

DEVELOPING MARKET INSTITUTIONS IN TRANSITIONAL ECONOMIES

Animesh Shrivastava*

Department of Economics
University of Reading

-
- I am grateful to George Tridimas for comments.
 - Address: Department of Economics, University of Reading, FOLSS Box 218, Whiteknights, Reading RG6 6AA. Email: A.Shrivastava@reading.ac.uk

Writing in 1991, Robert Solow cautioned: “There is not some glorious theoretical synthesis of capitalism that you can write down in a book and follow. You have to grope your way”.¹ Indeed attempts to develop market economy in the transitional countries represent experimentation on a gigantic scale. There are several reasons for this. First, the market economy is a *system* comprising a set of supporting institutions, ranging from economic to legal, political, social and beyond. This means that the set of potential “components” of a market economy is quite large and diverse. Further, observationally, there are marked differences between the institutions of the leading market economies. Hence the desiderata for transformation to a market economy are by no means either unique or uncontroversial. Second, the *raison d’etre* of institutions is to modify behaviour of economic agents: unless institutions do so they fail in their purpose. However, mere existence or formal adoption of institutions does not necessarily change economic behaviour. An institution’s rules and arrangements have to be credible to induce that. But credibility is a complex and somewhat amorphous attribute, having roots in enforcement mechanisms, expected durability of institutional change, commitment to complementary policy changes and so on. Moreover, institutional credibility can be acquired and enhanced in a number of different ways. Thus, even if the “targets” for requisite institutional change were uniquely identifiable, the “instruments” for bringing them about will not necessarily be so. Third, the problem of unclear guiding principles has been compounded by insufficient practical experience. The scale and scope of the attempted transformation to market economy in the transitional economies is without parallel. Reforms in China have provided only limited insights since they have occurred in a markedly different economic and political setting. And reform in Latin American economies was concerned more with macroeconomic stabilisation than large-scale systemic change.

Like all experiments, the development of market institutions in transitional economies has been a two-way process. Existing conventional wisdom about reforms shaped initial approaches; and subsequent experience has challenged working assumptions and theories, forcing a re-thinking of the overall reform framework in many cases. In particular, the reform experience has produced a number of “puzzles” and interesting patterns. First, the extent and severity of economic downturn that

followed reforms were not anticipated, at least publicly, by the early reformers. Second, countries that adopted a rapid programme of reform (“shock therapy”) as opposed to a gradualist one appear to have experienced less severe economic decline and faster subsequent growth (World Bank 1996, Aslund, Boone and Johnson 1996). Third, even among rapid reformers there have been important differences. For instance, despite following the shock therapy, the Russian economy has not experienced the rate of output growth and strong emergence of the private sector seen in Poland. Finally, and most piquantly, despite explicit moves towards a market economy through privatisation and de-statisation, the transition economies have not shown the growth rates that China has managed without any significant privatisation or relinquishing of state control (McMillan and Naughton 1992 and Bolton 1995).

This paper surveys issues in the development of market institutions and reviews the experience of the transition economies in this regard. The experience of transition so far is utilised to build a framework for understanding the issues and problems in the development of market institutions. Section 1 emphasises the fact that introduction of a market economy differs from other policy induced changes in that it involves large-scale inter-connected changes. As such, the ‘mechanics’ of such a transformation differs significantly from other policy changes. Section 2 argues that the main role of markets as economic institutions is to provide appropriate incentives and to coordinate agents’ actions. However, to do this efficiently the market mechanism requires the support of a number of complementary institutions which help address the problems of information, quality, contract formation and contract enforcement which lie at the heart of any impersonal, arm’s length transaction. In particular, the character of the legal system has an important influence on the development of market-based mechanisms.

Section 3 discusses issues in the design of a reform package. It stresses the notion that reforms are essentially incentive devices and, as such, can complement or substitute each other. More importantly, elements of an optimum reform package can be obtained by taking into account the incentive features of different reforms and the context within which they will be implemented. This framework is used to address the issue of optimal speed of reform or, alternatively, of ‘big bang’ versus ‘gradualism’.

¹ *The New York Times*, September 29, 1991, p. E1.

Section 4 deals with political aspects of market reform. It focuses in particular on the issue of maintaining political support for reform programme in the *interim* phase when costs of disruption to the old system are realised but the benefits from establishment of the new system have yet to be obtained. In this context, the strategic use of a ‘window of opportunity’ is discussed. Section 5 concludes.

1. MODELLING INSTITUTIONAL CHANGE

The move to a market economy does not merely represent an economic change (like ‘liberalising’ exchange rate or interest rate) but a deeper transformation of the social framework. While market-oriented reforms were motivated by a number of goals in practice (ideological, political, social, maximisation of government revenue, and so on), the economic case for market economy is based on allocative efficiency. The task of an economic system is to provide incentives to agents within the economy and to coordinate their actions. The case for market mechanism rests on the claim that as an economic institution for incentive provision and coordination, it is the best in the sense that it leads to the most efficient allocation of resources.

Standard microeconomic analysis, which helps in understanding and critiquing this claim, focuses on price determination and on incentive and efficiency aspects of the price system. Such a focus on the price system can convey the impression that market reforms are synonymous with (in particular, limited to) price liberalisation: institutional context does not matter. This view is of course erroneous. As discussed in section 2, the price system is highly institution-intensive, and probably more so than other forms of economic coordination (such as a command economy).

Accepting that markets are economic *institutions* has a number of implications for the design of economic reforms. To begin with, institutions are, as North (1990, p. 3) puts it, “humanly devised constraints that shape human interaction”. Voluntary behaviour can be shaped or modified only to the extent that there are carrots and sticks of personal gains and losses respectively. In other words, all institutions need to generate incentives and have some kind of enforcement mechanism which makes them credible. In practice, credibility of institutions rests on a complex set of formal rules, informal sanctions and behavioural norms. This embeddedness of institutions in

informal rules and behavioural norms means that quick, policy induced changes are not feasible. While the formal characteristics of a system may be changed overnight through political or judicial processes, the informal rules, traditions and behavioural norms may be impervious to deliberate policy. This is of course a major lesson learnt from the transitional experience. While ambitious privatisation and liberalisation programmes were adopted, behaviour of individual managers, workers, banks and so on did not change since many of the supporting legal, contractual and transactional structures which would make the changes credible were not in place.

A related problem is that the outcome of a policy induced institutional change is not entirely predictable. Experience of both developed and transitional economies shows that institutions grow through a dialectic process: individuals respond to 'opportunities' (positive and negative) created by a set of formal rules; and rules adopt either to enlarge or foreclose some of these 'opportunities'. Moreover, the path and pattern of development is determined to a considerable extent by the local conditions (i.e., presence or absence of the right set of supporting institutions). Thus, privatisation and market reform were presumably aimed at facilitating anonymous, arms' length transactions which form the basis of competitive markets in advanced market economies. However, lack of supporting institutions meant that they have in many cases strengthened relationship-based transactions. For instance, privatised banks in Ukraine had to operate without any systematic set of laws on collateral, debt recovery and bankruptcy (Jimenez 1997). As a result, their lending activities, instead of being market-based (i.e., determined by risk-return characteristics of loans) became largely network-based. Banks would lend mainly to customers that they had a personal relationship with. Thus, liberalisation in banking, instead of creating an economy-wide credit market, actually fragmented it along network-based lines.

The third problem in effecting institutional change relates to the self-enforcing characteristic of most institutions. Arthur (1988, p. 10) has pointed out that there are four sources of self-enforcing mechanisms: (a) large set-up or fixed costs, which serve to bring down operating cost as more people use a system; (b) learning effects, which lower transaction costs of operating the system as it gets used more intensively; (c) coordination effects, which raise the payoffs for all agents by better coordination over a larger set of actions; and (d) adaptive expectations, where greater adoption or use of a system leads to enhanced expectations about its durability and credibility. It is clear

that institutions possess all the four self-enforcing properties. This can explain why old systems and institutions in transitional economies have proved so difficult to dislodge, despite obvious evidence of their inefficiency. More importantly, though, it suggests that small scale-attempts to introduce a market economy will not work. Given the reinforcing character of existing systems and forces, piecemeal reforms would typically be either reversed or perverted. As some of the transitional experience suggests, reform has to be strategically organised on a broad front for it to succeed.

Finally, there is the paradoxical problem of state power with respect to market-oriented reforms. As noted in the next section, successful development of market institutions requires change on large number of economic, legal, political and social fronts. This raises an interesting political economy question: Is the state powerful enough to introduce all these changes? If not, then what is the case for attempting wholesale transformation of the economic system. If it is, then what is the guarantee that the state will not become acquisitive and use its power to promote its own interests and a structure of the economy that suits it best. Shleifer and Vishny (1998) have argued that one of the major lessons of transition is that political transformation (in the sense of responsible exercise of state power) is an important concomitant of economic transformation. They contend that the difference between the post 'shock therapy' performance of Russia and Poland can be explained to a large measure by the nature of their respective governments.

2. DEVELOPING MARKET INSTITUTIONS

The goal of transition to a market economy is not achieved simply by establishment of markets where commodities can be bought or sold. Market outcomes in many cases, such as monopolies or oligopolies, can be worse than those under non-market systems. To achieve allocative efficiency, which is the goal of economic transformation, markets need the support of a whole host of complementary institutions and practices.

Mechanisms for Enterprise Efficiency

To begin with, the benefits of price competition can be realised on the production side only if the supplying firms attempt to maximise profits. Otherwise, establishment of

even a competitive market for firms' outputs can worsen things. Privatising state-owned enterprises, for instance, is not likely to enhance productive efficiency unless accompanied by extensive restructuring which makes cost-effective, profit-maximising behaviour possible. Such a restructuring has several elements: change of management skills and personnel, provision of appropriate incentives (both short term and long term), reform of corporate governance and imposition of hard budget constraints. The cross-section of experience in transitional economies shows the importance of these factors. In Russia privatisation took place without any significant attempt to replace existing management and infuse new skills. Earle *et al.* (1995) found the following pattern of ownership in privatised enterprises: in 55 percent of the enterprises the insiders (managers or workers) predominated, in 34 percent it was the state and in the remaining 11 percent it was the outside owners. One consequence of this strong insider-bias was that the performance of the privatised companies did not appear to be significantly different from that of state-owned enterprises. A similar situation prevailed in many of the other east European countries. Exceptions to this trend, which highlighted the importance of internal restructuring, were the Czech Republic, Hungary and East Germany. In these cases significant management changes can be associated with the involvement of foreign firms with domestic enterprises (Carlin *et al.* 1995). This effect was particularly strong in East Germany where many of the enterprises were purchased by West German firms and where management restructuring was seen as an important of the privatisation process (Schott and Reilly 1994).

Similarly, the allocative efficiency of the market mechanism can be enhanced by imposing financial discipline upon firms through capital markets and banks. However, this requires development of complementary institutions. Privatisation, for instance, does not necessarily resolve the problem of 'soft' budget constraint and the pervasive losses that engenders. In Poland, for example, Calvo and Corricelli (1992) found that enterprises had a complex web of inter-enterprise credit as a legacy of central planning. In 1990 the volume of inter-enterprise credit was more than twice the volume of bank credit for working capital. However, in the planning era, information about the "quality" of these loans, the implied risk exposure of the relevant enterprises, creditworthiness of the counterparties, and so on was not available. As a result, even privatised firms had inter-connected balance sheets which made it difficult to

distinguish viable from non-viable firms. Hence, before external financial discipline can be responsibly imposed, appropriate information, accounting and evaluation systems need to be in place to disentangle and assess the economic characteristics of each enterprise.

Institutions for Supporting Exchange

One of the main advantages of the market mechanism is its low operating or transaction cost. In an efficient market any (anonymous) trader can turn up and either buy or sell as he wishes. The ease of this has to be contrasted with alternative, non-market arrangements where time and resources have to be expended in locating counterparties and agreeing terms of trade. However, the paradox of anonymous exchange, which epitomises the advantages of the seemingly institution-free market mechanism, is that it is probably more institution intensive than any other form of exchange.

Buyers and sellers typically have a number of concerns about any trade, the main ones being the quality of the goods being bought and the price being paid. If the transaction involves passage of time (between, say, agreement of contract and its execution or between delivery of goods and payment) then additional concerns arise, such as: (a) creditworthiness of counterparty; (b) reliability of counterparty (to honour contract rather than renege); (c) external enforceability of contract; and (d) remedies for contractual breach. For transactions to be successful, whether in the market or non-market mode, these issues have to be addressed. When trades occur in unorganised settings then these issues are typically tackled by the buyers and sellers themselves through a variety of methods such as information gathering, monitoring, private enforcement of contractual agreements and use of reputational mechanisms in repeated trade settings. While feasible, such a mode of transaction clearly involves high transaction costs which eventually get factored into the price of the commodity being traded. Consequently, trade volumes, and eventually level of economic activity in such high-cost trading environments is reduced.

Progress towards low-cost, anonymous trading can be made by developing institutions for dealing with each of these various dimensions of the trading problem. Once this is done then any buyer or seller can operate on any market without incurring large transaction costs. Development of such supportive institutions for organising

trade brings considerable advantages. First, there are likely to be high 'set-up' costs for an individual trader who wishes to perform these functions himself. Since these costs are repeated over traders, organising them through a common source can significantly lower the cost per unit trade. This brings down the overall cost of trades and therefore expands the volume of economic activity. Second, organising these activities commonly brings scope for specialisation and hence further increase in the efficiency of transactions.

The market ideal of anonymous trade therefore relies on a number of complementary institutions to sort out the various problems and concerns relating to any trade or exchange. Hence, introducing a market economy involves not just price liberalisation (i.e., determination of price by market forces rather than government fiat) but also the development of the various institutions that support market exchange. The experience of transitional economies suggests just how important these measures are.

Consider the problem of information. Successful markets require several kinds of information and hence information processing institutions. First, information needs to be collated about potential demands and supplies. This is what contributes to 'thickness' of markets and to the discovery of competitive prices (i.e., prices which ensure that goods come from lowest cost producer and go to the highest value consumer). In many transitional economies where coordination of demand and supply was previously done through plans, there were no natural mechanisms (e.g., business associations, business directories etc.) to facilitate search that produces information about potential trading partners. In Romania, introduction of markets initially worsened the situation. There was considerable local variation in prices and, with the partial abandonment of the planning framework, the coordination of inputs and outputs became more difficult (Ben-Ner and Montias 1991). Similarly, Carlin *et al.* (1995) report that enterprise managers in Poland, the Czech Republic and Slovakia, Hungary and Russia cited collapse of wholesale distribution networks as an important constraint in their attempts to restructure operations in response to market forces. Such problems can have two effects. First, trading activity of firms is restricted to information available from their personal networks. Thus, each firm operates in a narrower market with fewer economic prospects than need be the case. Second, the informational barriers which segment a potentially large (national) market into local, network-based ones also create, in effect, a multitude of monopolies which would again have the

effect of lowering the quantities traded. In transitional economies, few information-processing institutions existed or were created around the time of market reform. However, the need for information in order to have successful market organisation has brought about several responses. Trade associations, brokerage houses, wholesale traders and so on have emerged to intermediate between buyers and sellers, to reduce search costs and to gather as well as spread information. In Russia, for instance, markets for wholesale farm produce and for commodities such as aluminium and oil have evolved (McMillan 1997).

The second informational problem is one of quality. If trade is to freely occur outside the personal network of firms, then doubts about quality need to be resolved. If the trade concerned is a 'spot market' trade, where delivery of commodity and payment occur simultaneously, the main problem is one of adverse selection. However, in case of trades in which time elapses between the first steps and the final completion (say, between delivery and payment or contract agreement and execution), the adverse selection problem is compounded by a moral hazard problem as well.

The adverse selection problem affects the ability of the market mechanism to match up feasible trades (i.e., trades which both buyer and seller would be willing to undertake if doubts about quality were cleared up) and in some cases, as the literature shows², can prevent the emergence of the market altogether. In well-functioning market economies, a number of mechanisms exist to address the adverse selection concerns regarding quality. For instance, firms attempt to signal quality by offering a variety of warranties on product (e.g., money back guarantees or no-quibble replacement) or price (e.g., lowest price guarantee or promise to match the lowest offer). Screening mechanisms of various kinds grow up (e.g., government backed certification bodies or self-regulation of quality by producers' associations). Again, in transitional economies these quality issues were not systematically addressed as part of the market reform programme. However, as expected, a number of solutions have appeared over time. For instance, in Russia the government introduced a law on quality and on a national certification body (Goldberg 1992). Russian commodity exchanges attempted to resolve informational problems about quality through various routes: trade was focused on branded commodities; an extensive system of certification

² See Salanie (1997) for a recent review.

regarding nature, quantity and quality of good on offer was used; and compensation guarantees were offered to buyers against broker malfeasance (Davis 1998).

The moral hazard problem of ensuring agreed-upon contractual performance has to be addressed through a different set of institutions. Fundamentally, there are two ways of dealing with moral hazard problems: monitoring and incentive alignment. Monitoring can be done through a number of institutions such as consumer associations, watchdog bodies, public regulators and so on. Incentive alignment can, in principle, be done by drawing up a ‘complete’ contract covering all contingencies. Completeness of contract refers to the property that the contract specifies what is to be done by each party in each possible contingency. However, such complete contracting is infeasible for a number of reasons. First, it may not be possible to anticipate all contingencies. Second, it may not be possible to agree the terms of transaction for each contingency. Third, it may not be possible to credibly enforce all the terms of a contract. Hence, economic contracts are inevitably incomplete in the sense they do not cover many of the contingencies. Incentive alignment, in this case, requires appropriate *ex post* distribution of bargaining power (Grossman and Hart 1986). This is effected, to a large extent, by the legal system.

The Role of the Legal System

Transactions in a market-based economy can be broadly divided into two types: (a) arm’s length trades that do not involve the buyer and seller in any inter-related activity; and (b) other transactions in which there is some degree of joint ‘production’ or interaction between the trading parties. Examples of the first type range from the simplest purchases of goods in ordinary (“spot”) markets to agreements to buy or deliver at future dates (as in future deliveries of grain, oil, imported inputs, or futures contracts of a financial nature). Examples of the second type are employment relationships, relationships between various producers using a common resource, or relationships between governments and private businesses. The legal system performs an important facilitating role for both these types of exchanges which considerably lowers their transactions costs.

For ‘arm’s-length’ transactions the legal system supplies standardised contract ‘shells’(regarding, e.g., the implications of the various terms of offer or guarantee) and a judicial-cum-penal system for interpreting and enforcing contractual obligations. This

requires a framework of rules (regarding freedom to contract and exchange, protection of consumers, other consumer rights, suppliers' obligations, quality, health and safety, and so on) and a network of institutions for enforcing them. Such laws and institutions were not adequately developed in command economies where most of the goods and resources were moved by fiat and in which the state (or a state-owned enterprise) was typically one of the parties involved in economic transactions³.

Transactions involving joint production or, more generally, coordination between the various parties, typically involve interactions over time. As mentioned above, drawing up complete contracts for these dynamic transactions can be difficult, especially if the transactions involve inputs and outputs that are difficult to measure (e.g., effort and its marginal product or externalities relating to a trader's activity). Hence, such transactions are organised under 'incomplete' contracts which cover only the more important or standardised contingencies. This leaves open the issue of what happens in other possible contingencies. But, as Grossman and Hart (1986) and Hart and Moore (1990) point out, the way these gaps in the contract are filled crucially affects initial (relation-specific) investments and overall economic efficiency.

The legal system turns out to have a crucial role in filling these contractual gaps and thus encouraging long term transactions. First, a routine function of the legal system is to solve disputes which, reinterpreted, means adjudicating on the gaps in the actual contract between the disputing parties. Second, the legal system empowers other institutions of social ordering such as corporations, industry associations, arbitration bodies and so on which play a vital role in filling contractual gaps. The legal system does this by legitimising the institutions' procedures and decisions⁴. The most important contribution of the legal system is perhaps an indirect one. In any social system the overwhelming majority of dispute settlement takes place in the 'shadow of

³ This means that there was little room for development of (independent) institutions for monitoring and supporting exchange transactions. For instance, in the event of poor quality, delay in delivery or other types of non-performance of contracts by state enterprises there was little scope for or point in appealing to the state itself. Consequently, there was a general absence of third-party monitoring, evaluation and enforcement institutions on which much of market-based exchange relies. In a similar vein, Rapaczynski (1996) has argued that a state that exercise most of its policy through property rights (and the discretion that goes with it) tends to rely less on regulatory and quasi-judicial processes (which involve transparency and, hence, procedural restrictions on arbitrary exercise of authority).

⁴ It can do so, for example, through explicit rulings about the authority of arbitrators in labour disputes (Getman 1979) or commercial disputes (Goldberg 1976), or through immunity in the form of non-admittance of cases involving certain kinds of regulatory activity.

the law' in the sense that disputes are privately resolved largely on basis of disputants' expectations of the nature, uncertainty and cost of securing a formal settlement through courts (Galanter 1981). Therefore, the nature of the legal system - its extensiveness and reach, the predictability of its decisions, and the delay, cost and complexity of seeking legal redress - significantly affects long-term economic relationships and overall efficiency.

In centrally planned economies there was no significant institution for supporting private contractual exchange. This was especially so with respect to institutions for either 'completing' incomplete contracts or providing low-cost dispute settlement and contract enforcement. The main source of authoritative precepts was the state. But given the "grabbing hand" nature of many states (Shleifer and Vishny 1998) and the lack of effective institutions to curb the state's power to renegotiate, this did not provide a congenial legal environment for market-based activity. As McMillan (1997, p. 226) notes: "The existing legal system suited central planning, not a market economy".

Legal sanctions are not the only means to uphold contractual behaviour. The literature on repeated noncooperative games suggests that there are various circumstances and mechanisms under which self-interested players would adhere to an agreed outcome (Fudenberg 1992). In other words, business relations can develop ahead of developments in formal law. This has been the case in transitional economies. Banks have lent money, business deals have been struck and exchanges have been organised in the absence of a secure contracting environment. While encouraging in itself, the way in which these trades have been done suggest the inherent limitations of such spontaneous developments. Thus, banks have had to rely on personal contacts and extensive screening; and lending has been short term to reduce risk exposure. Businesses have had to screen potential partners and cultivate long-term relationships. In absence of efficient and reliable judicial systems contracts have had to be enforced through illegal or criminal means (Grief and Kandel 1995). It is clear that the 'transactions technology' underlying these exchanges is highly inefficient. Trade relations are limited to an (arbitrary) network of personal contacts; costs are high and can be physically and socially disruptive. This is in sharp contrast to the low-cost, economy-wide trade that the transactions technology of a market-based system permits.

The final part of legal transformation required for a market economy is the development of countervailing institutions to rein in state power and make it more accountable. Historically, the state in transitional economies has enjoyed supreme economic, political and legal powers and unchallenged discretion in its use. But, as noted above (Grossman and Hart 1986), such power to renegotiate contracts discourages, in effect, long term relationships and dissuades economic partners from investing in specific assets. This effect is quite general and holds beyond transitional economies. For instance, Borner *et al.* (1995, p. 36) find that in ‘discretionary’ states, in which power is not exercised in a ‘credible’ manner, “the private sector reacts by keeping its resources liquid and retreating into informal relationships”. Consequently, savings, investment, technological growth and, eventually, per capita income growth are lower. Borner *et al.* find empirical support for this proposition in a study of 28 developing countries in which they find that political credibility provides a potentially very important explanation of the differences in economic growth. In the context of transition economies, Shleifer and Vishny (1998) forward a similar hypothesis to explain the relatively poor growth experience of Russia in comparison with Poland. They argue that despite similar economic reforms (including the common ‘shock-therapy’ approach) the state in Russia has retained more substantial control over economic life and acts, in general, in a more acquisitive manner. Consequently, they argue that a central part of market reforms has to be the “... transition of the government from a Communist police state to an institution supporting a market economy (p 230)”.

3. THE DESIGN OF REFORM PACKAGE

It is clear from the discussion above that development of a market system requires institutional and policy changes across a very wide front. As Lipton and Sachs (1990) have argued, the required reforms are interlinked in a ‘seamless web’; hence, the reform process must be comprehensive. While the seemingly all-encompassing nature of the required change is easy to understand, the case for comprehensive reform does not necessarily follow from that for several reasons. First, any reform process entails adjustment costs which are frequently ‘convex’ in the sense that they rise

proportionately faster as the pace of reform increases. These costs may include costs of unemployment generated and the destruction of firm- or sector-specific assets and institutions in the process of structural change. Second, complementarities between reforms may only imply ‘connectedness’ of reforms over time (within the context of an overall reform package) but not necessarily simultaneity in their implementation. Third, some reform measures may be substitutes and hence need not occur together as a package. Fourth, lack of adequate information about the reform process and outcomes may mean that some experimentation through a limited reform programme may be desirable before attempting full-scale change. Finally, the political or administrative capacity for introducing and managing change as well as the economy’s capacity for absorbing change may be more much limited than envisaged by a reform programme. Bold but unrealistic reform programmes (like the 500-Day Plan for the Soviet Union) were common at the beginning of the transition experience and have been tried in other contexts too. For example, commenting on a ‘tough’ stabilisation and structural adjustment plan - which, note, did not still attempt an overhaul of the economic system - introduced in Bolivia in 1985, Williamson (1990, p. 5) noted: “In short, Paz’s advisers planned the equivalent of about five GATT rounds, six Gramm-Rudmans, and more deregulation than had been accomplished by the Carter and Reagan administration together, all overnight”.

In designing an optimum reform package, it is worth noting that development of a market system requires two kinds of reforms: (a) reforms that align agents’ incentives with efficient economic outcomes; and (b) reforms that reduce transaction costs. As a first approximation, it is reasonable to assume that agents maximise their self-interest (however perceived) in any circumstance. The problem with malfunctioning economic systems is that this could mean agents maximising leisure or personal gain at social cost (e.g., through work disruption or through ‘diversion’ of firm’s resources). The allocative merit of a market economy, enunciated first by Adam Smith, was that personal gain was pursued in a manner that promoted social wealth. Development of the market system in transitional economies requires similar incentive restructuring in the production sector. That is why the issue of enterprise reform is central to the proper development of markets.

The alignment of a manager’s incentives to socially efficient outcomes has several elements to it. First, the manager’s compensation must to be tied to profit

maximisation. Hence, changes in corporate governance and compensation arrangement that produce this will be required. Second, for the computed profit to reflect true (social) profit, the inputs and outputs must be traded at their correct (shadow) prices. This requires liberalisation of these markets (so that prices can find their shadow value) as well as 'regulation' of these markets to ensure that they operate in a competitive environment. It should be noted here that not only does alignment of managerial incentives require a number of things to be done (i.e., induce profit maximising behaviour and install correct prices), each of these things can in principle be done through a number of different reform measures. For instance, privatisation, regulatory oversight, finance market discipline, threat of takeovers, compensation through stock options, and so on can all serve to induce profit maximising behaviour. The question, implicitly posed at the start of this section, becomes clearer: which of these seemingly 'seamless web' of reforms should be chosen and how?

The key insight for analysing this issue is that, as incentive devices, reforms can function as complements or substitutes. A pair of reforms can be defined as complements if the incremental effect on incentives from implementing one is greater if the other is already in place (Milgrom and Roberts 1990). For example, input price liberalisation and capital market discipline are complements. A pair of reforms are substitutes if the effect of both of them together is not greater than the sum of the effects of each reform in isolation. Thus, privatisation and changes in management compensation schemes can be substitutes in enterprise restructuring. This is shown clearly by the experience of China which has managed pervasive restructuring and consequent growth without ownership change.

A major element of policy design, therefore, is to concentrate on complementary rather than substitute policies. Even so, the set of complementary reforms can be quite large, raising the issue again of whether a 'big-bang' approach is necessarily implied. Some progress can be made in this direction by employing additional considerations beyond that of complementarity between reform instruments. The first concerns expectations about behaviour over time. If a reform, which is expected to be implemented tomorrow (such as introduction of competition) produces offsetting behaviour today (such as erection of costly industry defences) then it may be better to bring forward the implementation of tomorrow's plan. The second consideration is uncertainty regarding the costs and benefits of reform, and hence the

need both for experimentation as well as keeping open the option of reform reversal. Dewatripont and Roland (1997) generate several interesting insights in this regard. They show that in a situation where there is uncertainty about outcomes, where reversal of reforms is costly and where reforms are complementary, gradualism or partial reform is costly. However, gradualism does provide the benefit of an option for early reversal (if reform outcomes are not as desired). Hence, if learning (about reform outcomes) is fast enough compared to the potential costs of partial reform then gradualism is to be preferred; otherwise, big bang is optimal. More generally, they argue that complementarity of reforms implies connectedness but not necessarily simultaneity: complementarity, it turns out, is also a necessary condition for gradualism to be optimal.

Over and above the reversal costs are the adjustment costs, discussed at the beginning of this section. How do these costs affect the debate about optimal pace and sequencing of market-oriented reforms? Friedman and Johnson (1996) have obtained some interesting results in this regard. First, they argue that the worse the initial condition of an economy is, the more ambitious and faster the reform programme should be. The intuition is that in critical situations a package of radical reforms may not appear too costly and the benefits of rapid change may be easier to sell. Thus, it is argued that the depth of the Polish crisis in 1989 made it a more natural candidate for shock therapy than the gradually reforming Hungary. Second, Friedman and Johnson argue that if the economic characteristics are more congenial to a market economy then a faster paced reform is more desirable. Finally, the less credibility a government has, the more intense or far-reaching its reforms need to be. The idea is that reforms succeed only to the extent that they influence behaviour of economic agents. A halting reform process from a seemingly insecure government would not induce rational agents to change their behaviour and expectations. However, a more radical package may cross a 'threshold' such that agents are also induced to make appropriate changes. In this context it is notable that in China even small policy changes produced significant results perhaps because of their perceived stability.

Overall, a large number of factors impinge upon the choice of a policy package so that designing it may be more akin to art rather than science, requiring astute judgements based on context-specific factors. However, ideas regarding complementarity between reform instruments, time complementarity, the trade-off

between inefficiency of partial reform and the option to exit with low costs if reforms do not work, the depth of economic crisis and the reform credentials of the state can be used to help identify a core package of reforms and a time sequence for its implementation.

4. POLITICAL ECONOMY

Reforms do not occur in political vacuum or as trial runs in an experimental setting. Benefits and costs are necessarily distributed unevenly as the structure of the economy is altered and resources are shifted out from some sectors into others. Since these reforms cannot be Pareto improving, policy makers typically back them on the basis that they increase aggregate wealth. However, this approach has a number of pitfalls. Since (full) compensation of losers by winners is not typically part of a reform programme, the argument about increase in aggregate wealth is not sufficient to secure general consensus for reform. The consensus becomes more difficult to maintain if even the goal of increase in aggregate wealth becomes difficult to reach.

In nearly all transitional economies, post-reform output fell sharply as economies slid backwards. “After five years of transition economics ...” Amsden *et al.* (1998, p. vii) note, “...[t]he popular mood is one of anger over rising unemployment, inflation, deteriorating living standards, the collapse of social services, and soaring crime”. Assuming that both market-oriented reform and its continuation are desirable, the challenging issue is how to create and sustain consensus for reform, especially in light of the adverse effects it has generated. Both economic analysis and experience of transitional economies help to show the problems and prospects in this regard.

To begin with, the size and sequencing of reform plan depends crucially upon initial conditions and the nature of the political process. Dewatripont and Roland (1997) have argued that if a gradualist approach to reform is preferred, then it is advisable to start with the implementation of highest-payoff reforms and reforms which benefit the median voter in order to maintain support for the reform. More generally, support for reform from key constituencies may have to be bought by relevant transfers. The experience regarding the nature and type of reform in transitional economies can be read as evidence of the significance of this factor. For instance, the

Russian privatisation programme has generally been criticised for favouring existing management and other stakeholders. However, Boycko, Shleifer and Vishny (1993) have argued that that was the only politically feasible method of privatisation. In Poland, the mass voucher privatisation programme was blocked for more than three years by insiders who did not want the benefits to accrue to the public at large (Roland 1994).

If a gradual path of reform may be difficult to sustain over time (since costs of disruption arise before the benefits of restructuring), then the idea of a 'window of opportunity' to introduce a programme of radical reform becomes appealing. A window of opportunity should be understood as any set of circumstances in which the proposed reform plan is *ex ante* acceptable to the population. *Ex ante* acceptability may arise either because the current economic situation is critical ('no way but forward' argument) or there are sizable benefits to acceptance (such as conditional loans from international organisations and banks) or the costs of reform are not well known or widely understood. The scale of reforms a government may attempt to squeeze through any window of opportunity would depend upon several factors. If there is a threshold level beyond which reforms are too costly to reverse then a 'big bang' that takes the reform programme beyond that threshold will be adopted. If there is a pair of reforms *A* and *B* such that *B* becomes much more desirable or acceptable once *A* is in place, then the initial programme may include only reform *A*. This way a government can build up future momentum for change. Similarly, governments may include reforms in the initial programme which constrain successor governments to change. Hence, discretionary elements (like reducing subsidies or cutting expenditures) may be tackled in the initial reform programme since successive governments cannot be constrained to specific policies in those spheres.

5. CONCLUSION

This paper has selectively surveyed the literature on development of market institutions and the experience of transitional economies in this regard. The central theme that emerges is that impersonal, competitive exchange, which the market system ideally produces, is perhaps more institution intensive than any other arrangement for

organising exchange. Typically, each supporting institution serves to enhance transactional or operational efficiency (by reducing costs and aligning incentives) so that it is economically desirable on its own. More importantly, however, these institutions are also complementary in the sense that the efficiency of each is enhanced by the presence of others. Consequently, development of market institutions involves a whole set of inter-related institutional changes. The experience of transitional economies has shown not only how complex the transformation process is but also how context- and culture-specific some of the supporting institutions can be. Still, the reform process in the transitional economies has in general proved robust and forward-moving. Significant reversals have not been experienced and, perhaps because of their complementary character, initial reforms have been followed by more market oriented ones. There has also been a significant growth in quasi-legal and social institutions supportive of market reform. In due time this should lead to the realisation by each country of its own specific 'brand' of the market economy.

REFERENCES

- Amsden, J. Kochanowicz and L. Taylor, *The Market Meets its Match* (Cambridge, Mass.: Harvard University Press, 1998).
- W. B. Arthur, 'Self-Enforcing Mechanisms in Economics', in P.W. Anderson, K.J. Arrow and D. Pines, eds, *The Economy as a Complex Evolving System* (Reading, M.A.: Addison-Wesley, 1988)
- A. Aslund, P. Boone and S. Johnson, 'How to Stabilize: Lessons from Post Communist Countries', Brookings Papers on Economic Activity, 1 (1996) 217-314.
- A. Ben-Ner and J.M. Montias, 'The Introduction of Markets in a Hypercentralized Economy: the Case of Romania' Journal of Economic Perspectives, 5 (1991) 163-70.
- P. Bolton, 'Privatisation and the Separation of Ownership and Control: lessons from Chinese enterprise reform', Economics of Transition, 3 (1995) 1-12.
- S. Borner, A. Brunetti and B. Weder, *Political Credibility and Economic Development* (Basingstoke: Macmillan, 1995).
- M. Boycko, A. Shleifer and R. Vishny, 'Privatizing Russia' Brookings Papers on Economic Activity, 2 (1993) 139-92.
- G.A. Calvo and F. Coricelli, 'Stagflationary Effects of Stabilization Programs in Reforming Socialist Countries: enterprise-side vs household-side factors' The World Bank Economic Review 6 (1992).
- W. Carlin, J. van Reenan and T. Wolfe, 'Enterprise Restructuring in the Transition: the case study evidence from central and eastern Europe' Economics of Transition 3 (1995) 427-58.
- J.D. Davis, 'Russian Commodity Exchanges: a case study of organized markets in the transition process, 1990-96' Economics of Transition 6 (1998) 183-96.
- M. Dewatripont and G. Roland, 'Transition as a Process of Large Scale Institutional Change' in D.M. Kreps and K.E. Wallis, eds, *Advances in Economics and Econometrics: theory and applications*, Volume II (Cambridge: CUP, 1997).
- J. Earle, S. Estrin and L. Leschenko, 'The Effect of Ownership on Behaviour: Is privatization working in Russia?' CEPR Discussion Paper (LSE: London, 1995).

- E.J. Friedman and S. Johnson, 'Complementarities in Economic Reform', Economics of Transition 4 (1996) 319-29.
- D. Fudenberg, 'Explaining cooperation and commitment in repeated games', in J.-J. Laffont, ed, *Advances in Economic Theory* (Cambridge: CUP, 1992).
- M. Galanter, 'Justice in Many Rooms: Courts, Private Ordering, and Indigenous Law', Journal of Legal Pluralism 19 (1981) 1-47.
- J. Getman, 'Labor Arbitration and Dispute Resolution', Yale Law Journal, 88 (1979) 916-49.
- P. Goldberg, 'Economic Reform and Product Quality Improvement Efforts in the Soviet Union', Soviet Studies, 44 (1992) 113-22.
- V. Goldberg, 'Regulation and Administered Contracts' Bell Journal of Economics, 7 (1976) 426-48.
- A. Grief and E. Kandel, 'Contract Enforcement Institutions: historical perspectives and current status in Russia', in E. Lazear, ed, *Economic Transition in Eastern Europe and Russia; Realities of Reform* (Stanford: Hoover Institution Press, 1995).
- S. Grossman and O. Hart, 'The Costs and Benefits of Ownership: a theory of vertical and lateral integration', Journal of Political Economy, 94 (1986) 691-719.
- O. Hart and J. Moore, 'Property Rights and the Nature of the Firm', Journal of Political Economy, 98 (1990) 1119-58.
- J. Jimenez, 'Issues for Banking Reform in Ukraine' in P.K. Cornelius and P. Lenain, eds, *Ukraine: Accelerating the Transition to Market* (Washington D.C.: IMF, 1997).
- D. Lipton and J. Sachs, 'Creating a Market Economy in Eastern Europe: the case of Poland', Brookings Papers on Economic Activity, 1 (1990).
- J. McMillan, 'Markets in Transition' in D.M. Kreps and K.E. Wallis, eds, *Advances in Economics and Econometrics: theory and applications*, Volume II (Cambridge: CUP, 1997).
- J. McMillan and B. Naughton, 'How to Reform a Planned Economy', Oxford Review of Economic Policy, 8 (1992) 103-43.
- P. Milgrom and J. Roberts, 'Rationalizability, Learning, and Equilibrium in Games with Strategic Complements' Econometrica 58 (1990) 1255-77
- D.C. North, *Institutions, Institutional Change and Economic Performance*, (Cambridge: CUP, 1990).

- A. Rapaczynski, 'The Role of the State and the Market in Establishing Property Rights', Journal of Economic Perspectives, 10 (1996) 87-103.
- G. Roland, 'The Role of Political Constraints in Transition Strategies' Economics of Transition 2 (1994) 27-41.
- B. Salanie, *The Economics of Contracts*, (Cambridge, Mass.: MIT Press, 1997).
- V. Schott and B. Reilly, 'Privatization in Germany – 1993' in A. Bohm and M. Simoneti, eds, *Privatization in Central & Eastern Europe 1993* (Ljubljana: CEPN, 1994).
- A. Shleifer and R. Vishny, *The Grabbing Hand* (Cambridge, Mass.: Harvard, 1998).
- J. Williamson, 'The Progress of Policy Reform in Latin America', Institute for International Economics, 28 (1990).
- World Bank, World Development Report: From Plan to Market (Washington, D.C.: World Bank, 1996)