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**Interaction between Formal and Informal Insitutions in the Process  
of Transformation from a Planned to a Market Economy**

**Abstract**

*In the light of new institutional economics and the history of transformation, the nature of social change becomes an issue of primary importance. To explain this phenomenon, the new institutional economics has turned to the theory of interaction between formal and informal institutions. In this article the thesis functions as a tool for interpreting political and economic changes in the countries of Central Europe, the Balkan countries, the Former Soviet Union and in China. Analysis of the Democracy Scores published by Freedom House seems to confirm the dominant presupposition saying that democracy, clarity and observance of social cooperation rules, a high level of social trust, and high moral standards of individuals favour economic growth.*

*But case of the China transformation shows that institutions that have proved successful in the West does not necessarily provide the best solutions for underdeveloped countries. An optimal transformation policy depends on a given cultural background and political situation. However, despite important differences, some similarities between the transformation processes taking place in different regions and countries are discernible. The common feature of all transformation processes is greed and a lack of responsibility on the part of the ruling elites, which pose the greatest threat to reforms and economic development in the long run.*

## 1. Introduction

The transformation from a planned economy into a market economy was initially considered by both political and economic experts as a closed process of economic change instigated by radical political changes, a short-term process controlled by the state. Such a closed process of transformation from a planned into a market economy implies the eventual outcome of political transformation and is known as *ex ante* (Selinger 2002, p. 39; Smith 1998, p. 362). The desired effect is said to depend on state-driven implementation of a new set of rules of the game, including private property, strict budget limitation, an unregulated pricing system and freedom of business activity. It is assumed that these new rules should automatically trigger processes that will boost the economy's production capacity to nearly its maximum value. Such a "technical" approach to transformation can be derived from neoclassical economics; its result was the so-called Washington Consensus or a transition policy based on stabilization, liberalization and privatization. In the light of this interpretation of transformation, it is sloppiness in the implementation of the new rules, incompetent politicians and unjustified political pressure on specific policy directions that underlie the failure and diversification of political changes currently observed in Eastern Europe.

That such an approach to transformation is incorrect has been indicated by enthusiasts of the new institutional economics (NIE). Popularity of neo-institutionalist economics can be attributed to the peaceful collapse of central planning in the Soviet Union and to the failure of growth policy in postsocialist countries. New institutionalists underline the importance of the historical and cultural conditioning of economic processes. They also claim that the post-socialist countries suffer from the lack of an institutional framework that would condition the development of efficient economic and political markets. The NIE perspective clearly indicates that transformation is a long-term process and its outcome is neither to be predicted nor planned. Ongoing changes may be as much spontaneous as centrally controlled, and the profound transformation the country's state structure is undergoing only makes things more complex. The conviction that the implementation of formal rules concerning property rights and freedom in business will result in a thriving market economy in a few years' time is unjustified, based as it is on the false assumption that individuals always act rationally (in the sense that they aspire to the maximization of material wealth, and that the rules of the capitalist game they are playing and the consequences of the game do not confront their own value systems).

In the light of NIE and the history of transformation, the nature of social transformation becomes an issue of primary importance. To explain this phenomenon, the new institutional economics has turned to the theory of interaction between formal and informal institutions. In this article the thesis functions as a tool for interpreting political and economic changes in the countries of Central Europe, the Balkan countries, the Former Soviet Union and in China. The outline of institutional transformations in post-socialist countries presented here is based on the democracy score provided by *Freedom House*.

## **2. Institutions, transaction costs and transformation**

Created and developed in a historical process, institutions are norms of social cooperation that help to overcome conflicts of interests emerging from shortage of natural resources or human intellectual and moral imperfection. Some of these norms are manifest in formal organizations, others remain but informal rules of behaviour. Formal institutions are legal systems governing political and economic relations: from a constitution to the internal rules of a company or an association (North 1990, pp. 3, 36; Hodgson 2004, pp. 424-425). The pillars of a society's institutional economic framework are property rights and contract law. Though formal institutions are enforced by the judiciary and the police, the efficiency of the whole formalized institutional system depends on informal institutions, i.e., rules of behaviour set by moral codes, customs, religious beliefs and the mentality of individuals.

It is often maintained that the social purpose of institutions is to govern individual behaviour. While such a teleological approach may suggest that institutions are deliberately and intentionally created by people, there is no agreement on the origins of social institutions. Some say social institutions are the results of intentional human activity, others point out that social processes are spontaneous by nature and that developing institutions according to some premeditated plan is an extremely difficult task. Irrespective of how institutions come into being, there is no doubt that they govern the behaviour of individuals and make it more predictable, thus reducing the uncertainty associated with the fact that an individual is dependent on the behaviour of others.

Institutions owe their significance to the fact that the quality of social cooperation and learning processes, as well as transaction costs, all depend on them. The concept of "transaction costs" as costs related to the market

mechanism was coined by Ronald Coase<sup>7</sup> in 1937, but has always given rise to controversy. There are still many doubts as to how to define and measure transaction costs, and the significance of the concept has remained obscure. For some people the term “transaction cost” is hard to specify and its uses are few; others consider it as a scientific breakthrough. Generally speaking, transaction costs are social coordination costs or the costs that arise due to the existence of an economic system. They can be divided into the following three categories: managerial costs incurred in companies, market transaction costs and political transaction costs - in other words, the costs related to the development, maintenance and transformation of institutions. R. Coase recognized market costs and managerial costs as terms that may be useful in explaining the co-existence of the market and firms as alternative forms of coordination. If the market mechanism did not generate any costs, there would be no firms; if running a firm was free, there would be no market. This conclusion can be drawn from Coase’s concept introduced in 1937.

With regard to transaction costs, the difference between a market economy and a centrally planned economy is analogous to the difference between a market-like coordination mechanism and a hierarchical coordination mechanism in a firm. Approaching the matter from this perspective, political transformation is tantamount to a transition from an institutional system dominated by a hierarchical organization (which is typical of firms) to a system dominated by market relations (Zhang 2000, p. 287). Specific transaction costs arise due to such a transition; these costs depend on how deep the institutional transformation is. The purer the form of a given planned economy, the higher the costs incurred due to the institutional transition.

The political transformation associated with laying the foundations of a market economy generates specific transaction costs that cannot be avoided, including the costs related to making people aware of the necessity of institutional reconstruction, the costs related to creating a new legal system and judiciary, the costs related to persuading people of the fact that a legal system should be based on the principle of the rule of law. Apart from all these, there are also transformation transaction costs, which are avoidable to a significant

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<sup>7</sup> This is how Coase comments on his discovery: „It was the purpose of my article on *The Nature of Firm* to provide a rationale for the firm and to indicate what determines the range of activities it undertakes. (...) In order to explain why firms exist and what activities they undertake, I found it necessary to introduce a concept which I termed in that article „the cost of using the price mechanism”, „the costs of carrying out a transaction by means of an exchange on the open market” or simply „marketing costs”. To express the same idea in my article on *The Problem of Social Cost*, I used the phrase “the costs of market transactions”. These have come to be known in the economic literature as “transaction costs” (Coase 1990, p. 6).

degree; these include the costs arising from frequent changes in the legal system, from the lack of both security and clarity of property rights and from weak legitimization of the new law and ruling coalitions (Pejovich 1997, p. 244). Moreover, an institutional transition generates costs resulting from the inability of many individuals and social groups to adapt themselves to new living conditions. The introduction of freedom of business activity and competitiveness is usually believed to trigger economic and production opportunities that have never been seen before. It is nevertheless true that alongside this positive phenomenon, transformation results in former skills and experiences becoming outdated. New formal rules and the demand structure precipitated by the introduction of market rules make some skills and capabilities obsolete, with the result that some social groups devote their energy to sustaining the status quo instead of adapting themselves to the new economic circumstances. Retirement, establishing security funds and compensation schemes for entire professions are examples of transaction costs related to institutional transformation.

From the institutional economics perspective, political transaction costs cannot be treated as undesirable side effects, as they are a natural consequence of transformation. This, however, does not settle the question of which transformation model should be followed, and at what pace with respect to starting conditions, since the total political transaction cost depends on how deep institutional transformation goes and how much time it takes to complete.

### **3. Thesis on interaction between formal and informal institutions**

The thesis on interaction between formal and informal institutions and their influence on the quality of cooperation and social trust – and on economic efficiency as an effect – has played a major role in the process of explaining the evolution of economic systems. The interaction thesis says that “when changes in formal rules are in harmony with the prevailing informal rules, the incentives they create will tend to reduce transaction costs (...) and clear up resources for the production of wealth. When new formal rules conflict with the prevailing informal rules, the interaction of their incentives will tend to raise transaction costs and reduce the production of wealth in the community” (Pejovich 1999, p. 171). To put it in other words, harmony between the new rules and the old ethos makes transaction costs fall and human energy go into the production of goods and services. On the other hand, if the newly implemented formal rules compromise the prevailing ethos, the costs incurred during transition are high due to the necessity of taking action to enforce those rules against the dominant tradition. Growing social conflicts and an overall deterioration of social

cooperation are indicative of the latter case. Social energy is mainly devoted to proper profit redistribution, and the effort made to increase production of goods and services becomes smaller and smaller.

North's theory underlining the importance of the correspondence between formal institutions and cultural legacies has been illustrated with examples of development discrepancies between the countries of South and North America. In the United States, adopting a constitution that did not compromise the settlers' cultural heritage paved the way for the institutional framework to evolve into political stabilization and the development of free economic markets, and at the same time helped to lay the foundations of a society that would look to and gladly benefit from technological progress. In South America, however, constitutions inspired by the U.S. Constitution and adopted all across the continent turned out to be completely foreign to the prevailing ethos, and as a result, central bureaucratic control typical of Spanish and Portuguese models was imposed once again. Further consequences included stubbornly persistent economic backwardness (North 2004, p. 101).

The theory of interaction between formal and informal institutions has been successfully applied as a tool to explain the processes of transformation from a planned to a market economy. In post-Communist countries reaction to the new formal rules and the reforms implemented has been influenced by the way individuals perceive and judge the new rules of behaviour; this in turn is defined by the prevailing culture. Thus, the outcomes of transformation may differ from one country to another, as each country can be characterized by a slightly different dominant ethos. It can also be argued that the differences in transformation derive from different dominant ways of thinking, customs and codes of behaviour, not all of them leaving equal room for an individualistic way of life. The point is that an economy based on the free market and private property is not just an alternative method of allocating financial resources, but has become a way of life within which everybody is held responsible for the decisions they make and has to suffer the consequences individually (Pejovich 2003, pp. 13-14). The more a post-Communist society is inclined towards collectivism and egalitarianism, and the more it expects paternalistic care from the state, the longer and harder the road to adaptation to the rules of the capitalist game.

The historical paradox is that the eventually failed attempt to shape the societies of Central and Eastern Europe in a constructivist way - an attempt inspired by Marxist ideology - has almost triggered the necessity for a further constructivist approach to social reforms with a view to introducing market stabilization. Such an approach could be characterized by an initial definition of the target economic model and an assumption saying that the central rules

underlying this very model should be introduced as quickly as possible. Choosing a market economy means that laws and regulations defining the right to private property, economic freedom, competition and the extent of state interference in the economy needed to be established. Passing a new package of bills as formal rules defining the new economic order can be arranged in a matter of weeks. The problem remains, however, that for a social system to function efficiently, its formal rules need to correspond to the informal ones prevailing in a given society. To change the latter takes much more time. Since informal institutions lie at the very foundations of the legitimization of law, social transformations are hardly ever as rapid and deep as their enthusiasts would like them to be. "The implication is that transferring the formal political and economic rules of successful Western market economies to third-world and Eastern European economies is not a sufficient condition for good economic performance. Privatization is not a panacea for solving poor economic performance" (North 1994, p. 366).

#### **4. Freedom House indices as representations of levels of progress in transformation**

Since 1994 *Freedom House* has carried out systematic research in the field of political transformation processes in the countries of Central and Eastern Europe. Results have been published in *Nations in Transit*, an annual study. Indices and ratings presented by *Freedom House* are meant to render institutional changes taking place in transformation countries in a synthetic, quantitative form. By making application of quantitative methods in studies on institutional conditioning for economic processes possible, these indices enhance the opportunity to elaborate on the institutional perspective on economics.

The research methods applied by *Freedom House* and the form of presentation of research results have undergone significant changes. From 1989 to 1997 the scores published by *Freedom House* represented levels of political liberalization progress. In 1998 the progress in political and economic transformation in transforming countries was evaluated, and measurements were made for each field separately (*Nations in Transit 2000*). From 1999 to 2002 three different measurement methods were applied: a democratization index (DEM), a rule of law index (ROL), and an economic liberalization index. In 2003, *Freedom House* ratings were limited to DEM and ROL indices. The democratization index (DEM) was an average of ratings for the following categories of social phenomena: the electoral process, civil society, independent media, and democratic governance. At the same time the rule of law index

**Table 1. Ratings and Democracy Scores 2007, and GDP 2006 in transition countries**

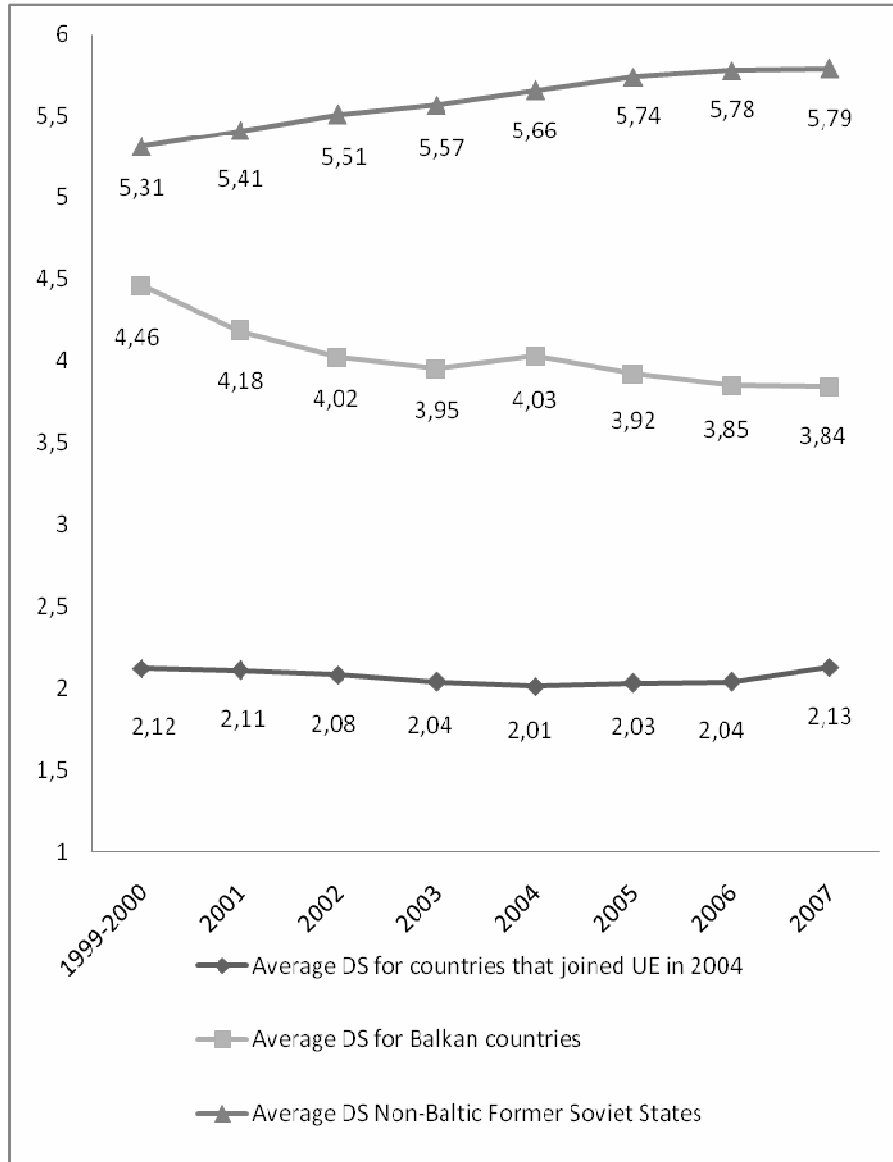
Country	EP	SC	IM	NGOV	LGOV	JFI	CO	DS	GDP per capita
Slovenia	1,50	2,00	2,00	2,00	1,50	1,50	2,25	<b>1,82</b>	18443
Estonia	1,50	2,00	1,50	2,25	2,50	1,50	2,50	<b>1,96</b>	12007
Latvia	2,00	1,75	1,50	2,00	2,50	1,75	3,00	<b>2,07</b>	8781
Hungary	1,75	1,50	2,50	2,25	2,25	1,75	3,00	<b>2,14</b>	11134
Slovakia	1,50	1,50	2,25	2,25	2,00	2,25	3,25	<b>2,14</b>	10221
Czech Republic	1,75	1,50	2,25	3,00	1,75	2,00	3,50	<b>2,25</b>	13863
Lithuania	1,75	1,75	1,75	2,50	2,50	1,75	4,00	<b>2,29</b>	8592
Poland	2,00	1,50	2,25	3,25	2,25	2,25	3,00	<b>2,36</b>	8801
<b>New EU Members Average</b>	<b>1,72</b>	<b>1,69</b>	<b>2,00</b>	<b>2,44</b>	<b>2,16</b>	<b>1,84</b>	<b>3,06</b>	<b>2,13</b>	-
Bulgaria	1,75	2,50	3,50	3,00	3,00	2,75	3,75	<b>2,89</b>	3956
Romania	2,75	2,25	3,75	3,50	3,00	3,75	4,00	<b>3,29</b>	5647
Serbia	3,25	2,75	3,50	3,75	3,75	4,25	4,50	<b>3,68</b>	4828
Croatia	3,25	2,75	4,00	3,50	3,75	4,25	4,75	<b>3,75</b>	9271
Albania	4,00	3,00	3,75	4,25	2,25	4,00	5,00	<b>3,82</b>	2929
TFYR of Macedonia	3,25	3,25	4,25	3,75	3,75	3,75	4,75	<b>3,82</b>	3096
Montenegro	3,50	3,00	3,50	4,50	3,25	4,25	5,50	<b>3,93</b>	3745
Bosnia and Herzegovina	3,00	3,50	4,00	4,75	4,75	4,00	4,25	<b>4,04</b>	2885
Kosovo	4,75	4,25	5,50	5,75	5,50	5,75	6,00	<b>5,36</b>	1402
<b>The Balkans Average</b>	<b>3,28</b>	<b>3,02</b>	<b>3,86</b>	<b>4,08</b>	<b>3,67</b>	<b>4,08</b>	<b>4,72</b>	<b>3,84</b>	-
Ukraine	3,00	2,75	3,75	4,75	5,25	4,50	5,75	<b>4,25</b>	2287
Georgia	4,50	3,50	4,00	5,50	5,50	4,75	5,00	<b>4,68</b>	1746
Republic of Moldova	3,75	3,75	5,25	5,75	5,75	4,50	6,00	<b>4,96</b>	876
Armenia	5,75	3,50	5,75	5,25	5,50	5,00	5,75	<b>5,21</b>	2128
Kyrgyzstan	5,75	4,50	5,75	6,00	6,25	5,50	6,00	<b>5,68</b>	536
Russian Federation	6,50	5,25	6,25	6,00	5,75	5,25	6,00	<b>5,86</b>	6877
Tajikistan	6,50	5,00	6,25	6,25	5,75	5,75	6,25	<b>5,96</b>	424
Azerbaijan	6,50	5,25	6,25	6,00	6,00	5,75	6,25	<b>6,00</b>	2362
Kazakhstan	6,50	5,75	6,75	6,75	6,25	6,25	6,50	<b>6,39</b>	5043
Belarus	7,00	6,50	6,75	7,00	6,50	6,75	6,25	<b>6,82</b>	3792
Uzbekistan	6,75	7,00	7,00	7,00	6,75	6,75	6,50	<b>6,82</b>	598
Turkmenistan	7,00	7,00	7,00	7,00	7,00	7,00	6,75	<b>6,96</b>	1327
<b>Non-Baltic Former Soviet States Average</b>	<b>5,79</b>	<b>4,98</b>	<b>5,90</b>	<b>6,10</b>	<b>6,02</b>	<b>5,65</b>	<b>6,08</b>	<b>5,79</b>	-

The Democracy Scores (**DS**) is an average of ratings for Electoral Process (**EP**); Civil Society (**CS**), Independent Media (**IM**); National Democratic Governance (**NGOV**); Local Democratic Governance; Judicial Framework and Independence (**JFI**); and Corruption (**CO**).

Source: Authors' research based on: *Nations in Transit 2007. Ratings and Democracy Score Summary*; *World Bank. Quick References Tables*.

(ROL) combined two indicators of the quality of social and political life: judicial framework and independence and human and minority rights protection on the one hand, and corruption on the other (*Nations in Transit 2003*, pp. xiv–xviii). In 2004 the two indices were replaced with one synthetic democratization index (New DEM). In 2005 national and local governance were separated for the sake of the research. As a result of all these changes the Democracy Score currently applied by *Freedom House* is an average of ratings for the following seven categories of social phenomena: the electoral process, civil society, independent media, national democratic governance, local democratic governance, judicial framework and independence, and corruption. Research results rely on partial indices based on a scale from 1 to 7. The final result – the democracy score – is an arithmetical average of partial indices; it is based on a scale from 1 (the highest level of democratic progress) to 7 (the lowest level, no symptoms of democracy, full authoritarianism).

Table 1 shows the democracy scores and GNI per capita of 29 transition countries. The diversity of the democracy scores suggests three different groups of transformation progress. The general outline of this diversity has been presented in the form of arithmetical average in chart 1. Table 2 shows coefficients of the correlation between the democracy scores and GNI per capita in 2006.



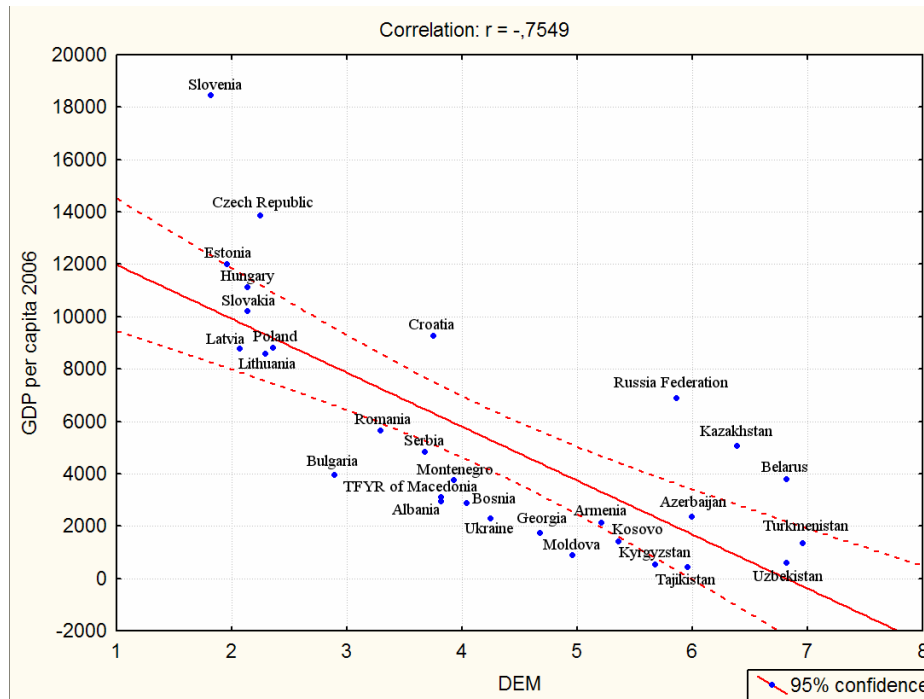
**Chart 1. Average Democracy Scores 2007 by Region**

Source: Authors' research based on: *Nations in Transit 2007. Democracy Score. Year to Year Summaries by Region.*

**Table 2. Coefficients of the correlation between the democratization indices 2007 and GDP per capita in 2006 in transition countries**

Ratings and Democracy Scores	GDP per capita
DEM	-0,75
EP	-0,67
CS	-0,64
IM	-0,72
NGOV	-0,77
LGOV	-0,77
JFI	-0,78
CO	-0,81

Source: Authors' research based on table 1.

**Chart 2. The correlation between the Democracy Scores 2007 and GDP per capita 2006**

Source: Authors' research based on: *Nations in Transit 2007. Ratings and Democracy Score Summary*; World Bank. *Quick References Tables*.

## 5. Conclusions drawn from the analysis of Freedom House Democracy Scores

The highest *Freedom House* ratings reflecting the whole research period have been given to those countries that joined the European Union on May 1, 2004. During 1999-2000 the Democracy Score (DS) for those countries ranged from 1.58 for Poland to 2.71 for Slovakia, and in 2007 from 1.82 for Slovenia to 2.36 for Poland. During the period 1999-2004 the average DS for this group of countries decreased from 2.12 to 2.01; in subsequent years, however, it increased, hardly noticeably at first, then significantly (2.13 in 2007). This unfavourable change has mainly resulted from the evaluation of transformation progress in Poland. According to *Freedom House*, Poland was ranked 1<sup>st</sup> until 2004, although the first symptoms of deterioration were observed as early as in 2002. During 2001 – 2007 the Democracy Score for Poland increased from 1.58 to 2.36 and in 2007 Poland found itself at the bottom of the *Freedom House* table with respect to the group of countries under discussion. Poland, however, is not the only country whose ratings have dropped. In comparison to 1999, higher, i.e., worse, democracy scores were given to the Czech Republic and Hungary. Furthermore, although Slovenia has occupied first place in the ranking since 2005, its Democracy Scores also deteriorated slightly during 2006-2007. Taking all the results into account, one might be tempted to make the optimistic view that the democratization progress taking place in this group of countries is proceeding quite smoothly when compared to all transformation countries. Yet it has by now become clear that changes do not always go in the direction expected. It seems that some pattern could be discerned in the way the countries that showed the greatest progress at first are now facing more and more difficulties (Poland, the Czech Republic, Hungary).

The second group is constituted by the Balkan countries. The democracy scores for the Balkans are significantly higher, which indicates a lower level of progress in institutional change. A major decrease in the value of indices, however, exhibits a clear tendency to narrow the gap between this region and the Western model. With respect to the research period, the average DS decreased from 4.46 to 3.84; the transformation process taking place in the Balkan countries is very diverse, though, and the level of diversity has not changed over the past few years. During 1999-2000 the DS scores for this group of countries ranged from 3.58 for Bulgaria to 5.67 for Yugoslavia, and in 2007 from 2.89 for Bulgaria to 5.36 for Kosovo. Their joining the European Union on January 1, 2007 gave proof that Romania and Bulgaria have been undergoing a successful

transition and that the situation in those countries has been changing for the better.

The third group includes the non-Baltic former Soviet states. High ratings were given here and the average democracy score increased from 5.31 (1999-2000) to 5.79 (2007). As far as the democratization process and creating conditions for economic growth are concerned, this fact is indicative of unfavourable institutional changes. The lowest scores were given to such countries as Azerbaijan, Kazakhstan, Belarus, Uzbekistan and Turkmenistan (from 6.00 to 6.68), while the greatest deterioration was exhibited by Russia (the DS score falling from 4.58 to 5.86). The only country among all other former Soviet states which showed some improvement was Ukraine (4.63 during 1999-2000; 4.25 in 2007). In the countries that emerged after the splintering of the Soviet Union, authoritarian political systems have shown a tendency to strengthen, except for Ukraine and the Baltic countries, where transformation policy and their effects have resembled those of Central Europe.

It is also worth mentioning that the partial indices on which the synthetic democratization index is based are most diverse. With regard to all the groups of countries distinguished above, the lowest ratings were given for the level of corruption, national democratic governance, and judicial framework and independence (JFI). In the case of most countries, higher ratings were provided for the electoral process and civil society. In general, such ratings imply a higher level of transformation progress in the areas that are directly affected by newly-introduced democratic procedures, and a lower level of transformation progress in the areas associated with the principle of the rule of law. What is most typical of the transformation countries is that of all ratings provided by *Freedom House* the poorest ones were given for the level of corruption. In the most recent research (2007) the average corruption index for 29 transformation countries amounted to 4.79, the highest of all indices concerning the remaining research areas. The average corruption index for the group of countries that became EU member states on May 1, 2004 was equal to 3.06<sup>8</sup> in 2007. The corruption index shows clearly that corruption presents the most serious and expanding threat to all those countries.

Both the diversity of transformation progress and the level of democratization progress being higher than the level of progress in the areas most influenced by the introduction of the rule of law supports the institutionalist theory that informal institutions are particularly important. Transformation processes proceed more smoothly wherever new formal institutions can find roots in the local cultural background. The democratization

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<sup>8</sup> Having allowed for Bulgaria and Romania, the average corruption index is increased to 3.23.

progress is greater because democratic philosophy has more in common with the ethos prevailing in the post-socialist societies than confidentiality limitations and observance of rules governing politics and other areas of social life have.

The importance of institutional arrangements for economic processes appears to be confirmed by analysis of the correlation between the democratization indices and the level of GNI per capita (table 2). What seems to be most striking is that the strongest negative correlation can be observed between GNI per capita and the corruption index (-0.81). As far as the institutionalist analysis of transformation processes is concerned, the corruption indices deserve special attention, as corruption can be treated as a measure of moral disposition, thus representing certain characteristics of informal institutions. It can be a tool for measuring discrepancies between the newly established formal institutions and the prevailing ethos. An outbreak of corruption often results from the fact that the new legal rules and regulations do not sprout from historically developed moral principles, customs or the mentality of the people. Therefore the level of corruption constitutes a significant factor that needs to be taken into account when evaluating the efficiency of the principle of the rule of law. The coefficient of correlation between the JFI indices and the level of GNI per capita (0.78) may also be argued to confirm the specific significance of those institutional changes which are associated with the rule of law. The conclusion can be drawn here that application of two different indices (DEM and ROL) was more justifiable than the new synthetic index introduced in 2004.

Analysis of the *Freedom House* indices and their relation to the level of GNI per capita supports the thesis that institutions matters. Moreover, the analysis seems to confirm the dominant presupposition saying that democracy, clarity and observance of social cooperation rules, a high level of social trust, and high moral standards of individuals favour economic growth. Finally, the conclusion can be drawn from the analysis that the closer the institutions are to the Western market economy model, the more efficient economic growth is.

## 6. The case of the People's Republic of China

The research carried out by *Freedom House*, with research results published in *Nations in Transit*, does not cover the People's Republic of China, whose economy has undergone regular transformation since 1978. Although it has proceeded under the Communist regime, the transformation in China has resulted in impressive economic growth. The course of the transformation of the

Chinese economy does not support the dominant thesis that economic reforms and democratization are interdependent. From 1978-2006 the Chinese economy was developing at a most impressive pace; the average annual per capita GNP growth has been estimated at almost 10%. According to the 2006 UN database, GNP per capita was nine times higher than the year the reforms began [UNSD 2007]. Acknowledging the poverty limit set by the World Bank, the number of people living on less than a dollar a day decreased in China by over 200 mln during the time of the reforms [Qian 2003, p. 298]. The progress made by China is also marked by an increase in the human development index HDI – from 0.557 in 1980 to 0.777 in 2005 [HDR 2007]. At the same time, China has remained a country ruled by a single party, with strict limitations still imposed on political and civil rights. According to a ranking made by *Freedom in the World*, the citizens of China have no political rights whatsoever (index 7) and hardly any civil liberties (index 6)<sup>9</sup>.

The significance of the Chinese transformation is not only proved by its spectacular results, but also by the enormous proportions of the Chinese economy. After all, in 2006 the population of China (1.3 billion of people) was three times higher than the combined population of all the other transformation countries (412 mln of people). In 2006, Gross National Income in China amounted to US\$ 2,6 trillion and exceeded the combined GNI of the transformation countries in Europe and Central Asia (close to US\$ 2 trillion)<sup>10</sup>.

The history of China's transformation differs from that of the countries of Central Europe with respect to both the time before and after the great breakthrough of 1989. Firstly, contrary to Poland or Hungary, where the economic reforms attempted under the Communist regime turned out to be failures, China, despite its single-party system, seems to have stepped onto the right path to transforming its planned economy gradually into an economy based on market mechanisms. Secondly, the Chinese transformation has proceeded against the transformation model developed by the Washington Consensus, i.e.,

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<sup>9</sup> Kang Xiaogung, however, draws our attention to the fact that the transformation of the Chinese planned economy into a market economy was accompanied by some essential political changes. A totalitarian policy was replaced with an authoritarian one. The private sphere of a Chinese citizen's life was partially liberalized. There were a number of significant changes introduced into the social structure. The economic and intellectual elite's importance grew, while the labourers' and peasants' status degraded. The new policy of the Communist Party of China was aimed at sustaining the status quo on individuals having no political rights, whereas domestic economic activity was promoted and an ideological consensus established among the Party and the intellectual elite of the country (Xiaogung 2002, p. 9).

<sup>10</sup> GNI, Atlas Method (current US\$). The World Bank Database. *A World Free of Poverty*, <http://devdata.worldbank.org>.

it has proceeded without China joining the full liberalization, deregulation and privatization processes.

**Table 3. Population, human development index and national income of China and post-Communist countries**

Country	Population	Life expectancy	Human development index		GNI billions USD*	GNI Per capita USD*	GNI Per capita USD**	Average GDP growth
	2006		1990	2005	2006	2006	2006	
	2006	2006	1990	2005	2006	2006	2006	1991–2006
China	1 311,8	72	0,634	0,777	2 641,6	2 010	7 740	10,2
<b>Selected UE countries</b>								
Czech Republic	10.2	76	0.845	0.891	129.5	12 680	21 470	1.7
Estonia	1.3	73	0.813	0.860	15.3	11 410	17 540	3.0
Poland	38.1	75	0.806	0.870	312.2	8 190	14 830	3.7
<b>Selected Balkan countries</b>								
Croatia	4.4	76	0.812	0.850	41.4	9 330	13 680	1.0
Romania	21.5	72	0.777	0.813	104.4	4 850	9 820	1.3
<b>Selected CIS countries</b>								
Kyrgyzstan	5.2	68	...	0.696	2.5	490	1 990	4.3
Russian Federation	142.4	65	0.815	0.802	822.4	5 780	11 630	0.1
Tajikistan	6.6	64	0.703	0.673	2.6	390	1 410	-1.8
Ukraine	46.6	68	0.809	0.788	90.6	1 950	7 520	-2.0
Uzbekistan	26.5	67	0.704	0.702	1602	610	2 250	2.3

\* in accordance with exchange currency rates

\*\* by purchasing power parity

Source: Authors' research on the basis of: *World Development Indicators database*, World Bank 2007; *Human Development Report 2007-2008*.

The case of the Chinese transformation gives arguments to critics of the Washington Consensus because it confirms the institutionalist view that not only institutions are important but also that institutions that have proved successful in the West does not necessarily provide the best solutions for underdeveloped countries. The idea behind the transformation process taking place in China is that underdeveloped countries need specific institutional frameworks. And these include a two-way liberalization process, business activity based on municipal and district property, a decentralized contractual system of public finance, and anonymous transactions and bank deposits.

A two-way approach towards the liberalization of prices translated into the simultaneous application of planned and market production mechanisms. Companies were obliged to complete specific production plans and sell produced goods at centrally defined prices, while they became entitled to produce and sell surplus goods at free market prices. In 1979 this system was first adopted in agriculture, then in the oil sector in 1981, and finally in the whole of industry in 1984. An opinion often to be found in the literature has it that this two-way liberalization created conditions associated with the market mechanism for enhancing efficiency, and the application of a plan as a proved institution, at the same time. In addition, it created a security system for existent business activity, thus protecting great numbers of people against the transformation process. Two-way liberalization made adjusting the pace of economic changes to political limitations possible, supported activities based on existent institutions and established transitory institutions. [Qian 2003, p. 297, Roland, p. 132].

Decentralization in public finance and combining provincial expenditure with local income generation created high motivation for regional authorities to take actions enhancing production and employment growth. Moreover, anonymous transactions available through the legal approval of cash transactions and anonymous bank deposits prevented the central authorities, despite their unlimited political powers, from imposing restrictive tax regulations, as the government did not possess any knowledge about a citizen's income. Anonymous transactions are interpreted as an institution limiting the government in cases where there is no rule of law [Bai 1999, Qian 2003, p. 318].

Interpreting the Chinese transformation calls for one further remark: on the one hand, specific Chinese arrangements were not impeded by the central authorities; in fact, the Party gave its consent to them. On the other hand, it was a grass-roots initiative more than anything else. To hold on to their power, the leaders of the Communist Party of China thought it better to limit the number of restrictions rather than to add new ones. Taking advantage of this newly emerging sphere of economic freedom, Chinese peasants, with the help of local authorities, disbanded rural communes spontaneously, supplanting them with a household responsibility system. The first county and district enterprises were established in a similar way. The pragmatic Chinese political leaders were convinced solutions which proved successful locally should be adopted in the whole country.

## 7. Conclusions

The case of China proves that there is no universal rule defining the proper sequence of economic and political reforms, nor the proper pace at which such reforms should be introduced. An optimal transformation policy depends on a given cultural background and political situation. The cultural background in Central Europe and in the Baltic countries did not obstruct the introduction of market reforms at a relatively fast pace, and there the Chinese model, of undertaking economic reforms without fundamental political changes, was out of the question. In China, however, economic reforms needed no radical change in the political system due to the level of social consciousness and the fact that a market transformation corresponded to the interests of the political elite.

The course of transformation processes confirms the thesis on the interaction between formal and informal institutions. It seems that in the case of China and the countries which joined the European Union, economic transformation has proceeded quite smoothly owing to the fact that the solutions and political instruments employed have not essentially compromised the dominant informal institutions which are rooted in the history and culture of a given country. Russia and the other post-Soviet countries, however, present a different challenge; the main problem is that the new arrangements are not suitable for the informal institutional background.

Despite important differences, some similarities between the transformation processes taking place in different regions and countries are discernible. Irrespective of the level of the political transformation progress, the permanence of the newly introduced changes is guaranteed primarily by establishing institutions that perform the following two functions: they increase productivity by means of using new economic factors and lead to effects corresponding to the interests of political and emerging economic elites. In most countries reforms merely boost the economic opportunism of the ruling elites. Even the leaders of Communist and post-Communist parties are inclined to favour private property when they realize that market transformation may function as a tool to strengthen their economic and political power [Smith 1998].

Summing up, the common feature of all transformation processes is greed and a lack of responsibility on the part of the ruling elites, which pose the greatest threat to reforms and economic development in the long run. This fact is reflected by the level of corruption growing in almost all transformation countries. Political stabilization has also been jeopardized by increasing income

inequalities. These inequalities have been increasing not only in countries where more radical liberalization strategies have been employed, but also in China, though the two-way liberalization process embraced there was allegedly supposed to protect great numbers of people against losing their fortunes during the transformation process.<sup>11</sup>

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<sup>11</sup>China has undergone a great transformation from an egalitarian society to a society where profit distribution is comparable to that of the United States and East Asia (Shujie Yao 1999; Jr-Tsung Huang, Chun-Chien Kuo, An-Pang Kao 2003).

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