

The undelivered promise of market socialism: Why the attempts at market-oriented reforms of the communist economy were doomed to fail?

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Abstract

The decentralized model of a communist economy based on autonomous state-owned or socially owned enterprises exposed to market signals (market socialism) was a response to the inefficiencies of the traditional model of a centrally planned economy, first introduced in the Soviet Union at the end of the 1920s and early 1930s. Market socialism was implemented in Yugoslavia from 1950 and in Hungary from 1968, bringing mixed results. A few other countries also tried this model, but either rolled back the reform soon after it began (Czechoslovakia in 1968–1969) or implemented it in a fragmentary and inconsistent way (Poland in the 1980s, the Soviet Union at the end of the 1980s), without positive results. The main obstacles to the implementation of this model had a political character, because it challenged the totalitarian character of a communist regime and the hegemonic position of the communist party. Only after the collapse of communist regimes in the late 1980s and early 1990s could genuine market reforms begin, but the concept of market socialism became useless.

Keywords: centrally planned economy, market socialism, employee self-management, economic reforms.

JEL classification: P21, P26, P31.

1. Introduction

In the late 1980s and early 1990s, the system of a centrally planned economy based on state or collective ownership of business assets collapsed together with the political and ideological monopoly of communist parties in Central and Eastern Europe (CEE) and the former Soviet Union (FSU). In the mid-2020s, it

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still exists in North Korea and partially in Cuba. For the rest of the world, it is only a subject of historical research.

While the deficiencies of the communist economic system are well known and frequently analyzed (in fact, they were known from the beginning of its existence; see, e.g., Mises, 1920; Brutskus, 1922), less discussed (at least *ex post*) have been attempts to reform this system undertaken in the former communist countries since the 1950s and the reasons for their failure. And this is the topic that this paper tries to address. For the author of this paper, it is also an occasion to come back to his own research and policy advocacy activity in the 1970s and 1980s, in the early stages of his academic career.

The special focus of this paper is devoted to one specific idea of reforming a communist economy based on the autonomy of state-owned enterprises and exposing them, at least partially, to market signals and forces, popularly called “market socialism.” This concept did not envisage any meaningful role for the private sector.

Market socialism was implemented in Yugoslavia from the early 1950s and in Hungary from 1968. It was announced in Czechoslovakia in 1968, but was abandoned the next year. It was tried, in part, in Poland in the 1980s, and in the Soviet Union at the end of the 1980s. While it introduced more flexibility and some external openness to the otherwise rigid and autarkic system of central planning, it failed to revive the declining growth rates and address some fundamental weaknesses of this system, such as its lack of innovation, weak external competitiveness, or chronic macroeconomic disequilibria.

Before we turn to the detailed analysis of market socialism and its weaknesses, we will present the basic characteristics of a centrally planned economy formed in the late 1920s and early 1930s in the Soviet Union and transplanted to CEE and communist countries of East Asia after World War II (WWII), including its minor modifications after Stalin’s death in 1953 (Section 2). It will be followed by a brief overview of the major directions of thinking on how to make a centrally planned economy more flexible and efficient (Section 3). Section 4 presents a summary of the theoretical discussion on how to make a market socialism model operational and on its potential weaknesses. Section 5 discusses the experience in implementing this model and lessons drawn for transition-related reforms in the 1990s. Section 6 summarizes our analysis.

We also want to make clear what remains beyond the thematic agenda of this paper. First, we are not going to analyze the economic reforms with a substantial role of the private sector, such as the New Economic Policy (NEP) in the Soviet Union in the 1920s, or Chinese and Vietnamese reforms since the late 1970s, because they went beyond the concept of market socialism as defined in this paper. Second, we will not analyze the experience of numerous partial/fragmentary reforms of a centrally planned economy, which were not intended to increase the autonomy of state-owned/collective enterprise substantially and diminish operational control of their activity by communist parties and government.

Another introductory comment concerns terminology. We use the terms “centrally planned economy” and “communist economy” interchangeably, describing the economic and political nature of the system prevailing in the Soviet Union and CEE. We do not use the term “socialist economy,” which may be misleading, given various forms and episodes of a “social market economy” in Western and Northern Europe and other parts of the world.

2. A centrally planned economy: Its birth and evolution

The “classical” model of a centrally planned economy was formed at the end of the 1920s and beginning of the 1930s, after a short and disastrous experience with “war communism” (1918–1921) and a relatively successful period of the NEP (1921–1928) (Leonard, 2023).

This revolutionary change had both ideological and more pragmatic (political) motivations. Ideologically, the All-Union Communist Party (Bolsheviks), the Russian-language abbreviation VKP(b), tried to implement the Marxist utopia of a non-market and non-private economy, and Lenin’s idea of the national economy as a single factory (Kornai, 1992; Temkin, 1998).¹ Private ownership of business assets (the “means of production” in Marxist terminology) was ideologically unacceptable as a source of income inequality and exploitation of workers by capitalists and, with a few exceptions, was banned. It was replaced by state ownership or cooperatives (the latter differing from the former only in name). The former private owners were expropriated and brutally repressed as class enemies.

Market “chaos” was replaced by a system of central planning. The strategic development decisions formulated in subsequent five-year plans were approved by the VKP(b) congresses, its Central Committee, and Political Bureau. The government and the State Committee of Planning (Gosplan) oversaw their implementation and monitoring. Gosplan set both detailed production targets and input allocations (including labor) for each enterprise. It also made investment decisions. The lower levels of the administrative hierarchy (sectoral ministries, branch organizations, and enterprises) were obliged to comply, subject to material and non-material reward and punishment. Prices, financial flows, and budget constraints played a secondary role. Prices and wages were determined administratively. There was a state monopoly on foreign trade, and the currency remained inconvertible, resulting in multiple exchange rates. The Soviet economy was broadly isolated from world markets (this also resulted from the international political isolation of the Soviet regime in the interwar period).

Pragmatically, a centralized model of economic management was to respond to two kinds of needs. First, it helped to establish totalitarian control over society, in which both the employment and material status of each citizen depended on their attitude toward the political regime. Second, it was an instrument of rapid industrialization with priority given to heavy industry and the military-industrial complex.

The historical and ideological contexts were important. Before the First World War (WWI), Russia was less industrialized than Western Europe and the United States, and the same was true of most of CEE (except Czechoslovakia) after WWII, while Marxist-Leninist ideology emphasized the revolutionary and progressive role of the industrial working class.

Between the late 1920s and early 1950s, subsequent five-year plans aimed at forced industrialization, with priority given to heavy industry and military

¹ The idea of centralised planning and management was also inspired by the experience of economic management during WWI, especially in Germany and Austro-Hungary. For example, the Austrian philosopher and economist Otto Neurath (1919) was the advocate of central planning of physical outputs and inputs. It was his paper, which provoked negative opinion by Mises (1920) about economic rationale in a collectivist economy.

production, at the cost of other sectors and heavy human losses and suffering (famine in the early 1930s and the second half of the 1940s; use of forced labor on a mass scale; deportation of large groups of people from the European part of the USSR to Siberia and Central Asia; the Great Terror of 1937–1939²), and far-reaching environmental damage. Collectivized agriculture was the primary source of financing industrialization, at least in its early stages.

After WWII, a similar economic model was implemented in CEE and Asian countries remaining under the Soviet political control, and in the 1960s in Cuba (Alvarez, 1990), everywhere at huge economic, social, and environmental costs. For example, one can mention the famine in Maoist China in the early 1960s, which cost some 40–45 million human lives (Dikotter, 2010).

The economic model and policy were modified partly after Stalin's death in 1953. Mass terror, deportations, and forced labor were abandoned, and part of the resources were moved from heavy industries to consumer industries, agriculture, and residential construction. However, the main pillars of a communist economy, such as the monopoly or dominance of state and collective ownership, centrally set production and investment targets, administrative allocation of resources, and administrative control of prices and wages, remained unchanged until the late 1980s in the Soviet Union and most CEE countries (except Yugoslavia, Hungary, and partly Poland; see Sections 3.3 and 5).

Unlike in the Soviet Union and CEE, China, Vietnam, Laos, and Cambodia started to depart from this model in the late 1970s and in the 1980s, opening the door to a substantial role for the private sector, while retaining a monopoly on political power by the respective communist parties (Vu, 2022). This model has continued until now.

There were various negative consequences of replacing a market economy based on private ownership with a communist model based on state or collective ownership and central planning.

First, competition between enterprises (and from outside, because of the state monopoly on foreign trade) was eliminated, and market incentives to increase productivity and innovate were killed. As a result, many sectors and industries were uncompetitive internationally. The production of natural resources was the only sector capable of competing in international markets. In the Soviet Union, since the 1970s, this has mainly been the oil and natural gas industry (Gaidar, 2007).

Second, the rigid system of central planning, supported by the fear of repression in case of non-compliance and lack of interest of state-owned and collective enterprises in maximizing profits, led to perverse incentives. Enterprises constantly bargained with higher authorities for lower planned targets and more resources. The higher authorities were unable to verify these demands due to insufficient micro-level information.

Third, perverse micro incentives, together with administrative price controls, produced widespread shortages of goods and services (Kornai, 1980), i.e., repressed inflation. Long lines of people trying to purchase basic food and non-food items, widespread black markets and corruption (despite criminal penalties for such activities), and special stores with better supplies for privileged groups of

² For an overview, see Ellman (2000, 2007).

the population were a common sight. External disequilibria took the form of persistent tensions in the balance of payments, leading to strict import rationing.

Fourth, centralized investment decisions, often determined by political considerations, led to structural distortions, which were the main cause of transition-related output decline in the 1990s when the post-communist transition started.

Beginning in the mid-1960s, economic growth decelerated both in the Soviet Union and CEE, arriving at stagnation or even decline in the 1980s (see Table 1 in Section 5).

3. How to reform a communist economy: Three directions of thinking

The classical model of a centrally planned economy was criticized not only by supporters of a market economy, such as the already mentioned Mises (1920), Bratskus (1922), or von Hayek (1935), but also from inside the Marxist/socialist camp—by those who wanted to make a centrally planned economy economically efficient and human-friendly.³

One can distinguish three directions of thinking about reforming/improving a communist economy: (1) rationalization of central planning; (2) democratization of central planning; and (3) a decentralized economy, but without private enterprises (market socialism).

3.1. Rationalization of central planning

This was the most technocratic direction of thinking, which tried to avoid challenging the main ideological assumptions of a communist model (see Section 2). The idea was to ensure that central planning decisions guarantee optimal allocation of resources and macroeconomic equilibrium. Various mathematical models, with an increasing engagement of computers (as their construction and processing power rapidly progressed), were to serve this purpose (see Kovacs et al., 2022). The leading role was played by the Soviet economic-mathematical school with internationally recognized names such as Leonid Kantorovich (laureate of the Nobel Prize in Economics in 1975), Viktor Novozhilov, and Vasilii Nemchinov (Belykh, 2016). They built models related to various sectors of a national economy and various aspects of economic policy. Similar research was developed in other countries of the Soviet bloc. Some inspiration also came from Western scholars, such as another Nobel Prize laureate (in 1969), Jan Tinbergen, who built a macroeconomic model of the Dutch economy (then applied to other Western economies).

The mathematical models built in centrally planned economies aimed at overcoming existing information and data processing barriers. Optimists like the Polish economist Oskar Lange (1967) believed that computers and mathematical programming could have an advantage over a market mechanism in the optimal allocation of factors of production. However, it never happened due to distorted micro-level information resulting from perverse incentives at the enterprise level (see Section 2).

³ Building the “socialism with a human face” was the leading slogan of the Communist Party of Czechoslovakia during the so-called Prague Spring in 1968, coined by the Czechoslovak philosopher Radovan Richta.

Three decades earlier, Lange (1936, 1937), in his polemics with Mises (known as the Socialist Calculus Debate), presented the idea of transmitting central decisions on production, input allocation, and investment to autonomous enterprises in the form of shadow prices instead of physical targets and limits.⁴ It was a combination of rationalization of central planning and market socialism (see Section 3.3). According to Lange (1967), employing computers and mathematical programming could make setting shadow prices faster than the original trial-and-error method.

Overall, the intellectual efforts to improve central planning, including the use of the then available computer techniques, could potentially help make better economic decisions at the central level. In practice, it rarely happened due to political constraints. However, it could not overcome information barriers in the multi-level process of plan bargaining and perverse incentives at the micro level created by the very nature of the central planning system.

3.2. Democratization of central planning

This was the least concrete and instrumentalized stream of reform thinking present in several works of non-Marxist scholars and non-orthodox Marxists (see, e.g., Brus, 1975). It was not always understood as building a Western-type liberal democracy. Rather, it was a belief that participation of various stakeholders, such as workers, consumers, local communities, or ordinary citizens, in central planning decisions would make them economically and socially more rational.

Unfortunately, as in the case of technical rationalization of central planning (Section 3.1), a broader participatory process in designing a central plan could not overcome information barriers created by a multi-level bargaining process and perverse microeconomic incentives associated with this economic system (see Section 2).

It could make sense if it were combined with a deeper decentralization of the economic system, which exposed autonomous enterprises to market signals, and the limited role of the central plan (concentration on the most strategic decisions taken at the government level), that is, a market socialism model (see Section 3.3).

For example, the Yugoslav decentralized model based on labor self-management,⁵ enterprise autonomy, and its exposure to market signals (see Sections 3.3, 4, and 5) tried to develop various participatory mechanisms, especially after the 1972 constitutional changes, sometimes called “social planning” (Estrin, 1983; Uvalic, 2024). However, these mechanisms were far from Western-type democratic institutions. They could not challenge the political monopoly of the League of Communists of Yugoslavia (LCY), even if the latter’s grip on power and control of society was relatively smaller compared to “sister” parties in countries of the Soviet bloc.

The Action Program of the Czechoslovak Communist Party (CSCP), adopted on April 5, 1968,⁶ envisaged both political liberalization and economic decentra-

⁴ He might be inspired by Barone (1908, 1935).

⁵ We use interchangeable “labour self-management,” “employees self-management,” and “workers’ self-management.”

⁶ See <https://archive.org/download/actionprogrammeo08komu/actionprogrammeo08komu.pdf>

lization measures (of the market socialism type). The former included, among others, freedom of speech and abolition of censorship, freedom of assembly, freedom to travel abroad, and rehabilitation of victims of Stalinist persecution. However, even such a limited program of political reforms (without a promise of a multi-party system and free elections) resulted in the Soviet-led intervention of the Warsaw Pact in August 1968 and the end of the Prague Spring.

The same happened in 1956 with the attempt at political regime change in Hungary and with the Solidarity movement in Poland in 1980–1981 (although Solidarity was defeated by the Polish authorities themselves, without Soviet intervention). This highlighted the fundamental conflict between any form of genuine democratization/political liberalization and the hegemonic role of the communist party and the geopolitical interests of the Soviet Union (the so-called Brezhnev doctrine).⁷

Overall, democratization or a broader participatory process in designing a central plan (even if politically possible, which was not the case) could not overcome information barriers and perverse microeconomic incentives created by the centralization of economic decisions and elimination of a profit-maximizing objective function at the enterprise level. It is also difficult to find any historical example of a sustainable liberal democratic regime with a non-market and non-private economy (Dabrowski, 2021).

3.3. *Decentralized economy without private enterprises (market socialism)*

Decentralization of a communist economy by giving enterprises more autonomy and exposing them, at least partly, to market forces was another direction of reform thinking. Its intellectual inspiration came from various streams of socialist/leftist traditions, practical experience of cooperative movements,⁸ and other types of collective enterprises,⁹ not necessarily in communist countries (for example, the Israeli kibbutz movement¹⁰).

The idea was to give the SOE or other form of collective/non-private enterprise a broad operational and, in some models, also investment autonomy (see Kornai, 1992). Unlike in the Lange (1936) model, enterprises had to deal with actual market prices (not shadow ones) and domestic and external competition. Such a reform required a significant change in the role, content, and instruments of the central plan. Instead of setting direct production and investment targets and allocating inputs to each sector/industry/enterprise, the central plan was to formulate government economic policy and its instruments and play a forecasting/projection role (so-called indicative planning).

One of the consequences was a radical change in the role played by the communist party apparatus, government bureaucracy, and intermediate levels of the management hierarchy, such as trusts, concerns, associations, etc. They resisted decentralization reforms, quite often successfully.

⁷ See <https://loveman.sdsu.edu/docs/1968BrezhnevDoctrine.pdf>

⁸ While cooperatives were formally accepted in communist countries (for example, collective farms [kolkhozes] had the legal form of cooperative), their autonomy was heavily restricted by political and administrative means, so their functioning did not differ from state-owned enterprises (SOEs).

⁹ See Dabrowski (1985) for an overview of origins and various traditions of this economic model.

¹⁰ See <https://www.jewishvirtuallibrary.org/history-and-overview-of-the-kibbutz-movement>

This type of reform also posed an ideological challenge because of the reintroduction of a market mechanism and the abandonment of the dominant allocative role of the central plan. Its authors used to be blamed for rebuilding capitalism. For example, this happened in Czechoslovakia after the Warsaw Pact intervention in 1968. To avoid such an accusation, ideological gymnastics were necessary. For example, Edvard Kardelj, the chief ideologist of the LCY and one of the architects of the labor self-management reform, wrote extensively about “social ownership” and “social planning” (see, e.g., Kardelj, 1976) as having their roots in Marxist tradition. Similarly, Ota Sik, author of the Czechoslovak reform in 1968, presented ex post ideas of a “market economy without capitalism” and a “third way” between Soviet-type real socialism and capitalism (see Sik, 1971; 1991). Even greater ideological “gymnastics” had to be exercised by the Chinese and Vietnamese communist parties when they started market-oriented economic reforms, which assumed a dominant role for the private sector. Not surprisingly, the decollectivization of Chinese agriculture was called the “household responsibility system,” while newly created firms in industry and services initially operated under the name of “township and village enterprises” (TVEs). They were founded and controlled by local authorities (Cheng, 1996).

Unlike in China and Vietnam, in countries of the Soviet bloc and Yugoslavia, the dominant role of state/collective/non-private firms was the “red” line, which reformers could not cross without the risk of being ideologically excommunicated and politically marginalized or even repressed.¹¹ Hence, a big interest in developing various variants of a market socialism model, which was seen as potentially feasible both politically (however, not always and not in each country) and technically (unlike rationalization and democratization of central planning—see Sections 3.1 and 3.2).

Yugoslavia, after its geopolitical split with the Soviet Union in 1948, was the first country to introduce economic decentralization based on labor self-management. The Yugoslav economic system survived until the breakup of Yugoslavia in 1991, but was modified several times, partly under political pressure from the LCY, which did not want to lose political control over the economy and society. The most market-oriented variant of this system functioned relatively briefly, between 1965 and 1972 (Uvalic, 2024).

In April 1968, the already mentioned Action Program of the CSCPC¹² declared Yugoslav-type economic reforms, including the institution of labor self-management at the enterprise level (see also Dyba and Kouba, 1989). However, because of the Warsaw Pact intervention in August 1968, the reform was abandoned in 1969–1970.

Hungary also implemented a decentralized economic model in 1968 under the name of the New Economic Mechanism (NEM) (see, e.g., Balassa, 1985; Kornai, 1992). It passed operational decisions directly to enterprise directors instead of labor self-management bodies. Despite an unfavorable geopolitical environment (after the defeat of the Prague Spring) and some reversals in the 1970s, the NEM

¹¹ However, pragmatic considerations allowed for some exceptions. For example, most agricultural farms in Poland and Yugoslavia remained privately owned (although with restrictions on their maximal size), small private firms in trade, industry and services were allowed in GDR, Hungary, Poland and Yugoslavia, peasants in collective farms in the Soviet Union and other countries of the Soviet bloc could have small household plots.

¹² See <https://archive.org/download/actionprogrammeo08komu/actionprogrammeo08komu.pdf>

survived until 1989 when a post-communist transition started (Boote and Somogyi, 1991). In the 1980s, especially in the second half of the decade, the reform effort was reinvigorated. Among other things, there was greater openness toward the private sector and joint ventures with foreign firms, and financial sector reforms, which created a good starting point for genuine market reforms in the 1990s.

The Solidarity movement in Poland in 1980–1981 created a political window of opportunity for political and economic reforms. Among several presented reform blueprints, the most radical one of Balcerowicz et al. (1981) recommended a radical market socialism model with labor self-management, partly drawing from Yugoslav and Hungarian experiences. Part of the Solidarity movement (the bottom-up Network of Organizations of the Solidarity Trade Union of Leading Enterprises) proposed the adoption of the law on social enterprise, in which the main strategic decisions, including nomination of enterprise directors, would belong to workers' councils. In the economic sphere, it supported the Balcerowicz et al. (1981) proposal, unlike the mainstream of the Solidarity Trade Union, which concentrated on social demands and was rather reluctant to market reforms. The ruling Polish United Workers' Party (PUWP) opted for less radical solutions and continued direct government control over various spheres of economic life.

The laws on the State Enterprise and Employees' Self-Management in State Enterprises, adopted in September 1981, were the political compromise between the Solidarity blueprint of social enterprise and a more conservative original PUWP position. For example, only the workers' council in smaller and medium-sized enterprises obtained the right to nominate directors (Jarosz and Kozak, 1992). After the introduction of Martial Law in December 1981 and the delegitimation of the Solidarity Trade Union, prerogatives of the workers' councils (and enterprise directors) were further curbed, although labor self-management institutions survived until the early 1990s (in the 1980s they were backed by the underground Solidarity Trade Union). Other components of economic reform were introduced only fragmentarily and lacked systemic coherence, so the actual economic regime in Poland in the 1980s was far behind the Yugoslav or Hungarian ones. Polish enterprises were still more dependent on the government's allocation decisions than on market signals (Balcerowicz, 1995). Consumer prices, and a substantial part of producer prices, continued to be set by the government, which caused widespread physical shortages and the necessity of administrative rationing of basic consumer goods.

Similarly, the perestroika reform started in the second half of the 1980s in the Soviet Union, despite granting state enterprises some operational autonomy, failed to expose them to market forces and hard budget constraints, using Kornai's (1980) terminology (Dabrowski, 2023). The Law on State Enterprises of 1987 introduced the institution of councils of employee collectives, drawing, among others, from Yugoslav and Polish experiences. However, their competencies were limited.

4. Market socialism: Theoretical and practical dilemmas

The attempts to implement a decentralized economic model (market socialism) raised several questions of theoretical and practical character. Although at first glance it looked economically more rational than the classical system of central planning, it differed from a market system based on private enterprises in several

important characteristics. These differences became a subject of an economic debate between the 1950s, i.e., after the first experience of the Yugoslav reform, and the early 1990s, when the communist political and economic systems collapsed. In this section, we concentrate on five issues: (1) institutional guarantees of enterprise autonomy; (2) the goal function of a decentralized enterprise, i.e., the logic of its microeconomic behavior and its consequences for the size of output and choice of production techniques; (3) distribution of financial surplus and investment decisions; (4) functioning of the market for goods and services, the labor market, and the capital market; (5) innovativeness in micro- and macroscale.

4.1. Mechanisms to protect enterprise autonomy

How to ensure genuine enterprise autonomy in taking microeconomic decisions, against government and communist party interference, was the most serious practical question, never fully resolved. Interestingly, this was not the top issue in the theoretical literature on labor self-management, where the assumption of its full decision-making autonomy was frequently taken (naively) for granted (see, e.g., Ward, 1958; Vanek, 1970).

As the experience of contemporary governance systems demonstrates, the government (in a broad sense, including its legislative and judicial branches) can seriously restrict economic freedom even in liberal democratic systems with a dominant role for private enterprises and market mechanisms. In those communist countries which tried to decentralize their economic systems, there were three additional obstacles: (i) the institutional legacy of a traditional system of central planning with the oversized government apparatus built according to sectoral/industrial lines and intermediate levels of management, such as branch or territorial trusts, concerns, associations, etc., used to set physical production and investment targets for enterprises, and physical limits of inputs; (ii) the political monopoly of the communist party, which used to interfere in various details of socioeconomic life, in particular, personal nominations (the so-called communist party nomenclature); (iii) the dominance of non-private ownership of business assets, in most cases, formally state-owned.

Even if the first obstacle could be removed, as it happened largely in Yugoslavia (due to a short period of the centralized system, and the federal character of the Yugoslav state) and partly in Hungary, two others remained.¹³ And the third obstacle was also non-trivial, from legal, political, and ideological points of view (see Section 3.3).

In this context, one must see the importance of labor self-management, not only as an ideological concept and, sometimes (as in Poland in the early 1980s), a political movement, but as the only governance mechanism which could protect enterprise autonomy (whether state-owned as in most communist countries, or socially owned, as in Yugoslavia¹⁴). Despite some popular clichés, which saw labor self-management as a symptom of anarchic democracy, which did not allow

¹³ Again, the LCY had the least hierarchical and most decentralised character among the ruling communist parties. However, it does not mean that it was free from temptations to interfere in enterprise business decisions.

¹⁴ In legal and economic practice, social ownership in Yugoslavia did not differ from state ownership in other communist countries (Uvalic, 2024).

enterprise managers to take swift and effective decisions, it was the institutional solution which insulated them from excessive political and administrative interference of a communist party apparatus and government administration, including the intermediate levels of management (if they still existed) (Dabrowski, 1985).

This was the reason why the Hungarian Socialist Workers' Party (HSWP), which was originally reluctant to this institutional solution (due to memory of the political role played by the spontaneously created workers' councils during the 1956 revolution), decided to establish employees' councils in the second half of the 1980s (Adam, 1987).

However, the institution of labor self-management, even if the workers' councils had the right to appoint and fire the enterprise director, was not a perfect mechanism to protect enterprise autonomy. This was due to limited employees' interest and, therefore, activity in labor-management institutions. Even in Poland in the early 1980s, where the labor self-management movement was politically backed by the Solidarity Trade Union,¹⁵ the share of active workers' councils did not exceed 10–15% (Jarosz and Kozak, 1992). In such circumstances, workers' councils could be manipulated not only by enterprise directors but also by the government administration and the communist party. And, indeed, this was the frequent situation in Yugoslavia in the 1970s and 1980s (Mencinger, 2000; Uvalic, 2024).

4.2. The microeconomic behavior of a self-managed enterprise

Unlike the previous question, this was the most frequently analyzed problem in the economic literature on labor self-management. Examples include works by Ward (1958), Vanek (1970), and Horvat (1975). According to these authors, a self-managed enterprise tends to maximize income (profit plus wages) per employee. Such a goal function leads to more rational microeconomic behavior than in the centralized system of central planning, in which SOEs fight to minimize production targets set by the supervisory institutions and maximize input allocation (see Section 2). However, it differs from a private enterprise in a market economy, which maximizes profit.

The difference between income per employee and the profit goal function has consequences for the size of optimal output (lower than in a private firm with similar factor endowments) and the choice of production techniques (a preference for capital-intensive and labor-saving methods in a self-managed enterprise).

However, the actual goal functions in Yugoslav enterprises differed from the theoretical behavior of the Illyrian firm as analyzed by Ward (1958), due to the actual economic and political environment, which differed from the model assumptions (Horvat, 1972). The Yugoslav economy, despite being the most reformed in comparison with other communist countries, was never fully market-based due to political and administrative interference by the LCY and the government, although predominantly at the republic and local levels (Lydall, 1984; Mencinger, 2000). The actual multi-goal function combined the economic, professional, and political interests of employees, management, workers' council functionaries, local government, and the LCY (Schrenk, 1981).

¹⁵ After the introduction of Martial Law in December 1981, workers' councils became one of a few platforms of social activeness tolerated by the authorities.

4.3. *Distribution of the enterprise's income and investment decisions*

Another problem discussed in the economic literature, particularly by the property rights school, concerned the supposed preferences of employees' collectives for wages and salaries (personal income) at the cost of undistributed income for investment purposes. According to Furubotn and Pejovich (1972) and Pejovich (1975), limited ownership rights in a self-managed enterprise (only the collective right of use of enterprise capital) made employees uninterested in investing in enterprise development. They could benefit from such investment only as long as they remained employed in their enterprise. Therefore, they would prefer higher personal income and use it for individual investment (outside the enterprise).

The same problem existed in a decentralized enterprise without the labor-management institution, where all decisions were concentrated in the manager's hands (the original Hungarian model).

The theoretical predictions of the property rights school contradicted, to some extent, findings of the neoclassical analysis presented in Section 4.2, according to which a self-managed enterprise would prefer capital-intensive production techniques (such techniques require investment). Arguments of the property rights school also did not take into account ideological constraints in communist economies (even in Yugoslavia), where opportunities to invest privately in business assets remained limited.

Furthermore, the property rights school's predictions did not find empirical confirmation in Yugoslav self-managed firms, which, similarly to SOEs in other communist economies, overinvested rather than underinvested (Uvalic, 2024). However, the actual market environment of these firms differed from theoretical assumptions (a free market), due to various forms of administrative and political interference in their activity.

4.4. *Functioning of the market for goods and services, the labor market, and the capital market*

While the market for goods and services in an economy dominated by non-private autonomous enterprises could function similarly to that in an economy dominated by private firms, the situation was different in the case of labor and capital markets.

Given the quasi-owner status of the employees' collective in a labor-managed enterprise and the goal function of the latter (maximizing income per employee; see Section 4.2), such a firm would be reluctant to hire new employees or fire incumbents. Wages would differ between enterprises. In such an environment, a single labor market could not exist, and wages would not be driven by the demand for and supply of labor at the macro level (or even within a region or municipality). They would not serve as an external parameter of economic decisions.¹⁶

The capital market, in its broad meaning (a market for savings), could exist only partially. Enterprises and individuals could deposit their savings in

¹⁶ According to Bartlett (1991), "the institutions of 'self-management' and 'associated labour' were designed in essence to substitute for a conventional labour market" in Yugoslavia. It was motivated by the desire to avoid exploitation and alienation of labour associated with the labour market in the Marxist doctrine.

banks, which would lend them to enterprises that needed more working capital or financing for investment. Hypothetically, enterprises could also issue debt instruments (bonds). On the other hand, the equity market could not exist in an economy based on state/collective ownership, which had systemic restrictions on private entrepreneurship. If such restrictions were removed, the private sector would gradually crowd out non-private firms even without an active privatization policy.

However, practice was even worse than the limited hypothetical room for the capital market described above. None of the countries that experimented with market socialism had a commercial banking system that could offer effective financial intermediation. In Yugoslavia, although a two-tier banking system was established in the mid-1960s, after 1971, commercial banks were transformed into a sort of nonprofit organizations serving the needs of enterprises, which controlled them via self-management agreements (Uvalic, 2024). In other countries, two-tier banking systems started to be formed at the very end of the communist system: from 1987 in Hungary, and from 1988 in Poland and the Soviet Union. No country had legislation allowing the issuance and market trading of corporate debt instruments.

In all communist countries, including Yugoslavia, governments retained an important role in investment policy and reallocation of savings between sectors, industries, and enterprises, despite attempts at market-oriented reforms (Sirc, 1983; Tardos, 1987; Balcerowicz, 1990). In the 1970s and 1980s, Yugoslavia had a system of horizontal self-management agreements and social compacts, in theory negotiated and signed voluntarily by the basic organizations of associated labor (BOAL),¹⁷ but de facto controlled by the LCY organizational structures and government agencies at the federal, republic, and municipal levels. One of their functions was to substitute for the missing mechanisms of the capital market and, in part, the labor market.

4.5. Innovativeness

The capacity of the decentralized communist economy to innovate was another topic of debate. The consequences of the goal function of a labor-managed firm (maximizing income per employee; see Section 4.2) might suggest that such a firm would be interested in innovations serving this purpose. Also, a participatory system of management in a labor-managed firm could help in accepting innovations and the risks associated with them. On the other hand, similarly to investment decisions, the lack of individual exclusive property rights in a labor-managed enterprise did not allow for full market pricing of innovation effects (positive or negative), in terms of personal income and wealth of those who take the respective decisions and risks (Pejovich, 1983).

At the macro level, administrative limits on the creation of new private firms, the absence of a stock market, and the absence of sophisticated capital market institutions such as venture capital funds (see Section 4.4) reduced the chances for breakthrough innovations (Balcerowicz, 1990).

¹⁷ In the 1970s and 1980s, these were the smallest units of a self-management system, frequently parts of large enterprises (Uvalic, 2024).

Far-reaching government interference in enterprises' production and investment decisions in all countries that experimented with market socialism further deteriorated chances for truly innovative behavior (Sirc, 1983; Balcerowicz, 1990). As a result, a decentralized economic system based on employee self-management, although it was more flexible and innovative than a typical centrally planned economy (Pejovich, 1984), lagged behind the market system based predominantly on private enterprises. In the case of Hungary and Poland in the 1980s, the differences from the innovative behavior of SOEs in an unreformed centrally planned economy were negligible (Balcerowicz, 1990).

5. Market socialism: Summary of experience and lessons for transition-related reforms in the 1990s

Below, we discuss (1) a summary of implementation experience; (2) economic performance of reforming countries; and (3) lessons for transition-related reforms in the 1990s, which were drawn from market-socialism reforms.

5.1. Summary of experience in implementing market socialism reforms

Analysis in Sections 3.3 and 4 shows that the concept of a decentralized non-private economy was never fully implemented, even in Yugoslavia, which was the closest to this model, especially between 1965 and 1972. Everywhere, the ruling communist parties and government apparatus retained extensive power to interfere in business decisions at the enterprise level, especially with respect to investment. A market mechanism was never adopted fully.

In Hungary, the government continued to set many prices and regulate profit margins for others. The Hungarian forint remained inconvertible. Enterprises had only partial access to foreign markets, mainly in the form of retention quotas of export proceeds in foreign currency (Boote and Somogyi, 1991).

In Yugoslavia, most prices were, in principle, free. However, authorities tried to influence them by various instruments, for example, price freezes or social compacts (see Section 4.4), especially in times of inflationary pressures (see below). The convertibility of the Yugoslav dinar, the declared goal of the 1965 economic reform, was never achieved. Multiple exchange rates prevailed between 1950 and 1989 (Stojanovic, 2007).

In Poland, in the 1980s, the implementation of enterprise autonomy and market mechanisms was much less advanced and more chaotic than in Yugoslavia and Hungary. Key prices were controlled by the government, which led to widespread shortages. The Polish zloty remained inconvertible, and enterprises had even more restricted access to foreign markets than in Hungary.

The incomplete and inconsistent implementation of market-oriented reforms led to a situation of systemic vacuum when central plan discipline stopped working, but market discipline did not work sufficiently or did not work at all. The very rare market exit of ineffective enterprises was the best illustration of continuous soft budget constraints, in Kornai's terminology (Kornai, 1980). Nevertheless, enterprises could learn to operate in a market environment, even a distorted one, which helped some of them during the post-communist transition (in comparison with enterprises in the unreformed system of central planning).

At the macro level, soft monetary and fiscal policies further contributed to weakening enterprises' budget constraints and building up domestic and external imbalances (see Section 5.2). Accommodative macroeconomic policies partly stemmed from the ideological legacy of central planning (financial flows should follow investment and production targets) and political constraints. Communist regimes preferred to increase subsidies rather than risk social and political unrest, which might be provoked by unpopular economic decisions such as price adjustments or closing ineffective enterprises. For example, attempts at administrative price increases in the Soviet Union in 1962, and Poland in 1970, 1976, and 1980 led to strikes and violent events in major industrial centers. In the 1970s and 1980s, communist parties tried to strengthen their political positions by offering societies new social entitlements, which caused additional macroeconomic imbalances.

In the case of Yugoslavia, the softness of monetary and fiscal policies also resulted from the relative weakness of the federal center against republican authorities. Since 1961, the country was a permanent client of the International Monetary Fund (IMF).

5.2. Economic performance

The comparison of the economic performance of reformed countries (those which experimented with the idea of market socialism) with the unreformed ones (those which continued the dominant role of central planning) is not easy due to the lack of fully comparable cross-country historical data, unreliability of statistics in communist economies, and several factors other than the characteristics of the economic model that determined economic results. Therefore, our analysis is selective and approximate.

Table 1 suggests that economic growth rates in the 1970s and 1980s in two reformed countries were no worse (Hungary) and even slightly better (Yugoslavia) than in others. However, a decentralized model did not protect them from stagnation or even recession in the 1980s, which was a common phenomenon in the whole region.

The two reformers (Yugoslavia and Hungary) and the only fragmentarily reformed Polish economy recorded higher inflation than their unreformed peers (Table 2). Yugoslavia ended up with hyperinflation in 1989, and Poland with

Table 1

Annual average rates of growth of real GDP, 1961–1990
(simple average of available estimates, in 1990 \$ and PPP terms).

Country	1961–1970	1971–1980	1981–1990
Albania		3.9	–5.7
Bulgaria	5.4	2.0	–1.1
Czechoslovakia	2.3	1.9	0.0
GDR	3.3	3.0	0.2
Hungary	3.5	2.3	–0.1
Poland	3.1	2.3	–1.6
Romania	4.2	3.6	–1.4
Soviet Union	3.7	2.3	–0.7
Yugoslavia	3.6	4.8	0.2

Sources: Dobrinsky et al. (2006, Table 3).

Table 2

Consumer price inflation, 1975–1989 (annual change, %).

Country	Average 1975–1984	1985	1986	1987	1988	1989
Bulgaria	0.8	2.8	2.7	2.7	2.5	6.4
Czechoslovakia	1.6	2.3	0.5	0.1	0.2	1.4
Hungary	6.2	7.0	5.3	8.6	15.5	17.0
Poland	19.0	15.1	17.8	25.2	60.2	251.1
Romania	2.9	−0.2	0.7	1.1	2.6	0.9
Soviet Union	0.8	0.7	2.1	1.5	0.3	2.3
Yugoslavia	28.2	75.7	88.1	122.1	200.0	1,257.7

Source: IMF (1993, p. 146, Table A13).

near-hyperinflation in the second half of that year. However, the higher inflation in the reformed countries stemmed mainly from more flexible price regimes (see Section 5.1). In other countries, in particular, Bulgaria, Romania, and the Soviet Union, inflationary pressures manifested themselves in the increasing physical shortages of goods and services, that is, repressed inflation (Poland had both open and repressed inflation).

Hence, despite higher inflation, economic agents in the reformed countries enjoyed a better quality of consumer and producer markets, without visible shortages of basic consumer goods and services, and producer supplies. There was also broader access to imported goods, especially in Yugoslavia. Besides, the population of Yugoslavia and Hungary had more freedom to travel outside the communist bloc than in other countries.

Unlike other communist economies, Yugoslavia dealt with the unemployment problem. The unemployment rate increased systematically, from 3–4% in the mid-1950s to above 16% in 1990 (Astrov and Jovanović, 2024), despite large-scale labor migration to Western Europe. It differed markedly across republics and regions, depending on their level of economic development. In 1988, it amounted to only 2.5% in Slovenia, the most developed republic, and 36.6% in Kosovo, the least developed region (Bartlett, 1991, Table 4).

Some authors (e.g., Lydall, 1984) saw it as the effect of maximizing income per capita by a self-managed enterprise (see Section 4.2). However, unemployment has been present in most market economies, not only in a labor-managed Yugoslavia. Alternatively, this might be evidence of more market-oriented behavior by Yugoslav firms, which did not hoard excessive labor resources, as compared to enterprises in typical shortage economies (Kornai, 1980). Differences between republics and regions could suggest the existence of internal barriers in labor and capital flows.

Macroeconomic disequilibria were also visible in external accounts, for example, in the statistics of external debt (Table 3). In 1988, both reformers, Yugoslavia and Hungary, were heavily indebted. As mentioned in Section 5.1, Yugoslavia had to resort to IMF assistance and debt restructuring in the 1980s to avoid sovereign default.¹⁸

However, high external indebtedness was not limited to the reformed economies. The unreformed economies of the Soviet Union and Bulgaria were also

¹⁸ Between 1961 and 1988, Yugoslavia negotiated 11 Stand-by Arrangements with the IMF (Avramov and Gnjatović, 2008).

Table 3
Hard currency (HC) external debt, 1988.

Country	Gross HC debt, \$ millions	Net HC debt, \$ millions	Net HC debt/ HC current account receipts
Bulgaria	7,810	6,032	1.56
Czechoslovakia	5,520	3,848	0.62
GDR	20,730	7,572	0.60
Hungary	17,349	13,880	1.80
Poland ^{a)}	35,470	37,497	4.21
Romania	1,931	1,122	0.12
Soviet Union	43,000	28,195	0.66
Yugoslavia	18,683	14,296	0.89

Note: ^{a)} 1987.

Source: Brainard (1990, Table 1).

heavily indebted. The Soviet Union de facto defaulted in 1990. Bulgaria experienced two debt crises: in 1962–1964 and in March 1990.

Poland, with its only partly reformed economy, was the most indebted communist country. It defaulted on its external debt obligations in 1981. It reached an agreement with its creditors only in the first half of the 1990s.

The German Democratic Republic (GDR) also had sizable debt, mainly to the Federal Republic of Germany, which was automatically resolved after German reunification in 1990.

5.3. Lessons for future reforms

The main obstacle to the full and consistent implementation of a market socialism model was political in nature. The idea of autonomous enterprises operating in a market environment contradicted the totalitarian character of communist regimes and the political monopoly of the ruling communist parties. It was also partly inconsistent with the official Marxist-Leninist doctrine, depending on how this doctrine was implemented in ideological practice.

The disappointing experience in reforming communist economies led many scholars and reform practitioners in the region to the conviction that genuine market reforms are impossible without major changes in the political system, that is, breaking the political monopoly of the communist party (see, for example, Gaidar, 1989) and rejecting ideological prejudices, especially with respect to the private sector.

In fact, these limitations started to be gradually ignored in the last round of reforms of communist economies undertaken between 1987 and 1990 in Hungary, Yugoslavia, Poland, and the Soviet Union, which opened, directly or indirectly, the door to private sector development, some forms of de facto privatization of SOEs/social enterprises, building a two-tier banking sector, and engaging foreign investors. However, the genuine market transition started only after the collapse of the communist political regime, which happened in 1989–1990 in CEE, and in 1991 in the Soviet Union.

The second lesson concerned the so-called critical mass of reforms (Dabrowski, 1996). The comprehensiveness and internal consistency of implemented reforms were a basic condition of their success (Balcerowicz et al., 1981). Partial reforms risked creating a systemic vacuum when enterprises would be neither exposed to

the discipline of a central plan, nor to market forces (see Section 5.1). However, they could also be simply rejected by the dominant power of the old system.

A closely related question concerned the speed of reform, an issue that was broadly and hotly debated in the context of the post-communist transition (see, e.g., Dabrowski, 1996; Havrylyshyn, 2020). However, it is relevant to all systemic and policy reforms. There are several arguments in favor of fast reforms. First, there are situations when policy actions must be bold and fast enough to stop further deterioration (avoiding a “too little, too late” reaction). Second, it is important to change expectations. This relates to macroeconomic stabilization, but also to changes in institutions, regulations, the role of government, etc., especially when previous reform attempts failed. Third, it is a political economy argument, i.e., the effective use of a political window of opportunity for reform, or the period of “extraordinary politics,” in Balcerowicz’s (1994) terminology, which is usually limited in time. Fourth, fast reforms help avoid the creation of “intermediate winners” who can block further reforms (Krueger, 1993; Hellman, 1998). Finally, fast reforms allow societies to enjoy their benefits earlier.

In terms of its agenda, the experience of market socialism reforms helped very little in setting the agenda of the post-communist transition. The latter could go much further than the political and ideological compromises of the 1960s, 1970s, and 1980s. Freedom for private enterprises and privatization of SOEs/social enterprises stopped being a taboo. Communist parties with their monopolies on political and economic power were dissolved, or transformed into social democratic parties. The government apparatus for central planning was dismantled. Former communist countries and their economies became open to the outside world.

In the new political and economic environment, the old ideas of decentralized state/social enterprises were largely abandoned in favor of privatization. The institution of employee self-management disappeared, also in the former Yugoslavia (Uvalic, 2024). The concept of market socialism or a third way was fiercely opposed by some leading reformers, such as Vaclav Klaus, the prime minister of the Czech Republic, who famously said that “the Third Way is the fastest way to the Third World” (Klaus, 1999). On the other hand, nostalgia for past reforms did not disappear completely. It was present in most former communist countries among some intellectuals and politicians, especially of the older generation, and served as the basis for opposition to radical market transformation.

The legacy of market-socialism reforms (or their unsuccessful attempts) had to be taken into account in privatization strategies in several countries, in the form of privileged employee and management buyout schemes.

6. Summary and conclusions

The centralized model of a communist economy, introduced in the Soviet Union at the end of the 1920s and early 1930s, and transplanted to other communist countries after WWII, proved dramatically costly in social and human terms and economically inefficient, with negative consequences felt to this day. Among various reform ideas considered by economists and other social scientists working within this system (and, therefore, constrained by its political and ideological limits), the decentralized model based on autonomous non-private enterprises

exposed to market signals and controlled by labor-management bodies, popularly called market socialism, looked like the only feasible option.

The theoretical debate on this model, which developed between the late 1950s and the 1980s, pointed to its potential weaknesses at both the micro and macro levels, as compared to the private market economy. At the same time, there was no doubt that it could be a more effective solution than the “classical” model of central planning with all its information barriers and perverse micro-level incentives.

Reality fell short of expectations. Only two countries—Yugoslavia and Hungary—implemented this concept comprehensively (but not always consistently). However, even there, the actual system differed from the theoretical model of the Illyrian firm. Political and administrative interference in enterprise activity continued, which resulted in only partial functioning of the market mechanism. There were frequent reversals of market-oriented solutions.

In other communist countries, market-oriented reforms either remained at the level of program declarations (Czechoslovakia in 1968) or were adopted only partially and inconsistently (Poland in the 1980s, the Soviet Union in 1987–1991).

Except for the GDR and Czechoslovakia, monetary and fiscal policies were highly accommodative, if not populist, which led to serious domestic and external macroeconomic imbalances. This did not help the implementation of market socialism reforms between the 1950s and the 1980s, and it dramatically complicated the post-communist transition to a market economy in the 1990s.

The main obstacles to the consistent implementation of a market-oriented variant of the communist economy were political and ideological. This challenged the totalitarian character of communist regimes, the communist party’s hegemonic position (also in the economic sphere), the personal interests of the communist party and government apparatus, and frequently the Soviet Union’s geopolitical interests (Brezhnev’s doctrine). There were also difficulties in accepting an extensive role for market mechanisms in light of Marxist-Leninist orthodoxy.

Only after the collapse of communist regimes in the late 1980s and early 1990s did these obstacles disappear. This allowed genuine market reforms to begin, based on a dominant role for the private sector. The concept of market socialism, a compromise solution within a political and ideological system that had passed away, became useless. One exception concerned the political economy of policy reforms. Leaders of the post-communist transition learned from the past, largely disappointing, experience of their countries how important the comprehensiveness and internal consistency of reform programs are, as well as the speed and consequences of their implementation.

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