26. Institutions and Firms in Transition Economies

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1. The Transition and the NIE

In 1989, the Soviet bloc in Eastern Europe disintegrated. In mid-1991, the old Yugoslavia began its painful, protracted breakup. Later that year, an abortive communist coup led quickly to the FSU (former Soviet Union). Twenty-eight countries were free to choose their own economic and political institutions. Public and elite opinion was set on a large move away from the old socialist system, towards some form of market capitalism. In most countries, there was an accompanying shift toward greater political freedom and democracy. All countries undergoing this transition have now experienced more than eleven years of post-communist change.

Several features of transition contribute to its particular pertinence to the NIE. The reforming countries ended the 1980s with a set of formal institutions far different from those of market capitalism. The predicament was not simply one of underdevelopment, with poorly working, incomplete market-capitalist institutions. Rather, under central planning, most essential economic activities were governed by powerful institutions that were antithetical to market capitalism. Mammoth institutional destruction and construction was on the agenda, whatever strategy drove that agenda.

Consistently, the internal organization of enterprises, the mechanisms of enterprise governance, and the governance of transactional relations were all a product of the institutions of central planning and communist politics. But since planning and communism were the two elements of the old systems that were most roundly rejected, firms faced a truly revolutionary situation. In contrast to normal processes of development, where expanding firms adapt to an evolving institutional environment, transition began with large production units facing an institutional earthquake.

This chapter focuses on how the NIE has been used to understand transition processes and how the experience of transition can help inform the NIE.[1] As the

[1] There are three earlier papers that have related goals, although all three focus on the first objective of this paper rather than the second. Lichtenstein (1996) constructs, and critiques, an NIE model of the decline of central planning and the process of transition. Smyth (1998) provides a broad-ranging review of the literature that lies at the intersection of transition and the NIE. Voigt and Engerer

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above clearly attests, transition inherently involves phenomena that are of central interest to students of the NIE. However, simply discussing these phenomena is not the same as using the NIE: related branches of economics study many of the same general issues. Therefore, to delineate this chapter's scope, it is necessary to draw the dividing line between specific application of the NIE and more general economic analyses of the phenomena on which the NIE focuses. The next two paragraphs do this by listing the analytical concepts that constitute the central core of the NIE. These paragraphs simply distill the essence of the *Handbook* essays by North, Williamson, and Shirley. They serve as a guide as to what is emphasized in the remaining sections of this chapter.

At a macro level, an analysis driven by the NIE would focus on institutions as the rules of the game. These are the prime determinants of the size and distribution of transaction costs. Institutional change is driven by the demands of organizations seeking to reduce transaction costs. Since the set of organizations present at any moment is determined by the inherited structure of institutions, the process of change is mainly incremental and path dependent: institutions tend to be long-lived and difficult to reform. Although institutional change is driven by the rational actions of organizations, there is bounded rationality and the mental models of actors are a prime ingredient in path dependence.

NIE microeconomic analysis takes the transaction as the basic unit of study and focuses on transaction costs, using contractual reasoning. Such analysis involves an examination of the allocation of economic activity across alternative modes of organization, with the governance structure of firms and of transactions being a central concern. A key focus is on whether there is a discriminating alignment between the attributes of transactions and the properties of governance structures.

This chapter's content reflects the intersection of the features of transition and the characteristics of the NIE that are delineated above. The first task is to assess the role played by the NIE in shaping the way economists analyzed the transition process. Section 2 examines the use of the NIE as an analytical tool, particularly focusing on the early phases of transition when there were vigorous debates on the strategy of transition. The overall conclusion from the section is straightforward: in the early transition, the NIE hardly played any role at all, but now the issues stressed by the NIE are a central focus of the transition literature.

Section 3 considers events in the early years of transition, which provide a concrete example of how strategies of transition might have been very different had they more directly embodied the lessons of the NIE. In the very beginning of transition, the political underpinnings of a set of powerful formal economic institutions were removed overnight. In most cases, the new politicians were either not willing or not able to slow the resultant institutional collapse. Since replacement institutions were not available immediately, firms were left to struggle in an immensely chaotic environment. The effect of this chaos on firm behavior,

(2002) consider policy implications of the NIE, reviewing elements of transition experience in the process.