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Institutions, Economic Performance and Transition

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Outline

Since the fall of the Berlin Wall, in 1989, the countries of Central and Eastern Europe (CEE) and the former Soviet Union (FSU) have been engaged in a historic transition process from centrally-planned to market economies. Economic performance among these countries has widely differed in the years since the start of the transition. So have economic policies. Of course, although the transition countries all came from a central-planning background, initial conditions also differed. Nevertheless, beyond the millions of affected lives, for the economist this is a unique 'natural experiment', giving useful data from which to distill lessons about the policies that have worked and those that have not. These may have broader significance than 'just' for the transition countries. They may also be relevant for developing countries in general, where similar issues play a role.

This thesis investigates how important differences in the quality of institutions have been as an explanation for differences in economic performance since the start of transition in the countries of CEE and the FSU, relative to other factors. Institutions are loosely defined as the rules of the (economic) game, encompassing both 'rule of law' (enforced by the state, for example property rights), or 'formal' institutions, and 'civil society' (enforced by convention, for example trust), or 'informal' institutions. Among other things, transition involves moving from plan to market institutions. It is fair to say that, at the start of transition, few economists recognized institutional factors as crucially important.1 Most stress was given on the quick achievement of macroeconomic stabilization and liberalization (privatization, price liberalization etcetera).

Chapters 1 and 2 are the only chapters in this thesis that are mainly theoretical. Chapter 1 focuses on the output collapse that all transition countries experienced on their way from a centrally-planned to a market economy. This transitional output collapse was much worse than initially expected. However, as central planning yielded an allocation far inside the production possibility frontier, the question may be asked why output needed to decline at all during the

1 However, the 'founder' of the modern economics profession, Adam Smith (1776), and even earlier Bernard Mandeville (1705), the first to celebrate the virtues of the market economy in their writings, at the same time would have recognized this, as the quotations on p xii make clear.
transition process. Chapter 1 reviews the most important theoretical explanations that have been offered in reply to this question, and makes a case for an explanation along institutional lines. Chapter 2 is connected to chapter 1 in that, among other things, it shows how transitional output collapse can be more specifically explained as an occasion of coordination collapse in institutional change, using some standard game theory. More generally, chapter 2 aims to illustrate in which ways the understanding of institutional change in economic transition can be aided by the notion of coordination games. It explains how institutions can be interpreted as ways of coping with coordination problems, and may help reaching an efficient instead of inefficient equilibrium. This also sheds light on the debate between the advocates of ‘shock therapy’ and those of ‘gradualism’ in reforming the transition economies. Relatively little formal theoretical modeling has been done so far in the spirit of the descriptive theoretical conclusions of chapters 1 and 2.

The rest of this thesis is mainly empirical, starting with chapters 3 and 4, which investigate how important the quality of institutions is for macroeconomic growth in transition countries, relative to other factors. As the transitional output collapse is of course part of their growth experience, some of the issues were already touched upon in chapters 1 and, to a lesser extent, 2. Chapter 3 surveys the most important empirical studies on the relationship between the quality of institutions and growth in general, and those that focus on the transition countries. Until recently, in particular the latter have been scarce. This has mainly been due to a lack of data concerning the quality of institutions, which is obviously hard to measure. However, increasingly, subjective measures of the quality of institutions, based on surveys of its perception by international analysts or local economic agents, have come into use. Chapter 3 identifies a need for more empirical studies of growth in transition countries using this kind of institutional measures, and makes some recommendations as to what to pay particular attention to. This leads to chapter 4, which contains an application of growth empirics with institutional measures for transition countries. Novel aspects of this chapter are fourfold. First, it uses some institutional data that has not been used before. Second, it includes a measure of informal next to formal institutions. Third, it performs a relatively extensive sensitivity analysis. Fourth, it explicitly addresses the possibility of endogeneity in the relationship between the quality of institutions and growth in transition countries.
Chapters 5 and 6 investigate the potential determinants of enterprise performance in the Russian transition, again giving particular attention to the quality of institutions. As, in order to achieve sustainable growth in transition countries, it is crucial that enterprise performance is improved, these chapters can be seen as a ‘micro mirror’ of chapters 3 and 4. Also, the methodology employed in both strands of the literature, and here as well, is basically the same. Russia is a particularly interesting case not only because it is the most important of the transition countries, but also because the performance of its enterprises since reform began has widely falsified expectations on the negative side. The groundwork is again laid with a literature survey, in chapter 5. This again identifies a need for further empirical work using institutional measures. While appropriate (institutional) macro data can be found (see chapter 4), it is much harder to find appropriate micro data on enterprise behavior in Russia. The investigation of the potential determinants of enterprise restructuring in Russia in chapter 6 therefore uses data obtained by means of an own survey among Russian industrial enterprises, which is a novel aspect of this chapter. The survey questions on the quality of institutions were explicitly designed with the subjective institutional measures used in chapter 4 in mind.

Finally, chapter 7 returns to (international) macroeconomics, investigating the potential determinants of capital flight from transition countries. For this purpose, to our knowledge, the first comprehensive data set on capital flight from transition countries is constructed. This creates the novel aspect of this chapter. The link with the previous chapters lies in the fact that capital flight can be a mechanism preventing transition countries from achieving sustainable growth, and can potentially be influenced by changes in the perceived quality of institutions. Chapter 7 uses the same subjective institutional measures as chapter 4.

Thus, the core of this thesis is in chapters 4, 6, and 7, as they contain some novel contributions, while the rest of the book is largely evaluating work by others. The seven chapters of which the book consists are separately-written papers, and can still be read as such. The first six were previously published as journal articles. Apart from editorial changes, they have been included in largely unchanged form, with the exception of the extension of chapter 6 with one section (6.6). This implies that these chapters have digested the literature roughly until their respective dates of journal publication, but not beyond that. Furthermore, there is some overlap in that chapter 4 uses parts of the literature survey in chapter 3.

2 See the acknowledgements, and the special footnotes to these chapters.
In spite of their inclusion in the form of separately-written papers, the common denominator of the separate chapters should be obvious from the above. All chapters have content about the role of institutions. Their effect on economic performance, specifically growth, enterprise restructuring, and capital flight, is also researched in all chapters. Finally, the focus is always on the transition from centrally-planned to market economy. Hence the title of this thesis: 'Institutions, Economic Performance and Transition'. 