INSTITUTIONAL BARRIERS IN THE TRANSITION TO MARKET

Examining Performance and Divergence in Transition Economies

Christopher A. Hartwell

STUDIES IN ECONOMIC TRANSITION
General Editors: Jens Hölscher and Horst Tomann

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This book is dedicated to all of those who have ever wished me success in my future professional endeavors. As you can see, it apparently worked.

Foreword

The collapse of the Soviet socialism and the subsequent developments, often called "post-socialist transition," are the most important changes since World War II, and – for any believer in individual freedom – hugely positive ones. What has been happening after the collapse of socialism has been a living laboratory which presented a great opportunity for social scientists to study and to test their theories. Individuals in charge of the post-socialist reforms obviously could not wait for the results of this research, but had to rely on accumulated knowledge, while facing unprecedented intellectual and practical challenges (as their knowledge was clearly insufficient to provide answers to some key questions). This was certainly true of mainstream (neoclassical) economics, which has largely neglected the institutional change that has been at the center of post-socialist developments. Mainstream economics was of more help in dealing with macroeconomic stabilization, as this policy, at least in the short run, is less dependent on institutions.

The reformers in the post-socialist countries faced two basic questions:

1. What kind of target institutional system should they aim at?
2. How could they make a successful transition from the inherited situation to the target system?

For people (like myself) who have studied the comparative systems, the first question was relatively easy to respond to, at least in broad terms: the target system should ensure macroeconomic stability and rapid (as well as sustained) catching up. Therefore, it should include strong stabilizing institutions (an independent and professional central bank, strong fiscal constraints, etc.) and it should be based on private ownership, free markets, and a massive market competition. It was the second question which presented the true intellectual and practical challenge, as the post-socialist transition was unprecedented, and, as I mentioned, mainstream economics largely omitted the problem of institutional change.

However, some insights might have been gained from the study of the reforms in various countries, including the socialist ones. It was this source of information which I used in 1980 in my studies on the necessary scope structure and timing of reforms, well before I was put in charge of them in Poland. These studies led me to the conclusion that, given the typical initial conditions at the end of socialism, the strategy which has the highest chance of success is a rapid and comprehensive change; this would include the simultaneous launching and rapid implementation of comprehensive economic liberalization though macroeconomic stabilization, and – much more time-consuming – deeper institutional change, including privatization, building various institutions,[1] and so on. This radical approach was largely put into practice in Poland in 1990 and later in some other countries, especially in the Baltics.

The developments after the collapse of socialism have been followed by an extensive literature on the post-socialist transition. Unfortunately, much of this output was not very useful, even as an ex-post commentary (not to mention as policy advice). Many authors who analyzed transition did not have any clear vision of the target system. The discussions were plagued by very impressive and often emotive terminology. This has been especially true of the debate on the relative merits of "shock therapy" versus "gradualism." In my mind, it only added to the confusion. Strong statements were made, based on variables which were not explicitly defined and the implicit meaning of which varied among the authors. Therefore, they were speaking about different things while creating a false impression that they were discussing the same thing. A prominent example is a thesis that in transition "institutions were neglected." The developments after socialism displayed huge variations which provide a great opportunity for empirical research. However, only some authors have made proper use of this source of information.

This book builds upon the best parts of the research on the post-socialist transition, and does so in a broader context of the institutional economics and growth theory. Dr. Hartwell starts with the careful discussion, definition, and typology of the key variables, especially institutions. In this way he avoids the conceptual confusion which has plagued much of the earlier literature on transition. However, the conceptual work is for him only an indispensable preliminary step in his empirical investigation of the fundamental question: what have been the main reasons for the huge differences in the economic outcomes (economic growth, growth of consumption, FDI) that have emerged after the collapse of socialism in the former Soviet bloc. He puts a special focus on the role of institutions, that is, on the contribution of the differences in the timing and magnitude of change in the various institutional variables to the differences in economic outcomes.

He first puts to rest the statement that "institutions were neglected," because, as it was often claimed, an excessive emphasis was put on macroeconomic stabilization and liberalization (which, by the way, should be regarded as an important part of institutional change, i.e. enhancing the scope of economic freedom and, as a result, that of the markets). He shows that countries which have done the most on the first two policies have also advanced the most on institutional change.

He then investigates the role of institutions relative to macroeconomic policies, and personality factors while controlling for other variables, and provides an interesting discussion of the interactions between these variables. He shows empirically that an important and positive role was played by key institutional change, such as privatization, establishing the ownership institutions, and banking reform.

Next, Dr. Hartwell deals with the question of changes in which institutions were especially important for economic growth and other economic outcomes. Property rights emerge again as the key ones, together with the strength of the executive constraints.

This book breaks new ground in the empirical research on the relative importance of the institutional change in shaping various economic outcomes, especially economic growth. Based on his research, he provides important policy recommendations which would be useful once countries such as Cuba and North Korea hopefully break from the communist yoke. His recommendations are also of importance for other economies, as he points out which institutions are especially relevant for economic growth – and no country can be considered to have achieved the perfect institutions.

Christopher Hartwell has made an important contribution to several overlapping fields: the economics of post-socialist transition, institutional economics, and growth theory. This book deserves to be widely read by the student of these disciplines, and more widely by anybody interested in comprehensive institutional change.

Leszek Balcerowicz
Warsaw, December 2012

Acknowledgments

I would like to thank Leszek Balcerowicz, my dissertation advisor, who helped lead Poland through a trying time in its history and also led me out of academic darkness and into the light; Andrew Warner, who held conversations with me that sparked the idea for this book while I worked at the Harvard Institute for International Development in 1997; my professors at the University of Pennsylvania (especially Tayyeb Shabbir, Janusz Szyrmer, and Yochanan Shachmurove) for sparking my love of economics so many years ago; my friends from Penn who challenged me and made me able to think critically (especially Abiel Wong); my colleagues at IEMS, including Bill Wilson, who have supported my re-launch into the world of research after years of consulting and international development; Agnieszka Kowalczyk, who assisted me with the processes at SGH, and especially Anna Maciążek, who helped me expertly navigate the dissertation process at SGH and has been so supportive of this book; Anders Aslund, who provided helpful comments and examination of an earlier draft of this book; my friend David Snelbecker, who helped me with an earlier version of this manuscript and also provided much of my work experience in the former Soviet Union over the past ten years; my diligent contacts at Palgrave Macmillan, for guiding me through the process of my first academic book; of course, my parents for their support over the years and my family writ large for their Polish heritage, which inspired me to learn more about the region (and hooked me on transition economics); and, finally, my wife Kristen, whose support, patience, good humor, and mere existence as my best friend made any of this book or, indeed, my life possible.

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Introduction

> *Why are Polish meat stores four miles apart? So the queues don't get tangled up.*
>
> Retold in Davies (2010: 22)

Jokes such as the one above were common throughout the Soviet Union and its associated satellite states during the years under communism, with only the location changing. More importantly, the jokes told under the communist regimes were not far at all from the truth. In each country under the yoke of communism, the continuation of an economic system that could not provide for its citizens resulted in rationing, lines for food and general economic stagnation. This reality was perhaps most evident in the Soviet Union, which, after 73 years under the communist system, still had (based on a "one-day check of [Moscow's] meat stores by Government inspectors") on one day in 1990 "no meat ... at 730 stores, or 57 percent" (Clines 1990). Lest we think that this day was an aberration, "in June [1990], 35 stores had no meat. In July, it was 65 stores, and in August, 272 stores, or 21 percent" (Ibid.).

The ubiquity of the horrible economic (not to mention political) conditions was reflected in the continued and comprehensive subpar economic performance of communist states: in 1950, Czechoslovakia was fairly well developed (having avoided most of the devastation of World War Two), with a per capita GDP even above that of Ireland and on a par with Italy (by contrast, the USSR, which had been living under communism for 33 years at that point, had a measured per capita GDP of $2,446.89, behind that of Gabon at $3,108.00 and on a par with the new state of Israel at $2,817.00; Maddison 1995). By 1980, however, the USSR, Poland, and Czechoslovakia had standards of living far