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THE IMPACT OF THE ECONOMIC TRANSITION ON THE DEVELOPMENT OF ECONOMIC FREEDOM – CASE OF POLAND

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Abstract

The changes in the Polish socio-economic system, initiated at the turn of 1989 and 1990, led to a systematic increase in the liberalization of economy and thereby the rise of the level of economic freedom. The aim of this paper is to examine the impact of the economic transition on the development of economic freedom in Poland. The analysis, carried out in the period 1995-2015, was conducted on the basis of the chain-linked Economic Freedom Index by the Fraser Institute and the Index of Economic Freedom of the Heritage Foundation and the Wall Street Journal. The analysis indicates that: (1) Poland cannot be considered as a country that is fully free economically, but the transition of its economic system has resulted in a rapid growth of economic freedom. (2) The impact of transition varies for different areas (sub-indices) of the economy. (3) The European economic integration stimulated the increase of EFI, but the economic crisis did not decrease the level of economic freedom.

Keywords: Economic Freedom, Economic Transition, Economic Liberalization, Poland

1. Introduction

Over the last 25 years Poland has undergone fundamental changes aimed at the transition from a centrally planned economy to a market economy, and subsequently at the support of sustainable economic growth. Political, social and economic transformations that have taken place during this period were first associated with the transition of the political system and then with Poland's accession to the European Union. The global economic crisis at the end of the last century also had its toll. One important consequence of the transition of Poland's economy is a systematic increase in the liberalization of economy and thereby the rise of the level of economic freedom.

The aim of this paper is to examine the impact of the economic transition on the development of economic freedom in Poland. The three research hypotheses have been posed in the study: (1) Transition of Poland's economic system has resulted in the rapid growth of economic freedom. (2) The impact of transition varies for different areas (sub-indices) of the economy. (3) The European economic integration stimulated the increase of EFI, but the economic crisis decreased the level of economic freedom.

The analysis, carried out in the period 1995-2015, was conducted on the basis of the chain-linked Economic Freedom Index by the Fraser Institute and of the Index of Economic Freedom of the Heritage Foundation and the Wall Street Journal.

The paper is divided into two parts. Part one of the paper presents the concept of economic freedom. In part two, which verifies the research hypothesis, the level of economic freedom in Poland is analyzed.

2. The Concept of Economic Freedom

The issue of the importance of economic freedom has been the subject of research and debate since the turn of the eighteenth and nineteenth centuries. However, there is still no single, universally accepted concept of economic freedom in the economic literature.

Freedom can be defined broadly as the powers available to individual people (Balcerowicz, 1998) or a situation of the lack of external coercion. This approach is derived from the liberal thought that wanted to create a system of freedom by eliminating compulsion. Initially, this referred to morality and religion (Locke), then economics (Smith, Bastiat), politics and customs (Mill). Locke's concept, according to which the individual has the right to liberty and the state in a free market economy should protect this right, was of particular importance in this field.

Economic freedom can be considered in three dimensions: economic, political and legal. In economic terms, economic freedom is regarded as the foundation of the existence and functioning of a market economy, and thus refers to the ability to take up and pursue economic activity in the free market (Smith, Ricardo, Mill, Hobbes) (Szarzec, 2011) if it does not violate the rights (freedom) of others. According to Friedman (1962, p.9) "A major source of objection to a free economy is precisely that it (...) gives people what they want instead of what a particular group thinks they ought to want. Underlying most arguments against the free market is a lack of belief in freedom itself". And according to Hayek (1944, p.96) "the guiding principle in any attempt to create a world of free men must be this: a policy of freedom for the individual is the only truly progressive policy".

From the point of view of this paper, the most important are the two approaches to economic freedom presented by the Fraser Institute (Gwartney and Lawson) and the Heritage Foundation.

"Economic freedom is present when individuals are permitted to choose for themselves and engage in voluntary transactions as long as they do not harm the person or property of others. (...) The use of violence, theft, fraud, and physical invasions are not permissible in an economically free society, but otherwise, individuals are free to choose, trade, and cooperate with others, and compete as they see fit" (Gwartney *et al.* 2013, p.1).

"Economic freedom is the fundamental right of every human to control his or her own labor and property. In an economically free society, individuals are free to work, produce, consume, and invest in any way they please. In economically free societies, governments allow labor, capital and goods to move freely, and refrain from coercion or constraint of liberty beyond the extent necessary to protect and maintain liberty itself" (Kane *et al.* 2007, p.6).

A characteristic feature of all the presented definitions of economic freedom is its consideration in terms of negative, not positive, freedom. Negative freedom (from something) means no interference or coercion on the part of others (economic freedom) and positive freedom (to something) is the right (guarantee) of access to markets (Berlin, 1958).

Economic freedom, regardless of the definition adopted, does not mean, however, absolute freedom as economic freedom requires rules and regulations to ensure compliance with it.

In this situation, the state is obligated to create such mechanisms (an institutional framework) that will protect economic freedom and not limit it at the same time (Opala, 2008). Smith has argued that ensuring legal protection and adherence to a contract is essential to the development of trade and industry - "The property which every man has in his own labor, as it is the original foundation of all other property, so it is the most sacred and inviolable" (Smith, 2013, p.121).

3. Index of Economic Freedom

There are many indicators to measure the level of economic freedom presented in the literature. The most prominent international rankings include EFI (Economic Freedom Index) of the Fraser Institute and IEF (Index of Economic Freedom) of the Heritage Foundation and the Wall Street Journal¹.

For the first time the possibility and usefulness of measuring the level of economic freedom became the subject of economic discussions in 1984 in Cambridge and was a result of the debate on freedom as such (Kondratowicz, 2013). This debate was continued in the following years (1986-1993) and many well-known economists² participated in it, including three Nobel Prize winners (Friedman, Becker, North). Consequently, in the early 1990's, attempts were made to quantify economic freedom, resulting in the publication of the first report by the Fraser Institute³ in 1996. Initially, the index covered 4 areas, 17 variables and was determined for 102 countries. In subsequent years, the index changed several times, and finally (2013) it analyzed 5 areas (42 variables) and covered 152 countries.

"To a large degree, the EFW measure is an effort to identify how closely the institutions and policies of a country correspond with the ideal of a limited government, where the government protects property rights and arranges for the provision of a limited set of "public goods" such as national defense and access to money of sound value, but little beyond these core functions" (Gwartney *et al.* 2014, p.2). EFW measures the level of economic freedom in five main areas:

1. Size of Government – indicates to what extent the allocation of resources in the economy is driven by market forces and shows the role of the public sector in the production of goods and services.
2. Legal System and Property Rights - the central element of economic freedom which shows how successful the state is in this regard.
3. Sound Money – the ease of access to money (domestic and foreign) and its cost is assessed.
4. Freedom to Trade Internationally – the components in this area measure the impact of various restrictions on international trade exchange.
5. Regulation – assesses regulations that restrict the freedom of contract in the labor, credit and product market, as well as hinder competition and freedom of economic activity.

Each of the analyzed sub-areas is assessed on a 1-10 scale, and the estimate of the component in each area is then averaged to obtain the ratings for each of the five areas. The level of economic freedom has not been classified in this method. It is only assumed that 10 denotes complete economic freedom and 0 its total absence.

The Heritage Foundation index has been published for 20 years and it measures economic freedom in 186 countries, based on 10 quantitative and qualitative factors divided into four main categories (pillars) of economic freedom:

1. Rule of Law – property rights, freedom from corruption
2. Limited Government – fiscal freedom, government spending
3. Regulatory Efficiency – business freedom, labor freedom, monetary freedom
4. Open Markets - trade freedom, investment freedom, financial freedom

Each of the ten sub-indices of economic freedom is assessed on a scale of 0-100 and the country's overall score is a weighted average of the sub-indices. The countries are divided

¹ In publications on economic freedom, it is often assumed that the Heritage Index is used by laymen, whereas the Fraser Index, due to its improved methodology, by professionals. The conducted comparative analyses indicate, however, that there is no significant difference between these indices. Due to the diverse range of information obtained from the sub-indices, both indicators will be used in the paper.

² E.g.: Alchian, Bauer, Becker, Block, Easton, Friedman, Gruber, Gwartney, Harberg, Jones, Kierzkowski, LaPage, Lawson, Lindberck, North, Pejovich, Rabuska, Scully, Stockman, Tullock, Walker.

³ The first measure of economic freedom to appear in the literature is by Scully and Slottje (1991 cited in Scully, 2002).

into five groups based on the level of this index: free (EFI(80,100)), mostly free (EFI(70-79.9)), moderately free (EFI(60-69.9)), mostly unfree (EFI(50-59.9)), repressed (EFI(0-49.9)).

4. Benefits of Economic Freedom

Theoretical and empirical analyses clearly show that economic freedom is one of the most important variables affecting the economic well-being. The impact of freedom on economic activity was (and still is) the subject of research conducted by many well-known economists⁴. Their findings indicate that economic freedom has a significant and positive impact on economic growth:

- “the extent to which countries possess free market institutions that protect property rights and implement policies which provide for trade and voluntary exchange is instrumental for achieving economic growth” (Justesen, 2008, p.645),
- countries which have reduced the direct involvement of governments in economic activities show rising rates of growth (Ayal and Karras, 1998) - it means that the relative size of the public sector is negatively related to growth,
- “free markets are conducive to growth, which is why measures such as privatization, freedom to establish new businesses, freer pricing, more flexible contract laws, and less regulation of domestic and international trade and of capital transactions are important” (Berggren, 2003, p.205),
- “economic freedom enhances growth both via increasing total factor productivity and via enhancing capital accumulation” (Ayal and Karras, 1998, p.9),
- protection of property rights as well as the quality and transparency of public administration have a positive impact on economic growth (De Soto, 2004; Heitger, 2004; Knack and Keefer, 1995), also through the inflow of foreign direct investment (Ahrens and Meurerers, 2000).

In addition, economic liberalization (a higher level of economic freedom):

- stimulates entrepreneurship,
- improves business efficiency,
- increases investments in profitable projects and the chances of their financing,
- increases technological progress and innovativeness of enterprises and economies,
- has beneficial environmental consequences (Norton, 1998, Carlsson and Lundström, 2001),
- promotes creating an economically independent and politically aware middle class (Griswold, 2004),
- tends to a higher level of human well-being,
- countries with a high EFW are significantly less likely to be involved in wars (Gartzke, 2005).

5. The Level of Economic Freedom

Political, social and economic changes which took place after 1989 were related to the political transformation involving the transition from a centrally planned economy to a market economy. When the transition process began, the state was the major economic actor. State-owned enterprises were dominant, and the allocation of resources was guided by state bureaucracies not by market forces. Public sectors, measured by government outlays and taxes, were not unusually high, however (Peev and Muller, 2012). In addition, the Polish economy was characterized by: administrative price fixing, a lack of independence of enterprises, soft budget constraints, demand imbalances in the labor market (hidden unemployment), high resource and

⁴ E.g.: Adkins, Moomaw and Savvides, Ali and Crain, Ayal and Karras, Bardhan, Barro, Sala-i-Martin, Carlsson and Lundström, Dasgupta, Dawson, Easton and Walker, Easterly and Pritchett, Gastil, Goldsmith, Grier and Tullock, Gwartney, Lawson, and Block, Hanke and Walters, de Haan and Sturm, Hanson, Heckelman and Stroup, Islam, Kormendi and Meguire, Pennar, Pitlik, Przeworski and Limoni, Ryan, Scully, Weede and Kämpf, Wu and Davis.

energy-intensive production, technologically obsolete, worn out and often incomplete production facilities, a low ability to absorb innovation, low productivity, low flexibility of businesses and the economy, a lack of capital market (compare: Balcerowicz 1990, Kornai 1986, 2000, Estrin 1994).

The disadvantages of a centrally planned economy meant that the level of economic freedom in Poland was very low. According to the Fraser Institute, EFI in 1985 was 3.50, and over the next five years, due to the launch of limited economic reforms, it slightly increased to the level of 3.60 (Figure 1). This means that at the beginning of the transformation, Poland was one of the "repressed"⁵ countries and ranked 104th (out of 113 countries) in the ranking. Only Algeria, Burma (Myanmar), Guinea, Congo, Nicaragua, Nigeria, Syria, Uganda and Zambia were characterized by a lower level of EFI.

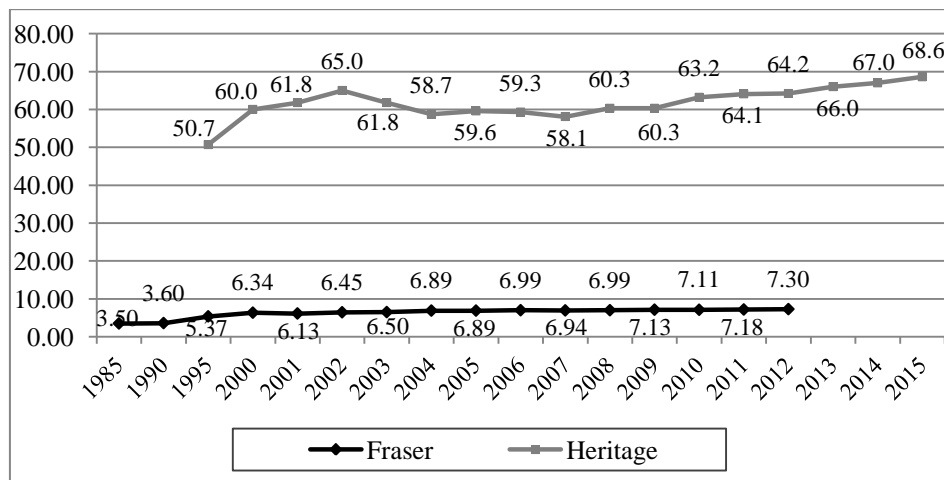


Figure 1. Index of Economic Freedom in Poland in the years 1985-2014

Source: The author's own compilation based on Gwartney *et al.* (1996; 1997-2014); Kane *et al.* (2007-2015).

The program, implemented since 1989, of building a market economy system was based on three pillars: stabilization, privatization and liberalization of the economy, and it sought to build a market economy. Adopted in December 1989, "Balcerowicz package" consists of 10 laws, envisaged, among others, the creation of a uniform tax system, absolute freedom of economic activity and a lack of state intervention in business transactions. The economic reforms introduced after 1989 facilitated the conducting of economic activity by private entities through: the elimination of most subsidies to state-owned enterprises (1989), the abolition of credit preferences for state-owned enterprises (1989), the introduction of a uniform 40-percent tax on all sectors of the economy (1989), liberalization of rules on capital movement (1989), the elimination of the state monopoly of foreign trade and the introduction of a single exchange rate for all entities and all types of transactions (1989), the introduction of uniform principles of customs clearance of imported goods for all business entities (1989), the introduction of the universal system of direct taxation of natural persons (PIT), including those engaged in economic activity (1991).

The economic reforms also included: the deregulation of prices, the introduction of internal convertibility of gold, the introduction of austerity policies, further changes in the tax system, the tightening of the monetary policy, the beginning of the reconstruction of the banking system, the onset of the process of de-monopolization of the economy and the laying of the foundation of the capital market (the establishment of Warsaw Stock Exchange).

That deep institutional reconstruction and liberalization of the Polish economy resulted in a rapid increase in the level of economic freedom. Over five years, the index increased to the level of 5.37 (Fraser) and 50.7 (Heritage). This meant that Poland ceased to be a "repressed"

⁵Classification used by the Heritage Index.

country and progressed to a group of "mostly unfree" countries. The level of the economic freedom was still low, yet an almost twofold increase in the index over five years should be considered a major success. To a large extent, it was the result of an explosion of entrepreneurship⁶.

In subsequent years, the steadily progressive liberalization processes (including privatization) and the accompanying reforms (though usually not so deep as before⁷) led to a further increase in the level of economic freedom. As a result, in 2000 Poland was classified as a "moderately free" country.

Poland's accession to the European Union also had a significant impact on the level of economic freedom. The analysis covering a period of five years (two years before the accession and 3 afterwards) shows that the largest improvement in the EFI (Fraser) occurred in the pre- and post-accession period. Dynamic economic growth which is the result of the implemented reforms and intensification of integration efforts have led to an increase in the level of economic freedom in most areas (more on the subject in the further section). Regrettably, the comparison of the Fraser and Heritage indices indicates that in the latter case the level of the index decreased in 2003-2004.

The global crisis that began in 2008 had no significant impact on the index level. Poland was hit by the economic downturn to the slightest extent out of all the Community countries. With a flexible exchange rate, an IMF credit line, access to international markets, and healthy economic policies, Poland was the only country in Europe to experience economic growth during the 2009 credit crisis. Thus, there has been no significant increase in the level of state intervention and automatically no decline in the level of economic freedom. Moreover, since the beginning of the crisis, Poland as one of the five members of the Community has shown an increase in the level of the economic freedom.

Poland's exploitation of the opportunity associated with its membership in the EU and systematic economic liberalization led to a further increase in the economic freedom. In 2009, the index (Fraser) exceeded 7, which places Poland in the group of "mostly free" countries. The Heritage Index also increased; however, the pace of change was slower. Therefore, Poland is still a country classified as "moderately free".

The change in the level of economic freedom has resulted in changes in Poland's position in the world ranking of the economic freedom (Figure 2). As mentioned earlier, in 1990, Poland ranked 104th (out of 113 countries) and was preceded not only by all the socialist countries but also by the poorest countries in Africa and Asia. The transformation of the economy meant that Poland climbed in the rankings - in 2012 it ranked 50th out of 152 countries (Fraser), and in 2015 ranked 42nd out of 177 countries (Heritage) (Stepniak-Kucharska, 2014); in the first case, an increase of 51 positions, and in the latter of 34.

⁶ In the years 1990-1993, the share of the SME sector in the total number of enterprises rose almost twofold (from 12.7% in 1990 to 23.1% in 1992 and 26.4% in 1993).

⁷ The four major reforms - of the education system, the pension system, administration and health care - carried out in 1999 were very important from the point of view of the economy. They did not, however, have a significant impact on the level of the economic freedom, maybe with the exception of the pension reform and the OFE (Open Pension Funds) created in the framework of the reform, which led to the development of the capital market.

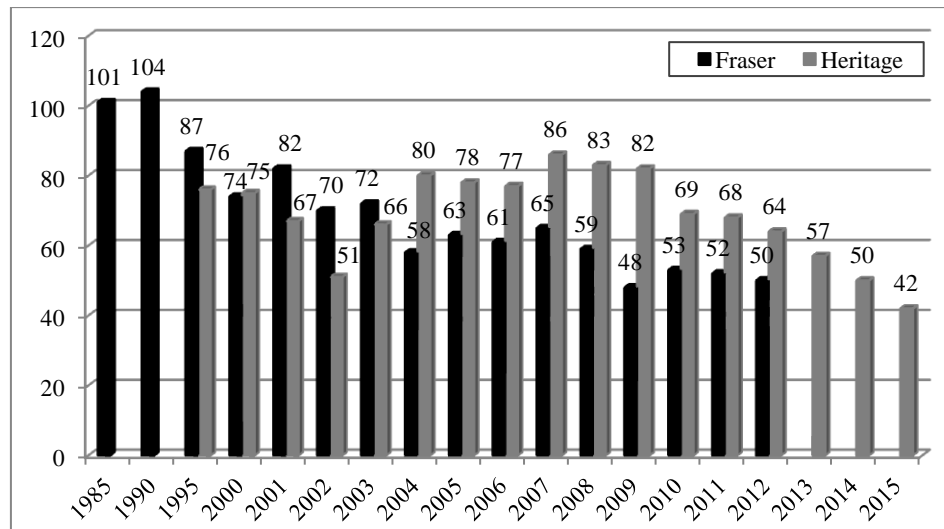


Figure 2. Poland's position in the ranking of economic freedom in the years 1985-2015

Source: The author's own compilation based on Gwartney *et al.* (1996; 1997-2014); Kane *et al.* (2007-2015).

6. Areas of Economic Freedom

The presented overall level of economic freedom does not mean that all the areas of the economy have an equal or similar level of liberalization. It is, therefore, necessary to expand the analysis of the various areas affecting the value of the index. Since the Fraser Institute and the Heritage Foundation include in their indices different, mostly non-overlapping, areas, taking into consideration both rankings will allow a wider assessment of the impact of elements influencing the overall level of economic freedom.

The increase in the level of economic freedom was accompanied by changes in the value of individual sub-indices that make up the EFI set by the Fraser Institute. Their analysis, however, indicates the existence of substantial disparities between these individual areas.

At the beginning of the transformation, Poland was characterized by a very low, close to 2, level of three of the five sub-indices (regulation – 2.2, access to sound money – 2.5 and the size of government – 1.9). This resulted primarily from the aforementioned very large involvement of the state in the economy (state-owned companies produced approx. 70% of GDP), the absence of a genuine banking system and an independent central bank, as well as very little freedom in setting up and running a business by private entities. The situation was slightly better in terms of freedom of international trade although also in this case the foreign trade restrictions, administrative pricing and exchange rates, as well as significant economic isolation, resulted in the index classifying this area as "repressed". The highest level of the index (6.2) was observed in the area of the legal system and the protection of property rights (Figure 3).

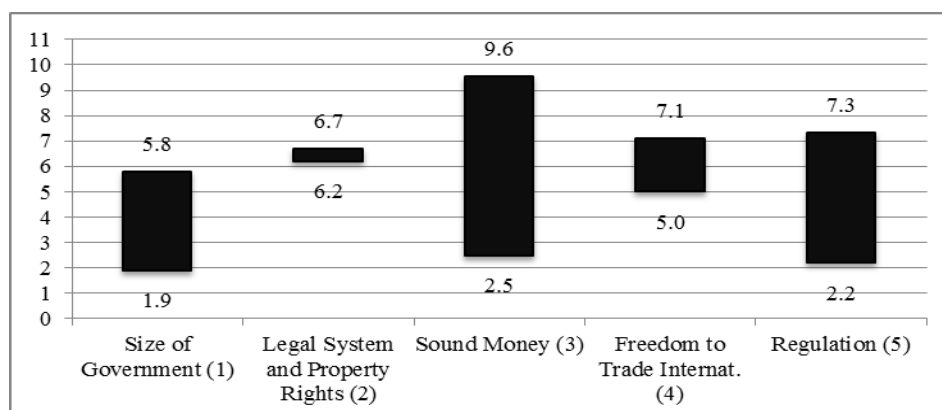


Figure 3. Sub-indices of economic freedom (Fraser) in Poland in 1990 and 2012

Source: The author's own compilation based on Gwartney *et al.* (1996; 1997-2014); Kane *et al.* (2007-2015).

The transformation of the system has led to an increase in the level of economic freedom in all the areas. The biggest changes have occurred in the case of monetary stability. The index in this area has increased by 7 points since the 9.55 level, the level close to absolute economic freedom. This high level of the index places Poland on the 15th place in the world.

The level of economic freedom in the area of regulation and international trade is currently 7.32 and 7.11. In the first case, the increase was much larger (5.1 pts.). In 2012, Poland was 38th in the world in terms of economic freedom in the area of regulations and 57th in terms of freedom of international trade.

The "size of government" is characterized by definitely the lowest level of the index. During the analyzed period it increased from 1.9 to 5.8, but is still low. A wide range of state ownership⁸, transfers and subsidies, public consumption and marginal tax rates result in Poland still finding itself at the end of the ranking (80th place in the world and 17th in the EU).

The smallest changes have taken place in the case of the legal system and property rights, the area which was originally the most liberal. Of the nine sub-areas of the index as many as five show a level of less than 7. The biggest problem is now the impartiality of the judiciary (3.0) and the ease of enforcing contracts (4.1). The level of this sub-index is relatively high compared to the world's economies. In 2012, Poland ranked 42nd in this area.

Summing up the analysis of the sub-indices, these sub-areas in which Poland has managed to achieve absolute economic freedom (Index = 10) should be noted. These include: military interference in the rule of law and politics (area 2), freedom to have foreign currency bank accounts (3), black market exchange rates (4), control of interest rates and compulsory military service (5).

The analysis of the sub-indices published by the Heritage Foundation also indicates that there are significant differences between the various areas. Unfortunately, the baseline indicators are for the year 1995, therefore they already take into account the effects of the profound changes that took place at the beginning of the Polish transformation. Thus, there is no possibility of comparing the level of the economic freedom in the pre-transformation period with the present state. Their advantage, however, is that they cover the period up to 2014 (the first half of the year).

In 1995, the level of economic freedom of seven of the nine areas was low or very low⁹. The sub-index for government spending was by far at the lowest level, which amounted to 9.6 (out of 100) (Figure 4). Only seven countries out of the 101 examined had a lower level of this index (Italy – 3.6; Angola, Cuba, North Korea, Nigeria and Sweden and Hungary – 0.0).

⁸ Public expenditures equal 42 percent of domestic production, and public debt is equivalent to 57 percent of gross domestic product.

⁹ The data for the sub-area "freedom of employment", not included in the Figure, have been published only since 2005.

Freedom in the area of property rights, corruption, taxes, money, trade and finance hovered around 50 points. By far the highest level of economic freedom (70.0) was recorded in conducting business activities and investments.

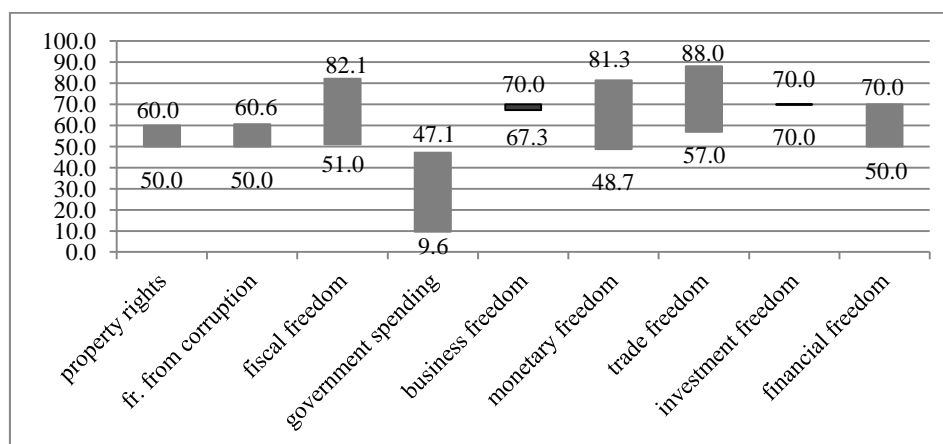


Figure 4. Sub-indices of economic freedom (Heritage) in Poland in 1995 and 2015

Source: The author's own compilation based on Gwartney *et al.* (1996; 1997-2014); Kane *et al.* (2007-2015).

The most surprising result in this ranking is government spending and business freedom. The first of these areas was also ranked low by the Fraser Institute, but not so low. The "government consumption" sub-area, which is the equivalent of "government spending", was assessed at the level of 5 (on a 10-point scale). The situation is reversed for the other area. It seems that the level of freedom in the ease of doing business was assessed too high. The corresponding EFI (Fraser) sub-areas of "business regulations" and "starting a business" were assessed at the level of 4.3 and 4.4 respectively. The reforms introduced in this area until 1995 (its first half) stimulated Polish entrepreneurship significantly, but it seems that they did not lead to significant liberalization.

The transformations carried out in subsequent years whose aim was to transition from a centrally planned economy to a market economy have led to an increase in the level of sub-indices in all the areas. The biggest change has been recorded in the case of government spending, although the level of economic freedom in this area is still the lowest. Significant changes have also taken place in the field of fiscal, monetary and trade freedom. Using the classification adopted in determining the index, it can be assumed that in 2015 the area of trade is economically free, while the five areas (fiscal, business, monetary, investment and financial) are mostly free. In the area of property rights and the labor market, Poland is a moderately free country. The level of corruption (mostly unfree) and government spending (repressed) is significant.

From the point of view of the position in the world ranking, Poland has the best rank in the area of trade (11th position out of 178 countries) and finance (19th). Poland also ranks high in terms of property rights (41st), corruption (41st) and investment (46th). The situation is worse in terms of monetary freedom (66th) business (75th). Definitely the worst, below the world average, Poland ranks in the area of freedom of the labor market (97th), the fiscal area (114th) and government spending (145th).

7. Conclusions

The analysis conducted shows that Poland is not a country that can be considered as completely free economically. This kind of situation, however, has also occurred in other EU countries. Political, social and economic changes which have taken place in Poland in the last 25 years have led to a significant increase in the level of economic freedom in Poland. Three events - the transformation, integration and the economic crisis have had an impact on the

formation of the index. The transformation of the Polish economy (stabilization, privatization and liberalization) started in 1989 has led to a significant increase in the level of the economic freedom. In subsequent years, the process of building economic freedom has been accelerated by the Polish accession to the EU. The third factor determining the index was the last economic crisis. The first two events have stimulated the process of building a market economy and led to an increase in the level of the economic freedom. However, a similar situation occurred in the case of the economic crisis. Among all the EU countries, Poland was hit by the slowdown to the slightest extent. Therefore, there was no significant increase in the level of state intervention and automatically no decline in the level of economic freedom. Thus, the hypothesis that the economic crisis decreased the level of economic freedom has not been confirmed.

As a result of the reforms introduced, Poland has achieved a similar level of economic freedom to the "old" EU members. The change in the level of economic freedom has also resulted in the improvement of Poland's position in the world's economic freedom ranking – by 51 positions (Fraser 1990-2012) and 34 positions (Heritage 1995-2015).

An increase in the overall level of economic freedom does not mean, however, that in all the areas of the economy the level of liberalization has been similar. Generally, over 25 years there has been an increase in the levels of all the sub-indices. The greatest progress has occurred in the area of monetary freedom (Fraser, Heritage), regulation (F), as well as fiscal and trade freedom (H). However, in some of these areas Poland is classified in the second quarter of the world ranking. Definitely the worst situation occurs in two areas – the size of government and partly in the legal system and protection of property rights. Although the liberalization of the first of these areas has been significant (the largest increase in the index), the impact of the Polish state on the economy is still too high. As a result, Poland is at the bottom of the two rankings for this area. The level of legal freedom is also low. This is primarily the result of corruption (although relatively low compared to other countries), the bias of the courts and the difficulty of enforcing contracts.

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