

Reflections on the evolution of institutions in post-communist countries

Pierre Garelo

Nikolay Nenovsky

First working draft: October 2003

This working draft: December 2003

Tout ce qui a historiquement résulté du développement occidental ne peut pas ou ne devrait pas être transplanté sur d'autres terrains culturels et, quelle que soit la forme de civilisation qui finira par émerger dans les régions sous influence occidentale, elle prendra plus rapidement ses formes appropriées si on la laisse croître d'elle-même que si elle est imposée d'en haut. S'il est vrai, comme on l'objecte souvent, que la condition nécessaire à une évolution libre – l'esprit d'initiative individuelle – fait souvent défaut dans ces pays, on doit dire que sans cet esprit nulle civilisation durable ne peut croître ou que ce soit. Dans la mesure où il manque effectivement, la première chose à faire est de l'éveiller, et cela un régime de liberté le fera, pas un système d'embrigadement.

Hayek, F. (1994), *La constitution de la liberté*, Paris, édition "Litec", pp. 2-3

I. Introduction

Every study is supposed to resolve a problem or give an answer to a question. The main question raised here is: how comes that the trajectories of development of post-communist countries (PCCs) diverge considerably (if not completely) from the ones expected at the beginning of the changes in early 90-ies¹. Or another question related to the first one: why similar reforms applied in different countries led to radically different outcomes? The answers are essential not only for understanding the past period. Today, (when most PCCs are at the threshold of EU accession) we face solutions, which would surely bring us to results quite different from what we expect².

¹We believe (see also Seliger, 2002) that the term "transition" is inappropriate; it implies an end point previously known. A more appropriate term is "transformation" as it stresses the openness of the process. Mises believes that economics is always in transition (Mises, 1963, p. 860). If we use sometimes "transition" it is only because of its popularity.

²In end 80-ies and the beginning of 90-ies the expectations for the final PCC status were associated mainly with the transition to a western model of market economy (defined in most general lines), while in end 90-ies, and even more today, the reliance is on the EU accession - a much more concrete

The first question raised here could be brought to several subquestions relating to the dynamics of the systemic institutional change in a PCC: (i) what are the processes or mechanisms of systemic evolution? (ii) how deep could we delve into and study this systemic change (positive problem)? and (iii) what is the range of our possibilities to plan and control such a change (normative problem)?

Undoubtedly, at the onset of reforms (in the light of the neoclassical paradigm of comparative statistics) transformation was seen as an elementary jump from one state of equilibrium to another, or as a mechanical act, which serves as a link between two different states (Colombatto, 2001, 2002)³. In order for this jump to take place the traditional approach of macroeconomic policy was used, whereby: (i) objectives were defined, (ii) instruments were selected, and (iii) it was supposed that these objectives had strong relationship with the instruments (drawn from the experience of other countries). All speculations centered around transition models "clear" of institutions. Within the framework of the traditional paradigm the institutions were taken for granted; they were thought as already existing; they did not emerge, nor were the result of transformations. Today, this fundamental flaw of the initial understanding has been recognised. A proof of this could be found in the growing attention paid to the importance of institutions, as well as in the voluminous theoretical and empirical publications in academic literature (Roland, 2001, 2002, Havrylyshyn and Rooden, 2003, Raiser et al., 2001), and that of international financial institutions (IMF, 2003, WB, 2002). Everything seems fine - "institutions now matter" - as if the only thing that remains to be done is select⁴ the right set of institutions and rules to support the traditional macroeconomic policy.

objective, which also intuitively implies expectations for wealth reallocations (EU subsidies, grants (assistance)) rather than generation of wealth (through one's own efforts).

³ Colombatto (2001) believes that the systemic crisis (or in other words "the jump approach") is the only way for former PCC elites to retain their power. Within the period the author identifies some kind of a coalition of various "rent seekers" (western experts, former functionaries, etc.). A similar dependence is suggested by Janos Kornai in a comparison, where a systemic change is similar to a situation, in which after shooting at a tree the flock of birds (in the case of transition this is nomenclature) flies away, but then again perches on the tree (Kornai, 2000).

⁴ The questions (who? and how?) come to mind immediately. This will be discussed further below

Unfortunately, things are more complicated. Rediscovering the importance of institutions for the economic development of a PCC is only the first step in the right direction, yet far from sufficient. It is urgent to make the next theoretical and practical step, and more specifically to make it clear: (i) how institutions in a PCC originate, (ii) to what extent are they spontaneous and planned (i.e. their level of hybridity), (iii) what should be the institutional policy (if any)?, (iv) which institutions are efficient and which are not?, (v) to what extent what is “normal, natural” for developed economies is also “normal, natural” for economies in a process of transformation? etc.

We believe that contemporary analyses of the role of institutions are strongly limited and do not give a realistic idea of what is going on and what could be expected from PCC economies. Of special significance nowadays is the analysis of institutions in the context of PCC EU integration when the accession process is viewed as a blind copying of institutions, as following a "road map" drawn by the bureaucrats in Brussels, or enforced *acquis communitaires*. This directly arouses the suspicion: what if the EU results are similar to past experiments such as the planned economy or yet another attempt at integration – Council of Mutual Economic Assistance (CMEA)? And what could be done to prevent partially at least such an outcome?

Of course, as was already mentioned, the analysis of changes under CBs is complicated by the fact that they have systemic and complex character, i.e., they do not happen as a result of gradually increasing the changes within a system. In this context, of special practical importance is the fact that the knowledge of the past system does not equip us with a basis for behaviour in the future system, even less does it give us knowledge of "transformation" itself. Before starting these changes the future expectations⁵ of PCCs were associated with western economies, i.e., the future was not seen as possibilities stemming from an open system, but it was approached building on the current status of neighbouring countries (parallel, external copying)⁶.

⁵ Part of the expectations for our future status was formed based on the past, i.e., they were retrospective. That part of formation of future-based and past-based expectations varied for different individuals. This is reflected in one of the basic classifications of economic actors in transition.

⁶ See, for instance, Gedeon (1997), who believes that the ultimate point of transition is undisputed (it *surely* coincides with the status of western economies). It is only possible that different roads lead to this end.

Or, in other words, "our" future was seen as "their" present. The model that was followed was believed to be a standard (pattern) of success. Paradoxically, the Marxian deterministic assertion was in effect taken as a basis, according to which more developed and wealthier economies blaze a trail for the less wealthy and less developed ones (Marx, ***). Thus, the neoclassical view coincided with that of historical Marxism, and in essence the transition was not looked upon as an open system, but as a system with a definite end in view; and what's more that was an end, which existed.... "today" (in the neighbouring developed economies).

Regardless of the epistemological limitations in systemic changes, we believe that some of the theoretical achievements of the Austrian School (Colombatto, 2002), and of the institutional analysis (Siebert, 2002), could not only give us an explanation of what happened, but also a hint of what to expect, as well as set up the limits of our behaviour. In the theoretical outlook of the Austrian School the transformation is seen as an endogenous process of discovery and adaptation, as achieving complexity through conflicts and cooperation. The institutional development is linked with the problems of knowledge, information and expectations, with insecurity and unpredictability of human action. The stress is on the importance of competitiveness and innovation in the area of institutional practices, which is the only guarantee for their effectiveness and stability.

This article discusses the ways that led to the origin of institutions in PCCs, which largely determine their subsequent evolution and efficiency. The period of post-communism is subdivided into two related systemic changes – the transformation of planned economy, or phase Ph1 (analysed in Part 2) and the processes of EU integration, or phase Ph2 (analysed in Part 3). We believe that EU integration should be built on the principle of institutional competition and innovation, and not on mechanical copying of institutions. In phase Ph2 the PCC transformations better be "left to the endogenous open process, and not to the compulsive construction". The European institutions can be most efficient and viable only if they are the result of the free choice of individuals. Following this logic PCCs could inject institutional innovations and competition in EU. In Part 4 we have included some illustrations of our theses - the copying of monetary practices and laws.

II. Emergence and evolution of institutions in PCCs

The emergence of institutions and rules⁷, and their classification according to the manner of genesis are one of the main contributions of the Austrian school. Under one form or another, it was gradually integrated by the various institutional schools. Let us remember that the beginning of the familiar division of institutions (within the institutional order) could be found in Menger's Principles (Menger, ***). As is known, Menger differentiates between two ideal types - organic institutions (or similarly: spontaneous, broadly defined or constructed, emerging from below, endogenous, abstract, etc.) and pragmatic institutions (or similarly: depending on certain will and pursuing specific goals, imposed, exogenous, specific, etc.)⁸. Subsequently, under one form or another and centering around one or the other of these types, the above differentiation goes throughout and becomes leading in the works of Friedrich Hayek, Ludwig Lachmann and the representatives of Austrian analysis⁹ in general.

It is known that the Austrians favour the first type of institutions (the organic institutions), which come closest to the idea that there is *always* a mismatch between what is planned and what actually takes place, as well as because that type of institutions make the best of tacit knowledge. However, this does not mean that they can not see the much more complex institutional reality (Radnitzky, 1999). Thus, even in Menger's understanding of institutions at any point of time there is a different level of hybridity of each institution, which is expressed in different combinations of elements from the two forms (Samuels, 1999). According to Menger, at every stage (i.e., in each generation of actors) the legacy of institutions has to be evaluated and revised by eliminating those, which have proved "folly", and retain those, which have proved "wise". It is worth mentioning here that within this revision, subject of

⁷ Without going into debates, the institutions can be defined as a system of formal and informal rules of conduct, including like the mechanisms of their enforcement. It is especially important how these rules are perceived, i.e., their cognitive models. This is closely related with the approach to institutions as a system of common perceptions of reality, which allows convergence of actors' expectations. Such an approach is typical of the Austrian school. See also Denzau and North (2000).

⁸ It could be assumed that specific institutions have a strong presence of organizational elements, i.e., they are a unity of rules and organizational form.

⁹ See for details Arnold (1980), Chamilall (2000), Hodgson (2002), Yu (2003).

revision are also institutions, which determine the manner of change and selection of institutions themselves. The understanding of the Austrian school has it that institutions allow best the mobilisation and use of dispersed knowledge, and the management of human coordination in conditions of uncertainty. They are a form of strengthening (or undermining) confidence (Centi, 1999). The continuous revision of individual plans allows better coordination and a trend towards equilibrium (Hayek) or an indefinite result because of the subjective nature of knowledge (Lachmann).

In Ludwig Lachmann's system the subjectivity of expectations and the subjectivity of interpretation of information lead to a much more opaque total result in the revision of plans than assumed by Hayek. Institutions, as Lachmann believes (see Longuet, 1998), reduce the volatility of plans, stabilise them and make human behaviour more predictable. It is suggested that organic institutions evolve within pragmatic institutions as a result of various types of institutional innovations and institutional entrepreneurs. The issue of the change of pragmatic institutions is more serious and less studied. It is also believed that as long as some of the basic institutions are survive (private property, freedom of agreement, money)¹⁰ the coherency and integration of institutional order will also be preserved. However, how these basic institutions would emerge after a period, during which they were eliminated or systematically destroyed, has not been elucidated.

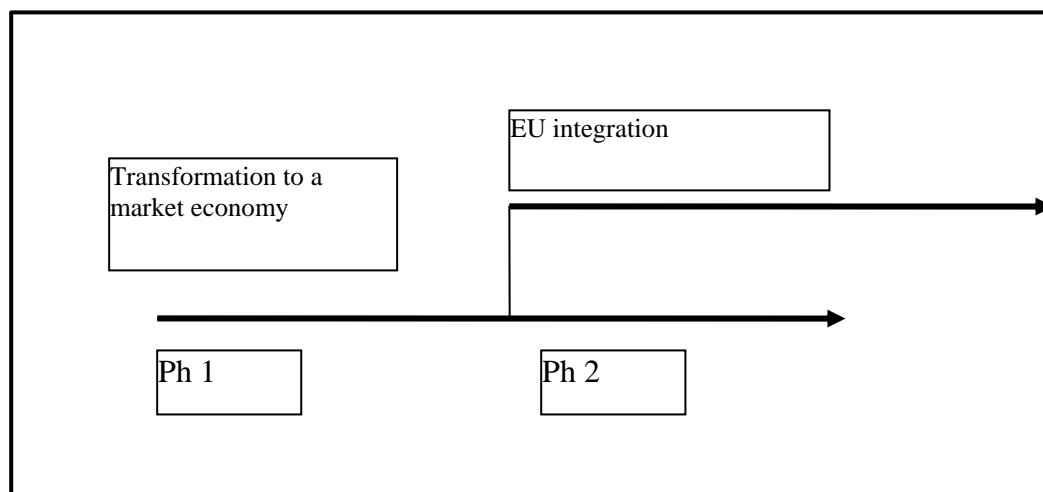
How could the above theoretical elements of the Austrian analysis (although in schematic form) help us to interpret the PCC institutional dynamics?

For facility's sake the history of PCCs could chronologically be subdivided into two overlapping phases, which reflect two significant systemic changes. Phase one Ph 1 (according to the individual countries until mid or end 90-ies) relates to the disintegration of the planned economy and CMEA, and the emergence of market institutions. The second phase Ph 2 is related with the EU accession processes. These two systemic phases have common features and definite differences as regards the

¹⁰ It is appropriate to make a parallel here with the attempts to differentiate between "systemic" and "nonsystemic" change in PCCs. Such an attempt was made by Janos Kornai, who, however, included in "systemic change" a number of specific institutions, while we are of the opinion that systemic

emergence of institutions (this will be explained further below). On the whole, the real dynamics in both phases was copying, import, and enforcing of institutions (in the first case related with the operation of market economy, and in the second with import of institutions and EU rules). While Ph 1 was more about import of both general and more specific institutions ("a result of our aspiration to become like them" because their achievements were better than ours), Ph 2 is about institutions and rules on a much more specific level. In Ph 1 the general institutions, which have otherwise spontaneously or (organically) emerged in the developed economies, were enforced (pragmatically) in PCC. Ph 2 includes simple copying of artificially created (pragmatic) EU institutions. The dominant approach at the emergence of institutions for the most part of both phases was the "top-down" approach. In most PCCs Ph 1 was characterised by extremely great economic, social and political instability and slow development in general (see Tang et al., 2000, Zoli, 2001).

Chart 1 Two analytical phases of transformation



We believe that the PCC problems in both phases (in spite of the common features) could have different explanation. The institutional decisions for more effective economic development could have been (and is still possible to be) different. This was dictated (and still is) by what we perceive as efficient or good.

institutions include only the basic, broadly constructed institutions. If course, the problem with defining the initial and final status of the system remains open.

Firstly, the origin of the problems of transformation as a whole could be sought in the crisis and the insufficiency of knowledge. Brian Loasby's theoretical analysis of knowledge could give us a hint for a number of decisions (Loasby, 2003). The crisis of knowledge is closely related to: (i) the great discrepancy between ideas and reality, (ii) the collapse of the old division of labour, which is genetically related with the division of knowledge, (iii) the lack not only of empirical knowledge, but also of knowledge about the process of knowledge formation, (iv) the intentional generating of and manipulating uncertainty, (v) allowing communications and blocking the channels and transmissions of information and knowledge, etc.

In the PCC context within a very short time the individual knowledge about the functioning of the old centralised administrative system became useless (even harmful) to the actors, while the knowledge of the new system was limited. The knowledge of the *new* future system (as far as it existed) came from the ideas about the functioning of western market economies (as we already mentioned, paradoxically, the Marxian thesis that economies pass through equal phases of development came to the surface). This type of knowledge carried the features of past practices. In other words, the only mainstay of *expectations*¹¹ was the status of the developed western economies. These expectations acquired legitimacy, i.e., they became “legitimated” (Garello, ***)

Secondly, the knowledge about the *transformation* itself was missing due to the unique character of the transition. There was no knowledge of the ways of changing the institutions, which change institutions, as well as about basic institutions (such as private property), eliminated under communism¹². The existing knowledge concerned other types of transition, or reforms in other countries (Latin America, Asia, etc.). Along these lines, in Ph 1 the limited elements of knowledge were in the hands of certain individuals: (i) who had access to the functioning of western economies (related with the nomenclature that had travelled abroad), (ii) who had intellectual knowledge about transitions (part of the intellectual elite), and of course, (ii) a

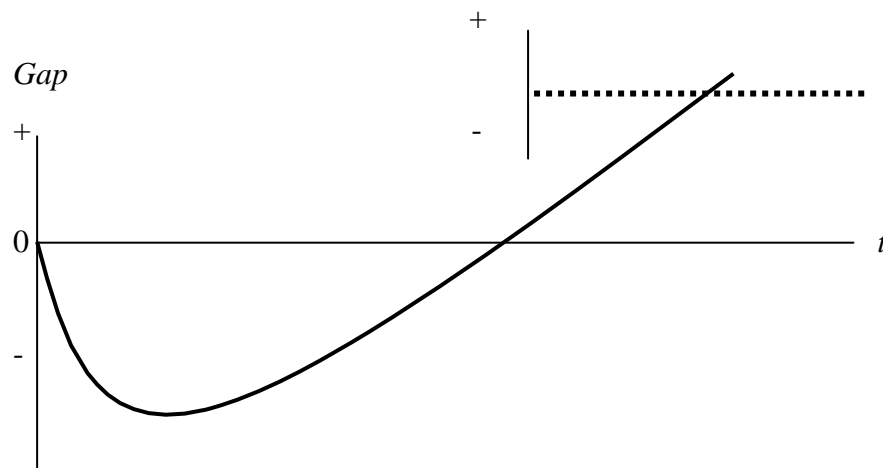
¹¹ According to Hayek expectations are formed based on the *future* (not the past) and are basic for economic decisions making by individuals.

¹² Although it could be assumed that these basic institutions are inherent in human nature, i.e. that they are natural. Hence the question how to restore them.

number of western experts.... These individuals and groups were initiators of the copying of western institutions, which corresponded with their personal interests (Colombatto, 2002, Pejovich, 2001). These groups in effect "captured" the creation of institutions with the purpose to redistribute wealth. The mechanisms of correction and self-correction did not function.

To sum it up, the great discrepancy between the old knowledge and the new knowledge, as well as between ideas and reality (i.e., what matters is not so much the volume but the structure of knowledge), could be illustrated in Chart 2. It is exactly the depth of this discrepancy that determines the depth of the institutional change (the moment this discrepancy is eliminated a new discrepancy comes in its place, etc., etc.).

Chart 2 The evolution of the gap of knowledge



The Ph 1 specifics were also expressed in the fact that even basic institutions such as private property and freedom of contract did not exist. If we follow Lachmann's logic, these are instrumental for setting the complete parameters of the institutional order. Money is one of these. If we think reasonably, the deliberate and intentional creation (which was more about "removing the barriers") of these two institutions had no alternative. Because there was no way waiting anew the spontaneous emergence of private property, private law and money, which are the result of thousands of years of

discovery¹³. Because unlike the transition to socialism, which required a forcible elimination of the above three institutions, their restoration did not need coercive actions but simply a return to the natural status of individuals (Kornai, 2000).

However, the specific way of getting there (especially the restoration of private property) was unclear, and, besides, was it possible to plan it? Anyway, these basic institutions were needed to establish an overall framework for the operation of any kind of entrepreneurial initiative¹⁴.

The deliberate creation (by means of restoration, elimination of barriers, import) of the basic (natural, broadly built) institutions was inevitable. Unfortunately, along with this were imported a number of institutions and rules at a very specific and detailed level (discretionary central banks will be discussed further below), which restricted the beneficial institutional innovation. The specific institutions, (which also determine the *organisational* form of basic institutions), imported in the local context, assumed extremely inefficient forms and even created the possibility for the emergence of new and unexpected institutional practices. These practices were the result of institutional entrepreneurs who adapted to the new environment. In this way, part of the entrepreneurs overcame uncertainty, while another part created new uncertainty¹⁵.

In spite of their inefficiency, part of the new practices were form of adaptation of individuals to institutional chaos, which came from the mechanical copying of specific western institutions and organisational forms. The continuous institutional uncertainty created considerable revisions of the plans of individuals, which caused cumulative instability in the relations among economic players and undermined their mutual confidence. This was greatly influenced by the situation where the copied institutions (such as laws) were not (and could not be) supported by mechanisms for their enforcement (Ialnazov, 2003), which added to even greater confusion and

¹³ Of course, viewed in a long-term horizon, these institutions are also an evolutionary outcome of human behavior. The aspiration to private business and entrepreneurship survived socialism, and emerged spontaneously even in the time of stagnation (Kornai, 2000).

¹⁴ According to Tyson et al. (1994) the two institutions, which are necessary to create conditions for the existence of entrepreneurship, are macroeconomic stability (that is, stable currency) and property rights.

¹⁵ Yu (2002) develops the idea of entrepreneurs overcoming insecurity, and entrepreneurs creating insecurity.

instability¹⁶. The crises (for instance banking panics, financial pyramids, hyperinflation, etc.) are a specific manifestation of accumulated instability. Along these lines, we could definitely speak of a conflict between basic institutions (integrational) and specific institutions, which were copied by western societies¹⁷. This is because the basic institutions in different societies take on various specific forms, which reflect the idiosyncrasies of each individual society¹⁸. In the different theoretical explanations these forms are referred to as "compatibility of order" (Eucken, 1952) or "institutional complementarities"¹⁹ (Aoki, 2000).

Ex post it could be concluded that probably the most appropriate decision was the creation (restoration) only of basic (broadly built) institutions by allowing the specific institutions in each country to emerge spontaneously, thus creating the overall institutional order. In this sense, the "import"¹⁹ of basic institutions was justified and inevitable.

Can we speak of institutional policy (Eggertsson, 1998) and of what scope? Taking as a basis what was said, it is possible under restricted conditions and a policy including three elements: (i) deliberate creation of basic institutions, those that are closest to the nature of individuals ("or deliberate removal of barriers"), (ii) freedom and innovation under their specific form, and (iii) replacement of institutions, which change the specific institutions (this should be done as a process of discovery)²⁰. Of course, it is disputable which institutions are basic, and everybody tends to either expand or reduce their scope. Our opinion is (if following Lachmann) that two institutions fall under this definition: private property and private negotiation. All other institutions can adjust to these principles²¹,

¹⁶ According to Buchanan (1994) even a liberal institution needs mechanisms for its enforcement.

¹⁷ For instance money as a basic institution and discretionary bank as its specific (concrete) form.

¹⁸ According to Seliger (2002, p. 48): "The institutions, which can be considered as suboptimal from the perspective of successful market economies, could be viewed as a benchmark by the economies under transformation".

¹⁹ Logically, this could be interpreted more as a return, restoration of principles, which stand closest to human nature, and which were suppressed under the planned economy.

²⁰ The role of the state in the process of transformation has to be reviewed. According to Siebert (2002) all disputes about a powerful state during the transition and the need of efficient regulation are a utopia given that the state (as a political institution) is transformed radically along with the economic institutions.

²¹ Although if we follow the logic of theoretical deduction (drawing) of these two basic institutions), the overall social system acquires specific configuration (this is best illustrated by Murray Rothbard).

Let us now discuss the second systemic transformation Ph 2 or the PCC integration processes in EU. Here the situation is different.

III. The need for institutional competition during the EU accession process

As was already mentioned, today the everyday life in PCCs is filled with words like ‘harmonisation’, ‘real and nominal convergence’, ‘unification’, ‘synchronisation’, ‘compliance with criteria’, ‘opening and closing chapters’, ‘road map’, ‘report on the preparation for membership’, ‘homework’, etc. In the course of the negotiations (which have nothing to do with negotiations) there is a strongly asymmetrical relationship of dominance where the new countries have almost no institutional choice²².

Unfortunately the deliberate restriction of the choice, which in itself is a violation of individual freedoms, does not only come from outside, from Brussels. It also results from the self-restriction advocated by the negotiating bureaucrats in PCCs. They themselves do not want to have any choice, led by their personal (realised or not) interests. In a sense, we could say that the negotiation process has been ‘appropriated’ by groups of people (politicians and bureaucrats). These officials see the EU directives as the ultimate truth, and these directives are copied directly without taking account of the realities in PCCs. It is amazing how all this reminds us of the integration processes in the former CMEA and the related enthusiasm, especially before the 1960s and 1970s (***)). Although these can be looked for (and perhaps will be ‘found out’ right away), the differences between the CMEA and the EU (and those between Moscow and Brussels) are almost negligible and are rather a matter of degree, and not of nature²³. From a long-term perspective, we have little doubt about it.

²² We are talking mostly about countries like Bulgaria and Romania, but the same is true (though to a lesser extent) for the other countries (those from the so-called ‘first wave of accession’).

²³ If we take an unbiased attitude, we will see that the two systems are based (though to a different degree) on centralised bureaucratic planning, on artificial and limited distribution and specialisation of labour, on distorted mechanisms of competition and pricing, on subsidies, uniformity, etc.

We argue that during the association process the institutional innovation and competition are suppressed. The major contradiction of the systemic phase Ph2 is the following: on the one hand, it is possible and necessary to have much greater institutional innovation and openness, and, on the other hand, the realities are quite different – the EU imposes a vast deal of detailed institutions and rules covering the entire economic and political life. We think that at Ph2 the import of institutions is absolutely unjustified²⁴ and detrimental not only to PCCs, but also to the EU (we will see the example of deposit insurance). This lack of necessity can be seen in the processes of restoring (and gaining) knowledge of the new system, the normal economic activities and the very processes of transformation.

At Ph1 the basic institutions were set up in general – those of private ownership²⁵, private negotiation and money (though distorted by copying specific organisational models) – and thereafter there are no reasons, in terms of efficiency, for artificially restricting the institutional development of PCCs. If there are any constraints, these only stem from particular groups' interests and the ideological instilling of particular theoretical models (of the transition and the EU accession). As a theoretical foundation we need to use the general principle that the wider the choice of the individual (the consumer) is, the greater his welfare is. The institutional choice is no exception. It is similar to the choice of any other good and has an organic link to the consumer's sovereignty.

Those speaking of PCCs harmonisation and convergence to the EU countries keep to the wrong perception that this can be done in a forced way. Actually, as Lottieri demonstrated (2003), there are two kinds of harmonisation: one of these is totalitarian, by force; and the other one – harmonisation that comes from the voluntary activities of individuals and groups. Because: Who can say where we should converge to?²⁶, and In what way?, and Why is there only talk of convergence, and no talk of divergence?, etc. In this vein, why should not there be criteria for

²⁴ If we take aside personal and group interest, rent seeking etc.

²⁵ At end-2000 (2002) % of the private sector in ***

²⁶ Should we converge with the lower levels of taxation or the higher ones (Lottieri, 2003)? Harmonisation, according to (Lottieri, 2003), would prevent consumers and investors from 'profiting' from the low wages in PCCs.

divergence, but only for convergence? Why the one is more logic than the other, and why convergence is more needed for the existence of a community than divergence?

The first type of harmonisation is conducted in an artificial forced way, whereas the second type results from an open process of interaction. The forced harmonisation or convergence, as adopted by the EU, is extremely ineffective and it serves the interests of those who do the harmonising. The forced harmonisation (or rather, unification) is very close to the familiar practices of the planned economy and mechanisms of the CMEA. The constraints of such constructions are very well known from the research done by the Austrian school.

However paradoxical it may sound (to some), it is the PCCs that are the last chance for injecting institutional freedom into the EU²⁷. The opposition, however, is fierce. The logical explanation is that the transposition of European institutions into PCCs, along with the assertion that more rules are needed to cushion the shocks of the ‘new undisciplined non-market’ countries, is the sole chance for the Europlanners (on both sides) to expand the scope of their activities and justify their existence. And yet, there is a paradox, which is the following. The faster the EU becomes harmonised (together with the new members), and the faster the convergence is, the faster the eurobureacracy’s future existence will become pointless. If we assume that, after all, regulation has its natural boundaries and from then on the collapse of the system begins, then the eurobureaucrats’ existence is limited in time. Unless they become aware that for their existence they would need ... divergence and differences (... so that they could fight with them afterwards).

The real competition among institutions consists of new institutional practices possibly appearing and coming to ‘the market’ at any time and mobilising in the best way the knowledge and resources, as well as the specific insecurity in a given sphere. At any time the individual (in this case the European) must be able to decide which rules to observe. Therefore, the competition of rules would come to select the most effective ones, and this process would be *continuous*. In this sense, the Austrian

²⁷ According to

school's understanding of competition has nothing to do with the 'pure and perfect competition' of the neo-classical model (Kizrner, 1973, Salin, 1995).

At present we see (and we suggest), two possible ways of competition of institutional rules within the EU. The first one is when the general rules or institutions (already set up) exist side by side with the national ones and compete with them. This opportunity was offered years ago as a procedure for introducing the euro (Basevi et al., 1975), but unfortunately was not used. Today, again, it is possible to launch this idea, but in a limited geographic region (PCCs). A suitable example would be to allow the legitimate circulation of the single currency in the new countries within the EU and let consumers themselves choose the best currency. Thus the specific types of monetary regime (which basic institutional form is money), which differ in PCCs, would also be involved in the competition (see part 4). In this configuration the very European institutions would be permanently under competitive pressure from the national institutions, and this would compel them to become more efficient (by changing themselves)²⁸. A similar procedure could also be applied in taxation, legislation, etc.

The second possible form is to assume that the general institutions and rules (that have not yet been set up) would spring from the selection of national institutions only. Consequently, the market of rules would be open as in the first case discussed above. The difference here is that European institutions and rules were constructed, from the very beginning, not artificially, but by selection. Unfortunately, this second way of creating euro-institutions has limited application as a large part of European institutions have already been built.

IV. Illustrations

To illustrate the above, we will discuss two examples taken from the experience of Bulgaria. The first one looks at the monetary practices, while the other one looks at the legislation.

²⁸ The best solution could be to allow non-European institutions to become part of the Europeans' choice.

Illustration 1 The currency board and deposit insurance

In terms of monetary practices we will give two examples: one of a successful institutional innovation (a currency board), and another one of mechanical ‘detrimental’ copying of European institutions (deposit insurance).

Example 1. At the very beginning of the transition, Bulgaria mechanically and all ‘deliberately’ adopted the model of a discretionary central bank, which is typical of developed countries. First, the mono-bank’s branches became autonomous overnight. Second, after a period of centrally managed money flows (was it money at all?) and *de facto* planning in accordance with the quantitative (accounting) theory of money ($MV = PY$), nearly all known monetary policy instruments were introduced in a very short time²⁹. Being applied in the environment characteristic of the early transition – predominance of the inefficient state-owned sector, a non-privatised banking system, distorted prices and incentives for economic activities – this type of monetary policy inevitably led to the financial crisis in 1996/1997.³⁰ At the end of 1996 the domestic and foreign debts became huge in size and this threatened their service.

In this situation, under the pressure of the IMF, a currency board arrangement was launched – a form of strict monetary rule whereby the central bank ceases to conduct any monetary policy and the money supply dynamics is linked to the balance of payments dynamics (Nenovsky and Hristov, 2002). Therefore, the introduction of a currency board, as a monetary institution, was intentionally (pragmatically) instigated from outside. In this case we could consider the IMF to be an institutional innovator or entrepreneur pursuing specific interests (Nenovsky and Rizopoulos, 2003). Although we could not expect that the currency board arrangement would solve all the problems in the economy, today we have no doubts that it greatly contributed to the low inflation, the financial stability and generally greater monetary confidence over the past years (1997 - 2003). A number of empirical studies also suggest that, generally, the developing countries with a currency board in place have far better

²⁹ Countries like Poland, Hungary, and Estonia chose a different way that was much closer to the centralised management during the socialist regime, limiting as much as possible the discretionary elements in their policy. This strategy proved very successful and is probably one of the reasons for the more successful reforms in these countries.

economic results than the countries with a discretionary monetary policy (Ghosh et al., 2000). In the light of the institutional analysis, the currency board can be interpreted as follows.

Money, as a broadly constructed or abstract organic monetary institution (and perhaps not only monetary), can exist in various types of monetary regime (concrete pragmatic institutions)³¹. In Bulgaria's example, the discretionary regime came into contradiction to the most profound essence of money, i.e. to reduce insecurity and ensure stability of individual plans, to build and keep confidence (Centi, 1999). The central bank used to generate shocks and, in addition, it was captured and subjected to wealth re-distribution. And vice versa, the currency board, as a type of monetary constitution, considerably reduces insecurity, enhances coordination of plans and helps for the best use of knowledge and information; it also lessens the politicisation of money generation³². Despite the temporary agreement that the currency board complies with the requirements for a transitional monetary regime ERM II³³, on the whole monetary regimes are expected to become unified during the eurointegration process. Therefore, we may face a situation where a successful monetary innovation (the currency board) could be destroyed in the name of unification and synchronisation with the EU. By the logic of institutional competition, it would be most appropriate for the currency board to be viewed as a competitive institutional form which exists side by side with other similar forms. If, for instance, the euro was officially allowed to circulate in PCCs in parallel with the national currencies, this would make possible the institutional competition between the ECB and the local monetary regimes. As we know, some PCCs have arrangements for inflationary targeting (Poland, the Czech Republic, Hungary), while others have currency board arrangements (Estonia, Lithuania, Bulgaria), etc.

³⁰ For more details, see Berlemann and Nenovsky (2003), Dobrinsky (2000).

³¹ Such systems are: a central bank (operating entirely on a discretionary basis, or by rules), currency boards, monetary competition, accepting a foreign currency as legal tender, etc.

³² There are no doubts whatsoever that, like any constitutional rule, the currency board arrangement could be violated. Therefore, an even more efficient form would be the monetary competition which poses a threat to any monopolist of a currency issue.

³³ ERMII suppose that exchange rate should fluctuate within the bands of +/- 15%.

Example 2. The deposit insurance under a currency board arrangement shows how the mechanical transposition of rules could become unacceptable when it is not based on the concrete conditions and could be a threat to the EU as a whole (Nenovsky and Dimitrova, 2003). As a result of the mechanical convergence demanding that at the time of joining the EU all PCCs must have at least 20 000 euro per depositor, and in compliance with the accession schedule (e.g. Bulgaria ‘according to plan’ must be admitted in 2007), today most PCCs have insurance levels much higher than the best world practices, and even higher than the levels in the EU countries (see Table 1). This can be seen in the ratio ‘maximum insured deposit/GDP per capita’ (which by good practices must not be more than 1- 2). The only low level - that in Estonia (0.51) - results from the Estonian authorities refusing to accept the European norms, and the Estonian proposal was finally accepted by the EU.

Table 1 Coverage ratio of deposits in accession countries (AC) and the euro area

country	Coverage ratio
Bulgaria	3.68
Czech Republic	3.51
Estonia	0.51
Hungary	1.79
Latvia	1.35
Lithuania	3.08
Poland	3.61
Romania	1.58
Slovakia	4.19
Slovenia	1.56
AC	2.49
Euro area	1.44

Note: Ratio of the coverage limit to the GDP per capita at the end of 2002 (Nenovsky and Dimitrova, 2003).

Given the deposit distribution in PCCs (these are predominantly small in size), the presence of foreign banks and the much more higher levels of capital adequacy and liquidity, it is logic to expect increased asymmetry of information and moral hazard not only in PCCs, but also in the entire euro area (Nenovsky and Dimitrova, 2003).

Illustration 2 The import of laws (Garello)

- Competition of laws, European constitution?!

V. Conclusion

Although not fully systematised, our views on the origin and dynamics of the institutions in PCCs can be summed up as follows.

Firstly, PCCs offer the unique opportunity for theoretical analysis of a large institutional transformation and could help us find more elements of a possible general theory of transformation. PCCs also enable us to compare the explanatory force of the various theoretical models which in one way or another involve institutions. The Austrian analysis can be a starting point for future studies of the genesis and evolution of the institutions in PCCs.

Secondly, the problems of knowledge, its qualitative features and its communication, can provide us with a proper starting point for better understanding the difficulties of transformation. Therefore, more studies are needed in this area.

Thirdly, in positive terms, we have no doubts that the transformation took up a wrong theoretical model, constructing, importing and copying institutions, initially, from the developed market economies, and, subsequently, directly and 'by force' importing the EU institutions. While we can debate whether some basic institutions (such as private ownership) could have sprung up spontaneously (the facts indicate that in certain aspects it did spring up), the import of concrete institutions into the specific context of the changes was inappropriate. It came into conflict with the very nature of the basic institutions (e.g. the discretionary central bank completely ruined the foundations of money, whereas the currency board preserves them to a larger extent). Another example – the transposition of European insurance levels in the banking system (i.e. deposit insurance), not taking account of the level of development and the condition of the banking system, increases the moral hazard. Throughout the transformation period the free institutional innovation and competition were brought down to the minimum, and this considerably reduced the efficiency of economies. As the aspirations for innovation cannot be fully stifled, the efforts primarily went into overcoming the obstacles and, on the whole, brought into existence a number of inefficient informal practices.

Fourthly, in normative terms, we are convinced that once we have missed the opportunity of viewing transformation as an open system, today it is possible to allow institutional competition and innovation (or rather remove the barriers) during the accession to the EU. There are no economic reasons not to do so, except purely political and ideological ones mostly related to specific groups of interests and rent seeking. The freedom of institutional choice, with European rules existing side by side with national rules, is the most appropriate form of control and selection.

And finally, if we quote Seliger (2002, p. 46): “Transformation can be seen as a large scale discovery procedure, extending the “gene pool” for institutional development, insofar as radical institutional change is quantitatively different, concerning the number of emerging institutions, as well as qualitatively different, concerning the robustness of institutional arrangements, from long-term institutional change”.

Bibliography

- Masahiko, Aoki (2000) “Information Corruption *Oxford University Press*, 2000
- Arnold, Roger (1980) “Hayek and Institutional Evolution” *Journal of Libertarian Studies*, Vol. IV, No. 4, Fall 1980
- Bavesi, G., M. Fratianni....(1975)
- Belermann B, N. Nenovsky (2003). "Lending of First Versus Lending of Last Resort: The Bulgarian Financial Crisis of 1996/1997", *Comparative Economic Studies*, forthcoming.
- Buchanan (1994)
- Centi, J. (1999) JEEH
- Chamilall, N. (2000). JEEH
- Colombatto, Enrico (2002) “Is there an Austrian approach to transition?” *Review of Austrian Economics*, 1, 15. January, pp. 61-74
- Colombatto, Enrico (2001) “Was Transition About Free Market economics?” *Journal des Economistes et des Etudes Humaines* Vol. 11 No 1, March 2001
- Denzau, Arthur T; Douglass North, (1994) “Shared Mental Models: Ideologies and Institutions” *Kyklos*, Vol. 47 – 1994-Fasc 1,3-31
- Dobrinsky (2000) CJE
- Eggertsson, Thrainn (1998), “State Reforms and the Theory of Institutional Policy” *Max Planck Institute for Research into Economic Systems*, 1998
- Eucken (1952)
- Gedeon, Peter (1997) The Economics of Transition and the Transition of Economics”. *Economic Systems*. 21 :1, pp. 72-77
- Ghosh et al. (2000)
- Hayek, F. (1994), La constitution de la liberté, Paris, édition “Litec”
- Havrylyshyn, O., R. Rooden (2000). "Institutions matter in transition, but so do policies", *IMF Working Paper* WP/00/70.

- Hodgson, G (2002) "The Evolution of Institutions: An Agenda for Future Theoretical Research" *Constitutional Political Economy*, 13, 111 – 127, 2002
- IMF (2003)
- Ialnazov, Dimiter (2003) "Why Do Capital Markets in Transition Economies Remain Underdeveloped? Some Evidence from Bulgaria" Paper presented at the EAEPE conference "The Information Society – Understanding Its Institutions Interdisciplinary", 7-10 November 2003, Maastricht
- Kirzner I. (1973**)
- Kornai, Janos (2000) "What the Change of System From Socialism to Capitalism Does and Does Not Mean" *Journal of Economic Perspectives – Volume 14*, November I-Winter 2000 pages 27-42
- Lachmann, L. (1986). *The Market as an Economic Process*, Basil Blackwell Ltd., Oxford.
- Loasby, Brian J (2002) "The Cognitive Basis of Institutions: An Evolutionary Perspective"
- Loasby, Brian J, (1999) "Decision Premises, Decision Cycles and Decomposition" *Max Planck Institute for Research into Economic Systems*, 1999
- Longuet, S. (1998)
- Lottieri, Carlo (2003) , "Harmonisation": quelques remarques sur un concept á la mode"
- Menger, K. (**)
- Menger, K. (1892)
- Mises (1963)
- Nenovsky, N., K. Dimitrova (2003) "Deposit insurance during EU accession" *Revue d'Economie Financiere*, No 72
- Nenovsky, N., Y. Rizopoulos (2003). "Extreme monetary regime change. Evidence from the Currency Board introduction in Bulgaria", *Journal of Economic Issues*, vol. XXXVII, n° 3, December, forthcoming.
- Nenovsky, N., K. Hristov (2002). "New Currency Boards and discretion. The empirical evidence from Bulgaria", *Economic Systems*, March, vol. 26. n° 1, pp. 55-72.
- Pejovich, Svetozar (2001) "After Socialism: Where Hope for Individual Liberty Lies?" *Journal des Economistes et des Etudes Humaines* Vol. 11 No 1, March 2001
- Radnitzky, (1999) *JEEH*
- Raiser, M., M. Di Tommaso, M. Weeks (2001). The measurement and determinants of institutional change: Evidence from transition economies, *EBRD Working Papers*, n° 60.
- Rizzello, Salvatore (2000) "Cognition and Evolution in Economics", *Max Planck Institute for Research into Economic Systems Evolutionary Economics Unit*
- Roland, G. (2002). "The political economy of transition", *Journal of Economic Perspectives*, vol. 16, n° 1, pp. 29-50.
- Roland, G. (2001). "Ten years after... Transition and economics", *IMF Staff Papers*, vol. 48, pp. 29-52.
- Salin, P. (1995)
- Samuels (1999)
- Seliger, Bernhard (2002) "Toward a more General Theory of Transformation" *Eastern European Economics, A Journal of Translations* January-February
- Tyson, Laura d' Andrea, Tea Petrin, Hasley Rogers (1994) "Promoting Entrepreneurship in Eastern Europe", *Small Business Economics* 6:165-184.1994
- Yu, Tony Fu-Lai (2001), "An Entrepreneurial Perspective of Institutional Change" *Constitutional Political Economy*, 12, 217-236, 2001
- WORLD BANK (2002). *World Development Report 2002: Building institutions for markets*, The World Bank, Oxford University Press.
- Tang, Melena, Edda Zoli and Irina Klytchnikova (2000) "Banking Crises in Transition Countries: Fiscal Costs and related Issues", *Policy Research Working Paper No. 2484*, Washington D.C.: World Bank
- Thimann, Christian (ed.), (2002) "Financial Sectors in EU Accession Countries", ECB Publication, Frankfurt am Main, July

Zoli, Edda (2001) "Cost and Effectiveness of Banking Sector Restructuring in Transitional Economies." Working Paper No. 157, Washington D.C.: IMF, 2001.