THESIS SUMMARY

Judit Kozenkow

Transition, institutions and economic growth

The role of institutions in the economic performance of Poland and Hungary from 1990 to 2010

Ph.D. dissertation

Advisor:

István Benczes, Dr. habil.
associate professor

Budapest, 2011
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1. Introduction and hypotheses

The processes of transition from a socialist to a capitalist system have occurred in the economic, political and social dimensions of the countries belonging to the Soviet block until 1989/91. Transformation from central planning to market economy, expansion of private property through privatization and emergence of democracy with civil rights instead of dictatorship haven’t finished in the post-Soviet countries yet but did end in the Central and Eastern European region with the EU accessions in 2004 and 2007.

During both the quantitative and qualitative processes of transition – the initial and overall transformational recession (Kornai 1993) with decline in output, employment, income and living standards; as well as inevitable structural changes and institution-building – each country has selected its own methods and transformation paths. Consequently, the diversity has led to different economic performances. Researchers dealing with transition countries such as Cernat (2006), Havrylyshyn (2006) or Csaba (2009) apply different aspects and indexes to categorize and compare economic performances of the countries. Several countries swing between categories making it hard to decide on their real performances. Apparently similar, often jointly mentioned economies can show differences. Consequently, we are formulating the following question:

*How can we explain better and deeper the differences among the economic performances of transition countries?*

In order to answer this question we compare Poland and Hungary. The selected two countries were featured in the same above mentioned categories. Both of them had similar characteristics at the end of the socialist era according to the report of the European Bank for Reconstruction and Development (1999). In addition they were the most frequent examples of successful transition in the 1990’s. However differences can be observed between the economic growth rates and between growth trends in the long run (from the beginning of the transition to 2010). Poland has had constantly good performance while Hungary has provided varying performance.

While explaining in depth the similarities in economic performances between Poland and Hungary the specific determinant factors of the differences of the two countries could be more emphasized. Similarities manifest frequently in quantitative indexes and enable us to
concentrate on factors that are ignored by the mainstream neoclassical economics or by the growth theories based on neoclassical theses. Based on the similarities between the two countries and being aware of the divergent economic performances we can specify and narrow our earlier formulated research question:

What causes the difference between the Polish and Hungarian economic performance? What are the determinants of the economic growth in the two countries?

Studies on transition of the 1990’s were based almost entirely on grounds and methods of the neoclassical economics and applied its quantitative approach. Most prominent of all are the work of de Melo et al. (1996) titled „From Plan to Market” which analyzed the relations among economic growth, inflation and liberalization as well as the study of Fischer et al. (1998) which explained the economic growth with austere fiscal policies, fixed exchange rate regime and mostly with complex structural reforms. Fischer – Sahay (2000) attributed the economic growth of initial years to the years under socialism and the development of human capital while they identified the dominant role of stabilization and structural policies in the long-term economic growth.

All the above studies and later works based on quantitative approach have described Poland and Hungary as similar post-socialist countries. The applied traditional quantitative indexes – such as general government balance, general government debt, inflation, unemployment or GDP growth rate – have provided least credible and reliable picture about the transition countries. Based on these problems the relevance of the neoclassical economics in studying transition was severely queried by the end of the 1990’s. (Csaba 2002)

With the appearance of new theories and empirical works from the 1970’s institutions have become more and more important in explaining economic growth. Analyses emphasizing institutional factors and concentrating on transition countries have started with the reports of the European Bank for Reconstruction and Development. Transition Reports are published annually and describe the changes of the institutional quality (with a special economic focus) of 29 transition countries. Among the authors covering transitional topics Havrylyshyn presents evidences that besides macroeconomic policies and structural reforms the level of institutional quality has significant effect on economic performance. (Havrylyshyn – van Rooden 2003, Havrylyshyn 2006) Others like Bönker (2006), Cernat (2006), Opper (2004), Pejovich (2003) and Roland (2000) integrate formal institutional variables into their analysis to explain more comprehensively the economic performances of the transition countries.
Bönker examines the path of fiscal reforms of the Czech Republic, Poland and Hungary until joining the European Union. Cernat analyzes the effects of the following institutional variables on economic growth in Central and Eastern Europe applying regression analysis: labor market positions, development of bank sector and level of state intervention. Opper studies the effects of property rights on growth through the processes and mechanisms of privatization. Pejovich fundamentally observes the guarantee of property rights, contract enforcement, independent legal conditions and constitutions but also integrates individual behaviors and norms. All of the above mentioned studies prove the significant effect of the applied formal institutional variables on growth. However we cannot find evidences of the effects of informal institutions on the macro level regarding transition countries except the evolutionary results of Pejovich.

Based on previous studies on transition and on the growing literature of institutional variables we formulate the following hypothesis and three subhypotheses:

**The different economic performance of Poland and Hungary is due to the different institutional characteristics.**

a) **There is no significant difference between the Polish and Hungarian economic institutions so these factors do not explain the differences in performance.**

b) **The different economic performances originate in the diverse political institutions.**

c) **The differences of the informal institutions have decisive role in the economic performance of the two countries.**
2. Methodology

We started to test our hypotheses with reviewing the neoclassical economic explanations of economic growth (from the fundamental Solow-model to the endogenous growth theories) and the critics on their deficiencies. Following the criticism from the 1970’s new or renewed theories have expanded the narrow theoretical framework of mainstream economics and they have slowly integrated the institutions into the theoretical models as direct and indirect explaining variables of economic growth. The review of the theoretical literature on growth concluded that comprehensive and deep explanation of economic performance needed the integration of institutions into the analytical framework.

Only the new institutional economics (NIE) provides complex and detailed studies on institutions. Related to the mainstream, NIE has several new remarks and findings. It emphasizes the institutional and cultural factors that can not be found in mainstream economic theory. Its analysis is openly interdisciplinary, recognizing insights from politics, sociology, psychology and other sciences as well as extensively using historical and comparative empirical material regarding socio-economic institutions. There is no recourse to the model of the rational, utility-maximizing agent. Its explanations are based on individual decision making (methodological individualism) when individuals seek their own interests (opportunism) and maximize utility within constraints established by the existing organizational structure. Individuals have only limited ability to acquire and process information (bounded rationality). Mathematical and statistical techniques are recognized as the servants, rather than the essence, of economic theory. Furthermore, the analysis does not start by building mathematical models: it starts from stylized facts and theoretical conjectures concerning causal mechanisms. Finally, instead of standard neoclassical theoretical models (moving from a universal framework concerning rational choice and behavior directly to theories of price or economic welfare) institutional economics moves from the abstract to the concrete by stressing the need to show how specific groups of common habits are embedded in and reinforced by specific social institutions. The new institutional economics is an evolutionary theory that is built from an applied perspective and provides an open-minded, heterogeneous (including in-depth case studies, historical analysis, econometric tests, experiments, modeling and so forth) economic analysis.

The new institutional economics has provided robust empirical evidences on the direct and indirect effects of formal and informal institutions on economic growth. Regarding formal
institutions the works of Acemoglu (2005), Alesina (2004), Barro (1996), Clague (1997), Mauro (1995) and Lane – Tornell (1999) could be highlighted. Regarding informal institutions Boettke et al. (2008), Knack – Keefer (1997), Pejovich (2003), Tabellini (2005) and Williamson (2009) are the most influential ones. Consequently, we found the new institutional economics appropriate for analyzing the institutional transformation in the economic, political and social dimensions of transition. It provided proper theoretical and methodological basis for examining Poland and Hungary.

We also applied the findings of comparative economics. Due to its interdisciplinary approach it does not ignore the institutions and provides appropriate basis for the comparative analysis of economic systems. Furthermore some analytical tools of econometrics and statistics namely correlation, average and trend calculation were used. Qualitative, dynamic and deductive approach was applied in our case studies.

In the hypotheses the dependent variable was the Polish and the Hungarian economic performance. We measured it with the real GDP growth rate. The independent variables were the institutions which are “the rules of the game in a society or more formally, are the humanly devised constraints that shape human interactions.” (North 1990, p. 3) We examined three main independent variables namely the political institutions, economic institutions (together called formal institutions) and informal institutions. We accepted the joint effects of formal and informal institutions on economic performance as well as their feedback based on the models of Williamson (2000), Acemoglu et al. (2004) and Alston (2010). Figure 1. shows the applied concept for our empirical work.

Figure 1: Relationship between institutions and economic performance

Source: own figure
In the course of our research we were doing secondary analysis of statistical data. We collected data with non-probability sampling, expert selection. We used the following databases and data sources for measuring the GDP, formal and informal institutions: International Monetary Fund – World Economic Outlook Database 2011; Heritage Foundation – Index of Economic Freedom; Worldwide Governance Indicators – rule of law, government efficiency, political stability; Freedom House – electoral process; our own index using data from the European Values Study. We analyzed within the time period of 1990 to 2010.
3. Results of the thesis

After defining the theoretical framework our empirical study focused on the description of the Polish and Hungarian institutional characteristics as well as on the identification of their specific differences. Our findings are based on the institutional reforms under socialism, main macroeconomic indexes, political and economic processes from 1990 to 2010 and public survey data.

3.1 Institutional characteristics of Poland

In the case of Poland we stated that the development in the economic dimension, especially the reforms launched by the first finance minister Balcerowicz and maintained consistently until the millennium, resulted in stable economic institutions. Regarding property rights the early introduction and success of small scale privatization led to a dynamic expansion of the private sector. Progress in large scale privatization had been more erratic therefore 50 percent of the Polish large enterprises were still state properties in 2010. The development of the financial system started with the establishment of a two-tier banking system before the transition. Later on with consistent state presence a huge progress was made by applying the international ruling standards and establishing effective supervisory authorities. As a result of stabilization, liberalization, privatization and later reforms of the tax system the Polish fiscal control over economic processes was continuously declining. Despite political debates and government changes the fiscal control was executed consistently in the first decade of the transition. The implementation of reforms in the next ten years advanced much slower and the increase in the budget deficit also caused problems. Monetary control in the first decade aimed to decrease inflation consistently and later to maintain its reached low level. Monetary policy framework consisted of an independent central bank and a monetary council as well as floating exchange rate regime.

Regarding the Polish political institutions we stated that the rule of law was established through fundamental democratic institutions within the framework of a semi-presidential system created by compromises at the early roundtable negotiations and enforced by the constitution of 1997. In Poland presidential elections were held every five years and the two chambers of the National Assembly were elected in every four years based on a proportional electoral system. This electoral system enabled multi-party representation which led to a high number of parties in legislature and multi-party coalitions in the early years. Over the years
several modifications in the electoral law contributed to the consolidation of political relations. Executive power was exercised by the President and the Council of Ministers. In the first decade after the transition the average tenure of the governments was less than one and a half year. In the second decade the situation consolidated but frequent changes of governments still characterized the political sphere. Once, early parliamentary elections were needed. Conflicts between the president and government set significant brakes in decision-making but the implementation of the macroeconomic reforms was executed continuously throughout the examined period – independently from the ongoing political debates.

Polish informal institutions were found to have been strong. Social values that have direct positive effect on economic growth such as freedom of choice and control over one’s life even more tolerance and respect showed high levels of presence while the level of trust was low in the Polish society. Obedience has negative effect on growth but this value proved to be at a low level during the 20 years. Informal institutions having indirect effect such as justification of norms were found to have been at high levels. However Poles showed a low level of interest in politics and elections. The society supported the shock therapy of Balcerowicz at the time of transition but soon they turned to prefer a gradualist approach instead.

3.2 Institutional characteristics of Hungary

In the case of Hungary we stated that the transformation of property rights had already started in 1968 but the essential progress in the expansion of private sector proved to have been the instant large scale privatization after transition. Small scale privatization was launched later but was finalized quickly - before the end of the 1990’s. The evolution of financial markets began with the establishment of a two-tier banking system under the socialist era. Later it improved constantly through effective regulation and implementation of the Western standards. Privatization in the banking sector finished relatively soon with the appearance of non-banking financial institutions after the year 2000. The Hungarian fiscal control was strongly linked to the electoral cycles and reflected the interest and will of the actual governments. The state intervened deeply and comprehensively in the economic processes. This fact made the fiscal policy (and the general government balance) a strong influencing power in economic performance. Monetary control including an independent central bank and a monetary council aimed primarily at inflation targeting but in the 2000’s it could be described with mainly inconsistent steps. The introduction of a floating exchange rate regime occurred relatively late, in 2008.
In the political institutional system of Hungary the rule of law was implemented by the formal legal frames of democracy in the early years of transition. The foundations of the Hungarian parliamentary republic were based on the modified constitution dated back to 1949. The mixed electoral system based on the German model was not modified during the 20 years. It provided advantage to the bigger parties and biased in favor of the winner. The executive power had a strong constitutional position. Almost all governments endured the electoral cycles and there was no need for early elections. However governments were rearranged a couple of times in the 2000’s. The decisions on macroeconomic policy of the governments, especially the fiscal steps, had a dominant influence on the economic performance of the country during a given electoral cycle.

We found that the Hungarian informal institutions were relatively strong. Social values with direct positive effect on economic growth such as freedom of choice and control over one’s life as well as tolerance and respect showed moderately high levels of presence while the level of trust was low in the Hungarian society. Obedience has negative effect on growth but this value proved to have been at a low level during those 20 years. Informal institutions having indirect effect such as justification of norms were found to have been at high levels. Voter turnouts in elections were relatively high, however Hungarians had a low level of interest in politics. The Hungarian society had a continuous preference of gradualism throughout the 20 years.

### 3.3 Comparative analysis of Poland and Hungary

After analyzing Poland and Hungary one by one in details we made a comparison between the two countries based on their macroeconomic indexes and described institutional characteristics in order to identify the determinants of the different economic performances. Macroeconomic performances of the two countries between 1990 and 2010 had similarities in:

- relatively high level of average economic growth in the 1990’s
- decline of inflation and unemployment rates in the 1990’s
- continuous inflow of FDI during the entire period.

Differences were significant in the fiscal performances and in all the examined macroeconomic indexes after 2000. Poland performed better in every respect. We found fiscal and structural differences between the two countries and these findings were supported by the comparative analysis of institutional factors as well.
Regarding economic institutions we stated that Poland and Hungary were similar regarding the system of property rights and financial markets. During the examined period we found differences in the fiscal and to a lesser extent in the monetary control. We adjudged the quality of all the institutional factors good and strong in Poland. We identified the quality of institutions in Hungary good and effective except the fiscal control which we considered weak.

We identified essential differences in the political institutions of the two countries. The legal framework, electoral system and executive power were found to have been different. Considering the evolution of the quality of institutions during the 20 years we stated that the rule of law while enforced effectively had different foundations in the two countries. The electoral system did not change in Hungary while the modifications in Poland led to improvements in the political conditions. The executive power was found weak in both countries but due to different reasons. In Poland the limited constitutional power of the governments was further weakened by the frequent changes in government as a result of the fragmented party structure but these conditions did not show up in macroeconomic policy-making which was consistent throughout the period. Concerning Hungary the strong constitutional position of the executive branch and the stable electoral cycles coupled with inconsistent policy-making.

Regarding informal institutions in Poland and Hungary we stated a few minor differences in the level of tolerance and respect as well as in voter turnouts. The former had higher level in Poland while the latter was higher in Hungary. We adjudged the informal institutions strong in both countries. We found differences in emergence: in Poland they had stronger influence due to the lower level of state intervention while in Hungary they were overshadowed by the influence of the executive power in economic performance.

We reinforced our statements with a brief quantitative analysis. Regarding formal institutions we applied correlation and found out that in Poland neither of the institutional variables showed strong correlation with the real GDP growth rate. In Hungary freedom of property rights, quality of electoral process and quality of executive power (measured by political stability and government efficiency) had strong positive relations with economic growth. We could not define the relationship between informal institutions and economic growth using econometrics due to the lack of time series in data but we created an index measuring the average quality of informal institutions. This index proved the insignificant difference we found during the qualitative analysis between the two countries.
In conclusion we stated that in Hungary the executive power played a dominant role in the economic processes and putting both the economic and informal institutions in the background determined the economic performance of the country from 1990 to 2010. In Poland the better economic performance was determined by reliable and consistent economic institutions and strong informal institutions during the same period.

3.4 Summary of the results

The three empirical chapters of the thesis together served to test our hypotheses and to decide whether they are true or false. Applying the theoretical and methodological foundations of new institutional economics we regarded institutions as determinants of economic performance. With the detailed analysis of the Polish and Hungarian economic, political (together called formal) and informal institutions as well as by their comparison we identified several differences between the two countries. These facts served as evidences to verify our main hypothesis namely the different economic performance of Poland and Hungary is due to the different institutional characteristics.

Regarding the three subhypotheses:

- We confirm that the different economic performances of Poland and Hungary primarily originated in the diverse political institutions. We found the main differences in the political institutions. In the case of Hungary it was the main determinant factor (executive power) as well.

- We confirm the hypothesis about economic institutions with the complement that fiscal control was found to have been different among the institutions and this factor influenced the differences of the economic performances. The Hungarian fiscal control through the dominance of the executive power played a significant role in the economic performance while in Poland the stable and effective economic institutions altogether were proved to have been determinant factors.

- We reject the third subhypothesis that the differences of the informal institutions did have decisive role in the economic performance of the two countries. We could not find significant differences between the countries. The only differences we identified are that the Polish institutions had stronger influence on growth due to the relatively independent functioning of the economic system while the executive power overshadowed the effects of the Hungarian informal institutions.
Based on the verification and rejection of our hypotheses we describe the relations and connections between formal and informal institutions as well as their channels and mechanisms as further potential research topics. We also express the importance of deeper theoretical and empirical research in the field of informal institutions and their role in economic performance.

The novelty of the thesis manifested in the joint study of formal and informal institutions to explain the economic performance of Poland and Hungary. Institutional factors proved to be appropriate in describing the long term economic performance in the transition countries where the quantitative approach and assumptions of the neoclassical economics has limitations. Our thesis is unique in the sense that based on the long term economic performances it compared along the formal and informal institutions two countries that were successful in the early years of transition. The comparison of the stable economic performance of Poland and the volatile performance of Hungary emphasized the role of such factors that could support better economic performance or sustain the existing one in case policy-makers pay more attention to them in the future.
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5. Related publications of the author

**Book chapter:**


**Peer-reviewed journal:**


**Other journal:**