

## TRANSITION TO A MARKET ECONOMY

*Anatoly A. Sobchak*

The Soviet Union is facing a choice of which path to follow to promote economic development. Today, virtually everyone—the economists who for decades have insisted on the need for transition to a market economy, the politicians who as recently as six months ago denied the necessity and the possibility of such a transition, and the overwhelming majority of the population—seems to have arrived at the same conclusion: The transition to a market economy is inevitable, as night follows day, and is the only way to economic revitalization for this country. We have no current alternative. The strongest argument to support this conclusion is the road traveled by a number of countries in the post-World War II period: the road from dictatorship, from totalitarian states and totalitarian economies, to the market. Unique as this road may have been for each country—Spain, China, South Korea—the end result has been the same: rapid economic development and economic prosperity. That is to say, each country reached the goal toward which our country is now striving.

### Conditions for a Successful Transition

There is, however, far less unanimity concerning the problem of how to make the transition to a market economy. Yet this transition question—the problem of defining the mechanism; the ways; and the forms of going from total state monopoly of ownership, production, and all economic activity to a market economy—is the most fundamental question of all. How this question is solved will determine whether we succeed or fail in accomplishing the transition, whether this transition will be possible, and in what ways it will be made.

---

*Cato Journal*, Vol. 11, No. 2 (Fall 1991). Copyright © Cato Institute. All rights reserved.

The author is Mayor of St. Petersburg and Professor of Law at St. Petersburg State University.

Yet the program proposed by the government in May 1990 was essentially not a program of transition to the market economy but a program intended to discredit the market economy. The only thing about this plan that the population clearly understood from the report of Prime Minister Nikolai I. Ryzhkov was the government's intent to raise prices—prices, moreover, on basic food staples, especially on bread. The very idea of a price increase imposed by directive is incompatible with a market economy in which prices are determined by supply and demand, that is, by agreement between producers and consumers. The government can intervene in this process only by exerting a certain kind of influence on pricing and price balances to protect the economic well-being of the majority or of certain groups; it certainly cannot fix prices from above by fiat. Indeed, such price fixing is characteristic of the economies of the administrative command system and of barracks-style socialism, not of the market economy. What is it that we are being offered today? In my view, the conditions under which I believe the transition to a market economy is possible in this country are not very clearly defined either in the program proposed by the government or, though to a lesser extent, in the program proposed by the Shatalin team (the program coordinated with the 500-Day Plan developed by the group of economists and political leaders who support Boris N. Yeltsin).

In my opinion five conditions are necessary for a successful transition to a market economy: (1) economic stabilization, (2) a market infrastructure, (3) property ownership, (4) a change in mentality, and (5) public support. Let us consider each of these in turn.

### *Economic Stabilization*

First, a market economy must be preceded by a period of economic stabilization. In a crisis, when the economy is deteriorating drastically, it is impossible to switch at once to a market economy without first arresting the economic decline and securing a period of economic stabilization. Such economic stabilization can be secured today primarily by activating both administrative and economic levers that I would characterize as emergency mechanisms. We could go so far as to spend certain government reserves and stockpiles, including some of our gold reserve. We must also drastically curb government spending—both domestic spending and expenditures to maintain our government's offices abroad, revise our foreign aid policies, stop government spending on large-scale economic projects that do not yield immediate benefits, sell off "frozen" uncompleted units to private owners, and so forth. In other words, we are describing a comprehensive program of economic action whose content is

fairly well known. This program is meant to secure a period of more or less certain economic stabilization for the next 12 to 18 months; it should saturate the market to the point of meeting the basic survival needs of the population. Only against the background of such relative material well-being can the transition to a market economy—the accomplishment of the essential tasks that are the goal of such a transition—become possible.

### *Market Infrastructure*

Second, parallel to economic stabilization, we must take measures to create the market infrastructure. The Soviet economy today is extremely primitive. It is represented by huge, monopolistic state enterprises and amalgamations. But it does not have the infrastructure required for a market economy to function. What I have in mind is a labor market, a capital market, and, as a necessary condition, numerous small and midsize enterprises that will fill the gaps in the economy and create the possibility of competition among producers and, most importantly, the possibility of economic maneuvering. The recent bread and tobacco crises are a good example of a primitive economy. They occurred mainly because most of the state-run factories producing bread and tobacco products have obsolete and shabby equipment. Either most of these enterprises had to be shut down for repairs or retrofitting, or they are facing the threat of a shutdown because their equipment will break down or need preventive repairs.

Steps must be taken to prevent such crisis situations from regularly occurring. However, we must note that today these crises are also caused partly by conservative forces trying to sabotage democratic change and to subvert the work of new local governments in large cities such as Moscow, Leningrad, Sverdlovsk, and Chelyabinsk. The main problem, however, is the absence of room for economic maneuvering. Let us imagine that these same cities not only have state-run bread factories but also have an extensive network of small bakeries, which are owned by cooperatives or individuals and are capable of taking over most tasks for producing these vitally needed staples if state bread factories grind to a halt. The same arrangement goes for all other basic foodstuffs.

We need a program designed to create small and midsize enterprises that are both collectively and individually owned. Such a program could establish a network of enterprises that could compete with the state sector and, most importantly, could take over most of the work if state enterprises specializing in the same products shut down.

Moreover, creation of a market infrastructure requires efficient transportation and well-developed information networks with adequate means of communication, which we do not currently have on a sufficient scale or on a modern level.

Among other things, the decision has already been made to open financial and commodity exchanges in Moscow and Leningrad. This, too, is a necessary element of the infrastructure without which the market cannot exist. But for exchanges to function, we need an extensive network of joint-stock companies and associations. Those organizations do not yet exist, nor do we have effective legislation on joint-stock companies. We need to return to an extensive turnover of securities. This change, however, will take time. There will have to be a period of adjustment to a market environment, which, along with the period of economic stabilization, should last a year and a half to two years. Without our going through this stage, it is naive to think that the market economy can be introduced by an order from above.

#### *Property Ownership*

Third, the transition to a market economy requires a well-developed stratum of commodity producers who own property in different forms. To demonopolize and get the state out of the main sectors of the economy, we should create a multitiered economy primarily by privatizing trade, eateries, household services, and a major part of the state-run industry. We should also privatize agriculture as a necessary condition for providing the country with adequate food supplies. The program of privatization and the establishment of mature sectors of collective, including cooperative, ownership and of individual private ownership will take time.

As can be seen from the experience of the Moscow and Leningrad City Councils when they attempted to privatize trade and household services, such a program of privatization cannot be carried out quickly for a number of reasons. First, credit resources are needed to encourage small entrepreneurs and workers' collectives. Today, we do not command such resources. Our only hope is the establishment of investment banks, which would attract foreign investment that would allow us to secure the credits needed for privatization. Given that this process brings quick profits and that the loans would soon be repaid, this prospect is quite promising. But, again, this process will require no less than 18 months to two years. Therefore, from this angle as well, the immediate transition to a market economy, which has been proclaimed by the authors of programs now under consideration in the country's Supreme Soviet, is impossible.

*Change in Mentality*

The next condition for the transition to a market economy means a profound, fundamental revolution in more than just the industrial and economic conditions of our society. What is necessary is a far-reaching change in the structure of life itself, in our way of life, in people's thinking, and in the way they see their place in the system of social production.

For decades, we have fostered a beggar mentality: The state will provide and decide everything for you—poorly, perhaps—but it will provide equally for everyone and supply all the basic necessities. This parasitic mentality is very widespread here. In contrast, a market economy, in order to function, requires a very different type of mentality: responsibility. Every person must be responsible and solve his or her own problems. The government will do nothing more than create conditions in which one can use one's own initiative and enterprise; the rest will be up to the individual. The government will maintain a social safety net for the indigent, for large families, for the disabled, and for the aged—but its interference in economic life will be limited to that. That is, government's role in economic life must be drastically reduced, or there can be no market economy. But this change requires a revolutionary transformation in the minds of people, in their psychology. Obviously, such a revolutionary transformation cannot be accomplished overnight. Any program of transition to a market economy that does not take into account this social and psychological atmosphere is doomed from the start.

*Public Support*

The last condition is perhaps one of the most important. A change as fundamental as the transition to a market economy can be accomplished only when it is carried out by a government that enjoys the full support and confidence of its people. Without such support, one can say in advance that any program of transition to a market economy—no matter how good it may look in theory and in the abstract—is doomed to failure.

More than once in our recent history and during perestroika, we have found that the most logically correct, theoretically well-grounded, and seemingly impeccable projects turned out to be absurd in practice and led to absurd results. Let us recall, for instance, the campaign against unearned income and the war on alcoholism; or consider what has happened to cooperatives. We know the negative consequences of all these measures, which seem based on impeccable theoretical constructs and are motivated by lofty ideals that, I would say, even have a certain romantic appeal.

The failure of all these efforts was largely due not only to the methods or means by which they were pursued but also to the lack of necessary trust and support by the people.

Another important factor is found in the negative attitudes of government bureaucracies, particularly at mid- and lower-level, that pushed all these initiatives to an absurd extreme—deliberately in some cases or out of incompetence and ignorance in others. But today, we must be very clear as to who is going to execute all these plans. On the one hand, there must be a government trusted by the people. On the other hand, it is essential that most officials in the machinery of the state support and implement these measures. Otherwise, as before, this bureaucracy, mostly staffed by past or present functionaries of the Communist party, will be hostile toward these efforts, will try to turn them into their own opposites, will reduce them to absurdity, and will discredit them in the eyes of the public.

### Creating a Legal Foundation for a Market Economy

In addition to the political, socio-psychological, and economic conditions needed for the transition to a market economy, there are also legal conditions that must be met. To create the legal foundation for the functioning of the market requires a fundamentally different approach to the legislative regulation of the economy than we have had in Soviet legislation up to now. Until now, the major share of legal norms has consisted of administrative rules, that is, direct regulation from above of all economic relations and all economic ties in the country.

It is natural that the transition to the market economy should require a fundamentally different approach, a transition to economic ties based on horizontal relations. If our economy today is dominated by vertical relations, that is, legal-administrative regulation, then tomorrow we must have relations of a civil and legal nature. These are horizontal relations, that is, economic interaction between independent economic agents—between free producers of commodities. This change requires eliminating the existing hierarchy of enterprises, so that enterprises will not be subordinate to Union, republican, or local authorities.

We must make changes in the way that enterprises are launched and closed down. If the overwhelming majority of enterprises in our country today are opened and closed by administrative decision, tomorrow it should be done on a contractual basis. That is, enterprises will be created by agreement between interested parties and will

**YES! I want  
to subscribe to the  
CATO JOURNAL.**

- 1 year (\$24.00)    2 years (\$48.00)    3 years (\$72.00)  
 New subscription    Renewal

My name \_\_\_\_\_

Address \_\_\_\_\_

City \_\_\_\_\_

State \_\_\_\_\_ Zip \_\_\_\_\_

*(For foreign subscriptions, please add \$5.00 per year regular delivery and \$10.00 per year airmail delivery.)*

My comments on the JOURNAL:

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

**Please enter a  
GIFT SUBSCRIPTION  
for the person(s)  
named below.**

- 1 year (\$24.00)    2 years (\$48.00)    3 years (\$72.00)  
 New subscription    Renewal

Gift to \_\_\_\_\_

Address \_\_\_\_\_

City \_\_\_\_\_

State \_\_\_\_\_ Zip \_\_\_\_\_

- 1 year (\$24.00)    2 years (\$48.00)    3 years (\$72.00)  
 New subscription    Renewal

Gift to \_\_\_\_\_

Address \_\_\_\_\_

City \_\_\_\_\_

State \_\_\_\_\_ Zip \_\_\_\_\_

**Please start a  
subscription for  
the LIBRARY  
named below.**

- 1 year (\$50.00)    2 years (\$100.00)    3 years (\$150.00)  
 New subscription    Renewal

Library \_\_\_\_\_

Address \_\_\_\_\_

City \_\_\_\_\_

State \_\_\_\_\_ Zip \_\_\_\_\_

Total: \$ \_\_\_\_\_  Check enclosed.

Please bill my:  Visa  Mastercard

Account # \_\_\_\_\_

Exp. date \_\_\_\_\_

Signature \_\_\_\_\_

*the* **CATO**  
**JOURNAL**



No Postage  
Necessary  
if Mailed  
in the  
United States

**BUSINESS REPLY MAIL**  
FIRST CLASS PERMIT NO. 13690 WASHINGTON, D. C. 20024

Postage will be paid by addressee



*the* **CATO**  
**JOURNAL**

224 Second Street SE  
Washington, DC 20003



cease to function, once again, by agreement between the shareholders, or, in the event of incompetence, by a court decision.

In the matter of economic regulation, there should be certain changes in the relationship between Union and republican legislation. Up to now, the legislation that is currently in effect has given priority to Union laws over those of republics. However, the declarations of sovereignty passed in the Union republics have created a fundamentally new situation. If yesterday the axiom was that Union law took precedence over republican and local legislation, today declarations on the sovereignty of all Union republics are stating that Union laws are effective in a republic only when they do not contradict the republic's own legislation and only if this Union legislation is ratified by the republic—or by the appropriate body of republican government. In such conditions, there will be a natural downward shift of economic regulation, to the level of republican and municipal legislation. This shift is absolutely necessary to enable various regions and republics to show their own initiative in solving their own economic problems.

Thus a fundamentally new approach is needed when we prepare the new civil legislation. If yesterday the Basic Civil Law of the USSR, as well as a number of Union codes, dealt with questions of regulating the country's economic life, today the center of economic legislation must shift to the republican and municipal level. As an example, one can point to this process in the free enterprise or free economic zones.

In July 1990, the Supreme Soviet of Russia created a number of free economic zones in the country: Sakhalin, Leningrad, Kaliningrad, and a number of other regions. The notion of a free economic zone, as applied to the Leningrad region, is understood as giving regional authorities the necessary powers to run the local economy independently; to regulate the creation of enterprises, joint-stock companies, and new banks (including foreign ones); to attract foreign investments; to conduct foreign trade; and to handle currency, tax, and customs issues. The advantage of a free economic zone, over other regions of the country, is that it provides an opportunity to develop the mechanisms of transition to a market economy more quickly on a municipal or regional level.

The rights that will now exist in free enterprise zones, granted as exceptions to the governments of these areas, must eventually be extended to other regional governments as well. Thus, today's experiment in developing market mechanisms will become tomorrow's way of economic life on the regional level. Only this approach to free

economic zones appears positive and realistic in the conditions of the Soviet economy.

It is important that the center of legislative regulation of economic activity in a free economic zone shift completely to the regional (or municipal) level. The appropriate authorities created by the administration of free economic zones, along with the appropriate municipal or regional bodies of government, must have the power to regulate economic activities independently. Shifting the center of legislative power (with regard to economic matters) to the republican and municipal level must also manifest itself on a number of other issues.

The transition to a market economy will require a fundamental change not only in civil and economic legislation but also in labor laws. This transition will be from a system of blind universal guarantees for any worker, even a lazy one, to a contractual system under which a worker who does his job poorly or sloppily will lose his job.

There is also a need to overhaul financial, tax, and land legislation. Virtually every law dealing to any degree with regulating economic relations must undergo significant modification. And the change must affect not only details but the most basic questions. I think the most important direction of legislative change is to purge the outdated administrative restrictions, plus the endless instructions and circulars, and to switch to a limited number of laws and sophisticated municipal legislation. These laws should comprise all necessary regulations to protect the environment and to balance the interests of producers and entrepreneurs with those of the city, the region, and the republic—that is to say, of society as a whole.

If we compare our current regional and municipal legislation with the sophisticated municipal legislation in other developed countries, the contrast—both in volume and in the legal quality of the statutes in question—is staggering.

There is yet another question of extreme importance related to the transition to a market economy. We have just taken the first step toward institutionalizing property relations. A law on property allowing for a variety of forms of ownership has been adopted. This basic legislation must be carefully developed, and more work is needed on all the secondary legal statutes that would give property owners full rights of control, possession, and use over property that belongs to them.

The legal mechanism of privatization also needs work. It is on this question that I would like to dwell. Privatization is among the most promising of the processes needed for transition to a market economy. Privatization and destatification essentially mean the creation of a multitiered economy with a variety of property owners and with

competition, thus ensuring that the consumer can choose between producers and their goods. Today, privatization faces many obstacles. Some of these are of a legislative nature, such as restrictions imposed by law. There are also economic obstacles having to do with insufficient funds and a lack of resources for credits and loans to small entrepreneurs and workers' collectives. There are also social and psychological obstacles.

### Encouraging Foreign Investment

To overcome these obstacles, we must work on legal mechanisms for attracting foreign investors and for creating joint ventures, as well as foreign-owned firms, on Soviet territory. Today, the regulation of such relations is quite complicated and is mostly left to the discretion of various administrative bodies, such as the Ministry of Finance and the Ministry of Foreign Commerce. To give this process a push, a switch to republican and local regulation is needed, along with, most importantly, removal of this legal tangle of regulations governing such contacts.

What is to be done? There are several options (given a nonconvertible ruble) to attract funds of Western investors into our economy, allowing us to ensure that they would get adequate returns.

One option is to create an investment bank or get Westerners to invest in joint-stock companies that buy back enterprises and their properties from the state. As investors channeled money into enterprises, there would be funds to rebuild and to change product lines to goods that are in demand and are competitive in domestic and foreign markets alike. This scheme would allow a faster transition of enterprises from state to collective or private ownership.

Another option is for Western investors, through Soviet banks or investment banks created with the help of investors, to give loans to small enterprises and to workers' collectives that want to set up new enterprises or buy back existing ones from the state. Investors do not acquire shares in these enterprises but rather extend loans at interest rates that would be attractive to investors and would not be prohibitive to small enterprises. Interest must be at a fairly high rate. However, making small enterprises or collectives tax-exempt for the first two years and giving them substantial tax relief in the following two or three years—which would help the private and collective sector of the economy get on its feet—would make it easier for them to pay back the interest.

A third option is also possible: The Western investor gives the necessary funds to Soviet banks or to a government body, such as a

municipal council. The latter uses these funds to invest in privatization and repays the Western investor on a barter basis, through sales of goods manufactured by the region's enterprises, or through other means. Profits in rubles obtained by investors from joint ventures or from sales of imported goods in Soviet markets can also be invested in the tourist business. This option would allow foreign investors to receive hard-currency profits from each Western tourist who uses the hotels they have helped build or renovate—that is, to profit from international travel.

Thus, even with a nonconvertible currency, there are fairly attractive conditions for foreign businesses to invest capital in the Soviet economy. To ensure the security of these investments, it is necessary to institutionalize special legal guarantees protecting the interests of foreign investors—particularly with regard to free economic zones, where attracting foreign capital investments should be sped up as much as possible.

## Conclusion

Generally, legislation in effect in the Soviet Union today already creates an adequate legal base for establishing joint ventures, joint-stock companies, and foreign investment. It does not, however, provide adequate protection for foreign investments; it makes establishing joint ventures, licensing foreign trade, and so forth a complicated process that depends primarily on administrative whim. We need a major revision of customs regulations toward more favorable conditions for foreign investors. Thus, the necessary legal conditions for successful capital investment in the Soviet economy have not yet been achieved.

To be fair, however, I must point out that an entire package of legislation has been prepared dealing with joint-stock companies, foreign investments, and entrepreneurship. These laws were designed to create a system of legal guarantees protecting the interests of foreign investors. Therefore, our conclusion should be optimistic, and the prognosis is encouraging. Only yesterday, it was extremely complicated to work with Soviet enterprises and Soviet partners, which are represented mainly by state companies or functionaries of various ministries and agencies. Yet even such contacts allowed opportunities for profit-making and successful capital investment.

We are entering a new stage when we must create and, to some extent, have already created the necessary conditions for a climate most favorable to attracting foreign investment into our economy.

## TRANSITION TO MARKET

The faster we complete this process of creating the legal and economic conditions for foreign investment, the faster our economy will grow, the greater our chances of success will be, and the faster we will achieve economic prosperity.

## PERESTROIKA AND THE LIMITS OF KNOWLEDGE

*Henry G. Manne*

The possible introduction of economic, social, and political freedom to the Soviet Union and its people is one of the most dramatic events in modern history. To participate, even intellectually, in this process is an enormously exhilarating experience. Scholars and public affairs experts in the West have been galvanized into a near "feeling frenzy" of papers, conferences, seminars, and colloquia on this subject. Nor are the Russians themselves immune to this same excitement from travel, meetings, bold proclamations, and new friends.

As might be predicted from all this intellectual socializing, a consensus has begun to emerge as to the "proper" solution to Russia's problem. The typical Western academics who accept the prevailing ideological orthodoxy will not want to miss the boat and the chance to become "recognized experts" in the field. Therefore, it is not surprising that this emerging consensus looks a great deal like the dominant academic view of what is needed for Western Europe and the United States: well-regulated markets, a bit of socialism, and a generous welfare program.

Be that as it may, it would be extraordinarily surprising if the Russian "experts" did not jump on the same bandwagon and for some of the same reasons; after all, they like good meetings too and invitations to the "right" universities.

It is refreshing then to hear this subject addressed by someone like Mayor Sobchak, whose views are somewhat less likely to be influenced by this academic process. He is, after all, a serious player in the real political process, and he seems well informed about the more sensible academic proposals as well. Not surprisingly then, there is evidently in Mayor Sobchak's remarks a certain realism

---

*Cato Journal*, Vol. 11, No. 2 (Fall 1991). Copyright © Cato Institute. All rights Reserved.

The author is Dean of the School of Law and Chairman of the Law and Economics Center at George Mason University.

(or is it wistfulness?) as he proclaims the fundamental necessity of changing popular attitudes, a notion I strongly second. At the same time, however, Sobchak has proposed practical, detailed plans for action, such as his various alternative proposals for effectively financing privatization of state-owned firms. Such details coming from someone of Mayor Sobchak's experience and sophistication certainly deserve greater attention than comparable proposals coming from individuals lacking detailed experience with the Russian legal and political system.

But even from so impressive a source, detailed policy prescriptions should perforce be addressed with considerable skepticism. Some of Sobchak's remarks, for instance, may be a bit premature; he is certainly overly optimistic in assuming that changes of such profound import could be accomplished in 18 months to two years.

I propose, therefore, that for starters we all step back and attempt a more generalized, less-specific approach to Russian reform than has been popular thus far. Let us see what lessons, if any, can be learned from the long-term legal, economic, and political history of the West. This exercise may prove more effective at this juncture than any effort to emulate specific existing Western institutions where emulation is almost certain to fail.

## Evolution of Economic Liberalism

In the main, the West's development of capitalist, private property, free-market institutions has been unplanned and unself-conscious. The system has evolved from historic origins little understood or recognized today. And it represents an incredibly complex intermixture of political, economic, cultural, religious, legal, and technological factors. Indeed the subject of how the system developed has been so complex that most Western, and especially American, scholars have largely despaired of even dealing methodically with it. The works of such classic figures as Locke, Smith, Hume, and other intellectual giants are little studied today in the United States. As a result, much discussion of these issues has a heavy ideological and political cast.

There are certain factors within the academy that have reinforced this tendency. The dominant Keynesian thinking from the late 1930s to the mid-1960s eclipsed the older, more philosophically oriented approaches, and the development of mathematical economics and econometrics (especially as aided by the introduction of the computer) did nothing to promote intellectual considerations of market institutions. Added to this, of course, was the heavy flirtation—in

many cases a conjugal relationship—of many Western academics with Marxian and other socialist ideas. Ironically, however, it was during this same period that some of the most important developments in our intellectual understanding of free-market institutions occurred, and it is largely to these, as well as to some of the aforementioned classical writers, that scholars and people of practical affairs are now turning.

#### *The Austrian School*

The first of these major developments occurred in the 1930s (with recognition coming several decades later) in the work of what are now referred to as “Austrian” economists, particularly Ludwig von Mises and Friedrich von Hayek. Out of this work has come such important concepts as the subjective theory of value, the evolutionary nature of many social and legal institutions, and the impossibility of socialist calculation because of our inability to determine correct relative prices. Hayek’s work is also important in the development of modern constitutional theory, a subject whose study had languished for at least two centuries.

#### *Public Choice Theory*

Closely related to this Austrian development, though with very different origins, is the modern public choice school, the first methodical, analytical tool available for explaining the behavior of political agents. While still in its infancy (or perhaps its pubescence) today, and always beset with incredibly difficult problems of empirical proof (traditional economics suffers this too, but not nearly to the same extent), public choice offers us a first insight into the relationship between private and public behavior that goes beyond mere description, rhetoric, and exhortation.

#### *Property Rights Theory*

Perhaps the most important work for our present purposes is what we now term “property rights economics,” largely associated with the names of American economists Armen Alchian, Ronald Coase, Harold Demsetz, and Oliver Williamson. Early traces of this approach to economics can also be found in the major work of Ludwig von Mises. Modern property rights economics goes beyond the simple labeling of things as “public” or “private” property and instead looks at the various rights, powers, and entitlements individuals have under different legal rules. While the focus of this work has kept it within the traditional domain of economics, it has also spawned an extremely important by-product called “law and economics,” or the



economics of law. Obviously, public choice theory, constitutional theory, traditional market theory, and a variety of other notions come into play in this field as well. It remains to be seen whether law and economics will become as comprehensive in its coverage as 18th-century political economy was.

This introduction is by way of suggesting how ill-prepared we are to deal confidently with an effort to convert a Marxist-Leninist socialist economy into a private-property, free-market system. Still we are not bereft of all knowledge, and the recent scholarship is enormously relevant to the task at hand. Whether it is sufficient is another question. But it is clear that no one would have supposed 15 years ago that this contemporary American economics scholarship might eventually have a larger role in the remaking of the Soviet economy than it did in the deregulation, for example, of the American airlines. So, with considerable humility, I would like to explore a bit more deeply some of the complexities involved in the process of legal/economic development and see what we may conclude about the issue at hand.

## Legal and Economic Development

One overarching difficulty needs to be established at the outset. There is no simple, magical way to achieve a complex free-market system quickly. The U.S. economy, with its attendant legal rules, has evolved over a period of at least 500 years, beginning especially with the protection of private property afforded by the English Common Law and the various relevant provisions of the U.S. Constitution, now over 200 years old. This long, largely evolutionary, and pragmatic development must be dramatically distinguished from what is being faced in the Soviet Union today. No one ever had to plan for the United States an entire system, all of whose pieces fit together in some sort of social and economic equilibrium, that had popular political support. Some of the most significant changes in the American economy over its 200 years have come about because of a complex interaction between existing laws, technological developments, and legal responses. The regulation of privately owned real property nicely illustrates this, especially since much of the Anglo-American common law had its origins in property rules.

Externalities, or third-party effects, were treated at common law mainly through the doctrine of "nuisance" or in some cases trespass. But with the development of modern cities with high population densities, traffic congestion, and pollution, this approach gradually gave way to a regime of comprehensive local and in many cases

regional regulation. This regulation has remained economically tolerable—even if frequently undesirable and costly—for the good reason that it is so local in scope. Another way of talking about this is to point out that a lot of American regulation is, fortunately, only very weakly enforceable. Factories could simply be shifted to less costly sites, developers could build residential complexes where the regulations were less onerous, and courts do occasionally declare particularly bad regulations unconstitutional. The cumulative effect of this regulation has unquestionably been negative, but the relationship between political demands, development interests, private property ideals, constitutional limitations, and even emerging traffic patterns has by and large nestled into a relatively stable equilibrium pattern. There is at this moment no strong movement in the United States for deregulation of local zoning plans—neither is there any clamor for an expansion of the present rules.

We have, through an enormous amount of trial and error and adjustment and readjustment, reached this pragmatic position. To an innocent outsider it may look like a wonderful “system,” but the truth is that this end point has no intrinsic merit or justification. It is merely the point we have reached, starting where we did with the rules and institutions we had. The process is, of course, a continuing one, so no one could reasonably advocate that the precise “logic,” such as it is, of American zoning regulation should be exported to another regime. Nor is it likely to happen that completely unregulated land use can emerge in such a thick political atmosphere. It is probably impossible to guess what will be the eventual equilibrium situation in Moscow or other Soviet cities as they begin the process of adjusting to new political pressures, to some version of private ownership of land, to market transfers, and to new technology. It will not be Houston, even if it will also not be a planner’s utopia. Who could be so naive as to try to predict what will ultimately emerge?

This exercise, of demonstrating the modern evolution of complex partial equilibria in various components or institutions of the American economy, could be repeated at great length in many fields and in incredibly vaster detail. But these are only piecemeal pictures. Obviously, the idea of then assembling all of these varied institutional arrangements into one relatively stable general equilibrium (for an entire nation) is a feat that not only defies our ability to perform but even our ability to describe.

That leaves us then with the annoying and frustrating question of what can we project intelligently as the most desirable program for the Soviet economy? I do not believe it is politically (or intellectually) feasible to move to a more liberal free-market system than is

presently found anywhere in the West. Such dreaming can even be dangerous if it is not recognized as purely idealistic. But there are certain prescriptions of a general nature that can be helpful, and the more widely understood and acceptable these generalizations are, the more likely is the Soviet economy to achieve a somewhat stable equilibrium at a high level of human welfare.

## A Framework for Reform

The first of my recommendations is for a massive public education program to dispel the misunderstandings and prejudices about private property, profit, freedom of contract, private enterprise, and competitive markets that are still endemic in the Soviet Union today. While ideological brainwashing by the state is generally anathema to the liberal values we in the West honor most, I believe that broader popular understanding is a necessary, though not sufficient, condition for liberalization of the economic regime. For the more popular support there is for the various institutions of a private property system, the shorter will be the period required for equilibrating all the variables involved and the less easy it will be for demagogic reaction to form.

Related to this is a second notion, perhaps as quixotic as the first and to some degree related to it. There must eventually be explicit constitutional protection for private property and freedom of contract. While constitutions must of necessity be general enough to allow flexibility in more specific lawmaking, they must at the same time put some constraint on the inevitable effort of politicians to suppress private freedom of the use and transferability of property.

Somewhat related to the idea of constitutional protection is another idea that can tremendously assist in facilitating social adjustments. I have reference to some sort of dispute resolution mechanism that has the confidence and support of the public. This clearly does not have to be precisely like the court system generally utilized in Western capitalist countries. But there must be some mechanism, ultimately with the force of the state behind it, that allows private individuals to resolve their disputes without resorting to violence.

At a minimum this is what is meant by a "rule of law." The mediating agencies need not be institutions of the state. Certainly in many commercial sectors of capitalist countries, private dispute resolution (whether arbitration or mediation) is widely used and often more respected and honored than the alternative judicial system offered by the government. But in Russia today there is no independent, non-political judicial apparatus in place, and private dispute resolution

mechanisms might take a long period to develop. Probably some combination of private adjudication with ultimate state authority to back up its decisions is the most that a rapidly emerging free-market system can hope for.

One aspect of any workable dispute resolution system that is often overlooked is that its decisions must eventually be enforceable. This implicates some use of political power, and this by itself is sufficient to explain the necessity for the development of a system of criminal law. Thus, borrowing from the American legal model, if a civil decree is not honored by one of the litigants, criminal procedures may be used to punish the recalcitrant party. Of course, criminal law is needed in a private property system for other reasons as well. Protection of private property and persons against private interferences cannot be completely ignored by the government. Thus a regime of private property probably requires that rules against theft and intentional damage be enforced by some governmental agency. But the more localized and circumscribed this authority is, the less danger there is of an abusive police authority emerging. Thus a system of government protection of private property through criminal law also implicates the strong desirability of a constitutionally restrained federalist regime (which is *not* the same as a merely *decentralized* law enforcement authority).

I am now close to a level of specificity that I opened this paper by decrying. But something must still be said about the definition, specification, and protection of private property rights. Modern property rights economics made us realize that the concept of a "property right" is best viewed not as a specific entitlement or right but rather in a generic sense as representing those particular rights or entitlements that the "owner" in fact has.

Ultimately, a thoroughgoing private property system is one that maximizes individual freedom. The two ideas are fundamentally one and the same. To the extent that "property rights" are clearly delineated and enforced, they are worth more in a market system than they would be if these matters were less clear or certain. I am not here prescribing any specific set of powers and rights that go into making what we might call "private property"; rather I am suggesting that whatever kind of private property right is allowed and protected, it will be worth more to the extent that these rules are clear and are well understood by participants in the marketplace. Thus some form of public or private title registry, or other kind of "proof" of ownership, is highly desirable. This protection is a low-cost device for making all property more valuable than it would otherwise be. One of the many inherent inefficiencies of any socialist system is the fact

that no one recognizes or understands who really owns a large part of the goods and services. Thus cultural attitudes develop of disrespect for any property, and no effort is made to safeguard property or husband it. This situation leads, in turn, to iron-fisted policing by the state if socialism is insisted upon, and eventually that too fails.

Related to this idea of clearly defining property rights to increase property values is the notion of developing other public and private institutions in order to minimize transactions costs. An apartment that can be transferred with a simple contract registered with a "title" agency makes the property "worth" more than it would be in a system in which a large number of bureaucratic permits have to be secured before this transfer can be accomplished. The same is true with any permits a government may require for what would otherwise be a private transaction. The greater the time and cost required for accomplishing any agreed upon transfer, the less the property is worth.

### Trial and Error

I have no doubt that perestroika will result in a large amount of trial-and-error experimentation, and I have no doubt that many Western institutions will be copied in a vain hope that they may perform as well in the Russian context. But there is probably no way to avoid an upheaval of sorts in replacing an almost totally planned economy with a market system, establishing a voluntary and private property regime where an authoritarian socialist perspective has dominated all thinking, and where political accountability will perhaps now substitute for a dominant ideological party's edict. No one should believe that this can be done easily, and I believe that it is foolhardy to propose measures, like the so-called cold turkey approach to perestroika, that will necessarily lead to public turmoil, chaos, and eventually tragedy.

Some acceleration of the usual slow evolutionary process that has characterized the development of Western institutions of private property is probably the best the Soviet Union can hope for now, a compromise, if you will, between productivity and security. And the optimal speed of the process can only be guessed at. Oddly enough, the less copying there is of specific foreign institutions and the more copying there is of a foreign ideology, the better chance perestroika may have.