Institutions and Economics: 30 Years After the Fall of the Iron Curtain

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Reflections on Transition After 30 Years: Transition vs. Convergence[1]

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There is no doubt that the fall of the Berlin Wall in 1989 and the dissolution of the Soviet Union two years later were dramatic and significant historical watersheds. The Cold War that defined international relations in the post-World War II era came to an end and with it the idea that central planning and state ownership were viable approaches to economic organization. In the course of a few years, about 30 countries were thrust into a transition from one system to another. Many observers thought at the time that transition would take a very long time and involve enormous economic shocks. In fact, the depth of the transition shocks was probably underestimated. Many transition economies experienced both enormous declines in output and hyperinflation immediately after the onset of transition. However, my contention here is that transition did not take as long as anticipated and that in many instances the differences between transition economies and "normal" economies was smaller than originally thought. Thus, it is now no longer necessary to think of these countries as transition economies. Instead, the 30 odd countries of transition are emerging market economies that look very much like their peers without the same central planning legacy.

The differences between developing economies with extensive government intervention and direction of market outcomes and ones where communist ideas – government control of all resources and the absence of market mechanisms to determine prices – prevailed were overemphasized. Political realities more than economics gave emphasis to the differences between the Soviet bloc and the rest of the world since the Iron Curtain veiled the entire bloc – particularly in the eyes of the postwar baby boom generation that grew up in its shadow. But the fact was that many third world (as they were then called) economies were highly controlled statist economies and many communist countries had some market mechanisms or were starting to introduce market-oriented reforms.[2] In the postwar period prior to transition, both developing and communist countries emphasized capital accumulation. They differed with respect to the strength of the planning mechanism – whether it was centralized control or centralized nudging. The objective – invest for import substitution – was shared by communist countries and many former colonies that gained independence in the postwar period. Banks in many developing countries were largely state-owned and the financial system was used to channel credit in support of government objectives; further, major industries were often stateowned resulting in state control of a large share of output. The extent of state ownership did suggest some significant differences between developing economies and communist countries, and the communist countries were distinguished by efforts to abolish private ownership of property altogether.

These observations are made with the benefit of hindsight and differ from the standard views at the time transition began. The dissolution of communist regimes was rightfully viewed as a unique occurrence. As "*The Economist*" opined (March 24–30, 1990, p. 22):

> "Hundreds of books have been written on the transition from capitalism to communism but not the other way. There is no known recipe for unmaking an omelet."

Further, it was assumed that the unmaking would take a very long time. As a result, new institutions were developed to study the new phenomenon: SITE at the Stockholm School of Economics started in 1989, the Bank of Finland's Review of Economies in Transition began publishing in 1991 and became part of BOFIT, and the European Bank for Reconstruction and Development started operation in 1991 and established the journal, Economics of Transition, in 1993.

In the introduction to the first issue of *Economics of Transition* (1(1), p. 2), Jacques Attali, President of the EBRD, wrote:

> "Immediately after the overthrow of totalitarianism, the consensus approach was to favour a simple and immediate implementation of laissez-faire doctrines… Today there is growing awareness of

[1] Able research assistance from Aparajitha Suresh is much appreciated.

[2] Yugoslavia was always "reformed"; central European economies had moderately large amounts of private sector activity and ownership and had begun to reform; even Russia introduced reforms by the 1980s. Without any political reforms, China turned to private entrepreneurship in the quest for economic growth.

> that these countries face structural and institutional obstacles…"

He then went on to cite examples of institutions that were weak or non-existent in these countries such as means for tax collection or methods for transferring securities or property ownership or a banking system based on lending. He concluded:

> "…it is impossible to divorce economic questions from the wider institutional background against which they arise….it is not just a question of putting in place market economies: it is a question in many cases of rebuilding the entire fabric of a nation."

His brief comments suggest a realization that the essence of transition from the very start was institutional development. Perhaps what made transition seem so different was the fact that economists at that time were just beginning to think about the importance of institutions.

The new institutional economics (NIE) which emphasizes the role of political structures and public institutions was gaining prominence just as transition was occurring (see Williamson 2000).[3] In a survey, Murrell (2008) shows how studies of transition through the 1990s slowly began to appreciate the importance of NIE. In addition, empirical work demonstrating the importance of institutions in economic outcomes generally did not begin to appear until the 1990s. For example, empirical work on the finance-growth nexus that associates credit deepening and the quality of financial intermediation with economic growth begins with Barro (1991) and King and Levine (1993), among others, with cross-country panel data sets and Wachtel and Rousseau (1995) with historical time series data. Similarly, the cross-country empirical literature on legal institutions starts with the LaPorta, Lopes-de-Silanes, Shleifer, and Vishny (1998) research on law and finance, which focused on the protections for investors in different legal systems. Research on the role of cultural institutions on economic outcomes, such as the influential book by Acemoglu and Robinson (2012), is even more recent.

Economics was developing an appreciation for NIE just as transition was occurring. The lessons of transition for NIE were observed by Ronald Coase in his 1992 Nobel address (quoted by Murrell, 2008, p. 672):

> "The value of including institutional factors in the corpus of mainstream economics is made clear by recent events in Eastern Europe…without appropriate institutions no market economy of any significance is possible."

Murrell suggests that the early failures of transition reforms (e.g., the privatization and banking debacles) made economists generally more aware of NIE. The intellectual influences between NIE and transition ran in both directions.[4]

Measurement of institutional development and quality only began in the 1990s. Among the first such efforts were the EBRD's Transition Indicators, introduced in 1994, which are very popular and widely used in the research community.[5] Havrylyshyn and van Rooden (2003) discuss a number of other institutional indicators, most of which started about the same time. The very popular global data from the World Bank's Doing Business project were only introduced in 2002.

The political and economic shock of transition brought about surprisingly deep recessions. This was true in countries that adopted a "shock therapy" policy as well as those that chose a more gradualist approach. The argument that transition was surprisingly rapid does not imply that the recession shocks were mild. The transition recessions were deep and the dislocation of resources, individuals, and institutions was extensive (Campos and Coricelli 2002). Nevertheless, within a few years, efforts to measure transition progress began to appear. An early retrospective by the Task Force on Economies in Transition (National Research Council, 1998) stated that (pp. 1–2):

> "Current reforms will alter fundamentally the way post-communist societies, political systems, and economies function and interact. More than 5 years into the process, what do we know about social change at this pace and scale?
>
> From its inception, the task force doubted that present versions of any existing theories – including various theories preferred by its own members – could adequately encompass these extraordinarily complex processes and explain the very different rates and patterns of transformation across the post-communist world.
>
> Moreover, many people thought that road was plainly marked: stabilization, liberalization, and privatization would transform highly bureaucratized, statist economic systems into dynamic, competitive capitalist economies."

Anders Aslund (National Research Council, 1998, chapter 18) provided an early evaluation of transition progress. He suggests three criteria for transition progress: stabilization (particularly of inflation), liberalization, and private sector development. By 1997, transition, according to these criteria, was accomplished in most countries with the exception of five failures: Azerbaijan, Belarus, Bulgaria, Tajikistan, and Turkmenistan. In Bulgaria, failure was due to the inability to stabilize the macro economy and lower inflation. In the others, there was little effort to embark on deregulation or liberalization; a market economy had not been established.[6]

[3] NIE has origins in economic theory that go back many years. The importance of institutions was more broadly recognized when Douglas North and Robert Fogel shared the 1993 Nobel Prize "for having renewed research in economic history by applying economic theory and quantitative methods in order to explain economic and institutional change."

[4] Olofsgård, Wachtel, and Becker (2018) discuss the influence of transition on the economics literature.

[5] See https://www.ebrd.com/what-we-do/economic-research-and-data/data.html and Myant and Drakokoupil (2012) for a critical evaluation

[6] Another early retrospective on transition, Fischer, Sahay, and Vegh (1996) focused on macroeconomic performance in the early years.

The ten-year mark led to several retrospectives on transition progress including studies from the IMF (Fischer and Sahay 2000), the World Bank (2002), and the EBRD (Gros and Suhrcke 2000). Fischer and Sahay (2000) examines differences across the region in the initial transition shock:

Table 1

	GDP decline	End of decline
Central and Eastern Europe	28%	1992
Baltics	43%	1994
Other former Soviet Union	54%	1995

By 1998, only three countries had recovered sufficiently to match the level of GDP prior to transition (1989): Poland, Slovakia, and Slovenia.[7] Further, monetary stabilization had brought inflation rates to single digits in most countries by 1998. The report emphasizes the differences emerging at the ten-year mark in transition progress between CEE and the FSU countries.

Along similar lines, Gros and Suhrcke (2000) ask whether we can distinguish transition economies from the other 130 countries of the world, holding the level of GNP per capita constant. The answer is yes but it is not a very strong yes. The transition economies have more employment in industry, more energy use, and a higher fraction of the population in secondary and tertiary education, all legacies of the structure of planned economies. There is a split among the transition countries when measures of financial and institutional framework are examined; the central European countries which were candidates for EU membership were indistinguishable from other countries with their level of GNP, but the CIS and SEE countries lagged.

A symposium in the *Journal of Economic Perspectives* in 2002 provided comprehensive evaluation of the transition economies. Svejnar (2002) made a distinction between type I reforms (macroeconomic stabilization, price liberalization, small-scale privatization, and breakup of state-owned enterprises) and type II reforms (large-scale privatization and development of banking and legal systems). This typology is useful today to distinguish between transition and development. Transition is characterized by the first type of reforms, macroeconomic stabilization and the establishment of a market economy. In that sense transition had been completed by the late 1990s.[8] Even with transition in this narrow sense complete, many countries were still very poor and vulnerable to crony capitalism and structural rigidities that could inhibit growth.

In this view, transition to a market economy with the end of the communist era took place quickly. So why is it so often viewed as a complex and lengthy process? The answer lies in the distinction between transition (to a market economy) and convergence (to a Western level of development). The creation of the institutions that make Western economies successful engines of growth is quite something else. Thus, convergence to living standards found in developed countries takes a long time. Many non-communist societies are bureaucratized and statist because institutions to foster competition and increased productivity do not exist. Poor institutions have made the pace of convergence very slow though large parts of the noncommunist world (e.g., much of Latin America, Africa, the Middle East, South Asia) although these countries did not have to go through a transition. The slow pace of convergence is a global issue and not a problem specific to transition.

The transition countries differ among themselves in the way that they undertook the reform process. In the early years of transition, western economists debated the merits of big bang vs gradualism. In a 15-year retrospective on transition Havrylyshyn (2007) examines the difference between rapid reformers and gradualists. Table 2 shows his grouping of countries by their early reform strategies. It goes without saying that the big bang countries (in the first column) have out-performed the gradual reformers (in the next to last column). However, a quick glance suggests that the distinguishing factors might not have been a random choice of reform strategy. The rapid reformers had initial institutions and cultural attitudes that enabled them to succeed.

Table 2

Transition Countries Grouped by Early Reform Strategies

Sustained Big-Bang	Advance Start/ Steady Progress	Aborted Big-Bang	Gradual Reforms	Limited Reforms
Estonia	Croatia	Albania	Azerbaijan	Belarus
Latvia	Hungary	Bulgaria	Armenia	Uzbekistan
Lithuania	Slovenia	Macedonia	Georgia	Turkmenistan
Czech Republic		Kyrgyzstan	Kazakhstan	
		Russia	Ukraine	
Poland			Tajikistan	
Slovakia			Romania	

Source: Havrylyshyn (2007, page 6).

Countries with a greater willingness and ability to undertake reforms were able to stabilize their economies and create market institutions that put them on the road from transition to convergence. This conclusion is echoed in the IMF's (2014) history of the first 25 years of transition; the report's executive summary says (p. v):

> "To revitalize the convergence process [after the financial crisis,] … stronger commitment to market-based policies is needed. Two broad priorities stand out. First, a renewed focus on macroeconomic and financial stability in some countries, to rein in persistent deficits and increasing debt, and to address rising levels of bad loans in banks. Second, to raise the pace and depth of structural reforms in areas such as the business and investment climate, access to credit, public expenditure prioritization and tax administration, and labor markets."

It is interesting that this conclusion says nothing about the communist era's legacy; it could be applied as a prescription for convergence to any emerging mar-

[7] GNP is an imperfect measure of economic well-being for countries undergoing structural upheaval and is subject to measurement error during the transition. The GNP declines overstate the fall in consumption and well-being. Nevertheless, income inequality, measured by Gini coefficients, increased in most countries during the 1990s.

[8] With the exception of Aslund's five failures noted above.

ket or developing economy around the world. Transition is complete in the sense that the formerly planned economies might be indistinguishable from other countries around the world.

To compare the transition countries to others, we divide them according to their World Bank income group. Among the transition countries, eight are lower middle income, 13 upper middle income, and eight are high income.[9] The high income countries are the Baltics and the formerly planned central European countries. The upper middle income countries are five former Soviet republics now in the CIS, mostly those like Russia with natural resource wealth, and countries in southeastern Europe. The lower middle income countries are all former Soviet republics.

Table 3 shows data on the economic structure from the World Bank. The average for the transition countries and for all the countries in the income group are shown. The data on the structure of GDP suggests two observations. First, there are not enormous differences between the transition economies and peers in their income group. Second, the differences observed reflect communist-era legacies that are slow to change. For example, there is more manufacturing in the high income transition economies than in their peers, and less in the upper and lower middle income groups than in their peers. This reflects the structure of economic planning in the communist world, which concentrated manufacturing in central Europe. There is about as much capital formation in the transition economies as elsewhere but less expenditure on education and on R&D. There tend to be more armed forces personnel in the transition economies than elsewhere because a handful of the countries are in or not far removed from conflict (e.g., Georgia, Ukraine, Bosnia, Serbia).

The structure of output and the characteristics of the labor force are areas where path dependence from the communist era is slow to change. However, much of the discussion of transition emphasizes the creation of institutions that did not exist in the communist era. In some instances, institutions have developed slowly; in others, not. Table 4 contains data on the business and financial environment, which shows the extent to which institutional change has occurred.

The financial sectors of transition economies at all levels of income lag those elsewhere. Domestic credit to the private sector as a percent of GDP is much smaller than in comparable upper middle or high income countries.[10] On the other hand, the World Bank's Doing Business surveys indicate that substantial progress has been made. The time required to start a business or enforce a contract is much lower in lower middle and upper middle income transition countries than elsewhere. Interestingly, the high income transition countries where legal institutions existed prior to transition and where EU membership led to substantial reforms still lag their peers. The credit indexes show that that for all income groups, the credit environment is better in transition countries than in their peers. Perhaps where new institutions were created from scratch, they are created with the benefit of experience around the world. Moreover, it is easier to create new institutional frameworks than enterprises and industries. Finally, when it comes to the technologies that postdate transition – mobile phones and internet use – the transition countries have largely converged with their peers.

In Table 5 we show data from the IMF for the transition countries in each income group and a sample of others in the group (the control). The government sectors are not noticeably different in transition and control countries. In the bottom of the table, we provide information from the IMF's Financial Development Index Database, which combines World Bank data on financial institutions and information from the financial access survey. Financial Institutions Depth is a measure of the amount of intermediation relative to GDP. Financial Markets Depth is an index that measures the size of stock market capitalization and trading and debt securities to GDP. The Financial Institutions index combines the depth measure with indexes of financial institution access and efficiency. Similarly, the Financial Markets index combines the depth index with indexes of access and efficiency. The maximum score on each of these indexes is 1.0.

The depth of financial institutions (which consists largely of bank credit to the private sector as shown in Table 4) and of financial markets is substantially lower in transition countries than elsewhere for all income groups. The differences are less profound for the aggregate indexes that combine depth, access, and efficiency.

All in all, it would be an overstatement to say that transition economies are indistinguishable from their emerging market peers. In some respects, the transition world clearly lags, namely in the development of financial institutions. On the other hand, these same countries have outstanding performances in the use of technology and in putting in place business-friendly institutions.

When transition sprang into view almost 30 years ago, we thought that it would be very important because of the unique nature of the transition from a planned to a market economy. To the surprise of many, the changes occurred very quickly and the transition countries – though sometimes unstable and struggling – do not look all that different than emerging market economies around the world. This is particularly true in areas where new technologies or new institutions have grown around the world during the transition generation. In this respect, transition was important because

[9] Data is not collected for Kosovo and Montenegro and data for some other countries is often missing.
Lower middle income transition economies: Armenia, Georgia, Kyrgyzstan, Moldova, Tajikistan, Ukraine, Uzbekistan.
Upper middle income transition economies: Albania, Azerbaijan, Belarus, Bosnia, Bulgaria, Croatia, Kazakhstan, Macedonia, Romania, Russia, Serbia, Turkmenistan.
High income transition economies: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia.

[10] Further evidence on the lagging financial sectors is shown in Table 3.

Table 3

Economic Structure

	Lower middle income		Upper middle income		High income	
	Transition	All	Transition	All	Transition	All
			Structure of output, % of GDP, 2015			
Industry output	23.6	29.0	29.2	33.1	27.6	22.9
Manufacturing	11.1	15.7	11.6	20.4	18.0	14.2
Gross capital formation	26.1	27.6	23.9	32.1	22.8	21.8
R&D expenditure	0.3	--	0.6	1.5	1.4	2.5
Government expenditure on education	5.3	--	3.6	4.3	4.9	5.2
			Labor force, 2015			
Male labor force participation (% population 15+)	67.3	77.7	66.1	75.6	66.2	68.4
Female labor force participation (% population 15+)	47.2	35.4	50.1	55.0	52.1	52.4
Researchers per million	--	--	1375	1201	2822	4158
Armed forces, % of labor force	1.2	0.8	1.7	0.8	0.9	0.9
			Education – school enrollment, 2016			
Secondary	--	69.6	98.9	93.0	106.8	108.5
Tertiary	37.9	24.2	60.8	50.7	65.9	77.1

Note: Data not shown if not available or if it is available for less than one-half the countries in the group.
Source: Author's calculations.

Table 4

Business and Financial Environment

	Lower middle income		Upper middle income		High income	
	Transition	All	Transition	All	Transition	All
			Structure of finance, % of GDP			
Domestic credit to private sector, 2017	35.9	43.6	43.6	115.3	48.8	148.8
Broad money, 2016	40.8	65.1	56.8	146.4	--	122.5
			Doing Business survey, 2015			
Starting a business –time required (days)	7.1	27.5	17.9	30.3	15.2	12.0
Enforcing contracts – time required (days)	402	691	488	632	650	616
			Getting Credit indexes, 2015			
Strength of legal rights (0–12)	7.2	4.8	6.2	5.0	6.9	5.4
Depth of credit information (0–8)	6.7	4.2	6.3	4.9	6.5	5.8
			Technology use			
Mobile cellular phones per 100 people	113.3	88.4	125.6	105.4	128.6	123.7
% of population using internet	45.2	26.7	61.7	52.0	75.6	79.6
Energy use, kg of oil equivalent per capita, 2014	1095	642	2491	2193	3005	4733
			Quality of business environment			
	Transition	Control	Transition	Control	Transition	Control
Corruption perceptions, 2018	34.0	38.0	36.9	39.5	58.1	72.0
Institutional Investor credit rating, 2016	29.1	42.3	43.4	47.2	70.1	79.4

Note: The control group countries were randomly chosen from the World Bank list of countries in the income group, omitting very small countries and countries in conflict. The number in the control group is the same as the respective number of transition countries.
Source: Author's calculations.

Table 5

Government Finance and Financial Institutions, IMF Data

	Lower middle income		Upper middle income		High income	
	Transition	Control	Transition	Control	Transition	Control
			Government finances, % GDP, 2017			
Government revenue	30.6	--	34.9	29.1*	39.5	41.5
Government borrowing	-1.2	--	-0.2	-4.6*	-0.4	-0.5
Primary borrowing	0.2	--	1.1	-2.0*	1.0	1.4
			Financial institutions quality and access, 2017			
Financial institutions	.38	.37	.47	.49	.55	.73
Financial institutions depth	.10	.21	.17	.31	.28	.69
Financial markets	.07	.13	.09	.28	.16	.56
Financial markets depth	.06	.16	.11	.27	.13	.68

Notes: * 2009 data. See note to Table 2 for definition of control groups. The financial indexes are based on World Bank data and the financial access survey. Financial Institutions: Aggregate of Financial Institutions Depth Index, Financial Institutions Access Index, and Financial Institutions Efficiency Index. Financial Institutions Depth: Compiles data on bank credit to the private sector in percent of GDP, pension fund assets to GDP, mutual fund assets to GDP, and insurance premiums and non-life to GDP. Financial Markets Index: Aggregate of Financial Markets Depth Index, Financial Markets Access Index, and Financial Markets Efficiency Index. Financial Markets Depth: Compiles data on stock market capitalization to GDP, stocks traded to GDP, international debt securities of government to GDP, and total debt securities of financial and non-financial corporations to GDP.
Source: Author's calculations.

it became a laboratory that taught economists and policy makers a great deal about economic growth and development, particularly the role of institutions. The transition experience turned attention to institutions and away from traditional development ideas that emphasized capital accumulation. Nevertheless, the puzzle about the next stage remains. In both transition and other emerging market economies, convergence continues to be very slow. Perhaps further study of the transition experience can help us understand how to speed it up.

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