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Jacek Rostowski

Institutional Transplants in the Transformation of Poland's Economy and Polity

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Abstract

The collapse of communism faced Poland and other former Soviet bloc countries with the need for a massive "institutional refit", as regards both economic and political institutions. This paper describes where some of the key new institutions were derived from (either in the form of transplants from other countries, revivals of pre-communist domestic institutions or completely new local "institutional innovations"), and proposes some tentative views as to *why* the particular developments we observe took place, and whether they corresponded to needs at the time. In the case of transplants, we attempt to explain why these were copied from one particular country rather than from others.

Introduction

Why different economies grow at different rates is one of the most important questions in economics. Barro's (1991) classical paper on economic growth across the world introduced dummies for sub-Saharan Africa and Latin America, and found that their coefficients were significant, but did not explain why this was the case. Many empirical studies show that so-called 'total factor productivity' accounts for most of the observed cross-country variations in income levels, yet, although it may well be more important than the accumulation of capital, population growth and even educational improvement, productivity is "the unexplained part of economic growth" (Easterly and Levine, 2002).

One of the reasons for the presence of this "residual" in cross-country comparisons may be that the neoclassical framework ignores institutions, "the humanly devised constraints that structure political, economic and social interaction". These include both "informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights)" (North 1991). Institutions are usually *stable* over time and they have a lasting effect that may explain the long-run persistence of discrepancies in economic performance. Two ways in which the impact of institutions on growth can be introduced into standard models of economic growth are presented in the Appendix.

The collapse of communism faced Poland and other former Soviet bloc countries with the need for a massive "institutional refit", as the institutions that existed under communism were naturally largely unsuitable for needs of a market economy. It is the purpose of this paper to describe where these institutions were derived from (either in the form of transplants from other countries, revivals of pre-communist domestic institutions or local "institutional innovations") and to propose some tentative views as to why the particular developments we observe took place, and to what extent they corresponded to needs at the time. In the case of transplants, one of the interesting questions is why they were copied from a particular country rather than from others.

1. Previous research on the economic importance of institutions and institutional transplants

Hayek (1960) argued that the common law is superior to the civil law in its economic effects, not so much because of substantively different legal rules, but because of their differing assumptions about the rights of the individual and the state, which go back to the philosophical writings of Locke and Hume on the one hand and Rousseau on the other. According to Posner, the efficiency of common law is due to the ability of judges to adapt old rules and create new ones suitable for new and difficult to predict circumstances.

La Porta, Lopez-de-Silanes, Shleifer and Vishny (1997) found that "countries with poorer investor protections, measured by both character of legal rules and the quality of law enforcement, have smaller and narrower capital markets." Countries belonging to the "French civil law school" (a subset of all civil law countries) have the weakest investor protection and the least developed financial systems. "Common law" countries tend to have the opposite characteristics. La Porta et al. (2004) find that, thanks to greater judicial independence, common law countries have more "economic freedom" (i.e. protection of property and contract rights) than others. They also point to the findings by King and Levine (1993) and subsequent authors indicating that financial development promotes economic growth.

Furthermore, Levine, Loayza and Beck (2000) found that, when they use legal school as an instrument for financial sector development, this *instrumented financial development* has a large and significant impact on economic growth over the 1960-95 period. Finally, Rostowski and Stasescu (2006) found that although legal school does not have a significant impact on growth, former British colonies grow significantly (and a lot) faster than former French colonies in the post-independence period. Thus there is both theoretical and empirical work suggesting that, when institutions are transplanted, it matters which country or countries they are transplanted from.

2. Historical background

In 1989 Poland and other former Soviet bloc states faced several key tasks. The two most pressing were, first, to restore macroeconomic stability and, second, to privatise state assets, which constituted the vast bulk of the productive capital of the economy. A third, less immediately obvious task, was to create the laws and accompanying institutions of enforcement that would sustain a macro-economically stable market economy that would generate sufficiently high levels of economic growth to allow the country to make up for the lost years of communism, by catching up with Western Europe.[1]

The three tasks were closely intertwined. Inflationary pressure stemmed primarily from the existence of absolute full employment under communism. Under absolute full employment both "vertical" and "upward sloping" models of the Phillips curve lead to explosively spiralling prices (Rostowski 1998a). This pressure had been restrained through administrative price controls, which over the years had led to massive misallocation of resources at the micro-economic level and to generalised shortages (often called "suppressed inflation"). At the same time, wage pressure from the fully employed workers, was restrained by the banning of trade unions and the repression of strikes by secret police action. When strikes were allowed, as during the so-called "Solidarity period" of 1980-1, while prices continued to be set centrally, shortages spiralled out of control.

Markets cannot work without free prices, but free prices combined with absolute full employment can only lead to hyperinflation. Yet under conditions of hyperinflation it is also the case that prices cannot efficiently perform their function as signals of relative scarcity. Agents cannot be sure to what extent a given price change reflects the general movement in prices and to what extent it reflects changes in demand for or supply of the good in question. Thus absolute full employment had to be abolished for the market to begin to function in Poland.

It was unclear to what extent managers of un-privatised state enterprises would be willing to sack employees, bringing us back to the question of privatisation. Yet many methods of privatisation were themselves unlikely to be possible unless the value of privatised enterprises could be realistically assessed. This in turn required market clearing (i.e. free) yet stable prices (i.e. the mastering of high inflation).

Moreover, state ownership of enterprises was not the only potential problem faced in attempting to end absolute full employment. For enterprises to sack workers it was likely that they needed to be subject to bankruptcy if they failed to meet their financial obligations. Yet most post-communist states had no bankruptcy law, and those that did had ones that left much to be desired, bringing us back to the need for new legal rules and their effective enforcement. Indeed, even if an efficient bankruptcy law existed, what good would it do if their were no mechanism to ensure that enterprises were forced to pay for the inputs they bought with money, rather than relying on trade credit willingly granted to them by their

[1] Before the war many East European countries were no poorer than those in Western Europe. Thus, the Czech lands (Bohemia and Moravia) were as rich as France, richer than Germany and far richer than Austria, while Poland was richer than Spain and about as rich as Italy. Estonia was far richer than Finland.

friends from other state enterprises (Rostowski, 1998b)? – which brings us back to the question of privatisation.

The foregoing description may seem to suggest that it was a miracle that any former communist economy managed to transform itself successfully into a stable market economy. And that is without mentioning the problems of massive foreign debt, immature new political and business elites (or corrupt old ones) or the need for a simultaneous political transition to democracy, in countries that had suffered from 40 or 70 years of totalitarianism, and often had previously had little experience of either democracy or the rule of law. Yet, despite these quite abominable "initial conditions" most of the countries have succeeded in their transitions (both economic and political) from communism.

In each country in which the transition succeeded there was some "chink" in the "vicious circle of impossibility" described above, which seemed to require that for any problem to solved, all had to be solved simultaneously. In the case of Poland the "chink" was the existence of a formal legal structure for the independence and corporate governance of state enterprises that was based on elected workers councils and on the existence, even under communism, of quite a large private sector (both in agriculture and outside of it). In Hungary, it was the willingness of the political elite to acquiesce in the selling of almost the whole of the industrial sector to foreign investors. In Russia, it was the political elite's acquiescence in massive "nomenklatura privatisation", in which the persistence of hyperinflation and "arrested transformation" actually played a crucial part (J.Hellman, 1998).

The presence of "chinks in the cycle of impossibility" in so many countries, suggests that something was driving political and economic systems towards sustainable (if not necessarily optimal) solutions. In certain cases, such as Russia, this sustainability has not included proper democracy as well as a functioning market economy.

3. Policies vs. institutions in the transition from communism: some problems and definitions

Glaeser et al. (2004) are critical of explanations of growth based on differences in institutions, first, because of the subjective nature of most of the institutional indicators used in the literature, and second, because of the strong influence of human capital stock on the very different *ways* in which quite similar institutions actually operate.[2] They therefore argue that it is *policies* that respect property rights and encourage education that determine growth. However, Rostowski and Stasescu (2006) argue that it is hard to distinguish clearly between

[2] Glaeser and Saks (2006) argue that levels of corruption (which importantly determine how formal institutions actually operate) differ across US states as a function of their level of education.

economic policies and institutions. For example, are the rights to price stability and to trade freely "policies" or "institutions"? Is an efficient system of universal schooling a "policy" or an "institution"?

Rostowski and Stasescu therefore suggest that institutions should be distinguished from policies through their far greater persistence (or even better, through the expectation of their future persistence).[3] Thus, a short period of stable prices or of a fixed exchange rate should be thought of as a policy, but if they are expected to last for the foreseeable future they become institutions. However, this criterion is far less useful during the transition from communism to capitalism, when (at least initially) almost everything was very "young" and short-lived, and people had few strong expectations as to the long term persistence of any particular arrangement.

Under these circumstances, it may be more useful to use the following commonsensical distinctions: Institutions are those rules that allow a very small degree of discretion in their application. Bureaucracies are organisations that apply rules and formulate policies. In doing so they may have more or less discretion. Policies are decisions made by bureaucracies in those cases in which they have a high degree of discretion. Thus, a Council of Ministers (a *bureaucracy*) may embark on a *policy* of economic reform that involves passing a large number of laws, some of which permit of very little discretion in their application and should therefore be considered *institutions*, while others allow for considerable discretion, and (if pursued with some minimal degree of consistency!) should therefore themselves be considered lower-level *policies*.

Some fundamental systemic rules that may allow for the exercise of wide discretion by well-defined actors are also often called "institutions". Examples here would be constitutional review of acts of parliament by supreme or constitutional courts, or review of the decisions of the state bureaucracy by ordinary or administrative courts. Another is the principle of private property, by which owners are allowed to dispose of their property largely as they wish. We will call these institutions "systemic rules".

All of the above come in at least two variants: economic and political. Thus, we have both political and economic "systemic rules", political and economic "institutions", political and economic "policies" and political and economic "bureaucracies".

Finally, it needs to be remembered that many "institutional" outcomes (in the widest sense of the term) turn out not as they were intended, and that in free societies and market economies a vast number of institutional outcomes are not primarily determined by the state or political processes, but rather by the interplay of private sector actors. Thus, for example, British banking law allows for the existence of German-style universal banks, which both

[3] I am grateful to Andrzej Bratkowski for this latter suggestion.

serve retail customers and have close ties to industry, while until recently US banking law did not. Yet the structure of the British banking system is far closer to that of the USA than to Germany.

4. Institutional transformation and transplantation in Poland in the early transition

The years 1989-1993 were a period in which speed was crucial. The economy was in deep crisis before the dismantling of communism. Indeed, it was this crisis that induced the Communists to surrender power. The dissolution of many communist institutions as a result of the loss of power by the Polish United Workers Party, as well as the dissolution of the Council for Mutual Economic Assistance (Comecon), which had regulated trade between communist countries, only added to the problems. Reformers and politicians therefore acted opportunistically, often following the line of least resistance so as to make pre-existing institutions "fit for purpose" under the new circumstances.

Political institutions

These were initially heterogeneous, with elements borrowed from a number of countries. The powers of the Presidency were modelled on those of the French V Republic: foreign affairs, defence and internal affairs were reserved to President Jaruzelski, who also appointed the relevant ministers. In this way, Jaruzelski could be guarantor or Poland's loyalty to the Soviet Union, in much the same way that De Gaulle could guarantee that Communists would never take France out of the Western Alliance unless they won the presidency. A similar institutional set-up was later established in South Africa, when free elections to parliament were preceded by the transfer of the Foreign, Defence and Interior Ministries to the control of President De Klerk, providing a guarantee of white security for a further period.

The similarity to France was increased when Jaruzelski (who had been elected by Parliament) was succeeded by Lech Walesa, who was elected by direct universal suffrage. The voting system for parliamentary elections was also based on the V Republic model of two round voting, with only the top two candidates going through from the first round to the second. This system makes sense when, as in France, the political stage is highly polarised into two camps, both of which consist of several competing parties. The first round then effectively acts as a primary for the selection of the left or right wing candidate for the second round. In Poland, however, although the political stage was highly polarised between

Solidarity and the Communist Party, the two camps were not at this time internally fragmented into independent parties.

The June 1989 elections were only partly free. Two fifths of all seats in the lower chamber of Parliament (the Sejm) was to be freely contested. The remaining seats were to be contested only among the parties of the ruling coalition (the CP, the Peasants' Party and the so-called Democratic Party as well as CP-friendly independents). Again, this system recalls other cases of de-colonisation. For instance, in British colonies, when elections were introduced they often provided for so-called "reserved seats". These either involved only voters of a particular ethnic group electing their representative, or alternatively all voters could vote, but only a member of the group for whom the seat was reserved to stand for election to it. The purpose was often to guarantee members of geographically widely dispersed ethnic minorities parliamentary representation that they otherwise would not obtain in a first-past-the-post system, but sometimes it was also to weight representation in favour of such minorities and away from the majority, which might be in conflict with Britain.

Economic institutions.

Among the hundreds of acts and regulations introduced or revived in the late 1980s and early 1990s, four stand out as particularly important. The first was the re-activation of the provisions of the pre-War Commercial Code regarding private companies, which fortunately had been merely suspended, and not repealed, when communism was imposed on the country in the late 1940s. This code was itself a transplant, having been largely copied in 1934 from the German Commercial Code of 1901. As important was the re-activation of fundamental property rights (to own private property, to form partnerships).[4] These were contained in the Civil Code, which had originally been transplanted from France to the Grand Duchy of Warsaw in Napoleonic times.

The second was the system of workers councils (*Samorząd pracowniczy)* and of workers council election of state enterprise directors. This had been introduced during the early 1980s, at the height of repression towards the Solidarity movement, in spite of the fact that workers councils were a key demand of Solidarity. Of course, during communist rule the freedom of workers to elect their representatives to the councils, and of the councils to act were limited by the activity of Communist Party branches in the state enterprises. Nevertheless, it sufficed to remove the Communist Parts branches from the enterprises for the councils to start functioning independently. While the interests of workers (which the councils represented) were not entirely congruent with those of the enterprise, as they

[4] None of these rights had been formally abolished. Nor were the ability of physical persons and private and "social" legal persons to enter into binding contracts formally withdrawn either. The only problem was the absolute need of "socialised" legal persons to follow the instructions of their bureaucratic superiors (in Ministries or HQs of Federations of Co-operatives), and the very limited access of private persons to assets.

tended to overstress the short-term interests of current workers against the interests of capital and potential or future workers, they were nevertheless able to provide some degree of corporate governance, and to ensure that managers were not able to steal enterprise assets on a massive scale. Workers councils had first been introduced in Poland in after World War II, then suppressed under Stalinism, re-introduced in 1956, then suppressed again, and re-introduced again in 1982. They were a truly domestic institution, although they also existed in other countries, such as Yugoslavia.

Third, came a whole host of liberalising measures: to free prices, wages, commercial property rents, sales and purchase of almost all goods and services, to engage freely in international trade, to exchange currency freely, and to use whatever currency one wished in domestic trades. None of these vital measures can be said to have had any particular national origin, although they were clearly inspired by a belief in free markets, which has recently been particularly strong in Anglo-Saxon countries.

Yet, what was probably the most important element of the legal aspect of the transformation of the Polish economy did not need to be changed at all. This was the fourth "institution" that made the systemic transformation possible in Poland. It was the existence of a clear "legislative hierarchy" and of a clear "judicial hierarchy" in the country's legal doctrine. In accordance with the western legal tradition, Acts of Parliament had to be in accord with the Constitution, decisions of the Council of Ministers (or regulations issued by the Council) could only be issued on the basis of Acts of Parliament that expressly envisaged them, and decisions of Ministers (or regulations issued by them) could only by issued on the basis of Acts of Parliament or decisions of the Council of Ministers, and so on. The moment as "superior" legal act was changed (for example removing the legal basis for price control in the country as a whole) all subordinate regulations (which depended on it for their legal force) automatically ceased to be binding.

This was quite different from the situation in the USSR, where the complete subordination of the whole of the state apparatus to the Communist Party for 70 years, meant that regulations were (even formally) issued by a state agency on the basis of a decision by the relevant CP branch, without reference to a coherent, nationwide legal hierarchy. As a result, when the power of the CP collapsed, regulations issued by local governments and ministries had often to be repealed or reformed one by one, as their authority did not depend on a "higher act", and therefore did not automatically cease with the repeal or change of that act. Reformers therefore had to hunt down thousands of pieces of legislation giving power over the economy to bureaucrats, and change them one at a time, a massive undertaking that made a swift "jump to the market economy" far harder in the former USSR.[5]

In Poland also, there were of course many problems, some of them resulting from a failure by the courts to understand key concepts of the market economy in the usual way. Thus, it took some time until all courts were willing to allow newly established limited companies to spend the money they had collected as capital freely. This was because of practice in the 1980s (when private companies were first allowed) of treating capital in them as a kind of deposit which guaranteed that a firm would fulfil its obligations to suppliers and the tax authorities.

Naturally, some of the institutions transplanted from the West were worse than the ones they replaced, even in the context of a market economy. Thus, ironically, it was the reformers who abolished the enterprise wage bill tax (which was effectively a flat employment income tax) and replaced it with a progressive income tax. This was done in the name of educating taxpayers to understand that state services were provided out of their taxes. Subsequently reformers have attempted (unsuccessfully) on several occasions to replace the progressive income tax with a flat one in order to compete with countries such as Estonia.

5. The period of consolidation

From roughly 1992 Poland began to establish its more permanent institutional structure. This focused mainly on the drafting and ratification of the new constitution, which came into force in 1997, and on the passing of a series of new laws (or amendments to old laws) that gave institutional expression and detail to the principles embodied in the constitution.

The main source of inspiration for these new institutions was Germany, and the second most important was the European Union, both in that the new laws needed to be "future EU membership compatible" and as a direct source of "institutional transplants".

[5] Even the USSR had a clear hierarchy of Criminal and Civil Courts. But in some ways it was even worse off in this sphere than in that of legislation, as formally it had no Commercial Courts at all! This was the logical consequence of all production and exchange being in the hands of the state for 70 years. It made little sense for different state agencies to be able to sue each other. The "State Arbitration" (*Gosarbitrazh*) system was only able to decide in cases of disputes **between** state entities (the assumption being that in a dispute between a private person and a state entity, the state entity must automatically be right, unless *individuals* within the state organization had acted in an illegal – and therefore criminal - manner). In 1991 the *Gosarbitrazh* system was transformed into "arbitrage courts" available to all "legal persons", not just state owned ones (however, they are not available to "physical persons"). Over time, these "arbitrage courts" developed into the commercial court system of the post-soviet states.

Political Institutions.

Inspired by German "ordo-liberalism", the political structure became more similar to that of Germany and less French.[6] Thus, the power of both the President and Parliament were reduced, while that of the Prime Minister was increased. This happened above all as a result of three main changes introduced under the new constitution: (1) The Prime Minister could now be removed only through a "constructive" vote of no confidence (by which his/her successor was simultaneously elected to the post). This contrasted with the situation under the previous "Small Constitution" of 1992 by which the Prime Minister was required to resign if he lost a confidence vote, and it was only once this had happened that a new Prime Minister was elected. (2) The Prime Minister could appoint and remove Ministers at will. Under the provisions that held until the enactment of the "Small Constitution" Ministers were directly approved by the lower house of Parliament (the Sejm) and could only be removed if their dismissal was approved by the Sejm. (3) The right of the President to be consulted on the appointment of Ministers to the three "power" Ministries (Defence, Foreign Affairs and Interior) was abolished.[7]

The result of these changes was at once observable. Whereas, in the years following the partly free elections of 1989 Poland had experienced eight Prime Ministers in as many years, under the 1997 constitution there were only three in the first eight years of its operation. Two further very important "German-type" transplants were strengthened as a result of the following measures: (1) Decisions of the "Constitutional Court" (a separate supreme court, charged with pronouncing on acts of parliament and decisions of the highest levels of the executive branch) which could previously be overturned by a 2/3 majority of the Sejm, were now made irreversible;[8] (2) Judges of the Tribunal were to be appointed in such a way as to have overlapping nine-year, non-renewable tenures, so as to increase their political independence; (3) The independence of the central bank was constitutionally guaranteed; and (4) The composition of its interest rate setting Monetary Policy Council was designed so as to encourage its independence. Nevertheless, many French-type elements remained in the new Constitution, such as the direct (two round) elections of the President by voters, and the (potentially wide) use of referendums in legislation.

Economic Institutions.

In two key areas the independence of institutions was strengthened, so as to increase the rules-based nature of decision-making, and to help ensure macro-economic stability.

[6] Although it is worth noting that German "ordo-liberalism" was itself strongly influenced by American constitutional ideas of citizens' rights, the division of powers and constitutional checks and balances.

[7] The super-majority required to override the Presidential veto was reduced from 2/3 to 3/5.

[8] The legality of lower level bureaucratic decisions was (and continues to be) controlled by so-called "administrative courts", which constitute a parallel judicial hierarchy which is topped by the third "supreme court" the "Naczelny Sąd Administracyjny".

The first was the independence and governance of the central bank, while the second was rules regarding the drafting of the budget, and the permitted level public sector debt. As mentioned earlier, the independence of the National Bank of Poland was written into the 1997 Constitution. Even more important, so was the composition and selection of the interest rate setting Monetary Policy Council. The MPC consists of the Governor (who is nominated by the President and approved by the Sejm) and nine members appointed for a six-year term that overlaps that of the Governor by three years. Three of the MPC members are appointed by the President, three are elected by the Sejm, and three by the Senate.

These provisions made the NBP legally and politically one of the most independent central banks in the world, comparable to the European Central Bank. Not only was its independence guaranteed by the constitution (by comparison the independence of the Bank of England is based on an administrative decision of the Chancellor of the Exchequer), but all of its main officers (the Governor, Deputy Governors and members of the MPC) are appointed for fixed terms. Possibly, even more important, the members of the MPC are chosen by the State's three directly elected legislative bodies (the Sejm, Senate and President), while the Governor is not only nominated by the President but also approved by the Sejm. The democratic legitimacy of such office holders is therefore similar to that of those elected in other countries for fixed terms by parliaments to protect various kinds of citizens' rights. Examples of such offices include the state Presidents of Germany and Italy, Ombudsmen and Chairmen of National Accounting Chambers in a number of countries (including Poland), and also the President of the European Commission. Analogously to these, the office holders of the NBP are charged by the 1997 constitution with maintaining the value of the national currency. Thus, when a conflict arises between the central bank and the government over monetary policy, it is not clear which side has the greater claim to democratic and constitutional legitimacy.[9] Indeed, conflicts with governments in 2003 and 2006 were decisively won by the NBP.

On the fiscal side, the 1997 constitution made it impossible for Parliament to increase the budget deficit above that originally contained in the draft proposed by the government, and limited public sector debt to 3/5 of annual GDP. The first provision was again in line with German practice, which goes even further, with the German "basic law" forbidding deficits in excess of net public sector investment. Taken together with the Polish provision that allows government to implement the draft budget even if it is rejected by Parliament, this provided a huge strengthening of the government's ability to impose budget discipline in the face of a recalcitrant Parliament. Indeed, taken together, these powers come close to those of French governments, which can pass laws (including the budget) by

[9] For the forcefully expressed presentation of the contrary view (though one which is not strongly grounded in Polish constitutional realities) see Mishkin (2002).

decree, as long as they have the confidence of Parliament. Such powers can be important for the maintenance of budget discipline. In the Polish case this is because proportional representation has led to a fragmented Sejm in which both the opposition and junior partners in the governing coalition often attempt to gain popularity at the expense of the main governing party, through fiscal incontinence.[10]

The second important fiscal provision of the 1997 constitution was the limitation of public sector debt to 3/5 of annual GDP. This was taken directly from the criteria contained in the Maastricht Treaty for the adoption of the euro by EU Member States. Taken together with the provisions of the Law on Public Finance of 1998 (which provided for corrective measures to be taken when public debt exceeded the 50% and 55% of GDP thresholds) this legal "straitjacket" successfully imposed a degree of fiscal discipline on the Miller and Belka governments of 2001-5, which would rather have spent their way out of the 2001-2004 growth slowdown.

6. Future challenges

One of the key problems associated with economic decision making is that in a democracy it is inevitable that politicians are only elected for a temporary period, otherwise their would be little scope for their accountability (through citizens ability to refuse them re-election). Nevertheless, this results in the danger that politicians will act opportunistically if they can find a source of revenue that can fund current consumption but only has to be repaid at a date subsequent to their departure from office (even after an initial re-election). In this way benefits to voters can be "front loaded", while costs are deferred for successors to deal with. This mechanism can be thought of as a form of "asset stripping" of various kinds of implicit citizens' rights, of whose existence voters may not be aware. A classical example is loose monetary policy, which initially increases aggregate demand, real output, real income and employment, all of which is reversed once inflationary expectations catch up with reality. Such a policy exploits the stability of citizens' price expectations, which is a "social asset" which is no longer available to subsequent governments once it has been used up. Establishing an independent central bank is a way of inhibiting such "social asset stripping" behaviour. Another example of a "political Ponzi scheme" of this kind is excessive government borrowing (something which the Polish constitutional public debt limit inhibits).

[10] This is especially the case in the last years of a parliamentary term, when the 5% threshold of votes obtained for entry into the new parliament often becomes a looming threat (particularly for smaller parties).

Nevertheless, when inhibited by institutional prohibitions of this kind, it is in the nature of temporarily elected officials to seek out new opportunities for "mortgaging the future". A recent example in Poland has been the approval of high pensions for miners, which though approved in 2005, will have its largest impact on the public finances only after 2010. For this reason Bratkowski and Rostowski (2005) have proposed the establishment of a National Actuarial Board (Państwowa Izba Aktuarialna) that would assess the long term impact of proposed spending legislation and pronounce on whether it would require offsetting revenues to be simultaneously provided for by legislation.[11]

Bratkowski and Rostowski have also suggested comprehensive reforms to the political structure so as to strengthen budget discipline across the board. These include: (1) shifting to a more bi-polar political system through a reduction in the size of multi-member constituencies for elections to the Sejm; (2) further strengthening the position of the government *vis-à-vis* the Sejm in the budget making process (thus, for example the Sejm would only be allowed to reduce government revenue forecasts, but not its spending forecasts - which it could, however, *increase* - and it could only amend the provisions of the budget by voting measures that increase revenues or reduce expenditures as compared with the government submitted draft); (3) strengthening the position of the Minister of Finance *vis-à-vis* the spending Ministries (by allowing the government to reject the draft budget in its entirety, rather than amending it before it was sent to Parliament for approval).[12]

7. Conclusions

We shall try to answer three questions. First, to what extent was the relatively high level of success of the transformation of the Polish economy due to the adoption of the right *policies*, and to what extent was it rather the result of good *systemic rules, institutions* and *bureaucracies* (as defined earlier)? Second, to the extent to which the success of the transformation in Poland was *not* the result of good policies, to what extent were the good systemic rules, institutions and bureaucracies which made it possible *new*, and to what extent did they already exist before the beginning of the transformation? Third, to the extent to which systemic rules, institutions and bureaucracies were new, to what extent were they *home-grown* rather than *transplanted*? And, if transplanted, can we say anything interesting about why they were transplanted from one country rather than another?

[11] I have recently learned that a similar proposal has been made by Deputy Prime Minister Jerzy Hausner.

[12] A different approach to strengthening budget discipline in Poland is suggested by Hallerberg and von Hagen. Their main proposal is that a multi-year "budgetary pact" between the political parties forming a multi-party coalition government become a part of standard political practice.

Our description of the key institutional elements in the success of the early period of the transformation of the Polish economy, suggests the following answers to our questions. First, the early transformation succeeded in Poland thanks to daring policies that were adopted within a framework of either *pre-existing* or *revived* "systemic rules" and "institutions". For example, had the "systemic rule" of "legislative hierarchy" not existed, the legal instruments (institutions) used to implement the new policies (free price setting, free international trade, internal convertibility of the zloty, small budget deficits financed by borrowing rather than money creation, etc.) could not have been introduced successfully, and it is possible that as a result the policies themselves could not have been implemented anything like as fast as they were.

Second, some completely new (or revived) systemic rules were introduced, and proved vital. They included: the legal equality of private and "social" ownership; a wide degree of economic freedom for individuals and companies; political freedom and democracy; the rule of law rather than the "leading role of the Party". However, the policies, institutions and systemic rules that were central to the transformation were implemented almost exclusively using *pre-existing* "bureaucracies" (Parliament, the Presidency, the Council of Ministers, the Ministries, the National Bank of Poland, etc.). In the early transition *very few* new public sector bureaucracies were created. One of the very few that was, was the Ministry of "Ownership Transformation" (i.e. Privatisation) and the extent of its success has been seriously challenged.

Third, in the early transition new systemic rules and institutions were on the whole either "home grown" (such as the system of "workers control" of state enterprises) or when transplanted, of such universal application for their origin not to be easily identifiable (such as the legal equality of all forms of property, or the freedom of owners and producers to set prices). However, as we have seen, the picture is far more complicated in the field of *political* institutions, with many more apparently being transplanted from abroad (in the early period mainly from France and Germany).

In the second period of the Polish transformation (post-1992), institution building appears to have played a more important role in the country's economic success. Indeed, one of the striking aspects of the story is the way in which, after having achieved a real breakthrough *via* economic liberalisation and stabilisation in the context of pre-existing (or easily adapted) institutions in the early transformation, the Polish political elites were able to adapt to the opportunity provided by a more stable economic (and indeed political environment) post-1992, and turn their attention to institution building (both political and economic).

Monetary and fiscal institutions and bureaucracies were strengthened under the 1997 constitution and accompanying legislation. This institutional strengthening helped to reduce inflation to a very low level, reduce the fiscal deficit significantly and limit the growth of public sector debt/GDP, which has set the framework for the resumption of rapid economic growth in the period after 2003. The institutional strengthening also made Poland's accession to the EU easier (although weaker institutions have not kept Hungary out of the Union). On the political side, there was also a strengthening of the mechanism for constitutional review by the Constitutional Tribunal (which provides a framework for guaranteeing all the other political and property rights of citizens) and of the position of the Prime Minister *vis-à-vis* Parliament and the Presidency. As we have seen, the new strengthened institutions were largely based on German "ordo-liberal" models.

Given the present state of research, it is impossible to say to what extent the success of the "second phase" of the Polish transformation was due to new "institutions" or new "bureaucracies", rather than new "policies".[13] It certainly appears to be the case that Polish governments have felt constrained by the limitations on their freedom of action imposed by the independent state institutions (such as the NBP and the Constitutional Tribunal) which were strengthened the 1997 constitution, and that these constraints have on the whole had a positive effect as far as the quality of economic decision making and economic performance are concerned.[14]

[13] Most of the key new "systemic rules" that needed to be changed for the economy to move from socialism to capitalism had already been introduced in the first phase of the transformation.
[14] Nevertheless, it is almost impossible to judge at this stage the relative impact of "transplanted" as opposed to "home grown" institutions on economic performance during this period.

Appendix - Modelling the effects of Institutions and Geography on Economic Growth.

Diminishing returns to reproducible factors. We start with a Cobb-Douglas type production function with both human and physical capital**:**

$$Y(t) = K(t)^{\alpha} [A(t)\ L(t)]^{1-\alpha} \qquad (1A)$$

where the symbols have the conventional meanings. We assume that $\alpha < 1$, which gives diminishing returns to capital and labour and constant returns to scale. With constant or increasing returns to capital we have endogenous growth, which we address below. The evolution of the economy is determined by:

$$\partial k/\partial t = s\,y(t) - (n + g + \delta)k\,(t) \qquad (2A)$$

The steady state of the economy is defined by:

$$k^* = [s/(n + g + \delta)]^{1/(1-\alpha)} \qquad (3A)$$

Substituting eq. 3A into eq. 1A and taking logs gives the log of steady state income per capita:

$$\ln [Y(t)/L(t)]^* = \ln A\,(0) + gt - [\alpha / (1 - \alpha)] \ln (n + g + \delta) + [\alpha / (1 - \alpha)]\ln s \qquad (4A)$$

Better institutions can affect the rate of economic growth in two ways. The first is through better incentives for agents in a given country to adopt new technologies, which gives a higher rate of technical change g and thus a higher long run growth rate for the economy. This will be the case whether technical innovations are domestically produced, as in advanced countries, or imported from countries at the world technological frontier as occurs in poorer countries.

However, there a problem with this model: the adoption of new technologies must be assumed to be costless (otherwise it is a form of capital expenditure) and yet at the same time it is not automatic, occurring everywhere as soon as an improvement is devised at the world technological frontier, because then it would be uniform across countries. Bad institutions work in this framework to inhibit the adoption of innovations to such an extent that no amount of capital expenditure will overcome this handicap, whereas good ones allow the innovations to be adopted without the need for any special expense.

A second channel allows an *improvement* in institutions to affect growth. Such an improvement may increase the rate of return on capital, which increases the steady state level of per capita capital for any given saving rate given by eq. 3A. This increases the steady state level of per capita income. To the extent that the actual level of income is now below the steady state (or further below it), this increases the rate of growth of output per capita, which is given by:

$$\gamma = \lambda \{\ln [Y(t)/L(t)]^* - \ln [Y(t)/L(t)]\} \qquad (5A)$$

Another way of thinking of this is that the increase in the marginal product of capital increases the growth rate of output/head for given increases in capital/head at the given saving rate assumed in the Solow model. Furthermore, if we go outside the Solow framework and make the savings rate endogenous and positively dependent on the rate of return on capital we will have an even faster increase in k and therefore in y.

However, in the Solow model countries that have had good institutions for a long time will *not* grow faster than those with worse institutions due to such effects *via* the productivity of capital. This is because faster growth *via* this channel can only occur as a result of a greater gap between actual and steady state income, something which is unlikely to be the case after particular institutions have obtained for a long period. The same is true for the positive or negative effects of geography, which operate in this model through the impact of $A(0)$ – representing endowments – on the steady state.

Constant or increasing returns. If we use a function with constant returns to broad capital (physical and human) we can write:

$$Y = AK \qquad (6A)$$

Then we get the growth rate:

$$\gamma = sA - (n + g + \delta) \qquad (7A)$$

Even if $g = 0$, γ will be constant as long as savings, population growth and depreciation rates are (and positive as long as $sA > n + \delta$). What is more, different countries will have different long-term growth rates depending on the values of these rates, and there will be no tendency for income levels to converge. In this case any factors that affect the savings (i.e.

investment) rate, be they institutions or geography (e.g. *via* transport costs in the latter case as illustrated by Gallup, Sachs and Mellinger) will affect the long run growth rate of an economy.

The problem with the *AK* function is that it does not allow for any, even conditional, convergence of income levels. However, a "mixed" *AK* + Cobb-Douglas function will give us both differences in long term growth rates, which depend on the savings rate (and therefore may depend on institutions or geography), and shorter term convergence in income levels:

$$Y = AK + BK^{\alpha} L^{(1-\alpha)} \tag{8A}$$

Where $A > 0$, $B > 0$ and $0 < \alpha < 1$. In per capita terms the function is:

$$y = Ak + Bk^{\alpha} \tag{9A}$$

The average productivity of capital is given by:

$$y/k = A + Bk^{-(1-\alpha)} \tag{10A}$$

which decreases in k but approaches A (rather than zero) as k tends to infinity, so that given:

$$\gamma = s\, y/k - (n + \delta) \tag{11A}$$

$$\gamma = s\, A + s\, Bk^{-(1-\alpha)} - (n + \delta) \tag{12A}$$

a higher savings rate gives a higher growth of GDP/capita at a given population growth rate and rate of depreciation, but that higher rate is itself smaller the higher is k.

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