26. Institutions and Firms in Transition Economies

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1. The Transition and the NIE

In 1989, the Soviet bloc in Eastern Europe disintegrated. In mid-1991, the old Yugoslavia began its painful, protracted breakup. Later that year, an abortive communist coup led quickly to the FSU (former Soviet Union). Twenty-eight countries were free to choose their own economic and political institutions. Public and elite opinion was set on a large move away from the old socialist system, towards some form of market capitalism. In most countries, there was an accompanying shift toward greater political freedom and democracy. All countries undergoing this transition have now experienced more than eleven years of post-communist change.

Several features of transition contribute to its particular pertinence to the NIE. The reforming countries ended the 1980s with a set of formal institutions far different from those of market capitalism. The predicament was not simply one of underdevelopment, with poorly working, incomplete market-capitalist institutions. Rather, under central planning, most essential economic activities were governed by powerful institutions that were antithetical to market capitalism. Mammoth institutional destruction and construction was on the agenda, whatever strategy drove that agenda.

Consistently, the internal organization of enterprises, the mechanisms of enterprise governance, and the governance of transactional relations were all a product of the institutions of central planning and communist politics. But since planning and communism were the two elements of the old systems that were most roundly rejected, firms faced a truly revolutionary situation. In contrast to normal processes of development, where expanding firms adapt to an evolving institutional environment, transition began with large production units facing an institutional earthquake.

This chapter focuses on how the NIE has been used to understand transition processes and how the experience of transition can help inform the NIE.[1] As the

[1] There are three earlier papers that have related goals, although all three focus on the first objective of this paper rather than the second. Lichtenstein (1996) constructs, and critiques, an NIE model of the decline of central planning and the process of transition. Smyth (1998) provides a broad-ranging review of the literature that lies at the intersection of transition and the NIE. Voigt and Engerer

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above clearly attests, transition inherently involves phenomena that are of central interest to students of the NIE. However, simply discussing these phenomena is not the same as using the NIE: related branches of economics study many of the same general issues. Therefore, to delineate this chapter's scope, it is necessary to draw the dividing line between specific application of the NIE and more general economic analyses of the phenomena on which the NIE focuses. The next two paragraphs do this by listing the analytical concepts that constitute the central core of the NIE. These paragraphs simply distill the essence of the *Handbook* essays by North, Williamson, and Shirley. They serve as a guide as to what is emphasized in the remaining sections of this chapter.

At a macro level, an analysis driven by the NIE would focus on institutions as the rules of the game. These are the prime determinants of the size and distribution of transaction costs. Institutional change is driven by the demands of organizations seeking to reduce transaction costs. Since the set of organizations present at any moment is determined by the inherited structure of institutions, the process of change is mainly incremental and path dependent: institutions tend to be long-lived and difficult to reform. Although institutional change is driven by the rational actions of organizations, there is bounded rationality and the mental models of actors are a prime ingredient in path dependence.

NIE microeconomic analysis takes the transaction as the basic unit of study and focuses on transaction costs, using contractual reasoning. Such analysis involves an examination of the allocation of economic activity across alternative modes of organization, with the governance structure of firms and of transactions being a central concern. A key focus is on whether there is a discriminating alignment between the attributes of transactions and the properties of governance structures.

This chapter's content reflects the intersection of the features of transition and the characteristics of the NIE that are delineated above. The first task is to assess the role played by the NIE in shaping the way economists analyzed the transition process. Section 2 examines the use of the NIE as an analytical tool, particularly focusing on the early phases of transition when there were vigorous debates on the strategy of transition. The overall conclusion from the section is straightforward: in the early transition, the NIE hardly played any role at all, but now the issues stressed by the NIE are a central focus of the transition literature.

Section 3 considers events in the early years of transition, which provide a concrete example of how strategies of transition might have been very different had they more directly embodied the lessons of the NIE. In the very beginning of transition, the political underpinnings of a set of powerful formal economic institutions were removed overnight. In most cases, the new politicians were either not willing or not able to slow the resultant institutional collapse. Since replacement institutions were not available immediately, firms were left to struggle in an immensely chaotic environment. The effect of this chaos on firm behavior,

(2002) consider policy implications of the NIE, reviewing elements of transition experience in the process.

and consequently macroeconomic performance, is a subject of much importance and controversy. The institutional collapse and the reactions of firms are examined in Section 3.

Perhaps one reason why the existing institutions collapsed so rapidly was that there was substantial political consensus on the outlines of institutional construction, which therefore moved forward quickly in virtually all countries.[2] But how long would such construction take and how successful would it be? Which institutions would be built most quickly and which would take more time? These questions bear on ideas that are central to the NIE. Armed with a greater sensitivity to institutions than ever before, economists could watch the construction process in real time and gain new information pertinent to these ideas. The relevant evidence is presented in Sections 4 and 5, which respectively examine the aggregate amount and the structure of institutional development.

At the micro level, firms faced a new institutional environment, which was changing at unprecedented speed. Governance structures, for enterprises and for their transactions, had to be built on new foundations. Which institutions would most influence firm behavior? Which new rules would affect behavior most quickly? How would variations across countries in the new regulatory frameworks and laws be reflected in variations in the behavior of firms across transitional economies? These issues are examined in Section 6 for Eastern Europe and the former Soviet Union. Section 7 ventures further afield by examining the case of China, whose process of institutional construction was largely unique. The conjecture is that China's transition process has elements that correspond quite closely to those that might have been fashioned by an advocate of the NIE.

Transition and the NIE offer lessons for each other, and this chapter considers lessons flowing in both directions. It considers how the immensely productive tools of the NIE have been applied to the study of the remarkable phenomenon of transition. Conversely, it examines how the unique historical experience of transition offers lessons of importance for the NIE, strengthening, or perhaps reshaping, existing knowledge. There are a large number of these lessons and they appear throughout this chapter. Section 8, the conclusion, returns to the most important lessons, ones that seem especially likely to challenge, or to qualify, the existing tenets of the NIE, drawing them together in an attempt to provide an analytical synthesis. This synthesis is left for the conclusion because it is the most conjectural element of the chapter, attempting to tie together the disparate pieces of evidence that are available on institutions and firms in transition.

This introduction concludes with two notes to aid the reader in interpreting what follows. First, much of the discussion focuses on empirical evidence. Nevertheless, readers must be cautioned that the pertinent evidence is often thin: empirical studies that focus directly on institutions in transition have not

[2] This consensus was especially the case for the countries that had the goal of entry into the European Union.

been commonplace and the quality of the empirical work has not been at the highest standards of the profession. Quite often it is necessary to infer results from studies that did not have institutions as their first order of business. Thus, the reader must be warned at the outset that at some points this chapter is forced to rely on evidence that is quite weak. That characteristic is a product of how little the NIE has been applied directly to the process of transition and how little we still know about institutions and transition.

Second, the discussion is only on those aspects of transition most germane to the NIE. There has recently been a flood of review papers that cover other aspects of the transition experience. The most informative as complements to this chapter are Djankov and Murrell (2002) on the determinants of enterprise restructuring, Estrin (2002) on competition and corporate governance, Campos and Coricelli (2002) on growth, Boeri and Terrell (2002) on the institutional determinants of labor reallocation, and Berglof and Bolton (2002) on finance. For those unfamiliar with the transition environment, comprehensive surveys are available at successive stages in the *Journal of Economic Perspectives* (Murrell, 1991; Murrell, 1996; Svejnar 2002).

2. The NIE and the Early Literature on Transition

One of the more curious aspects of the economics of transition is that the NIE, used consciously as an analytical tool, played virtually no role during the first few years of the 1990s.[3] Despite the great mutual relevance of transition and the NIE, described in the introduction, it is difficult to find analyses produced in early transition that follow the NIE at all closely.[4] This can be documented using a simple analysis of the subject matter of articles produced during the time period.

The *EconLit* database was used to search for documents (books, journal articles, working papers, and dissertations) that used 'transition' as a keyword.[5] The new institutional economics did not appear as a keyword within these documents until 1995. Transaction costs did not appear until 1992. In the first complete year of transition, 1990, only 3.3% of documents had institutions as

[3] The most common and most influential analyses during early transition did not use the NIE (Smyth, 1998, Voigt and Engerer, 2002). Benham and Benham (1997) document in great detail the degree to which the considerations emphasized by the NIE were missing from the debate at the beginning of transition.

[4] Grosfeld (1990), Ickes (1990), and Murrell (1990) present analyses of changes within the old systems using elements of the NIE, but these pieces were written before the political changes. Aoki and Kim (1995) is based on the notion that comparative institutional analysis can be productive in deliberations on institutional reform. Lichtenstein (1996) presents an NIE analysis of the fall of the centrally planned economy and optimal transition policy, but mainly from perspective of a critic of the NIE.

[5] The reader who is, justifiably, skeptical of this type of quantitative summary can be reassured that the conclusions have been verified by a reading of the literature that has been exhaustive (in both senses of the word).

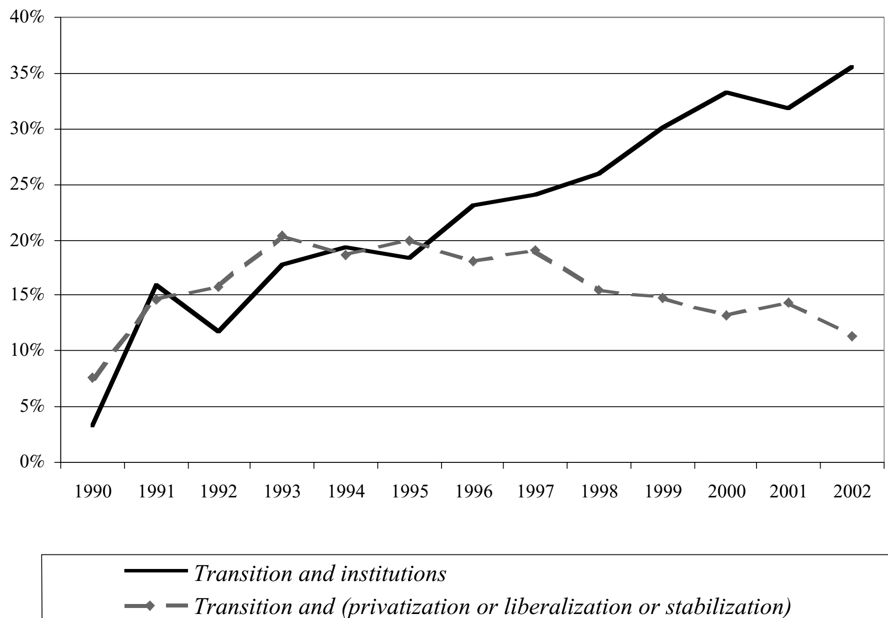

Figure 1. Percentage of those documents in the *EconLit* database having transition as a keyword that also use institutions or Washington consensus policies as keywords.

a keyword and in the first three years only 11.6% did. This can be compared to the Washington Consensus triumvirate of privatization, liberalization, and stabilization, at least one of which appeared in 7.6% of articles in 1990 and in 14% in the first three years of transition.

The simple quantitative story is told in the accompanying Figure.[6] This Figure shows in capsule form how institutional issues were underplayed in the early transition, relative to Washington Consensus issues, and how as time passes they have been ascribed an ever greater emphasis.[7] Even as early as 1991, the increase in attention paid to institutions was a reflection of the events in the preceding two years (Williamson, 1992, p. 69). The steep incline of the ‘institutions’ time-line and the fact that over 35% of articles on transition now involve discussion of institutions are surely signs that the process of transition has spurred interest in the NIE and that the NIE had something to offer at the beginning of transition that was not fully exploited by economists or policy-makers.

The fact that the NIE was not being used consciously as a primary analytical tool in the early transition is backed up by an examination of those items in the early transition literature that have had a significant impact over time

[6] One could tell exactly the same story by looking at the evolution of the subject matter of the EBRD’s transition indicators.

[7] The work of the World Bank shows similar changes in emphases over time (Landell-Mills, 2003).

and which reflect on issues closely related to the concerns of the NIE. Where core concerns of the NIE were invoked, the NIE did not seem to provide the stimulus. Kornai (1990) was obviously concerned about governance issues in privatized enterprises but Hayek is much more influential than Williamson in his analysis. Path dependence was especially central for Stark (1992), but this reflected the general interest in this phenomenon among social scientists. McKinnon (1991) emphasized the importance of institutional structure for financial and monetary policy, but his analysis did not reflect an NIE viewpoint. Murrell's (1992) concern with institutions came as much from Schumpeter as from North or Williamson. Dewatripont and Roland (1997) viewed transition as a process of large scale institutional change, but mainly from the perspective of political economy and principal-agent analyses of managerial incentives.

In sum, the NIE was a surprising spectator in the early transition debates. There were analyses that were highly compatible with those of the NIE, but none seemed to be explicitly driven by NIE. In Europe, with the greater prominence of more heterodox modes of analysis, there was probably a greater emphasis on institutions than in the U.S., where neoclassical analysis was relatively more popular.[8] However, these complementary analyses, with their focus on institution-related issues, did not represent the mainstream of the early transition literature.

Had the NIE been more prominent at the start of transition, there would surely have been more focus on institutions as providing the necessary rules of the game. As Coase (1992, p. 714) commented in his Nobel address:

> "The value of including . . . institutional factors in the corpus of mainstream economics is made clear by recent events in Eastern Europe. These ex-communist countries are advised to move to a market economy, and their leaders wish to do so, but without the appropriate institutions no market economy of any significance is possible."

This lack of focus on institutions in reform measures is generally credited as important ingredient in determining events in the first years of transition, events that proved to be an important stimulus to the increasing interest in institutions.

Gradually the mainstream view changed, as the Figure shows. Many factors contributed, the continuing recessions in the CIS countries after stabilization, the beginning of growth in some countries that had not fully stabilized, the

[8] At least, the greater emphasis on institutions in the European literature is a common assumption. After an extensive search of the literature, I am not entirely persuaded of this point. For example, in 2002, thirty European scholars replied to questions from the Hungarian journal, *Acta Oeconomica*, on what the main roadblocks to transition were. A reading of these papers leaves one with the surprising impression that the emphasis on institutions in Europe was not that much greater than in the U.S. at this time. Only one set of comments of these thirty seems to be influenced by the NIE (Dallago, 1992). Another two (Wagener, 1992, Hanson 1992) stress the importance of institutions. Interestingly, what seems common to these three scholars and those mentioned in the previous paragraph of the text is not the NIE, but rather the old comparative economic systems.

smaller GDP declines in some less-reformed countries, accumulating evidence on widespread corruption, an epidemic of broken agreements and lawsuits, and increasingly common ad hoc observations that firm governance left much to be desired. Roland (2000 p. xix) has described how the transition process has helped to change the very mode of analysis within economics:

> "The [events of transition] have further contributed to a change in focus in thinking about economics and have very much reinforced the institutionalist perspective, emphasizing the importance of the various institutions underpinning a successful capitalist economy . . . Thus, there is a shift of emphasis from markets and price theory to contracting and the legal, social, and political environment of contracting . . . transition has forced us to think about institutions not in a static way but in a dynamic way . . . how institutions can evolve . . . and how one can get stuck in inefficient institutions."

These sentences resonate closely with the summary of the core NIE issues presented in the introduction to this chapter.

3. The First Few Years

The transition countries experienced recessions of unprecedented depths. Svejnar (2002) places the declines in GDP at 13–25% in Eastern Europe, 40% in the Baltics, and 45–65% in the Commonwealth of Independent States (CIS).[9] Not surprisingly, there were also large declines in the productivity of existing enterprises. Anderson et al. (2000), for example, estimate a 78% drop in value added per employee within four years in Mongolian firms.

As detailed above, the NIE did not play a role in the most influential analyses during early transition. Fears of hyperinflation rather than recession dominated; macroeconomics governed microeconomics. The extent to which macroeconomics dominated was most clearly exemplified by the IMF's short-term focus on raising taxes in Russia, while largely ignoring sensible tax reforms (Black, Kraakman, and Tarassova, 2000). Rapid liberalization was advocated without consideration of its effects on the governance of contractual relations. Transaction costs during and after the process of privatization were rarely discussed. A simple political economy, which emphasized the destruction of the old institutions, trumped the NIE, which emphasized the dangers of an institution-free environment.[10]

These analyses turned out to be uniformly overoptimistic, as judged for example by IMF forecasts for GDP growth. When production declines proved to be larger than expected, the earliest diagnoses followed the earlier analyses:

[9] The CIS comprises the twelve non-Baltic countries that emanated from the Soviet Union.

[10] Early in the transition there were the beginnings of a more refined political economy, as exemplified in the work of Gérard Roland (see Roland 2000). The influence of this political economy grew as transition proceeded.

strong, but necessary, stabilization programs had led to recessions, which were exacerbated by the dilatoriness of politicians in pursuing reforms. For example, Berg and Blanchard (1994) concluded that Poland's fall in output was due to a drop in aggregate demand, not to dislocations of the economic system.[11] That is, in the early 1990's, the most influential analyses did not associate the transitional recessions with institutional problems. Such analyses led to the conclusion that liberalization, privatization, and stabilization should move even faster in Russia in 1992 than they had in Eastern Europe two years earlier. Early 1992 therefore provided an unfortunate conjunction of a momentous economic policy decision with the zenith in the popularity of a theory of economic policy that gave little acknowledgement to institutions.

What would have surfaced if the NIE had played a larger role in the debate at the start of transition? Murrell (1992) and Murrell and Wang (1993) provide some indication, even though these analyses are no more than suggestive and do not use the NIE as fully as seems appropriate in retrospect.[12] These papers stress the dependence of existing organizations on the current institutional framework, concluding that there can be much poorer firm performance in the short-term when old institutions are destroyed and new ones are not yet effective. The view of the market economy as simply decentralization of decision-making is rejected, with emphasis instead placed on the casting of decentralization within an appropriate institutional structure. The latter paper analyzes the interaction between the development of institutions and the implementation of other elements of reform, suggesting that fast privatization could slow the pace of institutional development. The paper argues that the emphasis should be on the growth of the new private sector and on the institutions supporting that growth.

As Section 2 clearly shows, gradually the economics of transition came to focus much more on institutions and transactions. Events on the ground were obviously responsible for stimulating this change. However, one paper that was undoubtedly influential in changing the mainstream focus was that by Blanchard and Kremer (1997), which formalized some of the existing inchoate analyses in a simple, but powerful model. While not cast in the NIE tradition at all, this paper embodies some key elements of the NIE, the focus on transactions rather than production and the need for an effective governance mechanism. The model highlights the incentives to break agreements in the absence of effective governance. Firms start the transition process with highly specific production relations, where large firms must buy inputs from a particular set

[11] Murrell (1995) uses simple transactions-cost reasoning to show that the evidence used in support of this conclusion could just as easily be used to support the opposite conclusion. The interpretation of evidence depends on the theoretical lens.

[12] These papers are used because they show what the NIE might have offered at the time reforms were being formulated. (Lichtenstein (1996) and Smyth (1998) interpret Murrell (1992) as being cast in the framework of the NIE.) Now, with the benefit of hindsight, many of the ideas of the NIE are absorbed into a mainstream consensus. McKinnon (1991), Dewatripont and Roland (1992), and Kornai (1990) also differed from the mainstream perspective at the start of transition, but their analyses are even more removed from the NIE.

of suppliers. Previously, supply was ensured by the planning system. But then institutional collapse occurs and alternative outlets appear for the suppliers. Once a single supplier defects, production in the large old firm is impossible. Defection occurs when a supplier receives a good counter-offer, even if the other suppliers do not. There is a loss of production and social welfare, which is greater the more complex are the old production relations.[13] If the outside opportunities for suppliers improve over time, the model generates a U-shaped growth path.

There is weak empirical support for this model, but precise testing is difficult, meaning that the pertinent empirical work is not as convincing as in many other areas. The most important problem in constructing tests lies in measuring the complexity of inherited production relations and the size of the institutional decline. For example, Konings (1998) measures complexity by the number of firms in the enterprise's sector, while Konings and Walsh (1999) use number of products produced by an enterprise. They obtain evidence that is generally supportive of the Blanchard-Kremer model for Bulgaria, Estonia, and Ukraine. Relatedly, Cungu and Swinnen (2003) find that hold-up problems do lead to lower investment levels in Hungarian firms.

Recanatini and Ryterman (2000) provide an empirical examination of the Blanchard-Kremer model that generates insights particularly pertinent to the NIE. Although, they do not find direct support for the specific prediction on complexity, they do find that growth was lower in those firms that formerly received the strongest institutional support from central planning. One interpretation of this result is that these firms have the greatest need for institutional support. Interestingly, some firms do find imperfect, informal substitutes for the moribund old and the embryonic new institutions. The firms suffering most from the absence of supportive institutions have the greatest tendency to join business associations, membership in which ameliorates the decline in production. This is consistent with the results of Perotti and Gelfer (2001), who present evidence that financial-industrial groups in Russia provide an informal substitute for capital markets.

Although the last few years have seen significant advances in the understanding of the relationship between institutional change and production decline in transition, there is much yet to learn. It is now well accepted that socialist economic institutions provided services that contributed to enterprise productivity (albeit contributing much less than many alternatives available in the longer run).[14] These institutions offered credibility that reduced the transaction costs of negotiating agreements, contract enforcement to reduce transaction costs during the implementation stage, specification of control rights over assets (both

[13] The loss occurs because the expected value of the first-order statistic of a sample of alternative offers (or social values) is higher than the expected value of the mean of the sample. In the model, complexity is captured by the number of suppliers, which equals sample size. The expected value of the first order statistic minus the mean is positively related to sample size.

[14] Joskow and Schmalansee (1997) make this point strongly in an analysis that uses the NIE.

within enterprises, and between enterprises), mechanisms for the allocation of working and investment capital, and a host of other services. When the communist systems fell apart and market institutions were still waiting in the wings, these crucial services were no longer supplied. Moreover, at the beginning of transition, institutional support was particularly critical because socialist firms were large, implying a need for sophisticated governance mechanisms, and because inter-firm relationships were highly particularized, implying great potential for hold-up. Hence, productivity declined with the decline of the old systems.

On all of this, there is much agreement. On what should have been done had economists pursued this line of thinking more strongly in early transition, there is little agreement. The idea of retaining some of the old institutions (e.g., Murrell, 1992) was rejected as not politically desirable because of the putative danger of the return of communism. The experience of East Germany indicates that immediate implementation of first-best institutions is not a panacea. The success of China, to be examined in Section 8, suggests that transitional institutions, produced by incremental change, can be productive.

4. The Development of Institutions: Aggregate Evidence[15]

One reason why institutions were not emphasized in early transition was the widely-held assumption that institutional development would be slow and could not contribute much in the short-run.[16] Existing work within the NIE certainly contributed to this general assumption, despite the fact that it is also acknowledged that revolutionary times lead to revolutionary institutional changes (Williamson 2000, North 1990). This pessimism has continued. According to the EBRD (2000, p. 23–5), institutional reform has lagged other reforms. Svejnar (2002, p. 7) concludes that:

> "Virtually no transition country succeeded in rapidly developing a legal system and institutions that would be highly conducive to the preservation of private property and the functioning of a market economy . . . This lack of a market-oriented legal structure appears to have been the Achilles' heel of the first dozen years of transition."

This section assesses these conclusions by reviewing evidence on the development of institutions in transition economies. Fortunately, the 1990's saw a proliferation of information that calibrates institutional levels across countries. Using surveys of economic actors, opinions of country experts, and objective information on laws and implementing organizations, many authors have constructed data sets that give a rough quantitative guide to comparative institutional

[15] This section and the next draw on Murrell (2003a).

[16] See Fischer and Gelb (1991) for this standard view. This assumption was not universal. Sachs (1991, p. 236) claimed that the economic, legal, and institutional basis for a market economy could be established in one year.

performance. Moreover, most of this data measures institutional effectiveness in some way, so the picture described here is not simply one of formal institutional development, but rather of real progress of institutions in achieving their fundamental objectives.

Campos (2000) generated a data set that covers both general political and economic institutions for 25 transition countries from 1989–1997. For all four of his measures (the quality of the bureaucracy, the rule of law, transparency of policy-making plus accountability of the executive, and the strength of civil society) the data give a very strong impression of profound increases over time, which occur in all time periods for all measures.[17]

The measures produced as part of the International Country Risk Guide (Coplin, O'Leary, and Sealy, 1996) focus more narrowly on economic issues and have been the most popular general measures of the strength of economic institutions (Knack and Keefer, 1995). There are five different series that are most pertinent for economic issues: law and order, corruption within the political system, the institutional strength of the civil service, the risk of repudiation of contracts, and the risk of expropriation of investment. According to these data, there have been widespread, large, continuing improvements in institutional quality. The one exception is in levels of corruption, which, after improvements, rose to back to the 1989 level.

These dramatic increases in measured institutional quality suggest an investigation into just how good institutions are now in transition countries. But what is a reasonable expectation? We know that the level of institutional quality is highly correlated with level of economic development. Therefore, it seems appropriate to examine how the transition countries fare when matched against countries at a comparable level of economic development (Murrell 2003a). This requires institutional measures for a rather large set of countries. For this purpose, the measures produced by Kaufmann, Kraay and Zoido-Lobaton (1999, 2002) are probably the most suitable. Their six measures are voice and accountability, political instability and violence, government effectiveness, regulatory burden, rule of law, and graft.

A crude statistical exercise analysis shows that institutions in Eastern Europe are better than would be expected on the basis of level of economic development (Murrell, 2003a).[18] Institutions in the former Soviet Union are worse than would be expected. Transition countries as a whole are about where they might be expected to be in 2000–1 based on level of economic development. On voice and accountability and political instability, transition countries are better than comparable countries; on rule of law and corruption they are where expected given levels of economic development; and on government effectiveness and regulatory burden they are worse. The regressions also indicate that there is improvement from 1997–8 to 2000–1 for the transition countries as a whole and for Eastern Europe and the former Soviet Union separately. A majority of

[17] Except for strength of civil society in the CIS.

[18] It must be emphasized that the statistical analysis is a simple descriptive one, not driven by a precise model of the relationship between institutions and levels of development.

countries is improving, measured either by the number of improving indicators or by the aggregate score. There is improvement on a majority of the indicators.

In sum, although institutional levels were low at the start of transition, there were remarkable improvements over the 1990s. And these were real improvements, not simply the setting up of formal institutions. By the beginning of the present century, the quality of institutions in transition countries was roughly as expected given levels of economic development. Moreover, there are strong signs of continuing improvement in many countries. These results suggest a reevaluation of the usual assumption that institutional development is a glacial process. The transition countries began the 1990s with many powerful institutions that were inimical to the functioning of capitalism and democracy. Most essential market institutions were absent, with dire consequences for economic performance. Yet, a decade later, institutional lacunae are no longer the defining feature of the transition economies.

The generation of this conclusion was based on rough empirical information, more like a hypothesis generated by the data than a test based on the data. To the extent that new independent information supports it, then one can place much more confidence in this conclusion. Such information was generated after the first version of this essay was written. The EBRD has conducted a follow up of its 1999 business environment survey and sees dramatic improvements between 1999 and 2002. One summary of the data examines changes in 7 institutional indicators for 24 countries (EBRD 2002, pp. 42–43). Of the resultant 168 institutional indicators, fully 87.5% show signs of improvement. For example, the quality of the judiciary has improved in 18 of the 24 countries and become worse in only 3. Corruption has declined in 15 countries and become worse in 8. To the extent that the conclusions of this section are conjecture, that conjecture has been ably supported by this later, independent source of information.

5. The Development of Institutions: Structure

How were these aggregate institutional developments produced? There are two ways to interpret this question. First, one can examine proximate cause: which types of institution-producing organizations have mattered most? Second, what factors within the politics and economics of transition economies led to a faster-than-expected development of institutions? Evidence on the latter question is unfortunately very scarce and only brief comments appear at the end of this section. The answer to the first question can take advantage of accumulating evidence on different institutions. However, it must be emphasized that this evidence is still quite thin and all conclusions must be conjectural.

At a very basic level, the following types of institutions can be identified:

1. Those produced by private bodies with a formal role promoted or facilitated by the state, e.g., self-regulation of stock markets; arbitration courts; accounting standards boards.

2. Political institutions, e.g., legislatures, electoral processes, etc.
3. Institution-like behavior by state administrative bodies, e.g., criminal law enforcement by justice departments; product safety and health standards by ministries; patent registration by a patent office.
4. The effects of the actions of independent quasi-governmental bodies, e.g., central banks issuing money and regulating banks; stock-market regulators protecting investors; bureaus licensing prescription medicines.
5. The legal system, e.g., contract law for transactions; systems of definition and enforcement of property rights; corporate governance law and enforcement; the courts and bailiffs.

The evidence on the effectiveness of each of these institutional types is scattered, staccato, and imprecise. It is hard to make definitive conclusions. Nevertheless, one can begin by examining on which of the Kaufmann, Kraay and Zoido-Lobaton measures the transition countries perform best. In order of success (relative to levels of development), the measures are voice and accountability, political instability and violence, rule of law, graft, government effectiveness, and, last, regulatory burden. It therefore seems safe to conclude that political institutions are making a large contribution to the relative overall institutional performance of the transition countries, while state administration (which is largely responsible for the regulatory burden) is a very poor performer.

There is considerable evidence from empirical work that the performance of legal systems in transition countries is much better than initially expected. Some examples are given here and more follow in Section 6.[19] Djankov et al. (2002) collect data on highly specific aspects of the functioning of legal systems in a variety of countries, such as collecting on a bad check. Their data reflect expert assessments of how things actually happen, as well as formal law. They find that the ex-socialist countries fare reasonably well compared to those countries whose legal systems have either French or German origins. The results for the socialist countries are clearly better than those for French-origin countries and slightly better than those for German-origin countries.[20]

Pistor, Raiser, and Gelfer (2000) provide an alternative method, looking at inputs, the quality of laws. They examine the strength of shareholder and creditor rights that have been enacted in transition countries. Formal shareholder rights in transition countries surpass those achieved by countries whose legal systems derive from French, German, or Scandinavian origins and are now midway between those of common law countries and those of French or German origin.[21] On formal creditor rights, the progress is even more remarkable. Creditor rights in transition countries score higher than rights in all other sub-groups

[19] There is substantially more evidence than this on legal systems, some of which is presented in later sections of this paper. A comprehensive discussion appears in Murrell (2003a).

[20] The regressions control for level of economic development.

[21] These results occur even though these comparisons match the transition countries against a group of countries in which OECD members are the majority.

of countries, when the groups are defined in terms of legal origins. This performance was essentially achieved in a matter of six years.

Of course, the Pistor et al. (2000) evidence is on formal law, not on its effectiveness, and it is not unusual for formal law to outpace its implementation. Successful reforms are marked by law in practice eventually catching up with the law on the books. Indeed, that is what might be happening in transition countries. For the year 2000, the EBRD (2000, p. 34) rated sixteen transition countries as having commercial law that was rated higher on extensiveness (i.e., formal quality) than effectiveness (i.e., practical effect) while the relative ranking was the opposite in two countries. By 2002, the situation was reversed, with four countries scoring higher on extensiveness than effectiveness and eight countries having the reverse relative ranking EBRD (2002, p. 38). This suggests that implementation might be better than is commonly supposed. Consistently, Ramasastry, Slavova, and Bernstein (1999, p. 39) comment on survey results indicating that court systems are viewed fairly favorably in terms of protection of shareholder rights:

> "At first glance, these results may seem counter-intuitive given the generally negative view of courts in the region. Criticism of the courts and judges ranges from allegations of corruption or bias towards the government or powerful commercial interests, to a general lack of understanding of newer commercial laws and complex commercial transactions. However, the survey results reveal that respondents do feel that the court system can provide an effective means of redress and protection for shareholders' rights."

There is also evidence that independent governmental bodies have contributed to institutional development. For example, Pistor (2001) documents how the success of equity markets in Central Europe depended critically on independent state agencies that supervised stock markets and implemented investor protection rules. Similarly, Johnson (2001) lays out a fascinating story of how great strides have been made in independent central banks. In contrast, there is little evidence that state-facilitated private bodies, e.g., domestic arbitration courts, are making a large contribution to institutional performance.

In sum, returning to the categorization of different types of institutions appearing at the beginning of this section, political institutions seemed to have developed fastest. The legal system and independent governmental bodies have made important contributions. State administration, that is the core governmental bureaucracy, has been very slow to change and offers a compelling example of relative failure of institutional adjustment.

As to the ultimate causes of these developments, only speculation is possible given the absence of empirical studies on the determinants of institutional construction during transition. One question that has been central in the literature is the relative importance of supply or demand. How much will be done by a reforming government that is not being pushed for specific measures by economic interests? The strategy of fast privatization in Russia was determined in part by an answer to this question: "Economic institutions cannot possibly

precede the reallocation of property from the government, because people do not care about these institutions until, as property owners, they have an economic interest." (Boycko, Shleifer, and Vishny, 1995, p. 126). But the pertinent empirical evidence has not yet been produced. One of the most fascinating intellectual exercises in the future will be to test this proposition, and other ones that predict the sources of institutional development. Certainly there is much evidence being generated by the transition countries on this score.

6. Changing Rules and Changing Behavior of Firms[22]

The Reaction to Changing Policies in the Short-Term

Section 3 examined the reaction of firms to the decline of the old institutions. This section focuses on the reaction of firms to the new environment created by reforms. Certain aspects of the new environment could be implemented quite quickly, for example, liberalization, privatization, and the removal of soft budgets. The effects of these policy measures have been intensively examined in a large number of empirical studies.[23] Although these measures are all outgrowths, in part, of the institutional framework, they are not extensively examined here, for two reasons. First, the connection between these policies and institutions is indirect and therefore the relevance to the NIE is less obvious. Second, there is an extensive survey on these issues, on competition (primarily induced by liberalization), privatization, and the effects of hardening of budgets (Djankov and Murrell, 2002). The results of pertinence here are:

1. Privatization is strongly associated with better enterprise performance in Eastern Europe, but not in the CIS. Differences in the effectiveness of corporate governance quite possibly explain the differences between the regions.[24]
2. State ownership within traditional state firms is less effective than all other ownership types, except for worker owners. Investment funds, foreigners, and other blockholders produce much more improvement in enterprise performance than diffuse individual ownership. The importance of these types of owners, which concentrate shares in large blocks, suggests a deficiency in corporate governance, which seems to be more pronounced in the CIS than in Eastern Europe.
3. State ownership within partially-privatized firms is surprisingly effective, producing better enterprise performance than that produced by insider-owners and non-blockholder outsiders. Independent state organizations might therefore perform better than some types of fully private actors, when the

[22] This section does not aim to be comprehensive, but rather focuses on issues where there is pertinent evidence.

[23] The overwhelming majority of these studies do not use the NIE. Shastitko and Tambovtsev (2001) is an interesting exception, viewing soft budgets as relational contracts.

[24] Section 5.1.d below examines the difficult question of whether it is the institutions of corporate governance or some other factor that has led to the deficiencies in corporate governance.

requisite institutions are lacking. This result resonates with the conclusion in the previous section on the apparent success of institutions produced by independent state bodies, and also with the later discussion of transitional institutions.

4. Product market competition has a large effect on enterprise performance. Institutions might have played a role in producing this effect. Dutz and Vagliasindi (2000) find that the quality of competition policy has a positive and significant effect on the expansion of more efficient firms and Vagliasindi (2001) finds that competition policy has a strong and robust effect on levels of competition.

While there are transparent lessons for the NIE in the above, this chapter turns instead to those areas of research that involve the NIE more centrally, either in methods used or in the direct relevance of the conclusions.

Boundaries of the Firm

The paradigmatic problem of the NIE is the determination of the boundaries of the firm. At the start of transition, firm boundaries reflected the demands of the socialist system, not the transaction costs of a market environment. This was recognized generally, and most explicitly stated by Earle, Estrin, and Leshchenko (1996, p. 7): "A principal task of transition is therefore the reorganization of the groups of productive units which comprised the enterprise sector in the formerly socialist economies through vertical and horizontal disintegration and reintegration to form an industrial structure in which the boundaries of the firm are set to ensure the costs within the new structures are at a minimum." Similarly, Joskow and Schmalansee (1997, pp. 122–3) in an analysis explicitly using elements of the NIE predicted that "Over the next few years, we are likely to see major industrial restructuring take place in Russia as privatized enterprises merge, diversify their product lines, spin off unrelated business activities, and are liquidated or restructured following bankruptcy."

In contrast to these expectations, reported results on changing firm boundaries are surprisingly few and they point to only small movements.[25] For Russia, Earle et al. (1996, p. 86) find that only 14% of firms had major asset sales or transfers over a two and half year period at the start of the transition. Only 3% of employees were in subsidiary firms. Miniscule amounts of work were being contracted out and only tiny amounts of labor were employed in units sold or units acquired. This is in contrast to a 20% drop in employment, a gross hiring rate of 41%, and a separation rate of 51%. In Georgia, Djankov and Kreacic (1998) finds that few directors resort to assets sales. In six CIS countries, Djankov (1999, p. 86) finds only 24% of enterprises engaging in asset sales, however small. For a sample of 300 firms in four East European countries, Earle, Pagano, and Lesi (2002)

[25] There are more results on such changes as the production of new goods. But, these can occur without redrawing the boundaries of the firm, as when a car company simply produces a new model with the same production process as before.

find that even though the number of split-ups and mergers is quite high, the resultant effects on employment are quite small. It seems necessary to conclude that market-induced restructuring of firm boundaries is proceeding very slowly.

In contrast, Lizal, Singer, and Svejnar (2001) study a political process at the start of reforms in Czechoslovakia. Divisions of state-owned enterprises could apply for a split, and these occurred in large numbers. These spin-offs turned out to be beneficial in all but large spin-offs, both for the parent enterprise and the subsidiary. This is substantial evidence that the enterprise boundaries inherited from socialism are far from those that would appear under market-determined transaction costs considerations, making the conclusion of the previous paragraph even more surprising.

There is something of a mystery here. There was much interest in this issue, and scholars did pursue it, especially using survey methods to obtain qualitative information on changes in boundaries. Why has so little evidence been produced? This is surely a case of a dog that did not bark in the night. The paucity of published results, and the small effects in those that have been published, suggests that systematic results cannot be found, either because firm boundaries are not changing much (especially relative to changes in output and employment) or because the process of change is dominated by chance rather than choice.

The application of transaction cost calculations in a rapidly changing environment is surely a task that any management team would find daunting, subject to huge error. Perhaps, such calculations are near impossible. Then, the reconstruction of firm boundaries on transaction costs considerations requires natural selection and creative destruction over an extended period. But this is only conjecture, based on the evidence to date, and particularly its paucity. It is certainly a possibility worth considering, and transition countries are producing immense amounts of pertinent evidence.[26]

Transactions in Goods and Services

Another central topic of the NIE is the governance of the firm's external transactions. Under the old socialist system, the central authorities were the overwhelmingly dominant governance mechanism, even to the extent of constructing agreements between firms, as well as enforcing them. With the collapse of central planning, firms were forced to find new mechanisms to support their relationships with trading partners. This was a process fraught with difficulty. Agreements were often not fulfilled and an epidemic of non-payments occurred. The consequences have already been examined in Section 3.

In the early years of transition, there was the almost universal assumption that the legal system, particularly the courts, would be of no service for firms

[26] This conjecture is consistent with the fact there is one set of firm boundaries that does seem to be changing very fast indeed: those of the enterprises that have been taken over by foreign corporations. Large experienced multinational corporations surely have far less tight bounds to their rationality than do the enterprises that emanated from the centrally planned economies.

looking to solve their new transactional problems.[27] The characteristics of the old systems led to this assumption. Pessimism was thoroughly justified given the instrumental use of law, the laws ignored and the laws flouted, the telephone justice, the settling of economic disputes through an administrative process (gosarbitrazh) and myriad procedural irregularities (Hendley 1996). Commentators, particularly on Russia, turned these assumptions into a description of interenterprise relations that included a larger role for the gun and the mafia than for contract and the courts. This is a truly interesting case where popular assumption and theoretical logic dominated, when empirical work would have shown a much different picture.

An important contribution to such empirical work, and to the methodology of the NIE itself, was that of McMillan and Woodruff (1999) on Vietnam. Their survey of private firms examines the bases of trust in contracting, using the amount of trade credit as a measure of trust in the partner. The paper identifies several ways in which agreements are secured, through the absence of competition, which reduces the incentive to renege, through the confidence generated by past information on behavior, and through the pressures resultant from membership in a network of firms. This type of relational contracting is highly productive, especially for new small firms. But there are costs in terms of efficiency. Continuing a relationship might mean forgoing new opportunities, especially if these opportunities lie beyond familiar territory. The empirical results in McMillan and Woodruff (1999) clearly show the importance of relational contracting, while at the same time identifying the costs of the absence of a viable court system that can enforce arms-length contracting.

However, Vietnam was quite unlike European and Eurasian transition countries. Vietnamese small private firms had no access to courts. In contrast in Eastern Europe and the former Soviet Union, courts of some substance were refashioned from the institutional legacies of the old planning systems or from pre-communist institutions that had outlasted communism. Contrary to popular assumption, firms used these courts and found them useful. On the basis of survey results, Hendley, Murrell, and Ryterman (2000) concluded that Russian enterprises do not reject the use of law and legal institutions. Many enterprises use the courts, while few resort to private law enforcement. In an econometric analysis of success in the implementation of agreements, Hendley, Murrell, and Ryterman (2001) find that the institutional environment rewards enterprises that pay attention to the legal side of their operations. Better transactional performance occurs when the legal staff works extensively on contractual matters, when enterprise personnel possess larger amounts of legal human capital, when old legal practices have been forsaken, and when new ones have been adopted.

Johnson, McMillan, and Woodruff (2002) come to similar conclusions using survey data from enterprises in five transition countries. In Poland, 72.9% of firms say the courts can enforce contracts, with corresponding figures of 67.9% in Slovakia, 86.9% in Romania, 55.8% in Russia, and 54.6% for Ukraine. Johnson

[27] See Hendley, Murrell, and Ryterman (2000) for citations to the pertinent literature.

et al. (2002) conclude that: "The courts . . . significantly affect contracting. Entrepreneurs who say the courts work behave differently from those who say they do not work." Several other papers with rather similar conclusions can be found in Murrell (2001).

These are somewhat startling results. The courts, burdened by the legacies of communism and often starved of funds, have played a significant role in the governance of transactions in transition countries. But just how significant? This question engages one of the central issues in the economics of institutions, the relative roles of trust and law in promoting cooperation between trading partners. Hendley and Murrell (2003) directly focus on this question when surveying Romanian firms. They asked Romanian company directors about the relative usefulness of six different alternative mechanisms of facilitating cooperation in transactions. The responses suggest that bilateral mechanisms, (i.e., either personal relationships or the shadow of the future) account for 55% of the production of the intermediate output that might be called the support of agreements, while the legal system accounts for 21%. Third-party networks, private enforcement, and the bureaucracy are much less important.

The results reported in this section in some ways diverge from prevailing views on the role of the legal system.[28] The legal system has never been identified as playing a strong role in developing countries, and certainly the transition environment was not conducive to the effectiveness of those institutions. Yet, significant effects have been identified here.

Corporate Governance

It is one thing for the legal system to be able to help enforce simple agreements; it is quite another to ensure that owners can reap the full benefits of complex property rights. It is even more difficult to create an institutional structure that leads to effective property rights when mass privatization has produced owners more dispersed than those in any developed capitalist economy. Thus, there is a general consensus that corporate governance has been a problem in transition and that the retrading of shares after privatization has been slower than hoped (Estrin 2002, p. 110–112). There is less of consensus on why this has been the case. Some see a failure to develop those institutions specifically pertinent to corporate governance (e.g., Zinnes, Eilat, and Sachs, 2001); some see a more general failure of institutional development (e.g., Black et al., 2000), while others have argued that mass privatization created principal-agent problems of such enormity that it would have been impossible for any conceivable set of institutions to straighten out the mess, in less than the long-term.[29]

[28] Ramasastry et al. (1999) report a similar inconsistency in the views on court decisions on corporate governance issues. Survey results report a much more positive view of the role of the court system in protecting shareholders' rights than prevails in the conventional wisdom.

[29] This view of the effects of mass privatization is foreshadowed in a very early paper by David Ellerman (1993), and then was developed in Stiglitz (2001a, b), when Ellerman was Stiglitz' advisor/speechwriter at the World Bank.

However, there is only a limited amount of hard evidence on these matters. Even some of the core facts are not known: for example, it is uncertain whether the decline in insider ownership in Russia is due to insider-owners leaving firms (and becoming outsiders) or due to real outsider-owners becoming more important. There is only a sparse empirical literature systematically relating the performance of the corporate sector of different countries to the character of the pertinent institutions. There is an absence of econometric studies relating particular corporate governance rules to the performance of firms.

Nevertheless, some conclusions can be made. The reliance on internally generated funds is so great (Berglof and Bolton 2002, EBRD 1998) as to suggest strongly that financial and corporate governance institutions have not succeeded in their most basic function, facilitating the flow of finance. The retrading of shares after privatization, to concentrate ownership, has been generally slow, except in the advanced reforming countries, suggesting problems with investor protection rules. Djankov and Murrell (2002) offer indirect evidence on the importance of corporate governance institutions. They show that performance after privatization is worse in those enterprises with owners who are more dependent on institutional support, such as diffuse individual owners. This effect is more pronounced in the CIS than in Eastern Europe, suggesting that corporate governance institutions have functioned less well in the CIS. Similarly, Poland and Hungary are often cited as providing examples of better corporate governance within Eastern Europe, while the Czech Republic has been cited as providing an example of what can go wrong (Pistor 2001; Cull, Matesova, and Shirley, 2002).

Pistor (2001) offers a fascinating analysis that interprets some of these differences. She examines the full set of rules that might affect corporate governance, not only the formal shareholder rights that come from corporate law but also investor protection rules that come from a broader set of institutions. The enforcement of shareholder rights usually requires that shareholders pursue their own interests through the courts. The state plays a more proactive role in enforcing investor protection rules, usually with some form of autonomous agency such as a securities commission. While Hungary and Poland established an independent securities commission as early as 1991, it took the Czech Republic until April 1998 to do so. Until then, Czech shareholders had to protect themselves using the courts, a difficult exercise anywhere. Shareholder property rights were weak in all these countries, while differences were more pronounced in investor protection rules, with the Czech Republic having the weakest stance.

Pistor argues that there were significant consequences of these different institutional structures. The Polish and Hungarian stock markets were more important than the Czech one as a source of new capital for firms. There was a stronger perception of stability of financial institutions in the former two countries. The general integrity of large firms and financial markets was questioned much more in the Czech Republic than in the other two countries. This could be a powerful lesson in the comparative performance of different institutional structures.[30]

[30] See Glaeser, Johnson, and Shleifer (2001) for a similar analysis.

However, there was a confounding variable that might also be relevant. Poland and Hungary did not have mass privatization, in contrast to the Czech Republic, and also to Russia.

Russia provides a sobering contrast to Poland and Hungary.[31] There is much evidence, albeit not systematic, that corporate practices in Russia are inimical to the development of a healthy economy. Using a small sample of large Russian enterprises, Black (2001) estimates that a 600-fold increase in stock-market valuation would follow from implementing best-practice, rather than worst-practice, corporate governance. These estimates are suggestive of the improvements that might be stimulated by more effective institutions.

There is a lively and continuing debate on the causes of the failures in Russian corporate governance. Black et al. (2000) provide the most detailed overview, suggesting several reasons for the problems in the post-privatization corporate sector in Russia. There was no effective infrastructure for controlling self-dealing by managers when they took control of companies before privatization. Control was given to those had an incentive to steal the assets. Incentives to restructure instead of looting were swamped by many aspects of the business environment, such as the tax system, corruption, crime, bureaucracy, and a business culture that encouraged illegal acts. Stock markets were illiquid, meaning that problems could not be solved by the concentration of outside ownership in powerful blocks.

Black et al. (2000) ultimately conclude, however, that no conceivable institutional development could have led to effective corporate governance immediately after mass privatization. The institutions would not have been strong enough to stop the asset-strippers, and politico-economic power was placed in the hands of those who were not enthusiastic about institutional development. This is consistent with the views of Stiglitz (2001a,b) emphasizing the enormous task of monitoring long agency chains, Heller (2001) arguing that no conceivable corporate governance regime can untangle Byzantine property rights, and Roland (2001) stressing that mass privatization creates a set of owners who are not interested in institutional development.

Viewed in this way, an important observation derived from transition experience on corporate governance is that narrowly targeted institutional reforms cannot quickly negate the effects of tangled and inefficient ownership structures created by mass privatization. The information that does exist on comparative corporate governance performance across transition countries is consistent with this observation.[32] That information is also consistent with the conventional wisdom that corporate governance mechanisms work well in the most advanced

[31] Foreign ownership could also explain many differences between these countries, with FDI being much more important in Eastern Europe than in the CIS.

[32] One way to check this point is to examine institutional effectiveness as a function of methods of privatization. Some very simple regressions using data from EBRD (2002) are consistent with the hypothesis that privatization by direct sales is positively related with the later effectiveness of corporate governance law and of financial regulations. Details available from the author on request.

countries but are much less effective elsewhere.[33] Indeed, the highly significant role of group and family ownership in the developing world suggests that the transition countries are not alone in exhibiting corporate governance problems (Burkart, Panunzi, and Shleifer, 2002; Yafeh and Khanna 2000). In this light, the success of the advanced reformers seems even more notable and their experience might point to important lessons about how to produce more effective corporate governance.

Perhaps another lesson is that the types of corporate governance institutions usually implemented in developed countries do not provide appropriate technology to transfer to developing countries when mass privatization has left highly dispersed ownership. Perhaps, transitional institutions are needed, ones that are more suited to the peculiarities of the ownership environment in which they are situated (Roland, 2000). The idea of transitional institutions leads directly to consideration of the Chinese transition.

7. Chinese Institutional Development[34]

China began the transition, not with system collapse, but rather with a powerful government desperate to shore up its legitimacy after a decade of turbulence. There was a willingness to adopt new measures to improve the economic situation, but within the requirement of not moving too far from the existing system.[35] This put a constraint on institutional change, which meant new institutions would not be best-practice, but rather incremental variations on existing ones. The puzzle that China presents is the combination of a very non-standard path of institutional development and amazing economic success. The lessons to be derived from the Chinese reform are not on the specific details of the institutional reforms themselves, since these details were partially a product of circumstances specific to China. Rather, the lessons are on the process of institutional reform. The NIE is very helpful in isolating the elements of that process.[36]

One way to interpret the Chinese approach to reform is through the NIE concept of remediableness, a criterion that places the burden on the policy-maker to show that the proposed alternative to the present arrangements will actually result in improvements (Williamson, 2000). The Chinese path of institutional

[33] But even in developed economies corporate governance laws can give wide latitude for majority shareholders to plunder the minority. See Johnson et al. (2000).

[34] This section draws heavily on the work of Yingyi Qian, particularly Qian (2003).

[35] Of course, the limits of acceptable change advance as the previous changes generated success.

[36] This way of understanding matters contains an implicit riposte to those who make the observation that Chinese-type reform policies were not applicable in the circumstances of Eastern Europe and the former Soviet Union. I regard this observation as wholly uncontroversial. It is the process of Chinese reform that is pertinent to other countries, not the detailed characteristics of the transitional institutions.

development matched this criterion in several ways. First, the leadership often simply endorsed the results of experiments that had already shown some success at a local level. Second, the effects of incremental changes could be more readily understood than those resultant from large scale changes. This made the decision problem easier for leaders when they chose institutions. It also meant that economic organizations could more readily understand how to react productively to the new institutions. Third, as Qian (2003) emphasizes, China's transitional institutions worked because they transparently protected all important economic actors from significant declines in economic welfare, while providing impetus for improved economic efficiency.

Qian (2003) describes four crucial, successful, transitional institutions. First, the dual-track approach to liberalization kept quotas and controlled prices on production up to those levels planned before the reforms, while freeing above-plan production. This measure promoted efficiency at the margin, while endorsing the existing set of informal rights to infra-marginal production, thus protecting the welfare of those who otherwise might lose heavily from reforms (Lau, Qian, and Roland, 2000). The dual-track was also a very crude contract enforcement mechanism on infra-marginal production. Of course, it slowed reallocation, but in the absence of other mechanisms this might have been exactly what was needed to prevent the types of transactional problems highlighted in Section 3. It is clear that the dual-track satisfied the criterion of remediableness, at least in the short-term, much better than any other process of liberalization implemented in any other transition country.

Second, a highly distinctive ownership form appeared, the township-village enterprises (TVEs), which blossomed in the countryside and were responsible for a large part of China's growth in the 1980's. Che and Qian (1998) interpret the TVE as a mechanism for protecting decentralized property-rights when the state is unable to guarantee more formal ones. Because the local politicians and the managers of TVEs have complementary incentives to produce, the central government finds that surrendering property rights to the local authorities is better than keeping these rights centralized. In the Che-Qian model, remittances to the central government can increase when the center surrenders its property rights. A government unconstrained by law must seek ways other than formal property rights to bind itself.

The third important transitional institution also worked through the mechanisms of governmental decentralization. Fiscal contracts between the central and local governments had high fixed remittances to the center and high marginal retention rates for the localities. These served the dual purposes of ensuring a steady stream of payments to the central government, while aligning the interests of local governments with local producers. Fourth, anonymous banking served as a commitment device, limiting government predation by reducing information flows. This arrangement, going against notions of best practice, can be understood as a crude substitute for the protection of financial property rights, where the independence of the legal system is not a real possibility in the short-term.

The progress of Chinese state-owned enterprises (SOEs) provides some evidence of the effect of transitional institutions, and the fact they eventually become outdated. In the first decade of the Chinese reforms, the SOEs performed at very creditable levels, producing rates of increase of total factor productivity growth that would have been judged as reasonably satisfactory in many contexts (Jefferson et al. 2000). Certainly, this performance contrasted with that in the first decade of transition for the enterprises that began the 1990s in the state sectors of Eastern Europe and the former Soviet Union. Empirical evidence suggests that managerial incentive schemes had an important effect on state enterprise performance in China, but not elsewhere.[37] In the Chinese context, managerial incentive schemes seemed to work well as a transitional institution. However, in the 1990s the incentive schemes were less effective (Shirley and Xu, 2001).

China's transitional institutions complemented managerial incentives in the 1980s. First, a powerful government was willing to impose harsh penalties for enterprise managers who abused their power. Second, the alternatives to focusing on improving efficiency within enterprises were not particularly attractive: moving enterprise assets into the private sector was not an easy alternative. In an environment where negligent or fraudulent behavior by managers is punished, as in China in the 1980s, and where the payoff from transferring assets to the private sector is less than attractive, managers have the choice of working hard and getting bonuses or slacking off and living off their salary alone. In contrast where punishment for bad behavior is not important nor immediate, as in most other transition countries and increasingly in China in the 1990s, managers have the choice of stripping enterprise assets and getting a huge windfall now or working hard through the years and receiving better compensation through bonuses. It is clear which choice is attractive in each instance.

Thus, the general lesson is rather similar to the one drawn at the end of the previous section, that many institutions require complements, and therefore identical institutions might work in one environment but not in another. Transitional institutions are, of necessity, institutions that must be designed to work in the environment in which they are to be implemented. But these transitional institutions outlive their usefulness, as seems to have been the case of managerial incentives in China.

8. Lessons Learned from the Transition for the NIE

One central lesson of transition reinforces a core proposition of the NIE, the importance of institutions. The experience of transition has contributed to the remarkable recent increase in the role attributed to institutions in processes of

[37] Djankov and Murrell (2002). This conclusion is based on an aggregation of the evidence in a number of studies.

economic development and economic change.[38] Transition has also reinforced the increasing popularity of research on issues deemed of central importance by the NIE. It has moved NIE methods, such as transaction-cost thinking, further into the mainstream of economics.

Paradoxically, however, this was not because NIE approaches were important at the beginning of transition. They were not. Neither was it because there was an early emphasis on institution-building in reforms. There was not. Rather, the reason for the present emphasis on institutions in transition is the relative failure of reform packages that were developed largely without a focus on institutions. An increasing amount of mainly anecdotal evidence from the formerly socialist countries points toward the crucial role of institutions in promoting the functioning of market capitalist society. However, this evidence is still thin. It is not as abundant as it might have been, since the NIE was not nearly so popular in analyzing transition in 1990 as it is now. NIE researchers still have much to accomplish in laying bare the fundamentals of the transition process.

This chapter contains many other lessons that reinforce propositions of the NIE. Rather than repeating them here, the remainder of this conclusion will focus on a more controversial topic: lessons learned from transition that might challenge existing assumptions of the NIE.

North (1991) characterizes economic history as predominantly a saga of the failure to produce institutions that induce sustained economic growth. The success of the western world is a very special story, one of demand-induced slow accumulation of productive institutions. Yet, Section 4 of this chapter describes a remarkable record of very quick institutional accumulation, especially in Eastern Europe, accompanied by very respectable growth performance.

If one takes the perspective of a decade, there are a number of countries in which success in institutional development is striking. Poland, Hungary, and Slovenia are obvious examples, and their progress is indeed remarkable. However, some observers might discount the importance of these examples because of favorable starting conditions and settled politics. But consider the case of Slovakia. The starting conditions were unfortunate. Slovakia inherited the least useful part of Czechoslovakia's industry. It could only begin building its own national institutions in 1993, after the split with the Czechs. The political situation was even worse. The country teetered on the verge of authoritarianism in the mid-1990's. Yet now institutions in Slovakia are judged better than would be predicted on the basis of its level of economic development, and there are continuing improvements (Murrell, 2003a, EBRD 2002, Kaufmann, Kraay, and Mastruzzi 2003). Such developments, in less than one decade, suggest reevaluation of the conventional story of slow accumulation of institutions.

[38] Using the EconLit database as in Section 2, one finds that institutions and development occur together in less than 5% of documents in the early 1990s and in more than 17% in the opening years of the present decade.

There might also be a necessity to reconsider the emphasis placed on the role of the demand side in the politics of institutional development. Although there is no reason to doubt that overall voter and business sentiment provided an important stimulus leading to rapid change, it seems clear that many of the details of the transformation in economic institutions were settled in a process that was rather divorced from politics, removed from specific pressures coming from the demand side. Supply factors were critical, with individual politicians, influential academics, and high-level state officials believing that institution-building was essential for the long-term success of their counties. Foreign actors played crucial roles, especially in the countries hoping to enter the European Union.

These speedy institutional developments contrast with the slower reactions of firms to the new institutions.[39] As Section 6 suggests, movement has been especially ponderous in the recasting of the boundaries of the firm.[40] In his survey of the NIE, Williamson (2000) contrasts the process of institutional development, which takes decades, with adjustments in the governance structures of firms, which occur within a decade. Perhaps, this contrast is true of change, per se, even if chaotic, but it does not characterize processes of successful change in transition. Transition evidence suggests that successful change in institutions can occur in a decade, while change within existing firms requires longer. Indeed, this raises the possibility that processes of entry and exit and natural selection are necessary to align governance structures with institutions. Perhaps, the application of cognitive processes within existing firms is not enough to produce such alignment.

This characterization resonates with the reflections on transitional institutions that appear briefly in Section 6 and that are the focus of Section 7's discussion of China. Perhaps, actors in the Chinese economy were able to react so quickly and so productively to the new set of institutions because the new arrangements were quite close to the old ones. The new institutions presented a simpler cognitive task to economic agents in China than in Eastern Europe and the former Soviet Union. This suggests that normative theories of institutional development must take into account limits on the processing capacities of economic agents. It would be extremely difficult to find a conclusion that is more consistent with the NIE.

So far the discussion has not addressed the mutual consistency of the somewhat disparate observations made above. Certainly, this chapter is not the place to present an extensive conjectural theory to produce that consistency. But adumbration of a general argument will be useful to tie some loose ends. First, it is useful to recap the principal observations. It is now assumed that institutional lacunae were the main source of the problems in early transition. Institutional

[39] At least for those firms that were part of the old system.

[40] Murrell (2003b) shows that firms have been slow in matching modes of transactional governance to the new institutions.

construction is happening very quickly, in a process whose detailed character is as much determined by the push of supply as by the pull of demand. Firm-level adjustments to the new institutions are lagging behind institutional construction: transitional institutions might have worked better (in the short-run) than best-practice institutions. The remaining paragraphs tie these conclusions together, highlighting their mutual consistency.

When there is a basic consensus on far-reaching reforms, economic institutions that might be functional in the short-run are demolished with the hated old institutions. Transition has shown that an institutional vacuum can be worse, in the short-run, than an economy with highly substandard institutions. Hence, a consensus on the overall direction of reforms and on the quick destruction of the old institutions can create both short-term economic dislocation and fertile ground for the rapid growth of new institutions. The impediments to change are fewer and the political need to act is very high. Thus, there is no contradiction in attributing the immense problems of early transition to poor institutions and observing that institutions are improving very quickly. Indeed, they are two sides of the same coin.

When the old institutions have lost all credibility and there is a basic consensus on far-reaching reforms, political agents find themselves with much latitude to press for change, with strong incentives to become institutional entrepreneurs. Such agents naturally seek existing models for the institutions to be created, and the ones that are most prominent are those of the developed countries. During transition, this tendency to use existing models was complemented by the pressing attentions of the developed countries, which provided human capital, financial resources, and more than a little political push. This supply-side process was apparently very successful, judged in terms of the institutions that were created. The ultimate reasons for the success are still not clear, but perhaps a role was played by the rather high levels of human capital in the transition countries.

Nevertheless, high quality institutions do not necessarily lead immediately to economic success, for at least three reasons. First, such institutions cannot immediately counter the consequences of past policies, such as jumbled ownership from mass privatization. Second, institutions that are not calibrated to local circumstances can easily be counterproductive in the short-run, even if they are best-practice for the long-run.[41] Third, economic agents need time to learn to use institutions effectively.

The last two reasons are especially important now because of the way in which institutions were built. In transition, capitalist firms, especially the new smaller and medium-size ones that would be the backbone of the reformed economies,

[41] To establish this point, consider the following thought experiment. Imagine the consequences of instantaneously and effectively implementing US financial institutions and Delaware corporate governance in Russia in 1997. The early-transition Hungarian bankruptcy law episode provides a further example (Bonin and Schaffer, 2002).

played less of a role in shaping these new institutions than did the institutional entrepreneurs.[42] The new institutions reflected the concerns of these firms far less than might have been appropriate. Moreover, the owners and managers of these firms were far removed from intimate knowledge of how the institutions of developed economies worked. Consequently, an extensive period of learning would be necessary before the adoption of the types of behavior that would be optimal in reaction to these new institutions. Perhaps, therefore, the real effect of the new institutions lies in the future. Perhaps, these businesses could have reacted more quickly to institutions that had changed more slowly and were closer in spirit to those with which the economic entrepreneurs were more familiar. Perhaps China was lucky in not feeling the strong drawing power of Western best practice models. Perhaps future generations in transition countries will thank their predecessors for forgoing the benefits of transitional institutions.[43]

But these last paragraphs are highly conjectural, based on cursory empirical information.[44] Their main purpose is to show the internal consistency of the observations that have been made in the preceding sections of this chapter. Much more empirical work needs to be done to investigate whether these preliminary observations can be established as hard empirical facts. As the above pages have emphasized, the empirical work on transition that has been directly driven by the NIE has been very limited to date. Thus, transition still presents fertile ground for application of the NIE.

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[42] This comment might seem, at first blush, inconsistent with the state capture hypotheses of Hellman, Jones, and Kaufmann (2000), but it is not. The notion of state capture focuses on the sale of micro decisions to firms, rather than the formation of broad institutions in response to the demands of firms. State capture is inversely correlated with institutional development across transition countries, suggesting that the processes of state capture do not lead to institutional development. Moreover, EBRD (2002, p. 30) states, rather cryptically, that "The experiences of recent years suggest that the degree of state capture was not as stable as earlier analyses indicated."

[43] This is the central trade-off raised by Roland (2000, p. xx) "Nevertheless, the question is raised whether 'transitional institutions' represent stepping-stones toward better institutions or whether they create vested interests that block further institutional transition."

[44] And on the author's personal observations on transition economies.

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