Institutional Change and Economic Performance in the Transition Economies*

by

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1. Introduction

From the very beginning of transition, institutional reforms formed a key component of the policy package that was recommended to the economies of Central and Eastern Europe and the former Soviet Union. The overall package was designed to transform them from centrally planned economies operating under the socialist system, into market-type economies operating under the capitalist system in a democratic political framework. However, for understandable reasons rather more emphasis was placed initially upon the urgent need to achieve macroeconomic stabilization, accompanied by extensive price and trade liberalization, soon giving way to privatization and enterprise restructuring. This basic agenda was already a huge one, not only for the established states but also - and even more so - for the new ones that emerged from the ruins of communism.

For all the states concerned, the basic transition agenda already entailed substantial institutional reform in such areas as central banking (especially, but not only, for the new states), taxation and fiscal policy, industrial and trade policy, property and commercial law, and so on. Further, as failing enterprises shed labour and unemployment became a reality in the region for the first time in several decades, it became necessary to develop a raft of labour market institutions and policies to deal with retraining, unemployment benefit and other forms of income support, and the collection of suitable statistics. These considerations help to explain why institutional change was not at the forefront of the reform programmes undertaken by the transition economies in the early 1990s, except as a by product of other policies initially perceived as of higher priority.

A second factor is the simple observation that the economic theory of the time seriously under-rated the role and importance of the institutional framework needed to operate a well functioning market-type economy. Most textbooks, even relatively recent and advanced ones, had little to say about key institutions such as private property, business contracts, or the role of trust in conducting business successfully. Implicitly, regarding the market system as a form of economic mechanism on a par with central planning, it tended to be assumed that the "operating costs" of the system were close to zero - indeed this line of thinking was often used (erroneously) to support the claim that a market economy must be inherently more efficient than a centrally planned one. In any event, once central planning was swept away, it was taken for granted that the opening of markets would bring with it - rather quickly and painlessly - the needed institutional structures to make the new market system work properly. By now, it is well understood that arguments like this are fundamentally wrong, and that active efforts to create and support new institutions are vital. For instance, McMillan (1997) puts it very nicely when discussing markets in transition economies: "A market is an institution, which needs rules and customs in order to operate. Given the uneven distribution of information among them, the rules of exchange must be cleverly structured for a market to work smoothly. Institutions and organizations must evolve, to transmit information and to provide appropriate incentives" (p222).

Third, some mistakes or misjudgements in early transition influenced the direction of institutional development even where the need for new or reformed institutions was acknowledged. Here I have in mind the widespread views that privatization was the best way to create a new private sector rapidly, rather than new business formation; and that banking reform could sensibly be delayed until later in the transition.

Last, from the mid-1990s onwards, for the 10 countries in the region that have applied to join the EU, a factor operating in the opposite direction and promoting institutional change across a broad spectrum of policy domains has been the requirement that these countries must fully conform to the Community's *Acquis Communautaire* prior to their accession to the EU. Commitment to this programme entails a huge amount of institutional modernization, renewal and, in some instances, creation. While confirming quite properly the key importance of the institutional framework, this approach raises some important questions of its own, notably whether the particular institutional framework that has evolved across the EU is the one most suitable for a group of transition economies still in the throes of major economic restructuring. We return to this question later on.

The above remarks tacitly assumed a certain uniformity across the transition economies in order to justify discussing them together. Specifically, it was assumed that the political entities that existed or came into being at the start of transition were the "correct" units for analysis, that the states concerned had the capacity to bring forward and implement deep reforms, and that all these political units shared the common objective of transforming themselves into "normal" market-type economies. Unfortunately, as the experience of the past decade makes abundantly evident, none of these assumptions is wholly accurate.

Political Configuration

Concerning the political point, several states that existed in 1990 or 1991 have since split into components or merged with others. First, the former East Germany became part of the existing German Federal Republic following unification in 1990, whereupon the new Eastern Länder found themselves both part of the EU, and undergoing comprehensive institutional reforms to align their structures and administrative practices with those already established in Germany; though traumatic in various ways - especially for the East Germans - this change occurred peacefully.

Then Yugoslavia (as it was in 1990) started to disintegrate, accompanied by bitter fighting whose legacy is still with us. The new states that have emerged to date are: Slovenia, Croatia, the former Yugoslav Republic of Macedonia (FYR Macedonia), and Bosnia-Hercegovina (this state still comprising two "entities", one Serb dominated, the other Muslim dominated and comprising the Muslim and Croat parts of the country). What remains of Yugoslavia, still officially named the Yugoslav Federal Republic, consists of Serbia and Montenegro, and the Federation took some important steps towards democratization and political renewal in late 2000. At the time of writing, though, it is unclear whether the two republics will remain together; it is also unclear what the future holds for the Serbian province of Kosovo, with its overwhelmingly Albanian population. Not surprisingly, as a result of these political upheavals, economic reforms have been seriously delayed in much of the former Yugoslavia.

Disputes over the nature and pace of economic reforms led to the disintegration of Czecho-slovakia from the beginning of 1993, the Czech Republic and Slovakia being the two successor states. Since this was a peaceful and orderly separation, the course of economic reforms was not greatly disturbed, though the two states pursued divergent approaches to reform for some years after the break. Ironically, in some respects their policies are now converging, stimulated by their shared goal of joining the EU.

From the former Soviet Union, 15 states emerged, the three Baltic States (Estonia, Latvia and

Lithuania), and the 12 states which formed the Commonwealth of Independent States (CIS). Of the latter, the states based in the Caucasus region - Armenia, Azerbaijan and Georgia - have experienced civil or international conflict, some of which is still not settled. In Central Asia, Tajikistan has been afflicted by intense civil war. Even Russia has not been free from separatist tendencies, with some regions openly discussing separation for a time, and sustained armed intervention occurring in Chechnya. For the time being, under the leadership of President Putin, the country appears to be politically somewhat more stable for the first time since the dissolution of the USSR. Interestingly, Belarus currently seeks a political union with Russia, though the commitment to this idea from the Russian side appears to be rather limited.

Overall, the picture that emerges is of a region whose political contours are far from finally settled. While in what follows we shall not further discuss the issue of possible further changes in the region's political contours, the possibility should nevertheless be borne in mind.

State Capacity

There is a tendency for economists to assume that where economic policy advice is to be proffered, the recipient state will possess the ability to take the advice on board and implement it effectively. However, as World Bank (1997) makes clear, states vary enormously in their capacities, for many different reasons. The transition economies are no exception to this general observation. Across the region, one can find examples of states with competent, reasonably well functioning and largely corruption free administrations, while others lie at the opposite pole - corrupt, inefficient, largely incapable of delivering anything but the simplest of policies. In the discussion below about institutional reforms, it will sometimes be necessary to qualify what is said in the light of nature and functioning of the different state structures that one can observe.

State Objectives

Last, some of the transition economies may not wish to transform themselves into market-type economies in the sense we generally think of, and for such countries the whole project of institutional change under discussion in this paper is immediately much less applicable. States that have not yet evinced a notable commitment to market-oriented reforms include Belarus, Uzbekistan and Turkmenistan among others. This is not to say that at some point these nations might not change tack, but for the time being, although there have been some limited market reforms reflecting the ending of some of the state controls that characterised the communist period, serious talk of transition is probably premature.

Outline of Paper

In the following sections of this paper we proceed as follows. Section 2 offers some definitions and explores what sorts of institutional structure are needed for a market-type economy to function well. It also examines some recently developed theoretical approaches to questions of institutional change. On this basis, Section 3 surveys the transition economies to assess how far they have undertaken market-oriented institutional change up to the year 1999 or 2000 (the cut off year depending on data availability). Next, Section 4 investigates the links between alternative indicators of institutional change and various dimensions of economic performance. Section 5 concludes and draws out the most significant policy implications from the foregoing analysis.

2. Institutional Change - Concepts and Definitions

What sorts of institution are helpful in supporting a well functioning market-type economy? To answer such a question, one approach is to appeal to the findings of various historical studies that seek to identify the factors that have led certain countries, or groups of countries, to perform well over long periods, as compared to other parts of the world. Thus Landes (1998) points to "culture" as key, while others have highlighted "the Protestant ethic", the existence of a strong "civil society", or the environment that nurtures "small-scale business enterprise" (on the last of these, see Braudel, 1985). Roberts (1985) places the emphasis on numerous institutional features of the "Western model of civilisation", often copied even in countries no longer, or never, dominated by western powers. More firmly grounded in the underlying economic reality, Kennedy (1988) argues for a link between "economic success and military might". His thesis is that economically successful countries apply resources to developing their military power, then later, strive to maintain their prowess through military means, eventually at the cost of productive investment and further development. Finally, Fukuyama (1995) acknowledges a tendency towards convergence across countries in many basic institutions of government and economic regulation, accompanied by continuing divergence in economic performance. This line of argument leads him to the view that deep seated cultural differences between societies explain the observed differences in performance. Clearly, there are as many views as authors, all of some interest and relevance to the present study, but none providing a sufficiently complete or compelling analysis to serve our purposes.

An alternative approach to these broad, conceptual overviews is more pragmatic and empirical, simply examining the institutions we find in modern, market-type economies in various policy domains, and arguing for their necessity in transition economies. This approach quickly encounters three types of problem: (a) it is descriptive and all encompassing, offering no obvious means of judging which institutions are more or less vital, which are desirable but not indispensable; (b) it does not provide a definition of what we mean - or ought to mean - by an institution, so is open to multiple interpretations; and (c) it gives us no theory of the market economy to explain the roles and significance of the various institutions observed therein.

Accordingly, this section is organised in the following way. First, we attempt - albeit briefly - a definition of what is meant by an economic institution. Then we list the typical institutions that characterise a "normal" market-type economy, while acknowledging along the way the huge diversity of practice and structure that can be found for any given institutional form. Third, since economies function even in the absence of what might otherwise be considered as key institutions, we consider some examples of what can happen in such situations. Fourth, we examine some theories of institutional development and change in market economies in order to throw light on what is more or less important, and on the processes whereby institutional change comes about.

Definitions

Economic institutions are social arrangements possessing a number of special features: (a) they *regulate economic behaviour* in ways which, in the short run, often conflict with individual preferences; (b) they are based on *shared expectations*, derived from custom, trust, legal provisions, etc.; (c) they make most sense if the economy is thought of as a "*repeated*

game" in which most types of transaction occur many times[1]; and (d) *anonymity*, in the sense that the functioning of a given institution should not be dependent upon the identity of the economic agents seeking to conduct the types of transaction to which this institution relates.

Given such characteristics, many institutions are likely to have the character of *public goods*. Among other things, this implies that the "supply of institutions" generated by the market mechanism left to itself is unlikely to correspond to the socially efficient level. Under these conditions, there is evidently a role for the state both in creating institutions which the market does not provide and regulating in the public interest those which it does. What this means in practice we shall see through various examples in the subsequent discussion.

Typical Institutions
Well functioning market-type economies are generally found to contain institutions or institutional arrangements to provide for the following key economic functions:

- Private property rights and contracts;
- Banks and other financial markets: existence, functioning and regulation;
  - Reliable access to credit on reasonable terms;
  - Bankruptcy/liquidation policy in place to facilitate orderly exit;
- Labour market institutions: social policy and the social safety net;
- Clear fiscal environment for firms, perceived as fair, predictable and enforced (this means, for instance, that in a multi-level country such as Russia it should not be possible for the regions to set taxes that conflict with national policies, and taxes should not be changed frequently);
- Institutions dealing with competition policy, industrial policy and trade policy.
- Trust between economic agents, trust and honesty in public institutions (lack of corruption, reliable law enforcement, incl. as regards business taxation)

Economic Behaviour with Missing Institutions
In the transition economies, it has sometimes been the case that important institutions have not been created at an early stage of transition, or that the relevant laws are incomplete, imperfectly enforced, or still subject to serious political controversy. In such unsettled institutional environments, several outcomes are possible, all of which can be found in one or other transition country (some aspects of this issue are studied in McMillan, 1997).

First, the private sector can step in to create a missing institution. For instance, in parts of the former Soviet Union, notably Russia itself, where business contracts and private property rights have not been reliably secured through adequate legislation, private means of contract enforcement have developed. Sometimes these private institutions act in the interests of particular firms or groups of firms, and can entail the use of violent methods to compel

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[1] This is not the place for an exposition of game theory. Suffice it to say that a repeated game is one in which the players make a series of moves, and their choices in later moves can be influenced by what happens in the early moves. This situation can provide incentives for good behaviour that could not be explained in a one-period or one-move game. For a thorough analysis of repeated games in the context of social institutions, see Schotter (1981). For a wider economic analysis of the institutional structure of a market economy, see Eggertsson (1990).

payment where necessary. This approach can prove effective for the firms concerned but it would not generally be regarded as desirable since it fails to offer a universal service and violates important principles to do with the "rule of law". It does, however, have the merit of filling a clear "gap" in the institutional space.

In contrast, where an existing institution is weak or the legal provisions supporting it are poorly enforced, more predatory private sector "solutions" can be observed, commonly associated in the public mind (and perhaps in reality - the evidence is seriously incomplete) with mafia-like criminal structures[2]. These include the widespread practice of demanding "protection money" and the like from many firms, as a condition for them to continue in business. Needless to say, such practices are wholly undesirable. They are likely to inhibit or delay the expansion of existing firms, and seriously discourage new business formation. Nevertheless, practices of this sort are common across the CIS, less common in Central and Eastern Europe[3].

Second, the state itself can step in to create a missing institution. A good deal of the EU's aid to the transition economies under the PHARE and TACIS programmes serves this purpose, and some institutional development also accompanies World Bank and EBRD projects in the region. Provided that the private sector has not already rushed in to pre-empt a state solution, and the aid is not diverted to finance those who strongly resist institutional innovations, this can be highly effective. Good examples of successful institutional creation through this sort of route are numerous, and only a couple of examples are cited here: (a) the development or local and regional development agencies in Hungary, as part of the country's evolving industrial policy; and (b) the design of new tax systems in many transition economies (though there are often residual problems of tax administration, income definition, coverage, etc.).

Third, a given institution might not exist and it may be impossible to create it due to political, legal or other obstacles. Thus in Russia and some other CIS countries, it is still the case that there is no legal private market in agricultural land, a circumstance resulting from vociferous political opposition to such an institution. The result, however, is that private farming in Russia is severely inhibited, while the state lacks the resources to fund adequately the existing state farms and other non-private organisational forms (e.g. remaining co-operatives). This is not the only problem in Russian agriculture, of course, but it is an important one, and remains unresolved despite several (unsuccessful) attempts to get suitable legislation through the State Duma.

Last, sometimes countries can lack an apparently important institution, such as private property, and yet find ways around the missing institution - possibly by accident - in order to

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[2] In some countries, the state itself can act in a predatory manner. This idea is discussed in Evans (1995), who distinguishes between predatory and developmental states in an interesting way. In an interesting case study, the issue is discussed for Russia in Buiter (2000).

[3] Unfortunately, no economy is totally free from such criminal practices. However, from the standpoint of economic policy what matters is the general expectations that firms hold. If most firms expect to have to pay protection money that is a far more serious situation than that where only a small proportion encounters these difficulties.

enable successful development to take place. The most spectacular instance of such a serendipitous process can be found in China, in terms of the unexpectedly rapid growth and spread of township and village enterprises (TVEs) since the late 1970s. Neither state-owned in the old sense, nor strictly private, and unprotected by clear laws on private property and commercial contracts, these firms have nevertheless thrived. They are established at a very local level, but serve both local and wider markets - provincial, national, international - and are obliged to operate competitively. There is no protection for those that fail commercially. These firms operate as they do, not quite in the institutional vacuum that one might imagine, but in a secure political framework and strong local networks of trust that take the place of the missing institutions. Local authorities support "their" firms, because a share of the resulting profits is what finances the development of local infrastructure. Everyone therefore has an interest in encouraging highly profitable, fast growing firms[4]. An interesting question, however, is whether such firms might soon reach the limits of their possible development in the absence of more fundamental institutional reforms.

Theories of Institutional Change

Theoretical approaches to institutional change in transition economies are already quite diverse, ranging from broad theories of the reform process as a whole through to very specific models of particular aspects of institutional reform. For space reasons, it is only possible here to cite some of the more interesting of the available studies, without going into great detail.

Probably the most ambitious, and most general approach is that of Roland, set out in numerous papers and nicely summarized in Roland (2000). Roland considers gradual and so called big bang approaches to reform, and investigates the formation of various types of coalition for or against different stages of reform. The approach is general in that no specific reform measure is characterised in the analysis, but the approach is virtually the only one that starts to get to grips with the complex political configurations that can inhibit or favour reforms.

Although not directly focusing on our institutional concerns, Stiglitz (1994) draws attention to the weaknesses of the standard, neoclassical model of a market economy as a basis for advising transition governments on appropriate reform strategies. He draws attention to numerous informational and incentive issues that arise in many markets, the resolution of which entails various forms of state intervention and regulation. In other words, Stiglitz's book can be regarded as providing a conceptual foundation for many of the institutional reforms now widely acknowledged as essential for economies in transition. Sometimes the outcome of such analysis, drawing on the economics of information, can lead to remarkably powerful conclusions, as for instance in the analysis of credit markets and banks, the role of competition, and privatization and property rights.

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[4] This raises the obvious question as to why such firms are not to be found everywhere, why only in China? Elsewhere there must be other obstacles such as a more centralised state structure (with less local autonomy than in China); or political elites could continue their old association with traditional state-owned enterprises rather than promoting new businesses (this option would not be available in most Chinese counties); or there could be insufficient trust and confidence at the local level to serve as a substitute for the missing private property rights.

Contrary to our definition of institutions given above, several transition economies - notably in the CIS - have developed practices that seriously conflict with the desirable features we listed. In particular, the "anonymity property" is frequently violated through forms of state capture by large enterprises and other economic interest groups whereby these agents are able to influence state policy in their favour, and hence undermine the proper functioning of economic and political institutions. Such practices have been analyzed in some depth for Russia in Ericson (2000), and more widely, based on extensive enterprise-level empirical data through 1999, in Hellman, Jones and Kaufman (2000). The former sees a continuation in Russia of the traditional inter-penetration of political and economic structures, and characterises what market structures there are as "fragmentary". The latter conclude that "improved property rights protection and civil liberties can significantly reduce the capture economy".

An alternative route for firms seeking to operate in a poorly defined institutional environment is the second, or shadow economy. While some firms operate outside the official system in all countries, the scale of such activities can be regarded as a measure of how badly the formal structures are functioning. The nature and diversity of second economy activities are explored in Schneider and Este (2000), which also presents estimates of the size of the shadow economy for many developing countries and for transition economies. In the latter, the shadow economy is estimated to account for 35 per cent of GDP on average in the former Soviet Union, and about 21 per cent in Central and Eastern Europe (taking, in each case, the lower of two estimates given in the paper). The corresponding average for OECD countries is estimated (on the same basis) as about 11 per cent of GDP. The authors conclude along lines highly material to the present study, "Most studies of the shadow economy focus on the influence on the allocation of resources and the loss of revenue for the state. But the impact on official institutions, norms and rules is even more important. The shadow economy can be seen as an indicator of a deficit of legitimacy of the present social order and the existing rules of official economic activities" (p108). Set against this remark, the above cited figures speak for themselves.

We expect economic performance - including overall economic growth and sustained enhancements in productivity - to depend fundamentally on what happens at the level of individual enterprises across any given economy. Key aspects of enterprise sector behaviour in this connection are: entry, exit, and the restructuring of incumbent firms. Hence institutional measures that foster these processes are highly desirable. Aghion and Schankerman (2000) provide a valuable formal analysis of such measures, under the heading of "market-enhancing infrastructure". Their model captures three aspects of infrastructural investment (often interpreted as measures that cut transport costs or reduce other forms of transactions costs), namely: direct market selection (more high cost firms are forced out of business), restructuring (stronger incentives for firms to engage in cost-reducing activities), and entry (less incentive for new, high cost firms to enter, stronger incentives for low cost firms to enter). In a dynamic framework, these processes generate productivity improvements across a sector, region or entire economy, though the relative importance of the different effects depends on initial conditions, the initial level of infrastructure and the costs of restructuring and entry. These are likely to vary across countries and over time. The authors conclude that an interesting extension of their work would be to examine the political economy of infrastructural investment (since existing high cost firms are likely to oppose it, low cost firms will support it), and to study the way in which infrastructural investment

affects firms' learning processes both through experimentation and via demonstration effects.

In informal discussions of transition institutions, the legal environment is often highlighted as critical for successful private sector development. Analytically, this can be approached at a general level, in terms of the economics of law enforcement, and at a more concrete level one can investigate specific areas of the legal regulation of market institutions, drawing conclusions about good practice from cross country comparisons. Roland and Verdier (2000) provide an example of the first approach, their general approach being illustrated nicely, in the context of property rights, by Rapaczynski (1996). Black (2000) presents an interesting case study of the second, in the context of securities market regulation and investor protection.

Roland and Verdier (2000) draw attention to a (social) co-ordination problem associated with law enforcement in that (a) people have to agree to levy and collect taxes in order to pay for law enforcement - but in jurisdictions where law enforcement is weak, tax collection also tends to be weak; and (b) for given expenditure on law enforcement, if people choose to be mostly law abiding then enforcement is effective, while if they do not so choose then the enforcement effort can be largely ineffective. In models with such co-ordination problems, it is well known that there can be multiple equilibria, with generally law abiding outcomes in some ("good" equilibria), serious disregard for the law in others ("bad"). While these models are rarely very specific about exactly which laws are under discussion, there is a presumption that law abiding behaviour is good for private sector development, business confidence, and the like; and conversely. Since there is little theory to help us determine which equilibrium will occur in a given situation, the authors consider what concrete institutional mechanisms might exist in transition economies to help eliminate the bad equilibrium. They identify two possible mechanisms: Chinese style "dualism"; and the prospect of EU accession (the argument here is that the prospect of effective law enforcement in the future provides incentives to be law abiding in the present). Since neither of these arguments applies to Russia or other CIS countries, it is perhaps not so surprising that they continue to perform so poorly.

In regard to the securities markets, Black (2000) draws attention to informational asymmetries and reputational issues in such markets. While formal, legal regulation is important, he also notes that securities markets cannot function well without a network of intermediaries prepared to invest in a reputation for honest dealing. Minority shareholders, in particular, need good information about company values, and need to have reasonable confidence that managers or majority shareholders will not cheat them. Ensuring both these conditions in an open and transparent manner is surprisingly difficult, and few countries can claim to be completely successful. Sometimes a (small) country can manage by issuing shares through the stock exchange of another country with already well established institutions, but mostly this option is not available. However, failure to develop a well functioning securities market compels firms to resort to self financing or bank financing. While clearly making important points about the complex and subtle structure of institutions necessary to support effective securities markets, it seems to me that Black over-generalises his case. For many countries have experienced successful and sustained economic growth with very poor or virtually absent securities markets. We should therefore be careful, especially in the context of transition economies where many new institutions are being created *ab initio*, not to insist that all must adopt a rather uniform model that might only suit some of them.

3. Institutional Change in Transition Economies

What exactly have the transition economies done as regards institutional transformation and the development of market institutions? Their progress in economic reforms has been tracked by the EBRD in successive issues of its annual *Transition Report*, which reports a set of qualitative transition indicators for 26 transition countries. The EBRD also tabulates summary indicators of macroeconomic stabilization (using GDP growth and the rate of inflation as key indicators), and of the extent and effectiveness of legal reforms, especially those to do with business contracts and property rights. IMF (2000) also reports a number of measures of institutional conditions: (a) an indicator of initial conditions; (b) liberalization index; and (c) institutional quality. Luckily, amongst the various indicators there is an extremely high positive correlation[5], implying that although they purport to measure somewhat different dimensions of institutional change, they are actually picking up essentially equivalent indicators of institutional development. This remark does not, of course, apply to index (a) in IMF (2000), since that does not measure change at all. Instead, it measures various aspects of the extent of distortions and institutional deficiencies in the transition economies around 1990. In other words, it is an attempt to measure the distance to be travelled once reforms get under way.

Table 1 to 3 summarize selected indicators of economic performance and reform progress across the transition economies, principally drawing on the above sources. Thus Table 1 presents data on growth of GDP and on the rate of inflation experienced by the transition economies. Table 2 shows indicators concerning the initial conditions for transition, a liberalization index, an indicator of institutional quality, and the EBRD's average transition indicator for each country in 1995 and 1999. Table 3 gives more EBRD transition indicators, this time to do with the extent and effectiveness of legal reforms in the areas of commercial law and the regulation of financial markets.

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[5] From a methodological standpoint, it should be pointed out that, strictly speaking, the calculation of simple correlation coefficients across sets of indicators based on rankings and qualitative scoring is not valid. Instead, Spearman rank correlation coefficients should be employed. However, performing the calculations correctly does not materially affect the finding reported in the text. This issue, and the related one of performing ordinary least squares regressions with qualitative/ordered variables where some form of ordered probit would be a more appropriate technique, crops up frequently in the empirical work reported in this paper.

TABLES

Table 1. Growth and Inflation

Country\ Group	GDP in 1999 (% of 1989)	GDP growth 1999, %	Forecast GDP growth in 2000, %	Highest inflation (1989-99)	Inflation in 1999, %	Estimated inflation in 2000, %
EU accession countries (except Baltics)						
Bulgaria	67	2.4	4.0	1082	0.7	7.0
Czech Republic	95	-0.2	2.0	52.0	2.1	3.9
Hungary	99	4.5	6.0	35.0	10.1	9.5
Poland	122	4.1	5.0	586	7.3	9.9
Romania	76	-3.2	1.5	256	45.8	45.0
Slovak Republic	100	1.9	2.0	61.2	10.6	11.9
Slovenia	109	4.9	5.1	1306	6.1	8.6
Baltics						
Estonia	77	-1.1	5.0	1076	3.3	3.8
Latvia	60	0.1	4.5	951	2.4	2.9
Lithuania	62	-4.2	2.2	1021	0.8	1.0
Other SE Europe						
Albania	95	7.3	7.0	226	0.4	0.4
Bosnia & Herzegovina	-	-	-	-	-	-
Croatia	78	-0.3	3.5	1518	4.2	6.5
FYR Macedonia	74	2.7	5.0	1664	-1.3	8.5
C.I.S.						
Armenia	42	3.3	3.5	5273	0.6	-0.5
Azerbaijan	47	7.4	7.5	1664	-8.5	1.5
Belarus	80	3.4	2.0	2221	294	168
Georgia	34	3.0	3.0	15607	19.3	4.4
Kazakhstan	63	1.7	8.2	1892	8.4	13.2
Kyrgyz Republic	63	3.6	5.0	855	36.8	18.6
Moldova	31	-4.4	-3.0	1276	39.3	32.0
Russia	57	3.2	6.5	1526	86.1	20.7
Tajikistan	44	3.7	5.0	2195	27.5	24.2
Turkmenistan	64	16.0	20.0	3102	24.2	10.0
Ukraine	36	-0.4	3.0	4735	22.7	28.0
Uzbekistan	94	4.1	1.0	1568	29.1	30.0

Source: *EBRD Transition Report 2000*, London: EBRD

Table 2: Progress with Institutional Reform

	Initial Conditions Index[1]	Liberalization Index[2]		Inst. Quality[3]	EBRD Transition Indicators[4]	
Country\ Group		1989	1997	1997-98	1995	1999
EU accession countries (except Baltics)		0.16				
Bulgaria	2.1	0.13	0.79	0.1	2.5	2.9
Czech Republic	3.5	0.00	0.93	6.8	3.5	3.4
Hungary	3.3	0.34	0.93	8.7	3.5	3.7
Poland	1.9	0.24	0.89	7.0	3.3	3.5
Romania	1.7	0.00	0.75	-0.8	2.5	2.8
Slovak Republic	2.9	0.00	0.86	2.8	3.3	3.3
Slovenia	3.2	0.41	0.89	8.5	3.2	3.3
Baltics		0.05				
Estonia	-0.4	0.07	0.93	6.1	3.2	3.5
Latvia	-0.2	0.04	0.89	2.6	2.8	3.1
Lithuania	0.0	0.04	0.89	2.6	2.9	3.1
Other SE Europe		0.27				
Albania	2.1	0.00	0.78	-7.1	2.4	2.5
Bosnia & Herzegovina	-			-9.9	-	1.8
Croatia	2.5	0.41	0.85	0.3	2.8	3.0
FYR Macedonia	2.5	0.41	0.82	-3.3	2.5	2.8
C.I.S.		0.04				
Armenia	-1.1	0.04	0.72	-4.4	2.1	2.7
Azerbaijan	-3.2	0.04	0.62	-7.8	1.6	2.2
Belarus	-1.1	0.04	0.51	-7.6	2.1	1.5
Georgia	-2.2	0.04	0.72	-6.1	2.0	2.5
Kazakhstan	-2.5	0.04	0.86	-5.3	2.1	2.7
Kyrgyz Republic	-2.3	0.04	0.75	-4.2	2.9	2.8
Moldova	-1.1	0.04	0.75	-2.0	2.6	2.8
Russia	-1.1	0.04	0.83	-5.4	2.6	2.5
Tajikistan	-2.9	0.04	0.45	-15.0	1.6	2.0
Turkmenistan	-3.4	0.04	0.36	-11.5	1.1	1.4
Ukraine	-1.4	0.04	0.65	-5.8	2.2	2.4
Uzbekistan	-2.8	0.04	0.57	-10.4	2.4	2.1

Sources: *World Economic Outlook - October 2000: Focus on Transition Economies*, Washington, DC: IMF; *EBRD Transition Report*, London: EBRD, various years.

Notes:

1. Initial Conditions Index - a weighted average of indicators for level of development, trade with CMEA, macroeconomic disequilibria, distance to the EU, natural resource endowments, market memory (measured by number of years of communist rule), state capacity.
2. Liberalization Index - a weighted average of three components: domestic market liberalization (weight 0.3), foreign trade liberalization

(weight 0.3), enterprise privatization and banking reform (weight 0.4). Each component, and the average reported in the table, is scored in the range [0, 1].
3. Institutional Quality - index based on five components, namely extent of democracy, government effectiveness, extent of regulation, rule of law, and extent of graft/corruption. Each indicator is scored in the range -25 to +25 and so the average lies in the same range. For developed market economies the average score is 12.6.
4. Transition Indicators - based on a simple average of eight indicators each scored in the range 1 (no market reforms) through to 4 (conditions as in a developed market economy) or 4* (exceptionally strong development of market-based institutions). Scores with an asterisk are treated as adding one-third of a point to the aggregate.

General note: Summing and averaging qualitative/ordinal indicators is, strictly speaking, methodologically rather suspect, but there is no obvious alternative and with careful judgement the method is probably not too bad. In this connection it is reassuring that indicators, scores and rankings based on different sets of underlying measures seem to yield broadly similar results.

Table 3. Indicators of Legal Reform and Effectiveness

	Commercial Law		Financial Regulation	
Country\ Group	**Extent**	**Effectiveness**	**Extent**	**Effectiveness**
EU accession countries (except Baltics)				
Bulgaria	4	4-	3	2+
Czech Republic	3	3+	4	3-
Hungary	4	4-	4	4
Poland	4-	4	4	4
Romania	3+	4-	4	3
Slovak Republic	3	3	3	3-
Slovenia	4	4-	4	4
Baltics				
Estonia	4-	3+	4	3-
Latvia	4	4-	3	3
Lithuania	4	3+	4	4-
Other SE Europe				
Albania	3+	2-	2	1
Bosnia & Herzegovina	3	1	1	1
Croatia	4	3+	3+	3-
FYR Macedonia	3+	2+	3	2-
C.I.S.				
Armenia	4-	2	2	3
Azerbaijan	3	2	2	2-
Belarus	1	2+	2+	2
Georgia	3	2	3+	2
Kazakhstan	4	4-	3	3-
Kyrgyz Republic	3+	3	3+	3-
Moldova	3	2	3-	2-
Russia	4-	3	3	3-
Tajikistan	2	2-	2	1
Turkmenistan	no data	no data	no data	no data
Ukraine	3+	2	3	2+
Uzbekistan	3	2+	2	2-

Source: *EBRD Transition Report 2000*, London: EBRD

Notes: Each indicator is scored on a basic scale running from 1 to 4, with 1 signifying little or no development of the relevant legal provisions and/or poor implementation due to badly formulated laws, poor administration, defective judicial procedures, etc. A score of 4 indicates that the legal rules are quite comprehensive in relation to what one would expect in a well ordered market economy, or that the implementation of legal provisions attains a high standard. Indicators + or - indicate that the achieved level is just above or just below the given score, but not be enough to move to the next level.

From the tables it is abundantly clear that the experience of the transition economies over the past decade, both in terms of growth and inflation, and in terms of the extent and nature of institutional reforms, is extremely diverse. Their starting points, measured by the indicator of initial conditions shown in Table 2, were also very diverse. These points make it hard to discuss the countries as a group, since virtually their sole common feature is the fact that they had communist governments in place prior to 1989. At the same time, the sheer diversity revealed in the tables helps to explain why it is nevertheless interesting to try to understand better the linkages that can be found between the economic performance of the transition economies and other indicators of their status and progress: initial conditions, effectiveness of macroeconomic stabilization, extent and nature of (market-oriented) institutional reforms, and so on. These linkages are explored in the next section, both at the macroeconomic level, and at a more microeconomic level by referring to studies based on the analysis of enterprise survey data.

To a large extent, the CEE countries that are candidates for EU accession stand out as having relatively favourable initial conditions, and they have also, for the most, liberalized substantially, achieved high levels of institutional quality, and perform well on the EU transition indicators. They suffered relatively modest post-communist recessions and their GDPs are already close to pre-transition income levels (Poland is already well ahead of this level). Mostly, these countries are growing at respectable rates now and there is every indication that their achieved rates are sustainable.

In contrast, many of the CIS countries had poor initial conditions, have not (yet) liberalized so decisively, still have poor institutional quality and their reform progress as measured by the EBRD transition indicators is modest at best. Many CIS countries have resumed economic growth, but their post-communist recessions were so deep and prolonged that they still have an enormous amount of catching up to do to get back to pre-transition income levels. Within the CIS group, Belarus and Uzbekistan are of interest as a pair of countries that have experienced post-communist recessions that were quite minor, while undertaking virtually nothing in terms of serious market-oriented reforms. This might be interpreted as an argument for institutional stability except that the longer term viability of these economies, based on their current policies, is questionable. At the opposite pole are Georgia, Moldova and Ukraine, whose (officially measured) GDPs fell by two-thirds during the 1990s. This truly shocking economic decline, virtually unprecedented except in wartime (both Georgia and Moldova saw serious civil conflict in the early 1990s, though Ukraine remained totally peaceful during the period), was accompanied by limited and inconsistent reform progress, albeit far from the worst in the transition economy region. Hence there remains a good deal to be explained in the exceptionally poor performance of certain countries.

4. Links between Institutional Change and Economic Performance

By now, numerous studies have sought to understand the connections between various dimensions of institutional reform in transitional economies, and their economic performance. Some of these studies have focused on macroeconomic performance, looking at broad features of the institutional environment and their impact upon aggregate economic growth. Others have focused more narrowly, studying the ways in which institutional change has supported or inhibited restructuring at the level of individual enterprises. Both levels of investigation are important, and examples of both are reported in this section. In principle, one might also wish to understand the forces explaining institutional change itself in various countries, so that one could see why some countries are able to re-build new institutions rather quickly while others seem to get "stuck" or "diverted". However, this causal direction has not yet been much studied, though a useful start was made in Raiser *et al.* (2000).

4.1 Macroeconomic studies

Already by the mid-1990s it was perceived that economic performance amongst the transition countries was diverging, with many of the countries of Central and Eastern Europe already recovering from post-communist recessions and resuming growth, sometimes - as in the notable case of Poland - at quite rapid rates. In contrast, all twelve CIS states were still plunged in deep recession, with output in most cases still falling rapidly or at best, starting to bottom out well below the levels that had been achieved around 1990. These observations, rough and ready as they were, made it natural to investigate whether and to what extent the earlier and more sustained recovery in Central and Eastern Europe could be explained by (a) earlier and more effective macroeconomic stabilization; and (b) greater commitment to market-oriented economic reforms, including the institutional reforms that form the focus of the present paper.

As background to such studies, it is worth pausing to note that there are now many investigations of economic growth and performance across a much wider range of countries than the transition economies alone, seeking to explain why some countries grow rapidly while others do not. Sachs and Warner (1995) is a particularly interesting example of such studies, focusing on the question of economic convergence. Rather than pointing to increasing returns to scale as a reason for persistent divergence between rich and poor countries, Sachs and Warner argue instead for the importance of sound policies. They find, by performing appropriate regressions across a large number of countries, that open trading policies and effective protection of private property rights are usually sufficient to enable poorer countries to achieve higher than average growth rates. In Sachs and Warner (1997), it is found that increased global integration (i.e. greater openness), higher government saving and better quality institutions all increase steady state income and hence boost transitional growth rates. Interestingly, countries with abundant natural resources can generally expect lower growth rates, other conditions being the same[6].

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[6] Reasons for this, at first sight puzzling, result are manifold. The most obvious points to make, though are: (a) large natural resource exports can push up the equilibrium exchange rate, making much of the rest of the economy internationally uncompetitive ('Dutch disease'); (b) incomes earned in the resource sectors may not be taxed adequately to spread the benefits across the whole economy (firms in the resources business may establish strong lobbies, for instance), so domestic demand for goods and services can then be very weak due to the low incomes; and (c) the resulting incentives for new firms to enter non-

The first serious attempts to investigate econometrically the performance of transition economies are associated with the names of Fischer, Sahay and Végh (1996a, 1996b, 1997), abbreviated to FSV below. FSV (1996a) performs a regression on a set of 20 transition economies using data for the years 1992-1994 (some countries could not be included due to data limitations), which examines the impact of macroeconomic stabilization and early reforms on growth. A second equation, not estimated by these authors, looks at more conventional determinants of growth that are postulated to come into play once a country is well down the transition path. The equations are as follows (figures in brackets are *t*-statistics):

$$\underset{(0.02)}{GR = 0.10} \; \mathbf{S} \; \underset{(-5.27)}{2.73\,LINF} + \underset{(1.90)}{0.24\,FISCAL} + \underset{(2.32)}{0.26\,OFAST} + \underset{(2.86)}{12.97\,LIP} \qquad (1)$$

$$\underset{(0.98)}{GR = -0.83} \; \mathbf{S} \; \underset{(2.50)}{0.35\,Y_0} + \underset{(2.82)}{0.62\,GN} + \underset{(2.46)}{3.17\,SEC} + \underset{(6.53)}{17.5\,INV} \qquad (2)$$

The variables in these equations are defined thus: GR is the growth rate of aggregate income (i.e. GDP growth rate), LINF is the *log* of the inflation rate, FISCAL is the budget surplus as a percentage of GDP, OFAST is official aid as a percentage of GDP, LIP is an indicator measuring the extent of banking and enterprise sector reforms. Y_0 is initial per capita income at world prices, GN is the population growth rate, SEC is the secondary school enrollment rate (used as a measure of human capital), INV is the share of investment in GDP.

Equation (1) shows the decisive role of high inflation and fiscal deficits in producing deep recession at the start of transition (second and third terms on the right hand side). Conversely, in countries that stabilized rapidly, the last term (LIP) shows the importance of early market-oriented - and largely institutional - reforms in kick starting the growth process. After a time, equation (2) should be the more relevant one. No longer are institutional changes highlighted. Rather, aside from variables that cannot be changed quickly or are not amenable to policy intervention at all, the key variable in (2) is INV. Thus in the medium and longer term, the message for transition economies wishing to grow rapidly is utterly clear, namely that they must devise policies to raise their rates of investment and then maintain investment at high levels. As FSV (1997) shows, with an investment ratio of 20% it will take transition economies an average of 45 years to catch up to current average OECD per capita income levels, while if investment can be raised to 30% of GDP, the average catch up time falls to 30 years, just one generation. In this regard, we note that those transition economies that have successfully stabilized and introduced many market reforms are already experiencing increases in investment, though not yet to levels much over 20%. In most cases the levels (expressed as a share of GDP) are still not very high in international comparison. We return to this issue towards the end of the paper when discussing industrial policy.

FSV (1995b) performs a somewhat similar analysis for 26 transition countries, strongly emphasising the stabilization variables in its conclusions. This stress on stabilization led the authors to predict that even the relatively laggard CIS countries, once they got inflation rates down to tolerable levels (taken to mean under 4% per month) and gained control of their fiscal positions and external balances, would quickly start to grow again. However, this did not happen to any marked extent, with Russia in particular only just starting to grow a little in

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resource sectors can be weak at best.

1997 before being knocked off course by the August 1998 financial crisis; Russian growth only resumed in late 1999. This experience suggests that while stabilization might be necessary for growth, it is not sufficient. As I argue below, some of the institutional reforms discussed in this paper appear to be critical for economic growth.

Perhaps the most comprehensive study of the links between institutional change and economic performance is to be found in Havrylyshyn and van Rooden (2000) (hereafter, HR). This paper starts by explaining the GDP growth of transition economies in terms of three sets of variables: (i) current inflation, INFL, taken to indicate the effectiveness of stabilization; (ii) current and lagged indicators of structural reforms; and (iii) two indicators of initial conditions, one reflecting macroeconomic distortions, the other reflecting the distortions associated with socialism before 1989/91. The empirical work was based on data for 25 countries over the period 1991-98 (with a few missing observations due to incomplete data). The basic regressions found a highly significant impact of the stabilization variable as well as the structural reform indicator, with initial conditions significant but rather less important in explaining GDP growth. The typical format of their regressions was:

$$GR = a_1\ INFL + b_1\ RI + b_2\ RL_1 + c_1\ IC1 + c_2\ IC2 + [d_1\ IR1 + d_2\ IR2] \qquad (3)$$

The variables in (3) are as follows: INFL is the current rate of inflation, RI is an indicator of structural reforms (the suffix, -1, simply denotes a lagged value), IC1 and IC2 are the two measures of initial conditions, and the terms in square brackets, IR1 and IR2, are measures of institutional change in the narrow sense employed by HR.

For HR distinguish between what they call *structural reforms* which can be measured by some of the EBRD's transition indicators to do with price liberalization, trade and exchange rates, banking and financial market reforms, private sector growth, and the like; and measures of *institutional reform*, which they take to be about the basic legal and political framework of the society concerned. The latter they measure using the EBRD's indicators of legal reforms (coverage and effectiveness of legal aspects of business), and measures of the extent of political liberalization. Including such indicators in their original regressions simply as additional variables confirms that institutional reform as defined by HR is important for growth, but is overwhelmingly dominated by what they call structural reforms. For purposes of the present paper, however, this distinction does not appear terribly useful, since both structural reforms and institutional reforms as defined here are included in the rather broad definition of economic institutions given in Section 2, above. Accordingly, our conclusion must be that institutional change in the widest sense is absolutely vital for sustained growth and recovery of the transition economies. This does not, of course, deny the importance of sound government policies, both to maintain macroeconomic stabilization and to promote through deliberate state action the very institutional reforms that must be in place for growth.

Grigorian and Martinez (2001) adopt a somewhat narrower focus, in that they study the impact of various institutional quality indicators on industrial growth in 27 Asian and Latin American countries. Five qualitative indicators are used to assess institutional effectiveness in these countries, covering: government repudiation of contracts, risk of expropriation (especially important for foreign investors), corruption, rule of law and bureaucratic quality. These dimensions each reflect different aspects of the interface between the state and private sector business, and taken together they tell us a great deal about how easy it is, and what sort of barriers there are, to doing business in a given country. Although not explicit in this study,

there tends to be a very high correlation between these types of indicator and the creation of specific institutions such as well functioning banks and financial markets, liberal and open trade, bodies to enforce competition policy, and so on.

The study found that their measures of institutional quality had a strongly positive effect on industrial growth rates, with indicators to do with the legal and regulatory framework apparently working through two channels: via encouraging higher levels of investment; and via improvements in general resource allocation. The authors conclude that rather than developing full blown industrial policies which states may be unable to manage effectively, for many developing countries it is likely to be better to pay more attention to basic steps to reduce corruption, to remove bureaucratic barriers to business formation and growth, and to strengthen the legal environment. For transition economies, such steps, it is suggested, should complement other policies to promote investment, education, R&D and large-scale privatization.

4.2 Enterprise level studies

What really brings about changes in economic performance in any economy is changes in the behaviour of enterprises. Hence to understand fully the role of institutions in influencing economic performance, we should think in terms of a two-stage process: (a) the institutional environment affects enterprise behaviour in various ways; and (b) the resulting changes in enterprise behaviour lead to different, and one hopes improved, economic outcomes, economic performance. As far as the first stage is concerned, one can look for three types of change, all of which are potentially important:

(i) the entry of new firms or the relative growth of high productivity firms;
(ii) the restructuring and re-organization of existing firms; and
(iii) exit from the market by failing firms, or the decline of low productivity firms.

This is the dynamic process whereby economies adapt, modernise, develop and grow, spurred by competitive pressures, market opportunities and different dimensions of the policy and institutional environment. Under different conditions, one would expect the balances between changes of types (i), (ii) or (iii), and hence their relative contributions to overall economic performance, to vary a good deal, for there is little in economic theory to tell us what these contributions ought to be though, as noted above, Aghion and Schankerman (2000) does set out a possible framework for analyzing these matters. However, the importance of careful empirical work cannot be underestimated.

The extreme instance of this dynamic process could be found under socialism, when, in the era of central planning, there was generally no entry except by new firms provided for in the prevailing plan; there was effectively no exit as enterprises were not permitted to go bankrupt (an aspect of the familiar *soft budget constraint* problem; see Kornai, 1992; Hare, 2000; Schaffer, 1998); and the extent of restructuring of existing firms was very limited indeed. Under these conditions, the distinctly lacklustre performance of the socialist economies by the 1980s should not have been very surprising. At the very micro-level of individual firms, stability and rigidity are disastrous for economic performance, and in all successful economies, success is built upon the ruins of many thousands of failed businesses. This elementary (but not very popular) observation has implications for policy that are taken up in the concluding section of the paper.

As Carlin *et al.* (2001) elucidate, the above dynamic process can be thought of as a combination of two parallel processes falling under the headings of *incentives* and *selection*.

Incentives basically drive the type (ii) change listed above, while selection drives types (i) and (iii). In order for these process to work well, it is important that market signals should be tolerably reliable, i.e. they should reveal real market opportunities. Also, as a form of positive feedback, it is important that there are plentiful examples of economic success for others to emulate.

These process are studied first for the UK, using a large sample of establishments in UK manufacturing, over the period 1980-1992. For each year, the dataset contained around 140,000 establishments. The findings for the UK are quite striking, with about one-half of productivity growth occurring in surviving establishments, and a further 30 per cent due to net entry (exiting units having lower productivity than entrants, on average). Productivity gains were especially strong in multi-plant firms, perhaps due to the operation of some form of internal capital market. Some evidence was found that in booms, entry is less selective in that some low productivity firms are able to enter the market. More surprisingly, recessions do not necessarily speed up the exit of low productivity firms/establishments, and appear not to encourage innovation. Last, stronger product market competition raises productivity, both levels and growth.

For the transition economies, such detailed data over many years does not exist. But Carlin *et al.* (2001) draws on the more detailed enterprise-level results reported in Carlin *et al.* (2000), which made use of a survey of over 3500 firms in 25 transition countries carried out jointly by EBRD and the World Bank. From this survey, some important conclusions emerged, most notably that: "Large-scale shifts of resources from inefficient to efficient sectors of the economy have played no significant part in productivity growth in transition countries" (p.81). Further, although most firms - both old and new - have engaged in a great deal of restructuring, and many new firms have expanded rapidly to achieve large market shares, the results in terms of overall productivity growth have not been as spectacular as might have been expected. Outside the CIS, where the institutional conditions are both stronger and more settled, outcomes have been fairly good; but in the CIS countries themselves, "turbulent" restructuring is at best only weakly associated with productivity gains.

Policy lessons for the transition economies are consequently not straightforward, but it is clear that weak property rights and poor market signals are major parts of the story. It is not sufficient for many firms to be undertaking restructuring, since for productivity improvements it is crucial that restructuring should be in appropriate directions - not merely frenetic activity for the sake of it, but purposeful, guided by tolerably reliable market signals. Similarly, enterprise owners, and the managers acting for them, need to be reasonably secure in their property rights in order to be willing to invest[7] in product or process innovations. This is why economic environments that are too turbulent are not conducive to useful economic advance. There can be too much, or the wrong sorts of competition. For as Carlin *et al.* (2000) notes, while monopoly power unambiguously gives rise to poor performance, excessive competition can both restrain firms' ability to finance needed investments (an important consideration in environments where the market for bank credit is likely to be severely limiting) and confuse the market signals that guide them.

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[7] There is also the question of firms' *ability* to invest, since their access to bank credit or their ability to secure funding through new share flotations are also likely to depend on secure property rights.

An extremely comprehensive survey of the research on enterprise restructuring in transition economies is presented in Djankov and Murrell (2000). By reviewing over 125 studies of restructuring, the aim of the authors is to identify what general findings there might be, and to elicit some general lessons including possible implications for economic policy. The (mostly implicit) presumption in this survey is that enterprise restructuring is desirable, associated with long-term improvements in economic performance, and that in transition economies, therefore, we should expect to see a good deal of restructuring going on. Further, in so far as there are policy lessons, they concern how best to create the conditions likely to foster restructuring. However, from the study we have just discussed, it is apparent that at best restructuring can only form part of the full story, and that the factors leading to the exit of unproductive/unprofitable firms and the entry of better ones are at least as important for long-term performance.

Nevertheless, some of the broad findings of Djankov and Murrell are of interest for our present exercise. In particular, they highlight the key importance of privatization, hardened enterprise budget constraints and a moderate degree of product market competition in promoting restructuring. At the same time they note that policies in these areas have proved far more effective in most of Central and Eastern Europe than they have in the CIS region, when evaluated in terms of improved economic efficiency and enterprise competitiveness. This raises questions about the wider institutional environment supporting market processes, and its links with enterprise ownership/corporate governance. Unfortunately, at this point the research is rather lacking in the detail that would be needed to reach very precise conclusion.

Some of the institutional features that influence how far hardening budget constraints are likely to be effective in compelling improved enterprise performance are investigated in Frydman *et al.* (2000). What they found was that efforts to harden budget constraints usually led to improvements in the performance of already privatized firms, since these firms lacked the political connections that might have enabled them to by-pass credit constraints and seek financial assistance through tax arrears, delayed payments to state creditors, and the like: hence such firms had no choice but to restructure or exit. But for firms still state-owned, these quasi-political links were still in play, and tended to be exploited. On the one hand, such firms then survived where they might not otherwise have done so; on the other, essential restructuring to facilitate longer term viability was often deferred. The implication drawn in the paper is that privatization should not be delayed, since only then will the remaining state-owned firms start to behave “properly”. In this way, the paper does correctly pinpoint the key role of achieving an effective organizational separation between enterprises and the state: the state sets the “rules of the game” - in accordance with my definition of institutions set out at the start of Section 2 - and enterprises then decide how they will play it. However, this rather stark, and perhaps over-simplistic approach to economic institutions requires further discussion in the concluding section of the paper.

Last, Commander *et al.* (1999), focuses on regulatory aspects of the nexus between enterprises and the state, noting enormous disparities across the transition economies. Broadly speaking, regulation becomes less effective, less satisfactory and in many respects more bureaucratic as one moves across the region from West to East. The authors focus on two principal areas where good policies and institutions can make a big difference to overall economic performance, namely: (a) supporting new entry and the growth of firms; and (b) dealing with firms in distress.

On new entry, this is partly a question of having in place the proper legislation (with enforcement) to protect shareholders, so that outsider control as well as new investment can both be encouraged. It is also important to have an effective approach to competition policy, not merely to stop the abuse of monopoly power by large firms, but far more importantly, to eliminate barriers to entry and limitations on competition that are frequently arbitrary, politically motivated, and economically wholly unjustified. For instance, in both Russia and Ukraine, regional authorities have frequently restricted trade with other regions, supposedly in the interests of protecting supplies to local markets, but the main effect of such regulation is anti-competitive, and it tends to discourage new entry. Likewise, the prevalence of non-market (barter) transactions has a similar effect. Far from positively promoting new entry and competitive behaviour, many transition economies - especially in the CIS - still operate complex arrays of regulations involving numerous permits and often licences to set up almost any kind of new business. Not only are such regulations economically inefficient, but they facilitate corruption and often encourage new firms to operate in the informal sector (hence avoiding taxation and regulation altogether) or result in extremely low rates of new business formation. Thus rates of business formation in Russia are scarcely a tenth of the rates found in Central and Eastern Europe. As Commander *et al.* (1999) points out, this is not surprising when: "....in Russia on average it took shopkeepers almost four months of permission-seeking to set up in business." (p.30).

Yet although the connection is not immediately apparent, high rates of new business formation are actually crucial for the successful treatment of firms in distress. In regions with many firms and substantial new entry, for instance, the best way of dealing with firms in difficulties is simply to allow them to close as rapidly and in as orderly a manner as possible, with all remaining subsidies, credit concessions and tax favours withdrawn forthwith. It is far more effective, in the medium and longer term, for available public resources to be devoted to new firms, mostly for the provision of business-related infrastructure. But in areas with few firms, or dominated by a single large firm, and with little new business entry, such a "hard line" approach is likely to prove politically unacceptable, regardless of its economic merits. The question then is where or how to start the process. Partly, it becomes important to reduce the resistance to change by lowering its perceived costs, e.g. through provision of a generous social safety net for displaced workers, including retraining and relocation assistance. This needs to be combined with measures to foster new firm creation in relatively depressed areas, a task that we know to be immensely hard from decades of experience in developed western economies. Realistically, given the costs and the difficulties, it is probably essential to adopt a targeted approach, either restructuring or shutting down these firms over a defined period. In the end, the resources thereby released can be used to stimulate a virtuous circle of productivity improvement and income growth. But designing an effective industrial policy to achieve such a delicate balance and get this process started is not easy.

5. Conclusions and Policy Implications

This paper has already covered a lot of ground and the purpose of this final section is to take stock, both by summarising the main findings and conclusions, outlining the associated institutional basis, and then by drawing out what seem to me the most pertinent implications for policy - both for the transition economies themselves and perhaps more widely.

5.1 Findings and Conclusions

In accord with the broad theme of the paper, I take it that our principal aim is to identify those aspects of the institutional framework of a market-type economy that are conducive to strong economic performance. The empirical work reported above enables us to highlight a few exceptionally important indicators of a flourishing economy, the first of which is essentially a macroeconomic condition, the next three being its microeconomic counterparts:

(a) High rates of domestic savings and investment;

(b) High rates of new business formation;

(c) Sufficient, but not excessive competition;

(d) Effective arrangements for orderly exit by failing firms.

On item (a), while there are virtually no cases of economies growing rapidly while only saving at a low level in relation to GDP, there are examples of economies with high savings ratios growing slowly. Hence high rates of savings and investment are necessary but not sufficient conditions for growth. In addition, it is important that the investment that is undertaken should be efficiently selected, with regard to its economic effectiveness (i.e., in most cases, its profitability). Further, no economy can simply take the view that it will rely upon foreign direct investment (FDI) in order to fund its investment programme, and hence avoid the need to mobilise domestic savings. The notion that FDI can be brought in on a large scale where domestic savings are insufficient is a widely held myth, but a myth nonetheless. For economies to grow, and sustain growth, they must save, regardless of how poor they are at the start of the process.

To give an indication of orders of magnitude for the transition economies, assuming they wish to advance at rates that enable them gradually to catch up with the per capita income levels of the more developed market economies, they need to grow by 4-5% per year at least (for several decades). To achieve this, savings rates of 25-30% of GDP will be needed. For most of the region, especially in the CIS countries, this condition is a long way from being satisfied. The institutions and policies that can give rise to such high rates of savings, and transform them into efficient investment, are sketched below.

Taking items (b), (c) and (d) together, the key point to re-emphasise is that overall economic performance has to relate back to what happens at enterprise level. All economies are undergoing constant change, evolution and development, and how this translates into broad productivity improvements and higher income levels through adaptation at enterprise level - entry, exit, and improved performance by surviving firms - is critical. Hence the institutions and policies that influence these processes are crucial for economic development; and as far as the economy is concerned, nothing else greatly matters.

5.2 Institutions

In order to discuss the institutional underpinnings of the transition to a market economy reasonably compactly, I need to put on one side the whole issue of macroeconomic stabilisation since its complex ramifications lie beyond the scope of this paper. Suffice to say that stabilisation is undoubtedly a necessary condition for sustained growth, and that it requires reasonably sound monetary policy to keep inflation down, and a state capable of managing the public finances while avoiding large deficits. Among other desiderata, stable, predictable and collected (!) taxes are important.

Besides stabilisation, though, the macroeconomic condition (a) requires extensive development of banks, financial markets, and financial intermediation, both to mobilise savings and to direct it towards profitable investment opportunities. This simple statement entails a long list of requirements, from which I summarise only a few key ones (mostly without being too prescriptive, since in most cases there are many ways of achieving a given objective):

- **$** a sound network or savings institutions/banks to hold and manage individual and small business deposits;
- **$** competent, competitive commercial banks able to select projects and monitor loans for investment;
- **$** a wide range of financial institutions and/or financial "products", e.g various forms of insurance, pension funds, and the like;
- **$** a wide range of financial assets for individuals and firms to hold - government paper, commercial paper (both bonds and equity shares), unit trusts, etc.;
- **$** effective regulation of the financial sector;
- **$** appropriate investor and saver protection (striking a proper balance between the need to encourage investment and savings, and the need to ensure that those involved bear a reasonable share of the accompanying risks).

Clearly, the institutional infrastructure required for all this, and the competence/probity required to run it properly, can be quite problematic for a small country with little or no prior experience of operating modern financial markets. In such cases, there can be advantages in a group of countries working together to set up joint markets, or working through the already established markets of third countries.

Turning to the microeconomic/enterprise level aspects of institutions, it is worth starting by asking what the role of the state might be. Fundamentally, the evidence both from transition economies and much more widely, is that the state should be as disengaged as possible from the day-to-day functioning of the micro-economy in almost all sectors. States - including in the transition economies - have an exceptionally poor record of running businesses, and are inclined both to protect the firms that already exist, to restrict new entry, and to delay or block productivity enhancing restructuring. In a sense the problem is that states tend to be too "soft" and responsive to lobbying, and are hence far more tolerant of business failure than are markets. To move away from these conditions, the following points sum up what is required:

- **$** extensive and well protected private property rights;
- **$** effective legal protection for private business contracts;
- **$** effective bankruptcy/liquidation legislation to facilitate the orderly closure of persistently loss-making firms;

- $ termination of most tax favours, subsidies, directed credits and other means to protect established firms in difficulty (i.e. the ending of "soft budget constraints");
- $ the completion of privatization, possibly including a second round of the process to ensure that firms are mostly held by owners capable of supplying new funding, new technology and competent management;
- $ effective and credible regulation of pricing policy, customer service and investment in those sectors - whether the producers are privatized or not - of public utility type;
- $ institutions to facilitate entry by new firms;
- $ institutions to facilitate labour mobility and the lower the costs to workers of essential restructuring.

5.3 Policy Implications

As we saw in Section 3, many of the transition economies have already undertaken a good deal of the institutional restructuring and innovation that they need in order to function as "normal" market economies, though it is clear that many also have a long way to go. In some instances, the steps already taken have created barriers to further institutional reform, and these barriers - political, economic, and social - need to be overcome if market-oriented reforms are to advance much further.

In the published discussions of transition policies there is relatively little to be found on what I have identified here as a key issue, namely policies to foster high rates of domestic savings and investment. There is rather more on industrial, trade and competition policy, both describing what exists and making recommendations about what else should be done. Policies for these broad areas are sketched out below. In addition, since it has become so critical for 10 transition economies already, I remark on the EU institutional model being adopted by these countries as they prepare for accession.

Savings and investment

In addition to the institutional requirements already listed above, what other policies can help to boost savings and investment rates? It probably sounds anodyne and feeble to include "propaganda" here, but it is worth doing because of the prevailing view in many transition economies (which I have personally encountered many times) that they are "too poor to save", and merely need "massive injections of foreign investment" to put them right. As I implied above, this line of thinking is pure fantasy, and repeating it does not make it any more sensible. Thus a vital educational role for governments in the region is repeatedly to stress the importance - for individuals, for firms, for the whole society - of high savings rates, and to build the institutions to correspond to that. In Asia, the examples of China and Singapore come to mind, but there are many others that one could point to, where high savings have played a critical role in bringing them up from the deepest poverty to medium income levels within a generation or so.

High savings, however, only deliver if most investment turns out to be profitable, and ensuring that is a more complex task than merely mobilising the savings in the first place. On the other hand, high savings and profitable investment are likely to be mutually reinforcing since individuals and firms will see their savings generating returns that will encourage them to go on saving. But what role can government policies play in creating the conditions for investment to be profitable?

At the macroeconomic level, perhaps the most important requirements are to maintain

stability of prices and the exchange rate, and to keep the public finances in order, with current spending on goods and services, plus net transfer payments, plus interest on accumulated government debt, kept in line with government revenues[8]. At the microeconomic level, much more depends on the individual investors, though they can be helped by a combination of measures:

- **$** Substantial de-regulation of the process of authorising or giving permission for a given investment project to go ahead; the simpler and quicker this is the better, both to reduce opportunities for corruption, to reduce involvement in the economy by a generally incompetent state, and to enhance economic flexibility. I acknowledge, of course, the need to have some controls over business location, health and safety issues, building regulations and the like, but much of this can be handled in a far less bureaucratic and more permissive manner than is usual, especially in the CIS. What regulations there are should be openly published, fairly implemented and open to timely appeal in cases of dispute.

- **$** Effective monitoring of investment projects by banks and/or shareholders, to ensure that when investments fail (as many will, as in any normal economy) they are stopped quickly, funding is reallocated to other activities and any equipment already in place is disposed of for others to use as productively as they can. Governments should rarely step in to perform rescue operations; nor should they lean on the banks to do so. On the other hand, activities that turn out to be successful, perhaps unexpectedly so, should quickly have access to additional funds so that they can expand.

Industrial, trade and competition policy

When states are weak, incompetent or corrupt, as is the case for many transition economies, especially in the CIS region and in the Balkans, it is pointless to put forward recommendations for complex and sophisticated policies. Instead, whatever policies are advanced, they should be simple and, where possible, self-enforcing. The state has to set the "rules of the game" which the business community then follows, without providing opportunities for all sorts of *ad hominem* bargaining, deals and corruption.

To illustrate what I mean, I give some examples of very bad policies, then move on to make some positive recommendations. For instance a trade policy based on a uniform tariff or a small number of standard rates covering broad commodity groups is far better than many of the existing tariffs which have several thousand separate rates, often with little or no economic rationale to justify them. A highly complex tariff is vulnerable to very easy manipulation by importers who can simply bribe customs officials to reclassify goods to obtain a lower tariff rate; this practice is widespread, and extremely inefficient.

Second, a policy to support small businesses that requires them to approach 20 different offices for permissions connected with different aspects of their business, in circumstances where most of the rules are not published and are subject to arbitrary amendment, invites corruption. At least 20 officials might have to be bribed, and even then the person setting up

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[8] Here I am being deliberately brief for lack of space. But my comment should be taken to include all off-budget government commitment and funds, and all levels of government.

the business may not feel secure in their rights to do so. In these conditions, many businesses will not even get off the ground, let alone flourish.

A third example concerns the inspection of already existing businesses. If, as in Russia and Ukraine among others, many public agencies have the right to inspect businesses with little or no notice, checking their accounts, their tax payments, compliance with health and safety rules, labour regulations, and so on, then again this can prove a fruitful source of bribes for officials (as well as consuming valuable management time), simply to get them to go away and allow normal business to continue. Inspection is not always a bad thing, but it should be openly conducted, based on clear, published criteria, with written reporting of any problems identified, and proper appeal procedures.

Last, the toleration of non-cash settlement either of tax payments or of inter-enterprise sales is almost always very inefficient. Barter generally only arises in environments where governments are too weak to enforce cash payments, or where other institutional deficiencies encourage it. For instance, in several transition economies, taxes from enterprises are collected through the agency of the banks, and this very bad institutional arrangement gives a positive incentive for firms to evade taxes by engaging in non-monetary transactions where they can. Likewise, the toleration of non-payment of energy costs by public agencies (e.g. in Russia) contributes to a climate in which non-payment is considered acceptable (with the damaging implication that some users of energy can treat it as a free good!), and encourages the energy utilities to engage in bargaining with the government over their tax liabilities.

Turning to more positive aspects of industrial, trade and competition policy, there is some useful recent literature that draws out lessons from relevant western experience, notably Elsner and Groenewegen (2000) and Cowling (1999). The former argue that industrial policy should focus on securing benefits for the home country, limiting the extent of siphoning off of incomes by transnational corporations; that it should support local companies that are not “footloose” in preference to multinational firms and foreign investors; and that rather than supporting specific businesses, most attention should go towards building up the business infrastructure and related institutions. Cowling argues against traditional, sectoral policies that would involve governments trying to “pick winners”, usually unsuccessfully, but proposes support for what he calls “local selection processes”. These might involve a sectoral aspect, but the choice of sector and mode of support would be determined more locally, more democratically than in the traditional approach to industrial policy. It is not wholly clear to me how this would work in practice, but in spirit it fits in with the analysis of productivity improvement reported in Section 4.2 above.

On the trade policy of transition economies, Hare (2001) gives a comprehensive survey of country-by-country experience, with advice on constructing sound trade policies (incl.WTO membership and the disciplines it imposes), allowing for different stages in the overall reform process and different degrees of competence/honesty in the governments concerned. Further, Brown and Earle (2000) argue that reductions in import barriers and geographic market segmentation - the latter being especially significant in the geographically larger transition economies - should encourage more rapid growth of industrial productivity by encouraging the right kinds of competition.

In relation to labour market aspects of industrial and social policy, Boeri (2000) offers some interesting suggestions, learning from the mistakes made in certain countries in the early

transition years. He points out that there is a high welfare/high tax model that has been followed to a large extent in the candidates for EU accession, and a low welfare/low tax model that has been followed elsewhere, notably in the CIS. It is argued that for all its weaknesses of implementation, the first model has proved itself unambiguously superior, since the low welfare model has seriously discouraged enterprise restructuring in many transition economies. However, there is an issue of feasible choices that Boeri does not directly address, in the sense that it might simply not have been possible for the CIS countries to choose the high welfare model because of their inability to raise sufficient tax revenues. Hence these countries might well have been politically constrained to develop low welfare models, despite their (known) damaging consequences. If this is correct, then a large research agenda is immediately opened up, to explore how countries initially trapped in such a bad model can find ways out into a better equilibrium. Such an investigation extends far beyond the limited scope of the present paper.

EU institutional model

Boeri (2000) also refers to aspects of EU accession and the credibility of the whole process that have an important bearing on the institutional focus of our discussion. For the accession countries themselves, it can be questioned whether the institutions and practices they are taking on as they gradually adhere to more and more of the *acquis communautaire* are good for their development at its present stage. And for non-accession countries, one might ask whether something like the "EU model" provides a conception of the institutional structure for a market-type economy that merits wider emulation - partly because it is a ready-made, and working model, partly because adopting it lowers the otherwise high costs of re-thinking all aspects of the institutional structure from scratch, partly for the practical reason that adoption might facilitate trading and other economic links with the EU.

These arguments are important for both sets of countries, but for the accession countries the overwhelming argument for adopting the *acquis* must be the political one, namely that doing so helps to lock these countries firmly into the western system of alliances. So far, only Poland, Hungary and the Czech Republic have already joined NATO and are members of the OECD, thus for all 10 Associated States EU entry will be a very important step. Hence it is regrettable that the entry process is turning out to be so prolonged now, with a few countries ahead of the game in the negotiations process (Hungary, Czech Republic, Estonia, Slovenia, Poland), the others (Latvia, Lithuania, Slovakia, Bulgaria, Romania) lagging far behind in terms of their satisfaction of the Copenhagen Criteria for accession, and even more in terms of their detailed compliance with the *acquis*. But if joining the EU is politically important for these countries, then it must surely happen, and be seen to happen. Instead, what we are witnessing at present in Brussels is a laborious serious of intricate negotiations on detailed parts of the *acquis* much of which, in my view, could safely be left for post-accession discussions.

As Boeri rightly stresses, continuing delays over accession reduce the credibility of the EU "project" in the transition economies, and are likely to undermine or delay their willingness to undertake the associated institutional reforms, especially as these are both complex and costly. The EU's institutional structures have evolved to suit a group of relatively developed economies with high incomes, accustomed to steady but quite slow economic growth. For the transition economies, however, seeking to catch up to more advanced countries within a reasonable period, there must be substantial chunks of the *acquis* that are simply not appropriate for them. Most obvious is the environmental component of the *acquis*, because

of its high cost, but many of the institutional arrangements and policies operated by the EU are very complex and require well trained staff, relatively free from corruption, to work effectively[9]. For much of the transition economy region, simpler policies with a better chance of being implemented properly would actually be more effective for the countries concerned.

[9] Some of the EU policies and recommendations concerning the regulation of public utilities, e.g. electricity supply or telecommunications, are nice in theory but rely on strong, credible government. Where that is missing, quite different approaches are likely to be called for.

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