

Forum Series on the Role of Institutions in Promoting Economic Growth

**Comments on Steve Pejovich's "Understanding the
Transaction Costs of Transition: It's the Culture Stupid"**

**Prepared by Richard Wagner
George Mason University**

Forum 6

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

4 April, 2003

Washington D.C.



MERCATUS CENTER
GEORGE MASON UNIVERSITY



Forum Series on the Role of Institutions in Promoting Economic Growth
Directed by the Mercatus Center at George Mason University and The IRIS Center
Sponsored by USAID's EGAT EG SEGIR/LIR PCE-I-00-97-00042-00, TO 07

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The objectives of the Forum Series are to help USAID make its donor assistance more effective and sustainable by incorporating insights from the New Institutional Economics into USAID's programming and delivery of development assistance. Services for Forums 6,7, and 8 are provided by the Mercatus Center at George Mason University and its consultants and the Center for Institutional Reform and the Informal Sector (IRIS). Editor for Forums 6, 7, and 8 is Peter Boettke, the project director for this portion of the Series with support from the overall project director, Clifford Zinnes, and the Forums Steering Committee (Ed Connerley, Jim Elliott, Jonathan Sleeper, and Tham Truong), chaired by the activity's COTR, Fred Witthans. Funding for the Series is provided by USAID's Bureau for Economic Growth, Agriculture, and Trade, Office of Economic Growth through SEGIR/LIR contract PCE-00-97-00042-00, Task Order 07. Copyright 2003 by the Mercatus Center.

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**Transition, Institutions, and Culture:
Reflections on and Ruminations about Pejovich's Interaction Thesis**

This is a valuable and important paper that brings themes from the New Institutional Economics to bear on the differential speed among nations in the speed of their transitions from socialism to capitalism. A key element in the New Institutional Economics is the distinction between formal institutions, which are largely established through legislation, and informal institutions, which largely emerge through cultural types of processes. Pejovich uses this distinction in an imaginative and fruitful manner to articulate his Interaction Thesis. According to this thesis, the speed of the transition from socialism to capitalism varies directly with the transaction costs of making that transition. In turn, those transaction costs vary directly with the intensity of the conflict generated by the interaction between the formal institutions of capitalism and the prevailing culture (informal institutions) of the formerly socialist states. The transition to capitalism has proceeded more fully and speedily in those nations where the prevailing informal culture clashes less sharply with the formal institutional requisites of a capitalist economy.

I think Pejovich has succeeded nicely in articulating and explaining the stylized facts concerning the differing experiences with the transition from socialism to capitalism among the various nations of Eastern and Central Europe. Pejovich's Interaction Thesis is an important vehicle for organizing thought about economic processes in general, as well as about the transition away from socialism in particular. The core of the Interaction Thesis involves a vision of a society in conflict unless its formal and informal institutions are congruent. This is a fruitful theme that is worth extensive exploration. In this short comment, I can do little but skim over a few points quickly. For the most part, I shall concentrate as what I regard as gaps in Pejovich's formulation, gaps that, if not filled, narrow the reach of his formulation. I shall start by considering some implications of Pejovich's formulation for the theory of political economy. I shall finish by considering some implication of Pejovich's formulation for the art of political economy.

Some Implications for the Science of Political Economy

Pejovich's analytical framework starts with an antinomy between the formal institutional arrangements of capitalism and the informal cultural sentiments of collectivism. The stronger those collectivist sentiments, the stronger will be the resistance to capitalism. An analytical framework centered on a clash among institutions is fraught with fruitful analytical possibilities. My only dispute with Pejovich's formulation is that he seems to portray the domain of this framework in an overly narrow manner, as being applicable only to formerly socialist nations. In doing this, Pejovich is following a common approach among economists, where an equilibrium is disturbed by

some exogenous shock, after which an equilibrium is attained once again. In Pejovich's particular case, capitalism is the equilibrium, and the nations of Eastern and Central Europe are now undergoing a transition toward that equilibrium state, with some likely to arrive there more quickly than others because their transaction costs of transition are lower.

There are two types of concerns I have about Pejovich's formulation viewed as a contribution to the theory of political economy. One concerns the treatment of formal and informal institutions as being generated by independent processes; in contrast, I would suggest that perhaps they are better viewed as reciprocals of one another. The other concerns Pejovich's end-of-history style of reasoning, which is, of course, a style of reasoning that is common to nearly all economic analysis. It is characterized by an equilibrium system that is disturbed by some exogenous shock, followed by a restoration of equilibrium. In contrast, I would characterize societies as being endlessly conflictual, and with that conflict being generated endogenously; accordingly, the task for the art of political economy is not to abolish that conflict, but only to contain or mitigate it.

Pejovich treats the basic legal framework of a market economy as comprising the formal institutions. The informal institutions that comprise what is regarded as culture would include such things as civic associations and patterns of moral belief. A legal framework of individualism could thus clash with a cultural or moral framework of collectivism. I am quite willing to admit that a legal framework grounded on individualism would clash with a cultural or moral framework grounded on collectivism.

What I find difficult to accept, though, is the treatment of legal and cultural processes as emerging and operating independently of one another. To the contrary, there is surely a good deal of mutuality and reciprocity between legal and cultural processes.

The institutional framework of a market economy is grounded on the legal principles of property, contract, and liability, as Walter Eucken (1952) explains particularly clearly. A market economy, or capitalism, is simply an abstract noun we use to describe the pattern of human relationships and governance that arise within the abstract framework provided by the legal principles of private property, freedom of contract, and personal liability. Those very principles, however, also imply a moral culture that characterizes the beliefs of people who populate a capitalist economy. The legal principle of private property, for instance, can be translated into the moral injunction to not take what is not yours. The legal principle of freedom of contract can be translated into the moral injunction to keep your promises. The legal principle of personal liability can be translated into the moral injunction to make good the wrongs you do unto others.

The more fully such moral beliefs as these are found within a society, the more fertile will be the ground for capitalist practice to spread. The realm of the moral or the cultural grows in the same soil as the realm of the legal. If this is the case, it is difficult to accept fully Pejovich's point of departure, which posits the antinomy between the legal and the moral or cultural. To say this, however, is not to deny the value of his Interaction

Thesis, with its grounding in institutional conflict. It is only to say that there might be other approaches to generating that same conflict.

In this respect, I should like to support a broader formulation of Pejovich's Interaction Thesis, one that holds that a conflict among institutions is always present, and which abandons any semblance of the end of history orientation that is present in Pejovich's paper. In saying this, I am reminded of Carolyn Webber and Aaron Wildavsky's magisterial treatment of the *History of Taxation and Public Expenditure in the Western World*. Webber and Wildavsky argue that all political regimes are characterized by conflict among people over how they shall conduct their lives. Even within largely market economies, for instance, there are strong conflicts among people over how they should conduct their lives. There are people, call them "leave us alone types," who think they should be free to make their own choices regarding their retirement, medical care, and the like. There are other people, call them "we are in this together types," who think that such matters should not be left to individual choice and circumstance. Similar to Pejovich, the central conflict that Webber and Wildavsky portray is between what they describe as individualist and collectivist cultures, even though they actually present several dimensions to this cultural conflict. This cultural conflict, moreover, occurs continually within all societies. It never goes away, though typically it cycles within some relatively narrow bounds. Not always, however, and sometimes that clash turns cataclysmic in one fashion or another. In any case, cultural wars are latent if not robust within all societies, and there is never any full congruency among all institutions of governance within a society.

The Italian economist Maffeo Pantaleoni articulated crisply some conceptual underpinnings for this type of continuing cultural clash or incongruence in 1911. Nine years before Ludwig von Mises articulated his widely acclaimed thesis about the impossibility of socialism, Pantaleoni articulated the impossibility of a fully collectivist economy. For Pantaleoni, societies were characterized at their core by incongruent institutions and cultures. He articulated this incongruence by comparing two systems of allocation, one based on market pricing and the other based on political pricing. Taxation transforms private property and the associated arrangements of governance into collective property, with its different arrangements of governance. Pantaleoni's approach to the mixed economy is thus one of incongruence and conflict, in his case one where the system of political pricing is parasitical upon the system of market pricing. Parasitical, I should note, is used in the technical sense. Pantaleoni explained that a system based wholly on collective property and political pricing could not operate. In Pantaleoni's formulation, a system based on collective property and political pricing could only exist when attached to a system based on private property and market pricing.

The idea of a clash between formal and informal is valuable and informative, and provides a fruitful way of organizing our thinking and our observations. I think it reasonable to say that Pejovich and I share the same analytical vision or orientation, as represented by internal incongruencies or contradictions that increase the costs of transaction and, hence, slow economic progress. I think that notions of incongruence or contradiction have much useful work to do in political economy, and Pejovich's paper

makes a valuable contribution in this direction. The uneasiness I have with Pejovich's effort in this direction is simply a sense that he did not pursue this clash with sufficient tenacity. The type of incongruence that Pejovich notes is surely alive within the generally capitalist nations, as well as everywhere else in the world.

Some Implications for the Art of Political Economy

The art of political economy involves working within the framework of the science of political economy to achieve desired outcomes, realizing that there is almost never any outcome that is truly universally desired, once you work through the details of what is involved in generating those outcomes. In this case, the desired outcome involves an expansion in the domain of market-governed relationships. Achieving this requires both legal and moral or cultural orders that support such a framework for human governance.

To some extent, to ask questions of how to promote more robust capitalist belief and practice brings us into confrontation with the present lack of strong microfoundations for institutional order. If the mind were properly analogized to a computer disk, the task would be a simple one of replacing old software with new. But the mind is not so simple, and neither is the task. It is not a simple matter of exporting legal principles and texts, for this would generate the type of conflict that Pejovich analyzes. But how can the moral or cultural order be changed to make it friendlier to capitalist governance?

I think there are some important lessons here from classical moral education. These lessons, moreover, generally seem to go in the same direction as some of

Pejovich's suggestions. In the classical approach, moral conduct is not an object of reflection and choice, but rather is a habit that has been created through practice. Moral education starts at a young age, though it continues throughout life. Probably, some analogies from the theory of capital are useful here. Without continuing practice, the moral asset will depreciate. It will probably also depreciate with contrary practice. In any case, the structure of morality, and, hence, legal practice as well, will depend on some combination of the education of youth and the subsequent domains of practice that people encounter as adults.

A moral injunction to not take what is not yours maps directly into a legal principle of private property. If a neighbor has a plot of land that you think would make a nice bird sanctuary, you could always buy it from your neighbor. Capitalist practice would in this case reinforce the moral framework that supports private property. Alternatively, you might convince a legislative assembly or zoning commission to declare that the land cannot be developed, leaving it effectively as a bird sanctuary. This is a form of democratic practice that teaches different lessons, for now whether taking property is right or wrong depends on how the taking took place. As such situations and practices multiply thousands of times, a societal architecture is created for the internal generation of institutional incongruence, in both the legal and the cultural or moral domains.

These suggestions about moral education and practice relate to two particular illustrations that Pejovich develops concerning transition. One concerns the distinction between fiat and contract. To be sure, the absence of microfoundations counsels against

being dogmatic. One extreme possibility is that legal fiat could drag moral and cultural belief in its wake. The other extreme is that fiat would generate revolutionary backlash, hangings, and the like, in response to the affront to cultural and moral beliefs. In any event, it would probably be necessary to deal with the reciprocal nature of the legal and the cultural or moral domains. A society where capitalist practice predominates probably requires individual minds whose moral constitution supports capitalist practice. But how to get there is not an easy matter, and may be something that can be attained only imperfectly in any case. Pejovich's discussion of Pathfinders and the over-40 group (and the former nomenklatura) is instructive in this regard.

The task is one of social agriculture, of how to promote the spread of desired plant forms, which in turn involves the restriction of undesired forms. There is much to be said in favor of by-passing the nomenclature and the over-40 group, as well as in supporting the formation of new enterprises over the privatization of state enterprises. But the analytical issues are difficult and tricky, both because of the weakness of institutional microfoundations and because of the complexity of the phenomena under consideration. With respect to complexity, these types of issues might be particularly susceptible to some of the newer techniques of agent-based modeling of artificial societies. Such modeling provides a potentially valuable tool for thinking about the complex types of interaction that are the object of concern here. In any such effort at modeling, Pejovich's paper will prove to have been a valuable and inspiring source of instruction.

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