

## Public Choice Theory and the Transition Market Economy in Eastern Europe: Currency Convertibility and Exchange Rates

### Introduction

In 1989, the people of Eastern Europe<sup>1</sup> revolted against their Communist governments with the hope of achieving political and economic self-determinism. These countries then faced the important challenge of transforming centrally-planned economies into market economies. This transition process has been a topic of much debate among economic theorists with little agreement as to which transition measures should be taken or when they should be executed.<sup>2</sup>

Public choice theory provides an analytical framework on which the nature and timing of the transition process can be better understood. Public choice theory posits that political decisions are made by politicians acting rationally in their own self-interest. Politicians will form coalitions when the potential benefits from legislative preference exceed the costs of organizing and supporting any given piece of legislation. The transition process in Eastern Europe is not a result of the uniform application of macroeconomic theory; rather, it is the result of competing interest groups acting rationally to further their self-interest.

This Article discusses the theoretical application of public choice theory to the economic changes taking place in the Eastern European countries and demonstrates the accuracy of the public choice theory. Part I discusses the origins of and dedication to transition in Eastern Europe. Part II explains the mechanics of economic reform. Specifically, this section examines the two fundamental macroeconomic elements of transition: (1) currency convertibility, and (2) issues that relate to the foreign

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1. Eastern Europe is not a homogenous bloc. Eastern Europe presently consists of some 30 independent states.

2. See CURRENCY CONVERTIBILITY IN CENTRAL EUROPE (John Williamson ed., 1991). 28 CORNELL INT'L L.J. 387 (1995)

exchange of domestic currency including the nominal exchange rate and the real exchange rate. Part III synthesizes public choice theory with the macroeconomics of transition, and Part IV applies this refined synthesis. The Article concludes that public choice theory accurately predicts the shape of the transition process, and that the public choice model of transition has normative value.

## I. The Origins of Transition

### A. Centrally Planned Economies

Before the latter half of 1989, most European nations behind the "Iron Curtain" had centrally-planned economies in which the governments were responsible for and made all decisions related to the production and distribution of economic resources in the nation.<sup>3</sup> Essentially, a government directed the managers of economic enterprises what to produce, how much to produce, where to obtain necessary inputs and to whom to send outputs. In many cases, the centrally-planned economy sought to maximize economies of scale by concentrating the production of any particular good in only one location.<sup>4</sup>

In the Eastern European nations, two types of centrally-planned economy existed before 1989. In one variation, government decision-making was based largely on the quantity of production, with little regard for any reforms targeted at increasing overall productive efficiency.<sup>5</sup> Bulgaria and Romania were examples of such economies. Nations following the other variation made attempts at limited reform in order to allow some market economy concepts to guide economic decisions.<sup>6</sup> While these reforms had some characteristics of a market-based economy, they also retained significant price and market controls. Examples of the latter type of centrally-planned economy included Poland, Hungary, and the former Czechoslovakia.<sup>7</sup>

Even with limited market reform, both types of centrally-planned economies were ultimately based on the principles of social ownership of the means of production and extensive central planning. Application of these principles led to fixed prices for all raw materials, products, and services, strict government control of all foreign trade, and completely undeveloped capital markets.<sup>8</sup> These policies, while essentially eliminating unemployment, also resulted in chronic shortages and misallocations of all types of economic resources and products.

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3. Nigel Healey, *The Transition Economies of Central and Eastern Europe*, 29 COLUM. J. WORLD BUS. 62, 65 (1994).

4. For example, in the former Soviet Union, it is estimated that 75% of the 6000 main industrial products were manufactured at only one facility. *Id.* at 66.

5. INES MOROVIC, CURRENCY CONVERTIBILITY AND ECONOMIC TRANSITION IN CENTRAL AND EASTERN EUROPE 14 (1993).

6. *Id.*

7. *See id.*

8. *See id.*

Both the centrally-planned economy and the individual firm in such an economy were bound by a "soft" budget constraint. A "soft" budget constraint is characterized by the absence of a bottom line and by economic decisions made in an environment which did not require that any budget, at any level in the economy, be balanced.<sup>9</sup> Thus, firms had no incentive to seek new markets, to develop new products or technologies, or to do much of anything except meet the government targets.<sup>10</sup> Workers and resources were employed, not in the most efficient manner, but in a manner made obligatory by state-supplied directives. Firm behavior was not guided by any sense of profitability.

Eastern European foreign trade policies were based primarily on the strategy of "import substitution." Under this approach, governments implemented a trade policy which would fill gaps in the economy left by the failures of central planning.<sup>11</sup> The gaps were the result of the socialist emphasis on heavy industries and an undeveloped service sector in these countries. Because foreign trade was closely monitored and controlled by various state agencies, the Eastern European nations were unambiguously autarkic.<sup>12</sup>

As a result of these policies, currencies in the Eastern European countries did not serve the same basic functions served by currencies in free market economies. In Eastern Europe, a currency did not function either as a store of value or as a means of facilitating exchange. Instead, the socialist governments resorted to printing money in order to fund all activities in the nation. This "soft budget policy" created excessively large money supplies in these countries and resulted in the rise of a dual currency system, where private transactions were conducted with Western currency. The Eastern European currencies were valueless in foreign markets as well as in the home country.<sup>13</sup> Furthermore, Eastern European economies were characterized by the complete absence of domestic competition and of a functioning price system. These currency problems made it increasingly difficult for any Eastern European nation to participate in international trade.

The soft budget policies caused hyperinflation throughout most of

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9. *See id.*

10. *Id.*

11. *Id.*

12. John Williamson, *The Economic Opening of Eastern Europe*, in CURRENCY CONVERTIBILITY IN EASTERN EUROPE 363, 365 (John Williamson ed., 1991).

13. In the Soviet Union in 1988, only five percent of the domestic interfirm transfers of materials and goods was completed by contract—the other 95% was transferred on orders from state planning agencies. The domestic currency was worthless because there was no use for it. Internationally, the ruble was equally valueless. For example, PepsiCo, Inc. invested \$3 billion in the former Soviet Union, with the purpose of producing and selling PepsiCo products. The return on PepsiCo's investment was not in currency: PepsiCo received ten sea-going tankers and freighters and huge shipments of Stolichnaya vodka. *See* Reuven Brenner, *The Eastern Bloc: Legal Reforms Before Monetary and Macroeconomic Policies*, in EXCHANGE RATE POLICIES IN DEVELOPING AND POST-SOCIALIST COUNTRIES 151, 164 (Emil-Maria Claassen ed., 1991).

Eastern Europe.<sup>14</sup> Nominal wages rose dramatically, but real wages declined.<sup>15</sup> Foreign debt also increased, and the absence of foreign trade allowed for only minimal repayments in hard currencies. Without a monetary means of exchange, centrally-planned economies became based on barter, both internationally and domestically. These barter-based economies were incapable of meeting even the most rudimentary demands of their citizens. The political changes in 1989, certainly encouraged by these economic failures, made possible the transition from planned socialism to a free market economy.<sup>16</sup>

#### B. Nascent Dedication to Transition

The new regimes in Eastern Europe generally favored expediting the transition to a market economy. These sentiments were particularly strong in Central Europe and East Germany.<sup>17</sup> These new governments were willing to run the political risks, inherent in a program of radical economic reform, in order to secure a rapid economic transformation.<sup>18</sup> The prevalent belief in the West was that these Central European nations would naturally prefer the type of social market economy that existed in Austria, West Germany, and Finland.<sup>19</sup> The unification of the East and West German economies fulfilled these expectations.<sup>20</sup>

The other Central European nations, such as Poland and Czechoslovakia, opted for a *laissez-faire* market economy. This preference may be explained partly by the legacy of socialism in those countries, which produced distaste for anything remotely "social."<sup>21</sup> It also may reflect a concern about the high costs implicit in a social market economy. The Minister of Finance of the Czech and Slovak Republic explained the preference for a *laissez-faire* market economy:

The decision to undertake this reform strategy rapidly and in this sequence was based on two deeply held convictions on the part of the Czechoslovak reformers. The first was that central planning and a free market cannot coexist without further destabilizing the already unstable economy. The second was that, because of the relative economic weakness of the government and the vested interests of government bureaucrats (as postulated by the arguments of the public choice school), the central authorities do not have the ability to organize economic life in an appropriate manner or to guide state firms toward rational economic behavior.<sup>22</sup>

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14. See MOROVIC, *supra* note 5, at 15.

15. *Id.*

16. For a discussion of pre-1989 reforms in Eastern Europe, see Williamson, *supra* note 12, at 367-72.

17. *Id.* at 373.

18. *Id.*

19. *Id.*

20. *Id.* at 374.

21. *Id.*

22. Vaclav Klaus, *Price Liberalization and Currency Convertibility: Twenty Days After*, in CURRENCY CONVERTIBILITY IN EASTERN EUROPE 9, 11 (John Williamson ed., 1991).

The Balkan nations, notably Bulgaria and Romania, did not move so quickly or emphatically to implement a market economy. In 1990, following the peaceful overthrow of the Communist regime in Bulgaria and the violent removal of the Communist government in Romania, both nations elected former Communists to power. These new leaders, however, declared their commitment to a market economy.<sup>23</sup> In the year following the elections, these Balkan nations took decisive actions directed at transition, albeit more slowly than the Central European nations. Yugoslavia's delay in making an economic transition is likely due to the extensive ethnic conflicts in that country.<sup>24</sup>

Despite these differences, the Eastern European nations shared two fundamental beliefs. First, Eastern Europeans recognized that central planning does not work, and that markets do.<sup>25</sup> Second, they comprehended the importance of the international economy. While economists in these countries once favored import substitution as the key to economic development in a relatively autarkic environment, they now favored outward orientation.<sup>26</sup> Eastern European countries wanted to open their economies and become integrated with the economies of the West, as well as those of the rest of the world.<sup>27</sup> The principle of comparative advantage became one of the basic tools that Eastern European countries used to achieve economic integration. This theory posits that the goods a nation can produce relatively more efficiently than the rest of the world should be produced and exported, while those goods which the country cannot produce as efficiently should be imported.

More broadly, the goal of each of the Eastern European nations was to establish a free market environment by dismantling the system of central planning and stabilizing the existing and evolving economy.<sup>28</sup> Generally, the Central European countries<sup>29</sup> appeared to be in a better position to quickly and successfully accomplish transition<sup>30</sup> because their governments had implemented some market-oriented reforms under the pre-1989 Communist regimes. Other nations in Eastern Europe, which had not previously attempted reform, were not so well-situated.<sup>31</sup>

In all of these nations, however, the reformers sought to achieve economic stabilization through measures such as control of the government budget deficit, elimination of excess money supply, price reform, foreign trade, property reform, and general economic restructuring.<sup>32</sup> By imple-

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23. The elected governments were comprised of former Communists under different party names: the Socialist Party in Bulgaria, and the National Salvation Front in Romania. Williamson, *supra* note 12, at 374.

24. *Id.*

25. *Id.* at 375.

26. *Id.*

27. *Id.* at 375-76.

28. MOROVIC, *supra* note 5, at 16.

29. Poland, Hungary, and the Czech Republic.

30. MOROVIC, *supra* note 5, at 16.

31. *Id.*

32. *Id.* Specific objectives included reduction in inflation rates endemic to the pre-1989 Communist regimes, and to increase exports.

menting these policies, leaders sought to restore confidence in and value to the domestic currencies.<sup>33</sup> Implicit in many of these objectives was the necessity to "harden" the "soft" budget constraint and to dismantle state-run monopolies.<sup>34</sup> Currency stabilization and price reforms would allow participation in international trade and fulfill the long-suppressed need for various foreign goods, services, and capital.<sup>35</sup> Fundamentally, the goal of each Eastern European nation was to become a successful and stable market economy based on the Western model in a relatively short time.<sup>36</sup>

## II. The Mechanics of Transition

The reform mechanism which is the subject of the most attention and debate is currency convertibility. Currency convertibility, generally, is the freedom to buy and sell foreign exchange with the domestic currency, usually for payments related to the international flow of goods, services, and capital. Current account convertibility is generally advocated as a source of domestic competitive discipline and price signals, both of which play a vital role in guiding domestic firms and individuals toward efficient production, consumption, and investment decisions. Capital account convertibility serves to attract foreign capital investment. Convertibility is often the centerpiece of the reforms established by Eastern European nations in transition. As such, it is not only symbolic of new openness and freedom, but also of the ability of an individual government to implement transition reforms.

A currency is convertible if it "is freely exchangeable for another currency."<sup>37</sup> This definition does not imply the right to convert (the domestic currency for foreign currency) at a fixed exchange rate, but rather to convert at the legal exchange rate.<sup>38</sup> The general definition of convertibility does not specify who is allowed to exchange the currency freely or for what purposes. Convertibility is unrestricted if anyone can freely exchange the domestic currency for any purpose at the legal exchange

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33. *Id.*

34. *See id.* A hard budget constraint requires a firm or government to balance the budget. This constraint necessarily involves a complete reconsideration of government subsidies which are made in order to keep inefficient industries from collapsing.

35. *See id.* at 16-18.

36. Williamson, *supra* note 12, at 376. A move to outward orientation of the economy has also marked Latin America and some Asian countries. Eastern Europe is unique, however, in the magnitude of its transformation from a planned economy to a market economy. Where transformation and privatization in other countries has involved at most 40% of the Gross Domestic Product (GDP), the transition in Eastern European countries involves over 95% of the GDP. Eastern European nations are essentially creating market economies from nothing. *Id.*

37. *Id.* at 377. Most developed, industrial nations have unrestricted convertibility, although this is a relatively recent development. France and Italy abolished their remaining capital controls in 1990. *Id.*

38. Eastern European countries were characterized by the rise of unofficial markets where foreign currencies could be exchanged. At the unofficial rate, the domestic currency was almost always depreciated in comparison with the official rate. *Id.*

rate.<sup>39</sup> Different types of convertibility limit the persons who may exchange the domestic currency and for what purposes they may exchange.

#### A. Current Account Convertibility

Current account convertibility is the freedom of anyone, specifically domestic importers, foreign exporters, and investors, to freely exchange domestic for foreign currency at the legal exchange rate in order to settle any transaction involving the purchase of foreign goods and services, interest payments, or the repatriation of profits.<sup>40</sup> Current account convertibility is often limited through restrictions on the amount of currency citizens may take out of the country for tourist expenditures. Some countries further limit current account convertibility by suspending payment of interest on their foreign debt.<sup>41</sup> A nation could further restrict current account convertibility by intensifying trade restrictions through methods other than limitations on the exchange of currency.<sup>42</sup> In general, the sum of currency exchange controls and trade restrictions determine the extent to which a country's goods and services markets are integrated with the rest of the world.<sup>43</sup>

In nations where the economy was centrally-planned, the establishment of current account convertibility, combined with minimally restrictive trade regulations, introduces a new degree of freedom into the economy.<sup>44</sup> In the absence of quantitative restrictions on imports, the direct benefits of current account convertibility may include significant increases in consumption and consumer satisfaction, as well as improvement in the domestic output of goods and services.<sup>45</sup> Improved access to production inputs and technology constitutes another beneficial effect of current account convertibility.<sup>46</sup> These changes may occur because of the opportunity to purchase foreign goods and services.

Traditionally, scholars have considered the indirect benefits of current account convertibility more substantial than the direct benefits. Indirectly, current account convertibility creates a more competitive environment within the country and promotes more efficient production and investment decisions.<sup>47</sup> The transition to a market economy requires the decentralization of production and investment decisions. In a market economy, information provided through market-determined prices coor-

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39. *Id.*

40. *Id.*

41. *Id.*

42. *Id.*

43. *See id.*

44. Joshua E. Greene & Peter Isard, *Currency Convertibility and the Transformation of Centrally Planned Economies*, in *WEALTH CREATION IN EASTERN EUROPE: FINANCIAL MANAGEMENT ISSUES AND STRATEGIES* 87, 92 (Fred R. Kaen & Ike Mathur eds., 1992).

45. *Id.* at 93.

46. *Id.*

47. Much of this improved efficiency is a result of the inevitable requirement that economic decision-makers consider the country's comparative advantage. *Id.*

dinates these decisions; the market's success depends on the quality of this information and the efficacy of the price-adjustment mechanism in equilibrating supply and demand.<sup>48</sup> Only a competitive, non-autarkic environment can supply the required price information.

Exposure to international competition introduces an economy to prevailing world-market prices. This competition provides domestic producers with a strong incentive to make more efficient decisions and enables them to produce more.<sup>49</sup> In addition, by opening vast markets, international competition provides domestic producers with an incentive to expand the production of some goods and services.<sup>50</sup> Competition also reduces the market power of monopolies and oligopolies, which are common elements of centrally-planned economies. In general, international competition, the result of current account convertibility and a liberal trade environment, induces domestic producers to allocate resources in the most profitable and efficient manner in order to exploit the country's comparative advantage. The long term result is an improvement in the quality and quantity of domestic industry.<sup>51</sup>

These improvements impose certain costs as well. In the short term, a nation will experience substantial domestic unemployment and idle economic capacity if it abandons domestic goods and services in favor of imports (adjustment costs).<sup>52</sup> Substantial reductions in real wages may be necessary to ensure that domestically produced goods remain competitive at home or survive in international markets, especially if the domestic goods are of a lower quality than goods and services available internationally. The result in both cases is a substantial reduction in domestic income.<sup>53</sup>

## B. Capital Account Convertibility

Capital account convertibility is loosely defined as the freedom to exchange domestic for foreign currency through capital transactions.<sup>54</sup> Economies in transition require sizable foreign capital investments and inflows. A significant factor affecting the willingness of foreigners to so invest is the prospect for repatriation of profits, interest, and investment principal, as well as the viability of individual projects.<sup>55</sup> Citizens of a transitioning economy with liberal capital account convertibility will also have

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48. *Id.*

49. *Id.*

50. Eastern European nations with relatively small populations are not large markets in and of themselves. The doctrine of comparative advantage posits that a nation cannot efficiently produce all the goods and services it requires. This inefficiency is especially true when the market is small because producers cannot capitalize on economies of scope and scale.

51. Greene & Isard, *supra* note 44, at 94.

52. *Id.*

53. Arguably, the effect of this reduction may be overstated because of the low standard of living which generally characterized Eastern Europe before transition.

54. Greene & Isard, *supra* note 44, at 95.

55. *Id.*

the opportunity to invest abroad and perhaps achieve greater returns on their foreign investment than would be possible through domestic investments.<sup>56</sup>

Foreign capital inflows are particularly important to the success of economies in transition. Foreign capital can make possible a multitude of economic developments otherwise impossible for want of domestic capital investment. Frequently, foreign investors will back their capital investment with support beyond mere funding.<sup>57</sup> As a result, economies in transition will benefit from an influx of technology, management, management techniques, and marketing information; this array of competitive assistance will increase the international competitiveness of the domestic economy.<sup>58</sup>

Capital inflows on a large scale may cause much greater macroeconomic turbulence. Significant foreign capital investment may lead to greater volatility in exchange rates, external reserves, and interest rates. If most of the capital inflow is in the form of foreign lending, the transitioning nation may face an excessive debt burden.<sup>59</sup> Capital account convertibility also creates a risk of domestic capital flight, as capital resources available from domestic sources are diverted to foreign investments with greater potential for return on capital.<sup>60</sup>

Generally, capital account convertibility is not an end in itself, but merely a function of other reforms. Capital account convertibility will not successfully attract foreign investment unless there is relative certainty and confidence in the country's current and prospective economic and legal reforms.<sup>61</sup> The inherent instability of transition economies, the tremendous risks of capital flight, and wide exchange rate fluctuations which follow a policy of complete capital account convertibility have led Eastern European nations to restrict the convertibility of various capital transactions.<sup>62</sup> Although restrictions on capital flows have become difficult to enforce as world capital markets become more integrated, the capital flow restrictions do have the notable effect of creating a dual exchange rate in a transitional economy.<sup>63</sup>

### C. The Dual Exchange Rate

In developing countries, the increasing openness of capital markets allows market forces to play a large role in determining the exchange rate of

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56. *Id.* at 122 n.8.

57. *Id.* at 95.

58. *Id.*

59. *Id.* at 96.

60. Domestic capital flight may also be considered a benefit to citizens. *See supra* text accompanying notes 51-53.

61. Green & Isard, *supra* note 44, at 96.

62. *Id.* at 97. The Czech Republic is expected to be the first Eastern European nation with full convertibility (complete current and capital account convertibility), but not for several years. *See Kocarnik Expects Full Convertibility in Two to Three Years*, CTN NATIONAL NEWS WIRE, Feb. 17, 1995, available in NEXIS, News Library, Allwld File.

63. Greene & Isard, *supra* note 44, at 97.

major currencies.<sup>64</sup> In developing and transitioning nations, the exchange rate is largely an instrument of policy, set by the government or monetary authorities. Thus, the exchange rate is not directly influenced by market forces.<sup>65</sup> Restrictions on capital account convertibility, universal in the transitioning economies of Eastern Europe, result in a dual exchange rate system. The dual rate follows from extensive current account convertibility (with convertibility for some capital transactions) without corresponding full convertibility for capital transactions.<sup>66</sup> In practice, different exchange rates prevail for different types of transactions.<sup>67</sup>

There are two aspects of the dual exchange rate system. The first is the nominal exchange rate, which is set by a declaration of the government. The second is the real exchange rate, which applies to certain mercantile transactions.

### 1. *The Nominal Exchange Rate*

The nominal exchange rate is literally the cost of foreign currency in terms of domestic currency. This rate is commonly found in newspapers and other easily accessible sources. It is ostensibly the rate at which any amount of foreign currency can be exchanged for an equivalent amount of domestic currency. Of course, this absolute freedom of exchange is often restricted by various convertibility regimes. For example, the nominal exchange rate may be fixed. In such a case, the government sets the rate of exchange by declaration. Alternatively, the nominal exchange rate may be determined in a floating regime in which domestic and international market forces determine the relative value of the domestic currency.

No Eastern European nation has adopted a floating rate regime. While it is arguably the apogee of a true market economy, governments have resisted the floating exchange rate for several reasons. One reason is the difficulty of interpreting the traditional monetary indicators under a floating regime. Another problem is that a floating rate can only function efficiently in the presence of a well-developed capital market.<sup>68</sup> The final explanation for the reluctance to implement such a regime is that floating rates have a propensity to induce large trade imbalances and consequent economic distortions even in large and well-developed economies.<sup>69</sup> Economies in transition lack both the expertise to resolve the first problem and the required capital market infrastructure to accommodate a float-

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64. Bijan B. Aghevli & Peter J. Montiel, *Exchange Rate Policies in Developing Countries*, in *EXCHANGE RATE POLICIES IN DEVELOPING AND POST-SOCIALIST COUNTRIES* 205 (Emil-Maria Claassen ed., 1991).

65. *Id.*

66. Greene & Isard, *supra* note 44, at 97.

67. Different exchange rates may apply to different types and quantities of imports, as well as to private debt service, profit repatriations, and other varieties of capital remittance. See Aghevli & Montiel, *supra* note 64, at 206.

68. *Id.* at 393-94.

69. *Id.* at 394.

ing rate regime. In addition, the final concern about distortions would only be magnified in Eastern Europe's infant market economies.

Each of the Eastern European economies in transition has adopted a fixed exchange rate. These countries may utilize a multitude of methods and policies to fix the rate.<sup>70</sup> However, all fixed rate regimes have several principles in common, including the willingness to interfere with capital and current account markets in order to maintain the fixed rate. If the exchange rate was determined by market forces, then it would not be fixed, but floating. Therefore, in order to maintain a fixed exchange rate, a government must adjust its economic policies to respond to changing market conditions.

There are two major requirements for the successful maintenance of a fixed exchange rate. The first is a willingness to restrict capital account convertibility. If capital mobility were unrestricted, it would be virtually impossible to maintain the fixed rate.<sup>71</sup> Second, a fixed exchange rate requires a willingness to allow the money supply to be determined by the balance of payments.<sup>72</sup> The government must be prepared to interfere with the balance of trade—through, for instance, protectionist intervention—in order to maintain the money supply. The stability and efficacy of the fixed exchange rate, as perceived by international markets, depends in large part upon the credibility of the government. Investors must believe that the government can and will undertake the measures necessary to maintain a fixed exchange rate.<sup>73</sup>

Government credibility forms the basis for the major objections to the fixed exchange rate. If an economy is in transition, investors may have little faith in the government's ability to determine the proper fixed exchange rate.<sup>74</sup> Eastern European governments, with their socialist legacy, may also lack the political capability or the willingness to undertake the austere economic measures which are sometimes necessary to maintain a fixed rate.

## 2. *The Real Exchange Rate*

The real exchange rate is an endogenous macroeconomic variable and cannot be directly controlled by the authorities.<sup>75</sup> It is a function of the relative prices of internationally traded goods, adjusted by the nominal

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70. For a detailed discussion of these methods and their respective merits, see *EXCHANGE RATE POLICIES IN DEVELOPING AND POST-SOCIALIST COUNTRIES* (Emil-Maria Claassen ed., 1991).

71. See Aghevli & Montiel, *supra* note 64, at 228-32.

72. Growth in the domestic money supply can result from an increase in government expenditures. If these expenditures are not restrained, inflation and a relative devaluation of the domestic currency will result. If the fixed rate is not adjusted to compensate for this growth in the money supply, the exchange rate will not be useful to markets as an indicator of relative prices. Parallel currency markets and alternate mechanisms for the store and exchange of value will arise. See Williamson, *supra* note 12, at 394-95.

73. *Id.*

74. *Id.* at 394.

75. Aghevli & Montiel, *supra* note 64, at 227.

exchange rate.<sup>76</sup> An economy in transition produces or uses three types of goods: importables, exportables, and nontradables.<sup>77</sup> The prices of both imports and exports are set on the world market. Domestic consumers must pay a price for imported goods set by the foreign producer, and the international market determines the price for exports. Various supply and demand conditions within the country determine the price for nontradables. The real exchange rate is the relative price of nontradable goods to tradable goods.<sup>78</sup>

In general, if the real exchange rate is weak, the domestic price of tradables is relatively lower than the price of nontradables. Conversely, if the real exchange rate is strong, then the relative price of tradables is higher than the price of nontradables. Where the real exchange rate is in equilibrium, the domestic market for both tradables and nontradables clears. In this case, the production capacity of the country in transition is utilized most efficiently, and there is no excess supply or demand for any tradable or nontradable good.

If the domestic economy is not current account convertible, variations in the real exchange rate are generally inconsequential.<sup>79</sup> However, if the domestic economy has implemented a policy of current account convertibility, disequilibrium in the real exchange rate leads to domestic economic turbulence. A simple example is illustrative.

An economy produces and consumes three goods: exports, imports and nontradables. Initially, the domestic price for each good is 5 DUs (Domestic Units). The price for each tradable good on the international market is 1 FU (Foreign Unit). The relative price of nontradable goods to tradable goods is 5:1. If the real exchange rate is devalued to 7:1, the relative prices change. The nontradable good price remains 5 DUs. However, while an export is still worth only 1 FU on the world market, the price received by the domestic producer of an export is 7 DUs. Imports also cost 7 DUs. If the real exchange rate is overvalued, the real exchange rate is 3:1. The nontradable still costs 5 DUs. The amount received by the domestic producer of an export is only 3 DUs, while an import also costs 3 DUs. Both the export and the import are still valued in the world market at 1 FU.

Generally, when the real exchange rate is weak (7:1 in the example), there will be an excess supply of exports in the domestic market. The reason for this surplus is that exporters receive relatively more in domestic currency for exports than they would if they produced nontradable goods or goods which could be imported. Domestic consumers will prefer non-

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76. *Id.* at 212.

77. Exports and imports combined are "tradables."

78. Deepak Lal, *Growth Collapses, Real Exchange Rate Misalignments and Exchange Rate Policy in Developing Countries*, in EXCHANGE RATE POLICIES IN DEVELOPING AND POST-SOCIALIST COUNTRIES 277, 286 (Emil-Maria Claassen ed., 1991).

79. This is because a nation without current account convertibility is essentially autarkic, and not dependent on world markets to satisfy economic needs. However, it is well-accepted that the autarkic, centrally-planned economy is unacceptable. This belief constitutes much of the basis for the transition to market economies in Eastern Europe.

tradable goods over imports, because, assuming that there is no difference in quality, nontradables are less expensive. The excess supply in the domestic market of exports will be consumed by the world market. With a weak real exchange rate, the country will have a foreign trade surplus. There will be a net increase in domestic productivity because not only will there be an increase in export production, but domestic consumers will also prefer nontradables over imports. This preference reduces net imports and expands the domestic market for and production of nontradables.<sup>80</sup> A weak exchange rate may also impose inflationary pressures on the domestic economy as increased foreign trade and the expansion in domestic output accelerate the demand for money.

When the real exchange rate is strong (3:1 in the example), the result will be a net reduction in output of the domestic economy. Producers will have an incentive to shift productive resources to the manufacture of nontradables, since their return on the production of exports is only 3 DUs, whereas the return on nontradables is 5 DUs. There will be an excess supply of nontradables because of producer conversion and reduced consumer demand. The net effect on the economy will be increased unemployment because the world market cannot absorb the excess supply of nontradables. Another potential effect is a trade deficit, which is produced by consumer preference for imports and the reduction in export production. However, the economy can benefit from the near elimination of inflation, since there will be a decrease in demand for the domestic currency.<sup>81</sup>

### III. Public Choice Theory and Transition

There is widespread agreement that the Eastern European countries will accomplish the transition to market economies.<sup>82</sup> There is equal agreement that the method of achieving this transition is through current account convertibility and, eventually, capital account convertibility. However, while there is substantial agreement as to what will be eventually achieved, there is considerable theoretical disagreement over how the transition to a market economy should proceed.<sup>83</sup>

Although economists cannot reach consensus as to the ideal theoretical transition policy, the actual policies implemented by Eastern European nations in transition have both remarkable similarities and significant differences. However, the theoretical debate about transition theory lacks a fundamental understanding of the process by which governments reach decisions. Public choice theory provides economists with a decision-making model. Vaclav Klaus was only partially correct when he averred that bureaucrats in a centrally-planned economy could not make the decisions

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80. See Aghevli & Montiel, *supra* note 64, at 225-26.

81. See *id.*

82. MOROVIC, *supra* note 5, at 1.

83. *Id.*

necessary to guide the entire economy.<sup>84</sup> In fact, self-motivated bureaucratic behavior is not confined to centrally-planned economies. While no government can successfully manage every aspect of any economy, public choice theory explains why politicians decide as they do.

#### A. Public Choice Theory

The economic (or "interest group") theory of legislation "asserts that legislation is a good demanded and supplied much as other goods, so that legislative protection flows to those groups that derive the greatest value from it, regardless of overall social welfare."<sup>85</sup> Under this theory, decisions made by politicians, bureaucrats, and political coalitions are analyzed according to generally accepted principles of rational economic behavior. The economic theory of regulation predicts different outcomes than the traditional "public interest" theory of regulation, which posits that regulation is designed to benefit the public by solving collective action problems and other sorts of market failure.<sup>86</sup> In contrast, the economic theory of regulation treats the behavior of political decision-makers just like that of their private-sector counterparts: they attempt to maximize their own self-interest, often at the expense of overall societal welfare.

Under the economic theory of regulation, interested parties form distributional coalitions in order to trade resources, such as power, influence, and money, in exchange for legislation that provides benefits to the coalition members. An effective distributional coalition will form when the benefits from effecting wealth transfers through the political vehicle outweigh the costs of organizing. Some groups will be able to organize into distributional coalitions more cheaply than others.<sup>87</sup> Groups that have already formed into coalitions for exogenous reasons, such as mutual professional organizations or unions, will find that the marginal costs of diverting their activities to the political arena are far outweighed by the benefits such activities can procure from favorable legislation and governmental policy.<sup>88</sup>

The economic theory of regulation recognizes that organized distributional coalitions are better able to provide the support politicians require to retain office and status than are disorganized citizens. Accord-

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84. See Klaus, *supra* note 22, at 11.

85. Richard A. Posner, *Economics, Politics, and the Reading of Statutes and the Constitution*, 49 U. CHI. L. REV. 263, 265 (1982).

86. ROBERT E. MCCORMICK & ROBERT D. TOLLISON, *POLITICIANS, LEGISLATION, AND THE ECONOMY: AN INQUIRY INTO THE INTEREST-GROUP THEORY OF GOVERNMENT* 3 (1981). The relatively naive view that legislators are public-regarding guardian angels who meet periodically to right the wrongs of society has been thoroughly discredited. See Joseph P. Kalt & Mark A. Zupan, *Capture and Ideology in the Economic Theory of Politics*, 74 AM. ECON. REV. 279, 279 (1984).

87. MCCORMICK & TOLLISON, *supra* note 86, at 16-18; MANCUR OLSON, *THE RISE AND DECLINE OF NATIONS: ECONOMIC GROWTH, STAGFLATION AND SOCIAL RIGIDITIES* 18 (1982).

88. See Jonathan R. Macey, *Transaction Costs and the Normative Elements of the Public Choice Model: An Application to Constitutional Theory*, 74 VA. L. REV. 471, 477-80 (1988).

ingly, politicians unable or unwilling to satisfy distributional coalitions will be driven from office by rival politicians more capable or willing to supply the demands of the distributional coalitions. For example, suppose a particular piece of legislation will cost citizens \$3.00 each in new taxes, but will transfer \$200 million to a particular distributional coalition. In order to oppose the legislation, the public will face costs of organization which will likely exceed the per capita tax increase of \$3.00. Furthermore, citizens must also expend resources to acquire information about the merits of the proposed legislation. This information cost per citizen will also exceed the individual tax burden. It is only rational that citizens not expend resources to acquire information beyond the per capita cost of the legislation or organize to oppose the legislation. Citizens will instead remain ignorant about the effects of the proposed wealth transfer and will not organize to resist it. The distributional coalition, however, has every incentive to expend resources up to the full amount of the proposed wealth transfer in order to effectuate the legislation and the wealth transfer.

A useful generalization, while not without some qualification, is that the economic theory of regulation predicts that legislation will typically grant concentrated benefits to discrete groups funded by widely dispersed costs. This result will occur because the cost of legislation is borne by the disaggregated public, who are in the worst position to object to it. The distributional coalitions, however, are able to successfully trade political support for the passage of wealth-transferring legislation. Politicians have strong incentives, notably the desire to gain office or to retain it, to seek out issues where the winners—the distributional coalitions—are easily identified and where the losers—those from whom wealth is extracted—are difficult to identify.<sup>89</sup> Such issues concentrate the benefits available to the distributional coalition, readily enabling their support, while camouflaging (and increasing organizational and information costs for) those who must pay for the coalition's benefits with higher taxes, increased regulatory burdens, and higher prices for goods and services.

Another aspect of the economic theory of regulation is "rent extraction." This process is distinguishable from "rent creation," by which a distributional coalition arises to support legislation which favors the coalition at the expense of the disaggregated public or rival producers. "Rent extraction" occurs where economic actors in markets which appear to be operating relatively free from government regulation must expend resources to keep their markets unregulated.<sup>90</sup> Politicians may then extract rent from economic actors in certain markets in exchange for their regulatory forbearance.

According to the economic theory of regulation, the economic and monetary policies of a nation in transition to a market economy reflect the

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89. Jonathan R. Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223, 229-30 (1986).

90. Macey, *supra* note 88, at 479; see Fred S. McChesney, *Rent Extraction and Rent Creation in the Economic Theory of Regulation*, 16 J. LEGAL STUD. 101, 102-03 (1987).

actions of rational and self-interested political and economic actors. For instance, if the transition process is generally successful, distributional coalitions will seek out and support new wealth-transferring policies made possible by the economic transition. Alternatively, coalitions faced with the loss of wealth-transferring legislation because of a successful transition will pay politicians to oppose legislation which alters the status quo. Regardless of the status of the transition process, politicians will attempt to identify and capitalize upon particular issues where the benefits are concentrated and the costs diffused. An especially powerful consideration for both politicians and the distributional coalitions is the magnitude of possible effects of the wealth-transferring legislation, in the form of monetary policy, on the welfare of the citizenry as a whole. While a wealth transfer to a distributional coalition funded by a disaggregated tax increase may impose relatively small costs on individual citizens, a nation's monetary policy, exchanged by the politician for support from a distributional coalition, may dramatically increase costs to individuals. In such a case, the costs to the individual of obtaining information about the policy and organizing to oppose it may be less, perhaps even significantly less, than the per capita cost of the legislation. Because of these increased costs, previously uninformed citizens and individual opponents to the legislation will coalesce into effective distributional coalitions to oppose the legislation.

#### B. Public Choice Theory and Convertibility

A policy of full convertibility, where the government of a nation permits its citizens to purchase unlimited amounts of foreign currency and other assets with domestic currency in both the exchange of goods and services and in capital transactions, may have either beneficial or destabilizing effects on the national economy. These effects depend on a nation's pre-transition capability in the tradable goods sector and its consequent ability to maximize the positive economic results of full convertibility and a market economy through comparative advantage.

Before transition, the tradable goods sector of an economy is not necessarily in a position to profit from trade with other nations. The doctrine of comparative advantage posits that the overall welfare of a nation will improve if it concentrates on producing goods and services that it can produce most efficiently, while importing goods and services which can be produced more efficiently elsewhere. A pre-transition economy may not be comparatively efficient in the tradable goods sector because a nation produces many goods and services which it would be better off importing, while it does not produce goods and services which other nations want to buy. Alternatively, the pre-transition tradable goods sector might produce goods and services which other nations wish to import.

However, the doctrine of comparative advantage must ultimately prevail. As a result, a nation with a full-convertibility policy will eventually

begin to produce in a comparatively efficient manner.<sup>91</sup> This conversion to a system of comparatively-efficient production, where a nation quickly adopts a full or current account convertibility policy, does not come free. The price is adjustment costs: large segments of the economy must be diverted to produce different goods and services. The economy as a whole, as well as individuals functioning in society, must bear the adjustment costs as entire industries are shutdown, jobs are irrevocably lost, and skills are made obsolete. The amount of the adjustment cost is determined by the configuration of the tradable goods sector of the economy prior to transition.

If the pre-transition production of goods and services is comparatively efficient—i.e., the nation already produces goods and services that are competitive on the world market and imports goods and services that cannot be efficiently produced at home—the adjustment costs will be small and the benefits from comparative advantage will be large. This is because the goods and services the country produces most efficiently will be exported at higher prices than the domestic market is willing to pay, while the goods and services the country cannot make efficiently will be imported at a lower cost than if they were produced domestically. On the other hand, if there is little pre-transition comparative efficiency in the tradable goods sector, then transition and full convertibility may impose tremendous adjustment costs. In the short term, the adjustment costs imposed on the economy as a whole may be so large that the long-term benefits resulting from full or current account convertibility seem relatively insignificant. Particular industries and other parts of the economy may have to pay the ultimate adjustment cost: elimination.

The economic theory of regulation provides a model to be used in evaluating and predicting the configuration of an economy in transition. Where the pre-transition tradable goods sector is configured to benefit from comparative advantage, the adjustment costs will be relatively small. Distributional coalitions, formed from representatives of economic sectors which stand to benefit from full convertibility, will support politicians who advocate full convertibility up to the amount of benefits the coalition would receive under that regime. Coalitions of economic actors in sectors which will have to pay for full convertibility through adjustment costs will also form and will expend resources to oppose convertibility. However, since the pre-transition tradable goods sector is positioned to benefit from convertibility, anti-convertibility coalitions will be willing to expend considerably fewer resources than pro-convertibility coalitions. This is because some coalitions will receive more benefits than the costs borne by other economic sectors.

In particular sectors of the economy, the costs of convertibility may be very concentrated and the benefits relatively diffused. The marginal costs

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91. In the long run, the important but indirect result of current account convertibility is an internationally-competitive tradable goods sector. See Greene & Isard, *supra* note 44, at 93-95.

to these narrow groups will exceed the marginal benefits which would accrue to many others. Therefore, the cost-bearing groups will have an incentive to organize to protect their particular sector, although the marginal costs may not be large enough to provide an incentive to resist convertibility in the nation at large. Although current account convertibility will progress in the country with the support of those who will benefit from it, some economic sectors may retain significant government regulation.

Where the pre-transition tradable goods sector is not well-configured to benefit from comparative advantage, and consequently the adjustment costs of a convertibility regime are large, the economic theory of regulation predicts that coalitions in support of convertibility will have less incentive to form. If adjustment costs are large, affected individuals, such as workers and managers in industries that convertibility would impact severely, have every incentive to seek information about relevant politicians and proposed legislation implementing a more full-convertibility regime. Such coalitions will expend resources up to the adjustment costs of transition in opposition to convertibility. The distributional coalitions that support legislation implementing convertibility also will have good reasons to expend resources, but this incentive amount will be relatively small when compared to that of the opposition coalitions. Politicians acting rationally to maximize their private interests will prefer the greater resources offered by the opposition coalitions, and full convertibility legislation will fail.

The economic theory of regulation also holds that politicians acting in their private interests will actively seek out issues where "losers" are not clearly identified and "winners" are. Politicians may then entice "winners" to expend resources in the politicians' favor in exchange for support of the wealth-transferring legislation. Conversely, politicians may also seek to extract resources from particular industries or markets in exchange for not imposing transition costs upon them. For instance, in a transitional nation with severe political and economic instability due to reasons extraneous to convertibility issues, distributional coalitions may not readily form because the "winners" resulting from a full-convertibility regime may not be discerned without relatively large organization costs. In essence, the long-term benefits of convertibility may not be readily attributable to newly-formed economic sectors. Indeed, the country may be disorganized to such an extent that the economic actors who would benefit from convertibility are unidentifiable. However, "losers" from full-convertibility may be identified more easily. These groups will include bureaucrats facing a loss of economic control, state-supported monopolies, and others who face considerable loss under a full-convertibility regime.

Politicians may seek to extract resources from these groups in exchange for opposing full-convertibility legislation. The targeted coalitions would be willing to expend resources for the absence of legislation up to the amount of losses they would experience if such proposals were approved. In comparison, distributional coalitions in support of such leg-

isolation may not be effectively organized and could not respond to such tactics by expending their own resources. Conversely, a large country, even in the face of instability, might present profitable markets to foreign distributional coalitions if it adopted a current account convertibility regime which allows access to domestic markets by foreign producers. These foreign coalitions may be willing to expend significant resources in exchange for convertibility legislation.<sup>92</sup> If the political environment is sufficiently unstable to endanger future transfers from coalitions which oppose current account convertibility, or if the foreign coalitions stand to benefit significantly from convertibility, politicians will favor convertibility legislation.

### C. Public Choice Theory and the Real Exchange Rate

The real exchange rate measures relative prices between tradable and nontradable commodities in an economy. In a nation with full convertibility, a weak real exchange rate will raise the price of tradable goods and services compared to the price of non-tradable goods and services. This situation will also create an excess supply of tradable goods and services which may be sold on world markets. Because domestic consumers prefer cheaper nontradables, there will be excess demand due to the low price and a reduction in the supply of nontradables as producers shift production resources to exports. The economy will experience a trade surplus. In addition, there will be domestic wage increases and inflationary pressure within the economy because of the increase in money supply which follows the trade surplus.

Conversely, if the real exchange rate in a current account convertible economy is strong, then the price of nontradable goods and services will be higher than the price of tradable commodities. Producers will respond by producing more nontradable goods and services and fewer tradables. Consequently, there will be no excess of tradable commodities to export and the country will have a foreign trade deficit. Because of the higher relative price of nontradable commodities, consumers will buy fewer domestically produced nontradables and more imports. This demand shift will result in an excess supply of nontradables, which the world market will not absorb. Deflationary pressure within the economy will follow as demand for the domestic currency decreases. Unemployment will increase as the production of nontradable commodities diminishes and the production of exports contracts.

A nation undergoing economic change will experience some unemployment because of the adjustment costs which invariably accompany transition. If these adjustment costs are combined with unemployment which follows from a strong real exchange rate, the country may experience very high levels of unemployment and significant economic turbulence. These side effects of convertibility will impose significant costs on

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92. Convertibility is all the more significant because it is generally a "one-time" bargain; once convertibility is introduced, it is difficult to undo.

large numbers of citizens. When those costs exceed the costs of organizing a distributional coalition, coalitions will form to oppose the policies which have imposed the costs. The economic theory of regulation recognizes that these distributional coalitions will expend resources up to the level of the imposed costs in order to either redirect the politicians' support or to replace them altogether with other politicians more responsive to the coalition's interests.

Other distributional coalitions may form to support the strong real exchange rate. Producers of nontradable commodities will organize to support a strong real exchange rate which transfers wealth to them. A strong real exchange rate produces the wealth transfer by increasing the prices of nontradables. State-supported monopolies and other elements of a centrally-planned economy can support a strong real exchange rate. Furthermore, distributional coalitions may form from the tradable sector to support tariffs and other protectionist policies which protect their interests from foreign competition.

A transitional country with current account convertibility may choose to adopt policies which strengthen the real exchange rate. The economic theory of regulation posits that the question of whether these policies will be enacted or continued depends upon the costs imposed, as well as the benefits made possible, by each policy. If the costs are high enough, the parties who bear them will have every incentive to become informed and organized to resist the policies which lead to a strong real exchange rate, and will expend resources to further this resistance up to the amount of the costs imposed by a strong real exchange rate. Citizens who stand to benefit from the policies will also expend resources up to the amount of benefits that the strong rate will transfer to them. The policy adopted turns upon whether the costs or benefits are greater, as well as the concentration of costs and benefits among the various economic actors. A country-specific analysis is necessary to determine which policy is most likely to be followed.

Concentration of the costs and benefits is a significant consideration. The economic theory of regulation holds that individuals are willing to expend resources to form effective distributional coalitions only up to the point of their personal cost or benefit from a given policy. If many individuals bear the costs of an unbalanced real exchange rate, then the costs may be small for each person even if they are large in the aggregate; those individuals are willing to spend little to organize. However, if benefits are concentrated, then those who seek wealth-transfers possess the incentive to spend amounts up to the level of expected benefits to ensure the adoption or continuation of wealth-transferring policies. For instance, unemployment is a diffuse cost; it is large in aggregate while the individual cost is relatively small. There is an insufficient incentive to form coalitions to resist policies which increase unemployment. However, a strong real exchange rate may benefit a relatively small sector of the economy a great deal, and the recipients of those concentrated benefits will form effective coalitions to support the strong rate. If, however, unemployment reaches

cataclysmic levels, the aggregate costs may become so large that individuals with few legal resources to spend in support of favored legislation will turn to revolution, assassination, and other extra-legal methods of influence.

Similarly, a weak real exchange rate in a transitional economy with current account convertibility generally reduces unemployment but may increase inflation. A weak exchange rate may ameliorate some of the unemployment which results from transition adjustment costs. Producers of tradable commodities will also benefit from the weak real exchange rate. In contrast, producers of nontradables, as well as various other economic sectors such as emerging capital markets which would be harmed by increasing rates of inflation, may resist weak exchange rate policies if the costs become too large. Ultimately, the policy adopted by the politicians will depend upon the absolute level of costs and benefits and upon their relative degree of diffusion among economic actors.

#### D. Public Choice Theory and the Nominal Exchange Rate

The nominal exchange rate is the price of a nation's currency in terms of another currency. If the country has both current account convertibility and some elements of capital account convertibility, the nominal exchange rate may be either fixed, where the government establishes the currency price, or floating, where the market determines the currency price.

A fixed nominal exchange rate implies that the nation also restricts capital mobility.<sup>93</sup> A fixed rate also implies that the government is prepared to remedy imbalances in the nominal exchange rate through protectionist intervention in foreign trade. If properly maintained, the fixed nominal exchange rate induces foreign investment in a nation because the nation's currency is stable and not subject to large fluctuations in relative value.

A floating nominal exchange rate is determined by the international market. While the fixed nominal exchange rate is a governmental policy which both influences and is influenced by other economic policies and indicia, the floating nominal exchange rate is purely dependent on other economic policies, as valued by international currency markets.

Maintenance of a fixed nominal exchange rate requires the government to intervene, or at least be prepared to intervene, in a nation's foreign trade in order to correct current account imbalances. A credible fixed nominal exchange rate regime may act as a nominal anchor for the domestic currency, ensuring price stability and attracting foreign investment.<sup>94</sup> The economic theory of regulation holds that individuals who stand to benefit from government intervention in foreign trade through tariffs, import restrictions, and similar measures will organize into distributional coalitions to support an interventionist policy.

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93. Greene & Isard, *supra* note 44, at 98-99.

94. Williamson, *supra* note 12, at 394-95.

Other distributional coalitions opposed to protectionist trade measures may organize to oppose the fixed nominal exchange rate scheme. Their ability to organize and effectively communicate to politicians their preference for a floating nominal exchange rate for various resources is a function of the benefits expected from a floating rate, as well as the costs of trade interventionist policy. Another factor postulated by the economic theory of regulation is the concentration or diffusion of benefits and costs. For example, trade intervention may cost many individual citizens a great deal as prices rise; the cost to any individual citizen, however, is likely to be relatively small, and this small cost is not enough to rationally justify the costs of information and organization by trade intervention opponents.

#### IV. Public Choice Theory as an Explanation for Form and Outcome in the Transition Process

The 1989 revolutions in Eastern Europe initiated an irreversible process of change from totalitarianism to political pluralism and representative democracy. Accompanying this political change is an economic change from centrally-planned economies to market economies dependent upon private enterprise, functional pricing mechanisms, and viable currencies.<sup>95</sup> Since political freedom is fundamentally linked to economic freedom, the transition to market economies is one of the most important issues facing Eastern Europe.

The form of the transition in Eastern Europe cannot be entirely explained by contemporary economic theory. Public choice theory, however, is the vehicle through which the transition process can best be understood. Political decisionmakers are certainly influenced by macro-economic theory; however, even more fundamental than theories which postulate the most preferable means to effect transition are the economic realities of public choice, which dictate the nature of the policies actually implemented.

The form and interim outcome of the transition process are functions of the costs and benefits of competing transition policies and their aggregate levels of distribution among the economic actors involved with and affected by the process. There are five groups which may significantly influence the nature of transition policies: country citizens, politicians, entrenched bureaucrats, nascent industry, and incumbent industry.

##### A. The Economic Actors

###### 1. Country Citizens

Citizens of a country usually bear the cost of wealth-transferring policies desired by distributional coalitions, because the costs of wealth-transferring legislation are typically disaggregated and any single citizen must only pay for a tiny portion of the absolute cost of the legislation. If wealth-

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95. See Domenico Mario Nuti & Richard Portes, *Central Europe: The Way Forward*, in *ECONOMIC TRANSFORMATION IN CENTRAL EUROPE 1* (Richard Portes ed., 1993).

transfer legislation imposes large costs on a readily ascertainable portion of the public, the cost borne by citizens within the particular group will increase dramatically. This segregated increase in cost will incite individuals in the targeted groups to organize, seek information, and resist wealth-transferring legislation. For instance, if a particular policy would dramatically reduce government pensions, pensioners would organize to resist this policy.

Resistance will often coalesce because, in many cases, the costs to citizens resisting a policy may be quite low. For example, it costs relatively little for a citizen to cast a vote for a rival political party. Information costs, which can be a barrier to acquiring correct or complete information, may be very low if the aggregated public group is motivated by an indefinite principle. An example of this low information cost is when a rival political party publicly announces that the policies of the majority party would 'hurt' pensioners. Pensioners would then resist the policy, whether or not it would actually impose excessive costs on them. The information costs of correcting the rival party's disinformation would not be borne by the pensioners, but by the majority party. This information cost may be too much for the majority party to meet, and the majority party would lose at the polls because of "disinformation costs."

## 2. *Politicians*

In addition to the general tenets of public choice theory, politicians in transition countries must consider the possible scope of wealth-transferring legislation. In relatively small countries, information and organizational costs may be significantly less than in larger countries. If these costs are low, the wealth transfer that may be effected without resistance is considerably less because opposing distributional coalitions will form when the costs imposed upon individuals by legislation exceed the low information and organizational costs.

When a politician may not rely on significant resource expenditures for political support by groups which stand to benefit from wealth-transfers, that politician must turn to other sources. In small countries, the costs of informing citizens may be substantially lower than the costs of camouflaging wealth transfers. Rather than seeking support from coalitions which stand to benefit from wealth transfers, the politician in a small transitional country may seek to inform the populace and receive political support directly from voters.

## 3. *Entrenched Bureaucrats*

Entrenched bureaucrats are a legacy of the centrally-planned economy in countries in transition. They may resist any transition policy that would reduce the amount of control that bureaucrats may exercise over the nation. Bureaucrats, just as politicians, broker support in various forms from groups which could be aided or harmed by policies under their control. Entrenched bureaucrats will resist legislation with higher costs, in the form of lost control and authority, than benefits.

Bureaucratic choice is particularly important in nations emerging from a centrally-planned economy in which the economic decisions made by entrenched bureaucrats had the greatest impact on the nation. A complex bureaucratic infrastructure cannot be easily dismantled overnight. The resulting chaos would be less desirable than the previous bureaucratic inefficiency. Therefore, entrenched bureaucrats in a nation in transition will retain and defend an important position in the nation's economic policies.

#### 4. *Nascent Industry*

Just as large bureaucracies cannot be dismantled overnight, prosperous industries generally do not come into existence quickly. The sudden introduction of private enterprise should cause many small, independent businesses to start up. However, organizations of nascent industries are not likely to arise quickly, and there will be a high marginal cost for an organization to divert its efforts to the legislative arena because there are no existing organizations. The marginal costs to new enterprises of becoming informed and organized may, indeed, be prohibitive during transition.

In contrast, foreign organizations may be willing to expend substantial resources in order to secure legislation which transfers wealth to them. These organizations do face low marginal costs in that they can merely divert their rent-seeking efforts from a different country. Domestic politicians will likely have only a very limited ability to extract rent from foreign enterprises, but foreign organizations may have the resources to influence substantially the character of domestic legislation.

#### 5. *Incumbent Industry*

Much like entrenched bureaucrats, incumbent industries once held positions of great importance in centrally-planned economies. Given the socialist propensity to centralize production, the entire national economy may have been substantially dependent on the viability of one incumbent production facility. Furthermore, incumbent industries in centrally-planned economies absorbed the natural unemployment which market economies produce; dismantling the incumbent industry may eliminate employment for an untoward number of citizens.

An incumbent industry may be especially resistant to wealth-extracting legislation, not because of its direct efforts or willingness to expend resources, but merely because substantially affecting the operations of an incumbent may dramatically injure the economy. Politicians may be unwilling to incur the indirect costs of extracting wealth from an incumbent industry. The relationship between incumbent industries and the entrenched bureaucracy is also significant because much of the control which bureaucrats exercised was a result of the industrial configuration of their centrally-planned economy. In essence, incumbent industries and entrenched bureaucrats constitute a vested coalition, influential

beyond its own resources because of the negative economic effect which would follow its demise.

## B. The Transition Hypothesis

### 1. *Current Account Convertibility*

Theoretically, the most free and successful economy will have full current and capital account convertibility along with a flexible nominal exchange rate. In such a hypothetical economy, free domestic or world markets determine the prices for all commodities and products as well as currency prices. However, the costs of radically transforming a centrally-planned economy into a liberal market economy are considerable. Each country in Eastern Europe will face different costs for various reasons, such as its size and pre-transition economic configuration. Because of these costs, the transition process in Eastern Europe has proceeded and will continue to proceed in ways not explainable by traditional macroeconomic theory. This nontraditional response is also attributable to self-serving goals of certain groups seeking personal benefits. In addition, because these costs and benefits vary for each country, transition policies will not be uniform across Eastern Europe.

Communism demonstrated that autarky does not work. In order to achieve a successful and dynamic economy, a nation must trade with the world. Therefore, current account convertibility will be a priority throughout Eastern Europe not only because of economic necessity, but also because of the link between free trade and political self-determination. However, the benefits from unrestricted current account convertibility are diffuse. Specifically, in previously centrally-planned economies, the particular economic sectors which would benefit from policies of unrestricted international trade are not readily ascertainable. This diffusion of benefits dramatically increases the organization costs of groups which support liberal trade policies.

In general, it costs very little for citizens to support a politician who promises "free trade" and access to international markets. Because of these low costs, politicians who support current account convertibility generally will receive electoral support. This general support does not necessarily encompass the transition policies and legislation which support free trade.

Specific and detailed legislation is the vehicle through which transition is implemented. The costs to the public of becoming informed and organized to support specific legislation are considerably higher than the costs associated with the support of nonspecific principles. These costs act as a barrier to the disaggregated public becoming informed and organized to support or resist such policies. However, specific industries and economic sectors will have an incentive to organize and support various policies when the costs of legislation to them are large. While the costs of a particular current account convertibility policy may be relatively small in the national aggregate, the costs to a specific industry may be significant.

That industry has an incentive to transfer resources to politicians up to the level of costs in exchange for protection and exemption from the policy.

Such sector-specific protections become even more likely because the centrally-planned economy concentrated many economic sectors. Large incumbent industries and entrenched bureaucracies are already organized and concentrated. The marginal costs to these groups of diverting resources to the political arena are relatively low. Countries in transition, while ostensibly supporting the principle of free trade through current account convertibility, will be characterized by protections and exemptions from trade liberalization for incumbent industries and economic sectors organized before transition began.

## 2. Exchange Rates

A fixed nominal exchange rate implies a commitment by the government to interfere with the balance of trade in order to maintain the fixed rate. The government's ability to maintain a fixed exchange rate is also a function of prestige and stability; nations which are capable of maintaining a stable exchange rate earn a greater level of foreign respect. In addition, foreign investors look favorably upon stable exchange rates because the value of their investments in the nation is less likely to evaporate. Politicians benefit from the existence of a maintainable fixed rate because of the increased influx of foreign capital as well as from increases in domestic and international political prestige.

The government's commitment to interfere with the balance of trade in order to maintain the fixed nominal exchange rate is also attractive because economic sectors will be willing to pay in order to benefit from restrictive measures. Economic sectors may also be willing to pay for the harmful regulation of their rivals. Politicians will support a fixed nominal exchange rate because they can benefit from brokering the succession of wealth transfers required to maintain the rate. The existence of a fixed nominal exchange rate also creates a separate real exchange rate, which the politician can influence through subsidies and favorable tax treatment.

Nevertheless, because of a multitude of exogenous factors, a strong commitment to a fixed real exchange rate may be untenable.<sup>96</sup> These factors may make maintenance of a fixed nominal exchange rate possible only if the government is capable of dramatically changing the balance of trade and the real exchange rate.<sup>97</sup> In some cases, the fixed nominal exchange rate cannot be maintained beyond the immediate term without throwing the transitional economy into greater economic chaos. Unquestionably, economic chaos is a dramatic incentive for many individuals to organize to oust politicians from power.

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96. See Aghevli & Montiel, *supra* note 64, at 208-10. Exogenous factors include spiraling inflation, fluctuations in the exchange rates of major currencies, and insufficient foreign currency reserves.

97. See *id.*

However, transitional countries may be able to maintain a fixed nominal exchange rate in the short term. Because a short-term fixed rate requires a significant amount of wealth-transferring legislation, from which various economic sectors stand to benefit, the fixed nominal exchange rate may be maintained in a country as a vehicle by which wealth-transferring legislation may be justified. If the economy is large enough, the short-term benefits to the politicians of orchestrating these transfers may be sufficient to overcome the prospect of losing office in the future due to large-scale economic turmoil.

Smaller economies, however, are unlikely to provide the politician the benefit of large resource transfers in exchange for legislation that effects immediate wealth-transfers. Because the economy is smaller, the short-term benefits which the politician could receive are smaller than the benefits which follow from long-term stability and wealth-transferring legislation. Additionally, small economies may present considerably lower information and organizational costs to individuals. The threshold at which individuals in smaller economies have an incentive to become informed and organized to resist certain costly legislative policies is lower, so distributional coalitions will form more readily than in larger economies. Therefore, flexible nominal exchange rates are expected in small economies; in large economies, where the possibility of short term resource transfers to politicians is greater, the fixed nominal exchange rate will be favored.

### C. A Public Choice Analysis of Transitional Policies in Poland

Some form of current account convertibility has been achieved in every country in Eastern Europe.<sup>98</sup> However, capital account convertibility has not been achieved in most of these countries.<sup>99</sup> No large Eastern European country has implemented full convertibility, which is the unrestricted ability of citizens and foreigners to exchange the domestic currency for current and capital account transactions.<sup>100</sup> Eastern Europe is characterized by fixed nominal exchange rates, with the notable exceptions of the Czech Republic and the Baltic countries.<sup>101</sup> While the paths taken by Eastern European countries in their transitions to market economies and democracy have frustrated explanation by traditional economic theorists, public choice theory accounts more accurately for the transition differences among countries.<sup>102</sup>

The transition policies in Poland illustrate public choice theory. In 1990, Poland suddenly introduced broad current account convertibility in

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98. See INTERNATIONAL MONETARY FUND, EXCHANGE ARRANGEMENTS AND EXCHANGE RESTRICTIONS (1994) [hereinafter IMF 1994].

99. See *id.*

100. *First Country in Eastern Europe With Full Convertibility?*, DEUTSCHE BANK RESEARCH, Feb. 19, 1994, available in LEXIS, News Library, Allwld File.

101. See IMF 1994, *supra* note 98.

102. Valtr Komarek, *Czech and Slovak Federal Republic: A New Approach*, in ECONOMIC TRANSFORMATION IN CENTRAL EUROPE 58, 64 (Richard Portes ed., 1993).

combination with capital account convertibility reforms. This sudden and radical transformation is called a "big bang." The purpose of this "big bang" was to radically and permanently improve the quality of the pricing mechanism in Poland, including interest and exchange rates, and to permanently stabilize these improved prices.<sup>103</sup> Between 1979 and 1989, the Solidarity party forced the Communist government to implement several economic reform measures. These reforms collapsed, and by 1989 Poland was in economic and political chaos.<sup>104</sup>

Out of this chaos arose a popular desire for immediate capitalistic reform.<sup>105</sup> However, these reform efforts were not affected by incumbent or nascent industries. The Solidarity movement made the cost for incumbent industries to influence the revolutionary government too high, and Poland had an underdeveloped economic sector which stood to profit from immediate convertibility reforms. As a result, revolutionary zeal, not distributional coalitions, shaped Poland's transition policies. In exchange for popular political support, politicians promised efficiency reforms. Since such reforms incur significant adjustment costs, the politicians, in order to retain their positions, also promised broader income distribution.<sup>106</sup> This policy resulted in deficit spending by the government, financed by the artificial creation of money. Inflation increased, and real wages declined precipitously through 1991.<sup>107</sup>

The transition costs significantly reduced broad popular support for the principles of immediate reform and thus dampened Polish revolutionary zeal. This significantly reduced the costs to incumbent industries of wealth transfers through legislative policies. Accordingly, the government implemented transition policies which favored certain economic sectors. In early 1991, the Polish government suggested that privatization should be pursued throughout 1991-92.<sup>108</sup> This emphasis did not, however, result in much concrete action. Of the 8,500 state-owned enterprises in Poland in 1990, only 52 had been effectively privatized by 1992.<sup>109</sup> Poland has a fixed exchange rate.<sup>110</sup> It also imposes considerable tariffs on imports, especially industrial consumer products (20%) and agricultural products and textiles (25%-35%).<sup>111</sup> As a result of these transition policies, Poland experienced a 4% growth in real output in 1993, largely concentrated in industrial and agricultural output.<sup>112</sup> Annual inflation has

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103. Stanislaw Gomulka, *Poland: Glass Half Full*, in *ECONOMIC TRANSFORMATION IN CENTRAL EUROPE* 187, 190 (Richard Portes ed., 1993).

104. *Id.* at 187-89.

105. *See id.* at 188.

106. *Order Disguised as Chaos*, *THE ECONOMIST*, Mar. 13, 1993, at 4.

107. Real industrial wages fell by 41% through 1991. *Id.* *See* Gomulka, *supra* note 103, at 193-96.

108. Dariusz K. Rosati, *Poland: Glass Half Empty*, in *ECONOMIC TRANSFORMATION IN CENTRAL EUROPE* 211, 234 (Richard Portes ed., 1993).

109. *See id.*

110. *Stabilization, Reform, and the Role of External Financing in the Countries in Transition*, International Monetary Fund, May, 1994, available in LEXIS, News Library, Allwld File.

111. IMF 1994, *supra* note 98, at 400.

112. *See generally Stabilization*, *supra* note 110.

been reduced by 35%.<sup>113</sup>

The Polish experience illustrates the basic applicability of public choice theory to countries in transition to market economies. A distributional coalition will organize to support wealth-transferring legislation when the benefits of that legislation to the coalition exceed the costs of organizing and supporting it. In Poland, when the costs to incumbent industries of supporting favored legislation became excessive because of backlash against the communist regime, uninformed popular ideology guided legislation. This result occurred because the costs to the public of supporting radical reform were significantly less than the costs of the previous economic configuration. When the costs of reform to the public exceeded benefits, support dissipated. Incumbent industries, no longer encumbered by popular political costs, supported and enabled legislation which restrained radical transformation and replaced it with measured protectionism and favors. The overall effect of this process is substantial progress in transition combined with substantially greater economic stability and expansion. Public choice theory is not entirely descriptive. Just as microeconomic actors who act in their own rational self-interest are the basis of the success of a market economy, economic and political actors who act in their own rational self-interest are, in the aggregate, most able to construct the foundation upon which a market economy is built.

## Conclusion

The process of transition to a market economy from a centrally-planned economy is not a simple or inexpensive task. The application of public choice theory to this process cannot alleviate the pains of change. However, public choice theory does rationalize this process. Rather than viewing transition policies as sometimes inexplicable conglomerations of sometimes questionable economic theory, this Article has introduced a framework under which transition policies are analyzed as the results of rational decisions made by self-interested actors.

Eastern Europe is, by any definition, far from homogenous. These sometime spectacular differences account for the considerable lack of overarching macroeconomic theories to predict and guide transition. The fundamental inquiries in the public choice analysis are the cost and benefit possibilities which each political and economic actor faces; the theory cannot determine the possibilities that these actors should face. Because of this mutable characteristic of public choice theory, it is readily adaptable to the different circumstances in each transitioning nation.

Public choice theory as applied to the transition process in Eastern Europe is valuable as a descriptive tool. It is also valuable as a normative principle. A market economy relies upon untold numbers of economic decisions to function. These decisions are made by individuals, acting in their own rational self-interest. This principle characterized the 1989 revo-

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113. *Id.*

lutions: the freedom to choose. Public choice theory reveals these rational transition decisions, and posits that the ultimate result of individual self-interest is collective efficiency and well-being.