MARKET FAILURE VERSUS GOVERNMENT FAILURE - THE OPTIONS OF THE EMERGING MARKET ECONOMIES

Vladimír Benáček [1]

CERGE (Center for Economic Research and Graduate Education),
Charles University, Taboritská 23, CS-13087 Prague

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A B S T R A C T

Transition is a global discontinuity in the evolution of a society. In economics it is characterized by an abrupt departure from one mode of economic behaviour, decision making and ownership to another: e.g. from a system of command to a system of market. Both polar concepts are described in the paper. The markets of a nation in transition out of the socialistic command system are highly underdeveloped, inefficient and liable to failure for many specific reasons. Markets are some of the most important public goods, thus there is a large reason remaining for the government to care about their buildup. However, the governments of societies in transition are also weak and prone to failure. Privatization is the paramount instrument of economic policy in their hands. The enforcement of new property rights is the most responsible task of the government in order to speed up the termination of the process of transition.

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"No", said the priest, "it is not necessary to accept everything as true, one must only accept it as necessary". "What a melancholy idea", said K., "it turns lying into a universal principle". K. said that with finality, but it was not his final judgment.

Franz Kafka, The Trial

1. INTRODUCTION

The purpose of this paper is to relieve ourselves from the routine thinking of the people enthralled in the daily fights for transition from a command system to a market society, and to ask questions about the real meaning of such a task. Are there any alternatives? Is the process of transformation viable and does it converge to a stable society ? Is the market system a final and an exclusive economic order or is it diverging from its archetype to a more disparate, eclectic system ? Once we proclaim that there must be limits to the government - are there also limits to a market? Once we accept freedom, choice and Pareto efficiency of allocations as cornerstones of a market system, is there still a space for absolute power, compulsory submission and rules of the authority ? As economic liberals, should we be unyieldingly consistent with the principles or is there a case for economic benevolence and compromise? Is the free market a self-installing and self-sustaining institution, or is there a need for its assertion by a command ? Was the past experience of communism in Eastern Europe just an absurd error in its capitalist history, sort of a caveat for all of mankind not to slip back from their unique capitalist path of development, or was it an unavoidable mishap in its trial-and-error search for new non-capitalist horizons?

The fall of the communist social system in Europe in 1989-91 can be interpreted as the fall of the whole Hegelian system of exogenously and objectively given laws of necessity. There seem to be no a priory warranted paths or given patterns. The future is a tabula rasa and its development proceeds through the independent actions of individual agents. Subjectivity, individualistic dissociation, uncertainty, mistrust in the powers of authority and reason - this is the legacy of modern Man. If it is true, then the notion of an exogenous market mediation is the most powerful instrument for guiding all of the most diverse human exchanges, both material or spiritual. Vaclav Havel's (1992) address at the World Economic Forum at Davos presents a similar idea which affirms that "the world of objectivity, generality and universality is in crisis". The communist dream collapsed because the irrationality of its imperative rationalism could by no means emulate the subjective rationality of the capitalist irrationalism.

2. THE TRICKINESS OF THE TRANSITION

When is an economy in the process of transition? Definitely it is not the case when it is undergoing intensive, but otherwise isolated, macroeconomic changes, e.g. changes from high inflation to low inflation, or from gradual to dramatic structural changes in production. Much more can be inferred from sweeping microeconomic changes, e.g. in the decision-making process: switching to a new objective function or to a new mechanism for the generating and treating of information. This is all connected with the extent of changes in how market and non-market information are used for decisions and their execution.

Nevertheless, these signals are far from being conclusive to solve our question. For the answer a much deeper insight into the **institutional changes** must be undertaken. The following factors, which are highly correlated, should be evaluated if we inquire into the intensity of the institutional transformations:

- massive entry of new economic agents into the production sector;
- changes in the property rights, transforming the whole ownership structure in the society;
- displacement of old ethics and values by new ones (e.g. in the issues of distributional justice);
- changes in the market structure and its organization, and their relationship to the non-market mechanisms;
- adoption of new distributional schemes (e.g. in the field of incentives, wages, taxation and subsidization).

The transformation of bankrupt command economies in Central and Eastern Europe into market economies, labelled as emerging market economies, is a typical example satisfying all 5 factors. However, they need not represent the only case of transition. The opposite transformation (i.e. from the market to the planned economies) presents a similar phenomenon. The abrupt changes caused by the mobilization of a peace to a war economy, by the occupation of a country by foreign troops or by the re-switching of the former to peace economies, can also be considered as cases subject to transition as defined above.

Up to the end of the 1980s economic theory did not consider transition as a topic worthy of special attention. Since the end of 1989 that literature has been booming.
This paper attempts to contribute, using generalizations based on long experience with transitions in Central and Eastern Europe.

The most surprising finding related to the emerging market economies (EMEs) of Eastern Europe is the depth of distress which accompanies the local efforts for reconstruction of capitalism. Without active individual commitments, based on collective consensus for tolerance and cooperation, there seems to be no progress. Capitalism can neither be imported from the outside (as the case of Eastern Germany shows), nor can it crop up automatically on the ruins of the old system. It has become clear that a functioning capitalism cannot be copied according to some blueprint outlined abroad. It must be re-born and re-installed subject to a wide consensus of the wills of its fellow co-travellers. In fact, capitalism is the result of evolution which started in renaissance and which was not spreading evenly to all parts of the globe. The system of totalitarian command, disguised into the ideologies of nationalism or racism, still has chances to recoil back if a decisive part of the society would like it to.

The surprising social explosion of 1989, and the hardships of the EMEs which soon followed, may have been a shock to all participating parties: in the East and the West; among both economic liberals and socialists; among advocates of authority and the advocates of free market (see Olson (1991), Kuran (1992)). The indeterminate openness of the future evolution in the East calls for different strategies to be adopted. On one extreme there is the orthodoxy of economic liberalism, relying preponderantly on the anonymous market forces; on the other end there is the call for the strong visible hand of a concrete authority. In between there is a series of diverse views inclined to various degrees of combination of the free market and central governance. It may be a false inference to assume that the practical solution rests in a combination of some parts of both, sticking e.g. to the common sense rule of the golden mean. An attempt to have the best of both worlds may end up in failing to achieve any of them. If we accept that pure capitalism is a myth of abstract thinking, which can be in reality somehow approximated but never practically achieved, it is not so obvious that we can ascribe the same status to a myth of pure socialism. It may be even worse to mix both of them purposefully together in order to "make" the reality viable. Now let us ask why are these myths [2] not logically

[2] *A myth is interpreted as a traditional story of ostensibly historical content, attempting to explain some*

symmetric ?

3. THE MYTHS OF A SOCIALISTIC COMMAND ECONOMY

If we accept that all social systems have some alternative, then in an ideal case of the pure capitalistic market economy we may pick up the pure socialistic command economy as its "natural" alternative or counterpart. Since the logical concept of the system of command economies is a rather blurry one, with many authorities claiming to provide the "right" (but still a very fuzzy) answer, we are pressed to turn to its rather intuitive description - a description based on the accumulated traditional stories of planned socialism appealing to common sense, but portraying in fact the myths behind its ill-defined pure concept.

1. **Framework.** The whole society (including economy) is a hierarchic structure where the only flows of information which matter are vertical ones. The vertical flows can be divided into bottom-up (cognition flow, reporting) and top-down (commands). This hypothesis of "democratic centralism" assumes a balanced interaction between the authority and the ordinary citizens, with the former proclaiming the determination to serve the benefits of the latter. In order to make the vertical flows productive, the horizontal interaction and its informational flows must be paralysed. So the massive nationalization of private property in these economies must be undertaken. There is no other solution but to give absolute powers in the decision-making to the state, represented finally by the bureaucracy of the planning system and the Party.

2. **Objectives.** The main instrument of economic policy in the command economies is then a command over the supply side (via the planned allocations). If there are some efficiency problems under this arrangement, they can be interpreted only as a sign of plan' s reserves - thus shortages can be described as bidding for "future improved planning and discipline". The objective of production is to maximize the productive potential of future generations (i.e. it is a posthumous reward for those executing it). Consumption, along with some other targets of final use (investments, exports, government expenditure), is thus seen as an ex-post effect of expanding the intermediate inputs side of the economy. Stalin's law of preferential growth of the first sector (production of machines and intermediate goods) over the second sector (consumer goods) can just be taken as a common-sense interpretation of Leontief's inversed model for providing the exogenously given final production by means of the intermediate consumption multiplier. The turnpike variant of J. von Neumann model, where the objective is to attain in some final time a maximal capital stock of some uniform composition which is consistent with the maximal rate of growth, can be used in a similar context.

3. **Counter-liberalization.** Any price system reflecting scarcities is awkward to rely on because of its intermediate role connected with a low speed of adjustment. For the allocative tasks a more advantageous direct decision-making can be exercised, instead of following the price signals, by means of "scientific" control over the expenditure on consumption (diet, clothing, housing, transport, culture, leisure, ...), technocratic control over technology and centralized capital stock investments. Foreign trade can be allocated in the form of planned quotas of supplies, subject to complete centralization.

4. **Quasi-equilibrium.** Due to a technocratic (human engineering) view on the economy,

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social phenomena, whose origin has been lost. In this paper I prefer the word "myth" to such expressions as "paradigm", "model" or "system" due to its intuitive contents, which is widely understood and empirically recognized, but unclearly defined. The advantage of working with the "myths" is that they are also neutral to their positive or normative contents.

there is always only one unique rational configuration of the system, ie. a "proportionally balanced system". Once the "proportional balance" is achieved, the system must evolve by linear incrementalism (by so called "indexed method of planning"), where a taut plan achieves a maximal (and uniform) growth of the economy. (The parallel with the original version of von Neumann model, where all activities of production or consumption evolve in fixed proportions, is once more apparent here.) There may be, however, changes in the final demand, innovations in technologies or in commodities, or even exogenous shake-outs in production, which put the economy into "disproportionality". The non-price control over allocation of resources uses such a leverage like queues, shortages, complaints ("voice") and morals. Subsidies are useful and lead to "proportionality" (or "equity" as its special case), i.e. they serve as anchors against "destabilization" and as a buffer for absorbing exogenous shocks and "price deformations". The market clearing price mechanism simply has no role in the whole process of reallocations to equilibrium.

5. **Constraints.** Wage control is the most important nominal anchor for price stability, thus the non-market nature of labour contracts must be always maintained. Inflation can be always avoided by price freezes, catching the excess money balances into the "liquidity trap" of the (unintentional) long-term overhang of "savings". Expansionary fiscal and monetary policy is useful, as well as the pent-up demand so created, since it is a sort of confirming the subordination of the demand side to the central command over the supply side. The supply side control is exercised as "an active discretionary structural policy of the centre", i.e. as a temporary selective political process of stop-go to some segments of the economy.

6. **Economies of scale.** The monopolies are always useful because they help to bring the plan to transparency and they increase the speed of adjustment and the control from the centre. The case of advanced capitalist economies (e.g. the role of monopolies in contemporary Japan or the rise of multinationals) is used as a proof that this policy is viable. Dismantling of the markets was initialized exogenously by the technological revolutions towards large production units. The increasing economies of scale are a universal law of reproduction and industrial organization, and as such should be pre-emptively advanced by the plan. The competition of a myriad of small economic agents is thus understood as an alien element to the efficiency of large-scale production. The rent-seeking of the monopolists can be regulated by direct government control.

7. **External links.** The economy must be closed to external shocks (e.g. to foreign prices, institutions, tastes, market ideology, ...) because they destabilize the balance of the domestic economy. The exchange rate should always be kept overvalued because it helps to avoid the unnecessary "loss" of production through exports and it thus facilitates bringing cheap imports into the country. The absolute purchasing power parity doctrine is the best guideline for determining the relevant and "justified" exchange rate. Foreign capital is always dangerous because it brings about property rights questions and challenges the exclusive control over the economy from one centre. Thus the claims on property rights from outside the domestic state sector are supposed to cause inefficiencies and political strife.

8. **Adverse role of profits.** Profit maximization on a micro level, as an objective function hostile to proportional planning, leads to inflation, slow adjustment and inequality (see Ellman (1969)). Bankruptcies and exits are completely avoidable and useless: the old inefficient organizations can always be resuscitated by changing the top management, adjusting the prices, production restructuring, granting short-term privileges (e.g. subsidies or soft loans) and by direct capital investments. That requires, on the other hand, a maximal accumulation of "surplus" in the hands of the state budget.

9. **Equity.** The egalitarian principle has, alongside its fundamentalistic ethics, also its pragmatic value, since it leads to stability and efficiency. The equality of opportunity can be valid only if the initial endowments are the same. Thus this system must always care about the "just"

distribution pattern of incomes or budgets and constantly revise the given factor endowments on a micro level. The Robin Hood appropriation and re-distribution of the property is economically justified and X-efficient in the long run. The collective ownership (e.g. direct state property or decentralized labour managed firms) is just another reflection of this principle.

10. **Lifeboats.** In case the domestic signals to central planning fail, structural development can be planned by copying some advanced economy (as the best examples Germany, Austria, Sweden, Japan and Korea were very often quoted). In the worst case the elements of decentralization through "optimal planning" can be introduced and combined with some of more than 100 existing schemes of decentralized planning (e.g. those of Lange, Lerner, Danzig, etc.). The people like the work for its own sake. Last but not least, there is always somebody who will voluntarily innovate and spill this public good over the whole society. Humans are generally non-selfish, altruistic beings, unable to deny, in the last resort, their strong urge for affiliation and cooperation.

4. THE MYTHS OF A CAPITALIST MARKET ECONOMY

1. **Freedom of choice.** The most fundamental attribute associated with the modern market economy is the notion of freedom (see Friedman (1962)). It consists in offering an individual a large choice of alternative options to satisfy their preferences for consumption or job, without subjecting him/her to ask permission from somebody else. However, the exchanges or contracts so generated are subject to budgetary constraints.

2. **Efficiency.** For another salient feature of the capitalist myths we must go back to Adam Smith and his invisible hand. According to his argument competition on freely functioning markets results in a full and Pareto-efficient utilization of resources, full employment, economic and technological progress and a rising standard of living. This holds on the level of both macroeconomy and microeconomy. The markets and their efficiency do not need to be painstakingly constructed or cared for the government - they emerge spontaneously and thrive under laissez-faire.

3. **Impersonality.** For the next statement we must turn on Hayek, who argued that an open market is the most effective system of social calculation, comprising signals of millions of consumers and producers. While an autocrat might have been able to coordinate the discretionary economic activities of simple economies of the past, he can never succeed in a more complex one. In other words, the more complex the economy is, the more dependent on the market it becomes. The market is an anonymous institution, where the personal identity of its agents, their social status, personal characteristics or motives of self-interest are concealed by the pecuniary nature of exchanges. Its objectivity and impartiality is achieved by jettisoning the inter-personal relationships, the authority and the power over the markets.

4. **Emergence of prices.** The forces determining the market are the single actions of individual economic agents motivated by the satisfaction of their own wants. It is the value judgments of these individuals, proclaiming their choices, which finally sets the exogenous price structure of the market. Thus it is the price structure which brings order and cooperation to the natural individual disharmony of interests (see Mises (1963, p. 258)). Because of the sophistication of the modern markets, any individual can neither outguess the market nor efficiently command over its prices.

5. **Competition.** Laissez-faire is based on free competition, where information is free and perfect. All markets must be opened - thus free trade is a necessary condition for an efficient market environment. The free entry and free exit must be guaranteed, too. No agent has power over the market, thus the market clearing and the consumer's sovereignty function perfectly. Any shift from this ideal results in a tendency toward monopoly, which implies reduction in output,

increased prices and inefficient allocation of resources. Few competing firms on a market (i.e. the oligopolistic competition) is a bad thing.

6. **Neutrality of government.** There is little to be done by the government for the welfare of the economy. The government should defend the country from external non-economic aggression, it should set the rules for the market game, safeguard the property rights and set up a mechanism for the enforcing of contracts. It acts more like a guarantor and a final judge than a manipulator. The market economy does not respect the political frontiers or the ethics of equity. The universality of money transcends the powers of any individual, whatever his/her position in the social hierarchy may be. It is only the choice of a sovereign solvent consumer what matters.

7. **Private property.** Since the resources are limited and their distribution is principally uneven, while their use is universal, there arises a natural need for establishing the private property rights. Markets cannot exist without private ownership, but the private ownership cannot exist without the government and its monopoly of power. Any preoccupation with the endowments privately owned or attempts at their redistribution are judged as infringements on individual freedom.

8. **Entrepreneurs.** The entrepreneurship function, i.e. the striving of entrepreneurs after profits, is the driving power of the markets. Its role rests in price searching, reallocation of resources, shifting both the demand and the cost curves, and in creating brand-new markets.

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If we would like to compare the above mentioned "myths" on which the real command and the real market economies are based, we must test their structure from two sides: the logical and the pragmatic (empirical) one. While the logical description of the pure competitive market economies can be supposed complete due to axiomatic General Equilibrium Theory, as developed by Debreu and Arrow, absolutely nothing of a similar logical framework can be found to back up the principles of the command economies. The theoretical extensions of the neoclassical mechanism (optimization under constraints), concerning the functioning of the mechanism of imperfect competition, the macroeconomic theory, the theory of public choice and the welfare economics, is a logical experiment which the scholars of the central command can only observe with consternation. Central planning completely lacks the theory of exchange and its theory of decision-making is logically flawed since it does not rely on exogenous prices. The theory of optimal planning was a miscarriage because it assumed the existence of economic agents and objective functions which did not (and could not) exist in any state economy.

Even though the myths of the market economies have not yet been logically closed into a simple system (e.g. Austrian economics, business and management studies and public choice theory successfully thrive on its various loopholes), the logical robustness of the market economic theories have been so far much more persuasive than what the command economic theories were able to present. One of the most flawed assumptions, integrated deeply into the command reasoning, was that the government can function as a supreme guarantee of altruism and virtues for the benefit of all, while the private vested interests can never surpass their egoism and malevolence, profiting only at the expense of the society. It was often omitted from the reasoning that actually it is the government which has holes in its integrity both as an collective agent and in its motives. Then it could be the uncontrolled self-interest of the totalitarian government and its bureaucracy that finally paralyses the economic system.

If we go through comparative pragmatic tests of the viability of the market and the command economies, we cannot find a **single** long-run evidence that would point to a higher viability of the command over the market. Even if we empirically tested each of our 10 points of paragraph 3, the empirical evidence would either directly falsify their existence, or point to their disfunctionality, inefficiency or disintegrity (see e.g. Ml_och (1990)). Of course, the proof of the latter requires acceptance of the principle of maximal satisfaction of the human needs as the exclusive criterion for the official objective function of the command economies.

The chief culprit behind the above mentioned failure is evidently the government failure (actually the bureaucracy failure) in all command economies. As the vast majority of comparisons of the efficiency of private versus public firms confirms (see Borcherding et al. (1982)), the state operated production units, even in capitalist economies, are in the long run generally more prone to inefficiency than the privately operated units.

Does it all mean that the government in the transient economies has in the long run no other economic roles besides provision of defense, rules of the market conduct and a judiciary system for contract enforcement and defence of the property rights ? Is this Minimal State Hypothesis valid even in the short run ? I think that especially for emerging market economies the answer must be decidedly **NO**. Why cannot these economies rely on the market and why do they have to resort to the discretion of the notoriously failing government on a much larger scale than would otherwise be expected?

5. THE MARKETS IN RUINS

Once society commits itself to scrap abruptly the paradigm of command and to switch to a market, the economy faces numerous obstacles which lock it into a series of vicious circles leading to a deadlock. The recent events of the last 25 months in Central and Eastern Europe have proven that the transition to a market economy presents a much more difficult problem than was originally thought. Indeed, no answer can be found within the seemingly similar, but reversed, process of switching from a market to a command economy, which was economically (but definitely not politically) smoother. The transient societies from the Elbe to the Kamchatka are floundering, showing little hope for quick recovery.

Why is economic instability, which radiates throughout the rest of society (e.g. into politics and morals), so difficult to solve in transient economies? Why are commodity market transactions and their contracting so inefficient? Why are transaction costs so exceedingly high? Why do markets not clear and instead operate in a highly distorted way, that is, in a situation of inelastic and contracting supply? Why is the reallocation of resources so slow? Why have the released resources not re-entered the production process? Why does the future play such a marginal role in microeconomic decisions? Why can we observe in all transient economies phenomena that have been seldom encountered in Europe before: deep depression coupled with high inflation? Why do signs of negative growth, rising unemployment and creeping international indebtedness suggest 1929-33, while other signs do not fit this image - such as rampant inflation and the parallel shortage of a number of commodities with deregulated prices?

The problem is that **"the market" is never just a neutral mechanism for evaluating and ranking of the human preferences among alternatives, but also a social institution** -a place where the autonomous individuals change into interacting organizations, where anarchy is transforming into a moral civil society, and where the changeable social values are hidden behind all revealed preferences. The answer to the questions just mentioned in the previous paragraph, could be labelled as the consequences of **collective action** (collective coordination) **failure**, where the externalities, the prisoner's dilemma and the free riding play a central role.

What rests behind the collective action concept? According to institutional economic theory (e.g. Commons (1934), (1970), Williamson (1975)), it is a set of man-made rules imposed on society - a society which is essentially scattered into elements that, without these rules and under conditions of uncertainty, clash into conflicts of interest and anarchy. These rules are intrinsically different in the totalitarian and the democratic society. The latter is marked by the paramount role of the market in achieving economic order. However, the existence of the "market" alone is generally not a sufficient condition to produce order from conflict. The creative and cooperative nature of agents in the market is finally achieved by the invention of rules of the market game and by economic institutions which constitute a more organized way of introducing human values, morals and a predefined behavioral pattern to the interaction of economic agents. The crucial motives for bringing about a social consensus for the build-up of market institutions are the resultant economies in transaction costs, the faster reallocation of resources and, finally, the easier adjustment of all participating agents to economic equilibrium under Pareto efficiency criteria.

Since during the transition the markets as mechanisms and the markets as social institutions are, by definition, in a state of fundamental and uncoordinated shake-out, their failure in functioning cannot be avoided. Market and collective action failure can be brought about by numerous causes:

a/ The intensity and the number of **exogenous shocks** to which the economic system must adjust. In this respect it is important to stress that mainstream economics (ie. the general equilibrium theory) is concerned with small (marginal, infinitesimal) changes of the old equilibrium, while the number of changing exogenous variables is kept to a minimum thereby allowing an analytically manageable solution (e.g. under conditions of ceteris paribus). Thus the process of subsequent piecemeal adjustments for the relevant variables to a new equilibrium (tatonnement) can be described by formal logic. Disruptive catastrophic shocks, present concurrently in nearly all variables, are less elegantly dealt with by this instrument. In addition, it has difficulty in explaining an out-and-out breakdown of the whole economy. In the moments of transition the explanatory and the prognostic power of general equilibrium economics is thus largely weakened, which undermines the analytical capabilities of economic agents.

b/ The extent of **uncertainty and risk** in future economic contingencies. The concept of bounded rationality (Simon (1958)) helps to explain some basic behavioral problems of transient economies. The disintegration of traditional foreign markets, coalitions of corporate management in a monopolistic environment, enormous shifts in relative prices and changes in consumer tastes, are just a few examples of the objective sources of uncertainty in transient economies. This uncertainty is amplified by infrastructural weaknesses (e.g. by failing telecommunications, thin electronic networks, malfunctioning banking, disorganized financial accounting systems, etc.) and by undeveloped market culture. In addition, the enormous potential for intentional distortion of basic information cannot be discounted, bringing thus the information failure to the core of the troubles.

c/ The degree of **market imperfections**. This may be the case of bargaining between bilateral monopolists or so called "small numbers" exchange relations, where no competitive forces drive the exclusive agents into competitive behaviour. Opportunistic outcomes of oligopolistic collusions naturally lead to price distortions, rent seeking and transactional difficulties. The two-person game theories apply well to this environment.

d/ The **pessimism of expectations**. The expectations in a transient economy are guided by two strategies:

- adaptive expectations which reflect the passive social role of its agents (generally the consumers and the non-entrepreneurially motivated bureaucrats),
- rational expectations which pertain to the small but rising new entrepreneurial and appropriative class.

As the political and the economic scene becomes trapped in the stalemate of redistributive bargaining and, with it, the adaptive expectations getting the upper hand, the whole long-term economic development gets to a stall. Once the agents accept the expectation of a continuing economic breakdown as a motive for their decisions, it is very difficult to persuade them to abstain from engaging in a vicious spiral of panicky myopic behaviour.

e/ The severity of **conflict of interests among groups of economic agents**. Here the depth of conflict among state producers, private producers, trade unions, consumers, central government and local governments can be measured by the extent of the expected redistribution of capital, bankruptcies, unemployment, inflation and reallocation of labour. It is expected that in Czechoslovakia in 1992 a quarter of the capital will be subject to a risk of reallocation. In East Germany it may be a reality for half of the labour force. Recent public opinion polls show that 54 % of the Czechoslovak state employees regard their job as unsafe or unperspective. In this respect the situation resembles more an economy routed by war than by a deep slump of a cycle. The lack of reconciliatory mechanism in early stages of transition is also reflected in the process of disintegration of the political parties. (E.g. in Czechoslovakia in April 1992, just two months before general elections, there were over 100 parties competing in some 40 coalitions.)

f/ The disparity of **time factor.** Once there is a difference between the lifespan of capital outlay and the lifespan of executive controls, while the former is evidently greater, the problem of long-term decision making arises. Seeking to protect his vested interests, the manager with only a short-lived executive power will be inclined to disregard the burden of future costs in favour of his own short-run benefits. Sound investment decisions in accordance with market signals will thus be distorted at the expense of future generations of owners or managers (viz. Pejovich (1991)).

g/ The **principal and agent problem**. This kind of market failure is caused by incomplete property rights, leading to the split between economic interest of owners (principals) and managers (their agents). It is quite common in transient economies that the real owner of a property is either anonymous (as in state companies) or is represented by a collective body without responsibilities of ownership (as in formal cooperatives). The managers either abstain from exercising the property rights, which provide the highest long-run returns to capital, or simply appropriate a part of the returns as remuneration for themselves. The clash between the vested interest of an established executive agent and the interests of a weak owner is a very serious cause of market inefficiency during transition when the judicial and ethical foundations of a society have been shaken.

h/ The **weak social ethics** of economic agents. A large portion of the market failure could be eliminated if the economic agents stuck to ethical principles of cooperation, self-sacrifice and communitarian values. The heedless selfishness, though acceptable as a part of the behavioral pattern in perfect market economies, is a very dangerous social feature in the emerging market economies. Due to improperly defined property rights, **free riding** is the most tempting among the predatory or proprietary options. If other people defect from productive activities and concentrate on redistribution of the existing property, the altruistic individual is doomed. As all people successfully cooperating, any immoral individual can gain even much more by unpunished defecting. This undermines the ethics of the well-behaved society to such an extent that it will founder in the long run. Also the privatization schemes (restitutions, auctions, giveaways through competing projects in a government tender or foreign buy-outs) offer many opportunities for free lunches by means of corruption, racketeering, nepotism, insider information, etc., which hamper the allocative efficiency of the resources.

i/ The role of **negative externalities**. In command economies the pollution and other environmental problems represent an enormous social cost in practically every production locale. Since these huge costs are generally exempted from the market, it is extremely difficult to treat them as economic variables and incorporate them into decisions, even if the markets were otherwise perfect. The Coase theorem and its vulnerable pre-conditions (e.g. well functioning legal framework for liability procedures, low transaction costs, well defined property rights, full information, etc.) is a prime illustration why negative externalities in transient economies are such a serious challenge to social efficiency.

j/ The extent of **public goods** aspects. This problem has three facets. On one hand it is connected with the enormous weight which the traditional public goods had in the socialist economies: like in health care, education, culture, sports, defense, transport, research, justice, judiciary, police, army, communications and public administration. The legacy of continued existence of these sectors in transient economies prevents large segments of the economy from making efficient market adjustments. On the other hand a large part (or even all) of remaining production was treated in the past as a sort of public good or common resource. (Then it is not surprising why it was also organized in a similar fashion as the army or the police.) It was so because stability, security, interdependence and equity were instrumental aspects for the viability of the whole system of commands. Some inertia can still be observed in the strategy of solving these social problems. A third aspect is represented by the relationship of the public to the production in the state sector where the attributes of positive externalities, non-excludability and of parallel use (especially in the private appropriative use of the state property) did not cease to be assumed. The history of the state property in socialist countries is just an analogue of the "tragedy of commons", as experienced during the breakdown of feudalism . Also many ailing state enterprises and cooperatives bargain for being classified as socially sanctioned and are subsequently bailed-out due to their alleged "public cause".

k/ The complexity of **behavioral patterns of managers**. Since many corporate producers and their agents in a post-command economy do not accept the long-run maximization of enterprise profit as their true objective function, their set of strategies is much more complex than is the case in a developed market society. This tendency is determined not only by the unexpected social situation the managers are suddenly faced by, but also by their own unreadiness for tackling this situation: the lack of economic, business and legal education, the dubious "entrepreneurial" philosophy taken as a result of past experiences derived from the markets in the planned (or black) economy. Various speculative strategies in their objectives are much more common. In transient economies even suicidal bankruptcy, stealing, embezzlement, rundown of capital, shutdown of production or maximization of hoarded "reserves" must be considered as economically rational behaviour, subject to given constraints (viz. Quandt, Tříska (1990)).

l/ The **disruption of property rights**. On one hand it is the disrupted state of the property register and of the legal and the judicial system which thwarts the creation of functioning property rights. Thus the risk of concluding an incomplete contract or a contract which is hard to enforce, is much higher in the transient economy than ever before in that country. On the other hand the property rights are also confused by the claims of the former owners (or a queue of their heirs), employees, spontaneous "wild" privatizers and the government on the public property, which brings the efforts for a quick consolidation of the management to a havoc.

To conclude, the more Heraclean are the labours loaded onto the weak emerging markets of transient economies, the higher is the risk of market inefficiency and collective action failure. The market itself is not a free good: it needs service, maintenance of rules and large investments into both physical and human capital. In fact, **the market is a typical public good with enormous spillovers all over the society.** It is a paradox that this crucial economic fact skipped the attention of many economic textbooks, including textbooks of public choice and externalities. **If it is generally accepted that it is the role of the government to take care of the provision of public goods, there should be no doubts that it is the government which**

should care of the buildup of the markets. The larger the burden loaded on it, the more demanding the requirements necessary for guaranteeing its smooth performance. Without a doubt, the markets of former command economies have been intentionally grossly neglected, ailing derelicts. In order to refine them, emerging market economies must build up during the period of transition competent and competitive market institutions and apply a strong leverage for helping to bring their markets from ruins.

6. DILEMMA IN THE SEARCH FOR SOLUTIONS

The failing and rickety markets of transient economies are not able to produce a quick solution for prosperity or even socio-economic stability. They do not offer straight remedies for achieving full employment, growth, external stability, equity and political and social peace. The uncertainties of their performance are hardly to be judged as socially bearable in the long run. **There is a large role remaining to be performed by the government.** But governments are notoriously failing in tackling their social tasks. As Grossman (1991) has pointed out, it was known already from the times immemorial: in the Bible (see First Samuel 8:4-22) the people request Samuel to "make us a king ... [who] may judge us, and go out before us, and fight our battles". But Samuel warns them that a king will impose all manner of heavy burden on them for his own benefit. In order for government to serve its essential social functions, the citizenry must subject itself to the ruler's sovereign power to act as the highest legal and fiscal authority. The resulting dilemma of government is that it furthers the ruler's own self interest, rather than that policy which promotes the welfare of the citizenry.

When granting the government and its bureaucracy a mandate for decisions and for power, we must not be surprised it is used for their own vested interests. It would be an overly optimistic case if the emerging market economies were able to form a strong and morally unimpeachable new governmental network, free of political shakeup, which could be given short or medium term tasks of authoritarian rule for establishing well functioning markets under the political control of the citizens and then dismantle its power. The advantage of a dictatorial illustrious authority is a simple and expedient strategic decision making (see Mueller (1989), p. 53 or Buchanan and Tullock (1962), p. 63-91). Let us point to some advantages of such a straight vision:

Since there are well defined ideas of how a market economy works, what its institutions are and what rules are to be followed, a dictator could do a lot in pushing the society on the market track. He/she can take over the legislative powers from the reluctant and quarrelling Parliament and import some well-tried Western legislature. The cheap give-away privatization schemes would be simultaneously supported by a strong legal system whose task would be:

- to guard the enforcement of the private property rights;
- to safeguard low transaction costs on property accumulation through re-sales;
- to administer a judiciary system for speedy bankruptcy and contracting problems resolution.

The state sector would be under strict centralized supervision, as e.g. Schacht in Nazi Germany had so efficiently introduced. The government would control the provision of necessary public goods, regulate the positive externalities by subsidies and the negative externalities by a sort of taxation. The prosecution of free riding would be in the centre of government supervision. The state would thus take over the buildup of infrastructure, education, social security and social safety net. It does not mean it implies that it is the state sector only which is granted the contracts - it can be the private sector which gets the major share. There is also an enormous **task for the economic policy of the government to bring the capital market to the core of the economy, especially in the sphere of the financial institutions** (see Benáček (1991)): reshaping the incoming and outgoing parts of the budget to a highly competent system, revamping the central banking, encouraging the buildup of the network of commercial banks, investment funds, pension funds, insurance and stock exchange. Another clear target of the government could be the mediation for the buildup of the labour market, the housing and the real estate market and the market for information.

There is only one condition for the above mentioned to be true: that the Strong Government Hypothesis is a viable one. The history has shown that it is not - in the better case it is just a delusion, in the worse case it is a political booby trap. **The emerging market economies of the East European type are notoriously politically weak** - they are not able to create a strong democratic government and an open civil society so quickly. **The government is just another very expensive public good which, during the transition, is going through a process of fundamental restructuring and needs urgently its own gradual buildup.** On a top if it, the idea of a strong illustrious authority, even in a more plausible circumstances, is a chimera anyway. Lenin, Mussolini, Stalin or Hitler failed in the long run in their attempts to build both a strong and a prosperous state. Even the recent rather cautious attempts of Treuhandanstalt for exercising strong government features have driven the German economy to a corner.

One way how to push weak, quarrelsome, corrupt or hypocritical governments (including their bureaucracies and the parliaments) towards responsibility and morality is by bringing them under international surveillance. The permanent working links between governments, parliaments and other state institutions of the countries in transition and the developed democratic countries should be made as intensive as possible. Binding the governments of EMEs by international treaties, contracts, informal commitments and projects is an important step in checking, at least partially, the local decision-making by the international bodies. The European Communities, GATT, the World Bank, IMF, NATO, etc. can play a very positive role in pressing the governments of transient economies to take more radical decisions, encouraging sound competition among themselves and sticking to ethics and discipline. International training of the governmental staff, which should be small but highly competent, is another step in that direction.

Such international dependence, however, cannot solve the core of the problem. The transient economies must reconcile themselves with the destiny of dealing with weak governments. It is a paradox that they are these very governments which hold a key to the future. Whatever these governments may be, they have one superior and irreplaceable task: they must bring the full-scale privatization to its life as soon as possible and enforce the property rights. **Privatization is the paramount instrument of the economic policy in the hands of the society in transition** (see Benácek (1991)). It is the most complex instrument to operate, laying enormous responsibilities on cooperation, timing, sequencing and technique. The scope of its influence is also colossal. It addresses nearly all points of market failure as listed under the paragraph 5 above. If fact, our points attempt to be in ascending sequence according to their sensitivity to the property rights and ownership changes. As we can judge, there is a significant correlation between the private property rights issues and the performance of markets. No government, proclaiming seriously its will to pass more decision making powers to markets, can avoid the problem of privatization. Or, put in the opposite way, any government of a society in transition, showing reluctance in its determination to proceed to radical changes in the property rights, demonstrates that its pro-market rhetoric is a false one.

The supreme **task of bringing privatization to its self-sustaining life** can be realized either by a strong or a very weak government. By all criteria (logical, historical and aesthetic) the privatization led firmly by a well organized government is a clear-cut first best and the first choice. Unfortunately the first best is not always attainable and the second choices must be considered. The latter case is effected by giving free reign to an "unlawful" magpie type of appropriation of the state property. Theft, robbery, mafian laws and chaos are by far less glamorous show cases than what a well managed, speedy and disciplined privatization scheme can achieve, but at least this "method" is doing the job. What is the worst case, is the perennial middling with a stop and go policy, coupled with endless scandals, which gets stuck in a final indecision leading to a complete loss of integrity of the society and which dissipates in eternity.

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