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CHARTING A NEW COURSE

> One morning . . ., according to a much-loved anecdote . . ., Lenin woke up in his mausoleum on Red Square. The father of the revolution made his way up to the street and started to look around. He spent all day walking and talking to people, reading newspapers, even watching this new-fangled television. At the end of the day he was seen in the Kiev Railroad Station – the station for trains to Poland and the West. 'Vladimir Ilyich,' someone asked, 'where are you going?'
> 'Back to Zurich,' he replied, 'to start over again.'
>
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INTRODUCTION

Several years stand out in history: 1688, 1776, 1789, 1917 – and now 1989 can be added to that list. 1989 was a year of tremendous change and the images that flashed before our eyes shall be etched in hearts and minds for a long time. From the lone unarmed protest student facing off the tanks in Tiananmen Square to the joyous dance on top of the Berlin Wall, from the accession of Solidarity in Poland and the Civic Forum in Czechoslovakia to the execution of the tyrant Ceausescu in Romania, the images of 1989 were an overwhelming affirmation of humanity's universal struggle for freedom.

These images of 1989, however, have to a large degree given way to the sober reality of the 1990s. The road from serfdom is tough going. The path from communist domination to economic and political freedom is one fraught with difficulty. The conflict between economics and politics is highlighted along this road. As the adjustments in the economic structure proceed to correct for the previous distorted

order citizens will experience overtly unemployment, higher prices and discrepancies in income levels that previously were only experienced in an implicit manner. This occurs at the same time that new-found political freedoms give greater voice to complaint. The danger in this situation is that the emerging democratic forces can potentially derail the emerging economic freedoms and lead back to the dominance of politics over economics.

While 1989 clearly saw the end of communism as a legitimizing ideology, the economic and political transformation of the former communist bloc is still far from completed. The political hypocrisy was best represented in the Soviet Union from 1989 to 1991, where the communist government remained formally in power until Gorbachev's resignation on Christmas day 1991. In addition, on the economic front each Gorbachev announcement of economic reform was followed by a reversal of the reform program so in the end no official reform had taken place and the Soviet economic situation grew worse.

In the Soviet context this led to a competitive duality in both the economic and political sphere. While the official economy grew worse, the unofficial economy maintained the population.[2] State supplies disappeared, but market bazaars emerged. The state budget became more out of line and roubles were printed at an ever-increasing rate, but the black market exchange rate for currency reflected the declining value of the rouble and citizens increasingly relied on alternative currencies and barter arrangements to satisfy their market demands. In the political realm, while power remained in the hands of the Party it was continually slipping through their fingers. The political forces unleashed with *demokratizatsiya* grew in legitimacy. And, with the failed coup of August 1991 the communists lost any remaining power they had. From August to 25 December 1991 all that remained of communist central power was symbolic.

Many observers saw this as tragic, but this was not tragic at all. The crucial lesson of the emergence of Western civilization is the importance of competition among governance structures for the development of peaceful co-existence and economic development.[3] Competition is one of the most important processes through which we learn how to live and organize our affairs. Economic competition and the recognition of the benefits of exchange provide the foundation for social cooperation not some mythical notion of communal belonging.[4]

The Soviet experience with socialism did not eliminate competition or the gains to be had from exchange, but it transformed the competitive struggle and the gains that were to be had. Political competition and political privilege substituted for economic competition and profits in the mature Soviet society as discussed in Chapter 4. Soviet socialism was a failure because politics completely dominated economics as the pre-eminent organizing principle of society. In order to correct the situation – to chart a new course – economic forces must be unleashed from political forces, even if those political forces are democratic. If the main failing of previous policy can be found in rules of the game which perverted the incentives and impeded the flow of vital information, then reform entails establishing rules of the game which provide high-powered incentives to actors to discover and use economic information effectively. Competition among alternative market experiments is the best way to assure that new ways to satisfy market demand are discovered and that power is divested from any single entity in society.

The problem with central planning never was in the idea of planning per se, but rather in the fact that planning was limited to the imagination of state authorities. Planning within a market environment is vast, but decentralized at the level of the firm or individual entrepreneurs that actively participate in the market process. Market competition, guaranteed by rule of law which protects the freedom of entry, sets in motion a process of learning and discovery that government planning simply cannot replicate.

The discovery procedure of competition is also vital in the political realm. Competition among localities, provided citizens are free to move, sets in motion a discovery process that provides an incentive to individuals to reveal information about the level of public services and role of the state.[5] *Freedom of competition*, both economic and political, should be the operative phrase along the road from serfdom.

FIRST PRINCIPLES

As socialism declines as a social theory, liberalism necessarily ascends as the only viable alternative. The grand debate in social theory boils down to the contrast between socialism and liberalism. This debate, to a large degree, was one over means and not ends. Promoting public welfare and eliminating poverty, ignorance and squalor are not only the ends of socialism, but also the ends of liberalism. The peculiar characteristic of the socialist solution to the social problem lay in the means advocated to reach that end.[6] Socialists argued that by bringing

social life under the conscious and planned control of associations of men social problems could be eliminated. The broadening of the public life, to such a degree that eventually eliminated the autonomous struggles of the private life, would rid society of the social problems of poverty, ignorance and squalor, and promote the public welfare. Emancipation from the dominance of both other men and nature was the promise of the socialist project. Historical experience has seriously called into question the efficacy of the socialist means to obtain the stated ends.

Just as there are variants of socialism (from the real existing models of Stalinist, Maoist and Yugoslavian, and the theoretical systems of classical Marxism, humanistic Marxism, market socialism and so on) there are also variants of liberalism (from the real existing liberal democracies of the US, Western Europe and the Scandinavian countries, and the theoretical systems of classical liberalism, modern welfare state liberalism and radical liberalism of the libertarian variety). The negative argument of this book, while directed mainly at the Soviet experience, implies that all variants of socialism confront the same fundamental structural failing of an inability to provide the incentives and information necessary to coordinate advanced industrial activity. On the other hand, some variants of liberalism suffer from the internal contradictions of democracy which allow politics to dominate economics with the consequence of perverting economic incentives and distorting the flow of economic information.[7] The task is to articulate a version of liberalism which corrects for the fundamental flaws of socialism and the flawed variants of liberalism.

Just as Marx's vision of socialism was implied in his negative assessment of capitalism, the positive vision of liberalism can be found in the critique of socialism I have offered. Positive liberalism strives to be what socialism and weaker versions of liberalism are not. The dialectic of social theory teaches through contrast and critical examination.

Justifications for the liberal order can be found normally in one of two directions, the Locke–Nozick natural rights justification or the Hobbes–Buchanan contractarian justification. Both of these justifications, however, are flawed.[8] A more satisfying alternative perspective for examining the properties of the liberal order can be found in the Hume–Hayek tradition.

The Locke–Nozick formulation of the liberal order begins with an assertion and not an argument.[9] The natural rights position of self-ownership is justified by Locke on religious grounds and Nozick simply begins with the Lockean position and attempts to derive the implications. The basic problem with this approach is not limited to the difficulty in its justification, but rather lies with the difficulty associated with delimitating the nature of the rights under consideration. The distinction between negative and positive rights does not seem to do the trick. What we want to achieve by delimiting rights is the 'good' society, i.e., a society in which the consequence of following the rules is beneficial. A moral society that yielded bad consequences would be neither desirable nor 'good.' In other words, what we expect from rights is increased opportunities to better ourselves, i.e., positive liberties. But once the desire for positive rights is recognized the limiting questions of which rights, and whose rights, are to be respected requires an alternative criterion for adjudication. Settlement of competing rights claims cannot be resolved by reference to natural rights alone.

The social contractarian approach of Hobbes–Buchanan tries to resolve the problems associated with natural rights theory by way of the social compact.[10] In Buchanan's scheme, for example, the leap out of Hobbesian anarchy is accomplished by individuals coming to agreement behind a Rawlsian 'veil of ignorance' as to the basic organization of society. But despite the logical rigor of Buchanan's analysis the system lacks any endogenous process by which individuals come to adopt rules of behavior.

In large number settings individuals treat rules as parametric, similar to how agents within the perfectly competitive model of general equilibrium treat price as given. But, in the perfectly competitive model if agents treat price as given, then how do prices ever adjust to clear the market? Price adjustments in the Walrasian model occur by invoking the extra-economic character of the auctioneer. In other words, the model fails in one of its most important tasks – explaining the process by which equilibrium could ever be achieved.[11] Buchanan's discussion of the social contract is vulnerable to a similar argument since he explicitly builds his Hobbesian model on the basis of the perfectly competitive model.[12] Since rules are treated as parameters in the Buchanan description of pre-constitution interaction, then how is it possible that individuals could ever come to observe social rules? Just like the Walrasian counterpart, the Hobbesian sovereign must be invoked in order to establish the appropriate rules. No endogenous process of rule formation is possible within this system.

In addition to this logical untidiness, the Buchanan formulation also

confronts a problem of constructivism. If a constitution could emerge in such an ahistorical fashion as is suggested in the Hobbes–Buchanan analysis, then it would be possible to develop blueprints for social order.[13] But if such blueprints were possible, then socialist social theory would not confront any difficulties in operation. In fact, the very problem with the original model of Marxian socialism was the desire to develop a detailed blueprint of social organization that would coordinate economic life in an *ex ante* fashion.

In the rationalistic-constructivism of Hobbes man can design the good society by devising the institutions that govern human intercourse.[14] Society is a product of man's reason and not the result of an evolutionary history of trial and error. Institutions which are not consciously understood are to be rejected. The constructed order is the product of man's rational ability to draw up a social contract. The fundamental problem with the Hobbesian decision-maker is that he must be every man and thus no man. His reason is sufficient to ascertain the vast amount of information necessary to deduce the first principles of society yet he is blinded by the veil of ignorance as to his future status in that society.

Social order, in contrast to this rationalistic conception, is the product of human action, but not of human design.[15] This is an insight which the Hume–Hayek perspective of the liberal order highlights.[16] Constitutions simply codify rules that have evolved to govern human intercourse, rules that had previously been respected tacitly by individuals.[17] Rules emerge endogenously to a process of human interaction through time as individuals attempt to resolve conflicts.

The Hume–Hayek approach to understanding the nature of the liberal order offers an alternative to either an approach which emphasizes religious tradition or rationalist design. Rather than contrast reason with tradition, this approach to social theory can provide an analysis of reason within traditions. History is seen as a discovery procedure in which different group practices compete with one another. Practices which enhance the well-being of the group are maintained while those practices which prove detrimental to the well-being of the group are discarded. Through a process of rule innovation, imitation and evolution rule systems emerge to govern human interaction.

This Hume–Hayek approach also has the advantage of being capable of incorporating the strengths of both the Locke–Nozick approach and the Hobbes–Buchanan approach into its analysis of the liberal order. Rather than stress the morality of private property as derived from some conception of natural rights as is found in the Locke–Nozick perspective, we can now examine the consequentialist rationale for private property. Moreover, since private property can be shown to be a vital precondition for the social experimentation – especially in the economic realm – that is necessary for the progress and development of social order many of the libertarian implications that Nozick derives from the Lockean perspective can be maintained.[18] In addition, since codification of tacit rules is recognized as a fundamental part of social development, the Buchanan emphasis on the constitutional moment in political economy remains potent.

The key point of the Hume–Hayek approach is a complete rejection of the command and control approach to social order. This does not mean that social order is unorganized or chaotic. Instead, social interaction in a liberal society is characterized by a high degree of internal predictability. But it is an order that emerges as a by-product of activity that does not intend to produce any particular overall system by conscious design. Rather than command and control, the Hume–Hayek program emphasizes *cultivation* of a social order that allows great flexibility in alternative experiences of life.[19] Governance structures are to establish rules of the game which cultivate and encourage individuals to experiment in alternative social arrangements.

Thus, besides enforcing respect for rules which serve as a precondition for experimentation there is little else that is left for governance structures to do with regard to detailed management of the social world. This should not be interpreted as an end to politics. Rather, the insights of the Hume–Hayek approach provide the basis for dealing with the politics and economics of the liberal order.

THE ROLE OF STATE ACTION

Beginning with a cultivation as opposed to a control mentality, we can start to provide statements concerning practical questions of public policy in the former communist countries. Under the former communist regimes the benefits of competition in politics and economics were explicitly disparaged. The defining characteristic of the real existing Soviet Union was *monopolization*. Conceptually, then, reform is a rather simple process of demonopolization. How to best do that, however, is not a simple matter. One thing we should know for sure, though, is that the policies advocated in the process of demonopolization cannot be policies which require vast amounts of

government control and command.[21] In other words, policies which try to micromanage the transformation process will confront the same difficulties that the previous socialist policy regime faced.

This paradox of transition policy is the fundamental problem that must be addressed in issues ranging from the very nature of the role of government to concerns of monetary and fiscal policy. James Madison, over 200 years ago, addressed the fundamental paradox of liberal governance when he stated in *The Federalist Papers*, No. 51 that:

> If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself.[22]

At the same time that state action is empowered to promote the general welfare it must be constrained through constitutional rules which limit this power. Traditional economic justifications for state action depended on the theory of market failure. It seemed a reasonable assertion to state that in situations where the market fails to promote the general welfare the government should step in and act accordingly. But this argument was curiously myopic. The dichotomy between the examination of the logic of market and the logic of politics is best characterized by the ancient legend that has it that a Roman emperor, being asked to judge a singing contest between two contestants, heard only one contestant and gave the prize to the second under the assumption that the second singer could be no worse than the first. The problem, of course, is that this assumption is unwarranted.

It is by no means unambiguous that in situations of market imperfections government action will improve the situation. Government may actually make the situation worse. In fact, many perceived market imperfections at one moment may spur entrepreneurial discoveries which correct the situation in future periods.[23] Government action in this situation merely would distort the learning function of the market process by substituting a political solution to a problem that could be internalized through entrepreneurial creativity. Moreover, it can be demonstrated that many so-called market failures are actually a product of faulty rules which govern the economic game.

The current crisis in the US Savings and Loan industry provides a concrete example. Rather than blame the débâcle on speculative investment behavior of bankers, a more appropriate argument would be to find fault in the liability and insurance rules which produced a situation where bank directors could accrue all the profits from their activities but remain largely protected from losses. Such an environment produced what is known in economics literature as a moral hazard in which risky behavior becomes the norm. Economics per se cannot provide moral statements about whether profits are deserved or not, but it can provide statements about the consequences of alternative rules on human behavior. Traditional market failure theory drew the economists' attention away from examining the structure of alternative rules which governed decision-making processes.[24]

Arguments about market failure, therefore, must be conjoined with an appreciation of the strong possibilities of government failure in implementing the proposed solution. This would seem to suggest that each case should be treated separately and that no general rule could be established concerning state action. Of course, in dealing with public policies there is always the question of magnitudes. Government failure may indeed exist, but it may be less desirable than the existing market failure. Such a cost–benefit calculus, however, is severely limited in practice since economically meaningful costs and benefits are purely subjective in nature. Objectivistic notions of costs and benefits fail to produce an adequate understanding of economic processes and mislead analysts when addressing public policy questions.[25]

Again, the problems that the socialist policy-maker confronted in policy formation suggests how to establish criteria for public policy in the liberal order. The command and control mentality translates economic questions into engineering problems and offers technological solutions. Such an approach assumes a degree of objectivistic measurement of the variables which does not exist in the economic realm. Offering technological solutions for problems that can only be appropriately handled as economic, fails as viable public policy.

The information that is vital for economic questions is contextual. One of the chief sources of error in the engineering mentality is the assumption that economic data, such as 'costs,' are objectively given facts ascertained by observation, when in fact the data of economics can only be understood within the context of the chooser. The knowledge and judgement of the decision-maker will be wholly

different when he acts in a competitive market from what it will be when he acts in a monopolistic one. Not only the nature of the incentives, but the nature of the knowledge generated and utilized, differs depending on the context of action.

The dynamics of economic processes require that viable policy discussion should be limited to an examination of the alternative rules. Even in situations when state action is deemed desirable it must be at the level of the rules and not particular market outcomes.[26] Given the experience of government failure in both the former socialist economies and Western democracies, the *presumption must go to the market.*

In addition, since the basic argument being offered here is that rules that govern social intercourse should cultivate experimentation, even in situations where the 'publicness' of the good requires state provision, private firms should not be excluded from attempting to provide the service on the open market.[27] Government may provide mail services, for example, but that should not mean that government can exclude competitors. And if technological innovations emerge which allow private provision of the service, then progress should not be deterred. Facsimile machines, for example, may one day eliminate mail carriers, but that would not be something to bemoan. The key ingredient to social development is free competition. Government too often is the source and protector of monopolistic practices. Competition, on the other hand, destroys monopoly and encourages experimentation. Not only does competition allow us to use already existing knowledge, but it is also the spur for the discovery of ever new and fresh knowledge. 'Competition,' Hayek writes, 'is not merely the only method which we know for utilizing the knowledge and skills that other people may possess, but it is also the method by which we all have been led to acquire much of the knowledge and skills we do possess.'[28]

One final point about state action must be made before we address more concrete questions of the policy of the transition. State action is by necessity non-neutral, i.e., intervention affects the underlying pattern and distribution of resources in society.[29] Intervention by definition changes the pattern of exchanges that would have voluntarily transpired on the market otherwise the intervention would not have been necessary – people would have already done what the intervention intends to compel them to do.

In a monetary economy the generally accepted medium of exchange represents a link in all exchanges. Money, in other words, is one half of all exchanges, i.e., it is the joint linking all transactions. This jointness aspect of money translates into the proposition that if policy alters the value of the monetary unit it also changes the pattern of exchanges in the economy.

The centrality of money in an economic system can be illustrated as follows. Imagine that the economy is like a well-shaped wheel, the spokes of the wheel represent the relative prices in the economy and the hub of the wheel represents the monetary unit. By either tightening or loosening the spokes we can change the shape of the wheel. The wheel may become distorted and not function as smoothly as before, but it can still roll. However, if for whatever reason the hub of the wheel was eliminated, then the wheel would collapse altogether and cease to function. Similarly, distorted relative prices disrupt economic forces, but destroying the currency would lead to the collapse of the entire economy.

Money cannot be viewed simply as a veil or tight joint, as is suggested in the classical dichotomy which stated that real variables only affect reals and nominal variables only affect nominals. The classical argument suggested that the real underlying distribution of resources would be unaffected by changes in the value of money. Changes in the value of money would be fully accommodated for by proportional changes in the price level. While the classical dichotomy contained an important argument against inflationists and monetary cranks who argued that by printing more monetary notes wealth could be achieved, it confused the nature in which changes in the value of money are transmitted in an economic system. This is not to suggest that Keynes's criticism of the classical dichotomy is to be accepted. On the contrary, Keynes failed to understand the workings of the monetary economy because in his system of thought money represented a broken joint.[30] Instead, the interesting questions in macroeconomics explore how monetary variables can alter the real distribution of capital resources in an economy by affecting the structure of relative prices. Recognition of this forces the economist to pay particular attention to systemic questions concerning the monetary regime itself and the rules under which it operates as opposed to particular pro- or counter-cyclical policies that are suggested by advocates of either demand-side or supply-side management of the economy.

Similarly, fiscal policy necessarily affects the pattern of exchanges. If you subsidize something you get more of it, if you tax something you get less. Of course, the magnitude of the effect varies, but the

general point remains. Neither monetary or fiscal policy can be neutral, and therefore, when discussing policy rules for sustaining a liberal order this must always be kept in mind.

ESTABLISHING A LIBERAL REGIME IN THE FORMER COMMUNIST ECONOMY

The distorted world of the Soviet economy is best characterized by the gigantomania of the Stalinist system. In the 1930s the farming system was colonized in collectivization and through a practice of internal imperialism an industrialization drive was financed. On the backs of the peasant community industrial cities were built. Giant enterprise monopolies, in the strictest sense of establishing single producers of a particular good for the entire country, were created under the influence of the Marxian illusion about the infinite efficiency gains of economies of scale in order to industrialize the 'backward' Soviet economy. This industrialization drive left its permanent stamp on the industrial structure of the Soviet system and is evident to this day throughout the entire economy. It was estimated by Gosnab in 1990 that 80 per cent of the volume of output in the machine-building industry was manufactured by monopolists, and that 77 per cent of the enterprises in machine-building were monopoly producers of particular commodities. Locomotive cranes, tram rails, sewing machines, coking equipment, hoists for coal mines, and sucker-rod pumps, for example, were products produced by absolute monopolists in the Soviet economy. About 2,000 enterprises throughout the entire region of the former Soviet Union were the sole producers of specific products.[31]

In addition, the industrial cities attempted vertically to integrate entire industries. A survey by Goskomstat in 1987 reported that out of every 100 machine-building enterprises, 71 produced their own iron castings, 27 produced their own steel castings, 84 their own forging, 76 their own stamping and 65 their own hardware.[32] There was virtually no specialized production in the entire Soviet industrial structure.

The highly concentrated industrial structure combined with the absence of any kind of market signals produced chronic inefficiencies in production. Historically, the criterion for success was meeting the gross output targets set by the planning authorities. Success had little to do with quality of the product and nothing to do with satisfying consumer demand. The consequence of this economic environment is illustrated in the case of the Magnitogorsk steel manufacturing complex.[33] Founded in 1929, Magnitogorsk steelworks was considered the flagship of Soviet technology and industrial development. Magnitogorsk became an industrial city of 438,000 people by the late 1980s, and represented the largest steel complex in the world, producing about 16 million tons of steel each year. But, this industrial city has a severe housing shortage and has difficulty lifting its population above mere subsistence standards of living. It has destroyed the surrounding environment and overwhelmed its population with lung and other respiratory diseases. What was once held up as an international showcase of Soviet achievement has been revealed as simply another Soviet example of an industrial white elephant.

Of its reported 16 million tons of annual production, for example, no one really knows how much is actually Magnitogorsk's own defective steel being recycled through the production process. The quality of the steel produced is quite low even by the minimal standards set by the planners let alone world market standards. Nevertheless steel is produced and becomes the defective input in the machine-building industry, which in turn manufactures defective machines intended to produce more steel. Such production for production's sake is one of the most prevalent characteristics of all Soviet industry. Moreover, to produce 16 million tons of steel, the Magnitogorsk complex employs more than 60,000 workers. In contrast, the USX plant in Gary, Indiana, the most modern and integrated American steel plant, employs 7,000 workers and produces about 8 million tons annually. In addition to poor labor productivity, the difference in the size of the workforce between Magnitogorsk and USX can be attributed to lack of capital investment, the necessity of maintaining a large portion of the workforce simply to repair and build machines and tools required to operate the Magnitogorsk Works and the importance of keeping a padded labor force so that the plant has the ability to engage in the Soviet industrial phenomenon of 'storming' that occurs at the end of each production period in order to meet planned output targets.[34]

Magnitogorsk is just a microcosm of the entire Soviet industrial structure.[35] The simple fact of the matter is that throughout the Soviet system most people wake up to go to work in a factory that is in the wrong place to produce the wrong goods. Most of the enterprises are negative value added firms, that is the inputs that go into the production process are more valuable than the output produced.[36] The industrial structure of the former Soviet Union cannot be restructured, it must be rebuilt.

To complicate economic matters, in the Soviet-type system

microeconomic inefficiencies translated into macroeconomic imbalances. Negative value added firms required production subsidies which bloated the state budget which in turn led to increased pressure to finance expenditures by printing more rouble notes. In other words, state subsidization of production generated budget deficits and inflationary pressures, and these macroeconomic distortions in turn perpetuated the already existing maladjustments in the economic structure.[37] Moreover, since most state enterprises could not survive a market test, employment in these enterprises was simply a form of welfare payment to workers who in reality were either 'unemployed' or more accurately 'underemployed.' The implicit Soviet compact was: 'We pretend to work and they pretend to pay us.'

Labor was misallocated, capital was misallocated, macroeconomic policy was distorted and consumers were ignored. That is the real existing situation from which transition policy must begin its assessment of alternative policy paths. To realize just how structurally distorted the economy of the Soviet Union was, one need only remember that prior to the fall of the Berlin Wall East Germany was universally considered the shining example of socialist industrial efficiency. But, once exposed to the West German and world market it was revealed that the East German industrial power was nothing but a grand illusion. The Soviet economy begins from a much worse starting point than any of its former allies in the socialist bloc if for no other reason than that it existed under the perverted incentives and distorted information of socialist policies longer than any other country.

The connection between individual enterprise performance and macroeconomic policy must be severed for the economic transition to be accomplished. Moreover, the monetary system must be completely independent from the fiscal policy regime. In the West, there exists only the myth of independence between say the Federal Reserve System and the organs of fiscal policy in the US.[38] As research on political business cycles suggests, the Federal Reserve System was created by Congress and the Executive and acts as an agent of these bodies of government which helps to explain to a large degree the tremendous percentage of incumbency re-election. Budget deficits, spiraling public debt and bouts of inflationary distortions are not only a result of poor policy choice by leaders, but more fundamentally a consequence of the structural incentives of the institutional establishments of representative democracy and central banking. Monetary and fiscal policies, in other words, have become tools of political manipulation and not just tools for managing the economy. Of course, even if we could somehow constrain the political process so that monetary and fiscal policy was not subject to political manipulation but was instead limited to attempts to promote the general welfare, a serious problem would confront policy-makers. Best of intentions does not mean that the information necessary to accomplish appropriate management would be available to policy-makers in any readily assessable manner. Macromanagement, just like micromanagement, of the economy is a mistaken approach to public policy. Transition policy should not only steer clear of repeating the previous mistakes of the socialist regimes, but it should not repeat the same mistakes that Western governments have made.

Competition among enterprises must replace monopoly and subsidization, and competition introduced into the monetary and fiscal sphere will also produce desirable results in terms of economic growth and development. Introducing free competition into the system as fast as possible should be the major priority of transition policy. Transformation policy amounts to price liberalization, privatization, establishing a viable currency and controlling the state budget. These policies cannot be phased in over time because each particular policy has consequences for the others so they must be introduced simultaneously. Shock therapy possesses a logic which its critics too often miss.[39]

1. Price Liberalization

Price liberalization should not be confused with administrated price increases. Freeing of prices means eliminating government control completely. Raising prices by decree at the state stores is not a price liberalization. Prices need to be free to adjust to the forces of supply and demand. The function of free prices is to bring into coordination the most willing suppliers and the most willing demanders in a market. Prices ration goods and services through their ability to adjust constantly to changing market conditions. Under the previous policy regime, rationing was done either through political means, such as the special privileges that Party officials possessed, or through queuing for goods in short supply. Price liberalization will destroy the old way of allocating scarce resources.

Immediate price liberalization disturbs many individuals because of the fears of inflation, monopoly profits and income inequalities. The fear of inflation is largely unwarranted because individuals already

exist in a situation of 'repressed inflation.' Long queues and persistent shortages of basic items characterize the socialist system. Freeing prices will simply eliminate the queues and shortages. Repressed inflation will become explicit as prices rise, but this will entice future competition which will lower prices. Inflation is not a matter of increases in prices, but rather everywhere and always a monetary phenomenon. Inflation is a consequence of the monetary regime reducing the value of the monetary unit. Free pricing is not the problem, the problem lies in the monetary regime.

The rouble overhang problem (i.e., the supply of notes held idle by consumers) is also largely a figment of planners' imagination. It is true that an overhang exists, but in an excess demand economy where black markets have flourished such as the former Soviet Union, it cannot be said that individuals are being 'forced to save.'[40] Instead, since goods can be readily had at the black market rate around the corner, individuals must be voluntarily saving under the expectation that they will eventually be able to acquire the goods at the artificially lower state price in the future. The rouble overhang problem emerged from the voluntary choices of Soviet citizens. In addition, the monetary authority had so destroyed the value of the rouble, that for many citizens the rouble was no longer convertible into goods. Barter became the predominant mode of trading with its corresponding problems for coordinating the plans of economic agents. Price liberalization is a necessary precondition for eliminating these distortions in the economic system.

The monopoly structure of the former socialist economies also creates a problem for many would-be reformers because it suggests that once prices are freed they will gravitate to monopolistic prices and not competitive ones.[41] It is argued, therefore, that privatization must occur before price liberalization.[42] But this misses a fundamental point about the introduction of market discipline. In order for markets to work they only require the lure of pure profit, the penalty of losses, free pricing and freedom of entry. The existing market structure does not matter as long as these preconditions for market operation are established. If so, then the current market structure will give way to a new order even if price liberalization brings monopolistic profits to the current enterprises in the short run.

Finally, the concern over basic equity is also a consequence of suspect reasoning. First, large discrepancies in income existed in the old regime. The Party elite lived an elaborate life-style compared to the average citizen.[43] In fact, these discrepancies were far more acute than those that exist in the West. While the average citizen struggled for the very minimum standards of existence in terms of housing, medical care and other basic services, the Party elite lived like kings. Introducing market forces into this situation destroys the old regime, it does not lead to gross inequities, it corrects them by eliminating the privileged position of state officials. Also, many argue that essential products, such as basic foodstuffs, should be exempt from price liberalization. But this gets the argument completely backward. Essential products are now in short supply in the official sector. Price liberalization is necessary to alleviate this situation. If anything, price liberalization should come to essential products first.

2. Privatization

How best to privatize the bloated behemoth of state enterprises in the former socialist countries is a subject of wide debate. Proposals range from voucher systems to controlled restructuring of state enterprises by Western institutions such as the International Monetary Fund, and public auction. Since I do not believe one can address past wrongs in any economically meaningful manner, and since in the absence of market signals the valuation of the assets of state enterprises is troublesome, I would suggest that ownership rights simply be given to the *de facto* owners, i.e., the state enterprise managers.[44]

Eliminating all subsidization of state enterprises and turning ownership over to the existing management, along with the introduction of price and trade liberalization will accomplish the goals of privatization without establishing a new bureaucracy – such as a Ministry of Ownership Transfer – to get in the way of the discovery procedure of competitive forces. Trade liberalization will import the price structure and discipline of the world market.[45] Price liberalization will force enterprise managers to pay attention to costs of production and other market signals.

In other words, privatize the economy – both small and large scale – as follows. The *de facto* property rights in the state enterprises that are held by current management be recognized as *de jure* rights. All consumer and producers' subsidies are abolished and state orders and price limitations are eliminated. Bankruptcy and liquidation of firm assets must be allowed. This has to be coupled with trade liberalization to eliminate the monopoly structure problem and import a market price structure. In this fashion, the fundamental industrial

restructuring and reallocation of capital resources that is necessary to get the morbid Soviet economy untracked will be accomplished.

3. Monetary Reform

Liberalization policy demands a convertible currency. One of the main problems of the transition of the former Soviet economy to a market economy lies in the inconvertibility of the currency. A market economy requires a widely accepted medium of exchange that can purchase goods and services on the domestic market (internal convertibility), and that is easily converted into foreign currency (external convertibility) at free market rates. The reality of the Soviet economy under Gorbachev was that the rouble was neither an internally or externally convertible currency. Despite the wide variety of proposals for rouble convertibility, most have in common the reliance of a central banking system to institute the reform.

Ronald McKinnon, for example, argues that Western and Soviet economists who press for price liberalization, floating exchange rates, privatization and decentralized decision-making are mistaken because they have got the order of liberalization wrong. Before any liberalization proceeds, McKinnon argues, proper fiscal and monetary control over the Soviet economy must be secured.[46] An alternative, non-central bank approach, to currency reform has been proposed by Steve Hanke and Kurt Schuler. Hanke and Schuler argue that the best way to achieve and maintain currency convertibility would be through a currency board system as opposed to central bank management.[47] Robert Hetzel, however, has pointed out that while the currency board system is a substitute for central banking a government currency board has the disadvantage in that there is no binding way to assure that government officials will not force the board to devalue for domestic political reasons.[48] Successful monetary reform can be nothing short of complete depolitization of the monetary system.

The reasons for depolitization of the monetary system are straightforward. Government can only finance its affairs in one of three ways: tax, borrow or inflate. Inflation represents a hidden tax to the citizens. Depolitization of the monetary system eliminates the inflationary ability of the government and forces government to either borrow in the capital market or raise revenues through taxation to finance its affairs. Also by eliminating the ability to finance its expenditures through inflation, depolitization makes government more interest sensitive to its borrowing behavior, and so forces government policy-makers to be more disciplined in their financial borrowing.

The logic of the depolitization of money is also fairly straightforward.[49] The market for monetary services is no different than the market for other commodities. There is no need for government to 'manage' money. Rather than a regulated banking system based on central bank monopoly note issue, a more viable alternative can be found in an unregulated banking system of competitive note issue.

The fundamental problem with central banking, however, is not the problem of political manipulation of the monetary unit. The real problem is that central banking presupposes the capability of state authorities to access information that is neither in their interest nor ability to gather.[50] For central banking authorities to manage the supply of money accurately they would have to possess knowledge of the conditions of supply and demand which is not available to any one mind or group of minds. Both the political and economic problems of central banking are inherent to the institution itself. As with other centralized planning institutions, the attempt to manage monetary resources through administrative methods produces economic and political irrationalities.

On the other hand, competitive note issue will set in motion an entrepreneurial process which will adjust supply decisions of bank managers to meet the public's demand for monetary notes. The clearing mechanism under free banking will assure that managers will receive the appropriate signals for effective resource administration. The clearing mechanism provides signals concerning debit and credit that follow from the bank's under- or over-issue of notes. This information will cause bank managers to adjust their liabilities accordingly. Moreover, in a free banking system of competitive note issue, the return of notes and checks for redemption in base money will also provide incentives and information that is vital for the proper administration of the money supply. Monopoly note issue by a central bank simply cannot generate the incentives or information required to manage the money supply adequately. Central banks are not well equipped to know whether an adjustment in the supply of money is needed, nor are they well equipped to assess changes in the demand for notes.

Competition in note issue, however, promises all the same benefits that competition in any commodity does. The availability of substitutes will force bank managers to act prudently in forming their

business decisions. Brand names will be important in the competitive process as some bank notes will become more respected than others. But as long as freedom of competition persists, then an effective administration of the money supply will result.

In the current situation of the former Soviet Union, the rouble has become basically worthless. Some reported exchange rates value the rouble at more than 100 roubles to one dollar in currency auctions at the end of 1991 and the beginning of 1992.[51] In the Russian Republic the printing presses have been running twenty-four hours a day. Free banking offers an alternative to this monetary chaos.[52]

Banks could offer notes backed by hard currency or some bundle of commodities or gold. The banks would offer deals on rouble exchanges to attract customers to their bank. Individuals would gravitate to bank notes that were most widely accepted for market transactions. Central bank roubles would disappear, as would the institutional organs of central banking, but monetary order would emerge and the money supply would be free of the manipulation of the political process.

One final note, free banking also offers an answer to the policy dilemma highlighted in Chapter 6 concerning commitment conveyance. Eliminating government control over the money supply not only pre-commits the regime, it also signals to market participants that the government is sincere in establishing restraints on its leading role in the economy. It will take such a drastic step that establishes binding constraints on government action and signals a firm commitment to structural reform to get economic liberalization policies on the right track. Allowing competitive note issue under a regime of free banking offers the best chance for achieving the simultaneity required for conveying a credible pre-commitment to liberal economic reform.

4. Fiscal Policy

If the political control of the money supply has been eliminated, then the government will not be able to finance its expenditures through the hidden tax of inflation. Without the ability to inflate, and thus pay debts back with cheaper money, government officials will in theory be more interest rate sensitive in their borrowing decisions. Of course, this reasoning is somewhat questionable because government officials are not in the same *context* as businessmen. They are not committing their own financial resources, nor do they face the discipline of market forces. In addition, given the changing fortunes of elected officials, those who borrow today most likely will not be in office when the bill is due in the future. Nevertheless, the elimination of the ability to inflate takes away one way in which political actors are able to hide the effects of their policies.

Political leaders will instead have to raise most revenues through taxation, which is directly felt by the electorate. Still the electorate may be rationally ignorant of a preponderance of legislative initiatives and the vote motive may be lacking, but making it more difficult to hide the costs of policies will reduce the ability of politicians to engage in special interest politics. Tax limitations along with balance budget requirements will also build in desirable constraints on government's ability to finance its affairs outside the consent of the governed.

The justification for activist fiscal policy derives mainly from Abba Lerner's concept of 'functional finance.' Lerner argued that economists should use the budget to balance the economy rather than worry about balancing the budget. During times of recession, when aggregate demand fell short of the level required to maintain full employment budget deficits could correct for the economic downturn. And, at times when aggregate demand exceeded full employment levels and produced inflationary pressures, budget surpluses could bring the economy into balance.[53]

This approach to fiscal policy belies a pretense of knowledge. In order to fine tune the economy with the tools of fiscal policy, government officials need to know not only what the current level of aggregate demand is, but also what the appropriate level of aggregate demand would be to maintain full employment. In addition, it is assumed that policy-makers can ascertain the precise effects of the multiplier so that full employment levels could be maintained. Without these crucial assumptions, government policy would not only be ineffective, it may actually be damaging to the economic order.

Budget deficits crowd out private investment activity and public debt erodes a country's capital stock. The problem with fiscal policy is an expenditure problem. A balanced budget with high levels of taxation and high levels of government expenditure would do little to promote the development of economic forces. The development of the economy requires reductions in the size and scope of government.

Government expenditures are largely justified in order to supply public goods. While few economists would question the public goods argument per se, there are severe problems that confront government

provision of public goods.[54] Most fundamentally, there is a problem of the demand revelation for public goods. Under the situation of monopoly provision it is difficult, if not impossible, to ascertain the demand for public goods. Individuals do not face high-powered incentives within the political process to reveal accurately their demand for public goods.

What is missing from the political process is a competitive discovery process which motivates demand revelation. This situation can be improved on, however, by introducing as much competition as possible into the political provision of goods. First, it is one thing to establish that a good is public, it is another thing to grant government a monopoly in its provision. Private firms should be allowed to compete with government in the provision of public goods. Second, individuals must be free to move among localities. By allowing free migration of the population, localities will compete with one another for a tax base and will have an incentive to offer the demanded bundle of public services at reasonable prices (taxes). High tax areas will lose residents unless they provide an appropriate level of public services for the taxes paid. Technological advances, for example, have increased the ability of businesses to move capital quickly and this in turn has the potential of increasing the competitive pressures on government policy makers to pursue desirable public policy at the local, national and international level.[55]

Competitive pressures will do their job most effectively as the locus of decision-making authority is reduced. The break-up of the Soviet empire, for example, might actually have been a necessary precondition for introducing the competitive forces which will aid in discovering the appropriate levels of tax and expenditure by regional governments in the former Soviet Union. The unintended consequence of ethnic strife and nationalistic awakening, may be the establishment of more manageable governance structures. Of course, the rhetoric of some of the nationalistic leaders is ugly and upsetting to liberal sensitivities (especially the rise of anti-semitism or the ethnic conflict between Armenia and Azerbaijan), but in a liberal environment these conflicts will give way to harmonious and mutually beneficial economic ties. The argument for the liberal free trade order was not limited to the gains in economic efficiency that followed from individuals pursuing their comparative advantage. Rather, liberal trade also promised peaceful social relations between individuals and nations as exchange came to dominate political conflict.[56]

During the communist period, the unique cultural and ethnic differences between the republics was officially suppressed. The first thing that occurred when the communist imposed order was lifted was that old sentiments of conflict arose again between republics. This is a natural reaction to the previous system of politically imposed order.

The old Soviet empire was doomed to collapse for structural reasons. In addition to the failed economic system, politically the empire simply overstepped the bounds of feasible control. Once Gorbachev unleashed the forces of *glasnost* and *demokratizatsiya* it was like squeezing a tube of toothpaste – the toothpaste cannot be put back in. The drive for independence by the republics was a necessary first step toward establishing a more liberal order.

Only independent states can decide that it is to their benefit to develop relationships with other states and enter into mutually beneficial agreements. There are potential dangers along this path of building a new liberal order, but there is in a fundamental sense no alternative.

The key ingredient in building successful bonds between the states is to guarantee free mobility of people, goods and services. The most effective check and balance to any political system is for the population to have the ability to vote with their feet. By allowing people and resources to flow freely, governments will be constrained in their activities.

Political competition in an environment where government's ability to hide the costs of its policies is constrained will generate a discovery procedure which will result in a close approximation to the desired bundle of public services and the level of taxation. The existence of readily available alternatives, rather than some a priori justification, will define the scope and size of the state. The basic precondition for this process to work is simply the elimination of any claims to monopolistic exclusion.

The fact that the ideal pattern of society cannot be arrived at in any a priori fashion does not mean that we must start from scratch. Historical experience and the insights of the social sciences provides us with some knowledge of which alternatives to avoid. Communism, fascism and other forms of authoritarian regimes which claim an exclusive right to truth are to be avoided. The fact that 'no utopia has ever been described in which any sane man would on any conditions consent to live, if he could possibly escape' tells us something.[57] Historically, most analysis of the ideal society concerns itself with the

particular design of communities. It is not that designing communities is unimportant, rather as I have suggested, it is in the competition between communities that knowledge will be revealed concerning the appropriate relation between the citizen and the state. But, the real emphasis for reconstruction of the post-communist world must lie in developing the *framework* for society within which competition among the communities transpires.[58]

THE LOGIC OF SHOCK THERAPY

Price liberalization, privatization, monetary reform and fiscal policy constraints cannot be phased in over time for various reasons. The interconnectedness of each demands that they be introduced simultaneously.[59] In addition to this interconnection, there are also other logical reasons for adopting shock therapy as a method of transformation.

First, in order to signal a complete break with the old regime and establish credibility, the reforming government must make a drastic gesture. Gradualism translates into capitulation to the old structures of economic management.

Second, the economic situation in the former Soviet Union is so maladjusted that only a radical and systemic restructuring will get the economy on the path to prosperity. Just as the heroine addict must go through cold-turkey in order to cure his addiction, the malformed economy of the former Soviet Union must go through a similar process of healing. The bloated bureaucracy and the inefficient enterprises must be subjected to harsh economic realities which will provide incentives to adjust the social structure in a manner more consistent with the demands of the public. Capital resources are both heterogeneous and specific to certain production processes. Military plants cannot be turned into beer barrel plants overnight. Capital must be created and reallocated. This kind of realignment of the structure of production in society takes a drastic introduction of market forces.

Moreover, it must be recognized that extensive public welfare must be financed through a sustainable economic base. The public sector lives parasitically off the private sector through its power to tax. Without a developed economic base, extensive public services will simply thwart economic progress, and drain the productive energy of the private sector. Shock therapy represents the decision to get on the highway of high growth. A decision to exit for equity may be made later, but for the present it is necessary to stay on this road.

As I said earlier, the situation in the former Soviet economy is one where labor is misallocated, capital is misallocated and consumers are ignored. The only way to change this situation is through a drastic and complete introduction of market forces.[60] This requires that transition policy:

a. abolish enterprise subsidies and allow the liquidation of unprofitable enterprises;
b. eliminate government's ability to engage in inflationary practices;
c. eliminate all wage and price controls;
d. refrain from attempts to stimulate consumption;
e. abolish unemployment subsidies.

The most important thing government can do is not to interfere in the adjustment process, and to establish binding constraints on its activities so that future maladjustments are not generated by public policy choices. Rather than a cruel punishment, shock therapy is the only viable cure to the sickness that communism wrought.

IS DEMOCRACY NECESSARY?

The great advantage of democratic politics lies in the peaceful transition of power it engenders. Democracy, however, unless constrained, can lead to the tyranny of the majority over the minority. Liberalism is a theoretical doctrine which suggests what the law should be, democracy is simply a theoretical doctrine concerning the method by which law will be determined in a society.[61] Democratic politics may generate laws consistent with liberal values, but it also may not. The precondition for unleashing the competitive discovery procedures in economic and political life advocated above is a framework of law consistent with liberalism independent of the establishment of democracy. In other words, democracy is neither a necessary nor sufficient condition for establishing the liberal order.

The extension of democratic methods into areas where it is unwarranted can generate not only gross inefficiencies, but also illiberal public policy. There is a definite limit to the kind of questions that democratic politics can answer. The inability to arrive at a consensus concerning the use of the coercive powers of the state should mean that nobody has the right to exercise those powers. The power of the majority must ultimately derive from, and be limited by,

the principles of conduct which the minority also accepts. Democracy is simply a means and not an end, and as such it must be constrained by the end for which it is to serve.

CONCLUSION

Conceptually the road from serfdom is not that difficult to figure out. Socialism failed because of its structural weaknesses. It could not generate the incentives and information necessary for economic progress. What is needed, therefore, to get the former socialist economy on the path of economic progress is to introduce as fast as possible the institutional structure which provides high-powered incentives to discover better ways of administering scarce resources. Free competitive markets provide the best institutional structure for this task.

Free markets, however, exist within a framework of liberal society. The main dynamic ingredient in a liberal society is the cultivation of experimentation with alternative social arrangements. Competition truly is the spice of life.

See Rodrik, 'Promises, promises: credible policy reform via signalling,' *Economic Journal*, 99 (September 1989), [illegible]

7 CHARTING A NEW COURSE

1 Robert Kaiser, *Why Gorbachev Happened?* (New York: Simon & Schuster, 1991), p. 314.

2 See Paul Craig Roberts, '"Property owners" are rising from Russia's economic rubble,' *Business Week* (13 May 1991): 16. As Roberts pointed out, though Gorbachev's reforms failed to produce results in the official sector, they unofficially succeeded by spurring the emergence of a *de facto* propertied class within whose hands the economic future of Russia rests.

3 See, for example, Jean Baechler, *The Origin of Capitalism* (Oxford: Blackwell, 1975), and Harold Berman, *Law and Revolution* (Cambridge: Harvard University Press, 1983). Also see Fernand Braudel, *Civilization and Capitalism*, 3 vols (New York: Harper & Row, 1982).

4 See Ludwig von Mises's discussion of the basis of human society in *Human Action: A Treatise on Economics*, 3rd rev. edn (Chicago: Henry Regnery, 1966), pp. 143–76. Also see Henry Hazlitt, *Foundations of Morality* (Los Angeles: Nash Publishing, 1972), and Murray Rothbard, *Man, Economy and State*, vol. 1 (Los Angeles: Nash Publishing, 1970), pp. 85–6.

5 The classic paper on this aspect of competition is Charles Tiebout, 'A pure theory of local expenditures,' *Journal of Political Economy* (October [illegible]), reprinted in Tyler Cowen (ed.) *The Theory of Market Failure* (Fairfax, VA: George Mason University Press, 1988), pp. [illegible]. Also see David Friedman, 'An economic theory of the size and shape of nations,' *Journal of Political Economy*, 85 (February 1977): 59–77.

6 See Bruno Leoni, *Freedom and the Law* (Los Angeles: Nash Publishing, 1972), p. 177.

7 Leoni makes the compelling argument that the problem of economic calculation under socialism is simply one case of the more general problem confronting complex human interaction; the discovery and use of knowledge that is dispersed throughout the society in order to accommodate the constantly changing conditions of human life. Leoni contrasts the evolution of judge-made common law which emerges out of an historical process with legislative law and argues that legislative law is vulnerable to the same problems that socialism confronts. See Leoni, *Freedom and the Law*, pp. 18–19, 90–1 (see Note 6). This is also a theme repeated forcefully in Hayek's writings. Also see the discussion in Bruce Benson, *The Enterprise of Law* (San Francisco: Pacific Research Institute for Public Policy, 1990), chaps 2–7, for a contrast between customary legal systems and authoritarian law. Chapters 4–7, in particular, discuss the public choice dimensions of authoritarian law under representative democracy. For a discussion of the contradictions of democracy see Murray Rothbard, *Power and Market* (Kansas City: Sheed Andrews and McMeel, 1977(1970)), pp. 189–99.

8 See Don Herzog, *Without Foundations* (Ithaca, NY: Cornell University

Press, 1985) for a criticism of foundationalist justifications of political theory found in Hobbes, Locke and the utilitarians, and an argument for the adoption of the contextual justification for political theory found in David Hume and Adam Smith.

9 See John Locke, *Two Treatises on Government* (New York: Cambridge University Press, 1991(1690)) and Robert Nozick, *Anarchy, State and Utopia* (New York: Basic Books, 1974).

10 See Thomas Hobbes, *Leviathan* (New York: Collier Books, 1962(1651)) and James Buchanan, *The Limits of Liberty* (Chicago: University of Chicago Press, 1975). Also see John Rawls, *A Theory of Justice* (Cambridge: Harvard University Press, 1971).

11 See Israel Kirzner, *Competition and Entrepreneurship* (Chicago: University of Chicago Press, 1973) for a discussion of the limits of equilibrium as opposed to market process theory in exploring the properties of competitive markets.

12 See James Buchanan, 'Ethical rules, expected values and large numbers,' *Ethics* (October 1965), reprinted in *Freedom in Constitutional Contract* (College Station: Texas A&M Press, 1977), pp. 151–68.

13 Ironically, it is also the case that if in the Hobbesian state of anarchy individuals could come voluntarily to agree to form a social compact and establish a government, then there would be no need to form a government since voluntary action could solve the public goods problem. Either government represents the ultimate public good and therefore cannot emerge out of the voluntary actions of individuals within the Hobbesian jungle, or it can be established through agreement and therefore is not necessary. See Joseph Kalt, 'Public goods and the theory of government,' *Cato Journal*, 1 (Fall 1981), [illegible]

14 See, for example, Hobbes's discussion of language and science in *Leviathan*, part 1, chaps 4–5. For a criticism of conventionalist views of social institutions, and money and language in particular, see Steve Horwitz, *Monetary Evolution, Free Banking and Economic Order* (Boulder, CO: Westview Press, 1992).

15 While rule-making may be the product of rational design, the processes of rule selection are spontaneous. Thus, in principle rule constructivism is not as flawed an approach to social theory as the preceding paragraphs may suggest. The problem with the approach, however, is that it does not pay sufficient attention to the evolutionary feedback mechanism in rule selection. The approach I advocate to discuss the first principles of the liberal order seeks to explore both the reason of rules and the evolutionary processes by which rules are selected over time.

16 See David Hume, *A Treatise on Human Nature* (Oxford: Oxford University Press, 1978(1740)), Book III, and Hume, *Essays Moral, Political and Literary* (Indianapolis: Liberty Classics, 1985), and F. A. Hayek, *The Constitution of Liberty* (Chicago: University of Chicago Press, 1960), *Law, Legislation and Liberty*, 3 vols (Chicago: University of Chicago Press, 1973, 1976, 1979), and *The Fatal Conceit* (Chicago: University of Chicago Press, 1988).

17 Hume argues that it cannot be denied that combinations of men were founded on a contract, but that this contract 'was not written on

parchment, nor yet on leaves or barks of trees. It preceded the use of writing and all the other civilized arts of life. But we trace it plainly in the nature of man, and *in the equality*, or something approaching equality, which we find in all the individuals of that species. . . . Nothing but their own consent, and their sense of the advantages resulting from peace and order, could have had that influence.' Hume, 'Of the original contract,' in *Essays*, p. 468 (see Note 16).

18 Israel Kirzner, *Discovery, Capitalism and Distributive Justice* (Oxford: Basil Blackwell, 1989) argues that standard ethical assessments of capitalism have failed not because of flaws in the ethical arguments themselves, but because they misperceive the nature of market processes; namely, the discovery function of market competition. The lure of pure profit sets in motion an entrepreneurial discovery procedure in which individuals tend to learn how to arrange resources in a more effective manner to satisfy the demands of others. Private property is an essential precondition for the learning process of competition to be enacted.

19 Hayek argues that:

> Activities in which we are guided by a knowledge merely of the principle of the thing should perhaps better be described by the term *cultivation* than by the familiar term 'control' – cultivation in the sense in which the farmer or gardener cultivates his plants, where he knows and can control only some of the determining circumstances, and in which the wise legislature or *statesman* will probably attempt to cultivate rather than control the forces of the social process.

Hayek, 'Degrees of explanation,' *British Journal for the Philosophy of Science* (1955), reprinted in *Studies in Philosophy, Politics and Economics* (Chicago: University of Chicago Press, 1967), p. 19.

20 'Life in a pluralistic liberal society,' Stephen Macedo writes, 'is a smorgasbord confronting us with an exciting array of possibilities. Society is open to change and diversity: less of a stigma attaches to unconventional lifestyles and to changes in lifestyle. The combination of diversity and openness to change constitutes an incitement to self-examination and invitation to experiment.' But as Macedo further points out:

> If all the world became liberal, all the world would become the same in certain important respects. Individuality, constrained by liberal norms, would flourish everywhere, but the diversity of forms of political organization would be eliminated, the differences between forms of social life would be reduced, and every sphere of social life would bear the peculiar tint of liberal values. It would be wrong to identify the spread of liberalism with the maximization of diversity or the liberation of unlimited experimentation: liberal norms rule out many experiments in social organization, require a common subscription to liberal rights, and encourage a uniformity of tolerance, openness, and broad-mindedness. If the spread of liberalism eliminates certain forms of diversity, it also extends the liberal community and liberal peace.

See Macedo, *Liberal Virtues* (Oxford: Oxford University Press, 1990), pp. 278–9.

21 'It must be remembered,' Richard Ericson points out, 'that the ultimate configuration of institutions and interactions is unknowable, a largely unintended consequence of the growth of decentralized agent interaction. Thus, a final lesson for successful reform taught by the nature of the traditional Soviet-style system is to abandon the Faustian urge to control, to know in advance, and thus to allow economic outcomes to arise naturally as the unpredictable consequences of market interaction.' See Ericson, 'The classical Soviet-type economy: nature of the system and implications for reform,' *Journal of Economic Perspectives*, 5 (4) (Fall 1991): 26.

22 James Madison, *The Federalist Papers* (New York: New American Library, 1961), p. 322.

23 The public goods problem exists, for example, because in situations where goods are characterized by (1) jointness in consumption and (2) non-excludability of non-payers, firms in private markets cannot survive and provide the service. However, the very existence of these problems may entice entrepreneurs to discover new technologies in order to overcome these problems and successfully enter the particular market in question. Some computer software programs, for example, contain 'worms' so that successful copying of the program is precluded. Shopping malls and condominiums are examples of the use of tie-in arrangements for the private provision of public goods. Shopping malls provide streets and security that are paid for by the provision of private goods such as clothing, food and other items sold in the mall. For a discussion of these issues see Dan Klein, 'Tie-ins and the market provision of collective goods,' *Harvard Journal of Law and Public Policy*, 10 (Spring 1987): 451–74. See also David Schmidtz, *The Limits of Government: An Essay on the Public Goods Argument* (Boulder, CO: Westview Press, 1991), for a general examination of the public goods problem.

24 For a collection of articles of both traditional market failure theory and its critics see Tyler Cowen (ed.) *The Theory of Market Failure* (see Note 5).

25 See James Buchanan, *Cost and Choice* (Chicago: University of Chicago Press, 1969).

26 It must always be kept in mind that political choices are not among alternative distributions, but rather among alternative institutional arrangements that generate patterns of distribution and allocation. See Rutledge Vining, 'On two foundation concepts of the theory of political economy,' *Journal of Political Economy*, 77 (1969): 199–218. Also see Vining, *On Appraising the Performance of an Economic System* (New York: Cambridge University Press, 1984).

27 See F. A. Hayek, *Law, Legislation and Liberty*, 3: 41–64 (see Note 16).

28 F. A. Hayek, *Law, Legislation and Liberty*, 3: 75 (see Note 16).

29 For a discussion of some of the issues involved with this proposition see Christos Pitelis and Ioanna Giykoy-Pitelis, 'On the possibility of state neutrality,' *Review of Political Economy*, 3 (1) (1991): 15–24. For the argument with regard to monetary policy see Ludwig von Mises, 'The non-neutrality of money (1938), in Richard Ebeling (ed.) *Money, Method*

and the Market Process: Essay by Ludwig von Mises (Boston: Kluwer, 1990), pp. 69–77, and with regard to fiscal policy see Murray Rothbard, 'The myth of neutral taxation,' *Cato Journal*, 1 (2) (Fall 1981): 519–64.

30 These issues are discussed in Roger Garrison, 'Time and money: the universals of macroeconomic theorizing,' *Journal of Macroeconomics*, 6 (2) (Spring 1984): 197–213.

31 See Heidi Kroll, 'Monopoly and transition to the market,' *Soviet Economy*, 7 (2) (April–June 1991): 144–5. Also see *The Economist* (11 August 1990): 67.

32 See Heidi Kroll, 'Reform and monopoly in the Soviet economy,' Briefing Paper no. 4, Center for Foreign Policy Development, Brown University (September 1990), p. 7.

33 See Stephen Kotkin, *Steeltown, USSR* (Berkeley, CA: University of California Press, 1991).

34 See Kontkin, *Steeltown, USSR*, p. 17 (see Note 33).

35 See Bill Keller's discussion of the Uralmash Machine Tool Works. This article highlights persistence of interlocking monopolies and near-total reliance on centralized decision-making that characterized the industrial structure of the supposedly reformed Soviet economy under Gorbachev. Keller, 'Industrial colossus typifies the miseries of the Soviet economy,' *New York Times* (6 January 1991): 8.

36 See Ronald McKinnon, *The Order of Economic Liberalization* (Baltimore: Johns Hopkins University Press, 1991), pp. 162–86, for a discussion of the phenomenon of negative value-added firms. McKinnon's conclusions, however, about adopting a cautious trade policy until privatization is accomplished do not necessarily follow from his analysis of the distinction between firms that just make losses and firms that are value subtractors. See the discussion in *The Economist* [illegible] in response by Jeffrey Sachs, *The Economist* (19 January 1991): 61.

37 See Judy Shelton, *The Coming Soviet Crash* (New York: Free Press, 1989): chaps 1–3. Also see Gur Ofer, 'Budget deficit, market disequilibrium, and economic reforms,' *Soviet Economy*, 5 (1989): 107–61, reprinted in Ed Hewett and Victor Winston (ed.) *Milestones in Glasnost and Perestroyka: The Economy* (Washington, DC: Brookings Institution, 1991), pp. 263–307. Ofer, for example, reports that *PlanEcon* estimates that in 1988 the Soviet government ran a budget deficit of around 98.7 billion roubles or about 11 per cent of GDP. Shelton, building on the work of Soviet emigrant economist Igor Birman, challenges Soviet budget records pointing out that there is a gap between claimed revenue and identified sources of revenue in the budget revenue numbers in 1987, for example, of around 146.4 billion roubles. This gap, she points out, is persistent from 1970 on and ranges from a 20 per cent gap in 1970 to a 36 per cent gap in 1987. Shelton concludes that the internal budget mess in the Soviet Union was quite severe even before Gorbachev.

38 See Richard Wagner, 'Economic manipulation for political profit: macroeconomic consequences and constitutional implications,' *Kyklos*, 30 (1977): 395–410; 'Boom and bust: the political economy of economic disorder,' *Journal of Libertarian Studies*, 4 (Winter 1980): 1–37; and 'Politics, central banking and economic order,' *Critical Review*, 3 (Summer/Fall 1989): 505–17. Also see Lawrence H. White, 'Problems inherent in political money supply regimes,' in *Competition and Currency* (New York: New York University Press, 1989), pp. 70–90.

39 See, for example, Tadeusz Kowalik, 'The costs of "shock therapy",' *Dissent* (Fall 1991): 497–504. Also see Valtr Komarek, 'Shock therapy and its victims,' *New York Times* (5 January 1992): section 4, 13.

40 See Michael Alexeev, 'Are Soviet consumers forced to save?,' *Comparative Economic Studies*, 30 (1988): 17–23.

41 For a discussion of why this dichotomy between monopoly price and competitive prices is analytically questionable see Rothbard, *Man, Economy and State*, pp. 560–660 (see Note 4). As Rothbard points out all we can really observe in a market economy is the difference between government established prices and market established prices. We do not have the *knowledge* to ascertain what the competitive price would be in comparison to some monopoly price.

42 This is the basic difference between the Pole and the Czech reforms. The Poles argued that price liberalization must be immediate to introduce market discipline and that privatization could come later. The Czechs, on the other hand, argued that this Polish strategy represented a 'reform trap' and that privatization must precede price liberalization.

43 See David Willis, *Klass* (New York: Avon Books, 1985) for a discussion of status, rank and privilege inside the Soviet Union prior to Gorbachev. Also see the classic studies by Milovan Djilas, *The New Class* (New York: Praeger Publishers, 1957) and Michael Voslensky, *Nomenklatura* (New York: Doubleday, 1984).

44 On the inability to recapture past losses from distorting government policies see Robert Tollison and Richard Wagner, 'Romance, realism, and economic reform,' *Kyklos*, 44 (1991): 57–70. On the political problems of redressing past wrongs consider the troublesome situation with the Czechs or Germans concerning the discoveries of ex-informers to the secret police of the Communist government. While historical understanding is a precondition for the awakening of civil society, endless debates about the compensation due to this or that group for past wrongs can tear the embryonic social fabric apart. One of the most important lessons of economics is that sunk costs are sunk, let bygones be bygones. One cannot influence the past, decisions must be focused on the future. Therefore, past imperfects inform the institutional rules that one may find desirable for future social interaction, but we cannot correct the past no matter how horrible it may have been.

45 This will also curb the monopolistic tendency of the domestic market by expanding the relevant market and, thus, expanding the availability of substitutes.

46 See Ronald McKinnon, *The Order of Economic Liberalization*, pp. 120–61 (see Note 36). On monetary reform also see Josef Brada, Vladimir Popov, Marie Lavigne, *et al.*, 'A phased plan for making the ruble convertible,' in Josef Brada and Michael Claudon (ed.) *Reforming the Ruble* (New York: New York University Press, 1990), pp. 93–131.

47 Steve Hanke and Kurt Schuler, 'Ruble reform,' *Cato Journal*, 10 (Winter 1991): 655–66. Also see Robert Hetzel, 'Free enterprise and central

banking in formerly communist countries,' *Economic Review of the Federal Reserve Bank of Richmond* (May/June 1990): 13-19. As Hetzel points out

> A market economy . . . is not established by a one-time reform. It requires a lasting commitment to limiting the role of government in economic activity. The existence of a central bank provides a continuing incentive for politicians under pressure to confuse money creation with wealth creation. The resulting inflation then leads to myriad interventions in the economy in the form of wage, price, interest rate, exchange market, and capital controls. Eliminating the central bank is one way of committing to a limited role for the state (p. 19).

48 Abba Hetzel, 'Free enterprise and central banking in the formerly communist countries,' p. 19, fn. 4 (see Note 47).

49 See the discussion of free banking theory in White, *Competition and Currency*, and George Selgin, *The Theory of Free Banking* (Totowa, NJ: Rowman and Littlefield, 1988). For an historical discussion of the operation of a free banking system see Lawrence White, *Free Banking in Britain: Theory, Experience and Debate, 1800-1845* (New York: Cambridge University Press, 1984). A key episode in White's discussion is how the banking system handled the Ayr Bank failure of 1772. As White points out, the Ayr Bank, which was in operation from 1769 to 1772, engaged in reckless management and extended a great deal of bad credit through note issue. The bank's failure also led to the failure of eight other private bankers, but it did not threaten the financial system as a whole. The note exchange system that emerged in the Scottish system served as an important check against over-issuance by a single bank and provided market incentives to discipline those that attempted to engage in over-issue of its notes through the law of reflux. White, *Free Banking in Britain*, pp. 30-2, 126-8.

50 For a discussion of this problem with central banking see Selgin, *The Theory of Free Banking*, pp. 89-107 (see Note 49).

51 However, see the report in *The Economist* (29 February 1992): 78-9 on the surprising rise in the rouble since mid-January 1992. Since the January price liberalization, the rouble rose from 110 to the dollar to 70.

52 See, for example, Annelise Anderson, 'Monetary competition and monetary stability in the transition from plan to market,' in James Dorn and Larisa Piyasheva (eds) *From Plan to Market: The Post-Soviet Challenge* (Washington, DC: Cato Institute, forthcoming).

53 See Lerner, *The Economics of Control* (New York: Macmillan, 1944), pp. 302-22. Also see Lerner, 'Functional finance and the federal debt,' *Social Research* (February 1943): 38-51, and 'The economic steering wheel,' *The University Review* (June 1941): 2-8. For a criticism from the perspective of the political incentives functional finance engenders see James Buchanan and Richard Wagner, *Democracy in Deficit* (New York: Academic Press, 1977).

54 For a discussion of the analytical problems with the notion of public goods see Rothbard, *Man, Economy and State*, pp. 883-90 (see Note 4). Also see Tyler Cowen, 'A public goods definition and their institutional context: a critique of public goods theory,' *Review of Social Economy*, 43 (April 1985): 53-63.

55 This argument is developed in Richard McKenzie and Dwight Lee, *Quicksilver Capital* (New York: Free Press, 1991).

56 This idea was directly challenged by Marxists. In the Marxist analysis of capitalism the logic of the system led to increasing monopolization. Since capitalism suffered from internal contradictions, monopoly capitalists would merge with the state to prop up their enterprises. These state monopoly capitalists would then seek to expand their market internationally and the competition between the various imperialistic state monopoly capitalists would breed war. This is how Lenin, for example, sized up the situation of the First World War. Socialism was the only logical leap to take. See Lenin, *Imperialism, The Highest State of Capitalism* (1916), in *Collected Works*, vol. 22 (Moscow: Progress Publishers, 1977), pp. 185-304.

57 Alexander Gray, *The Socialist Tradition* (New York: Harper & Row, 1968), p. 63. For a criticism of utopian reasoning from positions of moral purity see Isaiah Berlin, *The Crooked Timber of Humanity* (New York: Alfred Knopf, 1991). Berlin took the title from a quote of Immanuel Kant which reads: 'Out of timber so crooked as that from which man is made nothing entirely straight can be built.'

58 See Robert Nozick, *Anarchy, State and Utopia* (New York: Basic Books, 1974), pp. 297-334.

59 See the discussion on simultaneity in Janos Kornai, *The Road to a Free Economy* (New York: Norton, 1990), pp. 158-62.

60 This is also true for capitalist economies experiencing depressions. See Rothbard, *America's Great Depression*, 3rd edn (Kansas City: Sheed and Ward, 1975), pp. 25-9.

61 On this distinction see F. A. Hayek, *The Constitution of Liberty* (Chicago: University of Chicago Press, 1960), pp. 103-17.

8 CONCLUSION

1 F. A. Hayek, 'Individualism: true and false,' in *Individualism and Economic Order* (Chicago: University of Chicago Press, 1980(1948)), p. 32.

2 See Stephen Kinzer, 'East Germans face their accusers,' *New York Times Magazine* (12 April 1992): 24-7, 42, 50-2.

3 See 'Eastern Europe's past,' *The Economist* (21 March 1992): 24.

4 It was estimated in 1980 that 20 per cent of the Romanians over 18 years of age belong to the Communist Party, 18 per cent of East Germans, 14 per cent of Czechoslovakians, 13 per cent of Bulgarians, 12.5 per cent of Poles and 10 per cent of Hungarians.

5 Timothy Garton Ash has perhaps provided the best discussion of the intellectual and political movement behind the revolutions of 1989. See his *The Uses of Adversity* (New York: Vintage Books, 1990) and *The Magic Lantern* (New York: Random House, 1990).

6 In February 1992, however, a new blueprint for economic change was