STATE INSTITUTIONS - THE FRAMEWORK FOR ECONOMIC RESTRUCTURING AND REFORM

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In its last "World Development Report" the IBRD had dealt extensively with the question of how the activities of the state impact upon the economy; and vice versa. The EBRD has investigated the same issue in its transition reports. The findings of IBRD and EBRD converge. Both agree that the state and its institutions are essential for the development of the economy. This result is not very original or surprising. Clearly, in the absence of such institutions, an economy could never evolve.[1] IBRD and EBRD had simply pointed out the obvious. But if the inter-relationship and interdependence of the economy and the political administrative sphere is now accepted as a truism, the exact nature of this interdependence is still subject to debate and even controversy.

The political and economic transition of the formerly centrally planned communist states can be regarded as a vast experiment in which such conflicting views on the proper role of the state can be tested. These countries are being transformed both economically and politically - and profoundly so. This provides the opportunity to actually observe the causes and consequences of the different regimes governing the linkages between the economic and the political realms.

Looking back on the Cold War, it seems plausible that military means - that is mutual deterrence - had been prevented from turning into a hot war. But if the Cold War has been "won" (and we should be cautious in using that word) then it has been the first war to have been won by purely economic means. The communist, centrally planned system was abandoned because it proved to be economically inefficient. In the end, the communist centrally planned economies had become notorious laggards in the worldwide economic race. In fact - and if technology is taken as a gauge - the distance had grown to no less than 10 years. Closing this gap and becoming again "attached to Europe" is the prime political goal of the transition countries.

The motives for this effort are manifold. One of them is the simple desire to improve welfare. Opinions vary as to the relationship between social welfare and economic reform. Some even claim that the two goals - fast economic growth and the increase in social welfare - would be mutually incompatible.

Now, undoubtedly, some social hardship was bound to arise from economic transformation. Inequality in wages, for instance, was bound to increase as under the new circumstances wages had to reflect the realties of a free labour market with supply and demand varying in different sectors. Nonetheless, overall and contrary to such pessimistic views, the correlation between economic growth and social welfare is a positive one. The wealthier and the more resolute on economic reform, the better the average of the relevant social indicators.

Catching up with the rest of Europe can imply different goals. One may, for instance, wish to reach the average of the EU per capita income. Less ambitious is the goal of reaching the per capita income of the now poorer members of the European Union. High growth rates are required to reach even this less ambitious goal. In all cases, growth rates would have to be well above 5%. Is such rapid growth feasible? One of the requirements is that investment is sufficiently high.

Table 1 - International Comparison of Investment Rates

Slow-Growing Mature Economies		**Central And Eastern European Countries**	
United Kingdom	16	Bulgaria	21
United States	16	Romania	26
		Lithuania	19
Faster-Growing Mature Economies		Slovenia	22
Austria	27	Latvia	21
Netherlands	22	Poland	17
Fast-Growing Asian Countries		Russia	25
Singapore	33	Czech Republic	25
Hong Kong	33	Estonia	27
Korea	37	Hungary	23
Malaysia	41	Slovakia	28
Thailand	43		
Other Fast-Growing Middle-Income Countries			
Portugal	28		
Chile	27		

Source: IBRD World Development Report 1997

As Table 1 above reveals, investment is indeed high. At least in the more advanced of the transition countries investment rates now are well above the European average. We should assume that they will increase further.[2]

High investment is, however, only one of the factors facilitating growth. Other factors have to be present too for the transition economics to reach their full growth potential. The EBRD has attempted to assess all of these factors in its Transition Report of 1997. It assumes that the countries of Central and Eastern Europe and the CIS region are in a situation of being able to "catch-up". Thus the EBRD looked at two other instances of "catching-up" - namely at post-war Western Europe and at South-East Asia. In post-war Western Europe growth had been around 4% on the average. Growth in East Asia was around 5%. The EBRD then analysed the various factors that made such fast development possible in these two regions. It found the relevant factors to be, *inter-alia*, proximity to powerful markets; a low "starting point", and human capital; especially the human capital of a broadly educated and skilled labour force.

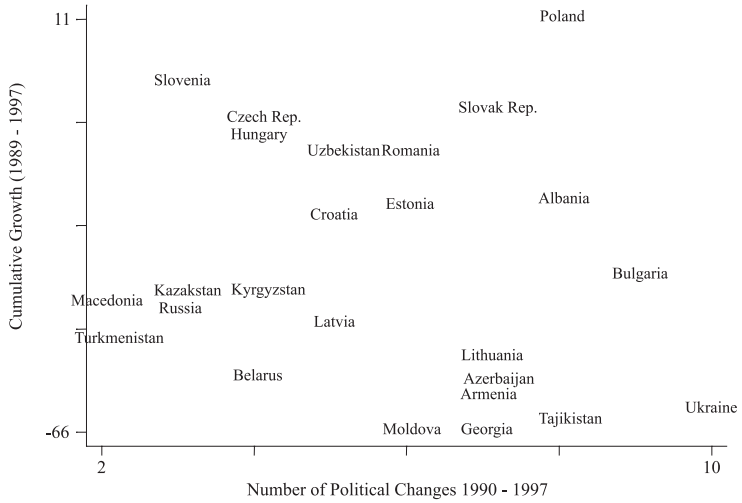
These factors are also present in the transition countries, in fact quite abundantly so. Taking into account just these factors, growth rates in the transition countries should thus be above those of post-war Europe and those of South-East Asia. In fact, growth will be much slower because of institutional deficiencies.

It needs to be emphasised that the term "deficiency" is not identical with the notion of "obstacle". The term "obstacle" would have us assume that it would suffice to remove it in order to achieve growth. Such obstacles indeed exist, for instance in the form of arbitrary licensing, of price controls, or credit allocation by administrative fiat. The removal of such obstacles is bound to facilitate economic growth. By and large, though, and as mentioned, this is not sufficient. Sound and long term development cannot occur in the absence of appropriate institutions. These do not spring into life through the mere lifting of obstacles. They have to be built.

If the EBRD concludes that the gap between potential and actual growth would be caused by institutional deficiencies it need not base this judgement on theory only. It is also corroborated by empirical data - the actual experience gathered in the course of political and economic transition. This experience substantiates the belief that institutional deficiencies are the crucial bottleneck. Suffice to mention the reversals caused by such institutional deficiencies and failures in Bulgaria, Romania or Albania or by the crisis in the financial sector in the Baltic countries. The slowdown of transformation to be observed in the Czech Republic is due to like causes.

What about other preconditions for a rapid and steady development? One would assume that political stability - long lasting parliaments and governments - would be prominent among them. But such an assumption is not supported by empirical evidence. Whether governments change frequently or not does not affect economic performance, as Figure 1 below reveals:

Figure 1 - No significant relationship between political continuity and economic growth



Frequently, it is also assumed that centre right governments would achieve better results promoting economic transition and reform. Centre left governments on the other hand, would tend to favour distribution over production. Therefore they would be less likely to make the hard decisions necessary in order to curtail fiscal deficits, to cut surging demand, to close loss making factories, etc. Table 2 below shows the number of months governments of various political "shades" have ruled in the transition countries of Central and Eastern Europe.

Table 2 - Dominant Parties

Group of countries	1990-1994					1994-1996			
Group 1	*1*	*2*	*3*	*4*	*5*	*2*	*3*	*4*	*5*
Czech Republic			28	31				38	
Hungary		6		50		38			
Poland		21	23	16		33		5	
Slovenia		3	29	25		38			
TOTAL		**30**	**80**	**122**		**109**		**43**	
Group 2	*1*	*2*	*3*	*4*	*5*	*2*	*3*	*4*	*5*
Albania	4		10	33		8	4	26	
Bulgaria		25	10	14		23		15	
Croatia					57				38
Macedonia		36				38			
Romania	10	32	13			22		16	
Slovakia			28	10	21				38
TOTAL	**14**	**93**	**61**	**57**	**78**	**91**	**4**	**57**	**76**
Group 3	*1*	*2*	*3*	*4*	*5*	*2*	*3*	*4*	*5*
Estonia			30	27		32	3	3	
Latvia			40	18			27	11	
Lithuania		25		33		22		16	
TOTAL		**25**	**70**	**78**		**54**	**30**	**30**	

Note: Party Classification as follows -
1. Regimes issued directly and without major break from preceeding communist ones.
2. Socialist. Social Democrat. Centre-left reformed ex-communist. Coalition dominated by centre-left.
3. Catch-All. Popular Front or non-party caretaker govt. Broad centre-left coalition.
4. Centre-Right. Right. Conservatives. Centre-right dominated coalition.
5. Populist. Nationalist.

As we see, in the more advanced transition countries, centre parties, and centre-right parties dominated in the period between 1990-1994. Thereafter the political power gravitated towards the centre-left. It was during their rule that economic growth set in. Therefore, the least one can say is that in the advanced transition countries the rule of centre-left parties has not impeded economic growth.

It has been the official doctrine among European countries and in the Euro-Atlantic community that a viable, open market economy, internal democracy and a cooperative international stance are complementary and mutually supportive elements of both a stable internal and external order. They would form the necessary pillars of a widely defined security. This assumption was, inter-alia, the base of the CSCE process. No politician or spokesperson would dare to question this assumption openly. Unofficially though, doubts continue to be raised as to the compatibility of tough economic reform on one hand and a democratic regime on the other. Who, for example, has not been confronted

with the claim that early democratic reform has been detrimental to the Russian Federation? Russia should have taken the "Chinese way". It should have started out with economic reform and should have begun democratisation only after the results of economic reform had become consolidated.[3]

The American "Freedom House" ranks states according to their civic and political liberty.[4] With its "transition indicators" the EBRD, on the other hand, rates states according to the performance with economic reform. If we now compare performance as economic reformers with performance in democratic consolidation, we find that the two correlate. Those who are good democratic performers are also good economic reformers, whereas those who have a poor democratic record also perform poorly with economic reform.

To sum up, political democracy and adopting a West European type of political regime are no obstacles to rapid economic reform and transformation. On the contrary, a good argument can be made that democratisation, consolidation and economic transition not only correlate but are mutually supportive. But this is not a place to develop this argument any further. We can retain as empirically proven the fact that the democratic nature of governance is not one of the institutional impediments that hampers the economic catching-up of transition countries. If not democracy, then what are those institutional deficiencies?

The transition index of the EBRD shows that in a majority of countries, privatisation and liberalisation are close to being complete. This is not the case with regard to the financial sector, competition policy, or the actual restructuring of enterprises (be they privatised or still state owned). These are fields where formal rules and formal institutions alone are not sufficient to reach a desired end. The formal rules and institutions need to be complemented by habits, expectations, informal rules, functioning networks and so on. The formal political and economic institutions have to rest upon the informal base of economic, civic and political society.

Evidently, there are no clear rules or prescriptions on how to reach such civic, political or economic society. No ready tool is in place to measure the growth of the necessary networks, the development of informal rules, the adaptations of expectations, etc. But we do have some data on the evolution of political society and political culture. These data show that such informal structures consolidate only after formal institutions have been established: democratic culture and civic society consolidate through the experience of living in a democracy - and one that works. We should assume that the same holds true for the economics sphere and that economic culture evolves in a similar fashion.

But this belief implies a kind of historic - societal determinism. The movement would be always upward and forward. Formal institutions and the invisible hand of history would quasi-automatically drag laggard societies forward. Societies which at the outset were hostile to markets would accommodate them over time once the formal rules and institutions of the market have been established.

Similarly in the political realm, citizens would become truly democratic in their attitudes and expectations once the formal democratic institutions are in place.

Unfortunately, historic experience would suggest this to be a somewhat Panglossian assumption. In a secular perspective - like the one of Francis Fukujama - such progress, such an upward and forward movement might indeed seem inevitable. But in observing actual reality, and especially the reality in transition countries, we have to accept that reversals are always possible. They even have to be expected.

It might very well be the case that the formal institutions on one side, and economic, civic and political culture on the other reinforce one another in a virtuous circle. But there might also be a vicious circle that leads downwards to a disappearance of both formal and informal cohesion.

Which of these two scenarios is likely to develop in the transition countries? Probably the optimistic one. But we can not disregard the pessimistic alternative. This was summed up recently by Troy McGrath, Deputy Director of the Central European University in an article in the renowned "Transition" magazine. He compares the present societies of transition countries to those that existed in Western Europe at the turn of the century. As we know, the latter experienced the "marginalisation of large parts of the population, the disappearance of social ties and informal support networks that bound communities together". After the crisis at the turn of the century too, it would have taken "generations before civil society emerged to buffer individuals from the existential uncertainties and rapacious self interest". The time in between had indeed been crisis ridden. Certainly the process was full of reversals - many of them costly and even tragic. Thus we should not exclude the possibility of setbacks occurring in the transition countries too. How likely are these?

Do we have empirical evidence that might lead to an answer and thereby would help us in choosing between the pessimist and optimist visions? One such indicator for the absence or presence of social capital and for the presence of civic, economic and political culture is the prevalence of corruption. The costs and dangers of corruption are evident. It is not simply a kind of tax that could be added to production costs. Corruption distorts and impairs the mechanism of the economy. But, even more seriously, it will in the end de-legitimise both economic and political institutions and can thus lead a country to the abyss of anarchy.

It is clear that the degree of corruption varies widely among countries.[5] Also, there is an obvious correlation between the level of corruption and geographic location, with levels increasing the further one travels from Brussels. As mentioned, corruption seems an apt tool to measure the existence and the strength of informal institutions, the solidity of civic, economic and political culture. These sustain and support the official structures and make them effective. In the absence of such networks and virtues and in the absence of mutual trust and trust in the official institutions, the latter cease to function. They are replaced

by other forms of economic and political exchange, be they quasi-legal or illegal/criminal.

The West-East gradient noticeable in the prevalence of corruption can also be observed in other fields, for instance in the varying capacity to implement economic reform. Let us thus return to the EBRD transition indicators that measure success in changing economic policy and performance. The correlation is evident and strong and similar to that for corruption in that the farther to the east, the worse, in general, the record as economic transformer and reformer becomes.

The West-East gradient is, of course, a historic one, tempting the belief that in their uneven performance as reformers transition countries only "return to history", to the historic pattern as it existed before the onset of Communism. Unfortunately, their predicament seems to be worse. Unfortunately, this historic gradient seems to have become steeper by the experience of totalitarian regimes which lasted longer and were harsher in the more eastern part than in the more western part of the former Communist empire. Already scarce "social capital" was further destroyed by this long and harsh reign, but more so in the East than in the West. Thus the burdens of history thus had been accentuated by the legacy of Communism.

Conclusion

State institutions are as essential for economic success as are the institutions of private enterprise. To be effective, both set of institutions need to rest upon a broad base of civic economic and political culture. These cultures, in their turn, are sustained by what is called "social capital", which is the accumulated capacity and readiness to cooperate. Also, as a consequence of their more recent history, transition countries are unevenly endowed with this social capital. This translates into widely differing performances both in economic reform and in democratic consolidation.

The optimist view is that, in the end, these gaps will narrow again and that, in the end, all transition countries will be sucked into a process of rapid catch-up. Not only would they become wealthier, but this catching up would also facilitate the accumulation of social capital; the building of economic, political and civic culture. One cannot exclude, however, a more pessimistic scenario. The positive scenario presents the picture of mutually re-enforcing positive developments. But instead of such a "virtuous circle", a "vicious circle" might prevail. Negative developments would re-enforce one another; and in the course of this downward movement social capital would become depleted even further.

As mentioned, the prevalence of corruption is an indicator of such a depletion of social capital. In the CIS countries, the situation is serious to the extent of seriously challenging the consolidation and functioning of institutions essential for democratic politics and economic development.

Notes

1. Just being guided by the "invisible hand" of the market. But this quotation by Adam Smith is taken out of context and totally misconstrues the main message of Adam Smith. He certainly was not the advocate of the minimal state. His main polemic was directed against financial interest capturing the policy of the state (mercantilism).
2. Investment rates were high in centrally planned economies. But much of the invested capital was wasted as being inefficiently employed. It is for this reason that in some of the transition countries and especially in the countries of the CIS investment rates have declined drastically in the period immediately after 1989. There is also some question as to whether high investment triggers economic growth or vice-versa. But there can be no doubt that, once in place, high growth does indeed require high investment.
3. China is a special case. It is still a developing country with a vast agricultural population and, of course, there was a huge internal market. Also, both capital and know how became readily available to China through the expatriate Chinese community. All these factors caution against the comparisons between the Chinese and the east European experience of "transition and reform".
4. The democratic performance is also being monitored by various other international government and non-governmental institutions. Their results are congruent with those of the Freedom House.
5. An index of corruption use has been prepared by the Economist Intelligence Unit. A broad investigation carried out by the World Bank arrived at similar results.