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Institutions, Economic Performance and Transition

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Citation for published version (APA):

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Summary

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, 'Institutions, Economic Performance and Transition', groups together seven separately-written papers (chapters), of which the first six were previously published as journal articles. The common denominator of all chapters of the book is that they investigate 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. The measures of economic performance that we concentrate on are growth, enterprise restructuring, and capital flight. 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. Most stress was given on the quick achievement of macroeconomic stabilization and liberalization (privatization, price liberalization etcetera).

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89 See the acknowledgements, and the special footnotes to these chapters.

90 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.
Chapter 1 focuses on the theoretical explanation of 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 transition process. Of course, the transitional output collapse does not have one single common cause, and the intensity of the effects of the separate causes can vary across countries and in time. Both demand and supply factors have played a role. Nevertheless, it seems primarily an institutional supply-side phenomenon. Transition has destroyed the formal institutions of central planning, which given that system had their own logic, without automatically replacing them with the required market institutions. The resulting ‘institutional vacuum’ contributed to economic destruction outpacing creation, and initially even to coordination disruptions, causing uniform output collapse. Historically, market economies have been co-shaped by state authorities, for example shaping and enforcing the rule of law. However, evolutionary forces involving long series of recurring situations through which new conventions could be gradually established also played their role. Both things inherently take time.

Among other things, chapter 2 shows how transitional output collapse can be more specifically explained as an occasion of coordination collapse in institutional change. More generally, this chapter illustrates in what ways the standard game-theoretical framework of coordination problems is relevant for the transition from plan to market. Coordination problems show path dependence and illustrate that lock-in in an inefficient equilibrium is a clear possibility. As such, this framework points in particular to the relevance of building institutions that can guide transition towards an efficient equilibrium and prevent collapse of coordination. Furthermore, it clarifies the trade-off that exists between complementarities and adjustment costs of different reforms, so that a priori it is not evident whether shock therapy or gradualism is to be preferred in reforming the transition economies.

The rest of this thesis is mainly empirical. In chapter 3 we start an investigation of 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 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. The recent literature shows that, as one of the few variables found to do so, the quality of institutions robustly matters for growth and particularly investment. Moreover, it seems likely that better institutions indeed cause higher growth and not the other way around. The very few applications to transition countries suggest that once a certain degree of macroeconomic stabilization has been accomplished, the institutional environment becomes the more important determinant of growth in transition countries.

Some of the issues identified in chapter 3 are taken up in chapter 4, which contains an application of growth empirics with institutional measures for transition countries. It uses cross-section data on 25 transition countries for 1990-98. It introduces some new institutional measures, performs extensive sensitivity tests, and checks for reverse causation. Estimation results suggest that state institutions in particular are quite robustly important for growth and foreign direct investment (FDI). The relationship between institutions and growth is likely to be a causation, that between institutions and FDI less so. The significance of macroeconomic stabilization and liberalization is also confirmed, but multicollinearity problems make it impossible to properly judge their importance relative to that of institutions.

In chapter 5 we move to the investigation of the potential determinants of enterprise performance in the Russian transition, again giving particular attention to the quality of institutions. In order to achieve sustainable (macro)economic growth in the transition countries, it is crucial that (micro) enterprise performance is improved. However, it is not a priori clear which factors are essential for this. 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. On the basis of the relatively limited empirical literature on potential determinants of enterprise performance in Russia, surveyed in chapter 5, only two firm conclusions can be made. First, more (regional) competition is related to better performance. Second, privatization per se is not. If there is one ownership category performing better, it is new private enterprises. The
The actual situation in Russia on these counts is bad. The chapter identifies ample room for further empirical investigations on the effects of potential determinants on enterprise performance in Russia, in particular those of different kinds of institutions.

This is followed up in chapter 6. 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 empirical investigation of the potential determinants of enterprise restructuring in Russia in chapter 6 therefore uses data obtained by means of an own survey among more than 1400 Russian industrial enterprises. This survey collects data on enterprise restructuring, ownership, competition, budget constraints and, particularly, institutions, covering the period between the start of 1992 and September 1999. The survey questions on the quality of institutions were explicitly designed with the subjective institutional measures used in chapter 4 in mind. The response per se shows a devastating restructuring crisis, massive privatization, rather weak competition, unexpectedly hard budget constraints, an overwhelmingly negative and relatively positive assessment of formal and informal institutions respectively, and largely the same ruling networks as before the start of market reforms. Ironically, preliminary results indicate that (un)important determinants of enterprise restructuring in Russian industry are exactly those on which, according to the response per se, least (most) reform has been accomplished. That is: stronger competition and better (formal and informal) institutions go with more restructuring, while privatization and harder budget constraints do not. Econometric results confirm this specifically for active restructuring, which is most needed for sustainable growth.

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. 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. On their own, the capital flight figures illustrate that the Russian case is extreme. In particular, the August 1998 crisis is reflected in capital flight of roughly 60 billion US dollars for that year according to the measure used most widely. With panel data for 22 transition countries for 1993-99, we investigate the ability of a rich set of potential determinants to account for the behavior of
capital flight, using a general-to-specific model selection approach. The results illustrate that it is quite hard to model capital flight, which is surely not just influenced by economic fundamentals, but also by the psychology of the market. Moreover, different figures and estimation results when using different capital flight measures illustrate that there is no such thing as ‘the’ capital flight from the transition countries, only different subsets of capital flows that may or may not be interesting for analytical purposes. Even in the best specification, only the following variables have a significant effect on capital flight, in decreasing order of importance: reserves, quality of property rights, growth, and pre-transition level of liberalization. Surprisingly, higher reserves are associated with higher capital flight. However, this may reflect that higher reserves imply more ‘availability’ of flight capital. Higher quality of property rights, growth, and pre-transition level of liberalization are all associated with lower capital flight, and the differences in impact are minor.

Nevertheless, from a policy perspective, the results in chapter 7 are suggestive of the importance of ensuring the quality of property rights and the growth of the economy in general as the best strategy to lower capital flight in the broadest sense. Recall that chapter 4 gives evidence that there is quite a robust positive relationship between the first two variables as well. Furthermore, chapter 6 leads to results that confirm the significance of the quality of institutions for (active) enterprise restructuring, which is a crucial factor behind economic growth. In all these cases the quality of institutions proves more important than a host of variables that are generally considered significant. Thus, this thesis can be seen as a small piece in the body of evidence that has developed that indicates that institutions ‘matter’ crucially, specifically for transition countries. It implies that more stress should have been given on institution building in economic transition, certainly early in the process. Partly under influence of the body of evidence, this is by now a point that is mostly well-taken, and also considered to be applicable to economic development in general.