

# TRANSFORMATION OF CENTRAL AND EASTERN EUROPEAN COUNTRIES FROM THE PERSPECTIVE OF NEW INSTITUTIONAL ECONOMICS

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*Economic transformation in Central and Eastern European countries is a very complex process widely discussed in the literature on the subject. It has also become the subject of research and analyses of New Institutional Economics which pays attention to new aspects of transformation. From the NIE perspective, transformation is a long-lasting process of changes of formal institutions, especially property rights and contracts, and informal institutions, such as ethical standards, conventions, religious beliefs and mentality of society. The success of the transformation depends on the degree to which new formal rules correspond to informal rules existing in society. The assessment of the quality of Central and Eastern European countries leaves a lot to be desired; the highest level was achieved by the EU member states, whereas the republics of the former USSR are in the worst situation. The underlying causes of such diversified results of political transformations are disparate historical traditions connected with the market economy and unequal preparation of societies to exist both in the free market conditions and in the diversified political, social and economic situation.*

*The improvement of governing quality is a priority in post-communist countries. Achieving a positive institutional effect requires much time and consistent actions, but from the time perspective it is crucial in order to enjoy economic success.*

## Introduction

Economic transformation in Central and Eastern European countries is a very complex process widely discussed in the literature on the subject. It may be generally described as transformation from the centrally planned economy, based on the state ownership of most economic resources to the market economy based on the market coordination and optimization of the activities carried out by individual subjects as well

as on the dominance of private ownership (Fiedor, 2007). The transformation process in Central and Eastern European countries has lasted almost twenty years now; nevertheless, the experience of these countries as well as the results of changes differ significantly. The causes of these differences can be explained by New Institutional Economics since it brings new aspects of the transformation to our attention.

New Institutional Economics holds a very important place in the contemporary

economics. Although the thought was developed in the 70s of the 20<sup>th</sup> century, in our region it won a particular renown only in the 90s. Friedrich Hayek and Gunard Myrdal, H. Simon, J. Buchanan, R. Coase, D. North, the economists and Nobel laureates, are considered as the forerunners and representatives of NIE.

NIE is one of the elements of the contemporary neoclassical economics; however, in its assumptions it aims at decreasing the abstraction level typical of the models of neoclassical economics. NIE includes in its models the assumptions moving them closer to reality. First of all, it replaces the assumption that a human being is hyper-rational with a thesis that its rationality is limited. It means that a *homo economicus* is neither perfectly rational nor perfectly honest; he / she still attempts to maximize their utilities, though their rationalism is limited, their knowledge imperfect; and some knowledge is unavailable to them, as well as they have inclination to opportunism which, according to O.E. Olson, consists in seeking a rent through deception and misinformation (Klimczak, 2006). Certainly, not all market participants behave in this way; nonetheless, even a small group may cause the asymmetry of information, and this may make market transactions uncertain and dangerous for those undertaking an activity. Therefore, it is necessary to establish institutions which by toning down conflicts of interests will provide the predictability and order of the market. The institutions constitute the major study object of New Intuitional Economics. This term covers the following issues: the social norms that govern individual behaviour established so as to put the social interactions in order and to

reduce the uncertainty. In fact, institutions shape the economic, political and social organization (North, 2004). D. North divides the institutions into formal and informal ones. The first group comprises legal norms that regulate political and economic interactions such as the constitution, legislation, regulations and orders as well as institutions with the organizational structure responsible for implementation of law, therefore mostly state institutions. Informal institutions include norms, customs, religions, and mentality of individuals. In order to make a state function efficiently, formal and informal institutions must be in harmony with each other. New Institutional Economy consists not only of institutions, but also of such theories as the Transaction Costs Theory, the Public Choice Theory and New Political Economy.

This article aims at analysing the transformation process of Central and Eastern European countries from the perspective of NIE. It also focuses on the new aspects of transformation that explain the sources of failures and diversity of the effects of political transformations in post-communist countries.

### **Transformation from the perspective of New Institutional Economics**

From the perspective of NIE, transformation is a long-term process consisting in changes of the formal institutions, particularly of the ownership rights, agreements, and informal institutions such as moral norms, customs, religious beliefs and mentality of society. Transformation from the centrally planned economy to the market economy will lead to an increase of the ef-

fectiveness and willingness of individuals and social groups to cooperate, and people will be ready to learn constantly and to compete as well as to take risk and to undertake all kinds of creative activity. It is important to make the institutional system adapt to the technological and demographical changes. New Institutional Economics makes us perceive the transformation of Central and Eastern European countries as a process conditioned by changes in mentality, customs and values systems. One must realize the historical and cultural background where the economy is set.

Political transformation forced all countries to seek models and detailed solutions. It mainly meant focusing on Western European countries with their developed market economy. Such a solution was favoured by the countries – members of the European Communities. Implementation of new political rules was connected above all with the change of formal and informal institutions. In accordance with the assumptions of New Institutional Economics, the results of the transformation depend on the extent to which new formal rules correspond to the informal rules that dominate in society. If the formal rules do correspond to the informal ones, a tendency appears for them to consolidate, which leads to a reduction of costs related to the establishment and maintenance of the system concerning the observance of the rules of the social game. The harmony results in low transaction costs, and people's energy is focused on the production of goods and development of services. If the formal rules introduced do not correspond to the prevailing ethos, the costs of the introduction of new rules are high because it is nec-

essary to undertake actions so as to make the rules be observed against the current tradition. The symptom of such actions consists in accumulation of social conflicts and deterioration of the quality of social interaction. Social energy is focused on the fight for redistribution of income, and the effort directed at the increase of prosperity is reduced (Godłów-Legiędź, 2005).

The necessity of adapting formal institutions to the informal ones is also raised by one of the currents in New Institutional Economics, i.e. the Transaction Costs Theory. R. Coase is thought to be the author of this theory. He perceived an economic transaction as the exchange of ownership rights between subjects; the main motive while conducting a transaction is to minimize the transaction costs (Staniek, 2006). A transaction cost means, in most general terms, the cost of ownership rights transfer; still, the definition of this term also includes:

- the cost of entering the market, in the form of establishing a production company or a distribution company;
- the cost of presence on the market as a vendor or a manufacturer;
- the cost of leaving the market, meaning the cost of liquidation of an enterprise even if a given business entity does not want to be present on the market any more (Bieńkowski, 2006).

The fact is that the cost and time of establishing a company depend to a large extent on the quality and stability of institutions in a given country. The most important matters consist in not only the transparency of regulations, the open nature of registration and procurement procedures, but also informal institutions such as corruption or con-

scious delaying of a registration due to, for example, deep-rooted biases against private ownership or foreign capital. The activity of formal and informal institutions has a great influence on the amount of transaction costs. A conflict of functioning of these institutions is a source of specific transaction costs stemming from frequent changes of law, the lack of protection and a low level of the observance of the new law. Other unavoidable costs, such as the costs of the development of a new law and administration of justice, costs of making people aware of the necessity of institutional changes and costs of convincing people that the legal system should be based on the rule of law, are created. The smaller the conflict between the rules of capitalism and the mentality of society, the lower the transaction costs and the higher the efficiency of the economy.

At the time of transformation, the issues of creating and functioning of groups of interest became particularly significant. They are in the field of NIE's interest thanks to M. Olson's work. In NIE, he presented the description of the way in which the groups of interests (such as professional, consumers' associations or trade unions) comprising participants of one side of the market function. He assumed that particular individuals taking part in the exchange are self-seeking, and they rationally calculate benefits and costs. Olson described a group as a voluntary contract concluded by those people who have rationally calculated that it is more profitable to achieve their personal interests by means of group actions than by means of an individual action (Klimczak, 2005). The time of transformation from the central economy to the market economy provided the group

of interest with many opportunities to act and to use a state to obtain personal benefits. The legal loopholes, inconsistency of law, lengthiness of court procedures, legal regulations of the privatization of state-owned enterprises, asymmetry of information, unformed market structure and distorted competition processes favoured such a situation. All individual and group actions consisting in influencing the state functioning in order to achieve advantages at the expense of other individuals and groups is called rent-seeking (Wrzeszcz-Kamińska, 2006). The rent-seeking behaviour may be considered as a typical characteristic of the early stages of transformation in post-communist countries. In this way, many social and professional groups tried to obtain a "special status" protecting them against risk. The resistance of people employed in state-owned enterprises against privatization of their workplace, which was connected with the loss of many benefits stemming from a preferential position in the system of goods and services distribution, constitutes a good example of such behaviour. This, on the other hand, resulted from rent-seeking actions within the previous system. If groups of interests are well organized and have a strong trade or political support, then they may be dangerous for the further transformation process of post-communist economies. They may introduce institutional solutions which contradict the rules of the market economy, for example, agreements concluded with managers in the power industry, which guarantee long-standing employment with favourable remuneration conditions (Fiedor, 2007). Such actions provide an explanation why there are

still many mistakes and delays in implementing new rules and establishing new institutions typical of market economies. The phenomenon of rent seeking is also characteristic of government functionaries. The representatives of Public Choice Theory (H. Simon, J. Buchanan, R. Coase, D. North) claim that officials and politicians first of all aim at maximizing their own private goals such as income, prestige and authority. Therefore, they prefer the expansion of state institutions and in this way hinder the transformation to the market economy.

The "rent-seeking" phenomenon is extremely destructive. It leads to maintaining GDP beneath the production capabilities; by means of transfer incomes (for certain groups) it creates stratification of income and the lack of sense of justice, corrupts state's institutional structures and constitutes the reason for their weakness. The way of elimination of the rent-seeking phenomenon is to limit the control role of the state to an absolute minimum and to increase the willingness of the economies to cooperate with foreign countries, to improve the information flow in economy and the transparency of governing authorities as well as decentralization of public functions (Przesławski, 2005)

### **Evaluation of state's institutional quality**

New Institutional Economics claims that the observance of the rule of law is crucial for an efficiently functioning market economy. It means that social life is based on the observance of accepted legal regulations recorded in the constitution and that the state authority is limited to the ob-

servance of only these, generally binding, laws, and the government does not impose its will onto people (Gośćków-Legiędź, 2005). Pejovich and Buchanan maintain that in a society of free and responsible individuals, the word 'constitution' must prevail over the word 'democracy'. If the countries do not stick to this principle, then the governing groups use citizens for achieving their own particular goals. If society observes the rule of law, then we deal with a long-lasting economic growth and stable democracy.

Nevertheless, the research conducted by the Freedom House shows that the democratic process in the transformation countries is more advanced than the process of establishing the rule of the law system. The former USSR republics constitute an exception to the rule. The results are presented in Table 1.

Slovenia reached both the highest level of democratization and the observance of the rule of law in 2006. One can also see that the countries that are members of the European Union have much better indices than the rest of Central and Eastern European countries. The results gained by the Balkan and Baltic countries reflect a significantly slower progress in the development of proper institutional structure (the exceptions are the EU countries Lithuania, Latvia and Estonia). It must be mentioned, though, that the situation of these countries is improving every year. The situation is worst in the republics of the former USSR. Here, the ratings are the highest, which means the levels of democratization and the observance of the rule of law are the lowest. Belarus is in a particularly difficult position.

**Table 1. Democratization ratings and the rule of law in the selected Central and Eastern European transformation countries, 2004–2006**

Country	DEM			ROL		
	2004	2005	2006	2004	2005	2006
<b>Central European Countries</b>						
The Czech Republic	2.00	2.00	2.00	3.00	3.00	2.88
Poland	1.63	1.80	1.90	2.00	2.50	2.75
Slovakia	1.75	1.80	1.75	2.63	2.50	2.50
Slovenia	1.69	1.65	1.70	1.88	1.75	1.88
Hungary	1.81	2.05	1.85	2.25	2.25	2.38
Average	<b>1.78</b>	<b>1.86</b>	<b>1.84</b>	<b>2.35</b>	<b>2.40</b>	<b>2.48</b>
<b>Balkan and Baltic countries</b>						
Albania	3.81	3.70	3.40	4.75	4.88	4.75
Bulgaria	3.00	3.00	2.75	3.75	3.63	3.38
Croatia	3.44	3.40	3.40	4.63	4.63	4.50
Estonia	1.81	1.95	1.95	2.13	2.00	2.00
Lithuania	1.88	2.00	2.00	2.63	2.75	2.75
Latvia	1.88	1.95	1.90	2.75	2.63	2.5
Romania	3.19	3.10	3.10	4.38	4.13	4.13
Average	<b>2.72</b>	<b>2.73</b>	<b>2.64</b>	<b>3.57</b>	<b>3.52</b>	<b>3.43</b>
<b>European Republics of former USSR</b>						
Belarus	6.69	6.75	6.80	6.25	6.38	6.50
Moldova	4.63	4.90	4.85	5.38	5.50	5.25
Russia	5.25	5.65	5.80	5.25	5.50	5.63
Ukraine	4.69	4.30	3.90	5.25	5.00	5.00
Average	<b>5.32</b>	<b>5.40</b>	<b>5.34</b>	<b>5.53</b>	<b>5.60</b>	<b>5.60</b>

Explanation. The democratization rating DEM is based on the evaluation of the election processes, institution of civil society, independence of the media and the quality of government. The Rule of Law rating, on the other hand, is established basing on the evaluation of constructional reforms, legislative and judiciary, as well as corruption. Both indices accept a seven-point scale where 1 means the highest and 7 the lowest level of democratic system development.

Source: Nations in Transition 2006, Democratization in East Central Europe and Eurasia, Freedom House.

Attention should be paid to the worrying fact that in the Central European countries the rating of the observance of the rule of law is systemically rising. Such a situation is also present in the republics of the former USSR.

Surveys estimating the state's institutional quality are conducted also by the World Bank. In September 2006, a paper summarizing the research on the governance quality was published<sup>1</sup>. Performing such an analysis

enables an identification of each countries' problems and shows the direction of necessary changes. The results explicitly show that improvement of governance quality in Central and Eastern European countries should be a priority for their governments.

The subject of the research was six dimensions of governance, and these are as follows:

1. **Voice and accountability** – shows to what extent citizens can influence the

<sup>1</sup> This research is a continuation of the analysis carried out for 12 years; the project is managed by Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi. The studies are conducted by various public opinion research

centers, international organizations and non-governmental organizations. Each state receives a grade which is a figure within the range <-2.5; 2.5>, higher rating values meaning a higher governance quality.

Table 2. *The ratings of the governance quality in the Central and Eastern European countries and in the EU, 2006*

Country	Voice and accountability	Politician stability	Government effectiveness	Regulatory quality	Rule of law	Control of corruption
<b>Central European Countries</b>						
The Czech Republic	0.96	0.75	1.01	0.95	0.73	0.36
Poland	<b>0.95</b>	<b>0.22</b>	<b>0.49</b>	<b>0.64</b>	<b>0.25</b>	<b>0.14</b>
Slovakia	0.99	0.85	0.91	1.08	0.43	0.35
Slovenia	1.10	1.05	1.11	1.18	0.79	0.92
Hungary	1.14	0.73	0.71	0.70	0.73	0.51
<b>Balkan and Baltic countries</b>						
Albania	-0.01	-0.37	-0.42	-0.14	-0.70	-0.67
Bulgaria	0.56	0.29	0.14	0.54	-0.17	-0.05
Croatia	0.42	0.47	0.52	0.35	-0.03	-0.02
Estonia	1.01	0.78	1.17	1.42	0.91	0.87
Lithuania	<b>0.93</b>	<b>0.89</b>	<b>0.82</b>	<b>1.02</b>	<b>0.45</b>	<b>0.11</b>
Latvia	0.83	0.81	0.73	1.06	0.52	0.38
Romania	0.43	0.12	-0.05	0.37	-0.16	-0.18
<b>European Republics of former USSR</b>						
Belarus	-1.71	0.16	-1.24	-1.60	-1.16	-0.84
Moldova	-0.48	-0.48	-0.85	-0.36	-0.61	-0.65
Russia	-0.87	-0.74	-0.43	-0.45	-0.91	-0.76
Ukraine	-0.11	-0.27	-0.57	-0.47	-0.72	-0.67
<b>Countries of „the Old Member States“</b>						
Austria	1.55	1.04	1.62	1.53	1.87	1.99
Belgium	1.46	0.74	1.64	1.32	1.45	1.40
Denmark	1.72	0.82	2.29	1.81	2.03	2.39
Finland	1.63	1.47	2.08	1.70	1.95	2.57
France	1.40	0.46	1.20	1.06	1.31	1.44
Greece	1.05	0.48	0.62	0.79	0.64	0.39
Netherlands	1.67	0.77	1.86	1.65	1.75	2.05
Spain	1.05	0.33	1.05	1.06	1.10	1.18
Ireland	1.42	1.16	1.53	1.75	1.62	1.60
Luxembourg	1.63	1.51	1.73	1.79	1.83	2.01
Germany	1.48	0.83	1.52	1.39	1.77	1.78
Portugal	1.27	0.85	0.95	1.00	0.97	1.11
Sweden	1.55	1.13	2.00	1.44	1.86	2.24
United Kingdom	1.42	0.46	1.83	1.76	1.73	1.96
Italy	1.14	0.28	0.38	0.84	0.37	0.31

Explanation. Definition and formal construction of ratings are discussed in the report prepared by D. Kaufmann, A. Kray, M. Mastruzzi,

Source: D. Kaufmann, A. Kray, M. Mastruzzi, *Governance Matters VI*, The World Bank, <http://worldbank.org>

- election of authorities and independence of the media.
2. **Politician stability** – presents the probability of destabilization / overthrowing the government by means of violence.
3. **Government effectiveness** – illustrates the quality of public and civil service and the degree of their independence of political pressure,
4. **Regulatory quality** – the ability of the government to make consistent legal regulations favouring the development of private enterprises.
5. **Rule of law** – shows the level of citizens' confidence in law and the level of its observance.
6. **Control of corruption.**

Data presented in Table 2 show that the governance quality of the countries – members of the EU is significantly higher than in the rest of Central and Eastern European Countries. Nonetheless, when compared with the results obtained by the Old Member States (the EU-15), their positions seem to be very weak. As could have been predicted, the situation is worst in the countries of the former USSR. The conclusions are the same as those drawn from the Freedom House research. Such low ratings of governance quality stemmed from the common corruption practices, the growth of political parties' control over the state, the lack of trust in the politicians. These factors breed citizens' reluctance to cooperate in the scope of public matters, an instability of the law system, bureaucratization of economy and administration and a low efficiency of administrative bodies (Przesławski, 2005).

In order to introduce the rules of the market economy effectively, the consent of society consisting in the acceptance of competition, the free market and enterprise, the sense of personal responsibility as well as the readiness to take risk is crucial. In reality, in post-communist countries the tendency to collectivism and egalitarianism prevails, and people have great expectations of the state concerning social benefits, combined with a very low sense of personal responsibility (Godłów-Legiędź, 2005). Additionally, the authorities' and the law's standing is very low. Based on these observations, D. C. North (Nobel laureate) has formulated the following conclusion: formal political and economic rules cannot be transferred from the successfully developing Western economies to the Third World and Eastern Europe since they do not

ensure a successful economic development. The historical and cultural background of a country undergoing transformation must be taken into consideration.

## Conclusions

The direction of systemic transformation in all Central and Eastern European countries is similar, but the effects are different. The underlying causes of these differences are disparate historical traditions connected with the market economy and the unequal preparation of societies to exist both in the free market conditions and in a diversified political, social and economic situation.

A research conducted by the World Bank and the Freedom House shows that the transformation countries which are the EU members have much a higher level of governance quality and the observance of the rule of law than the rest of Central and Eastern European countries. It may be assumed that the institutional changes, which are consolidated by the international obligations resulting from membership in such international organizations as the World Bank, IMF, WTO, OECD or EU, are more permanent. Only then there is time for changes in informal areas such as habits, respect of private ownership or considering corruption as a systemic flaw (Bienkowski, 2006).

The strengthening of the state institution and at the same time increasing the quality of governance – these are the priorities for post-communist countries. Achieving a positive institutional effect requires much time and consistent actions; nevertheless, in a longer time period it will guarantee social coherence, economic government and an improvement of competition.

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## VIDURIO IR RYTŲ EUROPOS ŠALIŲ TRANSFORMACIJA ŽVELGIANT PER NAUJOSIOS INSTITUCINĖS EKONOMIKOS PRIZMĘ

Małgorzata Swatek

S a n t r a u k a

Žvelgiant per naujosios institucinės ekonomikos prizmę, transformacija yra ilgai trunkantis formalių institucijų, ypač nuosavybės teisių ir sandorių, mainų procesas ir neformalių institucijų, tokių kaip antai: etiniai standartai, įsigalėjusi tvarka, religiniai įsitikinimai ir visuomenės mentalitetas. Transformacijos sėkmė priklauso nuo to, kiek naujos formalios taisyklės atitinka neformalias taisykles, egzistuojančias visuomenėje. Vidurio ir Rytų Europos įvertinimas palieka daug vietos dideliems troškimams; Europos Sąjungos šalys narės pasiekė aukščiausią lygį, o buvusią TSRS respubliką yra blogiausia situacija.

Esminės tokių diversifikuotų politinių transformacijų rezultatų priežastys yra nesulyginamos istorinės tradicijos, susijusios su rinkos ekonomika ir nelygiu visuomenės pasirengimu egzistuoti tiek laisvosios rinkos sąlygomis, tiek diversifikuotoje politinėje, socialinėje ir ekonominėje situacijoje.

Pagrindinės kokybės gerinimui yra suteikiamas pirmumas pokomunistinėse šalyse. Teigiamam instituciniam rezultatui pasiekti reikia daug laiko ir nuolatinių veiksmy, bet, žiūrint iš laiko perspektyvos, tai yra labai svarbu, kad būtų galima mėgautis ekonomine sėkme.