

Contractarian Analysis, Ethics, and Emerging Economies

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The transition from socialist to market economics is typically informed by outcomes-based social welfare theory (SWT). Institutionless, intentionally value-free SWT is ill-suited to this enterprise. The only evaluative standard to which it gives rise—efficiency—is indeterminate, and the theory is not accommodative of other dimensions of moral evaluation. By contrast, the contractarian enterprise focuses on the role and importance of formal and informal institutions, including ethical norms. Given that individuals should be treated as moral equivalents, the project assigns lexical priority to rights and regards justice as impartiality. This explicitly normative, institutional approach permits analysis of potential conflicts between informal norms and prospective, formal rules of the games. Moreover, it underscores the instrumental and intrinsic value of rights in the transition process. Finally, the emphasis on impartiality—embodied in the generality principle—facilitates analysis of constitutional constraints on behavior that is inimical to the transition process.

The Transition: The Consequentialist Approach

It is clear that the transition from socialist to market economies has typically been informed by received, consequentialist social welfare theory (hereafter referred to as SWT).¹ Because SWT is consequentialist, institutionless, and intentionally value-free it should come as no surprise that the standard reform prescription

begins at the endpoint, an idealized market, phrasing everything in those terms, ignoring the crucial question of how reforms engage existing society. The project of the economist is to grasp the institutional *tabula rasa* and design a new system, to match events against the yardstick of that design, and to diagnose as failures any deviations from design.²

The result consists of placing emphasis on the only evaluative standard to which SWT gives rise, namely, economic efficiency or first-best Paretian optimality. Moreover, because the path to first-best Paretian optima relies on the instrumental role of unattenuated property and exchange rights, the standard reform prescription contemplates “creating the legal framework for a market economy.”³ This, in turn, is difficult to reconcile with the view that “in the context of pervasive and cumbersome regulations in developing countries, corruption may actually improve efficiency and help growth.”⁴ Insofar as SWT is intentionally

value-free, it is perhaps not surprising that so perverse a conclusion might be drawn. While much can be said about this, our immediate interest centers upon a different conclusion:

As has been made apparent from the lack of useful advice from Western economists to policy makers in Eastern Europe attempting to convert economies from communism to capitalism, we know much less about our institutions, or, at least, much less about creating them, than our predecessors presumed.⁵

Given this circumspect view of the success of efficiency-driven transition prescriptions, the purpose of this paper is twofold. First, to provide a brief adumbration of the problems that attend the received SWT and, *pari passu*, limit its usefulness in any context. Second, to propose an alternative, contractarian approach that takes explicit account of formal and informal institutions, including the role and importance of ethical norms.

The Indeterminacy of SWT

Invocations of the efficiency of market economies are commonplace.⁶ The first fundamental welfare theorem asserts that a competitive economy will automatically move to a first-best Paretian optimum. In the characteristic approach, the institutionless decision environment is characterized by zero transaction costs and well-defined and unattenuated property and exchange rights. Granting this, instantaneous transactions among atomistic, autonomous, and classically rational and symmetrically and fully-informed utility (or profit) maximizers impel a society to its efficiency or welfare frontier. Stated differently, the three familiar welfare conditions will be satisfied at long-run, perfectly competitive equilibrium. From this, it is an easy step to conclude that the transition from a socialist to a market economy should be guided by the efficiency standard. On the presumption that the welfare conditions are violated in socialist economies, redress contemplates satisfaction of the three marginal equivalences. It follows that the standard reform prescription emphasizes the instrumental role, *inter alia*, of price and trade liberalization, privatization, and unattenuated property and exchange rights.

This analysis proceeds on the presumption that the efficiency frontier can be meaningfully defined. The problem with this stylized approach is that it gives rise to the nirvana fallacy. This fallacy obtains when the efficiency frontier is held up as a benchmark without taking explicit account of one or more real and unavoidable constraints.⁷ However, the problem with the social welfare approach is more fundamental than the nirvana fallacy would indicate.

As is well-known, SWT rests upon the foundation of received, neoclassical theory. It follows, *pari passu*, that the theory incorporates without revision the behavioral and technological postulates that define the neoclassical decision environment.⁸ While the postulates have come under increasingly robust attack, little attention has attended the implications for SWT. Yet the logical, empirical, and other problems that characterize the stylized neoclassical decision environment implicate both the efficiency frontier and the social welfare function. Difficulties arise when explicit account is taken of fundamental features of observable reality. *Inter alia*, decision-makers are boundedly rational, information asymmetries—both natural and contrived—are ubiquitous, and opportunistic behavior is observable. It follows that there is no one-to-one correspondence between objective and subjectively perceived decision environments. This is especially true when account is taken of the juxtaposition of the growth of knowledge and the cognitive limitations of decision-makers. Given these brute facts, transaction costs are positive, and the role of ethical norms in minimizing transaction costs and in facilitating increasingly impersonal transactions becomes apparent.

Granting all of this, it is straightforward to show that the space in which the efficiency frontier might be defined is indeterminate.⁹ Given this fundamental indeterminacy, the only standard for public policy evaluation to which SWT gives rise—the efficiency standard—is called into question.

Even if, in contravention to what has just been said, the existence of the efficiency frontier were granted, the internal logic of SWT militates against the path to first-best Paretian optima. The root cause of the problem is that, while it is intentionally value-free, SWT is, in fact, a hybrid moral theory. Difficulties arise because social welfare theorists implicitly assume that two distinct moral theories are reconcilable. On the one hand, given the implicit role of instrumentally important property and exchange rights—and given the view of most economists that freedom is morally exigent—SWT incorporates elements of right-based moral theories. On the other hand, because it is formulated in preference-, welfare-, or rule-utilitarian form, SWT is a goal-based or consequentialist moral theory.¹⁰ The fact is, however, that right- and goal-based moral theories are irreconcilable:

... utilitarian arguments for institutional design (the arguments that utilitarians might use in favor of establishing or maintaining certain legal rights) do not logically or morally exclude direct utilitarian arguments concerning the exercise of, or interference with such rights. As a consequence, evaluation of conduct from a utilitarian standpoint is dominated by direct utilitarian arguments and therefore ignores the moral force of rights.¹¹

A corollary of the hybrid nature of SWT is that social welfare theorists cannot regard instrumentally important—and therefore sanctioned—rights and correlative duties as having moral force.¹² The central idea is that the duty not to violate others' property and exchange rights can always be overcome by purely utilitarian considerations. It follows, *pari passu*, that the path to first-best Paretian optima is not assured.¹³ Moreover, those social welfare theorists (and others) who regard freedom as morally exigent in itself must recognize both that utilitarian considerations can be used to rationalize the attenuation of rights, and cannot be used inversely to derive the rights that are regarded as instrumentally and/or intrinsically valuable.¹⁴

Finally, it is easy to show that the juxtaposition of certain rights constructs and meddlesome preferences militate against the specification of a social welfare function.¹⁵ In particular, when explicit account is taken of meddlesome preferences and rights are respected, Pareto optimal solutions may not be possible. Reduced to its essentials, the impossibility of what has been styled the Paretian liberal militates against the accommodation by SWT of minimal privacy rights. When coupled with the well-known difficulties associated with interpersonal utility comparisons (IUCs), this calls into question the logical foundations of the social welfare function.¹⁶ Equally important, however, it is possible, following Professor Buchanan, to question the notion of social preference.

In sum, the indeterminacy of the efficiency frontier and the social welfare function implies that consequentialist SWT and its evaluative standard, efficiency, cannot meaningfully inform the transition process. Thus, something else is required.

An Alternative Approach

To review, the efficiency-driven transition focuses on outcomes and contemplates an institutional *tabula rasa*. Given this paradigm, the only institutional imperative is “the creation of a legal framework for a market economy.”¹⁷ *Inter alia*, the approach neglects the intervention of informal institutions or rules of the game:

In transition economies, rulers implemented far-reaching transformation of formal rules of the game to institute market economies....

But ... the behavior of economic actors frequently bears little resemblance to the legitimate courses of action stipulated by the formal rules. Instead, networks based on personal connections serve to organize market-oriented behavior according to informal norms reflecting the private expectations of entrepreneurs and politicians.¹⁸

It seems clear, then, that a society in transition is not an institutional *tabula rasa*. Characteristically, formal and informal rules of the game affect, and are affected by, the transition process.¹⁹ Moreover, both the formal and the informal institutions extant at a point in time reflect an intertemporal learning process; they are path-dependent:

Institutions form the incentive structure of a society, and the political and economic institutions, in consequence, are the underlying determinants of economic performance. Time as it relates to economic and societal change is the dimension in which the learning process of human beings shapes the way institutions evolve. That is, the beliefs that individuals, groups and societies hold which determine choices are a consequence of learning through time ... the learning ... is accumulative through time and passed on intergenerationally by the culture of the society.²⁰

The basic relevance of culture to economic behavior and, therefore, to the transition becomes clear once its nature is understood:

The term *culture* is osmotic, concerning all the usual artifacts and personal and social behaviors, but also alluding to values (such as trust, honesty, or complex systems of religious values) and models of organization of the kind that are starting to attract attention as disembodied "institutions."²¹

If one grants that trust and honesty are essential lubricants of a market economy, the relevance of culture to the transition is transparent. On this view, respect for rights and correlative duties is not simply the *deus ex machina* by which transaction costs are minimized. Respect for rights and correlative duties—and the trust that flows therefrom—is instrumentally important to the functioning of impersonal markets. As Furubotn and Richter have emphasized, "A market economy is perhaps best viewed as a network of rights and obligations based on contracts and legal requirements."²² Yet the moral imperative to respect rights and duties may have to be cultivated.²³ This understanding, it seems clear, must inform any transition process:

There is nothing automatic about the evolving of conditions that will permit low-cost transacting in the impersonal markets that are essential to productive economies.... Creating the institutions that will alter the benefit/cost ratios in favor of cooperation in impersonal exchange is a complex process, because it not only entails the creation of economic institutions but requires that they be undergirded by appropriate political institutions.²⁴

Neither the (possible) need to cultivate ethical constraints nor the creation of appropriate political institutions is contemplated by the efficiency-driven transition. What is required is an alternative, explicitly normative approach that concentrates on procedures rather than end-states or outcome patterns. Given its focus on decision procedures and the ethical and other “rules of the game,” the contractarian approach is accommodative both of the moral force of rights and their correlative duties, and of other moral dimensions of institutional evaluation. In effect, evaluative attention centers on decision procedures, and on the formal and informal institutional regimes that both constrain, and are affected by, revealed choice—and other—behavior.

The Contractarian Alternative

An appreciation of the instrumental role of trust in the functioning of market economies forces attention on the role and importance of ethical norms. Central to the contractarian project is the notion that persons are equal by nature. However, while the two contemporary contractarian (or social contract) theories take this as given, they differ in fundamental ways. On the one hand, the contractarian theory that regards justice as mutual advantage

... stresses a natural equality of physical power, which makes it mutually advantageous for people to accept conventions that recognize and protect each other's interests and possessions.²⁵

On the other hand, the contractarian theory that regards justice as impartiality

... stresses a natural equality of moral status, which makes each person's interests a matter of common or impartial concern.²⁶

The theory of justice as mutual advantage takes as its point of departure the notion that it is in the interest of “expected utility maximizers with common knowledge of everyone's capabilities, endowments, and preferences”²⁷ to adopt conventions against harming each other. On this account, the bargaining on which these conventions are adopted is the *process* by which a community establishes its social contract. This social contract, in turn, is seen as providing a moral code; a code that is “generated as a rational constraint from the non-moral premises of rational choice.”²⁸

Numerous empirical and logical problems attach to the justice as mutual advantage approach.²⁹ *Inter alia*, whereas equality of persons is asserted, *equality* is understood to be exhausted by physical power. In effect, the mutual advantage form of contractarianism “does not view individuals as having any inherent moral rights or status.”³⁰ It follows that nothing in the theory contemplates

moral claims that are *prior* to the pursuit of mutual advantage. *If* one accepts the view that such prior claims are extant, then the theory of justice as mutual advantage is unacceptable. This is the perspective of proponents of a theory of justice as impartiality.

The contractarian project that regards justice as impartiality is grounded in Kant's Categorical Imperative (CI). While the CI may be formulated in a number of ways, the version of immediate interest "demands that we treat humanity in your own person or in the person of any other never simply as a means but always ... as an end."³¹ On this account, one must seek to act on principles that all others could share, and that "respect all others' capacities to act."³² A principle of justice is such that it can be discerned by all rational beings as universalizable and must be accepted if persons are to be treated as ends in themselves. Finally, respect for another person's capacity to act requires one to honor rights and their correlative duties.³³

From the Kantian perspective, justice demands the promotion of institutions—in the sense of rules of the game—that respect the *moral* equivalence of persons. Significantly, however, the social contracts that give rise to those institutions do not justify the moral antecedent: the view of persons as ends in themselves. This is simply assumed.³⁴ Given this assumption, John Rawls, the best-known proponent of the view of justice as impartiality, argues that a contract can give equal consideration to each contractor—but only if the original (contracting) position contemplates negotiations from a position of equality. It follows, *pari passu*, that in the original position, the principles that shape a just society must be chosen behind a "veil of ignorance," thereby depriving each negotiator of knowledge of the role he would occupy in that society.³⁵ In effect, the content of persons' natural duty of justice is embodied in "a basic principle of impartial deliberation."³⁶ Reduced to its essentials, the Kantian/Rawlsian view of justice as impartiality assigns lexical priority³⁷ to rights, which demands that impartial institutions be promoted.

The justice as impartiality project has basic relevance for countries in the process of transitioning from socialism to capitalism. *Inter alia*, unlike the received SWT, the justice as impartiality project is not reliant upon theoretical constructs for which there are no operational counterparts. Moreover, it is accommodative of dimensions of moral appraisal—rights and justice—that SWT cannot logically accommodate.

The Contractarian Transition

To review, institutions—both formal and informal—affect, and are affected by economic behavior.³⁸ Recognizing this, Janos Kornai asks and answers his own rhetorical question:

What happens on the return journey from socialism to capitalism? Removing the barriers to capitalism includes providing constitutional safeguards for private property, officially encouraging free enterprise, promoting privatization, legalizing advocacy of pro-capitalist ideologies, and so on.³⁹

Kornai's invocation of the need for constitutional safeguards is important for its own sake—and stands in sharp contrast to the standard reform prescription that focuses on outcomes and Paretian optimality. That said, it is important also to recognize that, whether changes in formal rules of the game find their impulse in constitutional or ordinary conflictual politics,⁴⁰ formal and informal institutions may conflict:

If changes in formal rules are in harmony with the prevailing informal rules, the interaction of their incentives will tend to reduce transaction costs ... and clear up resources for the production of wealth. When new formal rules conflict with the prevailing informal rules, the interaction of their incentives will tend to raise transaction costs and reduce the production of wealth in the community.⁴¹

While it may be regarded as based on anecdotal evidence, Stahl-Rolf's analysis is heuristic.⁴² At issue is why "some countries in transition perform quite well while others still struggle with institutional reform, experiencing economic hardship and political disintegration."⁴³ Focusing on the development of landholding practices in rural Russia, Stahl-Rolf concludes that

... the response to any reform policy that aims to build up a system dedicated to the ideal of individual farming will be either indifferent ... or even hostile.... It becomes clear that promoting a family farm-based system is certainly not a good policy recommendation in the case of rural Russia.⁴⁴

On Stahl-Rolf's interpretation, the central problem with landholding reform is that it conflicts "very much with existing mental structures" and "specific traditions regarding property rights that shaped shared mental models."⁴⁵ In effect, the mental model that is conditioned to one type of property rights structure—collective farm ownership—conflicts with new legislation intended to facilitate achievement of the ideal of individual farming. Moreover, Stahl-Rolf emphasizes the instrumental role of trust:

Inducing institutional change by simply adopting new legislation (and possibly having it reinterpreted by local officials who are distrusted by the rural population and who are opposed to reform themselves) is certainly not the right way to foster institutional reform.⁴⁶

While Stahl-Rolf suggests that the International Finance Corporation's program is "often conceived of as Russia's second chance to privatization,"⁴⁷ he concludes that "it is much more certain that Russia will not copy Western European, or even U.S., international structures in the near future."⁴⁸

Stahl-Rolf's analysis simultaneously highlights the interaction—and possible conflict—between formal and informal institutions, the importance of path-dependencies, and the instrumental role of trust for the transition process.

While the interaction thesis⁴⁹ might be appropriately explored further, my immediate interest centers on the instrumental role of trust. It has become commonplace to observe that corruption is a defining characteristic of many economies in transition.⁵⁰ Indeed, as we have emphasized, there is a literature that asserts, in the context of developing countries, that corruption may be "efficiency-enhancing."⁵¹ While analysis of this particular casuistry may be put aside, it should be noted that the size, causes, and consequences of shadow or underground economies has received increasing attention. Schneider and Enste have, *inter alia*, measured the size of shadow economies in Eastern European transition countries. Their analysis of the causes of the growth of shadow economies includes the suggestion that

... an interdisciplinary approach seems to be necessary ... which would consider aspects like tax morale, perceived fairness of the tax system, and institutional aspects as well.⁵²

Central to this suggestion is the invocation of institutional considerations generally, and of perceived fairness in particular. Though Schneider and Enste refer specifically to the perceived fairness of the tax system, presumably, the point they are making is generic: The perceived fairness of prevailing formal and informal institutions is an important determinant of economic and other behavior.⁵³ The same is true, *pari passu*, of newly constituted formal institutional structures. Put another way, the perceived fairness of institutional arrangements is instrumentally important to the functioning of impersonal markets. Other things being equal, fairness is a *sine qua non* both for trust and respect for rights and their correlative duties. This, in turn, has basic relevance to economies in transition.

These considerations—and, in particular, the interaction between formal and informal institutions—lead to the conclusion that

... instead of building capitalism by fiat, Eastern European governments should try to provide—admittedly by fiat—a legal environment that would allow people to choose among alternative institutional arrangements, that is, to participate, in a market for institutions.⁵⁴

While it is by no means clear that, when confronted with a market for institutions, people would choose a capitalist system,⁵⁵ it is in peoples' interest to choose institutions that are just in a Kantian/Rawlsian sense. At the most general level, political legitimacy is at stake; legitimacy without which the stability of a society may be at risk.⁵⁶ Yet, political legitimacy cannot be introduced exogenously:

Political legitimacy must be earned, either by the persuasive force of ideology, by exemplary leadership, or, finally, by some sense of community in which persons are treated separately but equally in their capacities as sharers in both the burdens and benefits of collective endeavor.⁵⁷

On the presumption that political legitimacy and its concomitant, societal stability, are regarded as instrumentally and/or intrinsically valuable, account must be taken of its endogeneity, and of the importance of separate but equal treatment.

The notion of separate but equal treatment is central to the Kantian/Rawlsian enterprise.⁵⁸ It has found contemporary expression in the generality principle:⁵⁹

Persons are to be equal before the law and are to be equally treated by the law. Everyone is to play by the same rules; there are no persons or groups who are to be either specially privileged or specially disadvantaged.⁶⁰

Political legitimacy does not, however, exhaust the benefits of adherence to the generality principle. On the one hand, "polities that adhere to the generality principle will be more consistent, less arbitrary, and less costly to run than polities that do not."⁶¹ On the other hand, adherence to the principle serves to minimize resource-wasting political rent seeking.⁶² Moreover, it is possible that an operative generality constraint may reduce the excess burdens associated with nonpolitical behavior. If, for example, all incomes were subject to a non-discriminatory flat-rate tax, taxpayers would have no incentive to shift activity among various income sources. Under these circumstances, the prevailing tax structure would generate no excess burden.⁶³

These considerations suggest that it is in peoples' interest to choose institutions that embody the generality principle; institutions that are just in the Kantian/Rawlsian sense. Such a regime would give lexical priority to rights; to "an equal right to the most extensive total system of equal basic liberties compatible with a similar liberty for all."⁶⁴ While the primacy of rights is consonant with respect for the individual as an end in himself, it also underscores the intrinsic and instrumental value of respect for rights and their correlative duties. In effect, adherence to the generality principle would serve to facilitate

the working of *any* market order, including the capitalist system to which the transition aspires. Yet, as Buchanan has emphasized,

[While] the efficacy of any market order depends critically on ... endogenous behavioral constraints.... If the necessary personal constraints are not present, or if they have been or are eroding ... increased resource investment in both policing and preaching becomes more productive.⁶⁵

The essential point is that appeal to the generality principle—and all that it implies—may conflict with extant informal institutions. In the event, either preaching will resolve the conflict or, to paraphrase Kornai, the people will reject the transition.

It is tautological that the transition from a socialist to a capitalist market order is an intertemporal phenomenon. While it is also true that, whereas the generality principle can, in principle, find expression in autocratic as well as democratic decision environments, emphasis has been placed on its public benefits in the context of majoritarian democracy. On the presumption, then, that the institutional *portanteau* of an economy in transition includes a majoritarian democracy,⁶⁶ the phenomenon of intertemporal majoritarian cycling has basic relevance. The essential idea is that, absent an effective generality or nondiscrimination constraint, shifting majority voting coalitions will invest resources in wasteful majoritarian rent seeking.⁶⁷

Given that such cycling is understood *a priori* to be a likely consequence of majoritarian democracy, ruling majority coalition members may calculate that future majority coalition members may discriminate against them. Granting this, ruling majority coalition members may have incentive to embed the generality principle in the Constitution:

... a generality constraint seems genuinely to be in the public interest. Note particularly that there need be no psychological transformation on the part of the ruling coalition members—no transformation that involves some deliberate shift to a position behind some veil of ignorance or uncertainty. What is required is that constitutional alternatives be reckoned in present-value accounting; myopic majorities would never agree to generality constraints....⁶⁸

In effect, non-myopic ruling coalitions *may* perceive that a generality constraint is politically efficient in the sense that it reduces or eliminates “the incentives for participants to invest resources in rent seeking aimed to secure discriminatory advantage through majoritarian exploitation.”⁶⁹ The presumption is, in effect, that self-interested members of ruling majority coalitions both appreciate the threat of majority cycling and act to minimize or eliminate the present

value of the associated costs. In the event, a constitutional generality or nondiscrimination constraint may be put in place without appeal to a Rawlsian/Buchanan-style veil of ignorance/uncertainty.⁷⁰

While the orthodox, median voter analysis of majority voting concentrates, *inter alia*, on the emergence of cycling, almost two decades ago Gordon Tullock asked the question, “Why so much stability?”⁷¹ Twenty years later, Tullock suggests that he may have an answer for the United States:

Basically, the reason there are no cycles is that the particular assumption of the cycles, that is, there are more than two alternatives which are voted on, is frequently not true in practice. The bulk of the work on any legislation is done in what I call the black box, which is by no means entirely the congressional committees. There is a long procedure of all sorts of things including pressure groups. This means that a simple kind of cycle which potentially appears to exist ... will never get to the floor. If it did ... only two alternatives, pass or reject, would get through the conference committee and the presidential veto....⁷²

These conclusions may not have relevance to a nascent majoritarian democracy in transition from socialism to capitalism. Presumably, it takes time for opportunistic political entrepreneurs to develop the kind of institutional arrangements that are congenial to contrived information asymmetry; institutions such as the hugely complicated budget process employed by the United States Congress. At least on one interpretation, the budget process has enabled legislators—the agents—largely surreptitiously to discriminate among their principals, the voters.⁷³ Yet, if Tullock’s analysis is correct, it serves, the cycling issue aside, to make a case for constitutional generality constraints on legislative bodies. Legislative transparency, accountability, and impartiality are not characteristic of conflictual politics.⁷⁴ Intertemporally this may erode trust and, *pari passu*, the legitimacy of government. Granting this, it is in the interest of all persons—including citizens of a nascent majoritarian democracy in transition—to insist upon constitutionally imposed generality constraints.

The essential point is that the constitutional enterprise need not contemplate appeal to the veil of ignorance/uncertainty device. Persons must not be myopic, and they must take account of the rent seeking behavior of voter-principals and politician-bureaucrat agents.⁷⁵ On the presumption that voter-principals are aware of their own—and, by extension, others’—sometimes narrowly self-interested impulses, it seems plausible to conclude that they have an incentive to demand that the generality norm be embedded in the Constitution and that, *pari passu*, it be applied both to the law and to ordinary, conflictual politics.⁷⁶

From the contractarian perspective, therefore, any transition project should be informed by the interaction thesis, and by the instrumental/intrinsic value of the generality principle. While explicit account must be taken of potential conflicts between extant informal behavioral norms and newly codified formal rules,⁷⁷ the generality norm can, in principle, be employed to constrain policies under widely disparate rubrics. These include policies relating to externalities, domestic and international market restrictions, general taxation, deficit financing, the supply of public goods and services, and redistribution.⁷⁸

While much can be said about this, redistribution policies would seem to merit particular attention. As we have emphasized, the first principle of Rawlsian justice or impartiality assigns lexical priority to rights; to equal basic liberties under law.⁷⁹ When combined with the second principle of justice, Rawls' General Concept of Justice asserts that

All social primary goods—liberty and opportunity, income and wealth, and the other bases of self-respect—are to be distributed equally unless an unequal distribution of any or all of these goods is to the advantage of the least favored.⁸⁰

The essential point is that whether justice requires equality of “social primary goods,” of “capabilities,”⁸¹ or of “opportunities,”

If [principals at the constitutional stage] favor measures to equalize resources, they would prefer to embed particular distributive rules, say, a negative income tax financed by a flat tax rate directly into the constitution. Such constitutional distributive rules (like the institutions mandated by Rawls' principles of justice) should not in fact be considered redistributive since they would figure in the underlying definition of property rights....⁸²

While Buchanan and Congleton conclude that “Generality implies equal-per-head transfers (demogrants) or at least equal availability ...,”⁸³ this approach may conflict with the informal norms extant in a transition economy. Whatever else is said, it is important that, whatever distributive rule is employed, it be embedded in the Constitution.

Conclusion

The standard reform prescription for economies in transition has been informed by consequentialist social-welfare theory. Yet, given the logical, empirical, and other difficulties associated with the theory, analysis reveals that neither the efficiency frontier nor the social-welfare function is determinate. This calls into question the only evaluative standard to which the theory gives rise. In

effect, efficiency or Paretian optimality cannot meaningfully serve as a guide to transition or other policies. Beyond this, because the theory is both intentionally value-free and institutionless, the reform prescription—in obvious contravention of the facts—regards a transition economy as an institutional *tabula rasa*. Granting all of this, it should come as no surprise that, to paraphrase Demsetz, the standard reform prescription has afforded little useful advice.

Whereas consequentialist social welfare theory focuses on outcomes, the contractarian approach emphasizes procedures. Interest centers on the importance of formal and informal institutions, including ethical norms. The approach is accommodative both of the problems that attend the interaction of formal and informal institutions, and of dimensions of moral evaluation that cannot be accommodated by received social welfare theory.

Taking as its point of departure the ethical antecedent that individuals should be treated as ends in themselves, the contractarian enterprise gives lexical priority to rights and regards justice as impartiality. Reduced to its essentials, the ethical imperative is therefore to protect liberty and to promote impartial institutions. It is this generality principle that informs the Kantian/Rawlsian contractarian project.

The contractarian approach appears to be well-suited to inform the transition process. The explicitly normative, institutional approach allows for an accounting of potential conflicts between extant informal norms of behavior and prospective, formal rules of the game. Moreover, because it gives lexical priority to rights, it underscores their instrumental and intrinsic value in the transition process. Finally, the emphasis on justice as impartiality—embodied in the generality principle—facilitates analysis of constitutional constraints on rent seeking and other behaviors that are both wasteful of resources and inimical to the transition process.

While the contractarian cannot predict which institutions may emerge during a transition (or any other path-dependent process), that is not his or her purpose. Rather, the purpose of the contractarian enterprise is to offer a basis for normative evaluation:

Normatively, the task of the constitutional political economist is to assist individuals, as citizens who ultimately control their own social order in their continuing search for those rules of the political game that will best serve their purposes, whatever these might be.⁸⁴

Perhaps the contractarian approach can compensate for the lack of useful advice that has characterized the efficiency-driven transition.

Notes

1. P. Murrell, "The Transition According to Cambridge, Massachusetts," *Journal of Economic Literature* 33 (1995): 164, 171.
2. *Ibid.*, 177.
3. *Ibid.*, 164.
4. P. Bardhan, "Corruption and Development: A Review of the Issues," *Journal of Economic Literature* 35 (1997): 1322. There is also the view that, whereas corruption in less-developed countries may not be optimal, it may be equilibrium. See, for example, D. Acemoglu and T. Verdier, "The Choice Between Market Failures and Corruption," *American Economic Review* 90 (2000): 209.
5. H. Demsetz, "The Primacy of Economics: An Explanation of the Comparative Success of Economics in the Social Sciences," *Economic Inquiry* 35 (1997): 11.
6. D. Duffie and H. Sonnenschein, "Arrow and General Equilibrium Theory," *Journal of Economic Literature* 27 (1989): 565–98; and W. Novshek and H. Sonnenschein, "General Equilibrium with Free Entry: A Synthetic Approach to the Theory of Perfect Competition," *Journal of Economic Literature* 25 (1987): 1281–1306.
7. E. G. Furubotn, *Future Development of the New Institutional Economics: Extension of the Neoclassical Model or New Construct?* (Jena: Max-Planck-Institute for Research into Economic Systems, 1994).
8. T. P. Roth, *Ethics, Economics and Freedom: The Failure of Consequentialist Social Welfare Theory* (Aldershot, UK: Ashgate Publishing Ltd., 1999), 1.
9. *Ibid.*, chap. 4.
10. Right- and goal-based moral theories are fundamentally different: "The distinction between right-based and goal-based theories ... is that a requirement is right-based if it is generated by a concern for some individual interest, goal-based if it is generated by a concern for something taken to be an interest of society as a whole." J. Waldron, ed., *Theories of Rights* (Oxford: Oxford University Press, 1995), 13.
11. D. Lyons, "Utility and Rights," in *Ethics, Economics and the Law: Nomos XXIV*, eds. J. R. Pennock and J. W. Chapman (New York: New York University Press, 1995), 113. See also B. Almond, "Rights," in *A Companion to Ethics*, ed. P. Singer (Cambridge, Mass.: Blackwell Publishers, Ltd., 1993), 259–69; R. E. Goodwin, "Utility and the Good," in *A Companion to Ethics*, ed. P. Singer (Cambridge, Mass.: Blackwell Publishers, Ltd., 1993), 248; R. Dworkin, *Taking Rights Seriously* (Cambridge: Harvard University Press, 1978), 224–25; and Waldron, *Theories of Rights*, 18–19.
12. For more on this, see T. P. Roth, "Consequentialism, Rights, and the New Social Welfare Theory," *Journal of Socioeconomics* 28 (1999): 95–109.
13. There is an additional logical problem with the path to first-best Paretian optima. Reduced to its essentials, the problem is that the zero transaction cost assumption is congenial to the formation of coalitions that effectively rule out the satisfaction of the conditions for the General Pareto Optimum. See E. G. Furubotn, "General Equilibrium Models, Transaction Costs, and the Concept of Efficient Allocation in a Capitalist Economy," *Journal of Institutional and Theoretical Economics* 147 (1991): 664; and T. P. Roth, "Competence-Difficulty Gaps, Ethics and the New Social Welfare Theory," *Journal of Socioeconomics* 26 (1997): 542.
14. Roth, *Ethics, Economics and Freedom*, chap. 5.
15. *Ibid.*, chap. 6.
16. Efforts to overcome these difficulties by appeal to a consequentialist-procedural approach are unavailing. See, especially, *ibid.*, 59–63.
17. Murrell, "The Transition According to Cambridge, Massachusetts," 1640.
18. V. Nee, "Norms and Networks in Economic and Organizational Performances," *American Economic Review Papers and Proceedings* 88 (1998): 85–86.
19. See, for example, R. Levine, "Financial Development and Economic Growth: Views and Agenda," *Journal of Economic Literature* 35 (1997): 720–21.
20. D. C. North, "Economic Performance Through Time," *American Economic Review* 84 (1994): 359–60.

21. E. L. Jones, "Culture and Its Relationship to Economic Change," *Journal of Institutional and Theoretical Economics* 151 (1995): 271.
22. E. G. Furubotn and R. Richter, *Institutions and Economic Theory* (Ann Arbor: University of Michigan Press, 1997), 140. See also K. D. Wilde, A. D. LeBaron, and D. Israelsen, "Knowledge, Uncertainty, and Behavior," *American Economic Review Papers and Proceedings* 75 (1985): 406; R. A. Heiner, "The Origin of Predictable Behavior," *American Economic Review* 73 (1983): 560–95; and North, "Economic Performance Through Time," 359–68.
23. J. M. Buchanan, "Choosing What to Choose," *Journal of Institutional and Theoretical Economics* 150 (1994): 125.
24. North, "Economic Performance Through Time," 365.
25. W. Kymlicka, "The Social Contract Tradition," in *A Companion to Ethics*, ed. P. Singer (Cambridge, Mass.: Blackwell Publishers, Ltd., 1993), 188.
26. *Ibid.*
27. D. M. Hausman and M. S. McPherson, *Economic Analysis and Moral Philosophy* (Cambridge: Cambridge University Press, 1996), 158.
28. D. Gauthier, *Morals by Agreement* (Oxford: Oxford University Press, 1986), 4.
29. Roth, *Ethics, Economics and Freedom*, 65–67.
30. Kymlicka, "The Social Contract Tradition," 189.
31. O. O'Neill, "Kantian Ethics," in *A Companion to Ethics*, ed. P. Singer (Cambridge, Mass.: Blackwell Publishers, Ltd., 1993), 178.
32. *Ibid.*, 179.
33. See, for example, J. Waldron, "Rights," in *A Companion to Contemporary Political Philosophy*, eds. R. E. Goodin and P. Pettit (Cambridge, Mass.: Blackwell Publishers, Ltd., 1995), 583.
34. Kymlicka, "The Social Contract Tradition," 194.
35. J. Rawls, *A Theory of Justice* (Cambridge, Mass.: The Belknap Press of Harvard University Press, 1971), 12, 563. For more on the veil of ignorance and the justice as impartiality construct generally, see Roth, *Ethics, Economics and Freedom*, 67–71.
36. Kymlicka, "The Social Contract Tradition," 191.
37. For a discussion of lexical ordering, see Rawls, *A Theory of Justice*, 42–43.
38. Nee, "Norms and Networks in Economic and Organizational Performances," 85–89; North, "Economic Performance Through Time," 359–68; and Furubotn and Richter, *Institutions and Economic Theory*.
39. J. Kornai, "What the Change of Systems from Socialism to Capitalism Does and Does Not Mean," *Journal of Economic Perspectives* 14 (2000): 31–32.
40. J. M. Buchanan, *The Economics and the Ethics of Constitutional Order* (Ann Arbor: University of Michigan Press, 1991).
41. S. Pejovich, "The Effects of the Interaction of Formal and Informal Institutions on Social Stability and Economic Development," *Journal of Markets and Morality* 2 (1999): 171.
42. S. R. Stahl-Rolf, "Transition on the Spot: Historicity, Social Structure, and Institutional Change," *Atlantic Economic Journal* 28 (2000): 25–36.
43. *Ibid.*, 25.
44. *Ibid.*, 33.
45. *Ibid.* Stahl-Rolf's conclusion is broadly consistent with the view that "The old ethos in Eastern Europe ... clashes with capitalist culture, which emphasizes self-interest, self-responsibility, self-determination; puts a premium on the rules that reward performance; cultivates risk-taking attitudes; values the maintenance of individual liberties; and makes the keeping of promises important for accumulating wealth." Pejovich, "The Effects of the Interaction of Formal and Informal Institutions," 175.
46. *Ibid.* For more on groups opposed to institutional reform, see Pejovich, "The Effects of the Interaction of Formal and Informal Institutions," 176–77.
47. The Corporation's aim is "to introduce cooperatives and other forms of small-scale ownership." Given this new initiative—an approach that de-emphasizes "the ideal of family farming"—Stahl-Rolf "hope[s] that one day the number of farms based on alternative property rights for land

will become large enough for a spontaneous process transition to emerge...." "Transition on the Spot," 34. The view that the achievement of a critical mass and the passage of time may eventually animate the transition to market structures comports with the position adopted by Janos Kornai:

Capitalism does not need to be imposed on society, there is no need for a genetic program artificially implanted by a political party. If nothing else had happened but removal of the barriers, capitalism would still start to develop sooner or later, although the process would obviously have been much slower.

"What the Change of Systems from Socialism to Capitalism Does and Does not Mean," 32.

48. Stahl-Rolf, "Transition on the Spot," 34.

49. Pejovich, "The Effects of the Interaction of Formal and Informal Institutions."

50. See, for example, T. R. Tye, "Manufacturing Firms in Developing Countries: How Well Do They Do, and Why?" *Journal of Economic Literature* 38 (2000): 38.

51. S. Braguinsky, "Corruption and Schumpeterian Growth in Different Economic Environments," *Contemporary Economic Policy* 14 (1996): 14; and P. Bardhan, "Corruption and Development," 1322.

52. F. Schneider and D. H. Enste, "Shadow Economies: Size, Causes, Consequences," *Journal of Economic Literature* 38 (2000): 107.

53. For more on formal and informal institutions, see Pejovich, "The Effects of the Interaction of Formal and Informal Institutions," 166–67.

54. *Ibid.*, 177–78.

55. Kornai, "What the Change of Systems from Socialism to Capitalism Does and Does Not Mean," 40.

56. Schneider and Enste, "Shadow Economies," 108. See also J. Hampton, "Contract and Consent," in *A Companion to Contemporary Political Philosophy*, eds. R. E. Goodin and P. Pettit (Cambridge, Mass.: Blackwell Publishers, Ltd., 1995), 383.

57. J. M. Buchanan and R. D. Congleton, *Politics By Principle Not Interest: Towards Nondiscriminatory Democracy* (Cambridge: Cambridge University Press, 1998), 153.

58. S. Freeman, ed., *John Rawls: Collected Papers* (Cambridge, Mass.: Harvard University Press, 1999), chap. 13.

59. J. M. Buchanan, *The Collected Works of James M. Buchanan*, vol. I, *The Logical Foundations of Constitutional Liberty* (Indianapolis: Liberty Fund, 1999), 419–28; and Buchanan and Congleton, *Politics By Principle Not Interest*.

60. Buchanan, *Collected Works*, 420. See also Buchanan and Congleton, *Politics By Principle Not Interest*, 7–8.

61. Buchanan and Congleton, *Politics By Principle Not Interest*, 142.

62. *Ibid.*, 149–50. A fuller discussion of this point may be found below.

63. *Ibid.*, 93, 150.

64. Rawls, *A Theory of Justice*, 302. See also Buchanan and Congleton, *Politics By Principle Not Interest*, 8.

65. Buchanan, "Choosing What to Choose," 125.

66. In principle, Russia is an example.

67. Buchanan and Congleton, *Politics By Principle Not Interest*, 21, 27–28, 48, 54–55.

68. *Ibid.*, 58.

69. *Ibid.*, 40.

70. For more on this, see Roth, *Ethics, Economics and Freedom*, 68–74.

71. G. Tullock, "Why So Much Stability?" *Public Choice* 37 (1981): 189–202.

72. G. Tullock, "Why No Cycles?" *Atlantic Economic Journal* 28 (2000): 11–12.

73. T. P. Roth, *Information, Ideology and Freedom: The Disenfranchised Electorate* (Lanham, Md.: University Press of America, Inc., 1994).

74. Buchanan and Congleton, *Politics By Principle Not Interest*, 51–52.

75. For more on this, see Roth, *Ethics, Economics and Freedom*, 86–87.

76. Given that statutes can be overturned, ignored, or "sunsetting" it is important that the generality principle be embedded in the constitution. For more on this, see Roth, *Information, Ideology and Freedom*.

77. One of the consequences of such conflicts is the proliferation of transaction cost increasing secondary laws. See Pejovich, "The Effects of the Interaction of Formal and Informal Institutions," 174.

78. Buchanan and Congleton, *Politics By Principle Not Interest*.

79. Rawls, *A Theory of Justice*, 302.

80. *Ibid.*, 303.

81. A. Sen, *Development As Freedom* (New York: Alfred A. Knopf, 1999), 87–100.

82. Hausman and McPherson, *Economic Analysis and Moral Philosophy*, 160. Interestingly, Rawls argues that, "since the burden of taxation is to be justly shared ... a proportional expenditure tax may be part of the best tax scheme." *A Theory of Justice*, 278.

83. Buchanan and Congleton, *Politics By Principle Not Interest*, 127.

84. J. M. Buchanan, "The Constitution of Economic Policy," *American Economic Review* 77 (1987): 250.