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## **INSTITUTIONAL ASPECTS OF THE THEORY OF ECONOMIC TRANSITION**

The subject of this article is the specific character of the economic transition in the countries of Central and Eastern Europe (CEE) in the context of intensively running processes of globalization and localization. It underlines that the profound fundamental economic change can be accomplished through a number of system transformations connected with a certain aggregation of institutions. They are one of the most important factors, which determine the content and the structure of the economic interrelations between people, as well as the parameters and mechanisms of the economic order of the national economy. On this basis, the conclusion is drawn that the economic transformation cannot proceed without a relevant institutional change. If even temporary limitations to and difficulties for the process of establishment of the institutional change are created during the period of implementation of the economic transition, this will inflict an impact on the mechanisms, intensity and efficiency of the economic transition. It is pointed out, in this plan, that the speed, continuity and efficiency of economic transition in its integrity are determined by the effectiveness of the institutions and institutional transformation.

JEL: A10; O11; P11

### **Economic transition or economic transformation**

For the last several decades, the attention of *the scientific community* (especially in the spheres of economic and social sciences), *business and political elite* has been directed to the investigation of the causes, mechanisms and the results of the implementation of the *economic transition* in the CEE countries. This attention was initiated, before all, by the method of rejection of the political and economic system that formed one of the two poles of the contemporary world. Together with this, an important place is attributed to the issues of *the practical approaches* and investigations applied for the implementation of the profound *fundamental economic transformation* in these countries.

No matter how radical and specific this process might be, it cannot be considered in isolation of the *global changes in the world economy* and the lasting tendency toward formation of new principles in the interrelations between states - respectively between their national economies. The intensively running processes of globalization might be in the foundations not only of the preparation, but also of the acceleration of the fundamental collapse in the economic and political system of the CEE countries and the post-socialist transition that followed.

The economic globalism finds expression in energizing and complicating the relations in the world economic space in all aspects and at all levels. It is in the

process of being constructed on new principles of behavior of *the micro-*, as well as *the macroeconomic* systems, formed on the basis of the new computerized information and communication technologies. They create conditions for a new strategic behavior of the economic agents, directed to:

- Achievement of high integrative capacity;
- Competitiveness in and adaptability to the new global markets in formation;
- Ensuring of high rate of rationalization and optimization of the results of the practiced activities.

*The globalization*, accomplished on the principles of the contemporary technological revolution, creates more favorable conditions for the advancement of those economic systems which possess a greater economic and structural adaptability and more easily and more rapidly adapt their production and market structures to the ever changing economic and technological conditions. This enables them to attain a higher competitive ability, to open their economies and to be instrumental in entering new market areas. From this point of view it can be determined that *globalization is expressed by an increase of the volume and intensification of the integrational interactions in the world economy.*<sup>1</sup> The qualities needed to enable the real and effective inclusion into this process are inherent in the highly developed and rich national economies, in the transnational companies, possessing the economic and technological capacity for participation in the global market network.

#### *Prerequisites of the economic transition*

The described quality characteristics were not inherent in the CEE countries in their post-socialist period. The stability of their economic system, for a certain period before the changes, was built on the basis of their reticence, system interconnection of their political and economic principles and a considerable level of a resource potential, formed mainly on the basis of the natural wealth of the former USSR. In the course of time these factors exhausted their own possibilities. The limited economic and market space, the gradual depletion of the resource capacity and its ineffective and irrational exploitation gave birth to a number of lasting tendencies of economic and social retrogression. The most substantial of them relate to:

*First*, formation of a clear cut and durably developing process of a *slowdown of the economic dynamics*. The rates of economic growth in these countries during the last decades of their socialist period reveal the gradual exhaustion of their national economies (see Table 1).

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<sup>1</sup> On this issue see World Development Report 1999/2000. Entering the 21-Century. New York, Oxford University Press. 1999, p. 2.

Table 1

## Growth of the total production (average annual rate)

Country	1961 – 1970	1971 – 1980	1981 – 1988
Bulgaria	5.8	2.8	1.2
Czechoslovakia	2.9	2.8	1.4
GDR	3.1	2.8	1.8
Hungary	3.4	2.6	1.0
Poland	4.2	3.6	0.8
Rumania	5.2	5.3	-0.1
Soviet Union	4.9	2.6	2.0

Source: Kornay, J. Социалистическата система. С., 1996, Акад. изд. "М. Дринов", p. 196. (Remark by the author: The data of the production of the socialist countries refer to Gross National Product (GNP), but for a definite period of time they almost coincide with the estimations of the GDP). A more detailed picture of the dynamics and the cycles of the economic growth in the CEE countries for the period 1950 - 1989 see Kolodko, G. От шока, к терапии. Политическая экономика постсоциалистических преобразований. М., ЗАО "Журнал эксперт", 2000, p. 70.

Although the data on Table 1 differ from those of other statistical sources, it can be determined with certainty, that they give a true picture of the dynamics of growth during a typical period of the development of the indicated group of countries.

*Second*, delineation of a tendency to *stagnation of the living standard* of the population. The phenomena, characteristic of the so-called economy of the deficit, did not find a solution. The dynamics, quality and composition of the consumption in the investigated countries lagged considerably behind in comparison with the developed western economies. The differences in these indicators not only were not kept, but they even grew wider.

The data on Table 2 can be used to illustrate the tendencies, connected with the growth of the real consumption in some typical representatives of the two groups of countries.

Table 2

## Average annual rates of growth of the real consumption per capita of the population (1951 - 1978)

Socialist countries	Consum. Growth	Capitalist countries	Consum. Growth
Czechoslovakia	1.6	France	3.9
Hungary	2.6	Italy	3.8
Poland	2.9	Japan	6.5

Source: Kornay, J. Op. cit., p. 286.

Both examples - the slowdown of the dynamics of the economic growth and the lagging level of consumption in the CEE countries, reveal the internal insufficiency of the conditions for a favorable development, and the growing incompatibility of the results between the former socialist countries and the developed market economies in the economic field. It is sufficient to mention that at the beginning of the transition (1989) the level of economic development of the CEE countries is estimated to equal the per capita income of the population of USA in 1900, while the economic level of Czechoslovakia, the most advanced economy of this group of countries, in the early 90s was comparable with the level of France and Germany in 1950.<sup>2</sup>

However, in the complex of factors having influenced *the economic collapse*, and further on the scope and the orientation of *the economic transformation* (post-socialist transition) in the CEE countries, *the most important is the role of the irreversible and intensively developing process of globalization*. This process shows that when economies and technologies develop in direction to globalism, it is inadmissible to exclude from these processes an economic region consisting of seven countries with a population of nearly 400 million and a vast territory spanning over two continents.<sup>3</sup>

#### *Orientation of the economic transformation*

The profound economic transformation coupled with the tendency toward economic globalism found its concrete manifestation in two basic directions:

*First*, the new type of interactions of the economies in transformation could be effected only by observing the principles of the spreading marketization and the formation of the contemporary global markets. This determined the basic content of the transition - total *all-embracing market transformation* of the national economies. What is unique in this case is the transition from planned, centrally managed economy, to an economic system, which is an antipode by its character, organizational philosophy and its mechanisms for effecting relations. This suggests introduction and observance of *new principles of economic behavior*, i.e. of new institutions, new institutional environment, formation of new institutional subjects and mechanisms.

*Second*, the economic transformation suggests not only market orientation, connected with the introduction of new type of ties and interactions between the economic agents. It is also connected with the formulation of the orientation and guidance of the economic interactions, as well as the method of their introduction.

The transition itself, from centralized to market economy, requires creation of conditions for *liberalization* of the economic interactions and *opening up to the world*

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<sup>2</sup> See Emergence of Market Economies in Eastern Europe. Blackwell, Cambridge MA & Oxford UK, 1993, p. 25-26.

<sup>3</sup> The data refer to the former socialist countries - members of CMEA, and do not include Cuba, Mongolia and Vietnam. See: Социалистическата икономическа интеграция. Речник-справочник. С., 1986, p. 279.

*(global) economic structures.* In this sense the market character of the transformation creates the hand-over mechanism, the transmission of its commitment to the processes of globalization. In practice this means that the economic transformation must lead to building up of *an integrative capacity*, to form a whole system of constituting means for inclusion into the already functioning integrative mechanisms in *global and local aspect*. The market transformation and the integration with the more developed economic structures become the basic driving force of the development of the exhausted economies of the countries in transition. In this plan, the globalization (inclusion in the global market network and participation in the integration processes) should be considered a basic factor that not only provoked the transition, but which also has a determining importance to its content.

Globalism as a principle of economic behavior includes in itself the complex of conditions permitting the *integrated states to avail themselves more easily and on a wider scale* of the advantages connected with:

- The use of contemporary information and communication technologies;
- The opportunities of effective inclusion into the global market network and maximum use of competitive advantages.
- The recruitment of foreign investments accompanying the realization of the structural change and development of the real sector of the economy, etc.

For the CEE countries with economies in transformation, the most favorable regime for joining the process of globalization is their affiliation to, and in the long run full integration with the European Union. The conditions of a real alignment of the principles of globalization and localization are formed on this basis.

#### *Economic transformation and economic regionalism*

The transformation processes are provoked by the changes of the globalizing world and at the same time they turn into a substantial part of this very world, into one of the key elements of its content.

The formation of the new, contemporary global economic structures includes affiliation of the countries with transforming economies to these structures. This refers not only to the CEE countries. These processes include different economic regions of the world economy. An intensively developing tendency towards *an economic regionalism* appears clear cut. On the one hand this tendency suggests and is based on the intensity of globalization, and on the other hand it reflects a purposeful development of the principles and forms of localization.

In the 1999-2000 report of the World Bank a special attention is attributed to the localization as a process of decentralization within the framework of the national economies.<sup>4</sup> From the viewpoint of the globalizing world localization has a certain totality of dimensions.

In the system of *globalizing relations* and interactions of the economic subjects (transnational corporations, national economies) many dependencies are

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<sup>4</sup> See World Development Report 1999 - 2000, p. 1 - 10.

formed - economic, structural, technological, informational, institutional etc. They obtain *supranational character* and suggest creation of related economic and institutional mechanisms for their control, stabilization and strategic targeting.

At the same time in *the national economies* themselves, processes of decentralization which determine the basic content of the *localization* are underway - activating the participation of broad masses of the population in the processes of government and the creation of deserving living conditions for man. On this basis globalization is connected to the total set of problems, formed and developed on supranational level, while localization is connected to the complex of principals for democratization of the economic and social conditions of life at subnational level. "Both at supranational and subnational level the institutions of management, negotiating, coordination and regulation will play a decisive role in the search of a new equilibrium between the countries, as well as within their borders and in the assistance in creating of stable conditions, permitting to carry out the programs in the field of development".<sup>5</sup>

The processes of *localization* can be considered also in the limits of *the world economy*. In this aspect they manifest themselves through the principles and mechanisms of the *economic regionalism* as well as through the development of the processes of decentralization. This concerns mainly the decentralization of global markets, but also the local orientation of the investment flows. Presently about 85% of the world population live in the developing countries, where the solving of the problems of modernization, industrialization and urbanization requires a gigantic influx of capital.<sup>6</sup>

Globalization and localization formally progress as counteracting tendencies. However, in practice, they possess a common basis, they mutually presuppose themselves, and interweaving themselves, they create mechanisms for optimization of the economic processes and results, for higher stability, and overcoming of contradictions in a widest spectrum - in international and national aspects; on supranational and regional level; in economic (between the developed and the developing economies) and social (between wealth and poverty) plan.<sup>7</sup> On

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<sup>5</sup> Ibid., p. 2.

<sup>6</sup> Ibid., p. 35.

<sup>7</sup> As a tendency to liberalization and augmentation of the responsibility of the economic systems, the globalization creates indisputable economic privileges. But they can be utilized best by the developed and integrated (integrating) economies. The less developed and with limited integrative possibilities economic systems (micro- and macro-) cannot benefit from (or they make a less important use of) the advantages of the globalization - it is even possible that they harvest negative consequences. Their inclusion in the global economic connections and being with insufficiently developed economic and market structures, their low competitiveness create the basis of their destabilization - destruction of real acting structures in production, downfall of the level of the national production, high growth of unemployment, low solvency of the population and a decrease in consumption. If the globalization does not create prerequisites for stabilization and economic recovery of the more backward economies, if it does not create mechanisms for their real integration, then it may widen the abyss between affluence and poverty, and the gap between the developed and developing countries will become even larger. A part of these problems can find solution by stimulating the

this basis, deserving attention is the issue of delimitation of two important principles of behavior, reflecting the interaction and interweaving of the results of the processes of globalization and localization: the first one concerns the content of the mechanisms of the global localization, and the second refers to the same aspects of the local globalization. They permit to outline more precisely the conception, and on this basis also the strategy of economic transition in the CEE countries. These principles at first are connected with the behavior of the transnational corporations, but they may be related to all participants in the economic interactions (relations) on global and local level.

As a principle of behavior *the global localization* is committed to the drive (tendency) towards optimum location of the territorial production structures and conquering of market positions on a global scale. When it comes to the interactions of the national economies (interrelations between states) this principle is materialized by means of the forms and mechanisms of *the economic regionalism*. This relates to such local integration communities as the European Union, the North American Free Trade Area, as well as the gradual shaping of locally differentiated centers on continental (Asia, Latin America) or on intercontinental basis.<sup>8</sup>

*The local globalization* develops on the basis of application of the basic principles of global behavior on a local scale in conformity with the specifics of the separate economic region or integration community, i.e. the rules of this behavior are transferred to the local basis. *This principle has a particular importance for the realization of the transformation processes in CEE.* In a most general scope, the transformations in the process of the economic transition are caused and conditioned by the tendencies towards globalization. But they cannot be realized "in general" or isolated. The transformation processes in the CEE countries, including Bulgaria, make sense only in the system of real interactions with the already formed and functioning economic systems on a global basis. The most favorable rational, and for this purpose optimum, variant for overcoming the economic isolation, for opening up, and liberalization of the economic connections in accordance with the requirements of the globalization is the inclusion of the economies in transition in a definite *regional integration community*, organized in conformity with the considered principles. For the CEE countries this is the European Union. Although that this organization is a locally formed economic system, it abides entirely by the principles of a rational global behavior in the economic space. Joining the EU means in practice an effective realization of the economic transition and successful completion of the fundamental transformations (economic transformation). The basic outlines of the model of economic transition,

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processes of localization. However, on subnational level, the localization can also cause unfavorable consequences for the macroeconomic stability. That is why *the profound economic transformation* connected with the development of globalization, and further on with the localization, in addition suggests *relevant institutional solutions*.

<sup>8</sup> Petkov, P. Some tendencies in the world economy. - Economic Thought, 2000, N 3, p. 22 - 23.

permitting successful observation of the most important principles of globalization and localization, are connected mainly with the construction of a real and acting competitive market economy. The blue print of this model contains a system of institutional and economic changes.

### **The disorder of transition and the necessity of institutional transformation**

The implementation of the economic transition in the CEE countries ultimately comprises integral system transformation in their national economies causing:

*First, change of the basic quality* of the economic system, i.e. formation of a new economic system, with a new type of economic connections and interactions, built on the basis of the principles of *market behavior*;

*Second, change of the trajectory of the economic development* in the sense of higher rationalism, liberalization and openness, and on this basis attaining a constant high *competitiveness*.

This means that the content of the economic transition encompasses a whole multitude of transformations as a means of *long-term economic prosperity* and for achievement of a *higher quality of life* in these countries.

A more careful investigation of the character of the transition and its component transformations shows that it contains *two basic component parts* of the mechanism of economic change.

*The first one* comprises *the revolutionary*, sudden, spontaneous, economic changes (transformations), which are carried out in a *short period of time*. They may possess a different scope and strength, depending on the concrete conditions in the separate countries. Their realization depends on the stage of their social aptitude and their bearability for the prevailing part of the economic subjects and the population. Their depth depends on both the determination and competence of the political and economic forces having taken the responsibility of their realization. In any case these *revolutionary changes are inevitable*, as far as they are connected to the so-called *interrupted gradualness*, i.e. with brisk, rapid quality changes in the economic system and creation of a new type of interrelations. At the same time the character and the spontaneity of the changes inevitably cause a *state of chaos* in the starting economic transformation. The attempts to attach an image of completeness to these changes in the short run ended in failure.

*The second* component of the transformation mechanism comprises the totality of successive *evolutionary modifications* in the economic system, which have a *long-term character*. They include all economic and institutional alterations in the course of the market transformation and they must provide a step-by-step adaptation and harmonization of the transitional economies with effectively functioning market systems in global and local plan.

Accentuation on the *evolutionary approach* gives an opportunity for an easy build up of the entire mechanism of the economic change and formation of the



organizational behavior of the economic agents by successive interrelated systematic economic, technological, structural and institutional modifications. Thus the attention is directed from the beginning to *the replacement of the chaotic spontaneity by a purposeful change* for reaching of an economic and social growth, and on this basis, also to re-establishment of the external and internal equilibrium. In conclusion, from the point of view of the character and the pace of the changes, the transition from the old to the new economic system in all cases suggests:

- Destabilization of the economy caused by the spontaneous elimination of the working principles, structures and mechanisms of interactions at the realization of the transition, especially in its initial stage;
- A step by step evolutionary orientation of the economic system to achieve a long term tendency of economic and social growth on the basis of new principles and mechanisms of the functioning of the economy.
- Restoration of the internal and external equilibrium; creation of conditions for a greater security, overcoming of the indefiniteness and of the destructive economic and financial crisis; achievement of macroeconomic stability and steadiness of the economic development.

*The logic of economic (market) modifications. The inevitability of transformation chaos and economic slowdown*

The realization of the transition and the construction of the market foundations of the economy suggest the attainment of two fundamental requirements:

*First, total liberalization* of the economic relations (connections and interactions). This imposes the introduction of the principles of economic freedom in the behavior of the economic agents. The basic thing in the character and the content of the market interactions is the economic independence and responsibility for economic decision making. In this sense the market is the area, where the economic agents meet voluntarily and freely to conclude business.<sup>9</sup> The transition from centrally managed to acting market economy suggests liberation from economic dependence, liberalization of the whole system of connections and interactions of the economic agents.

*Second, creation of an effective private property* as a condition of market orientation and rationalization of the economic activities, for augmentation of their efficiency. The private property is the basis of manifestation of economic freedom, and from here to creation of economic relations on the basis of the market. In the presence of entirely state owned property, the starting point of transition with creation of private property is the *privatization*. The creation of competitiveness between those two ways of restructuring of the property would permit the rise of effectively functioning private property.

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<sup>9</sup> Marshall, A. Принципы политической экономики, Т. 2. М., Прогресс, 1984, р. 6.

The liberalization and formation of private property are new, quality characteristics of the transition economies under construction. In most cases they are spontaneously introduced with no advance preparatory work and in practice they bring *destruction to the old economic order*. They go side by side with a multitude of accompanying phenomena, which in practice discontinue the work of the basic coordinating mechanisms in the economy, create economic chaos, disorganize the connections and hence an unprecedented *transformation slowdown*. On this basis the liberalization and the privatization (as a basic method of restructuring the property) suggest a parallel undertaking of urgent measures for *economic stabilization*.

Table 3

Dynamics of GDP in transition economy countries, 1990 - 1997

Country	Average annual GDP growth			Index GDP, 1997 (1989 = 100)
	1990-1993	1994-1997	1990-1997	
Albania	-8.8	4.9	-2.0	79.1
Bulgaria	-7.4	-3.6	-5.5	62.8
Estonia	-9.7	4.1	-2.8	77.9
Latvia	-13.8	2.2	-5.8	56.8
Lithuania	-18.3	0.5	-8.9	42.8
Macedonia	-12.9	-0.8	-6.9	55.3
Poland	-3.1	6.3	1.6	111.8
Rumania	-6.4	2.1	-2.2	82.4
Russia	-10.1	-5.3	-7.7	52.2
Slovak R.	-6.8	6.3	-0.3	95.6
Slovenia	-3.9	4.0	0.0	99.3
Ukraine	-10.1	-12.1	-11.1	38.3
Croatia	-9.9	3.0	-3.4	73.3
Czech R.	-4.3	3.6	-0.4	95.8
Hungary	-4.8	2.5	-1.1	90.4

Source: Kolodko, G. Op. cit., p. 114.

Table 3 shows data of the dynamics of the GDP in the countries of transition economies. They relate to two subperiods of their development. *The first* encompasses the time up to 1993, when all transforming economies develop spontaneous (shock) chaotic tendencies of *economic (transformation) slowdown*. It is impossible to control the processes connected with the growth of *inflation and unemployment*. *The poverty* is turning to become one of the basic problems of these countries. *The second period* - 1994-1997 comprises the gradual mastering of the economic tremors. The greater part of the countries begin to overcome the destabilization and to switch gradually to evolutionary transformations. While in the

first subperiod the radical revolutionary changes cause destabilization by shock destruction of the old economic order, in the second subperiod the long term evolutionary changes are based on a determined stabilization strategy and policy.

According to G. Kolodko, at the beginning of the postsocialist period, the radical liberalization is a fundamental principle of the transformation, together with the privatization and the new market relations. This totality of transformations evokes the necessity of stabilization (*the liberalization of prices* for example induces strong inflationary tendencies). But at the same time the liberalization and stabilization give rise to and *enhance* the slowdown, because the hard stabilization policy causes a considerable limitation of the total demand. "The roots of decrease in production are based in the policy of the macroeconomic stabilization, which being directed to the elimination of the deficit and introduction of market prices, causes a decrease of the volume of production as a side product of curtailment of demand".<sup>10</sup> The negative effects of the drive to an all-embracing liberalization are connected not only with the radical and spontaneous (harsh, shock) liberation of prices. The liberalization of foreign trade deals a heavy blow on the national producers, who are not competitive both in the internal market (with the influx of foreign companies) and in the external markets. This is considered not only as a cause, giving rise to an economic slowdown, but also as one of the basic factors for its intensification and duration.

Very often the failures and contradictions of the economic transition in the CEE countries are committed to the application of the principles of the so called Washington Consensus imposed by the international financial institutions. "The prescriptions of the Washington Consensus failed in Bulgaria and the other CEE countries. Instead of growth the economy plunged into a deep recession".<sup>11</sup> Assertions like this one to a certain extent are well-founded. They are shared by many economists.<sup>12</sup> The reason for such assessments is that the ten principles of economic and financial stabilization, as summarized by G. Williamson, and on this basis of economic growth, which are accepted as a basis of the Washington Consensus, are valid mainly for the developing countries with already created, but not healthy market economy. Perceiving them as a basis for materialization of market transformation would mean to suggest that the market economy comes into being automatically and immediately. Naturally, such an approach gives rise to many embarrassments and misunderstandings.

The principles of Washington consensus can be adopted for the process of carrying out recovery procedures in less underdeveloped market economies in order to stabilize these economies and provide conditions for economic growth. However, they lack the elements connected with the *creation* of the institutions,

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<sup>10</sup> Kolodko, G. Op. cit., p. 90.

<sup>11</sup> Angelov, Iv. The Economy of Bulgaria at the Doorstep of the New Century. - Economic Thought, 1999, N 6, p.8.

<sup>12</sup> Эволюционная экономика и "мейнстрим". М., Наука, 2000, p. 31; Kolodko, G. Op. cit., p. 122 - 128.

subjects and structures of new market economies in the process of formation. "The absence of relevant structures is a key element, left out of the strategy of the transition suggested by the Washington consensus. Liberalization and privatization, which are not supported by well organized market structures, give rise to a continuing period of curtailment of production instead of a sustained growth".<sup>13</sup> In summary the economic transition *begins* without definite, tested in practice principles, with no clear-cut idea of the logic and succession of the economic transformations. The old mechanisms and economic structures are destroyed before the conditions for building new ones are created. J. Kornay underscores that the mechanism for coordination of activities under socialism, though ineffective, was operative. With the change of the system, the old mechanism wrecked, but the new one had still not mastered all the targets of coordination.<sup>14</sup> Even in certain aspects this mechanism was hard to create, because apart from the necessary rules for its effective function, a specific economic cultural level was needed. The realization of the economic transition in these conditions is connected with the formation of a "system vacuum",<sup>15</sup> i.e. an economy, where the plan principle is rejected and destroyed, and the groundwork to build a healthy market economy on, has not been done yet. This period of the transition includes mainly the shock transformations, but its duration is determined by the possibilities for a gradual taking the destabilization under control and alignment of transformation processes.

The presence of a system vacuum and the lack of possibilities for forming and mastering of effective rules in the creation of the economic transition are defined by J. Kornay as "no man's land" or interruption. The conviction that *the economic change* must go along with the completion of a purposeful *institutional transformation* is widely accepted at present. If the beginning of the transition might have a shock start (which it did as an admissible measure) as a process of rapid changes mainly in the field of liberalization, then the actual transformation process as a blending of economic and institutional changes should be more prolonged and should be of an evolutionary character.

#### *Institutional transformation*

For a more integral and profound investigation of the transformation processes in the transition economies, the purposeful and rational use of the methodological principles and achievements of several important theoretical schools (currents) is necessary:

- The Neoclassic economic theory;
- The Evolution theory of economic development;

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<sup>13</sup> Kolodko, G. Op. cit., p. 126.

<sup>14</sup> Kornay, J. Ten years after the "Road to free economy": Selfappraisal of the author. - Economic Thought, 2001, N 1, p. 55-56.

<sup>15</sup> Kolodko, G. Op. cit., p. 115.

- The Neoinstitutional economic theory.

In this plan it is possible to commit the economic transformation to a row of consecutive system changes effected on the basis of a definite aggregation of principles and institutions.

According to the representatives of the contemporary institutional theory, the institutions are rules which:

- Determine the forms and mechanisms of putting into effect of human interactions;
- Create conditions of achieving a definite stability in the functioning of the economy;
- Decrease the indefiniteness and form the structures in which the economic activity takes place (as well as any other human activity);
- Introduce the limitations (the boundaries) in which the human behavior is formed, and the principles of economic freedom are effected;
- Create the conditions for rationalization of the activity of people and for attaining of higher effectiveness of its results;
- Reflect the method the people process the information and realize their choice.<sup>16</sup>

From the point of view of the theory of the economic transformation the issue of *the form of the construction of the institutions* is of a particular importance. This is explicable, because on the one hand it is accepted that the functioning of the economy is determined by *the established system of institutions*. On the other hand it is clear that *an economic transformation* could not be effected without a relevant *institutional transformation*. If it is accepted that by their character *the institutions are stable*, it follows as a consequence that *the institutional transformation* is a product of continued *evolutionary alterations*.

The accomplishment of an economic and institutional *transformation with interrupting intervals*, as is the character of the economic transition, is a result of *radical revolutionary changes*. This has its impact on the formation (construction) and development of the institutional framework, the institutional structure, and institutional mechanisms, as well as of the respective economic transformations.

The model of institutions comprises several basic components:

- Informal institutions;
- Formal institutions;
- Mode of their formation and development;
- Mode of their accomplishment (realization).

The form of realization of the institutions suggests the differentiation and systematization into two groups of institutions - informal and formal limitations.

*The informal rules* or institutions develop in the process of *the institutional evolution*. In principle they are durable and channel the behavior, as they facilitate

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<sup>16</sup> North, D. Institutions, institutional change and economic results. C. LIK, 2000, p. 12, 16, 41 etc.

the interactions of the economic subjects (when this concerns the economic institutions). They are formed on the basis of definite traditions, customs, symbols etc., as they *rationalize the activities*, enable the appropriation of more favorable economic results, so that their observation (despite the restrictions) is in the interest of all or at least of the greater part of the society. In this aspect the informal institutions are an expression of the level and specifics of a given economic culture and attach a clear-cut identity of the behavior in individual as well as social plan.

*The formal institutions* are those that the society classifies in certain written rules, laws, constitutions. They reflect the movement of society towards more sophisticated social and economic formations when the implementation of the institutions is more closely connected not only with the separate personal interests, but also with the interests of the communities themselves. The construction of the formal institutions follows the natural process of evolutionary institutional modifications as well as the process of transformation of the informal rules into formal ones. This is the way of the gradual structuring of the institutions resulting into the construction of the respective *institutional framework*. It includes a whole system of legislative and legal rules, norms of behavior and the respective organizational forms of their realization.

Stemming from the specifics of the economic transition, the construction of the institutions may be perceived as a process of *institutional transformation with interrupting intervals*.

This is so because the complex transformations in the political, economic and social system of the society are brought down to radical, revolutionary changes. In practice this relates also to the institutional transformation as a process of construction, reformation (transformation), and further on to development of the institutional structure by means of alignment and subordination (co-submission) of the institutions. As the fundamental principle of the economic transition is its market orientation, it is clear that the institutional transformation process must be directed to *the construction of the institutions of the market* - to the creation of new institutional subjects, formation of an institutional market mechanism, and respectively institutional behavior. This is of particular importance because the functioning of the economic system (functioning market economy) depends on the erection, the system commitment and the development (evolution) of the institutional base of the market economy (the fundamental institutions of the market).

The institutions are one of the most important factors on the basis of which the structure of human interrelations is established. In this way the parameters of *the economic order* are determined thus obtaining a restriction on the economic ambiguity and the realization of the efficiency of the behavior of the economic subjects is guaranteed.

It is clear that under the economic transformation with interrupting intervals, after a certain interval of time the change of the institutional base will be accompanied by a process of destruction of the fundamental formal institutions of

the old economic order and at the same time a fierce *competition confrontation* between the informal institutions of the old economic order and the newly emerging one. The presence of a certain inertia of the old institutions, due to their relative durability, as a result of the continuous process of their evolutionary confirmation gives rise to considerable difficulties for the establishment of the new radical reformations in the economic order, high rate of chaos and lack of stability in the behavior of all economic subjects. It must be taken into account that under the transformation in the sphere of institutions, the build up of the new elements and new structures cannot be done automatically. The same is valid also for the cultivation of a new market behavior of the institutional subjects. As practice indicates, there is a certain stability and inertness in behavior, as a reflection of the former environment, former principles (institutions), traditions, culture. That is why despite the urgent necessity of a more intensive creation of a new institutional market environment and structure at the beginning of the transition, this will be done in an evolutionary way.<sup>17</sup>

In this plan it should be pointed out that on the basis of the theory of institutional transformation and the theory of the economic transition it is possible to reach the formation of such a model of *the institutions*, in which the construction and development of the new ones to be combined with *the demolition of the old institutional order*, as well as with the ensuring of some *succession of institutions* and where it is necessary and possible - with a certain *integration between them*. On its part this would ensure a restriction of the chaos in the process of the economic transformation.

#### *Economic transformation and effectiveness of institutions*

The economic transformation with interrupting intervals, as is the case with the economic transition to new market interactions and structures, is based on initial limitation and elimination of the formal institutions of the old constitutional and initiational economic order. In these conditions, as it has already been underlined, the circumstantial economic relations are formed on the basis of a harsh *competition clash between the informal institutions of the old and the newly emerging institutional order*. *The old institutions* are rejected because of proven inefficiency of the economic interactions and results. *The newly emerging informal institutions* are also unable to provide the necessary effectiveness of the human interactions due to a number of reasons.

*First*, the economic transformation in the CEE countries, caused to a certain extent by the growing tendency towards economic stagnation, is directed to imitation of the models of the more successful market economies. This provokes certain economic and political groups to press for institutional change and to try to introduce new principles of economic behavior. However, D. North underlines that

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<sup>17</sup> Spassov, T. The economic transition: theoretical aspects. - Alternatives, 2000, N 9-10 (N 33-34), p. 7.

the political and economic markets do not supply sufficiently full information for effective transformations and for this reason the development could be pushed into ineffective trajectories.<sup>18</sup> The lack of connecting information in similar economic transformations with interrupting intervals may lead to the formation of ineffective informal institutions and from this point to ineffective economic transformations. In the conditions of the shock, radical economic changes, the observance (or imitation) of definite informal institutions with no confirmed institutional framework and respective system interconnected institutional transformations, instead of pushing the economies to a certain stage of marketization, leads to reverse results. The price liberalization for example provokes exclusively high and continuous inflation. Coupled with insufficiently coordinated measures of stabilization it leads to a blunt restriction of the solvency of the economic agents, and instead of promoting the market connections it diverts them to barter operations. The same can be mentioned about the violent (spontaneous, shock) privatization. Instead of constructing effective forms of private property, conditions are created for decapitalization and liquidation of a series of production structures and for the spread of corruption.

*Second*, the spontaneous processes of formation of new informal institutions, committed with certain political and economic groups, reflect the evident tendencies of confrontation of private and public interests. The economic institutions are effective when they facilitate communications and the interactions of the prevailing number of participants in the economic process. Consequently, if the informal institutions promote group (limited) interests, they provoke formation of a disparity between the private motives and the social well being.<sup>19</sup> Efficient institutions limit the opportunities of monopolization of the situation (and the behavior) of separate economic agents. They stimulate the competitive behavior and by doing so they contribute to more favorable and more efficient results for the separate participants in the economic interactions as well as for the entire society.

*Third*, the institutional transformation involves not only the construction of certain system of *institutions-rules* (principles). It also suggests the construction of definite system of *institutions-organizations* forming the basic structure of institutional subjects of the economy. The system of the institutions-organizations comprises legally and organizationally confirmed mass of participants in the market economy - business organizations (organizational forms of the business), state and financial organs, government and nongovernment (civil) bodies and organizations, through which and between which the entire organization of market connections is carried out. *The economic and institutional transformations suggest a simultaneous creation (erection) of the rules of market interactions, as well as of the new institutional subjects, between which the principles of these interactions are practically carried out.* The institutionalization of the new market subjects (bodies,

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<sup>18</sup> North, D. Op. cit., p. 19.

<sup>19</sup> Ibid., p. 17.



organizations etc.), the build up of a relevant market behavior is a long lasting process. But this has an impact on the opportunities of effective application of the institutions-rules at the beginning of the economic transition. From this point of view it is important to determine that the institutional framework has a particular importance for the formation and development of a particular structure of institutional subjects (organizations). Besides, the institutions-organizations exercise a reverse effect on the institutional framework, both in respect of possibilities of practical implementation of the principles (institutions) and in respect of the opportunities of their development and perfection. In the process of radical economic transformations the institutional transformation is hampered by the slow build-up of new institutional subjects with market oriented thinking, culture and rational market behavior.

*Fourth*, the initial radical transformations in the process of the economic transition are connected mainly with informal institutions. They reflect the purposefulness, the character and the mechanisms of the newly emerging market relations and are characterized by a number of imperfections - urge for profiteering and personal wealth, corruption etc. That is why they are defined with reason as of lower importance and this is the reason why their efficiency is limited. The competitive interactions between the economic subjects will gradually arouse their rejection, by which the stabilization and structuring of the institutional framework will have its impact on the mechanisms of the economic transformations. From the point of view of the institutional theory of transition, importance is gained by such issues as:

- In result of which interactions are the institutions of lower importance and lower efficiency formed;
- Which institutions are unfavorable for the recognition of the market connections;
- In which sense and in result of the interactions of which forces the competitive pressure rejecting the inefficient institutions does develop;
- What are the mechanisms on the basis of which the transition is implemented by the radical, but not systematic and inefficient institutional changes toward the process of the institutional evolution, when gradually the efficient institutions get in their own form, i.e. when does the economic order gradually obtain its constitution?

It is only natural that, if with the implementation of the economic transition, even temporary restrictions and difficulties are created for the institutional transformation, this should influence the mechanisms and the intensity and effectiveness of the economic transition. That is why the issue of effectiveness of institutions, respectively of the institutional framework and of the entire process of institutional transformation attains a paramount importance.

20.1.2002