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Transition Economies: Rule of Law and Credible Commitment



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Abstract

Must the rule of law spring upon us solely by accident and force, or can it also emerge as a product of political reflection and choice? As the lessons from the political and economic transition of centrally planned economies in Europe and Asia illustrate, the transitional movement requires an element of political reflection and deliberate choice, specifically the establishment a binding and credible commitment to limits on state action. In order to do so, credible commitment to the rule of law must be signaled *ex ante* by political reformers if reform efforts are to be successful, from which economic development follows *ex post*. The historical record shows, however, that efforts to establish the rule of law in transition economies have been mixed. This chapter explains why this is the case, specifically by comparing Russia and China as case studies of transitional political economy.

Introduction

Must the rule of law spring upon us solely by accident and force, or can it also emerge as a product of political reflection and choice? In a previous chapter of this encyclopedia, we discussed the role in which interjurisdictional competition between states and intrajurisdictional competition between interest groups constrained governments to obey its political commitments to enforce property rights, in which the rule of law emerged as a by-product of this process. However, as the lessons in the political and economic transition of centrally planned economies show, the transitional movement requires an element of political reflection and deliberate choice (see Hayek 1973: 45; Wagner and Runst 2011), specifically the establishment of a binding and credible commitment to limits on state action (Boettke 2009). In order to do so, credible commitment to the rule of law must be signaled *ex ante* by political reformers if reform efforts are to be successful, from which economic development follows *ex post*. The historical record shows, however, that efforts to establish the rule of law in transition economies have been mixed. This chapter explains why this is the case, specifically by comparing Russia and China as case studies of transitional political economy.

The Problem of Credible Commitment

There lies a fundamental dilemma in every attempt to establish the rule of law in those economies undergoing a transition away from national economic planning: how do we resolve the paradox of governance? In order to create the conditions conducive to exchange and capital accumulation, governments must be strong to enforce property rights and contractual arrangements. Doing so enables individuals to devote less effort and resources preventing “first-level predation,” meaning predation by private actors, and specialize in productive entrepreneurial activities. Eliminating first-level predation, however, introduces the problem of “second-level predation,” or predation by public actors (Boettke 2009: 47; see Acemoglu and Johnson 2005). Governments that are strong enough to enforce private property rights and prevent private predation are also strong enough to break any constraints to such precommitments in the future. Public predation can manifest itself in several ways, including the outright confiscation of wealth, taxation, and inflationary finance through currency debasement (Montinola et al. 1995: 54). The cost of such predation in terms of economic development is “evasive entrepreneurship,” which includes the expenditure of resources evading the legal system (Coyne and Leeson 2004: 57), via tax evasion, bribery, or withholding efforts to invest in physical and human capital. If government is given enough power to enforce the rules necessary to maintain an economy, then it must also credibly commit to honor such rules.

Why is it difficult for government officials to credibly commit to the rule of law? This can be explained by the absence of a “political Coase theorem” (Acemoglu 2003). The Coase theorem states that when private property rights are well defined and transactions are low, individuals will bargain to an efficient outcome, irrespective of the initial assignment of property rights (Coase 1960; Stigler 1966: 113). Implicitly, the Coase theorem assumes that parties to an exchange are full residual claimants and will therefore bear the full costs and benefits of the outcomes of their decision-making. Therefore, if one party to an exchange

breaks an agreement, or if both parties are disputing an agreement, reputational mechanisms or the state is available to enforce contractual agreements. Failure to abide by an agreement will result in a loss of reputation in future trading periods and/or state punishment. The Coase theorem applied to the context of political decision-making, however, is quite different. The logic of political decision-making is to concentrate benefits on well-informed and well-organized interest groups that represent a politician’s constituency and disperse costs on the masses of the ill-informed population (Boettke 1993: 7). Such a logic prevails because the governmental official who promises institutional reform to their citizenry will not bear the full costs of renegeing on such a promise. Whereas in the previous example, a private actor faces costs in terms of state punishment and loss of reputation, government officials only bear a loss in reputation. However, even these costs are not fully concentrated on the particular public actor, but are spilled over onto future generations of public actors, who face an increasingly distrustful citizenry, making it more difficult in future “trading periods” to implement transitional reforms.

In order to overcome the expectations that the citizenry hold with regard to credibly committing to the rule of law, governments must signal their willingness to tie their hands *ex ante* against using discretion to unforeseen economic circumstances *ex post*. Signaling refers to the transmission of information that is costly for a sender to emit, but is “cheap” for another party to receive, in this case government officials being the senders and the citizenry being the recipients. Without a credible commitment to the rule of law via signaling, “it is of course perfectly rational for private agents to discount announcements of future policy reforms – or assurances of the continuation of present reforms” (Rodrik 1989: 757). Rodrik argues that any successful institutional reform will have a bias towards “overshooting” in its signaling strategy. This implies that there will be inverse relationship between policy overshooting and credibility: the more severe the credibility gap, the greater the policy must overshoot in order to send the appropriate signal and overcome

the problem of credible commitment. For example, a central banker who wishes to credibly commit to sound monetary policy could adopt a rule that pegs the exchange rate, allowing citizens to convert the domestic currency into foreign currency at a preannounced rate. However, a central bank with a long record of inflationary policy will be sending a noisy signal, especially if devaluation is expected in the face of speculative attacks. In order to overcome the gap of credibly committing to currency debasement, policymakers may have to overshoot even further by adopting a more binding constraint that eliminates its discretion completely. Examples include dollarization or the private-issuance of competitive currencies (Selgin and White 2005; see also White 2010). Therefore, establishing a credible commitment to the rule of law not only requires sending a strong signal to execute institutional reform, but also establishing a binding constraint that eliminates political discretion. Once this takes place, economic and political transition can move into a wealth-creating path.

The Rule of Law and Transitional Political Economy

Fundamentally, transitional political economy entails an institutional change in the manner in which property rights are structured and governed, both in terms of formal government enforcement and informal institutional arrangements, such as customs, traditions, and norms. Broadly speaking, property rights refer to social relationships that guide expectations about the use of scarce resources (Furubotn and Pejovich 1972). Political and economic transitions are intertwined by changes in the de facto structure of property rights. The transition to a private property rights-based economy, based on freedom of exchange and freedom of contract, leads to a reallocation of wealth previously based on political connection and patronage. Respect for private property under the rule of law promotes political freedom because it separates economic power from political power and in this way enables the one to offset the other. It enables economic strength to be a check to

political power rather than its reinforcement (Friedman 1962 [2002]: 15). Such an institutional transition will imply transaction costs that are not only economic and political, but cultural and historical as well.

Implementation of the rule of law in transitional economies implies the elimination of existing political privileges, specifically de facto control over the use of resources. Therefore, economic and political transition will generate a massive redistribution in income. This in turn will imply the opposition of a large class of government officials and military personnel whose rank and privileges will be threatened by transition to market economy under the rule of law. Theoretically, this problem could be eliminated by paying those individuals the present discounted value of the income derived from holding political power, particularly through de facto control over state-owned firms and its resources. However, when the transitional costs associated with compensating the current benefactors of the existing system are greater than the associated welfare gains dispersed among the population, this will create what Gordon Tullock refers to as a “transitional gains trap” (Tullock 1975) that impedes the implementation of the rule of law.

The process of institutional transition from a socialist economy to a market economy is not only economic and political in nature, but also cultural (Pejovich 2003). Culture refers to the context where goals of individuals and the means to be employed by individuals are shaped and given meaning (Storr 2013: 54). The way in which property rights are perceived and “what constitutes an appropriate disposition of property, are all (partly) determined by culture” (Storr 2013: 32). Therefore, culture will affect the ability for governments to credibly commit to uphold the rule of law. Steve Pejovich has argued that “*the cultural differences between Central and East European countries are a major determinant of the magnitude of their respective transaction costs*” (emphasis original, Pejovich 2003: 352). Countries that have a “command culture,” which perceives the exchange of property rights to be a zero-sum game, will face higher costs of credibly committing to the rule of law than a “culture of

exchange” that regards the exchange of property rights to be mutually beneficial (see Buchanan 1997: 95–101). This is because if the “gains from trade are seen as a redistribution of income rather than as rewards to innovators for creating new wealth,” then “[s]tate authorities are more likely to impose price controls on producers and/or merchants who earn large profits than to seek ways to create incentives for others to emulate such individuals in competitive markets” (Pejovich 2003: 351). The costs, however, of institutional transition present potential profit opportunities to be monetized by institutional entrepreneurs to change the rules of game, namely, through the establishment of private property rights (Leeson and Boettke 2009; Li et al. 2006). The role of institutional entrepreneurship will be discussed in the next section.

Moreover, not only does culture matter, but ideas also matter as well, namely, through the footprint of history. For example, one of the obstacles that China encountered during the early stages of its transition to a market economy, beginning after 1978, was the “Illusion of 1957” (Cheung 1982 [1986]: 26–27). According to this illusion, the Chinese regarded capitalism to be worse than communism by equating “capitalism” with the cronyism and corruption of the rule of the Kuomintang prior to 1949, which preceded a period of economic recovery under “communism” between 1949 and 1957. “Thus within living memory the Chinese people equate capitalism with the Kuomintang *débâcle* and communism with the ‘good years’ of 1949–1957” (emphasis original, Cheung 1982 [1986]: 28). Such historical perceptions, however false and misleading they may be, may only create further institutional inertia towards a complete and credible transition to a market economy.

Given all of these difficulties inherent not only to the problem of credible commitment via signaling, but also the transaction costs inherent to institutional transition, how have some countries been able to transition to a market economy under the rule of law and achieve economic development? Peter Boettke outlines the steps that must be followed to establish a path towards successful political and economic reform: “Reform in real

time must (1) start from the existing status quo, (2) unearth the *de facto* organizing principles of that status quo, (3) design a set of reforms which address the incentive and informational problems associated with that *de facto* system, and (4) send a clear high-quality signal that the proposed reforms are credible and commit the governance structure to the new system and in doing so close the gap for the *de jure* and *de facto* organizing system in the new regime” (emphasis original, Boettke 1999: 378). In the next section, we will show how this transition has unfolded under comparative systems of federal governance, using the transitional political economy of Russia and China as comparative case studies.

Russia and China: A Comparative Transitional Analysis

One way to explain this institutional transition is to compare the transitional path that Russia and China have taken. In doing so, we make a distinction between “market-preserving federalism” (Weingast 1995; Qian and Weingast 1997) and “cartel-federalism” (Wagner and Yokoyama 2013; Wagner 2016). Under a federalist system of governance, governance is divided into two levels of authority: a national level of authority and subnational level of authority of smaller local government entities. The distinction between market-preserving federalism and cartel-federalism is based on how the national level of governance sets the conditions of competition between subnational governments.

Under market-preserving federalism, the national government credibly commits to the rule of law, namely, by allowing the entry and exit of private-sector firms to compete with state-owned firms. As a result, the wealth created through private-sector firms within competing local jurisdictions will grow, eroding the relative value of the rents derived from the political control of state-owned firms. Therefore, with the growing extension of the market, the allocation of entrepreneurial talent becomes redirected towards productive activities, rather than unproductive activities, such as rent-seeking

(Murphy et al. 1991; Tullock 1967). However, decentralization and competitive, or market-preserving, federalism are not synonymous. For example, the Soviet Union was “decentralized” in the sense that policy was administered by local governments, but local governments lacked political autonomy and local authority over the economy (Montinola et al. 1995: 57).

Under cartel-federalism, the national government creates a framework of collusion among subnational political entities. Like a cartel of firms, subnational governments collude to act as a collective monopoly, with the government acting as the de facto enforcer against attempted “chiseling” by local governments. In effect, cartel federalism prevents the erosion of rents derived from political control of state-owned firms and resources, namely, by obstructing the introduction of pro-growth policies among local governments that would encourage the growth of the private sector of the economy. The different institutional arrangements adopted by Russia and China since the late 1980s are reflected in their respective economic trajectories. Ten years after the transition reforms, Russia’s GDP per capita had *fallen* by almost 30% (Leeson and Trumbull 2006). The same figures had more than doubled in China over the same period of time (World Bank 2017).

Whereas Russia’s transition can be characterized by cartel federalism, China’s transition followed more closely a model of market-preserving federalism. Under a model of market-preserving federalism, China’s de jure changes were far less important than the de facto changes that emerged spontaneously among competing local jurisdictions. However, the sequence of events which we describe should not undercut “the essential element in political and economic transitions of post communism – the establishment of a binding and credible commitment to liberal limits on state action” (Boettke 2009: 43). While the emergence of private property in China was not designed by government policy, this bottom-up reform would not have flourished without a credible commitment by the state not to obstruct the de facto changes in property rights. After the rise of Deng Xiaoping in 1978, the “first priority under the new economic policy was

agriculture” (Coase and Wang 2012: 157). However, agricultural reform was not initiated by the de jure privatization of farmland. Although land is still formally owned by the state, the introduction of a “household responsibility system” has led to a de facto reallocation of these rights to local stakeholders.

Under this system of landownership, peasants are allowed to lease an exclusive plot from the government, leaving the responsibility contract holder to grow and sell crops of their choice. By 1982, these responsibility contracts began to be traded among peasants, and such transfers became formally permitted by the government in 1983 (Cheung 1982 [1986]: 66). The household responsibility system arose in 1978, initially out of the institutional entrepreneurship of Yan Junchang, who was a villager in Xiao Gang, a poverty-stricken village in Anhui province of China. As Li, Feng, and Jiang describe the account, “[s]truggling to escape absolute poverty, on November 24, 1978, he and 17 other farmers signed a secret agreement to divide up the land and let each household work by itself, running the risk of jail sentences. They had the implicit support of local reform-minded officials. One year later, their innovation proved to be a big success: the total grain in production was equal to the sum of production over the previous five years” (2006: 245; see also Coase and Wang 2012: 47). This de facto privatization of property in agriculture occurred simultaneously with the rise of commerce in special economic zones (SEZs), which was first established in the Guangdong province on August 26, 1980, to attract foreign capital and investment (Coase and Wang 2012: 62).

It is no accident that the rise of the household responsibility system and SEZs coincided with institutional reforms that limited state action in terms of taxation and regulation within Chinese provinces. Starting in 1980, China instituted a fiscal revenue-sharing system between the provincial governments and the central government. According to this fiscal arrangement, revenue income in each province is divided between a fixed shares of revenue, which is remitted to the central government, allowing the remaining share of tax revenue to remain within the local

jurisdiction (Montinola et al. 1995: 63). Moreover, the Communist Party has retained authority to appoint and dismiss governments according to their ability to foster pro-growth policies. As an added incentive, and perhaps “as an ultimate prize, the governors whose regions perform well have been brought into the national government in Beijing” (Blanchard and Shleifer 2001: 175). This choice of institutional design addressed the incentive and informational problems associated with that de facto system, namely, by incentivizing and selecting for those local officials whose interests would be aligned with the pursuit of pro-growth policies that encourage increased labor productivity and capital accumulation.

Although China remains undemocratic politically speaking, its ability to achieve rapid growth since 1978 could not have occurred without a credible commitment to limits on political discretion and public predation, without which property rights in land, labor, and capital would not have emerged to foster economic development. The transitional political economy of Russia, however, can be characterized by cartel federalism. Although Russia has held democratic elections and has engaged in a massive privatization scheme, such de jure reforms have not accompanied de facto reforms. This has occurred because of the failure of political officials to signal a credible commitment to the rule of law.

The Russian experience differed drastically from China’s. Boettke (1993, 1995) argues that the failure of the attempts to reform the Russian economy (first under Gorbachev and then under Yelstin) is due to that the lack of an effective rule of law. Absent the rule of law, Russian citizens had to predict whether the government would go through with reform or, instead, reverse back to centralized control of the economy and social and political life. This prediction was rooted on the historical experience with economic reform in Russia since the time of Lenin: every time the Soviet government had announced a movement towards the devolution of economic and political decision-making, this decision was then reversed in the span of years and even months. With this reversion often came the persecution of those who had taken advantage of the new economic

opportunities. It is not surprising that the Russian people did not accept the promises of the Gorbachev government at face value. Moreover, the behavior of the regime was itself sending mixed signals to the population, making the unraveling of the “reform game” even more likely. The three major pieces of legislation under *Perestroika* (the Law on Individual Enterprises, the Law on State Enterprises, and the Law on Cooperatives) aimed at increasing the competitiveness of the Soviet economy were all radically modified during the (brief) period of their implementation. “Despite the rhetoric and promise of these laws,” Boettke writes, “they contained contradictions and ambiguities that prevented them from achieving the objectives of economic reform. Furthermore, they failed to convey any binding commitment on the part of the Gorbachev regime to true market reform. From 1985 to 1991, Gorbachev introduced at least ten major policy packages for economic reform under the banner of perestroika, *but not a single one was fully implemented*” (emphasis added, 1995 [2001]: 166).

As Russia began its process of privatization during the 1990s, it did so without a complete transition of its political institutions, within which privatization takes place. Without political reform of the institutions within which political decision-making takes place, the incentives that politicians faced during the transition period remained the same. As Milton Friedman points out, “Russia privatized but in a way that created private monopolies, private centralized economic controls that replaced government’s centralized controls. It turns out that the rule of law is probably more basic than privatization. Privatization is meaningless if you don’t have the rule of law. What does it mean to privatize if you do not have security of property, if you can’t use your property as you want to?” (Friedman 2002: viii). The inconsistency between the spirit and the letter (and application) of the reform plan only added to the skepticism of the Russian people. If the past behavior of the Soviet government suggested that its stated goals were inauthentic, its present behavior only confirmed these suspicions.

Shliefer (1997) and Blanchard and Shleifer (2001) identify another cause of Russia's reform failure, namely, its fiscal institutions, which contrast with that of China. Given the lack of the rule of law, the introduction of a decentralized political system is unlikely to lead to the desired outcome. Unlike in China, where tax revenues are raised locally, this encourages local political officials to expand their tax base by fostering economic growth. The political context in Russia, however, was best characterized by cartel federalism, since "local government revenues comes from their share in taxes collected by the central government. Moreover, while this share is in theory fixed, in practice it is negotiated. Regional governments negotiate with Moscow, and local governments negotiate with regions" (Shliefer 1997: 403), creating a collusive rather a competitive environment between regions and disincentivizing the institutionalization of pro-growth policies. Indeed, while Russia's transition has been characterized by greater de jure reforms than China, there have been relatively less de facto reforms, precisely because of a failure to credibly commit to changing the institutional incentive structure within which economic and political decision-making takes place. As Coase remarked in his Nobel Prize Address on the heels of transition of Eastern and Central Europe, "[t]hese ex-communist countries are advised to move to a market economy, and their leaders wish to do so, but without the appropriate institutions no market economy of any significance is possible" (1992: 714).

Conclusion

The problem of economic transition is fundamentally institutional in nature. For economic and political reforms to be successful in transitional economies, this entails a credible commitment to the rule of law. Absent this commitment, aligning incentives between political and economic actors becomes extremely difficult, condemning the transition process to a likely failure. The experience of postcommunist Russia and postreform China provides evidence for this hypothesis.

Cross-References

- ▶ [Capitalism](#)
- ▶ [De Jure/De Facto Institutions](#)
- ▶ [Development and Property Rights](#)
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- ▶ [Hayek, Friedrich August von](#)
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