AFTER SOCIALISM: WHERE HOPE FOR INDIVIDUAL LIBERTY LIES

By
SVETOZAR PEJOVICH
Professor of Economics
Texas A&M University, College Station, and
Imadec University, Vienna
and
Senior Fellow
International Centre for Economic Research
Torino, Italy

ABSTRACT

Institutional restructuring in West Germany and Eastern Europe is a consequence of the failure of two major socialist experiments, National Socialism and Marxism-Leninism. The paper addresses a number of issues such as: Why was the transition of West Germany in the 1950s more successful than the institutional restructuring of Eastern Europe in the 1990s? Why are the results of institutional changes within the former Soviet Bloc different from one country to another? Why do we observe no tendency in former Marxist-Leninist states for more efficient institutions to replace less efficient ones?

The paper identifies the rule of law, the carriers of institutional restructuring and informal rules in the community as three critical factors upon which the results of institutional restructuring depend. The paper then demonstrates the interaction between those three factors is a powerful and perhaps necessary method for analysis of institutional changes and their causes, directions and consequences. To that end, analysis internalizes the effects of the interaction between the rule of law, the carriers of institutional restructuring and informal rules on incentive structures and the costs of transactions, and the

effects of incentive structures and the costs of transactions on economic behavior.

Finally, the paper addresses three issues: Why has the use of economic policies based on neoclassical economics contributed to the rising strength of pro-socialist parties? What happens to the transition from socialism to capitalism when the carriers of institutional restructuring have comparative advantage in running a state-centered economy? And finally, the paper suggests a primer for changes in informal rules.

I would like to thank professors Enrico Colombatto and Victor Vanberg for useful comments. Jelena Vesovich of the Department of Economics at Texas A&M University helped with statistical calculations. I am grateful to the Lynde and Harry Bradley Foundation for financial support of my research on the effects of customs and morals on social stability and economic performance.

INTRODUCTION

The basic premise of socialist literature is that the institutions of socialism are capable of bringing about a "just" society. This premise has provided both the philosophical foundation and the political justification for the practitioners of socialism to replace the rule of law and individual liberties with the rule of men (hereafter: the arbitrary state) and a contrived concern for the "people." The term "people," a favorite cliché of all socialist leaders, is merely a façade of words behind which the ruling elite hides its own private ends.

The twentieth century witnessed the rise and failure of two major applications of the socialist doctrine: National Socialism and Marxism-Leninism. Like the competing families of the underworld, National Socialism and Marxism-Leninism were at war (cold and hot) with each other as well as with the rest of the world. And they both failed to deliver on their promises. The Second World War destroyed Hitler's socialism, while Marxism-Leninism decayed from within.

National socialists and communists shared many basic political and economic premises of the socialist doctrine. They both ran command economies. They made the individual a bare tool in the achievement of the ends of their ruling elites. National Socialism and Marxism-Leninism were hostile to the private-property free-market society, and its corollary, the society of free and responsible individuals. They favored a large and active state, created comprehensive welfare programs, and paid no heed to the rule of law. National Socialism and Marxism-Leninism were equally unrelenting in the pursuit of their primary targets: inferior races and the bourgeoisie respectively.

National Socialism and Marxism-Leninism had some fundamental differences as well. Communists were openly hostile to the right of ownership, while national socialists were comfortable with controlling and monitoring the behavior of private owners. National socialists saw the struggle for racial purity within national boundaries as the major mechanism for the development of their brand of socialism. Communists, on the other hand, saw the class struggle waged by the proletariat across national boundaries as the vehicle for the development of the Marxist-Leninist type of socialism. In 1972, Nicolae Ceausescu, the communist leader of Romania, tried to bridge the gap between nationalism and internationalism. He wrote:

> The dialectical process of bringing together nations presupposes their strong affirmation…. Between national and international interests not only is there no contradiction, but, on the contrary, there is a full dialectical unity.[1]

Institutional restructuring in former socialist states is a consequence of the failure of socialist experiments. That much is clear. The objectives of institutional restructuring are, however, less clear. The leaders of former socialist states like to talk about liberty, social stability, and sustainable economic growth. However, those objectives have frequently turned out to be a façade of words hiding the leaders' real intentions. But this much is clear--economic reforms mirror the leaders' preferences, their philosophical premises, the political and economic constraints on their decision-making powers, and the incentives under which they operate. Observed results also incorporate the effects of uncertainties, incomplete information, and divergence of interests between policy makers and those who implement policies.

Institutional changes in former socialist states have produced results that raise some important questions. For example, why was the transition of West Germany in the 1950s more successful than the institutional restructuring of the Soviet Union and Eastern Europe in the 1990s? Why are the results of institutional restructuring within the former Soviet bloc different from one country to another? Why do we observe no tendency in former socialist states for more efficient institutions to replace less efficient ones?

Analysis in this paper identifies the rule of law, the carriers of institutional restructuring and the prevailing informal rules in the community as three critical factors upon which the results of institutional restructuring depend. The paper then demonstrates that the interaction between the rule of law, the carriers of institutional changes and informal rules (hereafter: *the interaction thesis*) is a powerful and perhaps necessary method for analysis of institutional changes and their causes, directions and consequences. To that end, analysis internalizes the effects of the interaction between the rule of law, the carriers of institutional restructuring, and informal rules on incentive structures and the costs of transactions, and the effects of incentive structures and the costs of transactions on economic behavior.

FRAMEWORK FOR ANALYSIS

In private-property, free-market countries, the rate of growth is a good yardstick for evaluating economic performance. However, socialist countries calculated their respective gross national products in state-controlled (i.e., non-scarcity) prices. For that reason, growth rates are not a reliable standard for measuring economic performance of former socialist states.

As institutional restructuring unfolded in former socialist states, scarcity prices began to replace accounting prices in measuring the value of gross national products. A smaller gross national product valued in scarcity prices could be worth more to citizens of former socialist states than a larger gross national product calculated in accounting prices. That is, slower and even negative growth rates *during* the process of transition do not necessarily signal economic retardation.[2] A Nobel Laureate James Buchanan wrote:

> Economic performance can only be conceived in values; but how are values determined? By prices, and prices emerge only in markets. They have no meaning in a non-market context... where the choice-influenced opportunity costs are ignored.[3]

The Rule of Law

An implication is that the evaluation of institutional restructuring, while the process is going on, requires a proxy for feasible economic growth. Such a proxy has to be a strong predictor of both social stability and post-transition economic growth. Academic research and empirical evidence have identified *the rule of law* to be such a factor.[4]

The rule of law means the absence of arbitrary power on the part of the ruling group, subjection of all citizens to the same laws, stable and credible rules, and an independent judiciary. By eliminating the time horizon problem and creating a sense of social stability, stable rules provide incentives for individuals in the community to maximize the extent of voluntary interactions. James Buchanan captures the critical importance of stable and credible rules:

> [In a capitalist society] there is an explicit prejudice in favor of previously existing rules, not because change itself is undesirable, but for the much more elementary reason that only such a prejudice offers incentives for the emergence of voluntary negotiated settlements among the parties

> themselves. Indirectly, therefore, this prejudice guarantees that resort to the authority of the state is effectively minimized.[5]

While democracy is about the process of selecting a government, the rule of law is about the limitation of government's power.[6] It protects individual rights against the majority rule. That is why in a society of free and responsible individuals, the word *constitution* must come before the word *democracy*. Cass Sunstein wrote:

> [The rule of law] creates a wall of protection around citizens, giving a guarantee of immunity and ensuring that they may engage in productive activity without fear of the state. And by creating this wall of protection, the guarantee creates the kind of security and independence that are prerequisites for the role of a citizen in a democracy.[7]

Robert Barro summarized his empirical research on the importance of the rule of law vis-à-vis democracy as follows:

> The overall effects of expanded democracy are ambiguous…. Madeleine Albright once [said that] democracy was a prerequisite for economic growth. This response sounds pleasant but is simply false…. For a country that starts with …little democracy and little law [like Hitler's Germany and the former Soviet bloc] an increase in democracy is less important than an expansion of the rule of law as a stimulus

> for economic growth…. If there is a limited amount of energy that can be used to accomplish institutional reforms, then it is much better spent …by attempting to implement the rule of law—or, more generally, property rights and free markets.[8]

Obviously, on the strict interpretation of the rule of law, no country would qualify. However, the concept of the rule of law provides an ideal yardstick for comparison of alternative institutions and their economic, political and social consequences. The farther a country travels away from the rule of law, the greater is the power of the ruling group to pursue its own ends.

The Carriers of Institutional Restructuring

Decisions made by governments, parliaments, corporations and other organizations are, in effect, decisions made by individuals. Individuals conceive ideas, invest time and effort in formulating policies, push others into accepting their innovations, and bear the risk of failures. Thus, the individual is the unit of economic analysis. Armen Alchian and William Allen wrote:

> Groups, organizations, communities, nations, and societies are institutions whose operations can best be understood when we focus attention on the action and choices of constituent members. When we speak of the goals and actions of the

> United States, we are really referring to the goals and actions of the individuals in the United States.[9]

To understand the direction of institutional restructuring in former socialist states, analysis must identify decision-makers, the method of choosing them, the incentives under which they operate, and the constraints on their decision-making powers.

The Old Ethos

Informal rules are traditions, customs, moral values, religious beliefs, and all other norms of behavior that have passed the test of time. In this paper the terms informal rules and the old ethos are used interchangeably, although the latter is a somewhat broader concept. The ethos defines the pattern of behavior in the community that emerges from the interaction between informal rules and a current set of values.

Institutional restructuring in former socialist states means that new formal rules are coming into force. Those rules have to interact with the prevailing customs, traditions, and moral beliefs of the community. The results of institutional restructuring then actualize the response of informal rules to those new formal rules. A harmonious interaction of new formal rules and the old ethos reduces the transaction costs in the economy and frees some resources for the production of wealth. However, when new formal rules are in conflict with the old ethos, the transaction costs of making exchanges and enforcing new the rules of the game will reduce the production of wealth in the community.[10] An implication is that a community in which rule- makers have incentives to enact formal rules that are in tune with the old ethos should be both stable and growing. Anglo-American common law stands out as an example of such a system of incentives. Henry Manne wrote:

> Anglo-American common law was primarily local, tribal, or customary law, and, probably for this reason, common law judges have always had a predilection to subsume local customs into decision rules.[11]

TRANSITION IN WEST GERMANY

The Rule of Law

Several factors contributed to the acceptance of the rule of law in West Germany within a decade after the Second World War ended. First, before the First World War, Germany was a liberal autocracy--that is, the country was low on democracy but high on law and order.[12] Second, national socialists stayed in power for about twelve years. Hence the period of their rule was not long enough to erase or seriously impair memories of law and order. Next, the end of national socialism in 1945 placed West Germany into the hands of three Allied Occupation Powers, all of them rule of law countries. The Allied

Occupation Powers imposed a number of rules, which were not meant to foster democracy but to create law and order. And the German tradition of law and order helped to reduce the transaction costs of accepting, maintaining and enforcing new rules.

The Allied Occupation Powers, with the assistance of the West German judiciary, carried out *denazification* of the country. The national socialist party and its various organizations were outlawed, and party bosses were sent to prison or to the gallows. Lesser functionaries were barred from important positions in public life. Of course, the transaction costs of denazification had to be high. When the cold war created a market for German scientists, business experts and former intelligence officers, the costs of denazification got to be even higher.

Yet, denazification had two critical consequences for the transition of West Germany to capitalism. By outlawing the national socialist party, denazification helped to absolve the German people of the crimes committed by national socialists. BY making it more difficult for memebrs of the Party to remain in public life, denazification also eliminated from the process of transition a large group of well-positioned people, whose comparative advantage was in running an arbitrary state. An implication is that denazification reduced the transaction costs of transforming West Germany into a rule of law country.

The Carriers of Institutional Restructuring

The process of institutional restructuring of West Germany began in the late 1940s. Ludwig Erhard, Minister for Economic Affairs in the government of Konrad Adenauer, was the architect of West Germany's transition from socialism to capitalism. Erhard wanted an economy based on credible private property rights, freedom of contract, scarcity (competitive) prices, and stable monetary and fiscal policy. To this end, he was assisted by a group of free-market scholars centered at the University of Freiburg.

Erhard had to sell his reforms to the Allied Occupation Powers, which held the ultimate veto power on institutional changes in West Germany. Erhard's problem was that the attitude of the Allied Occupation Powers reflected the mood of the era. It favored easy credit policy, public investments, and direct governmental regulation of business. John Kenneth Galbraith, then economic advisor to the American Military Government, expressed the pro-planning bias of the Allied Occupation Powers as follows:

> The question is not whether there must be planning—the assignment of priorities to industries for reconstruction and rehabilitation, the allocation of materials and manpower, the supplying of incentive goods and all the rest—but whether that planning has been forthright and effective.[13]

However, Erhard played the game right.[14] When the Allied Occupation Powers approved the new currency (Deutschemark), he saw a chance to remove price control, to implement non-expansionary monetary and fiscal policies, and to provide credible protection for private property rights. Erhard acted without approval, hoping that the Allied Occupation Powers would go along with his reforms once they proved successful. And he was right. "West Germany's performance in industrial output and exports was phenomenal, and by the 1960s the country was on top of the European economic league."[15]

The Old Ethos in Germany

The prevailing informal rules in Germany have a strong bias toward communalism; that is, limited government and methodological individualism are not part of the old ethos. I conjecture that the role of the state and codetermination are two important consequences of the conflict between German tradition and the culture of capitalism.

The Role of the State. The Anglo-American tradition considers the state to be a predator requiring a constitution to tame it. German tradition, on the other hand, sees the state as a partner in the social and economic life of the community. Even free-market economists, who provided Erhard with theoretical arguments and academic imprimatur for the transition to capitalism, did not believe that capitalism is a self-generating, self-equilibrating, and self-correcting system.[16] The market is great, they claimed, but some of its consequences are not. Thus, the state must step in to take care of market failures.[17]

Consequently, the government acquired a number of responsibilities. Initially the state was expected to focus on the so-called market failures. However, making the government an active player in the economy created incentives, which in turn produced "unintended" consequences. Before long, rent-seeking coalitions learnt how to use the state to obtain favorable regulations, while legislators and bureaucrats perfected the art of giving or denying favors via redistributive policies. The trend toward an ever-increasing role for the state in the economy accelerated in the 1970s, when Chancellor Willy Brandt introduced his concept of "rational planning." According to Christian Watrin, a leading German economist, the rate of growth subsequently declined to become negative in 1975. [18]

Codetermination. The Anglo-American tradition sees the community as a voluntary association of individuals who interact in the pursuit of their own private ends and, in doing so, create both order and unintended outcomes. German tradition, on the other hand, considers the community as an organic whole in which members cooperate with one another in the pursuit of a common purpose.[19] Codeterminaton is a consequence of that tradition.[20] Codetermination means that the employees of a firm join shareholders of that firm on the board of directors and take an active role in decision making.[21]

The codetermining firm *per se* is neither an anti- nor a pro-capitalist organization. It represents one of many types of business firms we observe in capitalist countries, such as corporations, partnerships, proprietorships, and cooperatives. However, the law that *mandates* this specific type of contractual arrangement and *protects* it from competition by other types of business firms is both an anti-capitalist and an anti-freedom rule.[22] The fact that the German government had to mandate the codetermining firm and protect it from competition by other types of firms is the best evidence of its inefficiency.[23]

Summary on Institutional Restructuring in West Germany

The rule of law and Ludwig Erhard were two key factors in the successful transition of West Germany from socialism to capitalism in the post-World War II years. However, informal rules in West Germany were in conflict with the capitalist concepts of a limited state and of individualism. The result of that conflict is the social market economy, which is a German variant of capitalism. The main features of the social market economy today are large subsidies, costly welfare programs, a myriad of rules regulating business activities, large nonwage costs, and weak incentives to innovate.

The 2000 Index of Economic Freedom identifies the consequences of the German brand of capitalism.[24] The book uses a scale of 1 to 5 for comparison of economic freedoms in 161 states.[25] With a score of score of 2.20, Germany is ranked as the 22nd freest country in the world.[26] However, the *Index* gives Germany the best possible score 1 for the protection of private property rights, and the worst possible score 5 for fiscal burden. The latter, I conjecture, reflects the costs of the compromise between the old German ethos on the one hand and classical liberalism and methodological individualism on the other.

TRANSITION IN EASTERN EUROPE AND RUSSIA

The Rule of Law

In the following observations more than thirty years ago, G. Warren Nutter captured the essence of what Marxists-Leninists thought of the rule of law

> It was Lenin's genius to recognize the importance of embellishing the Soviet system with all the trappings of democracy. If the people want a constitution, give them one, and even include the bill of rights. If they want a parliament give them that, too. And a system of courts. If they want a federal system, create that myth as well. Above all, let them have elections, for the act of voting is what the common man

> most clearly associates with democracy. Give them all these, but make sure they have no effect on how things are run.[27]

The development of the rule of law in the former Soviet bloc countries has been spotty and generally disappointing. While many factors might have contributed to the patchy development of the rule of law in the region after 1989, two are likely to have played major roles. First, the majority of the former socialist states in Eastern Europe had no memory of the rule of law. For centuries, benevolent and not-so-benevolent czars, local despots and foreign invaders ran those countries. A few countries in the region belonged to the Austro-Hungarian Empire, which was almost the classic example of liberal autocracy. This means we can expect collective memory in those countries to be low on political democracy but strong on civic and economic freedoms. However, almost five decades of socialist oppression had to make a dent in those memories as well.

Second, unlike West Germans in the late 1940s, East Europeans didn't have a "colonial master" to teach them that formal rules could be stable and credible, and that an independent judiciary could be relied upon to enforce those rules. New leaders had to take care of developing legal systems in their respective countries themselves. Unfortunately for their citizens, these leaders had to bear the costs of replacing the region's tradition of arbitrary states (and much discretionary power for the leaders) with the rule of law. Thus, they had little incentive to pursue the rule of law. Predictably, the development of the rule of law in former socialist states has been slow, uneven and spotty. And the farther eastward we move, the spottier the rule of law gets to be.

The 2000 Index of Economic Freedom shows just how spotty the development of the rule of law has been in the East. Of the ten factors the index uses to measure economic freedom in 161 countries, two are used here as proxies for progress in developing the rule of law. Those factors are private property rights, and prices and wages.

The private property factor measures the stability and credibility of property rights, which constitutes a good proxy for the stability of the legal system. A score of 1 means that the government and independent judiciary have made property rights fully secure, stable and credible, while a score of 5 means that private property is either outlawed or un-protected, or both.

The prices and wages factor measures the freedom (and enforcement) of contracts, a cornerstone of the private-property free-market economy. A score of 1 means that wages and prices are determined in competitive markets, and a score of 5 means government *dirigisme*. For reference, Denmark, the United States, and Iraq received the scores of 1, 1.5 and 5 respectively. The average of those two factors in column 2 shows the extent of the rule of law in former socialist states after a decade of institutional restructuring. Sliding down the table changes the mix of law and arbitrariness in favor of the latter. Those changes should, in turn, spell out mean more corruption, black-market activities, and government regulation.[28]

The 2000 Corruption Perception Index in column 3 of table 1 "ranks countries in terms of the degree to which corruption is perceived to exist among public officials and politicians. The 2000 CPI is a composite index, drawing on 16 surveys from 8 independent institutions. The surveys embrace the perceptions of business people, the general public and country analysts."[29] The Corruption Perceptions Index, clearly a very subjective index, includes 90 countries. Scores range from 10 (highly clean) to 1 (highly corrupt). For reference, Finland, the United States and Mexico received the scores of 10, 7.8 and 3.3 respectively.

TABLE 1: The Rule of Law, Corruption, and Black Markets in Former Soviet Block Countries

Country	Rule of Law	CPI	BM&Reg
Czech Republic	2	4.3	2.5
Estonia	2	5.7	2
Hungary	2	5.2	2.5

Latvia	2.5	3.4	3.5
Poland	2.5	4.1	3
Slovenia	2.5	5.5	3
Bulgaria	3	3.5	3.5
Lithuania	3	4.1	3.5
Moldova	3	2.6	3.5
Romania	3	2.9	3.5
Russia	3	2.1	4
Slovak Repub.	3	3.5	3
Albania	3.5	Not rated	4
Ukraine	3.5	1.5	4
Belarus	4	4.1	4.5
Croatia	4	3.7	3.5
Yugoslavia	Not rated	1.3	Not rated
Bosnia	4.5	Not rated	5

Sources, *2000 Index of Economic Freedom*, and *2000 Corruption Perception Index*, (see endnotes 23 and 28).

Column 4 shows the average score for black market activities and government regulation. Higher scores indicate more regulations and black market activities. Relationships between columns 2 and 3 and between columns 2 and 4 are statistically significant at the 5% level. That is, changes in the mix of law and arbitrariness in favor of the latter create more black market activities, government regulations, and corruption.

The Carriers of Institutional Restructuring

Decommunization did not happen in Eastern Europe. With only a few exceptions, communist parties in the former Soviet bloc were not outlawed, and party members were not brought to justice. Some decommunization did occur in the former East Germany. In a few places, like the Czech republic, former leaders and members of secret services were excluded, or were supposed to be excluded, from decision-making jobs in government. In a number of countries, the communist party merely changed its name and continued to function. In this paper all attempts on the part of communists to hide the past and/or signal newborn beliefs are ignored.

The fact that decommunization did not happen in most East European countries has had significant consequences. In 1989, communists held most of the important jobs in all branches of government as well as in business. They also had a well-established "old boys" network. Thus, communists were in much better position than other citizens to become or join the carriers of institutional restructuring. And, looking back, that is precisely what happened in many East European states

Once they along with others became the carriers of institutional restructuring, the behavior of communists, like that of everyone else, depended on the incentives under which they had to operate. Leaving aside the morality of their "conversion," and given their knowledge of and skills in *dirigisme*, the survival trait for communists was to favor economic policies based on more government and more public spending.[30] The bottom line is that the failure to outlaw communist parties and to prevent their members from becoming the carriers of institutional restructuring has raised the transaction costs of transforming former socialist states in Eastern Europe into free-market private-property economies.[31]

The Old Ethos in Eastern Europe

Informal rules in Eastern Europe are not homogenous, but they do have some common traits, such as a strong bias toward collectivism, egalitarianism, and the extended family. Although countries that belonged to the Austro-Hungarian Empire have a more Western tradition than do other East European countries, classical liberalism and methodological individualism, which are part of that tradition, do not have deep roots in the region.

Many communities in the region have developed customs and common values along ethnic lines. Frequently a person's ethnic origin predicts that person's religion--usually Islamic, Roman Catholic, or Eastern Orthodox--reinforcing the differences in customs and values among ethnic groups. Interactions within any specific ethnic group are then subject to rules of behavior that do not necessarily hold or that may not hold in exchanges across the ethnic lines. Most unfortunately, the tradition in Eastern Europe is a repository of the old unsettled scores among the region’s ethnic groups.

The old ethos, however, served East Europeans well under socialist rule. With its emphasis on ethnicity, the extended family and shared values, the old ethos gave East Europeans a fortress: behind its walls they could hide and survive socialist rule without having to accept it.

It is clear that capitalism and the old ethos in Eastern Europe do not mesh together well. The accumulation of private wealth in Eastern Europe is suspect, the more so the farther east one travels. Gains from trade are seen as a redistribution of wealth rather than as rewards that individuals receive for creating new value. The intellectual heritage in the East supports an activist state.

Given the ethos of the region and several decades of isolation from the rest of the world, East Europeans couldn't see capitalism as a *way of life* based on (1) the constitutional guarantees of individual rights, (2) credible and stable private property rights, (3) the freedom of contract, (4) the exchange culture in which each and every individual bears the value consequences of his/her decisions, and (5) the behavioral principles of self-interest, self-determination and self-responsibility.

Summary on Institutional Restructuring in Eastern Europe

The interaction of the rule of law, the carriers of institutional restructuring, and the old ethos suggests that the future of capitalism in Eastern Europe might be, at best, hanging in balance. With a few exceptions, East European countries are still short on the rule of law. The fact that privatization programs have made them rich is the best evidence that communists have been playing a major role in the institutional restructuring of Eastern Europe. The old ethos in Eastern Europe is not in tune with a way of life that rewards performance, promotes individual liberties, and places high value on self-interest, self-responsibility and self-determination.

IN LIEU OF CONCLUSIONS

The rule of law, the carriers of institutional restructuring, and the old ethos are three powerful and perhaps necessary factors for analysis of the causes, directions and consequences of institutional restructuring. Economic theories and policies that pay attention to the interaction thesis are likely to have fewer unintended consequences than those theories and models that do not. The analysis in this paper has shown us why the transition in West Germany was a success, and why it does not make sense to force East Europeans to accept capitalism until their leaders give them credible and stable legal systems and East Europeans become comfortable with capitalist culture.

Before leaving the interaction thesis and its as yet inevitably incomplete trajectory, it is worth briefly addressing three issues that have been playing important roles in the institutional restructuring of former socialist states. Those issues are: Why has the use of economic policies based on neoclassical economics produced the rising strength of pro-socialist parties?[32] What happens to the transition to capitalism when the carriers of institutional restructuring have comparative advantage in running state-centered economies? And finally, the paper suggests a primer for changes in the old ethos.

Neoclassical Economics and the Transition In Eastern Europe[33]

Neoclassical economics became a basis for the development of transition strategies as well as a yardstick for evaluating economic outcomes in former socialist states. While the intention here is not to denigrate an approach to economic inquiry that has made important contributions to the stock of scientific knowledge, the point has to be made that neoclassical economics falls short of explaining a wide-range of real world events, including the causes and consequences of institutional changes. It is important to understand how and why economic policies based on neoclassical economics have produced a host of unintended political and social consequences culminating in the rising strength of pro-socialist parties in the region.

I conjecture that neoclassical economics is ill-suited for informing the institutional restructuring in Eastern Europe, largely for its lack of appreciation for the importance of institutions and the assumptions of unbounded rationality, stable preferences, maximizing behavior, and market equilibrium. Why?

Neoclassical economics ignores the fact that alternative institutions have their own ethical roots, so that it can claim to be value-free. By ignoring the incentive effects of alternative institutions on transaction costs, neoclassical economics gave us erroneous evaluations of the state of socialist economies in the 1980.

> Robert Heilbroner and Lester Thurow wrote: “Can economic command significantly compress and accelerate the growth process? The remarkable performance of the Soviet Union suggests that it can. In 1920 Russia was but a minor figure in the economic councils of the world. Today it is a country

> whose economic achievements bear comparison with those of the United States." Paul Samuelson said: "It is a vulgar mistake to think that most people in Eastern Europe are miserable... The gap between Western and Eastern living standard may narrow in the future." Seweryn Bialer and Joan Afferica wrote: "The Soviet Union is not now nor will it be during the next decade in the throes of a true systemic crisis, for it boasts enormous unused reserves of political and social stability that suffice to endure the deepest difficulties." And John Kenneth Galbraith on his return from Russia in 1984 claimed that the Soviet economy had made great national progress in recent years.[34]

Then, in the early 1990s, neoclassical economics demonstrated a complete lack of understanding of the true nature of institutional restructuring in Eastern Europe. In a recent paper, professor Enrico Colombatto wrote that the process of transition is not aimed at starting some kind of a mechanical catch-up process; but rather at reducing transaction costs and providing better opportunities to meet individual objectives. Institutional restructuring, Colombatto said, is a cultural issue, rather than a mere technical one.[35]

Unbounded rationality exists only in frictionless blackboard models, which rule out positive transaction costs. However, ours is the world of bounded rationality in which individuals have different subjective perceptions of real events and different abilities to process new knowledge. Among the consequences of bounded rationality, then, are positive and variable transaction costs, information asymmetries, and opportunistic behavior. Neoclassical economics is ill equipped to deal with those consequences of bounded rationality.

The rational expectation theory and the principal-agent model are two best, but still inadequate, attempts by neoclassical economists to address the consequences of bounded rationality. The rational expectation theory considers the process of adaptation to an optimal solution as a steady trial-and-error process in which the participants are not acquiring new knowledge. With uncertainty and incomplete knowledge, the resolution of contingencies between the principal and the agent cannot depend on a contract but hinges upon the incentive effects of the prevailing rules. Herbert Simon wrote:

> [New economic theories] are not focused upon, or even much concerned with, how variables are equated at the margin, or how equilibrium is altered by marginal shifts in conditions. Rather they are focused on qualitative and structural questions, typically, on the choice among a small number of discrete institutional alternatives.[36]

The maximization paradigm of neoclassical economics translates the desire for more—an observable trait of human behavior since the *fiasco in the Garden of Eden—into the search for a single solution based on marginal equivalencies*. However, in a world of bounded rationality, the transaction costs of identifying marginal equivalencies are positive and not invariant with respect to alternative institutional arrangements. A Nobel Laureate Coase wrote:

> The reason why economists went wrong was that their theoretical system did not take into account a factor that is essential if one wishes to analyze the effect of a change in the law on the allocation of resources. This missing factor is the existence of transaction costs.[37]

Market equilibriums are conjectures about what the end results of human interactions would have been if relative prices were able to inform utility maximizing individuals of the best strategy to be pursued in each different situation. However, in a world of bounded rationality scarcity prices cannot transmit the information necessary to identify marginal equivalencies. Neoclassical economics is silent about the effects of alternative rules on the agents' costs of acquiring the knowledge needed to make optimal choices as well as about the effects of new knowledge on prevailing rules. Ronald Coase wrote:

> If [neoclassical] proposals were carried out, which they cannot be, the allocation of resources would be optimal. This I have never denied. My point is that such policies are the stuff that

> dreams are made of. In my youth it was said that what was too silly to be said may be sung. In modern economics it may be put into mathematics.[38]

The knowledge-creating process continuously changes our preferences. That is, preferences are neither stable nor entirely exogenous. Thus, assumptions such as given prices and given preferences are misleading. Those variables do not exist independently from the action-choosing process through which they are generated. The presence of endogenous preferences and their mutability cast serious doubts on the concept of efficiency in neoclassical economics, which is based on the results. The so-called Lange-Mises controversy is a good example of an impeccable technical discussion that wasted lots of resources on the wrong issue. An alternative concept of efficiency, which is preferred by growing number of scholars associated with the Austrian School, Public Choice School, Evolutionary Economics and New Institutional Economics is that efficiency is to be judged by the process through which transactions are carried out. The critical policy issue then becomes: what set of institutions provides incentives for transaction costs to be reduced by those who can do it at a lower cost, and how and why the observed patterns of behavior emerge.

Transition Industry

The carriers of institutional restructuring in former socialist states include a rent-seeking coalition that I call *the transition industry.* The transition industry, which has no geographical borders, is an umbrella for the latter-day socialists, social engineers, bureaucrats, reformed and nonreformed communists, university professors from the West and the East, policy makers from the Wold Bank and IMF, and others.[39] The common denominator of this diverse group of rent-seekers, who prefer public policy to spontaneous institutional changes and favor restricting the right of ownership, is the culture of collectivism. And their survival trait is to use the strong hand of the state to “build” capitalism in Eastern Europe and the former Soviet Union.

I conjecture that the World Bank and the International Monetary Fund are two most offending members of the transition industry. Since their activities do not have to pass the market test, the discretionary power of decision-makers in these two organizations is substantial. We observe that these two organizations primarily serve governments that all the various indexes of economic freedom classify as mostly unfree, and repressive. It appears that the more corrupt the country is, the better its chance of getting support from the World Banks and IMF. While the Czech republic and Slovenia could live without the World Bank and IMF, Russia and Ukraine can not.

Obviously, decision-makers in the World Bank and IMF have incentives to help corrupt governments, and in doing so they have been creating moral and economic problems. Their activities are immoral because they reduce the costs of keeping corrupt governments in power. And their activities are inefficient because they reduce the costs of maintaining inefficient property rights in arbitrary states. The so-called international financial crises are the consequences of internal problems created by corrupt governments. Yet, the World Bank, IMF have been helping corrupt governments to shift the costs of bailouts to the taxpayers of non-corrupt states. The same goes for loans to East European states. More often than not those loans are used to either subsidize large enterprises with no chance of surviving in competitive markets, or to enrich new ruling elite, or to pay off the loans that should not have been granted, or all of the above.

A landmark study on WB and IMF, which is usually referred to as Meltzer Report addressed the issue of incentives and institutional change as follows:

> The development banks cannot succeed in their mission unless the countries choose institutions and government policies that support growth. Developing country governments must be willing to make institutional changes that promote improved social conditions, reward domestic innovation and saving, and

> attract foreign capital. To foster an environment conducive to economic growth, the development banks *must change their internal incentives and the incentives they offer developing countries* (italics mine).[40]

A Primer for Changes in the Old Ethos

The essence of my argument in this paper is that the transition from socialism to capitalism is a cultural issue. Since the old ethos in Eastern Europe is not in tune with the culture of capitalism, the critical issue is who and how can reconcile the prevailing ethos with the culture of capitalism. Informal rules are not a policy variable. Thus, the state cannot reconcile the conflict between the old ethos and capitalism by *fiat*. The answer depends on who the carriers of institutional restructuring are and on their incentives.

Suppose a new idea hits a community. An important economic consequence of the idea would be to enlarge the set of opportunity choices for human interactions. However, if new exchange opportunities were not in tune with the prevailing ethos, the community would consider the behavior of those exploiting the opportunities as submarginal. But if operating below the margin of accepted behavior provided a differential return, the success of those individuals doing so would attract competition from others. If the returns were substantial enough to generate and sustain a large number of repeated interactions relative to the enforcement costs of informal rules (expulsion from the community, ostracism by friends and neighbors, loss of reputation, etc.), the prevailing ethos would slowly change to embrace the novelty. The essential requirement here is that the state does not interfere (one way or another) with the freedom of individuals to choose whether or not to bear the prevailing costs of violating informal rules. It is also important that the costs of institutional change are borne by those who capture the benefits.

The process outlined above is taking place in Eastern Europe. Thousands of small private enterprises have spontaneously sprung up in Eastern Europe, even though private property rights do not yet enjoy credible legal guarantees. Those enterprises are small stands lining the streets of East European cities or are conducted from the backseats of cars, and out of small rooms. Many have failed or will fail, but enough have survived and will grow.

Spontaneous enterprises represent an insignificant percentage of gross national products in their respective economies. However, they are performing the most critical function that huge and inefficient enterprises, privatized or not, cannot perform. The small enterprises are the breeding ground for entrepreneurs, a work ethic, and a capitalist exchange culture. They educate ordinary people to appreciate a way of life that rewards performance, promotes individual liberties, and places high value on self-responsibility and self-determination. These small enterprises are the engine of a slow and genuine reconciliation between the region's old ethos and the culture of capitalism.

Indeed, small entrepreneurs have begun to make contributions to both social stability and economic performance in Eastern Europe, especially in Poland, Hungary and the Czech Republic.[41] And in the process, ordinary people are learning about the costs and benefits of keeping promises, the rule of law, competitive markets and methodological individualism.

ENDNOTES

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[1] Nicolae Ceausescu, *Scinteia*, July 20, 1972, p.8, quoted in Isaiah Berlin, "The Bent Twig," in (Henry Hardy, ed.) *The Crooked Timber of Humanity*, pp.253-4.

[2] The same reasoning applies to the rise of unemployment in former socialist states, which is an unavoidable consequence of moving from a planned economy to competitive markets. Given the positive transaction costs of institutional restructuring, the emerging labor markets couldn't have reduced unemployment with the speed of neoclassical models.

[3] James Buchanan, "General Implications of Subjectivism in Economics," paper presented at the conference on *Subjectivism in Economics*, Dallas, Texas, December 1976.

[4] Robert Barro, *Determinants of Economic Growth: A Cross Country Empirical Study*, Cambridge: MIT Press, 1997; Fareed Zakaria, "The Rise of Illiberal Democracy," *Foreign Affairs*, 76, December 1997, pp.22-43; Alejandro Chafuen and Eugenio Guzman, "Economic Freedom and Corruption," in (Gerald O'Driscoll, Jr., Kim Nolmes and Melanie Kirkpatrick, eds.) *2000 Index of Economic Freedom*, Washington D.C.: Heritage Foundation, pp. 51-63.

[5] James Buchanan, "Policy, Property and the Law," *Journal of Law and Economics*, 16, 1972, pp.

[6] See the pioneering work by Bruno Leoni, *Freedom and the Law*, Princeton: Van Nostrand Co, 1961.

[7] Cass Sunstein, "On Property and Constitutionalism," *Cardozo Law Review*, 14, No 3-4, 1993, p. 923.

[8] Robert Barro, "Rule of law, Democracy, and Economic Performance," in *2000 Index of Economic Freedom*, op.cit., p. 47.

[9] Armen Alchian and William Allen, *University Economics*, Belmont: Wadsworth Publishing, 1964, p.12.

[10] We can think of many examples of the effects of the interaction of formal and informal rules. The formal rule that limited the maximum speed on American

highways to 55 miles per hour was in conflict with the driving culture of most American motorists and raised enforcement costs. Prohibition laws in the United States were in conflict with the country's prevailing tradition of social drinking. The high transaction costs of maintaining and enforcing prohibition laws opened up the market for the Mafia and eventually convinced the government to eliminate the conflict between formal and informal rules concerning the consumption of liquor. The interaction of formal and informal rules explains the costs of resources that were required to maintain and enforce the old regimes in Eastern Europe. It explains the differences in the costs of enforcing the right to life in religious and less religious communities. The rise of "ghettos" in American cities reflected a tendency on the part of various ethnic, racial, and religious groups (groups living under the same set of formal rules) to stay together with those individuals whose behavior they could predict.

[11] Henry Manne, "The Judiciary and Free Markets," *Harvard Journal of Law and Public Policy,* 21, fall 1997, p.21.

[12] Fareed Zakaria, "The Rise of Illiberal Democracy," *Journal of Foreign Affairs*, 76, December 1997, pp. 22-43.

[13] John Kenneth Galbraith, "The German Economy," in (ed. S. E. Harris), *Foreign Economic Policy for the United States,* Cambridge: Harvard University Press, p. 94.

[14] See an excellent paper by Norman Barry, *The Social Market Economy*, Bowling Green: Social Philosophy and Policy Foundation, 1993.

[15] Ibid., p.9.

[16] Two free-market economists and strong supporters of Erhard, Wilhelm Roepke and Walter Eucken, wrote: "Like pure democracy, undiluted capitalism is intolerable" (W. Roepke, *Social Crisis of Our Time*, London: Thames and Hudson, 1958, p. 119); and "The economic system cannot be left to organize itself" (W. Eucken, *The Unsuccessful Age*, Edinburgh: William Hodges, 1951, p.93

[17] In a private communication to the author of this paper, professor Victor Vanberg of the University of Freiburg wrote: "There was a systematic difference between Roepke and Eucken. Eucken's main argument was that the institutional framework that constitutes a well-functioning market cannot be expected to arise 'naturally' but is a matter of adequate political constitutional choice. Roepke was much more concerned with 'undesirable social consequences' of the pure market mechanism, despite his general pro-market attitude."

[18] See Hans Wllgerodt, op. cit., p.79.

[19] In the second half of 19th century, Germany became the very first modern welfare state.

[20] Codetermination in Germany has a long tradition. As early as 1835, Robert Von Mohl, Wilhelm Roscher and Bruno Hildebrand, all university professors, proposed to create "workers' committees" in business firms. The most recent law on codetermination was enacted in 1976. It applies to all business firms that have more than 2,000 employees. The supervisory council (i.e., the board of directors) for such firms has twelve members, of whom six are representatives of the shareholders and six are representatives of the employees. At least three members representing employees are appointed by labor unions. The chairman of the supervisory council is elected by the shareholders and holds the deciding vote in case of a deadlock.

[21] Whatever the facade of words, terms such as “stakeholders” and "labor participation" are code words for inefficient (non-contractual) transfers of wealth.

[22] American labor unions have refused to embrace codetermination. The president of the Machinists Union said: “We have no interest in replacing free enterprise with a Utopian system.... And we believe workers can receive a better share of free enterprise at the bargaining table than in board rooms.” Whatever their motives might have been, American labor leaders saved the country from political pressures to implement contractual agreements that wouldn’t emerge spontaneously.

[23] See C. Watrin, “The Case of Codetermination in Germany,” in (S. Pejovich, ed.) *Socialism: Institutional, Philosophical and Economic Issues*, Dordrecht: Kluwer Academic Publishers, 1987, pp277-314; and G. Benelli, C. Loderer, and T.Lys, “Labor participation in Corporate Policy Making Decisions: West Germany’s Experience with Codetermination,” *Journal of Business*, 60, 1987.

23. Gerald O’Driscoll, Jr., Kim Novak and Melanie Kirkpatrick, *2000 Index of Economic Freedom*, Washington D.C.: The Heritage Foundation and the Wall Street Journal, 2000, pp. 229-230.

[25] Scores 1–1.95 are “free” countries; 2–2.95 are “mostly free” countries; 3–3.95 are “mostly unfree” countries; and 4–5 are repressed. The United States was ranked the 4th freest country with the score of 1.80.

[26] This index is based on ten factors: Trade policy, fiscal burden, government intervention, monetary policy, foreign investment, banking, wages and prices, property rights, regulation, and black market.

[27] G. Warren Nutter, *The Strange World of Ivan Ivanov*, New York: The World Publishing Co, 1969, p.39.

[28] The extent of government regulation of economic activities in the country is a much better indicator of the restrictions on private property rights and contractual freedom than, for example, the level of government spending.

[29] "*2000 Corruption Perception Index,*" Transparency International, Berlin, September 13, 2000, p.1. The Index and information on methodology are available at www.transparency.de/documents/cpi2000.html.

[30] In multiethnic states, these leaders encouraged the perception of an external threat to their respective ethnic groups. In countries like Belarus and Ukraine, communists quickly learned that political democracy obliges them neither to respect nor to enforce civic and economic freedoms. In Russia, communists are in the process of re-creating the state-centered system. On the other hand, the influence of right wing parties led by free-market individuals helped the Czech republic, Hungary and Poland virtually to complete the transition to capitalism.

[31] Many educated and skilled people in former socialist states had joined the communist party in order to enhance their careers. The argument that those people warrant a different treatment from true communists is plain wrong. First, the transaction costs of separating "true" communists from "careerists" are significant. Second, giving aid and comfort to criminals is a crime.

[32] See Svetozar Pejovich, "The Market for Institutions Vs. Capitalism by Fiat," *Kyklos*, 47, No. 4, 1994, pp. 519-529; and "Law, Tradition, and the Transition in Eastern Europe," *The Independent Review*, 2, September 1997, pp.

[33] This section of the paper is based on Timothy Roth, *Ethics, Economics and Freedom*, Aldershot: Ashgate, 1999 (errors in interpreting the book are mine); and Svetozar Pejovich, *Economic Analysis of Institutions and Systems*, Dordrecht: Kluwer Academic Publishers, 1998.

[34] Svetozar Pejovich, *Economic Analysis of Institutions and Systems*, Dordrecht: Kluwer Academic Publishers, 1998, p. 14.

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[35] Enrico Colombatto, "On the Concept of Transition," ICER Working Paper, November 2000.

[36] H. Simon, "Rationality as a Process and as a Product of Thought," *American Economic Review* 68 (1978), p. 6.

[37] Ronald Coase, *The Firm, the Market, and the Law*, Chicago: University of Chicago Press, 1988, p.175.

[38] Ibid., p.179. This endnote compresses and generalizes Coase's original text. However, I believe that I have not changed the thrust of Coase's argument.

[39] In 1989, Western scholars associated with Russian centers, East European centers and various associations for comparative studies found, practically overnight, that the value of their human capital was gone with the wind. East European scholars had a different problem. After decades of teaching and writing about "scientific socialism" they had to do a complete turnaround (what a moral bunch of educators) and switch to lecturing about the benefits of competitive markets.

[40] See *Report of the International Financial Institution Advisory Commission (Meltzer Report)*, Washington D.C.: Government Printing Office, March 9, 2000, p.11.

[41] See Adrian Karatnycky, "Eastern Europe Rejects Communism—Again," *Wall Street Journal*, November 25, 1996, p. A16.