ABSTRACT

The usual view of the problem of transition in Eastern Europe is that the industrial plant is technologically obsolete and the countries involved lack many of the technical and managerial skills necessary to run a modern production process. In addition, the absence of a rational price system causes great misallocations of resources and creates wrong incentives for the people in control of enterprises.

While we share these concerns, we believe that the analysis of the difficulties facing the East European economies is often flawed by insufficient attention to what constitutes the most basic systemic obstacle to the growth of the region's economies. For in addition to all these problems, and beyond the political crisis they may generate, there remains what we consider to be the most challenging question of the whole economic reform: what will fill the gap created by the withdrawal of the state from the position of control? Indeed, without solving this problem, the process of modernization is bound not only to be costly, but also to fail.

We argue that the infrastructure of the market society will have to be _created_ for the market forces to begin to operate and that the main task of privatization in Eastern Europe is to introduce a rational structure of _corporate governance_. We have thus the makings of a genuine paradox which constitutes the most fundamental systemic obstacle to the economic transformation in Eastern Europe: The most important aspect of the transition to a spontaneously functioning market economy cannot be initiated by market forces themselves. Indeed, the only force powerful enough to set the market forces in motion is the very state which is supposed to remove itself from the economy.

We examine a potential role of economic theory in creating such an institutional infrastructure of market economy and analyze some theoretical and practical difficulties of the institutional design proposed in our earlier papers.