# Economic development and growth in transition countries

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# CHAPTER 1

# INTRODUCTION

## 1.1 Is transition just a historical concept?

The countries of Central and Eastern Europe and the former Soviet Union, commonly referred to as "transition countries", have undergone developments and transformations unparalleled in recent economic history. The largest part of these transformations took place before 2005. At present, referring to "transition" or "transition countries" often bears a historical connotation, implying that transition is considered to be a completed experience. What appeared as a result of transition seems to be an array of countries which are very heterogeneous in terms of degree of development and political systems. There are countries with authoritarian regimes at one extreme and others that have been members of the European Union for five years at the other.

In order to get an idea of the dispersion of the countries by economic characteristics, it is sufficient to have a look the UN human development index, an influential indicator of human well-being[1] in 179 countries. The highest-ranked transition countries have index values comparable to those of the developed economies (26th position for Slovenia and 35th for the Czech Republic). Russia and Ukraine are around the middle of the world list with positions 73 and 82 respectively. At the other end, Kyrgyzstan and Tajikistan occupy positions 122 and 124, and are therefore classified as countries with medium to low levels of human development.

There is a lot of evidence that currently transition countries are a much more heterogeneous group than when they started the transition process. This suggests that if we search for the reasons of the current huge differences between countries, we should consider the possibility that they are rooted in the transition process, for example in some historical circumstances or political and economic decisions with far-reaching consequences (for example, the decisions about the reform course and sequence taken at the onset of transition). In addition, multiple equilibria and poverty traps might also be relevant phenomena for shaping the final outcome. In turn, this would imply that these initial events could continue to play an important role for the fate of the countries for some more time to go.

But in spite of the differences, there is evidence that transition countries also share some common characteristics. For instance, in many countries the reforms in certain important areas like institutional development are still to be completed (Gros and Steinherr, 2003). Even for new EU members like Bulgaria and Romania, recent critical reports of the European organizations suggest that there is still a lot to be accomplished in the area of judicial system, the public administration or the fight against organized crime.

Finally, although transition countries have grown fast and achieved a lot of progress

[1] The Human Development Index (HDI) is a composite index, composed of measures of life expectancy, literacy, education and standard of living, which makes it a broad measure of human well-being. The index is comparable across-countries and is the basis of yearly world rankings.

in the last decade, the recent economic downturn has revealed substantial vulnerabilities in their economies – large debts, too large reliance on foreign capital, and lack of fiscal discipline. These have caused recessions in Latvia, Estonia, Ukraine, Hungary, Romania, more severe than those in the Western European countries.

These factors might suggest that after all, the transition economies might still possess characteristics that on the one hand, distinguish them from the rest of the world and on the other hand, allow their consideration as one group. Therefore, being aware of the transition developments and their consequences continues to be important since this could help for much better understanding of many phenomena today and in the future.

My work concentrates on the question about the possible reasons for the large differences among the countries, and tries to relate them to some transition phenomena. Due to the relatively formal and technical character of the research I look for general relationships and pay limited attention to country-specific factors. I consider three different but related aspects of the transition experience, each contributing some details to the general picture. First, I identify the factors playing a role in each of the two transition phases of reorganization and recovery. Second, I investigate the way international economic relations have supported the recovery of the transition countries by improving labour productivity. Third, I take a more detailed look at the institutions in transition and how they work, which can shed light on some transition puzzles and individual country patterns that deviate from the general pattern. Now, let us review each of these aspects in more detail.

## 1.2 What drives economic growth?

One of the keys to explaining the differences among countries is understanding, which factors have played a role for the economic development, and how relevant they are empirically. Traditionally, researchers look at the growth rates of the gross domestic product as an important measure of economic development. They have found that a large number of factors influence economic growth, including the so-called factor inputs, namely capital and labour, but also the level of human capital, and various political and institutional factors. We are aware that transition is a very particular period of recent economic history, characterized by profound changes in the way the economy functions, and therefore there might be forces at work that are quite different than those in the "normal" market economies.

It is worth briefly reviewing the starting position of the post-communist countries. Their economies were distorted to various extents, since economic development was not the result of conventional economic logic, but of central planning which had other types of considerations[2].

Prices did not reflect the economic value of goods and were not able to move in order to equate demand and supply. Instead, they were fixed, often at too low levels causing shortages of many products. Shortages were associated with substantial loss for society due to the time lost for queuing and efforts to acquire the products in an alternative, non-market way. Furthermore, capital and labour were not allocated to the sectors where they would be most useful, but their allocation was driven by the decisions of the central

[2] For a detailed analysis of socialist central planning, see for instance M. Ellman (1989): Socialist Planning, Cambridge University Press.

planners.

All these distortions led to situations that would not be sustainable under a market economy, like for instance the long existence of production processes where the value of the end product was lower than the value of the inputs. A drastic example was the evaluation by Western experts of the industry of the former German Democratic republic, which revealed that the net value of the entire GDR industry was negative at world market prices (Gros and Steinherr, 2003).

Another peculiarity was that the technology level in transition countries lagged substantially behind that in the leading economies due to the trade and political isolation (Campos and Coricelli, 2002), which represented a substantial disadvantage. The degrees of these distortions varied a lot across countries, but their presence suggested that there was substantial scope for improvement and increasing output through reallocation and reorganization alone, without increasing the amount of inputs. This could be achieved, for instance, by redirecting capital and labour to more profitable industries, and by opening to trade. With such efficiency-improving measures, growth would not depend on the amount of inputs, but rather on other factors like speed and success of the reforms.

We consider two phases in the transition period up to 2001: recession period (we consider the period up to 1995, although for some countries this is not the end of transition recession) and a recovery period after 1995, when most of the transition countries have already recorded at least a year of positive growth.

In addition, we pay attention to one further issue, namely the fact that the economic characteristics of neighbouring countries may be related to each other. For instance, this can be the case when a common shock, say war or a crisis) affects an area which includes more than one country. Moreover, even a shock originating from one particular country is also very likely to affect other countries, which are immediate neighbours or are related through trade and other links. Finally, if a country is split into two or more new independent countries, many characteristics of the new parts including even the statistical errors of measuring and aggregating the data are likely to remain correlated for some time.

If such interdependencies are not controlled for, some of their effects can be erroneously attributed to other factors. With appropriate statistical methods, we can control for their influence and therefore also estimate more precisely the effect of the other factors on economic growth. We find several countries which show strong interdependencies of their own economic data with that of their neighbours. For the first period, these countries are Armenia, Georgia and Azerbaijan, most likely due to the armed conflicts in the Caucasus in the 1990s, and in the second period it is Russia, related to the Russian crisis from 1998, which has had a profound impact on the many countries from the former Soviet Union (FSU), including the Baltic states and many other FSU countries.

To sum up, our results show that the transition period should be considered as consisting of two sub-periods. The first phase has likely been the period for removing the initial inefficiencies and developing of the fundamentals of the market economy. In this period, we can find no link between the stock of capital a country uses and the growth rate. In the second period, however, the growth pattern of transition countries starts to resemble the one of the established market economies. The two factors that appear to be important throughout the whole transition period (or at least for the period we consider) are the level of education and the legacy of the former Soviet Union.

| Country | Openness (exports and imports as a share of GDP), 2007 | Net int. Investment position as a share of GDP, 2007 |
|---|---|---|
| Bulgaria | 147 | -80 |
| Czech republic | 158 | -36 |
| Hungary | 158 | -97 |
| Estonia | 156 | -74 |
| Latvia | 108 | -80 |
| Lithuania | 122 | -56 |
| Poland | 85 | -45 |
| Romania | 75 | -47 |
| Slovak Republic | 94 | -53 |

Source: ECB Convergence Report, 2008
Note: A negative sign of the international investment position means that the country is a net recipient of foreign investment.

Table 1.1: Openness and foreign direct investment in new EU member states

## 1.3 Have trade and FDI helped transition countries?

Having established the significance of the classical factors for the second transition period, we devote more attention to two particular factors which in theory have positive influence on the economic performance of the countries. These are international trade and foreign direct investment by multinational enterprises.

These factors are of particular importance for the transition countries. Indeed, the speed and scope of the opening of the economies to the rest of the world varied substantially between the countries. The increase and reorientation of trade took place relatively early in transition, and already in the beginning of the 1990s the countries (particularly the smaller ones) became relatively open economies. The increase in FDI has been remarkable too, although it took somewhat more time to materialize.

In the last decade there has been a real surge of foreign investment to transition countries, in particular to the new EU member states from the core EU members. A significant factor for the large amount of FDI and the number of foreign-owned enterprises has been the privatization process, where many enterprises have been purchased by foreign investors. In many countries, all major commercial banks are foreign owned (e.g. by Italian and Austrian banks in Bulgaria and by Scandinavian banks in the Baltic states).

The following table presents an overview of the international trade and FDI investment as a share of GDP for nine of the countries we cover in our study (excluding Croatia and Slovenia).

If we measure the degree of openness as the sum of the exports and imports of goods and services divided by GDP, we see that these countries are extremely open – with up to 158% of GDP for the Czech Republic and Hungary. In comparison, the share of trade in USA is about 24 percent and in France around 56 percent[3].

Many have asked the question what is the nature of the incoming foreign capital in a

[3] Source: "Eurozone entry of new EU member states from Central Europe", by Willem Buiter and Anne Silbert, available at: http://www.developmentandtransition.net/index.cfm?module=ActiveWeb&page=WebPage&DocumentID=608

country? Is it only another source of capital identical to the national one, or is it in some way superior to it? A foreign enterprise entering a local market expects superior profits as compared to the local firms and these expectations are based on some advantage as compared to the domestic firms. A foreign firm might have a better technology that has not been used in the host country yet and which might allow producing with large cost advantage; it might have better organization of the production process or be aware of other cost-saving and efficiency-improving methods. Also, its managers and specialists may possess some specific knowledge resulting from the firm's experience in its field. Therefore, FDI can also be regarded as carrier of new technology and new knowledge in a fairly broad sense (technological or organizational). Then, if there is sufficient amount of FDI, it should have a beneficial effect on the efficiency of the whole economy.

However, exactly this generalization of the benefits from the firm level to the economy level seems problematic. It is clear, both theoretically and empirically, that FDI affects positively the performance and profits of the firm receiving it, but the aggregate effect is hard to detect. Some studies have identified it, but not for all country groups, and not for all economic sectors, while others concluded that it does not exist. One explanation is that although FDI improves the performance of the receiving firm and all firms vertically related to it (its suppliers and buyers) it might even affect negatively the competitor firms by squeezing their profits and decreasing their market share, which might outweigh the positive effect.

Transition countries can contribute to circumventing this problem since they have certain features which are considered to give optimal conditions for showing the positive effect of the FDI. Firstly, they have (or at least had at the beginning of transition) very good level of education, comparable to the developed countries, which suggests easy and smooth adoption of new know-how. Second, due to the long technological isolation, these countries had a technological level which was far from the world level, meaning that they had a lot to catch up with. Therefore, it seems that they would quickly bridge the technological gap and the improvement in productivity would be easy to notice in the aggregate statistical data. We consider labour productivity, or the amount of output per worker, as our measure of the efficiency of the economy, since this will give us an idea of how much can be produced by a unit of labour. We concentrate on a subset of all transition countries, namely the new EU members, due to better data availability and the particularly high levels of FDI.

Apart from FDI, we can expect to see a similar positive effect on productivity from imports of capital goods, i.e. the machines and equipment imported by domestic firms, which they need for the production process of other goods.

We can intuitively expect that the positive effect both does not take place instantaneously, i.e. that a certain time passes between the moment when the multinational enterprise enters the country and the moment when we are able to measure the positive effect on productivity. This has to do with the fact that it takes time before changes are implemented, staff is hired or re-trained and production is organized along the new lines.

## 1.4 The key to the difference: institutions

In the first two chapters, we concentrated rather on general relationships, established statistically for a large group of transition countries, leaving aside the country-specific factors. Devoting the necessary attention to country-specific factors in a formal analysis would be hard due to the small amount of data we have for individual countries. At the same time, although traditional factors like physical and human capital do play a role, they can only explain a relatively small part of the differences across countries. Initial conditions also cannot account for the vast differences among the transition countries we are observing.

Hence, let us return to one of the main questions of interest, namely why countries are so different in terms of economic performance. Searching for the answer, we look here at "Institutions" which is a fairly broad category of country characteristics comprising "the rules of the game" under which the economic agents make their decisions and act to implement them. This includes some measure of to what extent the citizens of a country enjoy political and economic freedom, whether proper laws are in place, to what extent the implementation of these laws is secured, whether the public administration responsible for providing public services to the citizens is efficient and non-corrupt, if the decisions and actions of public officials are transparent, etc. Institutions are usually measured using subjective data (how the institutions of a country are perceived by its citizens) collected by various international organizations (e.g. the World Bank, Transparency International, Heritage Foundation etc.).

One prominent empirical result that emerged after the first ten years of transition is that institutions play a role for explaining cross-country differences in output and growth. Countries with better developed institutions have higher output and grow faster. However, little is known about the nature of this effect. How exactly do institutions affect the economic performance and what is the channel through which this influence works? What determines the institutions themselves? Why have some countries achieved relatively fast institutional progress while others have remained with persistently undeveloped institutions, with high levels of corruption and organized crime? The formal research has provided an empirical confirmation to facts that are actually quite intuitive and each of us can observe daily in our life. If bureaucrats are corrupt and inefficient, we waste more time and more money (for a bribe) in order to obtain a certificate. We have to invest in security systems for our property if the police are unreliable. The public hospitals and schools are in a worse condition if bureaucrats loot money from the budget.

But if the benefits of better-developed institutions are clear both to citizens and to policy-makers, and if institutions are determined by them in elections, then why is there a lack of will to design and implement reforms which would improve the existing institutions and everybody's welfare? The answer is that if some interest group can privately benefit from the state of undeveloped institutions and has political power, it might use the power to preserve the status quo. This group might include individuals with connections and control over assets from the previous system, who can receive income that does not result from any productive activity, but from looting of funds that would normally constitute the income of someone else. This type of income is also known as rent-seeking, therefore we also call such individuals rent-seekers. We can think of this looting in a direct or indirect way – in terms of lower personal income or inferior public goods in quality and quantity.

For instance, if an official loots money from the local budget, allocated to the construction of a new public school, it might not be constructed at all or at a much higher cost than otherwise. This would then drain the budget of funds for other important projects to the detriment of all citizens. On the other hand, an insider manager who strips assets in a firm would decrease its revenue and therefore also directly the salary received by its workers.

Countries with deficient institutions are usually also characterized by low transparency and accountability of decision-making, which allows for the group's interference with the political decision-making in order to promote their own interests. By lobbying, bribing, and illegal deals rent-seekers can influence the way laws and regulations are formulated or the way they are implemented, and also block undesired laws, which could limit their opportunities to extract profits. For example, a law establishing clear procedures and control for assignment of public projects would prevent connected firms from receiving these projects. If this interference is wide-spread, the result might be that the passed laws have many built-in loopholes, ambiguities and hard-to-implement regulations, and leave a lot of discretion to corrupt bureaucrats to decide on the particular cases. In addition, their implementation might be poor and selective. This makes institutions as a whole dysfunctional and is a situation very hard to remedy since once rent-seekers have established their influence in politics, it is hard to remove them.

In order to be able to create a model of reality, we have to somehow express all these concepts quantitatively. This is done in the following way. We assume that there are two categories of people in the economy: a small share of the people have connections (often inherited from the old system) and control over assets that provide them with niches for rent-seeking, but they can also choose to work, depending on which of the two activities brings them more income. The rest of the population does not have access to rent-seeking; hence all they can do is work. Prevailing institutions (measured by an institutional index), and more specifically, the quality of law enforcement and the degree of protection of property rights, determine what fraction of the output can be looted by the rent-seekers. If appropriate laws are in place and there is strong law enforcement, then looting would not be possible at all, so even the most influential rent-seeker would give up looting and prefer working. If the institutional quality is very poor, then the rent-seekers would be able to extract a substantial part of the workers' income with small effort until the latter are left with a minimum subsistence income.

What do the rent-seekers do with the extracted income? They spend it on a luxurious lifestyle (one can think of the notorious oligarchs), but they are also interested to be able to receive similar income in the future. Therefore they invest in organized activity which aims at preserving as much as possible the current state of underdeveloped institutions – by political influence to block reform efforts, to prevent the laws that would limit their possibilities for rent-seeking from coming into power. In this way, we obtain a complex feedback mechanism - institutions determine the decisions of rent-seekers and the degree of looting in the economy, but are also a function of these two factors. This is the key to explaining the existence of countries which perform relatively well economically, but have underdeveloped institutions, high levels of corruption and huge income inequality.

We can imagine that this type of political influence is a substantial effort that requires a large investment – rent-seekers not only want to influence laws, but also have to "cover their traces" so that the process is invisible for the public or at least it appears legitimate, in order to avoid protests and revolts. The size and scope of such a task does not allow it to be performed by a single individual. The rent-seekers take their decision collectively, as an organized group with coordinated strategy and shared expenses for realization. Moreover, we assume that the coordination requires such a degree of information exchange that rent seekers observe perfectly who has benefited from the coordinated action and how much. In this way any organization member who has not paid an adequate contribution can be detected and effectively excluded (similarly to Mancur Olson's "Logic of collective action - Olson, 1971)".

What determines how much rent-seekers contribute for political influence? First, it depends on the amount "stolen", which determines how much is available for spending. Secondly, it depends on how costly it is to organize actions on the highest political levels. In turn, the cost depends again on the quality of institutions (measured by our institutional index). The worse the institutions are, the easier for the rent-seekers to transform their economic power into political power.