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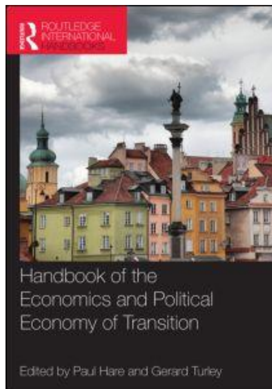

Handbook of the Economics and Political Economy of Transition

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Institutions In Transition

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INSTITUTIONS IN TRANSITION[1]

Paul Hare

Introduction

In the early years of transition – after 1989 for Central and Eastern Europe (CEE), after 1991 for the former Soviet Union – reformers in the new governments, as well as their external advisors, commonly advocated a 'standard reform package' that consisted of the following elements: (a) macroeconomic stabilization; (b) price and trade liberalization; (c) privatization and enterprise restructuring; and (d) institutional reforms. In this contribution I shall focus entirely on the last element of the package, *institutions*. It has always seemed to me that the institutional aspect of reform programmes aiming to build well-functioning market-type economies from the ruins of central planning was both very important and difficult to get right.

However, in practice its importance was often underestimated, as was the sheer difficulty of successfully implementing market-oriented institutional reforms and making them work well enough to deliver growth and higher living standards. An important reason for the underestimation of institutions in early transition reform programmes is, sadly, that in our economics courses – at all levels and in much of the world – we teach next to nothing about institutions. Consider the simplest possible *supply and demand model* as an illustration of what we normally take for granted:

- At the start of a transaction, the seller has ownership in the product being sold, say a consignment of small electric motors, for the sake of specificity.
- The transaction is essentially a transfer of ownership from seller to buyer, against payment of an agreed price, or the prevailing market price.
- At each stage of the transaction, the relevant ownership rights are protected.
- We assume buyer and seller to be honest and not to seek to cheat – to ensure this there might be some enforcement mechanism in the background (police, courts, legal system, etc.).
- The seller is expected to offer some guarantees of product quality and other technical characteristics – this might need inspection and verification services.
- The buyer is expected to pay using a valid means of payment, if need be supported by credit, and receipt of full payment might need to be verified.
- Because enforcement and verification are always costly, transactions are always facilitated (and are cheaper) if there is a high degree of trust between buyer and seller.

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Normally when we discuss markets, we just assume, if we think about it at all, that these types of institutional arrangements, are in place and functioning 'normally'. However, we don't often tend to discuss or analyse how they arose, and what makes them work (some discussion can be found in Hare, 2010).

In what follows, I start with some definitions and concepts, simply to clarify what it is we have in mind when we talk about economic institutions and the political economy of transition. Much discussion of the area is characterized by ambiguity and confusion, and while there are many partial theories of institutions covering specific cases, we still lack an all encompassing theory. The institutions important for transition are introduced next, this discussion helping to make clear the critical distinction between institutions *per se*, and the concrete organizational and legal forms through which they are implemented in particular country settings. For those transition economies that have already joined, or wish to join the EU, this includes some remarks on the *acquis communautaire*. I then review a range of empirical evidence on the role of institutions in facilitating transition and fostering post-socialist economic growth, finding support for the rule of law, secure property rights (ownership and business contracts) and liberal trade. Finally, the concluding section outlines what transition has taught us about the roles of institutions in economic life, and highlights some important unsettled issues, including the problem of embedding new institutions in different cultural settings. (For a broader discussion of institutions, not confined to the economies in transition, see World Bank, 2001.)

Definitions and concepts

Institutions are the relatively stable *social arrangements* in a given society that govern how people behave in a variety of circumstances. They can be formal or informal, state led or private, and embody diverse rules, norms and conventions. In economic life, we generally expect well-functioning institutions to possess the following properties:

- They regulate economic behaviour in ways that often conflict with the short-term preferences of economic agents – be they households, firms or agencies of government.
- They are based on shared expectations and meanings, often drawing on customs and legal provisions that establish trust.
- They are often most usefully thought of as 'repeated games' where most types of interaction are expected to occur many times (this strengthens incentives to follow the 'rules of the game' in many situations).

These features imply that institutions are rather like public goods. Hence the 'supply of institutions' generated by the market mechanism left to itself might not correspond with social efficiency. By 'supply' in this context, we mean both the question whether a given institution or type of institution would be created at all by the market, and more detailed issues such as the scale and coverage of the institution concerned. For instance, wealthy people might well provide themselves with services to protect their property rights, but such services might not extend to the poor (indeed, in the worst case, the property rights of the poor might be neither recognized nor protected).

There is evidently a potential role for the state both in creating institutions which the market does not provide and in regulating in the public interest those which it does. On the other hand, in considering the state we should not assume it to be an inherently beneficent agent, in some sense external to 'the economy' *per se.* What turns out to be critical for successful growth is a state that is effective and competent within its acknowledged spheres of authority, but whose discretion and power are subject to effective institutional constraints.

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In thinking about the institutions relevant for economic outcomes, several levels are important. The first is that of *social norms or customs*, which certainly includes the following three aspects:

- Honesty in performing agreed economic transactions or tasks.
- Trust between economic agents.
- Confidence about third-party economic behaviour (incl. behaviour by the state and its agencies).

The second concerns *assets and the rights associated with them*, such as:

- Property and the protection of property rights.
- Business forms (e.g. limited liability firm, co-operative, etc.) and their protection.
- Business contracts, the associated rights and responsibilities, and their protection.
- Freedom to initiate and conduct business, with limitations on state regulation at start-up, freedom from fears of expropriation (especially) in the event of success.

These merge into the third level, comprising the *actual institutional forms* established to protect various rights, limit state behaviour, etc. This includes diverse types of formal constraint on state intervention into the economy (via constitutional provisions, judicial review, appeals to higher courts, or other mechanisms).

To sum up, the institutional framework for a market economy ideally has to serve three key functions, namely: (a) protection of property rights; (b) facilitation of transactions; and (c) supporting economically/socially efficient collective action. The next section makes these general remarks about institutions rather more concrete in the context of transition.

Building a market economy – institutions for transition

In the transition economies, the first task for most of the new governments was to dismantle the institutional infrastructure associated with central planning. In discussions of transition, this key step is commonly overlooked, probably because it was entirely taken for granted. However, it involved two elements, both very important. First, the long-established *rules of the game* associated with central planning simply ceased[2] – so enterprises, for the most part, no longer received plan targets for their output, nor centrally determined supplies of inputs, nor instructions concerning what output to deliver to whom.[3] This was an amazing change, one that happened very rapidly in most countries, leaving in its wake an enormous institutional vacuum. Second, the specific *organizations* through which the central planning system functioned – central planning office, supplies office, and the like – were either closed down quite rapidly, or were assigned new tasks more in keeping with the needs of economic administration in the evolving market economies (e.g. with price liberalization, some price control offices became competition policy offices).

As for the institutional vacuum itself, how was that filled? Mostly, and in most countries, it was filled by deliberate decisions taken by the new post-communist governments, setting up new agencies, passing new laws, cancelling much of the former restrictive legislation that banned nearly all private sector economic activity. However, because of the complexity and urgency of the task, huge gaps were often left unfilled. It was often assumed, and foreign advisors were sometimes complicit in this, that where necessary the private sector – vaguely defined and poorly understood as it then was – would somehow step in to fill whatever institutional gaps might remain. However, the resulting private sector 'solutions' are not always very pleasant or socially desirable, and can be accompanied by threats, intimidation, serious levels of violence

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and large-scale theft of both public and (already) private assets.[4] A major reason for the importance of institution building for a market economy, I would argue, is to protect society against such very nasty outcomes.

That said, what do we expect the *institutional matrix* for a market-type economy to look like, what are its most important elements? (the idea of such a matrix has been discussed by North, 2010). In terms of our earlier discussion, we need to think of this at three levels: (a) customs and norms of behaviour; (b) assets and associated rights; and (c) specific institutional forms, as well as in relation to the three key economic functions that our institutions serve. In addition, it is vital to keep in mind the political dimension of the needed institutions. Table 2.1 illustrates all this.

Table 2.1 is quite complicated, of course, as it needs to be. Much of it speaks for itself, which is fortunate as we lack the space to discuss it in full. However, a few important points are worth bringing out before we move on.

- Much of what is in the table is about market economy institutions and practices that were absent or severely attenuated under central planning. Hence it is perhaps not so surprising that they did not spring to life instantly once central planning ended. A great deal of deliberate institutional design, with associated implementing legislation, was needed.
- Most items in the right-hand column of the table include an informal component, many of which emphasize the roles of trust, confidence, reputation, ethical behaviour, and the like. For a modern economy to function, these are vital aspects of the institutional matrix, the 'culture'. Formal institutions like police and courts will always be needed, but the less they have to be invoked to enforce transactions and protect property rights, the more smoothly the economy functions. The importance of this aspect of building the right 'culture' for a market economy was both underestimated and often poorly done in the transition economies.
- It will be seen that what market economies require, in order to function well, is a mix of *institutions* in the sense of laws, rules, practices, customs, etc, and *organizations* through which the rules are put into effect, e.g. tax office, central bank, competition office, etc.
- What I consider the two most important elements of institution building for a market economy, two that are often neglected by economists (especially those residing in the already developed countries), are in bold italics in the table: strong and effective government and the rule of law.
- ***Building strong government*** after the demise of central planning was easier for those countries that had started reforming early, and that had a history of independent statehood, e.g. Hungary, Poland, Slovenia, among others. It was far harder for the small states of south-eastern Europe that emerged from the disintegration of Yugoslavia and the Balkan Wars of the early 1990s; and for the republics of the former Soviet Union. They were embarking on state building, largely from scratch. They had limited experience of independent government, low administrative capacity and lacked many important institutions, e.g. currency and central bank; banks capable of handling international trade; familiarity with modern forms of taxation; social safety net and labour market institutions; legal and administrative framework for conducting private business, etc. Since strong governments can operate foolish policies, it is important to add that while they are necessary for successful transition, they provide no guarantee of long-term success.
- The ***rule of law*** is a critical element in the transition, widely misunderstood (see Bingham, 2011, and Dam, 2006). It not only entails private individuals and businesses being subject to the law, but also public agencies, public enterprises and the government itself. In a largely rule-based society, no one can be above the law. For the economy, its importance lies in the view that successful firms, earning decent profits, need to be secure against the risk of expropriation or theft by other firms and individuals, or, most importantly, by a greedy and

Table 2.1 Institutional matrix for a market economy

Group of Institutions	*Purpose*	*Examples*	*Regulation – formal* *Informal*
Property rights	Establish rights: decide between competing claims; inform non-owners; police claims and exclude non-owners.	Land tenure	Land registry *Local customs*
		Housing and personal property	Property registers, insurance and recording of transactions *Informal customs and trust*
		Business premises – buildings and equipment	Property registers, insurance and recording of transactions *Customary practice*
		Intellectual property rights – R&D and inventions	Copyright, patents *Secrecy*
Facilitating transactions	Establish rules of exchange, respect for contracts; provide information; facilitate transactions when some markets are missing or incomplete; reduce or reallocate risk	Contract law and means to handle business disputes	Civil courts Arbitration panels *Informal understandings*
		Provision of markets, e.g. commodities, finance, trade networks, auctions, etc.	Regulate business practices Local authorities and trade associations *Informal regulation and trust*
		Technical standards, e.g. weights and measures, quality measures, money	Standards offices Central bank *Trust in standards and the currency*
		Market information	Media, advertising, public information agencies *Word of mouth, reputation*
		Accounting and auditing rules	Professional bodies and public regulation *Trust and reputation*
		Banking and credit	Bank regulation *Custom and practice, trust*
Supporting collective action	To facilitate large-scale private or collective action, and large business organizations Also to facilitate international engagement	Building large infrastructure projects	Planning rules, building codes, other regulation
		Limited liability and bankruptcy laws	Civil courts, company registers *Informal understandings*
		Competition policy	Office to regulate competition policy and business practices *Local conventions, trust*
		Diverse business forms to support flexibility	Partnerships, co-operatives, third-sector firms, etc. Governance regulation
		Employment protection and wages	Courts and tribunals Trades unions *Good will and trust*
		International engagement – trade, FDI, credits, etc.	Exchange rate policy Banks to manage international transactions Laws on FDI and trade Membership of IFIs *Limited role for informal methods and trust*

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Table 2.1 (continued)

Group of Institutions	*Purpose*	*Examples*	*Regulation – formal* *Informal*
Politics	Democracy, elections and parties; Checks and balances; Accountability; Establish and maintain the rule of law; Public finance.	***Strong and effective government***	**Constitution, supreme court** **Armed forces under political control** **Effective ministries and competent civil service** **Convention and trust**
		Rule of law	**Courts, incl. supreme court** **Government must be subject to law** **Confidence and trust**
		Maintaining public order and security	Police, courts; in extremis, the armed forces *General public, public moral standards, trust*
		Party political competition	Free and liberal media Protection of core human rights Restrictions on lobbying and 'buying' influence *Trust in political system*
		Corruption	Institutions to make public officials and politicians accountable to parliament and the public Stiff penalties and exclusion from office for offenders. *High standards of private morality, a 'culture' of honesty*
		Public spending and taxation: (a) goods and services; (b) transfers; (c) taxes and other revenues; (d) debt and debt servicing.	Parliament, cabinet and ministries to set priorities, manage and administer spending, and collect revenues. Central Bank, Treasury (ministry of finance) and debt management agency to deal with debt. *Public trust in fair taxes and efficient spending*

opportunistic state authority. Rich individuals, too, need to be free from fear of arbitrary imposts on their wealth. Tax rules are fine, and should apply to all, but someone suddenly wealthy should not face extra taxes on that account, outside the established legal framework, unless a case can be made and proved in court that the wealth in question consists of ill-gotten gains. Normally, we think of the rule of law in formal terms, but to some degree, as in China, it can work through informal understandings, a tacit agreement between people and state that making money is legitimate and protected.

Significantly, the aim of reformers was not only to have the transition economies function as 'normal' market economies, drawing on the sort of institutional framework just discussed, but it was widely hoped and expected that they would enjoy rapid economic growth, improvements in living standards and hence catch up with the more advanced countries. This has turned out to be harder to assure, for reasons that are discussed a little further in the final section.

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By now, economists know a good deal about the requirements of sustained economic growth[5] (CGD, 2008), and this is normally thought of in terms of achieving high rates of capital formation (investing 25 per cent or more of the GDP), mostly invested in productive projects (rather than presidential palaces), having a sound macroeconomic framework (including a decent banking system), an open economy and having a pro-business political system. In addition, one has to think about the microeconomics of growth, in other words what goes on at the level of individual firms. Under socialism, this could scarcely have been duller, since established firms were not permitted to fail (i.e. there was no provision for bankruptcy), new firms could only commence with ministerial approval, as part of the prevailing plan. The consequence was an incredibly static business landscape with astonishingly few firms, of an average size (e.g. in terms of employment) over 10 times what one would expect in a normally functioning market-type economy. This turned out not to be conducive to innovation, and undoubtedly contributed to the lagging performance of the socialist countries in their final decade or two under communism. At enterprise level, therefore, the *desiderata* for successful economic growth are rather straightforward to summarize:

- Easy entry of new firms, few constraints and little regulation.
- Most new firms will fail quite rapidly, others will grow to become the successes of the future. Credit and well functioning financial markets are needed to support growth where it is profitable.
- The privatization of most state-owned firms in an orderly fashion, in a way that supports future production and employment where possible.[6]
- Easy exit of failing firms, requiring hard budget constraints, and quick and easy bankruptcy so that assets can be used productively elsewhere.

It is often thought that having an economy in which lots of firms fail must be inefficient, but exactly the opposite is the case. The point is that a well-functioning market economy offers lots of highly diverse opportunities for making a profitable business, but *ex ante*, no one can possibly know which will succeed and which not. Thus we need lots of start ups simply in order to allow some to succeed. Otherwise the *information problem* is completely overwhelming. Reflecting these remarks, the early transition years saw massive increases in the numbers of registered businesses (albeit with significant cross-country differences), from a few thousand under socialism, to many hundreds of thousands within two or three years. Within less than a decade, the size distribution of firms in most countries looked increasingly like that of an established market-type economy.[7]

What we have outlined above amounts to a complicated set of institutional requirements or *desiderata*, and one might think that a good approach would be to 'pick and choose', or even 'mix and match'. The former means looking at the list of what institutions a market economy typically possesses, and picking a few to implement, perhaps because they are measures deemed politically acceptable and feasible at the time. Some countries did operate this way for a while, and soon discovered that a well-functioning market economy actually needs an institutional structure whose components hang together in a moderately consistent way. So implementing a few bits and pieces just won't do. Likewise, with the 'mix and match' approach, which takes (i.e. copies) company law from France (say), competition policy from Germany or the EU, privatization policy from the UK, and so on. This, too, does not tend to add up to a coherent institutional framework.

At the other extreme is the comprehensive, ready-made institutional framework implicit in the EU *acquis communautaire*. The *acquis* is the set of rules and regulations to which all EU member states have to sign up and incorporate into their respective domestic legislation; it is variously estimated to run to between 80,000 and 100,000 pages (yes, really!), so even translating it

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(correctly) into the different community languages must be a logistical and technical nightmare. The *acquis* is split into 30 or so chapters, and covers virtually everything one could think of that concerns running the economy, including also provisions to do with social policy, the political system and the judiciary. Those transition economies that set their sights on EU membership knew that they had to adopt the *acquis* in full, this being one of the key Copenhagen criteria for accession. These countries therefore started to adopt and implement this complex EU framework, in some cases years before formal accession negotiations even got under way.

Without the incentive provided by the prospect of EU accession, I doubt whether many transition economies would have adopted the *acquis* in its entirety, nor indeed would I have advised them to do so. For the *acquis* has evolved to suit relatively prosperous countries with large welfare states, and countries that typically grow fairly slowly. For poorer countries with limited market experience and probably weak administrative capacity, and also wanting to grow fast and catch up, a rather more focused subset of the *acquis* would have made more sense, dealing with the investment climate, free trade, single market issues, competition policy, and the like.

Empirical evidence

Here we review some of the empirical evidence that has been explored to assess the impact of institutions on transition to the market, on recovery from the post-socialist recessions and on longer term growth. The first serious attempts to investigate econometrically the performance of transition economies were associated with the names of Fischer, Sahay and Végh (1996a, b, 1997), abbreviated to FSV below. FSV (1996a) performed a regression on a set of 20 transition economies using data for the years 1992–94 (some countries could not be included owing to data limitations), which examined the impact of macroeconomic stabilization and early reforms on growth. A second equation looked at more conventional determinants of growth that were postulated to come into play once a country was well down the transition path.

The first regression showed the decisive role of high inflation and fiscal deficits in producing deep recession at the start of transition. Conversely, in countries that stabilized rapidly, the importance of early market-oriented – and largely institutional – reforms in kick starting the growth process was evident. After a time, the second equation should be the more relevant one, with institutional changes no longer highlighted. Thus, in the medium and longer term, the message for transition economies wishing to grow rapidly was utterly clear, namely that they must devise policies to raise their rates of investment and then maintain investment at high levels. As FSV (1997) shows, with an investment ratio of 20 per cent it would take transition economies an average of 45 years to catch up to current average OECD per capita income levels, while if investment could be raised to 30 per cent of GDP, the average catch up time would fall to 30 years, just one generation. None of the transition economies of the former Soviet bloc (CEE plus FSU), however, is investing enough to catch up very rapidly.

A few years later, a comprehensive study of the links between institutional change and economic performance was provided by Havrylyshyn and van Rooden (2003). This paper started by explaining the GDP growth of transition economies in terms of three sets of variables: (i) current inflation, INFL, taken to indicate the effectiveness of stabilization; (ii) current and lagged indicators of structural reforms; and (iii) two indicators of initial conditions, one reflecting macroeconomic distortions, the other reflecting the distortions associated with socialism before 1989/91. The empirical work was based on data for 25 countries over the period 1991–98 (with a few missing observations due to incomplete data). The basic regressions found a highly significant impact of the stabilization variable as well as the structural reform indicator, with initial conditions significant but rather less important in explaining GDP growth.

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The authors distinguished between what they called *structural reforms* which could be measured by some of the European Bank for Reconstruction and Development's (EBRD) transition indicators to do with price liberalization, trade and exchange rates, banking and financial market reforms, private sector growth, and the like; and measures of *institutional reform*, which they took to be about the basic legal and political framework of the society concerned. The latter they measured using the EBRD's indicators of legal reforms (coverage and effectiveness of legal aspects of business), and measures of the extent of political liberalization. Including such indicators in their original regressions simply as additional variables confirmed that institutional reform was important for growth, but it was overwhelmingly dominated by structural reforms.

Falcetti *et al.* (2006) reviewed and updated estimates of the impact of reforms on growth in the transition economies and also looked for feedbacks in the other direction – growth in one period encouraging further reform in the next. Both types of effect were found, and were also found to be robust to alternative specifications. Not surprisingly, the impact of initial conditions (such as number of years under communist rule) declines over time, and the effects of other factors such as oil prices, growth in principal trading partners, and so on, were generally small or insignificant.

More recently, Commander and Nikoloski (2010) carried out a very careful study to test various hypotheses about institutions and performance. They examined three levels: (a) whether the political system affects economic performance; (b) whether the business and investment environment affects country economic performance; and (c) whether perceived business constraints affect firm performance. In all three cases, their regressions, mostly using data covering much of the world, not merely the economies in transition, found very weak effects. The authors considered why this might be the case, given the prevailing orthodoxy regarding the role of institutions, and concluded that there might well be a mix of data issues and model specification issues underlying the findings. For the transition economies, however, the evidence for a positive impact of institutions is generally clearer and stronger, as noted above, presumably reflecting the fact that institutional change has been at the heart of the whole transition 'project'.

Conclusions and unsettled issues

To conclude, I shall highlight some aspects of institutional change in the transition economies that remain puzzling, or that suggest the need for further research and better models of institutional change.

Institutional change is necessary but not sufficient for sustained growth

The market-type institutional changes discussed above are thought to be necessary for growth because they are conducive to economic flexibility, adaptability and innovation, factors important for continued growth in already high-income economies. However, in poorer countries, far from the technology frontier, there is much scope for growth even when the institutions are much less well developed. Even with apparently 'good' underlying institutions, growth is not guaranteed to occur without sound macroeconomic policy, adequate rates of productive investment, competent (and growth oriented) political leadership, and a good deal of sheer luck.

Formal institutions, informal institutions and culture (East Germany)

When East Germany was formally reunited with West Germany in October 1990, the institutions of the West – including the entire *acquis communautaire* of the EU – were more or less instantly transposed into the East. With such 'good' institutions in place, many observers expected

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the East soon to flourish, but it has not, or at least not yet. Two levels of explanation have been advanced for this. According to the first, some of the decisions made around the time of reunification, such as how to convert East German money balances and wage rates, were simply 'wrong' in macroeconomic terms, as East German productivity was far lower than had been estimated. According to the second, informal institutions to do with working practices, and the Eastern 'culture' stemming from several decades under communism (including the loss of several decades of market-economy experience), meant that the new institutions transplanted from the West could not work as expected (Carlin, 2011, and this volume).

Formal and informal institutions, and growth (China)

Some countries, notably China, have done astonishingly well despite appearing to have rather 'poor' institutions to support markets, private property, contracts, and the like. In part this reflects our still imperfect understanding of institutions, our lack of a really good theoretical framework to help us think about and analyse them. In part, however, it points to the importance of informal institutions, understanding, trust and confidence in facilitating economic activity. Especially in the early years, for instance, the development of township and village enterprises (the TVEs) in China worked so well because there was a tacit understanding at all levels that economic development was the name of the game – so anyone with a business idea that could make money (and hence pay taxes to the local authority) was to be encouraged, and it was understood that people would be allowed to get rich without fear of expropriation. No laws or formal framework supported this. However, China had suffered the horrors of the Great Leap Forward (with accompanying famine) and the Cultural Revolution, so by the mid- to late 1970s the whole country was ready for economic pragmatism and an end to political/ideological campaigns.

External anchors for institutional change (e.g. EU and WTO)

Many countries have found external anchors helpful in pushing forward reforms; for instance, countries seeking EU membership promoted many domestic reforms because they formed part of the *acquis* and so 'had to be done'. Likewise, countries joining the WTO sign up to a lengthy and complex *accession protocol* that not only requires measures to do with trade (e.g. tariff reductions and the like) but often also requires reforms to many areas of domestic economic policy and institutional arrangements. Perhaps surprisingly, countries – especially the larger and more 'visible' ones, like China – are often quite diligent in implementing the provisions of their *accession protocol*. I would expect Russia, whose admission to the WTO was approved in late 2011 (and was ratified during 2012), to take the provisions in its own *protocol* equally seriously. In this sense, we do indeed live in an increasingly rule-based world economy.

The forms and practice of democracy (e.g. Hungary and Russia)

Having the 'right' institutions in place is no guarantee that they will work as one might like them to, because countries have distinct histories, traditions and cultures. These affect both the functioning of their economies, as well as their political life. Hungary and Russia are interesting, and rather worrying examples of this remark.

Hungary, for instance, was required to establish a 'functioning democracy' as part of the Copenhagen criteria for EU entry, and in any case its last communist government had also sought to bequeath a democratically functioning state to its successors. But the two socialist governments of the past decade were beset by scandals and corruption, paving the way for a

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Fidesz victory in the 2010 polls – but with just 53 per cent of the vote, Fidesz secured a more than two-thirds majority in the parliament. The Fidesz government has since been able – and has chosen – to pass laws restricting press freedom, changing the constitution to constrain the judiciary and the Constitutional Court, and introducing a new constitution from January 2012. The European Commission has warned Hungary that its proposed new constitutional framework breaches EU law, and that the country's democratic credentials are being steadily eroded. Hence the stability of new and fragile democratic institutions cannot be taken for granted, it seems.

Russia, too, has the forms of democracy, but with major constraints on their proper functioning. These constraints come from two directions. One is the economic, through the economic power and political influence of the so-called 'oligarchs', the magnates owning and controlling Russia's most valuable productive assets. The other is political, through a variety of channels: voter registration; registration and funding of political parties; ballot rigging, reportedly widespread; a poorly functioning and reportedly quite corrupt judiciary; restrictions on the media; restrictions on political protest and demonstrations; and tendencies towards a Putin 'personality cult'. Despite these serious imperfections, Russian democracy remains far ahead of the single-party state that prevailed until 1991, and may yet advance further in a positive direction. The point, however, is that democracy is not just about the institutional forms, but about their practical functioning.

Notes

1 I am grateful to my co-editor for helpful comments on an earlier draft of this contribution. Remaining errors are my own.
2 Some countries, such as Hungary and Poland, had already moved away from central planning towards a greater role for markets long before the start of transition. They were therefore arguably better prepared for the changes to come, though in the event, a country that had hardly reformed at all, Czechoslovakia, proved able to introduce market-type reforms impressively rapidly.
3 I recall visiting firms in Russia in late 1990, a year before the disintegration of the Soviet Union. Some firms were clearly thinking already about 'life after central planning' and were re-thinking what they produced, seeking new suppliers and markets, and so on. Others seemed to be stuck in limbo. They had not yet received their plans for 1991, and stated that they could do nothing or decide nothing until these plans had been delivered; these firms were not at all ready for the central planning system to collapse.
4 An example of this is Russia's failure to establish adequate formal mechanisms in the early 1990s to facilitate the settlement of private business disputes – some form of commercial court might have sufficed, or agreed arbitration arrangements. Lacking such mechanisms, many disputes were settled violently, and at times businessmen in dispute were shot. As stated in the main text, private sector solutions need not be especially desirable.
5 We also know a great deal about how to ruin an economy. The recent and current examples of Zimbabwe and North Korea, and also Somalia, come to mind, three countries whose natural endowments and human resources could generate much higher living standards than they currently enjoy.
6 Other contributions deal with privatization in some detail. Some of the early stages of privatization in many countries were quite chaotic and uncontrolled, with many transfers of ownership that were little better than outright theft of state property. Moreover, a common, rather naive, assumption at the start was that new owners would always run the newly privatized firms as 'going concerns', whereas they quite often ran them into the ground, stealing assets and revenues through shell companies and the like. Luckily, many firms were run much better.
7 Yet many transition countries still underestimate the critical importance of this change to the business landscape. For instance, in several countries where I have worked recently, officials have emphasized how much their general business environment has improved. They are right, with reference to their own fairly recent past; but in comparison with well performing market economies elsewhere, they still have a long way to go. One simple statistic sums this up, namely the number of registered businesses per 1,000 of population: in long-established market economies this can be around 50, while the countries I just had in mind only had between 10 and 20.

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