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Institutional Systems and Their Dynamics, Including Good and Bad Transitions

I. Introduction

The mainstream economics has for a long time neglected the institutions. It either ignored them completely by focusing on the proximate determinants of economic performance (consumption, investment, employment, productivity, etc) or disregarded their variation by assuming an unrealistic set of market institutions (perfect competition) or on an idealized conception of a state as benevolent and omniscient entity. This institutional daltonizm has led the mainstream economics to either ignore the most important issues of the real world or to formulate the deeply wrong conclusions, usually with a statist bias: recommending various government interventions as a cure for various social ills.

Against this background one cannot overestimate importance of the development of the analytical institutional economics of Hayek, Friedman, Buchanan, Tullock, Coase and many others. It has to some extent correct the institutional daltonizm of the mainstream economics. But much remains to be done.

I have focused on the institutional issues both in my academic activity and as a policy maker in charge of Poland's economic reforms. The fusion of these two occupations has helped me to work out what are the main tasks of institutional economics. I think there are four:

1. Clarifying and standardizing the definitions of the main institutional variables and improving their measurement.
2. Exploring what institutional arrangements in various spheres of social life can lastingly co-exist (i.e. form a system) and which cannot.

3. Expanding the enormously important research on the relationship between various institutional systems (stable or changing) and various dimensions of the people's standard of living, both economic and non-economic.
4. Explaining the institutional change including transitions from one institutional system to another one (the political economy).

This paper focuses on the fourth problem which, I think, is the most complex. But in discussing it I have to touch upon the other issues. For example, the institutional dynamics depends on the type of the institutional system, so some conceptual clarifications were needed. Even though the link: the institutional system – a country performance is not the main subject of this paper, I have to refer to the differences in systems' performance in order to explore a naïve but important question: why regimes which perform very badly tend to persist and those which perform much better are often under attack by the domestic forces.

The structure of the paper is as follows: section II aims to clarify the basic concepts: institutions, institutional systems, institutional systems versus policies, the political and economic systems. Section III contrasts the dynamics of the two opposite systems: a highly centralized and highly decentralized one. Section IV presents a more extended typology of institutional systems as basis for the typology of major institutional transitions. Section V briefly discusses two major institutional transformations in the XX century: towards socialism and away from it. Section VI presents an analytical scheme for discussing the determinants of liberal or statist economic transitions in democracy. Section VII briefly discusses the recent bad political transitions after free elections. Section VIII concludes.

II. Institutions and Institutional Systems

Institutions are best conceived as variables– factors that take various forms across countries and through time in a given location. They are usually defined as rules which are not purely internal but are observed because of some mechanisms of external enforcement.

Therefore, one can distinguish two dimensions of institutional rules:

1. Their content
2. The mechanisms of their enforcement and the related level of implementation .

The level of implementation of the rules depends on their content. The story of the Prohibition in the US has shown that even a heavy involvement of the police power cannot stop certain behaviors - in this case of production and consumption of alcohol. In addition, Prohibition produced a wave of crime. This seems to be the case with the contemporary “war on drugs”, too.

Rules in the form of prohibitions may be unenforceable (unless under terror), while rules that describe the individual liberties are sometimes a sham and they are not taken seriously by their nominal beneficiaries (socialism). Therefore, one should distinguish between *de jure* and *de facto* institutions. The former are derived from what is written, the latter from the observation of the enforcement mechanisms.

These mechanisms are usually divided into those that are part of the state and those which are “operated” by the smaller or larger groups in the society, e.g. the caste system in India, the mafia in Italy, the public pressure in all societies. Rules enforced by the state are often called “formal”, while those enforced by non-state mechanisms are called “informal”. One of the most important issues in institutional economics is the relationship between formal and informal institutions, especially whether the latter strengthen the operation of the former, or - on the contrary - weaken it.

Rules are linked to the organizations and networks. First, some rules prohibit certain organizations. For example, under socialism private firms were banned to ensure the monopoly of state ownership (and of central planning). Second, the more repressive are the rules, the stronger must be the enforcement apparatus, lest they remain on paper.

Let me now move from institutions to a institutional system (regime). I define it as a set of institutions that have such an internal cohesion that they can lastingly co-exist regardless of their performance. Obviously, depending on the system’s performance there will be different use of force and intimidation with respect to its actual or potential opponents.

Institutional system should be conceived as consisting of rules and the related organizations (networks), which in turn consist of positions defined by some external and internal rules.

In discussing on the institutional regimes one can focus on the formal institutions (including the state) or consider both formal and the informal ones.

The institutional systems exists at various levels:

1. provinces (regions) in the federal states,
2. the countries (states),
3. the supernational level (nowadays the most important example is the European Union). The greatest variation of the institutional systems exist among the countries and it is this level I will focus on.

An important empirical question is which institutions in various spheres of social life, can lastingly co-exist, i.e. form an institutional system, and what are the “cohesion forces” or functional requirements (L.Balcerowicz, 1995) behind this capacity. For example, the central planning which replaces the market coordination requires massive, multilevel bureaucracy to distribute the commands and inputs. The existence of such a bureaucracy is a functional requirement of socialism. Central planning cannot co-exist with the decentralized organizational structures. This is, in turn, an example of an “institutional impossibility”. Socialism, i.e. a regime without private ownership and markets cannot lastingly co-exist, with democracy defined by an open and regular political competition as expressed by regular free elections. This is an other impossibility theorem.

Let me now distinguish between the institutional systems and policies. There is much confusion on this point in the literature: some authors include certain factors into institutions, while other authors classify them as policies. These conceptual differences, obviously distort the research on the relative role of institutions and polices in determining countries’ performance.

I define policies as actions of policymakers which:

1. Result in the change in the institutions, e.g. political or economic liberalization switching from the fixed rate to floating exchange rate regime, a change in the electoral law. These policies are usually called reforms; or
2. Operate through other variables, e.g. interest rates (monetary, policy), budgetary allocations (fiscal policy), changes, of personnel.

Various institutional systems give rise to different sets of possible policies. The most important of institutional variables which differentiates these sets is concentration of political power, inversely related to the constraints on the executive and the level of the rule of law.

What policy is chosen from the set of policies allowed by a given institutional system depends mostly on the personality factors and on the country's economic and political situation. The despotic regimes allow the psychopaths to gain and keep power and to pursue the most destructive policies, which produce terrible economic crises and sometimes genocide (e.g. Mao, Stalin, Pol Pot). Contrary to the widespread anticapitalist propaganda the worse crises in the sense of deep breakdowns in the economy occur under the socialist dictatorship, and not – under the market economies (for more see: Balcerowicz, 2015).

A radical change of the institutional system, especially in its key dimension: the concentration of political power, affects, country's performance through two channels:

1. it changes individuals' opportunity sets (the scope of freedom) and their incentives,
2. it changes the risk of very bad policies and the resulting risks of crises.

The first channel changes the speed of economic growth in periods when country is growing (or gradually declining), the second – changes the frequency and severity of the growth breakdowns. The change in the long-term economic growth results from these two channels.

Finally, one can distinguish within a country's institutional system various functional subsystems, including the political and economic ones. Both consist of various sets of intuitions. There is no

universal agreement, which institutions should be included in what system. Usually the political regime is defined as comprising the state organizations, the party system, the laws regulating the keeping and changing power in the state, the extent of state power. The economic system includes, by widespread agreement, institutions, which are most relevant for such economic outcomes as output, employment, saving investing, spending etc.

Obviously, such a conceptual separation should not be confused with the separation between the political and economic actors. As a matter of fact, it is the degree of separation between them that is one of the most important institutional variables that distinguish various institutional systems. At one extreme there is socialism a highly centralized system which displays enormous politization of economics life, and a very limited autonomy of economic actors. ¹ At the other extreme there is a highly decentralized system thank to the strong limitations and controls on political power (the checks and balances, the rule of law) which enables extensive and reasonably well protected private property rights and as a result – an economy regulated by the free markets. One would have to look for the examples of such a system to the most liberal countries of the turn of XIX and XX century (e.g. Great Britain, Sweden) and - with respect to the contemporary world - to Hong-Kong, Ireland, Switzerland, Sweden (in the two last cases if one disregards taxes and some regulations).

Very different systems display very different performance – an issue which is beyond the topic of this paper. Here, I would only like to say that the systems which are the closest to the highly decentralized ones perform economically much better than the highly centralized ones – for the simple reason that an extended and well protected economic freedom is widely superior to the politization of the economy. As the result the latter regimes have to rely on intimidation to keep the population in check. This is not required, in the case of economically superior, highly decentralized systems.

¹ Actual autonomy may be larger than the formal one because economic actors have better information about their own possibilities than their superiors. This information asymmetry cannot prevent the political rulers from taking very bad economic decisions.

Also, very different institutional systems displays very different dynamics (which influences their economic performance). It is this topic to which I now turn.

III. Different Institutional Systems have Different Dynamics

The institutional dynamics, i.e. the extend and direction of the change in countries' institutions, depends on their initial institutional system. Let me discuss this issue by contrasting a highly centralized and highly decentralized regimes which I have characterized earlier.

In the former, with its heavy concentration of political power which rules out both economic and civil liberties, the decisions regarding the institutions are centralized, too. At the same time a highly centralized regime with its ban on economic freedom, produces increasingly worse economic results compared to the more liberal systems and over time. The naïve question is why socialist systems persist and are not abolished by those who suffer, i.e. by the masses. The simple answer to this naïve question is that those who rule in such a bad regime are shielded from its economic consequences and those who suffer are intimidated and – in the worst cases – liquidated. Therefore, a radical change must come either form outside – see the occupations and reforms in Germany and Japan after the II World War, or from within the “black box” of the ruling group. The external isolation of a country and the internal controls make the prediction of the regime change practically impossible.

A less naïve question is why a top ruler who concentrates so much power does not use it to change the regime via economic liberalization so that it performs economically better. Mancur Olson in an illumination article (1993) has contrasted a “rowing” bandit with a “stationary one”. The time horizon of the former is short or uncertain, therefore he (she) is not interested in making the subjected population more productive, because it would not increase his take. However, the time horizon of the latter is long and reasonably certain. As a result, he should be interested in economic liberalization, as it would increase the population's output and , thus, the size of his share.

In the another papier Clague et all (1996) have suggested that, indeed, long-lasting autocracies have better economic system than the unstable ones. However, there has been enough long lasting

despotic regimes which have displayed a terrible economic performance. The USSR had existed for 70 years, Mao's China for 30 years, and North Korea and Cuba continue to exist to this day. And economically well performing autocracies are very rare (Edwards, 2011). Clearly, the economic incentives of a socialist autocrat to launch economic liberalization, are either not present or are dominated by other factors. There are three alternative reasons for this:

- An autocrat may be mostly interested in power and, therefore, in the preservation of highly centralized system. Stalin in the USSR is an example here.
- He may be blinded by the statist doctrine and isolated from the sources of an independent information. As a result he may believe in the superiority of the regime, he presides over. Gorbachev was intelligent man, but he was genuinely convinced that the Soviet Union is basically sound, and only accidentally - via openness (glasnost) – he had set in motion its demise.
- A dictator may be aware of the faults of the regime, he governs and he is interested in its economic liberalization. However, he may be afraid how his “selectorate” - the group he depends on – will react to his reforms or they may be sabotaged by it. This is a story of some tsars in Russia and some of popes in the Middle Ages.

In sum, bad economic performance of the socialist dictatorship is clearly not a sufficient reason for its quick transition towards economically more liberal. The link between the performance and the longevity of the system is weak. However, the socialist regimes in the real life have differed in their duration and the mode and extent of transformation. The most important difference had occurred between China where the change started in the late 1970s and the USSR and the former-Soviet bloc where it began during 1989-92. The comparison of these two cases is a fascinating subject for the comparative history and the political economy of institutional change. I will return to this topic in a while.

Let me now turn the opposite case - that of the highly decentralized institutional system with the extensive individual liberties, both economic and non-economic, well protected by the rule of law.

These features allow massive bottom-up institutional innovations in the way individual cooperate and interact: in contracts, networks, business models and organizations. Also, economic liberties and the related competition produce a constant stream of technical innovation which, in turn, spur the institutional ones – see how the Internet has transformed the ways people interact and cooperate.

In contrast to the highly centralized system, the highly decentralized one produces good economic and non-economic outcomes, and allows a lot of individual freedoms. The naïve question in the case of the former regimes was why they tend to persist despite their bad economic performance, and I tried to explain why. The naïve question in the case of the highly decentralized systems is: why don't they automatically persist thanks to their good performance in terms of prosperity and individual freedoms, i.e. why are they often subjected to various statist attacks, which if successful, worsen their aggravate outcomes. In other words: what factors weaken the link between the good performance of the highly decentralized systems and their continued existence? I will take up this question in section IV.

IV. The Typology of Institutional Systems and of the Major Transitions

There are various typologies of institutional systems. The one which I am presenting below is based on the several institutional variables which – thanks to organizations like Freedom House, Fraser Institute, Heritage Foundation etc – are nowadays measured by various indices.

Table 1. Types of Institutional Systems

Dimensions Types	Mechanisms of sucession	Civil Rights	Rule of law	Economic Rights (freedome)	Examples of countries
Socialism	Non-D	Banned	Very low	Banned Comand economy	Nowadays: North Korea, Cuba,
Quasi-socialism	Non-D	Banned	Very low	Very limited	Belarus, Venezuela, many Arab countries

Liberal capitalism	Usually D	Extensive	High	Extensive, well and reasonably equally protected	Hong-Kong, Ireland, Switzerland, Sweden, Estonia
Quasi-liberalism	Usually D	Extensive	High	More limited than under (liberal capitalism due to more regulations. Protection similar to that under (3)	Most of OECD countries
Crony (oligarchic) capitalisms	Non-D	Low	Low	Very unequal protection of private property rights	Russia, Kazakhstan

The organizations I have just mentioned offer extensive definition of the institutional variables. Here, I would like only to add a few words of clarification.

Every institutional system includes a mechanism at filling in the political (and other) positions, or – in another words – a mechanism of personal succession. The ultimate reason for this is that people die.

One of these mechanisms is democracy (D) a regular, open and legal competition for the political positions through free elections (cf. Schumpeter, 1947). Such a competition requires extensive civil liberties (freedom of speech, of association etc.) – this is an example of functional necessity. Therefore, limiting these rights, lowers the level of democracy, until it becomes a sham: elections without choice that serve as an instrument to check the obedience of the ruled. Alternative, i.e. non-democratic mechanism (non-D) of filling in the political position include the dynastic succession and the scheme whereby a ruler of the organization which monopolizes power in the state (the mono-party or the army) is also the ruler of the state.

Rule of law has many definitions. It is useful to define it as a variable, which has high level when the state rules through law (and not through secret police) and the law meets certain formal requirements e.g. clarity, consistency) and respects *de facto* the standard of the due process. The larger are the deviations from these definitional requirements, the lower is the level of the rule of law.

Economic freedom is conceptually related to the type of property rights (private, communal, state) and to the extent of regulations which limit the private rights (the attenuation of property rights). What is often overlooked is the distribution of the economic rights across the various groups in the society. Historically, freedom differed across groups – both *de jure* and in fact (see the rights of serfs versus those of aristocracy). In the modern times equality before the law is, a norm - a great achievement, i.e. there is no discrimination by the *de jure* institutions. But the protection of the economic (and other) rights may differ across groups. The distribution of the protection of economic rights across groups is an important variable, which differentiates institutional regimes and influences their economics performance.

Let me add that the definitions and measures of economic freedom often ignore the difference in the tax burdens which are strictly related to the size of the fiscal spending. Whenever the latter is large, it is because of the large size of the social expenditures – or in other words - of the welfare state. The more developed definitions of the economic freedom would have to include the differences in tax burdens.

Let me briefly comment on the types of the institutional systems which I sketched, based on the discussed institutional variables. Socialism overlaps with a highly centralized system, discussed in the previous section. Quasi-socialism similarly to socialism is non-democratic and also displays a very low level of the rule of law. It is dominated by the state sector but to a little lesser extent than under socialism as it allows a wider margin for a private firms and for markets. This, however, is not sufficient, to allow quasi-socialism to perform much better than socialism. Poor economic outcomes in many Arab counties are ascribed by some observers to their religion: Islam. The true reasons is that they are or were burdened by “Arab socialism” i.e. quasi-socialism (e.g. Egypt under Nasser, Syria under the Assads, Iraq under Hussein).

Capitalism is usually defined as a systems which allows privates ownership of the productive assets. This definition allows a huge variation of the capitalistic systems:

Liberal (entrepreneurial) capitalism overlaps with the category of the highly decentralized system. Its defining feature is a wide scope of economic freedom what is highly and reasonably equally protected within the framework of the rule of law. This produces wide scope of free markets.

Quasi-liberal capitalism differs from the liberal one in that it suffers from substantially more regulation which limit the economic freedom and the scope of free markets, especially with respect to the labor markets. However there are no sharp inter-group differences in the level of the protection of economic freedom. Quasi-liberal capitalism is a heterogonous category. Some of its representatives, e.g France or Italy, suffer from more regulation then the other e.g. Britain or Netherlands.

Oligarchic (or crony) capitalism is distinguished by very unequal protection of nominally equal economic rights: The ruling politicians and/or people close to them enjoy privileges in the form of government contracts, licenses and – in the extreme cases like Russia – the possibility to use the state apparatus to grab the assets of other businesses people. Such situation exists because of unofficial politico-economic networks, i.e. the informal institutions, which penetrate the formal ones. Crony capitalism is obviously not only unjust but also inefficient because it sharply limits the economic competition and – in its more extreme form – exposes normal entrepreneurs to the painful uncertainty.

Typologies of institutional systems , based on clear and measurable criteria, can serve four analytical proposes:

First, they are the indispensable for the comparative economics of the stable institutional systems², which aims at explaining the differences in their performance (growth, employment, inflation, health, inequalities, etc.) Mainstream economics has been for far too long a-institutional, i.e. it either disregarded institutional factors or disregarded their variation. In the first case it focuses on the proximate factors of growth like investment rates, in the second if implicitly assumes an idealized set of market institutions. In both cases this institutional daltonizm had led the most prominent

² Stability of the highly decentralized system is defined by the stability of their extensive freedoms which produces massive bottom up institutional change.

representatives of the mainstream economics to ignore the most important issues of the real world and –sometimes – to formulate deeply wrong conclusions (see the Samuelson-Nordhaus textbook where they seriously suggested that the USSR may overtake the US in the level of GDP). The neo-institutionalism of the Hayek, Friedman, Buchanan, Tullock, Coase, North and others has to some extent corrected the institutional daltonizm of mainstream economics. But much remains to be the done.

Second, analytically-based typologies define various types of institutional transitions, e.g.:

- towards liberal capitalism;
- towards socialism;
- from socialism to quasi-socialism, crony capitalism, quasi-liberal capitalism, liberal capitalism;
- from liberal capitalism to quasi-liberal or to crony capitalism;
- from quasi-liberal capitalism to liberal one;

By defining the institutional starting points and the direction of change, analytically based typologies may bring more order into a very broad and diffuse field of institutional change.

Third, typologies of institutional systems and the related types of transitions constitute the necessary basis for the economics of the systems in transition which deals with the performance of the economy under different institutional transitions. This should be distinguished from the economics under the stable institutional systems. The former deals with certain variables which are not present in the later, especially with the link between scope and the time structure of the economic liberalization and fiscal reform on the one hand, and the country's economic performance, on the other. This issue was widely discussed in connection with the transition after socialism often with reference to a misleading and primitive juxtaposition of the "shock therapy" versus "gradualism" (for more on that see Balcerowicz, 2014)

Forth, types of institutional transitions derived from the typology of institutional systems may be of help in the politics (political economy) of transitions which tries to explain – or even more ambitiously – to predict, the launching and the longevity of real-life reforms (or counter-reforms).

The comparative economics of the institutional systems is enormously important from the practical point of view. Fortunately we are – here on a relatively firm analytical grounds. One has to be blinded by the collectivist doctrines to deny the fundamental role of economic freedom and the rule of law for the economic and non-economic dimension of the people’s standard of living. Unfortunately, there is no lack of such people in academia, media and politics. But this is a fundamental political and communication problem, not the analytical one.

The economics of the systems in transition can build on the comparative economics of the stable systems in pointing out what is the best target system – the goal of transitions. There is still some confusion and some work to do regarding the modes of transitions and especially what is the optimal extent and the time structure of the reforms under different initial conditions. I am, speaking, of course, about the reforms, which aim at the lasting improvement in the people’s standard of living.

By far the more complex is the political economy (politics) of institutional transitions. The broader is the temporal and spatial scope of the history one deals with, the more tempting are sweeping generalizations, (“laws of history”), like the ones proposed by Hegel or Marks. They should be resisted as there are some fundamental reasons, why such generalization (not to mention predictions) are bound to be misleading or highly superficial:

- as distinct from the physical objects people engage in strategic behavior;
- it is impossible to determine precisely what are the thresholds which, if surpassed, set in motion radical changed group’s behavior, e.g. rebellions, civil wars
- social reality is not only shaped by some systematic forces (e.g. demography) but also by largely unpredictable shocks e.g. wars, fundamentally new technologies, the appearance and spread of collectivist doctrines. And shocks interact in various ways. For example, the Great Depression has been interpreted by many intellectuals as the proof that the free market economy is fundamentally unstable, and this interpretation had increased the popularity of the statist doctrine of Keynes.

In the following, I will briefly discuss few selected cases of transitions.

V. Transition Towards socialism and Away from It

Contrary to Marx's predictions, the socialist system first appeared in tsarist Russia and not in the most developed capitalistic countries. The Marxist ideology had infected a group of Bolsheviks: ruthless intellectuals-terrorists, headed by Lenin. They used the upheavals of the I World War in the Tsarist Empire to capture the state and the perpetuate their power by terror. In this process they have an unbelievable series of good luck (see Pipes, 1990). The socialist system did not need to happen but once it happened in the USSR, it was spread after the II World War by invasion or military intimidation in the CEE. Therefore, there was nothing secret or complex about the diffusion of the Soviet model in Europe. It was also adopted by the domestic dictators – via imitation and professional and financial assistance from the USSR and other socialist countries – in Cuba and many African countries.

China in 1949 became another center of socialism after the destructive civil war and the war with Japan. It was then subjected until the late 1970 to the inhuman rule of Maoism.

Socialism had always been introduced by the internal or external force. Once introduced, it has persisted despite its bad performance, because the mechanisms I have described before: the ruling elite was shielded from its worse consequences while the masses were intimidated and to some extent – indoctrinated.

The long existence of socialist systems despite their deplorable performance is not a puzzle. Much more puzzling and unexpected was their demise. This was – after the downfall of Nazism – the most liberating development in XX century, analyzed in many books. However no theory could have predicted what has happened in China in the late 1970 and in the Soviet bloc in 1989-91.

In China after the death of Mao, his successor Deng Tsio Ping has moved the country away from socialism, i.e. from the dominance of state ownership in the economy and central planning. The share of the private and quasi-private sector in employment as increased from close to 0 in the late 1970 to above 80% in 2016. This massive privatization – mostly thanks to the setting up and developing

new private firm, has been the main driving force behind the China's accelerated economic growth. And this happened under the rule of the monopolistic party which still calls itself "communist"! Chinese economic growth has been also helped by enormous private saving which, in turn, were possible thanks to keeping the welfare state in check. The fiscal spending has declined from 30% of GDP in the late 1970 to below 20% 15 years later.

The demise of socialism in the USSR was very different. Stalin, the Soviet despot, died in 1953 and his successor, Khrushchev reduced the intensity of people's intimidation. However, neither he nor his successors have attempted any serious liberalization of the economy – despite its growing inefficiency and massive shortages. This situation of growing economic problems and no market reforms continued during the 1980's – when Chinese rulers were liberalizing their economy. Only at the very end of the USSR, Gorbachev, legalized the creation of private firms (but under the socialist name of the co-operatives). However the forces he had inadvertently set in motion under the heading of "glasnost" (freedom of the media, more open political competition) has led to the dissolution of the his party and the USSR. One wonders why the Soviet rulers were so much more orthodox in their economic policies compared to their Chinese colleagues. My guess is that this was largely the result of the differences in the personality factors in the ruling groups in both countries. These factors matter in political developments, especially in systems with the heavy concentration of political power.

VI. Economic Transitions under Democracy

The economic transitions in the democratic countries can be divided into the liberal (deregulations, privatizations) and statist, i.e. those which increase the political control over the economy. There has been large variation in the frequency of both type of transitions across democratic countries in the XX century. Also, when we look at the single countries during this period we notice that their economic system was not stable. The liberal capitalism from the turn of XIX and XX century in countries like Britain or Sweden had been transformed – despite its good economic performance -into quasi-liberal one. After the II World War some countries with the quasi-liberal systems went further into the

direction of statism, e.g. Britain until Ms Thatcher or France under Millerand. Some states displayed a sort of institutional fluctuations: Sweden went from liberal capitalism to the quasi-liberal one, and in the early 1990 successfully launched liberal reforms. Britain show a similar trajectory, thanks to the Ms Thatcher reforms. However, the later developments, especially in the energy sector, have a statist direction. This is an example of the reform reversal.

There are many studies of the economic transitions under democracy. Obviously I cannot discuss them in this short paper. Instead I will sketch an analytical scheme which describes some of the variables that influence the probability of liberal or statist transitions (for more see: Balcerowicz 2015).

The future shape of the economic system can be conceived as it the resultant of two opposing forces: 1. The liberal: those promoting market reforms and defending them (if achieved) and 2. The anti-liberal: those opposing these reforms and defend the existing statist arrangements. Drawing on this analogy from physics we can say that an economically inferior system would persist or even get worse if anti-liberal forces prevail. Market reforms (but not always in a necessary shape) would be launched when the balance changes to the benefit of liberal forces. Of course, this is just a simple analytical framework.

To move further one has to specify what determines the relative strengthen of the liberal and anti-liberal forces over time and across countries. I think that the main situational determinants are as follows:

1. The relative strength of various interest groups;
2. The relative strength of liberal and statist doctrines;
3. The economic situation;
4. The positive or negative linkages between market reforms and some widely shared ideas in the society.

These variables interact in the short run. In the longer run some of them influence the others. For example, an economic crisis, interpreted by some influential intellectuals as a proof that free market capitalism is fundamentally fragile and thus demands more state intervention, is likely to strengthen the statist orientation in the society.

Speaking about the interest groups one must stress Olson's important contribution. First, he has shown in his path-breaking book (1965) that it is easier to create the narrowly based pressure groups (distributional coalitions) than larger ones, including the pro-reform ones. As a result, the former accumulate over time and increasingly harm the economic system and economic growth through various regulatory or fiscal privileges – unless and until they are destroyed by some special circumstances like wars. Olson's examples were Japan and Germany after II World War in contrast with Britain (1982). Olson's theory has spurred a substantial empirical research which – to some extent – supported his theory (Horgos and Zimmermon, 2009).

While Olson tended to explain much with little he never claimed that his theory of accumulation and discontinuity in the life of anti-reform pressure groups under democracy can explain all the variation in economic transitions under democracy. Indeed, there are some other factors at play:

First, there are some other forces than wars or revolutions that change the composition and the relative strength of various interest groups. For example, the Internet-based technical change tends to reduce the role of trade unions.

Second, Olson has focused on the pressure groups with financial incentives. However, there are also ideological pressure groups (including the radical ecologism) usually guided by the statist preferences and led by the anti-liberal intellectuals. One cannot help but be amazed that the economic freedom, so fundamental for economic prosperity and the existence of democracy, is so attacked in the West.

Third, there are other situational factors than the pressure groups that influence the probability of liberal or statist transitions.

One of them is the type of economic situation. It is useful to contrast a visible economic improvement with the economic crisis.

The improving economic situation reduces the pressure for liberal reforms and may facilitate the anti-liberal policies. Market reforms under improving economic conditions are not ruled out but require a special leadership which is largely a chance factor.

Improving economic situation results from previous economic reforms or from other factors including the external conditions. In the first case, the question arises: Will the economic improvement be sufficiently strongly linked in the people's mind to the previous liberal reforms, thus protecting them or would the anti liberal forces use the ensuing economic slack and reverse at the least some of those reforms? One can generally say that the improved economic performance due to market reforms is not a sufficient to protect them from the reversal. There are various reasons for that: generational change, prevailing statist interpretation of the economic crises by the gifted anti-liberal ideologies, the use of emotional issues like inequality against free markets etc. Therefore, the liberal reforms need protection by the liberal forces i.e. they have to win the communication battle with the anti liberal ones.

Economic improvement due to the non-policy factors (windfall gains) is not only likely to block liberal reforms but also to spur the statist ones. The reason for that is the factor of the contribution of previous liberal reforms to the prosperity is absent. And the windfall gains, e.g. discovery of couple natural resources or improved terms of trade, mask the structural problems in the economy and strengthen the voice of anti liberal groups relative to the liberal ones. The latter have to be especially skillful in communication to neutralize the harmful input of windfall gains upon the policies.

Let me now turn to the opposite economic situation: that of the economic crisis. It is usually thought that crisis favors economics liberalization and (fiscal) reforms, as other options become much worse in the eyes of the policy makers. Many examples confirm this point: reforms in South East Asia after 1988,

radical liberal transition in Poland and the Baltic countries in 1989-91, reforms in Spain during the recent global financial crisis.

However, the link between the economic crisis and liberal reforms is far from perfect, as there are two intervening factors: the prevailing interpretation of the root causes of the crisis and the availability of the windfall gains.

If like in Poland and some other post-socialist countries in 1989-91, the interpretation prevails that the crisis was due to the inherited statist system, the liberal reforms are likely to be supported. If on the contrary most people think that it was the market system or market reforms that produced the crisis, statist transition is likely to follow, e.g. New Deal Policies in the 1930 in the US. The prevailing interpretation of the root causes of the crisis depends on the relative success of the liberal and the anti-liberal intellectuals in the society. The communication battle about the root causes of the crisis is, therefore, a battle about the future policies. The result of this battle depends not only on the engagement and the communication skills of the opposing forces but also on the situational factors which influence public opinion.

Argentina provides a striking example of the power of the situational factors in shaping the public opinion in conjunction with the appearance of the windfall gains after the crisis. Under Menem and Cavallo, it had introduced in the 1990s some genuine market reforms: liberalization and privatization, but left intact some basic weaknesses of Argentina's system: rigid labor markets and the mechanisms of fiscal irresponsibility of the provinces. Together with the negative shocks in the late 1990s and early 2000s they undermined the economy and caused a deep crisis. The surge in anti-reform attitudes followed. However, even in such a situation, the increased anti-reform sentiment among the voters did not need to lead to anti-reform policies. The policy after the crisis is influenced by another situational factor: the external conditions that follow the crisis. If they remain difficult or get worse, the best choice even for the anti-reform politicians could be to reform, as there would simply be no money to pursue populist policies, especially in the fiscal sphere. In

contrast, if external forces provide a substantial relief, e.g. the demand for and prices of countries' main exports improve anti-reform policies pushed by the voters are likely to be pursued. This was the case of Argentina under the Kirchners - the increased demand for and prices of its main exports allowed them to go in the sharply anti-market direction (for more see Cavallo, 2017)

In general, it is bad for liberal reforms when bad (i.e. anti-reforms) guys in politics have good luck, or when good (i.e. pro-reform) guys have bad luck. It is good for the reforms when bad guys have a bad luck or when good guys have good luck. What combination of situational variables and personality factors appears in reality, is to a large extent a chance factor which introduces an element of unpredictability into the economic transitions under democracy.

The last situational factor I will discuss here are positive or negative linkages. The positive or negative linkages exist in people's minds because of the past situations and because of the developments that accompany market reforms. By definition, a positive linkage exists when market reforms can be linked to something highly valued by many people. Negative linkages exist when market reforms can be linked to developments regarded as negative by many people. Positive linkages existed and could be strengthened in many countries of the former Soviet bloc, especially in the CEE. The liberalization from the Soviet dominance was a highly positive factor for most people in these countries, and market reforms could be linked to this development as a part of a departure from the Soviet system.³ In contrast, in Russia there were many people for whom the dissolution of the Soviet Union had produced a disorientation and a loss of satisfaction they derived from belonging to the superpower. These attitudes could be easily mobilized by the nationalist and/or socialist politicians against market reforms (Gaidar, 2006). This is what has happened under Putin in Russia.

The analytical scheme I presented may be checked against a living laboratory: the transitions after the collapse of socialism in the former Soviet bloc. The newly liberated countries have differed

³ The strength of the national identity, a product of the past, has influenced the power of the positive linkage. For example, it was stronger in Poland, Hungary, the Czech and Slovak republics and in the Baltic countries than in Belarus.

enormously in the speed and scope of their economic (and political) transitions. On the one hand there were early radical reformers like Poland in 1990 and the Baltic countries 2 years later, on the other hand the laggards like Ukraine or countries which got stuck in quasi-socialism: Belarus, countries in Central Asia. (For more on the typology of economic transitions after socialism, see Balcerowicz 2015). All the early radical reformers started under serious economic crisis that was widely and rightly blamed on the previous socialist, i.e. anti-market, regime. Neither of them obtained any windfall gains just after the collapse of socialism. Among the countries that had represented the largest deviations from a radical approach (Belarus, most of Central Asia), the positive linkages must have been much weaker than in the CEE (if they existed at all) because the national aspirations – a product of history - were much weaker, too. And in the case of Central Asia, the unpopularity of the Soviet regime was bound to be much weaker than in the CEE because in former countries, given their inclusion in the USSR, the feeling that the Soviet regime produced a relative decline was probably absent or much weaker. This helps to explain why most of the presidents in the newly independent states were the former communist rulers in the respective Soviet republics.

Russia deserves a special mention. Despite a negative linkage, it launched under Yeltsin and Gaidar in the beginning of 1992 rather radical reforms. This illustrates the power of the personality factor. The political conditions for radical reforms were, however, more difficult than in Poland and in the Baltics, and reformers were more quickly replaced by non-reformers, whose fiscal policy produced in 1998 an acute crisis. The later developments – those under Putin regime – illustrate the power of the situational factors – in conjunction with a bad personality. Rising oil prices had produced huge windfall gains and negative linkages were activated against market reforms by the statist politicians of the nationalist or socialist variety. Market reforms stagnated and some were put into the reverse (especially privatization).

In sum, the situational variables are very important in explaining the timing and direction of the economic transitions. However, the personality factors are a necessary complement. On the one hand,

favorable circumstances may be wasted because of the lack of a proper leader. On the other hand, despite less favorable conditions, gifted and reform-minded leaders may launch economic reforms.

VII. Bad Political Transitions after Free Elections

Such transitions were widespread in Europe in the interwar period. However, what I have in mind here are recent developments in some countries whereby an individual and his (her) group win genuinely free elections and then – by reducing the civil liberties and the level of the rule of law - lower the level of the legal political competition (democracy).

There have been many examples of such bad political transitions which differ in how advanced they are. Some of them are already completed: the political system (both formal and informal) has been changed to such an extent that no opposition can – within its framework – replace this ruling group. Elections usually continue to be organized, but they are a sham. This group includes Russia under Putin, Belorussia under Lukashenka, Venezuela under Maduro, Nicaragua under Ortega, probably Turkey under Erdogan. According to Kornai (2016), Orban in Hungary has changed its political system so much that opposition can't win elections, either.

In the case of completed bad transitions the return to democracy would have to entail some splits in the ruling group because of personal conflicts, catastrophic economic situation or growing civic or external pressure.

In some other countries, bad transitions are less advanced. Poland since the elections in 2015 belongs to this group. There is also a category of democratically reversed bad transitions, where a ruling group with autocratic inclinations has lost elections (Macedonia in 2016 and Sri Lanka in 2015 fit this category).

There are not many comparative studies of the recent bad political transitions. What I can do here is to offer a few observations and to ask some questions with the view to such an investigation.

To start with, one should distinguish two issues:

- (1) How to explain the electoral victory of a group which tries to perpetuate itself in power by reducing the level of political competition?
- (2) What is the dynamics of bad transition and its determinants?

With respect to the first question one should avoid easy generalizations, like massive shifts in societies towards populism and nationalism. Behind each case of the start of a bad transition lies a different combination of factors. For example, the victory of Law and Justice (PiS) in Poland has happened under a very good economic situation and mostly because of a very bad electoral campaign of the incumbents. In Hungary the economic situation was worse than in Poland and Orban was helped by the scandals that plagued his competitors. Erdogan's authoritarian offensive was made possible by a failed coup against him. The start of a bad transition depends on some chance factors, but can have lasting consequences. And this brings me to the second issue.

The authoritarian rulers have three instruments at their disposal:

- (1) Buying the support of some targeted groups by distributing money and jobs (clientelism);
- (2) Indoctrinating people by the captured media;
- (3) Taking over the state apparatus (political police, prosecutors, tax administration and – in the extreme cases – the courts) in order to use it against opponents of the ruling group (intimidation).

The scope for clientelism depends on the economic situation. I have noticed in Section VI that improving economic conditions help the rulers who push economic statism. Such conditions also help those who implement bad political transitions. As in every society many people assess the ruling politicians through the prism of the current economic situation. The rulers with the authoritarian inclinations are likely to use the improving economic situation as a guise to mask the taking over of the state apparatus. This is what Putin was doing in Russia when the prices of oil were high, the economic situation in Russia was rapidly improving and he was genuinely popular. When the prices of oil collapsed and economic situation deteriorated, he was already in

control of the apparatus of intimidation. The lesson is that it is the early phase of a bad political transition which is crucial and during which the democratic opposition should be especially vigilant regarding the developments in the state apparatus.

The probability that the winner of free elections would try to take over the state in order to eliminate the political competition depends on a country's political culture: an important informal institution accumulated over a longer time. Therefore, bad economic transitions are much less likely in matured democracies than in the early ones. It is not a surprise that all the recent cases of bad political transitions have happened in the latter group.

Finally, it is also striking that these transitions are not linked to economic liberalizations, which would improve societies longer term economic situation. The opposite is rather true. The authoritarian rulers pursue - under the nationalistic or populist headings - a statist agenda of increasing political control over the economy. This would suggest that when the economy gets worse due to these policies, the bad political transition will be under popular pressure, especially if the civil society manages to block the attempts of the autocrats to turn the state apparatus into a tool of repression. Preventing such a development is a decisive determinant of the duration of a bad political transition.

VIII. Concluding Comments

The analytical institutional economics has been of enormous importance for correcting the statist bias of the mainstream economics and to direct the attention of the profession to the important problems of the real world. However, much remains to be done in every of the four fields I have listed in the beginning of this paper, including especially the most complex one: the driving forces of various institutional transitions.

However the main challenges for those who are rational believers in the institutional systems based on the extensive liberties within the framework of the rule of law, lie in organization and communication. Bad systems can unfortunately persist because of intimidation. Good systems based on freedoms and the rule of law are subject to various collectivist attacks, despite their superior performance. Only if these attacks are pushed back, can the liberal transitions be preserved and the statist ones – blocked. And this is an unending challenge for liberal forces.

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