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The Introduction of Markets in a Hypercentralized Economy: The Case of Romania

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In August 1944, when Soviet troops had already liberated a part of Romania, liberal political elements staged a coup and joined the allied side in the war against Germany.[1] By 1947, the Communist Party of Romania, which had perhaps 5,000 members at the end of the war, had gained exclusive political power with the help of the Soviet Union. Although a large part of the bureaucracy, the teachers, and the officer corps later joined the Party, it cannot be said to have had a really popular base, even in the cities.

In 1947, the standards of living of Romania's population (and especially of its peasant majority), the degree of literacy, and the provision with social infrastructure were on a level with those of the poor countries on the geographical periphery of Europe (like Yugoslavia, Portugal and Turkey), but lagged behind some East European countries (including Czechoslovakia, Hungary and Poland) and most Latin American countries (like Argentina, Chile and Mexico).

The Stalinist strategy of industrialization and the Soviet model of central planning designed to implement it were adopted from 1948 on. Romania, unlike Bulgaria, received no help in carrying out these plans. Worse still, it had

[1]See Lampe and Jackson (1982) on the economic history of Romania before World War II. To preserve space, citations in this paper are kept to a minimum, and sources are not given for easily accessible figures and facts. Statistical information about communist Romania is generally unreliable, more so than in other communist countries. It is not only that statistics are not corrected for waste and low quality, but they have been variously adjusted to project desired outcomes, especially in the late 1980s for agriculture. For an independent estimate of the growth in industrial output from 1950 to 1962, see Montias (1967, p. 56). The reader may consult further Montias (1991), Shafir (1985), and the new Romania Economic Newsletter, which reports economic information on Romania.

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to pay war reparations to the Soviet Union and lost control of most of its oil, mineral and timber resources through joint companies that operated largely for the benefit of the Soviet Union. From the early 1950s on, the economy was managed as an all-encompassing hierarchy. An early, unsuccessful effort was made to collectivize agriculture, which was only completed in 1962. The bulk of investment resources were directed to heavy industry. The economic model and the investment strategy were supported by an extremely restrictive political system, where the policy, culture, and educational system were used to exhort and mobilize the population to carry out the objectives set by the Communist Party (Jackson, 1977). Minimum reliance was placed on expensive (and perhaps economically infeasible) individual material incentives.

The Economy in the Ceausescu Era: 1965–1989

Nicolae Ceausescu became secretary general of the Romanian Communist Party after the death of Gheorghiu-Dej in 1965. The "Ceausescu era" marked a partial departure from the traditional centrally planned economy, towards an inward-looking, hypercentralized and politically repressive regime. At this time, Romania gradually established its economic and political autonomy vis-a-vis the Soviet Union. In 1964 it took a neutral stance in the Sino-Soviet dispute; in 1968 it opposed the Soviet invasion of Czechoslovakia; in later years, it continued to develop independent policies, particularly with respect to the third world; it insisted on pursuing its own economic policies aimed at rapid industrialization on a wide front, with limited cooperation with the Soviet-dominated Council for Mutual Economic Assistance.

Despite announcements of "decentralization" in both 1967 and 1979, the regime pursued a path of detailed personal control of the economy by the Ceausescu and Petrescu (Elena Ceausescu's family) clans. The dictator and his entourage aimed at transforming Romania into an industrialized self-sufficient fortress. Net investment (including increases in inventories) grew from 18 percent of net material product during 1951–55 to 34 percent during 1971–75 and 36 percent during 1976–80; it fell back to 27 percent in 1981–85 for reasons that will be explained presently. Employment in industry rose from 12 percent of the workforce in 1950 to about 37 percent today (contributing about two-thirds of net material product in 1989). Meanwhile, although the share of the population in agriculture remains the second highest in Europe (after Albania), it has fallen from 71 percent of the population in the early 1950s to 28 percent.

As part of rejecting Soviet political hegemony, Ceausescu pursued a trade policy of importing technology from the West and of increasing trade with less developed countries, which were willing to buy low-quality machinery (and armaments) on the basis of long-term agreements—generally accompanied by low-interest credits—with few political strings attached. They exported oil and other raw materials to Romania in return. By the mid-1970s, less developed countries accounted for 20 percent of Romanian imports, the Soviet-bloc share had declined to 40 percent, and the rest was accounted for by advanced market economies.

In the 1970s, Romania borrowed heavily from the West to finance industrialization. The return on these investments was very low, even negative in some cases. Owing to heightened global competition and an increase in real interest rates in the early 1980s, repayment of the foreign debt (which hit a maximum of $9 billion by 1981) became increasingly costly. By the late 1970s and 1980s, difficulties in financing trade with the West induced the leadership to swing some of Romania's trade back to the Soviet Union, exchanging low-quality machinery and consumer goods for Soviet energy and raw materials.

Irked by the IMF's attempt to impose conditionality, Ceausescu embarked on a ruthless program in 1982, perhaps unique in the world, to repay Romania's foreign debt, although it represented a smaller burden than the debt of many other countries. This aim was achieved in part by depressing living standards and in part by the already-mentioned reduction in investment rates. As imports of western machinery plummeted and Romania exported a good part of its best machinery, replacement of capital nearly halted. To service the debt, consumer goods and foodstuffs produced in Romania were earmarked for export. Domestic sales fell sharply. In 1989, sales of slaughtered meat were only 49 percent of what they had been in 1980; cheese, 60 percent; refrigerators, 44 percent; television sets, 64 percent; cars, 79 percent; and bicycles, 61 percent (Montias, 1991). Workers were forced to scavange for basic necessities, while living in cold quarters during the winter and dark homes and public spaces throughout the year. Moreover, they were discouraged by political oppression and continuous pressure to work harder and longer.

Economic growth slowed around 1980; by 1987, even the official statistics began to show it. The economic deterioration reached its nadir in November 1989, when the official press announced that the foreign debt had been paid back—but ruled out any easing of the consumption crisis. Shortly afterwards, emboldened by events in Eastern Europe, Romanians took to the streets.

The Economy After the Revolution of December 22, 1989

The first actions of the revolutionary government—the Council of the National Salvation Front—aimed at improving the lot of the population. The export of foodstuffs was halted; quantities of coffee and other necessities were imported. Despite the shortage of power, the price of electricity to consumers and municipalities was reduced and quantity restrictions on energy use were eliminated. To free power for private uses, the output of energy-guzzling industries was curbed; the aluminum plant at Slatina, which has been consuming as much electricity as the entire consumer market, was shut down entirely.

The permissible farm area for private cultivation was doubled, while price controls on private sales by peasants and forced deliveries were abolished. The work week was reduced from 46 to 40 hours. Secret police activity was greatly curtailed, and the freedom of the press and of personal expression were introduced. The Council established a political party (the National Salvation Front) with a social-democratic orientation, which won 80 percent of the vote in the May 1990 elections. It has committed itself to a program of transition to a market economy.

Privatization of land has progressed rapidly. Despite difficulties in the evaluation of land, several hundred cooperatives were liquidated in 1990.

By December 1990, there were nearly 100,000 small businesses in operation by official count, although with an extremely small average capital (about $500 at the black market exchange rate). The formation of such businesses had been hampered by a decree hastily drafted in March 1990, which limited private enterprises in size and controlled their access to inputs and capital equipment. On November 16, 1990, a law patterned after the French commercial code took effect, allowing all forms of organization to be incorporated, with no limits on the size of employment or assets (although some requirements for minimum investment and restrictions on the types of shares issued still apply).

At the end of 1989 there were only six joint foreign ventures in Romania, all (by law) with minority foreign ownership. Additional foreign investment was discouraged by nationalistic slogans of "self-reliance" during 1990, although the number of foreign firms did expand. But a new start was made in April 1991, with a new law which permitted foreign participation through either joint ventures or wholly-owned foreign firms.[2] Such requests are still subject to government approval. (Applications for registration that have not been rejected within 30 days are automatically approved.) Foreign firms enjoy a variety of tax and tariff advantages, and the law protects them against nationalization.

Another law provides for privatization and restructuring of state enterprises. State enterprises in the "strategic branches of the economy"—armaments, electric power, mines, natural gas, the post office, railroads, and some others—are to become autonomous state enterprise (*regies*). However, the law provides for their continued subsidization by the state, a practice that is sure to perpetuate their "soft" budget constraints. State enterprises in other industries will be converted into commercial firms.

The primary method of privatization of state-owned commercial firms will be through vouchers. The Agency for Privatization will issue vouchers with a certain nominal value to every resident Romanian adult. Despite difficulties in valuing the assets of firms, the vouchers are supposed to become tradable among Romanian citizens in November 1991. At that time, they can be converted into shares in individual firms at fixed prices on a first-come first-serve

[2]At the time the law was enacted, 2,500 firms with foreign capital were established, with total foreign participation of approximately $85 million (*Profitul Românesc*, "Investițiile Străine de Capital," April 19–25, 1991).

basis, or into shares in mutual funds. Employees will have priority for shares in firms in which they work. This method will be used to privatize 30 percent of the firms by value. The remaining equity will then be sold to the general public, with employees likely to enjoy rights to discounted shares. This method of privatization was chosen because few citizens have much capital; at the end of 1989 the average household held $35 (at the black market rate) in total savings and currency.[3] The stated goal of the government is that half the equity of all commercial firms will be privatized by 1993.

Unemployment remains small, but it is growing rapidly. Some unemployment benefits are available, and retraining centers will be opened for the benefit of unemployed and low income workers. One interesting innovation allows recipients of unemployment benefits to take them as a lump sum (instead of monthly payments), which they can use for the creation of a small business.

In an attempt to correct relative price distortions, consumer prices were administratively raised and adjusted in late 1990 and early 1991. As partial compensation, wages, pensions and income transfers were also adjusted upward by government edict. Wages are now being raised further through enterprise-level bargaining between management and newly formed labor unions. As a result, the wage level is likely to double by the end of May relative to its level in early April, although the price level will have more than doubled. The government plans to limit inflation with tight fiscal and monetary policies, and by curbing wage increases. However, the past practice of deficit finance by subsidizing state enterprises with off-budget non-reimbursable loans from the national bank appears likely to continue, and effective wage controls seem remote.

Problems and Prospects for the Economy

The outcome for the first year of the new regime is similar to other transition economies in Eastern Europe. Industrial output fell by about 20 percent between December 1989 and December 1990. Agricultural output, however, declined only by 3 percent. Deliveries of consumer goods to the population increased, often dramatically, but most changes were due to lower exports and higher imports. Consequently, the current account balance has moved from a $2.9 billion surplus in 1989 to a $1.7 billion deficit in 1990.

The decline in production was caused by several problems that will continue to beset the Romanian economy: 1) the curtailment of the work week;

[3]A government loan scheme to finance large scale privatization of state-owned firms was not seriously entertained in Romania. First, this would require extension of loans without collateral other than the assets of the firms. Second, the loan strategy is either equivalent to keeping ownership in government's hands (if it wants to ensure that loans are used properly, that is, that firms are run "correctly,"), or to a giveaway of the assets, which is equivalent to the voucher scheme.

2) a slackening in work discipline; 3) the shortage of inputs, due partly to the elimination of the partial coordination that planning did provide; 4) dislocations due to reorganization of large firms; 5) the difficulties faced by management in coping with the new economic environment; 6) the relative inexperience of many managers appointed after the revolution.

The third of these points deserves elaboration. There is still no clear vision of how the remnants of planning and the creation of free markets should be combined. A new Ministry of Resources and Industry continues to parcel out some 600 types of raw materials and semifabricates to producing firms, almost all of which are state-owned, while leaving specifics of production planning and decision on inputs and output to the discretion of firm managers. The result has been a serious decline in the extent to which inputs and outputs are coordinated (Corneliu Carlan in *Adevărul*, October 26, 1990).

Markets still perform hardly any coordinating function. Prices vary widely between different localities; managerial incentives like profit-sharing are not in place; and uncertainties remain about corporate control and ownership status. The new leadership is proceeding cautiously with privatization, which, in any case, is hampered by the lack of domestic and foreign capital. However, in future privatized firms, principal-agent problems are likely to cause a good deal of inefficiency, given the absence of widely diffused information, the narrowness of capital markets and the total absence of an effective market for corporate control. The government has also made little progress toward setting up competitive markets for state firms, many of which enjoy near-monopoly position in the goods they sell. The idea of liberalizing imports to introduce competition has little appeal for government officials, who seem convinced of the necessity of "protecting the balance of payments." The government has an important role in encouraging the development of the (already planned) mutual funds for the administration of privatized firms, the collection and dissemination of information, antitrust legislation, and other institutions that support the emergence of effective markets.

Along with this problematic mix of plan and market, Romania suffers from legacies and values that hinder the development of a market economy. Those individuals who do have experience with economic decision-making tended to acquire it either within the Ceausescu dictatorship or the black market, which has helped to create a negative public attitude towards entrepreneurs. Romania has been suspicious of foreign economic intrusion at least since the customs war with Austro-Hungary in the 1880s; protectionism and restrictions on foreign investments have been widely approved constants in Romanian external policy for over a century. The fact that the Ceausescu regime claimed to advocate employee ownership has tainted that idea for reformers.[4] The tradition of "bakshish," "gifts," and other side-payments and assorted bribes, inherited

[4]Employee ownership is therefore likely to be rejected, although it represents one possible method of privatization and of improving individual work incentives from a demoralized workforce under conditions where employees are likely to be as refractory to the authoritarianism of the state as they are to that of private owners.

from centuries of Ottoman rule, has been fostered in the last 40 years by shortages of goods. A poor population, accustomed to surviving through personal connections and favors, tends to be conservative and fearful of change. Some politicians appear willing to substitute nationalism and ethnic politics for more arduous reforms.

Romania was a relatively poor country when the communists came to power. In Romania, central planning came on the heels of a long depression followed by war; thus, after a reconstruction period of a few years, initial growth was relatively easy. Today, in comparison to countries that had similar levels of development around 1950, Romania ranks relatively high in terms of education and health facilities, in the middle in terms of infant mortality and life expectancy, and low in output per capita.[5] This story does not negate the possibility that a growth strategy of the type the Party adopted in 1948 can reap initial dividends; only that, when it is carried to an extreme, it must inevitably lead to a slowdown and eventually to a decline such as actually occurred in Romania. At that point, Communist parties (in one-party states) cannot initiate significant reforms from within; they hesitate until opposition has become so widespread that the economic system cannot be sustained, and promises of reform or "market socialism" are simply disbelieved. Hence, as Marx said of other economic systems, central planning could not be reformed, but had to be overthrown.

In addition to the systemic problems inherent in a centrally planned economy, in our view Romanian economic development was stymied by its fortress policy of excessively widening the gamut of the industrial products it produced. This policy made it necessary for the bulk of investments to be directed toward new industries, while equipment producing traditional lines remained antiquated. Many firms produced at inefficiently small levels of output. Hardly any attempt was made to exploit comparative advantage in final products and semifabricates.

The new leadership must recognize that it cannot maintain such a broad front of industrial production; it must wind up firms, and if necessary whole lines of industry. This will be painful, but the bulk of industrial investment must not be wasted on losers. Agriculture is one branch of the economy that holds out excellent prospects. The manpower is there, and the climate and the soil are favorable. Privatization of farm land has been taking place. But several questions remain: Will the government channel a large volume of bank credits to the new owners? Will it abrogate the limits on the farm size and the salability of land that presently hamper the profitability of investments? Will the European Community be willing to increase its imports of agricultural products from Romania?

[5]For example, Burkett (1985) finds in a cross-sectional study based on 116 countries in the 1970s that for Romania, "socialism" had a significantly positive effect in all models (and for most countries "socialism" had a nonnegative effect).

Only a government enjoying considerable legitimacy can bring about the sort of systemic changes—more open trade, liberalization of prices, shutting down unprofitable firms, the creation of temporary unemployment—that are necessary. But Romania's population is suspicious of any government policy. It will take many years to build up the confidence necessary to resume economic development.

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