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Lessons from Transition Economies: Strong Institutions Are More Important than The Speed of Reforms¹

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Introduction

Ten years ago, on the eve of transition, economic discussion in the profession was dominated by the debate between shock therapists, who advocated radical reforms and rapid transformation, and gradualists, justifying a more cautious and piecemeal approach to reforms. Shock therapists pointed out to the example of East European countries and Baltic states – fast liberalizers and successful stabilizers, that experienced a recovery after 2 to 3 years fall in output, while their CIS counterparts were doing much worse. Gradualists cited the example of China, arguing that the lack of recession and high growth rates is the direct result of the step by step approach to economic transformation. Shock therapists were arguing that “one cannot cross the abyss in two jumps”, that rapid liberalization allows to avoid painful and costly period, when the old centrally planned economy (CPE) is not working already, while the new market one is not working yet. As time passed, there appeared statistics that allowed to test the predictions of theories. Quite a number of studies were undertaken with the intention to prove that fast liberalization and macro-stabilization pays off and finally leads to better performance (Sachs, 1996; De Melo, Denizer, and Gelb, 1996; Fisher, Sahay, Vegh, 1996; Aslund, Boone, Johnson, 1996; Breton, Gros, and Vandille, 1997; Fisher, Sahay, 2000). To prove the point, the authors tried to regress output changes during transition on liberalization indices developed by De Melo et al. (1996) and by EBRD (published in its Transition Reports), on inflation and different measures of initial conditions. The conventional wisdom was probably summarized in the 1996 World Development Report From Plan to Market, which basically stated that differences in economic performance were associated mostly with "good and bad" policies, in particular with the progress in liberalization and macroeconomic stabilization: countries that are more successful than others in introducing market reforms and bringing down inflation were believed to

¹This paper is based on my article in *Comparative Economic Studies* Vol. 42, No. 1, Spring 2000, pp. 1-57.

have better chances to limit the reduction of output and to quickly recover from the transformational recession. “Consistent policies, combining liberalization of markets, trade, and new business entry with reasonable price stability, can achieve a great deal even in countries lacking clear property rights and strong market institutions” – was one of the major conclusions of the WDR 1996 (p. 142). The conclusion did not withstand the test of time, since by now most economists would probably agree that because liberalization was carried out without strong market institutions it led to the extraordinary output collapse in CIS states. Liberalization may be important, but the devil is in details, which often do not fit into the generalizations and make straightforward explanations look trivial.

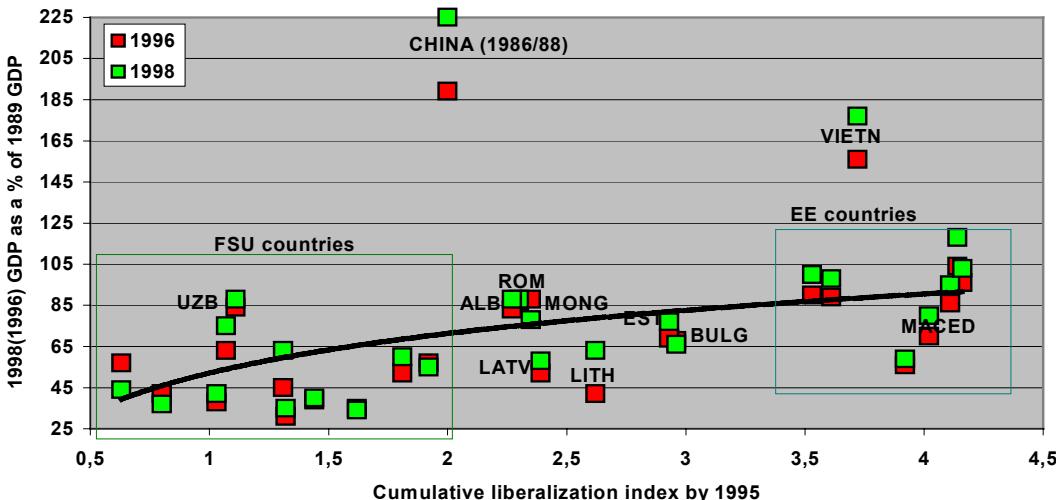
Take the example of Vietnam and China - two countries that shared a lot of similarities in initial conditions and achieved basically the same results (immediate growth of output without transformational recession) despite different reform strategies. While Chinese reforms are normally treated as a classical example of gradualism, Vietnamese reformers introduced Polish style shock therapy treatment (instant deregulation of most prices and introduction of convertibility of dong) even before Poland did, in 1989, and still managed to avoid the reduction of output.²

Or, take the example of the differing performance of the former Soviet Union (FSU) states. The champions of liberalization and stabilization in the region are definitely Baltic states (cumulative liberalization index by 1995 - 2.4-2.9), whereas Uzbekistan (with the same index of 1.1) is commonly perceived to be one of the worst procrastinators. However in Uzbekistan the reduction of output in 1990-95 totaled only 18% and the economy started to grow again in 1996, while in the Baltics output fell in the early 1990s by 36-60% and even in 1996, two years after the bottom of the recession was reached, was still 31% to 58% below the pre-recession maximum.

At a first glance, there seems to be a positive relationship between liberalization and performance (fig.1), but a more careful consideration reveals that the link is just the result of sharp difference in the magnitude of the recession in EE countries, as a group, and FSU states, also as a group (fig.1). Within these groups there is no correlation whatsoever.

² While Vietnamese industry, excluding constantly and rapidly growing oil production, experienced some downturn in 1989-90 (-6% in 1989 and 0% in 1990) agricultural growth remained strong, so that GDP growth rates virtually did not fall (5-6% a year).

Fig. 1. Liberalization and output change



Overall, attempts to link differences in output changes during transition to the cumulative liberalization index and to macro stabilization (rates of inflation) have not yielded any impressive results: it turned out that dummies, such as membership in the ruble zone (i.e. FSU) and war destruction, are much more important explanatory variables than either the liberalization index or inflation (Åslund, Boone, Johnson, 1996). Other studies that tried to take into account a number of initial conditions (repressed inflation -monetary overhang before deregulation of prices, trade dependence, black market exchange rate premium, number of years under central planning, urbanization, overindustrialization, and per capita income) found that in some cases liberalization becomes insignificant as well (De Melo, Denizer, Gelb and Tenev, 1997, p. 25; Heybey, Murrell, 1999; Popov, 2000).

This implies that there is still no good explanation even for the basic stylized facts, such as the ability of China and Vietnam to avoid the recession completely, or such as the markedly greater magnitude of the recession in FSU as compared to East European (EE) countries, not to speak about differing performance of countries belonging to the same geographical region.

This paper starts by separating the transformational recession (the deviation of actual output from potential) from the process of economic growth (recovery from the transformational recession). It is argued that the former (the collapse of output during transition) can be best explained as adverse supply shock caused mostly by a change in relative prices after their deregulation due to distortions in industrial structure and trade patterns accumulated during the period of central planning, and by the collapse of state institutions during transition period, while the speed of liberalization does not seem to play a major role. The latter process (recovery) should be treated as a normal growth process: it could be modeled by using conventional production functions and in the long run may demonstrate the ability to capitalize on liberalization by increasing factor efficiency (Shmelev and Popov 1989; Popov, 1998a, 1999).

Non-policy factors: distortions in industrial structure and trade patterns

In the first approximation, the transformational recession is basically a supply-side phenomenon, a structural adjustment process resulting from the need to overcome disproportions inherited from the centrally planned economy (CPE) - high militarization, overindustrialization and underdevelopment of the service sector, "under-openness" of the economy, the perverse structure of trade among former Soviet republics and among socialist countries. The greater the magnitude of these distortions inherited from the centrally planned economies, the more pronounced the reduction of GDP during the transformational recession.

The supply-side explanation implies that the reallocation of resources (restructuring) due to market imperfections is associated with the temporary loss of output. Thus, the decline in the production of non-competitive enterprises and industries is not offset immediately by an increase in the production of competitive industries and enterprises due to barriers to capital and labor flows such as poorly developed banking system and securities markets, uncertain property rights, the lack of easily enforceable and commonly accepted bankruptcy and liquidation procedures, the underdevelopment of land market, housing market and labor market infrastructure, and so on.

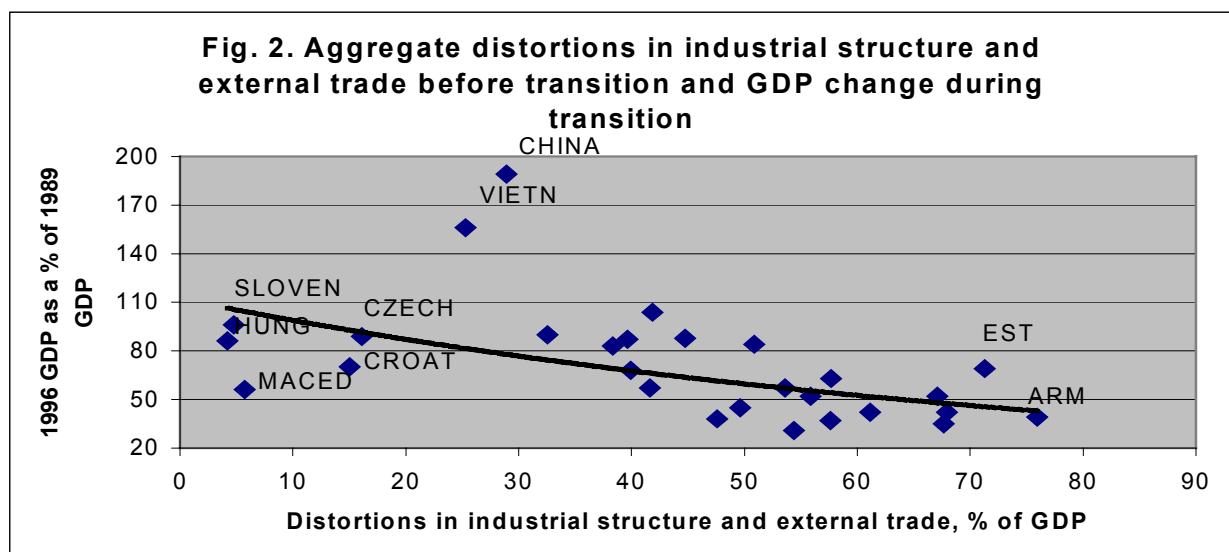
Attempts to separate non-policy from policy factors by running multiple regressions produce some statistically satisfactory and economically meaningful results.³ Though there is a relationship between the magnitude of output decline on the one hand and the liberalization index and inflation on the other ($R^2 = 65\%$), it weakens greatly or even disappears completely once variables that characterize objective conditions are factored in. It is noteworthy that nearly 70% of the variations in the magnitude of the decline of output may be explained by only two dummy variables (both significant at the 1% level) that account for membership in the FSU and for wars. It is even more remarkable that the addition of liberalization variable to the equation does not seem to make any difference: the correlation coefficient does not increase when liberalization is taken into consideration; to make matters worse, the coefficient of the liberalization index is not statistically significant and has the unexpected sign: the greater the liberalization, the larger the decline of output. Inflation variable is always significant and has the predicted (negative) sign, but this cannot be considered as an important finding: the link between macroeconomic stabilization and economic growth was demonstrated more than once for a much greater group of countries (see, for instance: Bruno, 1995; Bruno and Easterly, 1995).

These results suggest that the usual argument linking the better performance of EE, especially the Central European countries (as compared to the FSU, especially the CIS countries), to better economic policies (greater liberalization) does not necessarily hold. Indeed, the identification and decomposition of the "FSU effect" may be carried out more effectively by bringing into the equation not policy variables, but non-policy factors, such as the relative magnitude of the distortions in trade and industrial structure.

³ More detailed description of the data and regressions is in Popov (2000).

To avoid the multicollinearity problem, an aggregate indicator of distortions was constructed (summing up all the distortions mentioned above, since they are expressed as a % of GDP). There is a fairly strong correlation between aggregate distortions in industrial and trade structure before transition and the subsequent performance during transition, as measured by the GDP change (fig. 2). Among countries with minor aggregate distortions (less than 30% of GDP) are three former Yugoslav republics (Slovenia, Croatia, Macedonia), the Czech and Slovak republics, Hungary, China and Vietnam. All these countries, with the exception of war-affected Macedonia, are doing better than most other transition economies. On the other hand, among countries with most distorted economies (aggregate distortions of over 50% of GDP) we find all the former Soviet republics, except Russia (where aggregate distortions amounted to only 39% of GDP). In fact, aggregate distortions alone may explain 32% of output variations during transition and about 50% of variations if the economies affected by war are excluded. Taking into account the other two non-policy factors characterizing the initial conditions, we obtain statistically sound and robust results: over 60% of the variations in performance may be explained by (1) the advantages of backwardness, (2) aggregate distortions, and (3) the war dummy variable.

The addition of the FSU dummy to the equation leads to the absorption of the aggregate distortions variable (the FSU dummy thus plays the role of a proxy for distortions), while the impact of the level of economic development and war remains statistically significant. Adding inflation as an explanatory variable allows to improve the results, but the inclusion of liberalization index only deteriorates T-statistics and does not increase the explanatory power of the regression at all. To put it differently, the observed differences in performance may be explained *mostly* by the unequal initial conditions, while the role of traditional "good policy" factors appears to be quite limited.



Such an interpretation suggests, among other things, that recent research aimed at providing some empirical evidence for the conventional wisdom (greater liberalization and stabilization lead to better performance) may not

reach this goal by demonstrating that countries, which are more advanced in liberalization and in fighting inflation are doing better than others. Once the pre-transition initial conditions are taken into account, it turns out that conventionally monitored policy factors, such as the degree of liberalization and the rates of inflation, do not really explain much. Differences in economic performance in post-communist countries during transition appear to be associated predominantly not with chosen reform paths, but with the magnitude of initial distortions in industrial structure and trade patterns, and with the initial level of economic development.

This is not to say that government policy in general does not affect performance, but to admit that conventional understanding of the policy factors (progress in liberalization and macroeconomic stabilization) is not enough to account for all of them. It may well be that most important policy factors that affect performance are not associated, despite popular beliefs, with the speed of liberalization and macro-stabilization. Rather, these are the policy measures aimed at preserving and/or creating strong and efficient institutions.

Policy factors: institutions, rule of law and democracy

The decline of the institutional capabilities contributed a great deal to Russia's and CIS poor economic performance. If regression equations that account for initial conditions only are used to predict economic performance (GDP change), it turns out that China and Vietnam did much better than expected, EE and Baltic states on average did not so good, but still a bit better than expected, whereas most CIS states did much worse than expected. Exceptions within CIS prove the rule: Uzbekistan and Belarus, i.e. exactly those countries that are not only known for proceeding with slow reforms, but are also believed to have the strongest state institutions among all CIS states.⁴ Ukrainian example, on the other hand, proves that it is not the speed of reforms *per se* that really matters: being a procrastinator, it did nevertheless worse than expected due arguably to the poor institutional capabilities (trust in political institutions in Ukraine is markedly lower than in Belarus).

The efficiency of state and non-state institutions is not easily measurable. In most FSU and Balkan countries the collapse of the institutions is observable in the dramatic increase of the share of the shadow economy; in the decline of government revenues as a proportion of GDP; in the inability of the state to deliver basic public goods and appropriate regulatory framework; in the accumulation of tax, trade, wage and bank arrears; in the demonetization, "dollarization" and "barterization" of the economy, as measured by high and growing money velocity, and in the decline of bank financing as a proportion of GDP; in poor enforcement of property rights, bankruptcies, contracts and law and order in general; in increased crime rates; etc. Most of the mentioned phenomena may be defined quantitatively with a remarkable result that China and Vietnam are closer in this respect to EE countries than to CIS. However, the construction of the aggregate index of the efficiency of

⁴ The decline in government revenues as a % of GDP in these countries was less pronounced than elsewhere in CIS.

institutions is problematic because the rationale for choosing weights is not clear.

One possible general measure is the trust of businesses and individuals in various institutions - here FSU states rank much lower than East European countries in all available surveys. In the global survey of firms in 69 countries on the credibility of the state institutions, CIS had the lowest credibility, below that of Sub-Saharan Africa (World Bank, 1997a, pp. 5, 35). Especially striking was the gap between EE and CIS countries: differences in credibility index between South and Southeast Asia and EE were less pronounced than differences between Sub-Saharan Africa and CIS.

Another good proxy for measuring institutional capacity of the state is the financial strength of the government - the share of state revenues in GDP. Though much have been said about "big government" and too high taxes in former socialist countries, by now it is rather obvious that the downsizing of the government that occurred in most CIS states during transition went too far. This argument has nothing to do with the long-term considerations of the optimal size of the government in transition economies – it is true that in most of them government revenues and expenditure as a share of GDP are still higher than in countries with comparable GDP per capita. But whatever the long term optimal level of government spending should be, the drastic reduction of such spending (by 50% and more in real terms) cannot lead to anything else but institutional collapse.

Before transition in former socialist states not only government regulations were pervasive, but also the financial power of the state was roughly the same as in European countries (government revenues and expenditure amounted to about 50% of GDP). This allowed the state to provide the bulk of public goods and extensive social transfers. During transition tax revenues as a proportion of GDP decreased markedly in most countries. However, Central European countries and Estonia managed to arrest the decline, while Russia (together with Lithuania, Latvia, and several Southeast Europe and Central Asian states) experienced the greatest reduction. In Vietnam the share of government revenues in GDP grew by 1.5 times in 1989-93. Chinese government revenues as a percentage of GDP fell by over 2 times since the late 1970s, but it looks more like a conscious policy choice rather than a spontaneous process (authoritarian regimes have always better powers to collect tax revenues, if they choose to do so, as did all governments in the CPE's before the transition).

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