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Institutions; Institutional Reform

Introduction: economic objectives
Following the wave of (mostly) peaceful political revolutions that started in mid-1989, the new governments in Central and Eastern Europe and Central Asia faced an immediate task to fix the ailing economies. The West, which unlike the Soviet bloc achieved prosperity and economic stability, was an obvious point of reference. That implied replacing the command economy with the markets; that is with the conditions of economic freedom. Freedom of economic contracts and fully protected private property rights were expected to change the incentives: with rights to residual value, the profit motive – the anathema of the socialist system – was reintroduced. At the same time both price controls and state support for companies was to be removed leading to pressure on cost efficiency, including energy efficiency. Competition was to be reintroduced, replacing cosy socialist monopolies and sellers’ markets with buyers’ markets, that is exchanging planners’ sovereignty for consumers’ sovereignty. It was hoped that responding to new incentives, the economic actors will reallocate the resources from old to new activities, the latter being consistent both with real structure of costs and with consumers’ preferences. The reallocation was to be achieved both by restructuring of surviving old firms and by emergence of new players.

In the language of the previous two chapters, economic transition from plan to market consisted of changing the system of control and property rights, leading to changes in information flows and incentives in an economy. In socialist enterprises managers had control rights and it was unclear to whom the residual claims could be attributed so that the property rights were blurred. Private property rights restored a link between control rights and residual claims, making the motivation
of economic agents consistent with the aim of value maximization. As discussed in Chapter 2, one important element of efficiency relates to flexibility: unlike the inertia that characterized the command economy, under the market conditions, the producers should adequately respond and adjust to changes (1) in the real structure of costs (scarcity), and (2) in the set of preferences of buyers. However, it is not only the behaviour of producers, but also of other economic agents, that matters: households should be motivated to save money instead of hoarding goods, and investors to choose the long-term best value-adding projects.

In addition to the institutional change discussed above, macroeconomic outcomes as represented by budget balances, external balances and inflation needed urgent attention. In fact as we will argue later on, institutional change and macroeconomic policies are intertwined; yet to cope both with the reform of institutional frameworks and introducing new macroeconomic policies was a considerable challenge.

The main components of the reform programme and speed of reforms

Following Balcerowicz (1995: 239), with some slight modifications, we may distinguish between the three main components of reforms that characterized the transition process as implemented in Central and Eastern Europe:

(1) Liberalization (First-stage institutional reforms)
   - Microeconomic liberalization of prices (elimination of price controls)
   - Currency convertibility and removal of all major quantitative restrictions (QRs) on foreign trade; removal of external barriers to entry
   - Removal of internal barriers to entry (i.e. to developing and setting up new private enterprises)

(2) Second-stage institutional reforms (changes in existing institutions; privatization of state enterprises, reorganizing the state administration, reform of the tax system, financial system reform)

(3) Macroeconomic stabilization policies

Both liberalization and stabilization policies can be introduced immediately. Liberalization is equivalent to the removal of existing barriers. It is very easy in technical sense, even if not necessary easy in political