# ECONOMIC AND INSTITUTIONAL FUNDAMENTALS OF THE DIVERGENCE OF DEVELOPMENT PATHS IN CENTRAL AND EASTERN EUROPE

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***Abstract.*** *An analysis of the divergence of economic development paths of Eastern European countries (Poland, Hungary, Latvia, Lithuania, Czech Republic, Slovakia, Slovenia) that joined the EU in 2004 and of the European post-Soviet states (Ukraine, Russia, Belarus, Moldova) for the past twenty years with an emphasis on trade and financial openness is carried out in the article. A detailed description of institutional mechanisms and institutional changes in the economies of these two groups of countries is presented. In my opinion, in order to ensure a sustainable economic development and sustainable economic growth, the macroeconomic equilibrium has to be supplemented by the institutional equilibrium. The equilibrium criteria have to match the actual functions of the institutions, assigned to them by society, and contribute to the development of the whole society along with formation of the middle class.*

***Key words**: economic development, economic growth, institutional change, transition economy, Central and Eastern Europe*

## Introduction

The phenomenon of transition in postsocialist countries became one of the dominant events of the 90s of the 20th century in the world economy. Under certain circumstances it can be compared to the *economic miracle* that took place in the Western European countries and Japan in the 60s, and the emergence of new East Asian newly industrialized countries making a dizzying leap into the elite of the most developed countries in the 80s.

In fact, all of these phenomena in the world economy were accompanied by a transition from closed economies, focused solely on external relations with its political and military allies, to open economies which operate according to the world prices and use its comparative advantages effectively without excessive government intervention.

The irresistible striving of the Central and Eastern European nations to freedom, democracy, rapid integration into the civilized world, and rejection of their totalitarian past

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were accompanied by economic shocks caused by the reorientation of the economies into brand-new trading partners, skyrocketing energy prices, the lack of funds to keep unprofitable production going, entailing a corresponding decline in the gross domestic product and an extremely high inflation.

## Economic Development Paths of CEE Countries, 1991–2011

An almost 20 year-long experience of the economic development of Central and Eastern European postsocialist countries provides a possibility to draw some conclusions about successful and unsuccessful economic policies and conditions for a sustainable growth of living standards in these countries.

Let us begin with a brief overview of the main phases of reforming the administrative command economic system in Central and Eastern European countries. The first phase lasted from 1990 to 1994 and consisted in a rapid liberalization of commodity and currency markets while opening the economy to foreign goods and investors. In this first phase, two trajectories in the economic development of the Eastern European countries (Poland, Hungary, Latvia, Lithuania, Czech Republic, Slovakia, Slovenia) and European post-Soviet states (Ukraine, Russia, Belarus, Moldova, Georgia) may be observed. For instance, in the first group of countries the economic liberalization was carried out for almost all groups of products and all the markets, accompanied by creation of new effective market-friendly institutions. When it comes to the second group (post-Soviet states), liberal reforms culminated in an even greater imbalance of economy along with tight monetary policies and currency stabilization aiming at combating hyperinflation without creating market-friendly institutions, and were accompanied by a fall in gross domestic product.

The world experience of reforms in totalitarian societies was based on the process of economic liberalization, which is a necessary but not sufficient condition for successful development. In order to track the paths of economic transformation, one can analyze the World Bank research on the connection between the level of economic liberalization in a postsocialist country and its growth. This index is a weighted average of the liberalization of internal processes (price liberalization and prohibition of state trading monopolies), external ones (reduction of export controls and taxes, replacement of import quotas and high tariffs, and currency convertibility for current account operations), and the access of new companies to the market (privatization and private sector development). The weights of these three components are 0.3, 0.3, and 0.4, respectively.

The average index of liberalization in Ukraine in 1989–1995 was just over 2, while in Poland, Hungary, the Czech Republic it reached 7 and grew to 9 (out of 10) in 1995 versus the rate of 6 in Ukraine (World Bank, 1996).

As a result, in the abovementioned countries with the highest rates of liberalization, the growth rate of GDP reached 4.3% in 1994–1995 with an average annual inflation rate

of 18.7%. It was accompanied by a notable increase of services (by 12 percentage points in 1989–1994) and a falling share of industry and agriculture (by 12 p.p.) (IMF, 2012).

The main phases of the reform of the post-Soviet economies were as follows. The first liberal attempts led to a spontaneous transition from the *shortage economy,* which had been dominant in totalitarian societies, to the *consumption economy*, some kind of an on-demand economy with elements of overproduction, ending up in a distorted model of *common welfare economy* with huge social benefits for economically inactive population and hence large devaluations of not only the national currency, but even of the labour and production potential.

Starting at the end of 1994 and reviving in 1996, a new wave of liberalization was introduced, including the elements of a tight monetary stabilization. Thus, the Ukrainian government had to use the cure for economic crisis, proposed by the Keynesian school and the followers of Milton Friedman at the same time. All of these fragmentary reforms aiming at transition to a market economy ended up, leading to the lack of genuine market economy agents. This policy led to a greater dominance of old monopolies in the basic industries that received the power to set maximum prices and, consequently, to yield the highest incomes further invested mainly into foreign countries. At the same time, an excessive amount of small shopkeepers were excluded from the labour-intensive sectors, such as light industry, food industry, engineering, scientific and research institutions, etc.

The issue of restoring a positive GDP growth in Central and Eastern Europe was resolved within 3–4 years from the beginning of liberal reforms, with the exception of post-Soviet states. In my opinion, the first phase of reforms was associated with the structural adjustment of the financial and public sectors, as well as with achieving national currency convertibility for current transactions and a radical change of the direction and structure of export and import flows. These processes were accompanied by a decrease in industrial production, private and public consumption.

The rapid transition of the economy to world prices both in export–import operations and in the domestic market did not create suitable conditions for increasing the monopoly power of export-oriented companies and the formation of financial oligarchic structures; neither did it increase their impact on governance and its subordination to their interests.

Analysis of the economic development of postsocialist European countries shows the beginning of a new stage, the economic growth itself, in 1994–1995 when the GDP growth rose to the average of 4.7% per year until the world financial crisis in 2008 and resumed in 2009 (IMF, 2012). It should be noted that a new type of growth showed, differently from the socialist type based on a stable increase in the production of heavy industries, the lack of consumer goods, closedness to foreign markets, the inefficiency and high costs of economy.

Economic growth in Poland, Hungary, and the Baltics was carried out primarily due to the growth of private consumption, balance of the state budget, and a moderate devaluation of the national currency to maintain an effective external demand for domestic products.

Being closed to the outside world was the key principle of administrative and planning control in the socialist economy. The process of transforming the socialist economies started by the process of opening to trade with developed countries and liberalization of converting national currencies for current account transactions.

Liberalization, or decentralization, involves weakening of state control to overcome the state monopoly in the economy at the macro and micro levels. Another important external tool for the decentralization of transition economies and their macrostabilization is the liberalization of foreign trade as pointed by Blanchard (O. Blanchard, 1998). Indisputable benefits of its holding is that liberalized foreign trade restrains prices on imported goods, and hence inflation, raises living standards, stimulates foreign investment, and for the countries of Eastern and Central Europe also paves the way to the European Union. This package of measures includes the release of prices for most goods and services, the lifting of restrictions on the establishment of private companies, providing them the right way to the world markets, the transfer of power of the central government to local government authorities and the private sector. In Table 1, we present the dynamics of liberalization of the external market according to the methodology of the European Bank for Reconstruction and Development (EBRD, 2003). The success of a structural reform is evaluated on a point scale (the highest point means most succesful): 1, 2, 3, 4, and 4.3. Reforms in foreign trade and the liberalization of foreign exchange markets are evaluated by criteria associated with the level of quantitative and administrative restrictions on the export and import operations and the convertibility of the currency. The highest rates in this field (4+ or 4.3) mean the achievement of the standards and performance of advanced industrial countries, the removal of most tariff barriers, membership in the World Trade Organization.

Data of Table 1 show a very rapid trade liberalization in Central and Eastern European new member states of the European Union, unlike Ukraine and Russia where liberal reforms were slow and partial.

The reform of trade policy in countries with economies in transition was conducted in two different ways: as a fast liberalization of foreign trade or a gradual transformation in the field of foreign trade ("gradualism"). The countries of Central and Eastern Europe and the Baltic states selected the first fast track and the CIS countries the second. Synchronicity and the pace of trade liberalization are different in every country, but they all have introduced a unified exchange rate and a convertible currency, provided the private sector with full autonomy of operations in international markets and lifted export

TABLE 1. **Progress in liberalizing the foreign market in Central and Eastern Europe in 1995–2003**

| Countries | Liberalization index of foreign trade and foreign exchange market | |
|---|---|---|
| | 1995 | 2003 |
| Bulgaria | 4.0 | 4.3 |
| Hungary | 4.3 | 4.3 |
| Slovakia | 4.0 | 4.3 |
| Czech Republic | 4.0 | 4.3 |
| Poland | 4.0 | 4.3 |
| Romania | 4.0 | 4.0 |
| Estonia | 4.0 | 4.3 |
| Latvia | 4.0 | 4.3 |
| Lithuania | 4.0 | 4.3 |
| Croatia | 4.0 | 4.3 |
| Slovenia | 4.0 | 4.3 |
| Ukraine | 3.0 | 3.0 |
| Russia | 3.0 | 3.3 |

*Source*: Transition Report 2003, European Bank for Reconstruction and Development.

control. Besides, all of these countries have introduced new tariffs, the rules of customs duties, and protection procedures.

The CEE countries in their trade liberalization have passed three stages: the WTO membership in 1995, participation in the CEFTA, EFTA free trade zones, and accession in 2004 to the European Union, i.e. from unilateral liberalization to participation in multilateral regional integration associations.

Once governments in transition removed the protective shield that had protected domestic companies from international competition, they immediately felt pressure; from domestic producers. Not all governments have been able to resist this pressure, for example, the Polish government in 1992 increased tariffs on the import of agricultural products, and the Hungarian government increased the protective procedures. To some extent, the producer pressure on the government to strengthen protective measures is a positive sign. It indicates that the country has already moved towards a market economy, and domestic producers have felt the harsh conditions of international competition and become more sensitive to changes in world markets.

The countries that have chosen a different path of foreign trade reform – "gradualism" – failed to create conditions of genuine competition for domestic producers. The policy of the governments in these countries reflected negatively on exports: all countries – CIS members have a complex system of export licenses and registration, besides mandatory surrender of foreign currency proceeds and taxes on earnings in hard foreign

currency. All this leads to a lack of hard foreign currency in the country, and export transactions in foreign currency are reduced. This policy pays off in the early stages of stabilization programs when the purpose is to encourage domestic producers to use the national currency during internal operations. However, such a policy must be accompanied by the introduction of national convertible currency and shall be of a temporary nature.

The countries of the Central European region, which refused export restrictions and chose a liberal import regime, thereby affirmed their desire to join the European Economic Community and, to some extent, accelerated the integration process. For the further stage of economic reforms, important are liberalization of the import regime, setting the real exchange rate of the national currency, and the completion of the privatization process, i.e. the removal of import restrictions (within the safety of the national economy) and full support of the privatization process, the liberalization and stabilization of domestic prices, creating a competitive environment, weakening the power of the state monopoly by establishing common quality standards and new technologies. Thus, the foreign economic policy in transition countries should complement the internal policy, and vice versa. Only under these conditions rapid and positive results in economic transformation are possible.

TABLE 2. **The level of openness of the economy and the structural reorientation of foreign trade in Central and Eastern Europe, 1995–2010**

| Countries | Share of international trade in GDP, % (degree of openness of the economy) | | | Share of trade with nontransition economies,% of GDP | | |
|---|---|---|---|---|---|---|
| | 1995 | 2002 | 2010 | 1995 | 2002 | 2010 |
| Bulgaria | 80.6 | 82.1 | 81.0 | 65.4 | 76.4 | 72.5 |
| Hungary | 62.8 | 108.9 | 166.5 | 77.7 | 84.5 | 70.0 |
| Slovakia | 94.7 | 130.3 | 164.0 | 45.6 | 63.5 | 58.8 |
| Czech Republic | 89.4 | 113.2 | 132.5 | 68.1 | 80.7 | 73.0 |
| Poland | 40.0 | 40.5 | 85.7 | 82.3 | 81.3 | 74.3 |
| Romania | 49.0 | 66.9 | 53.2 | 88.8 | 84.0 | 66.1 |
| Estonia | 113.8 | 125.1 | 151.9 | 61.6 | 71.8 | 64.1 |
| Latvia | 75.1 | 78.5 | 109.0 | 49.5 | 67.7 | 47.8 |
| Lithuania | 98.6 | 97.2 | 138.2 | 43.0 | 61.5 | 46.0 |
| Croatia | 66.6 | 68.2 | 64.7 | 68.9 | 72.6 | 59.6 |
| Slovenia | 94.2 | 96.3 | 130.2 | 76.0 | 77.6 | 68.4 |
| Ukraine | 84.1 | 88.4 | 104.3 | 40.3 | 47.5 | 44.3 |
| Russia | 43.1 | 48.6 | 51.4 | 68.2 | 71.6 | 68.6 |

Source: Transition Report 2003, 2010 European Bank for Reconstruction and Development.

Overall, the analysis of external trade of transition countries in the CEE revealed the growth of openness of the economy and the share of trade with nontransition

economies (Table 2). In general, the CEE countries are small open economies with extremely high rates of dependence on foreign trade, the highest being in Slovakia, Hungary, the Czech Republic, and with very high dynamics, slightly lower in Poland and the Baltic states. Trade with nontransition economies changed in the shape of a parabola with a peak during the direct entry into the European Union, and the proportion of post-socialist countries began to increase, because incomes and, consequently, the amount of local markets in these countries increased significantly in 2004–2010. It should be noted that the external component (foreign trade, foreign investment, and association with world economic and financial institutions) is the key to achieving such a high rate of GDP growth. Uncompetitive production, weak financial and banking systems, and the lack of sufficient internal capital prompted the governments of postsocialist countries to pursue economic openness and rapid transformation. I would also like to note that the beginning of economic growth coincides with the accession of Poland, Hungary, and other Eastern European countries to the World Trade Organization (WTO) in 1995.

The fact that inflows of foreign capital played a decisive role in determining the structure and scope of national capital markets of CEE and 1.5–2 times higher than the rates of domestic savings is important for determining the direction of the impact of financial globalization and foreign capital inflows on the economic development of these countries.

For the whole sample of countries, financial globalization is strongly correlated with the inflow of foreign capital (a factor of 0.80); hence follow the importance of and the need to focus on the analysis of direct portfolio investments and loans invested in the country and not derived from it. Inflows of capital in all countries except Russia show that liabilities surpass assets; this leads to a negative international investment position of Central and Eastern Europe (See Table 3).

Most dependent on foreign capital are Bulgaria, Estonia, and Latvia. The dominant period in the growth of foreign capital inflows can be regarded to be 2006–2008 when the share of foreign capital in the CEE GDP grew on average 1.5–2 times versus the previous three-year period and accounted for 10–38% of GDP in these countries at the time of the global financial crisis of 2008.

Our analysis consisted of calculating the correlation matrix of the relationship between capital inflows and GDP growth and its components (public and private consumption, investment in fixed assets, exports and imports). We found a significant differentiation in the impact of the foreign capital on economic development in the EU and post-Soviet European countries.

TABLE 3. **Dynamics of foreign capital inflows to Central and Eastern Europe, 1994–2011**

| Countries | Indicators of inflow of foreign capital (average over three years, the share of GDP,%) | | | | | |
|---|---|---|---|---|---|---|
| | 1994–1996 | 1997–1999 | 2000–2002 | 2003–2005 | 2006–2008 | 2009–2011 |
| Albania | 0.01 | 0.05 | 0.07 | 0.06 | 0.11 | 0.12 |
| Belarus | 0.12 | 0.03 | 0.03 | 0.03 | 0.10 | 0.17 |
| Bulgaria | 0.06 | 0.08 | 0.08 | 0.17 | 0.38 | 0.03 |
| Czech Republic | 0.14 | 0.10 | 0.10 | 0.10 | 0.08 | 0.05 |
| Estonia | 0.12 | 0.18 | 0.13 | 0.25 | 0.27 | -0.03 |
| Hungary | 0.07 | 0.11 | 0.09 | 0.16 | 0.19 | 0.04 |
| Latvia | 0.16 | 0.13 | 0.14 | 0.23 | 0.35 | 0.00 |
| Lithuania | 0.10 | 0.12 | 0.07 | 0.12 | 0.19 | 0.02 |
| Moldova | 0.19 | 0.13 | 0.09 | 0.07 | 0.21 | 0.11 |
| Poland | -0.01 | 0.07 | 0.05 | 0.07 | 0.10 | 0.09 |
| Romania | 0.05 | 0.04 | 0.07 | 0.07 | 0.09 | 0.06 |
| Russia | 0.05 | 0.06 | -0.02 | 0.07 | 0.10 | 0.03 |
| Slovakia | 0.10 | 0.07 | 0.13 | 0.13 | 0.10 | 0.07 |
| Slovenia | 0.04 | 0.04 | 0.08 | 0.12 | 0.20 | 0.02 |
| Ukraine | 0.09 | 0.06 | 0.03 | 0.12 | 0.22 | 0.10 |

*Source:* author's calculations based on annual statistical reports of balance of payments of the central banks of the surveyed countries.

TABLE 4. **Relationship between the level of foreign capital inflows and GDP growth and its components (correlation matrix), 1994–2011**

| Variables | Total sample of countries | European Union countries | Post-Soviet European countries |
|---|---|---|---|
| Changes of GDP, % | 0.2269* (0.00) | 0.4340* (0.00) | –0.0806 (0.49) |
| Changes of government expenditures, % | 0.0044 (0.94) | 0.1018 (0.17) | –0.0278 (0.81) |
| Changes in investment in fixed capital, % | 0.1329* (0.02) | 0.2507* (0.00) | –0.0478 (0.68) |
| Changes in private consumption, % | 0.3017* (0.00) | 0.4555* (0.00) | 0.1191 (0.31) |
| Changes in export, % | 0.0230 (0.70) | 0.1159 (0.12) | -0.1231 (0.29) |
| Changes in import, % | 0.1536* (0.01) | 0.2304* (0.00) | 0.0176 (0.88) |

In parentheses presented is the *p* value for the correlation coefficient; *correlation coefficient significant at 5% level.
*Source*: author's calculations.

Capital inflows in the EU explain more than 40% of the overall rate of economic growth, but also positively affect the growth of private consumption, investment in fixed capital, growth of imports (Table 4). In the post-Soviet states, foreign capital doesn't affect economic growth and investment, essentially replacing exports of goods and services, but only promotes the growth of private consumption and imports. It should be noted that the relationship between financial globalization and economic development in post-Soviet countries in general is weak, although it has increased in the recent period due to a significant increase in the negative current account balance.

In the Ukrainian economy, in general, the monetary and financial stabilization achieved in 1995–1997 was not accompanied by radical changes in the structure of export–import operations, institutional reforms or restructuring of the productive apparatus. Therefore, in my opinion, a rather high level of openness of the economy of Ukraine did not create favourable conditions for its economic growth and caused a high vulnerability to external monetary and financial crises. Consequently, the growth of external debt is not conducive to investments in the real sector of the economy and its technological restructuring. The reverse situation occurred in more successful postsocialist economies of Central and Eastern Europe with the level of openness similar to that of the Ukrainian economy.

Thus, the process of economic growth based on external financial resources ensures structural changes in production and consumption. A detailed analysis of external trade and financial flows reveals certain positive signs of such a foreign policy. Firstly, a significant increase in the trade of investment goods creates conditions for the diffusion of high technology from the developed countries of the European Union. Secondly, the official reserves of the state are growing steadily as a basis for monetary and financial health of the economy and protection against external crises. Thirdly, the IMF loans have almost disappeared from the structure of external financing, while the proportion of private external debt, foreign direct investment, and portfolio investment has increased significantly.

All in all, a consistent liberal foreign policy may be considered to provide successful results only when based on economic restructuring accompanied by institutional reforms both in fiscal and industrial policy.

## Institutional changes: theoretical and empirical analysis

Interestingly the experience of institutional change in postsocialist countries of Central and Eastern Europe, held in a rather radical way and on a very large area, may be considered to be a kind of a socio-political experiment on the global level and regarded as a good example for analyzing the formation of an effective institutional framework in transition from one kind of political economy system to another.

The postsocialist countries of Central and Eastern Europe represent a specific example of institutional deformations bred by totalitarian and authoritarian systems with the communist ideology that devaluated the interests of an individual and limited their freedom. Institutional changes are complex and carried out at a different speed. The old rules of behaviour and limiting the economic development are being replaced by the new ones that would provide opportunities for prosperity. However, it is necessary to note that a sharp transformation of the institutional structure provides the opportunities to privilege certain social groups due to the growing asymmetry of information and the imperfection of the new institutions.

Recently, the scientific works of Douglas North, Dani Rodrik (North, 1990; Rodrik et al., 2002) and others have updated the research category of the institutional environment within the neoclassical economic theory as the mainstream of the modern economic science.

By the definition of Lance Davis and Douglas North, *institutional environment* is "a set of fundamental political, social and legal fundamental rules that govern economic and political activities (rules which control elections; property rights and contract rights are examples of such fundamental rules)" (Davis & North, 1970, p. 133) . Accordingly, society has a set of formal and informal rules that constrain and define the areas of behaviour of a certain institutional system. In my opinion, an institution is a set of certain rules of a socio-economic system, which reduce the uncertainty in the operation of the system and promote the welfare of society; formal and informal institutions that govern the behaviour of a family business, various market factors of production, government, banking and others; informal institutions that can be regarded as a set of specific values, motives, traditions, and customs.

I would like to note that the listed institutions, both formal and informal, which facilitate the effective functioning of economic processes and represent the social value and productive force in the socio-economic development, are a form social capital which complements and regulates the use of physical and human capital. The presence of social capital reduces the amount of transaction costs, and hence the number of services, by monitoring and controlling the behaviour of participants in the economic process.

The theory distinguishes between two types of institutional changes: induced and imposed ones. Induced institutional change is described as a modification or replacement of the existing institutional mechanism or the emergence of a new institutional mechanism voluntarily initiated, organized, and used by an individual or a group of individuals for new opportunities of a greater profitability. Imposed institutional changes, however, are introduced and provided by governmental regulations or laws. Induced or spontaneously initiated institutional changes must be justified by favourable revenue growth opportunities that cannot be achieved under the original institutional mechanism. An imposed

institutional change, however, can occur purely for the purpose of redistributing the existing income among different groups of constituents, although a voluntary change in institutional arrangement, especially a formal arrangement, often requires governmental actions to facilitate the process (Yifu Lin, 1989).

An institutional arrangement is chosen from a bunch of other possible arrangements if it is more efficient than the other ones, taking into account both production and transaction costs. Since the transaction costs of a particular arrangement depend on other arrangements (such as laws, customs, and ideologies), the most efficient institutional arrangement is a function of the other arrangements in the institutional structure. Yifu Lin emphasized that for "an induced institutional change to occur, there must be some profitable opportunities that arise from institutional disequilibrium; that is, there must be some reason why the existing institutional arrangement is no longer the most efficient one in the choice set"(Yifu Lin, 1989, p.14).

The institutional change in postsocialist countries of Central and Eastern Europe was in fact induced in the 80s and associated with a long-term economic stagnation, the lack of economic growth and total deficit in the consumer market, but it was also of an imposed kind, because the integration into the global financial economic institutions required a change in legislation, delivery and implementation of the liberalization processes into the social and economic life of a country.

All the above-mentioned factors enable a thorough analysis of an entire spectrum of changes in the institutional environment of countries representing about half a billion people, and these changes are quite revolutionary and differentiated region-wise.

A number of international organizations conduct systematic studies of the quality of institutions on a long-term basis, which enables including their results into a formal economic analysis. The most complete list of elements of the institutional environment is provided by the World Bank. The WB creates a database of worldwide governance indicators, referring to traditions and institutions that have authority in a country, particularly in the processes of selection, monitoring and replacement of the government, the ability of the government to effectively formulate and implement the right policies, and the respect for people and the state, for the institutions that manage economic and social interactions among them.

The first group of indicators includes political freedom and political stability, the second one shows the efficiency and quality of government regulatory activity, and the third group reveals the rule of law, which evaluates the quality of human rights, property, and the quality of justice, law enforcement, and control of corruption, also covering the evaluation of how the state power is used for private gain.

TABLE 5. **Institutional quality dynamics in Central and Eastern Europe**

| Countries | Government effectiveness | | | | Regulatory quality | | | |
|---|---|---|---|---|---|---|---|---|
| | Year | | | | Year | | | |
| | 1996 | 2000 | 2005 | 2011 | 1996 | 2000 | 2005 | 2011 |
| **CEE countries –EU members** | | | | | | | | |
| Czech Republic | 71.7 | 75.1 | 81.0 | 81.5 | 83.3 | 77.0 | 82.8 | 86.3 |
| Hungary | 78.5 | 81.0 | 75.6 | 73.0 | 76.0 | 81,9 | 82.4 | 81.5 |
| Latvia | 61.0 | 62.9 | 70.7 | 72.5 | 79.9 | 76.0 | 77.0 | 79.6 |
| Lithuania | 63.9 | 60.5 | 74.6 | 72.0 | 85.8 | 77.5 | 78.4 | 78.7 |
| Poland | 76.1 | 73.2 | 68.3 | 71.6 | 72.5 | 71.6 | 72.1 | 80.1 |
| Slovakia | 71.2 | 71.7 | 78.5 | 76.3 | 67.6 | 67.2 | 84.3 | 81.0 |
| Slovenia | 79.5 | 78.5 | 77.6 | 79.6 | 83.8 | 74.0 | 73.0 | 73.0 |
| **Post-Soviet European countries** | | | | | | | | |
| Belarus | 39.5 | 28.3 | 12.7 | 13.7 | 15.7 | 5.4 | 5.9 | 9.5 |
| Moldova | 41.5 | 30.7 | 26.3 | 33.6 | 52.9 | 38.2 | 35.8 | 51.2 |
| Russia | 32.7 | 26.3 | 38.0 | 42.2 | 38.7 | 29.9 | 50.0 | 38.9 |
| Ukraine | 23.4 | 23.4 | 33.2 | 21.8 | 38.2 | 28.9 | 33.8 | 31.8 |

*Source*: The Worldwide Governance indicators, available from: http://info.worldbank.org/wgi/

Analysis of the second group of indicators of institutional quality, which are necessary to ensure a successful economic development – the efficiency and quality of government regulatory activity – a shows significant differentiation of these indicators among postcommunist countries of Central and Eastern Europe (the measurement is based on the percentage rankings that determine the country's level of institutional quality environment, where the 1$^{st}$ place is 100%, i.e. the better the institutional environment, the higher percentile groups) (Kaufmann et al., 2010). Thus, the countries of Central Europe and the Baltics had the rank of around 70–80% in 2011 and have shown a stable dynamics of government efficiency improvement since 1996. The return dynamics was shown by Hungary and Poland. Among European CIS countries, in 2011, the lowest rate (9.5%) of regulatory quality was demonstrated by Belarus, 31.8% by Ukraine, and 38.9% by Russia. The main feature of these countries is the virtual absence of the dynamics of these indicators, which means that institutional reforms have not been implemented while the social and economic institutions are degrading and dysfunctional.

I shall try to analyze the nature of institutional deformations in post-Soviet countries, especially in Ukraine and Russia, in the context of economic development.

In a totalitarian society, everyone wants to get things without complying with the Pareto optimum. The state has always been the main agent, and citizens of the post-Soviet countries ended up acting just like the predatory state in the administrative system used to act for decades. Business leaders have mastered this technology and proceeded with

economic activity in a relevant way without paying for electricity and gas, without paying any wages at all or paying very low wages, without paying state taxes. The process of assigning common achievements to a single individual increased income differentials, violated the intellectual property rights, and blurred the motivation for creating effective high-quality human capital. Without an effective institutional framework, human capital externalities are out of reach of its owners and end up misappropriated by managers and proprietors, and therefore society suffers losses. Incentives for the development and shaping of a qualified human capital are gradually disappearing through the understanding of its carriers that their efforts shall be misappropriated for free by the more politically and administratively influential market participants.

Owning financial sources, the state can easily influence the course of events in the industry. Budget funds are only enough to provide political support. Markets of productive factors are disintegrated and inefficient. One market may dominate over another. Society is divided into segments which do not interact with each other. All the above factors further lead to a total chaos in the process of state building. The current economic system is random, inexplicable, unpredictable, and people do not want to dare to something they do not know, so reforms are tight.

Unfortunately, post-Soviet formal state structures behave as commercial through holding a huge commercial power without fulfilling coordination functions. On the one hand, there is no controlling party; on the other hand, there is no social contract between the government and the people it governs. The problem is not the legal enforcement of business contracts, but the enforcement of obligations and functions of regulatory state institutions. There is an interesting assumption that the centralized distribution system is much less expensive than the present market system of distribution, which is unreliable without a high level of confidence. It is necessary to create favourable conditions for successful economic development instead of enriching its agents (distribution systems). Supposedly, independent contemporary private companies and firms grew into appendages to large monopolistic structures rather than being independent structures operating with the maximum efficiency. They seem to be in servant positions sponsored by various benefits, loans, subsidies by the state and possessing the ability to exploit inflation instead of acting as independent agents.

Social capabilities are very retarded because the creation of the middle class stopped, pettiness overcomes society, and old political elite begins to reap economic benefits: profits, dividends on shares, and the distribution of budget funds for their own purposes. The policy of elimination of the middle class does not provide incentives for technological innovation.

Paradoxically, the collectivistic ideas that had prevailed in society were rapidly replaced by aggressive, selfish individualism, distrust of everyone and everything along

with the hope for oneself only. Thus, spillovers and rising returns from high-level education in schools disappeared.

The lack of any filters and sufficiently clear and effectively controlled criteria leads to the lack of meaningful actions in the general social context and causes the weakness or, generally, the lack of professionalism, consistency, experience and persistent changes in the form of the institutions rather than the content.

In general, governmental policy is necessary to achieve successful structural changes. The redistribution policy is necessary to raise the technological level of industry. The classical scheme of the development of primary industries leads to monopolistic industry, the economy that creates growth based on high levels of capital. Liberal market mechanisms with a strong camaraderie and without constraints and the necessary financial consolidation lead to monopolization and a greater income differentiation. Disequilibrium in the labour markets and capital occur due to such institutional component as directors of enterprises that have more freedom as compared with the Soviet period. Thus, the deformation of these markets deepens aggressively and uncontrollably in order for the enterprises to obtain profits and create oligarchic structures in the industrial, banking, and political environment (financial and political oligarchy). Simeon Djankov, Edward Glaeser, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer have argued that the institutions' function is to control the twin dangers of dictatorship and disorder, and analyzed the functioning of society through the Institutional Possibility Frontier (IPF). Disorder, in this framework, is also reflected in private subversions of public institutions, such as courts, through bribes and threats, which allow private violators to escape penalties. By dictatorship these authors mean the risk to individuals and their property that can be expropriated by the state in the form of murder, taxation or violation of property (Djankov et al., 2003, p. 598–600).

The second variant of dictatorship, in my opinion, seems to have lately become the prevailing institutional framework of economic development in post-Soviet countries. The monetary and financial crisis of 1998 in Russia and Ukraine and their absence in the first group of countries deepened the divergence of the above-mentioned trajectories. The depreciation shock in the post-Soviet countries led to the resumption of economic growth along with the further dominance of monopolies in basic industries, setting maximum prices and, consequently, getting the highest incomes, mainly from investments in foreign countries.

The global financial crisis of 2008 showed these disparities in the development of most affected post-Soviet countries as compared with the moderate negative effects of the crisis on the economic development of the Eastern European countries that joined the European Union.

The collision of reforms in Ukraine was caused by the numerous factors that must be recognized and disclosed for the system of economic management so that it could become

effective and reach the expected goal. Unfortunately, the realities of today show that the situation has long gone out of control, or perhaps simply cannot be regulated. Purely controversial motives cause a clash of interests of sides fighting for the spheres of influence. If there is no effective buffer, or even feedback to some extent, the pressure on the government, on the political and economic forces to implement the redistribution of wealth and not to create new incentives and motivation for productive labour gradually disappears as a result of the inert economic activity in Ukraine. What we actually see is the reduction of the necessary liabilities and feedback accompanied with an increase of entropy and a certain inertia of the economic system, all presumably caused by partial liberalization.

Therefore, nowadays the Ukrainian economy is in a vicious circle of development when twenty years' efforts failed to meet the desired expectations. This situation does not mean, however, that there is no chance for a successful application of modern macro- and micro-regulators that should provide for an effective national system of European-type economic governance with an internal logic and integrity based on the realization and protection of national economic interests. The main goal of the economic elite of the states serving the interests of the whole society is to leverage the knowledge of proven incentive and regulative instruments of the economic system and, most importantly, the ability to apply them in time and to hold the trust of the people.

Another important conclusion thet can be drawn from the analysis of reforming post-totalitarian states is as follows: when the national cultural and ethnic spirit permeates the creation of private property institutions, relations among employers, trade unions, and the government, the formation of the state elite (Czech Republic, Poland, Slovakia, Slovenia, Hungary, and even Japan, Germany in the past), a stable macroeconomic environment, the economic growth and investment rates are quite high.

The world economic history shows that since the era of liberalism no country has actually ensured a successful construction of the nation state while the national economy would be under the rule of liberalism. Only strict protectionism, state monopoly and control contributed to the consolidation of society and economic growth. Friedrich List also added the need of national unity in the country, priority development of education, culture, army, and police to the list of necessary tools. He argued that the "prosperity of a nation is not, as [J.B.] Say believes, greater in the proportion in which it has amassed more wealth (i.e. values of exchange), but in the proportion in which it has more developed its powers of production. Although laws and public institutions do not produce immediate values, they nevertheless produce productive powers…. The nation must sacrifice and give up a measure of material property in order to gain culture, skill, and powers of united production" (List, 1856, p. 219–220) .

Liberalism in the economic sphere generates a monopoly in autocratic political power. The problem of democracy lies not only in its political and economic sense. Members

of society should have equal access to the market in order to be able to implement entrepreneurial abilities. The hypertrophic number of ordinary trading and financial intermediaries poses a threat due to the growing magnitude of transaction costs and the reduction of technological innovations in the real economy.

## Conclusions

In the unsuccessful trajectory of post-Soviet countries, democratic institutions are being used for parasitic purposes, which means that investments into political activity provide substantial economic benefits to its investors rather than to citizens who elect investors of public institutions. Informal constraints (defined by Douglass North) are stronger than the formal ones. General economic proportions remain the same as back in Soviet times. There was no resistance to the dependence that had been created in the past and is so powerful with the support of political elites. In the times of crisis, the interest to the institutional component of economic processes increases significantly, as it has recently become the dominant feature of the functioning of the world economy, particularly in the industrialized countries.

The level of economic development, which is directly correlated with indicators of the quality of the institutional environment and vulnerability to the external financial and economic shocks, increases with stable long-term deformations of the institutional environment.

In my opinion, in order to ensure sustainable economic development and sustainable economic growth, the macroeconomic equilibrium should be supplemented with the institutional equilibrium. The equilibrium criteria must match the actual functions of institutions, assigned to them by society, and contribute to the development of the whole society along with formation of the middle class. There is an institutional divergence rather than convergence between the countries of Central and Eastern Europe that joined the European Union and the European states of the Commonwealth of Independent States.

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