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Chapter 11

Transition as Institutional Change

Aims of the Chapter:

- To review the discussion so far, through the length of institutional change
- To explore the literature on institution building
- To illustrate the interplay between formal and informal institutions

The transition from centrally planned economies to functioning market economies has proved to be a complex process. The discussion so far has led us to emphasise interconnections and complementarities between reforms, and the importance of getting the institutional framework right. We have very much made a case for understanding transition as “institutional change”: looking at institutional quality goes a long way in explaining successes and failures in transition, as well as cases of progress and stagnation along the transition path.

All this has wider implications. It is important here to explicitly place the lessons of transition in the broader context of economic development: indeed, the failure of the command economy model in the USSR and across Central Europe marked the end of what was seen by many as a credible alternative to the “market economy” model, and it thus led to a reframing of the question of economic development. From then on, many scholars adopted the view that economic development has to be understood as a process towards better functioning markets.

Of course, there are many types of market economies, some are more liberal than others, some more redistributive than others, but advanced economies, in general,

have better functioning markets because they have better institutions overseeing markets; creating a favourable environment for market-based interactions.

With this in mind, this chapter will first summarise our presentation of the experience of transition, putting a particular emphasis on the role of institutional quality. We will then discuss different lines of thought regarding the likely drivers behind institutional change. In the last section, we will discuss the empirical evidence regarding the drivers of institutional change in the transition region and we will focus on the interplay between formal and informal institutions.

1. Institutional Change in Transition: the Elements Presented so Far

Starting with Chapter 2 and its description of the “systemic failures” of central planning, we have in this book described the transition from central planning to market economy. In doing so, we have presented the mechanics of these two economic systems, their differences, the contexts in which they were more likely to work, and the outcomes they produced. In particular, we articulated the interplay between economic and political freedoms in Chapter 4, which focused solely on the political economy of reforms, exploring why consensus-building political systems facilitate reforms. But the interplay of economic and political institutions was also discussed in other places, notably Chapter 5, which highlighted the populist tendencies of weaker states and macro-economic instability generated by the soft budget constraint. In turn, Chapter 10 discussed the capacity of the state, both in terms of technical capacity and political will.

At each stage, explicitly or implicitly we have also described transition as a change in institutions, often focusing on formal, constitutional level institutions, but

also referring to lower order institutions (specific regulations affecting incentives for example) or informal institutions (such as corruption for example). It is now time for us to summarise these elements of discussion to reinforce the importance of institutional change in the process of transition, but first, we ought to clarify what institutions are.

1.1. Understanding Institutions

In Chapter 3, we discussed the different elements of reforms that needed to be implemented to transform centrally planned economies into market economies. Following Balcerowicz (1995), we showed that in practice reforms had progressed faster in some areas than in others, thus justifying a distinction between what we have called “first-stage institutional reforms” and “second-stage institutional reforms”. Later on, in Chapter 6, we discussed in broad lines the literature on the deep causes of long-term growth, and there we highlighted the importance of institutional quality, focusing mostly on high order formal institutions that is rule of law supported by checks and balances within the state, and resulting in secure property rights. Looking at the implied meaning of “institutions” in these two contexts shows that what we called the ‘first stage’ and the ‘second stage’ reforms was located on the low, regulatory level of institutions, and the high level institutions (in particular, the political ones) were taken as factors affecting what happened on the regulatory level. A reference framework is thus necessary, to clarify what exactly institutions are. We can start with a definition by North, a scholar who contributed immensely to our understanding of institutions and their importance:

“Institutions are humanly devised constraints that structure political, economic and social interactions. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights).” (North, 1991, page 97).

Institutions restrict human behaviour, yet as a result make it more predictable for others. That in turn facilitates cooperation and expands opportunities for action. Thus, the paradox of well-designed institutions is that while they appear to restrict human freedom, in fact they result in more freedom: creating opportunities for successful productive efforts.

The all-encompassing definition of institutions provided by North does clearly demonstrate the breadth of the concept, but, as explained in Hogson (2006), it may have left too much space for varying interpretations of the concept and thus misunderstandings, and a more detailed framework is thus needed here to further clarify what institutions are. In turn, that may help our understanding of the transition process. With this in mind, we will focus here on the typology proposed by Williamson (2000), which distinguishes between four institutional levels.

Level 1: Informal Institutions

At level 1, we have “informal institutions”, such as social norms and code of conducts. Culture and values belong here. These institutions constitute the (social) context in which all human interactions are embedded, and thus reflect, in Williamson’s framework, the highest possible level of institutions. From Williamson’s own admission, this level is still rarely studied and we know little about the emergence or evolution of these institutions, beyond a general consensus regarding the importance of certain “windows of opportunities”, when crises or shocks can lead to changes in what is socially acceptable and what can be done.

Level 2: Higher Order Formal Institutions

At level 2, we have higher order formal institutions. Here formal institutions relate to the constitution that is to a set of stable rules that define how the legal, political, and economic framework is organised. These rules may be written in one document - a constitution (e.g. US, Germany or France) or dispersed across many legal acts (as in United Kingdom). In contrast, there may be countries where documents called constitutions exist but these documents are of little practical importance, either because they are not followed, or because they are not stable and change frequently. But even there, a closer look may identify which are longer term political, legal and economic frameworks that define how these countries function. This constitutional level defines a position of a country on a continuum spanning between the rule of law and the arbitrary rule of the executive branch of the government, and if there is rule of law it secures it by a system of checks and balances between the different branches of the government, typically by pitching a strong independent judiciary against the executive. In turn, the degree of arbitrariness, or of unchecked power of the executive defines how insecure or secure property rights (and more broadly any other human rights) of individuals are. This high institutional level represents what most researchers refer to when they discuss the (formal) rules of the game, and long-term growth models tend to focus on this level of institutions.

Level 3: Governance

Moving further down, level 3 can be described as the governance level of institutions, this is where more specific rules are shaped, implemented and formalised to fit a particular range of human interactions (e.g. design of local laws and

regulations shaping specifics of contracts and dispute resolution, rules over the use of a specific resource).

Level 4: Transaction Level

Level 4 is the transaction level of human interaction. The word ‘transaction’ used by Williamson relate to any forms of cooperation, in particular in exchange and production, that is to economic cooperation as shaped by individuals within and between firms and businesses, or as consumers.

In practice, level 4 represents the micro-analysis level, where researchers focus on human interactions and where the rules of the game can be considered as exogenous. Level 2 and 3 are the domains of institutional economics, where formal rules of the games and their applications are dissected. Level 1, while understood as important, remains understudied by economists, because social norms and culture are difficult to measure, and because they are not easy to capture in standard economic modelling that assumes rational choice driven by quantifiable objectives and calculation. Historians, sociologists, and cultural anthropologist have more to say here.

But can distinguishing more clearly between these different levels help us understand the process of institutional change in transition?

1.2. Aspects of Transition and Institutional Change

With this typology in mind, we can revisit our discussion from Chapter 3 on the stages of reform. We explained then that progress in reforms, as measured through the EBRD transition indicators, could be separated into two types of reforms:

- Some reforms were easy to implement, and progress in these areas progressed swiftly. These “type I” institutional reforms represented “stroke of the pen” changes in policy enabling prices to be used as a vector of information and allowing free entry and thus competition for businesses,
- Others took much longer; these “type II” institutional reforms were indeed more demanding in terms of the supporting structures required for their good functioning (working legal system).

Further to this, we illustrated clearly that slow reformers did not catch up with the fast starters, as continued progress in reforms was more likely among fast reformers, thus contradicting the notion that slow reformers may have used their slower start to build more solid institutions.

We do note now, that a central distinction between type I and type II reforms was how much their success depended on the need for profound changes at Williamson’s level 3 (or higher order formal institutions); these higher level changes were more important for type II reforms than for type I. Thus, we reaffirm the importance of higher level institutional change to our understanding of progress in reforms. The feasibility of (sustainable) fast reforms and in particular of the more complex stage 2 reforms, depended on the political constitution that emerged as a result of the regime change (see Hellman, 1998, and Chapter 4), as countries that maintained the rule of law and voice (structure for consensus building) were better able to proceed.

Parallel to this, with Chapter 5, we emphasised the importance of macroeconomic stability for reforms to bear fruits. This focus on stability for growth was central to the literature on economic development in the 1970s, and has since

been popular and presented as one of the key dimensions of the “Washington Consensus” truly generating consensus amongst economists representing different policy viewpoints: As argued by Rodrik (1996) and as evidenced in the transition region and among the Asian Tigers in their fast-growth phase, macroeconomic stability is a pre-requisite to long-term growth and in periods of restructuring, as it reduces uncertainty and encourages productive activities and longer-term investments. Yet as we have explained, macroeconomic stability was far from easy to achieve in transition, due to a number of forces pushing for greater disequilibrium and inflation. Stability required an independent and efficient Central Bank (level 2 “higher order” formal institution).

At the same time, the links between the state and large scale enterprises had to be severed to prevent a persistence of the soft budget constraint (i.e. networks and connections and corresponding social norms, or level 1 informal institutions). Where such norms of behaviour persisted, the accumulated inflationary pressures, could create conditions for mounting demands on the Central Bank to accommodate those by easy money. Under such conditions, the formal constitution guaranteeing its independence could break down before the institution of Central Bank stabilised and consolidated. This is an example of how different levels of institutions interact and affect each other.

Likewise, weaker political institutions were generally associated with more difficult progress in reforms due to their inability to facilitate consensus between vested interests. Lack of a balanced fiscal budget is a direct result of the inability of the parliamentary institutions to negotiate successfully different claims on resources. From this point of view, again weak political institutions (level two) affect fiscal and regulatory decisions (level three), resulting in a tendency towards more populist

policies and thus lax macro-economic policies. These in turn may produce feedback effects undermining constitutional stability of the country (level three affecting level two).

Another example of this complex institutional change logic can be found in our chapter on privatisation (Chapter 7), where we used the notion of “pecking-order” of privatisation, to illustrate how “second-best” privatisation differed across the region, depending on the context, with institutional quality and economic factors both playing a role. At the same time, the changes to employment associated with this process of privatisation were shown to be strongly dependent on labour market institutions and in particular on non-work benefits (see Chapter 8), and on the availability of credit through newly created financial institutions (Chapter 9). Here we mostly deal with different elements of the Level 3 regulations and policies affecting each other. But we also have the issue of security of property rights (Level 2) affecting the path of privatisation (Level 3).

Finally, the ability of the state to fulfil its essential roles dependent strongly on its ability to collect taxes, which is always a difficult task, and relies strongly on state capacity (Chapter 10). However, in transition, the destruction of the structures associated with the direct collection of financial resources from state companies created an additional layer of difficulty as governments were at risk to becoming cash-strapped: the old sector shrank but was not always immediately replaced by new taxable industries. Here, implementation of constitutional change (eliminating the arbitrary, confiscatory government) resulted in temporary turbulences at the lower level of regulation.

Many authors, exploring the growth patterns in transition as we did in Chapter 6, have concluded that the extent of the fall in GDP following transition was

proportionate to the extent of distortions created under central planning, and that the recovery was facilitated by steady progress in reforms (see for example Efendic and al, 2011 or Babecky and Havranek, 2014; for up-to-date summaries of the literature).

Two underlying processes are thus seen to be at play. On the one hand, the distortions of the past needs to be corrected, and this requires large scale destruction of old institutions, and thus generates a short-term cost of disruption, while on the other hand, a completely new set of institutions needs to emerge to facilitate independent transactions at Williamson's level 4, to be based on price-signals rather than planned from above as part of the command economy. This new set of institutions encompasses changes at all the levels envisaged by Williamson: because transactions needs to be guided by prices and profit or utility maximization, formal institutions and their applications (governance level) will need to change, while informal institutions are expected to align somehow, moving away from a focus on networks and favours, towards a system requiring a greater level of generalised trust and therefore enabling more complex, wider reaching patterns of cooperation, not only with those one knows well, but also with those one does not know.

The question we want to address now is thus the following: can we reconcile all these elements into a coherent narrative of institution building in transition?

2. Drivers of Institutional Change

One key issue in understanding growth, in general, and in the specific context of transition, is thus to understand how institutions are built, or the drivers behind institutional change. To shed light on this process, we present below the main

narratives that exist in the literature to explain institutional change in the transition region.

2.1. The Importance of Liberalisation

Three main narratives can be ascribed to the overall experience of institutional change in transition. According to the first one, fast reforms are the key. Indeed, some will say that fast reforms helped minimising the transitional cost of reforms, as liberalisation and stabilisation meant working markets appeared faster and thus restructuring and growth. In this view of the world, some lower order regulatory reforms comes first, and higher order institutions building follows. Fast reforms allowed for a faster return to growth and implied more legitimacy of the higher order changes, in turn facilitating those (and creating a virtuous circle). This argument was explicitly put forward by Lipton and Sachs (1990) in their discussions of reforms in Poland. For them, economic and political liberalisation at the onset of transition would stimulate demand for subsequent institutional change. Here faster reformers are seen to have benefited from greater level of political freedom and what can be seen as supportive initial conditions, but at the same time strengthening the political foundations of freedom by bringing in more support for the new constitution as a result of the economic success arriving earlier on. The process was also facilitated by the pulling property of the perspective to joining the EU for institution building. But ultimately it is the fast pace of reforms that distinguishes the outcomes more clearly and explains faster returns to growth. The speed of the EU integration may itself be affected by the initial determination to reform, as exemplified by the Baltic Republics.

Indeed, fast reformers were also more likely to have improved the quality of

their higher order institutions faster (e.g. Havrylyshyn, 2007) and to have experienced less opposition toward further progress in reforms. This could partly be due to complementarities in reforms, whereby a piecemeal approach in fact limits the returns generated by reforms if they are not introduced jointly (da Rocha, 2015). Overall, the experience of transition makes it quite plain that slow reformers did not catch up with the fast-starter in terms of institutional quality and they do not have better quality of institutions at the end point. Fast economic reforms may therefore be a central driver behind institutional quality.

2.2. The Primacy of (Higher Order) Political Institutions

In a second narrative, the fact that progress in reforms depends on the political context is emphasised. In particular, the role of political interest groups, or vested interests, that are likely to block the economic reform process, is seen as central. This critique of the primacy of economic, regulatory reforms is best embodied by the work of Hellman (1998) and Stiglitz (1999) as it spells out the mechanisms through which elite groups or early winners of reforms may protect their interests and prevent further reforms.

Political freedoms have been shown to facilitate progress in reforms, in terms of exploiting the momentum and generating support (Ekiert and Kubik, 2001), with lively civil society prior to transition being associated with faster reforms (Bruszt, et al., 2012). This primacy of political institution is very much in line with Acemoglu and Robinson's (2012) views regarding critical junctures and drivers of long-term growth.

2.3.Culture and Social Norms

A third narrative exists, putting more emphasis on initial conditions and reforms as endogenously responding to the context of social norms or culture. In this view of the debate, fast reformers were able to reform faster because of their more favourable initial conditions, as well as the context in which institutional change had to happen: less distortion due to a shorter legacy of communism (and therefore social norms preserved from the pre-communist time; see e.g. Estrin and Mickiewicz, 2010) and a stronger pull from EU membership associated with geographical location and cultural affinity. Here policy reforms are not a choice, but a consequence of normative and cultural context. Political institutions are also seen as key, as worse performers are found in the group of illiberal slow reformers where the authoritarian rule was challenged but true democracy did not emerge; in the context of a weak state, the rule of law could not be upheld and state capture was more likely (Popov, 2007).

However, here emerging political institutions are themselves conditional on deeper traits of social values, norms and culture (possibly translated into the strength of the civil society which was seen as an important driver behind democratisation). In this view of the world, these informal institutions (Williamson's level 1) are the main drivers explaining whether changes to formal institutions will be implemented and accepted resulting in their long term stability. This view is for example implicit in Raiser (1997) where reforms are seen to be "path-dependent" and responding to local norms and values. It is also a view supported by Roland (2014) who shows that values have changed little across the transition regions since 1990, and support for government intervention and authoritarianism is still strong, markedly higher than in

the ‘old’ EU or United States. In his view, progress towards more economic and political freedom in CEE is still fragile (e.g. Hungary and Poland recent reversals).

3. A Rejoinder?

Ultimately, one needs to admit that the three narratives have a lot in common, as they all accept the three dimensions of policies, (higher order) political institutions, and culture as important drivers of growth in transition, but the key root causes, in each school, are different. One of the differences is in the view of reforms: were they chosen or endogenously determined? If political institutions or culture are stronger drivers of change, then policies were endogenously determined.

Table 11.1: Early Reforms Strategy in Transition Economies

Group 1: True Big Bang	Group 2: Advanced Start/ Steady Progress	Group 3: Aborted Big Bang/ Stalled reforms	Group 4: Gradual Reforms	Group 5: Limited Reforms
Estonia Latvia Lithuania Czech Republic Poland Slovakia	Croatia Hungary Slovenia	Albania Bulgaria Macedonia Kyrgyzstan Russia	Azerbaijan Armenia Georgia Kazakhstan Ukraine Tajikistan Romania	Belarus Uzbekistan Turkmenistan

Adapted from Havrylyshyn (2007)

Then how do these interpretations fit with the experience of transition?

Havrylyshyn (2007) proposed to classify transition countries based on their initial reform strategy and experience. This classification is reproduced in Table 11.1.

Central examples for proponents of the view that fast reforms were important for success are Poland, Czech Republic and Slovakia, as their fast progress in the early years of transition led to better economic performances and also relatively better quality institutions.

But the Baltics States are even more spectacular examples of success than Central Europe, as their initial conditions were far less favourable. Being directly incorporated into the Soviet Union and subject to far more extensive waves of Stalinist terror after the Second World War, their societies had indeed been more affected under communism, they had also accumulated more distortions in their formal institutions, compared to Central Europe. Yet they reformed fast and returned to growth much faster than other former Soviet Union countries. Thus comparing the Baltic States to CEE countries may help support the notion that policies and early reforms were important. At the same time, comparing Baltic States to other parts of the former Soviet Union may suggest an alternative explanation: the latter spent more time under communism and had less historical affinity with Western European tradition of political and economic freedom. Thus the argument on positive effect of early reforms needs to be balanced against the one that sees the reforms as endogenous, stressing more favourable initial conditions of a different cultural tradition.

Groups 4 and 5 are not really controversial: the thirst for reform was limited or absent, the political context was stifled due to strong elites and weak civil society, the communist legacy was strong and only weakly challenged. Thus reforms, political

institutions and social norms all converged to make their progress in transition difficult.

Group 2 and 3 are therefore where interpretations differ the most. Hungary, for example, is either described as a fast reformer in disguise, as reforms progressed swiftly there, or as a stunning example of successful slow reforms, if one considers that reforms had in practice started decades earlier. Similarly, Russia can be seen as a failure of fast reforms, where an attempt to liberalise quickly crumbled in a context of unfavourable initial conditions and unsupportive political structure and social norms. Alternatively, Russia can be said not to be a big banger at all, since indeed, even liberalisation remained partial for years after 1991 and the will to push for comprehensive reforms seemed to be missing.

And last but not least, while we stressed the experience of communism, longer term history may matter as well. Central Europe looks different than the Balkan countries, due to policies. But it may not be a complete picture. We may dig in even deeper into historical and cultural influences related to the Ottoman Empire.

Likewise, at time of writing, cracks appear on the uniform picture of the Central European success story. On the level of political constitution, first Hungary and next Poland appear to be drifting away from the rule of law towards the arbitrary rule of man. Would that have something to do with the pre-Second War period? Hungarians never experienced political freedom before the Second World War, and Poland was the second country in the region to lose it, as a result of military coup d'Etat; both nations in stark contrast to – that time – Czechoslovakia, which retained a functioning democracy till the time France and United Kingdom offered the country to Hitler (who was actively helped by both Hungarian and Poles) in September 1938. But the more recent tradition matters as well. The Hungarian government has been

facing little effective opposition when installing a soft model of authoritarianism. Yet, at time of writing the same blueprint in Poland proves far more difficult to implement, due to its strong tradition of social, democratic self-organisation that stems from the “Solidarity” period in 1980s.

Beyond the transition narratives or descriptive presentations, empirical analysis of progress in reforms and institutions building are rare, but a recent effort by Di Tommaso et al. (2007) is particularly relevant to our discussion. Indeed, in this paper, institutional change is modelled as a latent concept, which is imperfectly captured through progress in reforms as measured through four EBRD transition indicators, namely “Governance and Enterprise restructuring”, “Competition Policy”, “Banking Reform and Interest Liberalisation” and “Securities Markets and Non-Bank Financial Institutions”. In other words, institutional change cannot be measured directly but correlates with progress in these harder-to-implement reforms, which indeed are recognised to require functioning higher order formal institutions. Accordingly, the four EBRD indicators selected were the constitutive elements of our 2nd stage institutional reforms component, together with “Large-scale privatisation” in the principal component analysis we conducted in Chapter 3 and they fit with Balcerowicz (1995) definitions.

In a second stage, this latent concept is then explained using three groups of variables. The first one captures the founding blocks of reforms, i.e. liberalisation, stabilisation and privatisation, where privatisation and liberalisation are lagged to minimise reverse causality. The second one captures political variables including EU agreement, political rights and civil liberties, government turnover, political cohesion, ethnic heterogeneity and gini-coefficient in the mid-1990s. The EU agreement

variable would be endogeneous as it marks a step towards EU accession and therefore a commitment to institutional change to match the “*acquis communautaires*”, it was thus instrumented with distance to Brussels. It then captures an institutional pull of the EU on the countries of the region. The other variables capture more straightforwardly dimensions relating to an efficient democracy where everyone has a voice. Last but not least, the third group of variables are described as “cultural” and capture the dominant religious traditions. Essentially, this model can be seen as trying to evaluate the strength of each of the three competing narratives we have described above, by assessing their significance against each other.

In a second specification, all the time-invariant variables are replaced by the “Kitschelt Index” and a more parsimonious model is thus estimated, including only the three policy variables, plus EU agreement (instrumented), “Political rights and Civil Liberties” and the Kitschelt Index. In this specification, the Kitschelt index can be seen to capture cultural legacies in a broader sense to include time-invariant aspects of political institutions.

Focusing on the first specification, the findings support that all the three dimensions of policies, political and cultural factors matter for institutional change and that the three groups of variables explain it roughly in equal measure. In the second specification, the role of policies and time-varying political variables continue to be significant, but the Kitschelt index (cultural tradition) explains a greater share of institutional change. This analysis therefore confirms the very strong impact of cultural and political legacies. However, once the role of these is accounted for, (i) progress with reforms, (ii) what is essentially institutional transplant (EU agreement) and (iii) early progress with political freedom all lead to better institutional quality. This can thus be interpreted as supporting the notion that policies are important, as

they are shown to matter even after the effect of political and cultural factors on institutional change have been accounted for. Overall, all the three dimensions seem to matter.

4. Conclusions

The debate around the true drivers of institutional change is far from settled. If institutional quality (where institutions are understood broadly so as to encompass formal and informal higher institutions, or, in other words, constitutional level institutions, regulatory institutions and culture) is today seen by most as a central deep cause of growth, there is still a lot to figure out to understand the role of different types of institutions, the primacy of some over others, the likely links among them and especially the causal chains of change.

A large proportion of the literature has focused on constitutional or higher order institutional quality and has convincingly demonstrated their importance for our understanding of economic development. In the context of transition, protection of property rights, rule of law and the quality of checks and balances on the executive have been shown to matter not only for long-term growth, but also for a rapid recovery after the necessary destruction of the inefficient structures generated through central planning. However, political institutions and culture matter too, and their interactions with higher order economic institutions are complex. But above all, a commitment to comprehensive economic reforms did pay off in the transition region.

Review Questions:

- In your view, can economic reforms be seen as exogenously set or are they the result of cultural and political legacies?
- Why was EU accession an important driver of institutional change in the transition region? Should Ukraine be encouraged to join the EU? And Russia?
- Why are slow-reforms so commonly associated with lower higher order economic institutional quality?

Suggested Readings:

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