Managing Intellectual Capital and Innovation for Sustainable and Inclusive Society
27–29 May 2015
Bari • Italy
make learn TIIM
Management, Knowledge and Learning
Joint International Conference 2015
Technology, Innovation and Industrial Management

CENTRAL AND EASTERN EUROPE´S 25 YEASRS OF TRANSITION - BOTTLENECKS OF INSTITUTIONAL TRANSFORMATION

Elena Fifeková
University of Economics in Bratislava, Slovakia
andy.vondrova@gmail.com

Andrea Vondrová
University of Economics in Bratislava, Slovakia
andrea.vondrova@euba.sk

Abstract:
Socio-economic development of cohesive economies of Central and Eastern Europe, that have undergone transformation process from a centrally planned economy to a market economy, is after twenty-five years since the transformation process started regionally differentiated. Socio-economic development suggests that the transformation process not always fully reflected the specific preconditions and developmental possibilities of individual economies. Among the most important facts that influenced different rate of achievement of development in individual countries can be included the impact of transformation process on the level of systemic and institutional complementarity, management of globalization processes, the degree of integration into EU structures and approach to the shaping of conditions that indicate a long-term development. The examination of the impact of these processes on the socio-economic development of cohesive economies of Central and Eastern Europe is the subject of the presented contribution.

Keywords: socio-economic development, transformation process, globalization, long-term development

1. INTRODUCTION

Twenty-five years after the start of the transformation process in Central and Eastern Europe is a sufficiently long period for assessing the success of the transformation and its impact on socio-economic development of individual countries. Different initial conditions of individual countries at the beginning of the transformation process, the nature and intensity of transformation steps have resulted in different depth of transformation recession and different period needed to achieve pre-transformation levels of economic performance.

The basic methodological approach of this study is to find the causes of the different developments in Central and Eastern Europe. The focus is on institutional quality, since the country's development is the result not only of the current decision, but it is also conditional upon the quality of path dependence. It means that the economic history is to a large extent a story of institutional evolution, which is a sequential North (1990). Therefore it is not enough in general if the country has comparable resources than its economically successful model, because its success is conditional upon the whole set of factors that determines the creation of formal and informal institutions.

Here are investigated two areas that have significantly influenced the quality of the institutions of the transition economies of Central and Eastern Europe: the access to shaping institutions in the transition process and the level of integration into EU structures. Evaluation of the development of quality of institutions at the time was based on data from the World Bank, The Worldwide Governance Indicators, which allow seeing a qualitative shift in the six core areas of public administration (Voice and Accountability, Political Stability and Absence of Violence / Terrorism, Government Effectiveness, Regulatory Quality, Rule of Law, Control of Corruption) from 1996 to 2013.

To evaluate the impact of institutional quality on economic performance of the transition economies have been used data from the World Economic Forum. The Global Competitiveness Report assess the quality of institutions, particularly through the achievement level of protection of property rights and intellectual property rights, the effectiveness of government spending and government support, transparency in public procurement, level of independence of judiciary and law enforcement effectiveness in the fight against terrorism and organized crime, quality of policing service level of ethical behavior, the degree of protection of the interests of minority shareholders and investors.

2. THE ROLE OF INSTITUTIONS IN THE SOCIO-ECONOMIC DEVELOPMENT OF CENTRAL AND EASTERN EUROPE

In terms of current perspective in the access to the system transformation in Central and Eastern Europe there might be identified several bottlenecks. The transformation process was based on the neo-liberal agenda of the Washington Consensus and it has created space for the relative velocity and the irreversibility of the systemic changes, to the forefront was placed an emphasis on reducing the extent of the state in the economy, changing its basic functions (reduction of paternalism) and strengthening the coordinating role of the market, also assuming that the creation of a market environment will more or less automatically generate high-quality institutional framework and accelerate institutional convergence to the standard market economies. The emphasis on the basic system pillars (liberalization, stabilization and privatization) led to the fact that the market economy was created without basic institutions[1] and institutions without basic infrastructure (Stiglitz, 2003). The Approach of Washington Consensus has suffered from a lack of institutional imagination (Rodrik, 2003). Creation of institutions did not form foundation stone of the transformation process. The mechanical transfer of the formal rules from the developed market economies into the legal and regulatory framework in transition economies was not able to sufficiently improve the quality of their institutional equipment.

Another bottleneck of formation of institutional framework in transition economies was the failure to consider the role of informal institutions. These institutions carried a reference to the long-term cultural

[1] Institutions are defined as man-made limitations that brings structure to the human action. They construct political, economic and social interactions and create procedures and reduce uncertainty in exchange. They consist of formal constraints (laws, constitution, and rules), informal constraints (norms of behavior, traditions, customs, mentality, customs, religion, human instincts) and methods for their enforcement. (North 1991).

evolution, evolution of traditions, customs, prevailing ethics and morale of society and have in them encoded regional specificities and capacity for absorption of changes in formal institutions. They change slowly and gradually. They are as important as formal institutions, because the success of formal rules depends on the success of their informal acceptance (Screeners, 2011). That is why in the formation of institutional framework is necessary the institutional complementarity (Amable, 2003), which due to the cohesion of the economic, social and political system ensures that changes in informal institutions do not lag behind the pace of formal changes. Failure to appreciate the fact that informal institutions are not able immediately and in a short time to adopt the changes of the formal rules, led to the so-called institutional "Blitzkrieg" (Stiglitz, 1999), which in many transition economies reflected in the institutional failures in the form of an increase in corruption, rent-seeking and etc.

Ultimately the lack of paid attention to the quality of the institutions in combination with low enforceability of institutional rules and slow change in behavior of individual actors has meant that macroeconomic stabilization programs failed to ensure long-term and stable environment that would be beneficial to the economic growth.

Strong macroeconomic restriction focused mainly on the elimination of inflationary pressures after the liberalization of prices, not always correctly managed the privatization process and low institutional complementary in all transforming countries of Central and Eastern Europe showed a significant decline of economic performance and rising unemployment and social disparities.

The stabilization measures were primarily designed to address the imbalances, while little attention to the sustainability of stabilization has been paid (Kornai, 2006).

Gross domestic product per capita of the cohesion countries decreased during the five years by third, while the pre-transformation level have fastest achieved the V4 countries[2] (in 1997) and the EU10 countries[3] (in 2001). The Baltic States (Estonia, Latvia, and Lithuania) have achieved the pre-transformation level of economic performance in 2003, Eastern Partnership countries[4] it has reached in the previous year and Eastern European countries (Belarus, Moldova and Ukraine) have the level of pre-transformation economic performance not reached yet. The sharpest decline in economic performance has been in Tajikistan, Armenia, Georgia, Moldova and Ukraine (in Ukraine has decreased the economic performance over ten years by two-thirds). Slow return to pre-crisis economic level means that in these countries the phenomenon of. "Commemorative optimism" decreased the level of tolerance towards more aggressive reforms in all spheres of the transformation process.

The level of the institutional complementarity in conjunction with relatively strong dependence on the past development, particularly in the post-Soviet republics, failed to ensure that after the removal of organizational and command coordination mechanism, the coordinating role in the economy was automatically taken over by the market mechanism. The result was that the institutional changes (often slow and inadequate) often worked against the systemic changes. Many times there were significant time delays and institutional vacuum was slowing the speed of system changes. This fact can be mainly seen in the development of Ukraine, where the lack of growth in living standards in the '90s was mainly due to weak government in terms of ineffective rule of law, insufficient protection of property rights, widespread corruption and the links between government and special interest groups (Kaufmann, Kraay, Zoido-Lobaton 1999). In general the increase in institutional quality has created better conditions for economic growth and development and gradually ensured the increase of the economic performance of individual countries.

3. THE ROLE OF THE EUROPEAN UNION IN THE TRANSFORMATION PROCESS OF CENTRAL AND EASTERN EUROPE

An important role in the process of the institutional convergence of Central and Eastern Europe has played an effort of several countries to progressively integrate into the EU and the subsequently developed pressure on institutional quality, which was from the EU on these countries. Since the transition countries had different economic and institutional profile than the EU member state, from the

---

[2] V4 – Czech Republic, Hungary, Poland, Slovakia

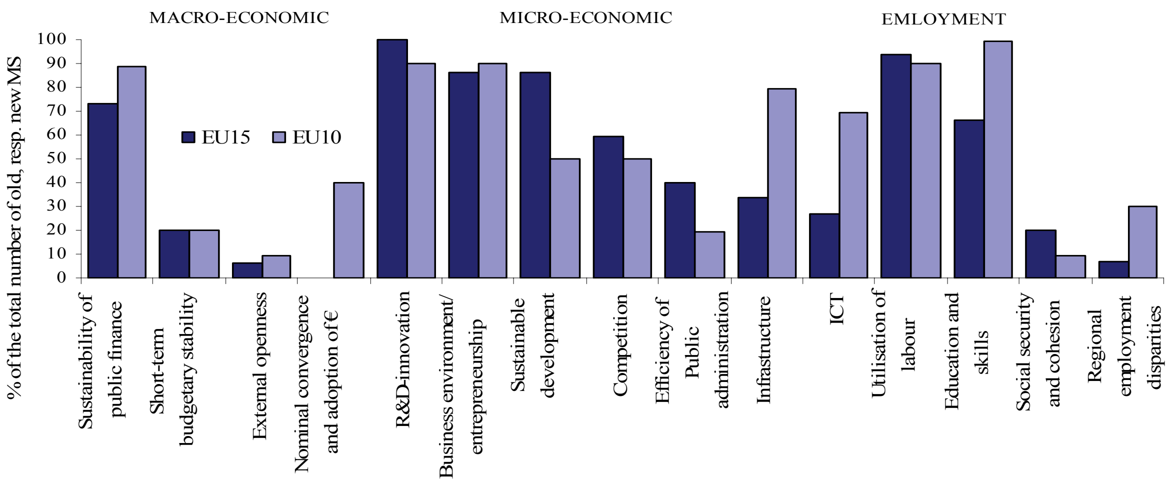
[3] EÚ10 – countries that are currently the members of the EU and have undergone a transformation: Bulgaria, Czech Republic, Estonia, Latvia, Lithuania, Hungary. Poland, Romania, Slovenia, Slovakia

[4] Eastern Partnership countries - Armenia, Azerbaijan, Belarus, Georgia, Moldova, Ukraine

beginning of the nineties, part of the Union had developed a framework that would foster their institutional convergence towards the old Member States. The emphasis was mainly on the regions of Central and South-Eastern Europe and the Baltic countries. Starting point was accounted for association agreements between the EU and individual countries.

The pre-accession process officially started in 1993 with the invitation to apply for membership of the EU (on European Council meeting in the Copenhagen) and the establishment of the convergence criteria (Copenhagen real convergence criteria) [5], which fulfillment has been required by the EU from individual countries in the pre-accession process. The real convergence criteria were focused on creating stable institutions guaranteeing democracy, the rule of law, respect for human rights, respect for the protection of minorities and ability to assume the obligations of membership, including adherence to the aims of political, economic and monetary union (adoption of the acquis communautaire). Each country that is joining the EU should dispose with a functioning market economy and a level of competitiveness, that would allow to cope with competitive pressure and market forces within the EU[6]. The real convergence criteria correspond with basic orientation of the transformation process and positively influenced the creation of conditions for long-term, steady and sustainable economic growth. They precisely penalised those processes that have led to growth in competitiveness through a stable macroeconomic and institutional framework and thereby created the space for increasing the economic performance of individual countries and narrowing the existing performance gap between the original and new EU Member States. At the same time they have created conditions allowing that the EU enlargement has not slowed down the dynamics process of European integration. After the accession of the EU10, countries have adopted national reform programs (2005) focusing on implementation of the Strategy. In the National Reform Programs have been identified the key challenges which should support macroeconomic stability, improve the business environment and quality of knowledge-based changes (Veugelers, Mrak, 2009).

Figure 1: Key challenges in National Reform Programs, EU-15 and new Member States



Source: Processed according to *Veugelers, R.and Mrak, M.(2009)*

The decisive impulse to sustain the growth dynamics was that the newly adopted countries (countries that joined the EU had to fulfill real convergence criteria and apply for admission to the EU) even after accession to the EU have been led to improve the institutional environment.

European Commission in 2009 noted that the enlargement process had on the economic growth of newly adopted countries positive impact, while stressing especially the positive effect of institutional

[5] They were set by the European Council in Copenhagen in 1993.
[6] A functioning market economy has been defined as the economy with macroeconomic stability, the real degree of liberalization (of prices, exchange rates, foreign trade, capital movements), a large share of the private sector in the economy, suitably growing financial sector, adequate institutional infrastructure and the existence of implementation of the legal framework guaranteeing protection of property rights and the same level of freedom of competition for all participants.

factors - in particular freedom of trade and improvement of the quality of the legal and regulatory system.

For those transition countries that were not included in the enlargement process was created Cooperative Initiative - European Neighborhood Policy (European Commission, 2004), which reflected the effort to accelerate the process of democratization, increase prosperity and strengthen stability and develop cooperation between the EU and its nearest neighbors. The initiative was established in 2004[7] and was aimed at supporting the development of a deeper cooperation between the EU and the new neighbors on the south and east of Europe.

Its aim was on the basis of bilateral agreements to promote the changes in the institutional environment that would allow share the same values among the countries as the EU (democracy and human rights, the rule of law, good governance, market economy principles, etc.), and ensure the sustainable development. The EU initiative at the same time monitors the maintenance of security and stability for external borders and eliminates the potential negative effects of enlargement. The European Neighborhood Policy essentially defines only functional cooperation without institutional ties on the EU.

Within the framework of the Neighborhood Policy in 2009 was created Eastern Partnership initiative[8], which is oriented on the deepening of relations between the EU and the countries of Eastern Europe - Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine (Ukraine has presently ratified Association Agreement with the EU).

The Eastern Partnership is an important tool of political, economic and institutional convergence of the participating countries to the EU standards, as it gives the countries the long-term support for the implementation of market and institutional reforms, and provides the basic framework for the creation of conditions for accelerating the political association and strengthening of economic integration into the EU internal market.

The aim of the initiative is to ensure that in addition to the deepening of mutual cooperation between the EU and the Eastern Partnership countries, progressively eliminates the differences between the new EU Member States and their neighbors in the post-Soviet space. For this purpose EU seeks for transfer its standards to the partner countries, ensuring convergence of their key policies with EU policies, promotes stability and democratic development. Eastern Partnership thus establishes a strategic framework for qualitatively new relations at bilateral and multilateral levels (European Commission, 2009).

In terms of the process of the institutional convergence towards EU standards the Eastern Partnership countries show certain specifications which result partly from their geographical location and partly from the level of persistence of depending on the historical development and both in the political, economic and cultural spheres.

EU has been positively influencing the formation of institutional environment of newly adopted countries, both in the pre-accession period and after their accession to the EU. Newly adopted countries as a whole achieve higher degree of the institutional convergence to the institutional environment of the original Member States than countries that are not integrated into the EU (Table 1).

[7] Into the initiative has been incorporated 16 states. Apart from former Soviet Union republics (Armenia, Azerbaijan, Belarus, Georgia, Moldova, Ukraine), has been into the initiative included Egypt, Israel, Jordan, Algeria, Lebanon, Libya, Morocco, Palestine, Syria, Tunisia.

[8] It is a partnership which complements bilateral agreements and the two existing European initiatives: the Northern Dimension and the Union for the Mediterranean.

Table 1: Indicators of public administration quality of cohesion economies in period 1996-2013 (%position)

	Finland *		V4 countries							
			Czech Republic		Hungary		Poland		Slovakia	
	1996	2013	1996	2013	1996	2013	1996	2013	1996	2013
Voice and Accountability	97,1	97,2	76,9	76,8	77,9	69, 7	78,4	78,2	66,8	76,3
Political Stability and Absence of Violence/Terrorism	97,6	97,2	84,6	84,4	76,4	69,7	70,2	78,7	72,6	88,6
Government Effectiveness	94,1	100	77,7	75,1	78,5	70,3	76,6	71,3	71,2	73,2
Regulatory Quality	93,1	98,6	82,8	81,8	77,5	77,5	70,6	80,3	66,7	78,5
Rule of Law	99,0	99,1	77,5	82,5	77,0	63,3	66,0	73,5	56,5	64,0
Control of Corruption	99,5	98,1	76,6	62,7	74,1	64,6	72,7	70,8	66,3	59,8

	Slovenia		Baltic States						Bulgaria	
			Estonia		Lithuania		Latvia			
	1996	1996	2013	1996	1996	2013	1996	2013	1996	2013
Voice and Accountability	89,4	74,0	84,8	75,5	74,0	84,8	75,5	78,2	31,5	58,3
Political Stability and Absence of Violence/Terrorism	91,8	68,7	68,2	57,7	68,7	68,2	57,7	78,7	39,9	54,5
Government Effectiveness	79,5	70,7	78,5	63,9	70,7	78,5	63,9	71,3	43,9	59,3
Regulatory Quality	83,3	90,7	90,1	85,8	90,7	90,1	85,8	80,3	48,5	67,9
Rule of Law	83,7	62,2	86,2	60,8	62,2	86,2	60,8	73,5	34,9	51,2
Control of Corruption	86,8	57,6	81,3	57,6	57,6	81,3	57,6	70,8	35,8	49,8

	Romania		Croatia		Bosnia and Herzegovina		Eastern Partnership countries			
							Eastern Europe			
							Belarus		Moldova	
	1996	2013	1996	1996	1996	2013	1996	2013	1996	2013
Voice and Accountability	58,2	57,3	46,1	45,2	17,3	43,1	17,3	5,7	49,0	45,5
Political Stability and Absence of Violence/Terrorism	62,5	52,6	40,4	23,6	45,7	36,0	45,7	46,4	43,3	45,5
Government Effectiveness	33,7	52,6	58,5	6,8	40,0	39,2	40, 0	17,2	41,5	41,1
Regulatory Quality	55,4	69,4	46,5	24,5	15,7	50,7	15,7	14,3	53,4	49,3
Rule of Law	49,8	56,4	31,1	43,1	27,7	50,2	27,7	20,4	47,3	42,6
Control of Corruption	49,3	52,6	23,9	41,9	20,0	52,1	20,0	37,3	50,7	23,9

	Eastern Partnership countries							
	Eastern Europe		South Caucasus					
	Ukraine		Armenia		Azerbaijan		Georgia	
	1996	2013	1996	2013	1996	2013	1996	2013
Voice and Accountability	34,6	37,0	26,0	29,4	14,4	10,6	36,1	54,5
Political Stability and Absence of Violence/Terrorism	37,0	21,3	28,4	49,8	18,7	33,2	6,7	30,8
Government Effectiveness	25,8	30,1	40,0	57,9	16,6	38,8	28,8	69,4
Regulatory Quality	38,2	28,7	37,7	58,8	37,7	58,8	18,4	73,4
Rule of Law	19,6	23,2	34,4	45,0	34,4	45,0	8,1	53,5
Control of Corruption	13,2	12,0	36,1	37,7	36,1	37,7	4,9	66,5

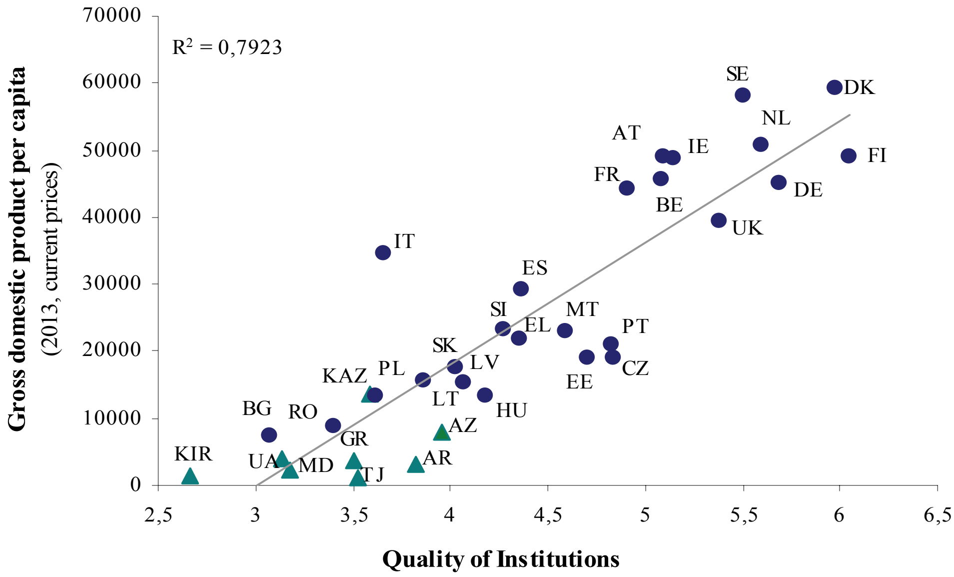
Note: Higher score means a better position. * Finland makes as criterial country that occupies a comparable international leading position in all indicators of quality of public administration.
Source: *World Bank (2014): The Worldwide Governance Indicators.*

For a summary assessment of the impact of quality of institutional equipment for socio-economic development, we used data from the World Economic Forum[9]. World Economic Forum in *Global*

[9] World Economic Forum assesses the competitiveness of countries based on available data and the global Executive Opinion Survey.

Competitiveness Report assesses institutions as one of the pillars that determine the competitiveness of the economy. Although the institutional environment is only one of the pillars of competitiveness, the conclusions of empirical work show that the increase in the institutional quality creates better conditions for economic growth and development (e.g. Acemoglu et al., 2004) and higher institutional quality is usually accompanied with improved performance of the economy.

Figure 2: Economic performance and quality of the institutions of the EU, the Eastern Partnership and Central Asia in 2013



Note: BE – Belgium, BG – Bulgaria, HR – Croatia, CY – Cyprus, CZ – Czech Republic, DK - Denmark, FI - Finland, FR - France, EL - Greece, NL – Netherlands, IE – Ireland, HU – Hungary, MT – Malta, DE – Germany, PL – P Poland, PT – Portugal, RO – Romania, SI – Slovenia, SK – Slovak Republic, ES – Spain, IT – Italy, SE – Sweden, UK – United Kingdom

▲ Former states of Soviet Union: AR – Armenia, AZ - Azerbaijan, EE - Estonia, GR – Georgia, KZ - Kazakhstan, KIR – Kyrgyz Republic, LT – Lithuania, LV – Latvia, MD – Moldova, TJ – T Tajikistan, UA – Ukraine

Source: *IMF, the Global Competitiveness Report 2014–2015.*

Figure 2 shows that the transition economies which have been deeply integrated into the EU, despite several persistent problems in the quality of institutions are able to achieve higher economic development. Referred status is conditioned by the fact that from the EU is created permanent pressure to improve institutional environment, which gradually changes the behavior of society, reduces the tolerance to negative social phenomena and positively affects the quality of the business environment. In the case of the Eastern Partnership countries the institutional transformation has been in a large extent influenced by the fact that they were not fully able to cope with several elements of the previous development, which resulted in the fact that the creation of formal institutions is carried out largely in an inert informal environment. Regionally specific institutional environment, contingent on the historical development, dominant social norms, the mentality of the population and cultural traditions created by generations in the totalitarian period, greatly influenced the regional economic system and the nature of the institutional complementarity. Regional institutional complementarity of individual countries is highly differentiated. This fact occurs most significantly in Ukraine, where the eastern part of Ukraine focuses on heavy industry, the institutional dependence on the past is still palpable, while the western part of Ukraine is affected to greater extent by the closeness of the EU, what is through informal structures reflected in the pressure to change the formal rules in favor of the European type.

4. CONCLUSIONS

The analysis of the causes of differences in economic performance of countries suggests that not only the quality of factorial amenities of countries but also institutional quality significantly determines their economic development. The quality of the institutional environment mainly depends on the achieved level of institutional complementarity, i.e. interconnection between construction of procedural institutions and their informal application, and these interconnections are conditional upon historical development of the country, as well as the evolution of traditions, customs, ethics and morals of society.

Although the EU has established framework for cooperation and the establishment of common European standards for all transitive economies of Central and Eastern Europe. The socio-economic development of the countries that have not established a clear European perspective lags behind countries that are currently the members of the EU.

Cohesive economies that combined their transformation process with the preparation for joining the EU, and in the current period are integrated to the EU, have reached much higher degree of institutional convergence to the institutional environment of the original Member States than those countries who did not combined the transformation process with the preparation for joining the EU, which subsequently had a positive impact on their economic development. The pressure of the EU institutions to improve the institutional environment of cohesion economies gradually changes the behavior of society, reduces tolerance to negative social phenomena and positively affects the quality of the business environment. In other transforming economies is the institutional environment regionally differentiated, especially regarding to the power of ongoing influence of the previous system. The formation of their institutional environment suggests that in the present development the formal institutions moved in insufficient dimension towards the standards of developed economies and initiative of cooperation with the EU did not create sufficient pressure to accelerate the institutional convergence.

ACKNOWLEDGMENT

Contribution was established within the project VEGA (1/0313/14) Relation between efficiency and equity – implications for economic policy.

REFERENCE LIST

1. Acemoglu, D., Johnson, S., Robinson, J. (2004). Institutions as a Fundamental Cause of Long-Run Growht. *NBER Working Paper*, *10481*. Retrieved from http://www.nber.org/papers/w10481.pdf
2. Amable (2003). *The Diversity of Modern Capitalism*. Oxford: Oxford University Press. Retrieved from http://digamo.free.fr/amable2003.pdf
3. European Komission (2009). *Five years of an enlarged EU: Economic achievements and challenges*. Luxembourg: Office for Official Publications of the European Communities.
4. European Commission (2004). European Neighbourhood Policy. Retrieved from http://ec.europa.eu/economy_finance/international/neighbourhood_policy/index_en.htm
5. European Commission (2009). Eastern Partnership. Retrieved from http://ec.europa.eu/dgs/home-affairs/what-we-do/policies/international-affairs/eastern-partnership/index_en.htm
6. Kaufmann, D. – Kraay, A.- Zoido-Lobatón, P. (1999). Aggregating Governance Indicators. *World Bank Policy Research Working Paper, 2195*. Retrieved from https://openknowledge.worldbank.org/bitstream/handle/10986/4170/WPS4978.pdf
7. Kaufmann, D., Kraay, A., Zoido-Lobatón, P. (1999). Governance Matters. *World Bank Policy Research Working Paper, 2196.* Retrieved from http://info.worldbank.org/governance/wgi/pdf/govmatters1.pdf.
8. Kornai, J. (2006). The great transformation of Central Eastern Europe. Success and disappointment. Economics of Transition Volume 14 (2) 2006, 207– 244. Retrieved from http://www.kornai-janos.hu/Kornai2006%20The%20great%20transformation%20--%20EconTrans.pdf
9. Lucas, R. E. (1988). On the Mechanics of Economic Development. *Journal of Monetary Economics* 22, s. 3-42.
10. North, D. C. (1990). *Institutions, institutional change, and economic performance .* Cambridge University Press, Cambridge; New York. ISBN 978-05-2139-734-6.
11. North, D.C. (1991). Institutions. *The Journal of Economic Perspectives*, Vol. 5, No. 1. (Winter, 1991), pp. 97-112.
12. Rodrik. D. (2003). Aj hospodársku reformu treba reformovať. SME, 20.11.2003.
13. Stiglitz, J. E.(1999). Hraběcí rady západních expertů. *Ekonom,. 24*.

14. Stiglitz, J. E.(2003). *Globalization and Its Discontents*. New York, W.W.Norton & Company, 2002. ISBN 978-0-393-32439-6.
15. Tridico, P. (2011). *Institutions, Human Development and Economic Growth in Transition*
16. *Economies.* UK: Palgrave Macmillan.
17. Eurostat (2014). *National accounts*. Retrieved from http://epp.eurostat.ec.europa.eu/portal/page/portal/national_accounts/data/database.
18. UNDP (2014). *Human Development Index*. Retrieved from http://hdr.undp.org/en/content/human-development-index-hdi
19. Veugelers, R.and Mrak, M.: The Knowledge Economy and Catching-up Member States of the European Union. Retrieved from http://ec.europa.eu/invest-in-research/pdf/download_en/kfg_report_no5.pdf
20. WEF (2014). *The Global Competitiveness Report 2014 – 2015*, Retrieved from http://www.weforum.org/issues/global-competitiveness.