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# INSTITUTIONAL CHANGE AFTER COMMUNISM

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## I. Introduction

A broadly defined country's institutional system consists of: 1) the legal framework; 2) organizational set-up; 3) types of individuals' interactions (commands or markets): I first characterize the communist system (Section II), and then describe the components of institutional change, necessary to bring about democracy, the rule of law, the market economy and the civil society (Section III). Section IV offers some remarks on the actual institutional transformation after the collapse of communism. Section V presents selected observations on the political economy of this change.

## II. The Communist Institutional System: a Stylized Description.

The communist institutional system had three main features:

### 1. **The control, exerted by the Party-state was exceptionally extensive, e.g.:**

- Private entrepreneurship was banned, which together with the initial nationalization, resulted in the monopoly of the state sector;
- The market interactions between firms were replaced by the central planning, i.e.

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the command-rationing mechanism;

- Foreign exchange was rationed, i.e. money was not convertible;
  - The establishment and functioning of non-economic organizations were also heavily controlled by the nomenclatura principle, i.e. civil society was suppressed and political opposition was banned;
  - Foreign travel was restricted;
  - The media were subject to censorship and party control; they were largely an instrument of official propaganda;
2. As a reverse side of extensive controls **the party-state has a special native and structure:**
- The political power dominated the society, it was concentrated at the top of the party apparatus and was not divided; there was no room for independent courts, or an independent central bank. Elections were a test for people's obedience;
  - The legal framework and the justice system criminalized private economic activity, civil society and independent political activity;
  - Constitution provided broad individual liberties but these were a fiction; i.e. attempts to use them were punished by the state authorities;
3. Extensive control co-existed with an **overgrown welfare state**, which included:

- Relatively large transfers in kind (education, health);
- Social protection delivered via state-owned enterprises;
- Artificially low (subsidized) prices for foodstuffs, energy, housing;
- A state safety net, typical of some market economies did not exist as the need for it

was sharply limited through the suppression of economic competition, the resulting inefficiencies (overemployment) and the safety net, described above.

This characteristic allows us to make some other observations:

- Liberty (“negative”) rights of all kinds were effectively suppressed, while social (“positive”) rights were wide and ostensibly respected – to the extent an increasingly inefficient economy allowed it.
- Large transfers in kind and subsidies produced an overextended **fiscal position of the state**; as measured by fiscal spending (or tax) to GDP ratio. It was much higher on average than in market economies with a similar GDP per capita. The **regulatory role** of the state was also hugely inflated due to restrictions, commands and rationing it run and enforced. Thus the Communist state was overextended in all dimensions: public ownership, regulation, and fiscal.
- Restrictions, **commonly called “economic” had both economic and political consequences**. For example, the ban on private entrepreneurship and the rationing of hard currency, not only damaged the economic performance but also contributed to the dependence of individuals upon the party-state.
- Constitutionalism usually means a limited and divided state power. On this definition **there were constitutions but no constitutionalism** under a communist system. A related concept of a **rule of law** has many definitions (Shapiro, 1999) which can be largely reduced to the situation whereby the state rules by law (and not by the secret police) which meets certain criteria, e.g. generality, publicity, exclusion of retroactive legislation, due legal process, etc. Given the fictitious nature of liberty rights, the politicization of the justice system, the extensive use of political police, we may also say that **there was a law but little rule of law under communism**.
- Each type of institutional system contains a characteristic set of organizations. The organizational legacy of communism was very specific and of little use in transition to a rule of law, democracy and market economy. On the one hand it

included organizations of “negative” value like the censorship, political police, the apparatus of communist party and that of related organizations, branch ministries and compulsory enterprises associations. On the other hand it displayed huge gaps, e.g. the stock exchange, NGO’s, regulatory agencies were lacking. Finally, many organizations: enterprises, schools, hospitals, required extensive restructuring, as it was impossible to disband all organizations and to start from scratch.

### **III. The Necessary Institutional Transformation.**

Such was the point of departure: the communist institutional system. Assuming that the end-goal was the opposite system: democracy, rule of law, civil society, market economy, huge institutional transformation was needed. This transformation can be conceptualized in various ways. For example, it is often divided into political, economic, legal, etc. I propose here another way of looking at post-communist transformation, derived from a broad definition of a country institutional system, as consisting of: 1) the legal framework ad two further components, related to this framework, and namely: 2) the organizational set-up; 3) the types of individuals’ interactions. Institutional transformation after communism includes changes in these three components.

More specifically, this transformation can be decomposed as follows:

1. Changing the **legal framework**, i.e. enacting new legislation. This can be subdivided into:
  - 1.1. Liberalizing legislation, e.g. eliminating the central planning and bans on setting up of new organizations, both in the economic and non-economic sphere. This was necessary (and largely sufficient) to eliminate the first feature of communism: extensive controls over individuals.
  - 1.2. Legislation, which formed the legal basis for the setting up of some new organizations, e.g. the constitutional court, the central bank, financial supervision, election bureaus.

- 1.3. Legislation which had to deal with the negative organizational legacy of the communist system, e.g. eliminating censorship.
- 1.4. Legislation, providing the legal basis for transformation of many inherited organizations, e.g. for enterprises privatization, for the restructuring of the justice system and of public administration.

2. Changing a **country organizational set-up**. It can be decomposed into:

2.1. **Spontaneous growth of new organizations**, released by liberalizing legislation, i.e. the development of the private sector and of civil society;

2.2. Changes resulting from other types of legislation. They were bound to have their own dynamic, i.e. with the same legislation, privatization of SOE's could proceed at different pace, depending on various political and economic circumstances.

3. **A shift from command-rationing mechanism to market interactions**. This shift was largely due to liberalizing legislation which released the market forces in the society. However, the growth of more complex and longer-term transactions (e.g. the financial transactions) also requires the supporting legal and organizational infrastructure, e.g. insolvency law, credible and efficient courts, credit bureaus (Johnson et al, 2002). Therefore, the type and structure of the market economy, which was to emerge after the collapse of communism, also depended on quality of other parts of legislative and organizational outcomes.

**Constitutional framework** can be defined as a special subset of the overall institutional system, a subset which consists of: 1) special legal norms; 2) organizations which are empowered by (1) to be guardians of these norms (e.g. constitutional courts). Constitutions compatible with constitutionalism and the rule of law limit and divide the state powers, thus defining various individuals rights. Broadly conceived constitutional norms include both “domestic” constitutions and international treaties.

As mentioned before, large parts of communist constitutions were incompatible with constitutionalism and the rule of law. Therefore, the post-communist institutional transformation had to include the introduction of new constitutions. This opened the question how to ensure that the successive governments respect these constitutions.

#### **IV. Post-communist Transformation: some ex post observations**

There is a lot of data and research on what has happened after the collapse of communism. I can present here only some observations:

- After a brief period of political liberalization some countries (Belarus, Turkmenistan, Uzbekistan) relapsed into dictatorships. These post-communist dictatorships display much lower levels of market reforms and of rule of law than democracies (see, *EBRD Transition Reports* and Kaufmann et al, 2005). In other words, there is no counterpart among the former communist countries of market-oriented authoritarian regimes like South Korea under general Park, or China since the late 1970's;
- Research shows that countries which accumulated more market-reforms (privatization, liberalization) tend to achieve better economic results, i.e. faster growth than countries which introduced less reforms (L. Balcerowicz, 2002; Falcette et al, 2006). Also, countries which managed to accelerate such reforms, e.g. Armenia, Slovakia, Lithuania during recent years, tend to be rewarded with faster growth
- Interestingly, countries which achieved better economic outcomes also achieved better results on health and environment and registered smaller increases in income inequality. More transition to a free market economy and to the rule of law seems to be the main reason for both better economic and on-economic outcomes (for more on this see: L. Balcerowicz, 2002). Therefore, institutional change after communism has proved to be productive both from economic and non-economic point of view;

- There have been differences in the extent of **various types of reforms** implemented in various countries (I disregard here the anti-market dictatorship);
  - Privatization of the economy is pretty advanced in most post-communist economies and its extent displays relatively little differentiation. However, there are large differences in the presence of FDI: CEE economies have attracted much more FDI per capita than CIS countries. This implies that corporate governance in the private sector differs across post-communist countries;
  - External trade and financial liberalization are very advanced in CEE as well as in Armenia and Georgia. Its level exceeds that in other CIS countries;
  - Fiscal position of the state appears to be most differentiated. Some countries outside the CEE (Armenia, Georgia) have reduced it to the level of the Asian Tigers while in most CEE economies (especially Hungary, Poland, Czech Republic) spending GDP ratio exceeds the level reached in Sweden or France when these countries had similar income per capita to that CEE economies. These differences are obviously linked to different developments in the welfare states;
- As one can expect, the legislative change turned out to be much faster than the required organizational adjustment of the state apparatus. It is just less time-consuming to enact the new legislation than to create or to transform the organizations so that they are capable of efficiently enforcing it. Therefore, an “implementation gap” emerged (see: *Law in Transition*, 2005). This does not necessarily mean that it would have been better to delay the legislative change until the implementation capacity matures. For such delays in legislation, especially in the liberalizing one, would also delay the spontaneous developments of organizations and the release of the market forces. Besides, much of the preparations of the implementation capacity relies on learning by doing. However, with the benefit of hindsight one can notice that more emphasis on the selection and training of, say, judges and prosecutors would have been probably useful in that it

could have reduced the implementation gap<sup>2</sup>. On the positive note, we can say that reducing this gap, i.e. providing more secure property rights and better contract enforcement through a sort of “second generation reforms”, can improve the economic performance. (This assumes that legislation does not get worse with the passage of time).

- Liberalizing legislation and the related spontaneous developments in organizations have been fundamentally important part of the overall institutional transformation after communism, both in the economy and in the civil society. However, the rate of growth of the new private sector also depended on the privatization of the inherited SOE's. If not privatized in a regular way, these enterprises would either be subject to various forms of asset grabbing and/or they would demand more subsidies. In either case they would become a drag on the spontaneous development of a private sector. Therefore, this development was not an alternative to the SOE's privatization but largely depended on it. Besides, SOE's privatization reduced the scope of political control and of political patronage in the economy and thus constituted fundamentally important political reform. (see L. Balcerowicz, 1995).
- Finally, there is a vast and fundamental subject of **new constitutions and their enforcement**, which I can only mention here. The new constitutions included not only the standard set of individual liberties (“negative” rights) but also a wide menu of social (“positive” rights). (see, e.g., J. Elster et al, 1998). The latter are controversial as they may weaken the legal force of a constitution and/or give the constitutional courts the discretionary power in the fields where they do not necessarily have the required competence and where they could be in conflict with the reform agenda of the governments (cf. Sunstein, 1993). Besides, extended social rights are in conflict – via increased taxation and regulation – with the liberty rights (cf. L. Balcerowicz, 2004). This raises the question what contributed to such a broad inclusion of social rights, and more specifically: what was the role

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<sup>2</sup> To what extent it would have been possible, is a different matter. Much depended on the frequency at which key ministers changed. For example, in Poland since 1989 there have been 17 ministers of justice.

if any of the mental and political legacy of communism with its vast array of social rights. Has the constitutionalization of these rights been in conflict with the reform of agenda, i.e. have these rights been invoked and enforced by some constitutional courts? I can remember a case of Hungarian court striking an important part of Bokros plan.

- Another set of issues refers to the attitude of those in power towards the constitutional limits of this power. The Polish example shows two worrisome phenomena. First, legislation recognized by experts as unconstitutional often gets passed in an open disregard of the constitutionality issues. Second, many rulings of Constitutional Tribunal are disregarded, i.e. legislation ruled unconstitutional remains on the books, or is replaced by a very similar legislation (*Rocznika Informacji*, 2006). These two problems got worse during the last two years which shows that, even under democracy, a respect for constitution does not necessarily simply grow with time.

## V. On the Political Economy of Institutional Change

I don't think any formal theory can explain in detail varieties of institutional change including the collapse of communism and the subsequent developments. Even less likely is a theory that would predict future institutional developments; history is largely unpredictable, full of chance factors and unintended consequences.

What we can feasibly try to do is to develop an analytical schemes that would define the main variables (mechanisms) affecting institutions. It is up to the various empirical studies (cross-country or panel econometric investigations, historical research, case studies, pairwise comparisons, etc.) to give some content to these variables (mechanisms).

I believe that a simple scheme would include:

- 1) Initial conditions, which comprise the initial institutional system;
- 2) Two types of countervailing forces:

2.1. Collectivist (statist) forces, which act to preserve inherited statist elements and create resistance to market reforms.

2.2. Liberal (anti-statist) forces, which act to preserve the inherited market elements (if any) and drive market reforms.

Both types of forces include domestic and external influences, which interact with each other and with initial conditions. In a dynamic setting, early initial conditions interacting with various forces produces outcomes that constitute the next initial conditions which interact..., etc.

It is not difficult to explain the emergence of communist system in CEE countries: it was imposed ultimately by the force of the Red Army, so the statist forces necessarily prevailed upon all countervailing factors, regardless of the differences in the initial conditions. What remains to be explained, of course, is why communism was introduced in Russia in the first place.

Communism produced bad economic results and in relative performance worsened over time. Naïve thinking would suggest that bad economic results – a deepening crisis – should weaken the statist forces and lead to market reforms, so self-correction would operate. However, the Soviet Union existed for over 70 years, Maoism in China for 30 years, and communism in Cuba and North Korea still survives – all with disastrous results. Clearly, the self-correction mechanism under extreme statism, if it operates, takes quite a long time. And it is impossible to predict when exactly a totalitarian system will break down from within, or reform (like China).

The simple reason for the fact that bad economic results produced by totalitarianism are not rapidly translated into strong pressure for market reforms is that this very totalitarianism keeps the population under harsh control. Therefore, the change must start either from outside or from within the black box of the entrenched elites<sup>3</sup>. The latter can take quite a lot of time, perhaps because rulers are shielded from the economic consequences of the system they run and because they are isolated from the external world.

This is not to say that extreme statism is not subject to long-term pressures. One such

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<sup>3</sup> The Solidarity movement may appear to be and – to some extent was – an exception. One should remember, however, that: 1)Solidarity was suppressed in December 1981; 2)The Polish system was not a typical totalitarian system; and 3)later developments in Poland interacted with a change within the Soviet elite – the “Gorbachev factor”.

pressure is due to the technological superiority of the market system, which can be translated into a military threat (the Reagan factor during the Gorbachev years or the American black ships on the coasts of Japan before the Meiji reforms).

A breakdown of extreme statism is not only difficult to predict, it is also difficult to explain in terms of “winners” and “losers” of change. For such a breakdown involves a lot of confusion, uncertainties and chance factors. Most people cannot define their absolute and relative positions in the future system, which nobody can clearly describe. One can only say that the breakthrough would not have happened if a large part of the armed elite strongly believed that they would suffer under whatever new system was emerging. If they had such strong beliefs they would most likely stop the change.

Radical liberating breakthroughs happen, and usually happen unexpectedly. This is certainly true of the *collapse of Soviet communism*. It opened the way for fundamental institutional change. I have mentioned that post-communist economies have differed widely in their growth record so far, and that these differences are strongly related to the extend of accumulated market reforms: countries that amassed more reforms tend to perform better than those that amassed less reforms. What explains the differences in the extent of market reforms? Why has the balance of statist and liberal forces been so different across countries, and – to some extent – across time in the same countries? Let me make some suggestions:

- Countries differed in what I call **reform linkages**. In some countries market reforms were linked – objectively and in the public’s perception – to some important non-economic goals, like entering the EU or preserving independence (e.g., the Baltics). Other countries did not have such positive conditionalities strengthening the liberal forces. And in Russia market reforms following the collapse of USRR might have been linked to the loss of empire, so a negative linkage might have operated<sup>4</sup>. It is an empirical question to what extent the IMF and World Bank conditionalities might have substituted for the EU conditionality.
- Countries may differ in the popularity of collectivist doctrines and the populist

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<sup>4</sup> Another negative linkage may be generated by the existence of large mineral resources as it produces incentives to capture a non-reformed state, and weakens pressures to implement market reforms (see: Beck et al, 2005).

clichés among their citizens. And mass media may differ in the extent of its use of populist techniques.

- Political shocks, e.g. corruption scandals, which often create opportunities for statist political forces, were surely not identical across countries.
- Pro-reform political forces, when in power, are inclined to pursue reforms even during a good economic situation, while statist political forces that inherit the same situation are likely to delay market reforms or even to revert to statism. They can safely do that for a certain time because financial markets are **not** an early warning system. Other external warning mechanism (e.g., rating agencies and international financial institutions) operate more strongly when the economic situation has already gotten worse. During a bad economic situation – especially an acute crisis – both pro- and anti-reform forces are likely to reform, the former both due to conviction and necessity, the latter only because of necessity. Now, countries surely differed in their economic-political trajectory: some countries probably had more instances when a good economic situation was inherited by anti-reform forces. This might have contributed to a slower accumulation of market reforms.

All the previous remarks on institutional dynamics disregarded **the role of the individual**, which to some extent is a chance factor. However, any serious account of deeper institutional change must include this factor. Differences in the personalities of the occupants of the top positions matter. An analysis of deeper institutional change that omits this variable is like an analysis of the war that disregards the differences in the quality of the opposing commanders.

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