Informal institutions, social capital 
and economic transition: 
reflections on a neglected dimension

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INTRODUCTION

Few issues in economics have experienced such a grandiose revival as the role of institutions in economic development. The institutional tradition may be traced back to the writings of Thorstein Veblen in the United States at the end of the nineteenth century and to the German Historical School represented by authors such as Schmoller. The role of institutions was also recognised in the early writings of development economists (Hirschman, 1970). However, it took North’s (1990) formulation for the role of transaction costs, imperfect information and a variety of resulting sociocultural constraints to be fully integrated into the analytical framework of mainstream economics.

One of the most promising terrains for an application of institutional economics is provided by the current transition process in central and eastern Europe and parts of Central and East Asia. What distinguishes the reforms implemented in all of these countries from earlier stabilisation and structural adjustment policies in developing countries is their systemic character, aiming to change not only relative prices but the entire set of economic, legal and social incentive structures governing human economic behaviour (for an early recognition of this task and a rebuttal of partial reforms on that basis, see Kornai, 1980; similar ideas are expressed in Balcerowicz, 1995). The directors of this project have thus correctly noted that “the success of the overall reform effort depends to a considerable extent on the existence of adequate institutions ...” (Cornia and Popov, 1996, p. 10). One might go further and state that what transition is all about is a redesign of the institutional framework of formerly centrally planned economies. A transition theory therefore will necessarily be a theory of institutional change.

This paper focuses on one particular subset of institutional change, namely the role of informal institutions in economic transition. In what follows, I will adopt North’s definition of institutions as “humanly devised constraints that structure political and social interaction” (North, 1991, p. 97), or more specifically economic exchange. Informal institutions may then be understood as the collection of social norms, conventions and moral values that constrain individuals and organisations in pursuit of their goals. The distinctions between individual goals and informal institutions as constraints on the realisation of such goals may seem arbitrary. Indeed, psychologists and sociologists often argue that individual goals and the social environment in which they are formulated cannot be analytically separated. For Elster (1989, p. 103), for instance, “social norms ... are emotional and behavioural propensities” and Adams and Neal (1993) consider institutions as “sets of opportunities” rather than as a set of constraints. North’s definition is retained here because it highlights the conceptual similarity of informal and formal institutions and their joint role in reducing transaction costs and facilitating economic exchange. At a practical level, whether informal institutions are considered to be constraints or parts of a society’s opportunity set is probably less important than the recognition that informal institutions fundamentally influence human behaviour while not being directly amenable to policy. Any process of rapid formal institutional change such as currently observed in the transition economies must contend with the legacy of an inherited set of informal institutions that may or may not be efficient under a changing economic and social environment.

1 The same argument is often attributed also to the “old institutionalists” who question the rationality assumption underlying neo-classical economics (for an application in the context of Africa's development see Stein, 1993). The methodological debate is reviewed in the collection of essays edited by Maski et al. (1993).
The first part of this paper will focus on the interrelationship between informal institutions and economic development. Section 1.1 looks at how informal institutions constrain economic choice. It argues that informal institutions are a particularly powerful set of constraints as they become internalised by economic actors and hence typically need no third-party enforcement. Hence, informal institutions are an important complement to formal rules in reducing the costs of enforcement. While there is a tendency for some informal institutions, such as social monitoring through reputational mechanisms, to be replaced by formal rules as the division of labour becomes more complex, informal institutions continue to exert a strong impact on institutional performance. Section 1.2 asks whether an efficient set of informal institutions will naturally evolve as economic development proceeds. Platteau’s (1994) recent review of the literature on the evolution of cooperation suggests that social norms will not necessarily evolve efficiently. Several equilibria are possible, when there are both agents with and without a moral predisposition to cooperate. To the extent that such moral predispositions are historically rooted, a change in formal institutions alone may not suffice to shift a society from a “bad” to a “good”, i.e. cooperative, equilibrium. Drawing on these results, Section 1.3 develops a stylised model of the role of formal and informal institutions in socioeconomic systems. Particular attention is paid to the interface between formal and informal institutions and the potential role of government. From this, three possible strategies for institutional reform are identified and related to the patterns of institutional change observed so far in transition economies.

Part 2 applies the analytical framework set out in Part 1 to the transition economies. Section 2.1 analyses the interaction between the government and economic actors. It focuses on East Germany and China as polar cases in the implementation of institutional reforms. While East Germany imported Western-type institutions almost at one stroke, China is generally regarded as a model of evolutionary and experimental institutional change. At least for the Chinese case, there is strong evidence that informal institutions have influenced the outcome of formal institutional reforms. However, in both cases institutional reforms were also supported by an effective state. Section 2.2 turns to institutional change in transition economies in the context of a weak state. It is shown how, in the case of Russia and Ukraine, the combination of existing organisational networks, a legacy of corruption in the state sector and the breakdown of government authority has led to the emergence of the Mafia and a so far largely predatory state. On the other hand, a rapid political change such as in Poland offers the scope for rebuilding trust in government institutions, thus fostering the dynamic efficiency of the newly emerging political economic equilibrium. Section 2.3 extends this reasoning by reviewing survey evidence on the trustworthiness and credibility of east European governments. Their determinants and effects on economic performance are also analysed, drawing partly on cross-country evidence from other parts of the world. The influence of informal institutions on actual policy outcomes in the area of institutional reforms is finally analysed in the case of privatisation (Section 2.4). It is shown how the existence of implicit property rights in state-owned enterprises may influence what privatisation method is politically acceptable and hence feasible. It should be noted that all this evidence is extremely thin and as yet preliminary. However, I hope the issues raised in this paper will stimulate further research which enhances our understanding of the impact of informal institutions on economic development and performance. Conclusions are offered in Part 3.

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2 This impact may be positive (e.g. through the accumulation of “social capital”, as in Putnam, 1993; Coleman, 1988) or negative (for examples, see Elster, 1989).
1 INFORMAL INSTITUTIONS: BRINGING ECONOMICS BACK INTO THE SOCIAL SCIENCES

1.1 INFORMAL INSTITUTIONS AND ECONOMIC DEVELOPMENT

What are informal institutions?

Driving a car in Rome can be a very different experience from driving a car in Helsinki. This is so, although formal traffic rules do not differ greatly between the two places. However, people’s perceptions differ as to how binding these official rules are. The expectations of traffic participants, which help to coordinate their decisions whenever their paths cross at any one junction, vary from place to place. For a Finnish driver, driving in Rome must be difficult.

In some ways, what makes traffic differ between Rome and Helsinki is akin to the role of informal institutions in economic systems. Informal institutions encompass a whole array of social and moral norms that constrain individual behaviour and thereby allow the coordination of expectations in social and economic exchange. In the case of traffic, for instance, Finns expect drivers to stop at a red light, even if there is no cross traffic. Romans are less rigorous in their interpretation of formal traffic rules. Helsinki does not need a large battery of traffic police to enforce the rule that red lights signal “stop”. Any non-obedience might be sanctioned by other drivers sounding the horn or even reporting the incident. Finnish drivers have internalised the rule since long before they first attended driving lessons and passed a theoretical drivers’ test. In Italy, horns are sounded all the time, even if there is no obvious offence on the side of the other party. This weakens their effect as a sanction. Moreover, taking calculated traffic risks might be considered a proof of manhood. At the same time, Italians know each others’ propensities for fast and risky driving. The coordination of expectations prevents a total traffic chaos from emerging and relieves the police from having to invest huge resources forcing people into compliance with traffic rules.

The implicit traffic rules example above is a case of what Sudgen (1989) calls a “convention”. Conventions arise in problems of collective choice, because people generally have to make use of past experiences to coordinate their decisions. Conventions have the property that, once adopted, people are better off adhering to a convention, even if it does not guarantee the global optimum. In the traffic example, for instance, drivers would put their life in considerable danger, or at least risk not advancing in the traffic very much, by violating the convention “when in Rome, do as the Romans do”. However, it is arguable that a more cautious driving norm, such as prevalent in most Scandinavian countries, contributes to lowering the incidence of road accidents. Conventions are a special case of social norms, in that they generally lead to better (but not optimal) outcomes (Elster, 1989). The most powerful conventions are those that are useful in many social choice situations and may thus be transferred from one to the other by analogy. However, not all social norms are “useful”,

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3 Although traffic density and road and vehicle quality probably have a large role to play in determining the level of road accidents, it is nonetheless remarkable that in Sweden, Norway and Denmark, there were less than 1.5 deaths and around 35 injuries per 100 million vehicle kilometres, against 2.0 and 90 in Germany, 4.2 and 86.7 in Spain and 20 and 329 in Turkey (United Nations Statistics of Road-Traffic Accidents in Europe and North America, quoted in the Motoeuropa page on the Internet. Unfortunately data on Finland and Italy were not provided).
as Elster (1994) shows. What social norms have in common is that they are sustained by people’s desire to be socially accepted rather than deriving directly from rational self-interest. In this sense, social norms actively interfere with the “rational” pursuit of individual goals. This makes them powerful mechanisms for avoiding “prisoners’ dilemmas” in social choice.

A social norm may be distinguished from a moral norm in that it is non-consequentialist. Finnish drivers stopping at a red light are not generally judging the consequences of their action for society as a whole. There may be a higher motivational force deriving from a moral norm never to take any action that could endanger the life of an innocent third party, but I doubt that differences in moral attitudes are what sustains the wide variation in traffic behaviour observed across countries. Nonetheless, moral norms may be important in supporting social norms and, as we shall see, moral predispositions may strongly influence the likelihood that a cooperative equilibrium is reached by social evolution.

The property of self-enforcement distinguishes social norms from legal norms and regulations that are typically enforced by professionals, such as judges, solicitors and the police. Consider the difference between modern financial intermediation and the traditional norm of reciprocity. In both cases, an intertemporal exchange takes place. However, while in modern financial markets compliance with a loan agreement is typically enforced by appeal to written covenants and insolvency laws (if need be in court), the norm of reciprocity is sustained merely by a feeling of obligation on the part of the individual who first called on the other’s goods and services. This does not imply that social norms may not be manipulated to one’s individual advantage. But, just as I cannot freely pick which formal laws and regulations to abide by and when to do so, social norms derive their acceptance from the fact that they form an integrated system against which I have to judge my own actions no less than the deeds of others (Elster, 1989).

Institutional change and the relationship between formal and informal institutions

Institutions are never static. They change in response to new economic opportunities and advances in the division of labour (North, 1981; 1990). In the process of institutional change, the relationship between formal and informal institutions is affected in a variety of ways. Social norms, like the norm of reciprocity, play a prominent role in coordinating economic activity in small, “face-to-face” communities. When the probability of repeated interactions is high, social sanctions against cheating are extremely powerful. Failing to abide by a given rule would trigger one’s exclusion from the existing network of social relations. One’s access to important information would be restricted, one’s credibility as a partner to economic exchange undermined and the transaction costs of participating in intracommunity exchange could become prohibitively high.

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4 A particularly interesting example from Elster is the social norm against buying one's place into a bus queue. There would appear to be substantial mutual gains from trade in this situation. Nevertheless, it is hardly ever observed. The existence of queues generally suggests an inefficient rationing mechanism. In the case of shortages in socialist economies, queuing led to the emergence of black markets, but not all goods would seem to be “tradable” in a normative sense on such markets (e.g. access to limited hospital beds for heart surgery).

5 Rationality is defined here in the strict sense of economic theory, implying maximisation of utility, taking into account all given information about another player's move. In the more general sense of relating means to ends, rationality may encompass norm-guided behaviour (Adams and Neal, 1993).
As the division of labour expands across the border of a small community, individuals acquire increasing exit options and the threat of social exclusion loses in importance. Yet intercommunity trade still requires some mechanism for reputation building, otherwise contract compliance would be too uncertain and transaction costs prohibitive. The demand for social mechanisms to reduce the uncertainty of intercommunity exchange may lead to the transfer of reputation building out of the local context, such as in the exchange of gifts among traders in the Trobriand islands (Belshaw, 1965; Polanyi, 1968, as cited in Platteau, 1994). In larger societies, more formal institutional arrangements are sought that may substitute for reputational mechanisms in face-to-face communities. Adherence to a specific religion and command of a certain language might be taken as a signal of trustworthiness and members of peripheral ethnic groups would be forced to join the persuasions of the host society. The demand for reputation building in intercommunity exchange has promoted the development of specialised ethnic or religious groups as intermediaries that traditionally controlled a large proportion of long-distance trade in many parts of the world (Platteau, 1994). In the colonisation of America, adherence to an evangelist denomination often served as a trust-enhancing device and regular church attendance was a precondition for access to credit from the settler community (Weber, 1968). The Commercial Revolution of the eleventh to fourteenth centuries saw the emergence of merchant guilds as an institutional innovation facilitating trade expansion (Greif, 1992).

In the course of economic development, informal institutions are partly replaced by more formal arrangements, first within a closed social group but ultimately within the structure of a codified system of laws and regulations at the level of the nation state. It should be emphasised, however, that this process of substitution is far from automatic and far from complete. With respect to the first, traditional societies have differed greatly in their ability to coordinate economic exchange through a system of self-enforcing collectivist attitudes that urged members to sanction deviant behaviour even if not directly affected. The more successful and persistent such collectivist attitudes, the less need there is to adopt more formal rules of conduct (Platteau, 1994). According to Greif (1994), the collectivist attitude of the Maghribi traders of Northern Africa and the Mediterranean prevented this ethnic group from adopting the institutional innovations of the Italian city states (the family firm and the merchant guild) because they were not perceived as necessary. By contrast, the individualist attitudes characteristic of the Italian city states at that time led to social innovations that proved to be more efficient in handling the growing intercommunity trade and laid the ground for the Italian cities’ economic supremacy during the fourteenth to sixteenth centuries. The upshot of the comparison is that these social innovations took place under largely similar economic geographical and technical conditions and hence may be directly related to differences in prevailing informal institutions between the Maghribi and their Italian counterparts (Greif, 1994).

The replacement of informal institutions by more formal coordinating mechanisms is also far from complete even in more advanced market economies. First, the establishment of formal institutions requires the existence of some organisations able to enforce laws and regulations. As I will argue below, the state’s capacity may be an important determinant of the speed with which formal institutions are adopted to a changing economic environment and of the role inherited informal institutions play in socioeconomic coordination.

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6 Even today, business people may seek trust-building mechanisms such as a joint meal or a game of golf before concluding a deal.
Second, institutional performance continues to be influenced by informal institutions long after economic coordination takes place predominantly through formal rules. On the one hand, transactions costs of economic exchange would become prohibitive if all contingencies were to be fully covered by contract covenants and their breach enforced in court. In the United States, where contract enforcement is largely the responsibility of the formal legal system, measurable transaction costs have been estimated at 40 per cent of GDP (Wallis and North, 1986). A certain amount of mutual trust and goodwill may be essential for the full potential of the division of labour to be realised. On the other hand, public expectations and existing social and moral norms also influence the behaviour of those agents entrusted with both the formulation, implementation and enforcement of a new set of rules. A society in which cheating is the norm in bilateral transactions is also less likely to benefit from impartial and incorruptible third-party enforcement.

Putnam’s (1993) study of the performance of regional governments in Italy illustrates the last point. In the 1970s, a wave of administrative decentralisation considerably increased the leverage of regional governments in policy design and implementation. The Northern parts of Italy made good use of additional resources and responsibilities and ruled largely to the satisfaction of their constituencies. By contrast, institutional performance in the South, as reflected in a variety of output measures and in the satisfaction of the local population, was generally disappointing. Putnam explains these differences by reference to the higher level of “social capital” (see also Coleman, 1988) existing in the North, which he traces back to the development of a dynamic and horizontally structured civil society in the Northern Italian city states of the early Renaissance period. By contrast, a hierarchical and increasingly predatory state in the Bourbon Kingdom of Naples and Sicily prevented the development of mutual trust among its subjects and entailed a legacy of corruption, disinclination to cooperate and administrative inefficiency, even once the formal institution of feudalism had been abolished. The fundamental conclusion is that “social context and history profoundly condition the effectiveness of institutions” (Putnam, 1993, p. 182).

Putnam’s analysis effectively seems to leave little room for policy action in strengthening social capital. However, recent work on policy reform implementation in developing countries suggests that governments can actively engage in policy dialogue, thus enhancing their credibility and promoting participation in public affairs (Nelson et al., 1994; Borner, Brunetti and Weder, 1995; and see also Stern and Stiglitz, 1997). I shall consider the room for policy action in transition economies in Section 2.3 and provide some empirical evidence in Part 2 of this paper.

1.2 THE EVOLUTION OF INFORMAL INSTITUTIONS: THE ROLE OF GENERALISED MORALITY

Effective informal institutions fundamentally influence economic development and performance, both by providing self-sustaining contract enforcement, which reduces transaction costs, and by supporting efficient third-party enforcement from the state. How do they come about?

The following short account is mainly built on Platteau’s (1994) review essay. Part 2 of this essay analyses variations to the classical “prisoners’ dilemma” in which cooperative outcomes are ensured. One version that captures the way in which cooperation among a large number of individuals paired at random might result is the so-called “assurance game”, where honesty is allowed to influence the pay-offs of the individual players directly. In this game, a cooperative solution will emerge if (a) there are a sufficiently large number of honest players and (b) these players believe that there is a certain probability of being paired with another
honest player. The likelihood of cooperation is also increased by the strength of the moral predisposition to cooperate, the lack of an exit option and the prevailing information technology.

Platteau then goes on to consider the dynamic stability of a cooperative equilibrium. When the experiences of all players are common knowledge, an honest majority will be stable, because meeting a cheater does not change the subjective probability of an honest player of meeting an honest player at the next encounter. However, when information is imperfect and honest players become discouraged after meeting a series of cheaters and decide to turn cheaters themselves, the cooperative equilibrium may disentangle. In the presence of a sufficient number of cheaters, a fully non-cooperative equilibrium is the only stable solution.

Further generalisations allow for detection technologies that help to identify the disposition of another player, guilt feelings on part of the cheaters, and sanctioning of cheaters by third parties, even if not directly affected by their action (the “collectivist” attitude of the Maghribi traders discussed above). The conclusion from all these models is that the emergence of cooperation through an evolutionary process where players constantly re-evaluate their strategies depends on the initial distribution of moral propensities and the prevailing technology for disseminating information about other players. Platteau (1994, p. 765) argues that the fulfilment of these conditions “largely depends on the prevalence of moral (other-regarding) norms in the society”.

As noted above, moral norms are distinguished from social norms in that they engender consideration of the consequences of individual behaviour for others and not just for oneself. In the case of the assurance game, the presence of moral norms may be conceptualised as a direct pay-off from cooperation, because an honest player feels grieved by the disappointment and damage caused to the one that has been cheated. In the case of economic development, the establishment of moral norms allows trust to emerge within societies too large to accommodate reputational mechanisms based on ethnic or religious allegiances. In this context, it is interesting to return to Putnam’s example of Northern Italy. Thus, the city states were the place where the doctrine of classical republicanism was developed at the same time as these cities expanded their commercial activities. This doctrine provided the background for a generalised morality that pays no regard to the kinship group. Arguably, this generalised morality is one of the crucial ingredients of social trust and the emergence of a civil society.7

Moral norms have to be sustained and reinforced just as other social norms. However, the ability to exert negative sanctioning for disregard towards others is limited, because such moral behaviour is typically not verifiable. Rather, moral predispositions are instilled by socialisation.8 While a charismatic leadership and ideological persuasion through the state may supply a framework of generalised morality, this is unlikely to be sustained. Reinforcement of moral norms is primarily effected through demonstration effects of role model behaviour and through ongoing communication (Platteau, 1994).9 To return to the example of the Northern Italian city states, the moral predisposition to cooperate was

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7 Existing Western theories of justice (Rawls, 1970; Nozick, 1974), but also the religious traditions of Asia such as Buddhism and Taoism draw on concepts of generalised morality.

8 Coleman (1988) similarly argues that social capital is accumulated in the family through the time that parents spend with their children.

9 See also Habermas’ (1988) theory of communicative action.
constantly reinforced (and continues to be) through a wide array of elements in the civil society, such as choirs, football clubs, an active media, etc. (Putnam, 1993).

A final point bears emphasis which has considerable implications for the discussion of institutional reforms in the next section. Both in the case of social norms considered in the previous chapter and in the case of generalised morality, any resulting social equilibrium is likely to display a substantial degree of path dependence (North, 1990). To shatter an existing social norm or erode a given moral code of conduct would require the costs of compliance to rise quite substantially. In other words, informal institutions are typically subject to increasing returns to scale, due to large set-up costs, learning effects, demonstration effects, and the integration of individual norms and coordinating mechanisms into a system of largely complementary rules. While external shocks or individually deviant behaviour may ultimately cause informal institutions to disappear, this process is likely to take considerably more time than changing a set of formal rules and regulations. The next section will focus in particular on identifying areas amenable to policy action.

1.3 INFORMAL INSTITUTIONS AND INSTITUTIONAL REFORMS

In the following, I shall first summarise the previous discussion in form of a general model of social interaction and the role of formal and informal institutions. This will provide the basis for discussing various reform strategies and their associated problems.

In Figure 1, the various formal and informal institutions are presented in boxes, the formal ones on the right and the informal ones on the left, and their functional interrelationships are represented by arrows. The top and bottom of the figure are taken as largely exogenous. On the top, I place history, ideology and leadership as exogenous conditions that determine what particular set of institutions is present in a given society at any one point in time. For Boswell (1990), for instance, the evolution of cooperative societies in several European countries as opposed to the more conflictual social model prevailing in Britain is due to a combination of structural factors, such as limited size (e.g. in the case of the Scandinavian countries, Austria and the Netherlands), ideological factors, such as the importance of Christian Democratic politics (e.g. in Germany) and historical accidents, such as wars or economic crises, which impose more cooperative solutions to social interaction. At the bottom of the figure, I place preferences and technologies. These are factors typically considered to be exogenous by economists (although new growth theory attempts to endogenise at least the latter, e.g. Aghion and Howitt, 1992). Technologies and preferences also influence the institutional framework, because they determine the costs and benefits of compliance with a set of formal and informal rules (North, 1981). In the figure, I allow preferences and technologies to influence institutions only indirectly through the process of social and economic interaction. Note that the feedback arrows to formal and informal institutions are broken, to express the idea of path dependence.11

10 I do allow for some feedback from economic and social interaction to the top box but shall not spend much time speculating on the dynamics of grand historical change.

11 Path dependence also exists in the formal institutional framework, mainly because implementation costs are high and the stability of rules as much as their quality is what contributes to lowering transaction costs.
The main body of the figure is filled up with six boxes, standing for the broad sets of formal and informal institutions that are to some extent present in all societies. The box at the top left is the set of moral norms. I do not attempt to explain the emergence of these norms from an evolutionary process. Rather, I presume that morality is influenced by ideology and

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12 See Sudgen (1989) for such an account drawing of Hayek’s notion of institutional change as a process of social innovation. For a discussion of Hayek’s notion in the context of transition see Voigt (1994).
leadership as much as by historical convention. The presence of a specific type of moral norms (i.e. generalised morality as opposed to kinship solidarity) feeds into the emergence of a civil society, understood as comprising all non-governmental organisations, such as the press, leisure clubs, churches, neighbourhood associations and so on. The existence of a working civil society in turn tends to reinforce the moral predispositions of individuals, as noted in the previous section. It also creates “trust” among economic actors, thereby facilitating economic exchange under imperfect information. The sequence of boxes on the left side of Figure 1 represents a stylised model of how “social capital” is accumulated.

On the right hand side of the figure, I represent the sequence that leads to an efficient set of formal institutions and a particular form of governance. Again, the form of governance that evolves is partly a result of exogenous factors, as noted above, but it is also influenced by the existing set of moral norms. A society that values honesty, solidarity, modesty, etc. is less likely to end up with a dishonest, predatory and wasteful government than one in which cheating does not meet sanctions, individualism prevails and social prestige is connected with an exuberant display of wealth. The form of governance impacts on the enforcement of a system of laws and regulations that formally structure social interaction and economic exchange. The sixth box is placed in the middle and represents the interface between government and society. What role is accorded to this interface is partly a function of the government’s willingness to engage in policy dialogue, but also crucially contingent on the existing level of trust in government institutions. The sociopolitical interface may involve formal arrangements, such as the East Asian “deliberation councils” (Campos and Root, 1996) or the German “konzertierte Aktion” (Boswell, 1990). However, it could also take more informal forms, for instance when politicians become active members of social clubs and thus exposed to monitoring by their constituencies. There is strong complementarity between the existing level of trust (or social capital) and the effectiveness of government. When trust in government institutions is low, the pressures on public officials to deliver better governance are weak. Bad governance in turn undermines trust because it generally leads to inferior economic outcomes. As a result the social capital of a society depreciates.

The above model identifies several levels of action in bringing about institutional change. First of all, institutional change is brought about by exogenous shocks, either from the polity (i.e. a change in ideology or political leadership) or from the economic sphere (a change in technologies or preferences). Second, institutional change may occur from inside the institutional framework. Governments can change the formal rules, either in response to an exogenous shock, or in anticipation of future changes, or, less benevolently, in maximising their own returns from a position of power. Governments can also improve incentives for better governance by public officials, through reducing the scope for policy discretion, increasing job competition and raising public sector pay (Rose-Ackerman, 1996). Third, governments can attempt to influence positively the interaction between formal and informal institutions by engaging civil society in a policy dialogue. However, this will depend on the given level of trust in government and its formal institutions. When social capital is low, the government’s best chance is to enhance its credibility through signalling reform commitment and hoping that real economic improvements will in time feed back into a higher level of social trust.13

13 The evidence in Section 2.3 shows that trust in public institutions may be enhanced if future economic prospects look bright. If people are forward looking, a comprehensive reform effort may be one way to enhance social trust.
What does this suggest for the challenge of systemic reform faced by the transition economies? Most evidently, exogenous shocks have varied from case to case. In much of eastern Europe, the economic shock of opening to world markets was accompanied by the political shock of a shift to democratic politics (Nelson et al., 1994).14 Political changes have been less in China and parts of Central Asia. Furthermore, the impact of economic shocks has to some extent depended on initial conditions, including first and foremost the weight of industry in the labour force (Sachs and Woo, 1994). The nature of the exogenous shocks has obviously influenced the choice of reform strategies in transition economies (Fan, 1994; Friedman and Johnson, 1996). Bearing such constraints in mind, I want to propose three possible reform strategies that form the basis for the typology of patterns of institutional change in transition economies to be developed in this paper.

One strategy is to emphasise the importance of stability of the formal institutional framework and to change laws and regulations only gradually. The attempt in this strategy is to reform the formal institutional framework in step with changes in informal institutions so as to minimise the potential for friction. However, when exogenous shocks are large, the inefficiencies resulting from failing to rapidly adapt the set of formal rules may outweigh the costs of friction with a more slowly changing set of informal institutions. Institutional stability, which is the aim of this strategy, could be undermined from within, as compliance with formal rules becomes too costly and attempts to budge the law increase.15 The second strategy, diametrically opposed to the first, is to change the formal institutional framework at one stroke to conform with the fundamental requirements of a new economic system (Lipton and Sachs, 1990, are among the early proponents of this strategy). This strategy wagers that enforcement costs of the new rules will be substantial for quite some time, because they are not matched by a set of self-enforcing informal rules. Both the first and second strategies presuppose the existence of an effective government able either to maintain institutional stability or to implement rapid institutional change. The third strategy accepts the limitations of government, particularly in most transition economies. Institutional design in this strategy is oriented towards political feasibility. This implies that institutional reforms will be more rapid in areas where the costs of adapting to new rules is lower, because of their simplicity, ease of implementation and lower demands on changes in people’s behaviour.16 Political developments during 1989-90 qualify as exogenous shocks is demonstrated by the East German case, with which I am most familiar. The Monday demonstrations in Leipzig set the tone for rapid unification long before it became official government policy in January 1990. Similarly, political developments in Poland and Hungary urged for rapid responses by economic policy makers suddenly confronted with the task of taking over. In Czechoslovakia, by contrast, the economic reform programme was internally debated for a full year before coming into effect in January 1991 (Myant, 1993).

14 That political developments during 1989-90 qualify as exogenous shocks is demonstrated by the East German case, with which I am most familiar. The Monday demonstrations in Leipzig set the tone for rapid unification long before it became official government policy in January 1990. Similarly, political developments in Poland and Hungary urged for rapid responses by economic policy makers suddenly confronted with the task of taking over. In Czechoslovakia, by contrast, the economic reform programme was internally debated for a full year before coming into effect in January 1991 (Myant, 1993).

15 I have formulated the reform strategy just outlined as one emphasising institutional stability, although it is closely related to proposals for evolutionary institutional reforms (Murrell, 1992). To be feasible, such proposals implicitly assume that the existing institutional framework has not fully disintegrated.

16 The latest Transition Report Update of the EBRD (1997, Introduction, p. 2), for instance, notes that “progress in transition has been particularly obvious in fields where the necessary development of institutions and behaviour, be they in government or in the private sector, is less demanding. Accordingly, it has been most rapid in the areas of price and trade liberalisation and small-scale privatisation. Progress has been slower in large enterprise privatisation and restructuring, competition policy, financial sector reform and development, and legal reform”.

12
economy considerations often force the adoption of the third strategy. However, it runs the danger that institutional reforms remain blocked by powerful insiders or become bogged down in interest group conflict. Arguably, focusing attention on the sociopolitical interface is of particular importance in this third case and varying degrees of success may be attributed to varying degrees of existing social capital.

On the basis of this typology, one may attribute each of the transition economies to one of the above strategies, bearing in mind their ideal-type nature and the considerable variation in actual outcomes. China is the model case for strategy one. As I shall argue in the next section, China has combined overall institutional stability with gradual changes in specific areas. The existing informal institutions, partly of communist inheritance, partly dating from before 1949, have considerably affected institutional design in practice. East Germany is the only country that has truly followed the second strategy. The monetary union with West Germany transferred virtually the entire set of formal institutions to the new Länder, although considerable set-up costs (building courts, training lawyers, etc.) have delayed their full operativeness for several years. Most other transition economies fall into one or the other variant of the third strategy. For instance, variations in existing implicit ownership rights have greatly influenced both the design and outcomes of privatisation in Hungary, the Czech Republic, Poland and Russia (Section 2.4). In Russia, the existing network of corrupt officials has transferred with ease into the new system, providing the foundations for the thriving Mafia (Section 2.2). In general, although the principles and goals of market reforms continue to be widely shared across the region, the implementation of reforms often bears the hallmark of interest group influences and attempts by government officials to extract maximum rents from their position. More worryingly, there is an indication that, where government weakness has led to delays in institutional reforms and hence disappointing economic performance, the trust in government remains low (Section 2.3).

2 INFORMAL INSTITUTIONS AND TRANSITION

2.1 INSTITUTIONAL REFORMS UNDER A STRONG STATE: TOP-DOWN VERSUS BOTTOM-UP

The Chinese economy has been booming for the past 15 years. By contrast, East Germany has experienced one of the largest industrial recessions in eastern Europe and average growth rates such as achieved by neighbouring Poland or the Czech Republic still elude the five new Länder. On the face of this evidence, one might easily conclude that the strategy of gradual institutional reforms in China is vastly superior to the shock approach chosen with German unification. This section attempts to put these claims into perspective. It argues that the Chinese success relied to a considerable extent on informal institutions present already under socialism. Without this inheritance gradualism might not have worked in China. Moreover, favourable structural conditions in the form of high potential productivity gains from further industrialisation in China contrasted with East Germany’s over-industrialised structure, which was aggravated by inappropriate wage policies. Relating economic performance to institutional reform design is thus complicated by the importance of other largely exogenous conditions. What this section will stress is the communality between both polar cases, in that there was a strong state able to determine the pace for formal institutional change. Arguably,

Far less successful and with considerable doubts as to whether transition will seriously get under way, North Korea and Cuba might also be attributed to this group by virtue of their leadership’s stress on stability. Uzbekistan, Turkmenistan and Belarus might also qualify, although institutional stability there has been shaken by the break-up of the Soviet Union.
the dichotomy between shock and gradualism breaks down in countries where this condition is no longer met.

**Invigorating the local economy: the roots of China’s success**

One of the central elements of economic reforms in China since 1978 has been progressive administrative and fiscal decentralisation (Qian and Roland, 1994). Local government authorities have taken responsibility over a wide range of economic decisions, and with fiscal decentralisation have had increasing access to funds for financing local development. The process of decentralisation has thus created strong incentives at the local level to implement policies that would favour the prosperity of the locality.

To a large extent, decentralisation has been remarkably successful in China. At the root of China’s impressive growth performance are the dynamic township and village enterprises (TVEs) (Table 1). The notable feature of this sector is that it is collectively owned but managed to maximise profits rather than worker incomes. Further, because the resources at the disposal of local governments are limited, TVEs have typically faced hard budget constraints (Bird and Qingsong, 1990). The local government has effectively acted as a holding company with majority shareholdings in each TVE, maximising the extraction of residual profits to further the development of the local economy as a whole (Sun, 1996).

**Table 1:** Selected performance indicators in Chinese industry: SOEs, COEs and TVEs, 1983-93

<table>
<thead>
<tr>
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<tbody>
<tr>
<td><strong>Output growth</strong>&lt;sup&gt;a&lt;/sup&gt;</td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SOEs</td>
<td>9.4</td>
<td>8.9</td>
<td>12.9</td>
<td>6.2</td>
<td>11.3</td>
<td>12.6</td>
<td>3.9</td>
<td>2.9</td>
<td>8.6</td>
<td>12.4</td>
<td>5.7</td>
</tr>
<tr>
<td>COEs</td>
<td>15.5</td>
<td>34.9</td>
<td>32.7</td>
<td>17.9</td>
<td>23.2</td>
<td>28.2</td>
<td>10.5</td>
<td>9.0</td>
<td>18.4</td>
<td>39.3</td>
<td>35.9</td>
</tr>
<tr>
<td>TVEs</td>
<td>31.5</td>
<td>61.7</td>
<td>38.9</td>
<td>28.0</td>
<td>27.7</td>
<td>28.0</td>
<td>2.8</td>
<td>14.5</td>
<td>27.8</td>
<td>51.6</td>
<td>54.9</td>
</tr>
<tr>
<td><strong>Profit rate</strong>&lt;sup&gt;b&lt;/sup&gt;</td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>SOEs</td>
<td>–</td>
<td>–</td>
<td>23.5</td>
<td>20.7</td>
<td>20.3</td>
<td>20.6</td>
<td>17.2</td>
<td>12.4</td>
<td>11.8</td>
<td>9.7</td>
<td>9.7</td>
</tr>
<tr>
<td>COEs</td>
<td>–</td>
<td>–</td>
<td>24.6</td>
<td>19.4</td>
<td>18.2</td>
<td>19.8</td>
<td>15.4</td>
<td>11.5</td>
<td>11.9</td>
<td>10.1</td>
<td>–</td>
</tr>
<tr>
<td>Other&lt;sup&gt;c&lt;/sup&gt;</td>
<td>–</td>
<td>–</td>
<td>28.2</td>
<td>23.3</td>
<td>24.9</td>
<td>24.7</td>
<td>16.2</td>
<td>11.3</td>
<td>12.9</td>
<td>11.1</td>
<td>11.3</td>
</tr>
<tr>
<td><strong>Share of enterprises making losses</strong></td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>SOEs</td>
<td>–</td>
<td>–</td>
<td>9.5</td>
<td>13.1</td>
<td>13.0</td>
<td>10.9</td>
<td>16.0</td>
<td>27.6</td>
<td>25.8</td>
<td>23.4</td>
<td>30.3</td>
</tr>
<tr>
<td>COEs</td>
<td>–</td>
<td>–</td>
<td>11.7</td>
<td>13.2</td>
<td>15.7</td>
<td>11.7</td>
<td>15.7</td>
<td>19.4</td>
<td>16.7</td>
<td>13.7</td>
<td>–</td>
</tr>
<tr>
<td>Other&lt;sup&gt;c&lt;/sup&gt;</td>
<td>–</td>
<td>–</td>
<td>10.2</td>
<td>15.8</td>
<td>15.5</td>
<td>17.2</td>
<td>26.7</td>
<td>32.6</td>
<td>31.7</td>
<td>27.9</td>
<td>–</td>
</tr>
</tbody>
</table>


<sup>a</sup> In per cent per annum, calculated from SSB (1994).

<sup>b</sup> Profits/total value of capital (net fixed assets + working capital).

<sup>c</sup> Other include TVEs, joint ventures and individual business.

18 The theory of the labour-managed firm suggests that collectives would maximise worker incomes rather than profits (Ward, 1957). Moreover, concerns generally are that collectives would underinvest and that individual members would attempt to free-ride on other members’ efforts, if residual profits are evenly distributed.
Additionally, around 80 per cent of all state-owned enterprises (SOEs) are owned by provincial, county and city level governments, ostensibly facing a similar incentive structure as the village governments in maximising residual profits in their SOEs. Many industrial reform initiatives were thus pioneered at the local level and substantial differences in enterprise autonomy and performance exist between different regions (Raiser, 1996; 1997). As argued by Jefferson and Rawksi (1994), decentralisation has set the incentives for local governments to experiment with new institutional solutions in the context of still largely dominant public ownership and thus has created an “endogenous” drive towards market-oriented reforms.

What is often not recognised in accounts of China’s reform success is that Chinese socialism also differed significantly from the Soviet model of central planning. Since the “Great Leap Forward” of the late 1950s, China has experienced several waves of decentralisation, the most coherent and permanent one in the early 1970s (Riskin, 1987). During this time, local governments already acquired “quasi” property rights in local SOEs. The fiscal incentives provided by the formal decentralisation process of the 1980s were thus introduced into a local economy used to advancing its collective interest in a variety of bargaining relationships both with the centre and with other localities (Granick, 1990). The process of learning to live without central subsidies was thereby considerably eased.

At the village level, moreover, discontent with the previous system of collective farming within the commune was already rife when agricultural reforms started in 1978 (Watson, 1992). Hence, the decollectivisation and introduction of the household responsibility system met an enthusiastic response from local farmers, in contrast to the muted reaction of workers on the Soviet Kolchozes and Sovchozes, unsure what to do with their new-found responsibilities. With 70 per cent of employment in agriculture, the fact that existing informal institutions supported decollectivisation must be regarded as a central ingredient of the overall reform success, at least until the mid-1980s.

One of the central elements of institutional continuity in rural China has been the extended family (White, 1996). The Chinese family has been one of the sources of entrepreneurial activity across East Asia. Apart from the reduction of transaction costs achieved through relations of trust among family members, White notes the following advantages of family businesses in the Chinese context. Family businesses face lower employee monitoring costs as turnover is low. Moreover, they allow for risk pooling among different branches of family business interests, while at the same time promoting competition among junior family members. Finally, the Chinese family encourages social mobility by investing their resources in family members with the highest career prospects. Thereby they mobilise and channel rural savings into productive uses.

While the above advantages may in principle apply to business families in general, White’s major concern is to show how Confucian family values interacted with changing rural institutions during pre-communist and Maoist times in a way that was more favourable to the development of rural entrepreneurship than, for instance, in Russia. In many respects the century prior to 1949 was one of extreme institutional insecurity in China. Under such conditions, the inherent entrepreneurial strengths of Chinese families could not develop. Nonetheless, the underlying historical tradition was that of a competitive society with considerable social and geographical mobility (Greenlagh, 1990). By contrast, the Russian peasantry was trapped in serfdom until 1860. Incentives for social mobility hardly improved thereafter, as Russia remained an essentially aristocratic society and rural property rights were subject to constant shifts and confiscations. Arguably, then, when agriculture was
collectivised in the two countries, very different modes of behaviour were already enshrined in the peasantries of China and Russia. Moreover, according to Whyte, the impact of socialism was to reinforce these differences by respecting and possibly even reinforcing family ties among rural Chinese families, while disrupting most existing family ties in the Soviet Union.\footnote{Specifically, in China rural collectivisation was combined with a policy that inhibited migration, thus tending to keep family members together in the same rural collective. In Russia, the forced industrialisation drive transferred entire generations from agriculture into industry, often involving large geographical distances as well.}

The discussion so far has emphasised the importance of institutional continuities in China’s gradual institutional reforms. Central government initiative often merely legalised given practices on the ground, thus greatly reducing enforcement costs of new regulations. However, the central government’s role was far from passive. In several instances, central authority was reasserted, as Beijing attempted to reconcile regional autonomy with the national interest. The traditional policy measure used to this effect has been the central credit plan (Ma, 1994; Naughton, 1996) but occasionally, such as during the 1989-91 rectification programme, direct interventions in pricing decisions and material allocation were also used. Moreover, as economic liberalisation has tended to undermine the authority of the communist party, its leaders have repeatedly resorted to brutal force to maintain “social order”, most deplorably in June 1989 on Tiananmen Square. While institutional design in the Chinese context thus emerged from below and institutional reforms may duly be characterised as bottom-up, the reform process has also been tightly controlled by the top and experiments deemed unsuccessful have been reversed. The strength and credibility of the central government’s reform commitment have thus been of crucial importance for China’s success so far. The challenge for the present leadership is to maintain this degree of government credibility while shifting from direct to indirect instruments of control.

**Legislated shock therapy: German unification**

With German Monetary Union, implemented in July 1990, the existing formal institutional framework of West Germany was essentially transferred to the five new Länder. The contract on unification specified minor exemptions in the applicability of West German laws, and the regional governments themselves were entrusted with legislative responsibility in a number of areas, just like their West German counterparts. Nonetheless, the body of national laws and regulations was to be applied in the East as in the West, from traffic rules to insolvency law.\footnote{East Germany had an interesting traffic rule idiosyncrasy in that a green right arrow allowed right turns even at a red traffic light. Although it enjoyed vast support among East Germans, the rule did not survive unification.}

This legislated shock therapy in East Germany provides an interesting application for the previous assertion that informal institutions change more slowly than the formal institutional framework and that the resulting friction may substantially increase transaction costs during the transition phase. One piece of evidence comes from the prevalence of payment arrears, even in circumstances where Western bankruptcy rules are in place and the judicial system arguably is already much better equipped to handle complaints. In an enterprise survey in 1995 60 per cent of all firms still reported slow payment by customers as one of the major causes of financial problems (DIW et al., 1996).
Mummert (1997) has made a recent attempt to find empirical evidence for differences between East and West in the behaviour of economic agents that might be attributed to differences in informal institutions. He examines the finding that discounted bills of exchange account for a much smaller share of short-term bank credits in the new than in the old Länder. Mummert has conducted interviews with company managers to find out how they evaluated their external environment and what their specific attitudes were towards discounted bills of exchange, a means of finance non-existent under socialism. The interesting conclusion emerging from his study is that monetary union fundamentally changed the external environment as perceived by East German entrepreneurs and made their expectations statistically indistinguishable from their West German counterparts. At the same time, significant differences persisted with respect to attitudes to bills of exchange, with East German managers generally expressing a more sceptical attitude regarding their value to their company (Table 2). Mummert explains his findings by reference to competitive pressures. While a correct perception of the external environment is crucial for enterprise survival, the use of bills of exchange is not. Hence, argues Mummert, one is likely to observe more path dependence in areas less central to enterprise competitiveness.

Table 2: Perceptions about external environment and attitudes towards means of financing: East vs West German entrepreneurs

<table>
<thead>
<tr>
<th>1. Perceptions of external environment</th>
<th>E.Germany</th>
<th>W.Germany</th>
<th>Test statistics for difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>How probable do you think it is that you are able to repay your loans?</td>
<td>1.591</td>
<td>1.875</td>
<td>1.25</td>
</tr>
<tr>
<td>If you had bad luck and would have to close your enterprise - what do you think would happen with the loans you have taken?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• You would have to repay the full loan</td>
<td>1.806</td>
<td>0.375</td>
<td>1.73</td>
</tr>
<tr>
<td>• The Federal or state government will take a part of the debt</td>
<td>-1.776</td>
<td>-2.25</td>
<td>-1.06</td>
</tr>
<tr>
<td>• The Federal or state government will release you from the loans by the European recovery programme</td>
<td>-1.677</td>
<td>-2.25</td>
<td>-1.18</td>
</tr>
<tr>
<td>• The banks will at least partially grant a debt release</td>
<td>-2.149</td>
<td>-2.125</td>
<td>0.09</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2. Attitudes towards means of financing</th>
<th>E.Germany</th>
<th>W.Germany</th>
<th>Test statistics for difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Attitude toward taking a loan</td>
<td>1.022</td>
<td>1.196</td>
<td>0.83</td>
</tr>
<tr>
<td>Attitude toward banks</td>
<td>0.406</td>
<td>0.214</td>
<td>-0.86</td>
</tr>
<tr>
<td>Attitude toward the bill of exchange</td>
<td>-0.264</td>
<td>0.944</td>
<td>3.24</td>
</tr>
</tbody>
</table>

E.Germany = East German respondents  
W.Germany = West German respondents  
Source: Mummert (1997), page 145 and 147
The evidence in this respect remains scarce. Nonetheless, the adjustment by East German enterprises to changes in the formal institutional framework appears to have been relatively rapid. Thereby, existing social networks have often supported rather than hindered new business formations (Grabher and Stark, 1996). Hence, institutional friction due to the sudden replacement of one incentive structure by another is probably not at the root of the rather disappointing East German growth performance so far.

However, the East German top-down approach to institutional reform, even more than in the Chinese case, relied on the credibility and strength of the West German state. It is arguably precisely the trust in West Germany’s institutions that has led to a rapid convergence of expectations among East and West Germans. The challenge for German politics at present is to maintain this credibility. Among the senior political figures in the country, East Germans are few and not noted for their influence. At the same time, the electoral success of the former communists (the PDS) is partly built on its very strong links to local communities. While beneficial for the reconstruction of a dilapidated local economy, the strength of the former communist “Seilschaften” may prevent the growth of East German businesses beyond the local market by supporting informal enforcement mechanisms unsuited to transactions out of the local context. The institutional performance of the new Länder may still be negatively affected by the inheritance of a socialist past.

### 2.2 Institutional Reforms under a Weak State: The Role of Social Capital

In most countries in central and eastern Europe and the former Soviet Union, institutional reforms have proceeded in a sequential manner, moving from the easy to the more complex and administratively demanding as the transition proceeds. The EBRD’s (1996) country ratings for the various areas of market-oriented reforms show wide variations among countries while at the same time identifying a general trend towards more market-based institutions. This sequence corresponds to what would be expected under the third strategy outlined in Section 1.3. There it was contended that, in the context of a weak state, institutional reforms are highly contingent on existing informal institutions and the way in which they constrain rule enforcement.

This first part of this section will focus on Russia and Ukraine as cases where a legacy of distrust in the state and of corruption within official distribution networks has blocked institutional change and erected considerable barriers to private sector development. Poland will serve as an example of a country where entrepreneurial initiative was kept partly alive during the late communist period and where this asset was capitalised upon by a government that quickly established a firm reform commitment by tying its credibility to economic transition.

**From the black market to the unofficial economy: distortions and institutional performance in Russia and Ukraine**

Mancur Olson (1993) has argued that what allowed the Soviet system to survive for over 70 years in Russia and 40 years in eastern Europe was the highly efficient revenue mobilisation for the state at the expense of the consumption standards of the ordinary population. While this explanation may be true for the early Stalinist period in the Soviet Union, communism arguably survived in later years despite rather than because of strict hierarchical controls. By the 1980s, the Soviet economic system was permeated by bargaining and black market trading, both within and outside the official distribution networks. Hence, even before its dissolution, the socialist state had lost a significant degree of control over the final allocation of resources and was concerned more with the allocation of rents among public servants.
The legacy of a weak state and the use of public office for personal gains today retains a strong impact on institutional performance in many of the successor countries of the Soviet Union. There are two aspects to this predicament. The first relates to the continuing discrimination against private businesses implicit in remaining bureaucratic distortions and the absence of efficient third-party enforcement across the former Soviet Union. The second concerns the transformation of former black marketeers into outright criminals acquiring substantial domestic business interests.

While previously public servants used their discretion over material allocation to extract rents, now businesses in countries of the former Soviet Union are highly taxed through a variety of official taxes and unofficial fees for government services. Table 3, reproduced from Kaufmann (1997, p.7), gives an indication of the extent of unofficial fees in Russia and Ukraine and their development over time. While there is some evidence that the share of enterprises covered by these fees has been declining in Ukraine (no evidence is given for Russia), the amounts paid remain substantial, particularly for small businesses. Kaufmann estimates that unofficial taxes may add up to 9 percentage points to the total tax bill expressed as a share of turnover. New private businesses are particularly affected as, unlike established enterprises, they cannot rely on existing contacts to reduce the bribes necessary to evade state regulation. Kaufmann’s (1997, p. 18) survey results for Ukrainian enterprises indicate that new private enterprises pay an average US$ 400 per year per employee in bribes, against US$ 40 for privatised SOEs and collectives and only US$ 3 for state enterprises. Last but not least, unofficial taxes have the effect of driving a substantial amount of economic activity into the unofficial economy. The returns from going unofficial will depend on the official and unofficial tax burden, but its costs again include side payments to be made to protect the business from “detection” by government officials. The increase in unofficialdom in turn further enlarges the discretion of individual government agents, while depriving the state of much-needed revenues.

How can the situation described above be altered? The problem is one of collective choice. First, the rents available to government officials typically result from remaining regulatory distortions, leaving substantial room for discretionary decision making. Government officials will have no incentives to surrender their discretionary power, although the government as a whole would gain in the medium term from higher economic growth and enhanced tax revenues. Second, were the government to announce a reform initiative lowering tax rates and abolishing remaining distortions, this move might not be credible, as the private sector would anticipate a return to higher tax rates once it had joined the official economy (Borner et al., 1995). The point here is to show that, unless the government can establish a third party that oversees the enforcement of its own commitment, or enhance its credibility by some other means, the necessary institutional reforms might not be forthcoming.\(^\text{21}\) Having inherited a corrupt public administration and a weak central government, the new leaders of Russia and Ukraine have yet to prove that they can replace the “grabbing hand” by the “invisible hand” (Frye and Shleifer, 1997).

\(^{21}\) One means of external enforcement is of course political competition in working democracy. Shleifer (1996) emphasises that the replacement of corrupt local officials by new blood would be one way to strengthen bureaucratic efficiency in Russia.
Table 3: “Unofficial” payments by enterprises for official permits, etc.
Ukraine and Russia survey results, 1996

(For Ukraine, mid-1994 survey results are in parenthesis)

<table>
<thead>
<tr>
<th></th>
<th>Ukraine</th>
<th>Russia</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Average &quot;unofficial&quot; fee</td>
<td>% of enterprises</td>
</tr>
<tr>
<td></td>
<td>required for</td>
<td>admitting need to</td>
</tr>
<tr>
<td></td>
<td>&quot;unofficial&quot; fee</td>
<td>pay &quot;unofficially&quot;</td>
</tr>
<tr>
<td></td>
<td>required for</td>
<td></td>
</tr>
<tr>
<td></td>
<td>&quot;favour&quot;</td>
<td></td>
</tr>
<tr>
<td>1 Enterprise</td>
<td></td>
<td></td>
</tr>
<tr>
<td>registration</td>
<td>$176 ($186)</td>
<td>66% (64%)</td>
</tr>
<tr>
<td>2 Each visit by</td>
<td></td>
<td></td>
</tr>
<tr>
<td>fire/health inspector</td>
<td>$42 ($40)</td>
<td>81% (72%)</td>
</tr>
<tr>
<td>3 Tax inspector (each</td>
<td></td>
<td></td>
</tr>
<tr>
<td>regular visit</td>
<td>$87 ($91)</td>
<td>51% (56%)</td>
</tr>
<tr>
<td>4 Each phone line</td>
<td></td>
<td></td>
</tr>
<tr>
<td>installation</td>
<td>$894 ($550)</td>
<td>78% (95%)</td>
</tr>
<tr>
<td>5 Lease in state space</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(m² per month)</td>
<td>$7 (na)</td>
<td>66% (88%)</td>
</tr>
<tr>
<td>6 Each export licence/</td>
<td></td>
<td></td>
</tr>
<tr>
<td>registration</td>
<td>$123 ($217)</td>
<td>61% (96%)</td>
</tr>
<tr>
<td>7 Each import licence/</td>
<td></td>
<td></td>
</tr>
<tr>
<td>registration</td>
<td>$278 ($108)</td>
<td>71% (93%)</td>
</tr>
<tr>
<td>8 Each border crossing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(lump sum)</td>
<td>$211 ($194)</td>
<td>100% (90%)</td>
</tr>
<tr>
<td>9 Each border crossing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(% of value)</td>
<td>3% (na)</td>
<td>57% (na)</td>
</tr>
<tr>
<td>10 Domestic currency</td>
<td></td>
<td></td>
</tr>
<tr>
<td>loan from bank</td>
<td>4% (na)</td>
<td>81% (na)</td>
</tr>
<tr>
<td>(preferential terms)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11 Hard currency loan</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(preferential terms)</td>
<td>4% (na)</td>
<td>85% (na)</td>
</tr>
</tbody>
</table>

* Average among those that admit making unofficial payments.

Preliminary data based on March 1996 Survey of 150 state/private enterprises in five large Ukrainian cities and of 50 enterprises in three large Russian cities. Caution should be exercised in interpretation of the data, which are not representative of the whole country (particularly in Russia, where the sample is small). The mid-1994 survey results for Ukraine (in parenthesis) are based on a similar survey instrument.


The second aspect of the institutional predicament of many countries of the former Soviet Union is the transformation of black marketeers into modern-time Mafiosi. Black markets in Soviet times were supported by networks of business groups that ensured contract enforcement among themselves as the legal system could not be relied on. These existing networks could be easily adapted to new economic opportunities (Greif and Kandel, 1995)
“The black economy which had existed in parallel with the state had the money and the infrastructure already in place to take advantage of the new opportunities for open commercialisation” (Prior, 1997). As black market trading in the past had involved considerable access to government favours and protection, the new criminal entrepreneurs could often count on influential government contacts to protect their businesses. In Russia, a number of former criminal groups have transformed themselves into legal conglomerates by acquiring substantial business stakes in the process of privatisation, while retaining their close links to government. At the same time, the continuing absence of reliable and cost-efficient third-party enforcement from the state has provided huge profit opportunities for so-called “security firms”, often linked to former KGB officers and military officials. Again, these activities discriminate against the new private sector, which cannot rely on existing contacts with such security firms and may be forced to pay substantial premiums to benefit from their services.

In sum, bureaucratic red tape, corrupt public officials and the preponderance of private and legally unaccountable security firms that substitute for third-party enforcement from the state continue to present serious obstacles to private sector development and ultimately to economic recovery in the former Soviet Union. Reinvigorating the region’s economies will have to involve both further economic and administrative liberalisation and the rebuilding of trust in the state’s institutions. Unfortunately, the path dependence of informal institutions and the considerable private business interests associated with the present predatory system are likely to mean that the accumulation of social capital in support of the transition may take a considerable amount of time.

**Establishing reform credibility: Poland**

Poland is the most successful of all east European transition economies so far. This success seems due in large measure to the rapid expansion of new private businesses, in contrast to experiences further east. As Frye and Shleifer (1997) have shown, Polish businesses face far less governmental restrictions and are also less subject to demands for unofficial fees and bribes. How has the Polish state escaped the collective choice dilemmas outlined above?

First of all, Poland entered the transition with a completely new political leadership, committed to a radical programme of economic reform. At the central government level, the packaging of macroeconomic reforms allowed the government to signal their irreversibility and thus enhance its credibility at a moment in time where resistance was not yet articulated. But electoral turnover was also high at the local level and government officials were often being replaced by new political faces as early as 1990. Shleifer (1996) quotes evidence that only 8 per cent of local government officials elected in Poland in 1990 were former communists. By 1993, 30 per cent of the political elite in Poland and 57 per cent of the economic elite were former communist party members, against 83 per cent and 53 per cent respectively in Russia. Thus, while in the economic sphere existing party networks

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22 Johnson et al. (1997) have calculated the share of the new private sector in GDP in a sample of transition economies. For instance, in Poland it was 50 per cent in 1995, in Hungary 45 per cent, against only 20 per cent in Russia and 30 per cent in Ukraine. The latter countries also score far worse in the same authors’ indicators of progress in legal reform or of corruption of public officials.

23 Public support for the Balszerowicz programme was high initially. In October 1989, 45 per cent of the population supported the principles of shock reform against 10 per cent opponents. The remainder were undecided.
continued to hold together both in Poland and in Russia, in Poland such networks could no longer rely on political support.

This political revolution must be considered an exogenous factor in our model and is hence not part of the reform strategy. Yet, the implementation of Poland’s radical reforms and their success arguably relied on beneficial institutional legacies. One beneficial legacy in Poland was the existence, even under communist rule, of a substantial number of private businesses. Indeed, even excluding agriculture (which was never collectivised in Poland), the private sector share in GDP was as high as 35 per cent at the start of reforms, providing a strong basis for the rapid expansion of the new private sector. Poland’s entrepreneurial talent was thus not exclusively concentrated on black marketeering and able to seize the legal opportunities opened after 1990 relatively quickly.

Possibly of even greater importance were the popularity and strength of the civil opposition to the communist government in the form of Solidarity and the Catholic Church. When this movement seized power, the new government was ab initio endowed with a higher degree of trust than would have resulted from more political continuity. The implementation of policy measures providing for a substantial real wage decline by a government that grew out of the trade union movement testifies to the presence of a generalised morality that was identified as one of the factors contributing to trust in government institutions. Against this view, Shleifer (1996) has argued that differences in social capital do not explain the diverging performances of Russia and Poland, referring to international survey evidence that shows a similar ranking of the two countries on the extent of trust and civic engagement in the economy. However, the questions about trust were asked in a general way (“Would you say that most people can be trusted?”, p. 17) and not specifically directed at trust in government institutions. As shown below, such differences exist among the transition economies. Shleifer’s main point is that competition within government is needed to create appropriate incentives for good governance. Awaiting further evidence, the additional role attributed to social capital in this paper does not contradict his argument.

In sum, Poland inherited a stock of social capital that could be harnessed for transition, while the political turnover at the start of reforms encouraged the new government to draw on this resource possibly to a larger extent than elsewhere. As described by Kolodko and Nuti (1997), the government coalition that took office after the general elections of 1993 has attempted to steer a reform path in consultation with existing social groups. It is suggestive of the relative success of this strategy that Poland shows the highest increase in approval rates for the current political regime among all east European countries, increasing from 52 per cent at the end of 1991 to 76 per cent four years later (Rose and Haerpfer, 1996).

2.3 Social capital and economic performance: cross-country evidence

How far do the conclusions obtained so far hold at a cross-country level? This section will review evidence regarding the determinants of trust in government institutions in transition economies and the impact of a lack of government credibility on economic performance. Generally, this is a two-way relationship in that governments that can build on trust in public institutions tend to have higher credibility, which contributes to better economic performance. This in turn serves to increase confidence in a given institutional set-up.

The first study I refer to uses data from the New Democracies Barometer, which has already been quoted above (Rose and Haerpfer, 1996; Rose, Mishler and Haerpfer, 1997). For the present data set, survey responses were collected from a total of 10,087 individuals in 1993 in nine east European countries (Bulgaria, the Czech Republic, Slovakia, Hungary, Poland,
Romania, Slovenia, Belarus and Ukraine). Respondents were asked a range of questions regarding their approval of the existing political and economic system, the previous regime, and specific public and civil institutions. The ratings for 15 political and civil institutions in the nine countries are reproduced in Table 4. In general, east Europeans are “sceptics”, a majority of respondents expressing neither fundamental trust nor distrust in the set of institutions. What is particularly striking is that scepticism concerns not just political institutions such as government, parliament, political parties, civil servants or the police, but generally applies to civil institutions as well. This suggests that the region has inherited a relatively low level of social capital. Moreover, in spite of the substantial differences in economic policies that had been implemented in the various countries by 1993, the variation in the ratings is higher among individuals than among countries. This might be taken as evidence for the argument that social capital changes only slowly. However, what country differences there are confirm the arguments made so far: trust is lower in the two countries of the former Soviet Union (and Bulgaria) and highest among the more advanced transition economies.

Rose, Mishler and Haerpfer (1997) use the above ratings to form an overall index of social trust, which they correlate with a variety of potential determinants. The most important conclusions from this exercise are the following. First, the personal evaluations of the past play virtually no role in determining the level of trust. Nostalgics are just as likely as dissidents to distrust present institutions. Hence trust has little to do with political affiliation. Also, trust is hardly affected by demographic and sociological factors such as age, educational level, gender, town size or church attendance. Second, individual perceptions about current institutional performance are the main factor explaining variations in social trust. Thereby, political and economic performance have a roughly equal impact, each explaining around 8-9 per cent of the total variation. Political performance includes increases in political freedoms (significant impact), increased political fairness (significant impact), and increased personal influence (insignificant impact). Economic performance is measured by evaluations of the current and future macroeconomic situation and current and future family finances. An independent influence is also assigned to perceptions about current economic deprivation. Future economic prospects dominate evaluations of current outcomes in their impact on social trust. This entails the possibility of creating trust through a credible reform commitment at the start of transition, such as described above for the case of Poland. In general, this second result gives strong empirical support for the indirect feedback effect from institutional performance to trust and the accumulation of social capital.

A third result should be noted, although evidence here is particularly thin. The insertion of country dummy variables raises the explanatory value of the regression by around one-fifth to 25 per cent overall. While the country dummies have smaller influence than that exerted by political and economic performance, their significance serves to highlight the fact that transition economies embark on institutional reforms from different levels of social capital. Belarus, Bulgaria and Ukraine in particular record a significantly lower level of average trust even once all other variables have been taken into account. Unfortunately, I can only speculate on the causes of such differences, but I would maintain that they relate to the prevalence of networks of corrupt officials and rent-seeking businesses inherited from the communist past.

What impact does social capital have on economic performance? As contended in Section 1.3, social trust tends to increase public pressures for efficient governance, which in turn positively influences economic growth. Government officials under public scrutiny are more effectively discouraged from corrupt behaviour as the penalties for being detected increase.
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Note: Trust is scored on a 7-point scale with 7 = maximum trust and 1 = maximum distrust.
BUL = Bulgaria; CZE = the Czech Republic; SLK = Slovakia; HUN = Hungary; POL = Poland; ROM = Romania; SLE = Slovenia; BEL = Belarus; UKR = Ukraine; Mean = Average for all 9 countries.
Ns for each country / institution range between 755 and 1000 cases.
Social trust will also increase the flow of information from the economic to the political sphere, making policy changes more predictable. Trust in government institutions will increase the reliability of formal institutional arrangements such as property rights and a given set of laws. In preparation for this year’s *World Development Report*, the World Bank has commissioned a survey of 3,685 private business people across industrialised, developing and transition economies. The subjects were asked to rate their institutional environment for predictability of laws and policies, stability of government, security of property, reliability of judiciary and the extent of corruption. All five scores were combined into an index of government credibility (see also Borner et al., 1995; 1996 for a related approach). This index varies between a high score of over 4 for the OECD and a score below 3 for the CIS, which thereby comes below sub-Saharan Africa in terms of government credibility. Central and eastern Europe has a higher average index, placing the region on a level above Latin America but below South and South-East Asia. Because individual scores were unavailable for the credibility index, a correlation of this measure and the index of trust developed by Rose, Mishler and Haerpfer (1997) was not possible. On the basis of the foregoing analysis, I expect the correlation to be positive (see also the results of La Porta et al. 1996, quoted in Shleifer, 1996, p. 17).

2.4 INFORMAL INSTITUTIONS AND THE DESIGN OF INSTITUTIONAL REFORMS: THE CASE OF PRIVATISATION

The case of privatisation will be used as a final empirical example of the impact of informal institutions on the design of institutional reforms in transition economies. The central argument is based on the observation that the actual privatisation paths chosen have differed substantially. I argue that this is not so much because of differing government opinions as to the best privatisation method, but rather due to considerations of political feasibility. In short, the relative power of insiders in SOEs will determine whether sales to an outside investor or the distribution of state assets among the population are feasible. When such power is large, insider privatisation is much more likely. Moreover, the longer privatisation is delayed, the more likely insider privatisation becomes, because SOE managers and workers have meanwhile acquired implicit rights in “their” enterprises, not least by taking some painful adjustment measures in order to ensure survival. What implications this has for the long-term performance of the enterprises concerned is as yet unclear. What is clear is that first best solutions to privatisation have had little empirical relevance so far.

My argument is largely based on Heinrich’s (1993) comparative analysis of privatisation methods in the Czech Republic, Poland and Hungary. I choose the former two to demonstrate my point. The Czech Republic has chosen voucher privatisation as the main method of mass privatisation. It has been applied in 50 per cent of all large privatisations, although this accounts for only a quarter of all state property that has switched to private or municipal ownership, the remainder being small privatisations, restitution and free transfer to...

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24 In an analysis based on a similar methodology, Borner et al. (1996) compute an index of credibility across eastern Europe and the Baltics which broadly supports the regional ranking presented by the World Bank.

25 One obvious implication not further addressed here is that the dependence of the privatisation method on the distribution of power within firms and between firms and the government introduces an important element of selection bias in the comparison of firms privatised by different methods. See Marcincin and Wijnbergen (1996) for econometric implications for the test of relative enterprise performance.
municipalities (Marcincin and Wijnbergen, 1995). Nevertheless, with large-scale privatisation more or less completed by 1995, privatisation in the Czech Republic has been very fast, rivalled only by the East German and to some extent the Russian experience. By contrast, Poland has experienced repeated delays on the way to mass privatisation. The original intention to privatise through 10 state-owned holding companies was finally realised in 1995. However, of the total of 3,349 enterprises in the process of privatisation by December 1995, only 834 (25 per cent) were included in the so-called capital path, which involves direct sales to outside investors and mass privatisation through holding companies (Table 5). By far the largest proportion was privatised through “liquidation” involving either the dissolution of the firm and sale of its assets to other owners (Article 19) or the transfer of assets to a different owner, usually a collective of SOE managers and/or workers (Article 37). The latter most closely approximates to insider privatisation and has a far higher completion rate than either of the other two paths. Overall, privatisation in Poland has been slow, the largest share of employment creation in the private sector coming from the growth of new private enterprises (Belka et al., 1994).

Table 5: Progress in Polish privatisation, 1991-95, various methods

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</table>


What may account for these differences? It is argued that the main difference lies in the existence of customary property rights by SOE workers and managers in Poland, in contrast to Czechoslovakia, where the relative power of the central government in relation to SOE insiders was far greater prior to 1989. The evolution of such customary rights in Poland followed the partial reform attempts during the 1980s. This led to a considerable role for worker councils in enterprise decision making. With the legitimacy of the state impaired by the imposition of martial law in 1982, and with the ensuing increasing loss of control over government agents at various levels of the bureaucracy, SOEs were able to take control of enterprise decisions while being largely shielded from the resulting consequences.

Consequently, Polish reform efforts concentrated first and foremost on introducing financial discipline into the state sector. One positive surprise was that, given hard budget constraints, Polish SOEs would display considerable adjustment efforts, at least when they were financially viable (Pinto et al., 1993). With performance improving, it became even more difficult to introduce outside ownership into SOEs. Insiders feared redundancy from more vigorous externally imposed adjustment measures, while claiming legitimate rights over state enterprises which they had helped to preserve by initiating adjustment. The policy reaction to the establishment and strengthening of customary rights was to give them legal protection through Article 37. Major adjustment problems remain in financially weak SOEs, and the low completion rate of Article 19 privatisations suggest that, in these firms, the struggle for
control continues and is likely to be an important drag on the respective enterprises’ performance.

The voucher privatisation method adopted for mass privatisation in the Czech Republic relies on public bidding for SOEs and leaves only a small role for insiders after privatisation is completed.26 In practice, the Czech government has allowed SOE managers to come forward with privatisation proposals during the first round of voucher privatisation, which shows respect for insider interests even in a country where tight hierarchical control persisted right up until the Velvet Revolution of 1989. Nonetheless, the weakness of the Czechoslovak labour movement after 1968 has been reflected in the virtual silence over worker concerns during the process of privatisation, an achievement that has certainly contributed to the speed of the process, but which would have been unthinkable in the Polish sociopolitical setting. It is interesting that Slovak privatisation has shifted from the initial participation in voucher privatisation to what may be termed “crony” privatisation. In the latter, state assets have been distributed at give-away prices to public officials and their families (Marcincin, 1996). Here, the legacy of tight state control has resulted in the development of a predatory state in which privatisation largely follows the rationale of political patronage. To what extent this pattern links into an older Slovak tradition is unclear to me.

The above analysis might easily be extended to the case of privatisation in Russia. Although Russia nominally followed a voucher privatisation method, managers of SOEs more often than not have been its main beneficiaries. Even where they do not hold controlling stakes, cross-ownership within large industrial conglomerates has meant that property rights are vested in networks of insiders with close connections to the government. As explained above, this pattern reflects a degree of institutional continuity, as it recognises the implicit property rights that were gained by an alliance of directors and bureaucrats during the late Soviet era. Any privatisation programme that had not respected these implicit rights would have met with strong insider resistance. The speed of Russian privatisation has been contingent on this recognition.

3 CONCLUSIONS

This paper has made three major points. First, the transition process is eminently a process of institutional change. As such, it is conditioned to a substantial extent by the inheritance of a given set of informal institutions that shape people’s expectations and constrain the enforcement of new market-based incentive structures. History matters for transition outcomes and the assets on which reformers can build in this respect differ between the various transition economies. This implies that there cannot be one optimal strategy for institutional reform, but that the given strength and legitimacy of the state has to be taken into account in designing policies for institutional reform. Second, theoretical, historical and cross-country evidence suggests that a crucial role of informal institutions in all societies is to facilitate economic exchange both by supporting self-enforcing “rules of the game” and by fostering trust in third-party enforcement through the state. Such trust will grow out of an articulated civil society in which individuals communicate and seek cooperative solutions to dilemmas of collective choice. In other words, trust positively depends on the level of social

26 I am not touching here the issues of corporate governance involved in judging the ultimate efficiency of new property rights arrangements. It is now widely recognised that the Czech voucher privatisation has only partially resulted in strong corporate governance through external owners.
capital in a given society. This in turn relies to some extent on the existence of a universal morality at least at the level of the nation state. Third, trust in government institutions is promoted by good political and economic performance. While governments cannot directly influence trust in public institutions, they can do so indirectly through formal institutional reforms that limit the scope for predatory behaviour by public officials and improve political and economic performance. Advance signalling of reform commitment through packaging of individual measures may increase trust by enhancing public perceptions of future economic prospects.

The outlook for transition economies based on the analysis in this paper is mixed. In the most advanced central European nations, growing integration with western Europe will firmly root democratic and market-based economic institutions in their societies. For the Czech Republic, Hungary, Poland and Slovenia at least, a rapid return to the group of prosperous industrial nations seems probable for the beginning of the next millennium. Further east, the prospects look much bleaker. As a result of a persistent fiscal crisis, state capacity has been eroded to an extent that control over the reform process may have been taken from government agencies and institutional power transferred to criminal organisations. These countries are in danger of reverting to an archaic situation of institutional competition among “roving bandits” (Borner et al., 1995), which is likely to drive the economy underground for a considerable amount of time. In China, lastly, administrative capacity has remained intact, albeit regionally fragmented. The major challenge in this country will be the build-up of a popular legitimacy once the population demands more from the government than guaranteeing economic prosperity. The fragility of an autocratic regime that has few institutionalised channels for participation by the various emerging groups in society remains a threat to China’s institutional development in the future. One can only hope that it follows the path of gradual democratisation that other successful autocratic regimes in East Asia have adopted over the past few years.
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Institutions constitute the social, political, legal and economic system of a state. According to North (1990), institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction. They structure incentives in human exchange, whether political, social or economic (p. 1). Hence, institutions are the rules that regulate social interaction. The corresponding transmission channel is the individual himself as informal institutions affect economic development on an aggregated level through their influence on people’s behaviors. However, even Adam Smith (1759) discussed the impact of cultural traits on economic development in his *The Theory of Moral Sentiments*. Institutions strongly affect the economic development of countries and act in society at all levels by determining the frameworks in which economic exchange occurs. Cooperation and Social Capital. Institutions which are conducive to development ensure greater self-expression, allow the free flow of information and encourage the formation of associations and clubs. These form prosperous social relationships, which are conducive to greater economic interaction by increasing levels of trust and wider availability of information (Putnam, 1993).