

**Determinants of catching up or falling behind:  
Interaction of formal and informal institutions**

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Why some countries catch up with those ahead of them or, alternatively, fall behind belongs to crucial analytical issues in modern economics. Large tracts of the world lag, often increasingly, behind, as testified by the case of Africa. Analytically even more interesting are cases, where a group of economically quite similar countries splits into leaders and laggards in the process in question.

The determinants of such split are to be seen, in the opinion of the present writer [see, primarily, Winiecki, 2000a] in the influence of institutions, both formal and informal. In this article I intend to look largely - but not exclusively - to that XX century laboratory of social change, that is East-Central and Eastern Europe. Two major discontinuities, shifts to and recently away from the communist political and economic system are a gold mine for analysts looking for answers to complex institutional questions.

### **Availability of Resources**

#### **Tell Little About Performance**

Looking at the successes and failures in establishing new market institutions in post-communist economies and linking these to economic performance allows us to clearly see the differentiated performance. The experience of this author suggests looking at differences between institutions, both formal and informal, influencing the behavior in these countries.

Since this type of approach is not widespread, some definitions are in order to avoid terminological confusion. Following North [1990] and Voigt [1993] (quoted in Winiecki [2000a]), I define institutions as spontaneous or humanly devised arrangements, which shape repeated human interactions. Formal institutions, or formal rules (as they are more often called), are constitutions, codes, statutes, as well as other legislative acts. They also include common law and administrative rules.

Much more varied informal institutions, or informal rules, consist of customs and other tradition-based conventions, beliefs (religious, ideological), self-imposed codes of conduct, etc. One should include here ingrained habits, often shaped by previous formal rules. It should be noted in passing that such

habits were themselves an amalgam of the impact of still earlier formal rules, which together with the previous formal rules (then in existence), influenced the interactions.

A suggestion to look at informal rules as largely a legacy of communist past is tempting, here. But I posit that it is not so much the legacy of communist informal institutions, but first of all the *l e g a c y o f p r e – c o m m u n i s t* informal institutions that differentiates between countries surging forward and those falling behind.

Why should we concentrate on institutions rather than on such bread-and-butter issues for economists as availability of savings, investment ratio (GFCI/GDP), availability of labor, human capital, characteristics of output structure, indicators of comparative advantage, macro-stability indicators, etc.? The answer is indirect.

Let us have a look at the World Bank produced diagram, which I use at my *Economics of Development* lectures. I call it a “tinkerer’s dream”. In Figure 1 have a hypothetical GNP *per capita* curve of Zambia. It is based on the once fashionable “two-gap model” of Chenery and Strout. Zambia story assumes, first, that all resources available for investment went into economic growth and, additionally, all external aid (in addition to domestic resources) went into investment. If this had been the case, then the growth trajectory over the 35 years period, since Zambia’s independence in 1961, would have raised GNP *per capita* in Zambia above \$19 000 (in 35 years period). For comparative purposes it is worth reminding that it would then approximate Irish GNP *per capita*, when Ireland was catching up with the European Union average.

Yet Zambia’s GNP *per capita* was in late 1990s *l e s s t h a n o n e t w e n t i e t h* of the dreamland modeling level. In fact, it was less than at the start of independence! If the resources were available, then other determinants were preventing the catching up process from being initiated (let alone accomplished!). Property rights’ theorists, Jensen and Meckling [1979], stressed long ago that “*it is of little importance to know that it is physically possible to produce 100 units of a good with some given level of factor inputs if no one in the system has the incentive to do so*” [p.471].

The quotation suggests we ought to shift our attention to incentives. That is, in our terminology, to the formal rules establishing the structure of incentives in

Zambia in the independence period. And, inevitably, also to informal rules, which might have prevented formal rules from operating with even a modicum of efficiency.

Another indirect answer, closer home in geographic terms, also concerns investments and their transformation into economic growth. As shown by Pryor [1985], in capitalist market economies roughly 1% growth of gross fixed capital investment produced 1% GDP growth. Yet in communist centrally administered economies identical GDP growth rate of 1% required, also roughly, 2% of GFCI (data for selected countries are shown in Table 1). We may suspect - following Jensen and Meckling's reasoning - that the incentive structure in communist economies was much less conducive to transforming investment growth into output growth.

In these terms, the post-communist transition, seen as a shift from the economic system with the internally inconsistent structure of incentives to the economic system with the internally consistent incentives' structure, should be a - if not t h e - major enabling factor in the catching-up process. However, having the opportunity to reduce and actually reducing the GNP *per capita* gap are not exactly one and the same thing. The transition process created, as stressed already, both leaders and laggards in the process in question.

### **Disposing of Some Red Herrings**

There is usually little, if any, disagreement about who the leaders and laggards are. Quite a few institutions and a plethora of analysts have been continuously analyzing the countries in question, in many, also institutional respects. The disagreement starts, whenever explanations are formulated and discussed. Before pursuing various aspects or, more precisely, l e v e l s of institutional analysis, this author would like to dispose of those explanations that seem to be wide off the mark, often being red herrings in the debate.

The first red herring to be disposed of is resources, including production factors. The data in Table 1 suggest that it was not the v o l u m e of investment (GFCI/GDP ratio) that was scarce. Thus, at the start of transition there existed a potential for investment in all economies in question. The very well known fact of excess demand for labor also suggests the same answer in quantitative terms. As for the resources understood as inputs, the much

higher use of energy, steel, cement and other basic inputs per \$ 1 of GDP in communist countries [see Winiecki, 1984, 1988] also suggested that these economies were in fact *e x c e s s i v e l y* supplied with the resources in question. And if we look only at the mineral resources (both actually produced and attractively located reserves), then we must stress the fact that such riches are available *p r i m a r i l y* in the transition laggard countries.

Differential performance must, then, have other causes than resource availability. One of the red herrings of the debate on the transition progress that was very popular in early years of transition were the so-called initial conditions *a s t h e y w e r e t h e n d e f i n e d* [see Fischer and Gelb, 1991].

The present writer strongly supports the thesis of the crucial role of initial conditions. However, the authors in question concentrated on the legacy of *c o m m u n i s t* past. The communist past, although not the aspects stressed by Fischer and Gelb, was indeed the determining factor, e.g., in explaining the sharp output decline in early transition. But the communist legacy has been, in my opinion, of surprisingly limited importance for the success or failure of transition and the catching-up process.

The two determinants used by Fisher and Gelb have been the degree of macroeconomic imbalance at the start of transition (macro-stability variable) and the degree of tinkering with the orthodox central planning, or the so-called “reform socialism” (institutional variable). In half a decade’s time it turned out that these variables were largely irrelevant for the success of transition.

Among the success stories, or leaders, of transition one could find countries with relatively limited macro imbalances (the former Czechoslovakia, Hungary) and those with severe imbalances (Poland, Estonia). Looking at the foregoing transition leaders we may also point out that we find there perennial tinkerers with the communist economic system (Hungary and Poland) as well as countries with suppressed or near non-existent socialist reforms (Czechoslovakia and Estonia).

I assume that there is today relatively little disagreement with respect to the irrelevance of the “initial conditions” as defined by the authors in question, broad agreement quite probably including also the authors of the 1991 article. I do not harbor similar convictions about the next red herring on my list,

though, that is the impact of geography on longer term performance [the idea presented in a number of publications co-authored by Jeffrey Sachs , e.g. in an early paper by Gallup and Sachs, 1999]. I see the idea of land-lockedness as a determinant of inferior performance to be doubtful in the extreme.

Rich land-locked countries are as we know surrounded by rich countries with the access to the sea, while poor land-locked countries are surrounded by correspondingly poor countries with an access to the sea. In the post-communist area the pattern looks the same. We have middle developed land-locked countries in East-Central Europe surrounded by other middle developed countries with an access to the sea, and the farther East we go the poorer land-locked countries we see, surrounded also by poorer countries with the access to the sea. The foregoing is not meant to suggest that neighbors do not matter. On the contrary, neighbors do matter – and matter a lot. But in another way.

The idea of *i n s t i t u t i o n a l c o m p e t i t i o n*, dating back to the fountainhead [see, Smith, 1776, Liberty Classics edition, v.2, pp.330-31], but elaborated by North and Thomas [1973], North [1981], Eric Jones [1988], Rosenberg and Birdzell, 1986, and others, suggests that the existence of the neighbors, ready to offer more economic liberty and open to economic experimentation, was a powerful weapon in the hands of West European entrepreneurs - merchants, craftsmen, and financiers - in their search for new, better, and less costly ways of doing things, as well as in their fight against tax oppression. The right to exit constrained the aggrandizement of various local lords (*seigneurs*) and the overlords of the latter in early and late medieval Europe. A number of neighbors also mattered; the political decentralization of Western Europe made entrepreneurs beneficiaries of institutional competition among many rulers afraid of losing the exiting taxpayers' money.

Thus, Tchad, or closer (post-communist) home, Tajikistan, is poor not so much because it is a land-locked country, but because it has poor, that is inefficient, growth-hostile, institutions. No less importantly, neighbors do not differ from either country in this crucial respect.

A more important example is that of historical China. The failure of imperial China to have generated lasting economic development may also partly be ascribed to the now considered lack of institutional competition. The

challenges it faced were those from economically inferior northern nomadic peoples or from the breakdown of the empire and incessant wars between the warlords. Also in the latter case there was very little institutional competition as warlords modeled their rule along the oppressive imperial lines.

And it should be noted that the only - partly successful - imitation case began roughly in the last quarter of the XXth century. The emergence of highly successful alternative centers of economic power in the vicinity of the communist China, first Japan and later “Little Dragons”, threatened to have made China a poor, backward relation of its much richer cousins from the area.

It is to these institutional success stories that the Chinese owe the end of the Maoist aberration and the market-oriented Deng Hsiao-ping reforms. Incidentally, the half-hearted Sun Yat-Sen revolution of early XXth century failed because the only competing institutional framework was that of far away Western powers.

### **What Happens When Formal and Informal Rules Are In Conflict?**

But here we have been concerned only with formal rules, and policies pursued within these rules. In the institutional competition case we did not address an important question: “What happens, in terms of the wealth creating potential, when formal rules and informal rules come into conflict with each other?”

Clearly, communist China introduced from the start *inefficient* formal rules. But gradual market reforms and the growing freedom to establish non-state enterprises, initiated in 1979, modified the formal rules sufficiently to at least slow the process of increase in the GNP *per capita* differential between China and its Sinic neighbors. The case of communist China and Hong Kong is shown in Figure 2.

The enormous gap between the two in GNP *per capita*, even after the dozen years of Deng Hsiao-ping reforms, reflects the respective *institutional* gap, measured in terms of civic and economic liberties. Intuitively, we would be ready to ascribe the infinitely superior Hong Kong performance to greater *economic* freedoms. However, economic freedoms are not enough to maintain high economic performance in the long run.

It is civic liberties, with their guarantees of personal liberty, security of property, independent judiciary, due process of law, right to free speech, association etc., which underpin economic liberties. Where civic liberties are weak or downright non-existent, even the best-designed structure of incentives will operate much less efficiently. Precariousness of civic liberties will create strong disincentives to purposive, long run goals-oriented profit making activities.

Let me once more compare medieval Europe and imperial China to underline the role of civil liberties in economic development. The city *communes* in Western Europe were negotiating their rights and duties with kings or local *seigneurs*. The self-rule, or sometimes even full independence, in return for tax payments was the result of a mutually binding contract. Each party to the contract had some bargaining power, each could lose something, sometimes a lot, if it reneged on the contract. The security of merchants, craftsmen, and financiers and that of their wealth had both power-based and contractual basis.

This was not the case in imperial China. Whenever the emperor wanted to establish, e.g., a new city, he ordered his bureaucrats to resettle the needed numbers of city dwellers with the respective skills and resources (forcibly if need be). Merchants, craftsmen, and financiers were subjects, not citizens as in the West, also in medieval times. And if you are a subject, dependent on whims and wishes of a despotic ruler, your planning horizon gets shortened sharply - from generations to days, months, and at best years [see, e.g., Jones, 1988, and Landes, 1998].

Thus, to succeed, the post-communist transition required a mix of liberties to be recreated - or created from scratch. Both sets of liberties could be established through newly issued formal rules. But their operation would strongly depend on the degree of concordance of both sets of formal rules with the informal rules at work in their respective societies [see Winiecki, 2000a].

With the new formal rules radically different from the formal rules of the communist past, in both economic and civic respects, the ease of adjustment of economic agents, and whole societies, to new formal rules would be dependent on informal rules carried over from pre-communist past.

The closer had been the pre-communist past to the institutional framework emerging from post-communist transition, the greater has been the ease of adjustment – and accordingly the more successful institutional change and economic performance. These pre-communist institutions, whose survival in the minds and behavior of those moving away from communism, may be called *civilizational fundamentals*. And, since they are all coming from the *one* civilization, I should define them as *Western civilizational fundamentals*.

### **Three-Level Analysis of Transition**

These fundamentals have rarely been considered at a greater depth in transition-centered studies. What we have seen was more or less thorough and sensible studies of the change in what in Hayekian terminology could be called *general rules* and *specific rules*. The former were what I called the “Holy Trinity” of transition (liberalization, stabilization, privatization), while the latter were regulating particular areas of activity, particular procedures, or particular exceptions from general rules.

The present writes suggests adding one more level of analysis, that of civilizational fundamentals, making an important part of informal rules. Nowhere else the decisive impact of the informal rules carried over and/or resurrected from the pre-communist, often distant, past could be seen more clearly than in the case of performance of new entrepreneurial private sector in transition. The early and dynamic recovery from transformational recession [on this issue, see Kornai, 1994] was almost completely dependent on the establishment and expansion of the new private firms. For neither shrinking state-owned firms nor restructuring privatized firms, could bring positive net contribution to output in the early period [see Winiecki, 2001a, 2003 and 2004, forthcoming].

But the expansion of the entrepreneurial private sector was, in turn, dependent on the institutional framework emerging in post-communist transition. And the framework in question consisted not only of the formal rules, general and specific, being introduced, but also of the interaction of the said formal rules with the informal rules. And the latter have been an amalgam of pre-communist customs, beliefs, self-imposed codes of conducts, etc., and

new habits acquired during the communist rule in the process of adjusting (often in vain!) to the inconsistent rules of the latter system.

The importance of Western civilizational fundamentals carried over from pre-communist past can best be seen if add to the traditional two-level analysis such civilizational fundamentals as political liberty, law and order, and generalized trust. Let me identify the crucial role of civilizational fundamentals relative to specific, or even general, rules established in the transition process.

- Firstly, all would agree that the freedom of entrepreneurship, as embodied in the general transition framework, is important for all market participants. It is v e r y important for the new participants, who bear the disproportionate cost of any barrier to entry and expansion (relative to larger, already established firms). However, the e c o n o m i c liberty, embodied in the liberal regulatory framework, even if necessary for good performance of *de novo* firms, is not sufficient to make the institutional environment really conducive for the entrepreneurs.

The framework of economic liberty should necessarily interact with, or be embedded in, a much b r o a d e r f r a m e w o r k o f l i b e r t y, including civic and political liberties. It is the wider framework of liberty rather than a more narrowly focused freedom of entrepreneurship that underpins the entrepreneurship-friendly environment. The wider framework in question is needed to give actual and potential entrepreneurs the assurance of b r o a d e r s t a b i l i t y, understood, *i.a.*, as safety from any later persecution for their earlier pursuance of profit through the lawful operations of a private firm.

This is a minimum requirement, but a v i t a l minimum in the part of the world, where private profit seeking had been for decades legislated to be a crime. Even in late “reform socialism”, when the constrained private sector was allowed to exist in some areas of the economy, it continued to be touted as the symbol of evil (and discriminated against). The assurance of stability is needed all the more so, since entrepreneurial success often breeds envy and discrimination (at times even blackmail and persecution). Incidentally, it is the lack of such assurance that condemned to failure attempts to revive private entrepreneurship under East European „reform

socialism” [see Winiecki, 1991, and 1997a]. No formal, even constitutional, rules or policy pronouncements (the proverbial „green light” declared from time to time by communist rulers) helped the regimes to generate the dynamic expansion of the generic private sector. The would-be entrepreneurs perceived that the communist rulers simply were not credible and the entrepreneurial response has been, generally, very limited. Where it did take place, it was usually distorted as most of the registered effort went into activities that did not require much investment, nor long period for pay-off.

A comparison of the rate of formation of new firms in pre-transition and early transition period shows striking difference. When the emergence of political and civic liberties have been widely acknowledged by the population, the dynamics of establishment and expansion of new firms accelerated sharply in the countries under consideration (see Laky, 2001, for Hungary and Winiecki, 2001b, for Poland].

- Secondly, well designed and efficiently enforced property rights are an important part of the general institutional framework in every transition program, albeit realized so far to varying extents (even in the leading transition countries it leaves much to be desired!). And, again, it matters that there are gains forgone, when some sophisticated types of business deals are not entered due to the unclear, imprecise, or conflicting rules and/or their weak enforcement. But it matters even more that much more numerous, standard business transactions are not entered into because economic agents perceive that their businesses - and they themselves! - are not protected by the despotic, corrupt, and inevitably inefficient ruling regime.

Thus, however important the property rights’ regime may be for enhancing economic development in general and the expansion of the entrepreneurial sector in particular, it is again too narrow an interpretation of the institutional framework, protecting the property of economic agents. The perception of the existence of an efficient law and order regime is, then, yet another prerequisite of the successful establishment and expansion of the new private sector.

Wherever and whenever law and order is absent, due to the weakness of the (otherwise highly activist) state, or even the absence of the *Rechtstaat* tradition, transaction costs increase enormously. If the property can easily be stolen, robbed, or damaged by criminals (including those in the government!!), operating with near impunity, then the best designed property rights' rules will not spur much entrepreneurship (except in pathological forms).

- Thirdly, and finally, it is important that *t r u s t* develops over time as the honesty becomes increasingly rewarded through repeated business deals with those individuals, whose reputation for honest dealing becomes established. The capitalist market economy is particularly well suited to develop that kind of trust, given the concordance of the structure of incentives with reputation-enhancing behavior.

What is also needed, however, is a dose of trust that is not so much the outcome of interactions on the market (stressed earlier in this article), but a fundamental characteristic underpinning the emergence of a market, if the market is to operate at the low transaction cost levels. Such *g e n e r a l i z e d t r u s t* is more a consequence of the long tradition of the *civil society*, that is the ability and willingness of citizens or inhabitants, to organize themselves for the joint pursuit of various common goals. The interaction across political, religious, and other divides teaches them cooperative behavior and makes them more ready to accept the duties needed for the advancement of various, non-exclusive, goals.

Such "trust" (in Fukuyama terms) or „social capital" (in Putnam's terms) is usually low in societies emerging from the communist anomy [compare results of surveys referred to in Lovell, 2001]. But whatever trust has been found at the start of transition, it was invariably *i n h e r i t e d f r o m t h e p r e - c o m m u n i s t p a s t*, which implies that countries embarking on the path of transition have been differently endowed with that kind of trust.

It is of great importance that those taking part in the capitalist market economy, investing their time and money, trust not only economic agents known for their good reputation, but also trust the stability of the regime.

Those already in business and would-be entrepreneurs should rest assured that there is a high degree of *c o n t i n u i t y* based on

civilizational fundamentals. They should expect that compromises among conflicting ideas and interests are achievable - and that electoral results will not change the regulatory and/or policy landscape overnight. With low trust and little prospect for continuity, the time horizon for entrepreneurs is shortened considerably and the new private sector will be both substantially smaller and oriented toward short-term gains. Both prospective outcomes are equally undesirable.

Summing up the foregoing, the liberty, law and order, and generalized trust are civilizational fundamentals that underpin transition efforts. However well designed and consistently implemented general and specific transition measures may be, the presence or absence of fundamentals in question may differentiate between creating transition leaders and transition laggards. At a minimum non-existent or weak fundamentals may drastically lengthen the prospects of transition laggards to catch up with transition leaders.

### **Two Sides of a Specific Civilizational Divide**

An example on a broader scale is based on the juxtaposition of two sets of transition economies. During my lectures on transition, while discussing civilizational fundamentals, I offer two maps (see Figure 3A and 3B). The first presents East-Central and Eastern Europe's divide between leaders and laggards in XXth-XXIst century post-communist transition. Nobody has ever contested the classification; everybody can see the difference between success and the lack of it. The second map displays the XVI century divide between Western and Eastern Christendom. Here there is no arguing with facts, either.

The impact of Western civilizational fundamentals is clearly seen, when I put one map upon another. It is roughly the same divide. All transition countries that are widely regarded as success stories are countries of predominant or exclusive Western Christendom. This is undoubtedly a politically incorrect conclusion. For the present intellectual fashion frowns upon cultural/civilizational comparisons. However, there is no denying the different impact of Eastern and Western Christendom-based civilizations upon

the shift to the capitalist market order in general and the expansion of the new entrepreneurial private sector in particular.

Interestingly, the foregoing division of transition countries into leaders and laggards along civilizational lines has been confirmed of late by no other than that paragon of political correctness, the European Union. For a l l eight new post-communist members admitted to the E.U. are countries from one and the same side of the divide in question: the Western Christendom...

Clearly the past casts a very long shadow, when it comes to the impact of institutions. As stressed already in Winiecki [1997b], the separation of the temporal and transcendental authority in the West since the IVth century A.D. created some space for individual choices. As Landes [1998] noted "*Christianity ... early made the distinction between God and Ceasar. ... This did not preclude misunderstandings and conflict...*" But the benefits were very significant. "*Where authority is divided, dissent flourishes. This may be bad for certainty and conformity; but it is surely good for the spirit [of inquiry – J.W.] and popular initiatives*".

A good indicator of a readiness to take an initiative may be, for example, the willingness to work for oneself. From an article in *Financial Times* it transpires that in an answer to a cross country survey almost 80% of Poles expressed their preference to be self-employed; the same preference was expressed by only about 30% of surveyed Russians (see Figure 4).

Other differences existed between two rites of Christendom as well. The already stressed feudal decentralization of political authority in Western Europe gave an edge to the innovative. Wherever rulers put obstacles to their inventions, they could easily exercise an *e x i t o p t i o n*. That meant moving to places, where rulers accepted innovative craftsmen, merchants, financiers, etc., in the hope of increasing their tax *v o l u m e* (rather than tax *l e v e l*!).

Even greater contribution to the uniqueness of the West came from the gradual strengthening of the position of Western cities relative to the countryside and its local *seigneurs*. These processes had been increasing (however unevenly) the economic freedom. It is not surprising that in Hanseatic cities of Northern Europe the proud slogan had it that "*Stadtluft macht frei*".

But where societies have been living for centuries under one exclusive, overarching authority, as they did in Czarist Russia and other countries of Eastern Christendom, a sharply differing - and much more constrained - perspective on individualism has evolved [see, e.g., Brenner, 1990]. In the Byzantine empire, the cradle of Eastern Christendom, the patriarch, head of the Church, had simply been the emperor's deputy for ideological affairs (to use a more contemporary communist terminology). That story was later repeated everywhere within the Eastern Christendom.

These divisions between Western and Eastern Christendom, lasting for thousand years, have been overlaid with the more recent influences of the corrosive communist system. This is yet another example of the impact of institutions. For the less painful were the ravages of communist moral nihilism, the less widespread the application of "technical rules of survival" (to use Zinoviev's term), and the closer the society had been to the mainstream moral order of capitalism in pre-communist times, the faster and less costly has been the transition to liberty.

### **A Comparative Case Study: Poland and Russia**

The gulf between good performers from the East Central Europe, stretching from Estonia in the Northeast to Slovenia in the Southwest, and the rest of the post-communist group of countries is probably best exemplified by the comparison between Poland and Russia. It has been generally agreed that Poland is an economic success story (at least until very recently!), while Russia is not (in spite of a recent acceleration of the rate of output). Where analysts differ, it is usually with respect to the causes of this difference.

The mainstream explanation of Poland's success is as follows. Strong stabilization measures at the start of transition and rapid liberalization are seen as both necessary and sufficient conditions to force adjustment on the then overwhelmingly dominant state enterprise sector. Early initiated (albeit slow) privatization „from above” helps to shift some firms from the inefficient state sector to the efficient private sector. To a greater extent than anywhere else - except Hungary and later Estonia - bad performers are allowed to fail (even if actual exit drags on). The foregoing creates enabling conditions

conducive to early recovery that starts in mid-1992. From then on it was, more or less, plain sailing.

There is a weak spot in this mainstream explanation, though. It may be easily noted that the mainstream explanation tells us nothing about the *sector*, which generates output growth. For even if we assume that state enterprises and privatized firms adjust to the new market conditions they do not generate net output increase in early transition (see above).

The mainstream explanations concerning Russia are the reverse of what Poland did. Thus, the stress is put on failed stabilization (with the government and the central bank working most of the time at cross purposes), on erratic and incomplete liberalization, and on the impact of the foregoing failures on privatization „from above”. The privatization in question was, indeed, one of the few successes of Russia’s incomplete transition.

Yet stabilization and liberalization failures did not allow ownership transformation to continue. In unstable macroeconomic conditions and much microeconomic interference there were few potential buyers of Russia’s firms from the incompetent owners-insiders. The necessary restructuring, aimed at selling firms to strategic outside owners (the most efficient form of private ownership), did not take off. The result has been continuing output decline and, consequently, much delayed shift from transformational recession to transformational recovery. Again, the mainstream argument, just as in Poland’s case, glosses over the same issue: who is to generate the recovery? To illustrate the main thrust of the reasoning of the present writer, I suggest the following counterfactual scenario. Let us assume that Russia started *successful* transition, that it pursued consistent macroeconomic policy and, in consequence, increased markedly the level of price and output stability. Also, it liberalized rapidly along the same lines as Poland did.

Would that, in accordance with the mainstream reasoning, ensure early recovery? My answer is NO! In Poland state enterprises’ output declined for six years in row, since 1990 until 1995. At the same time the net contribution of privatized enterprises to output has been low and most of that time negative.

The mainstream explanations on Poland or on Russia say *nothing* on the new entrepreneurial private sector. Therefore, they are unable to explain why

Polish GDP stopped falling in the third year of transition, while Russian GDP was falling for seven years in row, recovered slightly in 1997, and fell again the next year.

Clearly, differences between Russia and Poland must lie elsewhere. As stressed earlier in the article, it is the *i n f o r m a l r u l e s*, that is Western civilizational fundamentals, that were crucial for the success of post-communist transition. Polish case was not different. Russia's lagging performance is well exemplified by considering its relative success, that is privatization „from above”, in the light of the preceding considerations. In this author's opinion, Russia failed not only because macroeconomic stability had not been achieved early enough and the economy has not been liberalized enough. Russia failed primarily because almost *n o n e o f t h e e a r l i e r e n u m e r a t e d f u n d a m e n t a l s h a v e b e e n p r e s e n t* there. And it is these fundamentals that underpin transition's success or failure.

Without fundamentals, to which we should add the clear-cut perception of irreversible political change, the level of risk associated with entrepreneurship has been in Russia extremely high. The foregoing affected both privatization „from above” (few outsiders were ready to take over Russian insiders-managed firms) and privatization „from below” (high risk as deterrent to private entrepreneurship). The level of entrepreneurship, as evidenced by almost any indicator has been very low, relative to transition leaders.

Compared to Poland, where the fundamentals may be regarded as being, more or less, present (or at a minimum significantly stronger than in Russia), the level of Russian entrepreneurship is *d r a s t i c a l l y* lower. The rough measure of the number of entrepreneurs per 1000 inhabitants in late 1990s, presented for a number of transition economies in Table 2, reveals the ratio for Russia to be almost *t e n t i m e s l o w e r* than that for Poland.

The stronger impact of civilizational determinants on performance may also help us in explaining why certain specific rules, or sometimes even general rules, are found in transition laggard countries. For example, a Djankov *et al.* [2000] study on the barriers of entry shows some laggards superior to leaders with respect to some barriers. But these partial advantages are unable to change the aggregate outcomes.

For example, Polish, Czech, or Hungarian entrepreneurs complain about high taxes and onerous regulations. And rightly so, since barriers in these respects are much stronger than those of entrepreneurs from the continental E.U. countries, to say nothing about the Anglo-Saxons and Scandinavians. But given the more supportive fundamentals and steadier progress in general rules of stabilization, liberalization, and privatization „from above”, they perform much better even under some more intrusive specific regulations. The case such as the pre-electoral imprisonments of Russian tycoons of known political preferences different from those of President Putin and his post-KGB clique are simply unheard of in transition leaders catching up with Western standards.

### **In Place of Conclusions**

The main aim of this paper has been to stress the need of a broader, more encompassing view on the success or failure, on catching-up or falling behind, among transition countries. Their ability to catch up with the standards of performance and to reduce the economic distance to the Western economies (measured by GNP *per capita*) has been dependent not only on the formal rules, both general and specific, but also - in fact primarily! – on the informal rules. The existence or non-existence of certain Western civilizational fundamentals, carried over from the distant past, has been decisive for falling into the group of transition leaders or transition laggards. The past casts, then, a very long shadow. Processes of catching up with standards and/or wealth levels may last much longer than expected earlier if the fundamentals in questions are weak or have to be built up from scratch.

Three additional comments seem to be in order. First, the dominant role of civilizational fundamentals should not absolve policy makers from not doing their job. That is from lowering taxes, simplifying or eliminating burdensome regulations, reducing corruption, and generally minimizing the burden of doing business by economic agents.

Second, this author believes that the civic and economic liberties, as well as political ones, are not forever limited to a certain subset of countries privileged by history. It is not impossible to establish free market economies, for example, on the other side of the „faultline” between Western and Eastern

Christendom. It will, to repeat, take more, in many cases much more time than in countries, where the room for individual initiative, innovation, and entrepreneurship has been so much greater for centuries.

And, third, being a transition laggard need not mean that the transition country is still a communist one, with a superficially reformed centrally administered economy, and a new dictator, instead of a communist party secretary at the top (in certain cases it may be one and the same person). Some post-communist countries fit the foregoing definition, but fortunately only a few. As for the rest, they are simply very high transaction cost economies, on a long, bumpy, zigzagging road to political, civic, and economic liberties.

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## Tables

Table 1

Ratio of Respective Growth Rates  
Of Gross Fixed Capital Investment and GDP  
During 30 Years Period (1950-1979)  
In Selected Economies

Communist Planned Economies	Ratio	Capitalist Market Economies	Ratio
Bulgaria	2.04	Canada	0.95
Czechoslovakia	1.66	Finland	1.01
East Germany	2.26	Greece	1.15
Hungary	2.43	Italy	0.97
Poland	2.35	Netherlands	1.11
Romania	1.95	Sweden	1.13
Soviet Union	1.62	Germany (FRG)	1.17
Average (unweighted)	2.04	Average (unweighted)	1.07

Source: Pryor [1985].

Table 2

Entrepreneurial Density in Selected Transition Economies  
(Measured by a number of entrepreneurs  
per 1000 inhabitants)

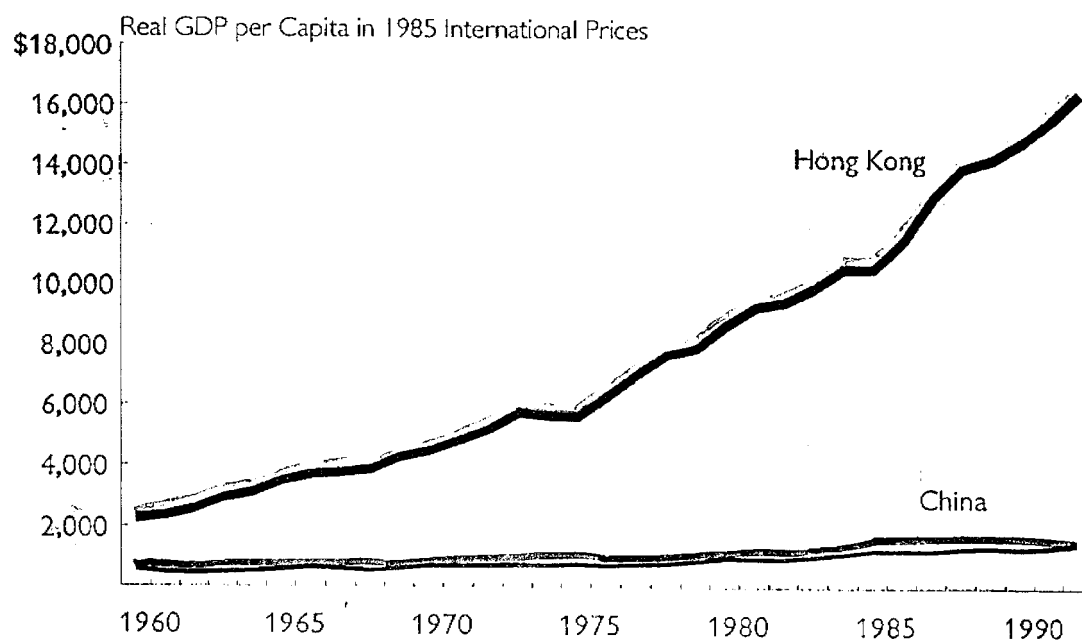
Country	Year	Ratio
Czech Republic	1998	139
Hungary	1998	64
Poland	1998	59
Slovakia	1998	56
Slovenia	1998	32
Romania	1998	15
Russia	1996	6

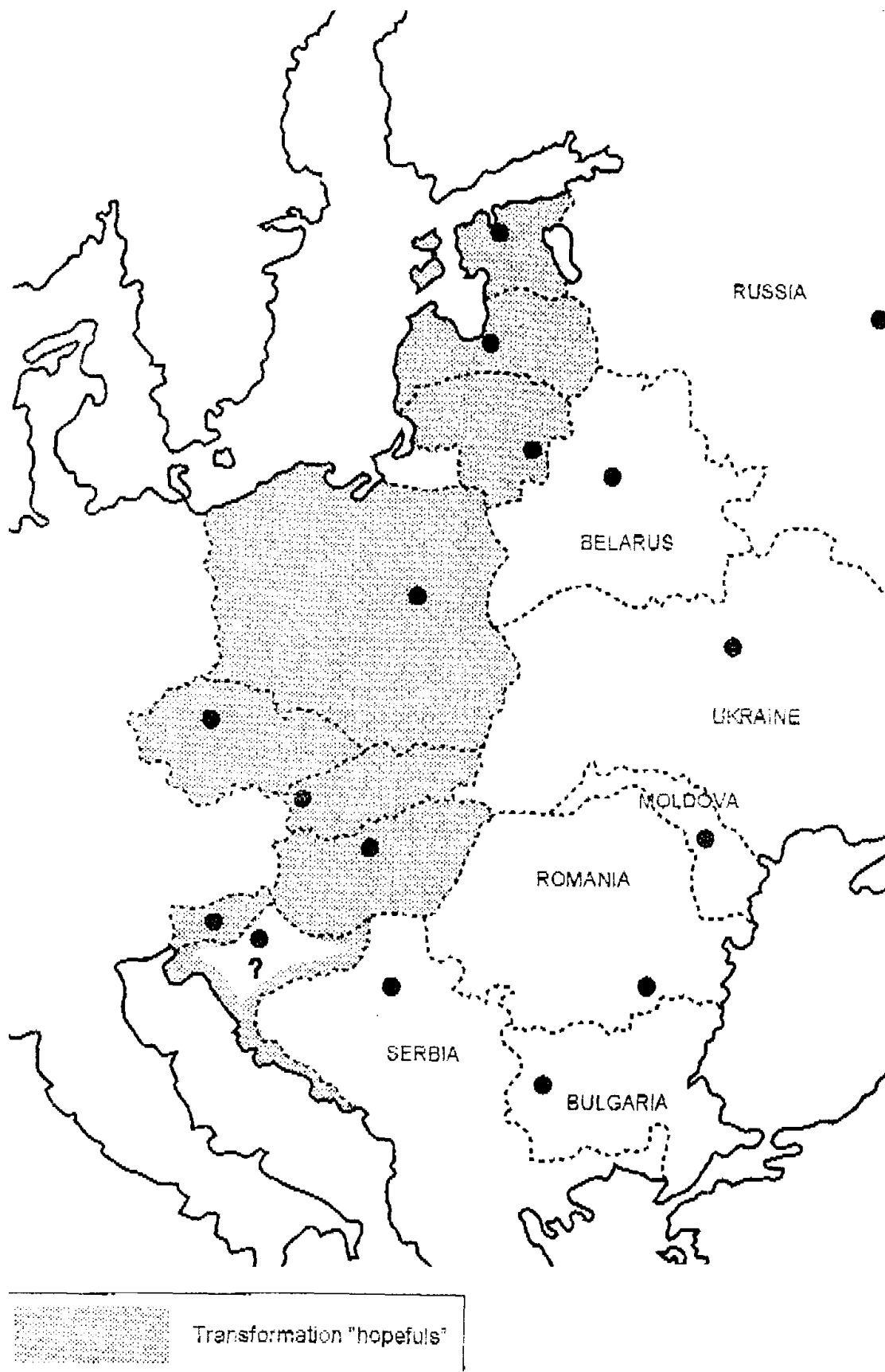
*NOTE: Other estimates show different values of the density coefficient. But they do not undermine the major difference in the order of magnitude between leaders and laggards.*

Sources: Winiecki [2000b]

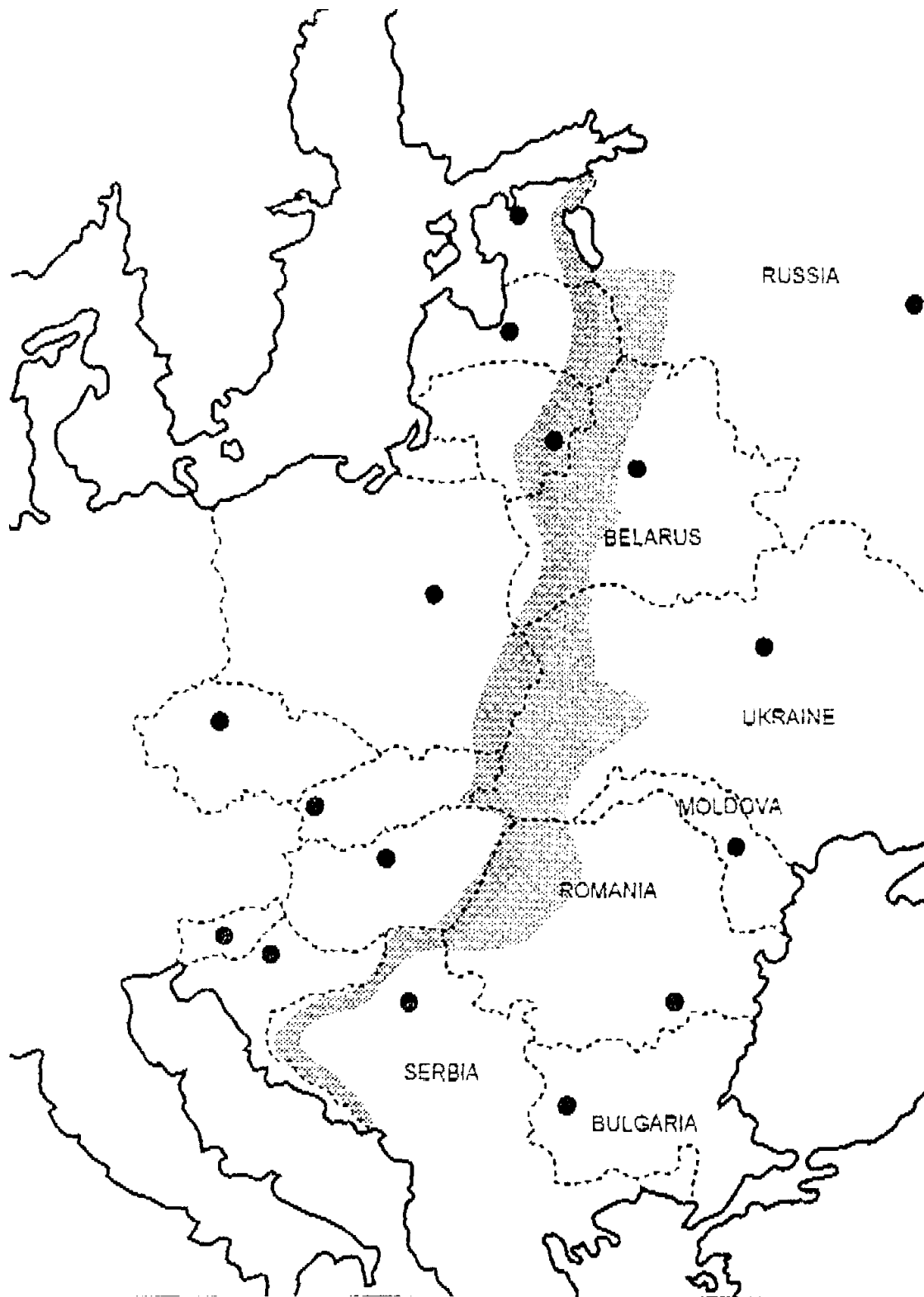
## Figures

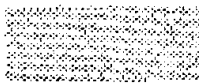
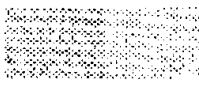
### Real GDP per Capita in China and Hong Kong, 1960–1992





**East-Central European & East European  
transforming economies**



	Eastern borders of Western Christendom (XVI century)
	Territories with mixed population (Western and Eastern rites)