Russian-European Centre for Economic Policy

WORKING PAPER SERIES

«ECONOMIC LIBERALIZATION AND NEW INSTITUTIONS»

D. Golikov

August 2001

In the last quarter of the 20th century the governments of many countries, becoming aware of increasing inefficiency, slowing growth or inappropriate allocation of resources, addressed these problems by initiating economic liberalization. As we know, a lot of those liberal reforms failed, some from the outset, especially large-scale programs in the so-called crony-capitalist and post-Communist economies that all suffered from excessive state control and the connected behaviour, where the democratic tradition had not taken root.

We learn from recent history how strongly institutions may affect macroeconomic adjustment. It is needless to say that a policy for new institutional development must be consistent with macroeconomic policy and, in particular, if one puts forward an economic liberalization program, this naturally concerns the issue of the institutions of democracy.

It can be inferred that while a liberal economy implies democracy, transition to the liberal order through formal democracy procedures is difficult; thus democracy may be absolutely futile in implementing reforms. In this paper we attempt to test this arguable and, in some sense, ‘uncomfortable’ question.

We discuss how the organization of society, the complexity of the economy, and its level of technological development affect the relationship between the institutions of democracy and economic growth; why the foundation of democracy and market institutions at the same time, in a society without a relevant historical background, remains problematical; and whether enforcement of the institutions of democracy is helpful for stabilization and further sustainability of growth.

***

We begin with an introduction of the basic notions and a summary of facts in an attempt to understand what is crucial to the success of economic liberalization policies (Section 1). This allows us to formulate our basic hypothesis, namely, that while a liberal economy implies democracy, transition to the liberal order through formal democracy procedures is difficult, so enforcement of the institutions of democracy is necessary. The hypothesis is elaborated in Section 2. In Section 3 we examine the relation between liberal market, democracy, and economic development, while in Sections 4 and 5, using the new institutional approach, we analyse democracy failures in an economic context. We proceed with an analysis of authoritarian governance in Section 6, and in Section 7 consider some implications for policymaking and the methodology of economic analysis. Conclusions are outlined in Section 8.

Let us first take two seemingly different cases which we believe are be helpful in understanding the core of the problem.

Case 1: Liberalization in Latin America. Until the late 1920s, Argentina and Brazil had per capita GDP and growth rates comparable to those in the USA and other developed countries. However, the Great Depression, the limits of natural resources and rich, extensively engaged in agriculture lands slowed the export-led growth.[1] In an attempt to protect national interests, governments closed the economies, replaced foreign investments by transfers which they financed through borrowing, and nationalized entire industries. It can be added that policymaking became dependent on the discretionary decisions of poorly trained bureaucrats accountable only to the political bosses who controlled their badly paid but highly profitable public jobs (Naim, 1995).

With all this, output growth remained generally slow and by the 1970s - 80-s these economies had come to a profound structural imbalance, deep recession, high inflation, and debt crises. The

[1] For some data in support of the conclusion see, for example, Mundlak, et.al.(1990), Taylor (1999).

rethinking of economic strategy had enabled the new generation of leaders to start the new macroeconomic and fiscal policies; however, in many cases the governments had to launch reforms again and again as their first attempts failed.

Case 2: Liberalization in the former USSR. Over the decades of Communist rule, the Soviet economy had grown largely due to a relatively low individual consumption and a literally destroying use of the natural resources, for instance, by keeping low prices for energy and other inputs disregarding the long-term investments. From the mid-1970s, the USSR had enjoyed a huge revenue from the exports of oil and natural gas, while the extracting and other industries had been suffering from capital depreciation. By the late 1980s net capital accumulation had become negative and growth ceased. Outdated technologies through isolation from the world economy, an excessive share of intermediate production, military and sheltered sectors, and the rent-seeking motivation in all aspects of economic activity were amongst the factors contributed to the economic decline of the Soviet Union.

Then, initiated in April 1985, Gorbachev's perestroika opened up the Communist regime to the world. The word "transition" gained a new meaning and, about ten years later, we can see that the former Communist countries, having followed various routes to transition, found themselves in completely different states. While Poland, Hungary, Czech Republic, Slovenia, and the Baltic countries had already achieved sustainable growth and social stability, Russia and Ukraine fell into a political mess and a deep recession. Russia, the former dominator, setting the rules, possessing huge deposits of natural resources and on the face of it demonstrating growth of economic and military power for decades, had almost collapsed.

Russia turned to growth after the abrupt four-fold devaluation of the national currency in August of 1998, but this soon stopped. The country showed positive trends again only with the policy actions aimed at restructuring and the changes in institutions, attempted since 1999.

1. The facts: what lies beyond the success of policies for economic liberalization?

A steadily growing, *efficient economy* is normally regarded as a competitive market in which private funds are highly encouraged and resources can be reallocated relatively freely at relatively low costs. Hence *economic liberalization*, that is the development of such an economic system and the social, political, and economic institutions associated with it, often becomes a strategic target of governments facing rising inefficiency, slowing growth, or inappropriate, for some reasons or others, allocation of resources.[2]

If we look at the facts, we will see that recent history gives many examples of failed liberal reforms, especially in the so-called crony capitalist and post-Communist economies, all suffering from state control and connected behaviour, where democratic tradition has not taken root and democratic rule needs institutionalisation. A list of those successful economic liberalizations which have brought about macroeconomic stability, rapid restructuring, and growth is short indeed. It includes such different cases as Chile, Poland, the Chinese model and, with less accuracy, a few others from East Europe and Latin America. More examples from the East Asian Tigers could probably be added in the near future.

Where do the failures come from? A specific market experience clearly matters. The presence of *informal democracy institutions*, which implies trust among people, the ability to manage networks, trade rights and develop public agreements (laws) on the basis of economic rationality rather than on family or pulling social strings, an unerased experience of democratic rule in the past, must be

[2] In the context of this paper, the term *institutions* has a broad meaning, encompassing the norms, considerations, and perceptions shaping the pattern of individual behaviour, the networks in the sense of the non-functionalist approach, the infrastructure, and the specific mode of coordination. Hence, this term basically refers to informal institutions.

important as well if "this tradition is considered to be a variant of the definitional norm for individualism" (Buchanan, 1975) because, at any stage of evolution, the market becomes naturally framed in and shaped by the informal democracy institutions.

But whatever the historical meaning of institutional background – is that a sufficient condition to determine the success or failure of liberal economic reforms? Seeing the future of a nation as being predetermined by its past when it is new circumstances that make people reflect on problems and think about reforms, does not look very encouraging. Central European countries have a Western-type democratic tradition, developed over the centuries; however, China, East Asia and Latin America definitely do not have this. Nevertheless, the latter have demonstrated success in economic liberalization as well. So it makes sense to assume that the historical background is still not crucial and in analysing successful and failed attempts of liberal economic reforms, the proper question to ask would be whether the actual economic proposal was relevant to institutions *and* the current economic conditions.

While differing as regards market experience, varying from almost an unleashed economy in Latin America to a centrally planned system in China, all successive in liberalization nations were always free from the sheltering state – the state securing not only access to needed public goods but taking over the bulk of economic activities, and regulating the consumption and production of marketable goods and services. Even in China, with the profound lack of freedom, not only the majority of the population outside the reforming sector but also those living in the big cities and in the South-Eastern area, now experiencing system transformation, have never had a full range of pension and social benefits of the Soviet type. Such experience must shape social tensions and expectations. If so, it may be assumed that the degree of individual responsibility for present and future means much more for the success of liberal reforms than does the degree of economic freedom. Is not the difficulty of assimilation that the East Germans are experiencing after national unification evidence enough for our conclusion?

An overview of the reform policies, the initial economic conditions, social systems, and the historical and cultural backgrounds of the nations, also suggests that only nations driven by a clear and strong motivation in developing a liberal order have managed a restructuring and achieved sustainable growth. Sometimes this motivation stems from social tensions, especially if these are provoked by influential formal institutions. People in Poland, for instance, always identified themselves as a European nation and openly expressed concerns about the former Big Brother's instability and imperialistic ambitions, while the national Catholic Church which is probably the most influential non-governmental institution in Poland unambiguously supported such ideas. To a large extent, thanks to these tensions, economic liberalization was accepted by the majority of people as a sort of movement from the Soviet past toward national independence; transition has turned out to be quite rapid and has not faced considerable counteraction. It seems convincing that the presence of democratic tradition in Eastern Europe has allowed those nations to become credible and, therefore, politically strong governments within relatively short periods of time.

However, in many cases the motivation in developing the liberal order was brought about by a strong authoritarian government (Chile, China). Yet the history of Latin America in the late 20th century shows that, even if liberal reforms were initiated by democratic regimes, the positive results were not achieved and fixed until the policies had been implemented by a politically strong, highly credible government in a relative isolation from the rest of the democratic system. (Hachette and Luders, 1993).

So the facts lead us to the conclusion that, while a liberal economy implies democracy, transition to the liberal order through democracy is difficult as democracy may be absolutely futile in implementing reforms. Hence, the foundation of democracy and of market institutions at the same time in a society without a relevant historical background remains problematical, and institutionalisation of the liberal economy is possible only with a strong government which is allowed to pursue authoritarian policy. Let us elaborate on this hypothesis below.

2. The hypothesis: institutional basis of the power of government

In developed countries the need for liberalization was often recognized in the course of cycle recessions (U.K. in the late 1970s or Japan in 1999-2001), while many of the developing and post-Communist nations got down to implementing some liberalization plans only after having experienced high inflation and a deep structural imbalance. They had to tackle economic liberalization along with macroeconomic stabilization; what is crucial, therefore, is that the necessary condition for achieving stabilization is a political will, which implies a strong government. So the question of success of economic reforms inevitably leads to the question of political power. If a government proposes economic liberalization, does it have sufficient resources to control the masses, to manage the balance of interests of various groups? This question probably arises ahead of those about professional skills of policymakers or the correctness of target figures.

Strong power can be built in (formal institutions of) an *authoritarian regime* which may pursue someone's private as well as public interests, may allow public discussion but in a pure case implies no independent judiciary, no public participation in decision making, even with regard to the distribution of public goods, and no public control over the authorities. This inevitably induces the government to use repressive tools for controlling its citizens.

Alternatively, strong power can be based on informal social and economic institutions. The social contract, which emerges in this case, provides a basis for the formation of effective and credible and, thereby, strong government.

In countries where democracy is deep-rooted, liberalization can be pursued on the basis of the existing institutions through enhancing democracy. This is what we can learn from the example of Poland given in the previous section; this is what really happened in Eastern Europe and the Baltics. But the implementation of an economic liberalization policy bringing in revolutionary changes (Mau, Starodubrovskaya, 2001) in countries with a poor democracy tradition is seen as much more difficult and complicated, even if the policymaker relies on public support in his or her liberal initiative.

If the policymaker is wholeheartedly given to democracy as the superior value, he or she should think whether democracy would actually work on the new ground. Given the right to speak freely and vote freely, would the majority of the population work out the variety of alternative views and competing proposals in order to vote correctly, from the policymaker's point of view? The same policymaker could be easily voted out, so the reforms can be at a stalemate from the very beginning and the liberal idea be misinterpreted and distorted and be, thus, given up by the people for a long time to come. Therefore, if democracy comes first, the economy may go from bad to worse. Latin America and the former Soviet Union provide strong evidence for this. Does not the vicious circle of transition (the more seriously ailing the economy, the deeper the social and political conflict and thus the more serious the economic problems) give weight to the unpleasant conclusion that it is hardly possible to establish democracy and market institutions at the same time in a society which has never had such things before? The only argument weakening this inference is that as the rule of law, economics and politics are usually studied separately, their interaction is still unclear, while the East European countries are laboratories where this interaction now actually occurs (Elster, 1993; Soili Nysten-Haarala, 2000).

On the other hand, we see only two problems when the government is allowed to use authoritarian tools of control. Firstly, the threat of Leviathan (Buchanan, 1975) eventually becomes unavoidable and this is largely a political issue. Secondly, limitation of democracy may be inconsistent with complexity of the economy, with the level of technology and human capital as, for instance, it increases costs and reduces the quality of coordination or heightens the risk of wrong decisions. This second point is a purely economic issue.

3. Liberal economy, development, and democracy rule

Let us examine the latter issue in a broad context. How does the problem of democracy concern economics? In what way, to what extent does the social and political institutional framework determine economic development and growth in particular? What can we say about the relation between the level of economic development, liberal order, and democracy? Economic, historian, and political literature suggests this is a controversial subject.

It is widely accepted that individual freedom is a superior value, so this is regarded as the only appropriate political system. Democracy and political liberty have an importance of their own (Sen, 1999). Barro (1994), using economic data, wrote that since good 'democracy' is desirable for its own sake, rich countries consume more democracy because they can afford the reduced rate of economic progress. In other words, rich nations render some part of 'real' wealth for democratic values.

We also accept the superiority of freedom, but also see a pure economical reasoning behind democracy. As was mentioned above, it implies trust among people, the ability to manage networks, trade rights and develop public agreements (laws) on the basis of economic rationality rather than on family or pulling social strings. So if we believe that democracy is good to the extent that it allows individuals to get what they want, individual freedom becomes the overriding objective for social policy – not as some metaphysically superior value, but as a necessary consequence of an individualist-democratic methodology (Buchanan, 1975). Another important consideration is that the practice of democracy gives economic agents the opportunity to learn from each other, and to re-examine their own values and priorities, along with those of others (Sen, 1999). Finally, democracy appears as a mode of coordination. With these premises, the problem turns out to be an issue for economic policy and economics; a link between efficiency and liberal order becomes clear.

Taking into account all the comparative studies that are now available, the hypothesis that there is no relation between economic growth and democracy (democratic rule) – in either direction – remains extremely plausible (Sen, 1999). According to Barro (1994), who examined growth and democracy (subjective indexes of political freedom) for a panel of about 100 countries from 1960 to 1990, the favourable effects of democracy on growth include maintenance of the rule of law, free markets, small government consumption, and high human capital. But once these kinds of variables and the initial level of real per-capita GDP are held constant, the overall effect of democracy on growth was found weakly negative. It enhances growth at low levels of political freedom but depresses growth when a moderate level of freedom has been attained. This is certainly echoed in history, and in more than just a partial correlation of democracy indicators and growth outcomes. Indeed, investigations can take us beyond the surface level findings of reduced-form growth empirics and into some of the more detailed mechanisms by which political structure affects policy choices and hence growth (Taylor, 1999).

So what makes transition to the liberal market through the formal institution of democracy really difficult? We begin with the assumption that difficulties in transmitting policy decision into economy, imperfections in economic adjustment largely come from the interaction of competing individuals within a certain institutional framework; so it is essential that the policy be addressed to decisions and actions of such individuals against other agents.

4. An individual against individuals: effect of inequality

The political economy literature emphasizes the importance of the public agreement and a coalition of support which should be created by the government (for a review see, for example, Toritsin, 1999). It suggests that liberalization requires the transformation of old institutions and the building of new ones to bring about an improvement in democracy mechanisms, in particular, entailing more effective and, probably, wide-ranging public control.

Suppose, however, that an explicit or implicit agreement has been achieved and is adhered to. Let us think that, while necessary, social peace and public consensus are not sufficient for the success of liberal reforms. The democratic system is by nature conservative (Naim, 1995) and may prove absolutely futile in providing reforms. Indeed, in adapting to a new economic policy, people change views, considerations, norms, actions that partially replace or complement currently existing ones. And these innovations may support as well as hamper the policy pursued by the government. Since the process of institutional innovations is naturally contingent on the existing institutions, new ones may be inconsistent with the targeted liberalism as well as the old. For instance, formal establishment of the democracy rule can bring about even more inconsistency, cause more structural imbalance or capital flight and, therefore, stave off economic growth and even cause people to vote down the liberal reform.

Why does this happen? It can be shown that the effectiveness of markets comes about because good decisions are rewarded more often than bad ones. As in biological selection, the reward system only slightly favours the fittest and the best. But over time, that small margin is enough to secure continuous improvement (Kay, 1999). Whether this small margin is big enough to secure progress against external or exogenous internal social-driven shocks seems to be the crux of the problem. This approach, becoming popular in recent years, while seemingly impressive and probably convincing, can hardly be incorporated in the conventional economic framework as it generates serious methodological difficulties at the level of assumptions.

In this paper we proceed from the new institutional concept and assume that, first, the society consists of heterogeneous individuals who differ in preferences, capacities, access to information and, thus, in types of economic activity. If this is so, a fairly uniform distribution of the social, political, and market power among individuals can hardly be imagined. Second, we acknowledge that signalling and the process of interaction of individuals are economically costly. Thus, complex problems of coordination and distribution arise.

Heterogeneity of agents and the presence of costs of individual interaction shape the society as a hierarchical structure which makes coordination more efficient. And democracy is considered to be a mechanism securing individual interests in society by allowing individuals to deliver their needs to the upper hierarchical levels and to control them. But why democracy? If the examples of today's Malaysia and Singapore are convincing, an authoritarian regime may be effective in control – but only democracy seems to be effective in both functions.

But efficient to what extent? To a large extent, distortions of efficiency are the result of the interaction of heterogeneous agents. As follows from the theory of public choice, small numbers of individuals and groups with equal market power can the more easily manage a coalition and lobby their interests than large numbers, because organizing a large pool takes higher economic, coordination, and social costs than does organizing a small one. Therefore, initiative and power is naturally reallocated into the hands of minority.

On the other hand, relatively large and well-defined (though not necessarily well-organized) communities may be captured by the influential minority to be used in holding political negotiations and lobbying as the reference groups. But these large and well-defined groups may also be found to not necessarily be able to secure their interests and make the government or politically powerful groups satisfy their demands, even if a contract between them has been established. A more influential though still minor lobbying party can, with ease, break promises and agreements with the reference group. Why? The answer is that the latter may hardly be able to counteract simply because it is likely to be too large to do so at a reasonable low cost of coordination, etc. Thus, a policymaker working for social welfare actually represents individuals proportionally to the influence they have on him or her.

The degree of influence crucially depends on, first, the degree of heterogeneity in preferences, capacities or access to information and, second, the costs of interaction/coordination. As well social institutions impose on individual behaviour and interaction restrictions, related to existing family strings and altruistic norms, beliefs, caste, etc.

Democratic mechanisms are supposed to make for revealing individual wishes, irrespective of the social and economic power of each person, and then select and fulfil the alternatives reflecting the will of the majority – while, at the same time, protecting the minority. Protecting minority probably means helping them to adjust to the situation they did not welcome and which has resulted from the choice they did not vote for. To what extent democracy should be protective, should be prescribed by the higher law.

However, the more unequal the distribution of economic power or individual characteristics and the higher the costs of interaction, the lower is the individual ability to affect the public decision-making process. Thus, the less effective is democracy. Moreover, having achieved or initially possessing more economic power or enjoying a higher social status, an individual becomes able not only to use the delegated public resources for private needs but also to secure the advantages he/she has obtained. As this proposition primarily concerns those who, as a result of liberal reforms may be replaced and deprived of the rent, it should be clear that a majority voting will most likely fail in implementing the much-needed liberal reforms.

Is this problem easily manageable? We believe that it is a question of institutions – public tensions and expectations, the structure of the society, etc. – but also of the initial allocation of factors. The latest ‘natural’, purely economic circumstances cannot be ignored. For example, rich endowments of oil and other tradable natural resources, exploration of which is associated with a significant economy of scale, sentence Russia not only to the notorious Dutch disease but also to a high concentration of capital and, therefore, of market power. This makes the development of democratic rule in Russia countrywide problematic, if not hopeless. Which is similar, for instance, to the centuries-long history of the Americas. Factor endowments, including climates, soils, and the density of native population, predisposed North America toward a path with relatively equal distribution of wealth and corresponding institutions that favoured of the participation of a broad range of population in commercial activity from the era of colonization (Engerman, Sokoloff, 1994). In contrast, Latin America was fain to develop in the opposite direction and the differences in economic performance between them is a clear evidence for our theory.

5. An individual against individuals: rent-seeking versus economic competition

Also, hierarchy naturally results in the situation where rent-seeking becomes an effective way of competition among individuals; this becomes even more effective if the degree of heterogeneity and the costs of interaction are high. This just aggravates the problem of simultaneous institutionalization of market and democracy. Rent-seeking does not only mean an unproductive use of resources, it may also result in providing wrong incentives leading to the selection of economically inefficient decisions and promoting those agents who do not possess the best knowledge, skills and technologies (Meyer and Vickers, 1997; Golikov, 1999). Such adverse selection arises if, in implementing economic policy, influential groups – in line with above – manage to substitute private interests for public ones. Then the choice shifts to alternatives that satisfy those private interests but which do not necessarily secure the greatest contribution to economic growth and certainly redistribute welfare for the benefit of those private persons and groups – thereby, moving the economy away from the Pareto-optimum resources allocation.

This last means that some of the physical and human resources needed for the implementation of the rejected alternatives become unemployed. A part of these resources may be forwarded to implementation of the selected decision but the other part will be redundant. In general, this means an excess supply: workers, for example, would be left with a choice between working for lower wages under their potential, and undertaking activities which are more rewarding, given the new distribution of economic power. If individual assessment of costs, losses, and difficulties associated with coordination, interaction, learning, and adaptation to new conditions, multiplied by the evaluation of risks, exceeds expected benefits, then, in addition to the deviation from the Pareto-optimum, a persistent long-run unemployment emerges, affecting with higher probability those resources and technologies which would be the most suitable for the satisfaction of public interests.

Accordingly, rent-seeking entails a decrease in the efficiency of democracy mechanisms in representing individual interests and in exercising control of the top levels of the hierarchy. On the other hand, democracy – at least in theory – is the institute that holds back the Leviathan. Here we encounter an obvious contradiction between the liberal economic order and democracy: institutionalisation of the liberal order, which implies rent reallocation, in a rent-seeking economy with deep distinctions between people as regards degree of economic influence and social status through democracy is simply a nonsense.

6. Liberal economy, development, and an authoritarian regime

Now let us turn to an analysis of the evolution of institutions and authoritarian governance. Examples from Latin America and post-Communist East Europe given in the introduction and Section 1 are useful in understanding this issue. Another example is Japan: there is no doubt that new norms, views, considerations, and concepts brought into Japanese society during the post-War American occupation became significant, if not necessary, conditions for a remarkable economic growth. It is interesting that Brazil, in contrast, "after the U.S. commitment to multilateralism in 1934, exploited a marked unwillingness by the United States to use its commercial leverage to constrain Brazil to adopt specific policies which would favor US interests – and this apparently contributed to Brazil's decline" (Cambridge History of Latin America, 1999). Similarly to Japan, three decades later in Malaysia and Singapore, authoritarian governments made economic growth possible.

However, by the end of the 1990s, when globalisation, integration, and the international financial market development had made each economy open and exposed to external shocks and, at the same time, drastically complicated coordination, the lack of democracy and liberalism generated crises in East Asia; structural disbalance and the current slowdown in Japan featuring quite different trends from those which had appeared during previous recessions.

As mentioned above, democracy is in fact a means of exchange of ideas; it brings about positive externalities, synergy, and allows the protecting of intellectual property rights. It also facilitates trade as a mode of coordination. This reasoning is becoming more and more important in the new global, highly integrated economy in which macroeconomic dynamics become increasingly determined by international companies' decisions, and which features almost perfect informational exchange and strongly relies on futures, options, and currency swaps. With these innovations, development will probably soon become impossible without democracy. Moreover, we believe that while the advances in communication technologies clearly work for convergence of nations, the lack of democracy may be a serious obstacle to development in the future. First, because it naturally freezes intercommunication as well as intellectual and human capital and, second, because it leads to reallocation of intellectual capital from unfavourable places, thus, restraining economic development and slowing, if not reversing, convergence.

Hence any policy-purporting economic development and long term growth should address institutions, should involve restructuring of formal institutions, and should be conducive to the introduction of new informal institutions. This conclusion allows us to offer a sort of recipe of economic liberalization. If democracy is not deep-rooted, if the historical background of democratic order is rather weak, a strong authoritarian regime (as defined at the beginning of Section 2) can help push-start and manage transition at the initial stage, especially if macroeconomic stabilization is needed. In such conditions, only an authoritarian regime seems to be able to secure property rights, to manage public finance, or to put in effect legal system favouring private property and market behavior. This will facilitate new views, perceptions, and social norms and shape new patterns of individual behavior.

All the above innovations which an authoritarian power can afford are essentially static. The authoritarian regime may also be able to efficiently maintain coordination in an unsophisticated economy with a simple structure. It follows from the same study by Barro (1994) that a negative overall effect of democracy on growth over 1960–90 appears as countries at low levels of development typically do not sustain democracy; for example, democratic regimes installed in newly independent African states in the early 1960s tended not to last. He argues that improvement in the living standards – measured by real per-capita GDP, life expectancy, and education – substantially increase the probability that political institutions will become more democratic over time. Development of liberal economy institutions will bring about welfare growth, so the country would tend eventually to become more democratic on its own.

But an authoritarian regime will probably not be able to manage the market in a complex economy enjoying a relatively high level of human capital and integration in the world economy.[3] Hence, after liberal market institutions have been established, the sooner the government turns its efforts, its power toward building formal democracy institutions, the higher is the probability that the economy will turn to sustainable growth. Thus, development of liberal market institutions will be driven, to some extent, by the development of informal democracy institutions which, in their turn, are supposed to be driven by the formal democracy institutions set up by the authoritarian government.

Not to put too fine a point on it, if people are not used to the liberal market, they should learn to become so. They can do it from macroeconomic stability and formal democracy institutions which should be, respectively, achieved, set up and maintained by the power of government. This logic suggests a reverse sequence of events and relies on a reverse causation that is apparently unusual and not in line with Barro (1994), who suggested that advanced Western countries would contribute more to the welfare of poor nations by exporting their economic systems (institutions), notably property rights and a free market, rather than political systems which typically are developed after reasonable living standards have been achieved. Therefore, one can assume that our proposal simply may not work. However, any other way of restructuring in countries with no liberal market institutions can hardly be seen and the examples of successful and failed reform programs, summarized in Section 1, support our conclusion.

7. Evolution of institutions, external conditions, and individual preferences

Now we come up with the question for policy-makers: can it be possible to stimulate emergence of new institutions and the crowding out, a meltdown of the old ones?

External conditions or an exogenous shock can make people change their views and behaviour. Once allowed, openness – or, for instance, a recognized failure of the central planning system – can seed the Communist society with the Weber ethic of capitalism and make adherents of communes accept private property rights. Macroeconomic stabilization, for example, can make people save more in deposits and other market-friendly ways. Dried-up rent incomes or economic freedom can lead to more efficient allocation of labour. However, the speed of adjustment varies widely across different post-high-inflation countries and no single regression has been found. Convergence of

[3] It is worth noting that the term ‘authoritarian’ has little in common with the term ‘central planning’.

East and West parts of Germany came to a halt in 1996–97, and this country even tends to repeat the case of Italy with its divergence of South and North. The East now suffers from a strikingly high 15–20% unemployment and, at the same time, unfilled vacancies with excess new capacities.

Not don only these examples suggest that, despite changing macroeconomic, political, and other external conditions, distortions may still exist. When external conditions change or an exogenous shock affects the economy, this naturally causes a response among individuals, so an adjustment process starts. However, such an external shock proved to be insufficient to generate needed changes in institutions. Insufficient or inadequate adjustment of institutions leads to rigidities in the dynamics of nominal and real macroeconomic variables. The problems of Germany can be explained by the crowding-out effect of the huge federal subsidies to the East and by fixing the minimal wage rates in the East as high as it is used to be in the West (see Sinn, 2000). But the attitude of many people in the East is obviously different to that typical in the West and this, we believe, does matter. Underdeveloped, low-liquid financial markets and limited credit is only part of the explanation as to why the gross saving/income ratio is relatively high in the Russian or South-East Asian economies. It would be worth examining the hypothesis that people in Korea or Japan are accustomed to higher saving and to planning for a longer perspective than are the Americans or Russians.

We believe that another possible explanation stems from the people's habits, beliefs, perceptions, ultimately from institutions, which shape individual preferences, though this conclusion still needs empirical testing. Forcing a person adjust to external conditions or to change his or her mind are different matters. The former is about constraint – the opportunity costs of behaving differently – while the latter concerns preferences, so individual mentality, the immanence.

The latter, therefore, concerns individual rationality and has an important implication for methodology. Each individual, in accordance with the neoclassical concept, is assumed to be free as to taste and a right to make choice, thus to be rational in oneself – and also restricted in access to information. The limits of information, the presence of asymmetric information, produce dependence of preferences. This may become crucial, for example, in understanding the response of economic agents to policies or other external shocks; thus, for the purposes of study, we suggest assuming endogenous preferences.

8. Conclusions

We argue for an increasing significance of a positive link between democracy, a liberal market, and economic development in the complex and new economy. However, the institutionalisation of democracy and a market at the same time, in a society without a relevant historical background, is problematical because formation of new institutions is contingent on the old ones. While existing institutions become inconsistent with a liberal economy, new institutions appearing as a result of individual adaptation to the new situation, may either support or hamper policy, and also be inconsistent with the liberal economy.

If in East European countries democracy functions imperfectly, this is not because of the absence of a 'culture' of democracy, but because that culture is subject to conflicting cross-pulls (Kelsall, 2000). On the contrary, application of democratic tools, such as majority voting and free elections or separation of powers, in countries with different than democracy historical tradition, is likely to bring about more of a political mess and further economic decline.

Thus, a successful policy for economic liberalization is impossible without the introduction and enhancement of democracy institutions. However, for this enhancement, even enforcement cannot be brought about with only vertical public control, since the latter is not only inefficient in the presence of old informal institutions but simply does not work due to the initially unequal allocation of economic and social power. Besides, due to the hierarchical organization of society, an effective way of competition among individuals becomes rent-seeking, especially if the degree of heterogeneity and costs of interaction of agents are high.

This is our understanding of what in Section 2 is called ‘the conservative nature’ of the democratic system. ‘Conservative’ means conserving the current state of society, protecting it against changes for a new order if the latter implies reallocation of rent to any small degree. So this logically requires developing a system of measures aimed at preventing adverse selection and rent-seeking. Any structural policy must be concerned for rent owners. A realistic scheme for removal agents who are expected to be expropriated from their rent, for instance, a scheme for compensations, should be worked out.

Therefore, if democracy is historically not deep-rooted, if experience of the liberal market is rather weak, a strong authoritarian regime empowered to use repressive tools of control is needed for implementing liberal economic reforms. However, we foresee two problems if the government is allowed to do this. Politically, the threat of Leviathan (Buchanan, 1975) eventually becomes unavoidable. Economically, limitation of democracy may become inconsistent with the complexity of the economy, the level of technology and human capital, thereby, deteriorating allocation of resources and restraining economic growth. It would be wrong to regard these impediments simply as the price to be paid by a society for allowing authoritarian rule. Indeed, these impediments are conditions shaping the evolution of the society and imposing on the decision making a set of restrictions, which should have been realized by policy advisors.

Therefore, authoritarian tools of control and decision making can help in running the transition at the initial stage, especially if macroeconomic stabilization is needed. But after that, the sooner the government turns its efforts, its power toward building democracy institutions, the more probably will the economy turn to sustainable growth. Thus, development of liberal market institutions will be driven, to some extent, by development of informal democracy institutions which, in turn, are supposed to be driven by the formal democracy institutions set up by the authoritarian government. Accordingly, authoritarian tools (as this term was defined in Section 2) remain the second best but still the appropriate choice.

Any policy must be coherent and a policy for new institutional development aiming at institutionalisation of democracy clearly must be consistent with macroeconomic policy. Development of institutions and economy is an iterative process but macroeconomic stabilization is not sufficient to generate the needed (or desired) adjustments in institutions favouring liberalization and irreversibility of the reforms. In this context, the Russian turmoil of the 1990s, referred to as Case 2 in the introductory section, should be considered as intrinsically predetermined by the centuries-long historical background and, especially, the social and economic performance during the Soviet period. The 70 years’ wasteful growth had come to its anticipated dead end by the 1980s. Gorbachev's economic program within the well-organized social institutions only accelerated the meltdown, and by 1991 had reduced the economy to a shambles. Furthermore, the Soviet legacy and reallocation of economic power during the years of perestroika, together with the institutional adjustments, became the most important reason behind the failure of the liberal reforms attempted by Yeltsin six years later.

Selected references

Alesina, A., R. Hausmann, R. Hommes, F. Stain (1996). Budget institutions and fiscal performance in Latin America, NBER Working Papers 5586.

Alesina, A. et al. (1992). Political Instability and Economic Growth. NBER Working Paper 4173.

Barro, R. J. (1994). Democracy and Growth. NBER Working Paper 4909.

Brunat E., X. Richet (2000). Asset specificity, restructuring and industrial policy in transforming economies: the Russian experience. European Integration and Economies in Transition, January 2000.

Buchanan, J., R. Wagner (1997). Democracy in Deficit: The Political Legacy of Lord Keynes.

Buchanan, J. (1977). The Limits of Liberty: Between Anarchy and Leviathan. University of Chicago Press.

Birdasll, N., C. Graham, R. Sabot (Eds.) (1998) Beyond Tradeoffs: market reforms and equitable growth in Latin America. Brookings Institution Press.

Caballero, R., M. Hammour (1996). On the ills of adjustment. Journal of Development Economics 51.

Cambridge History of Latin America (1999). Ed. by L. Bethell. Vol. 11. Cambridge Univ Press.

Campos J. E., D. Lien (1994). Institutions and the East Asian miracle: asymmetric information, rent-seeking, and the deliberation council. The World Bank WPS 1321.

Debating democracy's discontent: essays on American politics, law, and public philosophy. Ed. by A. Allen and M. Regan (1998), Oxford Univ. Press.

Dow G. (1987). The function of authority in transaction cost economics. Journal of Economic Behavior and Organization 8 (1).

Gaidar E. (1990). Economicheskie reformy i erarhicheskie struktury (Economic reforms and hierarchical organizations), Nauka, Moscow.

Golikov (1999). Adverse selection in hierarchical organization: competition against economic growth? Mimeo

Golikov, D. (1999). Russia, in: The CIS Handbook, ed. by P. Heenan, Fitzroy – Deaborn Publishing: NY.

Edwards, S., A.Cox (1987). Monetarism and liberalization: Chilean experiment. Ballinger: Cambridge.

Egidi, M. Virtuous and adverse selection within economic organizations, Trento, 1995.

Elster, Jon (1993). The necessity and impossibility of simultaneous economic and political reform. In: D. Greenberg and S.N. Katz (eds.) Constitutionalism and Democracy. Transitions in the Contemporary World. Oxford University Press, New York, pp. 267–274.

Engerman, S. L., Sokoloff K.L. (1994). Factor Endowments, institutions, and differential paths of growth among new world economies: a view from economic historians of the United States. NBER Historical paper 66.

Hachette, D., R. Luders (1993). Privatization in Cile: an economic appraisal. ICS Press: San-Francisco.

Kay, J. (1999). Invisible hand or chaos? Financial Times, December 8, 1999, p. 18.

Kelsall, T. (2000). Subjectivity, Collective Action and the Governance Agenda in Arumeru East. Queen Elizabeth House Working Paper 42.

Kofman, F, J. Lawarree. Collusion in hierarchical agency, Univ. of Washington in Seattle, Institute for Economic Research Working Papers, 1990.

Latin America's Turnaraund, ed. by P. Boeker (1993), ICS Press: San-Francisco.

Mahathir's anniversary plus: Kuala Lumpur after 20 years in power, can anything persuade the strong man to step down? Economist, July 14-20, 2001.

Mau, V., I. Starodubrovskaya (2001). Velikie revolutsii: ot Kromvela do Putina (Great revolutions: from Kromvel to Putin). Moscow – Vagrius.

Meltzer, A. (1993). United States leadership and postwar progress. International Center for Economic Growth Occasional paper 42.

Meyer, M., J. Vickers (1997). Performance Comparisons and Dynamic Incentives. Journal of Political Economy 105 (3), pp. 547-581.

Mueller, D. C. 1996. Constitutional Democracy. Oxford University Press, Oxford.

Mundlak, Y., D. Cavallo, R. Domenech (1990). Economic policies and sectoral growth: Argentina 1913-1984. OECD Development Centre Technical Paper 18.

Naim, M. (1995) Latin America's journey to the market. From Macroeconomic shocks to institutional therapy. International Center for Economic Growth Occasional Paper 62.

North, D. (1989) Institutions and economic growth: an historical introduction. World Development 17 (9), Pergamon Press.

North, D., R. Thomas (1973). The Rise of the Western World. Cambridge University Press.

Przeworski Adam, et al. 2000. Democracy and development: political institutions and material well-being in the world, 1950-1990. Cambridge studies in the theory of democracy, Cambridge : Cambridge University Press.

Rauch, J. (1995). Choosing a dictator: bureaucracy and welfare in less developed policies, NBER Working Paper 5196.

Rodrik, D. (1996). Coordination Failures and Government Policy: A Model with Applications to East Asia and Eastern Europe. Journal of International Economics 40, pp. 1–22.

Sachs, J., Wing Thye Woo (1997). Understanding Chaina's economic performance, NBER Working Paper 5935.

Sartori, Giovanni 1994. Comparative Constitutional Engineering. Macmillan, London.

Schmuhl, R. (1994). Demanding democracy. University of Notre Dame Press.

Sen, A. (1999). Democracy and social justice. International conference ‘On Democracy, Market Economy, and Development’ (Feb 26 – 27), Seoul.

Sen, A. (1987). On ethics and economics. Royer Lectures Series. Oxford: Basil Blackwell.

Sinn, H.-W. (2000). Germany’s economic unification: an assessment after ten years. NBER Working paper 7586.

Soili Nysten-Haarala (2000). Development of Constitutionalism and Federalism in Russia. International Institute for Applied Systems Analysis, Report IR-00-042.

Stigliz, J. (1994). Wither Socialism? The World Bank.

Swedberg, R. (1998). Max Weber and the idea of economic sociology. Princeton Univ. Press

Taylor, A. M. (1999). Latin America and foreign capital in the twentieth century: economics, politics, and institutional change. NBER Working Paper 7394.

Valenzuela, J. S. (1994). Issues in democratic consolidation: The New South American Democracies in Comparative Perspective. University of Notre Dame Press

Wintrobe, R. (1999). The political economy of dictatorship. Cambridge Univ. Press: NY.

Russian-European Centre for Economic Policy

Potapovsky Pereulok 5, building 4, Moscow 101000 Russia
http://www.recep.org
e-mail: recep@recep.ru
tel +7 (503) 232 3613 fax+7 (503) 232 3739