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C e n t e r f o r S o c i a l
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Leszek Balcerowicz

Institutions and Convergence (preliminary version)

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Contents

Abstract 5

1. Economic Convergence and Divergence 6

2. A Problem of Convergence and Divergence in the Economic Literature 7

3. Institutions: some clarifications 10

4. Propelling and Stabilizing Institutions 14

5. Some Propositions on Convergence 20

6. Explaining the Institutional Change 26

References 34

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Abstract

Institutional variables are the most important factor explaining real convergence. But what are institutions? This paper examines the relationship between institutions and policies, institutions and organisations, and formal and informal institutions. The concept of propelling and stabilizing institutions is introduced and used to explain differences in real convergence. Finally, issues of institutional changes are analysed based on an analytical framework which consists of initial conditions and two types of forces: collectivist and liberal.

I first briefly present some basic facts about economic convergence and divergence over the last 200 years. I then discuss how the problem of long-run growth has been treated in the economic literature. Section 3 attempts to classify the concept of institutions – the key explanatory variable in the deeper analysis of the relative pace of development. In Section 4 I describe two types of institutions, propelling and stabilizing, and their relationship to economic growth. Based on previous sections and the empirical literature on convergence, I then formulate some broad propositions concerning why countries converge or diverge (Section 5). The explanation runs in terms of institutional variables. In Section 6 I go one level deeper and ask what explains institutional change[1].

[1] The first two sections are largely and Section 5 is party based on my contribution to L. Balcerowicz and S. Fisher (2006).

1. Economic Convergence and Divergence

1. It is believed that prior to 1800 living standards differed little across countries and time (Parente and Prescott 2000, p. 23). Modern economic growth started around 1800 in Western Europe (and its ethnic offshoots), bringing about an unprecedented acceleration in the growth of living standards in Western countries the per-capita GDP of which grew about eight times as fast between 1820 and 1989 as it had during in the precapitalist epoch (A. Maddison, 1991, p. 48). Such acceleration did not take place in other countries until about 1950. Thus, ''the big story over the last 200–300 years is one of the massive divergence in the levels of income per capita between the rich and the poor'' (Easterly and Levine 2000, p. 18).

2. As is well known from the work of Kuznets, Solow and others, productivity increase plays the most important role in countries at the technology frontier. Factor accumulation can also play a substantial role in countries that are converging toward the technology frontier, as can the reallocation of labor from agriculture to the modern sector.

3. While the Western countries as a group surged ahead, there was a substantial convergence of income levels in the West itself. The most widespread and intense convergence occurred from 1950 to 1973, when all the Western economies grew considerably faster than the United States (which grew at 2.2 percent). The fastest growth per capita was achieved by Japan (8 percent), Italy (5 percent), Germany, Austria (4.9 percent), and France (4 percent) (Maddison 1991). Spain surged aheadfrom 1961 to 1975 with a growth rate of 6.9 percent. A true growth miracle happened during the 1990s in Ireland.

4. The post–World War II period brought about an accelerated convergence among Western countries and an impressive catching-up of some other economies—particularly in Japan and among the East Asian tigers. Taiwan, Thailand, Singapore, South Korea, Malaysia, Hong Kong and China entered the race in the late 1970s and increased their per-capita income from 6.7 percent of the Western European average in 1976 to 17.9 percent in 2001. A slower but still impressive catching-up has been achieved more recently by India. Outside Asia, Chile has been a growth leader over the past 15 years.

5. There were also important examples of divergence during this period, most notably in Africa and to a lesser extent in Latin America, as well as among the former Communist economies. From 1970 to 1998, per capita income fell in 32 countries, while only seven developing countries showed rapid convergence. However, China and India are among the seven fast-growing countries. As a result, 70 percent of the population of the developing world lives in countries where per capita income growth has exceeded that in the developed economies, while less than 10 percent lives in countries where average income declined (World Economic Outlook 2000, pp. 15–16).

2. A Problem of Convergence and Divergence in the Economic Literature

Both the emphasis on and the approach to growth in the economic literature has varied over time. It was the main topic for Adam Smith and his followers and successors. The marginalist revolution in the late 19th century shifted economists' attention to the issues of market exchange and allocation under given resources - technology and the consumers' tastes. This static tradition was taken up and developed in general-equilibrium theory. Nor did monetary and macroeconomic analysis focus on long-run growth until after World War II.

Schumpeter (1913), one of the few to break away from the dominant static analysis of his time, has been retrospectively identified as a pioneer in the modern analysis of both growth and development. He focused on major technological breakthroughs and on the related role of the entrepreneur (defined as a persons implementing inventions in business practice). However, his views on what type of institutional framework is conducive to technical change were rather ambivalent.

Issues of risk-taking and technical change also surfaced in the debate over whether socialism can be as economically efficient as capitalism. Lange (1936) argued that the first-order conditions for a static optimum could be implemented as well by a planner as in a market system. Critics, notably Mises (1951) and Hayek (1935, 1949), emphasized issues of uncertainty and change and the need for incentives. Subsequent experience awards the victory in the debate to the latter group[2].

[2] For an analysis of his debate from the point of view of the experience of real socialism see Balcerowicz (1995).

Starting after World War II, the economic profession and multinational organizations had to address the problem of underdevelopment in poorer countries, now named the less developed countries (LDCs). Among the pioneers in this literature were Albert Hirschman, Arthur Lewis, Paul Rosenstein-Rodan, and Walt Rostow.

Two basic approaches to the study of longer-term growth can be distinguished. The first limits its attention to such variables as land, labor, capital, and productivity, which constitute the **proximate causes** of growth. The institutional framework of the economy, which underlies these factors, is typically taken as given - i.e., it is not analyzed as a **variable** explaining the variation of the long-term growth rates. Within this literature, early models by Harrod and Domar were the precursors of two generations of growth models, those originating from Solow (1956) and the ever-growing endogenous-growth theory approach starting from Lucas (1988) and Romer (1986). Barro pioneered cross-country econometric research on the determinants of longer-term growth.

The second approach omits or goes beyond the proximate causes and includes more deeply rooted factors of a more qualitative nature, most often institutional.

So long as growth theory and empirical work remains within the first framework, it is guaranteed to omit variables that are clearly crucial for growth (for example, whether an economy is socialist or capitalist, as in the cases of North and South Korea or East and West Germany)[3]. It is possible to include measures of institutional variables (such as the extent of democracy and the monetary and fiscal frameworks) in empirical work, which has thus begun to bridge between the two approaches.

Within the second approach, one can distinguish two main and conflicting economic directions, free market and statist.

The free-market direction is rightly associated with Adam Smith and classical economics. Smith confronted the system of "perfect liberty" with that of the state-controlled protectionist economy, and linked economic freedom to the extent of the market and that to the division of labor (which was his name for technical change, Blaug, 1996) and division of labor to wealth. He stressed the positive role of market competition - a product of economic freedom - and was very critical of monopoly. He emphasized the ''unproductive'' nature of the public sector and was skeptical of public regulation of the economy[4]. Smith's basic insights were maintained by his classical followers and successors. According to J. S. Mill

[3] For example, in his overview of the recent developments in growth theory says, J. Temple (1999): "few of the variables considered here would offer much weight into the experience of China or the former command economies, for example" (p. 141). N. Kaldor (1961), one of the pioneers of the growth models, emphasized that a "genuine" theory of economic growth will require drawing upon "sociological" factors to a much larger extent than is so far the case in economic theory.

[4] "No regulation of commerce can increase the quantity of industry in any society beyond what its capital can maintain. It can only divert a part of it into direction which it is by no means certain that this artificial direction is likely to be more advantageous to the society than that into which it would have gone on its own accord" (A. Smith, p. 79, quoted after A. Skinner).

the state's despotism - including predatory or arbitrary taxation - is much more dangerous to a nation's progress than almost any degree of lawlessness and disturbance in the ‘‘system of freedom.’’. he prescribed strict limits to public intervention, emphasized the tendencies of governments, including democratic ones, to expand, and warned that active and benevolent governments would stifle individuals' initiative and that government's officials do not have proper incentives to direct business enterprises (J.S. Mill, 1909).

The statist direction regards the free market and the related limited state as fundamental obstacles to economic development and consequently recommends the state's expansion as the key to growth. This tradition included the mercantilists, so much criticized by Adam Smith, but found its most vocal and somewhat paradoxical exponent in Karl Marx. While praising the technological dynamism of capitalism, he predicted its demise, pointing out (among other things) the allegedly destructive role of the ‘‘anarchy of production’’—that is, of market competition. Marx's central message was implemented in the form of the planned or command economy. North (1998, pp. 100–101) notes that ‘‘it is an extraordinary irony that Karl Marx, who first pointed out the necessity for restructuring societies to realize the potential of new technology, should have been responsible for creating economies that have foundered on these precise issues.”

Schumpeter's writings display a similar, if not so visible, tension. In his early "Theory of Economic Development" (1912) he stresses the role of revolutionary technical change in capitalist development and links it to the activity of entrepreneurs. However, he claims that some of the motives of these drama personae may be present in non-capitalist systems and that capitalist profit motive can be replaced (p. 151). He goes much further in his "Socialism, Capitalism and Democracy" (first edition 1942). Here he positions himself firmly on the side of the proponents of the efficiency of socialism against L. von Mises and F.A. Hayek and alleges that industrial managers under socialism would be instructed to produce as economically as possible and as a result ‘‘in the socialist order every improvement would theoretically spread by decree and substandard practice could be promptly eliminated’’ (p. 196).

Reflecting the view that Soviet growth in the prewar period and the Great Depression showed the superiority of extensive state intervention, the early post–World War II development economists postulated that a free market in the LDCs cannot be relied on to produce growth and that the state can successfully generate a take-off by concentrated investments, protectionism, and forced industrialization at the cost of agriculture[5].

[5] For more analysis of the old development economics see: P. Bauer, K. Brunner, D. Lal, A.R. Waters, Ch. K. Rowley, and D. Bandow in J. Dorn, et al (1998). See also A. O. Krueger (1990). On the use or rather misuse of the growth models in policy advice to the LDC's see W. Easterly (2002).

The failure of state-led development, including the crisis and breakdown of Soviet socialism, has demonstrated the bankruptcy of the statist approach and contributed to the revival of a free-market orientation in economics. This shift was helped by the increased focus on institutions and institutional variables, among them property rights (A. Alchian 1977, E. Furubotn, S. Pejovich 1974), public-choice theory (J. Buchanan 1989, G. Tullock 1998, W. Niskanen 1971), constitutional economics (Hayek 1960, Buchanan 1989), interest-group theory (Olson 1965, Becker 1984), and economic history (North 1998). Empirical research linked economic growth to the development of the market-oriented financial sector (T. Beck, R.Levine, and N. Loayza 1999; R. G. Rajan and L. Zingales 2001) and to economic imbalances and inflation-products of unconstrained governments (S. Fischer 1991). Various indexes of economic freedom were developed after 1980, and a strong link between the extent of that freedom and economic growth was shown (Scully 1992; Hanke and Walters 1997).

Summing up: developments in economics during the last twenty to thirty years have increased the importance of the problem of economic growth, rehabilitated the role of institutional variables, and shifted attention to the classical issues of economic freedom, the market, and the limits of government. This transformation is far from finished. Few today, however, would object to North's assertion that, ''the central issue of economic history and of economic development is to account for the evolution of political and economic institutions that create an economic environment that induces increasing productivity" (1991, p. 98).

3. Institutions: some clarifications

According to North, ''Institutions are the rules of the game in society; more formally, they are the humanly-devised constraints that shape human interaction. Thus, they structure incentives in exchange, whether political, social or economic'' (1998, p. 95).

This definition may serve as a point of departure but requires some clarifications, so as to establish what set of factors which may affect outcomes is included under "institutions". Obviously, the larger this set, the stronger the impact of "institutions". Some differences in the views on the strength of this impact arise from conceptual confusion (i.e., grouping unequally large sets of variables under the same term of "institutions").

The conceptual classification should refer to the following relationships:

1. institutions versus policies,
2. institutions versus organizations,
3. formal and informal institutions.

Some authors regard the extent of economic freedom as a fundamental institutional variable while other authors classify, say trade liberalization as a “policy”. As a result the second group may ascribe more explanatory power to “policies” and less to “institutions” than the first group. In order to avoid such confusion one should classify the conceptual domains of “institutions” and “policies”, and then the casual relationships between the variables designated by these terms.

“Policies” denote actions taken by certain actors. If our unit of analysis is a country, we usually speak of public (state) policies. Such policies can be usefully divided into:

1. reforms or institutional (structural) policies,
2. macroeconomic policies.

By definition, policies of the first type result in a change in a country’s institutional system (framework), which consists of all the institutions influencing individual’s behavior in a given country. Policies of the second type do not operate through institutions but through their impact on the economic variables, such as interest rates or aggregate demand.

Correspondingly, effects of reform policies should be ascribed **both** to policies and to institutions. However, the institutional framework does not only depend on top-down reforms (or the lack of them) but may change due to bottom-up institutional change (e.g., various forms of self-regulation or spontaneously evolved, new forms of contracts). The proportion between top-down and bottom-up reforms depends on a basic feature of the institutional system: *centralization of decisions* regarding interpersonal interactions or - conversely - *freedom of interpersonal interactions*. It includes freedom of setting up and shaping of various organizations for both economic and non-economic purposes, as well as freedom of contracts.

Turning to macroeconomic policies, let me point out that they depend on the existing institutional framework: that is, on the extent of the independence of the central bank, institutional fiscal constraints (if any), and the proportion of mandatory budgetary spending.

Both institutional and macroeconomic policies depend not only on the inherited institutional framework but also on non-institutional factors, which include the personality features of the top decision-makers. Obviously, the weaker the institutional constraints on these individuals, the larger the potential impact of the personality variables. They matter more in the case of absolute than constitutional monarchs. However, even the best absolute

ruler cannot overcome the basic weakness of absolutism as an institutional state; that is, the impossibility to make credible commitments (North and Weingast, 1989). Therefore, there is limited substitution between personal factors and institutional reforms. It is also limited because personal factors in the case of absolute rulers are hardly a control variable; they are rather subject to chance variation.

Finally, let me point out that the role of an individual may consist in changing the inherited institutional system in a statist or liberal direction.

D. North has sharply separated the concept of "institutions" from that of "organizations". However, in his recent work with B. Weingast (2006), he stresses the fundamental role of organizations in development. I personally don't find it useful to keep organizations outside the analysis of institutions, as some institutions (in North's original sense) shape the organizational set up of the society. It is better to distinguish between:

1. primary institutions, and
2. secondary institutions.

Primary institutions determine the shape of secondary institutions. This is not a full determination as various no-institutional factors influence what use is made of given primary institutions. The basic primary institutional variable is – already mentioned – freedom of interpersonal interactions. It shapes two secondary institutional variables:

- the variety and type of organizations acting in society
- the mode of coordination of economic actions of various individuals and organizations, i.e. whether it is of market or non-market type, and – within market type – the intensity of market competition.

Finally, institutions are often divided into formal and informal. Both types perform similar functions in a society (dispute, resolution, contract enforcement, crime prevention and punishment, etc.), but differ in that formal institutions are somehow related to a state as an ultimate and specialized enforcer,[6] while informal institutions do not need the state but rely on shared beliefs regarding proper or prohibited behavior, and on informal social sanctions (e.g. exclusion, disapproval), as an enforcement mechanism (see e.g. Elster, 1989). Each society has some social norms and the related interpersonal networks. Societies differ in that some have only such informal institutions ("traditional" or "primitive" societies) while others have both formal and informal institutions. The existence of some formal institutions appears to be regarded as one of distinguishing features of a "civilization".

[6] I leave aside here the difficult question, "what is the state," and how to distinguish some states from a mafia.

I think it is analytically useful to define institutions broadly, i.e. to include under this heading both formal and informal institutions. For:

1. it facilitates the comparison of the efficiency of informal and formal institutions; and – thus – the comparison of traditional and non-traditional societies;
2. it highlights the problem of the dynamic interactions between informal and formal institutions (see "Building institutions…", 2002).

One issue here is how different informal institutions (cultures) interact with similar formal systems, e.g. to what extent differences in outcomes under centrally planned economies in Soviet Asia and Europe were due to different informal institutions. This issue also includes the question of whether differences in religious beliefs influence outcomes of capitalistic systems.

Another aspect is whether and how a given formal system shapes certain social norms. For example, initiatives related to central planning encouraged cheating, e.g. manipulating superiors to get a plan that would be easy to (over)fulfill. One wonders whether a competitive market economy puts a premium on business honesty and thus strengthens the appropriate social norms.

Having emphasized the importance of considering both informal and formal institutions, let me stress that the latter are a much more powerful determinant of economic performance than the former. This is being shown by huge differences in outcomes achieved by culturally similar societies subjected to very different formal systems (e.g. North, and South Korea, East and West Germany, the Czech Republic and Austria). They are surely much larger than differences in outcomes achieved by culturally different societies which started from the same level of economic development and were then subjected to similar formal systems.

Also, cultures are not so different that under any pair of countries, say A and B, country A would achieve the best outcome under a formal system, which would be the opposite from that of country B. To put it more simply, under **any** cultural conditions a command economy performs worse than a competitive market economy. This is because, besides cultural variety, human beings have certain cognitive and motivational invariants (human nature), which prevent a command economy from being superior to a market one.

Finally, informal institutions that are detrimental to the efficient operation of a market economy are likely to be **even more detrimental** to the efficiency of a planned economy. Take ethnolinguistic fragmentation. It is thought to limit the extent of market exchange across ethnolinguistic lines ("Building Institutions, 2002). However, under a command economy the

same fragmentation would endanger serious conflicts regarding the centralized distribution of resources, and the related additional inefficiency.

4. Propelling and Stabilizing Institutions

Growth trajectories differ enormously in the extent of their variability (OECD, 2000; W. Easterly and R. Levine, 2000; V. Hnatkovska and N. Loayza, 2003). Some countries grow steadily, albeit at different pace, while others are plagued by serious development breakdowns. These differences are partly due to differences in the external shocks that hit economies. However, many negative shocks are produced at home and countries differ in their ability to cope with external shocks. Finally, the very vulnerability to such shocks, due – for example – to the composition of domestic output, is an important variable which merits some explanation.

Sudden slowdowns, even if followed by rapid spurts of growth, may lower the average long term rate below that which is achievable under steadier growth. Indeed, a recent study ("Economic Growth in the 1990", World Bank, 2005) found that the 18 most successful LDC's "show remarkably narrow fluctuations in their growth rates over time" (p. 82)[7]. Preventing serious growth breakdowns belongs, therefore, to growth strategy.

Against this background I propose to distinguish two kinds of institutional variables, or sets of institutions within a country's (or region's) institutional system:

1. Propelling institutions;
2. Stabilizing institutions.

By definition, propelling institutions determine the strength of the systematic forces of growth, while stabilizing institutions influence mainly the frequency and severity of domestic shocks and the capacity of the economy to deal with external shocks.

A country's growth trajectory depends on the strengths of its propelling and stabilizing institutions. When both are strong, growth is fast and relatively smooth (say the United States). When both are weak, growth is slow and interrupted by serious breakdowns (e.g., in some countries of Africa and Latin America). In the intermediate case propelling institutions are strong but stabilizing institutions are weak (e.g., South Korea, Thailand, and Indonesia

[7] These were countries that met two criteria: 1) their rate of per capita income growth exceeded that of the United States (7.7 percent a year) during the 1990's, and 2) the same rate in the 1980's was at least one percent a year (p. 79).

before the 1998 crisis), or the propelling institutions are weak and the stabilizing institutions strong (like Portugal under Salzar until the economic liberalization in the 1960's).

Propelling institutions may be conceptualized through two – partly overlapping – institutional variables:

1. The extent of economic freedom,
2. The fiscal position of a state (or community in the case of societies that have only informal institutions)

Both variables determine the potential scope of and the relative incentives regarding productive (or developmental) actions, such as: work, innovation, saving, investment, and education.

The extent of economic freedom is an important component of a more general variable: freedom of interpersonal interactions. Economic freedom can, in turn, be expressed through the concept of *property rights*.

Let us start with *elementary* property rights, which – by definition – enter the concept of a property rights *regime* in the sense that these regimes may allow one or more type of elementary property rights.

Elementary property rights (and property rights regimes) differ in two dimensions:
the content (structure) and level of enforcement.
Both dimensions have an important impact upon the strength of propelling institutions. Regarding the content, the first division of property rights would be into: communal and non-communal (individualized) rights.

Communal property rights create a common pool problem: "a resource gets overused because too many agents have the right to use it" (A. Schleifer, 1995 and the quoted literature). Communal property rights are typically informal institutions, and a feature of many societies without a state.

Non-communal property rights are usually formal institutions, and include various forms of private firms as well as public ones. Notice that the distinction between a private and public firm should be primarily based on who is the owner – that is, whether it is a public institution or not. The theory of ownership is largely the theory of owners, as different types of owners face different sets of incentives, and – as a result - tend to behave quite differently. The basic distinction is between public and non-public owners (for more on this theme see L. Balcerowicz, 1995).

Let us now move to property rights regimes. I believe that the most important dimension of economic freedom and – consequently – of propelling institutions, can be captured by the following typology:

1. An open (or liberal) property rights regime, that allows for the choice of various forms of private and non-private (co-operative) enterprises;
2. A closed regime, that ensures the monopoly of one form: communal (traditional societies), state-owned (Soviet socialism), or labor-managed (former Yugoslavia)[8];
3. A mixed regime, which preserves the monopoly of SOE's in some sectors (e.g. oil in Mexico or copper in Chile).

The property rights regime matters because it shapes the ownership structure of the economy and the extent of market competition, the latter both through the contestability of markets and through the behavior of established firms. The open regime gives rise to a private economy because entrepreneurs tend to prefer private firms as they give them more control than the co-operative ones. The closed system perpetuates a traditional community or produces an economy dominated by socialist firms, and the mixed regime creates a mixed ownership structure.

There are some other institutional dimensions which may be expressed as changes (differences) in the control or cash flow rights belonging to the respective elementary property rights (enterprise forms).

One such dimension is the government regulation that limits the extent of these rights, usually involving safety reasons, the protection of the "weaker" side of a contract or the prevention of fraud. The effects of creeping regulation are often referred to as the "attenuation" of property rights.

Some regulations - like price controls and barriers to entry and imports - strongly limit market competition. They should be singled out as *anticompetitive regulations*, which lead to distorted market economics and – in the extreme – to a market economy without competition. *Corporatist structures,* which can be conceptualized as informal institutions tolerated or even supported by the state, can have similar effects.

Countries differ sharply in the extent of governmental regulations of various sectors and markets. The most pronounced differences among contemporary economies are present in the labor market and in the service sector - especially in retail trade, the financial sector and construction. These differences have a profound impact on the pace of technological change and on productivity growth as market or sector specific regulations limit the flexibility of supply and the pace of restructuring (see, Scarpetta et al, 2002). Large differences in the extent of regulations of the same sectors among countries with a similar per capita income produce huge cross-country differences in their productivity. And large differences in the

[8] Ostensibly labor manager firms Yugoslavia were subject to control from the party – that is, the state. Thus the control rights of the workers were seriously limited.

extent of regulations of various sectors in the same country are responsible for equally striking productivity differences (W. Lewis, 2004). This shows the power of institutional variables and suggests that a given country's institutional system may include various institutional subsystems that differ sharply in the extent of economic freedom.

Let us now turn to the second dimension of property rights: *their enforcement*. Informal property rights - these which are based on ties of kinship or ethnicity - have a limited scope of enforcement and, may limit the spread of markets across larger groups, thus hampering economic growth ("Building Institutions for Markets"). Traditional societies would then be locked in to a stationary economy because of: 1) the communal nature of their property rights and/or 2) the limited scope of the market due to the deficiencies in the enforcement of property rights.

However, even if an efficient third party enforcer is necessary for the market transactions to spread and the economy to grow, we should not draw hasty conclusions about an economically beneficial role for the state. For the structures called "states" vary enormously: from *protective states* (Brunner, 1998) to predatory (Olson, 1982) or failed ones. And even under "protective" states, a large role is played by non-state mechanisms for dispute resolution (arbitration, mediation). Finally, even if traditional societies are likely to be condemned to a stationary economy, the worst case scenario under the state may be even worse: a predatory state crowding out the informal institutions without creating efficient formal ones in their place. This appears to be the fate of some African countries. Systems consisting only of informal institutions are likely to display much less variation in their economic performance than systems dominated by formal institutions.

If property rights have the right content (i.e. creating strong incentives for individuals to engage in productive actions), then the higher the level of their enforcement, the better it is for economic growth. However, the issue of enforcement goes beyond its average level and includes inequality of a state's enforcement of property rights across various groups in a country. This latter point was argued by De Soto (2000) with reference to the enormous size of the informal sector in Latin American economies. Reforms which improve the enforcement of private property rights by reducing such inequalities or raising the overall efficiency of the legal apparatus can substantially contribute to economic growth.

However, one cannot expect such effects if improved enforcement is attempted under badly structured property rights that is, a closed property rights regime. Such attempts amount to a fight with the informal sector that is an enclave of a private economy under socialism. Therefore, the growth effects of increased enforcement of property rights depend on their content.

The second component of propelling institutions, besides various dimensions of property rights, is the **fiscal position of the state**. I define this variable by the relative size and composition of budgetary spending and taxes (usually expressed as a percentage of a country's GDP). The third dimension – that of a fiscal balance and of public debt - related to stabilizing institutions.

Taxes can be conceived of as a reduction in economic freedom, so there is some overlap between property rights and the fiscal rate of the state. Increased taxes tend to reduce the benefits of effort. Besides some of them, like anticompetitive regulations, distort the way the effort is used. Thus, what matters for incentives and therefore for the strength of propelling forces is not only the tax/GDP ratio, but also the structure of taxes (see W. Leibfritz, I. Thorton and A. Bibee, 1997). Countries differ in both of these dimensions considerably. However, it is not clear how large the differences in the incentive effects of various taxes are and – as a result – how much growth one can achieve via tax reforms compared to the reduction of the overall tax burden. This is an important topic for research.

Speaking about taxes one should remember that low effective official taxes can go hand in hand with large bribes. This is especially likely under a highly discretionary state with a corrupt administration. The fiscal position of the state should include all compulsory payments related to the existence of the state - that is, both official taxes and bribes. Only then can we have the full picture of the incentive effects of the state[9]. What matters for an affected individual or a firm is, first of all, how much he/she has to pay and much less what form the forced payments have.

Increased budgetary spending is the only reason for increased tax burden and thus it is responsible for its negative effects. Practically all the enormous increase in the spending to GDP ratio (and consequently tax to GDP ratio) that happened during the last 100 years in the developed countries and among many of the less developed ones, has been due to the rise of social spending (i.e., the so-called welfare state). There is a strong link between the structure of social transfers and their share in GDP: a high replacement ratio (rewarding non-work), easy access to social benefits, and a large share of the public spending of health and pensions produce large welfare states.

Growing social transfers not only weaken propelling institutions by producing a large tax burden. In addition, they can discourage some productive actions in a direct way. Large "pay-as-you-go" (PAYG) systems, if credible, tend to reduce private savings and – as a result – domestic investment (There is still limited substitution between foreign and domestic

[9] The inclusion of only official taxes in the empirical research May lead to the underestimation of the importance of low taxes for growth. For countries with low official tax burden include those that are plagued by large required bribes and have large total forced payments and - as a result – low growth.

savings). This lowers both the capital outlays and via reduced embodied technical change – productivity growth. Many social benefits systems discourage work and thus reduce labor supply[10].

Finally, state-financed health and education-especially if linked with state monopolies on the supply side-is likely to produce large opportunity costs (i.e., innovations that would appear if the private sector were allowed to operate).

The destructive force of large social transfers in the underdeveloped economies has been shown in a spectacular way by two natural experiments: the introduction of the costly West German Social System in East Germany and increases,, U.S.-financed social transfers in Puerto Rico.

Since Keynes, the economic profession has focused on analyzing the self-equilibrating properties of the macro-economy, taking the market structure of the economy as given. While there is much to be discussed in this regard, there is little doubt that the worst breakdowns in economic growth in the contemporary world have occurred under extended and not laissez-faire states, and because of the actions of the governments of former states.

In his seminal paper, S. Fisher (1993) has shown that macroeconomic policies that help to determine the rate of inflation, the budget deficits, and the balance of payments matter for long-term growth. And in a recent paper, V. Hnatkovska and N. Loayza (2003) investigated 79 countries during 1960-2000 and conclusioned that "volatility and long-run growth are negatively related" and that "this negative link is exacerbated in countries that are poor, institutionally underdeveloped, undergoing intermediate stages of financial development, or unable to conduct countercyclical fiscal policies". They add that this link does not result from small cyclical deviations but from "large drops below output trend". Therefore "it's the volatility due to crisis, and not due to normal times that harms the economy's long-run growth performance".

Against this background it is legitimate to ask whether the propensity to crisis does not depend on some institutional features and to propose the concept of stabilizing institutions.

These institutions:

1. Determine the frequency and severity of the main types of crisis: monetary (high or sudden inflations), fiscal (large deficits and growing public debt, GDP ratio), and banking (the collapse of systematically important banks).
2. Determine the vulnerability and response to external shocks.

Correspondingly, one should look for stabilizing institutions to:

[10] Under badly-administered welfare states many people Draw various social benefits and work In the informal economy. However, in this situation increased taxes are required too.

- monetary regimes: to what extend they protect the stability of money,
- fiscal regimes: whether they put any constraints upon budgetary spending, deficits and public debts,
- banking regulation and supervision,
- regulations and arrangements influencing the flexibility of prices.

There is some overlap between the propelling and stabilizing institutions. For example, ownership of banks matters both for their efficiency and for stability. State-owned banks, inherently susceptible to political pressures and having worse corporate oversight, are prone to grant more bad loans than private banks (see "Finance for Growth"). The institutional structure of the labor market influences both employment and the reaction of the economy to external shocks.

Also, some stabilizing institutions would not only influence the volatility of growth but also the strength of systemic growth forces. Persistently high inflation, a sign of macroeconomic instability, damages in many ways the more permanent conditions for economic development.

Finally, let us recall that stabilizing institutions do not fully determine macroeconomic policies, as there is usually the role of personality and chance factors. The scope of this role varies depending on the strength of institutional constraints upon policymakers. In an extreme case rules would substitute for policymakers and then there would be no role for personality with their stabilizing or destabilizing potential[11].

It should be obvious that stronger propelling and stabilizing institutions imply stronger constraints upon policymakers (i.e., a limited state that presupposes some basics of the rule of law). In this sense economic institutions are at the same time political institutions.

5. Some Propositions on Convergence

Based on the previous sections and on my reading of the empirical literature I will formulate some broad propositions with respect to the failures and successes of convergence.

The main proximate force of convergence is borrowing and the adaptation of broadly-defined technologies, stemming from more advanced economies. *Failure to converge*

[11] His is the essence of Milton Friedman's famous monetary rule.

happens when serious weaknesses of propelling institutions block this force and/or when serious weaknesses of stabilizing institutions produce profound disruptions.

Here are the main institutional configurations that preclude convergence:

1. A system consisting of informal institutions with communal property rights and/or informal enforcement (traditional community).
2. Statist systems, i.e.:

2.1. Systems with a closed property rights regime (i.e., with a ban on the creation of private firms). The main example is Soviet socialism in which, in addition, central planning replaced co-ordination by the market.

2.2. Systems with nominally liberal or mixed property rights regimes that have at least one of the following features:
- A dominant state sector;
- Very limited competition due to strong anticompetitive regulations on entry and/or on imports of goods, capital, and technology;
- Other very restrictive regulations impacting the adoption of new technologies, especially restrictive labor practices or a high level of job protection.
- The protection of property rights is limited to a privileged minority, while a large part of the population operates in the informal sector.
- Low overall protection of property rights.
- A large welfare state in a poor country.
- A profound weakness of stabilizing institutions, leading to chronic or frequent and profound macroeconomic imbalances.

3. Predatory or failed states;

Countries that are nowadays advanced owe this lucky situation to having had strong propelling and stabilizing institutions in the past. If they preserve this feature to a sufficient extent they would constitute a moving target for societies have institutional characteristics (1), (2), or (3).

Traditional communities fail to converge because of improper content of market transactions. Statist systems fail to converge because the state is so unconstrained that it damages propelling institutions. Another reason may be a state capture by a minority that benefits from economic rents by limiting the competition. Failed and predatory states fail to converge because they destroy propelling institutions as they produce no - or even negative- protection of private property rights.

Failure to converge happens not only under each of these systems but also under transition from one of them to another one. We can speak here of *unlucky transitions*. To be more precise, I postulate that no *lasting* convergence is possible under transition:

- From a traditional society to a statist or failed (predatory) state;
- From a statist system to a failed (predatory) state or vice versa;
- From one type of statist system to another;

Let me now turn to the institutional conditions of **successful (lasting) convergence**. I believe that all the success cases of sustained convergence have happened:

1. Under more or less free market systems with relatively strong stabilizing institutions or
2. During and after the transition to such a system;

The market systems in question are based on open property rights regimes that contribute to stronger market competition compared to any case of a failed convergence. There are only a few cases that would fall into the first category, as only a few countries including Hong Kong and (perhaps) the United States have preserved a more or less free market system during their whole existence.[12]

The second group of countries is much more numerous because most here have suffered episodes of statism. Their initial conditions include different varieties of statist systems. The transition consists in strengthening propelling—and sometimes of stabilizing - institutions, and includes some or all of the following:

- A shift from a closed to an open property rights regime;
- Privatization of SOE;
- Liberalization (deregulation): elimination of anticompetitive regulations and other restrictions;
- Building institutions supporting markets, including increased enforcement of property rights;
- Introducing stability-oriented monetary or fiscal arrangements.

Much more empirical research is needed to establish what packages of market reforms and what initial conditions are likely to bring about sustained convergence. Here I will mention two other issues.

[12] Such countries needed to catch up because they emerged later than other economies. If they had been created earlier, they would not have needed to converge because they would grow the fastest from the very beginning thanks to their free market systems.

First, one should distinguish between *transition effects* and *permanent effects*. Acceleration of growth does not have to wait until the completion of reforms (i.e., until "good" institutions" have been achieved). Rather, growth may accelerate *during the reforms*: improvements in the direction of a market system can increase growth. These can be called transition effects. The transition effects increase growth because they increase productivity in the previously repressed sectors (e.g. agriculture in China after Mao or retail trade in the Soviet system) or because the previous incentive structure encourages massive waste (command socialism). The larger the relative size of the repressed sectors and the deeper the repression, the larger the magnitude of transition effects. For example, the share of repressed agriculture in China was much larger than in the Soviet bloc, and this explains to some extent the differences in the growth performance between the two regions during the early years of reform.

Transition effects tend to expire after a certain time and the rate of subsequent growth largely depends on the strengths of permanent incentives to work, save, invent, and innovate.

Second, some exceptionally rapidly-growing countries have been referred to as the *growth miracles*. Some have argued that a growth miracle can occur only in countries that started with a large development gap and especially a large technology gap relative to the leader. This is Gerschenkron's (1962) advantage of backwardness (see also Madison, 1991 and Parante and Prescott, 2000). However, Ireland shows that it is not necessary to begin far behind to start growing very fast over a number of years. One wonders whether the Irish case has broader policy implications.

What explains growth miracles? There are three alternative explanations in the economic literature:

1. Some special state interventions, like directed credits and state-led industrialization;
2. The combination of such interventions and an improved framework for private economic activity;
3. An improved framework for private economic activity alone, which was better than in other LDC's.

A closer look at the experience of growth miracles (e.g., Taiwan, South Korea, Malaysia, Thailand, Indonesia, Hong Kong, Singapore, and Botswana) suggests that the third explanation is most plausible. The argument is that while the miracle economies differed in the extent of special state interventions (e.g., none in Hong Kong but present in most other countries) they had one thing in common - a large dose of market reforms. Combined with

their initial conditions, this ensured a larger extent of economic freedom (i.e., stronger propelling institutions than in other developing countries). This better framework included a limited fiscal position of the state: budgetary spending as a percentage of GDP among the "Asian Tigers" rarely surpassed 20 percent-compared to almost 40 percent in Brazil in the 1990's.

One lesson from the miracle countries, I believe, is that rapid catching-up requires keeping the welfare state at a minimum. This is not to say that people are then deprived of "social" security, as the rapid growth of incomes allows for the development of private savings and commercial insurance, and a limited welfare state leaves space for the growth of a "welfare society" in the form of family networks and mutual aid associations.

Returning to the question of why special state interventions cannot explain the growth miracle, let me note that an analysis of such interventions in the miracle countries tended to obstruct rather than promote longer-term growth – as, for example, South Korea's state – led heavy industrialization drive in the 1970's (see Quibria, 2002).

While all the successful cases of sustained convergence have taken place under more or less free market systems, or during and after the transition to such systems, not all market-oriented reforms have led to lasting convergence.

It is all too easy to find examples of market-oriented reforms that failed to produce lasting convergence. I would distinguish between ostensible and genuine failures. Let us start with the first group:

1. Reforms are frequently announced but not implemented or are implemented to a lesser extent than planned.
2. Reforms may be implemented initially, but then reversed or seriously attenuated. In both cases, critics may blame the announced reforms, rather than the failure to implement them, for the failure to converge.
3. Some authors acknowledge that it was the reversal of reforms and not the reforms themselves that caused a lack of convergence, but blame the reforms and the reformers for their rejection, linking them to social or political protests. Such critics tend to take it for granted that there existed some milder reforms which, if implemented, would have avoided the protests while producing the desired economic results.

There are nonetheless genuine reasons why market reforms may fail to generate lasting convergence. Let me note three, which should be regarded as a hypothesis meriting future research:

1. Market-oriented reforms may fail to produce convergence if they are **incomplete in a critical way,** in particular **by violating crucial complementarities**.
   One example would be introducing a fixed-exchange regime without adequately strengthening the fiscal framework (as occurred in Argentina). Another is an external opening with very rigid markets and barriers to job creation that hamper the reallocation of labor from sectors exposed to competition. Yet another is the opening of the capital account in the presence of an insufficiently strong macro framework and financial system.
   An important research and policy question is to discover which partial reform packages can be introduced successfully, and which are likely to fail. Quite likely, a package that does not leave any part of the economy in critically bad shape is more likely to generate convergence than a package – even a very ambitious one – that leaves a major weakness in a significant part of the economy. However, under certain initial conditions a rather large minimum scope (threshold) of reforms may be required if they are to be sustained and to produce convergence. This was, for example, the case of centrally planned economies (Balcerowicz, 1995).

2. Market-oriented reforms may fail to generate convergence if some of their crucial details are badly structured and induce operational failures. Examples include a serious misspecification of the initial level of a fixed exchange rate peg, or a wrong incentive structure in the bankruptcy law.

3. Some regions may be of such an inhospitable nature or so distant – in terms of transportation costs – from large markets that no profitable economic activity can develop there (Gallup, Sachs, Mellinger, 1998). In such situations market-oriented reforms cannot produce lasting convergence. However, such a geographical predicament at the country level, while present in parts of Africa and on other continents, is still relatively rare, as there are few countries with a sizeable population that consists only of inhospitable and distant regions.

The remarks so far have focused on the link between the nature of a country's institutional system and convergence. One can go a level deeper and ask the question "What accounts for changes or differences in this system?"

Answering this question requires us to look at the political economy of institutional change.

6. Explaining the Institutional Change

A brief look at history gives us the following picture:

- Western countries changed their institutional systems in a market-oriented direction during the 19th century; this has not happened in other countries, except for Japan[13].
- The liberal change that occurred in the West during the 19th century was rather gradual. In the early 20th century, especially after the Great Depression, a change occurred in a statist direction (i.e., protectionism, increased regulations, and the increased fiscal position of the state), to be followed by a wave of market reforms. Still, different countries displayed various time patterns of institutional change, and their present systems differ substantially, in particular with respect to the size and structure of the welfare state and institutions affecting the supply of labor.
- In most LDC's the expansion of statism in the 20th century was much more pronounced – witness Russia under the Bolsheviks and China under Mao. Statism also spread in Africa, Latin America and Asia. Only a minority of countries (the so-called "Asian Tigers") moved in the market direction in the 1960's and 1970's. They were followed later by China, India, some countries of the former Soviet bloc, and some Latin American and African economies. Still statist systems (or failed states) survive in the Middle East and much of Africa (not to mention North Korea and Cuba), and some states have recently started to move toward more statism, for example Venezuela under Chaver or Argentina under Kirschner.
- The *dynamics* of institutional change differed. Some changes consisted of a gradual accumulation, while others included radical initial breakthroughs. This is true of both statist and liberal transformations. Examples of gradual statist change include Western countries after the Second World War, while dramatic statist expansion occurred in Soviet Russia and Maoist China. Gradual market reforms prevailed in the Western countries during the last 30 years and in India; radical breakthroughs in the market direction happened in most CLE countries after the collapse of communism.
- Some market reforms started under democratization of the political system, while other market reforms were implemented under inherited democracy (e.g., Western countries, India during the 20th century), still others under non-democratic regimes (e.g., most Asian tigers in the 1960's and 1980's, and China and Vietnam since 1980's).

[13] India does not appear to have been catching-up during the 19th century and it his raises the question of the impact of the British rule on the institutions of India.

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

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

I believe that a simple scheme would include:

1. Initial conditions, which comprise the initial institutional system;
2. The types of countervailing forces:

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

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

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

I will now describe several distinct cases of institutional change:

1. From an analytical point of view the easiest case is that of an **imposed institutional change** that is introduced by an outside force. A Soviet-type system was imposed on Poland and other countries ultimately by the force of the Red Army, so the statist forces necessarily prevailed upon all countervailing factors, regardless of the differences in the initial conditions. What remains to be explained, of course, is why the Soviet system was introduced in Russia in the first place.

   Another example is the imposition of liberal constitutions in West Germany and Japan by the Western occupying forces. As distinct from the Soviet system, these constitutions were later voluntarily maintained.

   Imposed systems may also include institutional arrangements introduced by the colonial powers in Africa, Latin America and a large part of Asia. The basic question here is - What were the differences in these early systems and how can one explain them? According to one interesting hypothesis, a large proportion of settlers brought in a

political culture that embraced the limited state and - interacting with the abundance of land - produced a competitive market economy and limited government. This large proportion itself is explained by the absence of tropical diseases (Acemoglu, D., S. Johnson, and I. A. Robinson, 2001; Easterly, W. and R. Levine, 2002). It is also claimed that the differences in the initial systems persisted over centuries. This finding - derived from econometric studies - begs many questions and certainly does not prove a general point that early institutions always perpetuate themselves, and even less that the world is permeated with institutional determinism. We know from history that radical institutional change happens, and most often happens unexpectedly.

2. Take as a point of departure a country with a large extent of freedom (i.e., **a competitive market economy and limited state)**. This produces many spontaneous innovations which ensure the adaptability of the system to new opportunities and threats and relatively rapid economic growth. Therefore, a virtuous circle should operate as follows: good initial institutional system → good results → support for this system (strong proportion of liberal to statist forces) →good future system, etc. Are there any threats to this virtuous circle? History shows this is not a bullet-proof mechanism: statist forces can sometimes prevail over liberal ones and produce increased state intervention even in the initially freest society.

I have here to be more specific about the statist forces. I divide them into:

- Situational (especially dramatic events);
- Systematic (i.e., acting constantly even though with varying intensity).

Situational forces could be exemplified by the Great Depression or recent corporate scandals in the United States. These can be called political shocks. They interact with the systematic forces in producing messages (interpretations) that affect public opinion and – as a result – policies.

Systematic forces include:

- *Collectivist doctrines* (e.g., Marxism; crude Keynesism with its belief in fiscal stimulation as a panacea for all economic ills and its distrust of private investment as a destabilizing force; old fashioned welfare state economics and a related misuse of its concepts of externalities, public goods and market failures as justification for state intervention);
- *Widespread collectivist clichés*, partly fuelled by the collectivist doctrines (e.g., disregarding the link between spending and taxes (believing in free lunch, perceiving

the market transactions especially in the labor market as an exploitation of the weak by the strong, statism as a part of national identity, the lump sum fallacy of labor and many, many others);

- *Statist interests* (collectivist clichés are genuinely believed and mixed up with powerful emotions, which interest groups manipulate to their advantage emotions. Some politicians are power-hungry therefore inclined to support the extension of state power. Some businessmen seek protection against competition, and there is a demand for social transfers, etc. Interest groups use political system or create new legal arrangements within the overall legal framework, allowing a broad flexibility (e.g., poison pills and other defenses against hostile takeovers).

The moral from the above is that even the best institutional system - i.e., the one most favorable for long-run economic growth - is in danger of some doses of statism. To reduce this danger liberal forces in society have to be well organized and – nowadays – capable of winning the constant battle of mass communication. Good economics does not win by itself.

3. Forces of statism may sometimes prevail in a free society, as shown by the experience of the Western countries between the Great Depression and the turn of the 1970's and 1980's. This experience has produced an institutional system with a sharply-increased fiscal role of the state due to expansion of the social transfers and with visibly-increased regulations. We may call this a constrained market economy. However, during the 1970's and 1980's a wave of market reforms followed. To be sure, they are largely not completed and countries differ in the time pattern of their liberal transitions and in the results achieved so far. Still, the economies of the West are now much less regulated (O. Blanchard, 2004); the change in the fiscal position of the state has been generally much less pronounced. Some countries have strengthened their institutional stability by increasing the independence of their central banks (e.g., Britain and Sweden) or by introducing stability-oriented fiscal frameworks (e.g., Sweden and Denmark).

The wave of market reforms may be explained – to some extent – by the bad consequences of the constrained market economy. They were aggrevated by the economic shocks of the 1970's, which also discredited Keynesian demand policies in the economic profession. All these must have weakened the relative strength of the statist forces.

If increased statism in a free society is always possible but tends to be reversed because of its own economic consequences, then perhaps free societies have a

propensity to "institutional cycles" influencing their long-run economic cycles. Do successful market reforms become socially entrenched because of their good economic results? Or is the opposite true: Do good economic results – by lessening the economic pressure – allow more scope for statism (e.g., expansion of the welfare state)?[14] Why has the retrenchment of the fiscal size of the state so far been much more modest than the progress on deregulation? Why is the relative position of statist forces in the first proposition stronger so far than of the second one? Is it because the expansion of the welfare state – at least in some countries – has produced some statist "equilibriums" (e.g., large costs of transition to funded pension systems due to a previously expanded PAYG system and the number of non-beneficiaries of social transfers exceeding that of not payers)?

These and other questions require further research.

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

   The simple reason for the fact that bad economic results produced by totalitarianism are not rapidly translated into strong pressure for market reforms is that this very totalitarianism keeps the population under harsh control. Therefore, the change must come either from outside or from within the black box of the entrenched elites[15]. The latter can take quite a lot of time, perhaps because rulers are shielded from the economic consequences of the system they run and because they are isolated from the external world.

[14] One example may be Britain, which suffered a deep relative decline due to statist policies, then had fundamental market reforms under Ms. Thatcher. These reforms largely improved the performance of the British economy, to be followed by the expansion of the fiscal position of the state under New Labor.

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

This is not to say that extreme statism is not subject to long-term pressures. One such pressure is due to the technological superiority of the market system, which can be translated into a military threat (the Reagan factor during the Gorbachev years or the American black ships on the coasts of Japan before the Meiji reforms).

A breakdown of extreme statism is not only difficult to predict, it is also difficult to explain in terms of "winners" and "losers" of change (for a similar point see: Lal, 2006). For such a breakdown involves a lot of confusion, uncertainties and chance factors. Most people cannot define their absolute and relative positions in the future system, which nobody can clearly describe. One can only say that the breakthrough would not have happened if a large part of the elite strongly believed that they would suffer under whatever new system was emerging. If they had such strong beliefs they would most likely stop the change.

5. Radical liberating breakthroughs happen and usually happen unexpectedly. The recent, and enormously important, example is the *collapse of Soviet communism.* It opened the way for fundamental institutional change. Massive research shows that part-communist economies have differed widely in their growth record sp far, and that these differences are strongly related to the extend of accumulated market reforms (see Aslund, 2002): countries that amassed more reforms tend to perform better than those that amassed less reforms. Countries that catch up with growth as well. What explains the differences in the extent of market reforms? Why has the balance of statist and liberal forces been so different across countries, and – to some extent – across time in the same countries? This is another area for more empirical research. Here I can only make some tentative points[16]:
   - Countries differed in what I call **reform linkages**. In some countries market reforms were linked – objectively and in the public's perception – to some important non-economic goals, like entering the EU or preserving independence (e.g., the Baltics). Other countries did not have such positive conditionalities strengthening the liberal forces. And in Russia market reforms following the collapse of USSR might have been linked to the loss of empire, so a negative linkage might have operated. It is an empirical question to what extent the IMF and World bank conditionalities might have substituted for the EU conditionality.
   - Countries may differ in the popularity of collectivist doctrines and clichés among their citizens. And mass media may differ in the extent of its use of populist techniques.

[16] Some of them may apply to non-post communist countries.

- Political shocks, which create opportunities for statist political forces, were surely not identical across countries.
- Pro-reform political forces, when in power, are inclined to pursue reforms even during a good economic situation, while statist political forces that inherit the same situation are likely to delay market reforms or even revert to statism. They can safely do that for a certain time because financial markets are **not** an early warning system. Other external warning mechanisms (e.g., rating agencies and international financial institutions) operate more strongly only when the economic situation has already gotten worse. During a bad economic situation - especially an acute crisis - both pro- and antireform forces are likely to reform, the former both due to conviction and necessity, the latter only because of necessity.

Now, countries surely differed in their economic-political trajectory: some countries probably had more instances when a good economic situation was inherited by anti-reform forces. This might have contributed to a slower accumulation of market reforms.

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

Individuals that played key roles in the expansion of radical statism include Lenin, Mao, and Castro. Among individuals on the opposite side one should name Gorbachev, Wałęsa, Reagan, Thatcher, and Deng.

Let me finish on a **normative note**: the forces of statism will always exist. In order to prevent their triumph – that is, their reversing of some of their market reforms or blockage of some necessary ones - the proponents of a limited state, of free economy and of free society, have to be well-organized and efficient, both in research and in mass communication. Systematic intellectual work and organizational preparation is needed to be able to move fast on specific reforms whenever an opportunity appears. An important role can and should be played by strong, independent think tanks. However, research on reforms, though necessary, is not enough: professional, systematic mass communication is needed to neutralize statist doctrines and clichés and to unmask the statist interests. This appears to me the greatest challenge we should take on.

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