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INSTITUTIONAL DYNAMICS AS A DETERMINANT OF ECONOMIC DEVELOPMENT – WITH REFERENCE TO CHINA –

Institucionalna dinamika kao determinanta privrednog razvitka – sa osvrtom na Kinu –

Abstract

It has for quite some time now been recognized that the rhythm and strategic directions of economic development cannot be explained by resource availability as the latter is not a precondition of economic development but rather its result. Thus institutions have been carefully examined as the nexus of determining forces, together with political and broader social factors affecting perceptively institutional evolution. It soon transpired that another closely related dynamic force plays a significant role in determining the development trajectories. That force is the institutional change which affects directly the resource flows and dynamic tendencies and at the same time mightily motivates economic agents with strong effects on both mobilization and allocation of resources as a predictable consequence. The proposed theory is illustrated and preliminarily tested on the example of China.

Key words: *economic development, resource endowment, institutions, institutional change as a growth factor, political and social constraints on institutions, China*

Sažetak

Dugo je već poznato da tempo i strateški pravci privrednog razvoja ne mogu da se objasne raspoloživošću resursa budući da ona nije preduslov razvitka nego u osnovi njegov rezultat. Stoga su institucije bile brižljivo ispitivane kao bokor opredeljujućih silnica zajedno sa političkim i širim društvenim činiocima koji vidno deluju na institucionalnu evoluciju. Brzo se ispostavilo da u određivanju razvojnih trajektorija značajnu ulogu igra jedna druga dinamička sastavnica. Ta sastavnica je institucionalna promena koja neposredno utiče na tokove resursa i dinamičke trendove i u isti mah silno motiviše privredne aktere sa jakim posledicama i po mobilizaciju i po alokaciju resursa kao svojom predvidivom posledicom. Predložena teorija je ilustrovana i preliminarno testirana na primeru Kine.

Ključne reči: *privredni razvoj, raspoloživost resursa, institucije, institucionalna promena kao razvojni činilac, politička i socijalna ograničenja na institucije, Kina*

Introductory remarks

The conventional approach to explaining the mechanics and sources of economic development has been framed in terms of resource availability and the presence of mostly material factors accounting for variously generated growth impulses. Scarcity was a key concept in identifying the factors thought to play the decisive role in determining

1 The author is an associate of the Institute of Strategic Studies and Development of the Alfa University in Novi Beograd. The extraordinary quiet, perfect peace and very, very friendly relations with people around have, as usual, greatly contributed to the stimulating atmosphere in which writing is somewhat less burdensome than it usually tends to be.

the rhythm of growth and its direction in a dynamically stable environment. *Dynamically stable* is defined by a set of conditions under which the process of growth can and would proceed at a constant rate and be sustainable for an indefinite time. Having predominantly dealt with underdeveloped economies, whose salient characteristic was the scarcity of capital and relatively large populations, the incipient theories and accompanying models dealt with one-factor production functions. That led to the resulting growth models dealing typically and for those conditions to some extent justifiably only with capital as the unique constraint on the volume of production and the rate of growth [7, pp. 70-82], [7, pp. 154-194].

As the scope of theoretical conceptualizations broadened and the set of examined economies expanded, the theories and related models diversified in several directions and amalgamated into an incomparably richer, more comprehensive and visibly more realistic picture. The principal directions into which the families of models evolved were (1) incorporating two basic production factors, capital and labor, and soon thereafter branching into multifactor growth models, and (2) moving from the incipient one sector into more complicated and hopefully more realistic multi-sector dynamic models. One can speak about heyday of the elegant, highly formalized and fully rigorous mathematical growth models. Batteries of such models are developed with extreme scrutiny in an amazingly large number of excellent books, each of which is worth reading and rereading, as well as keeping permanently in the most selective personal libraries (e.g. [12], [15], [6] and, more recently, [2]).

These models and theories embodied in them dealt extensively with systems with two production factors, but worked out all fundamental issues associated to underlying features of the complex dynamic processes described and analyzed by these sophisticated methodological tools. Such issues were the existence of solutions, their stability, feasibility of various patterns of movement, efficiency of resulting growth trajectories [6, pp. 311-349] and even optimality of such dynamic paths [6, pp. 352-417]. It is worth emphasizing that the mentioned fundamental characteristics of growth paths were carefully looked into and assiduously worked out for significantly larger and more involved multi-factor and multi-sector models [2, pp. 92-136], [6, pp. 202-307], [15, pp. 114-126], so that the grand analytical picture of sophisticated and refined theoretical constructions was in a way fully completed. Exquisite contributions to that literature were also given by *Branko Horvat* [10], who worked out basic elements of abstract technology and made particularly valuable additions to the theory of technical progress.

The models depicting the interdependencies between production factors and the resulting outcomes of economic processes, between inputs and outputs, will never be redundant and never futile. The connections between two sets of the basic economic variables will preserve their analytical relevance under all imaginable research agendas. Multifarious revealing economic conclusions will permanently be derivable from formalized and rigorously proven findings about numerous regularities connecting the two sets of the key economic indicators. It is true, however that the analysis cannot stop at establishing these fundamental interdependencies. Rather, that seems to be the place where meaningful examination of the forces accounting for growth should in fact start.

There are certainly much deeper and more fundamental layers of variables and their interdependencies. This may turn out to be the place where more foundational and perhaps ultimate determinants of the grand economic dynamics lie. That is also the nexus of interdependencies where one might hope to find the effective levers of economic change which could be instrumental in regulating development process and preventing its most conspicuous harmful deviations. Small wonder that the next natural step in developing the theory of economic development turned out to be institutional arrangements and their causal factors in the political spheres of the examined societies ([2, pp. 237-260], [2, pp. 399-415] and the monumental and unrepeatable *Acemoglu* [1, pp. 109-141] and [1, pp. 781-857]). The next unavoidable step in reviewing the deeper going layers of hierarchically placed growth determinants is to look into institutional arrangements, then, even deeper, into political factors as determinants of institutions. Not even that could be taken as an end of the enquiry. Behind or, rather, under political conditioning of institutional changes there could possibly be discerned still more removed general social groupings and their interrelationships. These certainly represent a diffused and difficult to capture collection of influencing factors accounting at least partly for the political blocs themselves and their multifaceted interrelationships. The road to understanding economic development is long, fraught with uncertainties and extraordinarily involved. In this paper it will end with institutional dynamics, a topic which does not seem to have been properly recognized so far, not to speak about its thorough investigation.

Towards more fundamental development drivers

Deeper layers of the growth determinants are foreshadowed in the preceding section of this paper. They have been adduced to serve as a reminder that explanations of economic development and more broadly conceived systemic dynamics cannot rest on the sheer resource availabilities as explanatory factors of the movement of the major macroeconomic aggregates through time. The reason is quite simple despite the fact that it had not been recognized over a long enough series of decades in not such a distant past. Namely the quantities of available resources, rather than being the sources and prime movers of growth are preponderantly the *results and consequences of development*.

True, there are a number of exogenous circumstances given by nature, such as geographical location or possession of particularly valuable natural resources such as oil deposits, but (1) they are far from being particularly influential in arriving at a high growth rate, (2) there are numerous counterexamples of richly endowed with resources and yet unsuccessful in the development process as well as those highly successful despite being deprived of any natural advantages worth speaking of, and (3) there are quite a few countries, such as those in Arabian Gulf, where abundance of resources not only does not contribute to development *along the lines of modernization* but in fact acts as a hindrance in spite of earning huge income thanks to massive exports of products based on these resources; not even the sustainability of large exports over long stretches of time has produced truly modern development which could be taken as reasonably sustainable. One might add one more factor (4) consisting in the fact that even the conventional natural resources, such as agricultural land or mineral deposits, acquire full economic value only after, and under condition of, significant investment necessary to open such resources and bring them to profitable uses.

The basic fact that resource availability, consisting mainly of produced resources, cannot be taken as a fundamental source of growth derives from another plain truth that what really matters from the point of view of the long run economic development is not what quantities and qualities of resources economic actors have at their disposal but how they use and what they do with whatever resources they have to deal with. In the long run only those countries come out as successful in which decision making units *use the existing resources "wisely"*, i.e. allocate them to the options on which they produce the highest economic effects. This has to do with savings and efficient investing whatever is saved (or borrowed) and with all kinds of entrepreneurial undertakings through which various innovations are created, new products and processes are discovered and, in short, ways are found to create more and more value on the basis of given resources or, alternatively, to deliver a given value by deploying and consuming ever smaller quantities of resources. Let it be added that *economic freedom*, as well as all other types of freedom, does play in this context a crucially important role, turning out as a decisive productive force and development driver at the level of economies and societies considered as immense and incomprehensibly complex wholes. Economic freedom is, at least at the level of economic application and business practice, the ultimate source of technological advance and the effective way for the system as a whole to quickly learn and to successfully apply the manifold findings of that generalized learning.

It will suffice just to mention in passing the features of institutional order determining the ability of the system to learn collectively and, additionally and independently, to mobilize resources and to allocate them efficiently. One such feature – economic freedom and other liberties – is just pointed out in the preceding paragraph in view of the fact that only reasonably free societies can account for a number of potential innovators to be as large as possible – unequivocally larger than in alternative arrangements – and for them on the average to be more creative than under any competing regulative regime. The other important characteristic is the *Hayekian* [9] use of (dispersed!) knowledge in the society.

Associated to it is the quantity and quality of information generated by a particular system and the channels through which it is being transmitted, as well as the ease with the streams of information flow through the system. The distribution of decision making authority over the sets of agents, and even over the individual agents themselves is yet another important feature of the institutional order, dealing with the degree of centralization within the system but certainly not entirely reducible to it. The last and probably the most important feature of a systemic arrangement coordinating economic decisions and regulating the resulting flows of tangible results is what *Neuberger* used to call the incentive structure. This structure is about tying most closely efforts and rewards, the consequences of decisions with the authority of making them and, intimately associated to it, this structure is about a sound, purposeful institutionalization of risk. It all comes down to having an environment in which everyone will be able to reap freely the fruits of his decisions and to bear the consequences of whatever he has freely decided.

This last systemic trait is evidently of key importance. It obviously has much to do with mobilization of economic resources: knowing that he will be unimpairedly rewarded for whatever effort he makes, everyone will deploy his capacities to the maximum and whatever potential is available will, most likely, be put to good use. This characteristic of the institutional set-up will also motivate to the maximum the choice of the most efficient options for engaging resources and spending on whatever brings positive economic effects. It is thus of crucial significance for both mobilization and allocation of resources.

It turns out that the key to successful development is not to work or hope for the largest possible resource endowment – it is largely the result rather than the precondition of development – but to look for socially purposeful, economically efficient set(s) of institutions which will motivate the economic actors and people at large to activate to the utmost whatever may turn out to be useful as any kind of resource and to see to it that these resources are not only channeled into the most profitable uses but also continuously reshuffled among the alternative uses as impact of exogenous factors sets in and as relative profitabilities of such uses evolve in time. The bundle of institutions is what matters, not the quantities of whatever production factors and financial means are available to individuals and their variously defined collectivities. This is best seen from the disastrous failures of foreign assistance throughout the world [5, pp. 345-367]. It is safe to assert that there is not a single instance of a country having been successfully launched on a growth trajectory through alien resources, i.e. those generated out of its own economy. A delusive conclusion might be drawn from this simple proposition that the institutions are the right element to rely on in search for stimulative conditions of successful – sufficiently rapid and sustainable – development. It inescapably revokes to remembering another similar illusion in the past. When technological progress was discovered as the principal driver of economic advance and many countries diagnosed as technologically far behind the relevant frontier, it was simply suggested that they should rely on the huge backlog of unutilized, yet widely available technical knowledge and relatively quickly join the club of the most developed countries. The recipe did not work and it has been long and widely known why.

A similar delusion may come out of the proposition that the "right" institutions lead to desirable speed and pattern of development. Such institutions have been at work and developing in many countries, they are well known and if not sufficiently known, they can be learned rather fast, so that they may be implanted in the foreseeable future. As it has been learned from the widely found and abundantly accumulated experience, the transplantation of the "desirable" institutions is not a feasible undertaking and severe constraints on the road of institutional development have to be faced. What is achievable in one country may not be feasible in another. To this further, as it were derived, set of constraints we turn in the next section.

Political constraints on institutional development

The idea of the successive layers of constraints in the epochal task of developing overall organization of a society was introduced in the first section. Despite the perception and even cognition of the "efficient and desirable" institutional arrangements, their introduction may not be feasible because there is a further, perhaps adjacent to economic institutions layer of constraints which make it impossible to implant systemic mechanisms which could prove productive in terms of development potential and actual growth achievements. It is easy to see that one encounters here the political constraints to economically beneficial and even needed institution building. It is not possible to understand development of the economies without reliable and rather complete insights into the institutional machinery of given societies and it is further impossible to comprehend the uneven and highly imperfect institutional development without delving into the political systems of the analyzed societies. Fortunately, economists have become aware of the need to go far beyond the economic variables alone to understand economic change as such, and of the necessity to analytically penetrate political determinants of institutional evolution and even of the imperative to cut through wider social tissue in search for the influencing, if not determining, factors of the political interrelationships themselves. A recent book [5, pp. 171-309] has gone far in this direction and advanced significantly our understanding.

The simplest way to approach the constraining influence of political inhibitory factors on development of institutions is to observe that no society is homogenous and compact and that it is regularly partitioned into distinct groups with differentiated interests and visibly varying amounts of social power. General social consensus can only, if at all, be achieved about the most fundamental tenets of the "rules of social game", it being understood that about less fundamental issues manifold interest conflicts may and are likely to be encountered. The lack of agreement is by itself an obstacle to reaching collective consent to desired systemic changes. More than that, various groups look for and see in any proposed change their particular interest and it is almost impossible to imagine a change to which at least some groups, no matter how small and few in number, will not be opposed. The dissenting groups are the source of resistance which is occasionally prohibitive and most of the times just one component of cost of the proposed change and a part of the answer why the change unfolds slowly, if at all.

It is apposite to weigh the particular(istic) interests of various groups in connection with their social power. Obviously the most constraining and the most damaging combinations are the ones combining the conservative (in the sense of opposing to change) interests and significant social power, "significant" meaning sufficient to block the change and even to prevent it for a considerable time. It is a trivial matter of simple definition to find out that no change, how ever desirable from whatever "social" point of view, will ever be realized if there is just a single group opposed to change and powerful enough to obstruct it. The impeding circumstance is that different groups manage to adjust to exogenously given circumstances to widely different degrees and that the best adjusted become the most powerful. Regrettably, those who adjust the most successfully are not only the most powerful but also the most interested in preserving the *status quo*; the motivation to prevent the change, no matter how beneficial, goes hand in hand with the ability to circumscribe it or to stymie its execution.

Society can be looked at as a large and complicated nexus of interacting groups. As the number of players is limited the interrelationships are complicated and unpredictable. Unlike the conventional analysis of the market outcomes, the stable interdependencies cannot be identified and the usual equilibrium configurations cannot be analytically established. The theory of (involved) games rather than the standard theory of equilibrating processes is applicable in such markedly dynamic and highly uncertain set-ups. A number of unfavorable conclusions follow with three of them perhaps worth mentioning. *Firstly*, the outcome is hard, close to the impossible to predict. *Secondly*, out of many possible outcomes hardly any one has a genuine and certain normative significance. At last, *thirdly*, none of the interacting players has control over final outcome at the level of the system as a whole. The usual procedure, the one to which the economists are so much accustomed and so firmly attached, of giving recommendations loses appeal and becomes almost senseless: there is no one to direct advice to. Evolution of institutional order becomes a matter of spontaneous and largely unpredictable interactions, without any determinable objectives to be reached. It follows that it becomes hardly possible even to forecast changes in institutions, not to speak about control or steering of their transformation.

Let it be just mentioned in passing that not all institutions are subject to social engineering and that some of them are truly uncontrollable, account being taken of just elaborated generally low level of manageability of institutional adjustments. The case in point is the large, poorly structured and not easily identifiable set of *informal institutions* [13, pp. 155-63]. Informal institutions are heterogeneous and extraordinarily versatile: social values and ethical standards, national myths, time-honored habits of doing things in the style of ancestors, collective memories... Not infrequently informal institutions are a direct obstacle to adopting solutions tested and proven efficient in other countries. There are other cases in which the alien institutions can be transplanted, but their efficiency is seriously impaired through the adverse influences of the informals. In such cases solutions proved rational elsewhere may not be adopted in the observed country for simple reason of low or altogether lacking efficiency. The arrangements successful in one country do not have to be workable in another country, and indeed for reasons of wide differences in culture, which is just shorthand for the collection of informal institutions. That amounts to a truly large part of the answer to the question why so many obviously favorable and evidently advisable policy shifts and analogous changes never get implemented.

An ameliorating circumstance pops up nevertheless. Not all groups are completely devoid of any controlling powers and some of them are in fact in the possession of governmental authority wrought out at the immediately preceding elections. The electoral victory may have been won on the basis of some political program which to some extent binds the incumbent group and forces it to do certain things in, so to speak, a broader social interest. More importantly and metaphorically speaking, how ever it is defined, social interest or public good may enter as one of the arguments of the incumbent's utility function. To the extent that pursuing broader social aspirations may strengthen support of the voting public at the next electoral clash, public interest, together with the now scrapped corresponding theory, may regain some significance and the institutional development may reenter into the rulers' endeavors as a meaningful objective. However, this effect is likely to be weak and more often then not it will practically vanish. The more so as the semblance of he objective function of the directorate is distorted in the well known way. *Firstly*, what pays politically diverges widely from what is beneficial from the point of view of the society or, more accurately, from what most individuals would be able to accept as reasonably tolerable if not quite satisfactory. *Secondly*, the rulers' time horizon is limited and all they purport to produce is heavily skewed towards the short run. To this one might add the high discount rate of the electoral body and its sensitivity to short run benefits with proverbial ignorance for incomparably higher costs regularly pushed into a somewhat removed future. There are many more complications in the political system and even in the broader social fabric encompassing it and surrounding its major segments [1, pp. 799-865], but they will be skipped here for lack of space.

Given the fact that economic performance is highly dependent on institutions, and that they, in turn, are decidedly impacted by largely uncontrollable political relations and practically uncontrollable changes, it becomes clear why it comes close to impossible to transplant institutions which elsewhere have proven to be efficient. It also vividly transpires that the true and ultimate destiny of most (all?) economies lies far outside of these economies themselves. Taking into account that most ultimate causes of systemic changes are practically uncontrollable, one is led to another discouraging conclusion: much of what happens regarding the rhythm and directions of economic development is a matter of exogenous, largely stochastic components or, to put it simply, a matter of sheer luck. The rarely met sunny side of this gloomy picture is that occasionally a set-up may appear in which the far-reaching changes may be affected, usually starting with political turnarounds, extending into institutional shifts and resulting in the glorious upsurges of the inordinately quick and protracted growth, unexpectedly sustained over long periods. The example of China, with which this paper will terminate, is a case of point demonstrating what typical attributes of usual macroeconomic configurations have to vanish for such rare growth miracles to happen.

The big point: The speed of reform and the jump from the initial institutional set-up as the generators of fast development

Economists are used to interpreting various economic phenomena not only in terms of absolute magnitude of underlying macro aggregates and in terms of their variously defined ratios, but also in terms of their rates of growth. Thus, it has been repeatedly admonished that the absolute magnitude of the Serbian external debt, and not even its ratio to the GDP, is not sufficient and reliable indicator of the burden of indebtedness; the speed of its growth, as well as of the change of the said ratio has also to be taken into account [8]. In the same vein, in analyzing relative positions of various regions within a given country and the position of the individual countries within the broader, internationally defined regions, not only the levels of *per capita* and other indicators have been observed and followed, but also the levels and the dynamic tendencies of their rates of growth [14, pp. 11-30], [14, pp. 81-99]. It goes without saying and is widely accepted without expanded elaboration that the same, say, difference in the income *per capita* between entities *A* and *B* in favor of the former has entirely different meaning and vastly diverging policy implications if *B* has significantly higher rate of growth then if the rates are equal or even if the rates differ to the detriment of *B*. Taking account of the rate of growth puts the observed entities into entirely different perspective.

It is rather strange and certainly unsatisfactory that the same type of reasoning has not been applied to the issues of institutional change. In analyzing the sources of growth impulses economists have almost unexceptionally been taking into account only the given systemic configurations, examining the possible effects of various configurations regarding motivation, information generating, the use of knowledge, distribution of decision-making authority... No heed was taken of the changes of these arrangements. These changes are, however, extremely important and in certain situations may be more influential and generate more powerful impact than the structure and functional characteristics of the arrangements themselves.

To begin with, these changes call for adjustments and introduce a peculiar dynamics into the economy quite independently of whether they improve or worsen the allocative efficiency of the arrangements. The necessity of adjustment introduces, on the one hand, the cost of the adjustment and the uncertainty regarding the direction of change and the proper degree and the velocity of the adjustment. But, on the other hand, it shakes up the systemic structures and forces economic agents to act and move; this may lead to new entrepreneurial ventures and freeing of energies which may prove as an entirely new growth determinant. It may also, and in most cases is quite likely, speed up technological development and raise the dynamic efficiency of the economy. The other force at work is the nexus of expectations. Institutional shifts or steady and persistent tendencies of change may significantly increase the level of business optimism and spur up the "animal spirits". The result may be a marked increase in the mobilization of resources – an augmentation of the degree of capacity utilization and the expansion of employment – with precious additions to the GDP. Of course, the changes do not have always to be for the better, but those undertaken by agents authorized to formulate public policy are more likely than not to be in line with the overall systemic advance.

One thus comes to the conclusion that the change of the system itself pops up as a powerful generator of the growth impulses, working through the modification of the motivation structure of a given society. Institutional change forces the change in the real sector either through the unavoidable adjustments or via simple fact that change in the rules may create and reveal profitable alternatives for rather different uses of resources. It might be useful to distinguish between the phenomenon of change as such and the distance which arises as a consequence of change between institutional constellation behaving before the change and the new one which results from such shifts in the rules. The very difference between what is arrived at through such change and the initial, starting state, definitely abandoned as a result of it, may act as a strong source of motivational impulses and thus of the developmental performance of the economy.

It follows that one might postulate that the growth potential of an institutional set-up depends not exclusively on its proper structural characteristics and its functional capabilities, but very much on the difference on what it comes out to *now* and what it used to be *before*; another way of stating this is to note that potential performance of the system depends on the conceptual and structural *distance* between what the system was before and what it amounts to now. The speed of institutional transformation takes on a particular importance in this context. The higher the speed the higher the usual hazards of mistakes resulting from the hasty changes. However, higher speeds make for higher differences in institutional machinery and thus possibly for stronger motivational impulses resulting from – perhaps not conscious and not explicit but present and active nevertheless – comparison between the previous abandoned arrangements and the ones that are available (and hopefully superior) in the current period. In any case, one might attribute unambiguously importance to the fact that the institutional distance between dynamically shifting regulative constructions depends not only on where one gets transforming this complicated architecture but, quite obviously, on the point from which one was in the position to (have to) set off.

It seems proper to add that an analogous sequence of interdependencies could be expected in cases of institutional deterioration and regress as opposed to – what is widely expected and generally taken for granted – progress and improvements in the architecture of the regulative structures. In cases of *dismantling* the inherited institutions which have successfully passed the test of time and been proven as highly functional in coordinating economic activities and steering their development – one should expect the above described phenomena but reversed in the direction of acting and the nature of consequences. Thus the change (for the worse) is bound to produce additional and separate influences largely independent of the working efficiency of the inferior arrangements resulting from such institutional moves and the speed of change would appear do be an additional adverse factor in reducing the overall efficiency of the system. It may look bizarre even to touch on such a scenario of systemic regress, but one should not forget that history is strewn with instances of such reversals and sinkings to the states of society far behind the achieved level of civilization. The relevant instances encompass numerous revolutions having taken place in the course of long centuries, including socialist revolutions which are now overwhelmingly considered to have been major setbacks in the history of civilization.

Growth potential of institutional change: The case of China

China is far from being a completely transformed, fully adjusted capitalist country. As forcefully underlined by *Huang* [11, pp. 10-24], quite likely the most authoritative source on Chinese performance and policy, a textbook kind of testing of the features of the Chinese systemic set-up would demonstrate that many typical and even necessary capitalist traits are conspicuously lacking and many policies are directly opposed to what is generally perceived to be the spirit of capitalism. A single policy alone, the one of tenaciously preserving and recklessly subsidizing the clumsy and grossly inefficient state-owned companies, the so-called *socially owned enterprises (SOE)*, would be sufficient to conclude that the remnants of the old socialist structures are so marked as to make any talk of Chinese full-fledged capitalism plainly groundless [11, pp. 11-14]. *SOE* still account for a large part of the Chinese economy and serve the same purpose which was typical for them in the past, namely to represent comfortable and reliable base for accommodating the experienced and deserving party cadres. *SOE* are a mighty instrument of unrestrained state dirigisme and a cruel and unscrupulous means of exploitation of the market-based segment of the economy by relying on coercion and unbridled use of the state power. Yet, despite the vestiges of the socialist economy and the heavy hangovers of the collectivist consciousness, China has managed to achieve spectacular development performance which seems to have impressed the entire world. This is exactly why Chinese case is almost ideal for illustrating the *mighty effects of institutional change*. The system is not capitalistic, but the change is undoubtedly directed to capitalism and it is the change that gives the deepest imprint to the Chinese society.

China is thus a rare and exceedingly interesting combination of the two contradictory features of social realities. One is the *economic system* which is still dominated, but certainly not exclusively occupied, by the vestiges of the socialist past and the *conspicuous systemic change* which is entirely in the sign of the capitalist systemic transformation and evidently the herald of the capitalist future of the country. One encounters here, as it were, a conflict between the *state* and the *tendency*, with the state belonging to the old socialist world and the tendency representing the announcer of a future, completely different world. This change has clearly produced far-reaching changes in the structure of the Chinese economy, but the mighty growth impulses and the unheard of development potential come principally from the change itself, from the widely undertaken adjustments throughout the economy and from positive expectations generated within the society as a whole.

All of this is firmly connected with the unprecedented liberation of the society. Again, analyzing civil and other freedoms relying on the standard criteria of developed democratic countries and finding out that (1) China is not a democratic state, and (2) that many freedoms are simply absent and quite a few of those granted leave so much to be desired, i.e. using the conventional criteria for measuring and evaluating freedom(s) would be an entirely mistaken approach. The existing level of freedom(s) and the form in which they happen to be institutionalized is *not* what should be looked at what would be representative for actual Chinese realities. It is the affected change which critically colors that reality, as well as living and still vivid memories of a depressing past which is in stark contrast with newly emerging irresistible tendencies.

Just a cursory look in the past readily confirms the huge jump that has been made with respect to such abysmal past. *Babić* [3, pp. 358-71] systematically and to a significant detail reports on the unheard-of turbulences imposed on the Chinese society by so-called Great March Forward (1959-1961) and the ill-famed Cultural Revolution (1966-1977). The system of notorious people's communes was just about the most totalitarian form of social organization applied to such a large number of people. In short, the initial state from which the emancipatory movement of 1978 started and the unbearable turbulences to which hundreds of millions were exposed could easily be recognized as devastating and inhuman; the initial, starting condition was evidently such that noticeable normalization of life initiated with the reform of 1978 and constitutionally formalized and guaranteed appeared to the vast majority as obtaining foothold on a different, vastly superior planet. Again, the change was the key element of this spectacular turnaround. It is not the profoundly different system as such which was unexpectedly launched and continued to develop more or less uninterruptedly that accounts for the epochal awakening of the society and for impressive growth. Rather, the decisive driving force was the spectacular *change* that was performed in a short span of time and produced positive expectations, while unleashing rarely seen entrepreneurial initiatives and stimulated all kinds of efforts leading to rapid development. In other words, it is not the system as such, whatever form and structure it might have has at any given point in time, that accounts for admirable Chinese economic takeoff, but the *same system in comparison with what it was on the eve of this magnificent liberation.*

Whatever approach is taken to the Chinese development miracle, it inevitably leads or comes back to one key word: *freedom*. In China, as elsewhere in the world and in other exciting episodes of international successful development, freedom proved to be mighty development driver and the unrivalled productive force. Allowing people to work, invest, learn and venture into entrepreneurial undertakings seems to be the right recipe for putting the economy onto the trajectory of rapid and sustainable development. Certainly, the state has its part to play: no superior agency can be found for protecting property, enforcing contracts, guaranteeing personal security, providing public goods which no one other would secure... All of these pertain to the province of government, but not stepping into the shoes of producer, merchant, entrepreneur... Governments indulging into the counterproductive and inadvisable dirigisme have, most regrettably, little capacity to carry out their proper functions, the ones of the highest priority for market economies and the ones in whose execution governments are simply irreplaceable.

Concluding remarks

One of the most frequently asked and in the most variegated ways answered questions is what determinants of economic progress are, what are the ways of securing stable and sustainable growth and what place in this grand venture should be reserved for public policies and government acting behind and through them. It took some time to ascertain that the secret of successful growth cannot be sought in resource availabilities as these are the result rather then preconditions of development. The next unavoidable step was the recognition that the truly important matter is not what means economic agents have at their disposal but what they do with them and how they put them to economically efficient uses. Thus institutions came to the top of research and deliberative agenda and, immediately following, political interrelationships and broader social conditionings determining the choice and development of institutions.

Recent experiences revealed another important determinant of the growth performance of individual countries, their variously defined groups and eventually of the world as a whole. It turned out that not only the institutions as they are, with their involved structure and not easily predictable functional characteristics, could fully account for empirically ascertained growth performance. The *change* of institutions proved to be highly relevant explanatory factor and a powerful contributor to the rate of growth and other development indicators. The institutional change makes economic agents to adjust thoroughly and thus introduces a precious element of dynamism into economic system. It also significantly affects the agents' expectations, revives their "animal spirits", introduces into the system the valuable elements of optimism and credibility and thus steps in as a powerful driver of economic development. The change encompasses several components which separately and in differentiated ways contribute to the development of the economy. For one, the speed with which the change unfolds affects growth potential in several important ways. It foreshadows the future improvements of the system, encouraging the agents to venture into the new entrepreneurial actions. It also contributes to the cleaning of sorts of the institutional scene by eliminating the vestiges of the old arrangements and the legacies of the past behavioral patterns. It also contributes to expanding the volume of transactions by pointing to changes in the broadest social environment which are likely to facilitate various business operations.

The theory of institutional change as a distinct driving force of economic development is illustrated and substantiated by the contemporary development experience of China. Among the countries having produced conspicuous institutional shifts China is evidently the most representative. Without democratizing the political system, China has produced another epochal change, certainly more beneficial regarding economic development and possibly more valuable from the broadest social point of view. She has scrapped the old totalitarian system of people's communes and opened up wide spaces for free entrepreneurship and offered expansive vistas of economic freedom. China reintroduced the market as the basic mechanism of coordination of economic decisions. A complete market system, with the plethora of accompanying institutions, cannot be reconstructed overnight. It will take years and decades before China rounds off the diversified machinery of markets and their supporting regulative arrangements. However, despite the fact that this collection of arrangements is far from finished, the economy makes gigantic steps in her spectacular development. The key explanatory factor for such amazing success is the *change* itself. Quite independently of the level at which it is affected, the change acts as an independent, and powerful at that, growth encouraging factor. The same set of institutions may produce vastly differing growth performance depending on the speed with which it unfolds in time and on the initial systemic configuration from which institutional development started and with which economic agents consciously or unwittingly compare the given regulative set-up.

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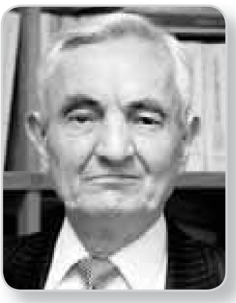

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