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**INSTITUTIONAL BARRIERS TO MARKET TRANSACTIONS  
IN AND BETWEEN CIS COUNTRIES**

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## INSTITUTIONAL BARRIERS TO MARKET TRANSACTIONS IN AND BETWEEN CIS COUNTRIES\*

### 1. Introduction

According to conventional wisdom, economic decision making was governed by a tight hierarchical command structure in the former Soviet Union. The functioning of the old socialist institutions was regulated and enforced by the government and the Communist Party. Central planning of prices and output was the most important economic feature of this system. After the dissolution of the Soviet Union, the now independent CIS countries have step-by-step started to dismantle their socialist institutional structure and to replace it by market type institution. Russia, the most advanced CIS state, liberalised most consumer prices in 1992, and a bulk of production decisions were delegated to the firm level. Nonetheless, a steep decline of output and investment as well as the break-down of trade among CIS countries suggest that Russia and the other CIS countries have - among other things - failed to solve a number of difficult institutional problems. Some of these problems are briefly sketched in the following section. It will then be shown that the difficulties with institution building are deeply rooted in the legacy of the old socialist system. A major common cause is the dissolution of command structures long before political and economic transformation was on the agenda. Against this background, new institutions cannot be build by simple copying western style democracies. It is suggested in the final section that CIS countries will have to apply a more radical approach.

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## 2. Institutional Shortcomings

The by far hardest institutional constraint facing CIS countries is a rapidly growing gap between the demand for legal protection of property and contracts and the dismal supply of these services. The more resource allocation becomes subject to the new market mechanisms, replacing the old administrative system, the more urgent becomes a framework of contract and business laws rigorously enforced by police and courts, if high (prohibitive) transaction costs are to be avoided. The lack of an assured legal framework impedes the emergence of markets and results in ad hoc arrangements between enterprises or between regional governments and enterprises often involving barter trade, as well as in a waste of resources through corruption or private protection of property. These consequences are easily observable in Russia and other CIS countries [DIW, IfW, IWH, 1993].

Very similar institutional reasons have contributed to the break-down of intra-CIS trade [Michalopoulos, Tarr, 1992]. The former central planning system was only partly replaced by trade agreements between the now independent states which has caused a host of legal and practical problems. To name only a few, there is little cross-border co-ordination of infra-structural facilities; customs procedures are surrounded by tremendous uncertainties; and existing agreements as well as contracts are even less enforceable among CIS countries than domestically [Langhammer, 1994]. The main constraint is, however, emerging from the absence of a mutually agreed payments mechanism which would allow to settle balances in intra-CIS trade. Such balances must arise since Russia is economically more advanced than the other CIS countries and the for many CIS countries the only supplier of raw materials and energy. Disputes over the settlement of accumulated debts to Russia have resulted in a disruption of badly needed energy imports for some CIS countries (in particular Ukraine).

The deadlock in the negotiations on a payments mechanism is rooted in the lack of a universally accepted currencies over which CIS countries themselves would have

control. Monetary policies of all CIS countries including Russia are not credible and hence, economic agents revert to barter trade or use foreign currencies. In both cases, transaction costs are usually increased.

The institutional vacuum in the economic sphere is accompanied by a collapse of the general state administration. Licenses, permits, safety and health controls as well as other public services required for an orderly conduct of business relations are no longer easily obtainable. The respective administrations have either ceased to function at all, or the supply of these services became subject to a bargaining process which entails uncertainty and delays as well as in many cases high costs. The inherent efficiency losses tend to be even higher since many regulations were inherited from the previous socialist system and do not fit into a market mechanism. Nonetheless, such regulations are used by respective administrators as means of generating additional income (rent-seeking).

These severe institutional deficiencies constitute a substantial danger for the success of the transformation process. The complete failure of legal systems is a problem, which does not only impede market transactions and increases transaction costs but can undermine the very existence of the newly emerged states and produce *smuta* or permanent turmoil. Compared to this failure, the danger of monetary instability is not as terminal, because the population of the CIS has learned to use all the other means of payments, ranging from different sorts of barter to foreign hard currencies. But the failure to establish a reliable monetary system in the CIS could produce long-term inefficiency and stagnation in a huge continent and possibly become a major source of regional and world instability as well.

### **3. The Legacy of the Past**

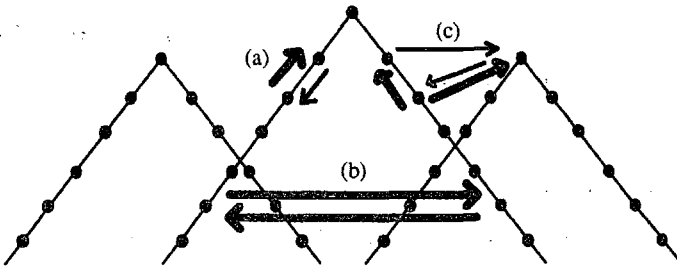
The failure to establish adequate institutions is not the result of lacking knowledge or capabilities but rather reflects fundamental changes in the organisation of the Soviet society which evolved since the late 1950s. The central hypothesis is that socialist

command structures were gradually replaced by bargaining processes, thus changing the rules for all social transactions. As elaborated elsewhere in greater detail [Naishul, 1990], the Stalinist command structures based on hierarchical decision-making were no longer able to fulfil their tasks of overseeing and guiding all aspects of economic and social life when the economy grew much more complex in the aftermath of World War II. The inability of the highly centralised hierarchical system to cope with the processing of enormous amounts of information and to translate this information into detailed production quotas necessitated discretionary decision-making at virtually all levels of the hierarchy, i.e. plan targets became negotiable to some extent. In addition, the unavoidable loopholes of central planning created a demand for horizontal relationships supplementing the hierarchical subordination. Managers of firms without sufficient supplies of inputs entered into direct contact with respective suppliers. Both in vertical and horizontal relationships, goods and services were exchanged for favours or other goods and services in a bargaining process. Thus, one may say that the strictly hierarchical system was transformed into a bureaucratic or administrative market, as several Russian scholars showed [Aven and Shironin, 1987; Belanovskii, 1991-92; Kaganskii, 1991, 1992; Konstantonov and Naishul, 1986; Kordonskii, 1986, 1991; Naishul, 1990; Pavlenko 1989, 1990; Rodnyi, verbal memo, 1981].

This model of decision making processes in the former Soviet Union can be characterised by three major types of social interactions. The first concerns the bargaining relationship between subordinates and their superiors which involves a vertical exchange of goods and services or favours for both public and private purposes. By its very nature, vertical trading is carried out in an "unequal" fashion, i.e. because of their statuses in the hierarchy superiors are in a better bargaining position than their subordinates (Diagram 1:(a). By contrast, horizontal trade among people at a similar hierarchical level takes place on an equal footing and is therefore more balanced as indicated in case (b) in Diagram 1. These horizontal relationships include legal or ex post legalised transactions as well as illegal swaps of goods and

services. And finally, there is trading with hierarchical statuses. Subordinates are prepared to bid for better positions in the hierarchy to avail themselves of the benefits of unequal vertical trade. This trade is complicated by the fact that bidders do not operate in a single hierarchical but in a matrix system, i.e. a system of intertwined hierarchies in governmental agencies and in the Party. Therefore, trading of statuses may involve more than two parties, and each bargain can cut through several hierarchical cones (Diagram 1:(c)).

Diagram 1 : Stylised Trading Relationships in the Bureaucratic System of the Former Soviet Union



An institutional model with these characteristics has some interesting dynamic properties which can shed light on the present institutional problems in CIS countries. In the medium term, bargaining over statuses, between governmental agencies and the Party, changes the hierarchies and the influence over the appropriation of certain goods and services associated with each status. The matrix system becomes more multifaceted and less manageable over time. More importantly, however, trading of statuses means that the hierarchical system is flattened and there is less dependence on superiors than in the old system. As a result, the importance of vertical trade is diminished in favour of horizontal trade which constitutes the backbone of any market economy. The fading of hierarchical interdependencies of state institutions transformed e.g. government offices more and



more into sovereign firms engaging in market-type transactions with their 'customers'.

This process enlarged the customary rights of the managerial staff over the 'firm's' property as well as the customary rights of employees over the terms of their employment. An example for the latter may be the well-known informal non-dismissed rules. Other implications of the model which are matched by what can actually be observed in the Soviet Union, e.g. during the Perestroika period, include a reduction in the supply of public goods. The global marketisation meant that state institutions performed their duties only to the extent that they could directly benefit either through financial rewards or access to rights over goods and services. Thus, public goods became private goods traded in respective markets. Even law enforcement (legal violence) is subject to bargaining as anecdotal evidence indicates.

If the above theory about the main features of institutional development in the pretransformation era is correct, the legacy of the past has a tremendous impact on the chances of establishing the necessary institutional framework for a market economy. By destroying all the hierarchical systems, the Soviet Union was dismantled at a stage when there was virtually no apparatus of state coercion left. The existing state apparatus could not be used to build a new hierarchical system of state coercion. Therefore, the founders of new states will not only have to create new state institutions, but to re-invent new subordinative relations segregated from bargaining. This appears to be a heroic task which can hardly be solved in a short period of time. In the following, the implications of the legacy of the past are demonstrated for crucial areas of institution building described in Section 2.

#### **4. Legal Norms and Customary Rights**

The establishment of a legal framework conducive to market transactions is a major task to be accomplished in the transformation process. The analysis presented in the

previous section has demonstrated that the basis for building new legal institutions is extremely weak.

It is also important that in the system of central planning contract and property laws were virtually non-existent. On the one hand, citizens of the Soviet Union previously had no private property, and civil conflicts about the very small personal property were extremely rare. On the other hand, all the resources were allocated to firms (enterprises) by administrative bodies, and they were resolving all the arising serious conflicts by administrative means. The legal system when applied to enterprises was aimed at imposing regulations and not at resolving civil conflicts, and, therefore, had only few norms. Existing regulative legal norms were suited to facilitate bureaucratic control, and most of them cannot be used in a market environment.

The legal system when applied to citizens was aimed at and had norms for the punishment of crimes against 'personality', personal and state property. The real purpose of the legal system was to protect the state against the population, and not to preserve individual rights. This can be illustrated by the fact that theft of state property was punished much more severely than theft of personal property.<sup>1</sup>

Another impediment for the establishment of a new legal system is the multiplicity of powerful customary rights that were inherited from the bureaucratic market system [Naishul, 1993]. One important example of these customary rights is the above mentioned managerial control over enterprises. Another very vivid example is ownership rights of tenants over state apartments in which they live. These rights came into effect de facto as early as in the late 1960s and de jure in the early 1980s. In order to be effective or even simply viable, any future legal system will have to recognise and incorporate a majority of these rights. However, these rights are informal, and in most cases hidden until a conflict arises. This means that the

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<sup>1</sup> Until very recently thievery of state property could (and was) punished up to death penalty while a maximum sentence for thievery of personal property was five years [Ugolovniy Kodeks RSFSR, Criminal Code of Russian Federation, 1990].

legalisation of conflicts over customary rights is the only method of getting correct information about these hidden but powerful rights.

Under these circumstances, most of new legal norms can hardly be created by parliamentary vote or government decree. Rather, any future legal reform will have to pave the way for a formulation of legal norms at the grass-roots level which takes into account the existing conflicts over the possession and use of property. The solution may be a 'liberalisation of courts' which enables low courts to change norms of the written law contradicting customary ones or to create new legal norms. Such decisions would have to be adopted by high-level courts before they come into force. The legal system, reformed in this way, may become a Russian analogue of the Anglo-Saxon precedent system, i.e. few written laws and many case-by-case courtroom decisions.

## **5. Law Enforcement**

Law and order in the CIS countries are suffering not only from the lack of appropriate legal norms and non-corrupt apparatuses. The stumbling stone for many countries is a deficit of legitimacy of the state to exercise legal violence against people violating excepted laws. Presently, governments of most countries appear to be unable to break the resistance of special interest groups. In order to do this in a democratic country where the ultimate power belongs to the people, a homogeneous reaction of the society to the most important social matters, i.e. a national consensus, is a necessary precondition for the establishment of a strong legitimate power [Gellner, 1983; Lvin, 1991].

Several scholars [Gellner, verbal memo, 1993; Lvin, 1992] consider the modern Russian population as highly homogeneous, if some ethnically entirely different enclaves, like Chechnia, are excluded. That means, that in principle a strong government could be established in Russia. This homogeneity is, however, a more difficult issue in some other CIS states. Ukraine, for example, consists of at least

three major territories, differing according to language and religion: Russian-speaking Orthodox Eastern Ukraine, Ukrainian-speaking Orthodox Central Ukraine and Uniat Ukrainian-speaking Western Ukraine. Kazakhstan is almost equally divided between a Russian and a Kazakh part. These ethnical segmentations within CIS countries appear to be difficult to overcome as severe conflicts and sometimes even civil wars in several regions of the former Soviet Union show. If no mechanism for national consensus building can be found a solution for the enforcement problem cannot easily be envisaged, and the whole transformation process is endangered. In the extreme, major changes in the political map of the CIS may have to precede successful economic reforms.

National homogeneity is a necessary but not a sufficient condition for the emergence of legitimate power. The policy of communist despotism was to strengthen itself via forced alienation of individuals. For several generations communist power destroyed all attempts of horizontal co-operation among individuals. As a result, the social structure (in the Slavic republics at least) mostly consisted of a large number of very small overlapping "circles", i.e. groups of people knowing and trusting each other. Only in these groups a social discipline was preserved and real authorities existed. These circles formed the mighty social *kol-shuga* or *das Panzerhemd* which detached the society to a great extent from whatever any government was doing. They were responsible for maintaining order in Russia during a period of dramatic changes and extremely weak government which characterised the transformation process. However, the key problem is to establish new institutions as powerful as these circles, but extending to much larger groups of people. All the elected bodies (perhaps with the exception of the Presidency) do so far not possess any legitimacy and are, therefore, unable to set up an executive apparatus which could guarantee law and order.

Instead, the huge gap between demand and supply of legal protection produced high incentives for private enforcement of private laws. In the above mentioned circles the

discipline is high enough to solve most conflicts. That is why Russian businessmen are doing well when operating within these circles. This lowers their transaction costs but also produces enormous economic inefficiencies by greatly curtailing the choice of partners. Whenever they leave their respective circles they have to resort to the services of private protective agencies or to set up their own protective agencies.<sup>2</sup> Even segments of the Russian state police are often used as private protective agencies. Independent of the moral judgement on private justice, this 'industry' is now the only working instrument that is able to solve legal problems currently associated with economic transactions. These agencies' services are, however, imposing extremely heavy costs on all commercial activities. And furthermore, even the best protective agency is not able to operate e.g. all over Russia. Even more problems are emerging in cross-border trade, especially when two countries belong to different cultures.

The advancement of market relations makes a new system of law and order a key political requirement. The existing situation has become intolerable both for big business which is at best partially protected by its expensive private armies and for small businesses and rank-and-file people which are subject to exploitation by criminal organisations. This makes the formation of new legitimate centres of power a matter of highest priority in Russia and in the other CIS states. Only on the basis of such social institutions legitimate law enforcement agencies can be established. How such a transformation may be achieved is taken up in the last Section.

## **6. Monetary Issues**

The institutional vacuum in the socialist era not only destroyed the legal framework of CIS countries but also had serious implications for the ability of these countries to conduct monetary policies appropriate for market transactions. The collapse of the

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<sup>2</sup> The big financial group "Most" is said to have as much as 800 armed people for its own defence.

central authorities transformed the all-union bureaucratic market into a multiplicity of diminutive soviet unions trading with each other in the way the COMECON did, i.e. by exchanging a list of products of one region for the list of products for another region. 'Foreign trade' organisations of the region were special regional government division, regional supply-and-procurement agencies (former Gossnab) and special associations of enterprises. This regional barter market, although inefficient, was at the same time a decentralised system and to an important extent independent from political decisions of the central authorities.

This situation dramatically changed when the Gaidar government came to power. In the monetary field, the government attempted to impose on the economy a kind of exchange mechanism considered optimal rather than to provide means of payment which would assist trade with goods and services. These seriously hampered traditional ways of bargaining, deteriorated trade within Russia and produced a heavy blow to inter-CIS trade because of the dissolution of the ruble zone.

Except for the barter commodities, the only 'real' money before the reforms was cash money which traditionally served the two most monetised sectors of economy: consumer and labour markets. During the socialist years (excluding wars and Perestroika) a sufficiently tough monetary policy was exercised towards the supply of cash money.<sup>3</sup> Cash money was accepted all over the Soviet Union as a universal means of payment. Alongside with cash money and cash money accounts, convertible on demand or almost on demand into cash, there existed several types of other accounts. In contrast to real cash money, this *beznalichnye* or non-cash accounts were designed as instruments of supervision. As far as non-cash money were concerned, a special mechanism was implemented by local branches of the central bank, automatically providing credits covering all non-cash money costs of

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<sup>3</sup> Although cash money supply until 1985 is still a classified data (!), the statement can be proved indirectly by the fact, that average salary in the Soviet Union between 1960 and 1985 was increasing at 6 per cent average annual rate [Narodnoe khozjaistvo, 1985]. This implies that cash money supply was very modest and was very carefully watched.

plan-authorised procurement. That actually meant that the local branches could issue non-cash money according to local demand [Spravochnik, 1990].

After the dissolution of the Soviet Union there were two options for the reform of the monetary policy. One was to liberalise financial markets completely; the other to establish a western type banking system with severe governmental controls. In the first case, i.e. a kind of free-banking solution,<sup>4</sup> the monetary system would be commercial and to a large extent politically neutral, operating in the manner of international business firms [Hayek, 1974]. In the second case the functioning of financial markets would be linked to the particular political structure of each country and therefore divided into different geographical areas. A fully liberalised monetary system would make all the newly emerging, weak national governments non-responsible for the amount of money(s) in circulation. In a western type banking system each national government would have to use all the legitimacy it has to fight demands for easy money for years to come.

In light of the above observations about the extremely weak legitimacy of newly emerging governments in CIS countries, prospects for the monetary systems and thus, inter-republican trade look gloomy. Russia, the most advanced country, has opted for a two-tier banking system which was never fully implemented because strong interest groups pressure prevented the establishment of stringent controls on credit expansion and the supply of cash rubles. Therefore, the Russian government is carrying out a never-ending struggle with inflation which reminds of old Brezhnev battles for good harvest or fulfilment of plan indicators. Most other countries of the CIS are in an even worse position. Monetary stabilisation through a tougher

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<sup>4</sup> This option implies that there would be no single national currency at least as far as Russia is concerned. Everybody were free to use any currencies varying from dollars to rubles or gasoline contracts. The cash ruble became a currency of the privatised former central bank. Its local branches in any country, privatised as well, were free to issue their own non-cash money under their own brand names or to merge with others. All the banks would join the trading of different non-cash moneys.

monetary stance of the Central Bank fails. This means that the present monetary system of the CIS may jeopardise trade for many years to come.

## 7. Conclusions

In virtually all CIS countries, the transformation process from central planning to a market mechanism is plagued by severe adjustment recessions and a collapse of intra-CIS trade. The underlying rigidities and market imperfections are not failures of the market mechanism but failures to establish an appropriate institutional framework suited for these countries. This failure is not rooted in a lack of knowledge or capabilities; it rather reflects deep-seated deficiencies in the organisational structure of society. 70 years of socialism left a phenomenal legacy in the former Soviet Union. Hierarchical relationships were largely replaced by bargaining processes, thus eroding the backbone of any society, i.e. an institutional framework within which a national consensus can be formulated. As a substitute, the society has organised itself in overlapping circles which discipline and protect their members. This leads to the conclusion that with this existing institutional structures of their societies CIS countries are unable to establish the legal norms, law enforcement and a monetary regime required for a smooth functioning of market transactions.

This analysis demands to take extraordinary decisions in the reform process of CIS countries. A mere imitation of institutions as they are common in western market economies cannot remedy the deficiencies in the organisational structure of societies. The weakness of the parliamentary system in most CIS countries is a clear indication of such a failed attempt.

But what are the alternatives? In theory, there seem to be two approaches available. One is the emergence of a so-called 'stationary bandit' [Ohlson, 1993] which means the creation of authoritarian rule to substitute for the inability of societies to enforce their own rules. The other approach suggested by Buchanan [1975] envisages a recreation of rules and institutions through private initiative. The basic idea is that



self-organisation in an institutional vacuum imposes high costs on all members of the society. It would, therefore, be in the best self-interest of everyone to join like-minded people and accept certain common rules which would help to reduce transaction costs. In this process, institutional subordination and social decision making would be gradually built up from the grassroots level.

If this approach would be chosen it had far-reaching implications. New organisational structures for the society can only emerge when the old, inappropriate structures are completely dismantled. This condition required to speed up deregulation and abolish old institutions to an extent unknown in western market economies [Naishul, 1990, 1994]. A few of the required actions have been briefly hinted at in Sections 4-6. They would include a privatisation of government institutions, a new role for courts and the de facto privatisation of the monetary regime. It will, however, require further research to develop more detailed and more substantive reform proposals for different policy areas.

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