4
A Model of Institutional Change in Transition Economies

4.1 Introduction

In this chapter I will introduce a model of institutional change in transition economies, in which the behaviour of agents is affected not only by formal institutions such as new laws and organisations but also by social norms, those old values and habits which influence the shape of new institutions. The analysis is inserted within a political economy framework, where political preferences, social constraints and consensus as well as international conditionality matter. I will argue that institutional costs, which go beyond mere transaction costs, are emerging from the lack of consistency between formal and informal rules, and negatively affect economic performance (an extra cost of transaction). Among FCEs, an important example of this is given in what I call the ‘dichotomy thesis’. Adaptation and changes in the social behaviour of people are difficult and take time, as many surveys today show (New Russia Barometer, 2005; Levada Centre nationwide survey 2008).

4.2 Interaction and inconsistency between formal and informal institutions: the dichotomy thesis

In this section I will try to give a real representation of what has been stated theoretically in the previous chapter and I will show how an extra cost will emerge if formal and informal institutions are not consistent.

The transition from a planned economy to a market economy is not only an economic transformation but also involves the culture of capitalism, other values, different institutions, property rights, costs and time (Olson, 1996b). In fact, I would claim that at the heart of transition is institutional transformation. Capitalism is not only a different
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Q: Have you and your family already adapted to the changes that have happened in the country during the past ten years?

![Bar chart showing adaptation percentages over time](chart.png)

**Figure 4.1** Russia’s adaptation to transformation

*Source: Levada nationwide surveys, October 1998; March 2008*

system of allocating resources, it brings with it a ‘new style of life’ as well. During the transition, there is interaction between formal institutions, determined by the new system, and informal institutions of the old ethos, which are essentially determined by behaviour that is contingent on the past.

It could be argued that in FCEs the new formal rules are in conflict with the prevailing informal rules determined in the past. The discrepancy between formal and informal rules causes an increase in transaction costs. By contrast, if the formal change is in accordance with the informal rules, the transaction costs are lower and production will rise. The problem is that informal rules are not a policy variable. When there is no agreement between formal and informal rules, policy makers cannot directly change informal rules; however, they can directly influence the formal rules.

Hence, if any evolution towards new game rules takes place, it will be affected by the old behavioural norms and by previous rules and prevailing habits. In fact, the groups unwilling to change will try to protect their own interests by *rent-seeking* and *lobbying*. Thus, contrasting norms will cohabit and the transaction costs will be much higher than in one harmonious society, with consequent negative effects on economic performance.

We could have a society in which economic agents act in opposite directions because they use different and opposing goals and strategies to achieve their aims. Two different sets of norms can be identified. One