

THE SOFT INFRASTRUCTURE OF A MARKET ECONOMY

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A Western economist's first visit to a socialist nation is an eye-opening experience. One's first impressions are rather like those from visiting the poorer regions of our own economies—most visibly the lower levels of creature comforts, health, and environmental conditions. It would be a mistake, however, to explain the differences between the market and socialist economies in terms of the conditions that explain the differences over time or among regions in the productivity and average income within a market economy.

An economist studying a market economy, for example, is most likely to focus on the differences in human skills, private and public investment, and natural resources, and the incremental or small differences in government policy. We are less likely to study the basic institutions of a market economy, because they have changed only gradually over time and are common across the nation. Indeed, our standard graduate training in economics hardly mentions these institutions, and few economists have more than a shallow understanding of their importance.

The most important differences between the market and socialist economies, however, are the less-visible or quantifiable differences in these basic institutions. I am not a specialist in the socialist economies, so my understanding of the Soviet economy is necessarily secondhand. For the past several years, however, the inchoate reforms in the socialist economies and my own brief visits to several other socialist economies have led me to reflect on the basic institutions, or "soft infrastructure," of a market economy. The present paper gives me an opportunity to share my reflections in a systematic way.

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The Legal System

One of the three basic institutions of a market economy is the legal system. Specifically, a market economy is dependent on a comprehensive commercial code and a system of commercial courts to adjudicate disputes. A modern commercial code includes the laws bearing on property, contracts, torts, and those laws specific to the several major types of business enterprises. For this system to be fully effective, property rights should be

- *exclusive*—to provide clear title for the authority to use or sell specific rights;
- *alienable* (sellable)—to permit market exchanges of specific rights;
- *partitionable* (separable)—to permit the separation of a specific right from a package of rights; and
- *extensive* (universal)—to permit market exchanges of all valuable resources, a necessary condition to avoid the abuse of “common pool” resources that is characteristic of environmental problems.

In effect, the political economy of a nation is defined by the nature and distribution of these rights. The distinctive principle of a market economy is that any *change* in the distribution of rights must have the consent of *all* those who own the affected rights.

An American economist is reluctant to conclude that any nation might have too few lawyers. Our army of lawyers is about as large as the U.S. Army and is almost as dangerous. The socialist economies, however, clearly need to extend and refine their commercial codes. The following examples might be helpful.

Although most property in a socialist economy is nominally owned by the state, it is often not clear whether the workers, the local manager, some party official, or the relevant minister has the authority to sell the property and who is to receive the proceeds. This ambiguity has already created cases in which two firms have purchased the same property from different officials, with no clear process for adjudicating the title dispute. The important but necessarily complex process of privatization will be undermined if the general population perceives the initial distribution from the sales to be unfair. A strong assertion of clear title by the state may be the necessary, but somewhat ironic, first step to effective privatization.

In some cases, rights have been granted to farmers or cooperatives to use property but not to sell it. This situation generally leads to inadequate maintenance of the property, most visibly demonstrated

by the Yugoslav experience. In other cases, rights have been granted as a package but without the authority to sell specific rights to others. This condition leads to an underutilization of those specific rights that the owner is less qualified to use. In all nations, the most egregious environmental offenders are state firms, primarily because governments have exempted these firms from legal suits or from the regulations that apply to other firms.

A closer look at the Soviet economy would surely produce more examples. My main point is that many of the apparent problems of the socialist economies could be reduced by extending and refining their commercial codes. The Soviet Union should not try to copy the Western commercial codes; the U.S. code, specifically, is too complex and involves too much litigation. Nevertheless, there is a rare opportunity to learn from both our successes and problems. President Gorbachev has pledged to restore the rule of law in the Soviet Union. That task will not be complete until it is extended to the full range of economic rights and relations.

The Accounting System

The second basic institution of a market economy is the accounting system. Specifically, a market economy is dependent on the broad use of a common set of financial accounting rules and an independent system to audit financial reports. The two common reports are a balance sheet (a statement of the value of a firm's assets and liabilities at the end of the prior period) and an income statement (a record of the receipts and expenditures during the period). These reports, with additional internal information, are used by a firm's directors and managers to determine the costs and profits on specific products and the financial performance of component divisions. More important, these reports are critical to a bank or other firm that is considering a loan to or investment in the firm. The accounting rules and auditing systems have evolved over the many years and are not perfect, but one cannot imagine a market economy without a similar set of financial records.

My conversations with Western entrepreneurs who have considered joint ventures with socialist firms, however, indicate that the accounts of these firms are almost worthless, either for internal management or external monitoring. In most of the socialist nations, the accounts of state firms are designed and maintained to provide the insatiable data demands of the state planning system. Most of these data bear on physical flows and are of little use to estimate the costs or profits of individual products or the financial status of the firm,

even if the input and output prices were closer to market rates. Indeed, I am informed that the balance sheets of many state firms do not include a measure of net worth. At an earlier, more innocent, time, computers were expected to solve the massive data processing problems of a socialist economy. The problems of a socialist economy, however, are not from the lack of data; indeed, socialist economies are drowning in data. The problem is that these data convey so little relevant information.

One of the major advantages of a market economy is that it minimizes the necessary data flow, since prices convey most of the information necessary to coordinate economic activity among firms and with consumers. A financial accounting system, in turn, provides the information necessary for firm managers to respond correctly to the market prices of inputs and outputs. A major program to train accountants and develop modern financial accounts would be among the highest return investments in the Soviet economy.

Cultural Attitudes

The third basic institution of a market economy is the set of cultural attitudes. Again, this institution is one that Western economists take as given and, as a consequence, have often not understood its importance. The German liberal Wilhelm Ropke (1954) may have best expressed the importance of a specific set of cultural attitudes in concluding that

An intensive and extensive economic exchange cannot exist or last very long without a minimum of natural trust, confidence in the stability and reliability of the legal-institutional framework (including money), contractual loyalty, honesty, fair play, professional honor and that pride which makes us consider it unworthy of us to cheat, to bribe, or to misuse the authority of the State for egoistic purposes.

In turn, the single condition that most distinguishes a modern market economy from an oriental bazaar is the mutual desire for continued relations. I learned this lesson late. As chief economist of the Ford Motor Company, I was surprised to learn that Ford made billions of dollars of purchases a year from regular suppliers over the telephone with only the skeleton of a contract and with few contract disputes. The mutual desire for continued relations was what enforced the performance of both parties in each transaction. At any time that either party expected to end the relation or expected the other party to end the relation, moreover, the primary remaining discipline on the immediate transaction was the value of the firm's

reputation with other parties, not the protection of the formal contract. Only when Ford made a major purchase without the expectation of a future relation was the contract extensive and often disputed. The cultural attitudes that contribute to this “evolution of cooperation” are subtle but simple: a mutual commitment to *exchange* (rather than threat) as the primary means to coordinate economic activity, the self-restraint to leave something on the table for the other party in each transaction, and the use of the authority of the state only to discipline gross or repeated breaches of contract.

Ropke was most perceptive about the requisite cultural attitudes for a market economy. But he did not develop on those attitudes that would prevent or destroy a market economy. The one attitude most incompatible with a market economy is a profound and pervasive sense of envy. A society can survive pervasive egoism; indeed a market economy relies on it. A market economy, however, cannot survive the leveling instinct, the concern that your neighbor or former schoolmate might be doing better than you are. One should not be surprised that all of the major religious traditions regard envy, covetousness, or resentment as a major sin. Envy is a human condition, but it is most destructive of social organization. Envy, combined with the erosion of the constitutional limits on the powers of government, has progressively weakened the Western market economies. And envy may prevent the development of stable market economies in some of the current socialist nations. I am disturbed to hear of old Russian folktales in which the peasants prayed, not for a good harvest or a fecund herd, but for their neighbor’s barn to burn or for their neighbor’s goats to die. As Ropke observed, it is important not to “misuse the authority of the State for egoistic purposes.” It is also important not to misuse the powers of government as an instrument of envy.

Conclusion

In summary, the three basic institutions—the requisite soft infrastructure—of a market economy are the legal system, the accounting system, and the cultural attitudes. I have purposefully avoided a ranking of the importance of these three institutions. In combination, these institutions are rather like a three-legged stool, in that any one short or weak leg seriously reduces the stability of the stool. Individual and state investment in these three institutions is far more important than the other elements of a radical perestroika; indeed, these three institutions are requisite to the success of the other measures.

Reference

Ropke, Wilhelm. "Economic Order and International Law." *Recueil des Cours*, Academie de Droit Internationale, 86, no. 2 (1954): 207-71.