From Socialism to the Market Economy

Postwar West Germany versus Post-1989 East Bloc

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Socialist writers all presume that socialist institutions can bring about a "just" society. This premise has provided both the philosophical foundation and the political justification for the practitioners of socialism to replace individual liberties and the rule of law with the rule of men (hereafter, "the arbitrary state") and a display of concern for "the people." The latter term, a favorite of all socialist leaders, is a mere facade behind which the ruling elite hide their own private ends.

The twentieth century witnessed the trial and failure of two major applications of socialist doctrine: national socialism and Marxism-Leninism. Like competing families in the underworld, national socialism and Marxism-Leninism went to war (hot and cold) with each other as well as with the rest of the world. Both failed to deliver on their promises. Defeat in World War II destroyed Hitler's socialism, whereas Marxism-Leninism decayed from within and ultimately collapsed as a rotten hulk.

National socialists and communists shared many basic political and economic premises of socialist doctrine. Both operated a command economy and made the individual a mere instrument for the achievement of the ends of their ruling elites. Both despised the private-property, free-market economy and its corollary, the society of free and responsible individuals. They favored a large, active state, created compre-

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hensive welfare programs, and paid no heed to the rule of law. National socialism and Marxism-Leninism were equally unrelenting in the pursuit of their primary targets: inferior races and the bourgeoisie, respectively.

They also had some fundamental differences. Communists were openly hostile to the private right of ownership, whereas national socialists settled for monitoring and controlling the behavior of ostensible private owners. National socialists regarded the struggle for racial purity within national boundaries as the major mechanism for the development of their brand of socialism. Communists, on the other hand, considered the class struggle waged by the proletariat across national boundaries as the vehicle for the development of the Marxist-Leninist type of socialism. In 1972, Nicolae Ceausescu, the communist leader of Romania, tried to bridge the gap between nationalism and internationalism, declaring: "The dialectical process of bringing together nations presupposes their strong affirmation. . . . Between national and international interests not only is there no contradiction, but, on the contrary, there is a full dialectical unity" (qtd. in Berlin 1992, 253–54).

Clearly, it was the failure of socialist experiments that gave rise to the institutional restructuring of the former socialist states after 1989. The objectives of that institutional restructuring, however, are less clear. The leaders of former socialist states talk about achieving liberty, social stability, and sustained economic growth, but those stated objectives have frequently misrepresented these leaders' real goals. Indisputably, the economic reforms mirror the leaders' preferences, their philosophical premises, the political and economic constraints on their decision-making powers, and the incentives under which they operate. Observed results also incorporate the effects of uncertainties, incomplete information, and divergence of interests between policymakers and those who implement policies.

Institutional changes in former socialist states have produced results that raise some important questions. For example, why was the transition of West Germany in the 1950s more successful than the institutional restructuring of the Soviet Union and Eastern Europe in the 1990s? Why do the results of institutional restructuring within the former Soviet bloc differ from one country to another? Why do we observe no tendency in former socialist states for more-efficient institutions to replace less-efficient ones?

In this article, I identify the rule of law, the carriers of institutional restructuring, and the prevailing informal rules of the community as three critical determinants of the outcome of institutional restructuring. I argue that consideration of the interaction among these three determinants is a powerful and perhaps necessary method for the analysis of institutional changes and their causes, directions, and consequences—a claim I call *the interaction thesis*. Such an analysis treats as endogenous how the interaction among the rule of law, the carriers of institutional restructuring, and informal community rules affects incentive structures and the costs of transactions, and how incentive structures and the costs of transactions in turn affect economic behavior.

Framework for Analysis

For private-property, free-market countries, the rate of growth of real output is a good measure for evaluating economic performance, but it is not a reliable measure for a socialist state because such states calculate their gross national product (GNP) in arbitrary, state-controlled prices. As institutional restructuring proceeded in former socialist states, scarcity prices began to replace accounting prices in measuring the value of GNPs. A smaller GNP valued in scarcity prices could be worth more to citizens of former socialist states than a larger GNP calculated in accounting prices. Hence, slower and even negative growth rates *during* the process of transition do not necessarily signal economic retardation.[1] As James M. Buchanan has emphasized, "Economic performance can only be conceived in values; but how are values determined? By prices, but prices emerge only in markets. They have no meaning in a nonmarket context" (1979, 8).

The Rule of Law

An implication of the preceding observations is that the evaluation of institutional restructuring, while the process is going on, requires a proxy for feasible economic growth. Such a proxy has to be a strong predictor of both social stability and post-transition economic growth. Academic research and empirical evidence suggest that *the rule of law* is such a factor (Barro 1997; Chafuen and Guzman 2000; Zakaria 1997).

The rule of law comprises the absence of arbitrary power on the part of the ruling group, subjection of all citizens to the same laws, stable and credible rules, and an independent judiciary. By eliminating the time-horizon problem and creating a sense of social stability, stable rules provide incentives for individuals in the community to maximize the extent of voluntary interactions. Buchanan has described the critical importance of stable and credible rules as follows: "[In a capitalist society] there is an explicit prejudice in favor of previously existing rules, 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 parties themselves. Indirectly, therefore, this prejudice guarantees that resort to the authority of the state is effectively minimized" (1972, 452).

Whereas democracy pertains to the process of selecting a government, the rule of law has to do with the limitation of government's power (Leoni 1961), thus protecting individual rights against oppression by the majority. In a society of free and

1. The same reasoning applies to the rise of unemployment in former socialist states, which is an unavoidable consequence of moving from a centrally planned economy to competitive markets. Given the positive transaction costs of institutional restructuring, the emerging labor markets could not have reduced unemployment at the speed implied by neoclassical models.

responsible individuals, the word *constitution* must come before the word *democracy*. As Cass Sunstein explains it, the rule of law "creates a wall of protection around citizens, giving a guarantee of immunity and ensuring that they may engage in productive activity without fear of the state. And by creating this wall of protection, the guarantee creates the kind of security and independence that are prerequisites for the role of a citizen in a democracy" (1993, 923).

Robert Barro has summarized his empirical research on the importance of the rule of law vis-à-vis democracy as follows:

> The overall effects of expanded democracy are ambiguous. . . . Madeleine Albright once [said that] democracy was a prerequisite for economic growth. This response sounds pleasant but is simply false. . . . For a country that starts with . . . little democracy and little law [such as Germany in 1945 and the former Soviet bloc in 1989] an increase in democracy is less important than an expansion of the rule of law as a stimulus for economic growth. . . . If there is a limited amount of energy that can be used to accomplish institutional reforms, then it is much better spent . . . by attempting to implement the rule of law—or, more generally, property rights and free markets. (2000, 47)

Obviously, on a strict interpretation of the rule of law, no country would qualify as possessing it. However, the concept of the rule of law provides an ideal yardstick for comparison of alternative institutions and their economic, political, and social consequences. The farther a country travels away from the rule of law, the greater is the power of the ruling group to pursue its own ends at the expense of other citizens.

The Carriers of Institutional Restructuring

Decisions said to be made by governments, parliaments, corporations, and other organizations are actually decisions made by individuals. Individuals conceive ideas, invest time and effort in formulating policies, persuade others to accept their innovations, and bear the risk of failures. Thus, the individual must be the unit of economic analysis. As Armen Alchian and William Allen have written, "Groups, organizations, communities, nations, and societies are institutions whose operations can best be understood when we focus attention on the action and choices of constituent members. When we speak of the goals and actions of the United States, we are really referring to the goals and actions of the individuals in the United States" (1964, 12).

To understand the direction of institutional restructuring in former socialist states, analysts must identify the relevant decision makers, the method by which they are chosen, the incentives under which they operate, and the constraints on their decision-making powers.

The Old Ethos

Informal rules are traditions, customs, moral values, religious beliefs, and all other norms of behavior that have passed the test of time. In this article, I use the terms *informal rules* and *the old ethos* interchangeably, although the latter is a somewhat broader concept. The ethos defines the pattern of behavior in the community that emerges from the interaction between informal rules and a current set of values.

Institutional restructuring in former socialist states brings new formal rules into force. Those rules interact with the prevailing customs, traditions, and moral beliefs of the community. The results of institutional restructuring, then, reflect the interplay of informal rules with the new formal rules. A harmonious interaction of new formal rules and the old ethos reduces the transaction costs in the economy and frees some resources for the production of wealth. When new formal rules are in conflict with the old ethos, however, the transaction costs of making exchanges and enforcing the new rules will reduce the production of wealth in the community. An implication is that a community in which rule makers have incentives to enact formal rules compatible with the old ethos should be both stable and economically progressive. Anglo-American common law stands out as an example of such a system of incentives. As Henry Manne has observed, "Anglo-American common law was primarily local, tribal, or customary law, and, probably for this reason, common law judges have always had a predilection to subsume local customs into decision rules" (1997, 21).

The Transition in West Germany

The Rule of Law

Several factors contributed to the establishment of the rule of law in West Germany within a decade after the end of World War II. First, before World War I, Germany had been a liberal autocracy—that is, the country had been short on democracy but long on law and order (Zakaria 1997). Second, the national socialists had held power for approximately only twelve years, not long enough to erase or impair seriously the people's memory of law and order. Third, the end of national socialism in 1945 placed West Germany under the control of three Allied Occupation Powers, all of them rule-of-law countries. The Allied Occupation Powers imposed a number of rules intended not to foster democracy but to create law and order. The German tradition of law and order helped to reduce the transaction costs of accepting, maintaining, and enforcing the new rules.

The Allied Occupation Powers, with the assistance of the West German judiciary, carried out *denazification* of the country. The National Socialist Party and its various organizations were outlawed, and party bosses were sent to prison or to the gallows. Lesser functionaries were barred from important positions in public life. Of course, the costs of denazification must have been high. When the Cold War created a market for German scientists, business experts, and former intelligence officers, the costs of denazification became even higher.

Yet, denazification had two critical consequences for West Germany's transition to capitalism. By outlawing the National Socialist Party, denazification helped to absolve the German people of the crimes that national socialists had committed. By making it more difficult for members of the Nazi Party to remain in public life, denazification also eliminated from the transition process a large group of well-positioned people whose comparative advantage lay in operating an arbitrary state. Thus, it reduced the transaction costs of transforming West Germany into a rule-of-law country.

The Carriers of Institutional Restructuring

The process of institutional restructuring of West Germany began in the late 1940s. Ludwig Erhard, the minister for economic affairs in the government of Konrad Adenauer, was the principal architect of West Germany's transition from socialism to capitalism. Erhard wanted an economy based on credible private-property rights, freedom of contract, scarcity (competitive) prices, and stable monetary and fiscal policy. In his efforts, he received the assistance of a group of free-market scholars centered at the University of Freiburg.

Erhard had to sell his reforms to the Allied Occupation Powers, which held the ultimate veto power over institutional changes in West Germany. Unfortunately for him, the attitude of the Allied Occupation Powers reflected the mood of the era. They favored easy credit policy, public investments, and direct governmental regulation of business. John Kenneth Galbraith, then an economic advisor to the American military government, expressed the pro-planning bias of the Allied Occupation Powers as follows: "The question is not whether there must be planning—the assignment of priorities to industries for reconstruction and rehabilitation, the allocation of materials and manpower, the supplying of incentive goods and all the rest—but whether that planning has been forthright and effective" (1948, 94).

Erhard, however, proved himself a shrewd tactician. When the Allied Occupation Powers approved the new currency (deutsche mark), he saw an opportunity to remove price controls, implement nonexpansionary monetary and fiscal policies, and provide credible protection for private-property rights. He acted without approval, hoping that the Allied Occupation Powers would go along with his reforms once they had proved successful. His ploy succeeded. "West Germany's performance in industrial output and exports was phenomenal, and by the 1960s the country was on top of the European economic league" (Barry 1993, 9).

The Old Ethos in Germany

The prevailing informal rules in Germany have had a strong bias toward communalism. Individualism and limited government have not been part of the old ethos. I conjecture that the role of the state and codetermination are two important consequences of the conflict between German tradition and the culture of capitalism.

The Role of the State. In the Anglo-American tradition, the state is a predator requiring a constitution to tame it, whereas in the German tradition the state is a partner in the social and economic life of the community. Even the free-market economists who provided Erhard with theoretical arguments and an academic imprimatur for the transition to capitalism did not regard capitalism as a self-generating, self-equilibrating, and self-correcting system. Walter Eucken declared that "the economic system cannot be left to organize itself" (1951, 93), and Wilhelm Roepke regarded "undiluted capitalism" as "intolerable" (1958, 119). The market is fine, such scholars claimed, but some of its consequences are not. Therefore, the state must step in to take care of market failures.[2]

In harmony with German tradition, the postsocialist government assumed a number of responsibilities. Initially the state was expected to focus on the so-called market failures. However, making the government an active player in the economy created incentives that, in turn, produced "unintended" consequences. Before long, rent-seeking coalitions learned how to use the state to obtain favorable regulations, while legislators and bureaucrats perfected the art of giving or denying favors via redistributive policies. The trend toward an ever-increasing role for the state in the economy accelerated in the 1970s, when Chancellor Willy Brandt introduced his concept of "rational planning" (Willgerodt 1976). The rate of economic growth subsequently declined substantially.

Codetermination. In the Anglo-American tradition, the community is a voluntary association of individuals who interact in the pursuit of their own private ends and, in so doing, create both order and unintended outcomes. In the German tradition, the community is an organic whole in which members cooperate with one another in the pursuit of a common purpose. One outgrowth of that tradition was *codetermination,* an arrangement in which the employees of a firm join shareholders on the board of directors and take an active role in decision making.[3]

The codetermining firm per se is neither an anti- nor a pro-capitalist organization. It represents one type of business firm among the many we observe in capitalist countries, such as corporations, partnerships, proprietorships, and cooperatives.

2. In a private communication to the author, Victor Vanberg of the University of Freiburg wrote: "There was a systematic difference between Roepke and Eucken. Eucken's main argument was that the institutional framework that constitutes a well-functioning market cannot be expected to arise 'naturally' but is a matter of adequate political constitutional choice. Roepke was much more concerned with 'undesirable social consequences' of the pure market mechanism, despite his general pro-market attitude."

3. Codetermination in Germany has a long tradition. As early as 1835, Robert Von Mohl, Wilhelm Roscher, and Bruno Hildebrand, all university professors, proposed the creation of "workers' committees" in business firms. The most recent law on codetermination was enacted in 1976. It applies to all business firms with more than two thousand employees. The supervisory council (board of directors) of such firms has twelve members, of whom six are representatives of the shareholders and six are representatives of the employees. At least three of the members representing the employees are appointed by labor unions. The chairman of the supervisory council is elected by the shareholders and holds the deciding vote in case of a deadlock.

However, the law that *mandates* this specific type of contractual arrangement and *protects* it from competition by other types of business firms is both an anticapitalist and an antifreedom rule. The fact that the German government had to mandate the codetermining firm and protect it from competition by other types of firms is the best evidence of its inefficiency (Watrin 1987).

Summary of Institutional Restructuring in West Germany

The rule of law and Ludwig Erhard were two key factors in West Germany's successful transition from socialism to capitalism after World War II. However, Germany's informal rules clashed with the capitalist concepts of individualism and a limited state. From that conflict emerged the *social market economy,* a German variant of capitalism. The main features of the social market economy today are large subsidies, costly welfare programs, a myriad of rules regulating business activities, large nonwage costs, and weak incentives to innovate.

The *2000 Index of Economic Freedom* identifies the correlates of the German brand of capitalism (O'Driscoll, Holmes, and Kirkpatrick 2000, 229–30). This source book uses a scale of 1 to 5 for comparison of economic freedoms in 161 states: scores of 1–1.95 signify "free" countries; 2–2.95 "mostly free"; 3–3.95 "mostly unfree"; and 4–5 "repressed." The index is based on ten factors: trade policy, fiscal burden, government intervention, monetary policy, foreign investment, banking, wages and prices, property rights, regulation, and the black market. With a score of 2.20, Germany is ranked the twenty-second freest country in the world. However, the *2000 Index* gives Germany the best possible score for the protection of private-property rights and the worst possible score for fiscal burden. That burden, I conjecture, reflects the costs of the compromise between the old German ethos and the dictates of a free-market economy.

Transition in the East Bloc since 1989

The Rule of Law

More than thirty years ago, G. Warren Nutter captured the essence of what Marxists-Leninists thought of the rule of law:

> It was Lenin's genius to recognize the importance of embellishing the Soviet system with all the trappings of democracy. If the people want a constitution, give them one, and even include the bill of rights. If they want a parliament give them that, too. And a system of courts. If they want a federal system, create that myth as well. Above all, let them have elections, for the act of voting is what the common man most clearly associates with

> democracy. Give them all these, but make sure they have no effect on how things are run. (1969, 39)

The development of the rule of law in the former East Bloc countries since 1989 has been spotty and generally disappointing. Although many factors have contributed to this situation, two are likely to have played major roles. First, in the 1990s, few inhabitants of the former socialist states of Eastern Europe had any memory of living under the rule of law. For centuries, benevolent and not so benevolent czars, local despots, and foreign invaders had ruled those countries. A few of the former East Bloc countries had belonged earlier to the Austro-Hungarian Empire, almost the classic example of liberal autocracy. Hence, in those cases, we might reasonably expect collective memory to be short on political democracy but long on civic and economic freedoms. There, too, however, almost five decades of socialist oppression took a heavy toll on collective memory.

Second, unlike West Germans in the late 1940s, East Europeans have not had a "colonial master" to teach them that formal rules can be stable and credible and that an independent judiciary can be relied on to enforce those rules. In the former East Bloc since 1989, new leaders have faced the daunting task of developing the legal system from the ground up. Unfortunately for their fellow citizens, those leaders have also had to bear the costs of replacing the region's tradition of arbitrary states (and much discretionary power for the leaders) with the rule of law. In the circumstances, the new leaders have had little incentive to establish the rule of law. Predictably, its development in the former socialist states has been slow and spotty—the farther east, the spottier.

The *2000 Index of Economic Freedom* shows just how uneven the development of the rule of law has been. Of the ten factors the index uses to measure economic freedom (listed earlier), two are used here as proxies for progress in developing the rule of law: private-property rights and prices and wages.

The private property–rights factor, which measures the stability and credibility of such rights, constitutes a good proxy for the stability of the legal system. A score of 1 means that the government and an independent judiciary have made property rights fully secure, stable, and credible; at the other extreme, a score of 5 means that private property is either outlawed or completely unprotected.

The prices-and-wages factor measures the freedom and enforcement of contracts, a cornerstone of the private-property, free-market economy. A score of 1 means that wages and prices are determined in competitive markets, and a score of 5 signifies complete government dirigisme. For reference, Denmark, the United States, and Iraq received scores of 1, 1.5, and 5, respectively.

The average of the private property–rights factor and the prices-and-wages factor, displayed in the "Rule of Law" column of table 1, shows the extent of the rule of law in former socialist states after a decade of institutional restructuring. Moving down the table, one sees a change in the mix of law and arbitrariness in favor of the latter. That change, in turn, implies more corruption, black-market activities, and government regulation.[4]

The *2000 Corruption Perception Index* (CPI), shown in column three of table 1, "ranks countries in terms of the degree to which corruption is perceived to exist among public officials and politicians. The 2000 CPI is a composite index, drawing on 16 surveys from 8 independent institutions. The surveys embrace the perceptions of business people, the general public and country analysts" (Transparency International 2000, 1).[5] The Corruption Perception Index, clearly a very subjective measure, covers ninety countries. Scores range from 10 (very clean) to 1 (very corrupt). For reference, Finland, the United States, and Mexico received scores of 10, 7.8, and 3.3, respectively.

The column labeled "BM & Reg" shows the average score for black-market activities and government regulation. Higher scores indicate more regulations and black-market activities. The associations between the scores in columns two and three and between the scores in columns two and four are statistically significant at the 5 percent level. Specifically, changes in the mix of law and arbitrariness in favor of the latter are associated with more black-market activities, government regulations, and corruption.

The Carriers of Institutional Restructuring

Decommunization did not happen in Eastern Europe. With only a few exceptions, communist parties in the former Soviet bloc were not outlawed, and party members were not brought to justice. Some decommunization did occur in the former East Germany. In a few places, such as the Czech Republic, former leaders and members of secret services were excluded, or were supposed to be excluded, from decision-making jobs in government. In a number of countries, the Communist Party merely changed its name and continued to function.

The fact that decommunization was not carried out in most East European countries has had significant consequences. In 1989, communists held most of the important jobs in all branches of government as well as in business. They also had a well-established "old boys" network. Thus, communists were much better positioned than other citizens to become or to join the carriers of institutional restructuring, and they promptly proceeded to do so.

Once the communists (along with others) had become the carriers of institutional restructuring, they behaved in accordance with the incentives under which they had to operate. It is not necessary to call into question the genuineness of their hasty "conversion." Given their knowledge of and skills in dirigisme, their survival tactic was to advocate and support economic policies requiring more government

4. The extent of government regulation of economic activities in a country is a much better indicator of the restrictions on private-property rights and contractual freedom than, for example, the level of government spending.

5. The index and information on its construction are available at <www.transparency.de/documents/cpi/2000/cpi2000.html.>

Table 1: The Rule of Law, Corruption, and Black Markets and Regulation in Former Soviet Bloc Countries

Country	Rule of Law	CPI	BM & Reg
Czech Republic	2	4.3	2.5
Estonia	2	5.7	2
Hungary	2	5.2	2.5
Latvia	2.5	3.4	3.5
Poland	2.5	4.1	3
Slovenia	2.5	5.5	3
Bulgaria	3	3.5	3.5
Lithuania	3	4.1	3.5
Moldova	3	2.6	3.5
Romania	3	2.9	3.5
Russia	3	2.1	4
Slovak Republic	3	3.5	3
Albania	3.5	not rated	4
Ukraine	3.5	1.5	4
Belarus	4	4.1	4.5
Croatia	4	3.7	3.5
Yugoslavia	not rated	1.3	not rated
Bosnia	4.5	not rated	5

Sources: *2000 Index of Economic Freedom*, and *2000 Corruption Perception Index.* (see text for details).

control and more public spending. The upshot is that the failure to outlaw the communist parties and to prevent their members from becoming the carriers of institutional restructuring has raised the transaction costs of transforming the former socialist states of Eastern Europe into private-property, free-market economies.

The Old Ethos in Eastern Europe

Informal rules in Eastern Europe are not homogenous, but they do have some common traits, such as a strong bias toward collectivism, egalitarianism, and the extended family. Although countries that once belonged to the Austro-Hungarian Empire have a more Western tradition than do other East European countries, individualism and other classical liberal values do not have deep roots in the region.

Many communities in the region have developed customs and common values along ethnic lines. Frequently a person's ethnic origin predicts that person's religion—usually Islamic, Roman Catholic, or Eastern Orthodox—reinforcing the differences in customs and values among ethnic groups. Interactions within any specific ethnic group are then subject to rules of behavior that do not necessarily hold in exchanges across the ethnic lines. Most unfortunately, the tradition in Eastern Europe is a repository of the old unsettled scores among the region's ethnic groups.

The old ethos served East Europeans well under socialist rule. With its emphasis on ethnicity, the extended family, and shared values, it gave East Europeans a fortress: behind its walls, they could hide and survive socialist rule without having to accept that rule.

Capitalism and the old Eastern European ethos do not mesh well. The accumulation of private wealth is suspect in Eastern Europe—the farther east, the more so. Gains from trade are seen as a redistribution of wealth rather than as rewards that individuals receive for creating new value. The intellectual heritage in the East supports an activist state.

Given the ethos of the region and the several decades of isolation from the rest of the world, East Europeans have not readily accepted capitalism as a *way of life* based on the constitutional guarantee of individual rights; credible and stable private-property rights; freedom of contract; an exchange culture in which every individual bears the value consequences of his own decisions; and the principles of self-interest, self-determination, and self-responsibility.

Summary of Institutional Restructuring in Eastern Europe

Having considered the interaction of the rule of law, the carriers of institutional restructuring, and the old ethos, I am compelled to conclude that the transition to capitalism in Eastern Europe is, at best, highly uncertain and fraught with dangers. With a few exceptions, East European countries still lack a genuine rule of law. The fact that privatization has made the communist elite rich is the best evidence that they have been playing a major role in the institutional restructuring of Eastern Europe. The old ethos in Eastern Europe is not in tune with a way of life that rewards performance, promotes individual liberties, and places high value on self-responsibility and self-determination. It does not make sense to force East Europeans to accept capitalism until their leaders give them credible and stable legal systems and they become comfortable with capitalist culture.

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