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Статья поступила в редакцию 27.01.2006

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THE APPLICATION OF DOUGLASS NORTH'S APPROACH TO INSTITUTIONAL CHANGE IN TRANSITION ECONOMIES

*"When it is costly to transact then institutions matter."**

1. Introduction

Douglass North's research activities can be divided into three stages. In the first stage (the 70s) North follows neoclassical assumptions, considering rational behaviour of individuals.¹ In the second phase (the 80s) he changes the assumptions of neoclassical theory and considers positive transaction costs, information costs and uncertainty, trying to explain the institutional structure of economies.² It is only in the 90s that North develops an advanced theory of institutional change, integrating new concepts like path dependence, informal institutions and ideologies.³ North has recently begun to develop a dynamic theory of economic change which builds up on his previous research work.⁴ North's historical-macroeconomic approach to analyze the institutional environment is also known as the New Institutional Economics of History (NIEH).⁵ Basically, North tries to answer the following questions: Why do certain economies develop better than others? How do institutions develop over time? What causes institutional change? The general answer to these questions is that "institutions matter and history matters". Moreover, institutions and their change are also relevant to the development of transition economies. The aim of this paper is to ascertain whether North's concept of institutional change is applicable to post-communist transition economies and can be used as a pattern for further analysis. The paper is based

mainly upon North's book "Institutions, Institutional Change and Economic Performance" issued in 1990.

2. Fundamental concepts of North's approach

North's main concepts of his approach to institutional change are briefly defined and explained in this chapter. First of all, North defines institutions as follows: "Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction. In consequence they structure incentives in human exchange, whether political, social, or economic."⁶ Further on, he distinguishes between two kinds of institutions, formal (constitutions, laws, property rights) and informal (sanctions, values, customs, traditions, norms of behaviour).⁷ The following constructivist formulation about the intangible character of institutions is interesting: "We cannot see, feel, touch, or even measure institutions; they are constructs of the human mind."⁸ North explains the existence of institutions by combining the theory of human behaviour with the theory of transaction costs.⁹ Institutions have the task to structure human interaction and to reduce uncertainty. Thus they reduce transaction and cooperation costs.¹⁰

Transaction costs "...are the costs of measuring what is being exchanged and enforcing

* North, 1993b, p. 2.

¹ See Davis/North, 1971 and North/Thomas, 1973.

² See North, 1981.

³ See North, 1990.

⁴ See North, 2005.

⁵ See Richter, 2005, p. 11ff.

⁶ North, 1990, p. 3.

⁷ See North, 1990, p. 37 and North, 1991, p. 97.

⁸ North, 1990, p. 107.

⁹ See North, 1990, p. 27.

¹⁰ See North, 1990, p. 3ff.

agreements ...they are all the costs involved in human interaction over time.“¹¹ Furthermore he describes them as "the costs of defining, protecting, and enforcing property rights..."¹² Enforcement is carried out by a third party, which can be the state or the legal system. Unfortunately, North's argument of the capability of institutions to reduce transaction costs is empirically difficult to verify. Transaction costs and many institutions are seldom observable and thus difficult to measure.¹³

North makes a conceptual difference between institutions (the rules of the game) and organizations (the players of the game). "Organizations include political bodies (political parties, the Senate, a city council, a regulatory agency), economic bodies (firms, trade unions, family farms, cooperatives), social bodies (churches, clubs, athletic associations), and educational bodies (schools, universities, vocational training centers). They are groups of individuals bound by some common purpose to achieve objectives."¹⁴ Organizations can influence the creation of institutions but can in turn be influenced by the latter. Thus there is a constant interaction between the players and the rules of the game. This interaction shapes the institutional development of an economy.¹⁵

Ideologies are "subjective perceptions (models, theories) all people possess to explain the world around them."¹⁶ Ideologies can be religions or political theories such as communism, capitalism. "Ideas and ideologies matter and institutions play a major role in determining how much they matter. Ideas and ideologies shape the subjective mental constructs that individuals use to interpret the world around them and make choices."¹⁷ Additionally, North considers that human beings can perceive reality differently: "The reality of a political economic system is never known to anyone, but humans do construct elaborate beliefs about the nature of that reality..."¹⁸ Institutions are always created on the basis of their underlying ideologies or belief systems. If the perception of the reality changes, institutions have to be adjusted as well.¹⁹

North tries to answer the question why and how institutional change occurs and which consequences it may have for economic change. He argues that the permanent interaction between institutions and organization is the key for an understanding of institutional change.²⁰ Institutional change is a consequence of the change in formal and informal institutions, as well as the effectiveness of enforcement.²¹ As a deeper cause of institutional change North mentions changes in relative prices (changes in the ratio of factor prices like labour/capital ratio, changes in information costs, changes in technology).²² Although abrupt exogenous changes are possible by means of revolutions, they are often an exception and only seldom do they lead to fast institutional change.²³ Formal institutions can be changed overnight, whereas informal institutions require more time. Thus, institutional change occurs incrementally and is a gradual process of human interaction. But institutional change also depends on changes in preferences of humans. In this context one has to consider also the influence of ideas, ideologies and belief systems on the human perception of reality as well as their ability to change.²⁴

So, why does institutional change differ from country to country? Which resistance can occur to institutional change and why do inefficient institutions remain? North tries to answer these questions with the concept of path dependence. For this purpose he transfers Paul David's concept of the technological path dependence to institutional change.²⁵ Every country has a certain historical institutional path. Specific events and reactions to these events in one country lead to different institutional and economic structures. This historical path of institutional change is reinforced by positive feedbacks (economies of scale, complementarities, and network externalities). A further source for path dependence are informal institutions (norms, conventions, cultural values), which interact with formal institutions. This historical established in-

¹¹ North, 1994a, p. 1.

¹² North, 1990, p. 28.

¹³ An attempt to measure transaction costs on a macro level made by North/Wallis in the year 1986. However they admitted the difficult measurement of transaction costs at a later moment. See North/Wallis, 1994, p. 615.

¹⁴ North, 1990, p. 5.

¹⁵ See North, 1993b, p. 3.

¹⁶ North, 1990, p. 23.

¹⁷ North, 1990, p. 111.

¹⁸ North, 2003, p. 4.

¹⁹ North, 2003, p. 10.

²⁰ See North, 1993a, p. 1ff.

²¹ See North, 1994b, p. 8.

²² See North, 1990, p. 83f.

²³ Therefore North tries to discover mainly the endogenous reasons for institutional change, in contrast to the exogenous treatment of institutions and organizations by O. Williamson, 1975 and 1985; Alchian, 1965; Demsetz, 1967. See North, 1994b, p. 4.

²⁴ See North, 2003, p. 16f and p. 86.

²⁵ David analyzes path dependence within the scope of technological change and illustrates it with the inefficient QWERTY-keyboard which was nevertheless successful because of its positive feedback effects. See David, 1985.

terplay leads in the long run to the creation of irreversible paths within the institutional framework and in the economic structure of a country.²⁶ Additionally, these rigid structures are maintained by the resistance of organizations and interests groups, which try to keep their power and the established institutions.²⁷ This “egoistic” behaviour upholds inefficient institutional paths and structures. North himself mentions the difficulty of path dependence: “...specific short-run paths are unforeseeable, the overall direction in the long run is both more predictable and more difficult to reverse.”²⁸

In order to assess the adaptability of societies and institutions over time, North introduces the concept of adaptive efficiency: “Adaptive efficiency is concerned with the kinds of (tacit or explicit) rules that shapes the way an economy evolves through time. It is also concerned with the willingness of a society to acquire knowledge and learning, to induce innovation, to undertake risk and creative activity of all sorts, as well as resolve problems and bottlenecks of the society through time.”²⁹ This ability to learn and to adapt to changes caused by wars, external shocks and innovations, is a path dependent skill, which is of utmost importance for long lasting economic growth.³⁰ North’s approach about the formation and change of institutions is important for the understanding of economic growth or economic stagnation. In his latest works, North tries to develop a theory of economic change. In his opinion “...understanding the process of economic change is an essential prerequisite to improving economic performance.”³¹ Changes in the institutional framework, in the quantity and quality of human beings and in the stock of knowledge can generate economic change.³²

3. North’s concept as an approach to explain institutional change in post-communist transition economies

Applying North’s approach to transition countries, one can ask the question, why the economic performance in these countries was so diverse.³³ Economic growth can be explained by di-

verse variables (religion,³⁴ culture,³⁵ geography,³⁶ human capital,³⁷ trade,³⁸ social capital,³⁹ technological development⁴⁰). Institutional economists have confirmed a correlation between good formal institutions and economic performance.⁴¹ Although we know the explaining variables, 15 years after the beginning of transition, there is still disappointment and poverty in many former Soviet countries. Initially, the success of the transition process was explained through economic reforms and in particular by the way and speed of the reform implementation.⁴² “Big-bang” reformers or “shock-therapists” recommended a fast and simultaneous implementation of reforms, whereas gradualist stressed that market structures should be built-up incrementally.⁴³

A further explanation for economic performance and institutional change can be given from the institutional perspective. In the New Institutional Economics one crucial question arises: why did institutional change differ in transition economies? Was the difference only a result of different formal rules, or rather of the same rules, which were differently enforced? North comments on this: “Although the rules are the same, the enforcement mechanism, the way enforcement occurs, the norms of behavior, and the subjective models of the actors are not.”⁴⁴ Often one and the same measure can have different effects. Thus, we have to consider where, when and how we introduce new rules. The US constitution being transferred to East-European countries must not automatically produce democracy, stability and wealth. Hence questions about the effectiveness and enforcement of newly introduced rules arise. When applying North’s approach to transition economies,

political, economic and social domains. See Stark, 1992, p. 18.

³⁴ See Barro/McCleary, 2003.

³⁵ See Huntington, 1996, Landes, 1999, Inglehart/Baker, 2000.

³⁶ See Gallup/Sachs/Mellinger, 1998.

³⁷ See Barro, 2001; Benhabib/Spiegel, 1994; Bassanini/Scarpetta, 2001.

³⁸ See Dollar/Kraay, 2004, Frankel/Romer, 1999; Lucas, 1988.

³⁹ See Putnam, 1993.

⁴⁰ See Romer, 1988; Lucas, 1988; Zeira, 1998.

⁴¹ See Besley, 1995; Easterly und Levine, 1997; Knack und Keefer, 1995; Acemoglu et al., 2001; Rodrik, 2000; Rodrik et al., 2004; Clague et al., 1997. For critical comments see Aron, 2000, p. 115. She argues that although the correlation may exist, the causality is not clear.

⁴² See Voigt/Engerer, 2001, p. 155.

⁴³ See Roland, 2000, p. 1 and Stiglitz, 2002, p. 304.

⁴⁴ See North, 1990, p. 101.

²⁶ North, 1993a, p. 1 and p. 5.

²⁷ North, 1997b, p. 15.

²⁸ North, 1990, p. 104.

²⁹ North, 1990, p. 80.

³⁰ North, 2003, p. 13.

³¹ North, 2003, p. 1.

³² However, North prioritises the institutional framework over the other two factors. See North, 2005, p. 1.

³³ The transition in East-European post-communist countries is considered as a system change, occurring in

we have to consider the dynamic aspects of institutions, and especially the interplays between the institutions over time. In the following interdependencies between formal-informal, actor-structure and internal-external factors should be taken into consideration.

With the breakdown of communism in Eastern Europe, the hitherto existing belief system collapsed as well.⁴⁵ Communist ideology failed and people decided for a new ideology and a new system. With the adoption of new rules an abrupt change of formal institutions occurred. Changes in terms of privatization, liberalisation and restructuring took place literally overnight and were external concepts from the West. Initially, transition strategies were shaped by “Washington Consensus”⁴⁶ and in some countries were implemented as big-bang reforms (e. g. Poland, the Czech Republic, Slovakia) or as gradual transition strategies (e.g. Hungary, Slovenia).⁴⁷

Some concepts of North’s approach may help to understand better the transition period. The concept of “path dependence”, for instance, can help to explain the resistance against the introduction of new institutions, which stems from the informal inherited institutions from the communist time. This fact can be explained through the high uncertain and insecure situation in the first years of transition and the habit of people to adhere to habitual and well tried patterns. In consequence, hitherto existing behaviour patterns and mentalities changed only slowly. The informal institutions manifested themselves in specific property and relationship network structures.⁴⁸

Economists often speak about the compatibility of formal and informal institutions.⁴⁹ If there is no harmony between formal and informal institutions, transaction costs and resistance to institutional change increase, resulting in a lower economic growth and less wealth.⁵⁰ The relative success of the Czech transition as compared to the Russian one is explained through a better compatibility between new formal institutions and informal

institutions prior to the communist era.⁵¹ This example can be generalised on the basis of cultural areas. Scholars distinguish between two cultural groups, the Western influenced Central European countries (new EU-member states without Malta and Cyprus) and the Eastern-Orthodox Countries (CIS-countries, Bulgaria and Romania). They assume that Eastern-Orthodox countries were less successful during the transition than their Central European counterparts.⁵² However, one could argue this statement with the successful Latvian and Estonian transition economies, which have a considerable orthodox proportion of their population. Other examples are the orthodox countries Romania and Bulgaria, which almost completed their transition period and are soon to join the EU.⁵³

When explaining institutional change from a historical-cultural perspective, we should not overlook the actors (organizations). After the fall of communism, certain political and economic groups and insiders appeared, trying to influence the creation of new institutions in their favour. In so doing, insiders exerted their influence on privatization of state-owned enterprises.⁵⁴ The resistance from former communists and insider groups led to half-hearted reforms.⁵⁵ The transition was only successful in those countries, where encompassing interests were fostered and egoistic interests were pushed back.⁵⁶

However, the occurred resistance was not the same in all transition countries. Why? The answer can be found in the historical legacy prior to the communist period. Transition countries with more similarities to western culture countries experienced a lower resistance against the introduction of new rules. Let’s try to ascertain this further

⁴⁵ See North, 1997b, p. 16.

⁴⁶ “Washington Consensus” is a reform concept of the 90s which emphasizes strongly the neo-liberal economic policy (macroeconomic stability, price liberalisation, privatization of state owned enterprises). See Stiglitz, 2002, p. 304.

⁴⁷ Compared to North’s notion of time, who thinks in time spans of hundred of years, both kinds of reforms occurred quite fast. See Roland, 2000, p. 14ff.

⁴⁸ See Bohle, 1999, p. 5f.

⁴⁹ See North, 1997a, p. 16; Tridico, 2004.

⁵⁰ See for his the interaction thesis from Pejovich, 1998, p. 9.

⁵¹ See North, 1997a, p. 17f. and North, 1997b, p. 16.

Also, Winiecki highlights the important role of informal institutions on institutional change and economic performance. See Winiecki, 2004, p. 143.

⁵² See Panther, 1997.

⁵³ Note that parts of Romania (Transylvania, Bucovina, and Banat) belonged culturally and historically to the western-catholic Austro-Hungarian Empire.

⁵⁴ Members from “enterprise councils” of state-owned companies’ opposed several years the privatization in Poland. Only with the pressure of the EU, which wanted to privatize fully state-owned enterprises, could the Polish government break the resistance of the interest groups and enforce privatization reforms. See Vincensini, 2001, p. 21.

⁵⁵ Also managers from state-owned enterprises were against market liberalisation, because they feared too much competition of private companies. See Voigt/Engerer, 2001, p. 160.

⁵⁶ For thoughts on “encompassing interests” see Olson, 2000.

with the concept of “adaptive efficiency”. Were there post-communist countries which managed to adapt their formal and informal institutions quicker to the new changes? As mentioned before, transition economies were disposed to change their informal institutions quite quickly, however not their formal ones. The adaptation of new structures to cultural and historic conditions can be also questioned. Besides, the newly introduced economic system was still not resistant enough as compared to the established western market systems. It should also be considered that in the communist system there were no financial markets. An appropriate reaction to financial shocks was not developed.⁵⁷

Nonetheless there were some communist countries which had already some knowledge and experience about the market system prior to the transition. In less strict countries regarding the privatization (e.g. Poland or Hungary) market closeness was maintained despite the overall planned economy. This had positive effects on the working mentality and productivity. Many small Polish enterprises remained privately owned and the capability for trade or entrepreneurship persisted. The existing different degrees of freedom regarding the contact with the West or freedom of expression were reflected in the “social capital” of a society.

The incompatibility between formal and informal institutions increased transaction costs and made the enforcement of new laws difficult.⁵⁸ As a consequence, the new rules were disobeyed and in most countries corruption and underground economy came up. Moreover, these negative tendencies were aggravated by a non-functioning legal system and a weak state. The required third party to enforce the new rules was weak and in some cases too corrupt and not credible enough (e.g. Russia and other CIS-countries). But why could some countries cope with these negative consequences? Can the inclination to corruption be once more explained by cultural-historical factors? On the one hand, the historical legacy from the communist era may explain this inclination. On the other hand, in situations of distress due to the restructuring of the economy, most people’s income sources were semi-legal activities or retail trade. Do people follow the rules if the most elementary needs are not satisfied? In difficult situations people tend not to obey the law. Only with an economic improvement are reforms supported by people and the institutional system can stabilize. But how should these positive feedbacks occur, when

in most of the transition economies the GDP-level prior to the reforms is still not reached? A consequent thought could be that institutional change depends on the level of living standard or its change. Thus, the causality between institutions and economic performance can be put into question.

Which other factors can explain institutional change? Besides obstructive factors, were there also beneficial ones? For this purpose, one should look at the future and external influencing factors. Most approaches to transition research focus on the primacy of the nation state and national institutions and neglect the influence of international actors.⁵⁹ At least at the later stage of the transition process there should be made a link to the developments in Europe, especially to the influence of the EU-legislation.⁶⁰ On the one hand, the EU provided financial support to candidate countries already before their accession and on the other hand maintained a strong pressure to fulfil the accession criteria and adopt the “acquis communautaire”. This method of conditionality was applied for instance within the PHARE-programme.⁶¹

Thus the EU can be seen as a third external party, which enforced their rules via national governments.⁶² In doing so the EU had success with the administrative reforms in Romania and Latvia.⁶³ Other international organizations (e.g. IMF, World Bank) exerted also influence on the economic policy of transition countries.⁶⁴ Unfortunately, these external influencing factors on institutional change are not considered in North’s approach. In summary it can be ascertained that there are obstructive factors (path dependence, resistance of different groups, missing compatibility between formal and informal rules) but also beneficial factors (external influence of international organizations) for institutional change. Furthermore, we have to consider also short-run and long-run influencing factors.

4. Conclusion

North’s approach explains why some

⁵⁷ See Thurow, 2004, p. 27.

⁵⁸ See North, 1997b, p. 16.

⁵⁹ See Bohle, 1999, p. 3.

⁶⁰ This influence is mainly the topic of the “Europeanization“- literature. See on this Schimmelfennig/Sedelmeier, 2005. For critical comments see Hughes et. al, 2004.

⁶¹ See Dimitrova, 2004, p. 9.

⁶² For EU’s democratic influence on national minority legislation, see Kelley, 2004.

⁶³ For Romania see, Hinteá et. al., 2004 and for Latvia, see Reinholde, 2004.

⁶⁴ See Bohle, 1999, p. 17; see Linden, 2002.

countries develop differently from other ones, however his analysis remains historic descriptive and doesn't provide instruments or recipes how to achieve economic growth. Actually, the same institutions can have diverse effects in different countries. Thus North's theory offers only little normative help.⁶⁵ Furthermore institutional change remains uncertain as it depends not only on endogenous historical factors, but also on exogenous future and thus uncertain factors. North himself acknowledges this fact: "While we do have some idea of what has led to successful development in the past, we have very imperfect knowledge about how to achieve such results in the present."⁶⁶ Besides, we have to distinguish between long-run and short-run effects of institutions. North analyzes the impact of path dependent institutions on long-run economic performance of countries from a historical perspective.⁶⁷ The secret how to generate good institutions or economic success in the short-run or middle-run, which remain long-lasting, is not revealed.⁶⁸

On the whole, in his analysis of institutional change North rejects some assumption of the neoclassical theory and considers institutional, cultural-historical and dynamic factors. Also, the interaction of actors and structures partly exists. North's approach may help to explain the internal, cultural-historical resistance during the transition period, but fails to illuminate the external and beneficial factors of institutional change. Due to the former mentioned critical points I argue that North's approach should be adjusted, as it does not contain all the relevant factors. North analyzes mainly the long-run development of economies. The transition process, as well as the institutional change took place in a decade and were rather abrupt. That is why short-run and middle-run factors (e. g. external shocks, macro economic measures, geopolitical influence) should be considered as well. Besides, the external influence of the EU, international organizations or foreign investors should be also considered. Furthermore, initial conditions, such as the initial level of debt or the level of wealth, should be taken into account.⁶⁹

⁶⁵ See Colombatto, 2000, p. 64f.

⁶⁶ North, 1997a, p. 13.

⁶⁷ "Path-dependence is the key to long-run economic performance". See for this North, 1990, p. 112.

⁶⁸ Kolodko argues that in the short-run, macro-economic measures have greater influences on the economy than the introduction of new institutions. See Kolodko, 2004, p. 13ff.

⁶⁹ See Balcerowicz's analytical model to analyze the transition process, where initial conditions and external influences are included. See Balcerowicz, 1997, p. 155.

The insights of New Institutional Economics in its application to transition economies are still quite general and abstract, because the interdependencies between the different influencing factors are complex. Further research is required in order to give concrete political advises. As nowadays many transition countries already joined the EU, application potential remains for actual transition economies and developing economies. For this purpose we have to learn from the mistakes of the history with the help of qualitative-comparative studies and adjust present theory concepts.

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Статья поступила в редакцию 24.01.2006