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### Economic development and growth in transition countries

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## CHAPTER 5

### SUMMARY OF THE FINDINGS

In this chapter, we return briefly to the topics presented in the Introductory Chapter and summarize the findings of our research in each of them.

#### 5.1 On growth determinants...

The first question we asked was what factors have determined the speed of economic growth in the transition countries? In the first phase, the factors which appear to influence growth are whether the country has participated in a war or armed conflict, what percent of its trade has been within the CMEA trading bloc under communism, whether the country has belonged to the former Soviet Union and how high its educational level is. It is well known that wars and armed conflicts have a detrimental influence on economic developments and lead to destruction of the country's capital. As for education, other things being equal, countries with higher educational levels seem to have had somewhat milder recessions. This is also quite logical, since a better educated labour force could facilitate the process of redirection of factors towards new profitable sectors: better educated workers or technical specialists could easily become familiar with the new machines and technologies needed for the new production processes, and they tend to be in general more flexible and mobile across sectors or geographic areas. In contrast, poorly-educated agricultural workers would find it hard to find and cope with a new job if agricultural production in their area were stopped because of making losses.

In the second period, growth seems to be influenced by the amount of physical and human capital used in production, as predicted by neoclassical growth theory. Moreover, the quantitative measures of these effects are very close to those researchers have found for other country groups. Further, whether the country has belonged to the former Soviet Union or not continues to play a role. This probably captures unobservable factors like certain legacies or common traditions and informal institutions which have their roots in the communist period or even earlier. Finally, the more developed institutions the country has, the faster it grows. Under "institutions" here we understand a group of characteristics describing how corrupt the government is, if the legal framework is adequate and enforceable, how citizens perceive the work of public administration, and to what extent the country has economic and political freedom. This result has also been confirmed by many other researchers in the area, and is one of the main conclusions we can draw regarding growth in transition.

#### 5.2 ...On international economic linkages...

What can our statistical data tell us about the effect of FDI and imports? We find that there is a positive influence both from capital goods imports and from FDI of multinational

enterprises on labour productivity, but in order to discover it, one has to look in a long-run perspective. It means that the whole accumulated FDI stock (the stock of all the investment that has entered the country for a period of several years) has a positive effect on the level of productivity over that period. However, we do not find this relationship if we relate the FDI received in one particular year to the growth in productivity in the same or the following year. This FDI stock contains foreign knowledge and expertise which has been accumulated for many years and reflects fully the knowledge wealth of the source country. In turn, the effect of this new knowledge is not limited to one particular period but continues to have an effect on productivity over a higher horizon, possibly by triggering further improvements in other sectors.

Moreover, it matters where FDI comes from and which sector it is directed to. It seems that the foreign investment directed to the manufacturing sector has a larger positive effect on overall productivity than that in the rest of the economy (which consists mostly of services). Probably, this can be explained by the fact that the products of manufacturing industry are often used as inputs in further industries and sectors. Therefore, the advantages in efficiency gained through the new technology and know-how are transferred into lower prices and better quality for these intermediate products and this helps the advantages spill over to many other industries and sectors. The source of FDI also matters: FDI coming from technologically more advanced countries has a bigger positive effect on labour productivity for the receiving country.

As far as the capital goods imports are concerned, we also observe a similar long-run effect: the imported new machines and equipment over a period of several years, by transmitting the technology incorporated in them, improve labour productivity. Again, this effect does not work immediately and although we find also an instantaneous relationship between the amount of import in a certain year and the change in labour productivity for this year, it is weak. Similarly to the case with FDI, it matters where the new machines come from: those imported from countries with a better technology show a higher effect on productivity. This is a very intuitive result that has also been established earlier: the larger the difference between the two countries in terms of technological levels, the larger immediate improvement can be achieved immediately after importing goods containing this superior technology.

To summarize, more intensive international trade and the inflow of foreign capital from the advanced countries has indeed helped the economic recovery and development of those transition countries that have become EU member states. Moreover, the long-run nature of the effect suggests that these two international channels are indeed carriers of foreign knowledge and technology. These EU countries have had a chance to establish very intensive trade and economic relations with the highly developed EU countries. It would be an interesting research question whether this effects is also present in the rest of the transition countries, in particular those from the former Soviet Union.

### 5.3 ...and the role of institutions

What do we find as a result of our simple institutional model? First, we confirm that the institutions matter for economic performance (income, inequality, investment etc.) and we give one specific mechanism for this influence. If we are concerned about the level

of output, there are at least two channels. First, the worse institutions are, the larger the proportion of people who can rent-seek who will choose to rent-seek and not to work, therefore the capital and labour force they possess will be lost for production. Second, each individual rent-seeker can steal more from the workers, meaning that the productive capital left in the hands of the workers will also shrink, and less capital means smaller amount of production in the following period. Another intuitive result is that worse institutions lead to a higher income inequality (and this is also confirmed empirically), since in that case rent-seekers loot more and workers receive less. Also, once the institutions allow for the presence of intensive political influence, it is likely that it will persist since political influence naturally in the first place destroys the tools for its own removal.

However, there is also a less intuitive result. It was commonly believed in the beginning of transition that a more prosperous country would also improve its institutions faster. The logic was probably that institutional development is just a normal public good, which can be provided in better quantity and quality if a larger budget is available for it. It was also a concept underlying the famous Washington consensus in the beginning of transition – that the economic performance would improve by reforms like liberalization and privatization, which would pave the road for the emergence of the appropriate institutions. We show that, on the contrary, given that institutions are sufficiently bad initially, it is possible that a richer country ends up with worse institutions and lower chance for improving them than a poor one, since the rent-seekers have more to steal from, and this in turn enables them to invest more in preserving the possibilities for looting in future. Moreover, high expected future income provides them with an additional incentive for larger investment in the preservation of bad institutions. The expected large inflow from EU pre-accession and accession funds in Bulgaria may be one of the factors that contributed to blocking the institutional reform and reaching high levels of corruption and organized crime in the last several years. By a “richer country” we mean here not only a country that has a higher level of capital per worker, but also a country with more efficient production (possibly due to higher technological level), so that more can be produced with a given amount of inputs. Therefore, higher output not only does not mean better institutions, it can even imply the opposite if the starting position is bad enough.

### 5.3.1 What is left unexplained?

The results we have obtained show unambiguously that we are not able to explain the large cross-country differences only by considering general relationships. We also have to pay attention to idiosyncratic factors that cannot be systematized and captured easily in a stylized model. Rather, these factors can be best studied with the help of case studies on individual countries, taking into account country-specific historical circumstances.

There are also several directions in which the general analysis can be extended. For example, the political factor has received a very casual treatment in the current analysis, whereas the political systems and the political decision-making might play a role for the decisions taken. Moreover, the model could be extended towards a multi-period general equilibrium model including stochastic shocks

Being aware of the forces that played a role during transition and their consequences

would ensure better understanding of the future developments or possible weak points in these countries. Also, some more general conclusions can be drawn regarding economic reform in general and some of its aspects that require particular attention.