# Alternative Methods of Institutional Development for Transition Economies

by

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A radical economic change, such as moving from a centrally administered economy to an economy based on market relations, also requires reform of the institutional structure. The shock-therapy process of transition utilises market incentives to internalise the developmental process of institutions instead of relying on the government, an actor external to the whole process. In contrast, gradualists argue that the development of the institutional structure requires government action. Gradualists recommend active state intervention in institutional development. Empirical evidence is inconclusive as to the more appropriate method. It is argued that a combination of the two methods would produce an optimal sequence. (JEL: P 2, P 3)

## *1 Introduction: The Role of Institutions in Transition Economies*

The transition from a centrally administered economy to a market-based economy requires a reform of the economy's institutions. The proper functioning of a market economy necessitates fundamentally consistent institutional arrangements (FRYDMAN, RAPACZYNSKI, AND TURKEWITZ [1997, p. 45]). Economic reforms are just a small part of the institutional–constitutional transition (SACHS, WOO, AND YANG [1999, p. 1]). The transition economies, without the heritage of market dynamics and democracy, have to provide a hospitable foundation for the establishment of institutions in order to develop a market economy (NORTH [1997, p. 16]). Economic institutions are social arrangements regulating economic behaviour based on anonymity and shared expectations (HARE [2001, p. 7]). NORTH [1990, p. 134] stated that any reform that ignored institutions appeared to be a sterile exercise. Thus, while for social sciences the transition experience is unique and valuable, for institutional economics it is vital (CAMPOS [2000, p. 3]).

The role of economic institutions is to make individuals responsive to the economic environment and make the economic environment responsive to individual

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actions. The institutional structure determines "the rules of the game" in a society (HARE [2001, pp. 21 and 26]). They are humanly devised restrictions that mould human interaction (NORTH [1990, p. 3]). Institutions identify the constraints in which rational economic actors comprehend, plan, and endeavour to achieve their goals. They encourage competitive or cooperative behaviour, reduce or increase transaction costs, and provide the organisational foundation for production and exchange (CAPORASO AND LEVINE [1993, p. 149]). In addition, society's interests are embedded in the institutional structure and change in accordance with customs, regulation, ideology, and *ad hoc* decisions by those who hold power (NEE [1996, p. 908]). "Indeed, the market cannot properly be understood separately from the economic, social, and political institutions necessary for its functioning and its legitimacy" (STILWELL [1996, p. 95]). In transition economies, economic actors strive to establish institutions to facilitate competition and to serve their interests through formal and informal arrangements.

The market requires "complex institutional arrangements" (FRYDMAN, RAPACZYNSKI, AND TURKEWITZ [1997, p. 46]), resulting in an environment conducive to its operations, similar to those witnessed in mature market economies. The institutions embody the property laws, organisational relations, the role of the state, human and civil rights, habits, and other unwritten conventions. They have an important role in reducing uncertainty (KEYNES [1936/1967], NORTH [1990, p. 6], LIN [1989, p. 3]). While uncertainty, on the one hand, may have a stimulating effect, on the other hand, it discourages action. Institutions introduce, to a certain degree, regularity and predictability, and provide appropriate responses to unforeseeable changes in the economic environment. Institutions facilitate individual decision-making, especially with respect to investment decisions. For transition economies to grow rapidly they had to devise policies to increase the rates of investment and then to maintain investment at high levels (HARE [2001, p. 16]).

Accordingly, institutions influence the performance of the economy by influencing the cost of transactions and production (NORTH [1990, p. 5]). They minimise the transaction costs associated with economic actors, controlling and rendering precise their property rights and instituting transactions of these rights. The institutional framework provides the incentive structure that directs economic and political activity (NORTH [2000, p. 5]). Consequently, developing appropriate institutions was essential if the newly formed market economies were to obtain the potential benefits of market relations. This was because "exchange presupposes clear boundaries which the system must generate. Without clear boundaries exchange communication may lead to socially and economically intolerable consequences" (DIETZ [1992, p. 34]).

The development of the institutional structure involved the establishment of property rights: the right to exclude other members of the society from the appropriation of the resource and the right to use it, as well as the right to appropriate the surplus earned. The aim of establishing property rights in transition economies had to do with allowing economic actors to appropriate greater economic surpluses, which the state previously confiscated. The establishment of private property, by establishing property laws and setting clear rules of ownership and control, placed responsibility on the owner to obey the budget constraint. KLAUS [1995, p. 45] argued that the foremost aim of the transition process was the establishment of a "system of well-defined property rights, which forms the basis for the rationality of behaviour of economic agents and, therefore, the basis for affluence and prosperity." These institutions protected the owner from actions by anyone, even the government, to deprive individuals of their property rights. An independent judiciary can only sanction the removal of property rights after appropriate compensation, based on modern civil and commercial codes. Property owners are assured that the state or any individual cannot appropriate their property without consent, thus developing an environment conducive to the productive use of resources.

The development of private property required the emergence of particular types of institutions associated with the market process. Firstly, institutions had to enforce private contracts and related procedures for the settlement of disputes and compensation in the event of damage. A market system was founded on the presumption that individuals would respect their contractual arrangements under the civil law of contracts. Contracts were legal documents that forced the seller to deliver the good or service at the decided time and the buyer to pay the predetermined monetary value. If any of the parties did not uphold the contract, the damaged party could ask for fair monetary compensation by appealing to his rights under civil law. Contracts were an indispensable institution, which guaranteed appropriate behaviour by individuals in the market system, in line with commercial codes, civil law procedures, and collateral and bankruptcy provisions. Secondly, there had to be institutions to regulate the behaviour of those who manage the property of others, such as accounting standards, stock markets, and banking and securities regulations. Thirdly, there had to be institutions to determine a set of expectations as to how economic units, including the government, are to behave and respond to economic actions. These included regulatory laws to correct market failure. Lastly, there had to be labour laws to determine rules of employment and the industrial relations system. In the absence of these institutions, effective privatisation in transition economies could not have been achieved.

Market institutions in transition economies should also have encouraged the development of new enterprises. The advantage of market relations, in contrast to central administration, was not only the ability of markets to allocate resources efficiently, but also, according to the Schumpeterian view, that they encouraged innovation. Market relations provide the necessary information concerning profit opportunities to stimulate the development of new enterprises; thus, generating better technology and new products. This explains why the Soviet Union had to rely on foreign sources for technological development, since there was no reward for the risks undertaken by local innovators. Consequently, approaching the privatisation issue from this point of view, the question was not how to privatise state enterprises but, rather, how to develop the appropriate conditions to stimulate the development of new enterprises. A suitable legal environment and appropriate institutions were essential in this respect.

The privatisation process was consuming most of the scarce resources, including financial resources, managerial skills, and labour; thereby, hindering the growth of new enterprises. Consequently, there was an inverse relationship between the amount of privatisation and the rate of growth of new enterprises. As MURRELL [1992a, p. 46] stated, "privatisation has gained too much prominence as an objective of reform policy. The appropriate goal is creation of a private sector." In addition, the experience of developing countries showed that growth had taken place through the development of new enterprises, not by adapting the existing ones (KRUEGER [1992, p. 221]). Thus, while privatisation has been prominent in the headlines, it is often argued "that the privatisation issue deserves somewhat less – and the institutional requirements of a market economy much more – priority than in the past" (OLSON [1992, p. x]). Instead of speculating on the speed and the type of privatisation, reformers should have concentrated on the development of new enterprises, restricting the development of monopolies, and developing an appropriate institutional framework. This would have resulted in a set of conditions where the speed and the type of privatisation process would have been insignificant.

Domestic and foreign investors were discouraged by the lack of a clear and reliable set of institutions and supervisory organisations. However, each country should have developed its own institutional structures based on its traditions, historical and political background, and culture. The institutional models of other countries might have been totally inappropriate. It was unlikely that the adoption of a uniform model of institutional development would have suited all transition economies (HARE [2001, p. 12]).

The removal of state control over prices and output, and the development of the market process, gave rise to the problem of market power. Under the centrally administered system the obsession with huge enterprises, "gigantomania" as CAMPBELL [1991, p. 164] named it, was the result of overestimating the benefits of economies of scale and specialisation. The industrial structure was highly concentrated, and with the introduction of market relations the preconditions for abuse of monopoly power existed. Antimonopoly laws were necessary to encourage competition, allowing collusion only if it was in the public interest. The breaking up of the big enterprises, facilitating the development of new enterprises by freeing prices, and opening the domestic economy to foreign competition would have been the best antidote for market power. FLIGSTEIN [1996, p. 1079] agreed that "the problem for these firms is competition, not property rights."

The transition models had to answer the question how appropriate market institutions would develop in the transition economies. Did it involve government action? As LIN [1989, p. 4] and KREGEL, MATZNER, AND GRABHER [1992, p. 28] argued, institutions "often emerge spontaneously and through repeated social interaction but in many cases they have to be made by conscious action." RAPACZYNSKI [1996, p. 87] disagreed, stressing that institutions are "largely the product of market forces, rather than government fiat." In a similar vein, DIETZ [1992, p. 34] argued that "exchange communication alone is capable of generating boundaries (identities and environments)." Thus, there was a choice between creating the necessary market institutions by government or waiting for them to arise spontaneously from market forces.

The question of the development of the institutional structure was internally linked to the speed of the transition. With regard to speed there are two distinct alternative transition models: the shock-therapy and the gradualist model. Therefore, we can differentiate between the shock-therapy approach and the gradualist approach to institutional development in transition economies.

## *2 The Shock-Therapy Approach to Institutional Development*

The aim of the transition, according to the shock-therapy approach, was not only to eliminate the unreasonable distortions of the central allocation of resources, but also to establish the appropriate institutions in organising the new market mechanism for allocating resources. The core of transition was a large-scale shift of institutional rules. "Economic transition (i.e., price liberalisation and privatisation) is only part of the transition" (SACHS, WOO, AND YANG [1999, p. 2]). The transition economies did not have any capitalist institutions: they were command economies (DABROWSKI [1997, p. 44]). Participation in the market, as the shock-therapy supporters argued, was not based on the crude self-interested behaviour of getting what you want with whatever means; rather, the means you use to get what you want must be within defined rules. Thus, the transition economies required the development of an independent judiciary and an executive subject to the rule of law (LIPTON AND SACHS [1992, p. 259]). This was in sharp contrast to the traditions of autocratic rule by the Tsarist regime and by centrally administered socialism. Indeed, the transition to a market economy required the destruction of the legal and political processes of the past (BOONE AND FEDOROV [1997, p. 184]).

Shock-therapy economists argued that markets required a definite assignment of entitlements and procedures guaranteeing the execution of contracts. Transition economies had to develop appropriate laws and institutions, which included defined property rights and well-enforced rules of contract. "Without law, there can be no property rights and without these there can be no real economic stabilisation or development" (ASLUND [1997a, p. 14]). Corporation laws would have stimulated the establishment of new enterprises and removed licensing restrictions imposed on the domestic market and in international trade. An effective market system required bankruptcy laws to facilitate the elimination and restructuring of failing enterprises (ASLUND [1995, p. 264]). For equity markets to be operative there had to be specific rules and procedures (BOONE AND FEDOROV [1997, p. 181]). Indeed, the integration of transition economies into the international market, membership in the WTO, and the European Union agreements provided a stimulus for the adoption of consistent institutions (HARE [2001, p. 12], THOMAS AND WANG [1997, p. 222]). The institutional structure also guaranteed that there would be no return to the old state of affairs.

Institutional development was one of the most challenging aspects of the transition modelling process (SACHS [1991, p. 30]). The development of institutions appropriate to the market process, although essential, was extremely complex and time-consuming and, once operative, was very difficult to change (FURUBOTN [2000, p. 121]). This raised doubts regarding the feasibility of the shock-therapy approach. However, the shock-therapy supporters argued that these doubts were unwarranted. Property rights and the institutional structure, like any other good, were produced as a result of consumer sovereignty, due to effective demand. "Contrary to the common economist's assumption that a system of property rights is a precondition of a market economy, the development of market institutions is often a prerequisite for a viable private property regime" (RAPACZYNSKI [1996, p. 102]). The development of market relations did not need to be postponed until appropriate institutions were in place, since the emergence of markets did not require a sophisticated institutional structure in transition economies. A simple economy did not need an advanced judicially enforced system of property rights. "Little economic or legislative sophistication is required" (ASLUND [1992, p. 11]). Some simple rules were adequate (EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT (henceforth EBRD) [1999, p. 38]). Markets, the legal system, and enforcement mechanisms evolved in tandem. When the state was weak, the introduction of sophisticated new legislation was counterproductive. Moreover, if enforcement could not be guaranteed, the credibility of the new rules was undermined. According to Hayek, efficient institutional arrangements could only have emerged as a result of competition and voluntary trade (SACHS, WOO, AND YANG [1999, p. 9]). Fundamental changes in relative prices, by altering norms, were the most important source of institutional change, which subsequently created incentives to construct more efficient institutions (NORTH [1990, pp. 7, 84, and 138], NEE AND MATTHEWS [1996, p. 411], LO [1995, pp. 81 and 85]).

Individuals participated in the market process in accordance with a clear set of rules. The culture of respect for property rights in mature market economies was not the result of habits, convictions, or religious beliefs. These could not have sustained the complicated and innovative behavioural patterns; rather, they were the result of a self-enforcing process initiated by spontaneous market behaviour. "The reason why most people perform their contractual obligations, for example, is not that they are afraid of remorse or state coercion, but that in the extended context in which they are expected to conduct business, a breach would be against their best interests" (RAPACZYNSKI [1996, p. 89]). These self-enforcing mechanisms could not have preceded the emergence of market relations. Likewise, they could not have been the result of government action. Although government initiation developed the necessary institutions, market-produced institutions frequently appeared beforehand and therefore were more operative. "Legislation always comes last. Legislation determines normatively what rules shall be obeyed" (SCHRÖDER [2000, p. 198]). The German experience showed that legal rights take time to be realised: "to expect anything else would be naïve" (BLANKENAGEL [2000, p. 101]). Consequently, the development of institutions was a very elaborate procedure, which the government did not have the knowledge to implement. These institutions were "nearly never created by conscious design" (FRYDMAN, RAPACZYNSKI, AND TURKEWITZ [1997, p. 42]). In this context, since people were rational and made efficient choices using market relations, the market outcome was an efficient outcome. The market could only have resulted in efficient capitalist institutions. "Exchange is the basic communicative element from which all other modern economic institutions (prices, money, private property, organisations and so on) emanate" (DIETZ [1992, p. 37]).

An evolutionary process of institutional development – that is, a step-by-step building up of institutions in transition economies – was not viewed as a disadvantage compared to the well-developed legal systems of the mature market economies. Rather, such a process opened up the possibility of finding new and superior sets of mandatory rules, which could have constituted new and different orders. There were many sets of rules that could lead to workable forms of markets in transition economies, and, actually, there was little or no knowledge regarding which of these sets of rules was the most appropriate. In addition, there was the possibility of institutional innovations, implying the creation of new and hitherto unknown sets of rules. KERBER [2000, p. 148] argued that these innovations could have even led to a competitive advantage in interjurisdictional competition in comparison with the mature market economies. This was because the new legal systems of the transition economies might have been able to adapt much faster to new problems than the often sluggish legal systems of the mature market economies.

Government supervisory bodies were inherently inefficient in providing an effective overseeing mechanism. Accordingly, any interference from the state only subverted enterprise ethics; thus, the state should not have intervened in the market (ASLUND [1995, p. 213]). As long as soft budget constraints[1] prevailed, firms were not compelled to finance their activities through the banking system. Furthermore, as long as political considerations did not allow the closure of inefficient enterprises, bankruptcy procedures were totally ineffective. Consequently, enterprise managers had much to gain from antisocial behaviour, because antisocial gains were not punishable or even considered illegal (p. 299). Indeed, one of the main reasons for the presence of corruption in private business was the persistent presence of soft budget constraints (LIZAL AND KOCENDA [2001, p. 141]).

The shock-therapy process of transition utilised market incentives, rather than coercion, to internalise the developmental of institutions instead of relying on the government, an actor external to the whole process. For example, with respect to environmental policy, harnessing market incentives was the most efficient method for encouraging producers and consumers to internalise any externalities (ESTY [1997, p. 364]). Thus, an evolutionary theory of institutional development, as a re-

[1] Firms under central administration encounter a soft budget constraint. Whenever a socialist firm is in the red, the central authority will bail it out with financial assistance in the form of subsidies, reduced taxation, the provision of credit, or increased administered prices (KORNAI [1992, p. 104]).

sult of competition, would have predicted new institutional arrangements, created and tested in parallel. Institutional experimentation was taking place in transition economies with respect to the institutional ability to solve transaction problems during the transition. If new kinds of contracts or forms of organisation could have been learned by the economies from each other, this would have resulted in the spreading of these innovations via imitation. From an evolutionary point of view, market competition could therefore have been seen as a process of experimentation, in which new knowledge in the form of new institutional arrangements was created and disseminated (KERBER [2000, p. 145]). Consequently, a radical reform process did not inhibit the development of the institutional structure. Indeed, the mere fact of the existence of private enterprises and market relations created the need for an appropriate institutional environment. "The evidence suggests that institutional development is stimulated by early and radical reform" (ASLUND, BOONE, AND JOHNSON [1996, p. 249]). As WOO [1994] argued, the experience of China revealed that a deficient legal system is consistent with an economic growth rate of more than eight per cent.

All transition economies have experienced corruption and with it a rise in crime, which compromised economic reform programs. This led to inflation, inequalities, and disillusionment with the transition goals in the eyes of the people, because civil society was weak and disorganised (SACHS [1995, p. 22]). In many transition economies, the lack of credibility of the law has led to the emergence of private enforcement mechanisms, along with the arbitrariness and violence that this entailed (EBRD [1999, p. 38]). Indeed, corruption was not something new. The members of the party in the previous state of affairs used their political power for their own betterment by exploiting their country's resources, which "were nominally owned by the state and thus nobody" (SACHS [1995, p. 22]). However, with the establishment of political pluralism and democracy, corruption could be hidden under the party's shield. Nevertheless, the origins of corruption remained the same: the "old guard" using their inherited positions of power to accumulate wealth by illegal means. Furthermore, corruption was the result of implementing a gradual process instead of shock therapy. For example, there is no doubt that the gradual and ill-defined process of reform in Russia was induced and often motivated by corruption (BOONE AND FEDOROV [1997, p. 186]). The ill-defined laws and legal procedures, the piecemeal removal of price controls, the subsidies provided by the government, the maintenance of trade barriers and inconsistent regulations, were all the result of a gradual approach that resulted in the growth of corruption at every level of government. The only way to avoid becoming a mafia economy and to cure corruption and crime was, and still is, a credible commitment mechanism of radical liberalisation (ASLUND [1995, p. 170], [1992, p. 174]; SACHS, WOO, AND YANG [1999, p. 4]).

The inherited bureaucrats of the old regime did not have the education required for the new economic conditions. Being trained as engineers instead of social scientists, they did not necessarily share the values of democracy, freedom, and individual choice (ASLUND [1994, p. 28]). Their salaries were low. Without the appropriate law enforcement mechanisms, these circumstances only served to fuel corruption. Hence, the immediate response of advocating more power for the government was inconsistent with social reality. In contrast, the transition process required a reduction in the role of the government. "To argue for a larger role of the state in the early stages of the transition is to advocate more power and money to the corrupt" (ASLUND [1994, p. 29]). By expanding the free market instead of government coercion, corruption would have been reduced substantially. Removing the power of the bureaucracy in economic and political affairs and substituting the free market would have allowed coercion to be substantially reduced. It was essential "not to overburden the weak state" (p. 28), especially in the earlier stages of the transition. Correspondingly, "in the eyes of private entrepreneurs, crime may impede business, but the Russian state is potentially more harmful" (ASLUND [1997b, p. 199]).

In such an environment, spontaneous market relations were not operative. Not only did this result in inefficiencies in the operation of the market economy, but also, more importantly in this context, the institutional changes that result from free-market relations did not eventuate. State enterprises were operating, in effect, without any market norms, and there was no hope that the conditions would have improved as long as spontaneous market forces were inhibited in generating self-enforcing institutions. Where soft budget constraints were allowed to persist, new enterprises were discouraged, and there was a detrimental effect on the demand for institutions and good economic governance (EBRD [1999, p. 39]). Consequently, "in Eastern Europe, there is no effective governance of managers, and as a result there are no clear incentives to manage the enterprises in an efficient manner" (SACHS [1991, p. 28]). The only possible way to encourage some form of business ethics among managers was "to hit them hard and break the ties through strict macroeconomic stabilisation. The managers had to undergo true economic shock therapy" (ASLUND [1995, p. 187]). Therefore, the economic transition involved a transition to profound new values. Consequently, the reforms did not prosper until authorities and individuals developed respect for law and legal processes (BOONE AND FEDOROV [1997, p. 184]). Consequently, the current difficulties in Russia's transition were not unusual and cannot be attributed to the shock-therapy approach (SACHS, WOO, AND YANG [1999, p. 19]).

Hence, while prescribing an immediate transition to a market economy, the shock-therapy supporters believed that only the market could deliver operative institutions. For the shock-therapy supporters, it was quite clear that legislation could only solve problems when a sufficient consensus in the entire society had been reached. This could happen only as a result of an evolutionary approach to institutional development. Effectively and paradoxically, the shock-therapy approach recommended the gradual development of market institutions. In practice, the shock-therapy economists were willing to sacrifice speed in institutional development in order to avoid government intervention, which they regarded as totally undesirable.

## 3 The Gradualist Approach to Institutional Development

A proper institutional structure was "the Achilles heel" (SVEJNAR [1991, p. 134]) of transition, because "institutions matter" (BARDHAN [2000, p. 245]). Private property and the building of institutions were fundamental to a free market (KOLODKO [2000, p. 274], [1999, p. 249]; WAGENER [2000, p. 129]). While macroeconomic stability was a necessary but not a sufficient condition for transition to a market economy, institutions were both necessary and sufficient (SZEKELY AND NEWBERY [1993, p. 5]). A credible transition process could only have been achieved by getting the institution right in terms of an institutional structure that could have directed and channelled economic activity to achieve sustainable and equitable long-term growth (POIROT [1996, p. 1059], WILLIAMSON [2000, p. 92]). The evolutionary paradigm of economic development was also used to justify a gradualist approach to reform (SMYTH [1998, p. 383], KOLODKO [1999, p. 234], NELSON [1995, p. 85], ARROW [2000, p. 9]). This is because gradual transitions required guidance, and the only source of guidance was the state (ARROW [2000, p. 13]). In this process, "the resulting spontaneous order can indeed spread rapidly" (MCKINNON [1992, p. 35]). As COASE [1992, p. 714] advised, "without the appropriate institutions no market economy of any significance is possible." Gradualists realised that the overall institutional environment greatly restricted the policy options available to transition economies.

The shock-therapy transition model recommended economic policies independent of the institutional structure, since the same economic principles were valid in all societies. In contrast, for the gradualists, economic policy should have been based on institutions, since, they argued, there is path dependence. "Path dependence means that history matters. We cannot understand today's choices (and define them in the modelling or economic performance) without tracing the incremental evolution of institutions" (NORTH [1990, p. 100]). Path dependence is due to economies of scale, specialisation, and transaction costs (HEMMER [2000, p. 241]). Economic action in uncertainty is part of the economy in real time. The economy cannot be separated from history (NORTH [2000, p. 8], KIRCHNER AND RICHTER [2000, p. 1], ARROW [2000, p. 13]). "This means that the system is indeterminate because the future is indeterminate" (PETERSON [1996, p. 156]). Gradualist economists argued that economic behaviour was highly influenced by institutions. This was because economic behaviour was positioned in socially constructed institutional structures and not in an impersonal market process (JONES [1996b, p. 103]). Viewing individuals as social beings, rather than atomistic, necessitates the important role played by institutions and organisations (ARESTIS AND SAWYER [1993, p. 5]). Political–economic reforms failed not because market liberalisation proceeded quickly or slowly but because supportive institutional reforms proceeded too slowly (THOMAS AND WANG [1997, p. 238]). The pace of institutional development determined the pace of reforms in transition economies.

"Economic principles are neither timeless nor independent of the civic setting and the prevailing institutions" (DAVIDSON AND DAVIDSON [1996, p. 64]). This is because the market *per se* is not the important issue in the economic system. What matters is the institutions, which define markets (WALDER [1996, p. 1060]). Thus, as the market expands, institutions develop, as a result of the market process, or government action, or both. However, SCHLACK [1996] argued that institutional development was the result of discretion and not natural selection. Thus, institutional change could not have been based on the universal principle of market solutions adopted by the shock-therapy transition model.

The development of market institutions takes time, which was one reason why the transition recession in eastern Europe and CIS was so persistent. Appropriate government initiatives would have hastened development and helped to reduce the length of the recession. The institution of private property cannot exist without government (OLSON [2000, p. 131]). However, recent history has demonstrated that transition governments have "committed many sins of omission in this respect" (KORNAI [1993, p. 200], [1994, p. 49]). The collapse of centrally administered socialism did not leave the society in an institutional vacuum. Accordingly, the practices, habits, informal arrangements, organisational structures, and social norms of society were slowly transformed into the basis for the establishment of credible commitments: people rationally adopted the new conventions as they emerged (OLSON AND KAHKONEN [2000, p. 36]). The preexistence of an institutional structure, even though contradictory and segmented, provided the basis for "rebuilding organisations and institutions not on the ruins but with the ruins of communism as they (economic actors) redeploy available resources in response to their immediate practical dilemmas" (STARK [1996, p. 995]). Change – even if it is revolutionary, such as the process witnessed in the transition economies – is the result of adjusting to new uncertainties by adapting the previous norms to the new economic conditions (MURRELL [1992b, pp. 82 and 84]). Rather than regarding the features inherited from state socialism as liabilities, they should have been considered as, at least, potential assets (LANE [2000, p. 500]). This new institutional structure "is not replacement but recombination" (STARK [1996, p. 995]). This suggests a possible role for the state in fostering improvement in the preexisting institutional structure (HARE [2001, p. 8]).

For the shock-therapy transition model, there was no concern for the efficient design of institutions, the political and cultural consequences, or how the existing institutions influenced the transition to a market economy. Shock therapists ignored the importance of entrenched social institutions and the role of the state in the market (TAYLOR [1994, p. 65]). In contrast to the shock-therapy view, "actors, ideas, and politics are important to the shape of new institutions" (FLIGSTEIN [1996, p. 1080]). Gradualists stressed that institutions develop as a result of a specific cultural framework; that is, social experience and social norms. "Paths of change may be influenced decisively by local characteristics" (WALDER [1996, p. 1070]). This was because preexisting institutions influenced the shape of what would have developed (FLIGSTEIN [1996, p. 1080]). The development of institutions should have been conceived as a path-dependent process (NORTH [2000, p. 6]). This means readjusting existing institutions to the changing economic framework. Consequently, since institutional change was path-dependent and culturally dependent, "the process of transition is ... difficult and uncertain" (GROSSMAN [1997, p. 254]). For this reason, institutions did not change at the same pace or develop to a single institutional form and should not, therefore, have been treated as single variables (WALDER [1996, p. 1062], NORTH [2000, p. 7]).

Societies bolster a productive balance between self-interest and civic values through specific institutions. The historical development of markets was associated with preexisting institutions, which made possible the development of market societies in such a way as to maintain "liberty, prosperity and justice in their societies for many generations" (DAVIDSON AND DAVIDSON [1996, p. 15]). The aim of market institutions was to encourage self-interest and, at the same time, safeguard the society from any tarnishing of civic values by individualism. This was because the pursuit of self-interest unconstrained by suitable institutional structure did not foster the development of a cohesive society. This was exactly what happened in transition economies: corruption, while denounced, could not have diminished until the institutions of a market economy were more fully established and operative (OBERSCHALL [1996, p. 1028]). As BUNKNALL [1997] argued, when the state started to disintegrate, so that it could no longer foster a civilised institutional framework, the only path remaining was criminal sociopathy. "Neither self-enforcement by parties nor trust can be completely successful" in transition economies (NORTH [1990, p. 35]). Consequently, a broad variety of institutions of nonmarket coordination were necessary for high-performance market orientation in transition economies (STARK [1996, p. 1018]).

When the institutional structure did not ensure security of contracts and property rights, investors did not take risks and managers were able to abuse their monopoly power. It was essential to set up, early on in the transition process, some control mechanisms to restrain and redirect the managers. There was a need for appropriate institutions to accompany both private and state property, so as to ensure appropriate managerial behaviour. In the case of private enterprises, control over insider trading and financial institutional control were important; in the case of state enterprises, management accountability mechanisms and limited tenure of management were important. It was not bankruptcy that stimulated restructuring; rather, clarity of property rights provided the necessary incentives. In China, for example, it is not the privatisation of assets but, rather, the clarification of property rights that has contributed to the dynamism of light industry (STARK [1996, p. 1020]). In contrast, in transition economies, private rights to property were ambiguous and insecure, so privatisation did not really have a meaning (OLSON [1992, p. ix], OVIN [2001, p. 137]). Therefore, the privatisation of state enterprises should have taken place at a very late stage in the transition process, after establishing an efficient institutional structure.

Should the institutional structure be developed as a result of free-market transactions? Gradualists would argue no. First of all, it would be an extremely time-consuming process. Additionally, the market, due to imperfections, could not even respond immediately to effective demand. How, then, could it respond to the demand for an institutional structure, which was greatly complicated and was required urgently? Consequently, contrary to the shock-therapy transition model, the setting up of the institutional structure required government action: “it cannot be left to chance or left until later” (RIDER [1994, p. 8]).

Market-produced institutions, in the shock-therapy transition model, were assumed to be efficient. DUGGER [1996, p. 458] disagreed: “institutions and institutional change are not always socially efficient.” A coercive third party, instituted by government, was essential. Notwithstanding, a civilised society requires institutions, developed as a result of purposive action to satisfy specific needs, that are consistent with the civic values of the society. Accordingly, the institutional structure cannot wholly be left to market forces: its development is a purposive and deliberate process. The “deficiencies [of the shock-therapy model] are associated with the side-stepping of the institutional hysteresis associated with any market or government action” (YAVLINSKY AND BRAGUINSKY [1994, p. 90]). For this reason, the basic institutions cannot be completed gradually to introduce and preserve the rule of law (OVIN [2001, p. 136]). Consequently, the term “reform,” although frequently and widely used, did not really correspond to the nature of the transition process. The withdrawal of the institutions of centrally administered socialism was by no means orderly, stable, or gradual enough to justify the use of the term “reform.”

While mature market economic institutions contain some common elements, they vary notably because of the different civic values and self-interests and how they interact with each other. An efficient institutional structure has to be consistent with the country’s history, cultural framework, and political traditions. For example, the U.S. constitution was adopted with modifications by many Latin American countries. Third World countries have adopted the property-rights legislation of mature market economies. The results, however, are not comparable to those in either the U.S. or other successful mature market economies. The rules may have been the same, but the enforcement mechanisms and processes, the norms and values of behaviour, and the subjective perceptions of the economic actors were dissimilar (NORTH [1990, p. 101]). Precisely because capital goods had to be readjusted during transition in order to take into account new expectations, so too did the institutions for markets. “They cannot simply be imported as ready made copies of those in US or Western Europe. The entrepreneurs have to learn how to operate” (ARROW [2000, p. 13]). Therefore, “no single program could possibly fit the varying historical and institutional circumstances of each country” (GROSSMAN [1997, p. 252]).

The inadequacy of market institutions in transition countries, as a result of the shock-therapy approach, stalled the effectiveness of liberalisation (THOMAS AND WANG [1997, p. 238]). The development of market institutions in the shock-therapy model was supposed to be the result of the market. This, however, never materialised. Consequently, the unregulated market failures worsened the quality of life (ESTY [1997, p. 372]). Gradualists recommended active state intervention in institutional development, which blended self-interest with civic values to encourage the development of a civilised capitalist society. LAVIGNE [2000] argued that as soon as the need for institution building was recognised, the role of the state had to be emphasised. Organised crime and corruption were attributable to lack of integration and legislation at the beginning of the transition, and there was a regrettable lack of retroactive legislation (BLANKENAGEL [2000, p. 115]). Development in the institutional field by the state reduced firms' risk and enabled them to concentrate on growth. Thus, the state through this activity supported essential macroeconomic goals (OVIN [1998, p. 63]). Fraud, corruption, and organised crime were all pervasive in transition economies: the result of a weak state. The capitalist process could only have functioned properly under the rule of a strong state: a state that was able to create security, confidence in the future, trust, and predictability of the law. "Modern capitalism coevolved with the modern state" (WAGENER [2000, p. 127]). In such an environment a minimal institutional setting must be assured, and for that only the state, with its natural monopoly on introducing and protecting rules, could do the initial job. This is a necessary condition but still not a sufficient condition (OVIN [1998, p. 75]). Effectively, "capitalism without the nation state (especially that of the superpowers) is like a body without its skeleton. The so-called market mechanism does not have a backbone of its own" (JONES [1996a, p. 29]).

The immediate introduction of legislation might also have been viewed as a signal for a credible commitment to fundamental change. As a result, in the case of institutional change, faster changes offered more advantages than gradualism (OVIN [1998, p. 63], HERKENROTH [2000, p. 308]). Hence, the laws must first be introduced and then be subject to changes with democratic instruments. This process would have no doubt achieved results that would have survived the subsequent adjustments. The "market for institutions" was not a smoothly functioning mechanism. A society might hope to be able to choose among institutional arrangements periodically and revise institutional structures as learning and persuasion reshaped economic behaviour. "But practical realisation of this situation is unlikely for systems in transition" (FURUBOTN [2000, p. 122]).

In conclusion, gradualists argued that instead of building capitalism by fiat, the transition economies should have provided institutions by fiat; the changing of the institutional structure proposed by the gradualists is a nice example of a "big-bang" approach to reform. Consequently, institutional change is expectation-dependent as well as path-dependent (ARROW [2000, p. 18]).

## *4 Informal Institutions and Trust*

An institutional arrangement can be formal or informal (LIN [1989, p. 7]). Informal constraints and trust also have an important role to play in a market economy. Informal constraints and trust cannot be as precisely defined as formal rules. They are extensions, elaborations, and qualifications of rules that "solve" innumerable exchange problems not completely covered by formal rules; in consequence, they have tenacious survival ability. Routines, customs, traditions, and culture are words we use to denote persistent informal constraints. Trust "oils the wheels of social, economic and political exchange. ... A civilised society cannot function without a high level of trust" (LOVELL [2001, p. 30]). Consequently, path dependence, again, is a major factor in constraining our ability to alter performance for the better in the short run (NORTH [1997, p. 17], LIN [1989, p. 21], FURUBOTN [2000, p. 121]). For fear of social opprobrium and ostracism, an individual may be reluctant to violate the informal arrangements and trust, even if the material gains from this violation appear to be very large. Observance of informal institutions and trust only becomes rational when good faith is expected by others (BLANKENAGEL [2000, p. 115]). In transition economies, within the new institutional environment, individuals form expectations conditional upon the expectations of others. To consolidate the advances towards civil society and democracy in transition economies, particular attention has to be paid to strengthening informal institutions and trust. Trust requires not just the institutional framework appropriate to democracy and the rule of law, but also appropriate politics and a civil society. A real society cannot function, in the presence of large-scale conflicts of interest, without the institutions of civil society and democracy to contain, channel, and arbitrate this struggle (LOVELL [2001, p. 33]).

As a consequence, informal institutions play a role in shaping the formal rules (NORTH [1997, pp. 4 and 14]). Thus, "trust matters. Thus, hardening constraints *per se* is insufficient" (KIRCHNER AND RICHTER [2000, p. 2]). Kenneth ARROW [1974] argued that trust is an economic "externality"; it "saves a lot of trouble to have a fair degree of reliance on other people's word. Unfortunately this is not a commodity, which can be bought very easily. If you have to buy it, you already have some doubts about what you've bought." Trust is a basis for social cooperation, which gives rise to voluntary associations and can lead to economic development within the framework of the rule of law (LOVELL [2001, p. 36]).

However, trust cannot be simply legislated into existence either. It is developed by habit: it requires constant practice. Therefore, the production of trust and confidence is indispensable for the stabilisation and competition of transition economies (BLANKENAGEL [2000, p. 117], LOVELL [2001, p. 29]). As a result, institutional development in transition economies has involved the development not only of formal, but also of informal, institutions and trust. The development of informal institutions could only have been gradual, and the building of trust was not easy (LOVELL [2001, p. 36]).

In addition, the development of a market economy in transition economies must embody the institutional elements that existed under the previous regime. Here we are not concerned with the formal institutions, which could be easily changed, but rather with the informal institutions cultural and social norms, which underpinned the formal institutions. Informal constraints, which are culturally embedded, did not change immediately in response to changes in the formal rules. In fact, informal institutions are sometimes extremely persistent (HEMMER [2000, p. 243]). Informal constraints have great tenacity in spite of changes in formal rules because they solve basic exchange problems, whether social, political, or economic, among the participants. It follows, therefore, that the particular dominant cultural traditions and mores of the population are likely to be important in affecting the direction taken by the transition process (FURUBOTN [2000, p. 120]).

Enforcing formal institutions without considering informal constraints produces a conflict between formal and informal institutions. This inconsistency "will always lead to different interpretations and applications of such laws" (GROSSMAN [1997, p. 252]), producing outcomes that have significant implications for the way the reform program materialises. The result will be either a restructuring of the overall constraints to produce a new equilibrium, or an unresolved tension, which will result in political instability. Thus, changing formal institutions is inadequate; however, the informal institutions are very hard to change. For example, in Russia there was no cultural or social norm, even before the Bolshevik revolution, that made private property acceptable, especially in agriculture. Thus, the establishment of laws permitting private property, while it had stimulated the development of new firms, had not encouraged the development of private property in agriculture (GROSSMAN [1997, p. 253]). Consequently, institutional changes should not have been designed independently of informal constraints (OVIN [1998, p. 69]).

There was a gap between institutions and appropriate trustworthy behaviour in transition economies (LOVELL [2001, p. 28]). There are a number of reasons why the level of trust in transition economies was low: the real and perceived behaviour of current elites, disappointment with outcomes of the transition, cheating in the marketplace, and the legacies of the state (p. 32). The reluctance of mature market economies to provide large sums of foreign aid to Russia was due to a deep distrust of Russian sincerity (BLANKENAGEL [2000, p. 113]). This deficiency might have been addressed by establishing a political leadership that served the public interest, and by the civil toleration of adversarial politics. These political preconditions would have resulted in the spontaneous creation of a broad range of institutions independent of the government that would have regulated at least some aspects of social and economic behaviour (KMENTA [2000, p. 140]). This would have helped the proper functioning of the market economy by establishing trust between market participants. Effectively, fostering trust required reinforcement via the rule of law. This would have ensured that the state dealt predictably and fairly with all citizens and made certain that economic actors who were tempted to cheat knew that it was illegal and that they would be punished. Therefore, apart from the formal institutional reform, transition economies have to focus on stimulating the development of trust between market participants.

In Stalinist societies, the general public perceived every part of the state administration as a repressive body. The state was the "enemy." Small-scale theft of public goods and services became part of the passive opposition against the communist regime. After decades the theft of public goods became not only socially acceptable but also sometimes a norm of behaviour (LIZAL AND KOCENDA [2001, p. 138]). Moreover, the norm, in negotiation with the state administration, of using small gifts and small financial bribes has continued to date.

Eventually, public servants must look to the public interest and not see public life as an opportunity to plunder the public purse and misuse their position for their own ends. Nor should they be beholden to particular economic interests. The best way to ensure economic progress is transparent governance, allowing public servants to be held accountable for their actions, and strong laws enabling people to go about their business in security (LOVELL [2001, p. 34]). Consequently, enhancing trust is a prime responsibility of leadership in transition economies, amounting indeed to a definition of leadership. A culture of trust is a powerful force shaping the behaviour of public officers, including politicians. It also reinforces accountability, which is at the heart of democratic government. For politics to cater to the public interest, politicians and public servants must themselves embody that objective (p. 35). Building trust can consolidate liberal democracy and a truly civil society. In an important sense, this means creating and defending the public interest. Citizens must be educated in and embrace the new form and role of politics; public officers must be educated in the nature and importance of the public interest (p. 36). While institutions are important in transition economies, public-spirited actors are essential. A society where distrust is extensive may not be in danger of immediate collapse, but neither can it take full advantage of the opportunities offered by democracy and the market. Addressing the issue of trust is therefore a key matter in determining what sort of society will emerge from the collapse of Stalinism.

## *5 A Critical Perspective of the Alternative Methods of Institutional Development*

Analysis of the alternative strategies for institutional development reveals a surprising result. The shock-therapy approach, while prescribing an immediate transition to the market economy with respect to the institutional structure, argues that efficient operative institutions can only be delivered by the market: allowing the market to develop the institutions necessitates a gradual process. Meanwhile, the gradualists, while advocating a gradual transition process, with respect to the institutional structure recommend immediate state intervention in developing, implementing, and enforcing market institutions to create the preconditions for a market economy: effectively necessitating a shock-therapy approach. Hence, the shock-therapy approach recommended a gradual development of market institutions, while the gradualists suggested a shock-therapy approach.

On the one hand, acceptance of a gradual approach to institutional development through market forces, as the shock-therapy supporters recommended, gives rise to the problem of market failure. If institutions are a public good, as HARE [2001, p. 7], OVIN [1998, p. 65], [2001, p. 134], and LIN [1989, pp. 13 and 30] argued, the market process will be unable to produce the necessary institutions. In this case, it is the responsibility of the government to produce the public good. State intervention is required, and institutions have to be produced externally to the market. The public nature of emerging institutions in transition economies faces an unfavourable environment for their spontaneous development. To overcome this, the state has to supply the minimum institutional framework. In fact, OVIN [1998, p. 65] argued that state institution building represented the shortest way to prevent state interventionism and develop a free-market economy in transition economies.

SACHS, WOO, AND YANG [1999, p. 7], supporting the shock-therapy model of transition and gradual institutional development, argued that the relatively successful industrialisation in the Soviet-style socialist countries in the 1930s and 1950s was the result of imitation of the capitalist industrial pattern. This was created by capitalist institutions in the absence of capitalist institutional infrastructure in the Soviet Union. This imitation was the result of state action. The same argument could be applied to transition economies. SACHS, WOO, AND YANG [1999] did not investigate this. The free information created by mature market economies produced an opportunity for *big-push* industrialisation for the latecomers, in our case the transition economies. It is possible that big-push industrialisation could still have been carried out in transition economies that lacked the market institutional infrastructure essential for discovering the efficient pattern of industrialisation. This could have been achieved by imitating the institutions of mature market economies. Nevertheless, as in the case of the Soviet Union, in the transition economies imitation required state action.

On the other hand, acceptance of a shock-therapy approach to institutional development as a result of state action, as the gradualist supporters recommended, gives rise to the problem of *government failure* – in particular, failure to provide mechanisms of credible commitment to secure property rights (BARDHAN [2000, p. 232]). Shock-therapy supporters such as SACHS, WOO, AND YANG [1999] argue that government failure took the form of institutionalised state opportunism and corruption in the transition economies. Actually, experience revealed that, contrary to conventional notions of corruption, such as extortion from firms by bureaucrats (administrative corruption), many firms in practice engaged in high-level corruption as a strategic choice to collude with state officials or politicians for their mutual benefit. This strategic decision by firms, while the institutions were unfolding, is called *state capture* (HELLMAN, JONES, AND KAUFMANN [2000, p. 8], EBRD [1999, p. 117]). State capture commonly refers to the capacity of a narrow set of interest groups in the economy to unduly influence the formation of the basic rules of the game (laws, rules, decrees, regulations) through private benefits to public officials. Consequently, high-capture states tend to focus on providing specific advantages to influential firms and lobbies, while underproviding the institutions essential to improving governance (EBRD [1999, p. 115]). Firms both incur costs and receive benefits from this relationship. In this way, government officials intervene in a variety of company decisions, extract bribes from firms, and impose significant demands on the time of senior managers. At the same time, firms remain dependent on the state for a range of benefits including direct investment, tax and utility arrears, and influence over regulation and policymaking (p. 128).

To conclude, both the state and the market have been imperfect mechanisms for institutional development in transition economies. As a result, the gradualist approach to institutional development recommended by the shock-therapy supporters gives rise to market failure. The shock-therapy approach to institutional development recommended by the gradualist supporters gives rise to government failure. An analysis of empirical evidence from the transition economies might provide some insight into this important policy dilemma.

## *6 Empirical Evidence*

Measurement of institutional development is complemented by measurement of institutional governance. Measurement of the various characteristics of governance is no easy matter, because several of these characteristics are multidimensional. The multidimensionality may well imply the need for different measures for each dimension. Existing data sets have less than ideal information for this purpose (CAMPOS AND NUGENT [1999, p. 442]).

Empirical investigations into transition economies concentrate on five critical institutional dimensions of governance: (1) the executive, (2) the bureaucracy, (3) the rule of law, (4) the character of the policymaking process, and (5) civil society. Corresponding to each critical institutional dimension is a characteristic associated with "good governance" (CAMPOS [2000, p. 6], CAMPOS AND NUGENT [1999, p. 439]). Notwithstanding, good governance also implies that the different characteristics are complementary to one another. The satisfaction of any one component would likely have resulted in another being satisfied (CAMPOS AND NUGENT [1999, p. 440]).

Empirical findings have revealed that for each country a different institutional characteristic appears to have played the main role in improving development performance (p. 449). International experience reveals that the rule of law seems to be the primary institutional determinant of development performance in Latin America. In East Asia, the primary role seems to be played by the efficiency of the bureaucracy (p. 447). In transition economies, empirical investigation reveals that the rule of law is the most important institutional dimension, in terms of its effect on per capita income and school enrolments (CAMPOS [2000, pp. 5 and 21]). However, with regard to life expectancy, the quality of bureaucracy played a more important role than any other institutional dimension. While CAMPOS's [2000] analysis exposes the importance of economic institutions for economic development in transition economics, he does not tackle the issue of the process of institutional development.

In addition to the difficulties associated with the measurement of institutions, the process of institutional development in transition economies has another problematic dimension. In practice, the implementation of the shock-therapy model was short-lived. After substantial initial support by the people in transition economies for governments initiating the shock therapy, the process has had considerable undesirable outcomes, such as unemployment and low living standards, which lead to the government's unpopularity. The high inflation and unemployment resulted in social and political instability, threatening the fragile democratic governments and putting the reform process at risk. The risk was substantially increased by the adoption of proportional representation as the basis for parliamentary delegation, which resulted in multiparty coalitions that are weak and fragile, and therefore in easily pressured governments. These governments were in head-to-head confrontation with powerful political and economic blocs, populism, and the disillusionment of the public. Intrinsically, such governments did not have the power to pursue the policies required by the shock-therapy platform. In a democratic environment the substantial reduction in output and employment associated with the shock-therapy transition has resulted in the ultimate downfall of those governments through the electoral process. Table 1 presents the duration of shock therapy in transition economies.

*Table 1*
Duration of Shock Therapy in Transition Economies

| Country | Transition type | Reforms commenced | Gradual shift |
|---|---|---|---|
| Poland | Shock therapy | 1 Jan. 1990 | 19 Sep. 1993 |
| Czechoslovakia | Shock therapy | 1 Jan. 1991 | *Slovakia:* 1 Jan. 1993 (after the breakup of Czechoslovakia, Slovakia pursued a gradualist approach). *Czech Rep.:* 1 June 1996 (slowdown of some economic reforms – mainly privatisation of health system and railways) |
| Bulgaria | Shock-therapy concept – slow implementation | 1 Feb. 1991 | 18 Dec. 1994 |
| Russia | Shock therapy | 2 Feb. 1992 | 12 Dec. 1993 |
| Albania | Initially gradual, then shock therapy | June 1991: gradual; July 1992: shock therapy | 19 June 1997 |
| Estonia | Shock therapy | Sep. 1992 | 5 Mar. 1995 |
| Latvia | Shock therapy | 5 June 1993 | 25 July 1997 |

Consequently, it is difficult to assess the effect of the speed of transition on institutional development, due to the short-lived nature of the shock-therapy process.

Nevertheless, it is still interesting to analyse the empirical evidence in order to investigate which countries performed better in avoiding market and/or government failure in institutional development. Independently of the short duration of the shock-therapy approach, shock-therapy supporters in favour of a gradual approach to institutional development argued that empirical evidence confirmed their argument that liberalisation and privatisation must precede institutional development for successful economic performance, allowing, in this way, the market to develop the necessary market institutions. Shock-therapy supporters, as expected, highlight the negative outcomes associated with government failure in the form of state capture.

The EBRD [1999] empirical analysis of institutional development in transition economies confirmed that there was a strong link across the transition economies between the proportion of years in which liberalisation has been in operation and the level of development of supporting institutions. The most advanced countries show higher scores of governance than those countries that have maintained partial reforms. There was a strong link between the number of years since the completion of small-scale privatisation and the demand for institutional change. Small-scale privatisation directly contributed to creating a new class of entrepreneurs, which tended to promote institutional change, resulting in a strong link between the progress in institutional reform and trade with mature market economies. The results revealed that the demand for institutions arising from liberalisation and privatisation was strong even once the effect of initial conditions had been taken into account. Legal reforms could advance rapidly during the transition and were not strongly constrained by legal history (JOHNSON AND KAUFMANN [2001, p. 224], EBRD [1999, p. 37]). In summary, the transition economies that had achieved sustained progress in liberalisation, macroeconomic stabilisation, small-scale privatisation, and openness to foreign trade and investment had also advanced steadily in the development of market institutions. Consequently, firms had more favourable assessments of governance than those in the countries that had adopted partial reforms (EBRD [1999, p. 115]).

The high-capture countries in transition economies – Azerbaijan, Bulgaria, Croatia, Georgia, Kyrgyzstan, Latvia, Moldova, Romania, Russia, Slovakia, and Ukraine – were, in reality, also partial reformers in both political and economic transition. While they might have made some progress in liberalisation and privatisation, lesser advance was evident in the complementary institutional reforms to support a legal and regulatory framework for the emerging market. For example, special laws designed for a particular person or entity, as opposed to general laws addressed to an anonymous or only generally defined target group, have been rampant in Russia. These special laws provided the legal basis for tax exemptions, special privatisation rules, and allocation of rights to those with the best access to the president's decree power. As a result, the state retained large scope for arbitrariness, which not only created uncertainty, but also provided a breeding ground for corruption (SACHS, WOO, AND YANG [1999, p. 18]). Furthermore, while most high-capture countries have adopted the basic rules of democratic elections, the evidence raises questions about the concentration of political power, limitations on political competition, and impediments to full participation by civil society. HELLMAN, JONES, AND KAUFMANN [2000] argued that the data revealed that state capture appeared to thrive in an environment of only partial economic and political liberalisation. Moreover, in a comparison across enterprises within any given country, bribery, state intervention, and time spent with officials tend to go hand in hand (EBRD [1999, p. 125]). Not surprisingly, in countries with a high-capture economy, it was also found that captor firms perform substantially better than other firms in sales growth (HELLMAN, JONES, AND KAUFMANN [2000, p. 10]).

Higher levels of capture were strongly associated with weaker systems of governance. The state in many transition countries had still not fully adapted to the functions and tasks necessary for a developed market system. Key state institutions for protecting property rights and enforcing contracts were still functioning poorly. The promise of good governance remained largely unfulfilled, suggesting that poor governance weakens property rights (EBRD [1999, p. 115]). According to the enterprises in transition economies, high-capture states tend to tax and regulate more heavily, extract more bribes, mismanage the macroeconomic environment, and prove less effective at preserving law and order. The EBRD [1999] survey showed the greater capture of the state by vested interests had a powerfully negative effect on the quality of governance in transition economies. The effects of privatisation on the quality of governance differ sharply according to the degree of state capture (p. 115). There was a positive relationship between privatisation and governance in low-capture states. Progress in privatisation was associated with a higher quality of governance in these countries. For example, in Poland, which implemented shock therapy, state capture was very low, and its unofficial economy remained small (JOHNSON AND KAUFMANN [2001, p. 213]). Poland's experience revealed that the principal need was to reduce the scope for capricious action by government officials by implementing fast reforms, including changing government officials. However, the relationship between privatisation and governance was reversed in high-capture states and was negative.

Interestingly, both the quality of governance (positively) and the state capture index (negatively) are correlated with the change in share of state expenditure in GDP. Countries like Belarus and Uzbekistan fall into the same group with central European countries and Estonia in showing a small reduction of state expenditure as a percentage of GDP during transition, good quality of governance, little bribery, a small shadow economy, and a low state-capture index. This can be explained by the fact that the small reduction in state expenditure as a percentage of GDP made possible the adequate financing of social programs, so individuals and firms did not need to resort to illegal activities.

In conclusion, shock-therapy supporters have argued that across transition economies, liberalisation, privatisation, fairer taxation, and less regulation were all associated with a smaller unofficial economy and smaller state capture. Better provision of public goods to the official economy was associated with a relatively larger official economy. Transition countries with less distortionary tax and regulatory systems collected more tax revenue and provided more public goods to their official economies. However, tax rates did not appear to be an important explanatory variable. The problem did not appear to be high marginal corporate or personal income tax rates, but, rather, high levels of regulation, bureaucratic discretion, and corruption (JOHNSON AND KAUFMANN [2001, p. 212]). Enterprise managers may have been willing to be taxed fairly; however, they were unwilling to put up with the constant threat of arbitrary extortionate demands. Corporate tax rates were actually lower in Russia and Ukraine than in much of central and eastern Europe. The much larger underground economy in Russia and Ukraine appears to be the result of the more general burden imposed by government officials (p. 217). Overregulation, corruption, and a weak legal system bear primary responsibility for driving business underground. Most importantly for the shock-therapy supporters, empirical evidence revealed that institutions do change over time, gradually. This is in contrast with the rather pessimistic views of the path-dependence literature. Institutions "are by no means as immutable and unchangeable as that literature has suggested" (CAMPOS [2000, p. 23]). This implies that the feasibility options for policy choices in attempting to change institutions may have been much wider than is often assumed (CAMPOS AND NUGENT [1999, p. 449]).

In summary, the shock-therapy supporters argue that, according to empirical evidence, the transition economies that initially implemented liberalisation and privatisation and allowed the gradual development of institutions performed better in the long run and avoided state capture, even though the transition to the new institutional order had significant short-term negative effects on economic development (SACHS, WOO, AND YANG [1999, p. 2]).

The gradualist economists argue that, according to empirical evidence, the immediate development of the necessary institutions by state action must precede liberalisation and privatisation. The gradualists highlight the negative consequences for transition economies of market failure in the form of the transitional recession. Any benefits of liberalisation were noticeable only in economies with strong institutional capacities (POPOV [2000, p. 38]). For example, the Gorbachev reforms failed not because they were gradual, but because of the weakening of state institutional capacity, leading to the inability of the government to control the flow of events. Similarly, Yeltsin's reforms in Russia, as well as economic reforms in most of the other transition economies, led to a substantial fall in output, which was the result of the collapse of the institutions required to enforce law and order and carry out manageable transitions.

POPOV [2000] argued that differing performance during transition, after factoring in initial conditions[2] and the external environment, depended mostly on the strength of institutions and not so much on the progress in liberalisation *per se*. This can be demonstrated by the experience of China in pursuing incremental reforms, which managed to avoid recession. So too did Hungary, following a step-by-step strategy, deregulating prices and the exchange rate. In addition, Uzbekistan pursued gradual reforms under an authoritarian regime, which showed the best economic performance among FSU states in the 1990s (p. 10). The Czech Republic, which implemented shock therapy, is systematically ranked the lowest, in comparison with central European countries, with respect to the quality of the institutional environment and governance structure (LIZAL AND KOCENDA [2001, p. 157]). This is because the implementation of legal reform in the Czech Republic often followed the gradual process of learning by doing, not drawing upon the experience and errors of the mature market economies. The huge number of amendments made by the Czech Parliament to various laws has resulted in the Czech legal system being fragmented, unnecessarily complicated, incoherent, and sometimes unintelligible (VERNY [2000, p. 134]).

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[2] HARE [2001, p. 13] argues that it is awkward to group together transition economies whose sole common feature was the fact that they had communist governments before 1989.

An independent judiciary has been central to the process for establishing the rule of law, for policy formulation, and for democratisation in transition economies. This is understandable in that the judges in the former centrally administered socialist states were noted neither for impartiality nor for independence. Thus, decisions to empower judges in transition economies to overturn the decisions of other government actors, coupled with the decision to insulate judges from political pressure, represented a dramatic departure from past practice.

ISHIYAMA SMITHEY AND ISHIYAMA [2000] were able to quantify the independence of constitutional courts in transition economies by developing an index of formal judicial power. Low values of the index indicate an extremely weak constitutional court and high values an extremely powerful one, at least in terms of the powers assigned to the courts by constitutional designers. The values range from a high of 0.95 for Romania, which implemented a gradual transition, to a low of 0 for Poland, which implemented shock therapy. There was in fact no relationship between the performance of the economy due to liberalisation and the emergence of a constitutionally powerful judiciary. Economic development and liberalisation appeared to have had very little effect on the dynamics that led to the independence of the constitutional courts. Moreover, it did not appear that political culture and multiethnic fragmentation exhibited any significant relationship with the degree of judicial independence and power assigned to the constitutional courts by the constitutions (p. 177).

The standard policies of shock therapy – stabilisation, liberalisation, and privatisation – have all been implemented in Russia and largely in the Ukraine; however, these did not appear to be sufficient to ensure the rapid growth of the private sector (JOHNSON, MCMILLAN, AND WOODRUFF [2000, p. 18]; LANE [2000, p. 487]). This was because success in privatisation, in terms of revenues and enterprises sold, required suitable legal institutions, developed capital markets, and the security of property rights (BORTOLOTTI, FANTINI, AND SINISCALCO [2001, p. 109]; JOHNSON, MCMILLAN, AND WOODRUFF [2000, pp. 1 and 19]). International experience, which incorporated the privatisation experience of transition economies, revealed that successful privatisations took place in countries where the law-and-order tradition was well established and where the government showed commitment, reducing the risk of policy reversal and expropriation (BORTOLOTTI, FANTINI, AND SINISCALCO [2001, p. 131]). In addition, international empirical evidence, together with the experience of the transition economies, revealed that among the institutional factors that influence privatisation was the coefficient estimate for shareholder protection in the form of the quality of enforcement of laws with respect to corruption and efficiency of the judiciary. This influence is positive and significant. This indicated that governments should have relinquished control more rapidly in a country where control rights were appropriately enforced (p. 133).

The experience of transition economies seems to indicate that under weak rule of law, democratisation has a marked negative impact on economic performance (POPOV [2000, p. 42]). For instance, democratisation without strong rule of law usually leads to a collapse in output, because the decision-making process in transition economies was severely impeded when the laws were not adequate to respond to the rapidly changing environment (LIZAL AND KOCENDA [2001, p. 143]). There was a price to pay for early democratisation when the major liberal rights – personal freedom and safety, property contracts, and the right to a fair trial in court – were not well established (POPOV [2000, p. 38]). The importance of preserving strong institutional capacity of the state for ensuring good performance was imperative. After allowing for differing initial conditions, it resulted that a fall in output in transition economies was associated mostly with a poor business environment, leading to institutional collapse. Liberalisation alone, when it was not complemented by strong institutions, could not have ensured good performance (p. 44).

Consequently, nearly eighty per cent of all variation in output in transition economies can be explained by only three factors: pretransition distortions, inflation, and the rule of law in democracy. If the liberalisation variable is added, its effect is found not to be statistically significant (POPOV [2000, p. 42]). Consequently, initial conditions do matter. Initial conditions incorporate the appropriateness of the institutional structure for a market economy. Actually, liberalisation depended on the initial conditions and on political change (p. 6). The worse the initial conditions for transformation were, the more inappropriate were the institutions for a market economy, the greater the probability of deep transformational recession, and, hence, the more likely delays in liberalisation.

In conclusion, empirical evidence with regard to the institutional development in transition economies does not reveal a clear winner in the contest for an appropriate method of institutional development. “Policy lessons for the transition economies are consequently not straightforward” (HARE [2001, p. 19]). Shock-therapy supporters argue that liberalisation and privatisation did not hinder the development of institutions; rather, they fostered both institutional development and better economic performance. Gradualists argue that liberalisation and privatisation have only been successful in transition economies that first established institutions as a result of state action.

## 7 *Conclusion*

It is recognised that the development of market institutions has been one of the most challenging tasks for reformers in the transition economies. In many ways, the development of institutions that support markets and private enterprise was at the heart of the transition. However, the empirical evidence is inconclusive with regard to which method of institutional development is the most appropriate for transition economies. It appears that the method that should be adopted depends on one’s view of social reality and on what is acceptable, desirable, and feasible. The method implemented depended on the assumptions about economic behaviour, the method of analysis, and the goals associated with the transition process. The question appears to be normative in nature and not an empirical one. Essentially, the choice of the strategy that should be adopted depends on one's view of the effectiveness of the market mechanism (in providing market-produced institutions) versus state intervention (in providing state-produced market institutions).

The distinction between shock-therapy and gradualist models of transition becomes unconvincing as analysis reveals a contradiction in the fundamentals of each model. The shock-therapy advocates recommended a gradual process of institutional development, while the gradualists recommended a shock-therapy approach to institutional development. In fact, it would have been rational to recommend a combination of both strategies (BLANKENAGEL [2000, p. 117]). An optimal sequence, with regard to the institutional structure, required a combination of state- and market-produced institutions: a combination of the gradualist and shock-therapy approaches. Immediate government intervention was required in setting up the minimum institutional structure essential for the operation of the market. This is consistent with recommending a shock-therapy method. NORTH [1990] stated that "effective third party enforcement is best realised by creating a set of rules that then make a variety of informal constraints effective." Thus, it was important to allow the market to nourish and expand the state-produced institutions through the development of both formal and informal market-produced institutions and trust. This is because "the legal responses are often only effective against a background of self-enforcing market mechanisms" (RAPACZYNSKI [1996, p. 102]). This is consistent with the shock-therapy method, advocating a gradual process of institutional development. The argument is that an institutional core was essential for long-term successful economic development. Hence, the transition involved harmonisation of the institutions in ex-socialist countries with global market institutions, rather than creating institutional innovations that were substantially different from the capitalist institutions (SACHS, WOO, AND YANG [1999, p. 16]).

Meanwhile, the notion that careful preparation could have permitted the transformation process to "get things right" the first time was unrealistic. Both government officials and private individuals would normally have required time to experiment and learn before they were able to bring into existence anything approximating an efficient framework for the new market system (FURUBOTN [2000, p. 122]). Consequently, there is no conflict between shock therapy and gradualism, but rather a complementarity (HERKENROTH [2000, p. 306]).

A substantial change of approach to institutional development in transition economies has been necessary in order to prevent and fight corruption (LIZAL AND KOCENDA [2001, pp. 137 and 158]). The focus of reform options ought to have shifted to addressing the channels through which firms interacted with the state. A comparison of corruption, common under the previous regime and based mainly on mutual friendly services, showed that legislation and economic and trade liberalisation were quite appropriate in punishing classical bribery and the corruption of state officials. They were, however, completely inappropriate for preventing the newly emerged forms of corruption associated with state capture (HELLMAN, JONES, AND KAUFMANN [2000, p. 11]; LIZAL AND KOCENDA [2001, p. 138]; JOHNSON, McMillan, and Woodruff [2000, p. 19]). Eliminating state capture required administrative reform, greater transparency, a system of checks and balances, changes in institutional incentives, and, above all, the political will to remove corrupt officials (Johnson and Kaufmann [2001, p. 226]; Hellman, Jones, and Kaufmann [2000, p. 12]).

A policy implication is that the provision of financial aid should have been conditional upon introducing policies to improve the security of property and to help build market institutions. In the lending programs of the mature market economies and international financial organisations, conditionality should have been imposed not only at a macro level but also at a micro level. Promises should have been exacted from the borrowing governments that taxes and charges for publicly provided services would be set at reasonable levels, property rights be assured, corruption be controlled, policies impeding the setting up of new firms be removed, and the country's regulatory regime be made transparent and predictable. Government performance along these dimensions could have and should have been monitored regularly by independent organisations, and governments that failed to meet these micro targets should have had further funding withheld (Johnson, McMillan, and Woodruff [2000, p. 19]). Thus, "institutional change in the widest sense is absolutely vital for sustained growth and recovery of the transition economies" (Hare [2001, p. 17]). As the EBRD [1999] states, "the hope for second decade of transition is that this voice for market supporting institutions will become stronger."

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