative and political elite generated incentives for arranged marriages among the high echelons of power. The practice of employing relatives in high positions emphasises that the role of family bonding in providing trust is fundamental in preserving power. The family co-ordination mechanism therefore has been used as a vehicle to secure one’s position in the socialist society.

In essence, the dominant co-ordination mechanisms in the former socialist countries include political co-ordination through the nomenclature, controlled self-governing co-ordination through targets and externally set objectives, ethical co-ordination corresponding with the communist ideology, and family co-ordination particularly in the selection of political apparatus. These mechanisms in the centrally planned economies were conducted through mass political and professional organisations and through the monolithic party apparatus - selected and carefully positioned within the state-party hierarchy.

III. Administrative co-ordination and administrative strategies

All co-ordination mechanisms, used by the socialist system, were embedded in what Marx called the central allocation of social labour. Socialism eliminated both private ownership of the means of production and the anarchy of the market, and created a space within the social milieu of an organisation on the large scale of the entire national economy. The main tools of this organisation were the Annual and the Five-year Plans.
The institutions controlling the process in most countries were: the National Planning Office; the Central Plan (endorsed by the Central Committee of the Party); the Government (usually following instructions from Politburo), and the Parliament to enact the Plan. The planning methodology was based on a complex set of criteria aiming at an equilibrium both at the aggregate level of the national economy and at the subordinate levels of ministries, industrial associations and firms. The process involved a systematic disaggregation, further calculations and interpretations of the tasks in the Central Plan.

Even though it was a downward flow of information and had obligatory status as a command rather than a recommendation, it involved a number of institutions and individuals and that made it open to re-negotiations. It would be a practice for powerful managers of firms and industrial associations to negotiate at the level of Ministry a ‘better deal’, altering both inputs and output targets. This would happen either before the Plan was finalised, or even after its endorsement. The ‘correction’ of the Plan could be enacted through a decision by the State Council and the Council of Ministers (both controlled by Politburo).

Usually the reports of the implementation of the Plan would follow the same vertical line and, in the process of their aggregation, the accuracy would be traded-off for a demonstration of compliance. The horizontal links of information exchange and negotiations between Branch Ministries and Industrial Associations normally would focus on issues of resources and quantities, rather that improvement and development (see also Kornai, 1992). It has to be mentioned, that this downward and upward flow of information was facilitated not only by the formally responsible institutions, but also by the patronage networks and informal (or political) links.
between individuals (see also Willerton, 1992). Figure 1 describes the corporate governance in the socialist system, including information flow and subordination of decisions.

**Fig. 1: Administrative subordination and management in the system of central planning**
* governance structure (block 1) *

The main aim of the State Plan was to develop ‘quantitative macro-economic goals for the economy as a whole’, and to break them down to Branch Ministries (Chavance, 1994). The institutions involved in the process of formulation of these macro-economic goals are presented in (Fig. 1., block 1.), and are labelled ‘governance structure’. The role of the governance structure in the socialist economy was to set up economic targets, to define mechanisms for the achievement of these targets, and to establish the necessary institutional framework for monitoring and control of the performance of all economic agents. There were variations in each Eastern European Country of the responsibilities within the governance structure. However, the principle of the Central Plan remained the same.

The main governance structure comprises of five interdependent agencies: 1) Politburo and The Central Committee of the ruling Party (defining the ‘Party line’, the political aims for development and supervising the performance of the other institutions), 2) Ministry of Planning (responsible for the co-ordination of the Plan), 3) State Council (issuing normative documents that facilitate the implementation of the Plan), 4) Council of Ministers (responsible for the implementation of the Plan in individual sectors of the economy), and 5) The Central Bank (facilitating and recording information about the economic transactions between firms). The Parliament usually played an insignificant role in endorsement of decisions already made. The political control and supervision of the entire process was conducted by the Party apparatus, who was empowered to make value judgements and ‘recommendations’ in the form of instructions for action.
Neubauer and Demb (1993) quote Kester (1991, p. 10) for his definition of “governance system” which broadly implies the entire set of incentives, safeguards, and dispute resolution processes used to control and co-ordinate the actions of various self-interested parties (i.e. stakeholders) interacting in a bilateral exchange relationship. The State Plan indicators transmitted from the ‘governance structure’ to the ‘enterprise system’ (block 2.) would provide the instructions for company performance. However, the Plan itself, very well described by Kornai (1992), does not deliver incentives, or safeguards, or formalised dispute resolution processes. These mechanisms for corporate governance had to be designed at the level of the ‘socialist enterprise system’ which involved all related political organisations and intermediary institutions (Fig. 1., block 2.).

Our concept of the enterprise system corresponds with the proposed model by Hirschhausen and Hui (1995) of the ‘socialist industrial unit’, networked in a set of economic relations dominated by ‘scriptural flows’, or ‘scriptural money’ transfers. Scriptural money, according to Hirschhausen and Hui (1995, pp 422), is “...nothing but an accounting unit for balancing the Plans”. The real money become redundant and of second rate consideration in relation to economic decisions.

* enterprise system (block 2)

There were different numbers of intermediaries involved in the process of disaggregation of the State Plan into quantified figures. The figure determined ‘production sector goals’ and ‘mandatory targets’ for different sectors of the economy. The intermediary institutions were in charge of the operation management of all enterprises and, as Chavance described them, they “supervised all aspects of
the Production Plan: the supply and turnover of goods, the determination of prices, the wage fund, and relations with financial agencies” (Chavance, 1994, p. 13).

If we look at the corporation itself, it is intertwined with other economic and political organisations, playing a variety of roles in the company decision making process. In the model in Fig. 1. they are listed as: 1) the Branch Ministry, 2) the Industrial Association - as a holding company, 3) representative departments from the Ministry of Trade, responsible for the trade links of the company (including imports, exports, and realisation of the product on the market); 4) the local Party organisations, based in the firm and in the region, 5) the company branch and the regional branch of Youth Communist League (usually involved in career development and promotion), 6) the company branch and the regional branch of the Trade Unions, and 7) the employees (with their limited influence mainly at the level of supervisory management).

All relationships of the firm in the past were pre-determined by administrative and political decisions. There are already very good descriptions in the literature of the administrative allocation of inputs, the bureaucratic setting of prices, the budgetary redistribution of financial resources through local branches of the Central Bank, the administrative control of the wage scales and wage funds (Chavance, 1994). Kornai (1992) also points out that fundamental decisions for establishment of a firm, or its liquidation, for appointment, promotion and dismissal of managers, for allocation of products, materials and labour, for price setting and financial regulation, for investment and technical development, for foreign trade and international economic relations - all were made entirely by what he called the bureaucracy.
The political and administrative apparatus of the state had the most-comprehensive knowledge of the firms’ affairs, and were in control of all contracts and, what might be called, ‘business opportunities’ for individual firms.

It is clear, that no reform could liberate firms from their political and administrative supervisors - individuals and institutions that hold only collective responsibilities for misjudgements and misallocation of resources. This is why the political pressure to overthrow the system came from inside, rather than from outside.

Here, we would like to return to our discussion of the concepts bureaucracy, apparatus, and nomenclature, and particularly Chavance’s distinction between bureaucracy in the classical sense and nomenclature. A very important characteristic of the nomenclature, according to Chavance (1992) is the common practice of the socialist system for a ‘superior’ organ to intervene directly in the decision making of an ‘inferior’ to it structure, without following normal hierarchical procedures. The situation of a bureaucratic structure, which overrides its own rules suggests that the formal rules are either non-existent, or undermined by the superior authority, or by informal practices.

For example, the formal appointment of enterprise directors was controlled by administrative decisions at Branch Ministry level. However, the actual individuals were selected entirely by the ruling Party elite with the power to override the administrative decisions. The role of trust and loyalty in the selection process outwitted the evaluation of competencies and expertise. The appointment itself was formalised as performing ‘Party tasks’. Managers could be misplaced or re-located by the Party, or other superior officials without a procedure, or an opportunity for an
appeal. This suggests a highly uncertain political environment and is in contrast with the concept of bureaucracy which brings order and certainty through strictly defined set of rules and procedures.

The fact that all decisions were made by a group of individuals interconnected through political ties, is crucial in understanding the motives and the rationale of the decision making process in the former socialist system. In this context, it is more valid to describe the corporate governance in the socialist system as a political network, rather than a bureaucracy.

Kornai (1992) himself argues that in the classical socialist system politics pervades the economy. The political bargaining and negotiation between enterprise directors and ministerial officials created room for randomness and arbitrariness in the creation of the Plan and neither the Plan itself, nor the commitment of the negotiating parties could guarantee the full utilisation of resources and hidden productive reserves. Therefore, the Plan as the main means of co-ordination of economic activities became an obsolete social device, unable to reform itself and to perform its functions.

The operational management of firms was highly influenced by personal and group interests within the company and its immediate environment, rather than economic rationality. The strong personal ties that the company director usually had to maintain (both internally and externally) to secure the performance and the position of the company, were essential ingredients consolidating the system.
In our model we use the term ‘socialist enterprise’ as a single legal entity and administrative unit with a complex structure of subordinated firms and departments. Our model puts emphasis on its dependency on a network of institutions and agencies discussed above. The socialist enterprise in our model resembles the notion of the corporation in the western literature and has been the main target of all reforms of the socialist system with numerous attempts to shift power from one level to another, through centralisation or de-centralisation of decision making, and through shifts of control by the political authority.

* COMECON partners (block 3)
The third block in our scheme emphasises the role of international agreements for economic co-operation. Most of the international trade happened within the framework of the association for economic co-operation (COMECON). Contracts were signed in Russian Rubbles and the same principles of specialisation at macro level and elimination of competition between partner countries were applied. Decisions for business transactions between enterprises were negotiated at government levels. Crucial aspect of these business linkages was that the decision for co-operation was made by outside bodies, rather than by the enterprise managers themselves.

However, at firm level an intensive technical know-how exchange would occur directly between partner companies, linked into these international business networks within COMECON. These international partnerships did not expose the inefficiency of individual firms and did not provide incentives for improvement. As an element of the governance system of the socialist economies, it shows the efforts
by socialist governments to eliminate competition. The main vehicle was through increased asset specificity that matches long-term contracts.

* relationships with suppliers (block 4)

As it is indicated in (Fig. 1., block 4.), the company relationships with the suppliers were pre-determined by the governing structure. This form of ‘rationing’ of resources, coupled with the frequent disruption of the supply system, induced a specific type of protective managerial behaviour - overstocking and hoarding inventory, or establishing informal horizontal relationships with other inter-linked enterprises. This very much resembles the concept of an ‘alternative’ business strategy, aiming to serve as a buffer for supply disruptions (see also Chavance, 1994).

Some of the reforms in the past addressed issues of company management, creating incentives for improvement of company performance, productivity and efficient utilisation of resources. Other reforms like the creation of commercial banks in Germany (1967), Poland (70s), Bulgaria (80s) aimed to achieve more structural changes in the economy, and in this way to enable enterprises to perform better. In spite of the reformist efforts to build incentives through regulations of the firm’s relationships with suppliers and customers, the final product of the enterprises remained anonymous and undifferentiated. It was delivered through the retail and wholesale networks to anonymous customers in a deficit environment (Fig. 1., block 5.).

* customers (block 5)
The link between the firm and its customers in most cases was broken. There was no regular information on to what extent firm’s products satisfy real customer needs, and therefore there was no pressure on firms to improve their products and to extend their product range.

* general public (block 6)

The general public remained isolated from the process of quality evaluation and social control, and therefore could not signal in any way that its needs were not being satisfied, or its interests were being damaged. The system that was designed with the most humanistic values - to serve the interests of its citizens - failed to recognise that the needs of these citizens evolve and can not be framed any longer as mass consumption.

This is the point of our main disagreement with Kornai that the system is coherent and viable in a medium-term - “controlling social activities vital for survival” (Kornai, 1992, p. 378). This is a very narrow view of the purpose of the system. For those that were inspired by the system and supported it throughout its evolution, the purpose of the public ownership of the means of production was to create a better society, and not just to survive the post-war period.

Yes, there is a coherent match between public ownership and central allocation of resources. However, there is no coherence between political leadership (based on the leadership role of the Communist Party) and political discipline (eliminating alternative thinking from the whole society). There is no coherence between public ownership and elimination of competition in the economy. There is no coherence between public ownership and the elimination of money as incentives and means of
economic transaction. There is also no coherence between the democratic principles of representation and the centralised control and supervision. The contradictions built in the system were fundamental to lead to its failure.

It was the ideological blindness of the ‘Great Designers’ of the system - the ruling Political elite - that failed to acknowledge the fact that economic activities in a society have real value according to their efficiency and effectiveness, and have variable costs that can not be measured by the central planning authority, and consequently incorporated in the Plan itself. We can emphasis this point with just one example - the cost of delays.

The model of corporate decision making, presented in Fig. 1., raises the question of identifying the insiders. There are two groups that possess crucial information about the company - those within the firm with tacit knowledge about the product and the production processes, and those outside the company with detailed information and knowledge about the market, including resource suppliers and buyers.

The problem of information supply is indicated by the links shown on Fig. 1. The company would share information with all institutions closely linked with it - Branch Ministry, Trade Unions, local Party organisation and the rest. However, each of these institutions may withhold information to strengthen its position in negotiations with the firm. The information links with suppliers and customers would follow the pattern of predetermined exchanges and therefore would not pass any signals about the changes in demand and the customer response.
Once the communication infrastructure of the Plan was withdrawn after the collapse of the system in 1989-90, it certainly brought an array of new costs to individual firms, that increased the severity of the situation. The collapse of both the internal and the COMECON markets restricted the revenue options of the firms. At the same time, the managerial functions performed by the Central Planning authorities in the past had to be reconstructed at the enterprise level independently.

The model in Fig. 1 resembles broadly the system of all stakeholders, as described by Neubauer & Demb (1993): a) the providers of funds and the government (integrated in an interdependent network of institutions); b) the employees (assimilated within the enterprise system - a process facilitated by the subservient Trade Unions and other political organisations operating in the enterprise); c) customers and suppliers (centrally allocated to enterprises by the governing structure); d) and finally the general public, whose needs were satisfied through a centralised distributive network, and whose behaviour was highly manipulated by the local political organisations (see Neubauer & Demb, 1993).

It is clear that only the political and administrative elite involved in allocation of resources and supervision had any bargaining power. The rest of the stakeholders - employees, customers, suppliers, and the general public (who ironically ‘owned the means of production’) had no say on the management of all assets, or to express an opinion on any other more fundamental issues related to the co-ordination and control of economic activities.

IV. Administrative failure and the business environment during the transition period
The failure of the socialist system is very well described in a number of publications (Kornai, 1992, Chavance, 1994, Frydman & Rapaczynski, 1994, Dobrinsky, 1996). The description of the business environment during the transition period in Eastern Europe is dominated by some well established observations and a number of assumptions which are not supported by clear evidence. There are no doubts about the deep transitional recession, the lack of clear criteria to distinguish the potentially viable enterprises from the rest, the absence of well defined national strategies or policies, the operation of conflicting policy goals, the lack of public experience, and the strong and militant Trade Unions (see Dobrinsky, 1996).

At the same time, there are a number of assessments of the current systemic problems that are entirely speculative. Statements like the shortage of experienced and capable bureaucrats and enterprise managers, or the lack of proper institutional infrastructure (Frydman & Rapaczynski, 1994; Dobrinsky, 1996) are based primarily on personal observations, rather than systematic research. By institutional infrastructure it is meant merely financial institutions and controls. This narrow interpretation of the concept has induced delays in the restructuring of the ‘other’ non-financial institutions - the regulatory and law-enforcement bodies, the professional associations that embodied expert knowledge, and the public organisations that could exercise social control and could facilitate the protection of the public and the consumer interests.

In this context, the abolition of structures and procedures of the central planning system could be interpreted not merely as part of the reform process, but also as a destruction of the economic infrastructure. The State Plan centralised not only decision making power, but also managerial costs for a number of crucial
operational decisions about resources and supplies. The sudden collapse of the Plan created a regulatory vacuum for the enterprises.

The fact that is ignored from the current academic analysis, is that even in an ideal market economy the ‘spontaneous’ business transactions occur in an environment organised by rules, and all players are usually informed about these rules. With the collapse of the State Central Plan in Eastern Europe, the ‘administrative failure’ was associated with the inability of governments to determine the appropriate rules, to communicate them to businesses in an appropriate way, and to control how these rules are implemented.

The speed of the fundamental changes in co-ordination of economic activities was a major barrier to governments to design reform programmes and to acquire the necessary public support. In the case of Eastern Europe, the transition brought to power governments that were constituted by individuals with limited experience in government and with undermined credibility because of the dramatic decline in living standards. So, in principle, governments in the ‘new democracies’ were relatively weak.

Returning to the question of the ‘rules’ and regulations for macro-economic and enterprise restructuring, one thing is evident, that the instability of the business environment does not facilitate development of long term strategies, even if they are perceived as necessary by the managers. To give some examples - these are the monetary policies pursued by all governments in Central and Eastern Europe of high interest rates and frozen credit lines. The most exemplary regulations with contradictory consequences include:
- hardening budget constraints, which forced the enterprises to search for alternative sources of finance through increasing overdue payments and enterprise arrears (Dobrinsky, 1996);
- government intervention in the form of cancellation or rescheduling of enterprise debt, which resulted in delaying structural reforms, and new signals to managers encouraging opportunistic behaviour.

If we look at Fig. 1., with the collapse of the Central Plan, all communication links between the individual blocks of the system disappeared. Governments could not honour any longer COMECON agreements. Enterprises lost allocation of suppliers or customers. Firms lost information of the demand for their product, or, due to the economic recession, the demand dropped dramatically for many sectors of the economy. What the socialist countries faced was a bunch of dis-co-ordinated government agencies and disoriented firms in an information vacuum. Here we talk not about the media, but about specific information that could be used for business decisions. The Plan was the main information source for state firms.

The reversal policies that governments in Central and Eastern Europe had to adopt delayed further the inducement of market incentives. The re-capitalisation of some state owned enterprises by the State Ownership Fund in Romania, for example, induced incentives for short term opportunistic behaviour rather than for enterprise restructuring. Dobrinsky (1996) gives a good account of the response of the financial sector to transition policies. According to him, the increase of interest rates raised the price of credit and the credit barriers. This development was detrimental to firms in relation to their increased demand for finance, necessary to service the
enterprise restructuring. These financial conditions ultimately lead to corruption in the banking sector and uncontrolled insider lending (Dobrinsky, 1996).

The dominant motivation for all economic agents for individual and organisational survival suppressed any entrepreneurship and innovation within the state sector. Dobrinsky (1996) suggests that managers have become more risk averse and attempting to avoid radical measures for enterprise adjustment in a situation of collapsing markets.

The failure of the administrative system is manifested in its inability to provide incentives for restructuring, to exercise control over the dysfunctional behaviour of individual managers, or to obtain adequate feedback about the implications and effectiveness of specific policies. These failures marginalise business activities and transmit the message to managers that it is entirely in their hands to establish new business associations in order to survive in a hostile environment.

The new corporatised form of state companies effectively opened the space for control over state owned firms by individual interests. As Frydman and Rapaczynski (1994) point out, all the efforts to decentralise the system of decision making both before and after the collapse of the communist regimes freed the force of ‘special interests’ - group, professional, institutional and individual - instead of introducing incentives and releasing productive energies. These reforms in principle served to re-locate power, rather than to introduce competition and new incentives to firms. The most recent privatisation, in this respect, also has failed so far to assure effective control over the management of the enterprises, or in the majority of cases,
to provide access to fresh capital and foreign expertise, or to facilitate structural adjustments at macro level.

We see the main reason for that being the shift of emphasis on issues of ownership and property rights, rather than on issues of co-ordination mechanisms and organisational forms that stimulate innovation and improved efficiency. The need for systemic changes made the shift to liberal economic policies unobstructed. However, the lack of discussion on alternative economic scenarios and organisational forms, and the inability of governments to pursue long-term policies led to the total collapse of the economic system of the countries in transition.

V. Conclusions

Our aim in this paper was to develop an argument about the role of the institutional environment that facilitates the economic transition in Central and Eastern Europe. A review of the co-ordination and control of the economic activities by the socialist system of Central Planing in the past is compared with some of the transition mechanisms and policies at present.

Our argument is that the Central Plan played a fundamental role in Central and Eastern Europe, and its sudden abolishment was inappropriate for establishing new organisational forms of production. The successful replacement of the Plan with a deregulated market is obstructed by weak governments, by contradictory and reversal policies, and by the information vacuum that surrounds enterprise activities. This replacement was driven much more by ideological considerations - to secure irreversibility of the transition processes, rather than by economically viable decisions.
The collapse of the totalitarian political system that played a retrograde role in the development of the East European societies was welcomed by all citizens. However, the Neo-liberal economic policies imposed by the international financial institutions had a destabilising effect on these national economies.

We believe, there is no room for political obituaries for the Communist Party in those societies. However, Neo-liberalism is not a solution for the East European economies. A more gradual approach including industrial economic policies and institution building is required. We can not expect that economic activities in industrialised societies at the end of 20th century could be left to die away, and than to pick up again from scratch in a new ownership form without access to new markets.

It is equally utopian to believe that a successful systemic change could by supported mainly by new business start ups, foreign direct investment, and the growth of local financial markets (as in the case of Poland). The building of the economic infrastructure is a prerogative of the state, and the state’s position has to be re-established in relation to the market.

Further research is required to reveal the barriers for establishment of new corporate governance practices in Eastern Europe.

**Bibliography**


