Institutional Foundations of the Market Economy with Reference to the Transition Process taking Place in Eastern and Central Europe

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The formerly socialist countries in Central and Eastern Europe are restructuring their agricultural economies. Some are selling state enterprises and distributing land, legalizing the market, allowing private property, abolishing price controls, and reducing government food subsidies and other spending. This seems to be the agenda suggested by both the popular press and a lot of economists. There is only a little argument among economists over how fast this is to be done, though there is a lot of argument among politicians. Attention is focused on the convertibility of currency, tariffs, and when to open the stock market [Sachs 1990, McKinnon 1991, Claassen 1992]. These macro systems choices hold center stage, but there is a micro institutional foundation of the market that needs attention [Neale 1991]. Depending on the detailed rules, there are many different kinds of markets available. Which kind do these countries want? Or can they truly stand aside and let the best of all possible worlds emerge spontaneously? If new enabling rules are needed, which ones should be developed first?

To help answer these questions for policy makers in these countries, it will be useful to review some institutional theory, history and make a few observations. Peter Murrell (1991, 72-3) observes that, "In matters of economic reform, the skills and knowledge more usually associated with the philosopher and the historian must supplement those of economic theorist and the econometrician." First, some theory. Economic interdependence creates conflicts and these conflicts have to be worked out. Order and predictability are not to be taken for granted, but are the creative product of shared, collective choice. Freedom is not something that pre-exists in nature. It is the product of the choice of institutions [Polanyi 1944, Ch. 21]. Political economy and the legal-economic nexus mean that law is one instrument which defines what is economic growth given the need to resolve power struggles [Samuels 1989].

There is an emerging consensus on the basic concepts useful to study economic institutions. One of the concepts is the transaction as the unit of analysis. The second is that there is a set of goods characteristics which create different kinds of interdependence which are then directed by institutions to create a predictable performance. These characteristics include incompatibility, exclusion costs, economies of scale, transaction costs, and others. These different situational variables will be implicit in the analysis to follow. For theoretical detail see Schmid [1987]. It will be useful to note that agriculture differs from some other industries with respect to these characteristics and thus institutional issues may differ.

There is less consensus on whether there are genuine issues of power in any economy or whether they can be subsumed under the drive for efficiency. Institutionalists such as Allan Gruchy [1987] have made a strong case for collective planning even in market economies. The
"new institutional economists" such as Oliver Williamson [1985] have made a case for private governance. If public government will just get out of the way, people will bargain their way to an agreement on institutions which will achieve efficiency and maximize joint product. Williamson argues that much of our distrust of monopoly and non-standard contracts is misplaced because these arrangements often further efficiency. The parties in a market will choose just the right mix of hierarchy (integrated firms) and market contract to minimize transaction costs.

The economic historian Douglas North [1990] also emphasizes that the path to development is paved with institutions which reduce transaction costs and allow the maximization of the gains to trade. This not only requires government keeping its hands off private property but also contract enforcement which increases the predictability of one’s opportunities when they conflict with others. The historic success of England versus Spain is credited to arbitrary taxation and confiscation by the Spanish kings while the English barons kept their king at bay [North and Weingast 1989]. But we shall observe below that the early American government did a lot of clever confiscation to obtain a certain kind of growth. The right mix of continuity and change is difficult.

The coordination and combination of specialized activity mostly requires a passive role for government according to Williamson and North. Where contracts can be written to cover the relevant eventualities, government is only required to enforce private promises. Where contracts cannot be complete because of uncertainty, government should stand aside to accommodate benign private hierarchy. There is only joint profit maximization in this harmonious world, though sometimes it is recognized that there may be strategic bargaining over the division of these joint gains. On the other hand, Peter Murrell (1991, 72) observes that while "Nobody doubts the poor technological performance of the centrally planned economies...the causes of technological laggardness can be explained by many different theories, each having different conclusions for reform."

Now for some contemporary observation. Hernando De Soto [1989] provides a dramatic illustration of the constraint of governmental regulation. He pretended to establish a new business in Peru and documented the time and resources wasted to obtain all the necessary permits. In such an economy, all opportunities are obtained by tribute to bureaucrats. To avoid these costs, firms operate in the informal economy. But De Soto notes that there is a major drawback to being outside of the law. Government is unavailable to enforce contracts. The informal economy works fine between people who are related and known to each other. But you can’t take advantage of economies of scale and scope that way. This requires impersonal trade at a distance (Commons 1924).

Another major theme identified in the literature is the need for law to facilitate the aggregation of capital for development. This leads to the rules for the formation of corporations and to the institutions of credit, money and negotiable instruments [Galbraith 1975; Samuels and Miller 1987; Calomiris 1990].

Is there more to the role of government than contract enforcement and to define which goods should be publicly provided? Institutional analysts argue that cost is something chosen not found. When "growth" creates costs on others in an economy, does the actor have to compensate the loser or must the loser pay to avoid the effect if able? What is seen as a cost of action and to whom is a matter of rights. Legal historians such as Willard Hurst and Morton Horwitz note that American law seemed to express a preference for active developers over
passive rent collectors, which often meant a preference for industrial over agrarian interests. But thieves and gamblers are people of action and some selection seems necessary. This gets into the world of politics, ethics, and power play. Some choice among competing interests is inevitable.

To summarize thus far, several roles for the state in development have been advocated in the literature:

1. Get out of the way of private governance.
2. Reduce transaction costs to realize gains from trade. Be careful with anti-trust policy since integrated firms (hierarchies) may be desirable. Predictability of one's relative opportunities is fundamental.
3. Facilitate the aggregation of capital.
4. Reduce what is a cost to developers.
5. Favor developers over rent collectors.

Institutions as resolutions of power conflicts or institutions as rational instruments of efficiency is one way to look at the choices facing the formerly socialist nations today. Another perspective is Efficiency #1 vs Efficiency #2 where the issue is whose preferences and costs count when efficiency is calculated. We will explain the difference as we go. First, a bit more observation.

In Central & Eastern Europe (CEE), several countries are modernizing their commercial codes. In 1991, Czechoslovakia revised its pre-war code by adding new material patterned after German commercial law. These countries seem to be following Harold Demsetz's [1991] advice that legal capital must be acquired quickly. "Once adopted, say from Germany or Austria, this legal fabric, over time, can be shaped more appropriately to serve Hungary's special conditions (1214)." But, is all western legal capital the same?

One can't help but wonder if the commercial code that is appropriate for modern Germany or any rich country is appropriate for new market economies at a different stage of development. Does Eastern Europe have any further choices to make now that it has chosen the market? Do these countries have to ask which market? Do they have to examine their micro-institutions and the social system in which they are embedded? Do they have to make plans or are all good things spontaneous and automatic? Are these things easily changed later or will the institutions be path dependent? Will they need democratic politics and an ethic to choose among conflicting interests or is it all a matter of every one wins from a reduction of friction? For some clues let's look at a bit of history. The history of all successful countries would be relevant, but to keep the story manageable, I will look primarily at U.S. legal and institutional history during its period of rapid industrialization 1790-1850. Conclusive evidence should not be expected. The world of scholarship seems divided between those who speak of legal transformations to accommodate a certain kind of growth and to choose between interests, and those who speak of harmony and rational maximization from more or less timeless legal or economic principles—you want more rather than less don't you? Morton Horwitz [1977] observes a transformation in American law from 1790-1850 to fit the needs of merchants and industrialists at the expense of others, while Simpson [1979] and Teeven [1990] emphasize
continuity of principle. The latter theme emphasizes finding the law with improved logic while the former emphasizes creating the law to fit the dominant interests (dare we say classes).

**Historical Role of the State In A Market Economy**

Before just any Western capitalism is accepted wholly by new market economies, let’s be clear on where the U.S. came from. Five areas will be reviewed. 1. Macro-Policy, 2. Direct government investments, 3. Laws determining what is a cost to whom, 4. Commercial law, and 5. Law of negotiable instruments.

**Macro-policy**

Several things are basic to a market economy in agriculture: land tenure, monetary and credit policy, and competition policy including international barriers to trade (tariffs, etc.). Also basic to any economy are its human capital (education and training policy which is the subject of another background paper), infrastructure, and the basis for collective action in general. I don’t have an easy answer to which of these must be developed first since they all evolved together in the West.¹ In one sense, all are now needed at once, but since that is impossible, we need to be aware of how they are complements and substitutes for each other. Even after it is decided that private parties may own land, it is necessary to decide how one private party’s actions may affect another.

A market economy rests upon first deciding who has what to sell. There must be rules as to who controls natural resources and the structure of incentives of the participants (Brooks 1990, Schmitt 1990, Vandor 1992). Land tenure is the subject of another paper in this conference and thus is not elaborated here, except to argue that the outcome of changes in tenure depends on other complementary institutions. I would also like to call attention to a unique opportunity which the new CEE market economies have. Agricultural land will be converted to non-agricultural uses often as a result of public investments in transportation and other investments outside of agriculture. In most Western market economies, this process results in a capital gain to the lucky owners. The attempt to capture this rent frustrates public land use planning in the West and is often a source of bribes and corruption of public officials (Schmid 1968). The CEE countries have an opportunity to ask themselves if they want to follow the Western example or to regard the unearned land price appreciation as owned by all citizens whose efforts created the rent (Tideman undated).

**Direct Government Investment**

State and local governments made sizeable direct investments in post colonial America. They built roads, canals, and later railroads [Goodrich 1968, Sellers 1991]. The Pennsylvania Railroad was named after the state who was a major stockholder. The same was true of cities who made major investments in transportation and utilities. Cities were the first corporations who mobilized capital for works of improvement. Many of these were later sold. Maybe that’s the secret--knowing when to get out. The dominant contemporary theme is now privatization, but it was not dominant during our early rapid growth. Capital was scarce whether collected in taxes or attracted to shares. Governments searched for and found ways to make capital go further.
What Is A Cost To Whom?

There are inputs into a production function which are not costs to the decision maker. Cost is a function of rights. When a road or canal is built, some previous services of the land are lost. Government can tax everyone and compensate for these losses or it can simply assert that these opportunities were never the rightful property of previous users. Some states actually built roads without any compensation for the land. It was argued that the resulting increase in land value would more than compensate for any lost surface. This amounted to a kind of forced investment as a result of a collective decision rather than an individual purchase of shares. Less extreme were those marginal damages to previous activity which were not compensated. Governments or their associated private investors saved a lot of money by not having to pay for damages. Horwitz [1977, 63] sums this up by saying, 'The process of economic development in the United States necessarily involved a drastic transformation in common law doctrine which required a willingness on the part of the judiciary to sacrifice 'old' property for the benefit of the 'new'." Development requires choosing sides.

The erection of water powered mills was a strategic ingredient in the development of the country. The states did not have much in the way of direct investment but they did plenty to help private investors. Sites for mill dams and their reservoirs were scarce. Land owners of rare sites were in a position to capture much of the rent of a mill. To lower mill costs and reduce uncertainty, the states passed Mill Dam Acts which allowed condemnation of private property by another private party. [Sellers 1991, 52; Horwitz 1977, Schmid 1960] This meant that land owners received only the price for average land and not the unique site value. Previously, juries set the amount of damages. This subjectivity created uncertainty and it can be imagined that local juries favored the interests of long time landed interests over those of industrial upstarts. So the courts began to replace juries with court appointed appraisers.

And as if that wasn't enough, the courts disapproved of damage claims by users of the natural stream and its banks. Horwitz [71] states his transformation thesis thusly,

"At the beginning of the nineteenth century, ... courts were prepared to award damages for injury to property regardless of the social utility or absence of carelessness of the actor's conduct. By the time of the Civil War, by contrast, American courts had created a variety of legal doctrines whose primary effect was to force those injured by economic activities to bear the cost of these improvements."

Even the mills got in each others way eventually. In Palmer v. Mulligan2 [1805] a downstream mill owner asked to recover damages from a new upstream mill owner. The court refused to apply common law rule against obstruction of natural flow, but rather emphasized a functional analysis saying the upstream mill furthered competition. Soon the economy needed larger dams to support integrated cotton mills with their economies of scale and scope. But a bigger dam might flood an existing smaller upstream site. In Cary v. Daniels3 [1844] the court forgot its competition dicta and went for the advantages of scale.

Was this better for everyone? Were the gains in output large enough that the integrated mill could have bought out the smaller mill if the smaller mill had been granted rights to damage? At the average value of small mills, or at the strategic price that could be demanded for limited sites? Location of liability has substantial wealth effects [Field 1991]. It is doubtful that the resource would have had the same use regardless of the placement of ownership. The
courts spoke of efficiency, but it had a more qualitative meaning of a sense of direction. Big mills were determined to be progress and the law accommodated them. It helped not to worry about the income distribution departures from voluntary exchange. Today, liberals would probably object. But, where would we have been if the entrepreneur of the proposed integrated mill had to convince a banker to loan money to buy out the small mills? It seems like a profitable idea now, but these were uncertain projects then. Does development require collective choice of direction as well as incentives for individual calculation of marginal gains in bilateral trade?

The general issue here is one of continuity vs. change. If you want change, first in time can't be first in right. The court could say that property rights meant complete dominion over one's own land [Horwitz, 1977, p.105]. In the Hohfeldian and Commons view of property correlates, dominion and freedom for one party mean exposure and non-freedom for someone else. Freedom cuts both ways and never dispenses of interdependence. The court was choosing the definition of development and not protecting freedom in the abstract. It needed and in fact made a moral judgment choosing between conflicting interests though it did not always admit it.

What has this to do with new market economies? How are these little court cases relevant? Isn't the big issue capitalism vs. socialism? Firstly, the path of development is one of detailed resolution of all the ways that one person's actions affect another. After the market system is chosen, the question is which market and what are the market rules. Secondly, the cases suggest that the law must fit the time. America changed the English common law to suit its purposes [Nelson 1975, Bakken 1983]. That raises the question as to whether German, French or other modern law fits CEE's purposes. Stability is functional, but so is the necessity of change.

There are other human costs of progress. Industrialization and machinery create more opportunity for accident and injury. In the 1700's the American common law rule was one of strict liability. If your fire got away onto a neighbor's land it was a nuisance and you were liable. Same for your horse injuring a passerby. But as machinery proliferated the courts turned to the concept of negligence where the employer was liable only for gross negligence [Horwitz 1977, 85]. Loss of an arm in a machine was not the result of a direct act of the employer. Perhaps it was the result to a careless fellow worker, raising the question of liability for employee torts. These injuries were conceived of as inevitable and no one's specific fault, an act of god. Is this acceptable today?

Some less affluent countries have elaborate labor laws similar to rich countries. Worker's compensation statues protect workers against injury and dismissal. The result is higher labor cost relative to 19th century America. Even 20th Century America exempted agriculture from workers compensation laws. As De Soto observes, some firms escape these costs by hiding in the informal sector. But this means no economies of scale and no contract enforcement. Can less affluent countries afford western style labor rights? The West did not have these rules during its industrialization.

Regulation and court imposed rules of liability are substitute institutions. The rules of strict liability enforced by courts were the 18th century equivalent of today's Occupational Safety and Health Agency. So the choice is not just regulation vs. the free market, but what are the rules of the market. Who owns what? Under socialism there is some rule for who pays the medical care and lost salary of an injured worker and under the market there is either a regulation or a liability rule. The former socialist bureaucrats worried about their jobs should
take hope. They can all become negligence lawyers. So the issue is not regulation vs the market, but what inputs to production have to be paid for (who bears the cost of development).

Today's policy makers interested in natural resources issues can learn from cases like **Lexington and Ohio Railroad v. Applegate** [1839]. Citizens objected to railroads being built through cities because of noise and dirt. The railroads feared injunctions which would have meant that they would have had to buy the right to quiet from many citizen owners. Transaction costs were not zero. The location of ownership would have affected resource allocation and railroad building. Yes, we had environmental policy in 1839 and it had something to do with the path of economic development. In Eastern European countries with socialist ownership of land, government enterprise could proceed without paying environmental damages (Bochniarz 1990). Now if these industries are privatized, will they have to pay damages? Who are the approved developers and who the rent collectors? Private buyers of state firms in Eastern Europe must be concerned about their liability for the firm's past waste dumps. The placement of liability continues to play a role in the direction of economic development. In the U.S., the private nuclear industry could not have prospered in the face of uncertain and probably uninsurable risks of accidents without legislated limits to private liability for damages.

From the earliest of times, farmers' rights were defined by fence laws and trespass. Today, there are issues of strict liability or negligence for aerial crop spraying, personal injury to workers, effects on neighbors (attractive nuisance), and many other interdependencies which affect costs of production (Harl 1980, Looney 1990).

In early America, you could not start a business without the government's permission. Significant enterprises required a charter from the state. These charters served several purposes. As already noted above they served to cloak the business with the public interest and gave the enterprises rights normally reserved for public corporations such as eminent domain. Charters also served to regulate competition in a world of fundamental uncertainty of returns. For example, the State of New York offered a transportation monopoly on the Hudson River if Robert Livingston could invent a steam boat within a certain period of time. The state was not in a position to offer a cash prize or contract with a university, and expected competitive returns were not enough to bring forward the private investment.

Economies of scale and specific assets create coordination problems for countries who want to start up a new agro-industry. Suppose a firm thinks it might be able to compete in world markets for sugar. It needs a large plant with economies of scale. It needs to be assured that a sufficient number of farmers will grow sugar to satisfy its volume requirements. And because of specific assets, it can't have farmers changing their minds before the cost of the factory's capital assets have been recovered. In centrally planned economies, the land and factory could have been an integrated enterprise (Wadekin 1990, Hunek, et. al. 1992) In a market, the sugar processing firm might try contracts and hope that it has thought of every eventuality. But contracting costs would be high. And because of risks, it may be hard to persuade enough farmers to accept a contract. And, of course, the sugar plant cannot accept the possibility of a competing plant. So the government of Indonesia required farmers to grow sugar. If they didn't plant sugar, the refinery could plant sugar on private land with their own hired labor. The farmer can't suddenly decide to grow vegetables because of price changes. This sounds heavy handed and just the kind of thing the CEE wants to get rid of. The choice is not easy.
Similar arrangements occurred in contemporary Kenyan tea and sugar. The Tea Act gives the Tea Development Authority legal rights to take over the land under tea if the grower neglects it. [Buch-Hansen and Marcus 1987, 541 and Bates 1989]. With respect to sugar, the state preferred a contract farming pattern but the management firm "did not trust the farmers' capacity to deliver a constant and sufficient quantity of cane to the factory and hence demanded a nucleus estate run by the factory [Bates p. 542]." Management had a preference for estates and large scale farmers while the state preferred small scale contract farmers. "If the contract farmers do not carry out their obligations, they receive a warning. If the job is still not done, the company will have it done and charge the farmer for the service [Bates, 544]." This requires concurrence by the state.

It is not reasonable to expect this all to happen incrementally via private governance. If the state wants small scale contractors it will have to supply the safeguards or the factory will utilize integrated estates with wage labor, if it is legal. As Robert Seidman [1968, 542] puts it, "The state, by enforcing private agreements, lends its reserved monopoly of violence to enforce the norms agreed upon by the parties to the interchange (and) since every decision-making function is necessarily value laden, the state is not and cannot be a value neutral arbiter." Private governance is not the way Japan, Singapore, Taiwan or Korea did it, but that's another story [Amsden 1989; Rauss 1990; and Solo 1991, Ch. 4]. Privatization is a nice slogan, but anyone who believes that market coordination is a simple matter of declaration may fail or be an unwitting partner to an unforeseen growth and distribution pattern.

Consider an agro-industrial subsector such as the beef industry. In the U.S., consumers are demanding leaner and more convenient cuts of beef. Despite the fact that the U.S. is composed of profit oriented market firms, they have not fully responded to consumer preferences. The parties in the chain from the beef producer, to the slaughter-packer, to retail stores must all change in a coordinated way for all to profit. New cattle genetics are needed in connection with new feeding methods so that animals don't accumulate the fat in the first place. Cattle might be sold on a dressed carcass basis to encourage and reward lean animals, but farmers don't trust the packers to determine carcass grade. Some trimming and processing might be done with more economies of scale at the packing plant rather than in the back room of the retail butcher shop, but retailers need a better accounting system to understand the affect of this on their retail margins. The large integrated agro-industrial co-ops of some CEE countries may not have done a good job with this type of coordination either, but it will not be automatically solved by privatizing and breaking up these firms.

Commercial Law

After a country has chosen to be a market economy there are many more choices to make. For example, when a contract is broken and an appeal is made to the courts, a choice must be made between expectation damages and reliance damages, rules must be defined about what constitutes an offer and its acceptance, what constitutes the free will of the parties, what constitutes a material breach of contract, what are the rules of interpretation, and for formal requirements like recording and writing of contracts and titles to land (Erosi 1981). Governments must decide whether to regulate the substantive terms of some contracts through usuary laws, statutes of fraud, implied warranties, enforcement of perpetuities, etc. Will the state support one-sided exchanges? How will it treat contracts of adhesion? Can firms use contract terms to avoid the consequences of their own negligence? Daniel Oстas (1992) suggests that for some countries such as Hungary and Poland, reform may not require new provisions, but it will be made by re-interpreting previous provisions.
Contract law is what parties turn to when they think the other party has not lived up to the contract. This is where they learn what their words really meant. Contract law is what prevails if a matter at issue is not explicitly mentioned in the contract (for lack of certainty as to what to include or whatever reason). When trade was stable and prices customary, the American court could assume that all contracts implied the customary price and could enforce its payment according to its standards of justice regardless of the prices named in the contract. As markets became speculative, there was no natural price. This is a problem for CEE.

Modern markets are transactions in the present based on subjective future expectations [Lowry 1973]. When one party's expectations are thwarted by non-delivery of contracted for goods, the loss is not the price at the time of contract but the price at the time of delivery—which supposedly is what the buyer had in mind. Horwitz [1977, 169-70] observes that enforcement of executory contracts was rare until the 19th century. In Muir v. Kay [1787] a buyer of tobacco sued for non delivery and the seller counter sued for payment. The court would not enforce the contract because the buyer had not yet paid. Supposedly, the buyer could pay and then sue for damages for non-delivery. But what would be the basis for damages? In the fast moving world of modern commerce, the tobacco may already have been sold to a third party before the physical delivery date. It was not until 1790 that an American court said "Whenever a contract is entered into for the delivery of a specific article, the value of that article at the time fixed for delivery, is the sum a plaintiff ought to recover" (Davis v. Richardson).

English and early American courts sometimes voided contracts for lack of consideration. This meant that the court could substitute its own conception of fair value for the amounts stipulated in a contract. Horwitz argues that this substantive standard for price had to be abandoned in the modern world of speculation and executory contracts. So the courts invented the "will theory" of contracts. It would just execute the wills of the parties. But since wills are subjective, all that can be seen is the words of the contracts. The courts are the arbiter of what these words mean and of what was implied to cover an eventuality not anticipated. The active role of government can not be escaped. There are as many laws as there are ways for people to bother each other. The possibility of a minimal night watchman state is a myth. Pick up any commercial law book such as Atiyah's The Sale of Goods or Looney, et.al Agricultural Law and one is impressed by the variety of ways that people do bother each other. Consider just one example. What governs the right to reject goods as not conforming to the contract? Assume A agrees to sell peas to B, but delivers beans instead. In the meantime B sells to C without inspection. Can B or C have recourse to A? Can the contract be repudiated, payment denied, or if already made, can they get their money back or just sue for damages, and how will damages be computed? Karl Llewellyn [1936] describes the evolution of customary warranty of quality as the English speaking world evolved from the caveat emptor of horse trading to modern markets with more liability upon sellers in a marketing chain. But there is little capitalist custom to refer to where markets have been illegal and disputes were settled by appeal to the party hierarchy. And if the custom of England, France, or Germany is used, does it fit where CEE countries want to go? If America had to reject parts of the English common law to fit its situation and objectives, do the CEE countries have to reject some of the commercial code of the rich countries? Do modern western laws work in areas where supporting institutions are weak or missing?

Consider the case where a party has a contractual obligation to pay for a previously delivered good at a certain future time. The party owing the money may know that the provider of the good is near insolvency and therefore might accept partial payment because they could
not wait until the court could hear a suit for contract enforcement and damages. U.S. courts up to the 1950’s supported these contract modifications and offered the rationale that the insolvent party had the option of turning to the credit market to carry the firm over until the court could enforce the original contract (Teeven 1990, 306.) Whatever merit this argument had in the U.S., it seems less relevant in a CEE country where capital markets are less developed.

The rules for trade in agricultural commodities must accommodate to high transaction and information costs. What if diseased livestock or poor quality seed is delivered but not immediately observable? What constitutes grounds for breach of contract? What if mortgaged commodities were sold without the lenders permission? Even before the U.S. evolved such statutes as the Packers and Stockyards Act and pure seed laws, these conflicts were settled by court made rules or the uncertainty as to resolution reduced the volume of profitable transactions.

_Negotiable Instruments, Credit, and Money_

Person A agrees to give B a quantity of goods or sum of money at some future date. B in turn endorses this IOU and uses it to pay C for some service, and so on. Is this legal, and if A defaults can C have an action against A or any of the other endorsees? In a cash short economy, the negotiability of debt substituted for money and greatly increased its velocity [Lowry 1973]. But American states were divided in their attitude toward negotiability. One of the concerns was that if person A had good reason to repudiate the contract with B, was that good reason now lost because of C’s need to be able to rely on the second hand IOU. The needs of long distance impersonal trade had to run over a few individual problems in the way.

What is the relevance to CEE? Are wholesalers organized and are their IOU’s used as money? Do banks loan money based on warehouse receipts, and could the receipts themselves be negotiable among individuals? Is the problem one of grades and reliable warehousemen, attitude toward paper, or the law of negotiable instruments? These are candidates for future research.

Much has been written about credit problems in agriculture [Calomiris 1990]. Every merchant sees new opportunities if there just were more credit. What is credit? For one thing it is a substitute for cooperation. Suppose a wholesaler is aware of supplies in farmers’ storage bins and opportunities for delivery in large cities. To buy from the farmer requires credit. To buy trucking requires more credit and so on for all the participants. But if all these people were one integrated firm, they would all wait for sale of the goods at retail. A family work team does not demand payment at the time of individual performance.

Because of the contemporary credit crunch in Eastern Europe, firms risk insolvency and can’t pay their bills because they have not been paid in turn by their customers. In this context, the rules for trade in negotiable instruments may be especially relevant.

_Unemployment and Banking_

The problem of unemployment is an institutional failure [Schmid 1982]. If there are skilled people and natural resources why are they not used? It is common place to say they are waiting for scarce capital. But, they are also waiting for organization and coordination of their skills and expectations.
It is an accepted dogma of modern economics that the creation of money must be centralized to avoid inflation and crashes. But, America during its period of rapid growth did not have an orderly centralized banking system [Galbraith 1975]. It had local banks who saw local opportunities empowering local entrepreneurs to act. Not all of them worked to be sure, but they kept trying. Today their equivalents wait for the IMF and the World Bank. Unfortunately, some of the legal options that the U.S. had during its period of rapid development are not available to the newest capitalist countries who have to play by IMF rules. Wikto Herer (1990) suggests that "One can hardly imagine massive creation of new private firms under a general recession, which in Poland simultaneously leads to growth in cost and fuels inflation." The health of agriculture is linked to off-farm demand for labor which is inextricably linked to monetary and industrial policies.

Ownership of Markets, Forward Markets and Uncertainty

Farm produce markets in the rich countries are marked by disequilibrium and over production. Even colonial America had government production restrictions on the planting of tobacco. In theory, market competition will eliminate just the marginal producers and the market will clear at prices equal to costs of production. Many economists still believe this and recommend that we all take the free market medicine one time and all will be well. But the western countries can hardly prescribe medicine that they have declined to take (Tutwiler 1991). Could it be that agriculture does not fit the theoretical model? Could it be that the margin is a large lump, and any price that eliminates the production overhang also eliminates so many needed producers with similar costs of production that there would be widespread misery? Agriculture is also marked by substantial immobile assets and high transaction costs. As long as economists prescribe medicine that no one will take, governments will continue to spend large amounts of money for farm income support because they have not been offered any palatable institutional alternatives. The CEE countries may want to consider some experiments that could be models for the West. Land ownership does not assure access to predictable markets. Is it time to consider direct and tradeable ownership of market share at the same time that CEE countries are writing rules for tradeable ownership of land?

"The volatility of price and output within agriculture, and the absence of insurance markets, imposes unacceptable risks upon farmers, necessitating price stabilization programs," says Joseph Stiglitz (1990). At the time investments are made, the farmer has only a guess of what price can be realized. Charles Calomiris (1990, 10) observes that "It is an unfortunate irony that some of the riskiest assets in the economy are held as the sole form of wealth by some of the most risk-averse investors." Widespread use of futures markets has not developed even in the West because of transaction costs including asymmetries in information between farmers and large grain dealers.

James Shaffer (1990) has proposed a full participation market for contracts for actual future delivery. Buyers and sellers would participate in a double auction prior to planting and breeding seasons, each participant committing to quantity and price contingent on weather. Everyone's bid and offers are known to everyone in a nationwide computer market system. In the case of poor weather and a short crop, each buyer's contracted quantity would be adjusted downward by the percentage the actual crop was compared to the total. The contracted prices would be increased by the same percentage, leaving the total revenue equal to the contracted amount. Such a market in delivery contracts offers a real alternative to existing spot markets and gives deeper meaning to the theme of this paper that we must ask what kind of markets we want--not just do we want markets.
Conclusions

Markets are not completely automatic, self-regulating, or spontaneous. Now that Central and East European countries have chosen the market, the question becomes which of many different markets do these countries want. The answer to this question will become the micro-foundations of their markets in the future. Growth creates costs and conflicts. Who bears these costs and how the conflicts are settled influence the path and content of development. Everyone wants to be efficient--no one wants waste. But it is the detailed property rights and other institutional rules that reflect the choice of what to be efficient about, i.e. the content of the input and output categories which reflect whose preferences count.

What is a cost to whom? Markets, yes, but who is buying what from whom? When growth creates a cost, does the creator of the cost have to reimburse the damaged party or does the person harmed have to buy the opportunity to be free of the impact? This question involves everything from the impact of industrialization on agriculture and natural resources to worker safety.

Markets create incentives for coordination among separable activities in the production-marketing chain. But, there are information and assurance problems. Firm A could make more money if firm B were in place, but each may not be able to move incrementally to where they both want to be.

Everyone agrees that the government should enforce contracts. But, the words in a contract do not speak for themselves--they are interpreted by courts. The probable assessment of damages provides incentive for firms to perform as promised, but the basis for the amount has to be chosen from several possibilities. The government cannot escape the moral dilemma of enforcing what turns out to be very one-sided exchanges.

Western countries do not all have the same commercial code. Which one does the Central and East European countries want and which one fits other complementary institutions such as credit and insurance markets.

Agricultural markets are marked by disequilibrium and overproduction around the world. Some say it is because of too much government, and some say it is too little or the wrong kind. The argument rages and some policy innovations would be useful. The new market economies may have some options that the West does not. We have too many vested interests who block change even if all agree the present system is not the best. Whatever market foundation choices Central and East European countries make now will be the vested interests of tomorrow. It is not possible for these countries to answer all the questions I have raised before proceeding. The legal foundations will get placed and systems will evolve. But, there will be no chance to choose the direction of development if it is assumed that once markets and private property have been chosen there is nothing else requiring national debate and collective choice.
Amount or Kind of Government?

When Hernando De Soto [1989] pretended to set up his clothing factory in Peru he faced a lot of government constraints. But a lot of constraints are someone's right to be free of losses due to the actions of others. Some of the regulations are there to provide safety to workers and consumers. These are good objectives for many people, though I have raised the question of whether less affluent countries can afford them. But in any case, even good objectives frequently go wrong and become excuses for bureaucrats to extract bribes. The welfare state is difficult to manage. De Soto recommends that his country

"replace the state's regulatory control of the economy by control expressed in judicial decisions. It means granting access to the market to all citizens and extending facilitating legal instruments to all. It means increasing the proportion of available resources so that the state can do what private individuals cannot do well. Last, it means delegating to informal organizations the responsibilities they can best meet." [p. 250]

These are worth consideration, but difficult in practice. Even where the formal law is adequate, making it accessible to small firms is another matter.

Does De Soto's suggestion that the courts replace direct governmental administration of health, safety and other objectives mean less government and an escape from politics to rationality? Horwitz suggests that there was an alliance during the 19th century between U.S. lawyers and commercial interests to replace popular politics with an apparently rationalistic court process. Maybe this process fooled the losers who could not have been beaten in the legislature. Maybe De Soto will fool the losers in Peru and get the IMF off the government's back. Maybe the judges will not just replace the old corrupt bureaucrats. And maybe history will declare it all in the public interest. But, current policy makers should not be fooled. The size of the government budget or extent of state ownership is not an adequate measure of the role of the state in choosing among competing interests and promoting a particular kind of development. American history reveals periods where state budgets were constant for over a generation while the roads, canals and mill dams were built, but many of the costs were shifted around as the micro institutions of the common law of property and contract were changed. Several different kinds of government are probably consistent with improved economic performance.

Policy makers in Central and Eastern Europe will miss a unique opportunity if they fail to see that there is more than one kind of market possible. Efficiency is not a unique outcome, but follows from the choice of rights that determine whose interests count.
References


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I cannot put it better than Vaclav Havel (1991) who said, "Each day brings new problems, and each day we realize how interrelated they are, and how difficult it is to establish the proper order in which to deal with them."

2. 3 Cai. R. 307 (1805).

3. 49 Mass (8 Met.) 466 (1844)

4. 8 Dana 289 (Ky. 1839).


6. 1 Bay 105 (S.C. 1790).