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Institutions and economic growth in transition countries — new experiences and implications from financial crisis 2007–2010 (Part 1)

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Abstract

Motivation: Cross-country growth regressions indicate that institutions are important for growth. Some institutions are created, protected and enforced by the government — they are the institutions of state. The most important for economic growth are: economic freedom and protection of property rights, political freedom (or democracy), quality of governance and the rule of law. The changes that took place after 1989 in the countries of Central-Eastern Europe were not only political but also economic. The post-socialist transition was, above all, a change of the institutions of state. It was a kind of the so-called 'quasi-natural experiment'. Therefore, my intention is to answer the question: how the institutions of state affect economic growth in transition countries.
Aim: The aim is to identify the impact state institutions had on the economic growth in transition countries during the financial crisis of 2007–2010.
Results: In the first part of this article I review the literature and present hypothesis about dependency of economic growth and institutions during the financial crisis in transition countries. In the relevant literature there is a consensus that without an appropriate institutional background, market incentives do not lead to optimal resource allocation. Institutions have a particularly crucial impact in the case of post-socialist countries which have undergone political and economic transition. A significant and positive impact on economic growth rate is exercised by such institutions as: protection of property rights and political stabilization, government efficiency and rule of law. The experiences of transition countries confirm also the significance of economic freedom for economic situation.

Keywords: institutions; economic growth; transition countries; financial crisis
JEL: D02; O11; P30

1. Introduction

As North (1999, p. 3) put it: 'Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction'. Three basic types of institutions are: markets, firms, and states (Furubotn & Richter, 1998, p. xv). Cross-country growth regressions indicate that institutions are important for growth (Acemoglu et al., 2005, pp. 385–472; Aron, 2000, pp. 99–135; Keefer & Knack, 1997, pp. 590–602). Institutions affect the efficiency of an economy in the same way as technology does: an economy with good institutions is more efficient in the sense that it takes less input to produce the same amount of output. Moreover, bad institutions lower incentives to invest (in physical and human capital as well as technology) and to work and produce (Sala-i-Martin, 2002, p. 18). Some institutions are created, protected and enforced by the government — they are the institutions of state. The most important for economic growth are: economic freedom and protection of property rights, political freedom (or democracy), quality of governance and the rule of law. The changes that took place after 1989 in the countries of Central-Eastern Europe were not only political but also economic. But above all, the post-socialist transition was an institutional change — all basic types of institutions: markets, firms, and institutions of state had to be changed. At the initial moment of transition, post-socialist countries constituted a fairly homogenous group and shared a unique historic experience. Socialist states were especially homogenous as far as the relations between state and economic freedom were concerned, and from the perspective of the institutions of state (the lack of democracy, freedom, rule of law, poor protection of property rights and low governance quality). The post-socialist transition was a kind of 'quasi-natural experiment' (Acemoglu et al., 2005, p. 386).

This paper is an attempt to answer the question: how the institutions of state affect economic growth in transition countries and if the economic situation (the pace of the economic growth) has an impact on institutions. The aim of this paper is to analyse the relationships between state institutions and economic growth in 25 transition countries during the financial crisis of 2007–2010. The financial crisis of 2007–2010 is an important economic event, which forced economists to reconsider once more the issues of economic policy, economic growth and the institutions of state. We knew that good institutions were important for economic growth in transition countries but did it hold true during the financial crisis? Also we know economic development is good for institutions, i.e. helps to improve quality of institutions. But what happened to the institutions of state during the financial crisis? In the first part of this article I formulate two hypotheses. Hypothesis 1: quality of state institutions from before the crisis had a positive influence on the economic growth during the crisis. Hypothesis 2: the economic growth influences the changes of state institutions in such a way that the faster the growth the faster the improvement of state institutions, whereas a slow growth (recession) may lead to deteriorating of institutions.

The paper is structured as follows: the next section reviews the empirical literature on institutional determinants of growth in transition countries. Next section presents the hypothesis about interaction between institutions and economic growth during the financial crisis in transition countries. The final section presents conclusions.

2. A review of the literature on institutions in transition countries

In the relevant literature there is a consensus that without an appropriate institutional background, market incentives do not lead to optimal resource allocation (Wojtyna, 2001, p. 19). Moreover, many studies on economic growth confirm that institutional changes are the main determinants of economic growth (Acemoglu et al., 2001, pp. 1369–1401; 2002, pp. 1231–1294; Easterly & Levine, 2003, pp. 3–39; Rodrik et al., 2004, pp. 131–165).

Institutions have a particularly crucial impact in the case of post-socialist countries which have undergone political and economic transition. Transition economies inherited from their previous systems low efficiency of law enforcement and governance, and also corruption. Moreover, societies in these countries had a high deficit of experiences and knowledge of democracy, rule of law and human rights, i.e. values which make modern capitalistic societies. At the beginning of the political and economic transition countries were very homogenous (Kitschelt, 2003, p. 49) and a distance between them and democratic market economies was enormous. This group of countries shares, as many authors claim, a unique historic experience (Kornai, 2006, p. 218), while making a transition from dictatorial centrally planned economy towards democratic market economy. Post-socialist transition was a unique historic experiment in institution building (Beck & Laeven, 2006, p. 158), which affected almost 30 countries and 400 million people in Eastern Europe and the Former Soviet Union. A fundamental part of it was to build such state institutions as those in developed countries.

The role of the state in transition is very important (Wilkin, 2007, p. 45). It is the state which is the main initiator of transition changes and plays a decisive role as far as its pace and effectiveness is concerned (Kleer, 2003, p. 17). In relation to institutional changes, the state is responsible for their introduction and for the shape of the new economic system (Hockuba, 1995, pp. 500–501). The institutional environment of a market economy does not appear on its own. The institutions of a market economy which facilitate economic efficiency are not effects of spontaneous evolution taking place independently from the state. Institutions have similar characteristics as public goods — without the intervention of the state, their ‘supply’ will not be sufficient (Hare, 2013, p. 35). Therefore, social changes which aim is the increase of economic efficiency must be to a large extent constructivist, although they also should suit the historical and cultural conditions of a given country (Godłów-Legiędź, 2005, p. 187).

In the centrally planned economy the state was overgrown and interfered with the economy to a huge extent. At the same time, it was usually a weak state, in which laws were not respected; state officials were often corrupted. Also the post-socialist state — the one which started transition — was weak (Koslowski, 1992, p. 684). During the transition, the state had to not only limit its interference with the economy, increasing at the same time the scope of economic freedom and making space for private businesses, but also — at the same time — strengthen its role of the law executer. There was a serious threat that the state may remain large and weak (Kołodko, 1999, p. 144). This could lead to a situation which actually happened in some of postsocialist countries: the capturing of the state by interest groups and the rise of ‘capitalism for few’ (Havrylyshyn, 2006, pp. 2–3).

Since an economic transition is a comprehensive and enormous change of institutions (Dewatripont & Roland, 1996, p. 1), one can expect that a significance of this change for economic growth is particularly important in post-socialist countries (Grogan & Moers, 2001, p. 327). Indeed, an institutional change constitutes, alongside macroeconomic stabilization and microeconomic liberalization, a key element of economic transition. It is also the main determinant of a production growth (Havrylyshyn & Rooden, 2003, pp. 2–24; Campos & Coricelli, 2002, pp. 793–836; Merlevede, 2003, pp. 649–669; Falcetti et al., 2006, pp. 421–445). It supports significantly economic reforms aiming at decreasing inflation, balancing public finance, trade liberalization. Without it, these reforms could not bring expected results or even could fail.

According to many studies, a significant and positive impact on economic growth rate is exercised by such institutions as: protection of property rights and political stabilization (Brunetti et al., 1999; Godoy & Stiglitz, 2006; Iradian, 2009), government efficiency (Ahrens & Meurers, 2002, pp. 35–56) and rule of law (Campos, 2000; Crafts & Kaiser, 2004, pp. 101–118), whereas institutional weakness leads to a long-term and deep transitional recession (Castanheira & Popov, 2000). The experiences of transition countries confirm also the significance of economic freedom for economic situation (Mickiewicz, 2009, pp. 399–423; Pääkönen, 2010, pp. 469–479; Próchniak, 2011, pp. 449–468; Piątek et al., 2013, pp. 267–288).

Some controversies concern the impact of democracy on economic growth. Research studies dealing with this issue in the case of post-socialist countries are rather scarce. Mau and Yanovskiy (2002, pp. 321–339) find a significant and positive relationship between the variables connected with guarantees of basic rights (personal security, freedom of speech) and the pace of economic growth in Russia. Popov (2000, p. 38) points out that democracy combined with the lack of the rule of law leads to a decrease in production. The cost for the transition from an autocratic system to democracy before the introduction of 'the rule of law' is slower economic growth. Cheung (1998, p. 249) also warns against the introduction of democracy before privatization, claiming that it may lead to an over-regulation of the economy and rent-seeking. The analysis conducted by Hodgson (2006, p. 889) led him to conclude that in countries under transition the negative effects of democracy outweigh the positive ones — there appear powerful interest groups manipulating the political process and significant ethnic fractionization contributes to using power in order to improve the situation of the authorities' own ethnic group. The works of Fidrmuc (2000, p. 4) provide totally different conclusions. He claims that the interdependency between democracy and the economic growth is more complex and can be depicted in the shape of the letter 'U'. Both no democracy and full democracy lead to better economic results than its only limited existence, which — as Fidrmuc (2001, p. 10) points out — is the opposite of the 'interdependency' which resulted from the research of Barro (1996, pp. 1–27). However, in the initial period of transformation (1990–1993) the impact of democracy on economic growth was negative, unless democracy was combined with liberalisation. Still, Fidrmuc (2003, p. 599) points out that democracy exercises an indirect influence on economic growth — it contributes to the progress in liberalisation, which in turn has a positive impact on the pace of growth. Therefore, the total impact of democracy on production is a positive one. However, Apolte (2011, pp. 715–716) finds that only moderate democracy levels have a significant and positive effect on growth, while increasing the democratization on the basis of very moderate levels even tends to reduce growth. At the same time, Peev and Mueller (2012, pp. 371–407) indicate that there is a relation between democracy and economic freedom, and the quality of institutional environment in general. Economic freedom is stronger and corruption is weaker in former communist countries with strong democratic institutions. In this indirect way, democracy exercises a positive influence on the pace of the economic growth.

The main conclusion which may be drawn from the relevant literature is that institutions really matter in transition economies and are one of the main determinants of the economic growth and economic success of these countries.

3. Financial crisis in transition countries — virtuous and vicious cycle hypothesis

The financial crisis of 2007–2010 is an important economic event, which forced economists to reconsider once more the issues of economic policy, economic growth and the institutions of state. The impact of the crisis on the economic growth was particularly acute in transition countries (Myant & Drahokoupil, 2012, pp. 1–33; 2013, pp. 373–382). The crisis affected mostly the countries of Central and Eastern Europe, mostly the small ones, with significant imbalance in the banking sector (Furceri & Zdzienicka, 2011, pp. 1–25). In the year of the most severe depression, the GDP per capita in Estonia dropped by 14.05%, in Latvia by 17.55% and in Lithuania by 14.27%. At the same time, the countries-exporters of crude oil and gas, like Azerbaijan, Kazakhstan and Turkmenistan, as well as countries with weak financial and trade ties with the EU, such as Belarus and Uzbekistan, were the least affected by the crisis.

Although the relevant literature and empirical research confirm a positive impact of the institutions of state on the pace of the economic growth, a question arises, whether the institutions of state exercise this positive influence also in times of financial crisis. The financial crunch in the USA and Western Europe negatively affected the pace of the economic growth. Good institutions make it possible to limit such negative influence and avoid or at least mitigate the impact of a recession.

The condition of the economy also exercises an influence on state institutions. In the relevant literature it is indicated that recession and increase in unemployment contribute to a decrease in support for democracy in democratic countries (Akulava, 2014, p. 15). At the same time, Piątek et al. (2013, p. 267–288) showed in their research that in transition countries changes in the level of political freedom are affected by economic growth. Also historical experience indicates that recession in the economy is conducive to social unrest and increased support for populist and extreme parties which offer simple solutions to the existing problems. For example, the Great Recession of the 1930s was one of the factors which enabled A. Hitler to seize power in Germany as well as contributed to the increase in protectionism in international trade among developed countries. The financial crisis of 2007–2010 contributed to the increase in popularity of parties which contest the existing reality and search for alternative solutions. An example of this may be the results of the 2014 elections to the European Parliament in, which brought a noticeable increase in the representation of eurosceptic parties. Moreover, in the policy of certain countries particularly affected by the crisis, protectionist tendencies became visible, e.g. the 'Buy American' provision in the American Recovery and Reinvestment Act of 2009 in the USA, and the state started to interfere more with the economy.

Therefore, a question arises if in the period of financial crisis 2007–2010 in transition countries was it possible to observe a virtuous cycle and a vicious cycle. The virtuous cycle means that the countries with good state institutions go through a financial crisis smoother (with relatively small decrease in the pace of the economic growth). A relatively faster pace of the economic growth (a weaker recession) limits the occurrence of social unrest and the popularity of populist parties and at the same time influences the quality of the conducted policy, also in relation to the institutions of state, as a result of which they not only do not deteriorate but even improve. In contrast, the vicious cycle occurs in countries in which the experience of a deep recession leads to social unrest and power is seized by extreme parties which conduct a policy contributing to limiting political and economic freedom and lowering the quality of governance. As a result, the virtuous and vicious cycle lead to increasing institutional discrepancies between countries (institutional divergence) — in the countries with good state institutions, the institutions improve even further, whereas in the countries with bad institutions, they undergo further deterioration (scheme 1).

In order to verify the existence of the presented dependency, hypotheses were formulated to be verified in this paper. Hypothesis 1: quality of state institutions have a positive impact on the economic growth during the crisis. Hypothesis 2: the economic growth has an impact on the change in the institution of state in such a way that the faster the pace of growth, the quicker the improvement of state institutions, whereas a slow economic growth (a recession) may lead to the deterioration of these institutions. Our article contributes to the debate on institutional determinants of economic growth and on determinants of institutional change in the transition countries.

4. Conclusion

The aim of this paper was to analyse the relationships between state institutions and economic growth in 25 transition countries during the financial crisis of 2007–2010. The main conclusion which was drawn from the relevant literature is that institutions really matter in transition economies and are one of the main determinants of the economic growth and economic success of these countries. However there are some questions: were institutions important for economic growth in transition countries during the financial crisis? And what happened to the institutions of state during the financial crisis? Two hypotheses were formulated. Hypothesis 1: quality of state institutions from before have a positive impact on the economic growth during the crisis. Hypothesis 2: the economic growth influences the change in state institutions in such a way that the faster the pace of the economic growth the faster the improvement of state institutions, whereas a slow economic growth (a recession) may lead to the deterioration of these institutions.

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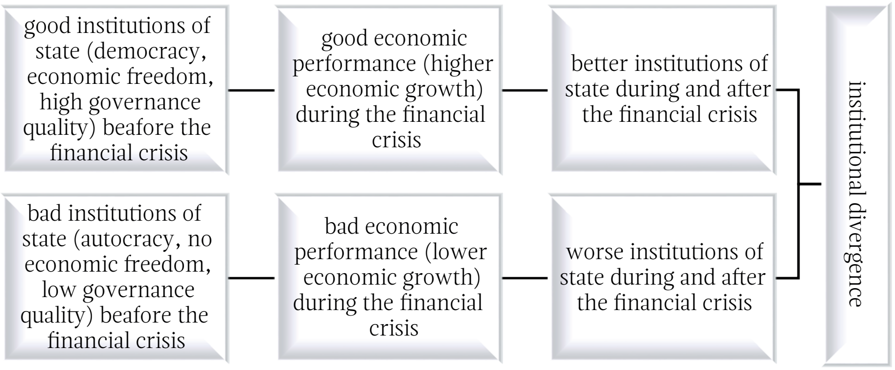
Appendix

Scheme 1.
Virtuous cycle and vicious cycle hypothesis



Source: Own preparation.