Beyond Transition
THE NEWSLETTER ABOUT REFORMING ECONOMIES

Institutions Count More than Liberalization Speed

by Vladimir Popov

The conventional wisdom suggests that differences in economic performance are 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 are believed to have better chances to limit the reduction of output and to quickly recover from the transformational recession. In general this may well be true, but the devil is in the details, which often do not fit into the generalization and make the whole explanation look trivial. In Russia, despite the high degree of liberalization and three years of macroeconomic stability (until the August crisis), the economic performance was poor and ended up in a spectacular crash.

The champions of liberalization and stabilization in the Eastern Europe-Central Asia region are the Baltic states (their so-called ABRADE cumulative liberalization index reached 2.4-2.9 by 1995), whereas Uzbekistan (with an index of 1.1) commonly is perceived to be one of the worst procrastinators. However, in Uzbekistan the reduction of output in 1990-95 totaled only 18 percent and the economy started to grow again in 1996, while in the Baltics output fell in the early 1990s by 36-60 percent and even in 1996, two years after the bottom of the recession was reached, it was still 31-58 percent below the prerecession maximum.

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. Decline in output is a supply-side phenomenon and is the result of a structural adjustment process that rectifies distortions of the centrally planned economy, including restructuring an obsolete militarized industry, strengthening the weak service sector, and developing a healthy trade pattern.

The decline of noncompetitive enterprises and industries is not followed instantly by an expansion of competitive industries and enterprises, due to barriers to capital and labor flows, including the poorly developed banking systems and securities markets, uncertain property rights, the lack of easily enforceable and commonly accepted bankruptcy and liquidation procedures, the underdevelopment of land markets, housing markets, and labor market infrastructure.

While initial conditions are important, government policy does affect performance. Policy measures are required to preserve or create strong and efficient institutions that facilitate the market economy. In most CIS and Balkan countries the collapse of institutions is apparent in the dramatic expansion of the shadow economy; the decline of government revenues as a proportion of GDP; the inability of the state to deliver basic public goods and appropriate regulatory framework; the accumulation of tax, trade, wage, and bank arrears; the demonetization, "dollarization," and "barterization," of the economy; and the decline of bank financing as a proportion of GDP. It is also demonstrated through the poor enforcement of property rights, the disregard of contractual obligations, the general breakdown of law and order and increased crime rates.

According to a recently conducted global survey that questioned firms in 69 countries about their trust in state institutions, firms in the Commonwealth of Independent States (CIS) had the lowest credibility, below that of Sub-Saharan Africa *(1997 World Development Report, The State in A Changing World).* Especially striking was the gap between Central and Eastern Europe and the CIS.

The share of state revenues in GDP can well indicate the institutional capacity of the state—the financial strength of the government. Though much has 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 led to the collapse of the state institutions.

There is enough evidence to show that differing performances during transition, after factoring in initial conditions and external environment, mostly depend on the strength of institutions and not so much on the progress in liberalization per se.

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