Transitions to Capitalism and Democracy in Russia and Central Europe

Achievements, Problems, Prospects

Edited by
M. Donald Hancock and John Logue
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M. Donald Hancock and John Logue

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Preface

This volume is the culmination of intensive transAtlantic collaboration involving fourteen American and European contributors and a number of expert consultants. The participants have joined in an extended, personal, and professional quest to explicate one of the most profound transformations of the twentieth century—namely, parallel economic and political transitions in Russia and Central and Eastern Europe from orthodox communist regimes, to a complex universe of market economies and pluralist democracies.

Planning for the project dates from the summer of 1992, when the coeditors conferred with Bernt Schiller of the University of Göteborg to discuss an appropriate sequel to their earlier highly rewarding venture, Managing Modern Capitalism: Industrial Renewal and Workplace Democracy in the United States and Europe (Greenwood, 1992). The intellectual impetus in both cases was the Council for European Studies’ daunting challenge to encourage multidisciplinary investigations of important political and socioeconomic issues transcending time and national boundaries.

Invited participants met in a planning session at Vanderbilt University and subsequently convened at research conferences at the University of Göteborg, the Wissenschaftszentrum in Berlin, and Kent State University. They exchanged and critiqued preliminary drafts of the country and comparative assessments, which, in edited versions, constitute the chapters that follow.

We gratefully acknowledge financial and institutional support from the Council for European Studies, which provided a Pan-European Research Planning Group award that enabled us to launch the project; the German Marshall Fund of the United States; the Washington, D.C., office of the Friedrich-Ebert-Stiftung; the Graduate Research Council and Center for European Studies at Vanderbilt University; the Research Office and the College of Arts and Sciences of Kent State University; the German Academic Exchange Service (DAAD); numerous contacts at the former trustee agency for privatization in Berlin; the
CHAPTER 10

Knowledge and Institutional Change: Market Leninism versus Popperian Incrementalism

David Ellerman

“Autonomous” derives from “self” (auto) and “law” (nomos)—the property of having the “law” or principle of operation being derived internally as opposed to being imposed from an external source (heteronomous). How can external agents sponsor autonomy-enhancing development in individuals, organizations, regions within a country, or whole countries? At first glance, that seems like a contradiction in terms, like “forcing spontaneity.” While not impossible, external aid to autonomous development is nonetheless a subtle enterprise. Much development assistance is paternalistic in many obvious and not so obvious ways and increases long-run dependence. But the road to autonomy is also not autarky or isolation (e.g., as in Albania or North Korea). External relationships can bring the fruits of specialization and gains from trade without sacrificing autonomy (e.g., compare modern Japan to its closed society before the mid-nineteenth century).

Capital has played a central role in development assistance in the past, but today knowledge, the fourth factor of production, is moving onto center stage. Compare, for example, the knowledge-rich, but resource-poor countries of the East Asian “miracle” with the resource-rich, but knowledge-poor, countries of the Middle East. My analysis therefore focuses on the role of knowledge in shaping the methodology of autonomy-inducing development. On this general theme, we may start by recalling Kant’s admonition at the beginning of his 1784 pamphlet What Is Enlightenment?

Enlightenment is man’s release from his self-incurred tutelage. Tutelage is man’s inability to make use of his understanding without direction from another. Self-incurred is this tutelage when its cause lies not in lack of reason but in lack of resolution and courage to
use it without direction from another. Sapere aude! "Have the courage to use your own reason!"—that is the motto of enlightenment.

THE SHAPE OF KNOWLEDGE

Abstractly, "information" is composed of 0-1 bits, but this is of little use in concretely understanding the profuse forms and varieties of knowledge that drive development and shape institutions. We must try to make do with rough measures of knowledge along many scales or dimensions such as explicit-implicit, specific-general, part-whole, local-global, analytic-synthetic, or external-internal dimensions. If we were to try to map out the domain of knowledge, then it is certain that the terrain would be quite uneven.

Methods of education and training for development as well as institutional capacity building need to adjust to the local terrain. For instance, is the important knowledge in each area so explicit (like the rules of arithmetic or a computer language) that it can be transmitted vertically from those who know to those who do not? Or is the relevant knowledge more implicit (like knowing how to ride a bike) and best transferred through more subtle horizontal methods from those who have done it to those who have not yet done it? It is not a matter of an institutional form's being "right or wrong" but of being well adapted or ill adapted to the demands of knowledge acquisition and dissemination in a particular setting.

The Implicit versus Explicit Dimension of Knowledge

From the Enlightenment descends the image of modern science as giving knowledge that is explicit, objective, and intersubjectively transmittable. The architect prepares the blueprint of the house, and the blueprint contains the explicit information that is sufficient for the engineers and carpenters to build the house. The model of explicit, objective knowledge (sometimes taken as a defining characteristic of "modernity") was often depicted as contrasting with a model of mystical "knowledge" that was dominant in premodern times. But that may not be the most useful contrast. It seems to be much more fruitful to contrast explicit knowledge with knowledge that is implicit, tacit, and personal. The scientist and philosopher Michael Polanyi has particularly emphasized the importance of tacit or personal knowledge. Consider, for example, the blueprint that is supposed to contain the information to construct a house. In fact, there is relatively "little" information in the blueprint itself. Most of the knowledge about constructing the house is embedded in the practical skills and routines of the engineers and carpenters. The blueprint transmits just the crucial cues to the holders of the necessary implicit knowledge to allow the latter to build the desired house.

Some training and education for development can be rather useless, if not dysfunctional, when they fail to pay attention to the explicit or implicit form of the important knowledge. Development experts, in effect, give "blueprints" to developing countries when, in fact, the missing knowledge may be the implicit "carpentry" skills to build the "house" from the "blueprint." The implicit practical knowledge might be best acquired "horizontally" by an apprenticeship or internship with those who have actually done it (which might not include the development experts).

The Local versus General Dimension of Knowledge

Another important dimension of knowledge is the local-general dimension. Local knowledge is particular to the specific situation, while general knowledge would be more universal and would apply across a wide variety of situations. For instance, the carpentry knowledge to build a house might be partly location-specific (the nature of the local building materials and site conditions) and partly general (applicable to building the house independently of location). Indeed, in some localities wooden buildings are considered appropriate only for farm animals, so the appropriate home-building knowledge might be more stone masonry than carpentry. The local-general dimension of knowledge may provide another reason why expert knowledge from a developed country might be inappropriate. Some of the most important knowledge (whether explicit or implicit) in the design and implementation of institutions may be specific or local to the developing country and similar countries.

THE LIMITED EFFECTIVENESS OF FOREIGN EXPERTS:
THE RELATIVITY OF "BEST PRACTICE"

Knowledge does not "travel" as well as money because of the importance of implicit, local, and practical knowledge as opposed to explicit, general, and theoretical knowledge. The stock-in-trade of foreign consultants is explicit and theoretical knowledge, whereas the problems might lie in the adaptation to the local situation. The foreign consultant's local knowledge would probably not extend to the client country's environment. The "devil might be in the details" of the local adaptation where the foreign consultant (no matter how highly paid and prestigious in his or her home country) is of little use.

These limitations apply even to technology transfer, which is often considered just a matter of transferring explicit technical knowledge. But in fact technology consists of complex "bundles" of information—codified and tacit—as well as physical capital. Because tacit information is not readily transferable among firms and countries, technological blueprints do not contain inherent performance characteristics (such as set productivity levels). Instead, these blueprints have to be translated into specifications and procedures that are specific to particular applications—an uncertain creative process that can result in highly variable levels of performance.

These limitations hold a fortiori for "expert knowledge" about social organizations and legal, economic, or political institutions. The dependence on local conditions renders the notion of "best practice" ambiguous. An institution that is
a "best practice" under one set of local conditions might be rather dysfunctional in a different concrete setting. What is best practice in America might not be best practice all the world over. A description of the perceived "best practice" is usually provided by a technical assistance expert. Yet:

[O]ver time, development experience has shown that when external experts alone acquire, analyze, and process information and then present this information in reports, social change usually does not take place; whereas the kind of "social learning" that stakeholders generate and internalize during the participatory planning and/or implementation of a development activity does enable social change."

External consultants tend to overestimate the relevance of the transferable technical information and to underestimate the need for the local adaptation and participation—which requires creativity, innovation, and autonomous action by the local counterparts.

The Self-Perpetuating Dynamics of Tutelage

Understanding some of the limitations of "expert knowledge" from developed countries (e.g., due to explicit-implicit or specific-general differences) is part of a developing country's "release from [its] self-incurred tutelage." Some institutional forces operate, however, to maintain a state of on-going tutelage. The experts will not easily accept that their "blueprints" are not the most important "truths"—much less that the "blueprints" might end up having a dysfunctional role by confusing the situation, misdirecting very scarce organizational energies, and precluding other, more fruitful lines of action. Any such recognition would tend to undercut and devalue the human capital of the experts or the institutions sponsoring the experts. Surely (it will be said) the clients do not appreciate that the expert knowledge comes from "Harvard" (taken as a symbol of an elite university) or an elite development institution. It might be subtly suggested that clients' lack of appreciation of the "expert knowledge" is just another symptom of their backwardness and their need for further tutelage to continue the cycle.

Horizontal Models of Learning

If the "vertical" transmission of "expert knowledge" from the developed to developing countries leaves much to be desired, then what are alternative models of learning? A model of learning might be called "horizontal" if it emphasizes learning from others from a similar background ("peers") who have had a head start or who have devised more successful methods. They have the relevant local knowledge, and local knowledge is best transferred through "apprenticeship" or other horizontal methods of learning such as study tours, cross-training, and twinning projects.

Study tours can be a powerful instrument if done well. But often study tours end up being junkets to advanced metropolises for high-level officials with a thin educational gloss. The site of the tour might be chosen on the basis of its attractiveness to high officials rather than its relevance to the developing country's real problems. The fundamental criterion for site choice should be whether or not the visited country offers a relevant and believable near future for the client country (so that the countries are roughly "horizontal" peers). Trips of Russians to America, Africans to Paris or London, and Vietnamese to Tokyo do not seem to fall into this category. The gap between the visited and the client countries should not be too large. The gap should be small enough so that it could be plausibly traversed within the political horizon of the current generation in power. In short, study tours are too often seen as tools of vertical learning (with the less-developed countries "learning" from the advanced countries), whereas they should be seen more as tools for horizontal learning (e.g., East-East or South-South) between slow-moving and fast-starting developing countries. Horizontally oriented study tours show the participants how some of their problems have been solved by comparable countries. The tours show a plausible future. With such suitably horizontal tours, the reaction is, "If they can do that well, then we can certainly do it, too."

A variation on horizontally oriented study tours is cross-training seminars ("twinning" is a form of long-term cross-training) in which the instructors are experienced practitioners from countries that are plausibly "nearby" in terms of development. Such seminars are not always supported by experts from elite institutions. Why should a world-class development institution subsidize or promote seminars taught by "locals" who came from distorted environments, who were taught by the wrong textbooks, and who could not possibly have the depth and breadth of Western experts? What if they teach "the wrong thing"? Thus, paternalism is often couched in the language of "quality control"—with "quality" defined by the Western experts.

In the early days of the transition out of socialism, lectures by Western experts were appreciated by the responsible authorities in the postsocialist countries. Certainly, they did not want to embark on the transition without hearing what the experts had to say. But those times have now largely passed. The generalities proffered by the experts were easily mastered, and the experts provided little concrete advice about how to implement the principles in such "distorted environments." That requires local knowledge. Such practical knowledge is best gleaned from comparable countries that have shown some measure of success. "Horizontal" seminars would gather together practitioners from the relative success stories to teach best practices to the relevant officials from the client country.

UTOPIAN SOCIAL ENGINEERING

The opposite to change that is part of autonomous development is change that is imposed from the outside—that is, heteronomously imposed change.
What are the sources of externally imposed change? One source is well described in Karl Popper’s treatment of utopian social engineering. Not all utopian social engineering is externally imposed, but most externally imposed blueprints have their source in some project of utopian engineering. Various, dubious assumptions underlie the utopian engineering orientation such as the assumption that there is “the knowledge” of a feasible first-best model or blueprint. Marxist-Leninism and neo-classical economics are both examples of this orientation.

If there is a single first-best model or blueprint of any institution (such as the Platonic “ideal”), then well-meaning reformers might take the imposition of “the best practice” as a natural means of development. The first problem is that the so-called first-best model might be misspecified. If the factors responsible for the relative success of the private property market economies were accurately specified in neo-classical theory (e.g., the Arrow-Debreu model), then it would be a relatively simple matter to reproduce or closely approximate that success under socialism. The failure of socialism in spite of considerable experimentation indicates that the success factors in a market economy are not well captured in neo-classical theory. Thus, social engineering in the transitional or developing countries that is naively based on abstract, neo-classical models may leave much to be desired. Another problem is that the first-best model might be rather infeasible. Second-best feasible models might be highly dependent on local conditions and thus nonunique. Attempts to impose the first-best model might thus lead to third-best results or worse. A feasible second-best solution followed by its continuous improvement might be the first-best solution in the circumstances.

There might be one best strategy to win from a given board position in a chess game, but it might be unknown due to the prohibitive costs of exploring all options. With such “bounded rationality,” optimization based on local knowledge is the preferred strategy. In the more complicated and less well defined “game” of institutional change, that strategy would be the piecemeal approach of “crossing the river by groping for the stepping-stones.”

Finally, the assumption might be false because there is no unique first-best model. A prime example is the current global debate between Anglo-American-style capitalism and Japanese (or German-Japanese-style capitalism). One reason for the possibility of “multiple equilibria in the institutional marketplace” is the interlocking or internally coherent nature of institutional features. These features cannot just be mixed and matched to arrive at one optimal combination. Only certain combinations interlock and hold together in a mutually reinforcing whole, but there might be a multitude of incompatible combinations and no obvious way to rank them (except through parochial predilections). Subsystems of one solution will interlock together but might malfunction if inserted into another solution.

The point is illustrated by a recent example in Europe, which remains an active battleground of different economic models. A rash of trucker wage disputes led to work stoppages, which had a particularly strong effect on a number of auto plants that had recently developed JIT (just-in-time) inventory systems. This showed the interconnectedness between the inventory system and the labor relations system. JIT worked best with a nonconfrontational cooperative system of labor relations, while confrontational labor relations required large inventories to buffer the effects of work stoppages. Figure 10.1 illustrates how the subsystems fit together.

**Figure 10.1**

**The Interconnectedness between Inventory Systems and Labor Relations Systems**

<table>
<thead>
<tr>
<th>Inventory System</th>
<th>Confrontational Labor Relations</th>
<th>Cooperative Labor Relations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large Inventories</td>
<td>Anglo-American Solution</td>
<td>Sub-optimal due to unnecessary inventory carrying costs</td>
</tr>
<tr>
<td>Just-In-Time Inventories</td>
<td>Sub-optimal due to vulnerability to labor stoppages</td>
<td>Japanese Solution</td>
</tr>
</tbody>
</table>


The interlockiness of institutional subsystems makes the task of the external adviser particularly delicate. The adviser might recommend a “best practice” subsystem that she or he “knows” works well. But that is in the adviser’s home country and other countries with similar institutions. The recommended subsystem might not fit well in the institutional setting of the client country, and it might be well beyond the powers of the clients to socially engineer a root-and-branch change in the whole system to fit the other model. Instead of helping, the well-meaning adviser who “knows the solution” might create a bit of a mess—a hodgepodge of system attributes that do not fit together. Moreover, those who are expert on one institutional solution will resist the devaluation of their human capital that is implicit in the recognition of multiple solutions. As in the old joke that a child with a hammer will find many things that “need hammering,” so an expert in one solution will find a multitude of cases that “need” a few strokes of “the knowledge,” whether appropriate or not.

**PIECEMEAL VERSUS UTOPIAN INSTITUTIONAL CHANGE “BIG BANG” VERSUS “GRADUALISM”**

Piecemeal change is the Popperian opposite to utopian social engineering. In the debate about the transition from socialism, the contrasts were usually stated as “big bang” (or “shock therapy”) versus gradualism with the implication that “big bang” was fast and gradualism was slow. But the fast-slow associations were often misleading. For example, in the much-debated Polish privatization program, the “big bang” solution supported by Western experts was the mass “privatization” program featuring national investment funds (NIFs). In contrast was the privatization by liquidation program designed by Poles without Western
advice wherein the productive assets of firms were transferred on a lease-purchase arrangement to new companies (created usually by insiders) while the original legal unit was liquidated. The blueprint for the NIF plan, highly recommended by many Western academic advisers (not to mention financial sector advisers) and their Eastern colleagues, took about five years of (rather predictable) parliamentary and bureaucratic torture to be implemented. Even then it accomplished only a formal “privatization” to the citizens of shares in what are, in effect, parastatal funds run by Western portfolio managers under lucrative management contracts. The “big bang” ended as a rather long-drawn-out whimper. Meanwhile, the privatization by liquidation program privatized to flesh-and-blood owners well over 1,000 small and medium-sized enterprises (SMEs) and thus jump-started the SME sector in Poland. In short, the “big bang” ended up being anything but fast, while the “gradual” privatization by liquidation program was hardly slow. Similar remarks apply to the quite rapid changes in China resulting from the non-big-bang family responsibility farming system and the system of township-village manufacturing enterprises in the Chinese nonstate sector. With popular participation, “change can come quickly—far more quickly than the tired and disillusioned ask us to believe.”

If big bang versus gradualism is not the best way to parse the conceptual issue (due to the inaccurate fast-slow connotations), then what is a better contrast? Since there is probably no simple way to characterize these complex issues, I settle for “cluster concepts” on each side of the issue. In the process I delineate situations in which each approach is appropriate.

When Is the “Big Bang” Appropriate?

One broad class of cases where the big bang approach is appropriate can be characterized as one using a part-whole framework. The “whole” is divided into many “parts.” Due to neighborhood or contagion effects, if only some of the parts of the whole are changed or “reformed,” then the remaining “unreformed” parts will tend to undo the changes. Thus, all the parts or all parts beyond some “critical mass” have to be changed in order for the changes or reforms to stabilize (i.e., for the whole to change). A simple example would be a “majority process” represented by an odd number of variables $x_1, \ldots, x_n$ where each variable has one of two values such as “unreformed” or “reformed.” There are a number of time periods. During each time period a variable may change its value, but at the end of one period and start of the next, each variable is reset to the majority value. Thus, starting in an “unreformed” state for all the variables, if less than a majority of the variables were changed, then the “reforms” would be reversed at the end of the period due to the “distorted” initial conditions of the “unreformed” variables. Only a “big bang” or “shock” of changing a majority of the variables to a “reformed” state would break down or break through the barriers opposing system change and stabilize the “reforms” at the end of the period.

One model would be an epidemic caused by a contagious disease. Piecemeal application of an antidote would allow reinfestation by the untreated parts orwould allow the treated “germs” to rally their forces and overcome the medicine. Only a wholesale application of the medicine or antidote would achieve the necessary “breakthrough” to stop the epidemic. A military metaphor is sometimes used as well. Small incursions can be repulsed, but a Normandy-style or blitzkrieg-style invasion can break through the defenses and succeed. Another metaphor would be a change from driving on the left to driving on the right side of the road. One cannot have cars switch sides this week and trucks next week. One of the models of shock therapy favored by economists concerned stopping hyperinflation. Unless applied across the board, anti-inflation measures would be soon undone by the contagion effects of the remaining inflationary trends and expectations.

The anti-inflation therapy, the more general epidemic-stopping therapies, and the related military metaphors were generalized into all manner of “shock therapy” or “blitzkrieg” prescriptions for institutional change in the transitional economies. Without a root-and-branch or canvas-cleaning change, the legacy of communism was seen as outweighing, reinfesting, and defeating piecemeal reforms. Thus, the transitional economies became fertile grounds for Western-inspired utopian social engineering, “market Leninism.”

When Is “Piecemeal” Change Appropriate?

Utopian engineering is often based on rather heroic assumptions about what is known, whereas the alternative, piecemeal approach emphasizes limited (explicit) knowledge and bounded rationality. The limitations on knowledge apply to the strategy of change away from the status quo and to the perhaps hidden or taken-for-granted properties of the status quo. When there is knowledge only about the local surroundings of one’s starting point in a journey, then it is foolhardy to rush off with all one’s forces or resources into the darkness. One’s local knowledge becomes increasingly useless the farther one is away from the starting point. Smaller, tentative, and reversible forays or experiments will allow one to gather knowledge about possible paths through trial and error and to plot a better course for moving forward. To continue the metaphor, the starting point might also have some underappreciated virtues (such as a food or water supply or a defensible position) that would be lost by impetuous advances into a different terrain.

When working to establish certain relationships in a complex, interdependent system, it is best “to define ‘isolation subsystems,’ that is, subsystems among which there is a minimum amount of interdependence, and then to adjust the resulting partial designs to each other.” Indeed, that is why it is called the “piecemeal” approach. Applied to social change, the piecemeal approach emphasizes experiments and trial and error to obtain knowledge about the best way to proceed—all the while trying to have the appropriate continuity to preserve the social capital or other embedded institutional virtues that once lost to ill-considered schemes cannot be readily recovered.
The distinguishing features of these two approaches to social engineering are summarized in Figure 10.2.

Figure 10.2
**“Big Bang” Versus Piecemeal Engineering**

<table>
<thead>
<tr>
<th>Approach</th>
<th>“Big Bang” Utopian Engineering</th>
<th>“Gradual” or Piecemeal Engineering</th>
</tr>
</thead>
<tbody>
<tr>
<td>Continuity versus Break</td>
<td>Discontinuous break or shock — raising the old social structure in order to build the new.</td>
<td>Continuous change — trying to preserve social capital that cannot be easily reconstructed.</td>
</tr>
<tr>
<td>Role of Initial Conditions</td>
<td>The first best socially engineered solution that is not “distorted” by the initial conditions.</td>
<td>Piecemeal changes (continuous improvements) taking into account initial conditions.</td>
</tr>
<tr>
<td>Knowledge Attitude</td>
<td>Knowing what you are doing.</td>
<td>Knowing that you don’t know what you are doing.*</td>
</tr>
<tr>
<td>Chasm Metaphor</td>
<td>Jump across the chasm in one leap.</td>
<td>Build a bridge across the chasm.</td>
</tr>
<tr>
<td>Repairing the Ship Metaphor</td>
<td>Rebuilding the ship in dry dock. The dry dock provides the Archimedean point outside the water so the ship can be rebuilt without being disturbed by the conditions at sea.</td>
<td>Repairing the ship at sea. There is no “dry dock” or Archimedean fulcrum for changing social institutions from outside society. Change always starts with the given historical institutions.</td>
</tr>
<tr>
<td>Transplanting the Tree Metaphor</td>
<td>All-at-once transplantation in a decisive manner to seize the benefits and get over the shock as quickly as possible.</td>
<td>Preparing and wrapping the major roots one at a time (nemawashi**) to prevent shock to the whole system and improve chances of successful transplantation.</td>
</tr>
</tbody>
</table>

* Note the reference to V. Benziger’s perspectice article in note 22.

**“It is a time-honored Japanese gardening technique to prepare a tree for transplanting by slowly and carefully binding the roots over a period of time. bit by bit to prepare the tree for the shock of the change it is about to experience. This process, called nemawashi, takes time and patience, but it rewards you, if it is done properly, with a healthy transplanted tree” (A. Morita, *Made in Japan* [New York: E.P. Dutton, 1986]), 158.

APPLICATIONS TO AUTONOMOUS INSTITUTIONAL CHANGE

It is quite useful to differentiate between the de jure institution (described in laws and regulations) and the de facto institution (the actual practices, routines, and habits that are the activity of the institution). There is often a considerable gap between the de jure and the de facto institutions in transitional and developing countries, and it is wise to follow the advice of the conductor on the London subway to “Mind the gap.” One might think of an elastic band as stretching across that gap. Small legislative or regulatory reforms will change the de jure institution and then the elastic band might pull along the de facto institution.

Incremental reforms will not suddenly devalue the skills and knowledge of the people involved in the organization so they might respond to the other incentives to shift the de facto institution into compliance.

“Utopian” reformers and advisers tend to extrapolate and conclude that great changes can be similarly induced by “writing new laws” (perhaps modeled on the best practices in the developed countries). “Why compromise with the distorted environment and write substandard legislation?” “Don’t our clients deserve the best?” For such large “shock” changes, the elastic band might snap as the participants dig in their heels and refuse to “ratify” the de jure changes by corresponding shifts in the de facto organization. Instead of the “utopian” reforms, some bizarre, noncompliant, de facto institution evolves which might be worse than the status quo ante. The machinery of law is devalued by the utopian “law-based economy” reformers, and extralegal mechanisms evolve to take its place. A surreal and grotesque landscape develops as a hodgepodge of dysfunctional institutional attributes, and the course of reform is itself threatened (e.g., Russia today).

Utopian social engineering is typically imposed by “experts” from above in a manner that “short-circuits” the judgment of the participants. There is an alternative that is not only more piecemeal and incremental but based on respect for the autonomy of the participants in the organizations. This alternative can be illustrated with the “paving the paths” example. A number of office buildings were built in the middle of a large field. Where should the sidewalks be? A central planner would design the sidewalks to “address human needs,” specify where the sidewalks should be built, and prescribe penalties for “walking on the grass.” Instead, the area was filled with grass for several months. By that time, paths had been worn in the grass by the self-directed activities of the users of the buildings. The paths were then paved to create a system of sidewalks that addressed actual human needs by using knowledge generated by the spontaneous activities of the users (rather than the a priori conceptions of the planners).

The moral of the story is that reformers would be wise to pay more attention to the spontaneous activities of the participants or users. Those activities will reveal knowledge that is difficult to obtain otherwise. Of course, not all “spontaneous” activity should be legitimated or “paved” by changes in the de jure institutions. “Paving the paths” might take the form of designing the new de jure institutions to be nearby the spontaneous de facto institutions but with certain modifications to respect the rights of others or to guard against certain abuses.

Paving the Paths of Spontaneous Privatization

The utopian versus piecemeal attitudes of Western advisers to the postsozialist transition is strikingly revealed by the reactions to spontaneous or “wild” privatization. The all-too-typical reaction was to condemn spontaneous privatization, to urge governments to quickly stop the “premature” entrepreneurship in all its forms, and to renationalize any such privatized companies. Then grand schemes were devised that were “fair” in the abstract sense of dividing every-
thing equally among the citizens (e.g., giving babies and pensioners equal claims on the fruits of past labor).

A piecemeal approach takes a different attitude toward spontaneous privatization. As the power of the communist governments weakened in the decades leading up to 1989, many decentralized reforms were implemented that devolved power to the enterprises and local municipalities. The self-management system in Yugoslavia was the leader in this decentralization movement; it was followed by “goulash communism” in Hungary with its enterprise councils, the Solidarity movement in Poland and the Polish self-management councils, and the Gorbachev reforms (e.g., the State Enterprise Reform Law of 1987), which significantly increased enterprise autonomy and self-accountability. These reforms represented something of a halfway station between the state and the market. When the socialist governments were finally overthrown, the spontaneous tendency was to continue the decentralization in the same direction all the way to the market with forms of insider-controlled enterprises. Those were the clear paths of spontaneous privatization. “Paving the paths” would mean devising a legal mechanism for management-employee buyouts (MEBOs) that put the process into a legal framework, usually with some changes such as installment payments over several years for the endowment originally received from the state.20

The lease buyout privatization program in the Soviet Union21 and the Polish privatization by liquidation program (also known as “Polish leasing”) are examples of following the flow of entrepreneurial activities by “paving the paths” to the market. Many countries chose the alternative path of mass privatization. In some countries, the residual power of the decentralization movements compromised the centralizing and redistributive intents of the mass privatization program. That resulted in voucher-based partial MEBOs (e.g., in Russia and Slovenia) that were confused mixtures of institutional attributes (and probably inferior to well-focused MEBO programs).

The piecemeal reform strategy in China also provides examples of “paving the paths.” Long before Deng blessed the agricultural family responsibility system as a de jure institution, it had evolved as a de facto institution. By allowing many de facto experiments, government learns where the paths are trodden in the grass, and then it can pave them and extend the results to other locales. The township-village enterprises grew out of similar experiments and are only now being “paved” with various legal forms (e.g., “employee stock cooperatives”). There is no small irony in the fact that the Chinese seem to be following the generic advice of Burke and Popper in their transition to the market, while so many other countries that knew closely to external advice are still devising their own Great Leaps Forward.22

Knowledge and Institutional Change

The Social Embeddedness of Change Agents

External advisers and reformers with “utopian” predications tend to overestimate the power of the government to change institutions by passing a law—even a law “with teeth.” Institutions can display remarkable forms of overt or, more to the point, covert resistance to sabotage change. It usually takes much more than passing a law and then trying to enforce it to bring the institutional players along and to effect lasting change. These points might be particularly evident at the enterprise level. Some foreign consultants or external advisers might have the formal power to “implement” their recommended “best practices” to, say, restructure a distressed enterprise. The “best practice” might be locally inappropriate, and the external agent would ordinarily not have enough leadership authority to bring the enterprise personnel along. As H. Wilson observes:

Corporate restructuring requires much effort and time, often years of intensive, single-minded concentration of resources. It cannot be imposed successfully from the outside (by shareholders, governments, or the public). It can only be instigated from within by managers able to carry the organization with them.23

It is most difficult to implement and sustain basic change by “giving orders.” Foot dragging and slow sabotage will take their toll. Forced compliance will, at least, yield external conformity and not bring about sustainable changes in basic structures. The entrepreneur is often characterized by the ability to innovate and raise financial capital, but there is another component or requirement for the success of a project or enterprise that the entrepreneur cannot easily purchase with financial capital:

This other component involves the ability to engineer agreement among all interested parties, such as the inventor of the process, the partners, the capitalists, the suppliers of parts and services, the distributors, etc., etc.; the ability—so important in the undeveloped countries today—to enlist cooperation of official agencies in such matters as customs duties, permits, exchange control regulations, etc.; the ability to bring and hold together an able staff, to delegate authority, to inspire loyalty, to handle successfully relations with labor and the public, and a host of other managerial talents.24

Today, these forms of cooperation might be termed “social capital” (to use Robert Putnam’s apt concept). The point is that such social capital cannot generally be imposed by diktats or purchased with ducats; it is the means as well as the outcome in the virtuous circle of autonomous development. These lessons from the enterprise would hold true, a fortiori, for institutional change in a society as a whole. To obtain more than sullen external compliance to legally enforced reforms, the reform leaders must have a certain “embeddedness” in the society or social organizations they aspire to change. This, in turn, requires that the people in those organizations participate in an autonomy-respecting way in the change process. Such autonomy-respecting participation was essentially automatic in the previous example of “paving the paths,” where the reform lead-
ers "followed" the successful spontaneous activity of the changing organizations.

When reformers aspire to lead the change process, then certain forms of participation will actually increase the effectiveness and power of the leaders rather than impede the process. Various deliberation councils, consultative groups, and associations are intermediating forms that can provide the leaders an embeddedness necessary to sponsor change and can allow people the participation necessary to enable internal compliance or "buy-in" to the change process. Without autonomy-respecting participation by the people who need to change, a long process of foot dragging, recalcitrant compliance, and petty sabotage may slowly grind down and neutralize the reforms.

THE LIMITATIONS OF DIKTAT

Surely the maximum power of heteronomous "diktat" would be held by an occupying military power. While that power can destroy much, it is quite limited in its capacity to create and sustain new institutions. It is useful in this regard to compare the changes effected in Japan and West Germany by the occupying Allied forces to the changes that Western advisers and institutions hope to effect in Russia. In Japan the Occupation destroyed the old, family-controlled zaibatsu and turned the zaibatsu firms into publicly traded companies with most or all of the shares in the stock market (like large companies in America). But within a short time, the companies had bought each others' shares to form groups called keiretsu. That took most of the shares off the stock market so that the companies would not be vulnerable to foreign takeovers, and it re-formed industrial groupings of companies on a new basis. The attempt of the Occupation to dictate the Anglo-American form of stock market-based corporate governance was not successful. Time will tell whether or not Western institutions have more success in Russia, where they lack the power of an occupying army.

It is also interesting to consider foreign ownership in this context. It would have been a relatively simple matter to auction off West German or Japanese assets to the "highest bidders" (which would be mostly from the conquering power) in much the way that East German assets were auctioned off mostly to West German companies and individuals. Yet that did not happen to West Germany or Japan. Without significant foreign ownership, those countries were nevertheless quite successful in rebuilding and modernizing their economies to become economic superpowers today. Far from conforming to the Anglo-American model of the occupying powers, these countries have autonomously evolved an alternative German-Japanese model for a market economy.

Given this recent history, it is perhaps remarkable that Western institutions are rather uniform in recommending foreign ownership as the most important path for Russia and the other postsocialist countries to obtain expertise and capital for modernization and redevelopment. In view of the German/Japanese precedent and in view of the fact that these countries are not defeated and occupied, it is unlikely that Russia (or any of the other transitional economies aspir-


12. "Grand privatization plans are likely to be frustrated by quarrelsome members of parliament, foot dragging ministries, stubborn local politicians, cautious and/or confused law enforcement authorities, opportunistic managers, entrenched unions, rebellious workers, sullen and resentful citizens, bankrupt companies, illiquid banks, revolving-door governments, and the general chaotic nature of post-socialism, plus an occasional *deus ex machina* (such as the Yugoslav wars, the ethnic conflicts in the former USSR, and the divorce of the Czech Republic and Slovakia)" (David Ellerman, "Management and Employee Buy-Outs in Central and Eastern Europe: Introduction," in David Ellerman, ed., *Management and Employee Buy-Outs as a Technique of Privatization* [Ljubljana: Central and Eastern European Privatization Network, 1993], 25-26). Thus, "market Leninists" have many excuses when the grandly laid plans do not work out. But realistic approaches to institutional change need to be as robust as possible against this sort of predictable chaos in a transitional economy.


14. See Murrell for a similar table applied to mass versus piecemeal privatization.


17. Edmund Burke’s 1790 *Reflections on the Revolution in France* presents the classic statement of the conservative case for judicious social change that will preserve the virtues of the past.

18. If the carrot is too far out in front of the donkey, then the donkey might turn elsewhere for food.


20. See Murrell for a similar argument.


22. "The Chinese were wise enough to realize that they did not, in fact, know what they were doing. No one had ever successfully done what they were attempting, and so no one was an expert. Thus they set out in an experimental way, trying out different kinds of small changes and seeing what worked best. That 'practice was to be the sole criterion for determining truth' was stressed again and again in the early reform documents. This was, naturally, intended mainly to rid the Party of the excesses of doctrinaire Maoism. It appears to have saved them from neo-classical orthodoxy, as well" (V. Benziger, "The Chinese Wisely Realized That They Did Not Know What They Were Doing," *Transition 7* [July-August, 1996]: 6).


26. The major postsocialist countries need "redevelopment" since these countries were more misdeveloped than underdeveloped.