FACTA UNIVERSITATIS
Series: **Economics and Organization** Vol. 3, N^o 1, 2006, pp. 87 - 94

DEVELOPMENT OF MARKET ECONOMY IS AN EVOLUTIONARY PROCESS

UDC 330.341.4

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Abstract. *The main objective of the post socialist countries is to develop a functioning market economy, which is to be achieved by establishing a complex set of market norms of behaviour. There have been various successes among transition countries in adopting this strategy. Newly introduced rules of behaviour induce the transformation of inherited institutional structure of these countries. It is indicated in the paper that the transformation of existing institutional matrices is a gradual, evolutionary process, especially in less successful transition countries. The rapidity of the institutional transition is the main determinant of the effectiveness of market-oriented reforms.*

Key Words: *Transition, neoclassical economics, institutions, path dependency.*

One of the main components of the current global economic architecture is the transformation of former socialist countries into market economies. The process of post socialist transformation has been in progress for more than fifteen years now. There is a huge amount of theoretical literature and empirical evidence that explain different dimensions of the transition and enable some generalizations about critical points of the overall process. There is general agreement within transition theory about the fundamental divide of post-socialist countries into two groups: successful reformers and less successful reformers. The paper is an attempt to point out some main factors that contributed to this differentiation. Therefore, some shortcomings of the so-called transition orthodoxy will be pointed out, the transition approach mainly based on neoclassical assumptions, and its consequences on the transformation results. Afterwards, it will be indicated that conventional economic analysis of transition should be joined by interdisciplinary concepts of neo-institutional economics, in order to comprehend complex transition phenomena. This will be followed by the analysis of the various mechanisms through which institutional matrices of some post socialist economies contribute to their poor transformation results.

Received March 16, 2006

Some relevant conclusions and suggestions for possible policy of institutional transformation will also be outlined.

Conceived as the substitution of a centrally planned model of economy by an economic and political framework of efficient market economies, the process of transition was based on optimistic predictions that the majority of market-oriented reforms can be successfully implemented in a relatively short period. The common belief was that within five years it would be possible to pursue systemic transformation, financial stabilization, structural adjustment and to create conditions for sustainable economic growth (Sachs, 1996, p.28.). The market-oriented reforms were the component of the more general process of imitative holistic social engineering, that was to lead to the (re)creation of a capitalist society. This type of social engineering is the opposite of the utopian social engineering, because the latter intended to create a totally new, socialist society (Ellman, 1997, p.26.). All crucial elements of market economy already existed in developed capitalist countries, thus the economic system that was to be introduced in post socialist countries contained no unknown variables. The problem was perceived as a simple transfer of norms from the system that was already in function in developed economies, to former socialist countries.

As for the guidelines for the realization of this project, all the transition countries followed the standard procedure, known as the Washington Consensus. This was the package of pro-liberal economic measures that were previously applied to combat inflation in some countries of Latin America. The pillars of this program for economic reforms were macroeconomic stabilization, privatization, economic liberalization and the development of financial market. It was believed that once the government is moved away from the economy, private markets would efficiently allocate resources and produce economic growth (Stigliz, 1998, p.1). A few economic variables are sufficient to control in order to pursue this policy: inflation, money supply, rates of interest, fiscal and foreign trade deficit. All the market reforms that were part of this agenda were to be realized in a very short time and radically. Once established, the critical mass of market norms of behavior should become the catalyst of the process of inevitable moving to a market economy. Due to their superiority, market solutions would be institutionalized, private property would be largely promoted and equilibrium would be sustained through standard stabilization policies.

However, although they applied similar transformation patterns, transition countries did not have convergent paths to a market economy. On the contrary, the outcomes of the market reforms varied significantly among these countries, in terms of their actual rapidity, efficiency and quality. If the successful transition is measured in pure economic indicators, it appears that the most successful were the Czech Republic, Slovakia, Hungary, Poland, Slovenia and the Baltic States. The common feature of all the transition countries was the sharp initial fall of the GDP at the beginning of the transition. In the aforementioned countries (except the Baltic States), output fall was not that huge (it was in the interval of 13-25%). These economies overcame this economic flow in a relatively short period (2-5 years) and established sustainable economic growth (Svejnar, 2002, p.8.). This group of countries also had better indicators of macroeconomic stability and attracted significant amounts of foreign direct investment.

The rest of the transition economies, Russian Federation, Ukraine, the other countries of the former Soviet Union, the countries of the Western Balkans, experienced much different economic flows in the post socialist era. The transformational recession was more severe, with a sharper decline in GDP (45% in Russia, 65% in Ukraine). The recession was prolonged and combined with macroeconomic instability in most of these countries, with modest inflow of foreign direct investment and a significant rise in social inequalities (World Bank, 2002, p.5-6.). The deficiencies of the reforms in these countries are not restricted only to macroeconomic indicators. Significant deformations are largely observed in all sorts of economic transactions. There is a large amount of literature describing the increasing corruption, rapid development of illegal economy, numerous violations in the privatization process (Rose-Ackerman, 2001.). In these economies, competition is not developed yet, and some sort of quasi-market system is beginning to emerge. The norms of this system govern transactions both in the public sector and private enterprises. There are also some observations that the competition is reduced to some primitive market structures, that many market substitutes were put in place, the result of which is the quasi-institutionalization of market norms (Drašković, 2003, p.145.). Some authors point to new oligarchs, who gained huge profits in the process of privatization and tend to monopolize all the crucial sectors of economy, or to control the governmental apparatus (Roland, 2002, p.35.). These socio-economic flows are certainly not guaranties for successful development of the efficient market economy.

All these findings lead to the conclusion that there is an evident discrepancy in the manner market economy develops in these two groups of countries. The successful transition countries fulfilled most of the criteria of efficient market transformation. In these countries, the centrally planned model of economy is successfully substituted, the production factors and consumer goods markets are established and the legal infrastructure is functioning. Their systems are also in accordance with other, qualitative criteria such as: the replacement of former bureaucratic structures, the private sector as the main producer of the GDP, the market as the main coordination mechanism (Kornai, 1999). Successful transition economies generated sustainable development and are able to trade with developed market economies without the usage of ordinary protection mechanisms. The proof of their successful market transformation is their entrance into the European Union in 2004. The less successful transition economies are still far from attaining these goals. They are faced with serious, sometimes devastating problems that disturb and constrain their ability to transform into functioning market economies.

The poor performance of less successful transition countries calls for a more subtle insight into the model applied for their economic transformation. All the elements of the standard set of measures that was to be adopted by all post-socialist economies originate from the ruling economic doctrine known as neoclassical economics. Key theoretical assumptions of this school of economic thought can be summarized as follows:

1. Methodological individualism-the only relevant economic actor is the individual. The individual is considered to be a rational, maximizing agent with fixed preferences.
2. The aggregate result of the actions of individuals is market equilibrium.
3. The absence of information problems. All the actors are perfectly informed (Hodgson, 1994, p.129.).

Neoclassical economics perceive economic process as the interaction among rational, maximizing individuals, with the general market equilibrium as its outcome. The assumption of the information problems absence means that actors have all the relevant information needed for maximizing their individual wealth. They utilize the information and maximize their utility function, which leads to the Pareto optimum in the economy as a whole.

Applied to the process of market transformation, this theoretical framework insisted on eliminating of all the norms of the previous, socialist system that would disturb the decision making of the individuals in these economies. These norms ought to be replaced by new market norms of behavior, transferred from the developed economies. Individuals in the transition countries were supposed to use opportunities that appeared in the new regulative environment for maximizing their utility functions. Entrepreneurial activities of the maximizing individuals would lead to the spontaneous creation of market economy (Lichtenstein, 1996, p.257.). However, this prescription turned out to be insufficient for successful transition. There is a significant gap between the individual that constitutes the core of neoclassical economic theory and the actual individual in the less successful transition countries. The behavior of individuals in these economies was much contrary to the predictions of the neoclassical economics and is characterized by opportunistic behavior, low propensity for transactions and modest ability to utilize information.

Therefore neoclassical economics offers insufficient theoretical tools for comprehending the transition process. The reason for this is its reductionism in defining key elements of economic process. As it can be seen from the previous analysis, neoclassical economics ignores the existence of any collective entities and any other motive of the individual other than utility maximizing. Critics of this approach (Hodgson, 1988) demonstrated that individuals have limited cognitive capacities, which means that they are not perfectly informed and cannot be maximizing agents. Another, perhaps more important, assumption is that there are some collective entities, in the form of socially created patterns, that govern the behavior of individuals. These patterns are called institutions and they represent the key theoretical concept of neo-institutional economics.

Within neo-institutional economics, institutions are more precisely defined as humanly devised constrains that structure political, economic and social interactions. These constrains can be formal (constitutions, laws, property rights) and informal (sanctions, taboos, customs, traditions and codes of conduct) (North, 1991, p.97). Institutions, both formal and informal, define acceptable behavior and represent the framework for the decisions of economic actors. Institutions structure inter-relations because they enable individuals to understand what other individuals are doing, what they are likely to do, and what may and may not be done (Neale 1994, p. 403, cited in Parto, 2005, p. 25). Institutions are the rules of the game in the society, while individuals and organizations are the players. Neo-institutional economics is divided in two intellectual traditions: old institutional economics, inspired by the works of Veblen, and new institutional economics, which attempts to extend neoclassical theory with the analysis of institutions. Nevertheless, both strands of neo-institutionalism underline the crucial importance of institutions and explore evolutionary aspects of economic activity. The question for most institutionalists in economics has been not how things stabilize themselves in a static state but how they endlessly grow and change (Hodgson, 1988, p. 130, cited in Parto, 2005, p. 22). The central thesis of neo-institutional economics is that institutions fundamentally shape the long-term economic performance of economies. The key for understanding complex interaction between institutions and economic outcomes of the society is the evolution of institutional structure. The evolution of institutions shapes the economic behavior of individuals thus affecting economic efficiency at the aggregate level.

Institutional economics pays attention to the institutional architectures of the transition countries and the way they respond to the newly introduced market institutions in the process of post socialist transformation. There appears to be interaction between new, formal market institutions, transferred from the developed economies, and inherited informal institutions in the transition countries. The outcome of this interaction will be one of the major factors to determine the efficiency and rapidity of transition. In order to enable successful transition, informal institutions in the post socialist countries must evolve in a manner consistent with the market-oriented behavior. However, this movement in informal institutions, induced by the establishment of the new economic system, significantly affects the behavior of individuals in the transition countries. In the successful transition countries, economic actors adopted market norms of behavior and the process of institutional transformation was more or less harmonious. In the rest of the post socialist economies, economic actors had serious problems in adopting new behavioral norms. Moreover, there has been evidence of behavioral disorientation of economic actors, which further reduced economic activity and contributed to the prolonged transformational recession in these countries. There are various explanations of this phenomenon within the institutional economics.

A very important concept that is regularly used in the analysis of the institutional transition is transaction costs. These costs represent: 1) the costs of measuring of economically relevant dimensions of goods and services and 2) the costs of enforcement of contracts (North, 1990). In the process of market transformation, due to radically increased uncertainty, transactions become too expensive. Transaction costs arise significantly and discourage individuals from entering into economic transactions. Therefore, the disorientation of economic actors in some transitional countries is generated by high uncertainty, which produces high transaction costs, and imposes serious constrains for economic activity. Proponents of this approach attribute much of this uncertainty to the indecisiveness of the state in imposing new, market-oriented rules of behavior. They recommend radical and rapid establishment of the new legal system. If new rules are coherent and concise, they will be less complicated to understand by the economic actors. This would end the disorientation of economic actors and make them more motivated to enter into various economic transactions (Ovin, 1998, p. 72-76). The reason for the disorientation of individuals is uncertainty, regarding what the future system would like like, what kind of protection of property rights would be provided etc. The state can do much in reducing this uncertainty by making clear that the future environment would be a market economy with all its norms of behavior and enforcement mechanisms. According to this strand of thought, it is possible to induce the evolution of the behavior of economic actors by the active role of the government in the sphere of the legal system establishment.

Another strand of institutional thought makes the distinction between formal institutional change that is realized in the establishment of the new legal framework and actual institutional change, which remarks the level of acceptance of the new formal rules by economic actors. Imposing new norms may be counter-productive in an environment that is still dominated by the institutional setting of the previous system. Economic actors have some kind of "tacit knowledge" that governs their activities and shapes their routines and habits. It takes time for new norms to transform into tacit knowledge, to become part of the routine behavior of individuals. The establishment of the new formal norms, joined by the spontaneous market forces, is not sufficient for institutionalization of the market economy (Ibrahim, Galt, 2002, p.106.). The observed disorientation of economic actors is the consequence of the fact that they must adapt their routines and habits to the new socio-economic pattern, through a slow, evolutionary process of learning.

There are approaches that indicate the psychosocial structure of the economic actors in less successful transition economies as the main factor of their inefficient transformation. The collective values of the population, known as the social genotype, favor modes of behavior incompatible with market economy. These behavioral patterns include authoritarian mentality, paternalism of the state, egalitarian values, avoiding private incentive etc. (Sekulović, 1997, p. 17). These norms make institutional environment resistant to market norms, which promote significantly different values. Explanations similar to the aforementioned account for the success of some transition economies by their nations' collective memory of the pre-socialist market system and the legal framework that existed in those countries before socialism. Countries that had previous historical experience with the rule of law within Austrian Empire (the countries of Central Europe) had strong memories of market norms behavior in their cultural heritage (Pejovich, 2001.). This also refers to the countries that developed strong trade connections with capitalist countries before socialist era (the Baltic Republics). When socialist norms were removed, informal institutions supportive of market economy that were captured in cultural repositories, simply reappeared and enabled the efficient transfer of formal market institutions. Other countries in transition had little historical experience of a functioning market economy, because even before socialist era informal institutions were not sufficiently adapted to the rule of law and market transactions. Thus, there was not enough memory of market norms in cultural heritage, and the evolution of existing informal institutional structures was gradual.

Within neo-institutional economics, North (1990, 1994) offered a subtle analysis of the role of informal institutions in shaping the behavior of economic actors. Since they live in conditions of uncertainty, individuals have limited cognitive capacities to utilize all relevant information. Informal institutions represented through tradition, customs, religion and codes of conduct, substitute the missing knowledge of individuals about important elements of an uncertain environment and permanently affect their cognitive systems and their behavior. All these institutions are the result of the long lasting, cumulative, cultural process of collective learning in the society. The transformation of this type of norms is an incremental, gradual and evolutionary process. Moreover informal norms inconsistent with the market economy can be persistent and lead to long lasting self-reproduction of the inefficient economic forms, which is known as path dependency (1994, p. 364). Many transition countries are inefficient in developing the market economy framework because their institutional development is path-dependent.

It can be concluded from the previous analyses that the transformation of the existing informal institutional network is the most delicate element of the transition process. The evolution of informal norms that govern individuals' behavior is an autonomous, gradual and partly cultural process. The nature of this process leaves little space to the government for any sort or regulation that would make it more rapid or less resistant to reforms. However, evolution of informal norms, in the absence of the adequate government policy, may cause undesirable economic flows. If governments do not pursue rule of law, then opportunistic behavior may become very profitable. This could lead to the emergence of rent-seeking entrepreneurship, which can deepen institutional and economic turbulence during transition. Such occurrences are already observed in some less successful transition countries like Russia, where profits earned by entrepreneurs remained very high several years after the beginning of transition, which is a proof of the undeveloped competition, existence of monopolies and dominance of rent-seeking behavior (McMillan, Woodruff, 2002, p. 156-157). In order to make this type of transactions non-profitable, the government must maintain the rule of law, through strong protection of property rights, enforcement of contracts and reduction of its arbitrary power to a reasonable extent.

Finally the transition to a market economy should not be perceived as the development of some pure, abstract form of capitalism. As Kornai (1995, x) puts it, there are different types of capitalism. The capitalism of United States is characterized by a high degree of individualism, and a limited state role; Scandinavian capitalism is known through the welfare state and extensive redistribution of income; Japanese capitalism sustains government intervention and mutual dependence of banking and industrial capital. Any other form of market economy is a combination of some of the aforementioned elements. Transition countries should tend to develop those patterns of market economy most suitable to their cultural heritage, in order to minimize resistance of the informal institutional structure and furthermore, to convert this structure into a source of sustainable development.

Summary

The explanation of different success rates of transition economies in implementing market economy must be looked for beyond the boundaries of neoclassical economics and its methodology of individualism. A critical dimension of the transitional process is the transformation of inherited socio-economic patterns of behavior that govern actions of the economic actors. Confronted with new market oriented norms, formerly established regularities in behavior are being interrupted, causing the disorientation of economic actors and causing well known consequences connected to prolonged transformational recession. The norms that constitute cognitive frameworks of economic agents are the subject of cultural, cumulative, evolutionary change. The rapidity of their evolution significantly affects the efficiency of the market transformation. Due to persistence of these norms over time, the transformation of less successful post socialist countries is path dependent. In the absence of proper transition policy, evolution of informal norms may produce various forms of rent-seeking and opportunistic behavior. In order to avoid these socially undesirable outcomes governments must maintain the rule of law. The transition economies should develop the type of market economy than can be successfully combined with existing cultural heritage, to enable sustainable development.

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RAZVOJ TRŽIŠNE PRIVREDE JE EVOLUTIVNI PROCES

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Osnovni cilj postsocijalističkih zemalja je razvoj funkcionirajuće tržišne ekonomije, što bi trebalo da se postigne uspostavljanjem složenog sistema normi tržišnog ponašanja. Zemlje u tranziciji imale su različitog uspeha u sprovodjenju ove strategije. Novouspostavljene norme ponašanja izazivaju transformaciju nasledjene institucionalne strukture ovih zemalja. U radu se ukazuje da transformacija postojeće institucionalne matrice predstavlja postepeni, evolutivni proces, naročito u manje uspešnim zemljama u tranziciji. Brzina institucionalne tranzicije glavna je determinanta efikasnosti tranzicije.

Ključne reči: *tranzicija, neoklasična ekonomija, institucije, zavisnost od putanje.*