

**An “Austrian” Economist’s Perspective on
Transitional Political Economy**

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In 1989, most economists thought the problem of the transition was one of allowing prices to float to market clearing levels. After all one of the most observable problems throughout the former socialist economies was the existence of pervasive shortages. Indeed prices did need to be freed up. But we learned in the process that free pricing required a network of institutional reforms to define and enforce private property rights and secure the freedom of contract. By the mid-1990s economic attention had moved away from the macroeconomic stabilization, privatization and price liberalization agenda to a broader notion of institutional reform. Since that time, political economists have also learned that discussion of institutional reform is incomplete unless we can talk meaningful about cultural attitudes and beliefs. There is no doubt that perhaps the most important advice an economist (of any stripe) can provide to a reforming government is to stress how incentives matter. But we do not adequately understand incentive mechanisms unless we also understand how individuals within a specific context attribute social meaning to the incentives they face. Thus, we economists are faced with dilemma at the beginning of the 21st century that was widely recognized in the 19th century – to do good economics one must study the interaction of the economy, polity, and society and that nothing is do dangerous as an economists who attempts to proffer advice based on a study of the economy isolated from all other factors.

In this talk I want to stress 3 simple points about the transition from the former socialist system to a market economy.

- Transition problems are not *economic problems*, but political and legal problems;
- Change requires an accurate defining of the “here” from which reforms start and a good idea of the “there” to which change is to accomplish;
- Effective change of the political and legal institutions requires government to establish a binding and credible commitment to reform

The sad reality is that throughout East and Central Europe and the former Soviet Union there has been a general failure to take the necessary political and legal reforms. Moreover, the analysis of the transition problem has been stymied over the past decade by a general failure to recognize the *de facto* organizing principles that governed the former socialist economy and thus analysts have failed to deal adequately with the socialist legacy in designing reforms. Especially foreign advisors have been content to proceed as if the *de jure* economic relationships in the former system defined economic life. But such intellectual laziness means that one can never develop a good political economy model of the transition because you have failed to accurately describe the

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“here” from which you hope to transition to a “there”.¹ Of course, the problem is compounded by the fact that no consensus has emerged on the “there” that policy reforms are to be directed at achieving.²

Before going further let me state the basic economic principles underlying my analysis, and the policies I would advocate. They are as follows:

- The economics of the transition is really pretty simple economics --- get out of the way of individual attempts to realize the mutually benefits of exchange.
- Economics is fundamentally about exchange and the institutions within which those exchanges take place.
- Secure property rights, freedom of pricing, sound monetary policy, fiscal responsibility and open international trade.

I simply do not see an alternative. Joseph Stiglitz might not agree with me, but the evidence simply does not support his claims that capital controls, infant industry protections, and Keynesian macroeconomic policies are keys to successful development. Economic development results from encouraging individuals to be willing to “bet on their ideas” and to find the financing to bring those “bets” to life. In short, economic development emerges in a social ecology that promotes freedom of action and internalizes the responsibility for those actions.

Ironically, one of the sure fired ways to determine whether a country has adopted successful economic reforms would be seeing the number of individual bankruptcies increase. The recent financial scandals in the US are not ‘collective’ tragedies. The ‘collective’ tragedy would be not let Enron go bust, or Arthur Anderson to lose its reputation because of the political clout of its officers. A vibrant market economy is a profit and *loss* system. If firms who do not satisfy the demands of consumer are protected from going out of business, then resource allocations will not result in a manner that tends toward efficiency. Waste of resources will result and the economic system will not generate generalized prosperity. It is precisely because entrepreneurs reap profits for satisfying the demands of their fellow men, and suffer losses for the failure to do so in a cost effective way that the market system is a reliable mechanism for resources allocation. The scourge of successful reform efforts is the desire to protect people from the rigors of market discipline. This is as true for the labor force as it is for the entrepreneurial class. Persistence of inefficient organizations and patterns of resource

¹ It has been a major theme of my work on transition problems – *Why Perestroika Failed* (1993) and *Calculation and Coordination* (2002) – to stress the *de facto* organizing principles of the former Soviet-type economy precisely because it is this system, and not the *de jure* system, that is being reformed. The *de facto* system includes the attenuated property right systems and the interest groups it engenders which must be accounted for in any political economy analysis of the transition problem.

² Perhaps one thing that membership in the European Union does bring is a consensus on the “there”. I personally have strong reservations about EU membership for the former socialist countries. Some of these countries, such as Estonia, will actually have to take steps backward in terms of economic reforms to conform to EU expectations. The vast majority of countries seeking EU membership, however, will move in a direction more amenable to market reforms than the path they have chosen so far. On the other hand, it is important to stress that EU policies are more restrictive than is necessary in my opinion to lift these countries out of their problems and lead to generalized prosperity.

(both capital and labor) use simply ensure that short-term pain is sacrificed for long term misery and economic deprivation. The pattern must be broken and the creative destruction of economic change must be allowed to run its never-ending course.

So when in a reforming economy you see zero to few bankruptcies (of either old or new firms), employment concentrated in the former state owned enterprises, and the persistence of the underground economy you can confidently conclude that *reforms have not been effectively implemented*. In short, the more things supposedly change, the more they in reality have stayed the same. There is no reason whatsoever for the persistence of an underground economy in a liberalized environment except for the fact that the costs of doing business have remained too high --- including taxes, regulations, and other fees.³

What is the persistence of an underground economy telling us?

- The political and legal environment makes it impossible for people to bet on their ideas and realize the mutual benefits from exchange in an above ground and transparent manner
- People will find creative ways to realize the benefits from exchange, *but* lack of transparency does present a serious limit to the expansion of this creative energy.

Once we recognize that the spirit of enterprise is not something that we have to create, but instead cultivate, then our policy advice moves from concerns with efficiency to questions of how to we get institutions that cultivate economic life. How do we get the correct institutions?

The institutions operating in a society can be defined, following Douglass North, as the formal and informal rules that govern social intercourse. It is important to understand that formal rules are only rules if they find legitimacy in the informal rules that individuals within that context respect. On a superficial level speed of reform is judged by changes in the formal rules, but this misses out on the constraint that the informal rules place on the acceptability of the formal rules. Whenever I discuss this I am reminded of the Woody Allen movie *Bananas* from the 1970s – after the revolutionary succeeds he announces that from now on everyone will wear their underwear on the outside of their clothes. The revolutionaries look at one another in bewilderment. The formal pronouncement has no resonance with the population. The same problem confronts the post-communist revolutionaries when they make the less bizarre pronouncements – such as, from now on everyone can buy and sell whatever they desire and pursue their fortune as they see fit provided they are responsible for costs they incur, or from now on everyone will respect private property and the freedom of contract. The problem isn't that the words spoken are incoherent, but rather that the words don't have social meaning to the audience who hears them, if they hear them.

³ My emphasis on the costs of doing business is highlighted in Hernando De Soto's *The Other Path*, and also in the USAID project entitled "Investor's Road Map", which tracks the transaction costs a foreign investor must deal with in setting up a business venture.

The most important issue the formal institutions must deal with is that of the threat of predation – from private and more importantly public actors. The social context of the socialist system was one of public predation, and the threat of private predation in the underground activities. The threat of private predation was real, but as evidenced through the choice by many to continue to engage in underground activity this threat was less onerous than the predation individuals were subjected to above ground by public officials. The persistence of underground markets in the post-communist period suggests that the situation has not changed as much as one might have hoped.⁴

Guarding against predation is a function of political and legal changes that establish a regime of private property rights and a rule of law. By this I don't mean the law of rules --- transition economies don't need more rules and statutes. What is required, however, is the firm commitment to a regime of private property and freedom of contract. The functional significance of the rule of law lay in (a) the generality of the law, and (b) the predictability of the law. By generality, I refer to the fact that the law is equally applicable to all citizens, including those entrusted to enforce the law. The arbitrary whim of those in positions of power is minimized, and rulers are held accountable for their actions along with everyone else in society. By predictability, I refer to the property of the rule of law that these rules are known in advance and thus actors can incorporate these laws and their enforcement into their commercial calculation when making decisions. Economic actors must be able to assess the risk associated with business ventures. To engage in this sort of risk-assessment, along with prospective entrepreneurial appraisal, the economic decision must be within a fairly stable environment. Just as unpredictable bouts of inflation can distort economic decision-making so can unpredictable bouts of predation from either private or public actors.

⁴ I don't want to risk of overstating this because the sort of political repression that was experienced under communist rule has ceased, and this is a great advance for human freedom. The ability to travel within the country and elsewhere, the ability to think and write what one thinks, the ability to voice opposition, etc. are all significant victories for humanity over tyranny and should be celebrated. Many of the students I teach at the program at Charles University every summer tend to forget how the freedoms they experience now were hard won during a long struggle against tyranny – even in the Czech Republic. Last summer I gave the students extra credit for going to the Museum of Communism that opened off the square. No doubt crony capitalism has serious problem, but it is much better than crony socialism! That much said, 'cronism' is not going to generate the pattern of economic development that is sought in the transition economies, and in fact, works to undermine the long term success of market reforms by discrediting them through corruption scandals, etc. as has been the case with Klaus in the Czech Republic.

The simple making of a public announcements by the government that from now on contracts will be enforced and public predation will be kept to a minimum are not enough to change the expectations of the entrepreneur or the private investor in a potential business venture. Talk is cheap as they say, and individuals in the transition economies do not trust their government. Mechanism of tying the rulers' hands must be introduced. A credible and binding commitment to limit government predation has to be established and must be signaled effectively to the population. If no credible commitment is established and signaled than reform measures will not be trusted and business ventures will be channeled to underground activity, or in non-productive activities intended to curry favor with government officials.

I have argued in my writings that this concern with signaling provides a new argument for 'shock therapy' than the more traditional emphasis on simultaneity. But I have also emphasized in my work that 'shock therapy' – as a literal reading of the analogy would suggest – is not a cure, it is a treatment that enables the patient to get on the path to recovery. In addition, I think there are certain policy steps that rulers' could take which would be more effective than others. First, we need to make sure that fiscal incentives are aligned to promote economic development. This is best accomplished through fiscal federalism – decentralize the taxing authority to the local level. Same thing with economic regulation. This would force localities to compete for their tax base. A minimum basic fee could be provided to the central government --- what is called reverse revenue sharing, e.g., 10%. This would give local rulers' an incentive to pursue growth enhancing policies because the incentives would be such that they could maximize their revenue by maximizing wealth enhancement. Second, I have argued that governments raise revenue in one of three ways – borrow, tax, inflate. The ability to monetize debt unleashes the natural tendency in democratic governments to finance their affairs through debt. So I have argued for a denationalization of money either through a currency board (a poor solution) or the adoption of a free banking system.⁵ By eliminating the government's ability to pay off public debt through the hidden tax of inflation, free banking is one component that would align the incentives such that government officials had to be prudent in their promises of government programs and subsidies to special interests. Finally, I have argued that another policy that would send a strong signal of a commitment to liberalization would be the pursuit of complete free trade in goods, services, and even ownership. Yes, let the foreign owners in to buy up your factors --- with this would come new technologies and new management skills that otherwise would take longer to seep into the economy. In addition, trade liberalization brings with it foreign products and a price structure unencumbered by government tampering. In short, fiscal decentralization, monetary denationalization, and trade liberalization credibly commitment the government to a policy of non-interference in economic life and signal to private actors domestically and abroad that if you want to invest in this economy you need to worry about the meddlesome actions of government.

My contention is that if real existing socialism was characterized by the omnipresence of the state in all walks of life, then the transition economies that are most successful will be the ones who minimize that presence the most. And thus, I often argue

⁵ On free banking I encourage the reader to look at the work of Lawrence White and George Selgin.

that the governing principle of a liberal society should be that a free society works best when the need for a policeman is least. Those societies that promote freedom and prosperity most are those that come as close as possible to invoking the principles of self-governance rather than coercive governance to ensure peaceful social cooperation.⁶

So what have we learned since 1989? Before addressing that it is important to stress that while many things have changed, the most essential economic reforms have been blocked. Shock Therapy hasn't failed, it hasn't been tried if we actually look at the substance of reform packages rather than the name that politicians give to their reforms. That much said, the difficulties of the past decade has taught us two striking lessons, and they are:

- Reform is not just a matter of getting the prices, but one of getting the institutions right so that the price system can work effectively.
- Getting the institutions right requires a broader change in belief systems among the public without which the needed institutions will only be words on paper and not guideposts for real-life.

The key changes in beliefs that must be adopted for the institutions of a free and responsible people to be adopted are (a) a shift from notions of collective responsibility to individual responsibility, (b) a respect and toleration of dissent and the dissenter in society, and (c) a general respect for science and in particular the idea that all opinions and norms must be submitted to critical scrutiny of argument and evidence.

In conclusion let me reiterate a basic tale about economic growth and development. An economic system operates on the basis of people, resources and institutions. The geographic location of a country and the amount of natural valuable resources at its disposal are exogenous factors. The disposition of a population in terms of beliefs and talents is also exogenous in the short run. But the institutions (the rules) which govern the way people interact with one another and nature are endogenous. The Czech communists were able to destroy an economy by a changing the institutions within which people interacted. And the Czech liberals will develop an economy to the extent they can change the institutions in a more wealth inducing direction. We can recognize the difficulties of institutional change, and they are severe, but we also must not lose sight of the basic lesson that the failure of socialism and the transition experience teaches us --- namely, that only a system of property, contract and consent can form the basis of a free and prosperous society. And we should recognize the wisdom that Adam Smith had when he wrote in his notebooks in 1755 that:

Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and a tolerable

⁶ I am currently conducting a study with my colleague Edward Stringham on the problems of self-governance on the Prague Stock Exchange. Our preliminary findings demonstrate that the difficulties associated with the development of capital markets in the Czech Republic has little or nothing to do with the failings of *laissez faire* as some have contended and everything to do with meddling government policies. Moreover, the establishment of a Czech SEC has not provided the solution.

administration of justice; all the rest being bought about by the natural course of things.

Hard to beat Smith's words. So establish private property, protect the freedom of contract, reduce the tax and regulatory burden to a minimum, pursue a policy of monetary freedom, and open your borders to goods, services and investors, and you will unleash entrepreneurial creativity of your population and neighboring countries. A century of political freedom and economic development was lost due to the seduction of the socialist promise that all you had to lose was your chains, but a real future of peace and prosperity awaits for those who finally throw off the shackles of the state and socialism and embrace the free market and the entrepreneurial ethos of creative destruction.

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