Free Markets at a Price

Finding the proper role for government in the economy is proving difficult for people in the FSU and Eastern European countries.

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The last decade has brought a parade of political news from the emerging market economies of the Former Soviet Union (FSU) and Eastern Europe. While coup d'etat, elections, and retrenchments have made headlines, economic imperatives have required that these nations concentrate on macroeconomic stabilization and state-sector privatization. Western governments and organizations have offered policy and technical assistance and, to a more limited degree, financial assistance for pursuing macroeconomic goals while pressing for a rapid transformation of the centrally planned economies.

Early reaction from World Bank, U.S. AID, and other international agencies contended that the transformation was proceeding successfully, but other more pessimistic views have emerged (Rowen, Infanger). It is apparent that the transformation process will be longer than forecast by the agencies and by the governments of the emerging market economies themselves.

Our observations and research tell us that transformation from a planned to a market economy is very difficult. The basic institutions necessary for the transformation simply do not exist in the FSU and Eastern Europe, and it appears that the populace does not understand the importance of government in a market economy. For a market economy to work, the government must play a strong role in areas, such as contract law and defining property rights. Moreover, the government, which sets up and supports these institutions, must be trusted.

The Process of Change

Douglass North identified one of the key problems of economic development as getting the state to behave as an impartial third party to any transaction. Effective economic development needs an impartial third party to monitor and enforce property rights and to maintain the institutions and rules that support market exchange. The government must act as a "mentor with teeth" to enable participants in the economy to develop their own mechanisms of change. Governments in these countries must be recreated with a new and different, but still very prominent, role.

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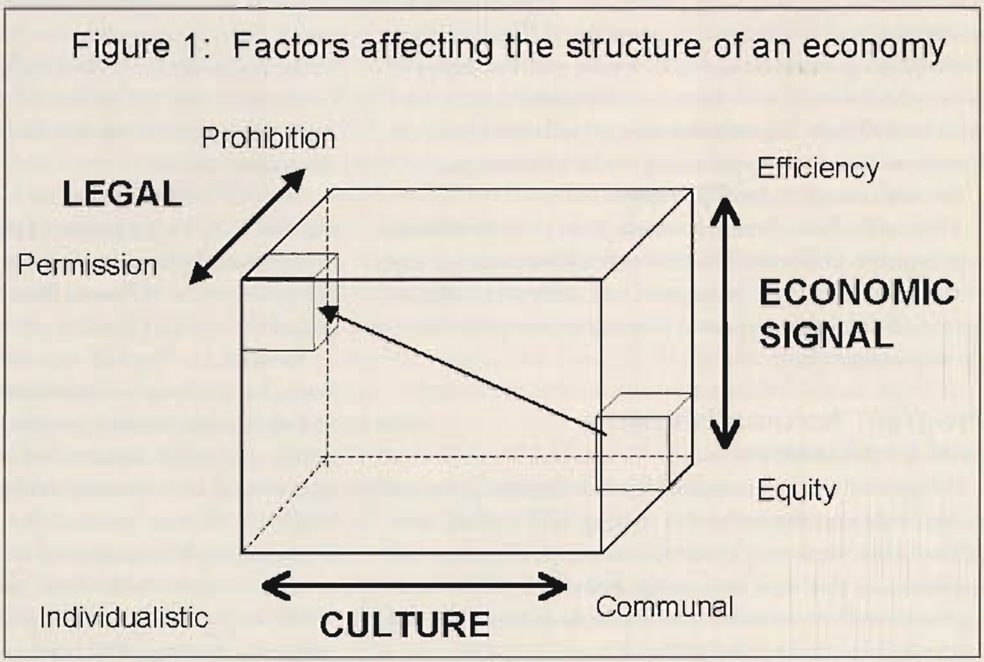

Outside the box. The structure of an economy results from the interaction of economic, legal, and cultural factors, displayed in three dimensions above. The two smaller boxes indicate the location of two ideal types — the market economy on the left and the collective economy on the right. No existing economy fits either ideal type. The set of structures capable of supporting a market economy generally are found in the upper left area surrounding where the smaller box is located. Outside of this area the imbalance between the three factors would impede the smooth functioning of a market economy.

ing difficult for people in the FSU and Eastern European countries. We offer two reasons. First, the history of the region has led people to distrust government. Second, the citizens have had little exposure to a market economy and, most likely, do not understand that a market economy cannot function without a strong government role.

Western advisers, including the authors, have underestimated the magnitude and timing of the transformation process because they have not fully grasped the large differences between the existing institutional structures of these economies and the institutional structures required for a market economy. This is because very little information was available about these economies for 50 years and because the neo-classical economics framework assumes an existing set of market institutions, the details and development of which are rarely examined. These new economies are influenced by their cultures and histories. At the same time, international consultants bring advice based on their own cultures and histories. The results may be conflicting advice from consultants or advice that conflicts with basic historical and cultural institutions in the target countries.

A particular market economy results from the interaction of economic, legal, and cultural factors. Each factor can act as a constraint or facilitator in the movement to a market economy. We illustrate this in Figure 1, where we have put each factor — economic, legal and cultural — on an axis. The interaction of these factors results in the formation of different institutional infrastructures that affect the ability to make the transition to a market economy, as well as the type of market economy that develops. The process of transition is not smooth and balanced between factors. All economies do not start at an "origin" with the extremes of (say) equity, communal, and prohibition. For example, in the late 1980's black market structures were rife in Poland in spite of being illegal. Individuals were rejecting the legal structures of prohibition and the tenets of socialist equity. Consequently, there was a nucleus of entrepreneurs ready to jump-start the transition process in 1989.

***Culture*:** Development of market institutions and the processes by which they operate is constrained by influences of culture, both historical and current. Does the culture exhibit individualism, with strong competitiveness and a commitment to self-preservation, such as the United States, or is the culture imbued with group or community loyalty that transcends individual interests (e.g., Japan)? These questions are critical for balancing cultural mores with restructuring of economic institutions to support a market.

Because institutions are defined by the aggregated set of rights, cultural expectations about rights will influence the new "rules of the market." It will take some time

From the government and here to help?

The history of the region has fostered a distrust of government.

Photo courtesy the authors.

for a new institutional structure to outweigh the influence on choices and actions of the coercion that was prevalent under central planning. The more rapid transformations to market economies, achieved by Poland and the Czech Republic, is probably attributable to the fact that their cultures were less influenced by socialism/communism (only since World War II) and thus could be shed more quickly.

Legal Institutions: Behavior in the planned economies was generally regulated in a way similar to civil law in western countries. Under socialist civil law, a person could act as long as the act was permitted by the statutes. If the law did not expressly allow it, an action was prohibited (Bromley). In western common law, a person can act unless prevented by statue or ordinance. The old legal systems in Eastern Europe and the FSU retard the ability of the populace to participate effectively in the market transition because of a perceived need for permission from the government, which in many cases is still required. The management and bureaucratic elites, however, appear not to feel the rules as strongly as ordinary citizens do. A frequently heard complaint about the privatization process is that the elites have "taken" ownership of assets, without waiting for permission. In fact, those who seize the initiative without explicit permission are commonly called "mafia businessmen" precisely because they operate outside old structures.

... the ultimate constraint to creating a market system may be the ability to generate trust in the government.

A widespread culture of black markets existed under the previous system. The black market entrepreneurs bought and sold until prevented from doing so by legal authority. It is thus not surprising that flea markets and informal bazaars have become a common form of market mechanism today. The legal permission to buy and sell that is essential for a market economy exists in small-scale form.

Economics: In the centrally planned economies, success was measured in terms of physical output. Input and output prices were set by a centralized body and influenced by the political environment. In this context, efficiency was not the objective, and prices could not provide a signal for the efficient allocation of resources. During the economic transition, the prices of internationally traded commodities quickly reached world levels, while locally manufactured goods, especially consumer goods, remained inexpensive relative to the rising costs of inputs.

In a market economy, participants acting individually, or as members of groups, generate signals that guide economic activity. The institutional framework, and its supporting rules, enables and protects market transactions. Under a centralized economy, government managers held the balance of economic power with considerable protection for labor. The transition to a market requires the balance of power to shift to business managers with less protection for labor. But markets permit frequent adjustments that lead to efficiency in resource use.

Institutional Formation: Institutions endure only if they are based on shared values. A. Allan Schmid points out that rules determine whose choices are most important and how they can be transmitted through the institutional system. The commercial code must reflect the participants' agreement to the rules if it is to be effective. If the code has been adopted from another economy, rather than being created by the participants, it may fail because it does not reflect their ethics, culture, and expectations.

The political instability of these countries in the last decade has not been conducive to formation of institutions that provide the backbone of a market economy. The continued political instability will cause continued economic instability and may create distrust, not only of the government, but also of the market system.

Transition to a Market Economy

Transition is dynamic, and the rate and path of the change depends on the environment within which it occurs. The emerging market economies did not all start their transitions from the same point, so their expectations will be very different. The rules they set up to govern the market will reflect those expectations. In addition, at any point there will be economies and economic sectors in different states of transition along the three axes illustrated in Figure 1. Depending on their market orientation at the demise of communism, adjacent economies (countries) could be in conflict as they move toward a market orientation. For example, Poland's transition economy started with land privatization and ownership much further advanced than in most of the Baltic States.

The following paragraphs provide examples from different countries of how the imbalance or lack of institutions have stymied transition.

Housing market: International advisers have emphasized the need for understandable and defensible rights to real property. Without a credit or mortgage system, however, the property right confers only ownership and occupancy rights, there is no ability to buy and sell. The displaced occupants of houses that have been returned to "legal" owners cannot buy or build without mortgages, and the same lack of mortgages limits construction of rental properties. Cultural mores have led to moratoria on displacement from housing. Thus the combination of a deficient credit system and cultural expectations have slowed transition in the housing sector.

Commodity exchanges: The recent history of commodity exchanges in the FSU illustrates several of the points we are making. Technical assistance has been extended to develop dozens of exchanges in many of the

Tough row to hoe. Even with reforms, governments have retained the power to restrict business ventures, control banks and retain ownership of key sectors.

Photos courtesy of the authors.

FSU countries because commodity exchanges provide price information and are an important market mechanism. These exchanges, however, have neither standardized contracts nor agreed upon delivery points, and confiscatory taxation forces most transactions off the trading floor. As a result, the exchanges are not providing the accurate and timely price data needed by producers, traders, and buyers. Most have collapsed. One American expert cautioned that "In our enthusiasm ... we must not forget that commodity exchanges are a support mechanism to privatization. Where privatization programs are operating successfully, an open market is being created. Commodity exchanges can help strengthen that open market by discovering prices and enforcing contract performance. But exchanges by themselves cannot create open markets ... [because] if there are not any sales in an open market, there will be no prices to discover," (Pendleton, pg. 12).

In the context of Figure 1, the institutional structure and some of the underlying laws and regulations have been established to enable buying and selling on an exchange. However, insufficient supporting structures and cultural responses have resulted in a failure to create effective economic signals. Without consistent transparent economic signals the nascent markets fail to thrive.

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Grain warehousing: Bulgaria's Grain Warehouse Receipt Law was a necessary precondition to establishing a grain marketing system. Prior to the law, the absence of a warehouse delivery receipt meant the producer had no means of proving ownership nor of defining the value of the crop. The receipt provided under the law describes the volume and quality of grain at the time of receipt. The value of the receipt (and the grain) is determined when it is sold in the market.

The law, while necessary, is not sufficient. Market interactions must be transparent for participants to compete equally in the marketplace. The capacity of the warehouse must be known and audited, the expected shrinkage specified, and assurance provided that the quality received is maintained for future delivery. These conditions require an institutional structure that includes impartial third party inspectors for warehouse capacity, accounting, and quality and quantity assurance. Without this assurance, there is no guarantee of physical or fiscal payment against the warehouse receipt.

Finally, for the receipt to retain value over time, both the owner and the buyer of the receipt must be assured of its authenticity and the legality and transferability of its ownership. To ensure the integrity of the receipt system, an indemnity or bond system must also be established. With physical ownership firmly and legally established, the asset has value on paper and legal ownership can be transferred across space and time without transferring the physical commodity.

Planting the Ukraine. Can farmers trust that the fruits of harvest will be theirs to enjoy?

Photo: Clear Window

Creating an exchange economy requires a set of legal and economic institutions that are transparent to participants and overseen by an impartial third party. Limiting government to the role of oversight in a previously state-trading system requires considerable behavioral change on the part of the government and cultural change on the part of market participants. Approximately 50 years of central planning have created a cultural response of distrusting government. Unless an alternative, credible third party can be designated, the ultimate constraint to creating a market system may be the ability to generate trust in the government.

Institutions Will Create the Future

The process of changing the structure of an existing economy from centralized planning and financing to a decentralized, market-oriented economy staggers the imagination. Both political instability in the region and disquieting macroeconomic conditions — deficit spending, double-digit inflation, fluctuations in exchange rates, confiscatory tax rates, and general uncertainty — increase the difficulty of restructuring. While macroeconomic stabilization has been the first order priority for economic policy, it is not clear that it can be achieved without addressing the significant barriers to market development.

"The first step in restructuring of economies ... is to modify government's role from one of operating businesses to supporting them," (Becker, p.6). The struggle to define a new economic role for government has become a protracted procedure for the emerging market economies. Experience to date shows that the interests of the state bureaucracy and political institutions are not market-oriented partly because of cynical self-interests and partly because of ideological resistance. Even with reforms, governments have retained the power to restrict business ventures, control banking functions and foreign exchange transactions, dictate the terms of foreign investment, and retain ownership and/or control of key sectors. Rather than moving to a market economy the objective of government seems to have shifted from centralized planning to centralized stabilization.

The basic need to get market institutions in place and working seems to have been overlooked. Misunderstanding the role of institutions is a major problem. A free market is not "free" of government. Rather, a free market is free of capricious action by government. Government plays a strong role within limits defined by legal institutions and cultural factors. This may be a difficult pill for a populace with a strong distrust of government.

While the original expectations for a rapid transition may have been unrealistic, continued economic instability, with little sign of improvement in living conditions, may so disillusion the populace that they may retreat to the known world of parastatal production. ■

■ For More Information

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