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Is the Transition to the Market too Important to be Left to the Market?

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IS THE TRANSITION TO THE MARKET TOO IMPORTANT TO BE LEFT TO THE MARKET?

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I. Introduction

Official economic statistics reveal that Russia's economic system has continually contracted since 1989. Indeed, by the end of 1996 the Russian economy was basically half the size that it was in 1989--a steeper fall than what the US experienced during the Great Depression of the 1930s. The Russian people have endured great economic hardship over the past decade with an estimated 22% of population now living below the official poverty line. Thus, the period of so-called "market reforms" in Russia does not show obvious improvements in the well being of its citizens. This has led to an emerging consensus within the professional and popular literature which argues that the "triple transition" – transforming the economy, the polity, and the national psychology – is too difficult to be left to the market. In contrast to this argument, we contend that it is precisely because the transition is so complicated and so important that market forces must be allowed to play the crucial role in the transition.

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II. FROM HERE TO THERE

The collapse of state socialism in the late 1980s ranks, along with the Great Depression, as one of the two defining political-economic events of the 20th century. As with the Great Depression, interpretations of the exact reason for the collapse and the implications for social theory vary. Already competing hypotheses on the causes and consequences of the collapse of socialism have been circulating: inherent contradictions of socialism, Western military pressure, bad luck (and corruption) in the selection of leaders, and poor economic management which could be repaired head the list. One hypothesis about the socialist world of East, Central Europe and the Soviet Union, however, has not made the list. And it is from the perspective of this hypothesis that we would like to consider the question of transition.

What is this conspicuously absent hypothesis? The socialist world of East, Central Europe and the former Soviet Union was simply *not socialist* as the word is technically defined in the history of ideas as the abolition of commodity production and thus the absence of private ownership of the means of production. This is not because of some perversion of the ideal in Soviet practice. It is because the idea of socialism is conceptually incoherent in a world of advanced material production. Within the ambiguous social arrangement created by the demand for observance of an incoherent formal rule, informal rules evolve to govern social affairs and ward off collapse. "The distinction between the private and public sectors," Yoram Barzel states, "is not a distinction between the presence and absence of private property rights. Such rights are necessarily present in both systems. The distinction lies instead in organization, and particularly in the incentives and rewards under which producers tend to operate" (1989, p. 107).

Markets are like weeds, they crop up anytime there exists an opportunity for individuals to improve their condition through exchange. Also like weeds, markets are amazingly resilient. Attempt to stamp them out here, and they grow over there. The market is, in some fundamental sense, inescapable. In other words, the market is omnipresent -- including in so-called command economies.

The socialist regime did not abolish the market anymore than the prohibition on alcohol in the 1920s stamped out the buying and selling of liquor. We know from historical examination of the War Communism period (1918-1921) that even during the height of the campaign against all forms of capitalist relationships (and the threat of death) some individuals still found it advantageous to enter the "black market." Of course, in both the attempt to eliminate commodity production in the Soviet Union and the attempt at prohibition in the United States, the nature of the market was transformed by the *de jure* structure. But if we want to understand how the market actually operated, the *de facto* rules must be the focus of our attention.

At the time of the introduction of radical market reforms in Russia (January 1992) there existed an array of ownership claims. The right of ownership constitutes a claim to (1) the right to use the asset, (2) the right to appropriate the returns from the asset, and (3) the right to change the asset's form and substance (see Furubotn and Pejovich 1974). Institutions are the formal and informal rules governing the social intercourse under discussion. In this regard, when discussing the institution of ownership we are attempting to specify those formal and informal rules that govern the use, transfer and capitalization of an asset. As noted above, in a world where formal rules are absent or defined in an incoherent manner, informal rules emerge to provide a governance structure within which economic decisions will be made. How effective or ineffective this system of governance will be is an empirical matter. Both formal and informal rules can imperfectly define rights and lead to social conflict. In pre-Yeltsin Russia, private property was not abolished despite the formal rules that said this was so. As Barzel put it: "The claim that private property has been abolished in communist states and that all property there belongs to the state seems to me to be an attempt to divert attention from who the true owners of the property are. It seems that these owners also own the rights to terminology" (1989, p. 104, fn. 8).

Socialism failed in the Soviet Union, but it failed in 1921, not in 1991. The system rejected in the late 1980s resembled neither the theoretical model of central planning nor even the market-socialist model of decentralized planning that is contrasted with the market. Indeed, this system was "embedded" in the market, but the market itself was "embedded" within a social ecology wholly different from Western conceptions of capitalist markets. Recognition of this fact has tremendous importance for the transition process. To begin with, it suggests that the first and most important challenge in reforming the political-economic system in these countries is to recognize *what* in fact is being reformed -- the 20th century version of the Ancient Regime. Failure to properly identify the actual character of former Soviet-style countries can only result in misleading or harmful policy prescriptions for transition.

Certain explicit "brute" facts are common across the Soviet-type political-economic systems:

1. Political monopoly of the Communist Party;
2. Industrial structure of the economies can be defined as literal monopoly (in terms of an actual government dictate that there be only one producer in an industry);
3. Shortage of consumer goods and poor quality of goods and services;

4. Repressed inflation (reflected in long lines and the so-called rouble overhang problem);

5. Fiscal imbalance (as a consequence of industrial, military and consumer subsidization and the persistence of problems associated with "soft budget constraints");

6. Welfare system is tied to the industrial workplace (reflected in the employment incentive problems.)

The socio-economic consequences of this constellation of facts under state socialism are now widely recognized. Production inefficiency, consumer frustration, political repression, and worker alienation within the workers' state were the norm. It is obvious that a path of reform must repair each of these situations if the transition is to be judged successful. But these explicit facts (and others that could be added to the list) are the consequence of underlying factors -- often implicit – that must be exposed if we are to get at the root cause of the "irrationalities" that were experienced. It is one thing to simply say that where there was political monopoly, we must replace it with democratic competition; where there was economic monopoly, replace it with competitive firms; where there were shortages, free prices to clear the market; where there was inflation, replace it with a tight monetary policy; where there was fiscal imbalance, replace it with fiscal responsibility; and where there were disincentives to work, institute high powered incentives for work. But this is much easier said than done.

James Buchanan has stressed that work in political economy, if we desire to retain some level of realism and relevance, must begin with the "here and now" and not just postulate whatever start-state of analysis might be desired to make the model tractable (see, e.g., Buchanan 1975, p. 78). Unfortunately, most models of the transition that have been developed fail to appreciate the *de facto* organizing principles that governed life in the Soviet-type system.

Concentration has instead been focused on the *de jure* statements of what constituted the system. It is this misidentification of the underlying conditions, we contend, which has caused the major problems for economists devising strategies for reform.

The Soviet system (we will use the former Soviet Union exclusively throughout for illustration) was made up of a series of interlocking "contracts" and "vested interests," and any attempt to change the system must begin with this institutional inheritance. *If* the Soviet system was actually a land without any ownership claims, then post-communist reforms would be immeasurably simpler than they are -- even given the cultural conditioning often invoked to explain the resistance to reform. But the social fact is that many limited--though tacitly legitimated--ownership claims had been established throughout the economic system.

The path from "here to there" requires then not only an idea of the "there" intended, but also the "here" from which one is starting, *before* an appropriate strategy for the path can be determined. With regard to the question under examination (i.e., the transfer of ownership) the steps required for the divesture of property from some owners, the legitimization of property held by others, and the establishment of conditions for the attainment, use, transformation, capitalization, and transfer of assets for new owners should be the focus of our attention. The appropriate policy path is necessarily multidimensional and grounded in the previous historical pattern of ownership. As David Stark (1992) has pointed out, post-Communist developments are following a path-dependent trajectory. Therefore, it is more appropriate to view post-Communism as a process of transforming existing institutions, than it is to view post-Communism as a transition to a new economic order lying outside of history.

III. ISSUES OF EMBEDDEDNESS AND HYSTERESIS

In addition to the multidimensional aspects of ownership transfer, once the *de facto* property claims of the previous system are specified it becomes clear that reform must tackle the issue of "embeddedness" as discussed in the economic sociology literature. The usual implications drawn from analysis of social transformations when concepts such as "path dependency" and "embeddedness" are introduced cut against *laissez-faire*.

The Nation-State plays a necessarily *active* role in industrial transformation, the argument goes, because the government provides goods and services that are essential for economic development. Without the Nation-State, the market and other institutions of modern society cannot work. This argument is an important one. Markets are indeed embedded within (and operate on the basis of) a governance structure, the formal component of which has in contemporary history been the domain of the Nation-State. But the Nation-State is itself embedded within a set of underlying cultural beliefs. Governance is required for the market to operate in a manner conducive to modern industrialization, but governance is also a function of market forces. Rules of the game engender patterns of exchange and production, and the emerging pattern of exchange and production aid in the selection between different regime rules. The center is rarely, if ever, truly uninhibited -- even in a totalitarian system. Pockets of civil society (perhaps *sub rosa*) emerge to challenge the legitimacy and power of the all-powerful. The center is inhibited, not only by formal rules of limited government, but also by the legitimating authority of civil society. Successful political and economic transformation, however, requires the development of transparent formal rules to subordinate the center to the rule of law. The key issue for this transformation is how to work through the indigenous institutions of inhibition to legitimate formal rules of subordination. The contrast is not really between the State and the Market. It is between the State and Civil Society, within which market activity and non-market voluntary association co-exist. In an ironic twist, the public space required by civil society for political voice might only be possible when the private space of market competition is guaranteed. Looking at the issue this way leads to widely different implications for the manner in which privatization (and transition policy in general) should be pursued. Constraints on actions come not only from formal rules of governance, but also from the informal rules rooted in "culture" as well. Hayek (and others) has stressed the tacit presumption that undergirds the formal adoption of law. In this sense, law is seen as a codification of rules of the social game that already attained a level of legitimacy through *de facto* observance, rather than as the creation of new rules. Attempts to impose rules unconnected to pre-existing social practices then are severely limited.

IV. ENTREPRENEURSHIP AND REFORM

If the discussion presented in the last section can serve as the basis of realistic political economic reform, then the emphasis on privatization and corporate restructuring in many authors (however laudable) is misguided. The social transformation required will not come from restructuring existing industry, but from creating conditions that lead to the introduction of new industry and competition from both below and abroad. Obviously, competitive entry will compel the pre-existing structure to mutate, but the metamorphosis of the old system is not the point of policy -- it is a by-product.

Entry of new competitors from below and abroad bring in benefits beyond the improvements in organizational efficiency. Competition compels individuals and firms to employ the existing stock of technological information in the most efficient manner possible. But new competition also prods economic actors to discover new technological knowledge, which expands economic possibilities. In addition, competition from abroad leads to the importation of improved technology and management practices as well as a pricing structure that is more or less determined by market forces.

Under the New Economic Policy (industrial plan released August 9, 1921), by 1923, of the 165,781 enterprises accounted for in an industrial census, 147,471 or 88.5 percent were owned by private persons, 13,697 or 8.5 percent were state owned, and 4,613 or 3.1 percent were cooperative enterprises. Although private enterprise amounted to 88.5 percent of the total enterprises, they employed only 12.4 percent of the total number of workers employed in industry, while the state-owned enterprises, which comprised only 8.5 percent of the total enterprises, ***employed 84.1 percent of employed workers***. Thus the state was freed from administrating small enterprises, while at the same time holding fast to the industrial base of Russian society. The "commanding heights" of industry remained state property (see Boettke 1990, p. 116). For present purposes, what is of concern is to focus attention on the empirical magnitude of transition efforts (either during NEP or during the Yeltsin post-Communist period). If 8.5 percent of industrial enterprises, which are state-owned, employ 84.1 percent of the work force, then clearly the magnitude of the industrial restructuring away from the previous ownership structure has not progressed very far (despite the 88.5 percent of firms being private).

Looking at the empirical information on current Russian privatization we must keep this point in mind. It is our contention that successful transition will be evidenced *not by the transfer of former state-owned firms to private hands (however important that might be), but through the establishment of* ***institutional conditions*** *such that private newly created firms come to dominate the economic scene.* The industrial reallocation necessary will not come from putting old wine in new bottles, but from the production of new wine, so to speak. If most measured economic activity remains in either the state sector or in mixed ownership structures, then despite privatization activity we could be witnessing a process similar to that experienced under the NEP, where the major organs of economic life remain outside of the entrepreneurial rivalry of transparent market competition.

The restructuring of existing economic entities, macroeconomic stabilization policies, or for that matter, technological change, are not sources of economic development and prosperity. Neither entrepreneurship nor technological innovations are the source of economic development alone. To realize the benefits in terms of more efficient production within the given state of technological knowledge, and even more importantly, to reap the gains from increases in productive capacity and exchange efficiency due to the discovery of new technologies and new opportunities, policies that enable entrepreneurship and risk taking must be adopted. "The policies must be such that entrepreneurs and merchants are willing to take risks and find the financing to bring these risks to life. When entrepreneurship is discouraged, the opportunities technical know-how provides stay unexploited. The state can offer the stability necessary for entrepreneurship to flourish, smoothing the way for opportunities to be discovered" (Brenner 1994, p. 52). A preoccupation with the past or with aggregate measures designed to convey knowledge of the economic health of the Nation-State as a unit, misdirects attention from the appropriate issue of building institutions that allow novelty to come to life. As Marshall Goldman stated with regard to the post-Communist efforts in Russia: "Under the best circumstances the reform would still have required decades to undo the damage inherited from the decades of central planning. Nonetheless, Yeltsin and Gaidar and their associates and Western advisers can and should be faulted for concentrating so much on monetary, fiscal and price reform and not enough on new investment and institution and infrastructure building. Had they done the latter, there would still have been difficulties, but there might also have been a few more success stories" (1996, p. 144).

V. HISTORICAL INTERPRETATION OF RUSSIAN PRIVATIZATION

In November of 1991, a reform government was formed and Anatoly Chubais was named minister of privatization and chairman of the State Committee for the Management of State Property. A figure of 70% of the economy was targeted for privatization. Measuring the effect of privatization on the transformation of the Russian economy is not easy. It must be admitted that at first glance the privatization program in Russia has been significant. The following table reflects the magnitude.

Russian Privatization

End of Month	Total number of privatized firms	Industrial workers in private enterprise %
March 1992	1,352	
April	2,995	
May	5,855	
June	8,933	
July	12,015	
September	22,572	
October	29,235	
November	34,932	
December	46,815	0.2
January 1993	54,243	1.1

February	57,989	2.0
March	59,495	4.6
April	66,000	8.6
May	68,000	11.3
June	72,000	15.5
July	78,000	19.1
August	81,000	22.9
September	82,000	26.8
October	83,000	30.9
November	86,000	35.1
December	89,000	40.0
January 1994	91,000	43.1
February	93,000	49.1
March	95,000	54.0
April	98,000	59.8
May	99,000	65.0
June	102,000	81.8
July	104,000	
August	106,000	
September	108,000	
October	109,000	
November	110,000	
December	112,000	
January 1995	113,000	
February	114,000	
March	115,000	

April	116,000	
May	116,000	
June	117,000	
July	117,000	
August	118,000	
September	118,000	
October	119,500	
November	120,800	
December	122,000	
January 1996	122,400	
February	122,900	
March	123,400	
April	123,900	
May	124,200	

Source: *Russian Economic Trends* (September 1996), table 12.

While these changes are impressive, we must be willing to look behind the numbers. State and municipal enterprises are counted as privatized provided there is a decision to transform the enterprise into a joint stock company and there is an approved plan for privatization. So the level of activity recorded may *overestimate* the actual privatization. This is reflected in the numbers when we look at the allocation of enterprises by ownership type in the Russian economy. According to data from *Goskomostat* (1996): state-owned firms constitute 10.7% of all economic organizations in 1996; federal property, 6.3%; property of the Federation, 4.4%; municipal property, 8.8%; public associations, 4.2%; private property, 63.4%; and other mixed property and other types of ownership, 12.9%.

It is also useful to look at employment information to gain some perspective on the economic developments in Russia over the past few years.

Employment by Ownership, 1990-1993
Millions

	1990	**1991**	**1992**	**1993**
Total Employment	75.3	73.8	72.0	71.0
State and municipal sector	62.2	55.7	48.2	41.5
Enterprises of mixed ownership	3.0	7.5	8.3	12.1
Social Organization	0.6	0.7	0.6	0.5
Joint Ventures	0.1	0.1	0.2	0.3
Private sector	9.4	9.8	14.7	16.6

Source: ***Goskomostat***, 1993.

By 1994, it is estimated that 60 % of the labor force was working primarily in the private sector. However, even this might *underestimate* things because many private activities still tend to go unreported in order to evade taxation and registration. *Goskomostat* estimated that in 1993 there were already 700,000 small enterprises accounting for 11.5 percent of all employment. From reported figures, 58% of Russian small enterprises are in trade and approximately 75% of retail trade is accounted for by new private firms (see Åslund 1995, pp. 263-264).

What is significant for our purposes, however, is how difficult it is to report on the activity of new private enterprise. From reports, we have "unprecedented" privatization -- ninety percent of industrial output is said to have passed into private hands -- yet state control remains in a large share of supposedly privatized firms. As Blasi, Kroumova, and Kruse (1997) report:

> The market is risky, it is unpleasant, it is not egalitarian; and it tempts the Russian state -- whoever possesses the state power at the end of each election -- to try to tame and control it in the interests of politicians. The fact is that the Russian state still owns more than 10 percent of about a third of all the already privatized corporations in the country and more than 20 percent of a quarter of them. On average, according to recent estimates, the state owns over a third interest in the top 50 corporations in the country and may own a modest interest in the next 250 large corporations, which may help determine who ultimately controls those companies. The state and existing owners or aspiring owners will struggle over what happens to this residual state interest -- which does not include several thousand firms that were never privatized in areas as diverse as coal, precious metals, health and communication services. The partial or full state role in these firms suggests a continuation of subsidies, a drain on the state budget, and ongoing attempts to combine economic and political activity (pp. 168-9).

The Yelstin years have witnessed a continuation of what was already prevalent under the Gorbachev regime, the continuation -- in fact, the expansion -- of black market activity (or at least unrecorded economic activity) at a time when the policy regime is supposedly favorable toward the development and expansion of markets. This is because registration and taxation remain impediments to the development of new enterprise and the discovery of better ways to satisfy consumers. Ambiguity and poor enforcement of property and contract by the official government has led to the rise of alternative enforcement mechanisms --- some desirable, some not. Compare the situation in Moscow and Warsaw for setting up a private shop as reported in table 3 of the April 1997 issue of *Russian Economic Trends*. The average time for registration (in months) is 2.7 in Moscow, but only .7 in Warsaw. The average number of inspections conducted last year at private shops was 19 in Moscow and 9 in Warsaw. In Moscow the percentage of shops fined by inspectors last year was 83% compared to 46% in Warsaw. Finally, 39% of private shops in Moscow report being contacted by the Mafia in the last 6 months, while only 8% of the shops in Warsaw report similar contact. The steps taken over the past few years have been drastic, but the further development of the Russian economy will rest with the ability to establish institutions of governance that reduce political uncertainty and maintain the balance in the political economy between tradition and novelty, which is essential for the entrepreneurial process of development.

VI. CONCLUSIONS

What is most important to emphasize is that the form of polity construction is not benign with regard to the operational properties we can attribute to the spontaneous order of the market. Privatization policy is but one example of the transition process that highlights this tension, as models of privatization from above may actually impede the privatization from below.

If the Soviet and post-Communist experience can teach us anything it is that we must, as Richard Ericson put it, " abandon the Faustian urge to control, to know in advance, and thus to allow economic outcomes to arise naturally as the unpredictable consequences of market interaction" (Ericson 1991, p. 26). At the same time, we have to redirect our efforts to questions of the institutional framework within which activities beyond our control will take place.

Economic performance is a consequence of the social ecology within which it is embedded, but the trick is that this social ecology is made up of forces that are on the one hand exogenously given by history and on the other hand endogenously generated by commercial interaction. It is the interaction between these two forces that mutate both the formal and informal rules of governance and how they are interpreted and legitimated. The analyst of social processes -- brought so much to the forefront in transition discussions -- must possess the keen sense and wise judgment to know the potential and limits of rationally organized social relations. In other words, evolution and design (both in terms of design within evolutionary processes and evolutionary selection between designs) must be accounted for. Analysts of the privatization process have committed an error with their preoccupation with design (represented in restructuring the old industrial base) in policy discussion, when the social process itself (independent of economists) has actually proceeded along evolutionary designs as new entrants have attempted to emerge to exploit the profit opportunities that await those who can satisfy consumer demands. These efforts, however, have to a large extent been directed underground rather than above ground so as to avoid private and public predation. Thus, Russia still lags behind what could be achieved precisely because the designs of policy are in conflict with above ground long-term investment (both domestic and foreign) in new industrial enterprises.

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