

Economic Theory and Transition: What Lessons from North Korea?

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1. Introduction

All former communist regimes underwent the transition from socialism to capitalism, except for North Korea and Cuba. It is only a question of time before these two countries go down a similar route. As latecomers, when the transition starts in those countries, they may have the benefit of learning from the experience of other transition countries. It is therefore important to understand the lessons from the transition experience in other countries. It is equally important to understand how these lessons apply in the specific context in those countries.

The goal of this lecture is to review the comprehensive lessons from transition and discuss their possible relevance for North Korea. The lessons from transition are there and will certainly be analyzed and debated for many years. However, the conditions for the transition process in North Korea are very uncertain. We do not have an idea of when it will start and even less under what conditions. One can argue that this uncertainty is of much higher order than the lessons from transition. While learning from transition, one must thus also cope with the uncertainty related to North Korea's transition.

In the face of uncertainty, it is useful to think in terms of possible scenarios for transition in North Korea. Not all scenarios are equally plausible though. I exclude a priori a scenario where the current Kim Jong-Il regime would engage in a comprehensive "Chinese-style" transition, i.e. a transition initiated by the current leadership with the objective of achieving economic prosperity through market reforms while keeping the current team in power. The reason is that the current North Korean leadership lacks the credibility to engage in such a path. In China, the reforms initiated by Deng could be credible because they came after very important changes at the top of the communist party. The team around Deng was determined to break with the legacy of the Cultural Revolution and the Maoist leadership. The reform process represented a definite break with decades of Maoism and the advent of a new team of leaders dedicated to the objective of transforming China into a modern economy, following the footsteps of the

growth success of Taiwan, Hong Kong, Singapore and South Korea. If Mao had still been alive and announced pro-market reforms, he would have lacked the credibility, given his disastrous economic track record. The same applies to the Kim Jong-Il leadership. Their economic track record is probably the most disastrous of the history of socialist regimes, with the exception of the Khmer Rouge regime. The North Korean economy has been in a state of agony for at least a decade. Living standards have been declining, mass starvation could only be avoided due to foreign economic assistance, the centrally planned economy functions mostly only to channel resources towards the military and the ruling elite. If Kim Jong-Il announced tomorrow that he will engage in Chinese-style reforms, few would give such an announcement any credibility. Lack of credibility itself would have very negative consequences for reforms. Large-scale redistribution of land would have no serious positive effects if people are not convinced that they can be allowed to be residual claimant on their effort. Any reform requiring people to invest substantial effort can only work if there is a minimum credibility that the returns to effort will not be expropriated by the communist regime. Moreover, a minimum of political liberalization, like was the case in China after 1976, would also be necessary to get the process started and to give the process a minimum of credibility. This would be especially risky for the North Korean leadership as any relaxation of the repression might lead the accumulated anger of the population to explode. Given the lack of credibility, there seem to be few benefits for the current leadership to engage in even limited political and economic liberalization but there would be clearly identifiable costs and risks. The optimal strategy for the current North Korean leadership is therefore, in my view, to extract a maximum of outside aid, using nuclear blackmail and feelings of sympathy from South Koreans to their brothers to the North, to keep the crumbling socialist economy alive. It is optimal for the current leadership to pretend to make changes if it appears in their benefit to do so but without attempting any real changes.

I see two possible scenarios: 1) a change within the leadership, as significant as the one that occurred in China in 1976, associated to attempts to establish closer ties with China, and a genuine attempt to emulate the Chinese path; 2) a sudden collapse of the regime necessitating outside intervention (mostly from South Korea) to maintain order, avoid

humanitarian chaos and start a serious transition process very quickly. I attach a higher probability to the second scenario but do not want to exclude the first one. In any event, even in the first scenario, outside intervention from China may be requested by the new leaders which could create international tensions. My favorite scenario is one where the North Korean transition starts under the auspices of outside intervention (plausibly and preferably from the international structure of the “six party talks”) with a very important practical involvement from South Korea. Under this scenario, fast unification is excluded but outside intervention forces will face the task of establishing political, legal and economic institutions. To use historical analogies, this is a scenario that resembles more the situation in Germany after the defeat of the Nazis in 1945 than the situation in the same country in 1989 after the fall of the Berlin wall. When thinking about transition in North Korea, it is more this scenario that I will have in mind.

From the point of view of economic theory, the transition experience has very much reinforced the institutionalist perspective, emphasizing the importance of the various institutions underpinning a successful capitalist economy. Successful institutions of capitalism are already present in advanced economies and we tend to take them for granted when reasoning on economies in transition or on developing economies where such institutions are absent. If anything, the experience of transition shows that policies of liberalization, stabilization and privatization that are not grounded in adequate institutions may not deliver successful outcomes. Much of this change of focus towards the institutionalist perspective had been already taking place with the development of contract theory, political economy, law and economics, regulation theory, corporate finance and other areas in applied economic theory. However, the experience from transition has contributed to accelerate various changes of focus in the way to think about economics. Thus, there is a shift of emphasis from markets and price theory to contracting and to the legal, social and political environment of contracting. Transition has not only helped to reinforce this change of focus in economic thinking. It has also renewed interest in thinking about the interplay and complementarities between the various constitutive institutions of capitalism. Finally, transition has forced us to think about institutions not in a static way but in a dynamic way: how momentum for reform is

created, how institutions can evolve but also how momentum can be lost and how one can get stuck in inefficient institutions. Roland (2000) contains a comprehensive analysis of these transition issues.

I will look at three important components of the transition process: 1) the political economy of reforms and the broader context of reform strategies, 2) allocative changes brought about by the introduction of the market economy, implying the expansion of some sectors of the economy and the contraction of others, 3) governance changes at the level of enterprises and government. Table 1 at the end of the paper puts together all the elements I discuss below.

2. Reform strategy and the political economy of reform.

Let us start with the focus of reforms. At the beginning of the transition process, the focus of reforms for the "Washington consensus" was to be on what is called the trinity "liberalization, stabilization, privatization". Few serious economists dispute the need to liberalize, stabilize and privatize. There is not much dispute either about the advantages of using shock therapy as a stabilization method when it is politically feasible. However, one of the most important lessons from transition is that liberalization, privatization and even stabilization will not necessarily deliver the desired outcomes in the absence of the necessary institutional underpinnings and may lead to unpleasant surprises. This is the case for the important output fall after liberalization. It was not predicted. Another unexpected outcome is the asset-stripping following mass privatization in Russia and the Czech republic. Also on the downside, the development of the Mafia, the strong increase in the size of the hidden economy in former CIS countries, the resistance of large Russian enterprises to tax collection were not predicted either. The latter examples are clear illustration of the neglect of institution-building. The transition experience has shown that the focus of reforms should be foremost on the creation of the adequate institutional underpinnings of markets to encourage a vigorous process of entry, competition and exit.

By institutional underpinnings, I mean not only the introduction of laws: adequate laws to secure private property, rights of shareholders, creditors, etc... One needs a more comprehensive view toward institutional conditions. These include not only legal and financial change but also comprehensive conditions of law enforcement, including reform of the organization of government and the development of self-enforcing social norms that foster entrepreneurship, trust, respect of legality and commitment. One cannot expect full-fledged institutions to be introduced overnight. However, minimum institutions underpinning market development must be present from the beginning because these define the rules of the game and thus place restrictions on undesired kinds of individual behavior. They also reduce uncertainty which is very important for economic transactions. Adequate institutions must develop via trial and error and must evolve over time toward more perfect institutions which cannot be introduced overnight.

These lessons are important for North Korea which should be able to avoid mistakes from other transition countries. Institutional reform should be the main focus from day one of the transition. In doing so, one must try to find the right mix between importing institutions from South Korea and build on the experience from the norms that developed in the shadow economy. I will come back later to this point.

A very important lesson from the transition experience is the presence of large aggregate uncertainty. Aggregate uncertainty means that aggregate, economy-wide reform outcomes may range from the very positive to the very negative. In other words, economy-wide success is by no means guaranteed. Initial views of transition, based on a strong faith in societal engineering, neglected this and emphasized that reform would deliver sure efficiency gains. Indeed, reforms have not uniformly delivered good outcomes or economy-wide efficiency gains. The differences in performance between the transition countries have shown wide variation in the evolution of output, between the strong growth of the Chinese economy on one hand, the U-shaped output evolution in Central Europe and the continuous decline in many former CIS countries throughout

most of the nineties on the other hand. The importance of these large unexpected outcomes shows the relevance of the emphasis on aggregate uncertainty. Copying successful capitalism from other countries does not guarantee success. The point is not whether or not we know what are the successful models of capitalism but what is the combination of ingredients that has delivered the observed successes and how difficult it is to export those ingredients. Even in trying to copy the better models of capitalism, things may go wrong. Our understanding of these large-scale changes is still rudimentary and nothing guarantees that there will not be huge unexpected and undesired outcomes. Even the experience of German unification showed that one cannot neglect aggregate uncertainty. This uncertainty will reflect in both popular attitudes towards reform and in decision-making by policy-makers. The main lesson to draw from the presence of aggregate uncertainty is the necessity of flexibility in policy-making and the use of experimentation in order to determine what works well and what does not work well.

In the North Korean context, aggregate uncertainty will also be present. One can however argue that it will be less important since we now know more about transition than 20 years ago. In the North Korean case, there is however large aggregate uncertainty over the initial conditions of future transition. Differences in initial conditions will require differences in policies. It is therefore important to establish already now contingency plans and to come up with different strategies corresponding to different initial conditions.

Initial conditions are very important and were neglected early in the transition process. The Washington consensus emphasized the need to create *tabula rasa* conditions by breaking as fast and as thoroughly as possible the existing communist state structure. The logic was one of "cavalry attack" to break any possible resistance and sabotage to reforms by the conservative communists of the former *Nomenklatura*. The rhetoric used revolutionary metaphors and comparisons were often made between post-communist transition and the French revolution (see e.g. Sachs, Woo and Yang, 1999). Early in transition, most experts on socialist economies were pushed aside and declared "obsolete" by the shock therapists. Many of the early transition experts stated repeatedly that

knowledge of the former system was a liability and ignorance an asset in understanding transition. This *tabula rasa* view has found its most accomplished implementation in East Germany where the old system was thoroughly broken up at grand speed while West German experts came to build their own institutions on the ashes of the old system. The transition experience has shown the limits to the revolutionary or Jacobine approach to transition. It showed the need to use the existing institutions to prevent economic disruption and social unrest while developing new institutions. The transition experience warrants a healthy skepticism toward the import of institutions from outside and a greater insistence on trying to guide an evolutionary and flexible change of institutions in accordance with the initial conditions.

These lessons only partly apply to North Korea. If the transition has to start under conditions of collapse, institutions will mostly be brought in from the outside but efforts will be needed to make them “fit” to the beliefs and norms that have emerged from the shadow economy.

Complementarities in reform are an important topic when discussing reform strategies. They have often been misunderstood. Since the transition process involves the change from one system to the other, there is the clear notion that the components of the capitalist system that must replace the socialist system “fit together” and are complementary. Doing price reform alone, without ownership reform for example, will not yield the same results. Price reform will be more effective if ownership reform is taking place as well. In other words, price reform and ownership reform are complementary. One can think of many other examples of complementarities between reforms. Complementarities between reforms has been used as an argument in favor of the big bang approach to reform whereby all reforms are introduced in a simultaneous and comprehensive way. This is however not an overriding argument. The success of Chinese gradualism shows that the reform process can be successful even if all reforms are not introduced at the same time as long as sequencing of reforms can be used to create momentum for further reforms. Models of reform sequencing by Dewatripont and Roland (1995, 1997) show that complementarities can be exploited by reformers when

choosing the order of reforms. Indeed, by starting with more popular reforms, it is possible to build constituencies and political support for further, initially less popular reforms. The idea is that positive uncertainty resolution enhances voters' perception of positive reform outcomes. In that case, when reforms are complementary, the only choices are to go forward or go backward. Voters will thus be more prepared to move forward in order to keep the gains from initial reforms after partial uncertainty resolution about those reforms. Reforms should thus be ordered in a way to start with reforms more likely to deliver good news for voters. Popular reforms should precede less popular reforms. On the contrary, starting with reforms more likely to hurt a majority of the population risks to create backlash as bad news on initial reforms tend to build support for reform reversal. In China, the success of decollectivization allowed to create momentum for reform in the state sector (see e.g. Naughton, 1995; Lin, 1992 and Qian, 1999). The transition process has started with reforms like decollectivization which has delivered enormous welfare gains and created constituencies for more difficult reforms like restructuring in the state sector.

In North Korea, constraints on the comprehensive introduction of reforms are likely to stem less from political constraints which were more important in other countries but rather more from scarcity of administrative resources. In the more likely scenario of collapse and foreign intervention, administrative resources to implement the reform will come partly from South Korea and partly from the remnants of the existing regime but they are likely to be very scarce. This means that it will be difficult to implement many reforms at the same time. Dispersion of resources might lead to lack of major progress on any front.

Lessons from the transition experience related to the political economy emphasis are to a great extent about the relative importance of irreversibility and flexibility. Early in the transition process, the main emphasis was on creating irreversibility. The idea was to use early windows of opportunity or periods of "exceptional politics" to push reforms through as fast as possible and to create irreversibility. This was one of the rationales behind mass privatization policies in Russia and in the Czech Republic. The transition experience has

shown that the latter strategy may be dangerous and lock whole countries in situations of inefficient economic outcomes that are hard to reverse. Such outcomes may break social cohesion and generate important political instability. The relative irreversibility of mass privatization has locked for many years the Russian economy in an inefficient situation where interest groups who gained most from mass privatization (the famous oligarchs) have become so powerful as to block further reform such as tax reform, government reform, stronger law enforcement and stronger security of property rights (on this see for example Polishchuk(1999) and Sonin (1999)). Later reversal of privatization of many large firms under Putin also showed that irreversibility was only relative in any case. The lesson learned from the transition experience is that the emphasis should be more on ensuring a continuous and growing support for reforms among the population. This implies a more gradual and experimental approach to reforms, relying on the flexibility of experimentation, with an adequate sequencing of reforms, to possibly reverse reforms that do not work and try other ones.

Surprisingly, it is the Chinese reform process that fits the most this pattern. The relevance of the Chinese gradualist experience is often dismissed because of the dictatorial character of its regime. However, it is interesting to note that, despite the political regime, it is not the case that painful reforms have been brutally imposed on the population. On the contrary, both the sequencing and the design of reforms have been tailored so as to hurt benefit a majority and hurt only a minority. The choice of dual-track price liberalization was in fact even designed to be Pareto-improving and to protect existing rents (see Lau, Qian and Roland, 2000). It is not clear that the Chinese reform process would have been politically infeasible if China had been a democracy or whether no democratic system could have sustained such a process. If anything, the absence of democracy has made it more difficult to enforce private property rights and the rule of law and to encourage the development of a *sui generis* private sector. Research on institutional innovations in the Chinese transition (Che and Qian, 1998) suggest that the development of township and village enterprises was a spontaneous response to the specific Chinese institutional situation with absence of the rule of law and the absence of sufficient safeguards against predatory government behavior.

In the case of North Korea, these lessons broadly apply even though I expect political constraints to be less important, especially in the scenario of an outside intervention. Reforms can however still go bad and deteriorate further an already disastrous situation. An area where political support will be needed throughout the reform process is international support from the major players in the region (South Korea obviously but also, China and the US and to a lesser degree Russia and Japan).

A final point when discussing political economy aspects of the reform process is which groups should be the main support groups for the reform process. Early in the transition process, the emphasis was on getting mostly the support from owners of privatized enterprises. The idea was that fast mass privatization creates constituencies among insider managers and among those who benefit most from mass privatization to block any reversal. That was one of the reasons for pushing for rapid privatization. Since the owners of privatized enterprises are a minority and are not likely to be median voters in elections, the focus was mainly on the creation of powerful lobbies for capitalism via mass privatization. The emphasis was clearly on special interest politics as opposed to general interest politics (on this distinction, see Persson and Tabellini, 2000). The turn of events in Russia tends to suggest that relying mainly on the support of owners of privatized enterprises was seriously one-sided. Not only did this lead to capture and relative lock-in. The fact that a great majority of the population has suffered from the transition through most of the nineties and has resented the strong concentration of wealth created by a privatization process viewed as illegitimate and corrupt, has undermined support for political and democratic stability and for the continuation of reforms. The success of Putin cannot be separated from the negative experiences of the nineties. The broader reality of transition has taught that the best support group is the broad group of small entrepreneurs and the middle class that emerges from the entry of new enterprises both in urban areas and in the countryside. The middle class always plays an important role in democracies since voters of that group are more likely to be pivotal in elections. This means that one should care for social cohesion and try to prevent too large inequalities

which are likely to create more pressures for redistribution and may generate political instability.

This lesson seems quite to apply in North Korea where the *Nomenklatura* has less reform potential and where less economic benefits can be expected from the privatization of large enterprises. Land privatization or land distribution should however be explored as a way of obtaining support for reforms. This might be an attractive way of getting widespread support for reforms but also at the same time securing protection of property rights.

3. Allocative changes.

Initial beliefs about the allocative effects of price liberalization were directly borrowed from the standard economics textbooks. The Washington consensus emphasized that markets would develop spontaneously provided there is price flexibility and the government does not intervene in markets. Markets (supply and demand) were the main focus of analysis and the main implicit theoretical tool guiding this vision was price theory and general equilibrium theory. Standard market and price theory was not able either to predict or even to analyze the output fall that followed price liberalization.

The important output fall that occurred after price liberalization in Central and Eastern Europe was not predicted. Standard textbook economics based on supply and demand at best would have predicted a low supply response to liberalization, but not a negative one. The debate on the output fall was in the beginning inspired mainly by the Washington consensus centered around macroeconomic policies, asking questions such as whether stabilization had been too harsh or not. When Russia liberalized but failed to stabilize and nevertheless experienced an output fall, it was clear that new answers were needed. Two transition-specific answers have come up so far and have not yet been refuted. One is the traditional double marginalization idea from the industrial organization literature. To the extent that central planning created monopoly-like structures without real substitutes across firms and to the extent that import competition does not play that role,

liberalization induces a cascade of price increases and output contraction along supply chains (Li, 1999). The other is that of disorganization. That view takes seriously the idea that markets have not yet been created when liberalization occurs. Due to bargaining inefficiencies or to a combination of investment specificity and search frictions related to the prior absence of markets, existing output chains may suffer from acute disruption where the efficiency gains reaped by the producers who exit the chain do not compensate the disruption losses for the other producers in the output chain (Blanchard and Kremer, 1997; Roland and Verdier, 1999). The ensuing macroeconomic fall in GDP and welfare losses can be very important. The Chinese experience is helpful because it shows that an output fall need not be an inevitable byproduct of price liberalization. A transition-specific institution has been created to prevent the output fall associated to liberalization: it is the dual-track liberalization. The dual-track liberalization has several interesting properties. Prices are liberalized at the margin so that the market information obtained from price liberalization is the same as what would obtain under full price liberalization. In the absence of preexisting markets, the most interesting properties of the dual-track are a) that it allows by construction, to achieve Pareto-improving gains from liberalization which is interesting from the political economy point of view because it is a way of overcoming potential resistance to price liberalization, due to its distributive effects; b) also by construction, it allows to prevent the output fall by maintaining past contractual obligations from the plan.

The evolutionary-institutionalist perspective (see Roland, 2000) that emerged from the transition experience relies much less on standard market analysis and emphasizes the institutional underpinnings of markets and the effect they may have on the speed of growth of markets and entrepreneurial activity. Contracts and the relations between contracting agents are the focus of analysis. Therefore, a strong emphasis is put on the general environment of contracting: the minimum legal environment, security of property rights and law enforcement, political stability, the development of business and market networks facilitating search, the development of specific investments in long term business relationships, etc.. The shift of focus from markets to contracts and its

institutional environment is one of the most important lessons from the transition experience for economics at large.

In the North Korean context, this lesson is completely relevant. In Roland (2008), I discuss more at length the issue of price liberalization in the North Korean context. An output fall may occur and it would be wise to associate price liberalization to the distribution of rationing coupons for basic foodstuff. Without such a rationing system, one cannot guarantee that people will not fall under the minimum survival income.

Early in the transition process, the Washington consensus emphasized the need for fast privatization to prevent asset-stripping and the need to close down as fast as possible loss--making plants and firms. Again, it is in East Germany that this approach was implemented the most thoroughly. This approach has led to a huge increase in unemployment and a large output contraction. Better results were obtained in countries like Hungary where governments took a less aggressive approach and adopted an attitude of containment and gradual downsizing and of hardening of budget constraints, taking into account political constraints. The lesson is that one should emphasize more the development of a strong new private sector to attract away workers from the state sector and to let the latter shrink gradually over time.

In the case of North Korea, state-owned enterprises might be in worse shape than in other transition countries and a faster pace of closing down might be warranted. Nevertheless, the same principles apply. The rhythm of closure of state-owned enterprises depends on the rhythm of development of the new private sector.

Another issue relates to the role of government in the economy. Given the omnipresence of the communist repressions apparatus, early views in transition emphasized the need to weaken the government as much as possible in order to "depoliticize" the economy and to prevent intervention in markets. The results were unexpected as mafias and criminal organizations sprang up faster than markets. The transition experience has shown the importance of government in enforcing the law and the security of property rights. In

particular, adequate government infrastructure (police, courts) is needed to ensure that the rules of the market game are followed. Among others, it is important to fight organized crime and racketeering. It is also important to enforce an adequate competition policy to prevent monopolization. In Russia, legal reform was not neglected. Many important laws were adopted, often with the help of prominent scholars, be it corporate law, commercial law, financial regulations. Nevertheless, law enforcement was completely neglected and confidence in courts has been lower in Russia than in Central Europe (see e.g. Black, Kraakman and Tarassova, 2000; Johnson, McMillan and Woodruff, 1999). The adequate social norms for a market economy have failed to emerge due to the lawless environment that prevailed in the nineties and the level of business trust remains today relatively low.

These lessons are clearly valid in North Korea where there is a real danger of development of criminal organizations once transition starts, especially if it is in the wake of a collapse of the existing government structure. Laws established in the beginning of transition must be initially simple enough as to be understood and embraced by the new business community emerging at the beginning of transition.

4. Governance changes

Let us now turn to governance changes, both in enterprises and within government administration. Privatization is undoubtedly one of the most important components of any transition strategy. The Washington consensus emphasized the need for a fast transfer of ownership in private hands via mass privatization to break government power and to jumpstart the market economy. Speed was considered to be of the essence. The idea was that any privatization is always better than maintaining government ownership so that the benefits of fast privatization outweigh the costs in terms of possible misallocation of assets to private individuals and groups. There was also a strong emphasis on developing stock markets so that efficient resale of assets could take place after privatization. Mass privatization turned out to be disappointing. The view according to which speed was of the essence in privatization in order to stop asset-stripping by incumbent managers has been refuted by reality as many managers in SOE's did show early signs of restructuring.

The doomsday predictions on the consequences of too low speed did not materialize in countries like Poland and Hungary where privatization took place in a gradual way. The prediction of generalized asset-stripping was wrong. It made sense for good managers to try to attract private investors and to engage in early defensive restructuring for that purpose. Also, both theory and evidence show the importance of using privatization to achieve efficient matching of managers and assets (see e.g. Bolton and Roland, 1992; Barberis, Boycko and Tsukanova, 1996). Insider privatization did not achieve that objective. Insider privatization did not in general lead to significant improvement in performance (see e.g. Frydman, Gray, Hessel and Rapaczynski, 2000). In reality, the expected efficient transfers of ownership did not take place. Vested interests created by insider privatization may actually have made ulterior privatization more difficult to achieve (Aghion and Blanchard, 1998) and may also have maintained or aggravated the soft budget constraints syndrome in firms privatized to insiders (Debande and Friebe, 1995). Countries that initiated privatization programs emphasizing competitive sales to outsiders to ensure efficient transfer of ownership from the start achieved better results. One must reject the idea of efficient resales given the necessarily rudimentary development of financial institutions and markets at the beginning of transition. The latter must necessarily evolve over time and cannot be jumpstarted.

These lessons seem clearly valid in North Korea. Given the importance of the shadow economy, it is important to institutionalize the private sector as fast as possible and to bring the shadow economy in the formal economy. As far as privatization is concerned, the South Korean connection can help a lot to foster competitive sales of SOEs.

The issue of the reform of the organization of government was nearly completely neglected at the beginning of the transition. The emphasis was on shrinking the size of government. The transition experience has however shown the importance of the incentives of government bureaucrats. Since government agencies and officials can predate on markets and the private sector and since they can be captured by interest groups such as monopolies, Mafia, etc.. it is important to implement reforms in the organization of government so as to align as much as possible the interests of government

bureaucrats with the development of markets. Markets and the private sector cannot develop in an environment of government hostility. Therefore, adequate reform of government administration is needed to create more congruent interests between the private sector and government bureaucrats. The Chinese experience shows the importance of reform in the organization of government with the decentralization of government and the development of different forms of competition between local governments that can be made to work in favor of market development. Also, the fiscal federalism arrangements which make local governments residual claimants on any increase in the tax base creates partial alignment of interests of bureaucrats with the development of markets and entrepreneurship (on all this, see Qian, 1999). In Russia, reform of the organization of government was relatively neglected as the main focus of reform was implementation of mass privatization.

This lesson seems particularly important in the case of North Korea. The situation is however more complex than in other countries. Changing incentives will not be enough. An important reshuffling of administration personnel will be indispensable and this will have to be carried out with great care.

Hardening budget constraints is a key component of governance changes in transition. Hardening budget constraints is however not simply an exogenous policy choice that depends on the political will of policy-makers. Soft budget constraints are related to a commitment problem. Because of this commitment problem, exhortations to harden budget constraints may not be credible. Hardening budget constraints must be an endogenous outcome of institutional changes designed to create credibility for hardening.

This is also relevant in North Korea. It might be less of a problem given the smaller importance of SOEs in the North Korean economy. It is important however to establish a banking system so as to allow entrepreneurs to borrow. Bankruptcy laws that are necessary to establish a credit market should not be too harsh and allow for failure given the positive externalities of entrepreneurship. People have to be given room to learn how to develop their entrepreneurial skills.

5. Conclusions.

What general conclusions can we draw from this list of lessons of the transition process for North Korea?

The lessons of transition may give North Korean transition the “advantage of lateness” provided the lessons of the transition experience are applied correctly. The discussion has shown that most of the lessons from transition are relevant to a certain degree for North Korea.

Aggregate uncertainty is particularly high as one can think of both very positive and very negative scenarios. The geographical location of North Korea, its borders with Russia, China and South Korea represent a huge upside potential for a surge of economic growth and prosperity in North East Asia. The existence of nuclear weapons on the other hand reminds us that the potential for destruction, death and chaos in the region is also huge. Less dramatic scenarios of anarchy, chaos and starvation following a regime collapse without adequate intervention can also easily be thought of. It is therefore not a luxury to have in mind different contingency plans for transition in North Korea depending on the conditions under which transition would occur. Flexibility in reform implementation, and rapid responses to unexpected reform failure will also be a key way to deal with aggregate uncertainty.

The issue of speed of reforms, which was a large object of transition debates is not that crucial in North Korean case and will depend very much on the initial conditions of transition. Under a scenario of regime collapse and outside intervention, the initial reforms must be fast and comprehensive but with a strong focus on creating minimum institutional underpinnings for market development and entry by small entrepreneurs. Under a “coup” scenario within the North Korean elite, reforms will be more cautious but must be substantial enough, akin to the Chinese decollectivization, to create credibility. In all cases, avoiding famine and chaos will be of utmost importance from the start.

Institutional reform should combine transplantation of institutions, most plausibly from South Korea, combined with possible institutionalization of some of the business norms that have emerged in the shadow economy and that will be useful to incorporate.

In the case of a collapse scenario, political institutions should initially be provisional and established with outside help before an internal consensus evolves. The model here is that of West Germany after the defeat of Nazism.

In all cases, the management of the international context will be crucial. Any major change in North Korea is likely to create tensions between the concerned parties (South Korea, China, the US, Japan and Russia). These tensions can be resolved as it is in everybody's interest to have a prosperous North Korea contributing to growth in North East Asia. Too fast moves towards unification of the two Koreas or any unilateral move by the US or China that may appear threatening to the other parties could be damaging.

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TABLE 1
A comprehensive view of transition and relevance for North Korea.

	Lessons from transition	Relevance for North Korea
1. The Political Economy of Reforms and reform strategies		
Focus of reforms	Create institutional underpinnings of markets to encourage strong entrepreneurial entry	Institutional reform is paramount to avoid anarchy and chaos.
Attitude toward institutional change	Comprehensive: legal and financial change, law enforcement, reform of organization of government, development of self-enforcing social norms	Find the right mix between importing institutions from South Korea and build on experience from norms that developed in the shadow economy.
Attitude towards uncertainty	Insistence on aggregate uncertainty; skepticism toward societal engineering	Additional large uncertainty over future initial conditions
Attitude toward initial conditions	Use existing institutions to prevent economic disruption and social unrest while developing new institutions.	Only partly applies to North Korea. Institutions likely to be mostly imported but effort is needed to make them “fit” to beliefs and norms that emerged from the shadow economy.
View of reform complementarities and partial reforms	Very important but comprehensiveness of initial reforms not necessary provided initial reforms can create momentum for further reforms. Partial reform can either create momentum or stall reform process	Scarcity of administrative resources likely to constrain comprehensiveness and to require sequential focus
Political economy emphasis	Ensure continuous and growing support for reforms	Additional need for international (6 party talk) support of orientations for North Korea
Main support group for reforms	Middle class and new private sector	Even more relevant.
2. Allocative changes		
Main view of markets and liberalization	Importance of institutional underpinnings needed to enhance market growth: minimum legal and contracting environment, law enforcement, political stability, building of business networks and long term partnerships; contracting agents and their institutional environment as unit of analysis	Relevant in North Korea. Price liberalization might need to be associated to distribution of rationing coupons for basic foodstuff
Main attitude toward inefficient SOE's	Containment and politically feasible downsizing. Rely on evolutionary development of private sector to shrink state sector.	Rhythm of closing down might be faster in North Korea but evolutionary development of private sector still key.
Main view of government	Role of government in law enforcement and in securing property rights.	Laws in North Korea must be initially simple enough as to be understood and embraced by the new business community emerging at the beginning of transition.
3. Governance changes		
Focus of privatization	Emphasis on organic development of private sector. Emphasis on sales to outsiders to achieve efficient transfer of ownership from the start.	Valid in North Korea. Given importance of shadow economy, important to institutionalize private sector. South Korean connection can help sales of SOEs a lot.
Main emphasis of government reform	Reform in the organization of government so as to align as much as possible the interests of government bureaucrats with the development of markets.	North Korean situation more complicated as important reshuffling of administration will be indispensable.
Hardening budget constraints	Endogenous outcome of institutional changes	Relevant. Less of a problem given the smaller importance of SOEs. Important however to establish banking system so as to allow entrepreneurs to borrow. Bankruptcy laws should not be too harsh and allow for failure given the positive externalities of entrepreneurship.

