Institutions, Ideology, and Economic Performance

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The central argument of this essay is that institutions and ideology together shape economic performance. Institutions affect economic performance by determining (along with the technology used) the cost of transacting and producing. Institutions are composed of formal rules, informal constraints, and characteristics of enforcing those constraints. While formal rules can be changed over night by the polity, informal constraints change very slowly. Both are ultimately shaped by people's subjective perceptions of the world around them; those perceptions, in turn, determine explicit choices among formal rules and evolving informal constraints. In succeeding sections I will develop this analytical framework, which I will use to diagnose the contrasting performance of Western market economies with those of Third World and socialist economies.

Institutions and Transaction Costs

Institutions are the rules of the game in a society; more formally, they are the humanly devised constraints that shape human interaction. Thus, they structure incentives in exchange, whether political, social, or economic. Institutional change shapes the way societies evolve through time and, hence, is the key to understanding historical change.

That institutions affect economic performance is hardly controversial. That differential performance of economies over time is fundamentally influenced by the way institutions evolve is also not controversial. Yet Western neoclassical economic theory is devoid of

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Cato Journal, Vol. 11, No.3 (Winter 1992).

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institutions and, therefore, is of little help in analyzing the underlying sources of economic performance. It would be little exaggeration to say that while neoclassical theory is focused on the operation of efficient markets, few Western economists understand the institutional requirements essential to creating such markets, because they simply take them for granted. Entailed in such markets are both a set of political and economic institutions that provide for low transaction costs and credible commitment that makes possible the efficient factor and product markets underlying economic growth.

Four major variables determine the costliness of transacting in exchange. First is the cost of measuring the valuable attributes of the goods and services or the performance of agents in exchange. Property rights consist of a bundle of rights; to the degree that we cannot measure precisely the valuable attributes of the separable rights being exchanged, then the costs of transacting and the uncertainties associated with transacting rise dramatically. Measurement consists of defining the physical dimensions of the rights exchanged (color, size, weight, number, etc.) along with the property rights dimensions of the exchange (rights defining uses, income to be derived, and alienation). The immense resources that societies devote to organizations and enforcement would be superfluous in a world where measurement costs were zero. But because such costs are extremely high and, in consequence, the rights are imperfectly specified, other variables become important in the cost of transacting.

The second variable in the costliness of the exchange process is the market's size, which determines whether personal or impersonal exchange occurs. In personal exchange, kinship ties, friendship, personal loyalty, and repeat dealings will all play a part in constraining participants' behavior, and they will reduce the need for costly specification and enforcement. By contrast, in impersonal exchange, nothing constrains the parties from taking advantage of each other. Accordingly, the cost of contracting rises with the need for more elaborate specification of the rights exchanged. Effective competition acts as an essential constraint when the parties are engaged in repetitive dealings in impersonal markets.

The third variable is enforcement. In a world of perfect enforcement, ideally, a third party would impartially (and costlessly) evaluate disputes and award compensation to the injured party when contracts are violated. Opportunism, shirking, and cheating would never pay in such a world. But such a world does not exist. Indeed, the creation of a relatively impartial judicial system that enforces agreements has been a critical stumbling block in the path of economic development. In the Western world, the evolution of courts, legal systems, and a relatively impartial body of judicial enforcement has played a major role in permitting the development of a complex system of contracting that can extend over time and space—an essential requirement of a world of specialization.

If we retain the neoclassical behavioral assumption of wealth maximization, then these three variables alone will determine the cost of exchange. Thus, individuals would maximize at every margin (if cheating pays, one cheats; if loafing on the job is possible, one loafs; if one could with impunity burn down a competitor, one would do so). But it is hard to imagine that complex exchange and organization would be possible if this assumption accurately described human behavior. The costliness of measuring performance, of fulfilling contracts, and of enforcing agreements would foreclose a world of specialization and division of labor. But ideological attitudes and perceptions (the fourth variable) matter.

Ideology not only plays an essential role in political choices (see North 1990a) but also is a key to individual choices that affect economic performance. Individual perceptions about the fairness and justice of the rules of the game obviously affect performance. Otherwise, we would be at a loss to explain a good deal of schooling, as well as the immense investment made by politicians, employers, labor leaders, and others in trying to convince participants of the fairness or unfairness of contractual arrangements. The importance of ideology is a direct function of the degree to which the measurement and enforcement of contracts is costly. If measuring and enforcing contract performance can be done at low cost, then it makes very little difference whether people believe the rules of the game are fair or unfair. But because measurement and enforcement are costly, ideology matters.

Adaptive Efficiency

Efficient markets are a consequence of institutions that provide low-cost measurement and enforcement of contracts. This outcome is accomplished by rules that encourage adaptive efficiency, by complementary informal constraints, and by effective enforcement. I shall take each in turn.

Adaptively efficient rules provide incentives for the acquisition of knowledge and learning, induce innovation, and encourage risk taking and creative activity. In a world of uncertainty no one knows the correct solution to the problems we confront, as Friedrich Hayek has persuasively argued. Therefore, rules should encourage trials and eliminate errors. A logical corollary is decentralized decisionmaking that will allow a society to explore many alternative ways to solve problems. It is equally important to learn from and eliminate failures. The rules, therefore, must encompass bankruptcy laws and provide incentives to encourage decentralized decisionmaking and effective competitive markets, as well as provide low-cost measurement of property rights.

Formal rules are only part of the institutional matrix. They must be complemented by informal constraints—extensions, elaborations, and qualifications of rules that solve innumerable exchange problems not completely covered by formal rules and that have tenacious survival ability. Informal rules allow people to go about the everyday process of making exchanges without having to think out, exactly at each point and in each instance, the terms of exchange. Routines, customs, traditions, and culture are words we use to denote the persistence of informal rules or constraints. They include (a) conventions that evolve as solutions to coordination problems and that all parties are interested in having maintained, (b) norms of behavior that are recognized standards of conduct, and (c) self-imposed codes of conduct such as standards of honesty or integrity. Conventions are self-enforcing. Norms of behavior are enforced by a second party (retaliation) or by a third party (societal sanctions or coercive authority); their effectiveness depends on the effectiveness of enforcement.

Self-imposed codes of conduct, unlike conventions and norms of behavior, do not obviously entail wealth maximizing behavior but rather entail the sacrifice of wealth or income for other values. Their importance in constraining choices is the subject of substantial controversy—for example, in modeling voting behavior in the U.S. Congress (Kalt and Zupan 1984). Most of the controversy has missed the crucial reason why such behavior can be and is important: Formal institutions (rules) frequently deliberately, sometimes accidentally, lower the costs to individuals of such behavior and can make their normative standards, which are embodied in self-imposed codes of conduct, matter a great deal. Individual votes do not (usually) matter individually, but in the aggregate they shape the political world of democratic polities and cost the voter very little. By strategic voting, legislators commonly find ways to vote their personal preferences rather than those of the electorate (Denzau, Riker, and Shepsle 1985). Judges with lifetime tenure are deliberately shielded from interest group pressures so that they can make decisions on the basis of their interpretation (subjective models) of the law. In each case the choices that were made may be different from what they would be if the individual bore the full cost that resulted from these actions. The lower the cost we incur for our convictions (ideas, dogmas, prejudices), the more they contribute to outcomes (for empirical evidence, see Nelson and Silberberg 1987).

How effectively agreements are enforced is the single most important determinant of economic performance. The ability to enforce agreements across time and space is the central underpinning of efficient markets. On the surface such enforcement would appear to be an easy requirement to fulfill. All one needs is an effective, impartial system of laws and courts for the enforcement of formal rules, for the "correct" societal sanctions to enforce norms of behavior, and for strong normative personal standards of honesty and integrity to undergird self-imposed standards of behavior. The creation and enforcement of efficient property rights depend on the polity. However, it is difficult if not impossible to derive a model of a polity that produces such results as long as one retains the standard wealth maximization postulate and accepts the time horizons that characterize political decisions.

Modern Technology and Organization

The preceding paragraph highlights the major dilemma resulting from the revolutionary modern technology that underlies contemporary economic growth. It is easy to devise a set of property rights that, if enforced at low cost, would create an adaptively efficient economy. But as briefly noted earlier, the costs of measuring and enforcing agreements are fundamentally influenced by the informal constraints in an economy. This phenomenon occurs because the economies of scale of modern technology, which can be realized only by specialization and division of labor and of national and international markets, entail impersonal exchange. In such an exchange the parties are no longer constrained by forces that cement agreements in personal exchange—loyalty, kinship, reciprocity, and clientization. Moreover, the gains from defection, to use game theory terminology, rise dramatically. They rise because the gains from cheating, shirking, and stealing rise as well as the costs of monitoring and measuring performance.

The 19th-century revolution in technology fundamentally altered the performance of those economies that would take advantage of the new technology. This second economic revolution has equally radical implications for the organization of societies.[1]

The term "economic revolution" is intended to describe three distinct changes in an economic system: (1) a change in the produc-

[1]The first economic revolution was the development of agriculture, which is believed to have begun in the eighth millennium B.C. in Mesopotamia.

tive potential of a society, which is a consequence of (2) a basic change in the stock of knowledge, and which entails (3) an equally basic change in organization to realize that productive potential. The change in the productive potential came about in the last half of the 19th century as a consequence of changes in the stock of knowledge arising from the development and implementation of modern scientific disciplines. These changes caused the systematic wedding of science and technology. The technology that characterized this revolution was one in which there were significant indivisibilities in the production process and large fixed-capital investment. The overall implications for economies that could take advantage of this technology were increasing returns and consequent high rates of economic growth; these features have characterized the Western world for the past century and a half.

To take advantage of this technology and realize this potential entailed fundamental reorganization of economies. In those Western economies that have, at least partially, realized the potential, the result has been stresses and strains that have threatened and do threaten their continued adaptive efficiency. For the remaining countries, the inability to reorganize has prevented them from realizing this productive potential and has produced underdevelopment and political instability. It is an extraordinary irony that Karl Marx, who first pointed out the necessity of restructuring societies to realize the potential of a new technology, should have been responsible for creating economies that have foundered on this precise issue. We will examine the microlevel characteristics of the organizational requirements before turning to the macrolevel implications.

Realizing the gains from a world of specialization requires occupational and territorial specialization on an unprecedented scale; consequently, the number of exchanges grows exponentially. To realize the gains from the productive potential associated with a technology of increasing returns, one has to invest enormous resources in transacting. In the United States, for example, the labor force grew from 29 million to 80 million between 1900 and 1970. During that period, production workers increased from 10 million to 29 million, and white collar workers (the majority of whom are engaged in transacting) rose from 5 million to 38 million. In 1970 the transaction sector (that part of transaction costs that goes through the market) made up 45 percent of GNP (Wallis and North 1986).

Let me briefly describe some measurement and enforcement problems that underlie the size of the transaction sector. Control over quality in the lengthening production chain and a solution to problems of increasingly costly principal/agent relationships are necessary for realizing gains in a world of specialization. Much technology has been designed to reduce transaction costs by substituting capital for labor or by reducing the worker's degrees of freedom in the production process and by automatically measuring the quality of intermediate goods. An underlying problem has been that of measuring inputs and outputs so that one could ascertain the contribution of individual factors, the output at successive stages of production, and the final outcomes. For inputs, there was no agreed-upon measure of the contribution of an individual input. Equally, there was room for conflict over the consequent payment to factors of production. For outputs, there was not only residual unpriced output (waste and pollutants) but also complicated costs of specifying the desired properties of the goods and services produced at each stage in the production process.

Another characteristic of this new technology was that one had large fixed-capital investments with a long life and a low alternative scrap value. As a result the exchange process embodied in contracts had to be extended over long periods, which entailed uncertainty about prices and costs plus the possibilities for opportunistic behavior by one party or the other in exchange. A number of organizational dilemmas have resulted from these problems.

First, increased resources are necessary to measure the quality of output. Sorting, grading, labeling, trade marks, warranties, and licensing are all, albeit costly and imperfect, devices to measure the characteristics of goods and services. Despite their existence the dissipation of income is evident all around us in the difficulties of measuring automobile repairs, of evaluating the safety characteristics of products or the quality of medical services, or of measuring educational output.

Second, while team production permits economies of scale, it does so at the cost of worker alienation and shirking. The discipline of the factory is nothing more than a response to the control problem of shirking in team production. From the employer's perspective, discipline consists of rules, regulations, incentives, and punishment essential to an effective performance. Innovations such as time and motion studies are methods of measuring individual performance. From the worker's viewpoint, these methods are inhuman devices to foster speed-ups and exploitation. Since there is no agreed-upon measure of output that constitutes contract performance, both are right.

Third, the potential gains from opportunistic behavior increase and lead to strategic behavior both in the firm (such as labor-employer relations) and in contractual behavior between firms. Everywhere in factor and product markets, the gains from withholding services or altering the terms of agreement at strategic points offer large potential gains.

Fourth, the development of large-scale hierarchies produce familiar problems of bureaucracy. The multiplication of rules and regulations inside large organizations to control shirking and principal/agent problems result in rigidities, income dissipation, and loss of the flexibility essential to adaptive efficiency.

Finally are the external effects: the unpriced costs reflected in the modern environmental crisis. The interdependence of a world of specialization and division of labor increases exponentially the imposition of costs on third parties.

Adaptive Efficiency and Modern Technology

Marxists would contend that these problems are a consequence of capitalism and that the inherent contradictions between the new technology and the consequent organization of capitalism would lead to its demise. But Marxists are wrong; these problems are ubiquitous to any society that attempts to adopt the technology of the second economic revolution. However, as I have attempted to make clear, Marxists are correct in seeing a fundamental dilemma in the tensions arising between the new technology and organization. These tensions have been solved only very partially in the market economies of the Western world. The technology of the second economic revolution, the resulting enormous increase in specialization and division of labor, and the consequent radical alteration of relative prices have altered the traditional structure of society—not only the organization of the economy, but also that of the family and the polity. The growth of government, the disintegration of the family, and the incentive incompatibilities of many modern political and economic hierarchical organizations are all symptoms of the consequent problems besetting Western economies.

However, it has been the relative flexibility of Western institutions—both economic and political—that has been the mitigating factor in dealing with these problems. Adaptive efficiency, while far from perfect in the Western world, accounts for the degree of success that such institutions have experienced. The basic institutional framework has encouraged the development of political and economic organizations that have replaced (however imperfectly) the traditional functions of the family; mitigated the insecurity associated with a world of specialization; evolved flexible economic organization that resolved some incentive incompatibilities of hierarchies and that encouraged creative entrepreneurial talent; and tackled (again very imperfectly) the external effects that are not only environmental but also social in an urban world.

It is easy in the abstract to state the conditions that underlie adaptive efficiency. They consist of formal rules (both political and economic) that result in well-specified property rights, effective competition, decentralized decisionmaking, and elimination of failures. But such formal rules by themselves are no guarantee of adaptive efficiency. After all, many Latin American economies adopted the U.S. Constitution (or variants thereof) when they became independent; many economies have copied Western legal systems. In fact, the simple-minded notion that "privatization" is all that is needed to set faltering and failed economies on the path to growth is a travesty of institutional reasoning that reflects the primitive understanding of most economists about economic history and growth. Creating efficient factor and product markets is a complicated process about which we know all too little. But the one thing we do know is that formal rules must be complemented by informal constraints and effective enforcement to produce such markets. Shaping the choices about formal rules that a society adopts, the complementarity of informal contraints, and the effectiveness of enforcement are the subjective frameworks that individuals employ to explain the world around them.

Ideology, Choices, and Adaptive Efficiency

Ideologies underlie the subjective frameworks that individuals possess to explain the world around them. Ideologies contain an essential normative element; that is, they explain both the way the world is and the way it ought to be. While subjective models may be, and usually are, a hodgepodge of beliefs, dogmas, sound theories, and myths, there are usually elements of an organized structure that make them an economizing device for receiving and interpreting information.

Ideology plays no role in neoclassical economic theory. Rational choice models assume that the actors possess correct models by which to interpret the world around them or receive feedback of information that will lead them to revise and correct their initially incorrect models. Actors and their organizations that fail to revise their models will perish in the competitive markets that characterize societies. At issue is the feedback of information that will lead individuals to update their subjective models. If, in fact, the instrumental rationality postulate of economic theory were correct, we would anticipate that false theories would be discarded and, to the extent that wealth maximizing was a basic behavioral trait of human beings, that economic growth would be a universal feature of economies. With a sufficiently long time horizon, that conclusion may be true, but in 10,000 years of human economic history we are still a long way from universal economic growth. The plain fact is that we do not possess the information to update our subjective theories to arrive at one true theory; in consequence no one equilibrium is the outcome; rather, multiple equilibria exist that can take us in many directions including stagnation and decline of economies. Ideology matters. But where do individuals' subjective models come from and how do they get altered?

The subjective models that individuals use to decipher the environment are partly a consequence of the growth and transmission of scientific knowledge and partly a consequence of socially transmitted knowledge that is the cultural heritage of every society. To the extent that the former type of knowledge determines choices, an instrumental rationality approach is the correct one in analyzing economic performance. But from the beginning of human socialization, people have created myths, taboos, religions, and dogmas to account for much of their environment that defied scientific explanation. They still do. Culture is more than a blending of different kinds of knowledge; it is value-laden with standards of behavior that have evolved to solve exchange problems (be they social, political, or economic). In all societies there evolves an informal framework to structure human interaction. This framework is the basic "capital stock" that defines the culture of a society. Culture, then, provides a language-based conceptual framework for encoding and interpreting the information that the senses present to the brain. As a consequence, culture not only plays a role in shaping the formal rules but also underlies the informal constraints that are a part of the makeup of institutions.

The ideological constructs that individuals possess to explain their environment do change. These constructs are clearly influenced by fundamental changes in relative prices, which result in persistent inconsistency between the perceived outcomes and the outcomes predicted by the subjective models that individuals possess. But that is not all. Ideas matter; what accounts for the evolving subjective models that shape choices in a society is the combination of changes in relative prices filtered through the culturally conditioned ideas that are generated.

The second economic revolution induced an equal revolution in individual perceptions. It questioned many traditional values and beliefs that had been associated with the traditional role of family, polity, and economic organization. The intellectual ferment of the past century and a half, including the diverse perceptions of economists from Marx to Keynes to Hayek, has been an integral part of this change in perceptions that has, in turn, shaped the ideological constructs and, therefore, the players' choices. But neither the constructs of economists nor the subjective perceptions of those making choices over political and economic institutions have been independent of the evolving external political and economic environment. Or to restate my earlier proposition, what shapes the evolving subjective models that humans use to make choices is the interplay among the evolution of culturally conditioned ideas, the contraints imposed by the existing institutional framework, and the consistency or inconsistency between perceived and predicted outcomes.

What characterizes the Western world is the institutional framework of market economies, which have adjusted to partially resolve the costs associated with the second economic revolution and have permitted the productive potential of the new technology to create high-income economies. For the Third World and socialist economies, the consequences of the institutional framework have been to incur the costs of the second economic revolution and to realize only very partially the productive potential of new technology.

The dramatic fall in information costs associated with this modern technology not only has sharpened the perceived inconsistencies between predicted outcomes and observed results, but also has made people acutely aware of alternative models that exist and that appear to offer improved solutions to economic problems. It is one thing to become disenchanted with the old subjective models that one has used; it is much more difficult to arrive at a new equilibrium in the context of rapidly changing external events. Feedback of information produces confused signals that can be interpreted differently by different individuals and groups. The reason for the confusion is the difficulty of fundamentally altering the path of an economy. An economy's organizations and the interest groups they produce are a consequence of the opportunity set provided by the existing institutional framework. The resulting network externalities reflect the symbiotic interdependence among the existing rules, the complementary informal constraints, and the interests of those members of organizations created as a consequence of the institutional framework.

A change in subjective perceptions about the efficacy of the existing framework will produce political and social fragmentation and political instability. For example, a change in the formal rules and, specifically, in property rights must be complemented by consistent informal constraints and effective enforcement to produce the desired results. But norms of behavior, conventions, and self-imposed codes of conduct change very slowly; moreover, enforcement would have to, at least partially, be undertaken by organizations and interest groups whose interests rested with the old institutional matrix.

A new, stable equilibrium would be one that produces new informal constraints (conventions, norms of behavior, and self-imposed codes of conduct) that solve the new problems of political, social, and economic interaction that emerge and are complementary to the new, formal rules that are devised.

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Institutional Development in the USSR

Vitali Naishul

Douglass North's paper deals with the frequently underrated impact of social institutions on the economic performance of market systems. It is difficult to disagree with his conclusions, which demonstrate, in particular, that the task of building a national market economy simply cannot be achieved by copying foreign models—no matter how brilliant—and that underlying the surface of rational market behavior there is usually a deep layer of informal (often unconscious) habits, customs, and norms that, in fact, make the functioning of the market possible.

In my commentary, I will not attempt to bolster North's arguments on the market impact of social institutions; instead, I will apply his analysis to the specific conditions of the modern Soviet economy and examine the emerging economic structure.[1]

The Administrative Command Economy and the Administrative Market

It is commonly held that prior to the Gorbachev reforms, the Soviet economy was run—and, to some extent, still is—by the administrative command system. Accordingly, it is believed that the task of "progressive" reformers is to transform the command economy into a market economy.

People who are actually familiar with planning practices in the USSR realize that this widespread view is incorrect. From the 1960s onward, the Soviet Union was a country with a market economy.

Cato Journal, Vol. 11, No. 3 (Winter 1992).

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[1]For a detailed discussion of the emerging economic structure in the USSR, see Naishul (1991).

However, the market that functioned *in it* was *not* an ordinary market but an *administrative* one (or, to use James Buchanan's term, a *bureaucratic* market). The administrative command system as the dominant system of economic governance really existed only in Stalin's lifetime. And even then, it existed in its pure form only in high-priority sectors: heavy industry and the military. As the economy grew more complex, management systems became less command-oriented and assumed characteristics of a *contractual* economy.

The typical pattern of administrative market interaction in the Brezhnev era was as follows. Enterprises made requests for resources, which accumulated as they moved up the administrative ladder until they reached an agency authorized to assign production tasks to producers. Then, tasks were distributed among manufacturing enterprises, which responded with new requests for necessary supplies, so that the planning cycle repeated itself over and over again. Brezhnev-era economic planning started *from the bottom up*, not from the top down as under Stalin; its nature was not directive but iterative or cyclical. The "upward" movement of each request for materials and the "downward" movement of each production task was accompanied by furious *bargaining* between superiors and subordinates trying to achieve maximum resource allocation and minimal production tasks.

Since the organizational capacity of the vertical bargaining system was inadequate, the social system was forced to tolerate legal, management-legalized, or simply illegal horizontal exchanges whose importance constantly increased as the economy grew more complex.

The results of both vertical and horizontal bargaining depended, to a large extent, on the characteristics of the partners: their power, their bureaucratic leverage, and their ability to bypass and break laws. Therefore, in a highly developed administrative market, there was trade not only in goods and services but in everything that has value in a hierarchical society: power and subordination, laws and the right to disregard them, diplomas, and social position.

The bureaucratic trade based on status and hierarchy of power ultimately began to sell itself as well by trading in status and power. As a result, the institution of subordination in society began to disintegrate rapidly. In most spheres of activity, it was replaced by short-term contractual relations: "You scratch my back; I'll scratch yours," which leading Soviet sociologist S. Kordonsky astutely labeled "exchange relations." Interestingly enough, such relations—founded, moreover, on contracts that had to be made anew on an almost daily basis—were able to penetrate even into the kinds of enterprises where, in any other country, subordination reigns. What is even more important is that these relations paralyzed the normal performance of regulatory government services that function in contemporary Western countries traditionally called capitalist.

Comprehensive exchange relations will ultimately trade away whatever is left of administrative regulation in Soviet society. They will accomplish a drastic deregulation of the economy—something that, so far, only a strong executive power in Chile has been able to do—and accomplish it in a decentralized manner. In the USSR, the future belongs to a market more liberal than in the West.

The Regional Barter Market

As a result of the "diffusion" of vertical relations, their significance kept declining, while that of horizontal relations grew. Gorbachev's political reforms, which allowed the popular resentment against the Soviet regime to spill out, led to an accelerated degradation of vertical connections.

Even as the socialist system in the Soviet Union disintegrates, virtually all organic memory of life before socialism has been erased from the collective consciousness of the people. The peoples of the USSR—Russia in particular—have retained virtually none of the habits that make the "stateless" flow of economic life possible in other countries. Only the vaguest notions of the future economic mechanism, of the structure of a market economy, exist in our society. This means a lengthy and painful search for paths leading back to a normal economic condition.

As a consequence of decades of totalitarian rule accompanied by suppression of truthful information, society has now proved unable to comprehend its present condition. Even the most "progressive" reformers view society as it was depicted for so long by official propaganda, and they are far from understanding the real processes of social life. For instance, it is revealing that Soviet people, who are far less inclined than Westerners to obey the higher-ups and who used to bargain with them constantly on every point, sincerely believe that modern Soviet society is, in essence, a command system. The bottom line is that all the projects of perestroika, including the 500-Day Plan, were projects for introducing a fairy-tale market in a fantasy land.

Yet self-contradictory, chaotically adopted, and unrealistic laws result in a legal indeterminacy that allows individuals and organizations to exercise economic freedoms. When it comes to law enforcement, the weakness of the state generates additional freedoms, since the prohibitive aspects of laws are bent or ignored and only the permissive aspects are implemented, as long as they are not at variance with the logic of actual interaction between economic agents.

Near the end of 1990, when the old system of vertical interactions was on the verge of collapse, it seemed that the country stood on the brink of chaos and anarchy. Both the government and the "democrats" began to speak of the need for urgent measures to avoid an acute crisis. And a way out was found—not, however, by directives "from the top," where all was consumed by endless political feuds, but because, amazingly, a system of exchange viable under these difficult circumstances had emerged "from below"—a regional barter market.

The replacement of older economic relations with barter rather than an ordinary money-based economy was determined by several important factors. Under socialism, there was never any money in the Western sense of the word—money that could be used as a universal tool of exchange. Instead, there were special types of pseudo-money, very limited in its functions. *Cash money* could be used only for the purchase of certain consumer goods by the population. It was turned over to banks by the shops and issued by the banks to enterprises for salary payments to employees. In the industrial sphere, *noncash money* was used, essentially of the sane nature as the internal accounts of large Western corporations—that is, it performed primarily an accounting function. It is important to realize that there was a great variety of types of noncash money, since accounts of different types were not mutually convertible. Finally, lack of money in an enterprise's account did not translate into lack of smooth access to goods, while possession of money—cash or noncash—in no way entitled an enterprise to acquire necessary consumer or industrial goods.

The absence of real money with real value led to the proliferation of barter relations, which, however, engendered a number of highly specific problems. In a barter market, as we know, getting what you need is not that easy. To survive in such conditions, enterprises today are not merely trading directly among themselves but uniting into regional power centers that force other power centers to supply the full quota of necessary products. The operating principle is: "Give us what we need or we won't give you anything." In Soviet conditions, great multitudes of goods have only one monopolistic producer, while the suppliers of virtually every enterprise are scattered all over the country. The mutual dependence of all enterprises on every enterprise allowed an expansion of barter trade, which, so far, has caused only a slight reduction in the general volume of output.

The new, barter-based market economy has given the impetus to a rather harsh structural transformation of the economy. Regions that produce universally needed goods—foodstuffs, fuel, paper, or car tires—as well as export goods not controlled by the central government find themselves at the greatest advantage; meanwhile, producers of complex machinery for which there is very little domestic demand at present are at the greatest disadvantage. Supplies to defense factories and their employees are falling drastically. The worst decline is probably being experienced by Moscow, whose main product—central government—is just not in demand any more.

Inside regional blocs, the distribution of products is usually handled by administrative means. Consumer goods are distributed legally through ration cards and coupons issued at work or by residence, or illegally at astronomical prices (usually two to three times the nominal price) that cover not only the cost of the goods but the costs of the punishable violation of trading regulations.

In the near future, we may expect that as administrative restrictions on commodity-money-commodity exchanges are relaxed and the transaction costs of such deals go down accordingly, a single ruble will emerge from the various types of cash and noncash money that exist today. However, as long as only the government can print currency, there will be no confidence in the value of Soviet money, and existing Soviet bank notes will not become a universal tool of exchange. The developments of the past few years show that the general public prefers new, better-controlled ways of limiting demand through currencies independent of the central state: coupons, vouchers, or ration cards.

Stable foreign currencies are already in wide use, and will be used more and more, as internal hard cash; however, this will not be enough to satisfy the demand for money circulation. Therefore, if Western banks were to undertake the printing of bank notes in the USSR, they could, on the one hand, reap huge profits and, on the other hand, do more to restore the Soviet economy than Western governments could do with aid programs and guaranteed credits.

Private money independent of the Soviet regime, particularly with reserves in Western banks, will enjoy more confidence in current Soviet conditions than government money. The Soviet Union has a spectacular opportunity to become the first country to implement Hayek's idea of competing currencies.

Self-Made Privatization

As the development of a mature administrative market and exchange relations proceeded in the Brezhnev era, organizations and individuals gained new rights, usually not encoded in law, or encoded only *a posteriori*. This process picked up with the start of perestroika, when the declining influence of vertical hierarchies of subordination drastically expanded the formal autonomy of legal entities.

The final disintegration of traditional hierarchies of subordination, which happened near the end of 1990, gave rise to an intensive process of self-made or spontaneous privatization. At first glance, it can be seen as normal commercial activity rooted in current legislation; upon closer inspection, as seizure of property and thievery; and, finally, upon mature analysis, as the best of the realistically attainable methods of privatization in this country.

The legal framework of this process is defined by the legislation of the years of perestroika, which gave freedom to organizations, not people. In the absence of real property owners, the expansion of the rights of organizations means, in reality, the transfer of prerogatives from the top bodies of power to the top managers of organizations. This process was boosted by the emergence of new types of business entities: cooperatives, joint ventures, and many others, which can be used to carry out transactions forbidden to ordinary state-run organizations. The emergence of these institutions opened channels for the privatization of state property by transfer to top managers of organizations.

A group of enterprises can, for example, set up its own commercial bank and deposit assets into it. The bank will thus belong to the enterprises and will be run by their chief managers. Then, the enterprises can issue shares to be acquired by a commercial bank, which will then own enterprises. The outcome is the establishment of a financial group fully controlled by the managers of enterprises.

A cooperative acting in concert with an enterprise can raise money to buy out the latter. The enterprise could also buy itself out, borrowing money and paying the debts by raising prices—but then the chief manager would get no more than any other worker, which is actually at odds with the already existing distribution of property rights. Therefore, it is more to the manager's advantage to enter a partnership with a cooperative, simultaneously becoming its co-owner (acting, in order to stay "clean," through another, intermediary cooperative). A number of such examples could be cited.

As a result of such transformations, property ownership in the Soviet Union is being transferred to the nomenklatura (deideologized party officials, heads of enterprises, and heads of departments), particularly young and middle-aged people; owners of cooperatives and joint ventures; and newly elected deputies of local soviets. They have one thing in common: They were all in a flurry of activity in the period of perestroika. They were the only ones who were willing to go into business when perestroika created still-limited opportunities for that. The rest of the population is either people best suited to follow directions (some of them outstanding employees) or future entrepreneurs in fields where there is as yet no room for private enterprise. Spontaneous privatization places property in the hands of those who want it and know what to do with it.

The crooked nature of this kind of privatization is, in many ways, a consequence of the ideologized envy that prevents society from taking a sober view of economic inequalities, and of the contemptuous underestimation of the nomenklatura's abilities by people who have never been in management. When I suggested recently that in the privatization process, managers should get a 20 percent share in the properties as a bonus, critics sneered that our stupid nomenklatura was unfit for the market and unworthy of such largesse. What will they say when the nomenklatura gets 50 percent of everything?

Spontaneously privatized properties are not given away for free; they are sold—but usually for noncash assets, which can always be easily obtained. These are assets accumulated in the accounts of enterprises (usually reflecting nothing more than the flaws in the system of pricing, deductions, and subsidies); of party organizations; and of cooperatives (usually earned by reselling foreign computers to state enterprises and providing them with scientific, consulting, and other, often phony, services).

Both the Communist party and the "democratic forces" are actively participating in this process. In the Communist party, the division between a managerial class that has already set aside profitable spots for itself in the new commercial structures and a relatively small group of "ideologues" associated with the Communist party of Russia is almost complete. The "democratic" circles that have come to power are being corrupted by involvement in business activities. In all likelihood, the process of transition to the market will be completed when all of the most active and the most influential members of the nomenklatura have found places for themselves in the new structures and the authorities no longer stand in the way of the transition. The redistribution of property and the cardinal change in the rules of the game can be carried out only by a totally new political movement enjoying broad popular support. And such a development, even if it were possible, should hardly be seen as desirable. The new regime would have to give industrial properties to people who have no need for them, taking them away from competent people who know how to use them.

Unfortunately, the military-industrial complex is less involved in the privatization process, both because of its secrecy, religiously guarded to this day, and because of the discipline that always distinguished this sector of the economy. The military-industrial complex resents this all the more since, unlike the civilian economy, it has the country's best engineers, workers, equipment, and materials. The fact that the military-industrial complex is cut off from the division of state property is the main cause of the present political crisis in the USSR.

The self-made or spontaneous privatization described above does *not at this point satisfy* the Western criteria for private property. Thus, for instance, an enterprise can be sold but cannot be bequeathed. A businessman's sudden death could leave his heirs without property. However, anticipating his future demise, an entrepreneur undoubtedly can provide for his children. Privatization is now developing in *two directions: It is broadening* to include more and more enterprises, and deepening as actual property owners gain more extensive rights.

What is taking place is a powerful Hayekian process of reorganization of Soviet society, with a strictly regimented order being replaced by a spontaneous one. The weakness of the state, on the one hand, makes it impossible to fit this process into the distinct forms developed by Western culture; on the other hand, it protects society from recurrences of social engineering.

Reference

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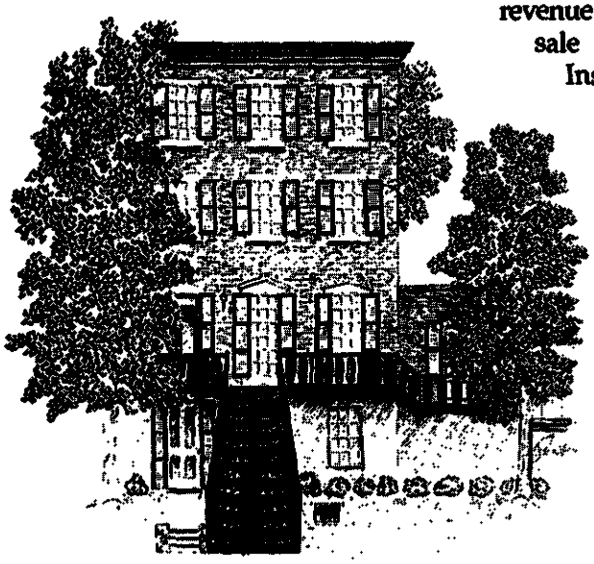

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THE ROAD TO SERFDOM

As soon as the state takes upon itself the task of planning the whole economic life, the problem of the due station of the different individuals and groups must indeed inevitably become the central political problem. As the coercive power of the state will alone decide who is to have what, the only power worth having will be a share in the exercise of this directing power. There will be no economic or social questions that would not be political questions in the sense that their solution will depend exclusively on who wields the coercive power, on whose are the views that will prevail on all occasions.

—Friedrich A. Hayek

The Road to Serfdom
(Chicago: University
of Chicago Press,
1944), p. 107.