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Let the markets begin: The interplay between free prices and privatisation in early transition

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ABSTRACT

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This paper revisits the period of early post-communist transition to study the immediate impact on economic growth of the interplay between price liberalisation and large-scale privatisation in 27 economies. The trajectories along these two dimensions were quite different across transition economies in the period under scrutiny – this diversity is well mirrored by available indicators, which I use to approach empirically the interaction between that pair of reforms. My estimates suggest that the negative short-run effect of privatisation may be counterweighted by the existence of a system of non-distorted price signals. These results seem to be in broad agreement with previous analyses, which I review briefly. Given the small size of my sample and other possible data issues, particular care is taken when examining the robustness of the findings. While not rejecting earlier explanations (e.g. based on the importance of initial conditions, namely the dimension of inherited distortions in production), this paper offers the suggestion of an additional view on why the so-called transformational recession was deeper in some countries than in others – countries which have privatised without fully liberalising prices may have experienced more economic harm. *Journal of Comparative Economics* **43** (2) (2015) 350–370. University of Essex, Colchester CO43SQ, United Kingdom; University of Cambridge, Cambridge CB39DD, United Kingdom.

1. Introduction

In standard textbooks the simultaneous existence of profit-maximising organisations (firms) and of a decentralised system of prices is the most basic pre-condition to generate welfare-maximising markets. Prices connect agents' actions by producing information that reveal the relative scarcity of goods being supplied and demanded and thus form a system of signals that agilely steer the allocation of resources within the economy. The long celebrated Hayekian insight on the superiority of a free-price system conserves today all of its eloquence: "The whole acts as one market, not because any of its members survey the whole field, but because their limited individual fields of vision sufficiently overlap so that through many intermediaries the relevant information is communicated to all... We must look at the price system as such a mechanism for communicating information if we want to understand its real function – a function which, of course, it fulfils less

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perfectly as prices grow more rigid" (Hayek, 1945: 526–7). Central planning was, evidently, a very different model, as prices were fixed by the authorities and production was essentially based on an integrated system of large state-owned industrial firms – the whole society as "a single office and a single factory", in the words of Lenin (1932).

The transition to a market-based economy was marked by a deep collapse in output; this tumultuous period is many times called a *transformational recession* (Kornai, 1994). Also, the end of central planning brought a radical change to the incentives faced by those large firms, from following their part of the plan towards decentralised profit maximisation. One should expect the "allocative environment" – i.e. the degree of price distortions in the economy – in which privatisation proceeded to have been of critical importance. The interaction between privatisation and such a basic element as price liberalisation must have played an important role in determining variation in output during early transition. Put simply, "[o]ne obtains a wrong picture of transition by focusing on individual reforms. There are, for example, evident complementarities between privatisation and price liberalisation. Profit incentives in distorted markets lead to resource misallocation, and free prices alone do not deliver optimal allocative outcomes if firms do not face incentives for value maximization" (Roland, 2000: 12). The price levels that are decided, and indeed the very existence of administered prices (which allows for arbitrary and politically-driven pricing policies, and in addition opens room for bribery) influence firms' actions in a direct way, either we talk about the price of the good they sell, or of the inputs they need, or of substitutes or complements of both; in such a distorted context decisions concerning *if*, *what*, *how*, and *how much* to sell, and if possible *at what price* will not produce a socially optimal outcome. Moreover in some countries the existence of price distortions may have contributed to the entrenchment of a "bad type" of owners interested mainly in extracting rents from arbitrage opportunities (e.g. buying artificially underpriced goods and selling them in the world market), instead of attracting better types of investors (namely foreign investors with capital and know-how).

The interplay between privatisation and price liberalisation was more or less explicitly addressed in theoretical models and informal analyses, but remains largely untested on empirical grounds. Testing the existence and extent of such interrelation at the macroeconomic level is hence the purpose of this paper. To anticipate the findings, my results appear to confirm that in fact the two reforms are linked by a nexus of interaction. More precisely, a potential immediate negative effect of privatisation on economic growth may be largely avoided if this is carried out in a free-price environment. Amidst the chaos of early transition, this route can be read as a way to help minimise the temporary harm associated to acquiring the basic machinery of a market-based economy.

A closely related work is Zinnes et al. (2001), which approaches the heterogeneity of the macroeconomic effect of privatisation on output through a different angle. They examine the interaction between privatisation and reforms directed at prudential regulation, corporate governance, hardening of enterprise budget constraints, and management objectives, and they conclude it is positive; they find that economic performance gains come only when change-of-ownership reforms occur once an index of key institutional and "agency"-related reforms exceed a certain threshold.[1] Although my paper also aims at contributing to the empirical literature on the macroeconomic effects of privatisation during transition,[2] I depart from their study as I examine two policy instruments that reflect both very fundamental features of a market economy, and whose interaction was in principle critical in the "shock" of the very first years of the transition process. Contrary to the institutional advancements of the type analysed by Zinnes et al. (2001), which normally need time to take place and moreover may be more endogenous to economic growth (also they are often rather difficult to measure), even a full price liberalisation may be achieved overnight. Indeed, this is a reform that proceeded rapidly in many countries.

The structure of the paper is as follows. The next section discusses the main theoretical arguments that support my empirical investigation. Section 3 describes the indicators for the reforms I want to study and in particular notes that they show quite different co-evolutions across countries during a certain period of time. This increases the potential for meaningful estimation. Section 4 starts by defining the period of study – which coincides with the "transformational recession" of early transition – and thereafter proceeds to presenting my empirical results, which appear to be robust across model specifications, data sources, and econometric methodologies. Section 5 concludes and refers to some limitations that this study faces.

2. Theoretical background

From the point of view of a policymaker that is facing the singular circumstances of a "transformational recession", how to lessen the temporary damage associated to the transition from central planning to a market-based economy is certainly an issue of great importance. Can we neatly extract from the existing literature testable predictions on the short-run macroeconomic effect of price liberalisation, privatisation of firms, and more specifically on how they interact during early transition? Existing analyses offer a rich mosaic of possible mechanisms, which I review briefly in this section. I start by discussing contributions that focus on the two policies and thereafter discuss more explicitly mechanisms of interplay between them.

[1] Nevertheless they also observe en passant that "the potential for efficiency gains from privatisation requires price and wage liberalisation in order to create a price system that reflects economic scarcity" (p. 151).

[2] To the best of my knowledge two other articles complete this strand of research, and both focus on the chosen methods of privatisation (the microeconometric literature is more abundant; see Subsection 2.2). Bennett et al. (2007) argue that only voucher privatisation is significantly associated with faster growth (management-employee buyouts and privatisation by sale seems to have no significant effect), although in an earlier version of their study those authors report that mass privatisation has a *negative* effect for the subsample of non-CIS economies, as noted by Gouret (2007). This author concludes from his own econometric study that it is difficult to find that countries which have implemented massive giveaways have a lower or a higher annual growth rate than those which have implemented gradual sales.