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## OUTCOMES OF THE TRANSITION PROCESS IN CENTRAL AND EASTERN EUROPE: THE ROLES OF CULTURE AND SOCIETY IN ADOPTING DEMOCRATIC CAPITALISM

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### Abstract

*In this paper, the author explores the reasons why some states have achieved higher levels of progress in transitioning from a communist system to a system rooted in democratic capitalism. Unlike the majority of scholars, though, he does not fault any one government's policies or the reform path chosen for a country's success or supposed failure along the way. Instead, the author concludes that the outcome of the transition process is dependent upon the interaction between the new formal institutions being adopted and the prevailing informal societal institutions and rules found throughout the region. If the formal institutions are in harmony with the informal institutions, then transition should occur relatively smoothly. Transaction costs will be lower, and individuals will be encouraged to engage in economic activity, producing wealth.*

*Using a panel growth regression and a data sample drawn from 20 transition countries in Central and Eastern Europe over the period 1990 – 2005, the author empirically tests the validity of this hypothesis. In order to measure whether the interaction between the new formal institutions and the informal institutions has a significant impact on economic growth in each sample country, he incorporates each state's score for overall economic freedom from the Heritage Foundation's 2006 Index of Economic Freedom, as well as its score for political rights and civil liberties from Freedom House. The more in tune a country's informal rules are with the formal rules being adopted – those of a market economy and pluralistic system of government – the better the scores it is awarded from each organization.*

*The results provide evidence in support of the author's hypothesis. Even though the impact of political rights and civil liberties is inconclusive, the regression estimation does show that the level of economic freedom enjoyed by the citizens of a country does significantly affect levels of GDP, meaning that greater levels of success along the path towards democracy and a market-based economy in Central and Eastern Europe can be attributed to each country's informal institutions. The more these are in tune with the formal rules being adopted, the quicker citizens in a country are able to adapt to the new institutions, allowing for a democratic, capitalist system to take root and flourish.*

### I. Introduction

The end of Communism in Central and Eastern Europe  
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Europe was a watershed event of the late 20<sup>th</sup> century. The authoritarian regimes of the region had succumbed to domestic pressures and relinquished their monopoly on power, and nearly overnight approximately 300 million Europeans were presented with the opportunity to choose their political and economic systems anew. Where should they begin? What was important? Where should they look for guidance and assistance? The citizens of each country had to answer these simple, yet crucial questions. In response, academics of all disciplines and convictions, governments, and international organizations attempted to provide guidance and advice on the steps of the reform process.

### II. Success in the Transition Process – The Interaction Thesis

A small group of economists comprised mainly of Enrico Colombatto, Jan Svejnar, Jan Winiecki, and Svetozar Pejovich, attributes the success of the transition process to whether or not the new market system, with its new and different rules and values, is adaptable to the culture and history of the country in question. As Svetozar Pejovich (2003) states:

Transition means institutional restructuring. Since formal rules are not a policy variable, transition has to mean the enactment of new formal rules: that is, constitutions, statutes, common law precedents, and/or governmental regulations. The results of transition then depend on the interaction of new formal and prevailing informal rules. Of course, the rules do not interact. Individuals do. New formal rules create new incentives and opportunities for human interactions. How individuals react to those new opportunities for exchange depends on how they perceive them. And how individuals perceive new opportunities depend on the prevailing culture.

In other words, the issue on which the success of the transition process actually hinges is not the technical aspects of reform or the numerous policies, but rather the transactions costs created by these reforms, costs which are defined as the cost incurred by an individual when engaging in economic activity. Transaction costs are indirectly related to the compatibility of these transition policies and the new market system with the history of the numerous populations in Central and Eastern Europe and the customs, traditions, and culture that grew out of this history. If the new formal institutions are in tune with the informal institutions, then the transition

should occur relatively smoothly because the transaction costs of conducting business are low and individuals will find it worthwhile to engage in economic activity and produce wealth. If the new formal institutions are not in tune with the informal institutions, then individuals will find that transactions costs are higher than before, which discourages them from conducting business and producing wealth. Therefore the question needing to be answered is whether the formal institutions being developed by the transition process and the values and behavior necessary for the proper functioning of these formal institutions agree with the informal institutions already in place in these countries (Colombatto and Macey 1999, Pejovich 1997, 2001, 2003 and Winiecki 2000, 2004).

#### **A. The Interaction Thesis**

Svetozar Pejovich (1997) terms this phenomenon the interaction thesis, which states that, if the formal institutions are compatible with the informal institutions, then the incentives they create will tend to reinforce one another. As Pejovich (2003) later summarizes:

When changes in formal rules are in harmony with the prevailing informal rules, the incentives they create will tend to reduce transaction costs and free some resources for the production of wealth. When new formal rules conflict with the prevailing informal rules, the incentive they create will raise transaction costs and reduce the production of wealth in the community.

The interaction thesis describes the scenario that had been unfolding in Central and Eastern Europe for years. Following the events of 1989 and 1990, the new governments in this region undertook the process of building capitalism, with the guidance and strong support from the West. Almost overnight the formal institutions that had been in place during the communist era had been deemed obsolete. In their place a new set of rules and institutions based on those found in Western societies was installed, forming the new framework by which the people in the region would conduct business and interact amongst themselves and with the rest of the world.

#### **B. Outcomes of the Transition Process if the Formal & Informal Institutions are Incompatible**

As Colombatto (2001, 284) points out, "...in the modern world, freedom is a secondary need. Security comes first." In the case of Central and Eastern Europe, such circumstances created the opportunity for the new system to be hijacked and run aground by those who wanted to use the political machinery for personal gain. This allowed members of the former nomenklatura and other rent-seekers to gain control of the new economic system and led to the development of a large informal economy or black market in some countries. Even though the emergence of practices such as the oligarchs in Russia or a similar business class in the Ukraine did little to promote the public welfare or the success of the transition

process, the majority of society did not protest against such behavior because it provided a sense of security, which arose from being able to engage in transactions much in the same manner as they had for the past decades and even centuries. These transactions were not based on the type of trust that permitted the creation of an extended order in society, which was needed if the new formal rules were to produce the desired outcome. Instead, these economic transactions were based on one's reputation and the personal relationships found in the close-knit communities of Central and Eastern Europe (Colombatto 2001 and Pejovich 1997, 2003).

The conflict between the new formal institutions and the region's informal institutions also led to the election of leaders who were able to undermine the reform process. Such leaders played on the fears of the populace, promising to provide security at a time when no one was certain as to the course economic and political reform would take. They were subsequently elected, but instead of promoting the aims of the transition process, these leaders sabotaged the entire process, effectively securing a monopoly on power for themselves and in doing so taking the newly-won political and civil freedoms away from the people. Vladimir Putin in Russia and Aleksandr Lukashenka are two examples of such leaders. This process was able to occur because only in a stable society, where people feel secure, can the exercise of freedom or personal economic interests become relevant. Until such a point has been reached, though, the desire for order and comfort takes precedence over any desire for freedom (Colombatto 2001 and Woodruff 2005).

#### **C. The Interaction Thesis and Central and Eastern Europe – A Summary**

The success of the transition process is not dependent on the technical steps taken during the reform process, rather on the interaction between the new formal institutions that are being transplanted and the informal institutions already present in the countries of Central and Eastern Europe. While certain steps must be taken if the transition process is to result in a market-based economy and a state that is democratic in nature and upholds the rule of law, these steps have only a marginal impact on the eventual outcome of the reform process. They are merely steps in the reform process, necessary in that they are required to complete the transition from a socialist economy to a capitalistic one. However, these steps can take varying forms and the end result will still be the same. For example, one can look at the process of transforming an economy as similar to remodeling a house. Someone can desire to remodel the house and transform it from its original state for various reasons, and through this process, the house can gain an additional pair of new rooms or the house can be altered so that it receives a different outward appearance. Such changes are usually carried out for aesthetic, not practical reasons. Either the owner had grown tired of the outward appearance of the house or he believed that an addition was needed in order to allow for more occupants, etc. These changes are aesthetic,

in that the foundation of the house has not been altered; only its outward appearance has evolved.

It is much like the process of a newly-elected government coming to power in Western Europe or the United States. The new government does not typically alter the political or economic institutions of the country; these institutions remain in place, but this does not necessarily mean that the government retains all of the policies of the previous government. It is allowed to pass laws and implement policy as it sees fit, according to its party doctrine and the promises supposedly made over the course of the campaign. The process of changing power within a system of government possesses many similarities with the process of remodeling a house after a new owner moves in. In both instances, the foundation of both the house and the system remains the same, only the appearance changes, in order to incorporate the preferences or policies of the new government or in this example, the preferences of the new owner. Such a process occurs regularly in Western societies. Power is exchanged peacefully within a system of government, and with this exchange of power, policies that have varying aims are implemented, but this does not mean that the foundation which the entire system is built upon has been altered. These governments must work within the institutional foundation of each country, a foundation that in the case of a Western society means the procurement of civil liberties as well as the property rights system and legal system necessary for a market economy. For each country that adheres to such a system, the content and aims of its policies may differ due to the preferences of its populace, but the foundation on which the entire system rests remains unaltered.

There are instances, though, that require one to rebuild the foundation of the house, not for aesthetic purposes, but in order to ensure that the structure will continue to remain in existence. This could be due to various reasons: erosion, a crack in the foundation, etc. In these circumstances, one would be required to either repair the foundation of the house to a large extent or rebuild the foundation in its entirety. Following the events of 1989 and 1990, the countries of Central and Eastern Europe found themselves in such a situation. No longer would it prove adequate to simply change the exterior of its house or in this case, the policies and regulations of the state. The people demanded a change in the foundation of each country. No longer could the leaders of each country attempt to simply alter the communist system and simply improve the political environment and increase economic growth. Instead, the citizens of each country pushed for the foundation on which the state stood to be rebuilt. They insisted upon the right to political participation, a guarantee of civil liberties, and the right to make economic decisions based on their preferences, not those dictated to them from the Communist party and its apparatus. They demanded to live under a political and economic system similar to the system found in the Western world, but in order for such a system to be successfully transplanted the new formal rules would have to be in tune with the informal rules that were already present throughout

Such a transition demanded more than simple adherence to a certain transition model or reform plan; it required the people of each country to be in a position to adapt to the new formal rules that were being exogenously “forced” upon them. The technical elements of the reform process did not determine the ultimate outcome; rather they served simply as a means to an end. Ultimately, the success of the transition process in each country depended upon whether the populace was able to adapt to the new formal institutions. If these new formal rules were successfully adopted then the foundation of the new market system would be able to stand firm, allowing for stable economic growth. If not successfully adopted, then the results would be different – economic growth would be volatile and the size of the informal economy would tend to increase as citizens began conducting business based on reputation and personal relationships, forgoing the voluntary exchanges with strangers that allow a capitalistic economy to operate optimally. In the case of Central and Eastern Europe, such results would derail the transition process as the people in each country reverted to methods of conducting economic and political affairs that might provide comfort and security, but were not compatible with the methods of a society supportive of a thriving market economy.

### *III. Support for the Interaction Thesis*

The successful transition from a communist system to a democratic government and an economy based on the market was dependent upon the interaction between the new formal rules being adopted and the informal ones already in place in each country throughout Central and Eastern Europe (Colombatto and Macey 1999; Pejovich 1997, 2001, 2003; Winiecki 2000, 2004; and Zweynert and Goldschmidt 2006). Hayek (1988) maintains that exposure to the West and its notion of an extended order encourages the development of the individual and promotes the self-serving decision-making process that underlies a capitalist system. According to the interaction argument, countries with this exposure were able to put in place a system of credible and secure property rights with its supporting institutions of a constitution, an independent judiciary, and freedom of contracts. This historical connection allowed the new market economy to take root quickly and begin to thrive within a relatively short time period as the population of these countries felt comfortable to engage in voluntary exchanges in the marketplace, fueling economic growth. On the other hand, countries lacking prior contact with the West and its traditions and practices had a more difficult time adopting the formal institutions necessary for a properly functioning market economy. In these cases, the transition to a capitalistic economy was derailed at an early stage, allowing for either strong-armed rulers or rent-seekers to stall both the economic and political transition process in these countries.

#### *A. Econometric Specifications*

The empirical methodology used in this thesis is based on the estimation of growth regressions using panel data. The data sample covers the period 1990 - 2005 and includes the

following group of 20 transition countries: Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Georgia, Hungary, Latvia, Lithuania, Macedonia, Moldova, Poland, Romania, Russia, Serbia and Montenegro, the Slovak Republic, Slovenia, and the Ukraine. Each of these countries is geographically located in Central, Eastern, or Southeastern Europe, and began the transition from a socialist economy to a market-based system in the early 1990s.

This sample utilized panel data, instead of time-series data. Unlike time-series data, panel data expand the size of the data sample by including more than one country, thus increasing the explanatory power of the regression. In doing so, the data sample increases substantially and the estimation results are therefore better able to explain the causes of the economic growth experienced by each country in the region. In working with the data sample, the author also used fixed effects techniques instead of random effects, allowing for the control of certain effects that remain constant over the chosen time period. By using random effects, it would have meant that there exist events or circumstances which cannot be controlled for and could therefore have a substantial impact on the economic growth of each country. The possibility that such events or circumstances could occur would alter the coefficient estimations and significantly decrease the explanatory power of the growth regression, and in turn damage the credibility of the empirical study. However, the author maintains that this is not the case for this data set, and thus utilizes fixed effects.

For this study, five-year running averages were used, instead of simple five year blocks. By incorporating five-year running averages into the estimations, the explanatory power of the growth regression is enhanced in two ways. First, five-year running averages, which cover time periods 1990-1994, 1991-1995, 1992-1996, etc., enable an increase in the explanatory power of the regression estimation by maximizing the number of observations. With five-year running averages, it is possible to include 15 five-year blocks, instead of three, which would be the case if the chosen time period were divided into three blocks. Second, averaging the data over five-year increments helps to eliminate the effects of short-run business cycle dynamics on growth. Failure to eliminate the effects of such short-run dynamics tends to lead to highly correlated time series and to gross overestimation of coefficients (Iradian 2007).

Following the example of Iradian (2007), Fidrmuc (2003), and Berg et al. (1999), the author uses the following growth regression model, hereafter called equation 1, to construct the econometric specifications:

$$g_{it} = \alpha + \beta \hat{C}_{it} + \lambda X_{it} + \varepsilon_{it} \quad (1)$$

where  $g_{it}$ , the dependent variable, is the GDP growth rate in country  $i$  during the time period  $t$ .  $\hat{C}$  is composed of a set of control variables that are often used in growth literature, including the level of development as proxied by initial GDP

per capita, inflation, the annual population growth rate, the total amount of government expenditure, school enrollment numbers, total investment, and a measurement of trade openness.  $X$  is the vector of explanatory variables the author wishes to test. These are the variables (including level of economic freedom, level of political rights, and level of civil liberty) the author uses to test the validity of the interaction thesis, and  $\varepsilon_{it}$  is the specification error term.

### ***B. Explanation of Variables and Data Sources***

The empirical analysis uses data from a sample of 20 countries during the period 1990 – 2005. Values of annual population growth rate, real GDP per capita, annual GDP growth rate, secondary school enrollment rates, levels of investment, inflation, trade openness, and the share of government expenditures in GDP are taken from the World Bank's World Development Indicators (2007). The values for overall economic freedom in each country are extracted from the Heritage Foundation's 2006 Index of Economic Freedom, and the scores regarding the level of political rights and civil liberty for each country are from the Freedom House (2008).

The first group of variables is a basic set of explanatory variables commonly used in growth regression analysis. They are used to control for some core components that usually drive economic growth in a country. Real GDP per capita is used to control for prior levels of development. For example, in this analysis, each five-year running average includes the beginning year's real GDP per capita level. If the five-year average corresponds to the period 1990 – 1994, then the real GDP per capita level from 1990 is used in order to see how the level of economic development in 1990 affected GDP growth over that five year period. Annual population growth rates take into account the size of the labor pool in each country. The secondary school enrollment rate measures the number of people in each country receiving a basic level of education and thus is a rough estimate regarding the skill level of the country's workforce, while the variable measuring the total amount of government expenditure represents the extent to which a state's fiscal policy aids or harms its economy.

By incorporating inflation into the regression, the author is controlling for overall levels of macroeconomic stability in each of the countries being tested. The level of investment is measured by the amount of capital available in each country and is used to show the amount of capital or funds earmarked for economic investment. Also included in this group of control variables is a measure of trade openness, since the level of openness in an economy can greatly affect the levels of economic growth experienced by that country (Arora and Vamvakidis 2004, and Kali et al. 2007). Trade openness is calculated as the total value of imports plus exports over total GDP ( $I+E/GDP$ ). The final variable included in each five-year running average is the initial level of GDP growth. Even though GDP growth serves as the dependent variable, preceding levels of GDP growth are believed to directly affect later levels of economic growth. Thus, for each five-year

running average, the average GDP growth for the previous five-year running average was included.

The second group of variables, including economic freedom, political rights, and civil liberties, comprises the vector of explanatory variables the author wishes to test. These three variables have been chosen in order to test the validity of the interaction thesis. By incorporating these three variables into the regression specification, the author is able to observe how the process of democratization influences levels of GDP in the region. More importantly, he can also see whether the compatibility or incompatibility of the new formal institutions and the informal institutions in each country significantly affects and leads to economic growth. The first explanatory variable, economic freedom, is included in order to observe how the interaction between formal and informal institutions in each country affects economic growth over the chosen period. As mentioned earlier, the values for this variable are taken from the Heritage Foundation's 2006 Index of Economic Freedom and are equal to the overall score for economic freedom of each country over the period 1990 – 2005. For each country considered, a score is given on a scale of 1 to 5, with lower scores translating into higher levels of economic freedom.

Due to its ability to measure the level of government participation in the economy, the author chose to incorporate the Heritage Foundation's Index of Economic Freedom into the growth regression as a measure of how well a state has progressed along the path towards a market-based economy. The notion behind this decision is that the lower the score a state receives, the better that country has performed in its transition to a market-based economy. The new formal institutions and rules of a capitalistic economy are in tune with the informal institutions already present in that country, thus, the new system has been successfully adopted by the citizens of that country. Now the question to be answered is whether the adoption of a market-based system leads to economic growth, and if so then to what extent. By including this measure of economic freedom as a variable in the growth regression, the author desires to answer this question, and see if there exists empirical support for the interaction thesis.

The final two variables included are political rights and civil liberties, and they are meant to measure the effect of democratization on economic growth in the region. Each of the values for these variables is extracted from the Freedom House's annual publication that measures the level of political freedom, which it defines as "opportunity to act spontaneously in a variety of fields outside the control of government and other centers of potential domination" (Freedom House 2008), enjoyed by the citizens of each state throughout the world. The organization states that it "... does not maintain a culture-bound view of freedom. The methodology of the survey is grounded in basic standards of political rights and civil liberties, derived in large measure from relevant portions of the Universal Declaration of Human Rights" (Freedom House 2008).

These two measures of political freedom were included in order to determine whether the democratization process occurring in conjunction with the economic transformation throughout the region impacts economic growth. Did the transition to a democratic system of government affect the standard of living in Central and Eastern Europe? Or did the process of political liberalization have little effect on the lives of individuals in these countries, except that citizens are now empowered to choose their own leaders and are better able to hold those elected accountable for their actions once in power, and to do so without fear of punishment if one's views digressed from that of the state apparatus? Inclusion of the two measures of political freedom in the growth regression provided a mechanism for answering these types of questions.

### *C. Empirical Estimation Results*

As mentioned earlier, the author utilizes five-year running averages when conducting fixed effects estimations of equation. In order to check for robustness, three different specifications are run. Each includes the basic set of control variables represented by  $\hat{C}$  in the equation, the difference among the three specifications being the inclusion of one of the three explanatory variables from vector X. The first specification includes only the variable measuring civil liberties; the second specification incorporates only the value that quantifies the level of political rights; and the final specification includes only the variable representing economic freedom. A specification incorporating all three of the explanatory variables the author wished to test is not possible due to the high levels of correlation existing between the variables. Thus, the author is only able to examine each of these variables individually. Additionally, the results presented here have been corrected for heteroskedasticity using White's correction method.

Table 1 presents the results of estimating equation (1) for each specification. Column 1 presents the estimation results for the first specification, which measures the impact of civil liberties on economic growth. The results for the second specification, which includes the political rights variable, are shown in column 2, and column 3 shows the results for the third and final specification, which calculates the effect of economic freedom on economic growth for the 20 transition countries included in study. In addition, located at the bottom of each column is the number of observations and the adjusted R-squared for the corresponding specification.

The results of the three specifications provide an interesting picture regarding the effects of democratization and economic liberalization on economic growth in the transition countries of Central and Eastern Europe. As one can see, the first two specifications generate similar values for the coefficients of each control variable. For each of the control variables, the impact on the GDP growth rate in each country is as expected. The initial levels of GDP growth significantly affect later levels of economic growth in a positive manner, meaning that the higher the level of economic growth at

the beginning of the five-year average, the higher the levels of growth a country experiences over that five year period. Trade openness leads to increases in GDP as does the level of investment in each country. As one can see, macroeconomic

Table 1. Dependent Variable: GDP Growth Rate for each Country

Variable	Specification 1 Civil Liberties and Growth	Specification 2 Political Rights and Growth	Specification 3 Economic Freedom and Growth
Initial GDP Growth	0.551645* (13.51078)	0.546439* (13.44697)	0.548847* (16.03929)
GDP per capita	-2.307336* (-2.797729)	-2.437126* (-2.905403)	-2.810426* (-2.645954)
Trade Openness	1.253509** (2.525684)	1.567780* (2.986241)	2.011660* (4.105607)
Government Expenditure	0.063396 (0.845368)	0.023469 (0.338747)	-0.143866** (-2.513882)
Investment	7.817959* (7.846429)	7.756691* (7.435501)	8.253516* (10.20491)
Inflation	-0.002346* (-3.411795)	-0.002205* (-3.089546)	-0.006991* (-6.624498)
Population Growth	0.200332 (0.410774)	0.213668 (0.441684)	-0.079532 (-0.183364)
Civil Liberty	-0.576084 (-1.188499)	-----	-----
Political Rights	-----	0.291137 (0.857902)	-----
Economic Freedom	-----	-----	-2.099691** (-2.374831)
No. Observations	152	152	108
Adj. R-squared	0.936754	0.937094	0.964658

Notes: The symbols \* and \*\* mean that the estimated coefficients are significantly different than zero at the 1 and 5 percent confidence level, respectively; t-statistics are in parentheses.

stability, which is measured by inflation, is necessary in achieving economic growth. GDP per capita, as expected, possesses a negative effect on economic growth, meaning that higher levels of initial GDP or economic development tend to slow economic expansion.

Population growth proves to be insignificant in determining levels of output, but this phenomenon could arguably be attributed to the fact that the population levels in each of these countries did not significantly increase in the period 1990 – 2005. In the first two specifications, overall economic growth is not significantly affected by the total amount of government expenditure in each country, and the effects of school enrollment levels on GDP growth cannot be included in either of the specifications due to the lack of observations available.

In both of these specifications, the level of civil liberties or political rights enjoyed by citizens of a country in the region proves to be insignificant in determining economic growth, although the coefficients for these two variables possess different values. According to results for the first specification, higher levels of civil liberties lead to greater economic growth, while greater political rights adversely affect economic output. However, despite this seemingly puzzling outcome, any further analysis of these two variables is irrelevant for two reasons. First, the estimated coefficients for both of these variables do not prove to be significant at either the 1 or 5 percent level, and for the purposes of this thesis the question as to whether the process of democratization significantly impacts economic growth has been answered. Neither the level of civil liberties nor the level of political rights in each country appears to have influenced economic growth during the period 1990 – 2005.

In the third specification, the estimated coefficients of the control variables do not alter significantly and the Adjusted R-squared increases only slightly from 0.936754 and 0.937094 to 0.964658, respectively. The only noticeable difference among the group of control variables is the finding that the total amount of government expenditures becomes significant at the 5 percent level. However, the estimated coefficient for economic freedom is significant at the 5 percent level. This means that, in contrast to the level of civil liberties or political rights, the amount of economic freedom enjoyed by the citizens of a country does impact economic growth, and as estimated by the regression specification it possesses an overall positive effect on GDP. In other words, if a country increases its overall score for economic freedom by one point, for example from 3.2 to 2.2, then that country should see its overall economic output increase by more than 2 percent. Such a result shows not only that greater levels of economic freedom lead to higher rates of GDP growth, but in doing so it also provides evidence in support of the interaction thesis, since the higher the score a country receives from the Heritage Foundation for overall economic freedom, the greater that country's economy operates according to market principles. Therefore, one can conclude that the culture and history, as well as the societal makeup of a country, do matter in determining the rate at which a system of democratic capitalism is adopted. The more in tune a people's culture and their corresponding informal rules are with the new formal institutions, the greater the level of economic growth a country can expect to experience.

#### *D. Implications of the Growth Regression Results for the Transition Process in Central and Eastern Europe*

Based on the results of the panel growth regression described in the previous sections, two points warrant further discussion. First, it was estimated that two factors, civil liberties and political rights, did not significantly increase economic growth for the region of Central and Eastern Europe from 1990 through 2005. Proponents of the Chinese model or the pluralistic market socialist transition model could utilize these results to support their argument that the former Communist countries in Europe should not have introduced reforms to transform the state politically, especially as these countries were transitioning from an economy run by the Communist party to one where the market was permitted to dictate the amount and types of goods to be produced. According to them, it would have been more prudent to follow a path of transition similar to that of China and other Asian countries or to implement an economic reform plan similar to the "reform socialism" pushed by the Communist governments in Europe at various times following World War II, the most notable examples being Gorbachev's policies of perestroika and glasnost. In both of these scenarios, a single political party or entity maintains a tight control over judicial affairs while supposedly liberalizing the economy in phases over an extended period of time.

However, in light of this critique regarding the transition process occurring in Central and Eastern Europe, the author 6

reiterates that such arguments are irrelevant and even erroneous for two distinct reasons. In both of the cases mentioned in the preceding paragraph, complete economic liberalization is usually not the main goal of the government in power. It is only lip-service to the outside world. The commanding heights of the economy remain in the hands of those holding political power, and the individual is still only allowed a limited role in determining economic outcomes in a market that remains handicapped by the self-interests and overbearing presence of the state or those in power. In other words, the reforms implemented only go so far. The entire economic system will never be transformed completely, because such a transition would undermine the interests of the political party or individuals who possess complete control over the political machinery within the country.

In addition, proponents of this and similar views fail to take into account the circumstances and sentiments surrounding the events of 1989 and 1990 in the Eastern bloc. According to the regression results, one can state that civil liberties and political rights did not significantly impact economic growth during the first 15 years of transition, yet from the same results one can also infer that these two variables did not adversely affect economic growth either (Fidrmuc 2003). The people living in the Eastern bloc desired both a standard of living similar to that of their neighbors in the West as well as a system of government in which they could elect their leaders and openly hold views that differed from those of the state. If the Communist party was to relinquish its control over the commanding heights of the economy, then it also would have to give up the reins of political power since the two systems were tightly intermeshed. The term “centrally-planned economy” did not simply describe the method by which the economy was managed, because the economy was an inseparable part of an authoritarian state where the party, governmental, and economic hierarchies were tightly intermeshed, with the party and its apparatus possessing the dominant voice among the three entities. Reforms were therefore inevitably blocked at the point where any further change in the system of economic management might undermine the interests of the party (Kozul-Wright and Rayment 1997). Hence, economic reform could not occur without political reform and vice-versa: the two processes of reform had to occur simultaneously if either one of them was to prove successful.

The second point worth additional commentary is the role a people and their informal institutions and rules played and continue to play in determining the outcome of the transition process in Central and Eastern Europe. The growth regression results show that a country’s level of economic freedom has a significant impact on economic growth. Despite this result, though, many economists would agree with Åslund (2002, 75) when he states that a country’s culture, history, and religion had only minimal impact on economic growth in Central and Eastern Europe from 1990-2005, especially in comparison to a country’s economic policy, geography, and levels of investment

and technology. However, this author strongly disagrees. It is true that current levels of development, investment and education, as well as previous levels of GDP, have a large effect on future rates of growth. However, in order to maintain satisfactory levels of investment and economic development, a country has to be able to create an environment that encourages individuals – foreign or domestic – to invest in its economy and engage in activity within its borders that creates wealth and leads to economic growth. If such an environment requires certain rules and standards that most politicians and economists agree are necessary for investment and economic growth, then why do some countries still lag behind in the transition process? Why are some transition countries unable to effectively implement these rules and standards, while other states have been able to do so and are now experiencing impressive levels of economic expansion?

As discussed by Friedrich von Hayek (1988) and others, certain cultures and societal orders are more conducive to a market-based economy and a political order rooted in the notions of democracy and individual liberties. These societies promote self-interest, self-responsibility, and self-determination; values that reinforce the formal institutions – secure property rights, a constitution, an independent judiciary, and freedom of contracts – underlying a capitalistic system (Colombatto and Macey 1997, Hayek 1988, and Pejovich 1995, 1997, 2003). If a people have had previous contact with a societal order that nurtures those or similar values, then they will be more inclined to successfully adopt a system of government and economics that are based in these formal institutions and rules. As a result, transaction costs will be minimal, and individuals will be encouraged to engage in economic activity, which in turn creates economic output and wealth. If not, transaction costs are high, leading to situations in which people do not trust the new system and revert to what is considered “comfortable” or secure. Special interest groups gain control of the political and economic system and encourage rent-seeking actions and other behavior that undermines the transition process. As a result, the new system does not take root and a political and economic doldrums emerges. Such is the case in Central and Eastern Europe. Countries having prior contact and interaction with the West and its values have arguably fared better in the transition process, while countries lacking such contact have not achieved the same levels of progress as some of their neighbors.

### V. Conclusions

The events of 1989 and 1990 opened a new chapter for Central and Eastern Europe. Almost overnight, Communism and its ideals lost favor throughout the region, causing communist parties to relinquish their control over society and a power vacuum to emerge. Elections were held shortly thereafter, and although there were varying opinions as to the new direction each state should take, the majority of citizens throughout the region desired a government modeled on the

democratic values of the West and an economic system based on the markets, allowing individuals to make consumption decisions based on their preferences and for goods to be allocated according to the law of supply and demand. These preferences represented a clear break from the past. No longer would the individual be forced to look to the state for guidance in every aspect of one's life. Instead, the people would be able to control the political and economic destiny of their countries.

The past two decades have witnessed the new governments in Central and Eastern Europe attempt to steer their countries down the long road to political and economic transition, reaching varying levels of success along the way. Some states have been successful in adopting a democratic, pluralistic system of government and a market-based economy, while other countries have been unable to achieve similar results. Why is this? Why have some countries succeeded and others lagged behind?

Numerous scholars have attempted to answer this question over the past 18 years, but they have yet to offer an explanation that is applicable to every country undergoing political and economic transformation in the region. Among other issues, many of these scholars have concentrated on whether or not each state should have followed a certain transition model when implementing reform measures, or whether enough time was spent on institution building at the beginning of the reform process. The question remains, why do none of these explanations provide convincing evidence as to why certain countries have failed and others have succeeded to varying degrees?

This author argues that a core issue is the lack of attention given to the interaction of the new formal institutions these countries were attempting to adopt and the informal institutions already present. Contrary to the presumptions of these other scholars, history and culture did play a pivotal role in determining whether a country succeeded in adopting the new formal rules of democratic capitalism. The West is associated with the notion of an extended order society, one that encourages the development of the individual and the decision-making process that underlies a capitalist system. Countries that had prior contact with the West and its notion of an extended order society were able to adopt the new formal institutions within a relatively short period of time. As a result, transaction costs decreased in these states, encouraging individuals to engage in the type of voluntary exchanges in the marketplace that fuel economic growth.

On the other hand, countries lacking such a cultural exchange with the West have tended to lag behind their neighbors in the transition process, unable to adopt certain aspects of either a democratic system or a market economy or both. Progress in these states has occurred more slowly, as individuals have taken longer to adjust to the reforms implemented since 1989 and 1990, but such delayed progress should not be interpreted as a sign that these countries will never succeed in their quest to shed the legacy of the communist era. In every transition process, time plays a role.

As evidenced by the improved scores for overall levels of economic freedom awarded by the Heritage Foundation, it is possibly only a matter of time before certain states catch up with their neighbors in adopting the institutions and rules necessary for a properly functioning market economy and a political order rooted in the principles of democracy and pluralism.

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### Mentor Comments

David Gay clarifies the scope of the research project from which this article was drawn. He leaves no doubt about the excellence of the work and the reason that the thesis received an Undergraduate Research Award from the Teaching Academy.

*This paper is an edited and condensed version of Brian Lee's honors thesis which is an exceptionally well-developed volume of nearly 150 pages. The condensed version of the thesis was presented at the Economics Scholars Program at the Federal Reserve Bank of Dallas in the spring of 2008, after a competitive selection process involving submissions from students at Texas A&M University, Michigan State University, Southern Methodist University, the University of Texas at Austin, and others. Brian and I met weekly for more than two semesters as he crafted the outline and details of his senior honor's thesis. The topic and approach were primarily worked out by Brian Lee. Knowing how well he nuanced answers on exams from our three courses together, it was clear that his literature review and focus using his majors in economics, German, international relations, and European studies would be an epic undertaking. We agreed that a crucial element to take his thesis beyond an exemplary review of the works of others was to employ empirical testing of the interaction hypothesis and other hypotheses. He was aided by Donna Daniels in the University Library, along with Professor Javier Reyes, who teaches econometrics.*

*Comparing the usual measures of economic freedom in the foreground of economic development during the 1990-2005 period yielded results that put economic freedom in the foreground of economic development. The Freedom House index did not yield the explanatory power of the Heritage Foundation index of economic freedom. In addition to this publication in Inquiry, I expect that a trimmed down version of this paper will be published in a high quality economics journal under his sole authorship.*

*Brian's thesis was the best that I've seen in 35 years. I have seen many great ones, but this has spoiled me (most likely, forever). The same theme was echoed by Professor Hoyt Purvis in international relations and University Professor Murray Smart ("better than many doctoral theses"). The topic was compatible with my own interests,*

*but Brian Lee did the yeoman's dogged work to organize, to compare and contrast positions and hypotheses, and to dig out the data to push his honor's thesis beyond the realm of being a great thesis into being an extraordinary one. I do not expect to see the likes of this quality again during what I hope are my next ten years at the university. It has been and likely will remain a highlight of a long academic career.*

*Brian Lee has received a Fulbright to study in Vienna, Austria. He will enroll in the Master of Advanced International Studies program at the Vienna School of Diplomacy. Under different circumstances, he would most likely have qualified for a Marshall Fellowship but his interests and experiences (both in Austria and as an intern with the German Bundestag) led him elsewhere.*