

Forum Series on the Role of Institutions in Promoting Economic Growth

**UNDERSTANDING THE TRANSACTION COSTS OF
TRANSITION: IT'S THE CULTURE, STUPID**

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Forum 6

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

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Forum 6 Session on the Interaction Thesis

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Executive Summary

Scholarly research and empirical evidence showing the strong positive relationship between the free-market, private-property economy and economic growth is very convincing. The Index of Economic Freedom published annually by the Heritage Foundation and Wall Street Journal demonstrates a strong correlation between economic freedom and economic growth. To measure economic freedom the Index uses a set of factors that also define the free-market, private-property economy.

In the early 1990s, the former socialist states in Central and Eastern Europe (hereafter C&EE) began transition into free-market, private-property economies. Thirteen years later, the Index of Economic Freedom lists only one country in the region as a free market country, seven countries are listed as mostly free, nine as mostly unfree, and two as repressive. The same initial objectives of transition have clearly produced different results in C&EE.

The paper argues that the interaction between the formal institutions of capitalism and the prevailing culture in former socialist states is a major reason for observed differences in the results of institutional restructuring in C&EE. The paper uses the terms culture and informal rules, and the terms capitalism and the free-market, private-property economy interchangeably. The relationship between new formal rules in C&EE countries and their informal rules, the paper calls it the interaction thesis, is summarized as follows: “When changes in formal rules are in harmony with the prevailing informal rules, the incentives they create will tend to reduce transaction costs and free some resources for the production of wealth. When new formal rules conflict with the prevailing informal rules, the incentive they create will raise transaction costs and reduce the production of wealth in the community.”

The interaction thesis suggests three issues for analysis of the process of transition: What are the most important formal institutions of capitalism? What kind of culture is in harmony with formal institutions of capitalism? What is the difference between that culture and informal rules in C&EE countries?

The paper defines private property rights, the freedom of contract, an independent judiciary and a constitution as the basic formal institutions that sets capitalism apart from other legal-economic systems. Those four formal institutions generate behavioral incentives that call for a culture, the paper calls it the culture of individualism, that encourages individuals to pursue their private ends via behaviors based on self-interest, self-determination, self-responsibility, and free market competition.

Informal rules in C&EE support collectivism, egalitarianism, emphasis on extended family, and shared values. Hence, the prevailing culture in C&EE is in conflict with the basic institutions of capitalism. An implication is that in the early 1990s East Europeans were not ready to embrace a way of life based on the principles of self-interest, self-determination, self-responsibility, and free market competition. Positive transaction costs specific to the process of transition are a critical consequence of this conflict.

Differences in the history and development of C&EE countries have created differences in their respective informal rules. Countries that used to belong to the Austro-Hungarian Empire or have been influenced by western states, such as the Baltic States and Poland, have memories of the Western tradition of individual rights and the rule of law. Russian, Turkish and Byzantine cultures have left their imprints on other countries in the region. That is why the culture of collectivism, egalitarianism and extended family is stronger the farther east and southeast one travels.

An implication is that the transaction costs of transition in C&EE should be higher the farther east and southeast one travels. And if so, those differences in transaction cost should explain (and predict) differences in the results of transition from socialism to free-market, private-property economies. Indeed, and with only one exception (Croatia), 2003 Index of Economic Freedom ranks C&EE countries with more of a Western tradition as free or mostly free, while Russia and countries that used to be dominated by Russia and Ottoman Turks rank as mostly unfree and repressed.

Observed results of transition in C&EE countries must then depend on policies their leaders decide to pursue in resolving the conflict between new formal rules and prevailing informal rules. Depending on the their respective prevailing informal rules and bargaining strength of those opposed to transition, most countries in C&EE have proceeded with the process of institutional restructuring either by fiat or voluntary contracts or, most likely, a mix of those two methods.

Finally, the paper provides several examples of the relationship between informal rules, transaction costs of institutional changes, and economic performance.

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INTRODUCTION: THE INTERACTION THESIS*

Scholarly research and empirical evidence showing the strong positive relationship between the free-market, private-property economy and economic growth is quite convincing. For example, Haan and Sturm find that greater economic freedom correlates with higher economic growth.¹ Torstensson demonstrates that unstable private property rights retard economic growth.² North and Weingast argue that the development of credible private property rights, the adoption of common law, and non

* I am grateful to Frederic Fransen, Robert Higgs, Milic Milovanovich, Stefan Voigt and Fred Witthans for very constructive comments on an earlier version of this paper. My long discussions with Veselin Vukotich have enriched my understanding of the process of Transition in Eastern Europe.

¹Haan, J., and Sturm, J. (2000), "On the Relationship between Economic Freedom and Economic Growth," *European Journal of Political Economy* 16, pp. 215-241.

²Torstensson, J. (1994), "Property Rights and Economic Growth: An Empirical Study," *Kyklos* 47, pp. 231-247.

enforcement of wage and price controls explain economic growth in Seventeenth-Century England.³ Economic studies covering eight countries on four continents show the power of property rights to explain and predict economic behavior over a range of cultures.⁴ The Heritage Foundation's *Index of Economic Freedom* and Fraser Institute's *Economic Freedom of the World* illuminate a strong positive relationship between economic freedom and growth.⁵

In the early 1990s, the end of socialism in Central and Eastern Europe (hereafter C&EE) created incentives to seek growth oriented institutional reforms. Responding to those incentives, the former socialist states in Central and Eastern Europe (hereafter C&EE) began transition into free-market, private property economies.⁶ Thirteen years later, the 2003 Index of Economic Freedom classified only Estonia as a free-market country.⁷ Seven other countries from the region were classified as mostly free,

³North, D. and Weingast, B. (1989), "Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England," *Journal of Economic History*, 49, pp. 803-832.

⁴Pejovich, S. (2001), *The Economics of Property Rights*, Edward Elgar, volume 2, part IV.

⁵ Both indexes are published annually.

⁶ I have here used the terms *capitalism* and *free-market, private-property economy* interchangeably.

⁷To measure economic freedom in any country, the Index uses the following ten factors: trade policy, fiscal burden, government intervention, monetary policy, capital flow and foreign investments, banking and finance, wages and prices, property rights, regulations, and black market activity. Thus, free-market economies and economic freedom go hand in hand.

nine as mostly unfree, and two as repressive.⁸ The same initial objectives of transition have clearly produced different results in different C&EE countries. I conjecture that differences in the results of transition are not accidental.

The process of transition from socialism to free-market, private-property economies calls for the development of new institutions. The transaction costs of institutional restructuring must then affect the results of transition. To understand differences in the observed results of transition it is necessary to inquire whether the transaction costs of institutional restructuring differ from one country to another, and if so, why so?

There is no generally accepted definition of transaction costs. The paper defines transaction costs as the costs of all resources required for making an exchange (e.g., discovering exchange opportunities, negotiating exchange, monitoring, and enforcement), and for developing, maintaining, and protecting the institutional structure (e.g., judiciary, police, and armed forces). This definition offers a conceptually useful perception of transaction costs, and is also consistent with the only major attempt to quantify them.⁹

⁸In the order of their respective ranking, mostly free countries are Lithuania, the Czech Republic, Hungary, Latvia, Poland, Slovenia and Slovakia. Mostly unfree states are Macedonia, Albania, Moldova, Bulgaria, Croatia, Romania, Russia, the Ukraine and Bosnia. Yugoslavia and Belarus are repressive states.

⁹ Wallis, J. and North, D. (1986), "Measuring the Transaction Sector in the United States Economy, 1870-1970," (S. Engerman and R. Gallman, eds.) *Long-Term Factors in American Economic Growth*, University of Chicago Press, pp. 95-161.

A major function of institutions or the rules of the game is to lower transaction costs of human interactions.¹⁰ The rules consist of formal and informal institutions. Since the behavior of individuals is rule-guided, the choice of new institutions and the method of choosing them must have strong influence on the results of transition.

My starting point is that the process of transition in C&EE from socialism to capitalism is a cultural issue rather than a mere technical one.¹¹ To support that proposition, economic analysis must explain why and how informal rules affect the results of transition.

While there is no generally accepted definition of culture,¹² the paper goes along with scholars who view culture as the informal constraints on human interactions.¹³ The prevailing culture in the community is then 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. The enforcement of informal rules takes place by means of sanctions such as expulsion from the community, ostracism by friends and neighbors, or loss of reputation.

¹⁰ I have here used *institutions* and *the rules of the game* interchangeably.

¹¹ See Colomatto, E. (2001), "Development and Transition," *Journal of Markets and Morality*, 4, p. 285.

¹² For example, Ruttan has an appendix listing different definitions of culture. See Ruttan, V. (1988), "Cultural Endowments and Economic Development: What Can We Learn from Anthropology?" *Economic Development and Cultural Change*, 36, No. 3.

¹³ See North, D. (1990), *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, p. 37. Gellner defined culture as "a distinct way of doing things which characterizes a given community." See Gellner, E. (1988), *Plough, Book and Sword*, London: Collins Harvill, p. 14.

The term *prevailing* culture requires a brief explanation. No community is culturally homogenous. There are always some individuals who seem to ignore the margin of accepted behavior. In some cases those individuals are social innovators or pathfinders. In some other cases they are criminals or bums. Sometimes they are both. For example, the settlers came to North America in the early days of the new frontiers because they opposed the established order, medieval traditions, and taxes imposed by secular and religious rulers. By the-then prevailing rules in Europe many settlers were criminals because they wanted to make their own choices, develop their own rules of the game, and choose their own morals. Also, there are people in most communities who want to impose the old ethos, as they subjectively perceive it, on their fellow citizens. Yet, all communities have their “mainstream” rules of the game. Those rules are the result of selective evolution. And they maintain themselves by incremental adaptation to changes in the social and economic conditions of life. The term prevailing culture refers to those informal rules.

Transition means institutional restructuring. Since informal rules are not a policy variable, transition has to mean the enactment of new formal rules; that is, constitutions, statutes, common law precedents, and/or governmental regulations.¹⁴ The results of transition then depend on the interaction of new formal and prevailing informal rules. Of course, the rules do not interact. Individuals do. New formal rules create new

¹⁴Government enforces formal rules by means of sanctions such as fines, imprisonment, and execution.

incentives and opportunities for human interactions. How individuals react to those new opportunities for exchange depends on how they perceive them. And how individuals perceive new opportunities depends on their subjective perceptions of reality, which is shaped by prevailing culture. Assuming the freedom of choice, their reaction can take three basic forms.

If informal rules were not in tune with new formal rules the resulting conflict between them would raise the transaction costs of institutional restructuring. For example, the leadership of the European Union wants to harmonize a number of formal rules because they differ from one member country to another. I conjecture that the rising strength of conservative political parties favoring the old formal rules is evidence that the “harmonization” of laws from Brussels is not in tune with informal rules in member countries.

Transaction costs are reduced when informal rules either ignore formal rules or render them neutral. The rise of ethnic and religious ghettos in many American cities reflected a strong preference of various ethnic and religious groups—all of them accepting the laws of the United States-- to stay together with those individuals whose behavior they could understand and predict. Moreover, Ellickson has shown how the residents in Shasta County set formal rules aside by choosing to rely on a

set of endogenous informal rules to resolve disputes arising from damage done by livestock.¹⁵

Finally, harmony between formal and informal rules reduces the transaction costs of maintaining the institutional structure in the community. A number of scholars have demonstrated how the transaction costs of the development of private property rights in the American West were reduced by the state passing formal rules that in effect institutionalized already established informal rules.¹⁶

The relationship between new formal and prevailing informal rules, *the interaction thesis*, can be then summarized as follows:

When changes in formal rules are in harmony with the prevailing informal rules, the incentives they create will tend to reduce transaction costs and free some resources for the production of wealth. When new formal rules conflict with the prevailing informal rules, the incentive they create will raise transaction costs and reduce the production of wealth in the community.

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. To that end, I analyze the implications of the

¹⁵Ellickson, R. (1986), "Of Coase and Cattle: Dispute Resolution among Neighbors in Shasta County," *Stanford Law Review* 38, pp. 624-687.

¹⁶For example, see Anderson, T. and Hill, P. (1983), "Privatizing the Commons: An Improvement," *Southern Economic Journal* 50, pp. 438-450.

interaction between formal and informal rules, the differences between the free-market, private-property economy and the prevailing culture in C&EE, the process by which the transaction costs of transition could be reduced, and the factors upon which that process depends.

THE CULTURE OF INDIVIDUALISM AND THE FREE-MARKET, PRIVATE-PROPERTY ECONOMY

The interaction thesis raises three important issues relevant for analysis of the results of transition from socialism to free-market, private-property economies (i.e., capitalism). Those issues are: (1) What are the most important formal institutions of capitalism; (2) What kind of culture is in harmony with formal institutions of capitalism; and (3) What is the difference between that culture and informal rules in C&EE countries.

The most important formal rules that set capitalism apart from other systems are credible and stable private property rights,¹⁷ the freedom of contracts, an independent judiciary, and the constitution.¹⁸ Many scholars refer to those four basic formal institutions of capitalism as negative rights. Two major functions of negative rights are to reduce the discretionary power of state legislators and bureaucrats, and to protect individual rights and private ownership from a majority rule.

¹⁷ In order to have expected consequences, private property rights must be both stable and credible.

¹⁸The *Index of Economic Freedom* published annually by the Heritage Foundation and the Wall Street Journal has a longer list of most important rules that define the free-market, private-property economy.

Negative rights create specific and predictable behavioral incentives. By creating a strong marriage between the individual's right to choose how to use a privately owned asset and bearing the costs (risk) of his/her choice, private property rights provide powerful incentives for the owner to invest time and effort in seeking the highest-valued uses for the asset.¹⁹ The freedom of contracts reduces the transaction costs of identifying the value of resources in alternative uses and enhances their transfer to more productive owners. An independent judiciary serves the function of protecting individual rights against the rest of the world.²⁰ The constitution protects the individual against majority rule. That is why Buchanan often says that the term *constitution* should come before the word *democracy*.²¹

However, formal rules of capitalism have been observed to produce different outcomes in different cultures. North wrote:

Many Latin American countries adopted the U.S. Constitution (with some modifications) in the nineteenth century, and many of the property rights laws of successful Western countries have been adopted by Third World countries. The results, however, are not similar to those in either the United States or other successful Western countries. Although the rules are the same, the enforcement mechanism, the way enforcement occurs, the norms

¹⁹Frequently, we voluntarily allow other people to make choices for us. The transfer of decision making is voluntary, and thus it is consistent with incentives to seek the best use for our assets (buying stocks).

²⁰ Two major requirements for an independent judiciary say that judges must expect that their decisions be carried out, and that their jobs do not depend on legislators and/or bureaucrats.

²¹Buchanan, J. (1993), *Property as a Guarantor of Liberty*, Edward Elgar, p.59

of behavior, and the subjective models of the actors are not [the same].²²

Given their behavioral incentives, the basic institutions of capitalism require a culture, let us call it the culture of individualism, that encourages individuals to pursue their private ends. Classical liberalism and methodological individualism²³ made major contributions to the development of the culture of individualism. They provided philosophical justification as well as methodological support for looking at the community as a voluntary association of individuals who, in the pursuit of their private ends, join and leave the community by free choice. The culture of individualism encourages the behavior based on the principles of self-interest, self-determination, self-responsibility and free market competition. It is merit-oriented, rewards performance, encourages risk taking, and promotes entrepreneurship.²⁴ The free-market, private-property economy is then not merely an alternative method for the allocation of resources but a *way of life* in which each and every individual bears the value consequences of his or her decisions.

²²North, D. (1990), *Institutions, Institutional Change and Economic Performance*, p. 101.

²³ Classical liberalism and methodological individualism are cornerstones of the free-market, private-property economy. The former is about individual liberty, openness to new ideas and tolerance of all views. The latter says that decisions made by governments, parliaments, corporations, and other organizations are decisions made by individuals. Individuals perceive ideas, invest time and effort in persuading others to accept their proposals, and bear the costs of failure. Hence, only the individual could be the unit of analysis.

²⁴As an example of performance being rewarded, in 1991, the median income of Asian-Americans (\$36,784), whose culture instills a strong work ethic, exceeded the median income of white Americans (\$31,435). See "Two Measures of Household Income," *New York Times*, July 24, 1992, p. A10.

Buchanan summarized a key consequence of the private-property, free-market economy as follows:

Economic performance can only be conceived in values, but how are those values determined? By prices, and prices emerge only in competitive markets. They have no meaning in a non-market context, where the choice-influenced opportunity costs are ignored.²⁵

INFORMAL RULES IN CENTRAL AND EASTERN EUROPE AND TRANSACTION COSTS SPECIFIC TO THE PROCESS OF TRANSITION

The prevailing culture in C&EE is not homogenous. However, it has some common traits. The community is seen as an organic whole with its own common good to which members are expected to subordinate their private ends. It means that the prevailing culture in C&EE has a bias toward collectivism, egalitarianism, emphasis on extended family, and shared values.²⁶ While the culture of individualism puts a premium on performance, risk taking and the freedom to choose, the old ethos in C&EE favors the equality of results and social welfare programs. In many parts of the region, gains from trade are seen as a redistribution of income rather than as rewards to innovators for creating new wealth. State authorities are more likely to impose price controls on producers

²⁵Buchanan, J., (1976), "General Implications of Subjectivism in Economics," Paper presented at *The Conference on Subjectivism in Economics*, Dallas, Texas, December 1976.

²⁶For more detailed analysis of the C&EE cultural heritage see Pejovich, S. (1993), "Institutions, Nationalism, and the Transition Process in Eastern Europe," (E. Paul, Ed.) *Social Philosophy and Policy: Liberalism and the Economic Order*, Cambridge University Press, pp. 68-74.

and/or merchants who earn large profits than to seek ways to create incentives for others to emulate such individuals in competitive markets.

During four decades of socialism (seven in the former USSR), the old culture of C&EE served the people of the region well. By subverting the rule law to the will of the ruling elite, socialism weakened people's confidence in enforcement mechanisms (i.e., the judiciary and police). Yet, with its emphasis on the extended family and shared values, the culture of C&EE created a powerful fortress within which people were able to hide and to go on with their lives.²⁷ Unfortunately, by creating a survival path for East Europeans, the culture of the region had a major unintended consequence of strengthening the collectivism and shared values in C&EE.

In general, the cultural heritage of C&EE supports an activist (paternalistic) state. An implication is that in the early 1990s East Europeans were not ready to embrace a way of life based on the principles of self-interest, self-determination, self-responsibility and free market competition. This, in turn, means that the acceptance, monitoring and enforcement of new formal rules in C&EE countries had to have positive transaction costs. We can say that *transaction costs specific to the process of transition arise from the conflict between the formal rules of capitalism and the prevailing culture of C&EE.*

²⁷Pekich, B. (1990), *Godine Koje su Skakavci Pojeli* (Years the Grasshoppers Ate), Belgrade.

Differences in the history and development of C&EE countries have created cultural differences among them. While classical liberalism, which is only a part of the Western tradition, has no deep roots in C&EE, countries that used to belong to the Austro-Hungarian Empire have memories of the Western tradition of individual rights and the rule of law. It is primarily through the Catholic Church that Western tradition has influenced the development of informal institutions in Poland. Germany, Sweden and Finland have influenced customs and tradition in the Baltic States. Turkish and Byzantine cultures have left their imprints in the Balkans. Greek culture reflects the knowledge-creating consequences of maritime trading. Russian Orthodox Church remained a servant of the state from the days of Ivan the Terrible. Thus, it failed to be an independent source of informal rules.

Numerous historical myths have created a strong marriage between ethnicity and nationalism in many C&EE countries.²⁸ By feeding on the conviction that the community's common good transcends the private ends of its members, nationalism in many C&EE countries has reinforced the culture of collectivism. While strengthening the bond within ethnic groups, nationalism has raised the costs of interactions with outsiders. The Serbs in Croatia, the Albanians in Serbia, the Turks in Bulgaria, and the Hungarians in Romania are examples of how the

²⁸Nationalism should not be confused with patriotism. The latter means attachment to a community and its institutions. Patriotism is then fully compatible with a voluntary association of diverse individuals who choose to live together.

marriage of ethnicity and nationalism creates spontaneous cultural autonomies.

The greater is the conflict between the formal institutions of capitalism and the prevailing culture in a country, the larger are that country's transaction costs of transition. Thus, to achieve the same transition results (e.g., the same ranking in the Index of Economic Freedom) a tradition-driven Montenegro would have to use more resources than a pro-western country like the Czech Republic. We can say that *the cultural differences between Central and East European countries create differences in their respective transaction costs of transition.*²⁹

Historical development and nationalism of C&EE explain why the culture of collectivism and egalitarianism is stronger the farther east and southeast one travels. The interaction thesis then suggests that the transaction costs of transition in C&EE should be higher the farther east and southeast one travels. And if so, those differences in transaction cost should explain (and predict) differences in the results of transition from socialism to free-market, private-property economies. Indeed, and with only one exception (Croatia), 2003 Index of Economic Freedom ranks C&EE countries with more of a Western tradition as free or mostly free, while Russia and countries that used to be dominated by Russia and Ottoman Turks rank as mostly unfree and repressed.

²⁹Cardinal measurements of transaction costs are still in a pioneering stage. References to the differences in transaction costs are in terms of more or less.

The results of institutional restructuring in C&EE should then depend on the ability of individual countries in the region to reduce transaction costs arising from the interaction between the formal institutions of capitalism and their respective cultures. It follows that analysis must identify some critical factors affecting the transaction costs of transition. The former nomenklatura and the forty-something group are two such factors.

By exploiting the prevailing culture in C&EE, the old establishment and the forty-something group have kept the transaction costs of transition from falling. In most C&EE countries, the old ruling elite, which includes party leaders, members of security services, upper level bureaucrats, managers of business firms, fellow travelers, etc., quickly did an about-face and began paying lip service to the transition to capitalism. However, the old elite has a strong comparative advantage in economic policies that favor a state-centered economy, the collectivist mode of looking at the world, and promotions based on loyalty rather than merit. While paying lip service to competitive markets, purely a façade of words, the old ruling elite has done its best to subvert the transition from socialism to capitalism.³⁰ The fact that de-communization didn't happen in most C&EE countries has then raised the transaction costs of transition in the region.³¹ Since the early 1990s, the political

³⁰Pejovich, S. (1993), "Institutions, Nationalism, and the Transition Process in Eastern Europe," pp.73-74.

³¹Some decommunization did occur in Germany. In a few countries such as the Czech Republic, former top leaders and members of secret services were to be excluded from

landscape of C&EE has produced very few leaders like Klaus and Maar, and too many like Meciar, Yeltsin, Kravchuk and Lukashenko.

The forty-something group is another factor responsible for high costs of transition in C&EE. This group's package of benefits consists of assets specific to a socialist state, such as job security, allowances for children, medical benefits, liberal pensions, low cost vacations, and subsidized housing. Members of this group fear that the remainder of their working life is not long enough to allow them to replace those benefits with private saving and investments. It is important to understand that they didn't purchase that package of assets by choice. However, it is all they got. Thus, members of the forty-something group in many C&EE countries have been voting against free-market parties not because they prefer socialism to capitalism but for reasons of self-interest.³²

THE CHOICE OF TRANSITION PROCESS

The transition of former socialist countries into private-property, free-market economies requires that some basic institutions of capitalism--private property rights, the law of contracts, an independent judiciary, and a constitution--be introduced by *fiat*. Sunstein wrote: "For Eastern Europe in general, the drafting of a constitution [begins] the process of

decision-making jobs in government. Otherwise, it is fair to say that in C&EE the old elite retained its position of influence.

³² Evidence is consistent with this proposition. Young people, who have made no investments in the assets specific to the old system, tend to support pro-reform parties, while members of the forty-something group can be seen carrying pictures of Lenin, Stalin, Milosevich and other communist leaders.

creating a legal culture with firm judicial protection of individual rights...prominent among them property ownership and freedom of contract.”³³

The interaction thesis suggests that new formal rules might create behavioral incentives that are not in tune with the prevailing culture. The resulting conflict between new formal rules and the prevailing culture would, in turn, increase the transaction costs of contracting, maintaining and enforcing new formal rules. The results of transition in C&EE countries must then depend on policies their leaders decide to pursue in resolving the conflict between new formal rules and the prevailing informal rules.

Belarus has failed to go beyond the initial promise of transition. “Its legal system does not fully protect private property, and the inefficient court system does not consistently enforce contracts...[for example] Belarus passed a law enabling the government to nationalize the property of any individual or business deemed to be damaging the state.”³⁴ Depending on the their respective prevailing informal rules and the bargaining strength of those opposed to transition, most countries in C&EE have proceeded with the process of institutional restructuring either by fiat or voluntary contracts or, most likely, a mix of those two methods. Let us now discuss those choices with reference to a specific country, say, Montenegro.

³³ Sunstein, C. (1993), “On Property and Constitutionalism,” *Cardozo Law Review* 14, p. 918.

³⁴ *2003 Index of Economic Freedom*, The Heritage Foundation and Wall Street Journal, p.102.

The Transition by Fiat. The government of Montenegro could take an active role in the process of transition by enacting “clarifying” laws and regulations. The purpose of those laws (employment policy, investment subsidies, laws protecting culture, etc) would be to reduce the conflict between new formal institutions and the prevailing culture.³⁵ Sunstein identified the costs of those secondary or modifying laws in C&EE as follows: “Without strong constitutional provisions on behalf of property rights, civil society, and markets, there will probably be a substantial temptation to intrude on all these institutions, and, by so doing, recreate the very problems that such institutions are supposed to solve.”³⁶ Then he added, “...the case for a firm negative constitution, and for creation and *protection* [emphasis mine] of property rights and free markets, is very strong in Eastern Europe.”³⁷

The old nomenklatura and the forty-something group have incentives to argue that a well-functioning market cannot be expected to arise “naturally.”³⁸ The outcome of their support for an activist state depends on their relative bargaining strengths in the community. But once they manage to get the government into the economy, rent-seeking coalitions

³⁵ This approach to transition derives its support from the mainstream neoclassical economics, which focuses on outcome-oriented changes in a world without institutions.

³⁶ Sunstein, C. Op. Cit., p. 935.

³⁷ Ibid.

³⁸ The proponents of the German social market economy advanced this type of argument back in the 1950s.

are going to emerge and use the state to obtain favorable regulations.

Stigler wrote:

The state is a potential resource or threat to every industry in the society. With its power to prohibit or compel, to take or give money, the state can and does selectively help or hurt a vast number of industries.³⁹

The transition by fiat means that Montenegrins would end up with a government-engineered compromise between capitalism and the old system. The costs of transition would be borne by all citizens regardless of whether they wanted institutional reforms, opposed them, or didn't care one way or another. Moreover, the new institutional structure would do little to increase people's confidence in the stability and credibility of private property rights and contractual freedom.

The Transition by Voluntary Contracts. Alternatively, the government could try to assure Montenegrins that private property rights, the law of contracts, an independent judiciary and the constitution are stable and credible rules of the game. That would clearly be not an easy job for new leaders in the region in which the rule of law is, at best, a distant memory. However, let us suppose that the government is willing and able to leave Montenegrins alone to resolve, *via* voluntary interactions (contracts), the conflict between new formal rules and their culture.⁴⁰

³⁹Stigler, G. (1971), "The Theory of Government Regulation," *Bell Journal of Economics* 2, p. 3.

⁴⁰ We can associate the transition by voluntary contracts with new institutional economics, Austrian economics and Public Choice.

The transition by voluntary contract means that the agent of the process of change is the individual. The enactment of private property rights, the law of contract, an independent judiciary and a constitution create for individuals new, and fully legal, opportunities to pursue their private ends. Some individuals will choose to take the risk of exploiting those opportunities for personal gain. However, if the new opportunities for human interactions were not in tune with the prevailing culture in Montenegro, a conflict would arise between the individuals trying to exploit them and the community at large. In practice, such conflicts have surfaced in many different forms in C&EE. People have said that individuals seeking new contractual arrangements are foreigners “who want to take our money abroad,” or women “who should be staying at home,” or enterprising men “who want to profit at other people’s expense,” or Baptist missionaries “who want to destroy our Orthodox faith.”

The behavior of the “pathfinders” would be below the margin of prevailing ethical standards in Montenegro. However, it is critical to recognize that *they* bear the costs of their activities. In addition to financial losses, those costs could range from losing friends to losing jobs and alienation from the community. However, if pursuing submarginal contractual activities (which, as noted, are fully legal) provided the pathfinders with a differential return, their success would create incentives for others to engage in the same or similar activities. And if the returns from those activities continued to be sustainable more and more individuals would find it in their self-interest to join in.

Eventually, spontaneous pressures arising from within the system would slowly compel the community to embrace those submarginal activities.

At that point, the transition by voluntary contracts would have reduced the conflict between the formal institutions of capitalism and the prevailing culture in Montenegro. The transaction costs of changing informal rules would have been borne by individuals whose expected benefits from changes in informal rules exceeded their costs of overcoming the community's resistance. The result of transition would then be a sustainable *voluntary* compromise between the free-market, private-property economy and the old culture. The people of Montenegro would get no more and no less capitalism than they are willing to support. Moreover, they would be able to continue voluntarily adjusting the mix of capitalism and their old culture in the future. To accomplish the transition by voluntary contracts, the government of Montenegro has to enforce negative rights, leave people alone to work out the conflicts of interest via voluntary interactions, and institutionalize (repeated) exchanges that have passed the market test.

Buchanan captured the essence of the difference between the two methods of institutional restructuring as follows:

An activist state [is] ever ready to intervene when existing rights to property are challenged, ever willing to grasp the nettle and define rights anew, which once defined, immediately become vulnerable to still further challenges. [In a passive state] there is an explicit prejudice in favor of previously existing rights, not

because this structure possesses some intrinsic ethical attributes, and not because change itself is undesirable, but for the much more elementary reason that only such a prejudice offers incentives for the emergence of voluntary negotiated settlements among the [individual members of the community].⁴¹

Given the region's prevailing culture of collectivism, welfarism, and egalitarianism, new leaders have incentives to erode the transition by voluntary contracts. Indeed, we observe different mixes of the transition by voluntary contracts and the transition by fiat. The ranking of C&EE countries in 2003 *Index of Economic Freedom* is a good yardstick for evaluating the prevalence of one or the other mode of transition. For example, the Index shows that institutional restructuring in Estonia has been close to the transition by contracts, while institutional changes in Serbia and Montenegro have been close to the transition by fiat.

THE ROLE OF CULTURE IN THE PROCESS OF TRANSITION: SOME EMPIRICAL OBSERVATIONS

The scenario outlined above suggests that the transition by fiat and the transition by voluntary contracts are two major methods for carrying out institutional restructuring. Let us now look at several observations that illustrate the role of culture in the integration of new formal institutions into the social life.

⁴¹Buchanan, J. (1972), "Politics, Property, and the Law," *Journal of Law and Economics* 15, pp. 451-452.

1. Niksicka Pivara (The Brewery of Niksich) in Montenegro is known all over Europe for its excellent beer. The firm won quite a few prizes in tough European competition. While the firm sold beer all over the former Yugoslavia and many European countries, its main profit came from summer sales along the coast of Montenegro.

The end of socialism in the early 1990s led to privatization of many enterprises including the Brewery of Niksich. A foreign investor bought 70% interest in the brewery. The buyer paid 16 million German Marks in cash and promised to invest another 25 million German marks in the firm. The employees and local citizens kept 30% interest in the brewery. In addition, foreign investor promised that the average real salary paid to the employees will not fall below the average real salary in the brewery at the time it was purchased. The average salary in real terms was 200 German marks per month. In those uncertain political and economic times in the Balkans, German mark served as the measure of value.

New owners kept their contractual promise and invested more than 25 million German marks in the brewery. Yet, after decades of socialism, private ownership was out of tune with the prevailing culture in Montenegro. The employees discovered that shirking, tardiness, and long coffee breaks were out and working discipline in. Former managers and some employees lost a number of pecuniary and non-pecuniary benefits characteristic of property rights in socialism such as using company's

trucks for private business, frequent trips abroad, cheap credits, and subsidized housing. Local officials lost gifts and patronage.

The first strike occurred over the salary issue. Ignoring differences between the exchange rate controlled by the state and the real value of dinar (Montenegro currency at that time), the local union asked the firm to raise the average salary to 600 German marks. The management said no. From then until 2002, strikes, strike threats, and labor disputes continued to plague the brewery. In May 2002, just as the tourist season was to begin, the employees demanded, through their local union, a big salary increase of 35%. At that time, the average pay in the brewery was equal to 400 Euro per month, while the average monthly pay in Montenegro was about 200. In addition to higher pay, the employees also wanted the firm to buy a car for the union office, to give a share of its profit to the union, to put representative of the employees on the board of directors, to provide opportunities for the employees to travel abroad at company's expenses, and to earmark a large amount of the firm's revenue to build subsidized apartments for workers.

By the fall of 2002, new owners had enough and decided to move the brewery out of Montenegro. The response from the striking employees and local politicians was quick and reflected their "understanding" of the right of ownership. They said that new owners didn't build the factory and, therefore, they have no right to close it down. Eventually, workers and management arrived at some sort of compromise and the brewery is still in Niksich. However, this story is not an inquiry into the terms of

collective bargaining in Montenegro. The message of the story is that the enactment of private property rights does not instantaneously create a neoclassical equilibrium. Different cultures require different expenditures of time, efforts and resources to bridge the gap between the enactment of private property rights and their eventual acceptance by the prevailing informal rules. To gain the benefits associated with the behavioral incentives of private property rights, new leaders must manage to create reasonable expectations about the credibility and stability of ownership.

2. In response to the acquiescence to their rule, the Romanovs (1613-1917) protected the Russian Orthodox Church from competition by other churches. Communist leaders abetted this protection by raising the cost of entry into the market for religion. The result was that the Russian Orthodox Church has come to consider itself the guardian of Russian customs and traditions. When in the 1990s, many Protestant denominations found the market for religion in Russia receptive to their teachings, the Russian Orthodox Church lobbied the state to pass laws prohibiting (or at least seriously restricting) other churches from marketing their services. Otherwise, the Church argues, Russian culture will be westernized. Clearly, the Church wanted new leaders to pass a rule that would raise the transaction costs of voluntary changes in informal rules.

3. The transition by voluntary contracts explains the development of property rights in the American West. Libecap analyzed the development

of mineral laws in the western United States in the second half of the 19th century. Noting that common law judges continuously adjust rules to changes in the game he wrote:

[As] the mining industry boomed, spurred by huge ore discoveries...pressure on existing legal institutions forced new ownership structure to emerge. This resulted in the observed progression in mineral rights law from general, *unwritten rules* [emphasis mine] in the 1850s to highly specified statutes and court verdicts by the end of the century.⁴²

4. Some decades ago, the growth of output coupled with an increase in the range of durable consumer goods changed the opportunity costs of being a homemaker in the United States. The-then prevailing rules expected men to specialize in earning incomes while women were expected to specialize in the efficient spending of that income and in raising children. Single women were socially marginalized. Wives went to work in order to pay some specific bills between pregnancies and after kids went to college. Predictably, the market treated women as a high-cost resource relative to men. Pressures from feminist groups to equalize money incomes of men and women by fiat (i.e., institutional adjustments by fiat)

⁴² Libecap, G. (1996), "Economic Variables and the Development of the Law; The Case of Western Mineral Rights," (L. Alston, T. Eggertsson, and D. North, eds.), *Empirical Studies in Institutional Change*, Cambridge University Press, p.57.

created additional problems because the competitive market for labor was not discriminating by sex; it was merely responding to the prevailing informal rules. The real issue was then to change informal rules so that the competitive market for labor would have no reason to treat women as a high cost resource relative to men. The pressure for change in the prevailing informal rules came from within the system (i.e., institutional adjustments by voluntary contracts) and was borne by career oriented women. Eventually, the country accepted the Pill, single motherhood, live-in arrangements and other norms of behavior that were submarginal not long ago but have now freed women from economic and social dependence on men. Posner had the following to say about the costs of changes in the sexual and reproductive freedom of women:

The more reproductive autonomy and sexual freedom women have, the less interest men have in marriage, because secure paternity is one of the principal benefits of marriage for a man...Women who would prefer to specialize in household rather than market production are therefore harmed by sexual freedom, while women who prefer specializing in market production are helped by anything that gives them fuller control

over their reproduction, though they too pay a price in reduced marital opportunities.⁴³

5. In a recent study, Allison and Angeles demonstrated how the prevailing culture explains the difference in the way Americans and Europeans react to income inequalities.⁴⁴ They quote a survey showing that 71 percent of Americans and only 40 percent of Europeans believe that the poor could do better via individual effort. Therefore, Allison and Angeles said, it is not surprising that the alleviation of poverty in the United States emphasizes work effort, while European governments prefer redistributive policies from above. Allison and Angeles wrote:

...in their attempt to improve the fairness of economic outcomes, Europeans choose more redistribution and more government intervention which, in equilibrium, distorts market allocations and makes economic outcomes unfair... Interestingly, the biggest differences in redistributive policies between the United States and continental Europe reside in the support for poverty per se. That is, if you are sick, old or disabled, have dependent children, or have suffered an accident at work, you do get substantial support in the United States; but if you are merely poor, you do not get much support in the United States.(pp. 32-33)

⁴³ Posner, R. (1995), *Overcoming Law*, Harvard University Press, p.183.

⁴⁴ Alesina, A. and Angeletos, G. (2002), "Fairness and Redistribution: US vs. Europe," National Bureau for Economic Research, Working Paper 9502.

PRIVATIZATION OF STATE-OWNED FIRMS VS NEVER-PRIVATIZED ENTERPRISES

Winiiecki, Benecek, Laki, and many other scholars have been arguing that privatization policies that favor the development of new private enterprises (i.e. entrepreneurship) relative to the privatization of state-owned firms are likely to produce consequences similar to those of the transition by voluntary contracts.⁴⁵ Why?

Suppose that the prevailing culture in Montenegro is in a serious conflict with the formal institutions of capitalism, or that the old ruling elite has managed to retain significant powers, or that the forty-five plus group supports pro-socialist parties, or all of above. The resulting transaction costs of institutional restructuring would reduce the costs of forming effective rent seeking coalitions. Former business managers and the employees of state-owned firms would have incentives to negotiate with the legislators and bureaucrats a favorable method of privatization. Indeed, many C&EE countries have adopted privatization schemes that can be easily characterized as stealing.⁴⁶

⁴⁵ Benacek, V. (2002), "The Czech Generic Private Sector in Transition: Developments and Their Impact on National Economy," unpublished manuscript; Laki, M. (2002), "The Performance of Newly Established Private Firms: The Case of Hungary," unpublished manuscript; Winiiecki, J. (2002), "The New Entrepreneurial Private Sector in Transition and Economic Performance," unpublished manuscript; Winiiecki, J. (2002), "The Polish Generic Private Sector in Transition: Development and Characteristics," unpublished manuscript

⁴⁶ Milovanovich, M. (2002), "Endogenous Corruption in Privatized Companies", unpublished manuscript.

On the other hand, the transition by contracts encourages the development of small, owner-managed, firms. The economic efficiency of entrepreneurs arises from the marriage between the right to capture the benefits of their decisions and bearing the costs of those decisions. The entrepreneur-owner is a person who perceives an opportunity, accepts the risk of exploiting it, and has the perseverance to follow through an idea. Thus, the entrepreneur-owner is a major dynamic force in the economy.⁴⁷ By lowering the costs of entry into business as well as the subsequent costs of taxation and regulation, a market-friendly process of transition creates incentives for new firms to emerge. A corollary is that subsidies to entrepreneurs create inefficiencies. Since the allocation of subsidies is a political decision, subsidies raise the transaction costs of allocating resources to the highest-valued *users*.⁴⁸

Improving economic performance is not the most critical role the entrepreneur plays in the transition process. The essential contribution the entrepreneur makes to the transition process lies in bringing closer the culture of capitalism and the prevailing culture in C&EE countries.

⁴⁷Laki compared the performance of two groups of Hungarian managers in the 1990s. The first group consisted of individuals who managed business firms before the end of socialism. The other group included individuals who became managers of their own firms after the transition started. The performance of the second group was by far superior. Laki, M. (2002), "The Performance of Newly Established Private Firms: The Case of Hungary," unpublished manuscript.

⁴⁸The argument that subsidies (or low interest loans) are OK because they have to be paid back is a bunk. Entrepreneurs who fail are not likely to pay back anything. That is, the costs of their failure are borne by a third party. For example, the government of Serbia recently announced a loan from the World Bank to "help" small private firms. The assumptions that the government is capable of identifying the most productive users at a lower cost than competitive markets can do, and that the government would use such information if it had it require a Second Coming of Christ.

Entrepreneurs can and do accomplish this purpose because private-enterprises are the breeding ground for a work ethic, a capitalist exchange culture, and a way of life that rewards performance, promote individual liberties, and places high value on self-responsibility and self-determination.

CONCLUSIONS

The paper started with a simple proposition that observed differences in the results of transition among C&EE countries are not accidental. It argues that transition is a cultural problem. The interaction thesis says that the conflict between formal institutions of capitalism and prevailing informal rules in C&EE countries explains differences in the results of transition. However, the actual results of transition depend on the way new leaders choose to deal with the factors affecting the transaction costs of transition. Analysis and empirical evidence suggest that the transition by voluntary contracts correlates with better economic performance.

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