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# Law, Tradition, and the Transition in Eastern Europe

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SVETOZAR PEJOVICH

**T**he end of communist rule in Eastern Europe and the former Soviet Union (hereafter jointly termed Eastern Europe) created an institutional vacuum in the region. New leaders faced two critical issues: what new institutions to choose, and how fast to substitute the new institutions for the old ones. After several decades of ideological brainwashing and intellectual isolation, East Europeans were ill prepared to quickly identify alternative institutional arrangements and evaluate their expected consequences. At the same time, intellectual and political leaders in the West interpreted the end of socialism in Eastern Europe as a vote for capitalism. Westerners provided public and private funding for the transition from socialism to capitalism. Eastern Europe was quickly flooded with a large variety of transition models, transition experts, and scholars who appreciated a new source of research grants.

Neoclassical economics provided the general framework for the transition debate in the early 1990s. The basic neoclassical model became a foundation for the development of transition strategies in most East European countries as well as a yardstick for evaluating economic outcomes. According to the tenets of neoclassical economics, the transition required macro-stabilization, privatization, market prices, free international trade (including convertible currency), and a balanced government budget. East Europeans

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were assumed to be rational utility maximizers who would quickly and costlessly perceive new opportunities, evaluate their consequences, and make the utility-maximizing choices. Privatized assets, regardless of their initial ownership, would quickly move into their highest-valued uses. In this scenario, it seemed appropriate to encourage the new leaders in Eastern Europe to use the strong hand of the state to build capitalism.

Many property-rights and public-choice scholars regard neoclassical economics as ill suited for informing the institutional restructuring in Eastern Europe, largely because of its lack of appreciation for the importance of transaction costs in a world of uncertainty and incomplete knowledge. Transaction costs are the costs of all resources required to transfer property rights from one economic agent to another. They include the costs of making an exchange (e.g., discovering exchange opportunities, negotiating exchanges, monitoring, and enforcement) and the costs of maintaining and protecting the institutional structure (e.g., judiciary, police, and armed forces). Academic research and empirical evidence have established that different institutional structures generate different transaction costs.

Enrico Colombatto and Jonathan Macey (1997) have commented as follows on the neoclassical model in the analysis of the transition process:

The virtues of this stereotype in a frictionless, zero-transaction costs world are beyond dispute. Nirvana economies always work, by definition. It [was] indeed acknowledged that the adjustment process involves some costs and that, as a consequence, national income may drop in the short run. But this [was] usually considered an affordable price to pay in order to achieve "optimality." In other words, transaction costs [were] not looked upon as part of the transition problems, but rather as an unpleasant by-product.

Most transition models paid little attention to transaction costs. They failed to identify, and therefore to reduce, some inevitable types of transaction costs specific to the post-1989 adjustment process in Eastern Europe: the costs of convincing East Europeans that the legal system could be stable and credible; the costs of training new judges and lawyers; and the costs of helping ordinary people understand the requirements of institutional restructuring. Moreover, the transition entailed transaction costs that could have been avoided: frequent changes of rules, insecure property rights, and restrictions on the tradability of privatized assets.

An important aspect of the transition debate in the early 1990s involved the comparison of alternative stabilization models. The debate, initiated by Jeffrey Sachs, gave rise to a number of impeccable technical proposals for solving economic problems such as inflation, unemployment,

and trade and budget deficits. But the proposals ignored the effects on transaction costs of frequent adjustments in the rules. Evidence shows that uncertainty about the rules had major effects on stabilization programs in the early 1990s (Bossak 1993, 15–17; Cuckovich and Sirotich 1994, 87–90; Madzar 1995, 223–63).

The privatization debate focused on the costs of alternative privatization techniques and their fairness (e.g., spontaneous privatization, preferential treatment of the employees of business firms, and restitution). With a few exceptions, such as Jan Winięcki (1991) and Ljubo Madzar (1994, 7–66), analysts failed to focus on the effects of various privatization rules on the incentives of owners to seek the most valued uses of their assets.

Finally, from the standpoint of ordinary people in Eastern Europe, the transition process forced upon them institutional changes alien to beliefs and behaviors embedded in the fabric of community life (the more so, the farther to the east). They experienced the switch of one set of institutions for another, neither of which they chose for themselves. In most East European countries, privatization programs ultimately favored former nomenklaturists, the Czech Republic being perhaps the only exception.

By the mid-1990s, procollectivist parties (socialists, social democrats, communists, nationalists, and other anti-free-market parties) were gaining ground in many East European countries. For example, Hungary and Poland elected socialist governments even though their economies were performing fairly well. Analysis and evidence suggest that the transition models of the early 1990s bear a major responsibility for reenergizing procollectivist parties in the mid-1990s. According to Zoltan Krasznai and Jan Winięcki (1995), “The number of confused people, convinced that all our economic problems started in 1989... seems to be quite large” (246). Zbigniew Janaz (1991), a leader of the old solidarity coalition in Poland, said: “The *laissez-faire* theory has not proven right. We have got to have the state intervention. The question is how deep it should be” (28).

### Informal Institutions and the Transition Process in Eastern Europe

In this section I shall first summarize recent research efforts to expand the economics of property rights by incorporating into its analytical framework the effects of the interaction of formal and informal rules on transaction costs and incentives, and the effects of transaction costs and incentives on economic behavior (Eggertsson 1990, North 1990, David 1992, Krasznai and Winięcki 1995, Pejovich forthcoming) and, second, employ the interaction thesis to help understand the difficulties of the transition process in Eastern Europe.

## The Interaction Thesis

The institutional framework of a society consists of formal and informal rules, all of which determine incentives and transaction costs. Formal rules include constitutions, statutes, common law, and other governmental regulations. Governmental authorities enforce these rules by means of sanctions such as fines, imprisonment, and execution. Informal rules, referred to in this article as the “old ethos,” include traditions, customs, religious beliefs, and all other interpretations of the social world that have passed the test of time. The enforcement of informal rules takes place in day-to-day life by means of sanctions such as ostracism by friends and neighbors or loss of reputation.

Clearly, informal rules are not a policy variable, whereas formal rules are. By freeing resources for alternative uses, formal rules that entail lower transaction costs contribute more to the production of wealth than do rules that entail higher transaction costs. Institutional changes and the production of wealth are then linked via the effects of those changes on transaction costs. Although some economists, historians, and sociologists have always appreciated the importance of informal institutions, Zoltan Krasznai and Jan Winiecki (1995) were perhaps the first scholars to try to embed in a theory of institutional change the effects of the interaction of informal and formal rules on transaction costs.

How formal and informal rules interrelate substantially determines transaction costs in society. I call this proposition the interaction thesis. If formal rules are in harmony with informal rules, the incentives they create will tend to reinforce each other. A harmonious interaction of formal and informal rules reduces the transaction costs of maintaining and protecting the rules of the social game and frees resources for the production of wealth. When formal rules conflict with informal rules, however, their respective incentives will tend to raise the transaction costs of maintaining and enforcing the prevailing institutions and therefore to reduce the production of wealth in the community. In particular, the prevailing incentive structures under which rulers operate and the constraints on their power to pursue their own private ends determine their opportunity sets and the trade-offs they face and therefore the decisions they make.

Various observations support the interaction thesis. It helps to explain the high costs of maintaining and enforcing the communist regimes in Eastern Europe. It helps to explain the differences in economic development between Catholic and Protestant countries in Europe, the effects of cultural differences on economic development in North and South America (Diaz 1988), and the differences in the costs of enforcing the right to life in religious and less religious communities. The rise of “ghettos” in American cities

reflected a tendency of various ethnic, racial, and religious groups, all living under the same formal rules, to stay close to other individuals whose behavior they could best predict because of cultural affinities. The formal rule that limited the maximum speed on American highways to fifty-five miles per hour clearly conflicted with the driving culture of most American motorists and raised enforcement costs.

Prohibition laws in the United States clearly conflicted with the country's prevailing traditions of social drinking. The Al Capones served the important social function of giving people what they wanted, at a price. Eventually the high transaction costs of maintaining and enforcing prohibition laws helped to convince the government to eliminate the conflict between formal and informal rules concerning the consumption of liquor. People who went to jail for selling liquor in one year were contributing to the country's GNP the following year.

Douglas C. North (1990) has observed that similar formal rules tend to produce different results in different circumstances:

The U.S. Constitution was adopted (with modifications) by many Latin American countries 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 [formal] rules are the same, the enforcement mechanisms, the way enforcement occurs, the norms of behavior, and the subjective models of the actors are not [the same]. (101)

A promising approach to evaluating the effects of the interaction of formal and informal rules on transaction costs is as follows. Suppose the leaders of a country decide to make a major change in that country's formal institutions (e.g., the 1964 Civil Rights Act in the United States or privatization laws in Eastern Europe in the 1990s). A new rule they enact signals their intention to restructure prevailing formal institutions. However, basic laws are often either ambiguous or too general to permit smooth application. In terms of our analysis, the new rule has to be integrated into the prevailing system of formal and informal institutions. Accordingly, public policy makers must make clarifying rules and regulations. The number of such secondary (implementing) regulations probably depends on the relation of the prevailing informal rules to the new formal rule.

Secondary laws and regulations are costly. First, their enforcement consumes current wealth. Second, they adversely affect the future production of wealth by creating a perception of frequent legal changes—as nature abhors a vacuum, investors abhor uncertainty about their property rights (Higgs

1997). Thus, the number as well as the content of clarifying laws and regulations can be viewed as a proxy for the effect of the new rule on transaction costs.

In comments on an earlier draft of this article, Thráinn Eggertsson summarized the interaction thesis as follows:

The basic idea underlying the [interaction thesis] is that formal rules interact with informal rules (culture) and outcomes will differ from the nominal implications of formal rules if the two are inconsistent in some sense. The viewpoint suggests that attempts to introduce structural change from above must be consistent with people's informal mental models if they are to be successful. Furthermore, different cultures are likely to follow different approaches to decentralized exchange systems, and it is hard to predict which path will be taken in a process that involves evolution and learning.

This statement nicely encapsulates the general ideas expressed by the interaction thesis. The hard part, of course, has to do with its empirical application.

### The Interaction Thesis and the Transition

The transition from socialism to capitalism in Eastern Europe required institutional restructuring. As socialist rule ended, East Europeans needed stable rules for carrying out interactions among themselves and with the rest of the world. Predictably, they fell back on the only rules they knew: customs and traditions. An important question to which we now turn is whether the new formal rules in Eastern Europe, as they interacted with the old ethos, created incentives that raised or lowered transaction costs.

Informal rules in Eastern Europe are not homogeneous, but they do have some common aspects. The old ethos in Eastern Europe was largely devoid of such Western ideas as those expressed in classical liberalism and individualism. Although the Czech Republic, Slovenia, and perhaps Hungary (though only in Budapest) have a more Western tradition than other East European countries do, classical liberalism, which is only a part of that tradition, does not have deep roots in the region. The prevailing concept of community has a strong bias toward collectivism and egalitarianism. Moreover, the communities in the region have developed customs and common values along ethnic lines. Frequently a person's ethnic origin determines that person's religion—usually Islamic, Roman Catholic, or Eastern Orthodox—reinforcing the differences in customs and values among ethnic groups. Interactions within most ethnic groups are thus subject to rules of behavior that do not necessarily hold in dealings across ethnic lines.

The old ethos in Eastern Europe clashes with Western culture, which emphasizes self-interest, self-responsibility, and self-determination; puts a premium on rules that reward performance; cultivates risk-taking attitudes; values the maintenance of individual liberties; and makes the keeping of promises important in the accumulation of wealth (Szymanderski 1995). East Europeans tend to view the gains from market activity as a redistribution of wealth rather than as rewards that individuals receive for creating new value. State authorities prefer to suppress the activities of individuals who earn large profits instead of encouraging others to emulate them in open markets. Members of collective farms in Russia have been threatening farmers who want to “go private,” a credible threat in a countryside with few means of communication with the rest of the country. Small shop owners in Ukraine are treated as thieves. In general, the accumulation of private wealth in Eastern Europe is suspect, the more so as one proceeds east. Many East Europeans have yet to understand that resources are created, not found.

In 1989 East Europeans needed time to learn that capitalism is not merely an alternative mechanism for the allocation of resources but a way of life in which individuals voluntarily interact with each other in the pursuit of their private ends and, in so doing, create a culture *sui generis*. Forcing East Europeans to accept the institutions of capitalism before they had become comfortable with the system's culture inevitably created a conflict with the old ethos. Of course, capitalism has had to leap similar hurdles in many other countries with strong collectivist traditions. However, Japan, Singapore, South Korea, and Taiwan, among other countries, have given their people freedom to experiment with alternative institutional arrangements (Rabushka 1988). People responded by exploiting various opportunities and adopted the institutions that passed the market test. Eventually, most of those countries developed a blend of capitalist institutions and old traditions. The Czech Republic, thanks primarily to Vaclav Klaus, is the only East European country taking this approach.

As new leaders in Eastern Europe, with considerable support from the West, used the strong hand of the state to build capitalism, in effect they replaced the old conflict between formal institutions and the region's ethos with a new one. The new conflict created an opportunity for two groups, former nomenklaturists and older people, to seek personal gains by using the machinery of the state. Pursuing their self-interest, these two groups have produced some unintended consequences affecting the character of social, economic, and political life in Eastern Europe in the mid-1990s. One such consequence is the rising strength of pro-collectivist parties in the region. In the summer of 1996, socialists made a good showing even in the Czech Republic.

## Former Nomenklaturists

As socialist rule ended in Eastern Europe, former leaders had incentives to seek ways to preserve their power and privileges. Their human capital equipped them for seeking advantages in a bureaucratic environment; therefore, the transition to a free-market, private-property system threatened their well-being. To preserve the value of their human capital, former nomenklaturists, while paying lip service to free-market reforms, had to maintain or re-create a state-centered system. They knew that encouraging the perception of an external threat to their respective ethnic groups would give them a good chance to stay in power. Most former nomenklaturists, then, quickly transformed themselves into nationalists.

Doing so was easy for them because nationalism and socialism have one important common aspect: a collectivist mode of interpreting the world. In general, nationalism embraces the conviction that the community's common good transcends the private ends of its members. This idea implies that individuals can attain their greatest potential only through their nationality. Nationalism is thus incompatible with individual liberty and open competitive markets.

Indeed, most leaders in the multiethnic states of Eastern Europe in the early 1990s were communists. Examples include Slobodan Milosevic in Serbia, Milan Kucan in Slovenia, Vladimir Meciar in Slovakia, and Leonid Kravchuk in Ukraine. The former Czechoslovakia is an important case. In their quest to retain power, Meciar and his friends adroitly exploited Slovak nationalism, eventually dividing Czechoslovakia into two sovereign states. In contrast, the Czechs, with virtually no former communists in positions of power, have treated ethnic issues as a nuisance that could only interfere with getting their country on the road to economic recovery. Recently, Kim Holmes, Bryan Johnson, and Melanie Kirkpatrick (1997, xxix–xxxii) ranked the Czech Republic as the eleventh-freest economy in the world, ahead of many Western countries including Austria, Italy, and Belgium. Slovakia was ranked seventy-fifth.

## Older Workers and Retirees

Under socialism, East Europeans had no opportunity to invest in privately owned assets. Instead, the state provided them with assets specific to a non-private-property economy, including (1) a variety of welfare benefits such as job security, allowances for children, medical benefits, and subsidized housing and (2) opportunities unique to the shortage economy. Retired people and older workers find the returns from those assets irreplaceable.

Older workers see capitalism as a threat to their current and future benefits from the socialism-specific assets. For good reason, they fear that

the remainder of their working life is too short to allow them to replace the lost benefits by means of private saving and investment. Retired people have experienced a decline in the value of their pensions and other benefits.

In the shortage economy, retirees were an important asset to their families in two ways. First, they had time to wait in the ubiquitous lines for consumer goods. Second, they specialized in knowing what goods would be available, where, and when. Thus, retired people raised the real incomes of their extended families. As market-clearing prices replace controlled prices, retired people fear that they will become a liability to their families.

Therefore, older workers and retirees have incentives to oppose the transition from socialism to capitalism. They perceive capitalism as a real threat to the value of their assets. They did not purchase the socialist welfare package by choice, but that is all they got. Accordingly, many East Europeans, whatever their ideological preference might be, are hostile to capitalism for reasons of self-interest and tend to support procollectivist parties. In contrast, young people, who have little or no investment in the old system's specific assets, strongly support the transition to capitalism.

### Implications of the Interaction Thesis for Eastern Europe

Some spontaneous institutional changes have occurred in Eastern Europe. For example, privately owned firms have emerged throughout the region even though private-property rights do not yet enjoy credible legal guarantees. Of the thousands of small private firms that have sprung up, many have failed or will fail, but many will survive and grow.

Spontaneous enterprises are performing a vital function that privatized enterprises do not and could not perform. They serve as the breeding ground for entrepreneurs, a work ethic, a capitalist exchange culture, and positive attitudes toward capitalism in general. They educate ordinary people to appreciate a way of life that rewards performance, promotes individual liberties, and places high value on self-responsibility and self-determination. These small enterprises will be the engine of a slow but genuine development of capitalism in Eastern Europe. Adrian Karatnycky (1996, 16) has alluded to the importance of these entrepreneurial developments. Indeed, small entrepreneurs have already begun to make contributions to both social stability and economic performance, especially in Poland, Hungary, and the Czech Republic. And in the process, ordinary people are learning about the costs and benefits of the rule of law, competitive markets, and authentic democracy.

The interaction thesis suggests that instead of building capitalism by fiat, East European governments should try to provide—admittedly by

fiat—a legal environment that would allow people to choose among alternative institutional arrangements, that is, to participate in a “market for institutions.” This arrangement would predetermine neither a specific transition path in Eastern Europe nor the rate of institutional change. But, as I have argued elsewhere (1994), the market for institutions would give people a chance to learn about the institutions of capitalism, try them out, and select those that perform well.

In contrast, using the strong hand of the state to build capitalism in Eastern Europe has raised transaction costs and distorted the politics and economic policymaking of the region. Some important consequences are given here:

First, using the strong hand of the state in the transition process requires an activist government as a means of imposing and maintaining new formal institutions. Where new formal rules were not in tune with the prevailing informal institutions in Eastern Europe, they have provided incentives for rent-seeking coalitions to be formed, and those coalitions have played a major role in subverting the transition from socialism to capitalism. Nomenklaturists and older people have adroitly exploited the old ethos to their advantage and pushed the region in the direction of government intervention in the emerging markets.

Second, exogenous institutional restructuring causes a dissipation of resources. The strong hand of the state interferes with “the constraints that are voluntarily arrived at when transactors are free to impose restrictions upon themselves” (Alchian and Woodward 1988, 65). Public decisionmakers do not and cannot possess reliable information about the economy’s dynamic responses to exogenous institutional changes. Human interactions continuously create and disseminate new knowledge. The discovery and assimilation of new knowledge are unpredictable, and opportunity sets and expectations about the future are continuously changing. To assume, as in neoclassical economics, that individuals’ preferences are given is misleading, as they are modified in the process of choosing and acting. In many East European countries, the conflict between new formal rules and the old ethos has given rise to nationalism, ethnic disputes, or inflation and high unemployment.

Finally, the people who impose new formal rules and those who have to implement them are not the same. The latter have considerable discretionary power in interpreting the intent of top policymakers. They also have their own incentives and private ends that are likely to differ from those of their superiors. Therefore, as the role of the state in the economy increases, additional resources are dissipated in monitoring the compliance of lower-level functionaries.

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