

The Role of the State in a Post-Socialist Economy

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Distinguished Lectures Series n. 6

Warsaw, 16 November 2001

Professor Andrzej K. Koźmiński: Welcome everybody. We are privileged and honored to have among us a famous Hungarian economist, Professor Janos Kornai. He will deliver a lecture to be published in our *Distinguished Lectures Series* initiated last year by Professor Robert Mundell, and followed by Vito Tanzi, Mario Nuti, Mario Blejer and Rosabeth Moss Kanter, etc.

Everybody knows how big of a name is Professor Kornai in contemporary economics. For those of us who were fortunate enough to deal with the so-called economy of socialism, we know how big of a breakthrough were Professor Kornai's ideas of anti-equilibrium, of economics of shortage and soft budget constraints. He was the first to provide hard evidence of the inefficiency of the communist economy, and had a very powerful impact both on our public life and on the science of economics in this part of the world. Professor Kornai is sharing his time between Budapest and Boston, between Harvard University and Collegium Budapest. Almost all his major books were published in Polish, with the unfortunate exception of *The Socialist System*, the most comprehensive book written, I believe, which I have read in English for myself. It seems though that our Leon Kozminski Academy Press might have a chance to contribute to the Polish bibliography of Professor Kornai's books by publishing in Polish the last book of Professor Kornai on health economics. Hopefully, the publication negotiations will come to an end soon. Let me now give the floor to Professor Grzegorz W. Kolodko, who will introduce our distinguished guest.

Professor Grzegorz W. Kolodko: Good afternoon everybody. Welcome again to our *Distinguished Lectures Series* at the Leon Koźmiński Academy of Entrepreneurship and Management. This is my great privilege to welcome today Professor Janos Kornai, a great

friend of Poland and a great economist. Whether one takes a global perspective or a western perspective, there is no doubt that Professor Janos Kornai has been the leading economist in our part of the world for already a number of years. I think it is also very important to add that despite being Hungarian, Professor Kornai, as far as his roots are concerned, is also East-Central European. This is very clearly to be seen from his distinguished lifetime achievements as a researcher and as a scholar.

Professor Kornai, the Hungarian, is a very well known economist associated for at least the last fifteen years with Harvard University. Out of these fifteen years, he has held the position of Allie S. Freed Professor of Economics for the last ten years. In the meantime, Professor Kornai has been taking short teaching assignments all over the world. In fact, he has been travelling between semesters at Harvard and semesters elsewhere, always to benefit students and researchers in Hungary, the United States, and the many other countries he visited.

We have also with us Doctor Zsuzsa Daniel, an economist, a scientist and a researcher in the Institute for Economic Analysis of Central Statistical Office in Budapest, but also privately Janos Kornai's wife. Dear Zsuzsa, welcome. We are glad that you are here with us.

Our distinguished Rector, Professor Koźmiński, has already mentioned the achievements and accomplishments of Professor Kornai. Professor Kornai has laid the foundation for understanding the way centrally planned economies has performed, through many circles in western economic thought. Professor Kornai's contribution to the theory of economics is of great importance also because of its interpretation of the socialist economic system and the system's legacy, which had so much influence on the process of the post-communist transition to the market economy. I am not sure, Janos you may correct me, but I think that your book *A Road to the Free Market Economy* has been translated into sixteen languages. This book is also, of course, available in Polish. Translation into sixteen languages is an achievement even for a good fiction book; it is all the more amazing that it happened to be a theoretical book on economic matters. As mentioned by Professor Koźmiński, we are now considering publishing the most recent book, just released by Cambridge University Press, written jointly by Professor Janos Kornai and Karen Eggleston from Harvard University on the *Welfare, Choice and Solidarity in Transition: Reforming the Health Sector in Eastern Europe*, at the Leon Koźmiński Academy Press. It is a long way, I think, to go from *Anti-equilibrium*, through *Economics of Shortage*, *Socialist Economic System*, and *A Road to Free*

Market Economy to reform of the health system. Yet, this is where we are now and we know that in very many transition countries, there is a great problem of trying to reform the provision of social services and healthcare, primarily.

Today we have quite a bold and fundamental topic, of which a heated debate is still going on. This is why we are so keen to listen to Professor Kornai, who will speak today on the new role of the state in a post-socialist economy. All of us know that we need a strong, efficient state, but strong in a very different way than it used to be in the past. The role of the state, as far as institution building, and investment in hard infrastructure and human capital is concerned, is still very important. There are, however, different views, economic theories, explanations, and different policy advice on how to reform the state to make it most suitable from the view point of raising efficiency, and therefore, the competitiveness of the emerging market economies in Eastern and Central Europe. I am sure that, as always, a contribution by Professor Kornai to our way of reasoning, this time vis-à-vis the new role of the state in transition economies will be of paramount importance. After the lecture, in a couple of weeks from now, we will publish Janos Kornai's lecture today in the *WSPiZ and TIGER Distinguished Lectures Series*. The electronic copy of the lecture will be available on the website of the Koźmiński Academy (www.wspiz.edu.pl) and the TIGER economic think-tank (www.tiger.edu.pl). Welcome again Professor Kornai, the floor is yours.

Professor Janos Kornai: Rector Koźmiński, ladies and gentlemen. First of all I would like to thank you for the great honor to address this audience. It is an especially good feeling to come to a private university in the eastern part of the world. The existence of private universities is a very important contribution to academic freedom and to the independence of academic life from the state. This brings me immediately to the topic of my lecture where I will talk about the role of the state.

My ideas are certainly influenced by the Hungarian experience but I would like to go beyond the Hungarian border and speak in more general terms. As a starting point I would like to use a conceptual framework introduced in my book *The Socialist System* (Kornai 1992), just mentioned in the very kind introductory remarks of Rector Koźmiński. I cannot assume that everybody here in the audience has read the book, so I have to start with explaining the theoretical framework.

Every economic activity requires co-ordination and I would like to distinguish three co-ordination mechanisms, which deserve special attention. The first one I would like to call *bureaucratic co-ordination*. That implies a hierarchical, vertical relationship between superiors and subordinates. It uses instructions and commands as signals sent from the top to the bottom of the bureaucratic structure, while reports, proposals, and requests for permission come from the bottom to the top. The motivation for participating in bureaucratic co-ordination is loyalty to the superiors and fear of punishment and penalty.

Then we have a second mechanism of co-ordination – *market co-ordination*. That is basically a horizontal relationship between a seller and a buyer. The main signals are the prices and other terms of a contract. The motivation is mainly material gain and profit.

The third co-ordination mechanism I call *associative co-ordination*. We can use this term more or less as a synonym of self-governance or civil society. This is mostly, but not exclusively, a horizontal relationship. Signals are participatory, small group decisions. Motivation is group interest and/or altruism.

These three mechanisms do exist in all societies. It is not anything specific; we can observe it everywhere. The question is the relative proportions of their roles. How big or how small is the influence of any one of them? Let us just consider one important aspect of that here in Warsaw. That is the change in the role of these three mechanisms following the largest phase of transition, which are more or less over in the advanced transition countries.

Under the socialist system, the dominant mechanism was bureaucratic co-ordination. By the end of the transition, bureaucratic co-ordination of course does not disappear, but it is downgraded, reduced to a secondary role. Under the socialist system, the market played only a secondary role. It did exist but it had only an auxiliary, supplementary place, partly illegal, partly informal, and partly underground. By the end of the transition period, if we look at co-ordination in the society as a whole, the market became the dominant co-ordination mechanism. Under the socialist system associative co-ordination hardly existed. There was something like pseudo associative co-ordination: various associations, trade unions, youth organizations, women organizations and so on, but even if they gave the illusion of being voluntary associations, they were practically controlled and penetrated by the communist party. By the end of the transition civil society emerged. So we see dramatic changes in the

role of these co-ordination mechanisms compared with the role they played before the transition.

My next step in this chain of thought would be to enter into a kind of dispute or debate with opinions about these three mechanisms, with which I disagree. I want to declare my disagreement with certain views. I would like to talk about three fallacies, three misconceptions concerning the role of these mechanisms. I met these fallacies all over the world: in the West, in the Far East, and here in our Central and Eastern Europe. I will talk, though, mainly about these fallacies in our part of the world.

The first fallacy is a fascination with the state, an excessive admiration for what a state can do. I met it several times in many circles in Eastern Europe. To me that came, I must confess somewhat as a surprise because very often I met this fascination with the state among people who categorize themselves as belonging to the left side of the political spectrum. I studied carefully Marxist political economy and the Marxist way of thinking and for a good Marxist it would be quite self-evident to be suspicious of the bourgeois state, which was a servant of the bourgeoisie. It was a surprise that suddenly these people who clearly had ideological roots in Marxian intellectual tradition, suddenly became admirers of the state. The intellectual motivation for that admiration was their aversion towards the market. Because they disliked the market, they suddenly started to think that the solution for all the troubles of the market would be the activity of the state.

But I do not want to be one-sided - I met this fascination with the state also in the circles of the political right. There is a certain type of thinking where an admiration for the state is associated with a strong belief in the role or mission of the state for the nation. Nationalistic ideas can be associated with *etatist* views. Those can be observed clearly in various intellectual currents of thinking. So you get this fascination with the state on various sides of the political spectrum. It is not a leftist or a rightist view, it is just a typical attitude vis-à-vis the state.

There are various well-known counter arguments. The most famous representative of this line of thinking is Buchanan, the Nobel Prize winning economist, who made important points in that respect (Buchanan and Tullock, 1962, Buchanan and Musgrave, 2000). The state can fail. Beside market failure there is government failure. The politician is not a wise man standing

above all selfish interests but he is a person who is seeking power, who tries to maximize votes and is looking for his own political interest. Also the bureaucracy is not necessarily the ideal Weberian honest bureaucracy – it, too, has self-serving purposes. And then there is also corruption and dishonesty (Rose-Ackerman, 1999). Therefore there are good reasons to have certain doubts whether the state can fulfil everything that the admirers of the state are expecting from it.

It is very characteristic for these admirers to experience a kind of schizophrenia in their thinking. When you talk to them, they admire the state, especially when there is a government in power, which they like. But if it happens that the government in power is not enjoying their support, then the same person starts to be very skeptical and has many doubts about what the state can do

Now let us talk about the second fallacy: the fascination with the market. This fascination is best embodied in the uncritical Chicago approach, which says that we should let the market run its own course and everything will be just fine. Again, we do not have to invent arguments against this admiration because we have well-established theories on market failure that started with the early stages of welfare economics and runs through contemporary Nobel Prize winners on the theory of information. The well-known counter arguments, I will mention only the key words, are increasing returns to scale, externalities, asymmetric information and distributional considerations (for a survey of factors leading to market failure see Stiglitz 1986). All of them can be reasons for market failure. As far as I can see, but I may be wrong, the purist Chicago approach is rather exceptional, not characteristic of Eastern Europe. The Chicago approach is taken with a few restrictions. Poland's experience in this respect is not much different from other countries. An extreme Chicago approach seems to be, in my experience, quite sporadic, yet it does exist.

Then comes the third fallacy: fascination with a civil society, non-governmental organizations (NGO), and non-profit institutions. This fascination is not very widely spread among larger groups of the population, but many intellectuals, so to say free floating intellectuals, who are not strongly associated with one or the other political party, tend to substantially share this admiration. They are attracted to this third mechanism because it is neither 'dirty' politics nor a profit hungry market, it is something different from the other two and therefore it seems to be nice and clean. The fascination with the third fallacy is much less debated, but nonetheless,

there are at least two important counter arguments against expecting too much from civil society.

The first one is, that the third mechanism of co-ordination is relatively weak compared to the strength of the state, bureaucracy, legal enforcement and compared to the strength and power of the market. Mechanism number one and two are strong, powerful mechanisms; mechanism number three is a weak one. One can not expect that a society could be governed by the third mechanism.

The second counter argument is that there are some false expectations concerning the cleanliness of the third mechanism. In fact, if we study it very closely, we can see that it is intertwined with politics; many voluntary associations have influential politicians on their boards, they are looking for political connections to get support of the state, to get some tax money or subsidies. It is also intertwined with business; there is no strict separation between NGOs, non-profit organizations and for-profit organizations. It happens quite often that the former is linked to the latter. The admiration for this third mechanism is overrated.

Here I come to the first conclusion of what I have tried to explain up to now. We have to be aware of the imperfections of all three mechanisms. None of them is really perfect; we must not have illusions. It would be a big mistake to rely on only one of them. All mechanisms have strong sides and weak sides.

Now I will focus on the state, which is the first mechanism, and go on with various roles and functions of the state. There are different taxonomies of how to survey the role of the state but most of them agree that the state has a kind of classical role. The classical role is to be a safeguard of law and order and represent national interest in foreign affairs. Even if there is a dispute about the welfare state and other roles of the state in the economy, there is no dispute that the state must take care of law and order, diplomacy, and foreign affairs. That is what we call the classical role of the state.

On a superficial level of observation one could imagine that since that is the classical role and every state has to satisfy this social demand for the classical role, there is not too much change concerning the extent of these activities. But a closer look will show that this is not

true. I will not talk about diplomacy and military, but I will focus only on one activity in this area of law and order – that of the police. I will use it as an example.

Under the communist regime the function of the police was under a state monopoly. No one other than the state could perform police activities. The central authorities of the state strictly controlled the police. Let us consider what is happening now. Part of the police function has been privatized. We use the term privatization very often but then we think always about privatization of a business firm or of banks, or telecom companies and so on. But let us look at the police. A large part of the police has been privatized. We have companies specializing in security tasks, taking care of the security of transport of money from one branch of a bank to the other, or protecting certain buildings. Many people acting as policemen, are hired by companies, institutions, also sometimes by individuals, often to celebrities who need bodyguards. It is quite hard to get relevant data, but in Hungary if one looks only at employment in firms specializing in security, then the number of employees in these companies represents almost 20 percent of the total number of the public police staff. It is a huge number! That does not include individually hired people who are in the security business - this could add at least an additional 20 percent or more. That is something brand-new. Is that good or bad? Let us think about it for a moment.

There are several considerations we have to keep in mind. As an economist I would start by thinking of a problem with economies of scale. There are advantages of keeping the police public. If you put many policemen on the street at night you do not have to protect every building separately, because the police on the street are taking care of public safety. That is for instance, an experience in New York where every building has a guard – would having more police in the street help? Economies of scale are calling for more public and less private police.

Nevertheless, there are private police that people and companies are ready to pay huge amounts of money to for their services. Interestingly, they are paying more for a private policeman than what is paid by the state for the public policeman. There are important arguments against public police. One is that the public police may abuse their power. There are cases of police brutality, discrimination, and corruption. I have recently heard that in Poland, penalties you pay for speeding can in many cases be negotiated, that is, the speeding driver and the policeman can agree on a price. Corruption speaks against the public police.

Then there is an even more serious consideration for us, Eastern Europeans. We have had a tragic experience with Orwellian police, who would watch everyone; there would even be police informers around us. Somehow people are concerned and worried if we have too much of the police. But, on the other hand private police can be also misused. For instance there are associations between private security people and the Mafia. The Mafia has its own police.

I will give only a temporary conclusion for this reasoning about the police. I cannot suggest to you any simple rule on what the proportion of the public and private police should be. I would make it dependent on several factors. First of all, how strong is the democratic process in monitoring the police? How effective is prosecution against police abuse and corruption? How reliable is the supervision and monitoring of the private police? It will depend on efficiency and efficacy of monitoring the public and private police for one to take a position on the borderline between the public and private police.

Now I go to the second role of the state, again a very broad role, that is the role of the state as an active player in the economy. Here we witness the most dramatic change following the transition. Before the transition the state was not the sole but the dominant owner of assets. The largest part of the economy was nationalized and under the control of the state. There was central planning and a centrally managed economy, which we call a command economy. The young students in this audience do not remember any more that this was the case but I can assure you that it was a real historical situation and the whole economy was commanded from one center. That has been abandoned and it became unquestionable that this excessive role of the state should have been eliminated.

But still the state retained an important job in the economy. No one denies this role of the state – it is generally accepted. Again, if we go along a spectrum of various economic views and economic schools of thinking, even those closest to the Chicago approach would still accept that fiscal policy and monetary policy is needed and it does matter. I do not want to enter into this dispute today between schools of thought on fiscal and monetary policy. I know it would be very timely to talk about it in Poland but that is not on my agenda for this lecture. I would like to say only a few words about the general quality of fiscal and monetary policy. These policies are necessary and inevitable, but still they can be conducted well or badly.

Let us look around in Eastern Europe and especially focus on the group of Eastern European countries, which most outside observers regard as the most successful or the most advanced, say: Hungary, Poland, and Czech Republic. What we can see in the course of ten or eleven years is that there were better years and worse years, some very bad years and certainly a few big mistakes. There are disputes, sharp controversies about who was responsible for the mistakes but we can agree that mistakes were made and they caused a lot of harm

Why do we make big and harmful mistakes? One reason is lack of practice and incompetence. That is a very important one. Everyone in our countries is a beginner. We are all in the first years of our studies, not yet graduate, but undergraduate studies. It is quite understandable that an undergraduate, who has just started to learn, makes mistakes. The problem is that all people pay a tuition fee and not only those who make a mistake.

There is also another source of bad mistakes, which is related to politics. I would like to look at this as a positive observer. I do not make judgements but I want to just look at causality. Fiscal expenditures are usually overblown for the sake of public relations and for getting votes. One can observe from time to time populist macro-policy. It is an observable fact that this kind of macro-policy is amplified when elections come closer. It is a well known and well demonstrated fact of political economy that there is such a thing as a political cycle, that is, when time comes closer to elections you have more spending. But the commitment to give handouts to various strata of a society to receive their support is done now and a payment for the commitment comes later. The idea of those who make the commitment is that either they will lose the elections and then another government will pay for their commitment, or if they win, they will have time to correct it. The whole bill will not be paid the next day but they will have time to make things right. This scenario makes for mistakes in fiscal policy.

We also see interventions in the market for the sake of popularity. For example, not allowing certain prices to rise or depressing prices for other products.

Then we have restrictions on competition to discriminate against foreign capital. That is a very important part of populist policies that aim at preventing the inflow of foreign capital to various branches of industry, agriculture, communications, and so on, which would be required for the sake of the efficient operation of the economy. That inflow is restricted just for political reasons to please nationalist sentiments and not for economic considerations.

We can also discern influence of these political considerations in public procurement – all sellers of certain goods and services are welcome but certain sellers are more welcomed than others because they are closer to the ruling party or to the ruling government. There is a building-up of a political clientele into business life by treating favorably those providers, sellers, producers who have good political connections with the ruling coalition. Again, something similar can happen with subsidies and with support of local communities. Local communities might be entitled to get various central support but if a local community is governed by a mayor or by a governor from the ruling party or ruling coalition, it may get central support easier than another community governed by those who are from the opposition side.

There are various forms of bias or distortions introduced in the economy by the state, because the state is not an impartial, wise collection of Platonic philosophers but it is a political body and the engine of its decisions is political. Although this is undesirable, as a matter of fact that is how governments are operating.

Let me immediately draw a conclusion on the second role of the state. Again, I want a certain, well-defined activity of the state. I am not, of course, against monetary and fiscal policy. I am not against state interventions and state procurement, which is needed. Finally, I do not oppose all central subsidies when needed. I admit that I cannot give a uniform, strict rule of how far the role of the state should go. The extent of the activity of the state and its intensity will depend on the situation of the democratic process. That is an issue to which I will come back to at the end of my lecture. It will depend on how strongly the state is being monitored, supervised, and controlled by the democratic process. The more arbitrariness in state decisions, the less discretion I would give to the state.

Now let me talk about the third role of the state – redistribution, and about the state as a provider of public goods. Provision of public goods is the most controversial role of the state. There is a large diversity of views on this issue. The classical role of the state is always accepted. Some additional economic role is also accepted. But the question of how far to go with functions of the welfare state is still very controversial. There was a traditional partition or separation of roles. Fifty or forty years ago social democrats were for the welfare state and conservatives were against it. That is not true anymore. It is much more mixed, I would even

say confused. One can observe that sometimes, socialist parties and social democratic parties are initiators of market-type, liberal reforms, while on the other hand Christian democratic parties and conservative parties are protecting the welfare state and fighting for it. So the traditional division – that is, just looking at welfare state policy and then knowing who is on the left side and who is on the right side – does not work anymore. One has to look specifically at party programs and at party practice.

In order to illustrate my ideas on the welfare state, I would like to talk about the health sector. Although I wanted to talk about the pension system as well, time constraints of the lecture do not allow me to do that.

As mentioned in the introduction, together with a co-author I wrote a book on health reform (Kornai, Eggleston, 2001). I cannot easily summarize a long book in five or six minutes, but I want to convey the main ideas. Let us go back again to the communist system as I did in other parts of my lecture because that was the initial point from which we started. Under the communist system, provision of healthcare was fully nationalized or almost fully nationalized. It was co-ordinated by a bureaucratic co-ordination system. Health care was free for everyone, as written in constitutions or in special laws on healthcare. Every citizen was entitled to free access to healthcare. In most communist countries, certainly in Hungary but as far as I know also in Poland, there was a strange market phenomenon in that we gave some money to the doctor under the table. The Hungarian term for that is ‘gratitude money’. This money was put into an envelope and, in an embarrassed move, you gave it to a doctor who said: ‘No, no, no’ but finally always accepted. There was an official market, but it was certainly a shortage economy with all its characteristics: long queues, inferior quality, forced substitution. However, parallel to the official health system there was a kind of a grey or black market – for a bribe you could jump the queue, get some extra attention or at least you had an illusion that you got some extra treatment.

That was the beginning and now in all former communist countries we are in transition to something else. I deliberately speak in very general terms talking about ‘something else’ because there is no clear model or country to be followed. If one wanted to create a stock exchange, then it would be reasonable to think about London or Zurich or other good stock exchanges in the world. If one was thinking about what should the legislation for shareholders be in joint stock companies – there is such legislation in mature market economies and one

can just learn how they do it. But as for the health sector, I would safely say that there is not one single country in the world that really has the right solution. There are different models and each of them has various specific weaknesses. Certain models have only weaknesses; others are combinations of strengths and weaknesses. There is no simple pattern and we are in a difficult situation since we have to make our own design for which direction to go.

One more preliminary comment to the health reform problem. Of course, economists are aware that scarcity is a general problem. Human needs are always exceeding available resources. Therefore decisions must be made for selection. But nowhere is the scarcity problem so painful as in health. That is because science and technology provide instruments, techniques, and knowledge for treatment and cures, but resources to use it are inevitably much, much lower. If we reformulate it in a negative way: we could then see how bitter the problem is in that we would have to deny access to contemporary medical knowledge to a certain number of people, who could be cured or their pain reduced, but it is impossible to do so because resources are scarce. There must be a painful selection process. It is very easy to declare that everyone is entitled to the best treatment but it is just not true. It is not true anywhere. It is not true in the richest countries in the world. The U.S. is spending a very high percentage of its GDP on health and still it would not be true to say that they could afford to cure every American citizen with the most modern technology. That is a painful dilemma, which also has an ethical dimension: who will be in and who will be out. Typically if you look at the whole health care debate, you rarely find the politician who is talking about the health sector and the scarcity of resources, and who has the courage to say that here we have a terrible ethical dilemma. There is rhetoric speaking around the problem, talking about efficiency and declaring that everybody should have the best treatment and so on, but politicians do not honestly face this bitter problem.

Our purpose in this book was to talk about this ethical health dilemma honestly and have a position on it. Our point is, and it is consistent with what I said before, that we do not have full confidence in the state and we do not have full confidence in the market. Both are imperfect mechanisms and the third one – the associative civil society – is also imperfect. We need a combined, mixed system counterbalancing each of the weaknesses of the three mechanisms. This idea has some similarities with the concept of a multi-pillar system in the pension sector, where we have to assure a mandatory minimum package for everyone. That should be financed from mandatory insurance fees plus mandatory co-payments by the

patients. For those who are not able, for instance, to pay the mandatory insurance and co-payment, the state can step in and help them out. That is a minimum, basic package for everyone without exception – it is all about assuring equality at a certain level. Above this level you can voluntarily pay for your own extra treatment and extra medical care. You can pay for that either out of pocket or by a private insurance plan. This payment should be arranged legally, not under the table, not in a grey or a black market, but in a regular, commercial market. The scheme as a whole is a combination of bureaucratic provision at a certain standard and a market provision above this standard.

I am ready to accept any attack that this position is not consistent with egalitarian views. According to radical, extreme egalitarians, our proposal is unfair because everyone should have equal access. I admit: our proposal does not assure equal access; it is equal only up to a certain level and unequal above this level. If we make extra payment for extra services illegal, there will always be a black market for extra services. Why not make it legal? Second, if I am for individual choice and individual freedom and if I allow a person to choose among consumer goods, between champagne and a luxury apartment, why would I deny him the ability to spend on his own health or on the health of his mother or his friends? If the market for health services were to be made illegal, it would be unjust and disrespectful to one's individual choice. I am convinced that we need a combination between two values - individual freedom and solidarity. Solidarity, or equal access to a certain level, but individual choice above this level.

All the above is based on the idea that if we combine an imperfect bureaucratic co-ordination with an imperfect market and some imperfect supervision of this process, then nonetheless these three mechanisms together will provide a somewhat better mix than a pure market solution or a pure bureaucratic solution. I cannot report to you that Hungary is clearly moving in that direction. We started various bits and pieces of health reform, some of them point in that direction, and some of them do not. It is a non-transparent package of fragments. I did not study the Polish health reform and what happened in that respect; you must know it. But here again, there is no clear, strict borderline between public and private but something to be tested in practice.

Now I can come to the conclusive part of my lecture. You could see that my lecture did not convey some kind of popular and charismatic message. If I spoke out a very clear and

unproblematic solution, that would perhaps be more attractive. But I am not seeking popularity. What I was suggesting is caution, balance and also a large dose of healthy skepticism. There are no simple, clear-cut solutions that are valid for every country and forever. There are no universal recipes on what should be the division of labor between these three mechanisms and where exactly the borderline should be between the state and outside the state activity.

I am not skeptical concerning primary values, that is I have my strong ethical conviction. I even explained my ethical position and demonstrated it on my suggestions concerning health reform. I am for two very important values. First of all, liberty, freedom of choice, and voluntary decisions. Secondly, solidarity and fairness. Where I am skeptical, cautious, and sometimes suspicious is when talking about not the ends but the means, not the goals but the instruments achieving these goals. Here I am not ready to go along these various fashions and great fascinations. I am not an admirer of the first, second or third mechanism. I have full respect for all three, but at the same time, I am full of doubts concerning all three. That is an attitude, which I learned through my life experience. However, this statement does not imply perfect indifference over these three alternative mechanisms. Let us assume that we are facing a choice between an imperfect bureaucratic solution and a not less imperfect market solution. Other conditions being equal, I would be inclined to choose the market solution. Let me explain why. Even if I know that the market would fail because of externalities or increasing returns to scale or asymmetric information, all these failures would be paying a price mainly in efficiency, perhaps also a price in fairness. I do not have illusions about that – the market can lead to unfair distribution and its consequences. But I am less afraid of these two bad things than I am afraid of tyranny. I am also more afraid of overcentralization, excessive power of the government, because I am Hungarian, because I am Eastern European, because I went through what all of us of the older generation went through. Therefore the protection of liberty, including individual freedom is *primus inter pares*, is most important among equally important things in my own value system. I do not impose my own value system on anyone - you choose your own value system. I am ready to announce my value system, I do not hide it as many economists do – you have to read very carefully their work and then you find out what is their value system – I put it on the table. That is my value system. In questionable cases, when I have no perfect confidence in the three mechanisms, my relative confidence first goes to the market for that reason. Without illusions – that is not a Chicago approach because I am aware of various imperfections. But still I am less afraid of the negative

consequences of a market failure than I am afraid of the negative consequences of the dominance of political decisions and of being at the mercy of a government.

Classical English political philosophy taught us that when you think about the state, your starting assumption should not be that you have a good government (Hardin, 2001). Instead, your starting assumption should be that you have a bad government, that in the government there are dishonest or incompetent people. Then think about the role of the state. That is a right assumption and then if you have in addition a good government, the better. But one must be prepared for the bad government – one must enact constitutions and laws according to the fact that governments might be bad. One should build all checks and balances against the cases when you could have bad luck and you get a bad government or some bad people in the government. That is how you have to be mentally prepared when you think about the state.

Professor Andrzej Koźmiński: Thank you very much for your words of wisdom, which were listened to in an almost perfect silence, which happens seldom in this room. Now I think we can open the floor for discussion and comments.

Professor Stefan Kwiatkowski, Leon Koźmiński Academy of Entrepreneurship and Management: I have one question, which can however sound as if there were two questions. Accepting the framework of your theoretical model so lucidly presented, I would like you to comment on possible changes in the current balance between the three modes of coordination: *i*) in transformation countries especially in Europe resulting from the challenges of globalization, and *ii*) in the leading industrial countries or post-industrial countries as a result of the 11th of September, if you accept that this is a major factor.

Professor Janos Kornai: I think both questions are very important and worthy of serious analysis. As for globalization, I am not able to make predictions because thinking ten, twenty, and fifty years ahead and predicting anything would be a risky task. Globalization is certainly weakening the possibility of state intervention on the national level. It is reducing the role of nation states from the feasibility side. There are so many examples of this tendency. For instance, it is extremely difficult for the state to step into the regulation of the Internet. There is some legislation, yet is very difficult to enforce. The whole evolution of the Internet is a typical “invisible hand” procedure, which can be and should be supported, but certainly not guided by nation states. The third associative mechanism can play an important supervisory

role - monitoring and so on. I was talking only about this Internet example but it is the core of all changes.

As for supranational, global government, I just cannot imagine it right now. But my imagination might be weak and maybe the global system will not evolve into a supranational government but the procedure will be regional integration and some supranational, international bodies like the UN. I think that the role of the UN can be strengthened. Globalization probably makes the state role relatively weaker compared to the other two mechanisms but I am not sure. It is such a difficult task to make predictions.

As regards your question about post-September 11th effects, I could, of course, escape your question by saying that it is much too early, as only two months have passed. But I can immediately tell you about one of my views and that follows the very ending of my lecture. I accept that antiterrorism requires strong police to fight against terrorists. If a person suspect of terrorism is detained then he must be questioned and may be detained for a while and so on. I accept the sad fact that post-September 11th, the police will have somewhat freer hands than in a traditional democratic country. But I am scared that we may allow too much unconstrained police power, as in granting the police legal possibilities to detain people for a very long period only because they are terrorist suspects. The idea of torture is coming up, that is, that you can save millions of lives by torturing one suspect. We know this argument because that was the Cheka's arguments. I am a bit concerned about it. Hopefully we will get over that. It is a good example of my first point when I talked about limits of the public police.

Profesor Tadeusz Kowalik, WSPiZ and Polish Academy of Sciences: I am trying to reconcile fascination with Kornai's publications and activity with an obsession about unemployment, social justice, equality, and so on. And this is very difficult task to combine these two things. In the interview some five years ago to *Nowe Życie Gospodarcze* you said that the welfare state was one of the greatest achievements of modern civilization. Today, however, you were talking, especially at the end, as if you rather accepted a concept of a social safety net rather than a welfare state as such. My question is whether the situation has changed with the passing of time or has there been a change of opinion on your part?

Another question connected with this is that in Hungary as well as in Poland during the last few years the scope for the welfare state and redistribution was quite substantially contracted.

Do you still think that we live in a premature welfare state as you have written a couple of years ago?

The last question is connected with the transformation problem. A year ago you took part, together with Rodrick, Sachs, Stiglitz and so on, in a conference on development organized by the World Bank. Stiglitz said there that shock therapy, as a method of change, was equally successful as the Chinese Cultural Revolution and the Bolshevik revolution. I wonder what is your opinion on shock therapy?

Professor Janos Kornai: It is not an easy question. I did not change my position on the welfare state at all and you quoted an earlier writing of mine. This earlier writing, if I remember my own writing correctly, admitted that the creation and the evolution of the welfare state is a very great achievement and I still maintain it. I would compare the early 19th century capitalism where the state played a very minuscule role in providing social services to the evolution of a welfare state like that in Germany, Scandinavia and so on, which proved to be a great achievement. This is an achievement since it showed that the state is responsible not only for law and order, the military and diplomacy, but also for the welfare of its citizens. That I still maintain. But in the same paper you just quoted I criticized the modern welfare state. I was very critical of it being so overblown and the state taking responsibility for affairs that go beyond its responsibility. That was not uncritical admiration or fascination with the state. One can admit something as a great achievement and at the same time be critical of it. I was critical and I am still critical. I was looking for a good combination of state and market and civil society at that time and I am still looking for that combination. I feel that in that sense I remain consistent.

You are talking about the World Bank's view of a social safety net and that you contrast with the welfare state. I do not want to speak on behalf of the World Bank, that is not my job, but what I am suggesting is much more than a social safety net. For instance in health, a social safety net would take care of emergency calls so that nobody would die on the street or in case of an infectious disease, vaccinations would be performed – that is a safety net approach. I am suggesting much more, I am suggesting equal access to a decent standard level of healthcare but not equal access to the same total level of healthcare. In that sense, if you characterize yourself egalitarian, I am half-egalitarian. I am not a hundred percent egalitarian because being an advocate of a market economy I cannot be completely egalitarian, it is just

not compatible with that. I am egalitarian to some extent, to a certain degree and non-egalitarian above this degree. Tobin introduced the term ‘specific egalitarianism’ and I like this idea, that is again, egalitarian up to a point and not egalitarian beyond that point, and I quote him in my book. That is my ethical position. That is much beyond a safety net, up to a level of something that everyone accepts as a decent minimum. Where this decent minimum lies should be decided on a country by country base.

As for shock therapy, please allow me not to enter this debate today. You and I have had plenty of discussions about that. That is not the topic of the lecture and I do not want to make it a topic of discussion. But let me mention that I have a paper on that, “Ten Years After ‘The Road to a Free Economy’”, which has been quite recently published in a volume. In this paper I elaborate my position on gradualism. I have views on that but allow me not to put it in this debate. Thank you very much for your attention.

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