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SUCH A BEAUTIFUL DREAM

How Russia did *not* become a Market Economy

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First Draft. Please do not quote or ridicule.

a r b e t s r a p p o r t e r
Working Papers
No. 111

ISSN 1103-3541
June 2007

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It all really was such a beautiful dream. In the wake of the fall of the Berlin Wall and the collapse of the Soviet Union, hopes were riding high that Russia would now be finally able and willing to cross that great and long-tormented divide – to secure full integration into the West. What was at stake here went far above and beyond even the dazzling hopes for a new world order that had marked the Gorbachev years, and that had resulted, in 1990, in the stunning award of a Nobel Peace Prize to the last General Secretary of the Communist Party of the Soviet Union.

The dream of the emergence of a “new” Russia entailed so much more than disarmament, friendly relations and even the potential for a new era of serious cooperation. Out from under the rubble of the crumbled Soviet edifice there would emerge a country that embraced Western liberal values. On this solid foundation, a rapid transition would be undertaken to democracy and a rules-based market economy. Francis Fukuyama’s proud pronouncement of the “end of history” may in retrospect be viewed as highly symbolic of both Western and Russian thinking at the time.¹

It was a tall order indeed. Centuries of Russian intellectual brooding over relations to Europe, over feelings of moral superiority versus technological inferiority, would now be relegated to the dustbin of history, as would decades of Soviet communist ambitions to stand up against the US and against the West in general. The apogee of this exhilarating new dream world was reached when suggestions began circulating that post-Soviet Russia might – and should – perhaps even join both NATO and the European Union.

¹ Fukuyama, Francis (1989), “The End of History?,” *The National Interest*, no. 16, summer, and Fukuyama, Francis (1992), *The End of History and the Last Man*, New York: The Free Press.

How distant this all seems today, and how easy it would be to poke fun at those who were sufficiently taken in to believe in the prospects for an instant and successful Westernization. This paper has no such ambition. On the contrary, the notion of a “dream” is used here for two very specific reasons, none of which is intended to be derogatory.

On the one hand, it is important to underline that the hopes and ambitions that made up the dream were highly laudable as such, and that the failure of the dream to come true must not be taken to mean that it was wrong *per se*. Despite the high popular approval that underpins Vladimir Putin’s increasingly authoritarian and xenophobic program, we must surely remain convinced that democracy and a rules-based market economy would still be in the best long-term interests of the Russian people.

On the other, and more importantly, given the means that were deployed by the architects of Russian reform, realizing the stated goals was never really within reach. As will be argued in the following, we are faced here with an issue that is of fundamental theoretical importance for the social sciences at large, an issue that concerns to what extent human action may be directly influenced by deliberate policy. Failure to appreciate limitations on this count may bring about serious collateral damage, as actors respond in ways very different from what was expected and as rationalizations emerge to deal with cognitive dissonance.

What went so badly missing in the at times acrimonious but on the whole rather superficial debates that surrounded the introduction of “shock therapy” and such was something that touches on the very core of what social science is, or perhaps should be about. The main fault of the Russian reformers was manifest in their failure to realize that the envisioned transition to democracy, market economy and the rule of law entailed so much more than simply rewriting the formal rules of the game. Behind the catchy slogan of “systemic change” lurked a project that entailed fundamental societal transformation. For that project to be successful, the architects of radical reform would have needed to achieve not only a rewrite of the formal rules of the game, but even more so a simultaneous reorientation of such norms and values that support the formal rules.

To phrase the challenge more specifically, a successful reform would have needed to aim for a transformation of *subjects*, who for generations had seen no reason to place any form of trust in the state or in public bodies, into *citizens*, who would be ready to abandon the ingrained practice of informal networking and to believe instead in the ability and willingness of the state to uphold contracts, to guarantee the sanctity of property rights, and to accept being held accountable in front of the electorate.²

Looked upon from this point of view, it at once transpires that the project of constructing a post-Soviet Russia was tantamount to aiming for a broad mental redescription, where the citizens *in spe* of “new” Russia would be required to evolve, more or less overnight, a whole new set of beliefs, values and norms. The latter, moreover, would have to be commensurate with the new, and to many frighteningly foreign, rules and organizations that were in the process of being introduced by ways of “shock therapy.”

Systemic change thus may be said to have entailed a dual challenge. While for Russia and the Russians it meant having to cast off a several centuries old cultural heritage, which had revolved around a state that accepted none of the responsibilities just mentioned, for the social sciences it meant setting out to achieve, by direct action, mental transformations that can only arise as byproducts of other action. It was, in short, an eminent example of what Jon Elster has referred to as the *moral fallacy* of seeking to achieve what cannot be achieved.³

In the following, we shall start by looking briefly at what it was that the dream of rapid and successful transition entailed. We shall look at some evidence on the outcome, and we shall seek to identify what the real problem was that *should* have been addressed by the architects of reform. Following these preparatory steps, we shall proceed to look at Russia’s historical and

² The alternative chosen by many of the Russian reformers was to simply deny the relevance of the issues that are raised here. If all cultures and all peoples are indeed the same, then it must follow that one set of policy prescriptions will have the same applicability and yield the same results in all thinkable social and cultural contexts.

³ Elster, Jon (1983), *Sour Grapes: Studies in the Subversion of Rationality*, Cambridge: Cambridge University Press, p. 43.

cultural heritage, seeking to pinpoint in which dimensions the main obstacles to reform were to be found, and we shall conclude with a discussion of the implications, both for Russia and for the social sciences, of the reformers' failure to identify and address the real challenges that were placed before them.

The Dream

For those who feel that likening the ambitions of Russia's post-Soviet transition to a "dream" is somewhat below normal scholarly standards, denying that Russia has become a market economy may seem to take us even further off the beaten path of serious scholarship. Yet, as we shall now proceed to argue, the two are connected, in a way that may help explain both the failure to deploy a proper policy and the failure to realize that the outcome has turned out so very differently from what was expected.

The connection in question proceeds via a set of firmly entrenched beliefs in economics, holding that since economic men are instrumentally rational and forward looking, matters of history and culture may be safely disregarded. As repeated *ad nauseam* by Russian reformers and their foreign advisors at the time, the mainstay of the since so vilified "Washington Consensus"⁴ was that from an economic policy point of view all countries and all cultures are the same and that the laws of economics are equally applicable everywhere, irrespective of cultural and historical specificity.

This warped belief system not only caused the reformers to fail to see the analytical connection between the introduction of a new set of rules and the promotion of such norms that will provide relevant actors with sufficient

⁴ This notion was originally coined by John Williamson, in order to capture the type of advice that was being offered by the World Bank and the IMF in support of economic reforms in Latin America in the late 1980s. (Williamson, John (ed.)(1990), *Latin American Adjustment: How Much has Happened?*, Washington, DC: Institute for International Economics.) Subsequently, it would become something of a household expression in discussions of reforms in the Former Soviet Union – used appreciatively at first, and then increasingly as a slur. (See also Williamson, John (1993), "Democracy and the 'Washington Consensus,'" *World Development*, vol. 21, no. 8.)

motivation to abide by the new rules. As a corollary, it has also caused many to remain blind to the fact that what we are presently witnessing cannot, from a theoretical point of view, be reasonably labeled as “market economy.”

There were two good reasons why the ambition to construct a functioning market economy must be placed at center stage of the more general Russian reform effort. The first and most intuitive goes back to the rather commonly held belief that functioning market economy is a prerequisite for building democracy. While this belief has not been proven, the empirical evidence is overwhelming. The number of command economies that are also democracies comes down to zero. The ambition to transform Soviet central planning into market economy could thus be rightly viewed as a *sine qua non* for overall success.

Accepting this conclusion, our second and more fundamental reason for placing the economy in focus relates to what was just said about the general belief system of those who were placed in charge of planning and implementing the “transition.” In retrospect, one is struck by the rather casual attitude with which the project was approached. While some did experience worry over the potentially violent scenarios that were involved in the Gaidar government’s vulgar rhetoric about being a “kamikaze government,” few indeed seem to have doubted in earnest that dismantling the command structures of the Soviet economy would serve to establish market economy.

The reason for this was very simple, and relates back to the fact that standard neoclassical economic theory provides no grounds on which to expect that abolishing central planning could lead to hyperdepression and to a set of seriously warped property rights.⁵ Given all that was known, or that was thought to be known, about the gross inefficiencies and malfunctions of central planning, it seemed to be a forgone conclusion that deregulation and privatization would

⁵ The more general failure of the Russian reformers to consider the insights of basic economic theory has been castigated at length by Nobel Prize laureate and former World Bank Chief Economist Joseph Stiglitz. Arguing that the reformers had committed the double sin of failing to appreciate both basic economics and the special conditions of the transition, he applies to them the derogatory label of “market Bolsheviks.” (Stiglitz, Joseph E. (1999), “Whither Reform? Ten Years of the Transition,” available on http://www.worldbank.org/research/abcde/washington_11/pdfs/stiglitz.pdf.) Importantly, however, his critique was fielded only after the crash of 1998, and his own account on what should have been done is rather thin.

simply have to produce sure efficiency gains.⁶ Transitory problems and short-term dislocations might certainly appear, but eventual success could not be called into doubt.

Given this initial belief structure, it was to be expected that early indications of things going seriously wrong would be met by a series of attempted rationalizations. The rapid collapse of GDP would be presented as a statistical illusion, holding that Soviet GDP had been inflated and could thus not be used as a benchmark. It was held that since the output of Soviet industry had been of little or no value, the much lower output of Russian industry in reality represented an improvement. And so it was that an unfolding hyperdepression, causing Russian GDP to be cut almost in half over the years 1991-98, could be spun into a success. For many it would not be until the August 1998 financial crash that the dream suddenly burst and morphed into a nightmare, to the tune of billions of dollars in financial losses.⁷

Lodged at the very core of the belief in sure efficiency gains was a clearly pronounced belief in the superiority of private property. Here the casual attitude was even more explicit. It was somehow symptomatic that the indicator of success with respect to the program of mass privatization would be not improved performance in production, but rather the percentage share of formerly state owned companies that had been privatized.

Again we must resist the temptation of scoring simple debating points. It would be all-too easy to argue that the best way to score success, according to criteria such as these, would have been to simply give everything away overnight. There may be a bit more substance in the argument that nobody has ever founded a large corporation, and that the excessive focus on *privatizing* state owned enterprises would have to produce substantial collateral damage in

⁶ See further Roland, Gérard (2000), *Transition and Economics: Politics, Markets, and Firms*, Cambridge, MA: MIT Press, ch. 15.

⁷ When the ruble was allowed to float and the financial markets collapsed, the volume of ruble-denominated short-term treasury bills – the GKO's – alone was worth \$40 billion, to which could be added a host of other forms of government and commercial debt. The main Russian insiders would walk away from this disaster with comparatively minor losses, leaving the brunt of the burden for foreign investors, and for the Russian general public.

terms of discrimination against such small *private* businesses that could have been formed to vitalize the economy from below.

Far more important than any of this, however, was the fact that the largely ideological conviction of the supremacy of private property was combined with a misreading of what economic theory has to say about the distribution of property rights. In a classic article from 1960, Ronald Coase argued that the initial distribution of rights to assets does not matter, for the simple reason that recontracting will take place until there are no possible deals left that will make at least one party better off, without making anyone else worse off. An efficient solution will thus be guaranteed.⁸ Much later on, this argument would come to be known as the “Coase Theorem.”⁹

As it was becoming increasingly obvious that the “privatization” of Russia’s “crown jewels” in oil, gas and minerals was being transformed into a cabal of looting by well placed insiders,¹⁰ it also seemed as though many of those who could and should have understood what was brewing had misunderstood what the “theorem” said,¹¹ much as they had misunderstood Adam Smith and his “invisible hand.” Grossly misleading parallels to the experience of the nineteenth century American Robber Barons served to compound the confusion. We shall have reason to return to these rather fundamental points at greater length below.

Here we shall merely note that what many Russians referred to as *prikhvatizatsiya* would produce an outcome that was far removed indeed from the initial beliefs in the creation of a high-performance rules-based economy that would provide fertile ground for the emergence of a middle class, and thus for sustainable democracy. Perhaps the most important aspect of collateral damage

⁸ Coase, Ronald H. (1960), “The Problem of Social Cost,” *Journal of Law and Economics*, vol. 3, no. 1. It is important to note that the argument relates to efficiency only, not to fairness.

⁹ It was not Coase himself but rather the Chicago economist George Stigler who formulated the “theorem” (Stigler, George J. (1989), “Two Notes on the Coase Theorem,” *Yale Law Journal*, vol. 99, no. 3).

¹⁰ Goldman, Marshall (2003), *Pirating Russia: Russian Reform Goes Awry*, London: Routledge.

¹¹ It is interesting to note that in his ceremonial lecture accepting the Nobel Prize, Coase noted that he was in agreement with Stigler about the theoretical stringency of the theorem, but that he doubted its practical relevance: “Its logic cannot be questioned, only its domain. I do not disagree with Stigler. However, I tend to regard the Coase Theorem as a stepping stone on the way to an analysis of an economy with positive transaction costs.” (Coase, Ronald H. (1992), “The Institutional Structure of Production,” *American Economic Review*, vol. 82, no. 4, p. 717.)

caused by the bonanza of plunder was the effective destruction of the state as an impartial third party enforcer. The associated absence of institutions to support the sanctity of contracts and property rights constitutes the main reason to maintain that Russia has not succeeded in building a functioning market economy.

By far the most long-lived part of the dream of a “new” Russia was that of global integration, of a Russian economy that in contrast to its Soviet predecessor would become increasingly diversified and thus less reliant on raw materials exports. The outcome would be increased value added and an increased demand both for human capital and for a sophisticated supporting institutional infrastructure, all of which is often referred to as “climbing the quality ladder.” Due to creative accounting, the mirage of this actually being about to unfold could be upheld throughout most of Putin’s first term as president.

In its *Russian Economic Report* from February 2004 the World Bank expressed great surprise that according to the Goskomstat, oil and gas could be said to account for merely nine percent of GDP (with a presumably vibrant service sector contributing 60 percent), while the same official numbers claimed that oil and gas exports accounted for no less than 20 percent of GDP.¹²

The simple answer to this puzzle was that for reasons of tax avoidance/evasion, Russian oil companies were using elaborate transfer pricing schemes to shift revenues out of their core businesses and into trading companies that in some instances were quite nebulous. While this made life harder for the tax man, it also gravely distorted the image of where Russian GDP is being produced.

Setting out to correct for such distortion, the World Bank analysts began by noting that while trade and transport margins for oil and gas in the Netherlands and the UK are zero, in Russia the former stands at 35 percent and the latter at 63 percent. With these bogus margins reassigned to their proper source of origin, it at once transpired that energy accounted for 25 percent of

¹² World Bank (2004), *Russian Economic Report*, no. 7, at www.worldbank.org.ru.

Russia's GDP,¹³ and this still did not take into account that much energy is sold domestically at prices below the world market level.

The whole issue of pending Russian membership in the WTO must be viewed against precisely this background. The real benefit of trade to modern economies comes not from having access to sisal and bananas but from intra-industry trade that introduces fierce competition between producers within the same industry. Based on recent Russian investment performance, it looks as though the pattern will remain one of trading oil and metals for computers and other manufactured goods. Not a happy prospectus.

The Evidence

While all of the above provides unquestionable evidence of how Russian progress towards a rules-based market economy has been accompanied by rationalization, obfuscation and sundry statistical distortion of facts, this still does not provide support for our contention that Russia has failed to "become" a market economy.¹⁴ On the contrary, for reasons of high politics as well as more down to earth trade policy, the European Union and the US Treasury have both officially recognized the goal to have been achieved, thus removing the possibility of resorting to such anti-dumping measures that may be used against non-market economies.

Admissions have certainly been made, that the creation may have both warts and wrinkles. Even under the successful stewardship of Vladimir Putin, the

¹³ What the World Bank analysts failed to note was that their job with Russian input-output tables had already been performed and presented by the Japanese scholar Masaki Kuboniwa. ("Hollowing out Industrial Production and Enlargement of Trade Sector in Russia's Marketization," paper presented to the AAASSS Annual Convention, Pittsburgh, PA, November 21-24, 2002.) Credit should be given where credit is due.

¹⁴ It is interesting to note how heavily the rhetoric of reform has been geared into usage of medical and psychological metaphors. Before it was incorporated into the economic jargon, "shock therapy" referred to electro-convulsive treatment of psychological disorders. Similarly, serious problems of reform implementation would be described in unsavory terms of extracting teeth, sawing off legs and turning aquaria into fish soup, none of which has any obvious relevance to the matter at hand. One also wonders what kind of drugs or therapy must be administered for a patient to "become a market economy." It all is rather strange.

Russian economy has aspects that seemingly need to be rationalized and placed into context. A prime example of the latter could be found in *Foreign Affairs*, in the spring of 2004, when Andrei Shleifer and Daniel Treisman suggested that Russia had quite simply become a “normal country,” with all the faults and problems that beset “normal” middle income countries.¹⁵

Attempted spin aside, the main case in favor of the success story has been that of macroeconomic performance. Over the years from 2000, when Putin was elected president, the Russian economy has been growing at a steady 6-7 percent annual clip. Compared to the hyperdepression of the Yeltsin years, this does represent an achievement and the consequences have not been hard to detect. Real incomes have risen, and with the federal budget showing healthy surpluses, previous problems with payment arrears have largely ceased.

By far the most important impact of the spike in hydrocarbon prices has been noted in the dimension of government debt. In the wake of the 1998 financial meltdown, Russia’s position was so precarious that many anticipated sovereign default and perhaps a total social collapse, however that might be defined. In the spring of 1999, one Western banker could sum up the general mood on the financial markets in the following rather poignant way: “After this, Western investors would rather eat nuclear waste than buy Russian debt.”¹⁶

The nature of the transformation was captured by a writer in *The Economist*, very much line with the style of that important business journal. Having long aspired to become a member of the “G7” club of the world’s wealthiest nations, Moscow now faced a risk of being relegated to a “P7” club of financial pariahs, where it would have joined the ranks of countries like Sudan, Liberia, Congo and Somalia, “poor, war-ridden places, some barely existing as

¹⁵ Shleifer, Andrei and Daniel Treisman (2004), “A Normal Country,” *Foreign Affairs*, March/April 2004. It is interesting to view how deceptively the notion of “normality” is used here, to suggest that Russia really is not all that different from other “normal” countries. An opposite interpretation might be that Russia under Putin has indeed become “normal,” only now defined according to what has represented “normality” in Russian tradition over the past few centuries. For a counter-argument, see Rosefielde, Steven (2005), “Russia: An Abnormal Country,” *The European Journal of Comparative Economics*, vol. 2, no. 1.

¹⁶ The original statement was made by Adam Elstein of Bankers Trust in Moscow. It was soon to become immortal.

states,” which had borrowed money from the IMF and failed to repay their debts.¹⁷

Today, the situation has been transformed beyond recognition. Central Bank reserves have risen from a miserly \$12 billion at the end of 1998 to an astonishing \$370 billion by the end of April 2007. Previously controversial Russian debt to both the IMF and the Paris Club has been paid back ahead of schedule, and remaining sovereign debt represents a mere trifle, standing at the end of 2006 at no more than \$45 billion.¹⁸

While all of this represents undisputable success, there still remains good reason to question what conclusions should be drawn. Has the Russian economy really been catapulted onto a trajectory of self-sustaining growth, or is it just another case of statistical illusion?

According to official statistics, 2006 marked the time when Russian GDP had again reached the level attained *before* the onset of those reforms that so proudly had promised high growth and sure efficiency gains. If we add that Soviet growth in the 1980’s was flat, it follows that Russia may look back at a quarter century of roughly zero growth. Meanwhile, the Chinese economy has been growing at close to 10 percent per annum. No matter how this is spun, it is not something to be quietly walked away from.

Objections may certainly be heard here, along lines similar to those in the early 1990’s when the onset of hyperdepression was met by denial. Today, an important source of optimism about Russian developments is what we may refer to as pure impressionism – “I have seen wonderful things, thus the numbers must be wrong.” One problem with this attitude is that it fails to distinguish between economic growth as such, and the use of available production potential. If capital stock that was used to produce weaponry is used instead to produce luxury goods, this will produce an image of progress that is only partially true. While consumers will enjoy a better position, the military will suffer and are likely one day to want to claw back what was once “theirs.” Another and even more

¹⁷ *The Economist*, February 6, 1999, p. 21.

¹⁸ Official CBR statistics, available at www.cbr.ru.

serious problem is that allowing investment to collapse may also create an image of current prosperity, at the cost of future generations.¹⁹

The bottom line is that economic growth must be defined not as increase in consumption or even in GDP, but as an increase in production *possibilities*. In a normally functioning economy, firms will be producing at or in the vicinity of their capacity limits and the distinction made here will be moot. In the Russian case, the impact of reforms in the 1990's was to depress capacity utilization to levels where some sectors were operating at no more than 20 percent of capacity. As ruble devaluation produced a rapidly growing demand for domestic goods, producers could draw on slack to increase production without running into bottlenecks, and without installing new capacity.²⁰ As much of the subsequent "growth" has thus been simple recovery, it is only logical that Yegor Gaidar has chosen to speak of "recovery growth."²¹

The main problem that must be addressed here concerns the *quality* of growth, i.e. to what extent the dazzling numbers on growth in GDP under Putin also reflect such technological renewal that will make Russian industry competitive on world markets; simply bringing back on line capacity that was outdated already in the 1980's will surely not do the trick. On this count, the OECD presents such an extensive list of recommendations on what still needs to be done, that the message between the lines cannot be but one of serious failure.²²

¹⁹ During the 1990s, the average age of Russian capital stock increased from 10.8 to 17.9 years, or by close to one year per annum, reflecting the almost complete absence of new investment. More specifically, the share of the Russian capital stock that was less than five years old, and could thus be considered modern, dropped from 29.4 to a mere 3.9 percent, while that being older than 20 years and thus clearly obsolete increased from 15.0 to 34.9 percent (Gavrilenkov, Evgeny (2000), "Savings, Capital Flight, and Economic Growth in Russia," paper presented to the AAASS Annual Convention, Denver, CO, 9-10 November 2000, p. 12, Table 3). As we are approaching the end of Putin's second term, the share of investment in GDP remains way too low to make up for this degradation. While China invests 40 percent of GDP and the Euro zone stands at 20 percent, Russia reaches only 18 percent. (OECD (2006), *Economic Survey of the Russian Federation 2006*, Paris: OECD, pp. 26-27.)

²⁰ Capacity utilization increased from an historic low of 42 percent in 1999 to 70 percent in 2005, indicating that the most efficient producers had reached capacity limits (ibid., p. 24).

²¹ Gaidar, Yegor (2005), "Recovery Growth as a Stage of Post-Socialist Transition?," *Studies and Analysis* no. 292, Warsaw: Center for Social and Economic Research.

²² OECD, op. cit., ch. 4.

Let us turn now to look at why economics came so ill prepared to deal with the challenges of post-Soviet reconstruction.

The Problem

Ever since Adam Smith presented the world with his immortal classic *The Wealth of Nations*, liberal market economy has been based on the centrality of opportunity. If only markets can be sufficiently deregulated, and the state can be kept at bay, good things will follow. Entrepreneurs and consumers will seek out and act on their best available opportunities for profit and utility maximization, competition will make sure that all resources are allocated to their best uses, and welfare will be maximized.

In the introduction to his provocatively titled work *The Wealth and Poverty of Nations*, Harvard economist David Landes formulates this world view as follows: "This is the classical economists' view: increase is natural and will occur wherever opportunity and security exist. Remove the obstacles, and growth will take care of itself."²³

The main problem with this intellectual heritage is that the bias towards beliefs in opportunity and deregulation so easily gives rise to expectations, tacit or otherwise, that the market forces are capable on their own to solve most if not all of the problems that surround us. Listening to the rhetoric of the Russian reformers in the early 1990's, it was easy to get the impression that market economy represents a societal default position of sorts. All that needs to be done is to reboot the system, and the outcome will simply have to be democracy and a rules-based economy.

While this may again come across as an unwarranted overstatement, it does point at another fundamental source of confusion in standard neoclassical economic theory. Accepting that economics is a theory of choice, and that actors

²³ Landes, David (1999), *The Wealth and Poverty of Nations: Why Some are so Rich and Some so Poor*, New York: Norton, p. 31.

who are faced with situations of choice are capable of strategic action, it follows that much effort must go into understanding *how* their choices are made.

If the widely accepted notion of economic man that underpins so much of economic theorizing had indeed been an adequate representation of individual decision making, the outcome would have been clear and predictable. With stable preferences, and full information on available opportunities, the only possible source of difference between actors in outcomes would be that of differences in opportunity. Faced with the same opportunities, all would make the same decisions and produce the same results. Now, as most would surely agree, the world does not work quite like that.

When Oliver Williamson sets out building his case for new institutional economics by stating that “in the beginning there were markets,”²⁴ Geoffrey Hodgson is quite right in retorting that “the market itself is an institution [that] involves social norms and customs, instituted exchange relations, and information networks that themselves will have to be explained.”²⁵ As many sociologists, especially those representing “new economic sociology,” would underscore, economic decision making is “embedded” in the social structure and actions cannot be studied in isolation.²⁶ At the very least, it should be obvious that for the rules of a market to be properly understood, actors must have a set of shared beliefs and understandings of the outcomes that the rules in question are intended to generate.

We shall have to be careful here not to get trapped in the tribal warfare that for well over a century has raged between *homo economicus* and *homo sociologicus*. As Elster notes, this represents one of “the most persisting cleavages in the social sciences,”²⁷ and it is not likely to be resolved any time soon. An important reason is that it is hard to find a solid analytical middle ground

²⁴ Williamson, Oliver E. (1975), *Markets and Hierarchies: Analysis and Antitrust Implications*, New York: Free Press, p. 20.

²⁵ Hodgson, Geoffrey M. (2004), *The Evolution of Institutional Economics: Agency, Structure and Darwinism in American Institutionalism*, London and New York: Routledge, p. 20.

²⁶ E.g. Granovetter, Mark (1985), “Economic Action and Social Structure: The Problem of Embeddedness,” *The American Journal of Sociology*, vol. 91, no. 3.

²⁷ Elster, Jon (1989), *The Cement of Society: A Study of Social Order*, Cambridge: Cambridge University Press, p. 97.

between arguing that individual action is instrumentally rational and forward looking, and that it is driven by social norms and thus anchored in history.²⁸

Again being wary of succumbing to temptations of scoring debating points, in either direction, it will have to remain a fact that individual action is guided not only by preferences and opportunities, but also by motivation. The latter insight at once creates problems for economic man, and thus for the belief in opportunity and deregulation that is to be found at the core of liberal economy.

As Avner Greif underscores, a narrow focus on the rules of the game alone, as implied by the notion of economic man, may lead those who are responsible for introducing rules to lose sight of the fact that there is nothing here to explain how compliance can be secured: “Yet behavioral prescriptions – rules and contracts – are nothing more than instructions that can be ignored. If prescriptive rules of behavior are to have an impact, individuals must be motivated to follow them.”²⁹

If we add that “motivation” should be understood here in the dual sense of wishing to cash in on rewards and to avoid penalties, it follows that predicting how different individuals will react to given changes in the rules of the game will be a fairly complex exercise. In a routine context, where all parameters are known and changes occur only on the margin, standard neoclassical economic theory may yield good predictions, but as soon as these preconditions are not met there will be trouble. As different individuals, and groups of individuals, will have different perceptions of both penalties and rewards, responses to extra-marginal change in non-routine contexts will be very difficult to predict.

Without going too far into the actual writings of Adam Smith, we may simply note here that being the holder of a chair in moral philosophy he was very well aware of the limitations that must be placed on his own account of how self-

²⁸ The distinction may also be reflected in the following quip by economist James Duesenberry: “I used to tell my students that the difference between economics and sociology is very simple. Economics is all about how people make choices. Sociology is all about why they don’t have any choices to make.” (Cited in NBER (1960), *Demographic and Economic Change in Developed Countries: A Conference of the Universities-National Bureau Committee for Economic Research*, Princeton: Princeton University Press, p. 231.)

²⁹ Greif, Avner (2006), *Institutions and the Path to the Modern Economy: Lessons from Medieval Trade*, Cambridge: Cambridge University Press, pp. 7-8.

interest seeking may lead to collectively rational outcomes. To some, it has even been a bit disturbing to watch how easily Smith has been dragooned into supporting neoliberal causes of deregulation that he himself would have found most troublesome.³⁰

It is surely the case that self-interest makes up a powerful driver in the “market force.” As indicated by Smith, in one of his most classic quotes, on most occasions this also is for the better of all: “It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own self-interest.”³¹ Yet, the recognition that humans are capable of strategic action must at once sensitize the observer to the risks of opportunistic behavior, what Williamson refers to as “self-interest seeking with guile.”³²

In his works, mostly so in *The Theory of Moral Sentiment* but also in *The Wealth of Nations*, Smith was very explicit about the dangers that rest in allowing a free rein for self-interested behavior. He would thus castigate the “mean rapacity, the monopolizing spirit of merchants and manufacturers, who neither are, nor ought to be, the rulers of mankind,”³³ and he would warn that “People of the same trade rarely meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.”³⁴ As Emma Rothschild notes, even the fabled “invisible hand” that has so often been abused in arguments for deregulation and self-interest seeking was most likely used by Smith as an “ironic but useful joke.”³⁵

While we must remain convinced that self-interest constitutes the main driving force in market oriented behavior, it is even more important not to forget the dark side of the force. Simply put, self-interest pursued without respect for the

³⁰ In his introduction to the edition of *The Wealth of Nations* that we are citing here, Robert Reich voices precisely this irritation: “One of the ironies in the history of ideas is that *The Wealth of Nations* – a book dedicated to improving the welfare of the common man rather than just the merchants or nobility – should have been used by a rising class of industrialists as theoretical justification for *not* seeking to remedy these and related social ills.” (Smith, Adam (2000), *The Wealth of Nations*, New York: The Modern Library, p. xix.)

³¹ Ibid., p. 15.

³² Williamson, 1975, op. cit., p. 26 and ch. 2 *passim*.

³³ Smith, op. cit., p. 527.

³⁴ Ibid., p. 148.

³⁵ Rothschild, Emma (1994), “Adam Smith and the Invisible Hand,” *American Economic Review*, vol. 84, no. 2, p. 319.

damage it may cause to others represents *the* major threat to functioning market economy. Lord Lionel Robbins sums it up rather nicely, when he notes that “the pursuit of self-interest, unrestrained by suitable institutions, carries no guarantee of anything but chaos.”³⁶

While this insight provides a sordid warning for policy makers to proceed with caution, whenever contemplating programs of deregulation that are based on self-interest seeking, the message to social scientists is not as clear. All the achievements of new institutional economics notwithstanding, it remains a deplorable fact that no one to date has been able to pinpoint exactly what should be understood by Robbins’s “suitable institutions.”

At a World Bank conference in 1994, Williamson could sum up the essence of the problem of providing advice on how to reform the formerly socialist economies: “‘Getting the property rights right’ seemed to be more responsive to the pressing needs for reform in Eastern Europe and the former Soviet Union ... but the deeper problem is that getting the property rights right is too narrow a conception of what institutional economics is all about. The more general need is to get the institutions right, of which property is only one part.”³⁷

Between “getting the property rights right” and “getting the institutions right” we may find the whole essence of the problem at hand. The core issue relates to the fact that individuals who are capable of strategic action will also face a strategic choice. In one direction lies the pursuit of constructive self-interest, which entails abiding by the golden rule and living up to the ideals implied by the invisible hand. In the other lies Williamson’s “self-interest seeking with guile,” implying redistributive activities that range from rule evasion to rent seeking and outright “state capture.”³⁸ Can policy makers realistically influence the direction of this choice?

³⁶ Robbins, Lionel (1952), *The Theory of Economic Policy in English Classical Political Economy*, London: Macmillan, p. 56.

³⁷ Williamson, Oliver E. (1995), “The Institutions and Governance of Economic Development,” *Proceedings of the World Bank Annual Conference on Development Economics 1994*, Washington, D.C.: The World Bank, p. 173.

³⁸ Hellman, Joel S., Geraint Jones and Daniel Kaufman (2000), “Seize the State, Seize the Day: State Capture, Corruption, and Influence in Transition,” *Policy Research Working Paper*, no. 2444, September: The World Bank.

Lord Robbins provides part of the answer when he notes that the Smithian invisible hand “is not the hand of some god or some natural agency independent of human effort; it is the hand of the law-giver, the hand which withdraws from the sphere of the pursuit of self-interest those possibilities which do not harmonize with the public good.” Thus underscoring the responsibility of the state to operate a “visible hand,” he also recognizes the crucial role that is played by surrounding informal institutions: “Without Hume’s theory of justice, or something very much like it, the Classical theory of self-interest and the market would remain completely in the air. Not only the good society, but the market itself is an artifact.”³⁹

To be more specific, it follows that simply decreeing rights to private property will not be sufficient. This, after all, was done by Catherine the Great in 1785, and the outcome left quite a bit to be desired. No matter how well formulated the laws, the crucial issue will have to remain that of making sure that the laws in question are upheld. This touches not only on macro level issues of credible commitment by the state to uphold contracts and secure rights to property. As Greif points out, it also brings into play the micro level question of *how* rights to property are rendered more or less secure: “Understanding how property is secured requires knowing why those who are physically able to abuse rights refrain from doing so.”⁴⁰

Let us assume here that the fundamental answer to the latter question will revolve not around the degree of severity in formal sanctions against those who violate the rules, but rather around the prevalence of informal norms that rationalize rule abiding behavior as being in line with best self-interest. It then follows that we are back at the point that was made at the outset of this paper, namely that undertaking fundamental societal reconstruction will entail not only rewriting the rules. Even more so, it will require a mental redescription of such informal norms that constitute the core of the called-for “suitable institutions.”

³⁹ Robbins, op. cit., pp. 56-57.

⁴⁰ Greif, op. cit., p. 7.

This in turn brings us into the territory of seeking to understand the role and origin of social norms, an area where Elster claims that social science stands essentially clueless. He is quite specific on this point: “I cannot offer a positive explanation of norms. I do not know why human beings have a propensity to construct and follow norms, nor how specific norms come into being and change.”⁴¹ Putting it rather mildly, this does not constitute particularly solid theoretical grounds on which to approach a task of broad societal reconstruction.

The Muscovite Matrix

Let us proceed now to look at the historical and cultural baggage that Russia carried into its post-Soviet phase of transition and reconstruction. This baggage, it will be argued, consisted not so much of Soviet-era deformations but rather of centuries-old institutional structures that had served to support a highly distinctive development model. By refusing its subjects any form of enforceable rights, and by laying *de facto* claims to disposal of all productive resources, the Russian autocracy had succeeded in combining economic backwardness with periodic spurts of high growth and impressive military might.⁴² The Soviet experience of forced industrialization, designed to create a vast military-industrial complex, may be viewed as the apogee of this pattern.

Once the time came to call for a transformation of Russia's traditional model of forced resource extraction into a rules-based market economy, it would become obvious just how deeply rooted those fundamental institutions were that made up its hard core. Above all, it would be made clear how limited the scope is for policy makers to achieve by direct action societal transformations that call for an alteration of norms and values. As indicated above, transforming subjects into citizens by way of shock therapy was a bird that just would not fly.

⁴¹ Elster, 1989, op. cit., p. 125.

⁴² Gerschenkron, Alexander (1962), *Economic Backwardness in Historical Perspective*, Cambridge, MA: Harvard University Press.

In the following we shall use the notion of a “Muscovite matrix,” and we shall do so for two good reasons. While reference to distant Muscovy serves to highlight the long-term nature of Russia’s historical legacy, portraying the country’s institutional structure as a matrix brings out the need to focus on the interplay between formal rules, informal norms and enforcement mechanisms that lies at the core of modern institutional theory.⁴³

Our account of how the Muscovite matrix emerged and evolved shall follow a pattern established by János Kornai in building his classic theory of the “shortage economy” that made up the core of the socialist system. With explicit parallels to a biological organism, he shows how the taking of one step (such as the introduction of a party monopoly on power) leads to the next (suppression of private property), and so on, with the logic being that each step in the chain is derived from and prompted by the previous step.⁴⁴

Unaccountable Government

The triggering force that caused the Muscovite institutional matrix to be formed was that of *unaccountable government*. In order to avoid unnecessary debate on definitions, we shall refrain here from using more traditional terms such as an authoritarian or totalitarian, or even an autocratic regime. Instead, we shall merely argue that the system featured no institutionalized means by which the ruler could be held accountable. This definition is consistent with the terms that we leave out, and it is generally applicable to a number of monarchies that were prevalent in Western Europe at the time when Muscovy emerged.

What it meant in the more specific case of Muscovy was that the Grand Prince, later the Tsar, ruled the land together with his boyars, initially as a *primus inter pares* but over time increasingly as an autocrat whose authority was not to be challenged. The latter, importantly, should be understood here not in the

⁴³ North, Douglass C. (1990), *Institutions, Institutional Change and Economic Performance*, Cambridge: Cambridge University Press.

⁴⁴ Kornai, János (1992), *The Socialist System: The Political Economy of Communism*, Oxford: Clarendon Press, esp. ch. 15.

sense of totalitarian control, but rather as a triggering factor, prompting actors to engage in peculiar games of influence that will be described further below.

The mirror of language provides perhaps the best way of illustrating the nature of this arrangement. Thus, the Russian word for state – *gosudarstvo* – relates back to the notion of a *gosudar* (implying lordship over others), and the word for nobility – *dvoryanstvo* – is derived from *dvor* (household) implying that even senior nobles were viewed as members of the household of their *gosudar*.

As Muscovy was transformed into a Russian Empire, which in turn was transformed into a Soviet Union, the mode of rule was modernized. Primitive *prikazy* were transformed into ministries that were staffed by an increasingly professional bureaucracy. Legal reforms added an image of order and due process. The Soviet experience may here again be viewed as the apogee of a long-term process, providing formal constitutional guarantees for rights and freedoms that in reality were mere decorations.

The key component of this process is that the system never came even close to anything resembling due process or accountability. This was true even under the Great Reforms of Alexander II, when the most liberal of tsars made it quite clear that there would be no questioning of the autocratic order: “But what Alexander adamantly refused to consider was the ‘crowning of the edifice’ hoped for by the liberals: a national legislative assembly. As he constantly repeated: ‘*surtout, pas d’Assemblée de notables!*’”⁴⁵

Conditional Property Rights

The second step towards forming the Muscovite matrix was that of introducing *conditional property rights*. Here too we shall be careful with definitions, only now we must excuse resorting to misleading terminology that has been otherwise accepted as standard usage. We shall thus speak of “conditional,” although in practice it was a one-way street. We shall speak of “property,” although the Grand Prince had no intention whatsoever to respect any such institution, and we

⁴⁵ Martin Malia (1999), *Russia under Western Eyes: From the Bronze Horseman to the Lenin Mausoleum*, Belknap, Cambridge, MA: Belknap, p. 168.

shall speak of “rights,” although there was no institutional arrangement whereby wronged subjects could demand – and receive – redress.

The “rights” of subjects to property, and to autonomous economic decision making, may be compared here to the rights of women and children in a traditional Russian peasant household. While they might at times be treated well indeed, and while they could at any time appeal for mercy, as soon as push came to shove it would be clear that they had nothing even resembling enforceable rights. The Grand Prince ruled his lands in precisely this fashion, as a *paterfamilias* or as a traditional Russian *bolshak*, with no need to consider any formal constraints on his exercise of power.

The property regime that existed before the emergence of Muscovy was based on heritage from father to son. Known as *votchina*, it was peculiar in two senses. First, during the Kievan period land was so plentiful, and profits from trade with Byzantium so abundant, that there never emerged any real sense of property in land; although the sources are weak, it is likely that peasants of that time enjoyed a fair degree of freedom. Secondly, there was a clear sense that the lands as a whole, the *russkie zemlya*, belonged not to any individual prince but to the whole line of princes jointly. What it all boiled down to was that the prime objective of the princes would be not to safeguard property but rather to secure their places, their *mesta*, in the pecking order.

The main problem that was faced by the Grand Princes in the early Muscovite era was that their boyars had a relatively free position. Principalities were small, boyars had properties in many places, and they were at liberty to come and go as they wished.⁴⁶ At times of conflict, the Grand Prince could thus never be really sure that “his” boyars would show up, or indeed that they would show up on his side.

This problem could have been remedied via contractual regulation, in a process that might have led to something akin to Western feudalism. The way actually chosen was highly different. In order to secure the loyalty of their

⁴⁶ The standard phrase employed in contracts at the time stipulated that “the boyars and servitors who dwell among us shall be at liberty to come and go” (Kluchevsky, V. O. (1911), *A History of Russia*, Vol. 1, London: J. M. Dent & Sons, p. 263).

subjects, the Muscovite princes first introduced a regime of demanding bondsmen to serve as hostages in case of defection,⁴⁷ and then proceeded to replace heritable *votchina* property with land grants known as *pomestie*. While the latter may initially have had a reciprocal element of granting land in return for service, during the sixteenth century it was transformed into *de facto* bondage. As lands that had been given could at any time be taken back, it makes no sense to speak here of *rights* to property.⁴⁸

Before we proceed, it is important to note that these arrangements emerged as rational and successful responses to problems that might otherwise have led to the disappearance of Muscovy. Faced with serious security problems, and having very poor resources to draw on, the Muscovites simply did not have many options. If they had gone down the path of monarchs in Western Europe, who were forced to engage in lengthy negotiations with nobles and parliaments before they could secure taxes and knights needed for warfare, Muscovy might not have survived.⁴⁹

As Marshall Poe notes, the fact that it did not merely survive, but proceeded to transform itself into an empire that eventually would have global reach, constitutes a remarkable achievement. Noting that the grand princes, supported by a tiny boyar elite, were faced from the very beginning with “the unenviable task of knitting together an expansive, poor, sparsely populated region of far northeastern Europe and mobilizing it for constant defense against a host of aggressive neighbors,” he underlines that “not only did the Russians survive, they prospered, creating in the span of a bit over a century an empire that stretched from Archangelsk to Kiev and from Smolensk to Kamchatka.”⁵⁰

⁴⁷ Dewey, Horace W. (1987), “Political Poruka in Muscovite Rus,” *The Russian Review*, vol. 46, no. 2.

⁴⁸ It is important to underscore here that we refer to the absence of an institutionalized order of enforceable property rights. Whether there was something resembling this order has caused much ink to be spilt, without adding to the essence of the matter at hand. (E.g. Weickhardt, George G. (1993), “The Pre-Petrine Law of Property,” *Slavic Review*, vol. 52, no. 4, Pipes, Richard (1994), “Was there Private Property in Muscovite Russia?,” *Slavic Review*, vol. 53, no. 2, and Weickhardt, George G. (1994), “Was there Private Property in Muscovite Russia?,” *Slavic Review*, vol. 53, no. 2.

⁴⁹ See further Poe, Marshall T. (2000), “*A People Born to Slavery.*” *Russia in Early Modern European Ethnography, 1476-1748*, Ithaca, NY: Cornell University Press, pp. 220-22.

⁵⁰ *Ibid.*, pp. 219-20.

What makes the Russian case so special is that an institutional arrangement that may well have been rational in the fifteenth and sixteenth centuries would prove over time to be so resilient to even the most determined and well-intended attempts of reform that in the twentieth century it could be viewed as a system of choice rather than of necessity.

Legal Regulation

An important part of the answer to the obvious question of how this can be lies embedded in the third step towards forming the Muscovite matrix, a step that concerns *legal regulation* and that was a direct consequence of the former two. Absent any need for political negotiations over taxes, and absent rights to property that could be exchanged on a market, there emerged no demand for those institutions that underpin “Western” political and economic systems.

Where Roman law, for example, had been very explicit about the distinction between power and property, and about regulating commercial transactions, the type of legal regulation that emerged in Russia was clearly aimed at protecting the rulers against the ruled. From distant Muscovy through the Soviet era, subjects would experience law not as a set of protections of rights but rather as an instrument that was pointed firmly at them. In the words of Thomas Owen, “the various codes of laws issued from 1497 onward, indicated the vigor with which the tsarist bureaucracy sought to regiment society by means of statutory compulsion and restriction. The law functioned as an administrative device, not as a set of rules to be obeyed by state officials.”⁵¹

The bottom line is that actors who are forced to play a game that has no enforceable formal rules, and where they have no private sphere that they can call their own, will be simply forced to engage in games of corruption and influence. In stark contrast to Western predatory games of *rent seeking*, the Russian version of “self-interest seeking with guile” should be properly termed *rent granting*. The distinction reflects that while in the former case it is predators

⁵¹ Owen, Thomas C. (1998), “Autocracy and the Rule of Law,” in: Sachs, Jeffrey and Katarina Pistor (eds.), *The Rule of Law and Economic Reform in Russia*, Boulder, CO: Westview Press, pp. 24-25.

that corrupt the ruler, in the latter it is the ruler who decides to whom rents should be allocated.

To see that this is not a moot point, we may consider what type of norms and values will emerge to rationalize effective submission and complete dependence as a system that is consistent with honor and respect. In the case of Muscovy, this worked like a charm. Already by the early seventeenth century, as Robert Crummey puts it, “the Russian nobility wore the harness of service like a well-trained horse.”⁵² And, by all appearance, they did so proudly.

Engine of Growth

The fourth step, which also serves to complete the formation of the Muscovite institutional matrix, was that of casting the state in the role as an *engine of growth*. Although Muscovy did feature merchants that could be both wealthy and influential,⁵³ and although even serfs could set themselves up as entrepreneurs, some even successfully so, none of this comes even close to what is normally understood as private entrepreneurship in a rules-based economy. On the contrary, the corruption and venality of Moscow merchants is just as legendary as is the pervasive involvement of the state in all aspects of economic life.

While over the centuries the Russian economy has certainly undergone broad processes of modernization that in many cases have been similar to those in the West, albeit with some time lag, there are dimensions where the Muscovite roots have remained stubbornly resistant to change. If we accept that the bottom line concerns enforceable rights to property and the sanctity of contracts, we may conclude that the outcome has been an environment that is very hostile to private entrepreneurship. If we further accept that the true test of whether the notion of “market economy” is applicable is that of autonomy in the market place, of entrepreneurs making decisions based on horizontal rather than vertical

⁵² Crummey, Robert O. (1983), *Aristocrats and Servitors: The Boyar Elite in Russia, 1613-1689*, Princeton, NJ: Princeton University Press, p. 34.

⁵³ Owen, Thomas C. (1981), *Capitalism and Politics in Russia: A Social History of the Moscow Merchants, 1855-1905*, New York: Cambridge University Press.

relationships, then we have also arrived at the main test of whether Russia has “become” a market economy.

If it is the case that the ruler remains focused on rent granting, and that entrepreneurs remain focused on “self-interest seeking with guile,” then the state shall have to retain its role as the main engine of growth. As we shall now proceed to argue, what is currently happening under Putin represents a predictable outcome of the way in which “systemic change” was designed and implemented.

A Predictable Outcome

The collapse of the Soviet Union was a momentous event, not only from the perspective of world affairs in a broad sense. More specifically, it also brought to a head a long-standing division within Russian historiography. Had it been the case, as suggested above, that in its Muscovite days Russia had evolved a set of rather specific institutional traits that would prove over time to be remarkably resistant to reform? This would be consistent with the “continuity theory” that is mainly associated with scholars like Edward Keenan and Richard Pipes.⁵⁴

Or, had it perhaps, on the contrary, been the case that from the times of Peter the Great, Russia had been on the same track as the rest of Europe, only with a fifty year lag, as is suggested by Martin Malia? According to the latter view, it is “Soviet Russia that represents both maximal divergence from European norms and the great aberration in Russia’s own development.”⁵⁵

Thus formulated, the positions would seem to be clear, and the introduction of “systemic change” could be construed as an acid test of who was right. While the former theory would predict lengthy problems of institutional readjustment, the latter would anticipate a less troubled process of normalization, once the Soviet debris had been cleared off the decks. In order to shed some

⁵⁴ Keenan, Edward (1986), “Muscovite Political Folkways,” *Russian Review*, vol. 45, no. 2, Pipes, Richard (1974), *Russia under the Old Regime*, New York: Charles Scribner’s Sons.

⁵⁵ Malia, op. cit., p. 12, and pp. 418-19 on the “fifty-year rule.”

more light on the core question of undertaking instant and fundamental societal reconstruction, we shall listen to a few words from Douglass North.

In his Nobel Prize speech, held in December 1993, when the attempted Russian reforms had already produced a terrible mess, North not only emphasized the need to focus on the interplay between rules and norms, and to realize that the latter change only gradually: “Since it is the norms that provide ‘legitimacy’ to a set of rules, revolutionary change is never as revolutionary as its supporters desire, and performance will be different than anticipated.” He also took issue with the then widespread belief in institutional imitation, noting that “economies that adopt the formal rules of another economy will have very different performance characteristics than the first economy because of different informal norms and enforcement.”⁵⁶

In order to highlight the importance of North’s statements, we may usefully recall here how Alexis de Tocqueville, in his classic work *Democracy in America*, placed great emphasis on the *side effects* of the introduction of democratic government: “This ceaseless agitation which democratic government has introduced into the political world influences all social intercourse. I am not sure that, on the whole, this is not the greatest advantage of democracy; and I am less inclined to applaud it for what it does than for what it causes to be done.”⁵⁷

The bottom line is that the social system that would come to be known as Western emerged not as a result of deliberate action, but rather as a set of positive byproducts of other actions: “I have no doubt that the democratic institutions of the United States, joined to the physical constitution of the country, are the cause (*not the direct, as is so often asserted, but the indirect cause*) of the prodigious commercial activity of the inhabitants.”⁵⁸

Given his previously cited warning about the moral fallacy of seeking to achieve what cannot be achieved, it is not surprising that Elster has picked up on Tocqueville’s account, deducing that the “advantages of democracies, in other

⁵⁶ North, Douglass C. (1995), “Economic Performance through Time,” *American Economic Review*, vol. 84, no. 3, p. 366.

⁵⁷ Tocqueville, Alexis de (1945), *Democracy in America*, New York: Alfred A. Knopf, p. 251.

⁵⁸ Ibid. (Emphasis added.)

words, are mainly and essentially byproducts.” While democracy is normally viewed as a good system of government, Tocqueville had argued that viewed purely as a decision-making apparatus it is inferior to aristocracy. Yet, he would nevertheless maintain that “the very activity of governing democratically has as a byproduct a certain energy and restlessness that benefits industry and generates prosperity.”⁵⁹

Let us juxtapose these insightful comments against the beliefs, mentioned at the outset of this paper, that the laws of economics are equally applicable across cultures and that a rules-based market economy represents a default position of sorts, which may be reached by deregulation alone. Accepting that unaccountable government and conditional property rights had constituted the hard core of the Muscovite model, it follows that the main test of the viability of shock therapy and systemic change would be that of mass privatization. Was it correct to assume that private property is something natural that will emerge spontaneously as soon as all obstacles are removed?

Reflecting on how Boris Yeltsin’s economic reform program could end in such failure, Mancur Olson effectively deflated the naïve belief in deregulation as a *panacea*: “Some enthusiasts for markets suppose that the only problem is that governments get in the way of the market and that private property is a natural and spontaneous creation.” This view he branded as “unquestionably and drastically wrong,” and the reason given goes to the very heart of the argument that is pursued here: “Though individuals may have possessions without government, the way a dog possesses a bone, there is no private property without government. Property is a socially protected claim on an asset – a bundle of rights enforceable in courts backed by the coercive power of government.”⁶⁰

Summing up our conclusions thus far, we have argued that the main challenge when introducing new rules will be to make sure that actors are sufficiently motivated to abide by these new rules, and that they will make choices that are aimed at constructive rather than redistributive outcomes. A key

⁵⁹ Elster, 1983, op. cit., pp. 95-96.

⁶⁰ Olson, Mancur (1995), “Why the Transition from Communism is so Difficult,” *Eastern Economic Journal*, vol. 21, no. 4, p. 458.

component here will be that the state is both ready and able to act as third party enforcer, which in turn underscores the need for it to make a credible commitment.

As Barry Weingast notes, this may not be so easy. Achieving a desirable shackling of a ruler's discretionary power requires not only "institutions that limit and define the legitimate boundaries of state action." To be successful, it will also require a "set of shared beliefs among citizens who react against the state when the latter attempts to transgress the boundaries defined by those institutions."⁶¹ With these observations, we have arrived at the real crux of the matter, namely the sadly neglected role of culture in undertaking systemic change.

A Culture of the Market?

In a speech held in June 1997, then Federal Reserve Chairman Alan Greenspan offered the following verdict over the beliefs in systemic change and shock therapeutic deregulation: "Much of what we took for granted in our free market system and assumed to be human nature was not nature at all, but culture." More specifically, he went on to argue that "There is a vast amount of capitalist culture and infrastructure underpinning market economies that has evolved over generations: laws, conventions, behaviors, and a wide variety of business professions and practices that have no important functions in a centrally planned economy."⁶²

Greenspan's statement is well in line with what has been argued above, namely that an excessive focus on the formal rules that were missing in the planned economy would lead reformers to neglect the surrounding "culture" that

⁶¹ Weingast, Barry R. (1993), "Constitutions as Governance Structures: The Political Foundations of Secure Markets," *Journal of Institutional and Theoretical Economics*, vol. 149, no. 1, p. 305.

⁶² Speech available on <http://www.federalreserve.gov/boarddocs/speeches/1997/19970610.htm>. It may be worth noting here that his speech was held well over a year before the financial meltdown that struck Moscow in August 1998. If Western fund managers had been ready to listen to Greenspan, whose word normally was not to be questioned, losses to the tunes of many billions in defaulted Russian securities and credits might perhaps have been avoided. Unfortunately, Greenspan's message on Russia was too far out of sync with the prevailing hype on the market.

must serve to motivate actors to abide by the new rules of market economy. The question that must now be addressed is to what extent and by what means the “culture” that supported the Russian and Soviet models of forced extraction from above, and of rents granted on the basis of corruption and influence games, could be transformed into a “culture” that would support democracy and a rules-based economy.

If “culture” is understood here as something akin to social capital, we may agree with Claus Offe that the solution to the problem of how to augment this elusive concept may be sought in two different ways, one being “top-down” and the other “bottom-up.”

The former holds that trust “can be increased if institutions and procedures generate an impeccable record in terms of truth-telling, promise-keeping, fairness and solidarity – and thus reasons for suspicion and cynicism are virtually nullified.”⁶³ Looking back at what went on in the Yeltsin era, “truth-telling, promise-keeping, fairness and solidarity” are not amongst the most immediate labels that come to mind. On the contrary, we may assume that the impact on norms and mental models was to further entrench age-old patterns of *distrust*.

The latter way of enhancing social capital will aim at making individuals less reluctant to show trust in anonymous others. The problem here is that no one really seems to know just how such a “friendly attitude towards fellow citizens” may come about: “All we know from recent debates on social capital is that it thrives where it is favored by supportive local traditions – and doesn’t where it isn’t.” To Offe, this leaves one really major question hanging: “Is it conceivable that the ‘social capital’ of trusting and cooperative civic relations can be encouraged, acquired, and *generated* – and not just *inherited*?”⁶⁴

Although there can be no clear-cut answer to the latter question, it does indicate the complexity of the matters at hand, and it does provide a link back to the argument that was introduced at the outset of this paper, namely that Russia has failed to “become” a market economy. It is, for example, only by viewing

⁶³ Offe, Claus (1999), “How Can We trust Our Fellow Citizens?,” in: Mark E. Warren (ed.), *Democracy and Trust*, Cambridge: Cambridge University Press, p. 85.

⁶⁴ Ibid., p. 85. (Italics in the original.)

private property as an institution that is embedded in a specific social structure that we may fully understand why deregulation alone will never be sufficient. This social structure, moreover, will be permeated by traditions, values and norms that are rooted in historical experience and collective memories.

It is for these reasons that transforming a command economy into a market economy cannot be viewed as a mere technical exercise in writing laws and creating oversight bodies. The simple fact that “transition” in Eastern Europe and the Former Soviet Union has resulted in such a broad range of outcomes provides conclusive evidence that the initial conditions in different countries also must have been very different.

The real challenge to social science, as we contemplate the failures to provide good advice on how to proceed with “systematic change,” is to unlock the relation between instrumentally rational forward-looking behavior, and the constraints on such behavior that are embedded in historically determined social structures.

As shown above, there has been a long awareness, from Adam Smith via Lord Robbins to Oliver Williamson, that self-interest seeking unconstrained by “suitable institutions” represents a serious threat to functioning market economy. What remains to be shown is how such institutions can be transformed or introduced. To be more specific, we must ask how a state can succeed in making a credible commitment to uphold property rights, and how individuals can be convinced that following the principle of *pacta sunt servanda* is in their own best interests.

The rather obvious ways in which Russia under Putin is reverting to familiar Muscovite patterns of unaccountability, conditionality, and a heavy preference for corruption and influence games provides a dismal illustration of just how path dependent these patterns are. From the point of view of social science, it is perhaps even more dismal to note how far we still are from a basic understanding of how problems like these may be approached, and perhaps also resolved.

In one of his works on institutional theory, North emphasizes the shortcomings of traditional neoclassical economics: “The disparity in the performance of economies and the persistence of disparate economies through time have not been satisfactorily explained by development economists, despite forty years of immense effort. The simple fact is that the theory employed is not up to the task.”⁶⁵

In conclusion of the present paper, something similar might be said about close to two decades of debate on “transition.” We are still struggling to achieve consensus on why everything went so wrong, and we have not moved an inch closer to unlocking the question of what should have been done. With specific reference to Russia, the age-old question of *Chto delat*, of what should be done, remains as urgent as ever. This is not a happy verdict, not for Russia and certainly not for social science.

⁶⁵ North, 1990, op. cit., p. 11.