Institutions and Transition

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Abstract

This essay examines the evolution of both institutions and economists' thinking on institutions during transition. Early in transition, institutions were virtually ignored in the majority of normative prescriptions, but were central in the evolutionary-institutional approach. Later, after events influenced intellectual developments, institutions were at the center of analysis. Growth is strongly related to institutional construction. Transition countries built institutions speedily but with marked variation across countries. Legal systems and independent governmental agencies were sources of institutional growth, while government bureaucracies and informal mechanisms detracted from institutional growth. In China, reforms addressed problems that institutions usually do, but in unusual ways.

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Transition is the widely accepted term for the thoroughgoing political and economic changes that followed the fall of Communism in Eastern Europe (EE) and the Soviet Union. Some 29 countries are involved in this continuing process, which began in 1989–91 and involves the types of transformations that usually took a century or more in today's developed countries. A related, but distinct, process has been under way in China since 1978.

Transition has been coterminous with a remarkable change in emphasis within economics. In 1989, to highlight the importance of institutions was a distinctly minority activity. Now, institutions are at the heart of both research and policy discussions. Similarly, while many early influential analyses of transition virtually ignored institutions, current discussions place them at the centre. Developments in transition countries made an important contribution to general trends within economics (Roland, 2000).

This article focuses on institutions in the transition process and in economists' deliberations on that process. It begins with early normative prescriptions, in which institutions were virtually ignored by the majority of contributors, and then examines changing views on institutions, showing how events on the ground influenced intellectual developments. We then provide basic facts on institutional development, describing the impressive progress that has been made, which suggests modification of the standard assumption that institutional construction must be slow. Nevertheless, there is marked divergence across countries. This article examines the sources of institutional growth and the 'great divide' between the successful and the unsuccessful institution builders (Berglof and Bolton, 2002). It closes by considering the seemingly anomalous case of China, showing that the anomaly is more apparent than real. China's reforms addressed the problems that institutions address everywhere, but in ways that are not recognizable to those using a first-best institutional template.

Ideas and institutions in the earliest phase of transition

Economists began to deal with the transition with a deluge of normative prescriptions. The majority view in its most stark incarnation came to be called shock therapy, the notion that the best way forward was as fast as possible on all fronts, taking advantage of a political window of opportunity. These types of reforms were certainly the aim of the first post-communist governments and their Western advisers in Poland, Russia, and many other countries. According to shock therapy's proponents, the soon-to-be-observed dissonance between objectives and follow-through was variously due to the absence of a clear vision, lack of willpower, and a nefarious political opposition.

Institutions were ignored within the shock therapy approach for a variety of reasons. They could be built so easily that they did not require much attention (Sachs, 1991). They were not deemed important enough to mention (Blanchard et al., 1991). They would take so long to develop that other elements of policy came first (Fischer and Gelb, 1991). Or, they could not be built without first creating the actors who would demand them within the political process (Boycko, Shleifer and Vishny, 1995).

In shock therapy analysis, political economy considerations led to emphasis on the destruction of the old institutions and trumped any concerns about the dangers of an institutional void. Macroeconomics governed microeconomic institutional change, as exemplified by the International Monetary Fund's short-term focus on raising taxes in Russia, while largely ignoring sensible tax reforms (Black, Kraakman and Tarassova, 2000). Rapid liberalization was advocated, while downplaying its effects on the governance of contractual relations. The transaction costs of ownership change and corporate governance after privatization were deemed of secondary importance.

When economic performance in the early years of transition proved disappointing, diagnoses followed the earlier analyses: strong, but necessary, stabilization programmes had led to recessions (Blanchard, Froot and Sachs, 1994); that is, in the early 1990s, the most influential analyses did not associate the steep, sometimes catastrophic, recessions with institutional problems. For example, such analyses led to the conclusion that liberalization, privatization and stabilization should move even faster in Russia in 1992 than they had in Eastern Europe two years earlier.

Kogut and Spicer (2004; 2005) use numerical citation analyses to analyse patterns in the early economics literature on transition. They document the links among a core group of economists subscribing to the shock therapy approach. This group had strong connections to the international financial institutions and the US government, and were able to spread their views in reforming countries under the auspices of these powerful organizations. Kogut and Spicer also identify dissenters from this point of view, in particular Murrell (1992), Dewatripont and Roland (1992), and McKinnon (1991). Early in transition the dissenting view was labelled evolutionary or gradualist, but was later given the much more felicitous name, evolutionary-institutional (Roland, 2000).

The evolutionary-institutional view emphasized the importance of institutions, suggesting, for example, that the nature and timing of liberalization, privatization and stabilization depended critically on the existing institutional framework. Some institutions were prerequisites for a functioning market economy, and the absence of these might necessitate the slowing of reforms.

Because new market economy institutions were hard to create, it might be better to use crude second-best institutions, even some of the old ones, while maintaining a focus on building new ones. This might lead to a two-sector approach, where a nascent private sector was governed by new institutions, while some of the old mechanisms of governance prevented convulsions in the old state sector, negatively affecting the development of the new capitalism. This approach was particularly congenial for those who thought that the growth of the new private sector was crucial (Kornai, 1990) or whose advice reflected elements of Chinese reforms (McMillan and Naughton, 1992).

The suggestion that economic reform should be gradual was a conclusion, rather than a starting point. It grew out of analyses that were standard in the literature (North, 1990). Because ideas and organizations adapt to an institutional framework, there is no certainty of an immediate functional response to new institutions. Difficulties in creating new institutions suggest a wariness of quick reforms when their success depends on functioning institutions. Instead, a nascent private sector produces the most nimble response in a new environment of fast-changing institutions.

Evolving ideas on the role of institutions

Events changed ideas. All transition countries experienced deep recession. Recovery began after several years, with its inception unrelated to any specific policy initiatives. If anything, recovery began on retreat from the earlier policies. The degree of adherence to standard policy advice could not explain the cross-country pattern of recession and growth.

Although these facts were consistent with the evolutionary-institutional view, the most influential contribution in changing the terms of debate was a paper co-authored by one of shock therapy's main proponents (Blanchard and Kremer, 1997). Undoubtedly, this paper had such a large effect because one of its authors was an influential economist who had previously attributed little importance to institutions (see Blanchard et al., 1991; Blanchard, Froot and Sachs, 1994; and the review of the latter in Murrell, 1995). The paper formalizes ideas already present in the earlier evolutionary-institutional literature in a simple, but powerful model. The model highlights the incentives to break agreements in the absence of effective governance, leading to a loss of production. Output decline comes later but is larger where the complexity of old production relations is greater. If opportunities improve over time, the model generates a U-shaped path for production. These predictions are consistent with the comparative profiles of growth in the transition countries, with recession initially steeper but ultimately shallower in Eastern Europe than in the former Soviet Union (FSU).

There is much to learn about the relationship between institutional change and production decline, but there is general agreement in some areas. Pre-transition institutions contributed to enterprise productivity. These institutions offered credibility in the negotiating of agreements, contract enforcement, specification of control rights over assets, mechanisms for the generation and allocation of working and investment capital, and many other services. When the communist systems fell apart and market institutions were still on the drawing board, these crucial services were no longer supplied. The lack of institutional support was particularly critical at the beginning of transition for several reasons: socialist firms were large, implying a need for sophisticated governance mechanisms; inter-firm relationships were highly particularized, implying great potential for hold-up problems; and necessary adjustments were enormous, implying the need for effective financial markets.

Even without effective institutions, production rebounded due to the spontaneous growth of private sector opportunities. Nascent small businesses could take advantage of these opportunities if they received a minimal amount of institutional support, that is, protection from extreme criminality, prevention of civil chaos, and the benign neglect of the state. Such businesses develop their own self-enforcing agreements and do not need sophisticated courts or contract law. Physical possession solves many concerns about property rights. Closely held firms that are self-financed do not need corporate governance institutions.

But to rebound from recession is not the same as sustained growth. The latter requires more than the benign neglect of the state: it requires a set of institutions that support non-self-enforcing agreements, secure property without possession, enable firms to expand beyond the limits of self-finance, and undertake many other activities that are not feasible without effective rules of the game. While such ideas seem commonplace now, they were not to the fore in the debates at the start of transition, except in the evolutionary-institutional perspective.

In addition to the institutional interpretation of the causes of collapse and recovery, two further factors contributed to economists' changing views. First, econometric studies showed that differences in the application of the standard policies did not explain differences in economic performance (for example, de Melo et al., 2001; Falcetti, Raiser and Sanfey, 2002). Second, variations in performance became more noticeable in the trajectories out of recession. Countries appeared to be sorting themselves into two groups. Those in EE were generally performing better than those in the FSU, but there were enough exceptions (for example, the Baltics, Serbia) to suggest that the EE–FSU distinction was not the key. As Berglof and Bolton (2002, p. 77) noted, 'A growing and deepening divide has opened up between transition countries where economic development has taken off and those caught in a vicious cycle of institutional backwardness and macroeconomic instability.'

Beck and Laeven (2005) were the first to test this new institutional paradigm of growth in transition in a rigorous framework, although their study is naturally characterized by a paucity of data points. They find that there is very large divergence in the performance of transition countries and that institutional development is the key factor in explaining the divergence. Moving from Russia's level of institutional development in 1996 to Poland's level would lead to a growth rate increase of 4.4 per cent a year. In contrast, differences in policies are unimportant. Papers studying privatization, agricultural markets, and foreign direct investment contain results on economic performance at a more disaggregated level that complement those of Beck and Laeven. While relative neglect of institutions characterized the early stages of transition, the centrality of institutions is now conventional wisdom.

Evolving institutions

One reason why institutions were not emphasized in early transition was the widely held assumption that institutional construction would be very slow. The transition countries provided an ideal testing ground for this assumption. Having rejected a set of old institutions and turned to creating new ones, how fast and how successful could institutional construction be? The answer, for some countries only, is surprisingly quickly and successfully. Transition experience refutes one element of conventional wisdom, that institutional development is inevitably very slow, while bolstering another, that failure is commonplace.

Murrell (2003) concluded that there had been widespread, large, continuing improvements in institutional quality from 1990–2000. An updating especially for this article extends this analysis to 2004, using the popular institutional measures developed by Kaufmann, Kraay and Mastruzzi (2005). This updating shows that institutional scores for transition countries as a whole are no better and no worse than one would expect given levels of economic development. This is remarkable, since it implies that in less than 15 years the transition countries built institutions that match those in countries that have had capitalist systems for much longer. For example, on the rule of law, Hungary, Slovenia, and Estonia are comparable to Chile, Israel, Greece, Italy, Spain, and Taiwan. On regulatory quality, Estonia ranks above Sweden, while Hungary, Lithuania, Slovakia, Latvia, and the Czech Republic are grouped with the United States, Japan, Italy, and Spain.

These results, which are based on expert opinions and surveys, are supported by studies examining the micro details of institutional development. Djankov et al. (2002) collect data on highly specific aspects of the functioning of legal systems, such as collecting on a bad cheque. They find that the ex-socialist countries fare better than both French-legal-origin and German-legal-origin countries. Pistor, Raiser and Gelfer (2000) examine the quality of laws on shareholder and creditor rights, finding the transition countries superior to many developed economies.

The second distinctive feature in institutional development is the divergence between one group of countries whose institutions are at a comparatively high level and improving and another group that has not crossed the great divide and is even losing some of the gains from the 1990s. By 2004, the EE–Baltic group has institutional scores higher than expected, given general levels of economic development on all six of the Kaufmann, Kraay and Mastruzzi (2005) indicators, and these scores improved dramatically in the preceding decade. The Commonwealth of Independent States (FSU minus the Baltics) scores below expected levels and has been regressing from 1996 to 2004, after showing remarkable signs of institutional improvement in the early 1990s.

It is difficult to exaggerate the importance of this empirical evidence on basic hypotheses on institutional development. Before transition, the assumption was that modern institutional development is a very long process, fraught with the possibility of failure. The first element of this assumption has been refuted. In the years before 1990, capitalism and democracy were absent in EE and the USSR. Then there was a mammoth fall in national income, due to institutional lacunae. Yet now a large group of countries seems set on the road to sustainable institutional development. In contrast, the second element of standard assumptions has been verified. In a significant number of transition countries, slow initial progress on institutional development has been followed by severe regression.

The sources of institutional development

There are two alternative perspectives to take when viewing the sources of institutional development. First, one can analyse which country-level factors best explain aggregate institutional outcomes. Second, one can ask which particular mechanisms or organizations inside a country contributed most to institutional performance. Evidence on both is only currently being generated, and is very scant. This is true both of transition and in general.

Beck and Laeven (2005) have carried out the most systematic study of the causes of aggregate institutional development in transition. They find two principal determinants: the strength of the incumbent socialist elite and the importance of natural resources (the resource curse). Both are negatively related to improvement in institutions. They also confirm the analysis of Black, Kraakman and Tarassova (2000) that certain types of privatization might have been inimical to institutional development. Early macroeconomic policies, belonging to the FSU, and being eligible for the European Union do not affect institution building. These negative results are important since they reject prominent hypotheses. One popular theory not explored by Beck and Laeven is that colonial heritage might have influenced institutional development, particularly in the case of countries influenced by the Austrian, Ottoman, or Russian empires.

One can also ask which particular mechanisms contributed most to institutional performance (Murrell, 2003). Formal institutions have played a more beneficial role than informal institutions, such as culture or pertinent elements of social capital. Of the formal institutions, political and legal structures and independent governmental agencies contributed relatively more to institutional development. State administrative bodies detracted from institutional performance, changing slowly and contributing to relatively high levels of corruption. These facts are generally consistent with the old Schumpeterian message of creative destruction, but applied to non-market organizations.

One very surprising feature of transition is the relatively strong role of some legal institutions. A series of empirical observations on the courts suggests a divergence from prevailing views on the role of the legal system (see the essays in Murrell, 2001 for example). The legal system has never been identified as playing a strong role in developing countries, and transition was not conducive to the effectiveness of the law. Yet current evidence suggests that it is easier than usually assumed to fashion a legal system that facilitates economic processes, even when that system is far from the standards of developed countries.

Institutions in the Chinese reforms

On the surface, Chinese reforms might be cast as a refutation of the above. China began its reforms with a basic constraint on institutional change – movement from the existing system could not be too great or too fast. This meant that new institutions would not be best practice, but had to be incremental variations on existing ones. Hence, China does not fare well when matched against standard criteria for judging institutions. This stands in contrast to the astounding success of the Chinese economy.

Nevertheless, China's reforms can be interpreted as bolstering the basic conclusion of the centrality of institutions in transition. China created successful, transitional institutions (Qian, 2003). By experiment, by confining itself to incremental changes that could be easily understood, and by implementing Pareto-improving changes in the early years of reform, China pursued a deft, but previously untrodden path of institutional change.

Qian (2003) provides examples of these transitional institutions. China implemented a dual-track approach to liberalization, which led to markets in above-plan production, but kept quotas and controlled prices on the levels of production that had existed before reforms. This promoted efficiency at the margin, while endorsing the existing set of informal rights to infra-marginal production, thus protecting the welfare of those who otherwise might have lost heavily from reforms. A highly distinctive ownership form appeared, township and village enterprises (TVEs), which played a significant role in China's growth in the first two decades of reform. TVEs can be interpreted as a mechanism for protecting decentralized property rights when the state is unable to guarantee more formal ones for private owners. Anonymous banking served as a commitment device, limiting government predation by reducing information flows. This arrangement can be understood as a crude substitute for the protection of financial property rights when the independence of the legal system is not a real possibility in the short-run.

Therefore, China constructed mechanisms to address the problems that institutions address in successful countries. However, those mechanisms would not look familiar when matched against best practice in developed countries. As the evolutionary-institutional perspective emphasized, it is fruitless to try to imitate best practices when human capital and institutional capability are not sufficient. In such situations, it might be best to deploy a set of transitional institutions, much more suited to the particular circumstances of a country and its capabilities. This observation resonates with the experience of EE and the FSU reviewed above. Countries with less benign starting points for creating best-practice institutions were doomed to fail in the process, while others could succeed given the right political and human capital preconditions.

Of course, there was a reason why in early transition best-practice institutions were advocated for all countries. It was feared that a country might find it hard to replace transitional institutions once they were set in place, becoming trapped at a low level of development. Whether this fear was ultimately justified will be addressed by Chinese experience in the coming decades.

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See also: COMMAND ECONOMY; DUAL TRACK LIBERALIZATION; GREAT DIVIDE; MARKET INSTITUTIONS; NEW INSTITUTIONAL ECONOMICS; OUTPUT FALL–TRANSFORMATIONAL RECESSION

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