

Forum Series on the Role of Institutions in Promoting Economic Growth

**Fred Witthans on Svetozar (Steve) Pejovich's
"Understanding the Transaction Costs of Transition: It's
the Culture Stupid"**

**Prepared by Fred Witthans
United States Agency for International Development**

Forum 6

*The Interaction Thesis: Alternative NIE Perspectives on Development
Economics and the Dilemmas of Foreign Aid Policy*

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As Professor Wagner so eloquently stated in his comments, Professor Pejovich's paper is an important contribution for understanding the difference in progress that nations are making in the transition from socialism to capitalism. In transition states, the prevailing culture favors collectivism, egalitarianism, emphasis on extended family, and shared values. Such a culture supports an activist, paternalistic state. In contrast, a capitalist economy requires a culture of individualism "that encourages the behavior based on the principles of self-interest, self-determination, self-responsibility and free market competition." In moving away from socialism and towards capitalism some states have incurred greater transaction costs than others due to the gap between informal institutions (culture) and formal institutions of capitalism. Hence some countries have made more progress than others have in the transition. Profess Pejovich's examination of Central and Eastern European countries supports his thesis.

An assertion or a refutable hypothesis?

Is Professor Pejovich's rationale for the interaction thesis a generalization applicable to other areas of the world or is it an assertion at this point requiring further supporting evidence before applying it elsewhere? I am not questioning the interaction thesis, only the supporting rationale for its existence. For example, is it possible that some of the recent rapidly growing countries started with an egalitarian, collectivist culture, yet have made a successful legal transition to capitalism, but nevertheless they still maintain a

culture supportive of egalitarian values? If true, then other aspects of culture or other influences and their impact on development need further examination. Professor Pejovich describes culture as " a synthesis of the community's traditions, customs, moral values, religious beliefs, and all other norms of behavior that have passed the test of time and bind the generations." Their role is to act as "constraints on human interactions."

Some interpret culture to mean how one understands how the world works, how one perceives opportunities, and how one perceives the fairness of desired outcomes. Those definitions are related to our mental constructs and are consequently different from informal rules that govern behavior (I believe). The mental constructs, of course, affect the acceptance of informal and formal rules and hence affect behavior, but it is an indirect route, not direct. Is it culture, is it ideology, mental models, and expectations, is it something else, or do all contribute to a rationale for the interaction thesis?

What difference does it make? The importance lies in what we should do about it. What are the practical implications? We know there is opposition to liberalizing the economy but what is the root cause for that opposition? We need to understand the root cause for the problem before we can identify solutions.

My remaining comments on the paper are mainly in the form of questions and most of them are based on what was not said rather than with what was said.

Is there a role for USAID?

Professor Pejovich examines the choices a society makes in moving from a socialist economy to a private-property, free-market economy. He distinguishes between transition by fiat and transition by voluntary contracts. He clearly prefers transition by voluntary contracts, but unfortunately he does not offer any policy advice on whether donors, such as USAID, have a role to play in supporting that choice. What should USAID do? Should we take an active role, such as providing direct support in say drafting laws and regulations? Or should we take an indirect role and support indigenous think tanks and scholars in identifying constraints and solutions? If mental models,

ideology, expectations, and culture are important influences on whether an economic reform program can be successfully implemented, what if anything can we do to influence them? What time frame is required?

Does privatization support or detract from the creation of an enabling environment?

At the end of Professor Pejovich's paper is a review of the results of privatization and a comparison of privatized firms with new start-ups. Currently USAID provides technical assistance to encourage both privatization and the creation of an enabling environment supportive of private sector led growth. Is this a good role for USAID?

Privatization generates social unrest and opposition to those politicians proposing privatization because management and workers of the to be privatized firms realize they will be made worse off. Is it possible that donors by advising governments to privatize are in fact destroying too much political support for those indigenous politicians who implement the advice? Alternatively does privatization generate positive externalities that make it easier to create an enabling environment?

Professor Pejovich refers to the Heritage Foundation Index of Economic Freedom and the poor scores it assigns to most of the transition states. These states have started privatization programs but they have not made much progress in reforming property rights, regulatory requirements, and policies affecting the macro economic environment. Would it be better to dialog only for an enabling environment supportive of the start up of new firms rather than dialog simultaneously for privatization and for the enabling environment? By dropping privatization and focusing on the enabling environment, including the imposition of hard budget constraints on state owned enterprises; the market will decide which firms can profitably operate. In such a case, workers and management will have less ground to stand on if the demise of their firm is due to market forces rather than to obvious political decisions related to privatization.

Should we dialog for privatization and an enabling environment together because privatization of firms will have external benefits that will contribute to establishing an enabling environment? Or should we drop privatization because it generates opposition that takes away political capital from politicians and prevents them from establishing an enabling environment?

Where do property rights fit in?

Several aspects of Professor Boettke's paper overlap with some aspects of Professor Pejovich's paper. My comment addresses both papers and it focuses on the absence of a discussion of property rights in their papers.

There are various types of opposition to reform. One is interest group opposition and the other is ideological opposition. The focus on culture by Professors Pejovich and Boettke addresses the ideological opposition to reform but it does not, I believe, address adequately the interest group opposition to reform.

Many or most pro-economic growth reforms are going to affect property rights in some way. When property rights change, opposition can originate from various sources. One will be at the economic level, because a change in property rights affects the distribution of wealth and income. Another source will be at the political level, because changes in property rights also affect the distribution of political power and influence. In other cases, changes in property rights may generate opposition from ethnic or religious groups that may foresee an adverse shift in their relative economic or political influence. Changes in property rights also may favor one segment of society over another, say unions over industrialists. Consequently, there are political implications for every change in property rights, and economic reform will generally affect property rights. Politicians serve as brokers and champions in defining and assigning property rights and in so doing generate political support for staying in power. A loss of property rights for one group can result in the loss of political support for a politician in office.

If property rights were brought into the discussion of transition and economic reforms, would it change Professors Boettke and Pejovich's analyses?

Are we looking for solutions in all the wrong places?

Do Professor Pejovich and Professor Boettke overplay the role of culture and underplay the role of political institutions in their analyses? They both emphasize the critical importance of the interaction thesis; the essential need for informal institutions to be in alignment with and supportive of formal institutions. Professor Pejovich writes, "The purpose of this paper is to suggest that the interaction between the formal institutions of capitalism and the prevailing culture in former socialist states might be a major reason for uneven results of institutional restructuring in C&EE." Professor Boettke writes, "Despite the fact that we may know what institutions are necessary for growth (i.e., capitalist institutions), we are still unable to impose them due to the fact that they will not be supported by the underlying "ideas" and values that allow for the widespread acceptance of institutions."

Professor Boettke later states, "Focus must be placed on policies that will result in changing the underlying cultural norms and conventions with respect to markets and the institutional infrastructure required to promote the vast network of markets which characterize a vibrant and progressive society."

While I believe that the interaction thesis is correct and I also agree that implementation of Professor Boettke's recommendation is necessary; I question whether it will be sufficient. The point I want to make in what follows is that we should make a distinction between economic institutional reform and political institutional reform. I believe that distinction is necessary because when we, the donors, engage in policy dialog we do so at the level of the reform of economic institutions. We dialog with the Minister of Finance, the Minister of Commerce or the Governor of the Central Bank. Are we looking for solutions in all the wrong places? The root source of economic instability may not be

remediable at the economic institutional level. Problems with the enabling environment and inappropriate economic policies may be due to inappropriate political institutions.

How often do we hear of the same economic reforms that were carried out multiple times? When Paul Collier met with us at the second forum, he referred to the World Bank funding the identical agricultural reform program in Kenya three times. The message is, I believe, that when an economic reform program has to be carried out more than once, it is an indication that the root source of the problem is not at the level of economic institutions. Rather the root source is at a higher level, the level from which economic institutions derive their authority, and that is at the level of political institutions. This observation is drawn from the writings of several political economists.

In an article summarizing the failure to transform transition states in Eurasia and in market economies in Latin America, Stephen Haber, Douglass North, and Barry Weingast write:

"A major reason for these failures is that the set of market-based policies--the so-called Washington consensus--that underpinned the Russian and Latin American experiments has a fatal flaw. It assumes that it is possible to carry out economic reforms to create efficient markets without a concomitant reform in the political institutions that limit government and guarantee property rights and individual liberty."¹

A similar focus on political institutions as the root source for economic problems is exhibited in a model developed by Carlos Acuna, Mariano Tommasi, and Pablo Spiller.² Many of you will recall that Professor Spiller was one of the discussants at our third

¹ Stephen Haber, Douglass C. North, and Barry Weingast, "The Poverty Trap," Hoover Digest, 2002 - No. 4 - Fall issue.

² See Carlos Acuna and Mariano Tommasi, "Some Reflections on the Institutional Reforms Required for Latin America," CEDI Working Paper, July 1999 and Pablo Spiller and Mariano Tommasi, "The Institutional Foundations of Public Policy: A Transactions Approach with Application to Argentina," CEDI Working Paper; and Mariano Tommasi, "Crisis, Political Institutions, and Policy Reform: It is not the Policy, it is the Polity, Stupid," ABCDE Europe, June 2002.

forum. In their model, three hierarchical levels for institutions are specified and the authors apply the model to Argentina. The lowest level of institutions (rules) are those that deal with specific outcomes. "A law or regulation establishing who pays and how much is paid as income tax is an example of this type of rule." The second level of rules is the source of authority for the lower level of rules. For example, a law that identifies who can set tax rates and at what level falls within the second level. The highest level of rules "define political participation and decision making processes at the social level." This is the constitutional level. The lowest level is the level of economic institutions; the next two levels are political institutions. The authors trace much of Argentina's economic difficulties not to a lack of understanding of what economic reforms are needed but rather to the political institutional infrastructure that prevents reforms at the lowest level from being designed and implemented. Is this a cultural problem or a political problem or do the two problems overlap so that in effect we have only one that can be called cultural?