CHAPTER 3

Economic institutions

How can countries improve their economic institutions? Cross-country analysis shows that institutional quality depends not only on a country's level of democracy, but also on many other factors. Some of these are fixed or difficult to change, such as history, geography, natural resource endowments or eligibility for EU accession. But there is potential to support improvements to institutions through international integration, political reform and greater transparency, particularly at the local level.

FACTS AT A GLANCE

ALMOST
25
years after the start of the transition process, economic institutions in the transition region are, on average, still weaker than in other countries with comparable levels of income.

0.5
The correlation between measures of democracy and regulatory quality in a global sample of countries.

THE
3
-year period prior to accession saw a peak in terms of institutional improvements in EU accession countries.

OVER
33%
of Kyrgyz SMEs say that unofficial payments are required in everyday business.

Building better economic institutions

Economic and political institutions play a key role in defining a country's long-term growth potential. Countries with a stronger institutional environment – effective rule of law, a good business climate, more secure property rights and market-friendly social norms – are better positioned to attract investment, to participate in trade and to utilise physical and human capital more efficiently.

And yet, as discussed in Chapter 1, the pace of economic reform in countries in the transition region has slowed. Is this because, on average, their economic institutions have caught up with those elsewhere? Or is the slow-down linked to limitations on political transition considered in Chapter 2? What other factors can explain the significant institutional differences seen across these countries which shared a broadly similar starting point? Do better economic institutions require more democratic political institutions? Or could countries improve them even in the absence of further democratisation?

This chapter addresses these questions, drawing on both cross-country analysis and case studies from a number of countries in the transition region.

Economic institutions are measured using a range of indicators, such as the World Bank's Worldwide Governance Indicators (WGIs) for government effectiveness, regulatory quality, the rule of law and control of corruption (as well as a simple average of all four). These indicators are based on data sources that include expert judgement and surveys of households and businesses. They therefore reflect the quality of institutions as perceived by users and professional opinion, rather than just the laws on the books. The WGIs are available annually from 1996 to 2011 for a large number of countries. They typically range from about -2.5 to +2.5, with higher values corresponding to better institutions.[1]

The analysis also uses the EBRD's transition indicators. These look at the period since 1989 and reflect cumulative reforms, as assessed by EBRD economists, in the areas of privatisation, liberalisation of prices, trade and exchange rates, enterprise restructuring, corporate governance and competition policy (see the methodological notes in the online version of this *Transition Report*). Hence, they are primarily a measure of structural policies – economic liberalisation and privatisation – which are typically undertaken in the early stages of transition. Only two indicators – governance and enterprise restructuring, and competition policy – have an institutional flavour.

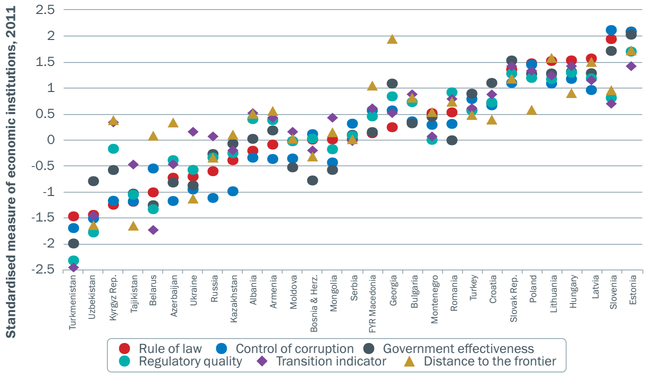
Lastly, the analysis uses the World Bank *Doing Business* reports, as well as two surveys conducted by the EBRD and the World Bank: the Business Environment and Enterprise Performance Survey (BEEPS) and the *Life in Transition Survey* (LiTS). The *Doing Business* reports, in particular, complement both the WGIs and the EBRD transition indicators by focusing on practical measures of the business environment – such as the number of days needed to obtain approval for a start-up or the cost of opening a bank account. An economy's performance is summed up by the "distance to the frontier" – that is to say, the difference between it and the best performer in each category.[2] The distance to the frontier is indicated on a scale of 0 to 100, where higher scores correspond to a better business environment.

One aspect that is largely absent from these datasets is the quality of private economic institutions, such as corporate governance in specific sectors. This arises from the interplay between the state – through its legal frameworks and their enforcement – and company practices. The quality of corporate governance is rarely measured, although one example, focusing on the corporate governance of banks in the transition region, is considered in Annex 3.1.

Chart 3.1 plots the main measures – the four WGIs, the average transition indicator and the distance to the frontier – for countries in the transition region (after rescaling to express all indicators in the same units as the WGIs). The measures are correlated across countries, but also reveal some interesting differences.

With some exceptions (such as Belarus and Turkmenistan), the countries on the left-hand side of the chart – those with scores for the rule of law that are below the median rule – tend to have transition indicator scores that are higher than their WGI ratings. This indicates that it is fairly easy, even for countries with weak economic institutions, to undertake first-generation market reforms that move them up the transition indicator scale.

Chart 3.1. Measures of economic institutions are correlated across countries

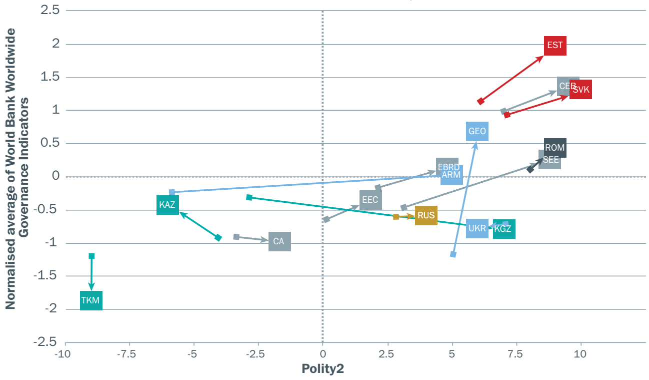


Source: World Bank and EBRD.
Note: Transition indicators and the distance to the frontier measures have been rescaled to express them in the same units as the Worldwide Governance Indicators (WGIs). Countries are shown in ascending order of their "rule of law" score.

[1] See Kaufmann et al. (2009) and the methodology and sources described at http://info.worldbank.org/governance/wgi/index.aspx#doc-sources.

[2] For example, New Zealand represents the frontier when it comes to starting a business, while the Hong Kong Special Administrative Region represents the frontier for dealing with construction permits. For each country, the distances to the best performers in each category are aggregated to form a composite measure of the distance to best practices and rescaled. See World Bank (2013) for details.

Chart 3.2. In the transition region, economic and political institutions have tended to move in the same direction, but not in all countries



Source: World Bank and Polity IV.
Note: Arrows show changes between 1996 and 2011. Regional averages are shown in grey and labelled with the following acronyms: transition region (EBRD); central Europe and the Baltic states (CEB); south-eastern Europe (SEE); eastern Europe and the Caucasus (EEC); and Central Asia (CA).

Table 3.1
Determinants of economic institutions in a worldwide sample

Dependent variable	Average of four Worldwide Governance Indicators				Distance to the frontier	
	Panel OLS	GMM	Panel OLS	Panel OLS	OLS	OLS
Polity2	0.025***	0.023*	0.034***	0.030**	0.166	0.275
	(0.007)	*(0.013)*	*(0.007)*	*(0.011)*	*(0.130)*	*(0.184)*
Natural resources	-0.004**	-0.009***	-0.004**	-0.003	-0.054**	-0.060**
	(0.002)	*(0.002)*	*(0.002)*	*(0.002)*	*(0.023)*	*(0.024)*
Low Polity*Natural resources				-0.002		0.136**
				(0.002)		*(0.053)*
Trade openness	0.205***	0.213	0.183**	0.142***	2.564**	2.564**
	(0.054)	*(0.129)*	*(0.087)*	*(0.049)*	*(1.072)*	*(1.137)*
Low Polity*Trade openness				0.178		-3.221
				(0.149)		*(5.417)*
Financial openness	0.124***	0.129**	0.185***	0.095***	1.385**	1.529**
	(0.022)	*(0.056)*	*(0.035)*	*(0.026)*	*(0.580)*	*(0.612)*
Low Polity*Financial openness				0.119**		-3.121
				(0.058)		*(2.709)*
Income	0.380***	0.417***		0.393***	5.353***	5.054***
	(0.055)	*(0.065)*		*(0.049)*	*(1.125)*	*(1.197)*
Ethnic fractionalisation	-0.197		-0.464**	-0.247	1.455	1.878
	(0.165)		*(0.221)*	*(0.187)*	*(3.465)*	*(3.724)*
Low Polity*Ethnic fractionalisation				0.276		-16.173*
				(0.210)		*(9.360)*
Distance from the equator	0.007		0.013**	0.009*	0.082	0.062
	(0.005)		(0.006)	(0.005)	(0.087)	(0.091)
Landlocked	-0.070		-0.197**	-0.026	-1.679	-2.444
	(0.083)		*(0.094)*	*(0.080)*	*(1.607)*	*(1.737)*
Ruggedness	0.009		-0.016	0.009	0.676	0.751
	(0.030)		(0.039)	(0.029)	(0.641)	(0.656)
State antiquity index	0.003**		0.003**	0.003**	0.036	0.044
	(0.001)		*(0.001)*	*(0.001)*	*(0.028)*	*(0.030)*
Transition country indicator	-0.256		-0.549*	-0.304	-2.875	-2.476
	(0.236)		(0.300)	(0.236)	(3.569)	(3.730)
Observations	601	603	601	488	120	120
Countries	122	122	122	122	120	120
R-squared	0.836		0.769	0.858	0.728	0.734
Adjusted R-squared	0.830		0.761	0.851	0.683	0.677
F-value	56.028	32.553	49.176	54.014	26.810	24.463

Source: See Annex 3.2.
Note: The table shows coefficient estimates from panel regressions, based on three-year averages. Regressions include region and time fixed effects (not reported). Standard errors are clustered by country and shown in parentheses. Polity2, trade openness, financial openness, income and the interaction terms are lagged by one period in the panel OLS regressions (columns 1 and 3). Column 2 is estimated using the GMM system (Blundell and Bond, 1998), with ethnic fractionalisation, the distance from the equator, a landlocked dummy, ruggedness and the state antiquity index included as additional instruments. The cross-sectional regressions for the distance to the frontier are based on the latest values and include regional fixed effects. "Low Polity" denotes a Polity score below -5. *p<=0.10; **p<=0.05; *** p<=0.01.

Towards the other end of the chart, Slovenia has very good economic institutions according to its WGI scores. However, its transition indicator score is less impressive. This reflects its continued relatively high level of state ownership and involvement in the economy.

The chart also shows that the correlation between the distance to the frontier and the WGIs or transition indicators is lower than that between the WGIs and the transition indicators.[3] This reflects the fact that the distance to the frontier can, to some extent, be lowered by rolling back and simplifying business regulations, although this may not improve other aspects of economic institutions (such as the rule of law). Several countries – such as Azerbaijan, Belarus and Georgia – undertook such efforts towards the end of the last decade.

FORCES SHAPING ECONOMIC INSTITUTIONS

DEMOCRACY

Chapters 1 and 2 showed that democratic political institutions – as measured by the Polity2 indicator, which ranges from -10 to +10 – are correlated with the transition indicators. Similar correlations apply when the WGIs or the distance to the frontier are used to measure economic institutions – from about 0.34 in the case of the distance to the frontier up to 0.51 in the case of the indicator of regulatory quality, based on 2011 data for a large cross-section of countries.

There are several ways to interpret these correlations, which are not mutually exclusive. Consistent with the findings of Chapter 2, better economic institutions might foster economic development – and thus, over time, democracy. Alternatively (or in addition), the causality might run in the other direction. Political competition and the checks and balances that are characteristic of democracy might restrict the government's ability to engage in expropriation and rent-seeking and lead to more business-friendly rules and regulations.[4]

Democratic regimes are also more likely to have an independent judiciary and regulatory bodies that serve a particular mandate, rather than the interests of ruling elites. The fact that the correlations between democracy and economic institutions are lower when the latter are measured using the distance to the frontier may reflect the fact that even less democratic countries can successfully improve aspects of the business environment when there is a political will to do so.

Chart 3.2 confirms that improvements in political and economic institutions have often gone hand in hand. With the exception of Central Asia, all transition regions (shown in grey) have moved upwards and rightwards on the chart, which shows the Polity2 measure on the horizontal axis and the average WGI on the vertical axis. That said, there are countries in which the development of economic institutions has far outpaced democratisation (Georgia), or vice versa (Armenia). There are also countries that have improved their political institutions, but not their economic ones (for instance, the Kyrgyz Republic). The opposite – improvements in economic institutions, but a decline in the level of democracy – appears to have happened in Kazakhstan.

The country experiences shown in Chart 3.2, as well as the fact that the correlations between democracy and economic institutions rarely exceed 0.5, suggest that there must be other factors shaping the quality of economic institutions. Understanding the potential influence of these other factors – and confirming that democracy remains a statistically significant influence on economic institutions even in their presence – requires a multivariate analysis.

Tables 3.1 and 3.2 contain the results of such analysis for a worldwide sample of 121 countries and 25 countries in the transition region respectively. Each column represents the result of one regression, which relates a measure of economic institutions to a set of potential explanatory factors. These factors include the Polity2 democracy measure, as well as measures of trade and financial openness, resource endowments, ethnic diversity, historical and geographical variables and (in some columns) per capita income. Table 3.1 focuses on either average WGIs (columns 1, 2 and 3) or the distance to the frontier (columns 4, 5 and 6), while Table 3.2 considers WGIs and transition indicators.[5]

One important concern in these regressions is to ensure that the coefficient for the Polity2 variable can be interpreted as the impact of democracy on economic institutions, rather than the other way around. The regressions aim to ensure this in two ways.

- First, most specifications include per capita income as a proxy for economic development.[6] Hence, the coefficient for the Polity2 variable expresses the correlation between democracy and economic institutions for countries at comparable stages of development. This means that this correlation cannot be interpreted as reflecting the impact of economic institutions on democracy working through higher income.
- Second, the possibility of feedback from economic institutions to both democracy and per capita income is minimised through the regression techniques used. In the panel regressions, Polity2 (and all other time-varying variables) always enters with a one-period lag – that is to say, the average for the preceding three-year period is used. As an additional check, an alternative technique is used ("GMM"; see second column of Table 3.1) that effectively estimates the relationship in terms of changes, rather than the levels of the main variables, and rules out contemporaneous feedback.

The tables confirm that democracy appears to lead to better economic institutions, and that the effect is generally statistically significant in both the world and transition region samples.

When the distance to the frontier is used, the relationship loses its statistical significance, perhaps because this

[3] The correlation between the average transition indicators and the average of the four WGIs shown in Chart 3.1 is 0.88. The correlation between the latter and the distance to the frontier is 0.80; and the correlation between the transition indicators and the distance to the frontier is 0.70.

[4] See Olson (2000), North (1990) and North and Weingast (1989).

[5] Because the WGIs and the distance to the frontier are available for different time periods (the latter only having been available since 2006), the regressions refer to different time periods. Furthermore, the short period of availability of the distance to the frontier implies that it can only be analysed using a cross-sectional regression. Because of the low number of transition countries, the distance to the frontier can only be analysed in the world sample.

[6] To confirm the robustness of the results, each set of regressions contains one specification in which per capita income is not included.

Table 3.2
Determinants of economic institutions in a transition country sample

Dependent variable	Average of four Worldwide Governance Indicators			Average of six transition indicators		
	Panel OLS			Panel OLS		
Polity2	0.022*	0.019	0.032***	0.023*	0.023*	0.012
	(0.011)	(0.013)	(0.010)	(0.013)	(0.013)	(0.009)
Natural resources	-0.007**	-0.008***	-0.006**	-0.007**	-0.008***	-0.007***
	(0.003)	(0.003)	(0.002)	(0.003)	(0.003)	(0.002)
Low Polity*Natural resources			0.001			0.003
			(0.002)			(0.002)
Trade openness	0.282***	0.296***	0.269***	0.125**	0.128**	0.059
	(0.077)	(0.093)	(0.069)	(0.055)	(0.053)	(0.039)
Low Polity*Trade openness			0.233			0.616*
			(0.250)			(0.341)
Financial openness	0.109***	0.099**	0.106***	0.077**	0.076**	0.070**
	(0.034)	(0.041)	(0.035)	(0.037)	(0.037)	(0.033)
Low Polity*Financial openness			0.167			0.240
			(0.119)			(0.151)
Income	0.269***		0.283***	0.042		0.130*
	(0.092)		(0.087)	(0.089)		(0.070)
Ethnic fractionalisation	-0.295	-0.577	-0.264	0.230	0.182	0.343
	(0.348)	(0.354)	(0.358)	(0.468)	(0.400)	(0.382)
Low Polity*Ethnic fractionalisation			0.990*			-0.502
			(0.499)			(0.460)
Distance from the equator	0.010	0.015	0.008	0.010	0.011	-0.000
	(0.014)	(0.015)	(0.015)	(0.019)	(0.019)	(0.016)
Landlocked	0.136	0.120	0.105	0.320***	0.316***	0.282***
	(0.113)	(0.148)	(0.101)	(0.113)	(0.112)	(0.100)
Ruggedness	0.051	0.018	0.061	0.090**	0.085*	0.028
	(0.040)	(0.048)	(0.047)	(0.041)	(0.042)	(0.038)
State antiquity index	0.003	0.004	0.002	0.010***	0.010***	0.007**
	(0.002)	(0.003)	(0.002)	(0.003)	(0.003)	(0.003)
EU dummy	0.262**	0.403***	0.273**	0.195*	0.217**	0.196**
	(0.107)	(0.120)	(0.108)	(0.098)	(0.092)	(0.084)
Observations	122	122	122	118	118	118
Countries	25	25	25	25	25	25
R-squared	0.834	0.804	0.847	0.788	0.787	0.837
Adjusted R-squared	0.810	0.779	0.818	0.757	0.758	0.806
F-value	77.529	61.433	55.313	17.077	19.716	68.257

Source: See Annex 3.2.
Note: The table shows coefficient estimates from panel regressions, based on three-year averages. Regressions include time fixed effects (not reported). Standard errors are clustered by country and shown in parentheses. Polity2, trade openness, financial openness, income and the interaction terms are lagged by one period. Standard errors are clustered by country. "Low Polity" denotes a Polity score below -5. * p<=0.10; **p<=0.05; *** p<=0.01.

institutional measure only covers a six-year period. Moreover, the distance to the frontier index captures a narrower aspect of economic institutions, which is less closely related to democracy than broad WGI measures such as government effectiveness or the rule of law.

To interpret the size of the effect that democracy has on economic institutions, let us consider some countries with low scores on the Polity2 scale, such as Turkmenistan and Uzbekistan (rated -9 on the Polity2 scale), and others with very high scores, such as Poland, Lithuania, the Slovak Republic and Slovenia (all rated 10). The average WGI for the latter group is about 1.4, but it is -1.6 for the former – a three-point difference. The coefficient in the panel regressions (about 0.03) implies that the 19 point difference on the Polity2 scale explains almost 0.60 point – about 20 per cent – of the difference in quality between the economic institutions in the two sets of countries.

Importantly, this merely captures the direct effect of democracy on economic institutions, keeping everything else constant. In particular, it does not reflect any effects through per capita income levels (with democratic institutions likely to lead to faster growth) or trade and financial openness, which are captured separately in the regression.

GEOGRAPHY AND HISTORY

To what extent might the quality of institutions be predetermined by geography or history? Tables 3.1 and 3.2 include a number of geographical variables that have been discussed in the literature on economic growth. Countries that are further away from the equator may have stronger economic institutions (for given levels of democracy) because temperate climates are more conducive to economic specialisation, the development of trade and industrial growth. Characteristics of the terrain – captured by a measure of the ruggedness of the territory – and access to the sea may also matter.[7] Being landlocked or having more difficult terrain increases the cost of trade and investment, but may, at the same time, encourage the development of institutions to compensate for this.

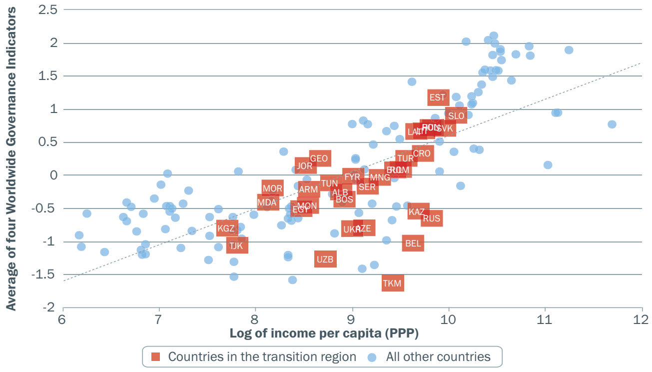
For the most part, these variables do not appear to be statistically significant in the regressions. Neither is the average distance to other countries weighted by their GDPs (a measure of a country's remoteness).

A country's history is a more important factor. Several recent studies indicate that economic institutions exhibit a strong degree of path dependence that may stretch back centuries[8] – in other words, colonial powers and empires can have a long-lasting impact on societies that come under their rule. Box 3.1 shows that there are large differences in terms of the average level of EBRD transition indicators between countries that used to be under the control of the Russian, Habsburg, Prussian and Ottoman empires. In particular, imperial history appears to influence the impact that natural resources have on transition trajectories. These effects diminish over time, but only slowly.

One significant historical factor is the length of time that a country has been an independent state. In Tables 3.1 and 3.2 this is captured by a "state antiquity index".[9] This appears to have an impact on the WGI average, and even more so on the transition indicators (see Table 3.2). All else being equal, the transition performance of "old" countries, such as Poland and Russia, appears to have been better than that of countries with shorter histories as independent states, which includes most Central Asian countries, the Baltic states and the Slovak Republic.

The influence of history is also visible in the fact that, more than 20 years after the start of the transition process, countries in the transition region still appear to have weaker economic institutions, on average, than other nations. Chart 3.3 shows that the quality of economic institutions in countries in the transition region tends to be below the levels observed in other countries with comparable levels of per capita income. However, as Table 3.1 shows, this effect is not generally statistically significant,

Chart 3.3. Economic institutions tend to be weaker in the transition region for comparable levels of per capita income



Source: World Bank and IMF.
Note: The vertical axis shows the average of the four WGIs related to economic institutions. The trend line is for all countries worldwide.

suggesting that the influence of the communist period on today's institutions in these countries mostly occurs through – rather than in addition to – its effect on other variables that are independently accounted for in the regressions. Comparing the outliers on both sides of the trend line in Chart 3.3 suggests that it is mainly some eastern European and Central Asian countries with weaker political institutions that are driving this effect.

FRACTIONALISATION OF SOCIETY

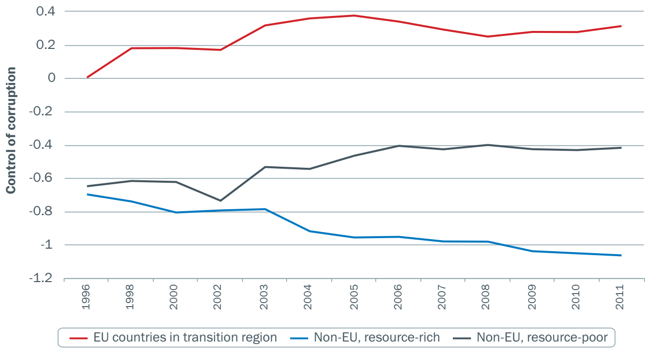
Another country characteristic that can affect the success of reforms is the extent to which a society divides along ethnic lines or in other ways.[10] In divided societies different groups may struggle to agree on the direction of reforms, or they may have little trust in each other or in government institutions more generally.[11] One commonly used indicator of such divisions is the index of ethnic fractionalisation.[12] This shows the probability of two randomly chosen individuals in a country belonging to different ethnic groups.

Tables 3.1 and 3.2 investigate whether ethnic fractionalisation has had an adverse impact on reforms and economic institutions for given levels of democracy, and whether this effect is blunted in the least democratic systems, which may be able to repress ethnic tensions (see the interaction term between a Polity2 score of below -5 and fractionalisation). They do not find strong support for either of these effects.

At the same time, anecdotal evidence suggests that ethnic divisions may have played an important role in some

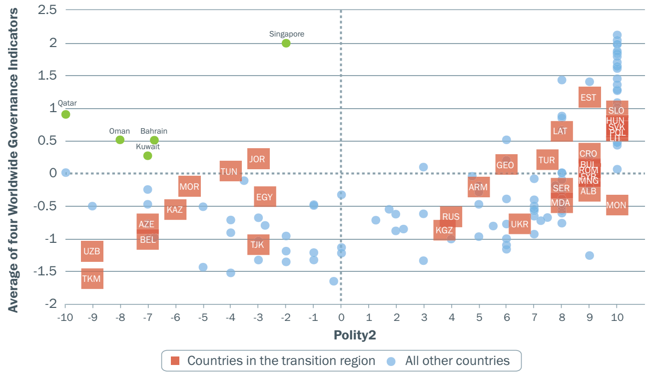
[7] See Nunn and Puga (2012).
[8] See Grosjean (2011a, 2011b) and Grosfeld and Zhuravskaya (2013), as well as the additional references in Box 3.1.
[9] See Chanda and Putterman (2007).
[10] See Alesina et al. (1999).
[11] See Putnam et al. (1994).
[12] See Wacziarg et al. (2003).

Chart 3.4. Corruption has become more widespread in resource-rich countries



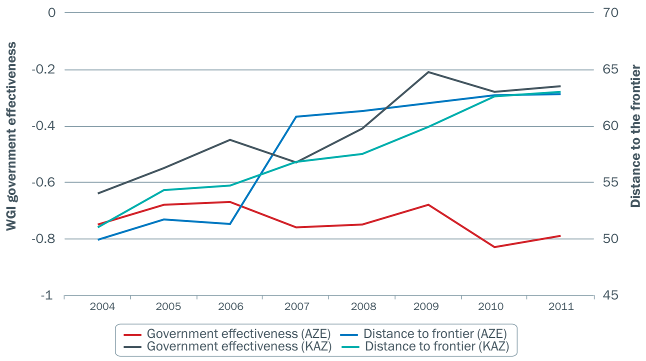
Source: World Bank.
Note: Countries are classified as "resource-rich" if natural resource rents amount to 10 per cent of GDP or more, based on World Bank data. In this chart the EU countries in the transition region are: Bulgaria, Croatia, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic and Slovenia.

Chart 3.5. Democracy is associated with better economic institutions, but there are significant outliers among less democratic countries



Source: World Bank and Polity IV.
Note: The chart plots the average of the four Worldwide Governance Indicators (WGIs) (rule of law, regulatory quality, control of corruption and government effectiveness) for 2011 against 2011 Polity2 scores.

Chart 3.6. Azerbaijan and Kazakhstan have improved some economic institutions



Source: World Bank.
Note: The WGI government effectiveness indicator is shown on the left-hand axis; the *Doing Business* measure of the distance to the frontier is shown on the right-hand axis.

countries, such as the Kyrgyz Republic, where ethnic fractionalisation may have cut both ways. On the one hand, it may have contributed to the development of democratic institutions; but on the other hand, it may have reduced their ability to implement effective reforms (see Box 3.2).

NATURAL RESOURCE ENDOWMENTS

As shown in Chapter 2, an abundance of natural resources – reflected in high natural resource rents (revenues net of extraction costs) as a share of GDP, or a large share of commodities in total exports – can lead to a weakening of democratic institutions.[13] One interpretation for this is that stronger political institutions impose checks and balances on the ruling elites and make it more difficult to appropriate natural resource rents. These elites will therefore be particularly opposed to democratisation and political reform.

For the same reasons, an abundance of natural resources would make improvements in economic institutions, such as the rule of law or control of corruption, less likely.[14] Chart 3.4 shows that resource-rich and resource-poor countries in the transition region (excluding the future EU members) had similar average scores for control of corruption in the mid-1990s. However, these levels have been steadily diverging, particularly during the period of high commodity prices from 2003 onwards.

Tables 3.1 and 3.2 confirm that an abundance of resources has a negative effect on economic institutions over and above its effect through weaker political institutions (which itself constrains economic reform). This effect is statistically significant regardless of which measure of economic institutions is used, in both the world and transition samples.

At the same time, there are important differences between the experiences of individual countries. Some Gulf countries, for example, have much stronger economic institutions than their political institutions would predict (see Chart 3.5). In the transition region this also seems to be true for Azerbaijan and Kazakhstan for some measures, such as the distance to the frontier measures in the World Bank *Doing Business* reports. Government effectiveness has also been improving in Kazakhstan (see Chart 3.6).

These improvements could reflect the use of natural resource wealth to strengthen the implementation capacity of governments, pursue basic business environment reforms and reduce petty corruption by raising the pay of officials, regulators and inspectors. In addition, countries with natural resource wealth may have an incentive to engage in such policies in order to attract the foreign investment and expertise needed for the exploitation of natural resources.[15] Similarly, the presence of multinational oil or mining companies can facilitate the transfer of skills and the adoption of international business practices, which may, over time, lead to improvements in some economic institutions.

Table 3.1 (last column) shows that, in a subset of countries with low Polity scores (less than -5), an abundance of natural

[13] See also EBRD (2009) and Boix (2003).
[14] See Karl (1997).
[15] See Nikolova (2012)

resources is positively and significantly associated with the distance to the frontier.[16] However, for broader measures of economic institutions – such as control of corruption or the rule of law, which are reflected in the average WGI score – the effect of natural resources generally remains negative, even for countries with low Polity2 scores. This is also true for regressions involving the transition indicators (see last column of Table 3.2).

ECONOMIC OPENNESS AND THE EU "ANCHOR"

Openness in terms of trade flows (measured by the trade intensity index, which compares a country's share of world trade with its share of world output)[17] and finance (measured by the Chinn-Ito index of capital account openness) is significantly associated with better economic institutions in both the world and transition region samples (see Tables 3.1 and 3.2).[18]

The regression results suggest that a one standard deviation increase in the index of trade openness is associated with an improvement of around one-eighth of a standard deviation in the average of the four WGIs. The effect of financial openness is larger: a one standard deviation change in the Chinn-Ito index is associated with an improvement equivalent to 40 per cent of a standard deviation in the quality of institutions (roughly equivalent to the difference between the average WGIs of Morocco and those of Georgia). Interestingly, these effects appear to be particularly strong in countries with low Polity2 scores.

Not surprisingly, the influence of EU membership on economic institutions is positive and statistically significant in all regressions involving the transition region sample. EU membership is captured by a variable that takes the value 1 as of two years before EU accession, as pre-accession reforms usually peak at this time (the following section investigates this effect in the context of case studies.) Note that the effect occurs over and above the influence of democracy, economic openness and per capita income, all of which are correlated with (and, to some extent, induced by) EU membership. Hence, the regressions indicate that, given two equally open, democratic and wealthy countries, where one is in the European Union and the other is not, the EU member would be expected to have better economic institutions.

POLITICAL SYSTEMS IN MULTI-PARTY DEMOCRACIES

Chart 3.5 shows that the quality of economic institutions varies widely among countries with Polity2 scores of between 8 and 10. In addition to the reasons considered so far, another possible explanation might be differences in the design of democratic political systems.

One relevant factor is the electoral system, which determines how votes translate into seats in parliament. This affects both the distribution of power within a government and the extent to which politicians are accountable to voters. In the absence of clear evidence, it is impossible to say which electoral system is most conducive to sustained economic reform. While majoritarian democracies usually lead to the emergence of single-party governments, proportional representation is more often associated with coalition cabinets, as it gives more weight to minority parties and independent candidates. Multi-party cabinets may be more representative, but they may also be more unstable, owing to internal ideological divisions. Similarly, countries with proportional systems may have higher spending and budget deficits.[19]

Another factor is the distribution of power across branches of government. Parliamentary democracies lack the strong leadership of a president, which may be crucial for pushing through essential but unpopular reform agendas. At the same time, they constrain the scope for abusing presidential power. Presidential systems may be particularly susceptible to corruption and clientelistic spending in the transition region, which had extensive experience of concentration of political power during communism.

Table 3.3 explores the link between a country's political system and its economic institutions by adding political variables to the first regression model in Table 3.1 and the first and third regression models in Table 3.2 (see the first four columns). It uses data on (i) the degree of proportionality of the electoral system (where 0 indicates a proportional system, 1 indicates a mixed proportional-majoritarian system, and 2 indicates a majoritarian system) and (ii) the distribution of power between the president and parliament (where 0 indicates a parliamentary system, 1 indicates a semi-presidential system dominated by parliament, 2 indicates a semi-presidential system dominated by the president, and 3 indicates a presidential system) from Comparative Political Dataset II.

The regression results show that countries with more proportional systems tend to have better economic institutions. The effect is slightly stronger for the transition region than for the worldwide sample. Perhaps surprisingly, the link between proportionality and economic institutions does not seem to be modified by the quality of the political regime, suggesting that broad political representation has a positive impact on economic institutions even in imperfect democracies. Presidential systems also appear to be associated with better economic institutions, but the effect is typically statistically insignificant.

The ideologies and relative strength of the main political parties may also affect the quality of economic institutions. Strong differences between the parties in parliament may slow down economic reform, not only because divided parliaments may find it difficult to agree on the design of economic institutions, but also because of the threat of policy reversals should the opposition gain power.

One way of expressing these divisions that has been proposed for the transition region is the use of an index of political polarisation. This measures the representation in parliament of the largest former communist faction when an anti-communist party controls the executive, and vice versa.[20] For example, in Bulgaria in 1994 the anti-communist Union of Democratic Forces won 29 per cent of the seats in parliament and was

[16] The total effect for these countries is the sum of the coefficient for the commodity share of exports and the interaction term between the commodity share of exports and a dummy variable for countries with low Polity scores (that is to say, scores below -5).

[17] More precisely, the index is a residual in a regression of the volume of trade on a country's GDP and a number of other characteristics that are commonly used to explain trade flows. See Pritchett (1996) and Chapter 1 of this report.

[18] See Chinn and Ito (2006) and Chapter 1 of this report.

[19] See Persson and Tabellini (2005) for a review of the literature on the economic effects of constitutions and EBRD (1999).

[20] See Frye (2010).

the largest party in opposition, with the government being formed by the former communist Bulgarian Socialist Party. Bulgaria's polarisation score in that year was therefore 29.

The last two columns of Table 3.3 show that political polarisation is indeed associated with lower-quality economic institutions in the transition region. The interaction term with the Polity variable indicates that the effect can only be felt in relatively democratic regimes, as one would expect. The next section explores some examples of how polarisation can undermine reform.

LOCAL AND REGIONAL VARIATION IN INSTITUTIONAL QUALITY

There can be large differences in the quality of local and regional institutions. An analysis using data from the most recent (2010) LiTS found that only about 20 per cent of the variation in the performance of local governments, as perceived by households across the transition region, was due to variation across countries; 80 per cent was due to intra-country variation. Similarly, only 31 per cent of the local variation in perceived corruption in administrative systems could be explained by differences across countries. At the regional level, the variation attributable to country-level effects totalled 57 per cent (for local government performance) and 47 per cent (for corruption).[21]

Even greater diversity across regional business environments is suggested by the World Bank 2012 *Doing Business* report undertaken in 30 regions of Russia. This subnational survey covered the four aspects where region-specific regulations or practices matter most: starting a business, dealing with construction permits, registering property and securing an electricity supply.

The survey revealed a surprising amount of cross-regional diversity in the Russian business environment. With the possible exception of Ulyanovsk, no area scored well on all four aspects, and virtually all areas featured among the top performers for one aspect while ranking poorly in others. For example, while it may be relatively easy to conduct business in Mordovia, North Ossetia and Rostov, it appears to be difficult to start a business there.[22] A 2012 BEEPS survey conducted by the EBRD and the World Bank in 37 regions of Russia with statistically representative regional samples painted a similar picture.[23]

Regional and local differences in business environment quality and related economic institutions could be due to similar factors influencing the country-level differences analysed in Tables 3.1 and 3.2. For example, local or regional histories may matter (with historical national borders often not coinciding with current national borders, as shown in Box 3.1), and ethnic composition, natural resource dependence and degrees of international integration may also vary within a country. As at the national level, some of these factors can be influenced by policies, others less so. Importantly, local political institutions may be easier to reform than those at the national level, particularly in less democratic countries. This point is considered further in the concluding section of the chapter.

CRITICAL JUNCTURES: A COMPARISON

The above analysis confirms the strong (and probably causal) effect of democracy on economic institutions and the likely relevance of several other factors: history, geography, per capita income levels, the presence of natural resources, political, ethnic and economic polarisation, international integration and the design of political institutions.

However, even accounting for all of these factors, at least 20 to 30 per cent of cross-country variation in the quality of economic institutions remains unexplained. This may relate to factors that are difficult to capture in a regression. For instance, trajectories of economic reform can depend on pivotal moments in history and the way in which they develop. This section examines some of these episodes to see if they confirm the relevance of the factors identified so far, and to see whether they hold lessons for successful institutional reform.

All transition economies went through a critical period at the beginning of the transition process – roughly between 1988 and 1993. Countries emerged from this period with vastly different political systems and at different stages of reform and institution building.[24]

The following analysis highlights further critical junctures after this period in countries that missed their initial chance to establish full democracies and gain a head start with economic reforms. Within this group, the focus is on reform opportunities triggered by political change in imperfect democracies, which have been far more frequent than transitions from dictatorships to democratic regimes.

From among a dozen or so candidates affecting 10 countries,[25] four episodes were chosen because they represented diverse experiences and were viewed as important windows of opportunity at the time they occurred: Romania in 1996, the Slovak Republic in 1998, Georgia in 2004 and Ukraine in 2005.[26] The first two relate to changes in government triggered by elections, and the last two relate to popular uprisings – the "Rose" and "Orange" Revolutions respectively.

- After the overthrow of Nicolae Ceauşescu's regime in December 1989, **Romania**'s former communist elite, led by President Ion Iliescu, managed to retain political power for the first half of the 1990s. With the exception of price and trade liberalisation, market-oriented reforms proceeded slowly, and Romania also lagged behind in terms of international integration. Parliamentary elections in November 1996 led to the formation of a centre right government led by Victor Ciorbea, backed by a 60 per cent majority in the lower house of parliament. Ciorbea announced his intention to break with Romania's communist past and fight corruption.
- Following Czechoslovakia's "velvet divorce" in 1992, the **Slovak Republic** went through a difficult period under Prime Minister Vladimír Mečiar, which involved non-transparent privatisations and high-level corruption. Of the 10 European countries in the transition region that applied for EU

[21] The analysis was based on answers to questions 6.20a ("Please rate the overall performance of local government") and 6.04 ("Did you or any member of your household make an unofficial payment or gift when using these [administrative] services over the past 12 months?"). The contributions cited are based on the decomposition of the R2 of a regression of these variables – average responses for all primary sampling units (PSUs; about 1,700 observations) and administrative regions (about 200 observations) – on a number of local level explanatory variables and a full set of country dummy variables.

[22] See World Bank (2012a).

[23] See EBRD (2012a).

[24] For analysis of these differences, see EBRD (1999), Frye (2007) and Aslund (2013).

[25] These were identified as improvements of at least one notch in the Polity IV democracy measure in countries with initial levels of democracy of between 1 and 7. These included episodes in Albania (2002 and 2005), Estonia (1999 2000), FYR Macedonia (2002), Georgia (1995 and 2004), Kyrgyz Republic

Table 3.3
Exploring the influence of the political system on economic institutions

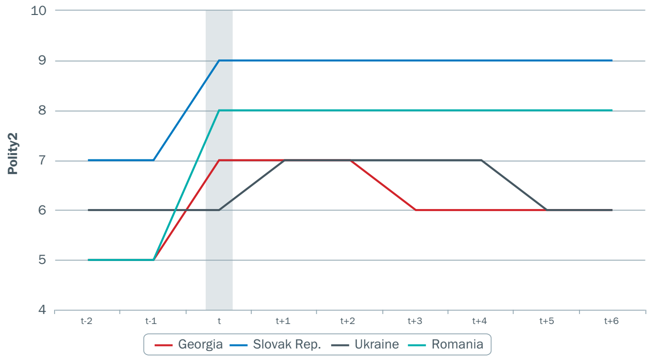
Dependent variable	World sample		Transition region sample					
	WGI average	WGI average	WGI average	Transition indicator average	WGI average	Transition indicator average	WGI average	Transition indicator average
Polity2	0.032**	0.083***	0.036*	-0.003	0.080**	0.054	0.058***	0.079***
	(0.015)	*(0.027)*	*(0.020)*	*(0.023)*	*(0.029)*	*(0.046)*	*(0.017)*	*(0.026)*
Majoritarian system	-0.201**		-0.229**	-0.407**				
	(0.084)		*(0.085)*	*(0.159)*				
Polity2*Majoritarian system	-0.002		-0.002	0.021				
	(0.010)		*(0.011)*	*(0.018)*				
Presidential system		0.156			0.158*	0.075		
		(0.094)			*(0.090)*	*(0.126)*		
Polity2*Presidential system		-0.016			-0.018	-0.009		
		(0.011)			*(0.011)*	*(0.016)*		
Polarisation index							-0.006	0.010
							(0.006)	*(0.008)*
Polity2*Polarisation index							-0.002*	-0.003**
							(0.001)	*(0.001)*
Natural resources	0.000	-0.001	0.002	-0.002	-0.003	-0.005	-0.001	-0.001
	(0.002)	*(0.002)*	*(0.002)*	*(0.003)*	*(0.003)*	*(0.005)*	*(0.003)*	*(0.004)*
Trade openness	0.374***	0.345***	0.511***	0.216	0.453***	0.184	0.418**	0.120
	(0.110)	*(0.111)*	*(0.110)*	*(0.179)*	*(0.148)*	*(0.215)*	*(0.151)*	*(0.169)*
Financial openness	0.139***	0.114***	0.153***	0.110***	0.131***	0.086**	0.088***	0.056
	(0.031)	*(0.038)*	*(0.029)*	*(0.031)*	*(0.036)*	*(0.040)*	*(0.031)*	*(0.037)*
Income	0.338***	0.359***	0.371***	0.081	0.354***	0.044	0.309***	-0.027
	(0.068)	*(0.069)*	*(0.068)*	*(0.079)*	*(0.080)*	*(0.111)*	*(0.058)*	*(0.083)*
Observations	184	184	96	96	96	96	92	92
R-squared	0.941	0.935	0.923	0.886	0.907	0.834	0.925	0.889
Adjusted R-squared	0.934	0.928	0.907	0.863	0.888	0.801	0.909	0.865
F-value	180.771	145.444	363.096	23.075	101.457	10.810	67.188	16.479

Source: See Annex 3.2.
Note: The table shows coefficient estimates from panel regressions, based on three-year averages. Standard errors are clustered by country and shown in parentheses. All regressions include the same controls as in Tables 3.1 and 3.2: ethnic fractionalisation, state antiquity, landlocked, ruggedness, EU membership (for transition region regressions), and time fixed effects (not reported). Polity2, trade openness, financial openness, income, electoral systems, political systems, polarisation and the interaction terms are lagged by one period. Standard errors are clustered by country. *p<=0.10; **p<=0.05; *** p<=0.01.

(2010), Moldova (2001), Romania (1996), Russia (2000), Slovak Republic (1998) and Ukraine (1994 and 2006).

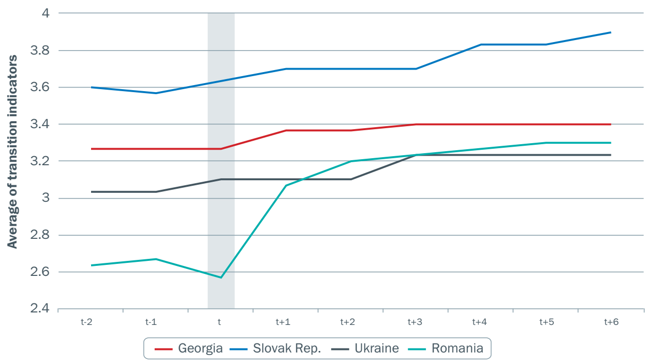
[26] The case studies that follow are based on past issues of the EBRD's *Transition Report* and the following additional sources: for Romania, Boia (2007) and Cviić and Sanfey (2010); for Georgia, World Bank (2012b) and Papava (2013); for the Slovak Republic, Eperjesiova (1999); and for Ukraine, Pivovarsky (2013).

Chart 3.7. Political improvements at critical junctures were not always sustained



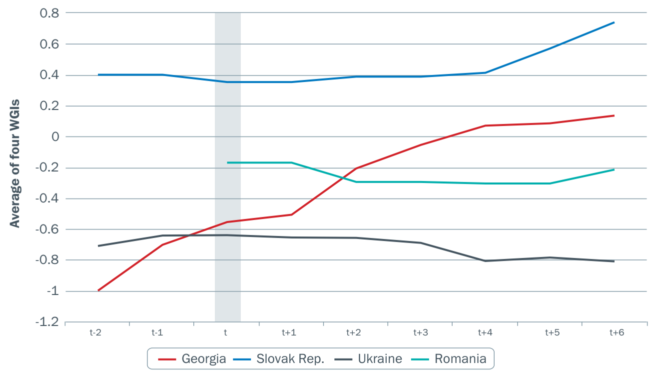
Source: Polity IV.
Note: This democracy index uses a scale of -10 to 10, where 10 is the most democratic.

Chart 3.8. All critical junctures were associated with a pick-up in economic reform



Source: EBRD.
Note: The chart shows the average of the EBRD's country-level transition indicators.

Chart 3.9. Two of the four critical juncture episodes failed to improve economic institutions



Source: World Bank.
Note: The chart shows the average of the four WGIs related to economic institutions: government effectiveness, regulatory quality, law and order, and control of corruption.

membership in 1994-96, the Slovak Republic was the only one deemed not to comply with the political requirements in the accession criteria. Parliamentary elections in 1998 led to a strong mandate for change from the electorate, which enabled the pro reform Slovak Democratic Coalition (SDK) led by Mikuláš Dzurinda to build a broad majority coalition. The timing of the elections – which were held in the immediate aftermath of the Russian financial crisis – may have influenced this outcome.

- As in Romania, **Georgia**'s early transition was dominated by elites affiliated with the former communist regime. Rampant corruption and crime, an erratic electricity supply and poorly managed state finances contributed to a popular insurrection following a disputed election in November 2003. This brought Mikheil Saakashvili, a young Western-educated lawyer, to power in January 2004.
- **Ukraine**'s first post-Soviet decade was marked by the presidency of Leonid Kuchma, a member of the former communist elite, who was first elected in 1994. Kuchma's government undertook first-generation economic reforms, but property rights, contract enforcement and competition policy remained weak, and corruption was widespread. A disputed election in November 2004 led to mass protests, which culminated in a second run-off in December 2004 – deemed free and fair by international observers – and the inauguration of Viktor Yushchenko as president.

Charts 3.7, 3.8 and 3.9 show measures of political institutions, economic reform and economic institutions two years before and six years after the critical juncture, which is labelled "t" in the charts. According to the Polity database, three of the four episodes were associated with at least a two-notch improvement on the -10 to 10 democracy scale. Ukraine recorded a one-notch rise one year into the Yushchenko presidency (see Chart 3.7).

Furthermore, all episodes were associated with a pick-up in economic reforms, as reflected in the EBRD transition indicators for privatisation, enterprise restructuring and market liberalisation – a modest pick-up in Georgia, the Slovak Republic and Ukraine, and stronger improvements in Romania, although this probably reflected the country's less advanced starting point (see Chart 3.8).

However, a different and more diverse picture arises from the broader WGI measures of economic institutions. Chart 3.9 shows the average of the same four indicators – government effectiveness, regulatory quality, law and order, and control of corruption – that have formed the basis for most of the previous analysis in this chapter.

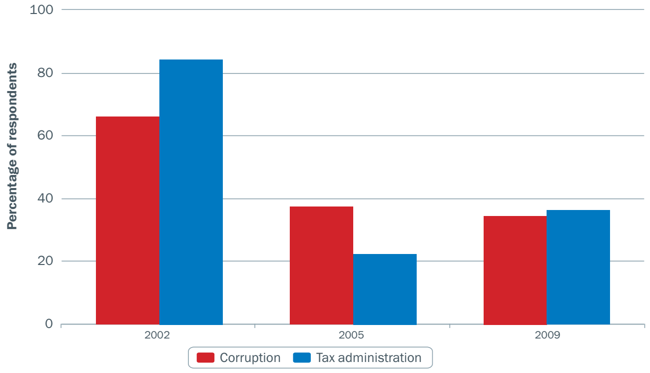
Of the four episodes, only the Georgian Rose Revolution was followed by sustained improvements in economic institutions according to the World Bank data. Institutions in the Slovak Republic improved only marginally, on average, in the first four years of Dzurinda's government (although from a much higher level than in the other three countries), and picked up only after

Dzurinda's re-election in 2002. In Romania and Ukraine, however, institutions deteriorated from what were already low levels. In Romania the downward trend continued from 1996 until 2002, while in Ukraine it continued until the end of Yushchenko's presidency in 2010 and has yet to be reversed.

This remarkable difference in performance reflects the different policy priorities of – and the constraints on – the governments that assumed responsibility at the beginning of each episode.

- In Romania Victor Ciorbea's government devised an ambitious IMF-supported stabilisation and reform programme in early 1997. However, after some initial successes – including the creation of a competition authority, the establishment of currency convertibility and acceleration of the privatisation programme – reforms stalled. In critical areas such as restructuring, privatisation of large enterprises and corporate governance, there was little further progress. Having lost support within his own party, Ciorbea resigned in March 1997. Two ineffective centre-right governments followed, bogged down by internal dissent and a confrontation with mineworkers in 1999. Iliescu and the former communists returned to power in November 2000.
- In the Slovak Republic the broad nature of Dzurinda's anti-Mečiar coalition – which included former communists, environmentalists, other left-wing parties, liberals and Christian democrats – precluded decisive reforms (with the notable exception of the successful sale of a number of state-owned companies previously deemed "strategic" to foreign investors in 1999 and some other measures to attract foreign direct investment). However, following Dzurinda's re-election at the head of a narrower coalition in 2002, there were further efforts to attract foreign direct investment. Reforms included a comprehensive review of the tax regime, amendments to the commercial and criminal codes and significant improvements in the business environment.
- In Georgia the new government under Mikheil Saakashvili – which had considerable parliamentary backing – focused on reforms of public revenue management, simpler and lower taxes, large-scale privatisation and an aggressive anti-corruption campaign that included eastern Europe's first law holding businesses legally liable for bribery. Perceptions of the business environment improved dramatically (see Chart 3.10). The same period, however, also saw increased government control over the media and a number of prosecutions that appeared to be politically motivated. Furthermore, the desire to limit state involvement in the economy led to a weak competition policy and market concentration in a number of industries. Income inequality (and inequality of opportunity; see Chapter 5) also remained high, prompting questions about the sustainability of Saakashvili's reform model.

Chart 3.10. Corruption and tax administration became less of an obstacle to business in post-revolution Georgia



Source: BEEPS.
Note: The chart shows businesses which stated, in each survey year, that corruption or tax administration were a "major" or "moderate" obstacle to business.

- With the exception of its accession to the World Trade Organization (WTO) in May 2008, Ukraine made no significant progress in terms of economic reforms under Yushchenko's presidency. Attempts to revitalise privatisation were marred by infighting within the government coalition. After the global financial crisis in late 2008, the government attempted to revive reform in the context of an IMF-supported programme. A number of laws were passed in 2009 to make it easier to set up new businesses, reduce regulatory burdens, improve public procurement and initiate gas sector reform. However, their implementation and follow-up was weak owing to opposition from vested interests and a deteriorating relationship between the president and his prime minister. The 2010 presidential elections handed power to Viktor Yanukovich, whose contested victory in November 2004 had triggered the Orange Revolution.

To summarise, the governments of Saakashvili in Georgia and (eventually) Dzurinda in the Slovak Republic managed to transform their countries' economic institutions for the better, while the Romanian and Ukrainian governments that assumed power in 1996 and 2005, respectively, failed. The remainder of this section discusses factors that may have played a role in generating these differences in outcomes.

EARLY TRANSITION HISTORIES AND VESTED INTERESTS

In Romania and Ukraine resistance to reform developed among strong vested interests following the collapse of central planning, although for rather different reasons.[27]

In Romania the former communist elites initially retained power, controlling a still largely state-run economy and opposing further enterprise restructuring and privatisation. In Ukraine industrial assets which survived the early transition recession were based primarily in the steel-producing east of the country and depended on access to cheap natural resources and energy, tax preferences and the protection of the domestic market. Their new owners permeated government and the media and amassed significant influence and financial resources. The leaders of the Orange Revolution sought to tap some of those resources in order to contest the elections, and the price was most likely an agreement to respect the status quo in terms of the business environment, ownership and business practices.

The Slovak Republic underwent a similar early period of privatisation, benefiting an anti-reform elite, but this was cut short by the 1998 election. Georgia was similar to Romania in that the former communist elites were able to consolidate their power. Unlike Romania and Ukraine, however, Georgia did not have heavy industries. Its surviving economic sectors were highly decentralised and there were no Georgian oligarchs. Furthermore, the old elites mismanaged the country so badly that they lost popular support to a much greater extent than the incumbents in Ukraine. Unlike the run-off election that followed the November 2004 Orange Revolution, the January 2004 election that brought Saakashvili to power was uncontested, and less than 4 per cent of the electorate voted against him.

POLITICAL POLARISATION

Political polarisation is defined in the transition context as the strength, in terms of the number of parliamentary seats, of the largest post-communist faction when an anti-communist faction is in power, and vice versa (see previous section). Between 1990 and 2004 Romania and Ukraine were among the three or four countries in the transition region with the highest degree of political polarisation (the others being Bulgaria and, depending on the methodology, either Albania or the Kyrgyz Republic).[28]

Political polarisation makes it more difficult for reformist groups to initiate and sustain change for two reasons. It is obviously harder to pass and implement reforms in the face of strong parliamentary opposition. More subtly, polarisation increases the likelihood of changes of government and changes to policies, so reformers can count on less support from the presumed beneficiaries of change – for example, new businesses – and their chances of defeating incumbent interest groups are lower.

It may therefore be costlier and riskier – not just for reformist politicians, but also for public officials and civil servants – to take on vested interests in a polarised political environment. This may explain why reforms in Romania between 1996 and 2000 were hesitant and undermined by dissent within the governing party, and why the Yushchenko administration in Ukraine was reluctant to reform the energy sector to the detriment of established industrial interests.

PRIORITIES OF GOVERNMENT LEADERS AND THEIR ADVISERS

Although observers of the Rose Revolution and its aftermath in Georgia disagree on Mikheil Saakashvili's overall presidential record, there can be little doubt that the success with institutional reforms reflected his priorities. In turn, these were influenced by his experience of training and living in the United States and France, with their accountable public institutions and comparatively low corruption.

In contrast, the leaders of the Orange Revolution were trained and made their careers exclusively in Ukraine during the Soviet and Kuchma eras, when they worked in government or industry. Institutional reform was not their main preoccupation, and that would probably have remained the case even in the absence of opposition from vested interests. The reasons for this may have included a limited understanding of the importance of institutions for well-functioning market economies, but also different priorities, such as nation-building through the promotion of the Ukrainian language and the rebuilding of various religious and cultural landmarks.

Reformist ideas and priorities also differed outside the inner circle of leaders and their closest associates. Saakashvili recruited many young, reform-minded Georgians who had trained abroad (and some foreign advisers), and who were keen to contribute to the post-revolution rebuilding of Georgian institutions. In contrast, there was no discernible increase in the number of Western-trained Ukrainians in government after the Orange Revolution.

Differences in leadership priorities were also apparent in the way in which post revolution governments approached the problem of corruption. Links between corruption and powerful vested interests may have made it even harder to tackle corruption in Ukraine than in Georgia. Nonetheless, in the immediate aftermath of the Orange Revolution, Ukraine's leaders had the opportunity to set an example – by cracking down on any signs of corruption within the new government – which could have changed public expectations and redefined standards of tolerance. Instead, examples of nepotism and corruption among the new authorities emerged soon after the elections, sending a clear signal to society that nothing had really changed.

EXTERNAL ANCHORS AND EXTERNAL SUPPORT

According to several authors, the prospect of EU accession created incentives for reform in many transition countries, particularly after they had submitted membership applications, and most directly during the membership negotiation phase,

[27] The general argument underlying this section – the argument that partial reforms and lack of initial political competition can create vested interests which oppose further reform – has been made by a number of authors, including Hellman (1998), EBRD (1999), Shleifer and Treisman (2000), and Aslund et al. (2001). See Aslund (2013) for additional references.
[28] See Frye (2010).

when the EU pressed for specific reforms.[29] Chart 3.11 shows that, in fact, reforms in the EU members that joined in 2004 and 2007 (the EU-10) peaked between one and three years prior to accession.

EU membership negotiations with Romania, the Slovak Republic and a number of other candidate countries started in early 2000. This was fortuitous for the Slovak reformers who had come to power in late 1998. Although both Romania and the Slovak Republic became EU candidates in the mid-1990s, the prospects of EU accession were clearer and stronger in late 1998 than they were in 1996, when Romania's window of opportunity opened under the new centre-right coalition government. Following the broad change in policy direction by the Slovak reformers who had come to power in 1998, the republic re-opened negotiations to join the first wave of EU accession, while Romania, alongside Bulgaria, was kept in the second wave.[30]

Both Georgia and Ukraine lacked this EU anchor. However, the objective of joining NATO, which received unanimous support from Georgia's parliament in 2006, may have provided an additional motive for Western-oriented economic reform, particularly prior to the country's 2008 conflict with Russia. Similar calls for NATO membership in Ukraine might have provided some initial impetus for institutional reforms, but these ceased after a negative reaction from neighbouring Russia.

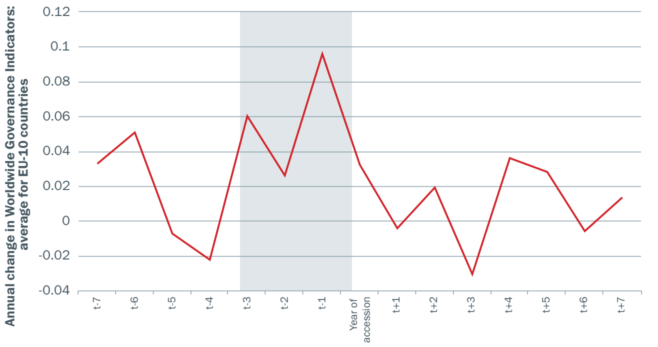
Western intellectual and financial support during and after the Rose Revolution may have also contributed to the success of some reforms in Georgia. According to World Bank data, net official development assistance and official aid received by Georgia from the United States and other partners fluctuated between 4.6 and 8.4 per cent of GDP per year between 2005 and 2009, compared with 0.3-0.6 per cent of GDP for Ukraine.

MACROECONOMIC ENVIRONMENT

The above episodes took place under very different macroeconomic conditions, which may have had an impact on demand for reform and its implementation. In the Slovak Republic Dzurinda's tenure began in a low-growth environment, from which the economy recovered as reforms began to attract foreign investment. In Romania the government's 1997 reform programme coincided with a macroeconomic crisis that reflected the mismanagement of previous years. This highlighted the need for adjustment and reform, but the resulting collapse in output (which fell by a cumulative 11 per cent of GDP during 1997-98) made implementation even more difficult.

Ukraine found itself in the opposite situation, as the aftermath of the Orange Revolution coincided with a boom in capital flows to emerging markets. This allowed Ukraine to grow quickly during 2006-07, even in the absence of reform. The fact that the Rose Revolution happened prior to this boom may have benefited reforms in Georgia.

Chart 3.11. Institutional improvements in EU accession countries tended to peak one to three years prior to accession



Source: World Bank.
Note: The chart shows the average change in the WGIs of the EU-10 countries in the seven years before and after EU accession. The EU-10 countries are: Bulgaria, Croatia, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic and Slovenia.

[29] See Roland (2000), Vachudova (2005) and Plümper et al. (2006).
[30] See Berglöf and Roland (2000).

CONCLUSION

Reform-oriented policy-makers can attempt to improve economic institutions by "just doing it": by passing an anti-corruption law, by changing the management and accountability relationships of a customs agency, by abolishing licensing requirements, by giving more independence to a competition authority, and so on. However, when faced with systemic obstacles, such as low levels of democracy, political polarisation or market aversion, their efforts could be unsuccessful. They may well encounter opposition from government, parliament or vested interest groups, and even if they do manage to pass legislation, its implementation could be undermined by corrupt officials.

What options could be available to policy-makers who wish to promote good economic institutions and help to implement economic reforms? This section concludes by outlining possible answers to that question, building on the evidence presented earlier.

INTERNATIONAL INTEGRATION

Unlike most other variables considered in the cross-country analysis, economic openness supports institutional quality and is achievable across a wide range of political systems. Such diverse countries as Azerbaijan, Estonia, Kazakhstan and the Slovak Republic have all, with at least some success, tied their development strategies to openness.

International integration may help institutions through several channels. The increased presence of international firms helps to disseminate international business practices and standards. It may also put pressure on national and local authorities to improve the quality of government services. Dual listing of company shares may contribute to improved corporate governance.

Such passive strategies for improving institutions through openness to trade and foreign direct investment can also be supplemented by more active policies.

First, even if a country does not have the option of joining the European Union, it may be possible to exploit international integration or external benchmarks to anchor reform. For instance, since 2008 Russia has sought to turn Moscow into a leading international financial centre. This has resulted in reforms within and beyond the financial sector that will help Russia regardless of whether its ambition is fully realised.

Compliance with the principles of the WTO or the Organisation for Economic Co-operation and Development (OECD) in the course of accession to these organisations can help to anchor economic reforms. Unlike the European Union, membership of these organisations is not restricted by geography. Russia joined the WTO in 2012, having made important adjustments to its laws and regulations on issues such as the protection of intellectual property rights. Tajikistan joined in 2013, and Kazakhstan is in the process of concluding its accession negotiations. Russia has also been negotiating membership of the OECD.

Another useful external benchmark is the World Bank *Doing Business* report. This may even help countries with weak political systems. Belarus is one of the four countries that have improved their *Doing Business* ratings the most since 2005 (along with Georgia, FYR Macedonia and Kazakhstan). Russia has recently adopted a *Doing Business* target. *Doing Business* is often publicised as a relative ranking of countries, comparing economic policies and achievements with those of a peer group – which is known to play a role in shaping economic policies.[31]

Second, international integration can take the form of institutional integration, as in the case of the EU. There is evidence that the quality of economic institutions tends to converge within regional economic blocs with deeper integration. Countries with weaker institutions tend to catch up (albeit slowly) with those that have stronger institutions, particularly in areas such as regulatory quality.

In some cases institutional integration may help even when countries have similar levels of institutional quality – as in the case of the Eurasian Economic Union that was recently established by Belarus, Kazakhstan and Russia – if it involves the transfer of certain competencies to the supranational institutions of the union. This provides an opportunity to build institutions from scratch.[32] The challenge is to make those supranational institutions stronger than the national institutions of the individual member countries.[33]

Lastly, international integration can facilitate the transfer of skills and ideas. Faced with severe skills shortages in a rapidly growing economy, Kazakhstan has adopted various policies to promote the overseas training of its workforce and to leverage the transfer of skills from multinational corporations operating in the country. In addition, as early as 1993, Kazakhstan launched its Bolashak scholarship programme, which is modelled on successful schemes in Singapore, Thailand and a number of other countries. This scholarship provides full funding for studies abroad to Kazakh students selected on a competitive basis. Recipients are obliged to return to Kazakhstan to work for a minimum of five years. Many of the returning scholars have taken up positions in government, state agencies and state-owned companies, strengthening the technical capacity of the civil service and helping to design and implement technocratic economic reforms.

TRANSPARENCY AND ACCOUNTABILITY AT REGIONAL AND LOCAL LEVEL

Reform-minded policy-makers in weak political systems may face a conundrum. On the one hand, economic reforms may be essential to improve the business environment and generate growth because they offer a channel for improving weak political institutions (see Chapter 2). On the other hand, the implementation of such reforms may be undermined precisely because political institutions are weak and impeded by vested interests.

[31] See Besley and Case (1995) for evidence from the United States.
[32] See Tarr (2012).
[33] See EBRD (2012b).

Reform of political institutions at the local and regional level offers a potential solution to this dilemma. The local business environment is particularly important for small and medium-sized enterprises (SMEs) and varies considerably within countries (as described previously). Local political institutions are critical to the quality of this environment. And, unlike at the national level, reform of local or regional institutions – for example, forcing local authorities into greater transparency – may be easier to achieve politically.

Russia offers an example of the importance of local and regional institutions for the success of economic reform. Between 2001 and 2004 several new laws limited business inspections, exempted many activities from licensing requirements and introduced a notification-based system for firm registration, eliminating the need to wait for authorisation from various government agencies. While this resulted in improvements, these differed widely across regions. Subsequent surveys found that, in some regions, firms were in fact inspected more frequently than was legally permitted, licences were still necessary for activities that were no longer subject to them and authorisation was still required from various agencies for firms to start operations.

Such anomalies occurred in those regions that had less transparent governance.[34] This suggests that governance reforms aimed at greater transparency and accountability at the local level could be a crucial complement to business environment reform at the national level.

A key instrument in achieving greater transparency is the media. Research suggests that independent media are a necessary safeguard against corruption, including at the local level. For example, there is evidence that the electoral effects of exposing corruption are stronger in places with local radio stations, and that the exposure of fraud improves corporate governance.[35] There is also evidence that social media can exert an important disciplining influence, both in local authorities and in state companies.[36] This suggests that social media may well become an important force supporting reform efforts in a wide range of political environments.

POLITICAL REFORM

In countries that are already democracies (even imperfect ones), there may be scope for top-down political reform. What kind of reform is needed will depend on the nature of the political problem. If the problem is unstable coalitions that give smaller parties, or the interest groups behind them, too much power, the answer may lie in a more presidential system or a less proportional electoral approach. Where there is a stalemate between two major groupings, with one blocking reform, there may be a need for wider proportional representation.

Estonia's creation of a pluralistic political system is one successful example of a power shift from president to parliament. A proportional electoral system with a 5 per cent threshold for parties' entry into parliament was implemented in the first few years of transition, preserving representation for minority parties. Also, the creation of a decentralised bargaining system between the state, employers and employees gave losers in the reform process a voice, without giving them the power to block the process entirely. Estonia's parliamentary democracy therefore helped to unite the population behind the early reform programme.[37]

The Kyrgyz Republic offers another example. In June 2010 the country adopted a new constitution introducing a parliamentary form of government and imposing an unusual limit preventing any one party from holding more than 65 of the 120 seats in parliament. While it is too early to assess how this political change will affect economic institutions, it will surely contribute to preventing abuse of power by any president or any party, which could undermine economic reform.

Electoral reform is clearly not a panacea. Political polarisation may emerge even in representative political systems. While proportional representation prevents the concentration of power in a single political party, the survival of strong former communist factions may produce strongly polarised political systems regardless of the electoral arrangements in place. For example, although Bulgaria uses proportional representation, it is one of the most polarised transition countries, as the Bulgarian Socialist Party (the successor to the pre-1989 Communist Party) is usually strongly represented in parliament.

Furthermore, it may be very hard to pursue electoral reform from a polarised starting point. That said, as the Kyrgyz example demonstrates, opportunities may arise where the balance of support for reform shifts in a new direction. It may be possible to lock in that support if leaders treat that moment as an opportunity to overhaul both political and economic institutions.

[34] See Yakovlev and Zhuravskaya (2011 and 2012).
[35] See Brunetti and Weder (2003), Ferraz and Finnan (2008) and Dyck et al. (2008).
[36] See Qin (2013) and Enikolopov et al. (2013).
[37] See Aslund and Dombrovskis (2011) for a comparison of Estonia and its Baltic neighbours.

Box 3.1
The legacy of former empires

For better or worse, empires and colonial powers may leave a long-lasting legacy in terms of economic and political institutions.

Ottoman rule, in particular, has had persistent negative effects on financial development and social norms relating to trust in south-eastern Europe.[38] Habsburg rule, in contrast, has had a positive legacy in terms of a lack of corruption.[39] Those areas of Poland that used to be under Prussian or Austrian rule tend to vote for more liberal parties today compared with areas that were once part of the Russian empire.[40] Such persistence could reflect the influence of long-lasting historical episodes on social norms, which have subsequently been transmitted from generation to generation.

Chart 3.1.1 shows how the EBRD transition indicators differ according to old imperial boundaries. The level of transition is markedly higher in countries that formed part of the Habsburg and Prussian empires compared with those that were under Ottoman and Russian control. However, a country's history does not tell the whole story. Within the boundaries of former empires there is considerable diversity across countries, as shown in Chart 3.1.2.

As discussed elsewhere in this chapter, this diversity may reflect other elements, such as initial factor endowments and their distribution in society.[41] But even then, inherited institutions or social norms might have continued to make their effects felt by modifying the way in which conditions at the beginning of the transition process shaped reform outcomes. For example, the failure of early privatisations is often attributed to control of the political process being seized by special interest groups which opposed reforms that would erode their rents. Yet their propensity, and ability, to oppose such reforms may have depended on the quality of contemporary economic institutions, whose foundations go back centuries.

A regression analysis was used to investigate this possibility with regard to natural resources. It transpires that the concentration of economic activity in the natural resource sector at the start of the transition process is not significantly associated with transition scores today for the transition region as a whole.[42] However, in the former Ottoman and Russian empires, this association is negative, significant and sizeable. On average, the effect of going from zero concentration in natural resources in 1989 to the average concentration for the sample, combined with Ottoman heritage, is associated with a reduction in the quality of economic institutions that is equivalent to the difference between the transition scores of Bulgaria and Estonia today. The combined effect of natural resource wealth and the legacy of the Russian empire is even larger.

On a more optimistic note, the same regressions suggest that although institutions are deeply rooted in history, they do change over time. This can be shown by repeating the analysis for different vintages of the EBRD transition indicators and plotting the effects of natural resource concentration over time for each empire. The gap between the average quality of institutions in the various former empires appears to be narrowing (see Chart 3.1.3).

Chart 3.1.1. EBRD transition indicators vary significantly across former empires

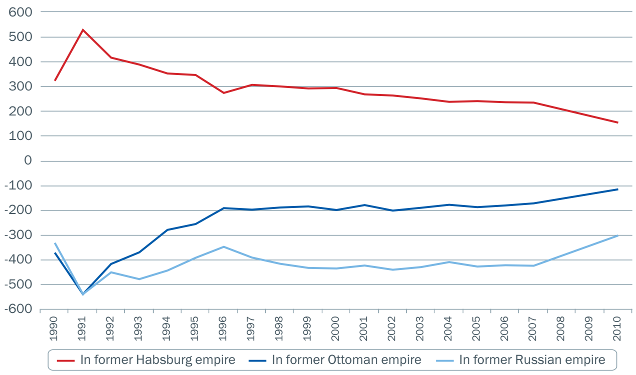
Source: EBRD and authors' calculations.
Note: The chart shows the sum of standardised individual scores for large-scale privatisation, small-scale privatisation, enterprise restructuring, price liberalisation, reform of the trade and foreign exchange system, competition policy and overall infrastructure reform. Standardised scores are obtained by subtracting the mean and dividing by the standard deviation.

[38] See Grosjean (2011a and 2011b).
[39] See Becker et al. (2011).
[40] See Grosfeld and Zhuravskaya (2013).
[41] See Engerman and Sokoloff (2000) for evidence for the Americas.
[42] The concentration of economic activity in natural resources in 1989 is measured by the self-reported shares of employment in mining based on the 2006 LiTS.

Chart 3.1.2. There are large variations in transition indicators within former empires

Source: LiTS (2006) and authors' calculations.
Note: See note on Chart 3.1.1.

Chart 3.1.3. The influence of history on transition indicators has declined over time



Source: LiTS (2006) and authors' calculations.
Note: The chart plots the estimated combined impact of the share of the population employed in mining in 1989 and the imperial legacy on the standardised transition indicators, based on coefficients from regressions estimated separately for every year between 1990 and 2006.

Box 3.2

Ethnic divisions in the Kyrgyz Republic

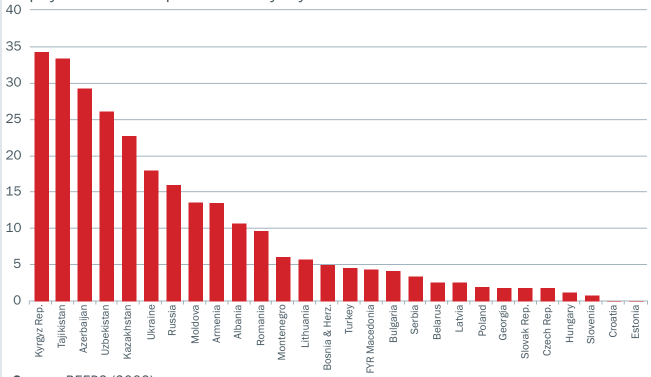
The Kyrgyz Republic was the first Central Asian country to adopt market-oriented reforms, proceeding faster and further than neighbouring countries with privatisation and the liberalisation of prices and foreign exchange. It joined the WTO in 1997, ahead of all of its neighbours – including China, which joined in 2001. As a result, the country scored higher than its Central Asian peers in terms of its average transition indicator score.

The Kyrgyz Republic has also generally been more democratic than all other Central Asian countries except Mongolia. In 2010 it adopted a new constitution introducing a parliamentary form of government. It is currently rated 7 on the Polity2 scale – at the same level as Georgia, and almost as high as the Czech Republic and Latvia.

However, neither early reform efforts nor democracy have so far translated into good economic institutions. With respect to governance, in particular, Kyrgyz economic institutions have generally performed significantly worse than its political institutions scores would have predicted. Petty corruption is considered pervasive. In fact, according to the BEEPS conducted in 2008-09, Kyrgyz businesses complained about this more than those of any other country covered by the survey (see Chart 3.2.1). This places a large burden on economic activity, particularly in a country where cross-border trade and SMEs dominate the economy.

Ethnic fractionalisation is greater in the Kyrgyz Republic than in any other country in the transition region for which data are available. This may have been a factor in both the Kyrgyz Republic's high level of democracy and its comparatively weak economic institutions. Ethnic divisions may have encouraged

Chart 3.2.1. Over one-third of Kyrgyz SMEs say that unofficial payments are required in everyday business



Source: BEEPS (2009).
Note: This chart shows the percentage of SMEs responding to the BEEPS survey who reported that unofficial payments were expected in everyday business situations.

the development of democratic institutions that are able to mediate between different interests, find compromises and build coalitions. At the same time, economic reform efforts have been frustrated by the divisions within Kyrgyz society.

Successive governments have lacked an economic reform and modernisation agenda that commands broad support. They have had to operate in an environment of political instability, exacerbated by ethnic tensions and regional divisions – primarily between the more industrialised north of the country and the more agrarian south. For example, reform of the business environment has taken a back seat to a row over an investment agreement governing the operations of Kumtor, a large foreign-owned gold mine. This issue has been much politicised by competing political parties amid rising nationalist sentiment over control of the country's resources.

Annex 3.1

A NEW DATASET ON THE CORPORATE GOVERNANCE OF BANKS

Table A.3.1.1 shows the main findings of an assessment of the corporate governance of banks in 16 countries in eastern Europe and Central Asia conducted by the EBRD's Legal Transition Team. The assessment focused mainly on internal corporate governance arrangements, particularly the role and composition of boards. It analysed the legal and regulatory framework, its implementation by supervisors and the practices developed by the systemically important banks in each country. All data relate to 2011.

The assessment was based on questionnaires completed by banks, regulators, banking associations and law firms, complemented by additional research on relevant legislation and banks' disclosures, as well as face-to-face interviews in some countries.

The table grades each aspect considered in the assessment using a colour system:

- dark green: fit for purpose and close to best practices;
- pale green: generally adequate, but would benefit from further reform;
- yellow: some positive elements, but in need of overall reform;
- red: needing significant reform.

Major shortcomings include a lack of transparency in succession and nomination processes, the unclear role of independent directors on boards and boards' committees, and the poor non-financial disclosure offered by banks.

A detailed description of the study and its findings will soon be presented by the EBRD.

Table A.3.1.1
Assessment of the corporate governance of banks

Issues	Albania	Armenia	Azerbaijan	Bosnia & Herz.	Bulgaria	Croatia	FYR Macedonia	Georgia	Hungary	Kazakhstan	Moldova	Romania	Russia	Serbia	Tajikistan	Turkey
The strategic and governance role of the board																
Strategic role of the board																
Does the legal framework establish a coherent governance system for banks?																
Do boards have a sufficiently active role in developing and approving the strategic objectives and the budgets of their banks?																
Do boards effectively review and evaluate management performance against agreed budgetary targets?																
Governance role of the board																
Do boards effectively shape the governance framework and corporate values throughout their organisation?																
Are boards of subsidiaries in a position to effectively control the operation of their banks?			n/a								n/a		n/a		n/a	n/a
Is there adequate transfer of good practice between parents and subsidiaries?			n/a								n/a		n/a		n/a	n/a
Boards' composition and functioning																
Size, composition and qualification																
Is the size of boards adequate?																
Is the board sufficiently independent from management and controlling shareholders?																
Are the duties of directors to their banks, shareholders and stakeholders clearly set out?																
Do boards provide adequate inductions and professional development to their members?																
Is the process for directors' succession and nomination sufficiently transparent?																
Functioning and evaluation																
Are the responsibilities, powers and terms of reference of boards and boards' committees clearly defined and documented?																
Are boards and boards' committees supported by a senior company secretary?																
Do boards evaluate their performance and discuss the outcomes of such evaluation?																
Risk governance																
Are boards and their risk committees sufficiently involved in setting the risk appetite and monitoring the risk profile of banks?																
Do banks appoint and empower senior chief risk officers?																
Do senior executives have a sufficiently integrated firm-wide perspective on risk?																
Are boards in a position to effectively review risk management?																
Internal control																
Internal control framework																
Does the organisational structure of banks include clearly defined and segregated duties for key officers and effective delegation of authority?																
Are there enough checks and balances to ensure the independence and integrity of financial reporting?																
Are conflicts of interest (including related party transactions) effectively managed?																
Have banks established effective and independent internal audit departments?																
Do banks establish effective compliance departments to ensure that they comply with regulatory obligations?																
Do boards and their audit committees effectively oversee and regularly review the effectiveness of the internal control systems?																
Audit committee																
Do boards establish audit committees?																
Are audit committees fully independent?																
Do audit committees include at least one member with substantial auditing or accounting experience?																
External auditor																
Is external auditor independence upheld by boards and their audit committees?																
Incentives and compensation																
Remuneration policy																
Do boards and their remuneration committees have a sufficient role in shaping the compensation systems of their banks?																
Is remuneration meritocratic and linked to firm and individual performance?																
Is senior executive compensation aligned with prudent risk management?																
Transparency																
IFRS																
Is IFRS required by law or regulation?																
Corporate governance reporting																
Do banks report regularly on corporate governance matters?																
Do banks publish key governance information on their websites?																
Do listed banks report and explain their compliance with a corporate governance code?	n/a		n/a							n/a					n/a	
Is disclosure proportionate to the size, complexity, ownership structures and risk profiles of banks?																

Source: EBRD survey of corporate governance of banks.
Note: Colours correspond to the degree of compliance with the best practice. ■ Dark green corresponds to practices that are fit for purpose; ■ pale green indicates practices where some reform is needed; ■ yellow indicates practices that contain some elements of best practice but are in need of overall reform; ■ red corresponds to practices that are in need of significant reform.

Annex 3.2

Table A.3.2.1
Sources and definitions of variables for cross-country regressions

Variable	Source	Description
WGI average	World Bank, 2012	Average of four Worldwide Governance Indicators: rule of law, government effectiveness, control of corruption and regulatory quality. Each index is on a scale of -2.5 (lowest rank) to 2.5 (highest rank).
Distance to the frontier	World Bank, 2013	This measures an economy's distance to the frontier on a scale of 0 to 100, where 0 represents the lowest performance and 100 denotes the frontier (that is to say, the most business-friendly regulations) in the *Doing Business* report.
Transition indicator average	EBRD, 2013	Average of six country-level transition indicators (large-scale privatisation, small-scale privatisation, enterprise restructuring, price liberalisation, reform of the trade and foreign exchange system, and competition policy). The measurement scale for the indicators ranges from 1 to 4.33, where 1 represents little or no change relative to a rigid centrally planned economy and 4.33 represents the standards of an industrialised market economy.
Polity2	Polity IV, 2013	The "Polity score" captures a regime's level of democratisation on a 21-point scale ranging from -10 to +10, where +10 denotes the highest score for democratisation.
Natural resources	EBRD calculations, based on WTO data	Mining as a percentage of exports.
Trade openness	EBRD calculations	Trade openness is structurally adjusted following the adjusted trade intensity approach used by Pritchett (1996). Values in the sample range from -1.2 to 3.4.
Financial openness	Chinn-Ito index	Index measuring a country's degree of capital account openness. The index ranges from -1.86 to 2.44.
Income	Penn World Tables 8.0	Log of GDP per capita in 2005 US dollars at purchasing power parity.
Ethnic fractionalisation	Wacziarg et al., 2012	Measures the probability that two randomly selected individuals in a given community belong to different ethnic groups.
Distance from the equator	CEPII	Absolute latitude.
Landlocked	CEPII	Dummy variable.
Ruggedness	Nunn and Puga, 2012	This index quantifies topographic heterogeneity (small-scale irregularities) in a country. Values in the sample range from 0 to 6.2.
State antiquity index	Chanda and Putterman, 2007	The state antiquity index (version 3) measures the extent of each country's experience with nationhood and is based on the following criteria for each country: (1) the existence of a government at the tribal level; (2) whether the government is local or foreign-based; (3) how much of the territory of the modern country was ruled by this government.
Majoritarian system	Comparative Political Dataset II	Discrete variable that takes the following values: 0 - proportional representation; 1 - parallel system (the chamber is elected using both majoritarian and proportional representation systems, and each is allocated a fixed number of seats); 1 - compensatory system; 1 - modified proportional representation; 2 - majoritarian system.
Presidential system	Comparative Political Dataset II	Discrete variable that takes the following values: 0 - parliamentary system; 1 - semi-presidential system, dominated by parliament; 2 - semi-presidential system, dominated by president; 3 - presidential system; 4 - other system.
Polarisation index	Frye, 2010	Political polarisation is defined on the basis of the number of seats in parliament held by the largest opposition party.

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