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Trust in transition

by Martin Raiser

Abstract

This paper examines the role of trust in transition. Trust is an important ingredient in the institutional infrastructure of a market economy. Trust between economic actors allows efficient trade to take place in the face of uncertainty and constrains opportunistic behaviour. Trust in state institutions reduces the costs of rule enforcement and supports collective action. A key message of the paper is that what is needed in a modern market economy, characterised by a complex division of labour, is extended trust, beyond the closed circles of family or existing business contacts. With reference to the countries of central and eastern Europe and the former Soviet Union, the paper argues that they face heavy legacies of distrust in the state and closed social and business networks which reduce competitive pressures on existing enterprises to adjust. A key challenge for successful transition is to rebuild confidence in government and provide a minimum level of rule enforcement, which would lower the risk for economic actors to break out of existing networks in search of new economic opportunities. The paper also examines other determinants of trust in transition, such as moral leadership by the government, constitutional safeguards for open and democratic government, and redistributive policies that lower social distance among various groups in society.

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INTRODUCTION

After almost a decade of reform in the countries of central and eastern Europe and the former Soviet Union, very different types of market economies are evolving across the region. While almost all countries in the region have made significant progress in the liberalisation of markets, and (more varied) progress in the privatisation of state assets, reform progress differs dramatically in the area of institution building and, in particular, the effectiveness of the new market-oriented institutions. At the same time, the transition has been marked by large differences in economic performance, which seem to be related to the types of economic systems that have emerged. A key question raised by the experience of transition so far, therefore, is in what way institutional legacies and institutional change have influenced transition outcomes.

This paper contributes to the growing literature on the role of informal institutions in the transition (e.g. Johnson, McMillan et al. 1998; McMillan and Woodruff 1998a,b; Raiser 1997). It focuses on trust as a key ingredient in the institutional infrastructure of a market economy. The focus on trust is inspired by its importance for business formation (Humphrey and Schmitz 1996; Bigsten, Collier et al. 1998) which in turn seems to be crucial for explaining the variation in economic performance in the transition economies (Johnson, Kaufmann et al. 1997). Entrepreneurship cannot flourish in an environment of distrust, since many economic opportunities are closed off. As Arrow (1975) notes:

“Almost every commercial transaction has within itself an element of trust, certainly any transaction conducted over a period of time. It can be plausibly argued that much of economic backwardness in the world can be explained by the lack of mutual confidence.”

The analysis will distinguish between the role of trust in bilateral exchange and a more general notion of trust in a society, akin to Putnam's use of the term "social capital". Trust in bilateral economic exchange allows efficient trade to take place in the face of uncertainty and constrains opportunistic behaviour. Social capital more generally facilitates the exchange of information and supports collective action. Moreover, the paper shall use Zucker’s (1986) distinction between various forms of trust, related to the social relationships that underpin its reproduction, in arguing that only “extended” or generalised trust can support the transition to a modern market system. I further argue that many existing business networks in the transition economies, grown out of former bureaucratic bargaining relationships, are not sufficiently open and trust is not sufficiently generalised to fully realise economic opportunities. In this the paper takes issue with some of the existing literature on business networks, which views their survival and adaptation as an efficient response to the uncertainty and imperfection of markets in the transition (e.g. Stark 1997). A key policy focus of the paper is on possible determinants of extended trust, paying particular attention to the potential complementarities between trust and the quality of formal institutions.

The first section of the paper discussed the role of trust in bilateral exchange and in the provision of collective goods. It then introduces the distinction between various forms of trust and develops the argument for the central role of extended trust. The section ends with an analysis of the determinants of extended trust. The second section examines the role of trust in transition. It first sketches the socialist legacies that may influence both the nature and degree of trust during the transition. It then looks at the role of trust in private business networks, both old and new. Lastly, I develop the argument that the lack of extended trust, including distrust in the state itself is one key factor behind the disappointing economic performance observed in many countries across the region. Section 3 draws some highly speculative policy implications and Section 4 concludes.

I. WHAT IS TRUST?

THE ECONOMIC ROLE OF TRUST

Trust has become a buzzword in recent writings on the role of institutions in economic development (see Humphrey and Schmitz (1996) for a recent critical discussion). There are numerous definitions of the concept and this paper makes no attempt to clarify or even cover all of them. I focus on two uses of the term: (i) trust as mutual confidence among parties to an economic transaction, (ii) trust as social capital facilitating the provision of collective goods.

When two individuals exchange goods and services they need to trust one another. This is particularly the case for incomplete contracts, where one party is unable to fully monitor the other party's fulfilment of his or her obligations taken under the contract, a typical problem in transactions that take place over time (see the above quotation from Arrow). The risk of opportunistic behaviour could be so great as to prevent the exchange taking place altogether. A lack of trust may thus impose prohibitively high transaction costs on contracting parties, thereby limiting mutually beneficial transactions.

The role of trust in bilateral economic exchange can be best illustrated with the use of a sequential prisoners' dilemma. In this game, pay-offs are distributed such that the second player maximises his or her return by cheating on player 1, after the latter has decided to play cooperatively. Anticipating this move, player 1 will not rationally cooperate and mutual cooperation, yielding the highest joint pay-off, is never achieved. In various extensions of this game, the introduction of an additional moral or emotional pay-off facilitates cooperation (Platteau 1994). In Bolle (1998), for instance, type 2 players feel compelled to reciprocate to a cooperative first move because of feelings of thankfulness or remorse. Feelings of thankfulness and remorse may be instilled through social norms and the wish to be accepted as a member of society. Emotional propensities and the knowledge that these correspond to shared social values allow people to trust one another and overcome problems of opportunism.

In repeated games, trust can be built through successful cooperation (see below) and sustained through reputational enforcement mechanisms. Players invest relational capital in the build-up of business contacts, and this capital would become useless were they to cheat on an established business partner, since their credibility as honest players would be affected. The need for a good business reputation closes off exit options or at least makes them more costly. The trust one puts in a business partner can be interpreted as a kind of relational collateral, in a way similar to the role of collateral in the resolution of moral hazard in the credit market (Hart 1993).

The discussion so far has concentrated on the role of trust in overcoming problems of opportunism in economic transactions. In these transactions, the benefits accrue to the contracting parties only if they enter into the transaction – both lose if they do not trade, while losses are one-sided in the case of opportunistic behaviour. However, social and economic interaction includes a variety of situations where the benefits accrue to a collective, and similarly the costs of non-compliance are socialised. These transactions concern the provision of collective goods. Examples of such collective goods are voting, participation in voluntary organisations, abstaining from littering the streets, but also refusing to accept and pay bribes. The exclusion of individuals from the benefits (a functioning democracy, a lively civil society and decentralised care for weak members, clean streets, and a culture of honesty among officials) is not possible, and the costs of non-compliance to the individual are small. Hence the problem of the "free rider" arises.

Trust has a role to play in the provision of collective goods, too. Reputational enforcement mechanisms can be extended to a multilateral context, if unaffected third parties are willing to sanction cheaters. There are a number of examples of such collective reputational enforcement mechanisms in history (Greif 1994, 1996; Milgrom, North et al. 1990). In the absence of a collective reputational enforcement mechanism, the provision of collective goods requires some common ideological motivation (North 1981) or the existence of altruistic preferences (Kirchgässner 1994). Assuming individuals obtain benefits from both the collective good and from their own contributions (they behave morally or altruistically), a typical person would contribute if the combined benefits outweigh his or her personal costs. This would usually be the case only if the collective good is actually provided, and hence confidence that one's commitment is widely shared will be required. [1] In other words, it requires trust.

FORMS OF TRUST

There are three types of relationships among parties to an economic transaction, and these give rise to three different types of trust. The first type of relationship is among kinship groups and family members. These relationships dominate economic transactions in subsistence economies and still characterise reproduction and the household economy (but also many small-scale crafts and trades). Transactions between members of a kinship group are based on what I shall call "ascribed trust", following Zucker (1986) (quoted in Humphrey and Schmitz 1996). The second type of relationship is between individuals who have known each other for a long time, without sharing the loyalty to a specific group. Transactions in this case are repeated and trust is "process-based". Most business networks are characterised by this type of repeated relationship and the prevalence of process-based trust. The third type of relationship is between individuals, who enter into a transaction with only limited information about the counterpart's specific attributes. For economic exchange to take place between these types of individuals, generalised or "extended trust" is needed. The importance of this third type of relationship and the correspondent economic transactions between largely anonymous individuals is a key element of a modern economic system.

In addition to the three types of relationship underlying economic exchange, there are also various types of social relationships supporting the provision of collective goods. Loyalty to a kinship group may limit free riding in small face-to-face communities, or in societies organised along ethnic divisions. As noted above, multilateral reputational enforcement mechanisms can sustain the provision of collective goods in societies governed by repeated interaction. In modern economic systems, characterised by the rule of law, cooperation in the provision of collective goods is ensured by trust in government institutions, and sustained by a widely shared belief in certain abstract principles of government.

The typology presented here suggests that the building of extended trust is a key challenge in economic development. Nonetheless, it is important to bear in mind the relationships between the various forms of trust. In particular, extended trust could not exist without the experience

[1] Kirchgässner (1994) distinguishes between a typical moralist and three other types of individuals in this context. The "hero" will contribute to a collective good that requires a low participation rate, even when his personal costs of doing so are high relative to his benefits. The "idealist" will always contribute, even when the collective good is not provided, but his costs of doing so are small. The "fanatic" always contributes, but at high costs to himself. Generally, the presence of these three non-average types is too small to matter for the design of public institutions, although the existence of heroes in providing ideological leadership and setting an example for cooperation may be quite important.

of reciprocity made in repeated interactions among family and other members of a social or business community. This includes social interaction, which may not have a direct business-related purpose, as shown in Putnam's (1993) analysis of the role of an active civil society in generating social capital. Where process-based trust is absent, extended trust cannot develop. Moreover, it is unlikely that extended trust in economic exchange could be sustained without the availability of third-party enforcement by the state. Hence, trust among anonymous individuals may be as much a function of their moral predispositions and social experiences as of their trust in government institutions to provide impartial enforcement. The behaviour of government has therefore an important role to play in the reproduction of extended trust.

THE DETERMINANTS OF EXTENDED TRUST

Economists generally believe that institutions, including informal institutions such as trust, can change in response to new economic opportunities. During the process of economic development, new economic opportunities are created by technological innovations in production and exchange (most importantly reductions in information and transportation costs) and the processes of economic specialisation they entail. Process-based trust, built on relational capital, can become inefficient if it restricts outside options, because these would hamper one's reputation. If the expected benefits from breaking out of existing business networks are sufficiently great, however, business relationships may be recast (Humphrey and Schmitz, 1996). Extended trust may be created through an expansion of existing networks, whereby these become increasingly open and allow members to seek outside economic opportunities.

However, process-based trust does not automatically generate extended trust through the process of economic development. Greif (1994) demonstrates how, in the case of the Maghribi traders operating until the 15th century in the Mediterranean, a collectivist culture supporting strong reputational enforcement prevented the expansion of the trading network and led to its disappearance in the face of competition from the Italian city states. The latter were characterised by a far more individualistic society and, as argued by Platteau (1994a,b), benefited from the rise of universalistic morality in Western political philosophy in supporting the emergence of extended trust, and trust in state institutions in particular.[2]

Moral innovations are not the only factor that can generate extended trust. The willingness to search for economic opportunities outside one's established social and business contacts will also depend on the distance between social groups or the homogeneity of society, and the risk associated with being cheated. Zak and Knack (1998) for instance present cross-country evidence that the extent of trust between anonymous individuals (derived from the World Values Survey) is positively related to measures of social distance (income and land inequality and ethnolinguistic fractionalisation). Offe (1998) suggests that extended trust is higher in societies in which the risks of being cheated may be pooled through social security arrangements (formal and informal through extended families, etc.), reducing the size of the material threat should cheating occur.

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[2] This begs the question of course whether this moral innovation was the result of the specific technological and social conditions prevailing in western Europe at the time. Only if a universalist morality could be derived from first principles, as suggested by Rawls (1974), it might count as a truly exogenous innovation, which might be successfully transferred to other social contexts. However, it is far from clear whether moral innovations would necessarily respond to economic opportunities, as moral norms may be manipulated by ruling elites (see for instance Harriss and de Renzio's (1997) critique of Putnam (1993)).

Probably the most important determinant of the emergence and sustainability of extended trust is the availability of complementary contract enforcement from the state. Zak and Knack (1998) establish a close statistical relationship between their measure of (extended) trust and the quality of formal institutions (the protection of property rights, the enforceability of contracts, the extent of bribery, and an index of investors' rights). However, the relationship between extended trust and third-party enforcement through the state runs both ways. The availability of third-party enforcement may be crucial to kick off a process of further economic specialisation, involving trade across previously closed social communities. This process will in turn increase the confidence of agents in members of different social groups, thereby facilitating the emergence and reproduction of extended trust.

On the other hand, extended trust is also needed to make third-party enforcement by the state function efficiently. First, the state faces huge information problems in trying to judge the behaviour of economic agents, and the costs of uncovering this information through the judicial system are very high (see e.g. Wallis and North (1986)). As a result, the reliance on third-party enforcement alone to prevent opportunism would be very inefficient and excessively bind scarce administrative resources.[3]

Second, the ability of the state to provide third-party enforcement is a function both of its monopoly over coercive power and the legitimacy and credibility of public institutions. In the absence of trust in public institutions, a ruler may not be able to commit not to abuse his coercive power and efficient third-party enforcement may never emerge (Greif and Kandel 1994; see also Diamond 1993). Trust in the behaviour of government officials may also be important in determining citizens' obedience to rules and hence the effectiveness of third-party enforcement (Clague (1993); Rose (1993)). In the first case, trust in the state is needed to overcome opportunism by public officials and allow the government to commit to impartiality; in the second case, trust serves to coordinate citizens' actions and allows the collective good of an efficient legal system to be provided.

[3] The costs of preventing free riding through formal institutions is prohibitive almost by definition.

II. TRUST IN TRANSITION

CENTRAL PLANNING – A LEGACY OF DISTRUST?

Central planning has left a profound legacy on the nature of formal and informal institutions in central and eastern Europe and the former Soviet Union, but analysts of this legacy have differed greatly in their evaluation of its impact on the transition. For some, communism has left a legacy of distrust, which continues to hamper the emergence of a market economy (Rose 1993; Rose, Mishler et al. 1997). For others, the very imperfections of central planning led to the formation of a second economy, in which the basis for market behaviour was laid and social networks formed that could efficiently adapt during the transition (e.g. Stark 1997).

This paper generally provides support for the first line of argument. While the second economy seems to have in many cases provided a fertile basis for the emergence of a private sector, its development still is in many ways dysfunctional to an open market economy. As argued below, business networks based on ties formed in the communist second economy often remain closed to outsiders and hence prevent the emergence of effective competition. Moreover, there is in many transition economies a legacy of distrust in public institutions. Widespread bribery corrupts the impartiality of public officials and contract enforcement is often delegated to private agencies, which challenge the state's monopoly over coercive power. While potentially efficient and justifiable from the point of view of an individual enterprise, the social costs are huge.

The centralised nature of resource allocation did not require decentralised contracting between parties to a transaction (Greif and Kandel 1994). Contracts were made between the planning agency and producers. Monitoring problems were acute and enterprises effectively suffered little sanction from contract under-fulfilment – they operated under soft budgets and soft contracts. Because the reliability of supplies under the planning system was low, enterprises were effectively forced to seek necessary inputs informally. Hence, one legacy of central planning was the emergence of informal networks between enterprises – often using specific contact persons – and based on repeated interaction. Bureaucratic coordination furthermore led to extensive bargaining, in which personal connections to government officials were a crucial asset. Central planning relied extensively on process-based trust, with enterprises, local and national government officials closely linked through informal networks.

Another characteristic of central planning was the pervasive political domination of the communist party, underwritten by the ideology of the dictatorship of the proletariat. While the ideology was formed during the years of revolutionary struggle against an oppressive Tsarist regime, and may have carried some legitimacy in this context, it was itself turned into a totalitarian dogma and thereby lost any of its moral justification. As a result, distrust of public institutions was a characteristic of all communist societies. Associational life was kept largely outside the public sphere – a circle of friends mattered more than involvement in football clubs, which might be exposed to political infiltration.[4] Following Putnam (1993), it could be argued that social capital was low under central planning. The scope for social interaction, which would have allowed extended trust to emerge and to be reproduced, was limited.

[4] The atomisation of civil society in communist countries is well documented. For an overview and references to the literature see Elster, Offe et al. (1998).

RECOMBINING NETWORKS – EFFICIENCY OR EXCLUSION?

There are three types of institutional links between enterprises in transition economies. First, there are business networks built on ascribed trust – usually confined to the local economy, with the potential to expand through selective interaction with outsiders. Second, there are networks based on existing ties between the previous members of the communist nomenclatura – recombined during the transition to accommodate the reorganisation of the enterprise sector through corporatisation and privatisation, but continuing to be built primarily on process-based trust. Third, there are links between modern corporations based largely on the allocation of property rights, formal contracts and the integration into global production networks. For most transition economies, the second type of interaction is by far the most common. For all of them, moving beyond the first type towards building effective linkages between all three types remains a key challenge.

Ascribed trust

Kuczi and Makó (1997) provide a positive example of the beneficial role of ascribed trust in sustaining a network of joiners in a Hungarian village. In this example, villagers were bound together by family ties and ethnicity, but also by social institutions such as a village foundation and Sunday club discussions. This facilitated a business organisation built on oral contracts only, which allowed individual craftsmen to benefit from economies of scale and contribute jointly to a major development contract.[5] Integration with outsiders was provided by a national entrepreneur with remaining local ties, as well as by a local entrepreneur, whose relationship of trust with the individual craftsmen ensured contract compliance. Kuczi and Makó (1997) liken this arrangement to the organisation of small-scale businesses in the famous industrial districts of Northern Italy, a pattern that has found a number of successful parallels in developing countries (Humphrey and Schmitz 1996).

In a similar vein, McMillan and Woodruff (1998a,b) analyse the role of trust in Vietnam's emerging private sector, in a context where formal institutions for contract enforcement were almost entirely absent. They propose the willingness of suppliers to extend trade credit as a measure of trust towards a business partner and found that it is positively related to the costs of finding alternative customers. Trust was more easily sustained in local industrial clusters because search costs created a disincentive to exit.[6] By the same token, business networks were important sources of information among its members: "Gossip matters in this economy. Time spent in teahouses serves a purpose." (McMillan and Woodruff 1998b, p.3).

But McMillan and Woodruff also point out the costs of business networks built on this type of ascribed trust. Thus, large and successful firms relied far less on family ties than did small firms, suggesting that to be successful firms had to break out of clientelistic relationships. One reason may be that the reliance on closed networks reduces the availability of economic opportunities. In the sample of Vietnamese enterprises studied by the authors, only 29 per cent of all enterprises said they would accept a lower price offer from a supplier that they had not

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[5] Note that the characteristics of this network correspond to the requirements of density and openness outlined further above as conditions for the reproduction of extended trust. Also, technological assets were complementary, encouraging network openness.

[6] Indeed, the authors find substantial evidence that enterprises are willing to sustain a commercial relationship even following the default of a counterparty, rather than sanction this behaviour with the termination of cooperation. In the absence of enforceable collateral and high search costs, sustaining the relationship is the only hope of getting one's money back.

done business with before. More than half would buy only parts of their inputs from the new supplier while continuing to trade with the old, more expensive partner, while 19 per cent would reject the cheaper offer outright (McMillan and Woodruff 1998b, p.18).

Process-based trust – old versus new networks

The “old boys networks” of managers of state-owned enterprises, party members and other members of the communist elite have, in many instances, provided the basis for the formation of new business organisations. Grabher and Stark (1997) provide a wealth of case studies of the nature and the origins of business networks during the transition. A number of salient characteristics of such networks can be distinguished.

Stark (1997) analyses the close linkages between old state-owned enterprises and private corporations in Hungary. According to Stark, the process of corporatisation and spontaneous privatisation in this country led to multiple remaining connections between state-owned enterprises, their privatised subsidiaries, banks and the state property agency – business networks that Stark calls *recombinets*. Significant economic uncertainty during the transition and the specificity of physical and relational assets in such a network made it efficient to preserve it, even in the face of government policies aiming to break it up through privatisation of individual units.[7] However, as Stark (1997, p.38) admits, the resulting organisational structure blurs the boundaries between public and private and “creates acute problems of accountability”. Indeed, *recombinets* may be an efficient short-run response of existing enterprises to the threat to survival. It is less clear whether they are similarly efficient at promoting deep restructuring in their constituent elements and at attracting outside investment – in many cases, including Hungary, a key element of effective business modernisation.

Sedaitis (1997) distinguishes two types of business networks in post-communist Russia. In a study of Russian commodity markets during the early 1990s, she found the simultaneous existence of “dense” networks based on previous bureaucratic ties (for instance resulting from the privatisation of operational functions of industrial ministries) and “loose” networks, created with little reliance on relational capital. Dense networks had small and largely constant membership, and catered primarily for the demand for subsidised standard goods, acquired through bureaucratic channels and sold for barter. Enterprises would supply these markets because of the security of transactions, even though prices were far below what would have been obtainable on competitive terms. Loose networks were larger and more variable in membership and oriented towards profit. Payment was largely in cash. Sedaitis (1997) highlights the advantages of dense networks in reducing transaction costs, but their inflexibility when it comes to innovation and exploitation of new profit opportunities.

During the transition, it would be expected that the importance of old relative to new business networks would decline, as more and more agents seek out new economic opportunities.[8] In some transition economies these outside options have indeed been provided: through trade liberalisation and through the privatisation of state assets to strategic outside investors. Competition between these alternative organisational forms provides a powerful way of efficient institutional adaptation. However, the initial dominance of old business networks has, in many transition economies, blocked off the emergence of such competition. Closed networks have been able to turn themselves into vehicles for rent seeking, and new enterprises

[7] A similar phenomenon is described for the Czech Republic by Hayri and McDermott (1998).

[8] The marginal benefits from forming a new business to exploit market niches would tend to decline as the new private sector develops, but the uncertainty of expected returns would also be reduced.

have been discouraged through persistent regulatory interference and corruption (Johnson, Kaufmann et al. 1997). It is here that the greatest costs of the blurred boundaries between the public and private lie.

Global networks – linkages or dualism?

East Germany is perhaps the clearest case of an economy where existing business networks have been largely destroyed from outside through corporate break-ups and a top-down approach to privatisation (Grabher 1997). Other economies such as Estonia and Hungary have increasingly followed a similar strategy. As a result, a considerable number of firms in these countries are now integrated into global networks. Vertical integration through strategic investment from abroad or tight horizontal integration through outward processing trade has overcome weaknesses in the domestic formal institutional framework for contract enforcement. It remains as yet unclear whether these members in global business networks will become fully integrated into their host economies through backward linkages to domestic suppliers. EBRD project experience points to the possibility that one strategic foreign investment can lead to fundamental organisational changes in an entire network of domestic suppliers (Matouschek and Venables 1998). However, a dualistic economic structure where globally integrated enterprises rely largely on external suppliers or, indeed, a fractionalisation and disintegration of domestic suppliers' networks are also possibilities, with considerably lesser benefits for the host economy.

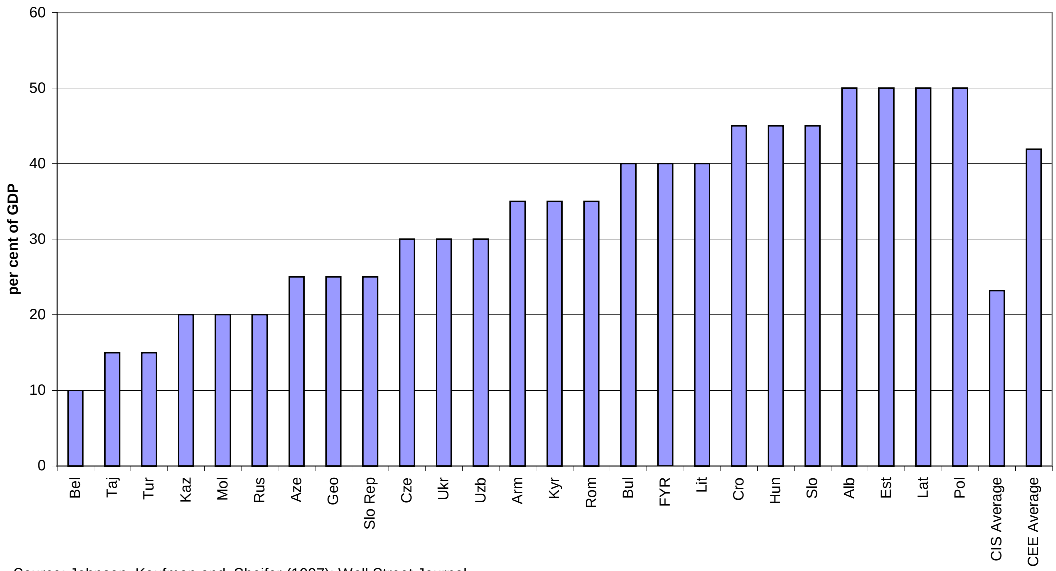
EXTENDED TRUST, ECONOMIC OPPORTUNITIES AND THE STATE IN TRANSITION

The communist legacy was thus one of dominant old-boys networks and significant distrust in public institutions; in other words, extended trust was low.[9] The new economic opportunities arising with liberalisation of markets and entrepreneurial initiative have been realised to a very different extent across the region. Chart 1 reflects these differences by reporting estimates on the share of the new private sector in GDP across the region. Does this variation reflect improvements in the creation of extended trust in the more advanced transition economies and were the foundations for these changes laid during the communist or the reform period? This section attempts to shed light on differences in private sector development by focusing on the interaction between communist legacies, different economic starting points and the behaviour of the state.[10]

[9] An interesting piece of evidence confirming this legacy comes from an experimental study by (Ockenfels and Weimann 1996). These authors find that East and West German students differ significantly in the extent of cooperative behaviour. A key feature of their experiment is that it is anonymous, and hence existing social loyalties do not count.

[10] Ideally, one would want to have a direct measure of trust such as in Zak and Knack (1998) and Keefer and Knack (1997) to situate the transition economies along a scale. Shleifer (1996) refers to values for Poland and Russia from the mid-1980s, which show little difference in the scores. I would argue that this has probably changed by now.

Chart 1. New Private Sector Share in GDP



Source: Johnson, Kaufman and Sheifer (1997); Wall Street Journal

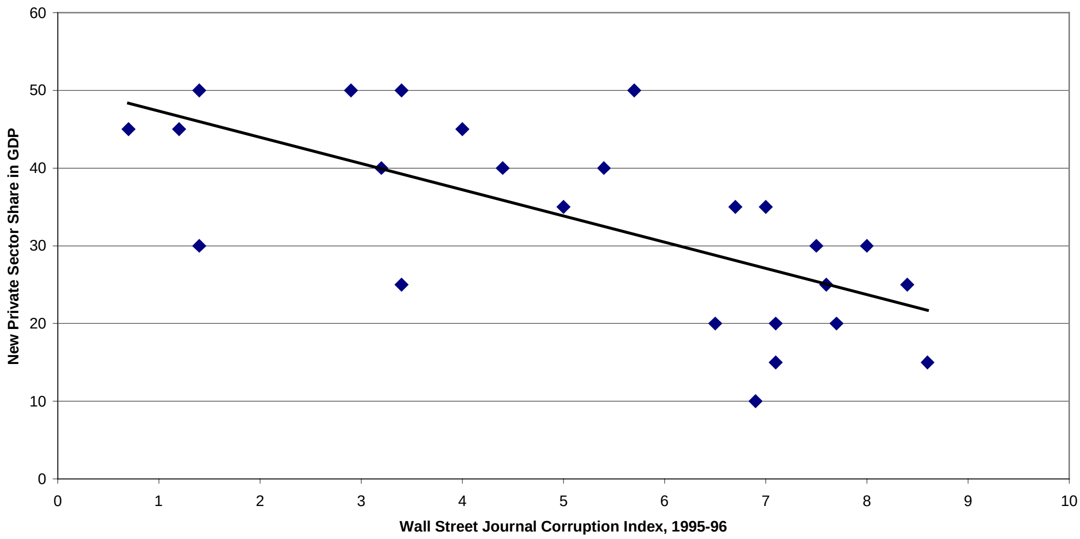
As argued in Section I, the emergence of extended trust can be facilitated by the parallel development of third-party enforcement through the state. However, government officials have few incentives to provide efficient third-party enforcement, if they remain members in “old boys” networks preserved for the purpose of rent-seeking. Through the toleration of barter in transactions with government, for instance, individual government officials gain substantial scope for personal benefits because of the lack of transparency associated with non-monetary transactions – to the detriment of revenue generation overall (Commander and Mumssen 1998). The support of loss-making industrial dinosaurs may be the source of political legitimacy for local government officials in “one-company towns”. Extortionate effective tax rates on the new private sector and repeated requests for side-payments are part of the same predicament of weak states, sustained by political coalitions of insiders, having benefited from redistribution during the initial phase of transition and now concentrating on preserving these rents.

The lack of incentives for government officials to provide efficient contract enforcement – and admittedly the limited capacity of the state due to absent legal and administrative skills – find their corollary in persistently low levels of trust in public institutions, particularly in the CIS (Rose, Mishler et al. 1997). This in turn would reinforce the difficulties of relying on formal institutions to facilitate the emergence of extended trust in transition.[11] The above argument suggests that the cross-country differences in this respect might be explained with the way in which communism was dissolved and economic assets redistributed during the early transition years. I sketch a possible explanation below, highlighting however the need for far more research to substantiate my claims.

[11] Indeed, the study by Johnson and McMillan (1998) quoted above shows that confidence in the courts is an important factor determining the willingness to extend trade credit (their measure of trust). Across the five countries in this study, confidence in the courts in highest in Romania (87%) and lowest in Russia and Ukraine (55%), with Poland and the Slovak Republic showing ratings of 73% and 68% respectively.

In the former Soviet Union, the loss of authority of the communist party under Michail Gorbatschow led to the disintegration of the state itself. In the face of great political uncertainty, public officials began stealing state assets by the mid-1980s (Solnik 1998) and actively promoting the disintegration of the state's monopoly in coercive power. The almost complete privatisation of the provision of public services allowed maximum short-term incomes to be derived from public office, at the cost of driving a considerable share of the economy underground and out of reach of the tax authority. Moreover, the assets stolen from state organisations often formed the basis of economic empires powerful enough to directly influence the course of policy making. Bureaucratic networks transformed themselves into business organisations aiming to secure maximum rents. Corruption became endemic during the closing years of the Soviet Union, and this inheritance was carried over to the period of market-oriented reforms. The stifling effects for private sector development are shown in the negative correlation between corruption and private sector development (Chart 2).

Chart 2. Corruption Hampers Private Sector Development



Source: Johnson, Kaufman, Sheifer (1997); Wall Street Journal

In central and (to a lesser extent) eastern Europe, political authority was never lost to the point of impairing the implementation of a national policy agenda. Tatur (1998) argues with reference to Poland and Hungary that elites appealed to different symbols in the process of reconstituting the state: continuity with the partial reforms in Hungary, and mass movement and conflict in Poland. These differences have influenced the techniques of institution building and may yet have lasting effects. However, political elites in both cases were able to draw on historical traditions of nationhood and rally public opinion around the principles of free market economy and democracy, with the ultimate aim of regaining a place among the European nations (see also Smolar 1996). This provided a long-term prospect and potential gain that helped public officials to bind their hands and achieve some policy credibility, against the background of public distrust. Hence, at least basic (if limited) third-party enforcement was available relatively quickly, supporting the gradual emergence of extended trust.

The importance of the goal of membership in the European Union in binding policy makers' hands in central and eastern Europe points more generally to the advantage of geographical proximity to the West. This significantly enhanced the set of economic opportunities and thus increased incentives for both public officials and private entrepreneurs to adapt their behaviour. Exposure to Western trading partners offered access to modern technology and marketing but required a change in business practices. Gaining the trust of foreign investors was often crucial against a background of continuing legal and economic uncertainty. Moreover, it could be argued that lower structural distortions increased the chances of survival of existing firms, reducing the incentives for managers to strip the firm of all moveable assets and then lobby for subsidies.

Lastly, cultural differences in the extent of acceptance of market principles must clearly play a role, too, in influencing the differences in extended trust across the region. Elster, Offe et al. (1998, p.301), for instance, argue that the pre-communist experience of an industrial free market economy helped the Czech Republic to achieve more rapid institutional adaptation and consolidation during the transition than in neighbouring Slovak Republic, which had been largely agrarian prior to World War II. Historical development levels were clearly much lower still the further one moves east. The emergence of extended trust will take considerable time, where it conflicts with existing norms of clan loyalty and where the development of a national rather than ethnic culture remains an unfinished task.

III. THE ROLE OF POLICY

A legacy of distrust is not easily amenable to policy changes. As Elster, Offe et al. (1998, p 18) note:

"Cultural patterns, identities and legacies, associative practises that help or hinder the solution of collective goods problems, and the vigour with which entrepreneurial and other economic interests are pursued are among those determinants of change that cannot be easily legislated into – or out of – being".

Nonetheless, public policy can help to shape the evolution of trust through moral leadership, through providing complementary third-party enforcement, and directly through its distributive policies and the support for the formation of new social networks. Through its actions, government influences trust in state institutions and helps to shape the structure of society, both of which, as mentioned before, are important empirical determinants of the degree of trust.

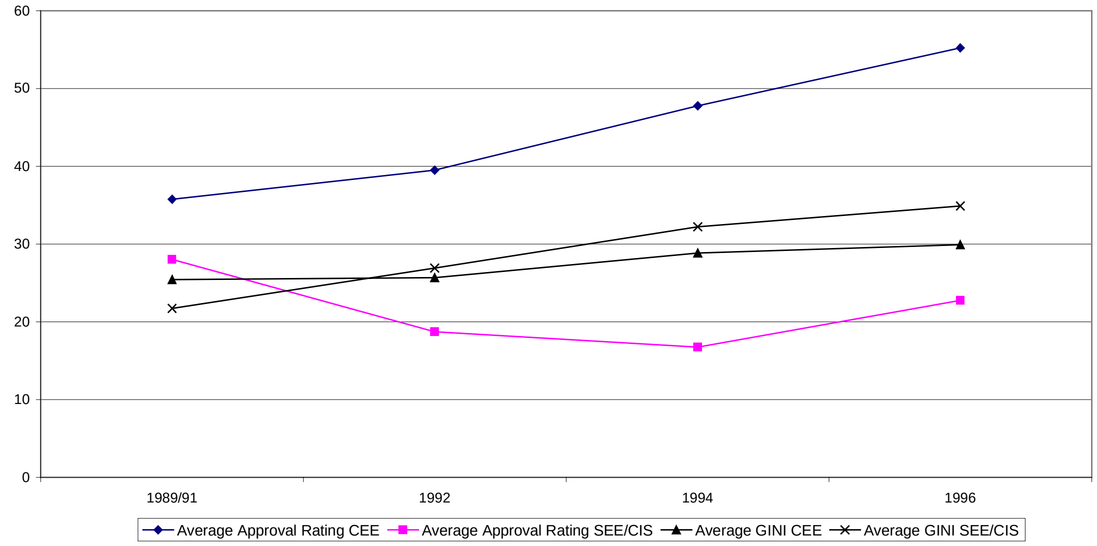
As North (1981) has stressed, ideological entrepreneurs perform the role of disseminating an alternative view of the world that may form a basis for legitimising changes in formal institutions, such as the structure of property rights. The transition involves large-scale changes in formal institutional structures. Moral leadership, including by public officials, is necessary to provide legitimacy to these new structures.

Moral and ideological leadership operates in different environments across the region. Elster, Offe et al. (1998) point out the different nature of existing political cleavages, which determine the appeal to either class, ideological and ethnic constituencies by political leaders. The authors argue that class conflicts, by allowing a "splitting of the difference", provide for a solution through a pluralistic and democratic political process, while ideological and ethnic cleavages often (although not inevitably) result in much less solvable conflicts over rules, procedures and identities. Countries characterised by ethnic divisions or strong residual beliefs in the socialist ideology are disadvantaged during the process of political consolidation. As argued above, moral leadership can also be boosted from abroad such as through the idea of European integration (Jacoby 1998).

Moral leadership and the power of ideas alone cannot guarantee impartial enforcement by state institutions. Competition from within – through the voice of democratic elections for public office – and from without – through the threat of exit of factors of production is needed to discipline public officials. As Shleifer (1996) argues, the rapid turnover of local political elites in Poland following the collapse of communism may have contributed to a lesser degree of discretionary intervention by local officials compared with Russia, where local elites remained more stable and government intervention was more acute. Economic crises across the region have forced governments to reconsider their policies to prevent further outflow of resources – into safe havens abroad and into the informal economy at home. Bulgaria and the Slovak Republic are recent cases, where economic difficulties have contributed both to a change in government and a dramatic reversal of policies to increase the attractiveness of the investment climate. Constitutional safeguards for open democratic government and policies that enhance a country's exposure to the discipline of foreign markets can thus be factors contributing to improvements in the quality of formal institutions and indirectly to the emergence of extended trust.

Government policies can also directly influence the social basis for extended trust. One key policy arena in this respect is redistribution. The perceived fairness of privatisation policies may be an important source of legitimacy for formal institutions more generally, as many of them are geared towards the protection of the newly created property rights. Chart 3 shows that increasing approval ratings for the economic system in central Europe go hand in hand with much lower increases in income inequality, compared with south-eastern Europe and the CIS, where approval ratings have been stagnant. Moreover, highly skewed privatisation policies could increase social distance considerably and undermine the basis for the development of extended trust. Increased income inequality in the context of reduced incomes overall also increases economic risks for individuals on the lower end of the wealth scale. Higher risks will tend to fortify reliance on closed social networks at the cost of lower extended trust.[12]

Chart 3. Inequality and Approval of the Current Economic System



Source: Paul Lazarsfeld Society (1998); UNICEF Regional Monitory Report

Lastly, as shown by examples from around the world, surveyed in Humphrey and Schmitz (1996), the state can directly promote the development of business networks built on mutual confidence. Government support for chambers of commerce, trade fairs, or other means for exchanging information and thereby overcoming barriers to the formation of trust are examples of such policies. As Milgrom, North et al. (1990) show, when impartial institutions exist that facilitate the exchange of information, prisoners' dilemmas between loosely connected traders may be overcome, even if the third party has no coercive power to enforce contracts.

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[12] Constraints on the feasibility of privatisation policies in the face of strong insider resistance have loomed large in the design of privatisation policies in many transition economies. The argument here is not to negate these constraints, but rather to direct the attention towards the much less discussed aspects of fairness of the process. My hunch is that the dynamic implications for institutional "consolidation", as outlined by Elster, Offe et al. (1998), of the fairness of privatisation progress could be important. The recent partial reversal of reforms in Russia would provide an interesting test case for analysis.

IV. CONCLUSIONS: TRUST AND ECONOMIC PERFORMANCE

Trust is a central element in most economic and social exchange. Without trust, opportunities for mutually beneficial trade remain closed-off, and cooperative outcomes are less likely. The result is lower economic welfare through less than optimal specialisation and arguably lower social welfare more generally, as altruistic preferences remain unfulfilled.

This paper distinguishes between family- or kinship-based trust, trust based on reputational mechanisms as present in repeated interaction, and extended trust, understood as the ex ante willingness to cooperate with anonymous others. It argues that what matters in complex societies is the existence of extended trust. Extended trust, including trust in state institutions, and impartial third-party enforcement are to a large extent complements in modern societies, and are likely to have arisen simultaneously in response to new economic opportunities. But the emergence of extended trust during the process of economic development requires moral leadership by the ruling elites induced by competition from within and without, and a social structure that reproduces appropriate social norms in dense but open networks.

Trust matters for economic performance, as increasing evidence from market economies reveals. For instance, Keefer and Knack (1997) have recently found a positive association of trust to economic growth, where trust is measured by the degree of confidence individuals would have in an anonymous counterparty – the precise definition of extended trust as adopted in this paper. Narayan and Pritchett (1997) find that the density of associational life contributes significantly to average household incomes in a sample of Tanzanian villages. Importantly, it is not just the relational capital accumulated by an individual or a household that raises incomes, the effect can be found at the village level. Trust is a truly social asset, as claimed in the notion of extended trust as a basis for the provision of collective goods.

Although the transition is far from over, the institutional outcomes as well as the economic performance in the more advanced transition economies of central Europe and the Baltics and in the countries of the CIS are nonetheless strikingly different. A general legacy of distrust in public institutions in both regions has given way to relatively stable democratically legitimated government in one part of the region and high levels of corruption, and the continuation of an opaque and oligarchic political structure, in another. This paper hints at one possible historical root of this difference, namely the varying way in which central planning and the communist party state were replaced. In particular, the root of power in post-Soviet Russia and elsewhere in the CIS in the usurpation of state assets during the demise of communist rule is argued to contrast with the shift in power in central Europe to an opposition movement which, albeit fragmented and weak, largely endorsed the tradition of Western liberal thought. These historical differences were compounded by differences in new economic opportunities, which increased the incentives for institutional adaptation, including the emergence of extended trust in central Europe relative to the situation further east.

However, a focus on personalities and different structural legacies is clearly too narrow and fails to appreciate the potential positive contributions, direct and indirect, that policy can make in building trust in public institutions and promoting mutual confidence among economic actors. The paper highlights three policy arenas of importance: 1) constitutional safeguards that allow for competition among government agencies and a democratically legitimised turnover of ruling elites; 2) distributional policies that influence the legitimacy of the new institutional structures through the perceived fairness of transition outcomes and that provide a basic safety for individuals allowing them to break free of existing social networks; and 3) direct policy intervention to strengthen business networks through facilitating the exchange of information.

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