Institutional Regression in Transition Economies

Playing ‘Follow the Leader’ During the Global Financial Crisis

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Executive Summary

Property rights, the judiciary, financial sector oversight agencies, and banking sector institutions have seen deteriorating quality and protections within the United States and the older countries of the European Union over the past five years. Given that many transition economies attempted to approximate Western (specifically EU) institutions during their transition, are they now aping the general decline in market-friendly institutions in the so-called "developed" world?

From 1989–2005, the countries of Central and Eastern Europe saw impressive gains in both their political and economic institutions during their transition to capitalism, while those in the former Soviet Union (excluding the Baltics) lagged behind in institutional development. Only in property rights did the transition countries need to improve their institutional bases overall; Estonia and many of the Balkan countries led the way in improving the protection of private property. The former Soviet countries, dominated by a single-party or single-person system and a lack of political plurality, also saw little political change.

However, for the majority of the transition economies of Central and Eastern Europe and the former Soviet Union, the progress made in institutional transformations during the first decade and a half of transition appears to have stalled or even regressed with the onset of the global financial crisis in 2007 and 2008. Democratic accountability in the former Soviet Union has fallen from already-low levels, while the impartiality of the judicial system has degraded across all sub-regions of the transition economies, including Central, Eastern, and Southern Europe, as well as the former Soviet Union.

Economic institutions have also seen a fall from their 2006 heights, although, again, the effects have been strongest in the former Soviet Union. In contrast to the Commonwealth of Independent States (CIS), the countries of Central, Eastern, and Southern Europe (CESE) have not seen widespread economic institutional degradation, with the exception of property rights in Hungary and Slovenia. Uniformly, however, across the CIS and the CESE countries, financial sector institutions have demonstrably regressed during this crisis period, following in the footsteps of the developed world.

The effects of the drop in institutional quality from 2006 onward have been felt in both growth and foreign direct investment. In particular, the slide in property rights shows significant negative effects on growth, while countries that have continued to develop in terms of property rights and democratic accountability have seen positive growth changes. Foreign direct investment (FDI) also increased more in countries with better property rights and more democratic accountability.

The recommendations from this examination are clear: Policies that threaten the very institutions of the market economy are deleterious for growth and attracting investment. Among these crucial market institutions, property rights remain most in need of attention and nurturing: A focus on legislative independence for the judiciary, regulatory protection of property, administrative efficiency, and equality before the law would be a better use of scarce government resources. Financial reforms within the transition economies also need to be rethought, including the regression in financial sector institutions that has become precipitous in the past five years, in order to focus on needed liberalization and move away from higher taxation and property rights infringement.

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I. Introduction

Property rights, the judiciary, financial sector oversight agencies, and banking sector institutions have seen deteriorating quality and protections over the past five years, especially within the United States and the older countries of the European Union. Similarly, the progress made by the majority of the transition economies of Central and Eastern Europe and the former Soviet Union in terms of institutional transformations during the first decade and a half of transition appears to have stalled or even regressed with the onset of the global financial crisis in 2007 and 2008. Given that many transition economies attempted to approximate Western (specifically EU) institutions during their transition, are they now aping the general decline in market-friendly institutions in the so-called "developed" world?

This paper will examine the state of political and economic institutional development in 28 transition economies and attempt to discern which specific institutions, if any, have suffered the most over the past five years. The innovation of this analysis will be the use of institutional data on a monthly basis as well as annual. (Most subjective institutional indices are aggregated at the annual level.) This will provide practitioners with good, high-frequency lessons on the importance of various institutions and ways their policies can negatively or positively impact institutional development.

Moreover, we will track which countries in the transition space have seen the most institutional regression, while highlighting the countries that have weathered the institutional degradation that has characterized so many of the OECD and EU countries, focusing on Estonia and Poland in particular. Are there reasons institutional deterioration has occurred in certain countries? What are the root causes and policies behind the changes of the past five years, and are there commonalities across the various transition countries?

Finally, we will examine the effects of institutional regression with an eye to how institutional change has impacted economic growth and investment. Using a streamlined but rigorous model, we will ascertain whether movements in institutional quality since the onset of the global financial crisis have impacted the real economy in transition countries. We anticipate that certain political institutions such as accountability and economic institutions such as property rights will have the biggest effects.

The rest of our paper proceeds as follows: Section II will review the types of institutions (political and economic) that have evolved over the course of the transitional period, while Section III will describe the evolution of institutions within the transition economies over both the first decade and the past five years. Section IV will analyze what institutional regression means for the real economies of transition countries, while Section V concludes with some policy recommendations.

II. Institutions in Transition

What is an 'institution?'

Some have defined institutions as "the rules of the game" or, in the more comprehensive words of Nobel Laureate Douglass North, "a set of rules, compliance procedures, and moral and ethical behavioral norms designed to constrain the behavior of individuals in the interests of maximizing the wealth or utility of principals."[1] Expanding this definition, we can also say:

In countries with poor contract enforcement, there is little incentive to enter the system; thus, activities are conducted mainly on a cash basis

Institutions are a set of rules, constraints, and behavioral guidelines, enforced by either formal or informal means external to the individual, which are designed or which arise to shape the behavior of individual actors.[2]

Thus, institutions are commonly classified in three categories:

- Political: Pertaining to distribution of political power, including arrangements such as type of government (democratic, authoritarian), presence of a constitution, or type and distribution of power across branches of government.
- Economic: Influencing and mediating economic outcomes, pertaining to distribution of resources. Economic institutions can be further categorized as "market-creating" or "market-dampening" institutions, depending upon their intended consequences (with property rights being an example of market-creating institutions and taxation an example of market-dampening).
- Social: Institutions not explicitly concerned with political power or economic incentives but geared toward behavior and norms outside these spheres (the most influential of these being religion, which may have a political or economic component but is more concerned with the intangible).

For the purposes of this paper, we will mainly examine economic institutions, but we will also focus somewhat on political institutions where appropriate, to track the progress (or regression) of transition economies.[3]

Quantifying institutions and data

The next challenge we face is how to successfully quantify institutional development in order to compare and track institutional changes across transition economies. This paper will use both subjective and objective indicators to give a complete picture of institutional development over the global financial crisis period[4]. A complete list of indicators used in this paper is shown in Table A1 in the Appendix and includes commonly cited indices of institutional quality, such as those from the International Country Risk Guide (ICRG), and the Polity IV political institutions database. For the most part, these indicators are annual, although some ICRG rankings are available monthly. These particular institutions are included based on previous work showing their significance in the transition context, and while this is by no means an exhaustive list, these indicators were found to be more relevant

1 D. North, 1981, Structure and Change in Economic History. New York: Norton & Co.
2 This definition takes into account the fact that some institutions are "created" while others "evolve." This is not the forum to debate this distinction, but we should note here that, while more evolutionary institutions can take longer to change, this is not always the case; property rights are seen as an evolutionary institution, but they were wiped out virtually overnight in the Bolshevik Revolution.
3 The omission of social institutions is based on the simple fact that social institutions tend to be even more immutable than economic or political ones, and 5 years is far too short a timeframe to see major social changes in the transition economies studied here. For example, 96% of Poles identify as Catholic, a number that has showed little change over the past decade.
4 "Subjective" indicators are, as the name implies, based on the subjective evaluation of experts, investor surveys, or other proprietary methodology that relies on judgment to rate the quality or efficiency of an institution. In contrast to these indicators are "objective" measures, generally a macro- or micro-economic statistic that serves as a proxy for the institution being studied. Both have flaws related to bias (subjective) or imprecision in coverage (objective), and it is thus common to use both objective and subjective indicators in examining institutions.

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since the transition served to form these fundamental components of a market economy rather than more advanced institutions.

Additionally, this report uses a relatively novel measure for property rights called contract-intensive money, which tracks the amount of money outside formal financial institutions as a percentage of all of the money in circulation. This measure is a proxy for property rights, in that under a system with perfect property rights, we would expect to see much higher percentages of money being held within the system rather than outside it. Conversely, in countries with poor contract enforcement, there is little incentive to enter the system; thus, activities are conducted mainly on a cash basis. This indicator should therefore give a complementary view of institutional development in transition, along with the indicators noted above.

III. What Has Regressed Over the Past Five Years

The track record of institutions in transition: 1989–2006

Transition was never, at its heart, merely about economic growth or increased investment. The true end goal of economic transition was a large-scale and systemic change of institutions from those that facilitated a planned, communist economy to those suitable for a market economy

Assessing the record of institutional changes in transition is beyond the scope of this report, but a brief overview of the early years of transition will suffice to set the stage. Given that the communist countries of the former Soviet Union (FSU) and Central, Eastern, and Southeastern Europe (CESE) began their transition with little to no formal capitalist institutions, a large hurdle had to be surmounted in a short period of time in order to grow a functioning market economy. Transition was never, at its heart, merely about economic growth or increased investment. The true end goal of economic transition was a large-scale and systemic change of institutions from those that facilitated a planned, communist economy to those suitable for a market economy. The experiment that occurred in the countries of the FSU and CESE over the past 20 years was precisely such an attempt to garner better economic outcomes via systemic change, jettisoning institutions that in some countries had been in place for decades.

Contrary to the many commentators who claimed that "institutions were neglected" in the transition to market,[5] for the most part, the challenge of institutional change was accepted and surmounted by many of the countries within the region. This does not mean that disparities were absent, however, as the countries of Central and Eastern Europe proceeded furthest and those of the former Soviet Union lagged somewhat behind in both political and economic institutions. Political institutions showed this disparity perhaps most clearly: Figure I depicts the level of "executive constraints," as defined by the Polity IV database, in each transition country in 2006, with a level of 1 being little to no constraint and 7 designating the highest checks on executive power. Central Asian countries, many of which kept the same leadership as in Soviet times, showed almost no executive constraints (see Box 1); while every CESE country save Serbia had the highest level of constraints on the scale. Similarly, the ICRG's "bureaucratic quality" index, rated on a scale of 1 to 4, measures whether a country's bureaucracy is insulated from political pressure and has its own internal mechanisms for recruitment and training. In regard to transition economies (Table I), bureaucratic quality in 2006 was medium to high for CESE countries (although still needing improvement in many countries) and uniformly low for FSU countries.[6]

As Figure II shows, disparities in institutional change were also pronounced among economic institutions, especially large-scale privatization, bank and financial sector reform, and property rights. Large-scale privatization proceeded at different paces over this time frame, with the CESE countries making the greatest strides and the FSU countries making little progress but still pushing forward. This reality was the same for financial sector reform, although the gap between Central and Eastern Europe and Southern Europe was less pronounced, while the movement of banking changes in the FSU was substantially slower.

Only in property rights has there been some merit to the "institutions were neglected" argument, as most governments across the transition

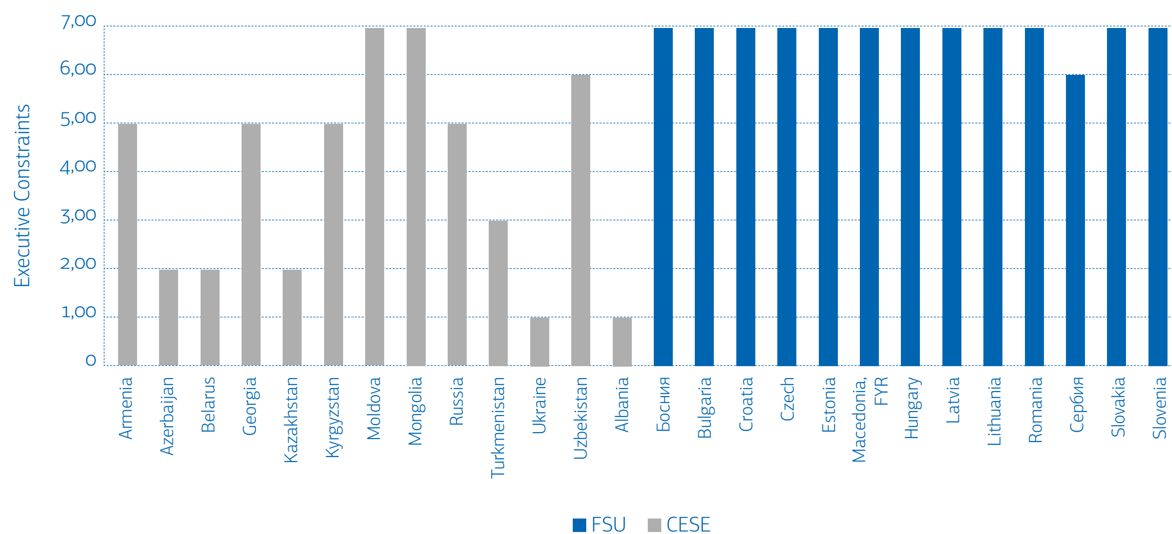
5 See especially G. Kołodko, "Ten Years of Post-Socialist Transition Lessons for Policy Reform," World Bank Policy Research Working Paper No. 2095 (April 1999) for an encapsulation of this argument.

6 As noted above, the ICRG indices suffer from lack of coverage of all transition economies.

Box 1. Lack of Political Transition in Central Asia

While the rest of the transition economies have seen political changes, ranging from the normal parliamentary elections in Poland and the Czech Republic to the family dynasty in Azerbaijan, the Central Asian countries of Turkmenistan, Tajikistan, Uzbekistan, Kazakhstan, and Kyrgyzstan have been stubbornly resistant to any change of leadership.
Kyrgyzstan has had the most changes of executive over 1989-2012, but this has been mainly due to political instability: Askar Akayev took over the reins in Bishkek immediately before the Soviet Union fell and remained in power until the 2005 "Tulip Revolution," but his successor Kurmanbek Bakiyev met a similar fate and was ousted in popular protests and riots in 2010. The political system was augmented to become a parliamentary, rather than presidential, democracy, but the Presidency is still the head of state and is directly elected. The current President, Almazbek Atambayev, was elected in December 2011.
Apart from Kyrgyzstan, Uzbekistan and Kazakhstan still have the leaders who were in place at the end of the Soviet Union, while Tajikistan has had Emomalii Rahmon as head of state since 1992 (President since 1994). Turkmenistan, one of the most repressive and least reformed countries on the globe, has only undergone a leadership change on the death of its "President for Life" Saparmurat Niyazov, also known as Turkmenbashi (or "Leader of All Turkmen"). However, his passing in 2006 did not lead to more freedom, and successor Gurbanguly Berdimuhamedov has continued with his predecessor's economic and political policies.

Figure 1. Level of Executive Constraints by Region, 2006



Source: Polity IV Database

countries installed systems of rights at the beginning of transition that slowly degraded. Indeed, the levels of property rights (measured in two separate ways) at the outset of transition varied widely among countries, with the CEE countries putting property rights in place at the beginning of transition at a high level and changing them very little, but, the FSU and Southern European countries putting in place much lower levels of property protection. As Figure II shows, property rights in the FSU declined from even these modest levels, meaning that perhaps more of a focus on private property was needed instead of the institutional development that governments concentrated on.[7]

Overwhelmingly, however, the picture has shown deterioration in property rights

The cumulative absolute progress of economic institutional change was also very different in 2006, as Figure III makes clear: According to the Heritage Foundation's Index of Property Rights (scaled from 0-100, with higher numbers representing more property rights), the levels of property rights were much higher in the CESE countries than in the former Soviet Union, with only Moldova having a rating of 50 in 2006 while most other FSU countries were at 30. More than half of the CESE countries were at 50 or above. Similarly, in 2006, the average rating of the EBRD's bank reform indicator was 3.42 for all CESE countries, while for those in the former Soviet Union, it was a mere 2.33 (corresponding to "significant liberalisation of interest rates and credit allocation; limited use of directed credit or interest rate ceiling" but falling short of Western prudential regulations, bank solvency laws, or

Table 1. Bureaucratic Quality in Transition Economies, 2006

Country	Bureaucratic Quality	Country	Bureaucratic Quality
CESE		FSU	
Albania	2,00	**Armenia**	1,00
Bulgaria	2,00	**Azerbaijan**	1,00
Croatia	3,00	**Belarus**	1,00
Czech	3,00	**Kazakhstan**	2,00
Estonia	2,50	**Moldova**	1,00
Hungary	3,00	**Mongolia**	2,00
Latvia	2,50	**Russia**	1,00
Lithuania	2,50	**Ukraine**	1,00
Poland	3,00		
Romania	1,00		
Сербия	2,00		
Slovakia	3,00		
Slovenia	3,00		
Average	2,50	**Average**	1,25

Source: ICRG Annual Index

7 Given the scaling differences between the absolute indicator changes and that of contract-intensive money, contract intensive money in Figure II is shown as a percentage change while the other indicators are absolute.

private sector involvement in the banking sector).[8] In short, institutions did change over the transitional period, but not at the same pace in every country, and uniformly slower in the former Soviet countries than in Central and Eastern Europe.

How have institutions evolved over the past five years?

As this brief examination showed, by January 2006, even the laggard transition countries had made progress in institutional reform. Having successfully undergone macroeconomic stabilization, after the Russian ruble crisis, the transition economies saw no major financial crises from 1999 onward, which helped create the conditions for further institutional development.

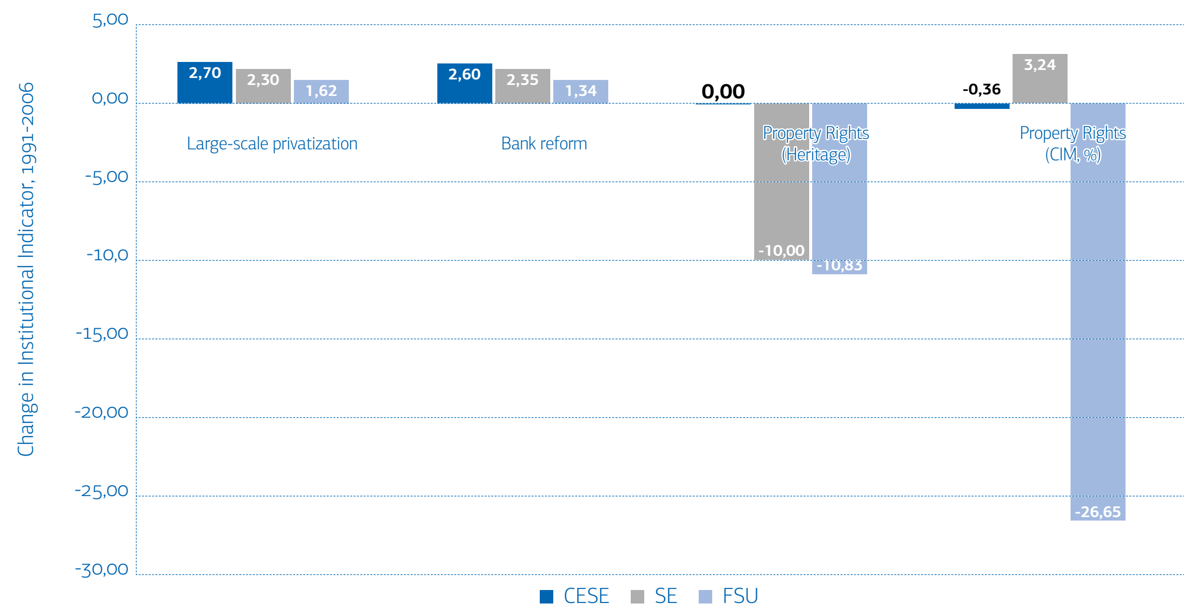
> Most interesting is the response of the Southern European countries: over the crisis period, they have increased their democratic accountability, driven mainly by changes in Albania. This demonstrates that during a financial crisis, democracy does not necessarily have to suffer

The transition countries were buoyed as well by economic growth in the advanced economies starting in 2001, after the dot-com crash, and this also helped to create a "zone of stability" that allowed these economies to further reform their major institutions without major disruption. Finally, institutions within the advanced economies were also moving in a more open and effective direction (Figure IV), giving transition economies a goal; indeed, for many transition economies, the institutions of the European Union were always to be emulated, in hopes of attaining accession to the EU.

By 2007, however, circumstances that impacted the institutional development of the transition economies had begun to change, both internally and externally. The enlargement of the EU in 2004, with its additional expansion in 2007, meant the attainment of a major goal for many transition economies; with some of these economies attempting to enter the Eurozone as well, institutional evolution could be expected to slow down.

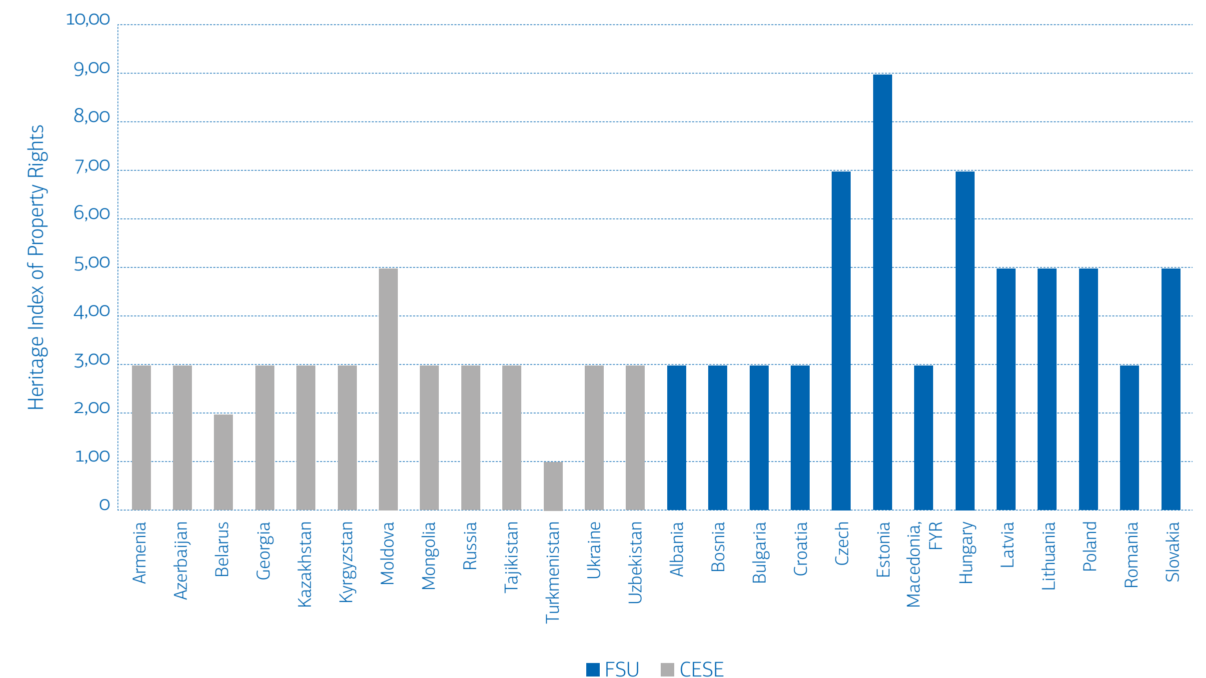
More threateningly, however, 2006 was also a high-water mark for the stability of the global economy, as the bubble that had grown in the advanced economies was starting to reach critical mass and burst in 2007, first in the US and then around the world. The Heritage Index of Economic Freedom values for the developed world shown in Figure IV began to decrease by 2008, losing an average of two points from 2008–2012 for developed Europe and 2.5 points—driven by declines in economic freedom in the United States—for North America. In particular, property rights have also decreased, again by 2.5 points in North America and 1.05 points for Europe. With the inception of the global financial crisis, the halcyon days of the early 2000s seemed to be long behind the transition economies (not to mention most of the advanced economies as well). Given these rapidly changing external and internal factors, how did institutions within the transition economies change? Was there a major institutional shift, or did evolution continue to proceed along its previous path?

Figure 2. Average Change in Institutional Quality by Region, 1991–2006



Source: Heritage Foundation, European Bank for Reconstruction and Development (EBRD) Transition Indicators, Author's Calculations

Figure 3. Heritage Index of Property Rights by Region, 2006



Source: Heritage Foundation Index of Economic Freedom

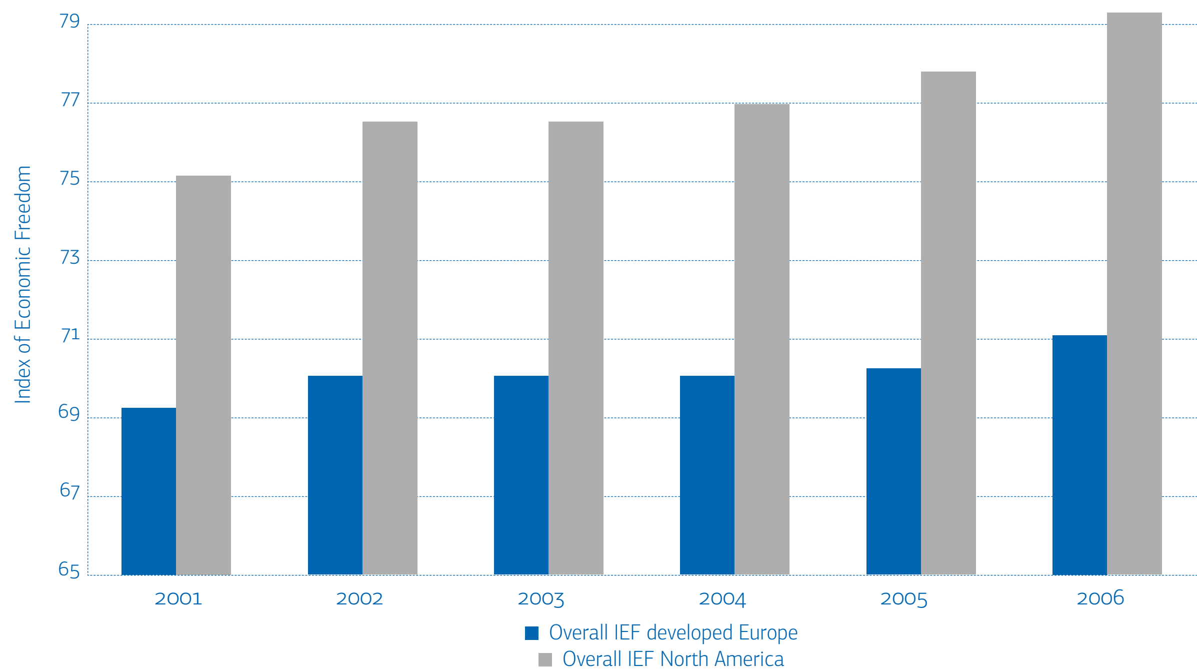
8 Wording taken from the EBRD website, http://www.ebrd.com/pages/research/economics/data/macro/ti_methodology.shtml. Accessed January 21, 2013.

As mentioned earlier, many institutional indicators are highly aggregated and available only at the annual level. The notable exception to this is the ICRG's risk indices, which can be obtained monthly and, for the most part, cover important economic institutions. While the coverage for the various ICRG sub-indices does not necessarily extend to all transition economies, it offers a valuable and high-frequency glimpse of institutional change in transition, and it will be the starting point for our examination of institutional change from 2007–2012.

Given the somewhat momentous shift in political structures during the 2000s, including the accession of many transition economies to the EU, we should expect to see changes in the political institutions of transition economies, although the direction of this change may not be immediately clear. Would EU accession improve the quality of political institutions in the affected countries, or did the hard work of institutional change occur before accession? Did the countries which were not part of either phase of EU enlargement see improvement or degradation of their political institutions? More importantly, with the global financial crisis continuing to batter economies, did the political landscape in all of these transition economies shift, in terms of their political institutions?

Our examination of political institutions in transition will begin with the ICRG's monthly rating of bureaucratic quality, which measures the professionalism and autonomy of the civil service from political pressures. As befitting an institution, the average bureaucratic quality across country groupings has not changed one iota since January 2007: The average rating for the CEE countries is 2.55, while for southern Europe (in reality, only Serbia and Croatia) is 2.50, with the FSU coming last at a paltry 1.25 out of

Figure 4. Index of Economic Freedom, Developed Europe and North America, 2001–2006



Source: Heritage Foundation Index of Economic Freedom. "Developed Europe" includes both EU countries and non-EU developed countries (Iceland, Norway, Switzerland, and Malta from 2001–2004), while "North America" refers to the US and Canada, excluding Mexico.

four points. Underneath these broader numbers is the reality that bureaucratic quality has not shifted at all during the global financial crisis; indeed, the real headline here may be that countries which did improve their bureaucratic quality during the early years of transition, such as Croatia and Hungary, have not seen improvements lately.

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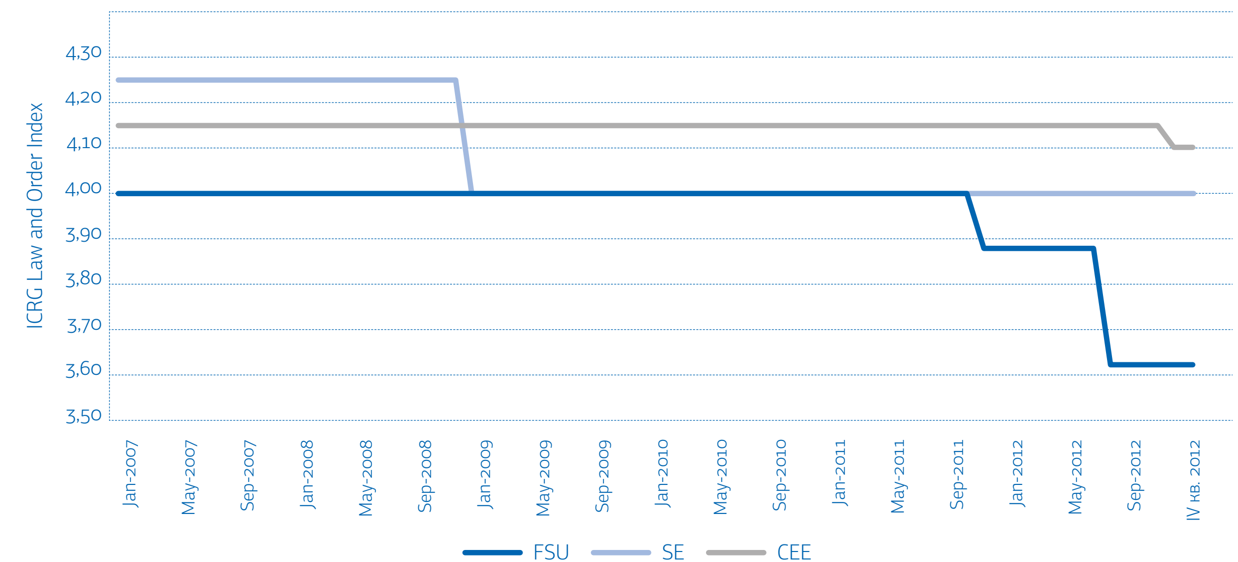
Similarly, the ICRG's "law and order" index measuring the strength and impartiality of the legal system has seen some degradation across all transition groupings (Figure V), albeit at discrete intervals. The former Soviet Union (driven mainly in this case by Russia, Belarus, and Kazakhstan) has seen the largest and most recent drop in its ranking; having weathered the worst of the global financial crisis, July 2011 saw a large fall in the impartiality of the judicial system due to rankings decreases for the three Eurasian Economic Union members. In Russia, high-profile cases involving alleged human rights abuses pushed the ranking lower, while Kazakhstan's rating change was attributed to internal changes in the administration of justice. It is unlikely that any of these measures can be directly attributable to the financial crisis.

Finally, an examination of the power distribution of a country will give perhaps the clearest picture of changing political institutions,

Figure 5. Average ICRG Law and Order Index, by Region, January 2007–August 2012



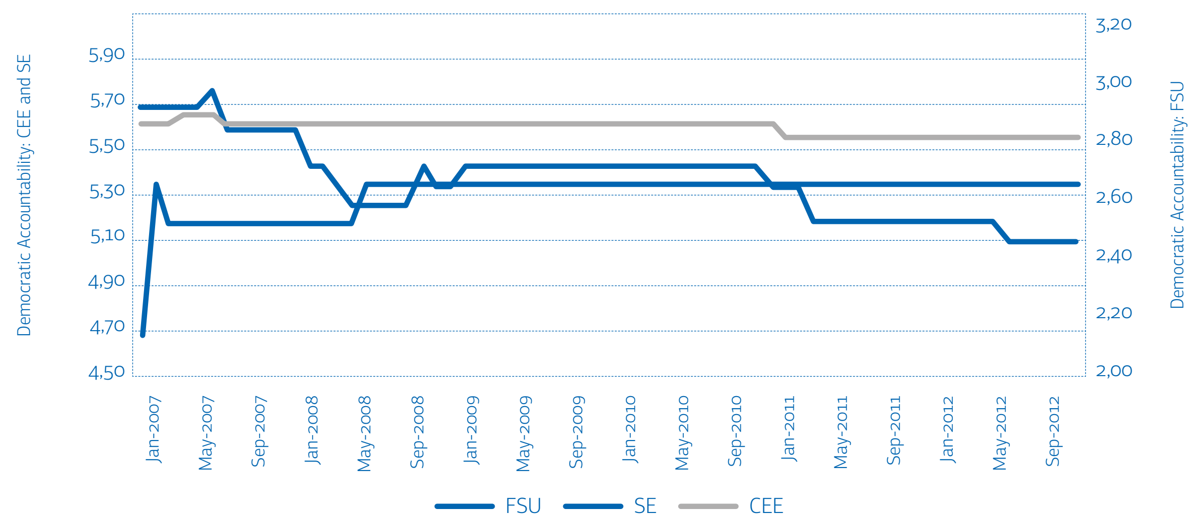
Source: ICRG Index, Author's Calculations

and for this, we use the ICRG's "democratic accountability" indicator. Scaled from 1 to 6, this measures how responsive government is to its people, with higher rankings corresponding to more democratic societies. As can be seen in Figure VI, the former Soviet Union is severely behind in this indicator across the board (shown on the right-hand axis, due to its mismatch in scale with other regions), and the crisis time of 2007–2012 has only led to more tightening of restrictions. The average for the FSU countries currently lies in the middle of the ICRG's distinction of "de facto" and "de jure" one-party states, and no country in the FSU ranked by the ICRG, apart from Ukraine, even scores higher than a 3 (de facto one-party state). Moreover, this ranking is much better than it could be—if the authoritarian states of Turkmenistan or Uzbekistan were included, along with the politically volatile states of Kyrgyzstan and Tajikistan, it is likely that the average rating would be much lower.

For the final word on the democratic accountability indicator, one only needs to compare the degradation (from an already low level) within the FSU to that of southern Europe and the Central and Eastern European countries. The CEE countries have seen a slow drift downward in accountability during the crisis period, an outcome that might be expected given the increasing involvement of the state in managing these economies through the recession. Most interesting is the response of the Southern European countries: over the crisis period, they have increased their democratic accountability, driven mainly by changes in Albania. This demonstrates that during a financial crisis, democracy does not necessarily have to suffer.

With only the exception of Hungary, which saw its property rights decline by five points from 2006 to 2012, every single loss of property rights occurred within the former Soviet Union, specifically among the members of the Commonwealth of Independent States (CIS)

Figure 6. Average Democratic Accountability, by Region, January 2007–August 2012



Source: ICRG Index, Author's Calculations

BOX 2 – Property Rights in Slovenia

Slovenia, one of the most successful of the former Yugoslav successor nations, has seen its institutional progression slow since entering the European Union in 2004, with substantial regression over the past 3 years. While political institutions have maintained their same high level, economic institutions have been increasingly degraded through policies meant, ironically, to stabilize the economy.

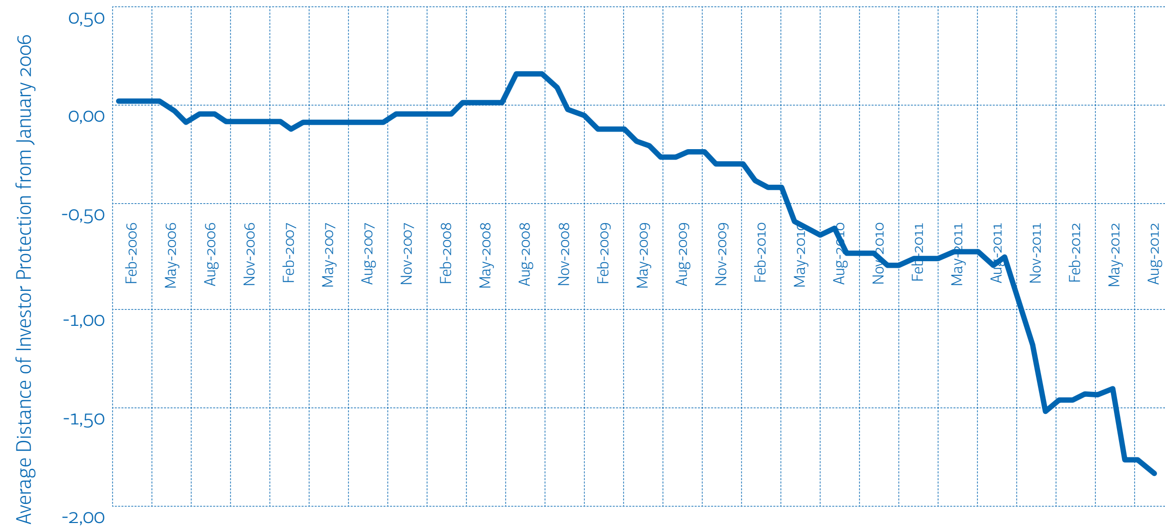
The most egregious policy was the passing of a bank tax in July 2011 equal to 0.1% of a bank's total assets, ostensibly designed to encourage banks to lend more to the non-financial sector (individual banks that expanded their loans by at least 5% on an annual basis are exempt from the tax). This levy, imposed on both Slovenian banks and EU banks operating within Slovenia, as the IMF pointed out in its December 2012 "financial stability review," actually "penalizes locally-owned banks, which have a larger share of liquid assets compared to foreign-owned banks."

Moreover, the tax led to large-scale capital flight from financial intermediation, as Slovenes who were in the formal sector and saving their money in banks decided that they had no need to subsidize imprudent behavior (or face a penalty). This translated into a steep drop in contract-intensive money, as well as declines in other international rankings: Slovenia now ranks 104th out of 185 countries on the World Bank Doing Business 2013 sub-indicator of "getting credit," and its ICRG investor profile has fallen to 7.50 from a high of 11 in 2007.

After political institutions, the first economic institutional indicator to examine is the ICRG's index of investor protection. Formerly known as "risk of expropriation," the investor profile number attempts to quantify property rights from a scale of 0 to 12, based on summation of three sub-components: contract viability/expropriation, profits repatriation, and payment delays. In order to see how this indicator has changed, we have constructed a distance variable for each country, showing the monthly change in the investor profile since January 2006. Figure VII shows the average distance in this rating for each month across all transition economies, and the results are not encouraging: With one brief exception, property rights have been trending downward, a trend that has accelerated since the beginning of 2010 and is showing no signs of letting up. There have been bright spots, as Belarus, which showed very little sign of institutional evolution in the 1990s, increased its property rights over the entire period, while Estonia and Kazakhstan both had gains in 2008 and 2009. Overwhelmingly, however, the picture has shown deterioration in property rights, typified by Bulgaria's four-point plunge in 2012 alone (from a near-perfect 11.5 in 2006 to 7.5 at the end of 2012) and Hungary and Slovenia's similar fall from a rating of 11 in 2006 to 7.5 in recent months.

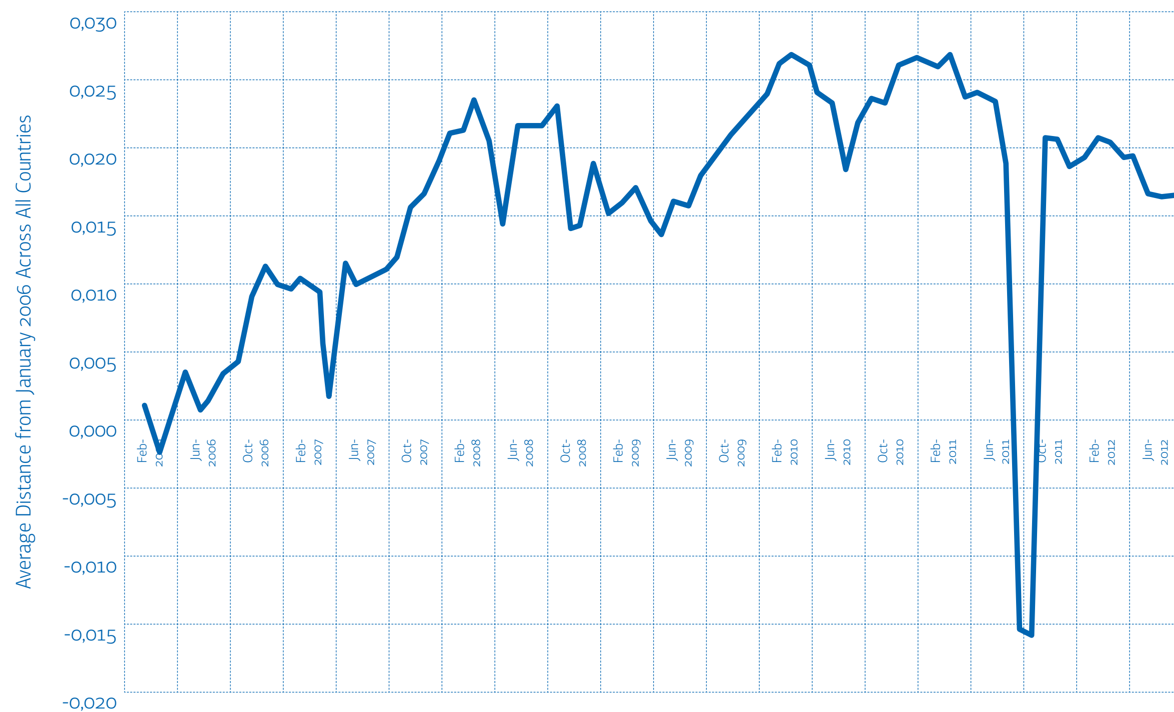
However, the ICRG indicators are subjective in that they rely on expert opinion or surveys to arrive at ratings, so as a robustness check, we also need to turn to an objective institutional indicator to trace the evolution of economic institutions in transition economies. The most important indicator is contract-intensive money, a proxy for both property rights and, in this context, the functioning of an individual country's financial sector. As Figure VIII shows, this indicator has shown some improvement over the past five years, with increases throughout 2007

Figure 7. Investor Protection Average Distance Since January 2006, All Countries



Source: ICRG Index, Author's Calculations

Figure 8. Contract-Intensive Money, Average Distance, From January 2006



Source: Author's Calculations from IMF and National Bank Data

counteracted by a decrease in 2008 and the beginning of 2009, followed by a rise throughout 2010. The one outlier, the incredibly steep decline shown in July–October 2011, is almost entirely attributable to Slovenia (Box 2); even without Slovenia, however, the trend in property rights peaked in early 2011 and has also been on a downward trajectory ever since, mirroring the drop in investor protection noted by the ICRG.

> Apart from Belarus, which was incredibly slow in its financial liberalization over the first two decades of transition and still has a low level of openness, every single transition country has either stagnated or retreated in its financial sector liberalization

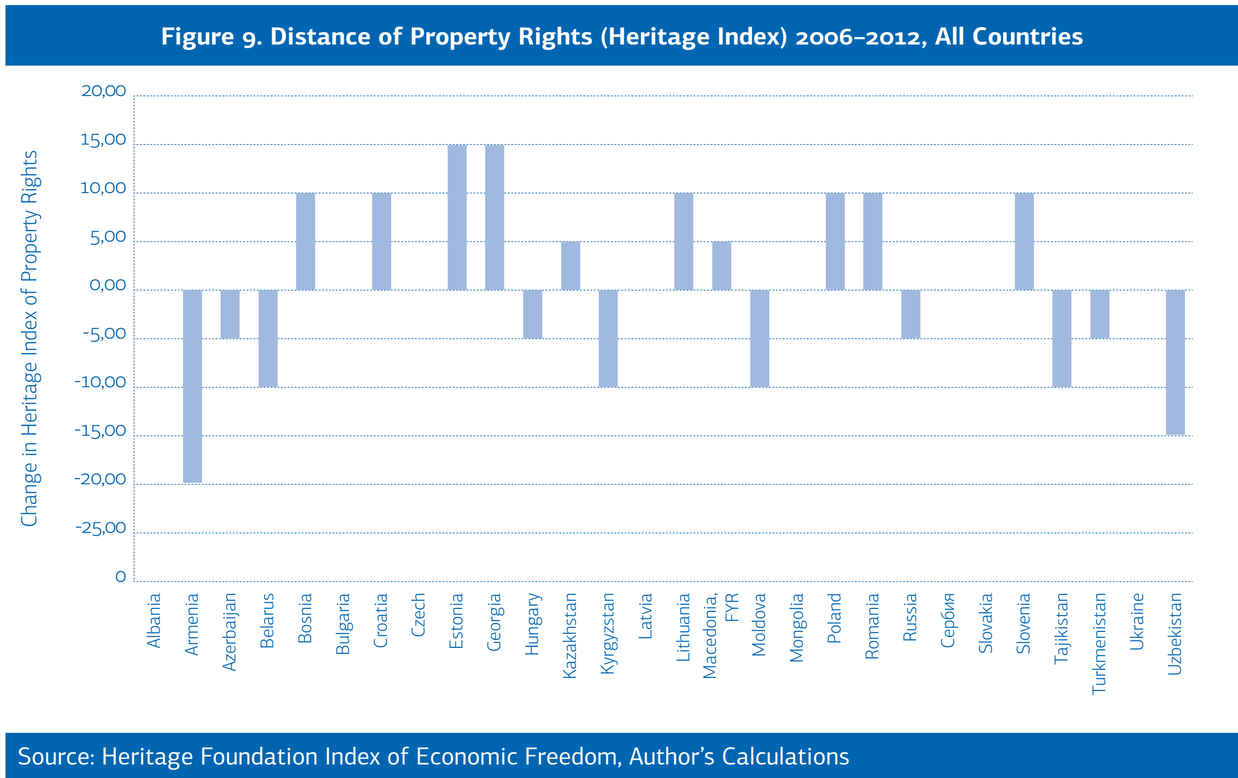
Finally, moving away from these high-frequency economic institutional indicators, the last subjective indicators to be examined are the annual reports from both the Heritage Foundation and the EBRD. Using a distance variable similar to the ICRG investor profile indicator above, measuring the change in property rights from 2006 to 2012, the Heritage Index of Property Rights in Figure IX shows that, by this rating system at least, many countries increased their property rights during the financial crisis. Moreover, the geographic dispersion of the changes could not be clearer: With only the exception of Hungary, which saw its property rights decline by five points from 2006 to 2012, every single loss of property rights occurred within the former Soviet Union, specifically among the members of the Commonwealth of Independent States (CIS).[9] Armenia saw the largest drop in property rights (due mainly to increased pressure from the executive on the judiciary), but every CIS member save Kazakhstan saw reductions in the protection of private property, even in repressive Turkmenistan (which went from an abysmal 10-point rating to a barely there five-point rating out of 100). While the Heritage numbers are highly aggregated, they comport with the monthly data showing increasing power of the state and low bureaucratic quality.

The transition economies have also benefited (at least in the data sense) from having the European Bank for Reconstruction and Development (EBRD) tracking the development of their institutions and policies. While the EBRD transition indicators have been criticized for their methodology in recent work, they remain a commonly used and valuable tool for comparing the relative evolution of institutions in transition.[10] This is especially true in relation to financial sector liberalization, which has generally been problematic to measure; indeed, the most commonly utilized objective measure, increases in bank credit, is strongly correlated with financial crises and may be more of a proxy for profligate monetary policy than financial depth. The "bank reform" index of the EBRD also shows more variability than other institutional indicators such as privatization; it has mostly been completed and reflects more of a sequencing of institutional change than an institutional stance per se.

Figure X shows the evolution of the EBRD bank reform index over the global financial crisis period for each country, measured as both the index value in 2012 and its change from the value in 2006. In financial sector development, there is no clear geographic pattern as with earlier institutions, nor is there any heartening trend. Apart from Belarus, which was incredibly slow in its financial liberalization over the first two decades of transition and still has a low level of openness, every single transition country has ei-

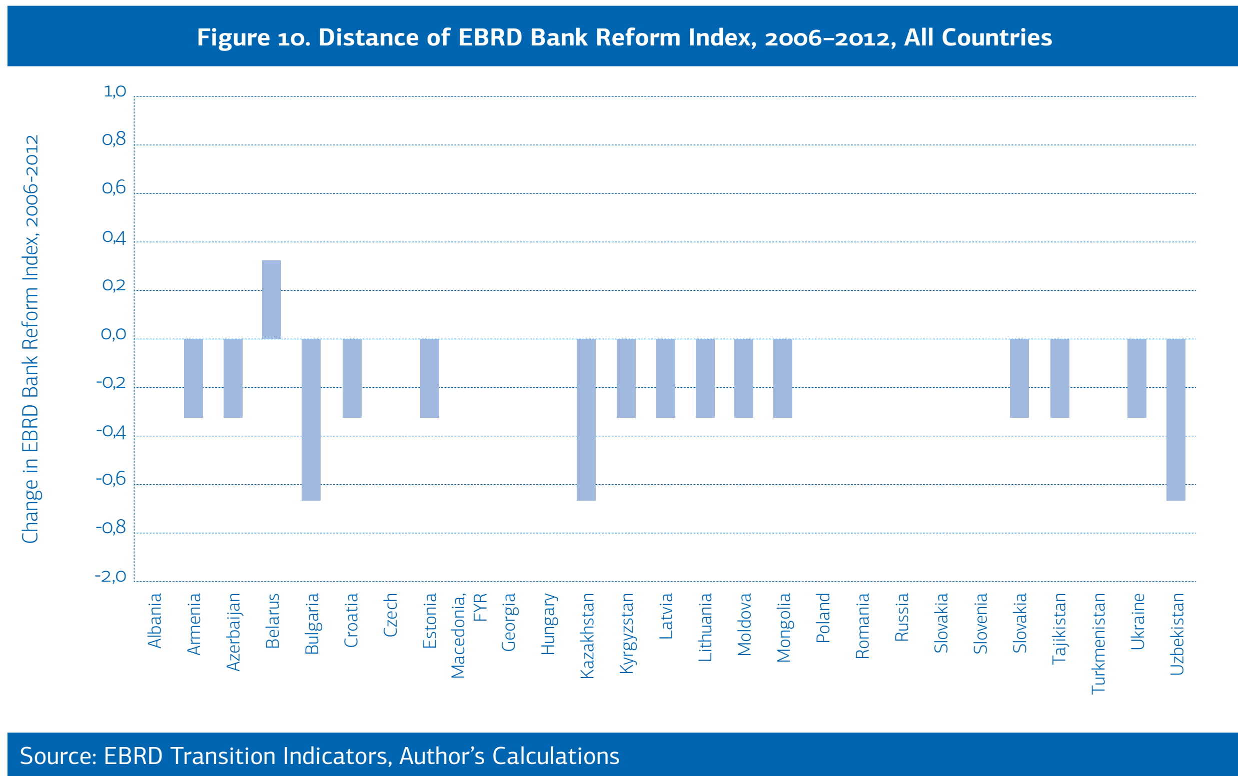
9 This distinction is used to single out the example of Georgia which has been undergoing a rapid institutional transformation. Georgia formally withdrew from the CIS in 2009 after its invasion by Russia.
10 See Campos, N., and R. Horvath, "Reform Redux: Measurement, Determinants and Growth Implications," European Journal of Political Economy, Vol. 28 No. 2 (2012) for a critique of the EBRD indicators.

Figure 9. Distance of Property Rights (Heritage Index) 2006–2012, All Countries



Source: Heritage Foundation Index of Economic Freedom, Author's Calculations

Figure 10. Distance of EBRD Bank Reform Index, 2006–2012, All Countries



Source: EBRD Transition Indicators, Author's Calculations

ther stagnated or retreated in its financial sector liberalization. Surprisingly (or not, given the Eurozone crisis), the largest drops have occurred in EU members, with Hungary and Bulgaria sharing the distinction of the furthest regression in their financial sector institutions. In this sense, the transition economies have indeed been following the lead set by the developed countries in the face of the global financial crisis, tightening their financial sectors instead of focusing on more and higher-quality liberalization.

IV. Has It Mattered?

Given this reality of institutional regression, especially in the CIS countries, has the change in institutions actually made a difference? In one sense, this is a facile question: Of course it has, there is no way that institutional change in countries that are still, in many ways, undergoing transition could not impact economic outcomes. The question is thus an attempt to quantify the changes that have occurred as a result of these institutional slippages. Previous work regarding the effects of institutional change showed that the distance a specific country's institutions traveled during transition indeed impacted the real economy, with property rights and executive constraints being the most important measures for increased growth, higher investment, and more savings. Has this relationship held throughout the global financial crisis? That is, did institutional regression have deleterious effects, much as institutional progression had beneficial ones?

> Positive changes in property rights lead to positive results in growth—or rather, to positive changes in the different rates of growth

In order to tackle the question of whether institutional change has impacted these economies, a simple yet rigorous methodology will be used, as shown in the technical appendix. This model postulates that economic metrics of success are a function of institutional change, prior period growth, the initial level of economically significant factors to capture convergence and country-specific effects, and standard macroeconomic controls from the literature.

The results of this examination are shown in Table A2.I in the Appendix. In Column I, we see the results of examining the incremental change of investor protection quarterly on the quarterly change in GDP growth, and the results are as expected: Positive changes in property rights lead to positive results in growth—or rather, to positive changes in the different rates of growth. Initial GDP and human capital played a small role over this short time frame, but investment and government size did, with both control variables negative and significant. This is to be expected for government size, but investment is a bit trickier, perhaps showing that fixed investments were hit very hard by the global financial crisis.

Column II repeats this analysis using the distance of democratic accountability over the first quarter of 2006, and the results also confirm that more democratic accountability over the period of 2007–2012 means better economic outcomes. However, these results are vitiated somewhat by a much lower number of observations, which is due to low coverage of investment and government shares at a quarterly pace from some of the poorer and more repressive countries, including Belarus, Azerbaijan, and the Central Asian states (except Kazakhstan). Indeed, given that the countries missing from this sample are also those that saw the greatest deterioration in democratic institutions, if more quarterly data were available, we should expect to see even stronger results.

Column III looks at the economic and political institutional development nexus from a slightly different perspective—what if the political institutional environment caused changes in the economic institutional environment? This is a plausible theoretical concept, and it can be tested for econometrically quite easily. Thus, in Column III, in addition to the instrumentation used for the previous two columns, the distance of property rights (proxied by contract-intensive money) is applied to the distance of democratic accountability. The results of this examination also show quite strongly that countries with improving political institutions saw improved economic institutions, and this paid off in terms of economic growth.[11]

11 There are, of course, many econometric extensions that could be made to this simple model; again, the point is not to engage in a lengthy econometric debate but rather to sketch the effect of institutional regression.

Finally, Columns IV through VI test another economic metric of success, net FDI inflows, to see if institutional change has had an effect. Given the difficulty in acquiring anything more frequent than annual data on FDI, there is a correspondingly much lower number of observations, but we may draw some conclusions. In the first instance, it appears that the countries that have traveled the farthest in democratic reforms have been penalized with much lower FDI net inflows (Column IV); the sign and magnitude of the distance in democratic accountability from 2006–2012 is the most significant among all explanatory possibilities. However, this effect could be due entirely to Russia, which has seen both its political institutions decline and the price of oil skyrocket, and sure enough, when correcting for this effect using a dummy for Russia (Column V), we see that democratic accountability (especially when affected by property rights) does have a positive influence on FDI. Finally, this result holds for property rights distance, albeit more muted, over this relatively short time frame.

The results of this examination also show quite strongly that countries with improving political institutions saw improved economic institutions, and this paid off in terms of economic growth

V. Conclusions

Most governments across the transition countries installed systems of rights at the beginning of transition that slowly degraded

This paper has looked at the extent of institutional regression in transition economies during the global financial crisis, concluding that institutional regression has indeed occurred but has been somewhat localized to the countries of the CIS. In particular, low levels of political institutional quality, including democratic accountability, degraded even further during the years of the global financial crisis; in many countries of the former Soviet Union, the political landscape is marginally better than it was during the days of the USSR. In regards to economic institutions, the CIS countries have also seen severe degradation of their property rights, which, admittedly, also started from a much lower level than in the other transition economies.

In contrast to the CIS, the countries of Central, Eastern, and Southern Europe have not seen widespread economic institutional degradation, with the exception of property rights in Hungary and Slovenia, and political institutions have remained at high levels. Where every geographic sub-region has seen deterioration, however, has been in the financial sector, with only one country in the entire transition space, Belarus, improving its financial institutions. Uniformly, across both the CIS and the CESE countries, financial sector institutions have demonstrably regressed during the financial crisis period, following in the footsteps of the developed world.

Our results confirmed that the drop in institutional quality from 2006 onward had a pronounced effect on both growth and foreign direct investment. This builds on previous work which showed that the transition countries that did not reform their institutions in the first instance saw worse economic outcomes than those that did; indeed, this paper shows that the effect can also run the other way, in that institutional regression can also negatively impact economic success. In particular, the slide in property rights, measured by contract-intensive money, showed significant negative effects on growth, while countries that continued to develop in terms of property rights and democratic accountability saw this reflected in positive growth changes. FDI also increased more in countries with better property rights and, controlling for Russia, more democratic accountability.

Of course, our model, while sound econometrically, may suffer conceptually from reverse causation: Did the severity of the recession and the effects of the global financial crisis lead to institutional deterioration, instead of institutional regression leading to worse economic outcomes? This would be a plausible explanation, if not for the experience of transition economies from 1991–2006, well before the global financial crisis, where some of the greatest institutional reforms came about precisely because of the steep output decline. Georgia saw drops of as much as 87% of its GDP in the recession yet is now one of the best-reformed countries, while the largest contraction Uzbekistan suffered was an 11% GDP drop in 1992, its first year of "independence." In fact, the countries that have seen the largest institutional deterioration are those which have attempted to manage transition the most, preserving many of their distortions so as to avoid large GDP contractions. This is doubly true of the least-democratic regimes, which need to avoid GDP volatility at the expense of higher standards of living in order to preserve regime power. Thus, in the transition context, it appears that the causality continues to run from institutional issues to economic outcomes, not so much in the other direction.

The recommendations from this examination are clear: Policies that threaten the very institutions of the market economy are deleterious for growth and attracting investment,

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unless there is a sizeable store of natural resources. This applies to both the development of the domestic market (decisions on how and where to invest, allocation of internal resources), as well as the attractiveness of a country to foreign investment (all things being equal, institutional deterioration can translate into higher risks for foreign investors). Among these crucial market institutions, property rights remain most in need of attention and nurturing: A focus on both legislative independence for the judiciary and regulatory protection of property and administrative efficiency (as well as equality before the law) would be a better use of scarce government resources, especially in the current constrained fiscal climate that governments face.

Institutions did change over the transitional period, but not at the same pace in every country, and uniformly slower in the former Soviet countries than in Central and Eastern Europe

Estonia can provide an illustrative example of where policymakers should focus their energies. Prior to the global financial crisis, even this free-market stalwart saw a gradual diminution of its property rights, driven mainly by an increase in government spending as part of its EU obligations. However, the completion of its long-simmering property restitution process, driven by claims of property loss during nationalization by the Soviet Union in the early 1940s, signaled a huge increase in the rights of landowners to dispose of property as they saw fit and eliminated the deadweight of unused or un-claimed property. Similar reforms in other transition economies, or even recognizing far-reaching ownership rights without the need for undergoing restitution, would also be welcome ways of improving property rights. As this examination shows, it would also translate to better economic outcomes.

Financial reforms also need to be rethought in the transition economies, including the regression in financial sector institutions that has become precipitous over the past five years. In particular, policies such as bank taxation in Slovenia and Hungary should be repealed, as they weaken the financial sector's ability to do its job without creating any additional oversight. In reality, the recent financial moves have been infringements on property rights (recent moves in Cyprus to tax deposit holders bear this out), a policy choice which we have shown to be harmful to growth and investment.

Poland, one of the few countries to weather the global financial crisis with its institutions fairly intact and growth resuming early on, can offer clues to continued financial sector development in transition and correct policy choices. Indeed, Poland's fiscal prudence before the financial crisis (and respect for property rights) meant that when financial disaster struck, the government was not in dire straits. This lack of a governmental budget crisis in Poland meant less need to attempt to ramp up revenue collection by killing the golden goose. In contrast, Hungary's financial sector regression was a direct result of its political institutions rather than economic institutional failings. In this sense, it seems that macroeconomic prudence led to the preservation of institutions in Poland, while macroeconomic profligacy in Hungary led to regression. We highly recommend that going forward, policymakers in these countries place less emphasis on securing higher government revenues via confiscatory taxation or pressure on businesses, which, after all, are privately owned, and more on basic stabilization. Poland has proved that a little prevention can go a long way toward protecting necessary institutions for growth.

Unfortunately, as we have seen here, protection of investors is lessening and infringements on property rights have been accelerating in transition economies since 2008. Even more unfortunate is that this is also the direction that much of the world has been taking since 2007. It appears that transition economies have indeed been following the leader.

Technical Appendix

In order to tackle the question of whether institutional change has impacted these economies, I fashioned a model based on prior research:

$$(1) \rightarrow \Delta Y_{it} = \psi \Delta INST_{it} + \beta MACRO_{it} + \delta INITIAL + \epsilon_{it}$$

where Y is either quarterly GDP growth over the same quarter last year (Columns I–III of Table A2) or net FDI inflows (Columns IV–VI).[12] Based on the number of observations, the institutional indicators will be narrowed down to property rights as represented by the change in the ICRG Investor Profile indicator or the distance in contract-intensive money and political institutions, as shown in the distance of the ICRG Democratic Accountability indicator. Given that institutional data can be found on a monthly basis but macroeconomic data cannot, the ICRG and contract-intensive money institutional indicators are aggregated in Stata, at their means, from monthly to quarterly data.

The macroeconomic controls utilized are standard in growth regressions and include quarterly fixed investment as a percentage of GDP and government share of the economy where available. Finally, the initial condition indicators are the growth rate of GDP in the first quarter of 2006 and the average level of secondary education in 2006 (as a proxy for human capital).

The specification of the parsimonious model of Equation 1 recognizes the problems inherent in this relatively small dataset. Given the all-pervasive nature of endogeneity in institutional examination, I use a system-generalized method of moments (GMM) estimation, working with lags to correct for econometric endogeneity. The system-GMM has been found to be particularly effective in controlling both for unobserved country-specific (fixed) effects and the potential endogeneity of all variables in the system, with little loss of observations, as well as allowing for inclusion of external instruments where necessary. We use lags of one calendar year as instruments in this examination, as institutional changes should take longer to work their way through to economic outcomes.

Table A1. Subjective Institutional Indicators

Political Institutions				Economic Institutions			
Institution	Proxy	Ranking System	Source	Institution	Proxy	Ranking System	Source
Executive Power and Abuse (II)	Democratic Accountability	1 to 6, higher scores are more democratic	ICRG	Property Rights (I)	Property Rights index	0-100, higher scores mean more property rights	Heritage Foundation
Effective Governance	Bureaucratic Quality	1 to 4, higher scores are more effective	ICRG	Property Rights (II)	Investor Protection Index	0 to 12, higher scores have more protection	ICRG
Independent Judiciary	Law and Order	1 to 6, higher scores mean a more impartial judiciary	ICRG	Financial Sector Institutions	EBRD Bank reform index	1 to 4.33, higher means more bank reform	EBRD

12 Change in quarterly growth rates is utilized as diagnostics showed the presence of non-stationarity in the series, a problem that can be corrected by differencing.

Table A2. Results of GMM Regressions Measuring Growth Versus Institutional Change

			Growth		FDI Net Inflows	
	1	2	3	4	5	6
Institutional Variables						
Δinvestor Protection	69,06					
	2,33*					
Democratic Accountability Distance		332,95		-7575,29	5469,97	
		2,38*		5,55**	2,20*	
Contract-intensive Money Distance			1627,80			59370,94
			2,25*			2,92**
Macro Variables						
Initial GDP	76,49	620,84	208,8	-9233,45	-1341,9	-2503,53
	1,53	2,14*	3,25**	3,34**	0,58	0,44
Fixed Investment as % of GDP	-8,96	-10,51	-4,67			
	3,96**	2,16*	2,15*			
Government as % of GDP	-12,94	-22,11	-6,23	303,55	-44,90	292,09
	2,66**	2,54**	1,20	2,93**	0,55	1,50
Secondary Enrollment in 2006	2,86	-18,56	-2,14	-13,94	116,55	-354,58
	1,08	1,47	0,63	0,11	1,08	1,64
Russia dummy					18215,33	
					3,08**	
n	283	130	276	191	191	183
Number of instruments	27	17	27	16	17	12
AR(2) (p)	0,72	0,31	0,994	0,172	0,172	0,161
Sargan test (p)	0,058	0,349	0,009	0,000	0,047	0,000
Hansen test (p)	0,954	1,000	0,970	0,995	0,994	0,530
Lags	4,8 collapse	4,8 collapse	4,8 collapse	4,8 collapse	4,8 collapse	4,8 collapse
Instruments	lags	lags	lags, Democratic Accountability Distance	lags	lags, Contract-intensive money Distance	lags

Note: Absolute values of t-stats are under the coefficients, with * signifying significance at the 10% level and ** at the 1% level. GMM system equations done with xtabond2 in Stata, with lags as shown in the table

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