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## Transition and Institutions: which further steps have to be taken?<sup>1</sup>

### Introduction

As transition is starting second decade of its realization, logical consequence is to start discussion on different approaches and solutions. 2002 Index of Economic Freedom characterizes Estonia as free country, but Lithuania, Check Republic, Hungary, Poland and Slovakia (after Mechiar Government) as mostly free countries. Same indicator classifies Slovenia, Croatia and other socialist countries as mostly unfree or unfree. If all those countries has started transition from more or less same starting point, which measures made different success in transition process in each country? Also, very important question is what is going to happened with those countries like our own which are still in phase of »delayed transition«.

Even there are a lot of more or less worthless articles, books, papers and analyses on transition, usually published under support from state or foundations, there are very few academics as Jan Winiecki, Enrico Colombatto and John Moore who make research on economic effects of transition under framework of new institutional theory and based on empirical researches. Analyze done by J. Winiecki (2002) shows that increase in number of new private owned companies is result of higher level of economic freedoms and at the same time causes economic prosperity. Colombatto (2002) claims, fully reasonable, that economic policy based on neo-classical economic theory, leads to dirigisme and corruption. We are adding that mass voucher privatization prevents from transferring private capital into state sector, making at the same time opportunity for creation of new middle class, which is social fundament for capitalism.

As well as »reforms« based on dirigisme, heritage socialistic habits from past as weak protection of property rights, different types of self-management in companies, boundaries for free capital movement among countries, etc., contribute to lack of economic freedom in many transition countries and to slow development.

We believe that consensus on three main factors influence success of transitions has been achieved. Those are:

1. Speed of establishment new private owned companies
2. Freedom of contracting

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### 3. Privatization methods for state owned companies

In order to understand why these three factors are very important, it is important to evaluate different transition concepts as well as forms of establishment of institutions and their importance for transition process.

#### **1. Different approaches to analyze transition processes in East Europe countries**

There are two different approaches to analyze transition process in East Europe countries, which determine the major differences in understanding of transition.

First approach is based on fundamentals of neo-classical economic theory. It starts from analyze of economic situation at the beginning of transition process and from expected results at the end of process; defines difference between expected and achieved results and gives advices and instructions for »catching-up« and fulfillment of that gap! This approach is more known as major track (»mainstream view«), and according to this, success in transition is determined by success of advisers to plan goals, define policies and control economic flows.

Alternative approach, less present in transition analyses, is more focused on rules of game or on institutions. It is focused on effects which institutions have on individual behavior, on voluntarism in relationships between individuals and organizations and on decreasing transaction costs. More precisely, this approach doesn't identify transition with goals which are defined in advance, but with passive role of state (Sunstein 1993) in establishment of formal institutions which will provide maximum of freedom for individuals to achieve their individual interests, but trough interaction with other individuals.

In practice of the most East European countries as well as in Soviet Union, first approach to transition process has been dominated or constructive approach to transition. Such constructive approach in many East European countries have created huge gap between expected and achieved results.

Expectations from transition, defined as »complete domination of western standards« in ex-socialism countries, have not been met! In contrary! Many painful processes have happened, resulted with redistribution of wealth, income and power! Great number of people have had lower standard of living than before! This is main reason that in many transition countries are still present tendencies to return to some non-democratic and non-market solutions!

Objective of this paper is to focus attention on limitations which result from »mainstream view« of transition problems.<sup>2</sup> In our opinion, common distinction of

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<sup>2</sup> In literature, "transformation" of country is usually grouped into one of two models:

1. Shoch therapy model
2. Gradualism model

transition models doesn't provide answers on questions as: How come that model of fast adjustments in CEE countries provided relatively successful results, but at the same time, the same model in CIS countries caused lot of problems! This is the reason why we believe both models, shock therapy and gradual approach, were based on wrong, neo-classical assumptions. Transition to market economy has been started without clear picture on economic and political situation in each country; which were worst than expected (Colombatto, 2000). Model for changes in transition countries was more copy of **state of wealth** and ambition of socialistic states to implement such model as soon as possible!

Significant role in transition process belongs to **privatization**. But, in many countries privatization process hasn't been followed with other changes in society, especially with straightness of rules of laws and protection of property rights, which are preconditions for successful privatization process!

**Macroeconomic stabilization** was treated as anchor of transition! Starting point was that aggregate demand is higher than aggregate supply, which caused budget deficit, high inflation and high interest rates. But, focusing on only those problems, without institutional development, strengthened role of Government, and instead of plans, western macroeconomic models were applied on institutional structure and non-profitable companies on the East. This is reason why foreign grants were invested into foreign banks, Government consumption and subsidies to companies which survived.

Establishment of appropriate legal framework and market institutions which would provide for »invisible hand« to act and replace administrative control, absented. Even in those cases where institutions and legal framework were established rapidly, results missed. New institutional economic analyze shows that work on market institutions depends on standards of social behavior. »Development of market institutions may be, as it was in West, gradualist process of integrations between economic development, policies and institutions of civil society« (Mencinger, 2001).

Before we continue discussion on need for affirmation of other approach to transition – enforcement of laws, rules of game and importance of culture (old ethos) and cultural transitions, just few remarks on political side of transition.

As some research shows (T.Carothers, 2002), political paradigm from the end of eighties and beginning of nineties, has been questioned. In that period political paradigm of transition was based on several assumptions:

1. Each country which abandons totalitarism and non-democratic regime, untruthfully goes toward democracy;
2. Democratization has been created three steps: period of opening (political liberalization), period of collapse of old system and at the end period of consolidation, in which new democratic institutions and new rule of game will be created;

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(First is usually adressed to Geoffrey Schacs, second to Janos Cornai).

3. Multi parties parliament elections are sufficient in order to create democratic legitimacy for new government;
4. For political transition are not the most important structural factors (level of economic development, political history of country, institutional background, ethics, sociokultural tradition,). It means transition depends only on political attitude and political actions.
5. Democratization process assumed redesign of state institutions (as new institution of electoral system, reform on parliament and reform of judicial system) – but modification of existing state as well.

If we analyze real effects of mentioned assumptions, we can subtract two syndromes common for most transition states:

1. Unpowerfull parliamentarism (power of political and elitist interests, corruption, use transition by government structure to achieve personal interests)
2. Domination of politics in society (reflected with close relations between major political party and state and political but non-professional state administration).

As T.Carothers says, most countries, following old paradigm on transition, entered so called political gray zone, which means those countries had huge democratic deficit, which further means weak representation of citizens, low political participation outside of elections, breaking rules of laws by high officials, low credibility of state institutions, and weak institutional performance of state.

Major lesson from recent experience is that assumptions from old paradigm were spent. We need new, long-term oriented approach, less universal (same model for each state) but more specific for each state, which means all specific attributes of each state have to be considered, as socio-economical, cultural and traditional! This conclusion shows that for further process of political reform, modification of transition paradigm is necessity.

Shortly, experience in conducting economic and political reforms shows that economic models of neo-classical dirigisme and pure implementation of western institutions into economic and democratic resources of transition countries, has big limitations! It means that analyze of transition has to be adjusted and has to consider social, cultural and other specifics of transition countries.

## **2. New institutional base of transition**

Rule of Laws, the carriers of institutional restructuring and old ethos are three the most important factors for analyze of sources, directions and consequences of institutional restructuring. Our starting point is that analyses of interdependence of three elements can explain many differences which exist in transition countries, and based on that, direction of transition can be improved.

## **Rule of Laws**

Rule of Laws means lack of any authoritative, decreative power of governing political elite, stable and credible rules and independent judiciary system. Stable and credible legal framework creates positive environment for initiative and creation of individuals, which is key for increase in economic efficiency.

While democracy is process in which government is elected, rule of laws leads to limitation of power of the elected government. Rule of Laws or constitutional government, protects individuals and his rights from will of majority. For example, former dean of the Law Faculty in Belgrade defended decision to dismiss university professors with explanation they broken law (passed under irregular circumstances) and that in legal state, laws have to be respected. But he simply forgot that in legal state, state has to protect individuals from such laws. According to DEAN, secret police defended legal state also.

This is reason why term »constitution« has to be in front of term »democracy«. Rule of laws creates protective wall for individual, protects him from majority opinion, but at the same time provides him opportunities to start new activities, without fear that state will change rules of game during the game.

We also point that it is wrong to believe that democracy is precondition for economic development and prosperity. Experience shows that rule of laws are more important for economic development and prosperity. As Robert Barro (1997) said: »If you have limited energy which can be used for conduction institutional reforms, that it is much better to allocate it to implement rule of laws and to establish rule of property rights and free market«.

Even there is no country where rule of laws are perfectly established (there is always some discretion power); this concept provides possibility to compare different institutional arrangements and their economic, political and social consequences. Index of Economic Freedom shown that as country has lower developed rule of laws, power of individuals and groups is bigger and economic standard is lower. Nobel's price winner, Douglass North (1988) said that Spain and England in sixteen century were at the same level of economic development, they even had the same major industry (wool). But, in following decade, England has become economic powerful state, while Spain went down. North concluded that main reason for this was that England limited power of sovereign and straightened rule of laws, while Spain didn't do that.

## **Essential base for institutional restructuring**

Who makes decisions in Government, State, Parliament, companies and other organizations? Individuals make them! Individuals start ideas, invest time and efforts

to define policy, encourage other to accept their innovations and take a risk of possible errors.

»Groups, organizations, communities, nations and societies are institutions which operations may be understood the best when we focus attention on their actions and on ways they elect their members. When we discuss goals and actions of USA, we speak about goals and actions of individuals from USA « (A. Alchian, W. Allen, 1964).

There is example from Second World War: At the end of 1940's and beginning of 1950's many African states got independence from colonialists. And all those states were at the same level of wealth and development. Today, Africa is still developed as it was then, even more. Why? Nobel price winner, Peter Bauer (1988) says that politicians in Africa were people educated abroad (Oxford, Harvard, Moscow) and they returned to Africa with ideas of planning and state control. In order to realize their ideas, they centralized power – transfer it from local level, and then enforced laws and regulations completely different and new for African heritage and culture. Most countries implemented socialism (their own way), implemented negative attitude to foreign investments and non-friendly attitude to private ownership (there were private ownership, but not credible and permanent). And they ruined whole continent.

This is reason why for understanding of institutional restructuring in ex-socialist countries, each analyst has to identify decision makers, method for their election, circumstances under which they work as well as limitations they have in decision making process.

### **The Old Ethos.**

Informal rules are tradition, customs, moral attitudes, religious attitude and all other norms of behavior which passed test of time. Goetz Briefs, a well known German economist-philosopher, defined ethos as synthesis of informal institutions and actual system of values in society.

Institutional restructuring in ex-socialism states means new formal rules will be established. Those rules have to be interacted with customs, tradition and moral attitudes in society. Results of institutional restructuring in transition countries emphasize role of informal rules in accepting and conducting new formal rules. Harmonization and interaction between new formal and old informal rules decreases transactional costs of institutional reforms in country. But, when formal rules are conflicted with informal rules, transaction costs increase, which influences lower economic efficiency!

Keith Richburg (1992) and Deepak Lal (1998) have shown the way how East Asian countries succeeded to provide good mix of local customs and capitalistic institutions. This resulted with fast economic development.

## **Establishing new theoretical transition paradigm**

Neoclassical economic theory does not include institutions as important factor of economic efficiency! The reason is simple. Neoclassical economic theory wants to be positive and without ethical charges. At that basis attitude of neoclassic is more directed to mechanical side of economic dirigisme and much less to process by which rules of game are created, motives of those creating rules and consequences of rules created! As E. Colombatto said, transition process should be essentially directed toward decrease of transaction costs and creation of better possibilities for accomplishment of goals of each individual. We accept Colombatto's statement that institutional restructuring is more cultural than technical issue. This Colombatto thought is supported with statement of Isaac Adigies, who said »development of a society is not issue of technology, is not issue of market, is not issue of money, but culture«! (Isaac Adigies, 2002).

Preferences of individual are not constant. Process of learning and creation continuously changes our preferences. Assumption of neoclassic that preferences of individual are given, as well as goals, is shown wrong in practice. These variables do not exist independently from process of constant actions and choices made by individuals. It is endogenous, not exogenous variable. This is approach of great number of researchers and professors of Austrian School, School of Public Choice, Evaluative Economy and New Institutional Economy. According to their theory efficiency of economy depends also on process through which transactions are done. Critical question of politics in that case becomes which and what network of institutions creates ambience for conducting transition and which influences level of transaction costs.

If we can already at level of practice of transition countries make conclusion about mistakes of orthodox economic approach, a question is raised why that concept is continued? Why is still dominant constructivist approach to transition? Why is still »pushed« model of welfare state? This paper does not argue answers to this question! But we remind to findings of professor Colombatto related to rent seeking used by many foreign and domestic advisors, state and private agencies. That statement one of us names »transition industry«. »Transition industry does not have geographic borders. That is »umbrella« for social engineers, bureaucracy, reformed and non-reformed communists, university professor from West and East, experts of World Bank and IMF« (S.Pejovich, 2001)

What neoclassic do not understand or do not want to understand is that institutions have ethical roots. Therefore, the same economic policies in societies with different institutions have different results (North 1990). Institutions influence motives of participants in economic and social life. The actors in economic game are not led only by rational motives and interests. Their actions are also structure by cultural framework under which rules are changed. Cultural framework is defining social concept in under which rational interests are defined. We would add one more

element as forced pressures that are defined as limitation of limitation of making decisions to some external forces (different interest groups, clan's etc.).

Therefore we are for institutional arrangements, which enable minimal transaction costs that are making possibility for creation, innovation and entrepreneurship for all individuals for protection of individual freedom. For institutional framework that will enable larger influence of spontaneous order then endogenous factors at total flow of transition.

What should be done in that direction practically?

### **3. Transition and development of culture of capitalism**

In previous part of paper we wanted to stress that transition from socialism to capitalism, is at first in great deal question of culture, respectively old ethos, non-formed rules, and incorporated systems of value.

Can capitalism be established where culture, norms of behavior of state and individual completely different from those needed for capitalism?

Children accept model of behavior from their parents and latter transfer hat to companies and wider social plan. Great changes are not happening just in the transition countries, but in the whole world. States that are not changing their cultural habits and concepts will remain undeveloped.

In the countries of Eastern Europe informal rules, respectively »old ethos« are not in melody with capitalistic culture. There comes question who and how can harmonize prevailing ethos with culture of capitalism? This much before because informal rules are not political variable. Could state harmonize that conflict among »old ethos« and capitalism administratively, by directive, constructively? State can not do that!

Answer depends on that that brings basic decisions in new institutional arrangement and what their motives are! How to create the ambience that stimulates *willing* not forced development of culture of capitalism and its harmonization with old ethos, respectively informal rules! Countries in transition that have succeeded more at the same time are more successful in changes of its old economic system. Based at experience of transition countries a consensus has been reached that it depends on following three factors:

1. New private companies.
2. Free contracting.
3. Method of privatization of existing companies.



## A. New private companies and transition

Foundation of new private companies is important for foundation of culture of capitalism, for harmonization of relations between new institutional solutions and old ethos. Thousand and thousands companies has been formed in Eastern Europe spontaneously, even when property rights are still enough credible and legally protected!

Data are indicating (Winiecki 2002) that small companies have already started to play big role in securing social stability and economic performances in Eastern Europe. So, SME's in Italy and Japan produces 55% and 43% of total production in u manufacturing. Percentages in the countries of successful transition as Poland, Czech and Hungary 38, 37 and 37. Importance of SME's in transition countries is clearer when we look at percentage of participation in employment: Switzerland 70%, France 63%, Hungary 70%, Poland 63% and Czech 52%.

These companies already make important part of GDP in all countries. But, their most important role is exactly in that those companies (private from foundation not privatized) base for entrepreneurship, work ethic and capitalistic ethic of exchange. These new companies are educating ordinary people toward life promoting individual freedom and great value of self-responsibility and self-respect. These companies are energy of gradual harmonization between regional old ethos and culture of capitalism.

New (private from foundation) private firms are contributing to economic prosperity of country from following reasons:

1. I largest number of new companies, owner is at same time manager. From that reason, new companies do not have “agency” problem. Results are smaller transaction costs and consequently greater efficiency.
2. Competition makes more discipline to small companies. In order to survive they have to be more efficient.
3. Foreign companies with their experience are making pressure at market to new companies to be more efficient.
4. Small companies have comparative advantage in diversification while big companies have advantage in production of standardized goods. It means that they can with smaller cost to satisfy specific needs and preferences of their consumers; differentiation and not standard is more and more characteristic of demand in developed world including countries that have passed transition exam as Estonia, Czech, and Hungary.
5. But, most important role of new private companies is that they are **creating culture of capitalism** at areas where that culture did not exist. Those companies are making feeling of ownership, feeling that individual and not community have rights and liabilities, that individual and not community is career of economic life, feeling of self-initiative, self-responsibility, self-decision making and accepting the risk. Together those are characteristics of culture of capitalism based at individualism. That role of new companies in creation of culture of capitalism

because according to our opinion is more important than their present role (that is important) in employment and production.

Largest problems of private (we repeat private, not privatized) companies are entry costs (including tie to get license), high taxes (for example taxi drivers in Belgrade have paid 100 DEM tax during Milosevic, while reformers have doubled tax) and many regulations (as in Poland according to Winiecki). Example is Montenegro where, till new legislation have been brought, it was necessary to satisfy 40 administrative requests in order to register business (it is simpler now). These problems are not surprising in atmosphere of dirigisme that is characteristic of almost all countries in transition. Bureaucracy see new companies as source of income and influence (by regulation) and not as instrument of economic development. New private companies are creating market for bureaucracy and members of parliament where they can sell favors for money or re-election. There is an example. "Reformers" in Serbia are spending more time traveling around world seeking for loans and gifts than for creation of legal state and free market for institutions to develop freely. There was recently a newspaper article that state is seeking money from side in order to support creation of new companies. We affirm that free entry, small duties and abolition of regulation should create more small private companies (domestic and foreign) than money that bureaucracy are giving to those that have influence at their career.

*What is necessary to provide inflow of new private companies*

- Credible and stable property rights
- Credible and stable fiscal policy
- Credible and stable freedom of entry including freedom of entry for foreign companies.

Private property is necessary but insufficient for economic development. Private property has to be credible (effectively protected at courts and police) and constant (without anticipation that ownership rights can change each moment or modify). Only then uncertainty about rights will disappear and people will without fear make long-term investments. Private property per se creates oriental bazaar (property is today yours but you don't know for tomorrow). Credibility and constant are transforming bazaar into normal market that does not have prejudices for short-term decisions.

There is an example from Serbia. Court has denied decision of Government (or National bank) that Karic bank is taken from owners and put into liquidation (we understood that there can be change between time of writing this paper and time of reading. Our purpose is to analyze reaction of bureaucracy from Serbia and consequences of court decision if remains). Executive of National bank has characterized court decision as creation of anarchy. Economically, that statement is scandal. Anarchy exists when courts and administration work as team. Without independent judiciary there is no credibility for private property. That is our point. We are not entering into whether Karic should have bank or not. We want to stress that

judiciary decision, even wrong, of long term importance for country. That decision, even wrong in specific case of brother Karic, gives one positive signal to future investors, decreasing their risk. How? That judiciary decision means that administration can not discretionary interfere in right of citizens for property.

Same can be applied for fiscal policy. If investors want to be encouraged to invest in profitable projects they have to be sure bureaucrats want play with taxes and change taxes voluntary.

Without free entrance of foreign companies and small entering prices, new private companies, which are engine of economic development and creators of **culture of** capitalism, can not efficiently play their role.

## **B. Free exchange**

Free exchange is one of anchors of economic development, and of course, of successful transition.

Free exchange means free contracting, in country and abroad. Liberal regime in foreign investment, import and export, trade in services and capital. Free contracting means stable monetary policy and law taxes. Otherwise, uncertainty would discriminate contracts with long term effects (I pay you now, and you will deliver me plane in next five years). Prices and wages have to be free from administrative control, and labor union limited of free-will agreements with employers. Employees have to be free no to be members of unions (here we name it as the right to work).

### *Problems*

There is no state bureaucracy or parliament which likes (except verbally in pre-election period) free contracting. Situation is even worst in transition countries where bureaucrats and politicians are dominantly from previous regime. It means their investment in political and economic problems is based on their behavior from planed economy and police governed state from the past.

### *What is necessary*

Credible and stable Company Law as well as Bankruptcy Law.

Replacement of old generations with new one, but also to decrease number of old professors who will teach to new generations.

## **C. Privatization**

It is necessary to distinguish privatization of existing companies from establishment of new companies. (Many economists the last one call as spontaneous privatization and first one as privatization from the top). Problems in privatization from the top are

enormous. Voucher privatization is good because it encourages creation of middle class and does not transfer (as selling of state companies) capital from private to state sector. Problem is that lack of ownership experience and high transaction costs transfer lot of power from secondary market to managers. It has negative consequences for company efficiency. But, step by step, development of capital market discards those negative aspects. We emphasize term of free market, because there is tendency from all government in Yugoslavia to beg for financial aid all foreign governments and dinosaur as World bank for grants and loans, and this creates limitations for free market development which would encourage bureaucrats to create institutions which decrease risk, making life more easier for bureaucrats but more difficult for future generations.

Internal privatization is worst than voucher privatization. It creates rent seeking coalition between managers and clerks which are than supported by politicians. Efficiency decreases. Professor Milovanović (2002) names it, correctly, endogenous corruption. Unfortunately, managers with old habits and system of values and different self-managers who are supported by politicians, help those companies to survive. Those managers are ling between politics and economy and limitation for economic freedoms.<sup>3 4</sup>

<sup>3</sup> Compare Cacak and Kragujevac. Cacak is full of small new companies and very economically progressive. Kragujevac has Zastava which causes big problems. Politicians, workers, managers make it survive on account of citizens. 40 years ago big auto company Studebeker from South Bend in Indiana went to bankruptcy (as well as Zastava). Studebeker was the biggest and the most important producer in South Bend. Whole city relied on it. As Kragujevac relies on Zastava. Whole South Bend begged for subvention in order to keep their jobs. They didn't get it and company was closed. After few years South Bend become diversified and prosperous city, but it wouldn't become as it is if managers and workers got subsidies. Health economy can not be established with subsidizing companies.

<sup>4</sup> Data shows that there is no the best privatization method. It seems combination of methods is the best solution.

*Table: Results and method of privatization in some transition countries, 1999<sup>4</sup>.*

Country	Result	Primary method	Second method
Czech republik	4.0	Vouchers	Direct
Hungary	4.0	Direct	MEBO
Slovakia	4.0	Direct	Vouchers
Estonia	4.0	Direct	Vouchers
Poland	3.3	Direct	MEBO
Rusia	3.3	Vouchers	Direct
Kirghistan	3.0	Vouchers	MEBO
Lithuania	3.0	Vouchers	Direct
Gergia	3.3	Vouchers	Direct
Slovenia	3.3	MEBO	Vouchers
Bulgaria	3.0	Direct	Vouchers
Croatia	3.0	MEBO	Vouchers
Kazakhstan	3.0	Vouchers	Direct
Latvia	3.0	Direct	Vouchers
Macedonia	3.0	MEBO	Direct
Moldova	3.0	Vouchers	Direct
Armenia	3.0	Vouchers	MEBO

### Instead conclusion

According to our opinion, common nominator for successful transition is:

1. **Rule of Law.** Clear procedures for adoption of laws are necessary, hard procedures for changing them, and judiciary system independent from members of parliament bringing those laws. This particularly stresses the need for reform of judiciary system, as one of the anchors of transition.
2. **Formal rules of game** (laws) have to be in accordance with informal (ethos) rules of game. If the laws are much different from customs, costs of their conduction are high and laws will be hardly applied. Therefore in the federal countries where republics vary much in customs, authority of federation has to be smaller (it is hard to adopt laws suitable for everybody) and authority of republics is larger.
3. **Property rights and their protection.** Only security that my property will not be confiscated or cause for problems with government can develop entrepreneurship in a society. In many transition countries, including Serbia and Montenegro, many recidivates from old system that are not stimulating investments into new economy are kept. This is related to constant wish that everything wants to be taxed, in order to realize wish for decreasing social differences, as well insisting on logic that wealth is not desirable and poverty .as attributed with virtue of fairness.

Our key assumption is that institutional development in transition countries has to more relied on rule of law, evolutive development of new institutions and respect for cultural inheritance, and less on following concept of welfare state and constructivism.

Romania	2.7	MEBO	Vouchers
Uzbekistan	2.7	MEBO	Direct
Ucrain	2.3	MEBO	Direct
Azerbegan	2.0	MEBO	Vouchers
Albania	2.0	MEBO	Vouchers
Tajikistan	2.0	Direct	Vouchers
Turkmenistan	1.7	MEBO	Direct
Belorus	1.0	MEBO	Vouchers
Bosnia	-	Vouchers	Direct

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