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JASNA **POČEK**

INSTITUTIONAL REFORM AND ENTERPRISE EMERGENCE IN A TRANSITION CONTEXT

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INTRODUCTION

In this book I explore how formal institutional reform unfolds and influences enterprise emergence in transition contexts. Focusing on labour law reform, I draw on theories of formal institutional transplants and their underlying rationales, applying them to the regulation and emergence of private market in a transition economy. This book also places particular emphasis on the relationship between formal institutional reform and the conditions under which private firms emerge and operate in transition contexts. Labour regulation does not only affect workers and employment relations—it also shapes the strategic decisions and organizational behavior of firms. The introduction or adaptation of formal institutions such as the employment contract, collective bargaining frameworks, and labour dispute resolution mechanisms creates both constraints and opportunities for new and existing enterprises. In transition economies, where institutional environments are often fragmented and rapidly evolving, firms must navigate significant uncertainty in interpreting and complying with labour regulations. Understanding how these actors respond to institutional change, how they comply, adapt, resist, or circumvent newly transplanted rules, is essential to grasping the broader dynamics of private market formation. This book therefore approaches enterprise emergence not as an isolated economic phenomenon, but as an outcome of contested institutional processes that unfold across legal, administrative, and organizational domains.

Here I consider the well-documented tendency, observed among both scholars and policymakers, for countries undergoing institutional reform to draw on comparative experiences. These typically come from systems that are either structurally similar or represent models that countries in transition aim to emulate in the process of private market development.(1) Often, this process includes the translation of the text of the formal institution- a legal text, from the country of origin or a supranational legal system and the direct transposition of the translated text in the recipient's country.

However, as Nelken noted, what is often overlooked is that during the process of political transition, many actors engaged in the process of institutional reform and borrowing draw from systems that come from quite different traditions compared to their own. In this book I ultimately explore what the results are when borrowing from rules and experiences that come from quite the opposite institutional system. This book argues that when a country's legal and political system collapses, particularly in cases where the institutional system is closely connected to the political structure, the country does not necessarily adopt the experiences of systems similar to the one that collapsed. Instead, the process of modernization may involve the transplant of institutional norms from systems that do not have a high degree of complementarity with the pre-existing domestic structure. Such institutional borrowing can result not only in changes within the formal-institutional domain, but also in the emergence of a new political, legal, and economic order. In these cases, institutional reform is unlikely to involve innovation in new rules. Rather, the country may attempt to catch up by adopting already existing and often prestigious institutional models, perceived as effective or legitimate. The motivations behind this form of borrowing are complex, involving strategic, symbolic, and practical considerations, especially in transition contexts where both legitimacy and functionality are in question and they imply specific dynamics for emergence of firms in newly established market operating.

The consequences of this type of borrowing are multiple. When institutional transplants are introduced without sufficient attention to

(1) R. Sacco, "Legal Formants: A Dynamic Approach to Comparative Law (Instalment II of II)", *American Journal of Comparative Law*, vol. 39, 1991, p. 399. 1-34 and 343-401, p. 400.

local administrative capacity, legal culture, and enforcement mechanisms, they often remain only partially implemented or operate symbolically. This can result in a persistent gap between law and practice, where formal institutions exist on paper but do not function effectively in reality. For firms, this creates environments marked by legal uncertainty, inconsistent regulation, and selective enforcement. Entrepreneurs may respond by avoiding formal channels altogether, relying instead on informal practices to manage labour and navigate regulatory obligations. Over time, this may contribute to the entrenchment of informality, regulatory arbitrage, and weak rule of law—factors that inhibit sustainable firm development and distort the competitive landscape. Moreover, it can undermine public trust in institutions and delay the institutional consolidation necessary for a functioning market economy.

In this book I will use the case study of Montenegro to examine the creation of private markets, which implies the formal emergence of private firms. Montenegro is a particularly interesting case due to the fact that in the last one hundred years it has experienced very different transitions in its institutional system. Before the Second World War, the country was organized by typical European civil law labour relations, in which the contract of employment emerged as a regulator, as well as by employment relations. However, instead of developing as the rest of Western Europe did, the political changes that occurred after the Second World War created a self-governing socioeconomic type of society, which led to the abolition of the institution of contracts of employment. This would again change in the 1990s, when the country experienced a transition towards a free market-based economy. It will be interesting to see how these market dynamics evolved within these different contexts, and to determine the differences between the types of relationships in two political and institutional systems.

The book also examines how institutional reforms affect the actual conditions under which enterprises emerge in transition economies. By focusing on changes to contractual frameworks, particularly in employment regulation, it explores how institutional borrowing can either enable or constrain private firm creation. The historical trajectory of Montenegro, from a self-managed socialist economy to a market-based

system, reveals how different phases of reform have shaped the governance structures that regulate firm formation and labour relations. Special attention is paid to the practical consequences of reform, including the persistence of informal employment, mismatches between formal rules and enforcement capacity, and the fragmentation of regulatory institutions. In this way, the book highlights how enterprise emergence is not simply a matter of liberalization or legal change, but rather a complex outcome of institutional design, translation, and adaptation.

Taken together, these reflections guide the way this book approaches institutional reform not as a linear or uniform process, but as one shaped by layers of historical change, ideological shifts, and the borrowing of norms from different institutional environments. By focusing on the case of Montenegro, the discussion aims to show how enterprise emergence is not only a matter of policy or economics, but of evolving institutional choices, contestations, and adaptations. Understanding how private markets are constructed through these processes—particularly in contexts of political and legal transition—can help us better grasp how institutions influence economic life in societies that are redefining their paths forward.

This book, therefore, situates itself at the intersection of institutional change and enterprise emergence, showing how institutional reforms, particularly those imported through legal transplants in employment regulation, shape the conditions under which private firms can be created and sustained in transition economies. By analyzing the specific case of Montenegro, the study contributes to a broader understanding of how institutional environments are reconfigured during periods of systemic change, and how these evolving frameworks directly influence the emergence, structure, and operation of market enterprises. Through this lens, *Institutional Change and Enterprise Emergence in Transition Contexts* examines the deep interdependence between institutional evolution and entrepreneurial dynamics.

CHAPTER I

FORMAL INSTITUTIONAL TRANSPLANTS AND COMPARATIVE INSTITUTIONAL THEORY

1.1. Why and when formal institutional transplants occur

Some scholars agree that in labour regulation, borrowing formal institutional rules has become an accepted modus operandi when it comes to the broader context of market reform.(1) Being "inspired" by best practices has become a common technique not only in the reform of labour and employment institutions but also across various domains of institutional development.(2)Also because of this, much has been written about the use of comparative law in processes of institutional reform.(3)

From the literature, it appears that the main purpose of what is called a formal institutional or "legal transplant" is reforming the institutions through policy choices, which ultimately affect institutional settings.(4) It is also suggested that any system that borrows institutional rules does so because it is believed that there is a failure of its own

(1) More information can be found in R. Blanpain „Comparativism in Labour Law and Industrial Relations" in *Comparative Labour Law and Industrial Relations in Industrialised Market Economies*, Roger Blanpain (ed), Kluwer Law International, Great Britain, vol. I, 1990.

(2) This technique is used by the governments, international organizations or private experst when advising on the law reform.

(3) J. H. M. Van Erp, „The Use of Comparative Law in the Legislative Process", in *Netherlands Reports to the 15th International Congress of Comparative Law*, E. H. Hondius (ed), Bristol, 1998.

(4) As it will be noticed from the literature overview below.

system or that there is a need to follow what may be called a civilizational trend, factor of globalization, market need, requirement for becoming a member of an exclusive club—the list can be exhaustive. As Sacco wrote, "A legal system will borrow when it's incomplete. An incomplete system will tend to imitate just to fill the gaps."(5)

1.2. Mechanisms and Contexts of Institutional Borrowing

In the case of institutional borrowing, I can think of some situations that may arise with regard to three patterns: the formal institutional system, the political system and the economic system. The situation in which legal borrowing has as a consequence new political, economic and legal institutional systems in a country is applicable to the case of Montenegro.

Countries often borrow institutional formal rules from the countries with which they have similar legal traditions.(6) However, this is not always the case with countries whose current legal and political systems have failed—also applicable to the countries of the former Yugoslavia but also for former USSSR countries. Furthermore, what should be noted is that formal institutional – legal, borrowing is almost never limited only to borrowing from only one legal model or system, unless that is, for example, a political requirement.

As demonstrated below, many scholars have contributed to the literature on legal transplants and have tried to define this trend from political, economical, legal, sociological and anthropological points of view. Legal transplants theory became well known when it was described and introduced by Alan Watson in his book *Legal Transplants: An Approach to Comparative Law*, in 1974.

Nevertheless, studies on the reception and diffusion of formal institutions in the history of legal-sociological-anthropological scholarship have been conducted since long before Watson published his work on legal transplants; among the scholars who have studied this are Jeremy Bentham, Charles-Louis de Secondat, Baron de La Brède

(5) Sacco, *op. cit.*, p. 400.

(6) H. Xanthaki, "Legal transplants in legislation: Diffusing the trap", *International and Comparative Law Quarterly,* vol. 57, 2008, p. 660.

et de Montesquieu, Gabriel Tarde, Sir Henry Maine, and Max Weber, among others. This is also because the question of transferability of formal instititions from one system to another is, among other things, one of the central questions in comparative law.(7)

Scholars who research this topic, like William Twining, observe that today, as during the course of history, formal institutional borrowings may symbolize the (colonial) power of institutions of some states over others,(8) most typical example being the unequal balance of powers among the so-called global north versus global south group of countries. Similarly, Paul Koschaker has argued that the transposition or transplant of formal institutions, in fact represents the power and prestige of some regions over others. In this regard, Koshaker observed that the reception of Roman law and the Code Napoleon occurred as a consequence of imperial power and not because these laws were superior in their quality.(9) Besides, as noted by Graziadei, "Legal transplants are surely of interest to those who are interested in the study of relations of power, such as those arising through colonization (and the fate of transplants tells us much about the postcolonial landscape)."(10)

In fact, the word "transplant", in its earliest use from 1440, according to the Oxford English Dictionary, was used in a farming context, while in the 1600s it became the "term of art to denote 'colony'".(11)

Historically, Montesquieu discussed the reception of Roman law in medieval Europe by considering the differences in local conditions and imported law,(12) finding that the main problem with the transplantation of formal institutions was differences in government, geography and culture.(13) Montesquieu observed that:

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(7) This conclusion is drawn from the fact that the topic has been researched by many comparativists.

(8) W. Twining, "Diffusion of Law: A Global Perspective", *The Journal of Legal Pluralism and Unofficial Law,* Vol. 36, Issue 49, 2004, pp. 1-45.

(9) Ivi, p. 9.

(10) M. Graziadei, „Legal Transplants and the Frontiers of Legal Knowledge", *Theoretical Inquiries in Law*, vol. 10:639, 2009, p. 694.

(11) A. Huxley, "Jeremy Bentham on Legal Transplants", *Journal of Comparative Law*, vol. 2, 2007, p.182.

(12) Graziadei, *op. cit.*, p. 696.

(13) Charles de Secondat, Baron de Montesquieu, *The Spirit of the Laws*, 1748, trans. T. Nugent and J.V. Pritchard, London, 1914.

> [The political and civil laws of each nation] should be so closely tailored to the people for whom they are made, that it would be pure chance [un grand hazard] if the laws of one nation could meet the needs of another…They should be relative to the geography of the country; to its climate, whether cold or tropical or temperate; to the quality of the land, its situation, and its extent; to the form of life of the people, whether farmers, hunters, or shepherds; they should be relative to the degree of liberty that the constitution can tolerate; to the religion of the inhabitants, to their inclinations, wealth, number, commerce, customs, manners.(14)

In this sense, Montesquieu was the first scholar to look at the spirit of the formal institutions, and not only at their body as some sort of an abstraction which id separated from the cultural, geographical and institutional scope in which it operates. In his opinion, only in the most unique cases could the transfer of formal institutional rules and norms from one geographical context to another be successful. Another important schola, Sir Otto Kahn-Freund asks himself whether Montesquieu would, in the time of globalization, write the same, since globalization understands also a set of important institutional formal rules to be common among the nations, including with regard to labour, trade and various other socio-economic issues.

In reference to globalization, another scholar who wrote about reasons for formal institutional borrowing is Mattei, who noted that in the globalized world, we must allow legal systems to learn from each other. Therefore, transfers of knowledge on legal regulation and formal institutional traditions, among other things, are needed not only "within different areas of a given legal system, but also among different legal systems."(15)

According to Mattei, intellectual globalization has as a consequence the fact that different views in the world of academia clash with each other.(16) If we apply this to formal institutional transplants, they will be successful only if their place of origin has a legal framework compatible

(14) *Ibid.*
(15) Mattei, *op. cit.*, p. 6.
(16) Ivi, p.7.

with the adopting country's framework.[17] However, if we deal with "legal imperialism", then in this case, according to Nelken, "the transfers of knowledge rather than being a pattern of communication and exchange between different […] systems, becomes a one-sided exportation of […] rules and concepts that usually end up being rejected, or creating intellectual dependency."[18]

Nelken wrote that in the present situation, unhappiness with the result of formal institutional transplants is often encountered in countries that seek to resist to the globalization trend,[19] because "globalization has palpably affected the supply and demand for law in many countries and highlighted the fact that law has different functions in different countries."[20]

Scholars such as Mattei have written about and elaborated on the path dependency of formal institutions: "Since comparison involves history, by means of comparative study, it is possible to identify the deep differences in the path of legal systems that make that dependency occur."[21] Path dependence, in this regard, refers to the history of the environment in which the formal institution operates and the way in which this history shapes both the existence and the application of the formal institution. Therefore, formal institutions are "path dependent" in relation to the environment that creates the "climate" and the realities of the path itself. According to Mattei, due to the path dependency phenomenon, we can also not only understand the formal institution better but also predict the failure or success of legal transplants: he observed that "path dependency seems to be what determines the success or failure of a legal transplant"[22] in so far those formal institutions that are aligned well with the path and its context have greater chances of success.

Similar to Legrand and Montesque, and as we will also see later, similar to Legrand, Mattei does not consider formal institutions to be made out of legal rules in a technical sense. The law, according to him,

(17) *Ibid*.
(18) *Ibid*.
(19) Nelken, *op. cit.*, p.350 and p.351.
(20) Milhaupt and Pistor, *op. cit.*, p. 45.
(21) Mattei, *op. cit.*, p. 6.
(22) *Ibid*.

cannot be deprived of cultural, historical and anthropological heritage. However, according to Mattei this does not mean that common elements to legal systems and laws (formal institutions) cannot be found—on the contrary, taxonomy, which "reflects the legal culture",[23] is the foundation to proposals of - what Mattei calls- "principled solutions" in law, and it helps lawyers and economists from different contexts to find a common language.[24] Consequently, the careful study of the path dependence and the correct taxonomy could perhaps predict the success or failure of the legal transplant, according to Mattei.

It should also be noted that formal institutional borrowing, as stated previously, is rarely based on or influenced by only one legal system:

> Modern Japanese law, for example, is as much influenced by American legal culture as by German or French. The new Dutch Civil Code is filled with rules borrowed from France, Germany, and the Common Law. The same may be said of Israel, Italy, and even England since its law has entered its new European dimension.[25]

Furthermore, institutional borrowing could be a matter of prestige, not only of a system but also of its particular parts. Thus, what should also be taken into consideration is "the prestige of the legal culture of certain portions of a particular legal system".[26]

The theories on the reception of formal institutions have been also closely linked to the theory of diffusion in cultural anthropology, in which "diffusionism represented a reaction against the prevailing nineteenth century view that there were natural laws of evolution governing human progress".[27] According to Twining, diffusion of formal institutions occurs when one legal system is considerably influenced by another and the definition of "influence" in this case is regarded as one kind of "interlegality".[28] In his work on diffusionism in law, Twining devel-

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(23) Ivi, p. 5.

(24) *Ibid.*

(25) U. Mattei, "Efficiency in Legal Transplants: an Essay in Comparative Law and Economics", I*nternational Review of Law and Economics, vol.* 3, 1994, p.4.

(26) Sacco, *op. cit.*

(27) Twining, Diffusion of Law, *op. cit.* p.9.

(28) Ivi, p.16.

oped a "model of reception that has twelve elements, none of which are necessary and some of which are not even characteristic of most processes of diffusion".[29] He presents his model as follows:

> [A] bipolar relationship between two countries involving a direct one way transfer of legal rules or institutions through the agency of governments involving formal enactment or adoption at a particular moment of time (a reception date) without major change…[I]t is commonly assumed that the standard case involves transfer from an advanced (parent) civil or common law system to a less developed one, in order to bring about technological change ("to modernise") by filling in gaps or replacing prior local law.[30]

As the opposite to formal institutional imperialism, which was mentioned previously, some scholars have written about voluntary reception of formal institutions, which occurred, as Twining mentions, in Turkey, Japan and to some degree Ethiopia.[31] Voluntary legal transplants in Turkey happened partially as a consequence of the prestige of certain legal systems, and are described by Turkish scholar Esin Örücü. As she explains, in the case of Turkey, voluntary legal transplants have their basis in the theory of competing legal systems, supported by a large number of scholars dealing with law and economics and economics in general. Örücü states that "What is regarded today as the theory of 'competing legal systems',[32] albeit used mainly in the rhetoric of 'law and economics' analysis, was the basis of the reception of laws that formed the Turkish legal system in the years 1924 - 1930. The various Codes were chosen from what were seen to be 'the best' in their field for various reasons".[33]

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(29) W. Twining, „Diffussion and Globalization Discourse", Harvard International Law Journal, Vol. 47, No 2, 2006. p. 511.

(30) *Ibid*.

(31) Twining, Diffusion of Law, *op. cit*. p. 9.

(32) Garoupa and Ogus provide with a theory of competition among legal rules according to which "a major step forward was taken with the hypothesis that competition between the suppliers of legal rules will significantly influence the evolution of law."

(33) E. Örücü, *"Critical Comparative Law: Considering Paradoxes for Legal Systems in Transition"*, *Electronic Journal of Comparative Law*, vol. 4, 2000.