

# Political economy of institutional reforms: Lessons from post-communist transition

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for Reconstruction and Development  
The usual disclaimer applies

# Political economy of institutional reforms

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1. Transition experience through the lens of political economy of reforms
  - Interactions of political and economic institutions
  - Inequality vs. inequality of opportunity
  - Governance, corruption and trust in institutions
  - Role of openness and external anchors
2. Implications for other reforming economies

## Transition as a comprehensive institutional change

- Replaces inefficient institutions hence should eventually raise living standards
- But involves major disruptions
  - And short-term costs may be unequally distributed

## Success stories

- Initial recession short-lived
- Reforms delivered broad-based income growth
- Democratic institutions consolidated
- International integration brought investment and competition

# What went wrong in other countries?

## Populist backlash

- Due to decline in living standards for the majority
  - ... and unfairness of the system

## Reversal of political and economic reforms

- Populists removed checks and balances and entrenched themselves
- Did not promote rule of law, openness and competition
  - In order to prevent empowerment of independent middle class

# The political economy of failed transition

## “Institutional economies of scale”

- Large businesses have disproportional access to courts and politicians  
... and disproportional access to the media

## Vicious circle of crony capitalism

- Access to courts, politicians and media results in rents in the oligarchs’ business empires
  - The rents are then reinvested into political influence
  - Oligarchs hence outperform firms without political connections
- Politicians use oligarchs’ contributions to deter political competition
  - Through bribing or censoring potential challengers

# Reformers' mistakes

## Indecisive and partial reforms

- Protracted transformational recession
- Increased rent-seeking opportunities

## Unfair distribution of burden of reforms

- Lack of social safety nets
- Delayed macro stabilization: disproportional burden of inflation on the poor and middle class

## Corruption

- Undermine credibility and legitimacy of reforms

## Lack of communication

- Should have produced realistic expectations
- Communicating the vision was easier for the EU accession countries

# Main lessons for reformers in developing and advanced economies

## Inclusion

- Compensate losers right away
  - "Short-term pain, long-term gain" scenario may fail
  - Populists take over and entrench themselves

## Fairness

- Level playing field, rule of law, equality of opportunity
- Integrity, transparency, and accountability

## Democratic institutions

- Prevent emergence of crony capitalism

## External anchors and openness

- Reinforce competition and commitment to reforms

## Communication

- Provides a clear vision of the reform path



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# Supporting evidence

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# Big picture: Empirical implications

## Cross-country differences

- Countries that build inclusive political institutions, also manage to reform
- Countries without democratic institutions end up with crony capitalism
- Strong correlation between democracy and economic reforms
- EU accession facilitates both political and economic reforms

## Within countries

- Burden of reforms: disproportionately on less skilled
- Corruption and inequality of opportunity reduce support for reforms
- In non-democratic countries
  - Oligarchs outperform others
  - Critical attitude to government among more skilled
  - Skilled also understand the presence of media capture and censorship

## Market reforms

- EBRD's Transition Indicators
- From 1 (command economy) to 4 or 4+ (market economy)

## Governance

- Average of four Worldwide Governance Indicators
  - Rule of law
  - Control of corruption
  - Government effectiveness
  - Regulatory quality
- Corruption experience from Life in Transition Survey (LITS)

## Democracy

- Polity score from Polity IV dataset

## Inequality of opportunity

- IoP: Part of inequality explained by exogenous factors (parental background, gender, place of birth, ethnicity, etc). Source: LITS.



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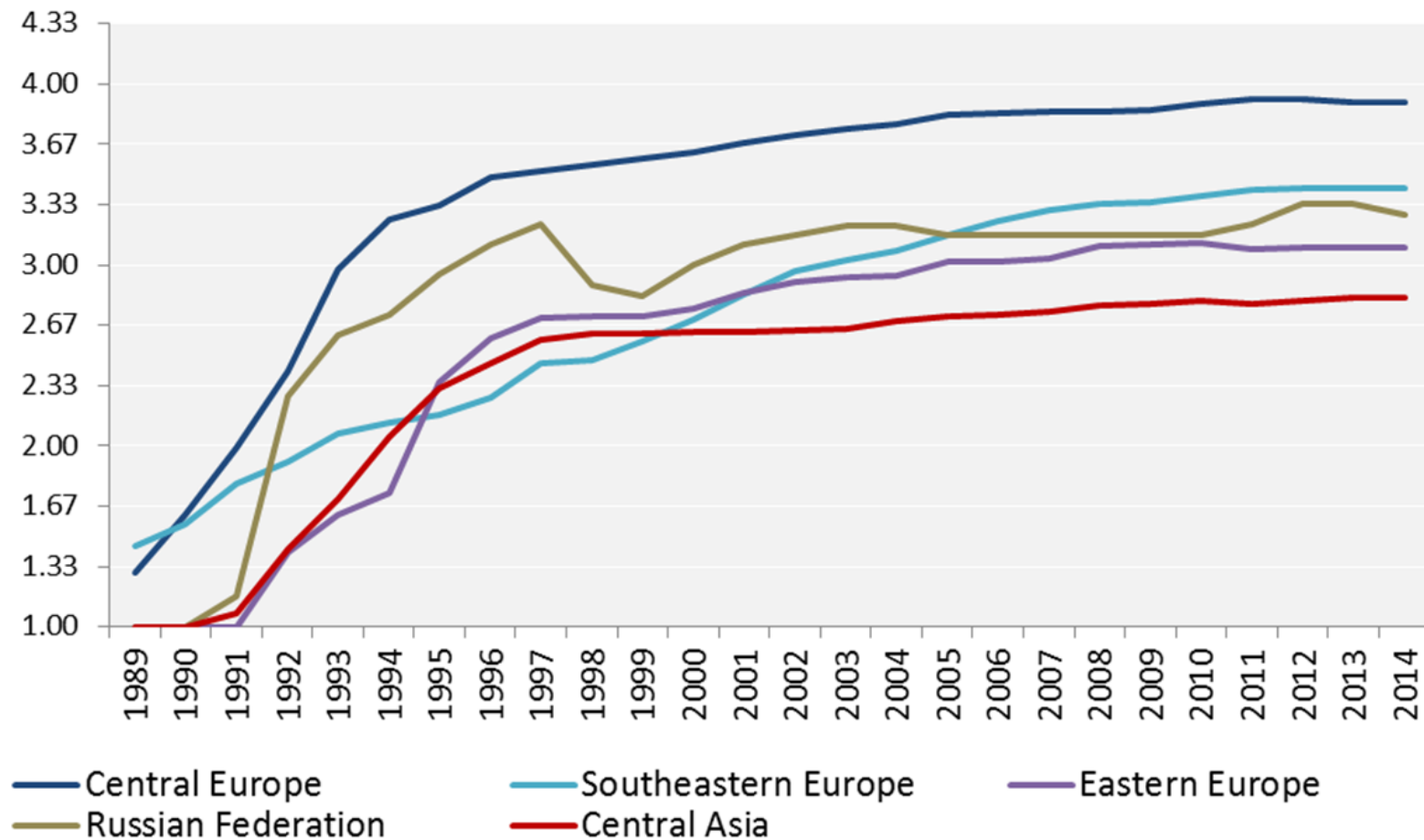
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Slowdown of reforms  
and decline of support  
for markets and democracy

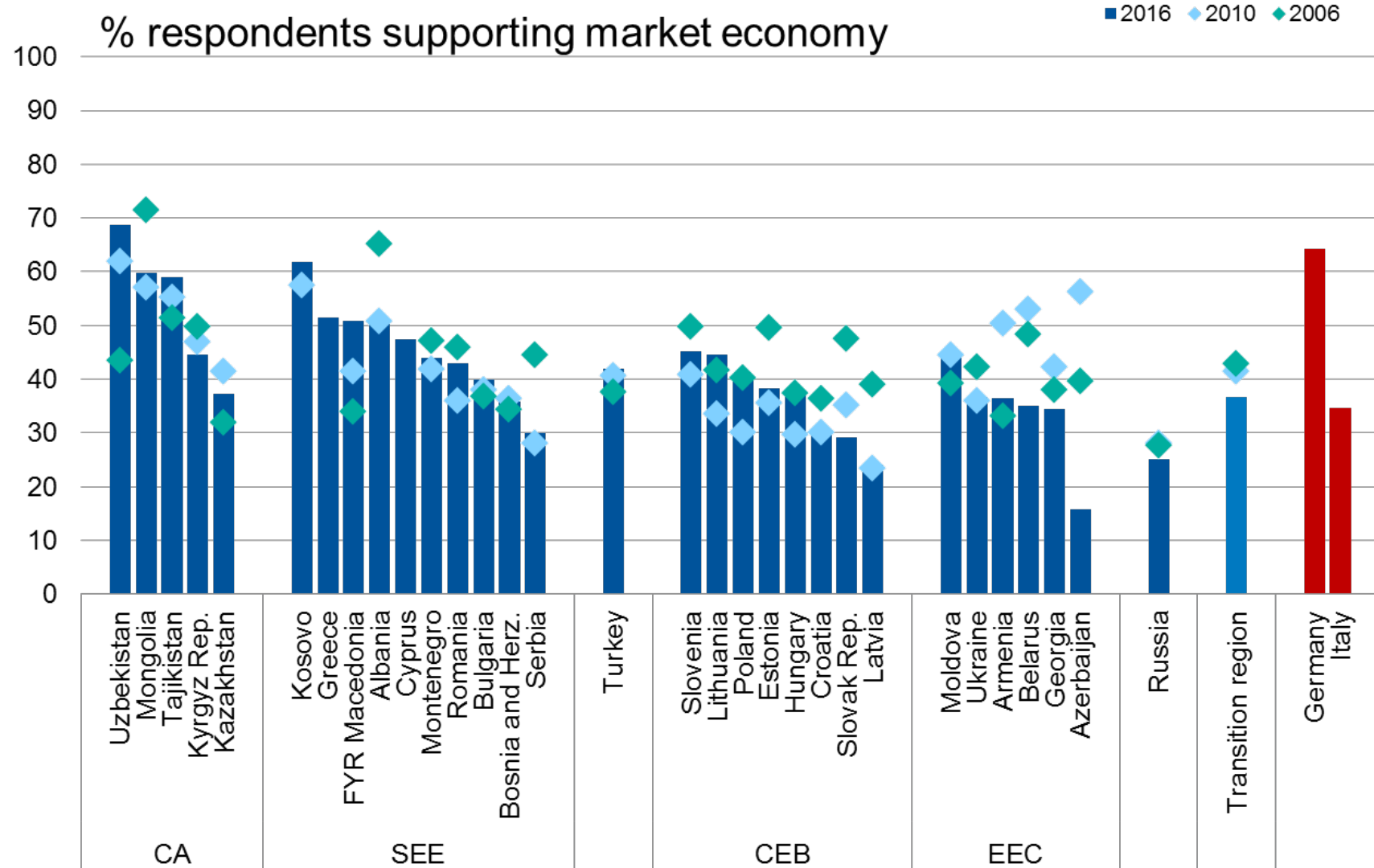
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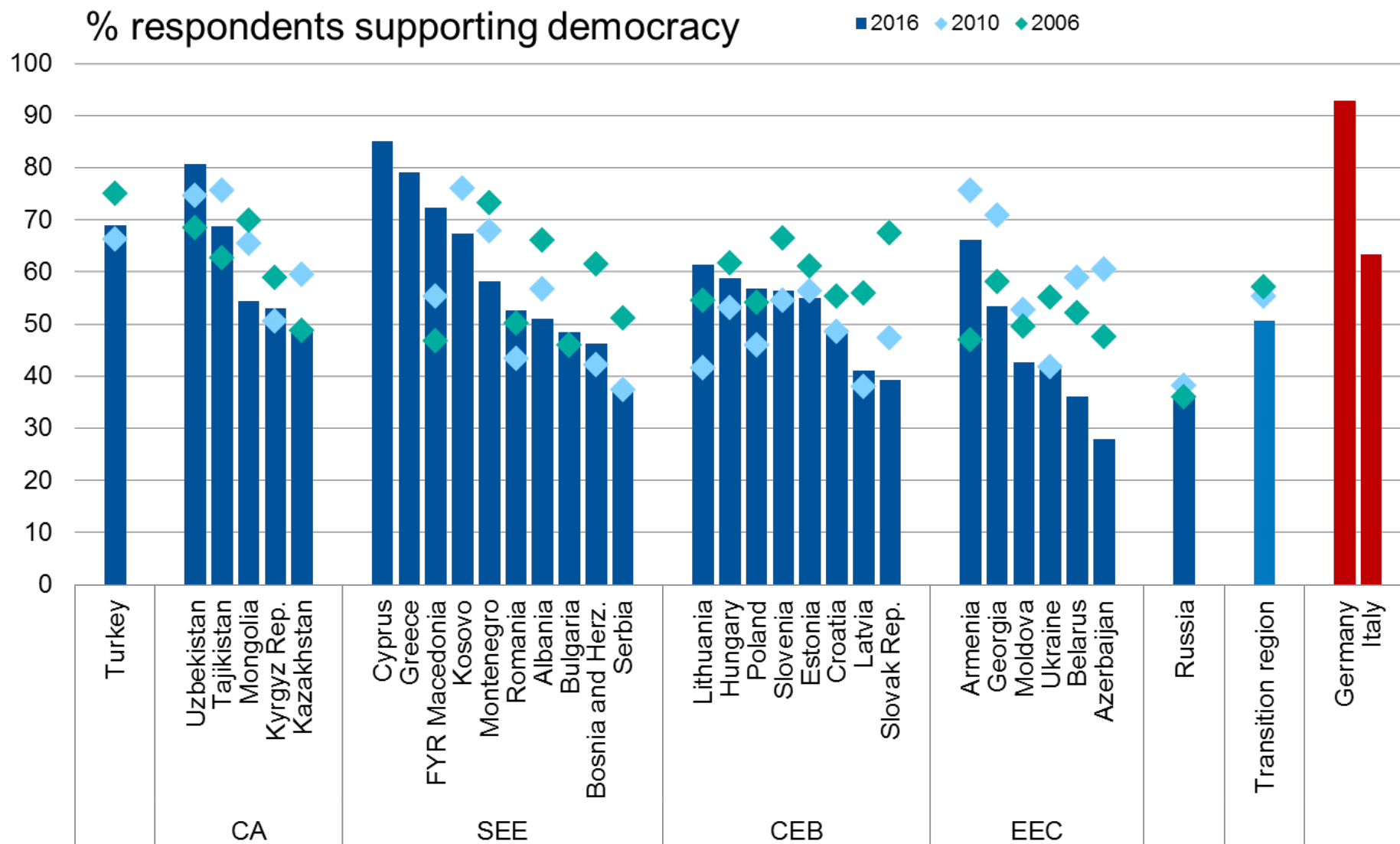
# In many countries reforms are stalled, in some even reversed

*Average of 6 country-level transition indicators*



# Support for reforms is low







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# Democracy and economic institutions

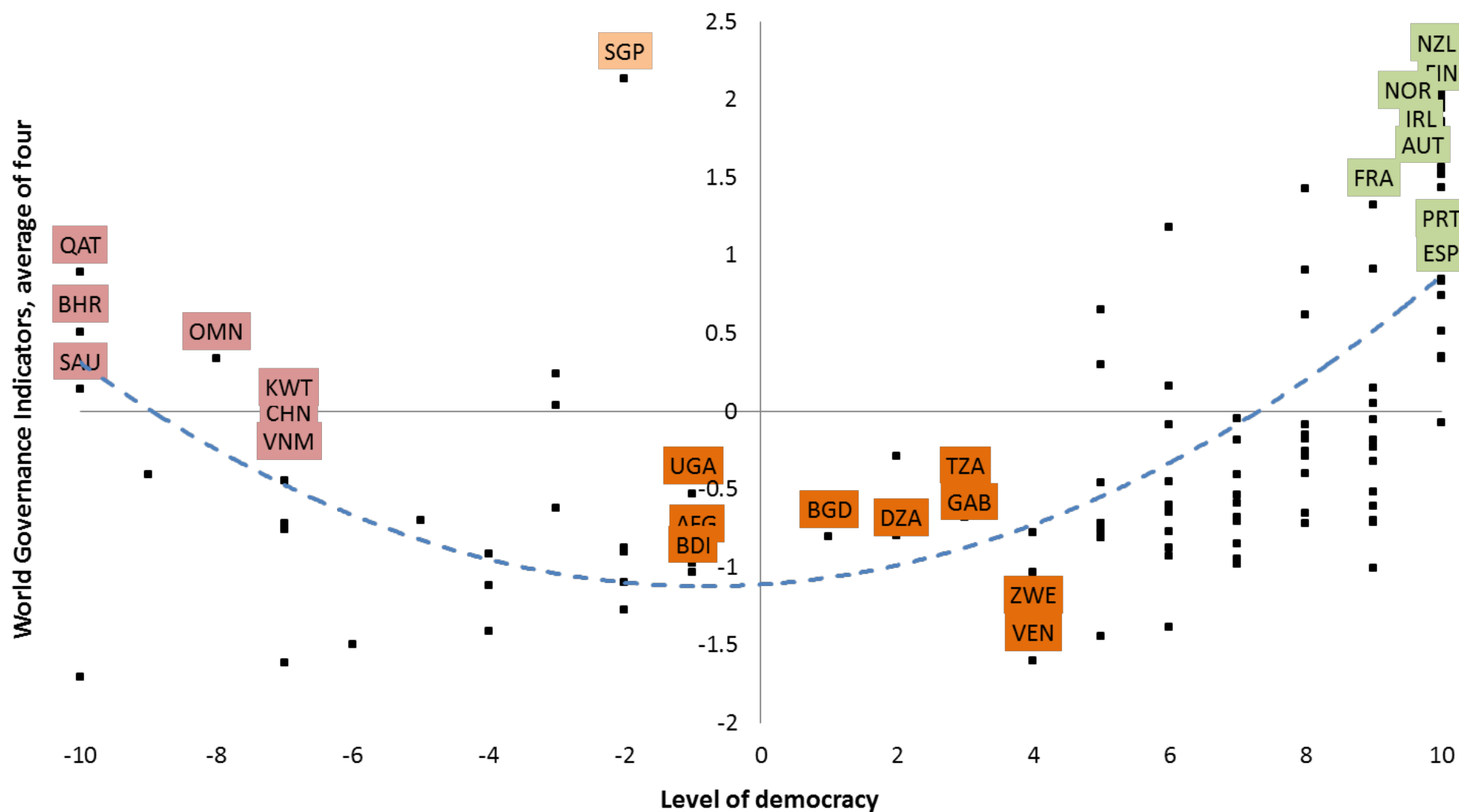
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# Economic institutions tend to be weak in non-EU transition countries



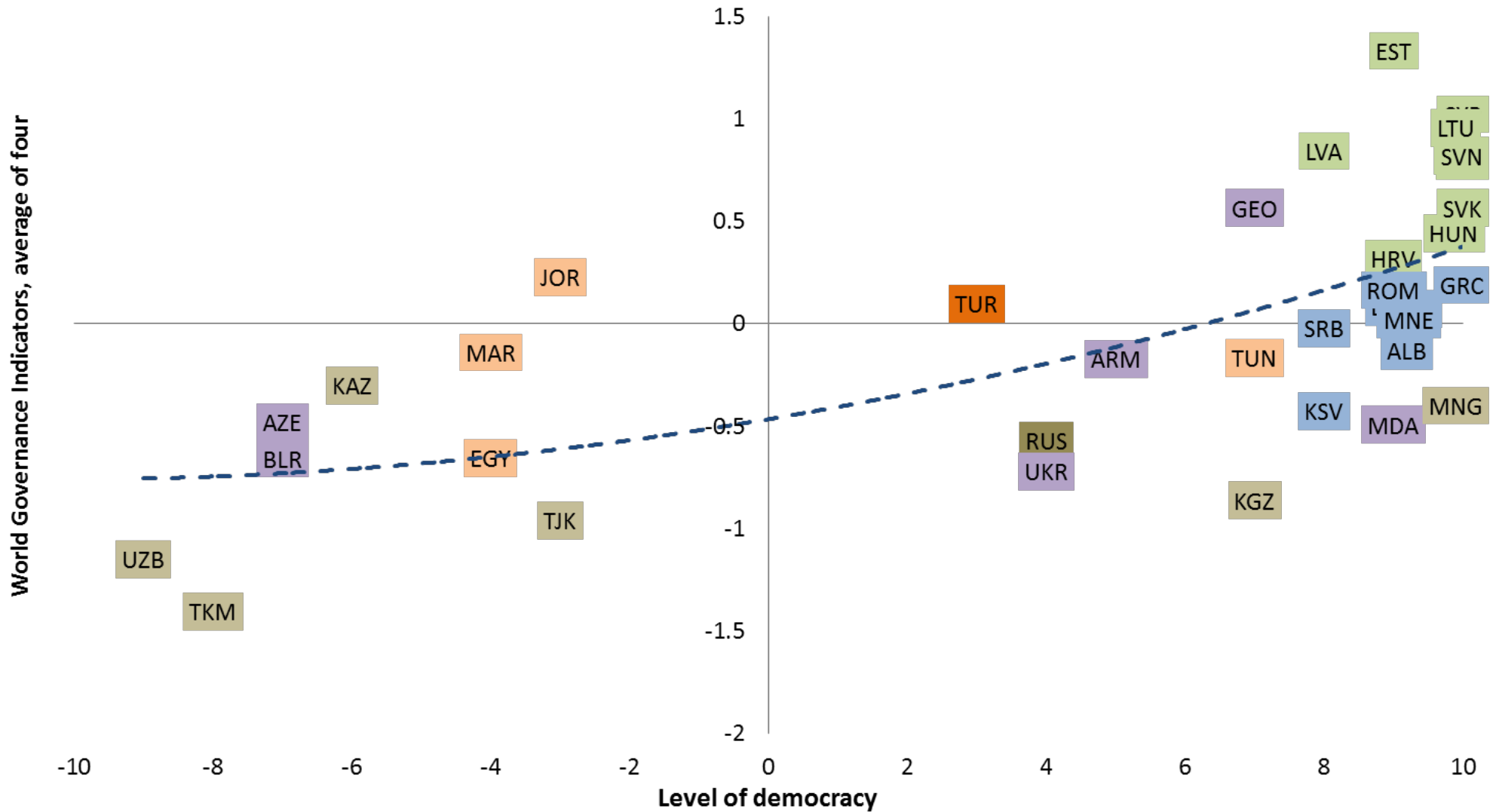


# Democracy and economic institutions around the world



Sources: Policy IV, World Governance Indicators. Based on 2015 data.

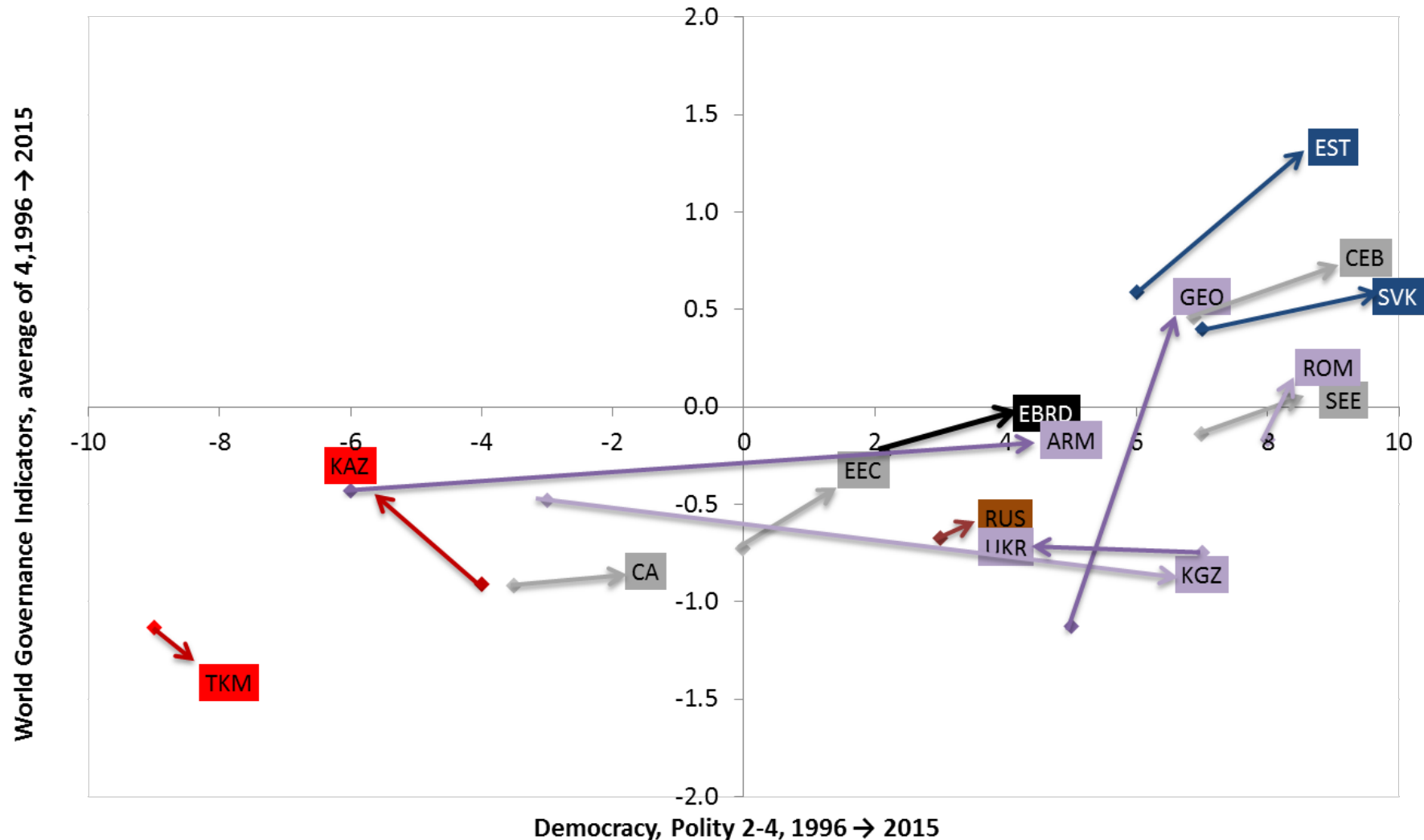
# Positive correlation in EBRD countries



Sources: Policy IV, World Governance Indicators. Based on 2015 data.

# Democratic and political change went hand in hand

Economic reforms can strengthen competition, weaken special interests, build constituencies for democracy



# Panel analysis of the determinants of economic institutions: positive effect of democracy and of openness

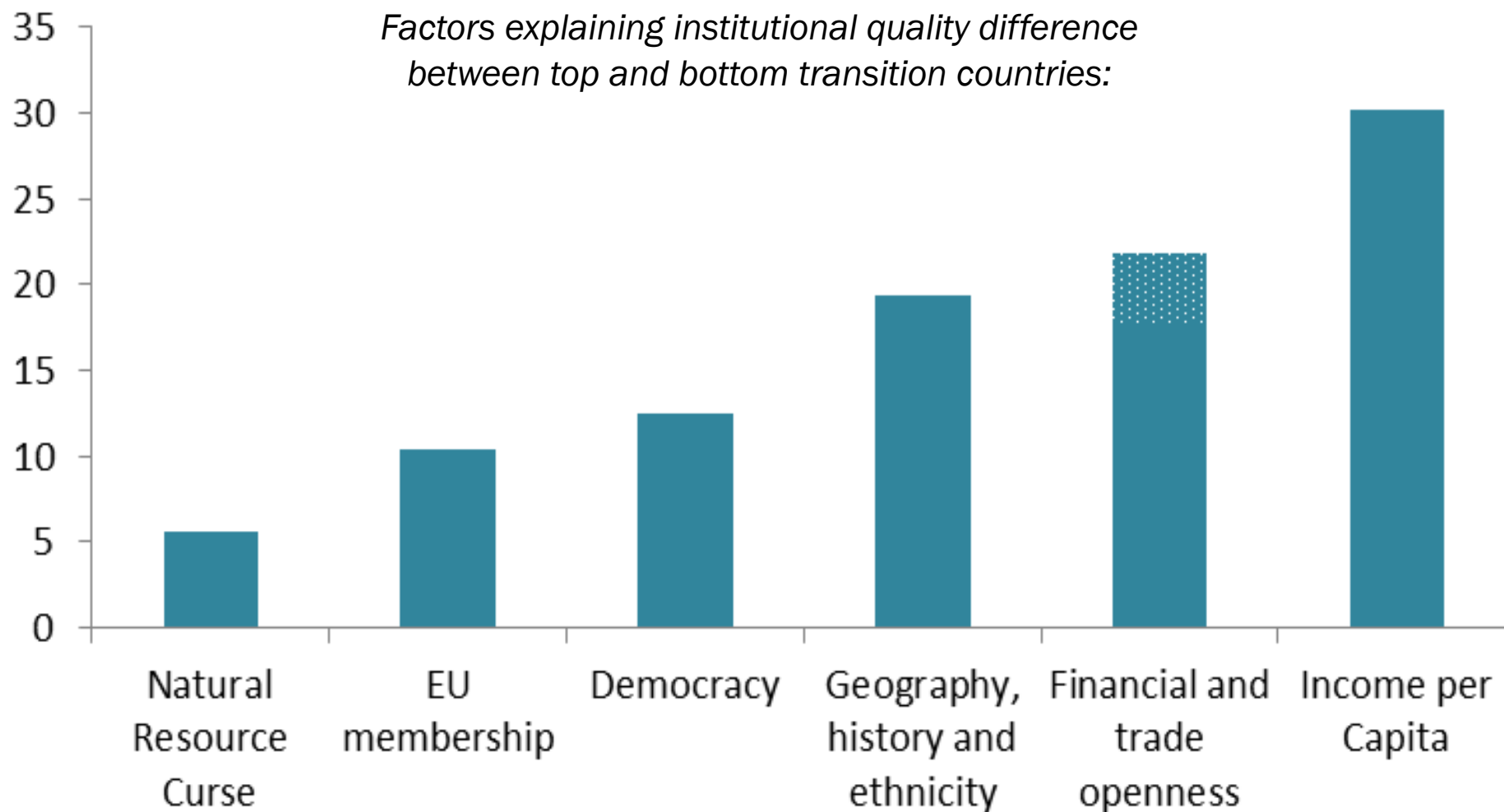


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Dependent Variable:	Average of 4 World Governance Indicators			continuation of the regression (left)			
	Panel OLS	Panel OLS	GMM		Panel OLS	Panel OLS	GMM
Polity2	0.0370*** (0.00396)	0.0433*** (0.00394)	0.00485* (0.00295)	Distance from the equator	0.0103*** (0.00184)	0.0109*** (0.00197)	
Transition country*Polity4	-0.0322*** (0.00714)			Landlocked	-0.0219 (0.0392)	-0.263*** (0.0452)	
Natural Resources	-0.361*** (0.0694)	-0.258*** (0.0763)	-0.151** (0.07)	Ruggedness	0.0137 (0.0156)	-0.00228 (0.0186)	
Transition country*Natural Resources	-0.620*** (0.157)			State antiquity index	0.00348*** (0.000653)	0.00471*** (0.0008)	
Trade Openness	0.267*** (0.0407)	0.419*** (0.0443)	-0.0233 (0.045)	EBRD country dummy	0.04 (0.151)		
Transition country*Trade Openness	-0.00925 (0.105)			EU membership	0.0254 (0.0713)	-0.0659 (0.0696)	
Financial Openness	0.539*** (0.0641)	0.881*** (0.0619)	0.00848 (0.0431)	Observations	710	710	612
Transition country*Financial Openness	0.0132 (0.0261)			Countries	177	177	177
Income	0.396*** (0.0235)		0.0829*** (0.0233)	R-squared	0.861	0.776	
Ethnic fractionalisation	-0.196** (0.0873)	-0.501*** (0.094)		Adjusted R-squared	0.8551	0.769	
Transition country*Ethnic fractionalisation	-0.272 (0.195)			F-value	0	0	

Source: Worldwide Governance Indicators, WTO, IMF, authors' calculations, based on the time period 1997-2014.

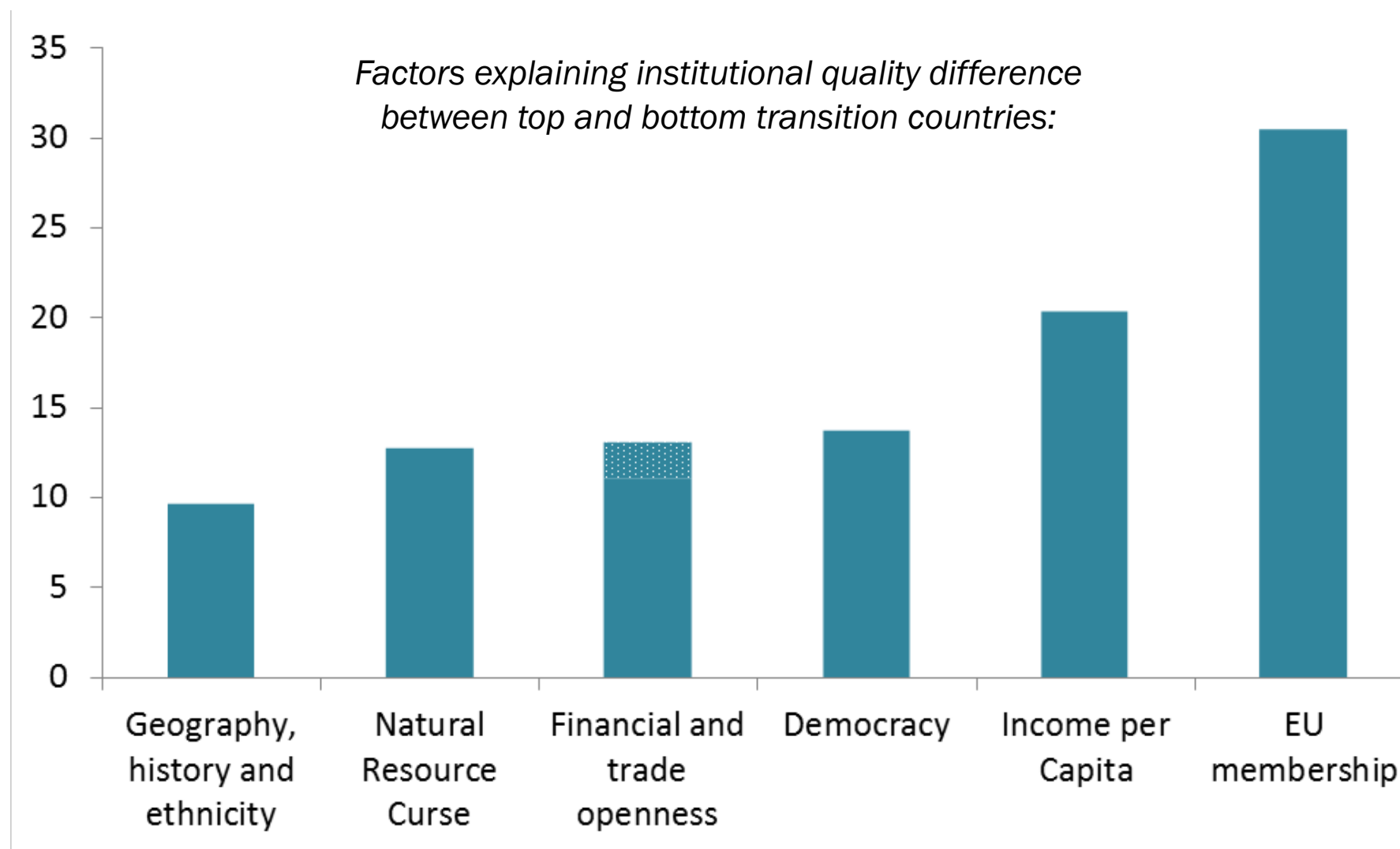
# International integration and income stand out as the major correlates of good institutions and reform



# Natural resource curse affects economic institutions in EBRD countries

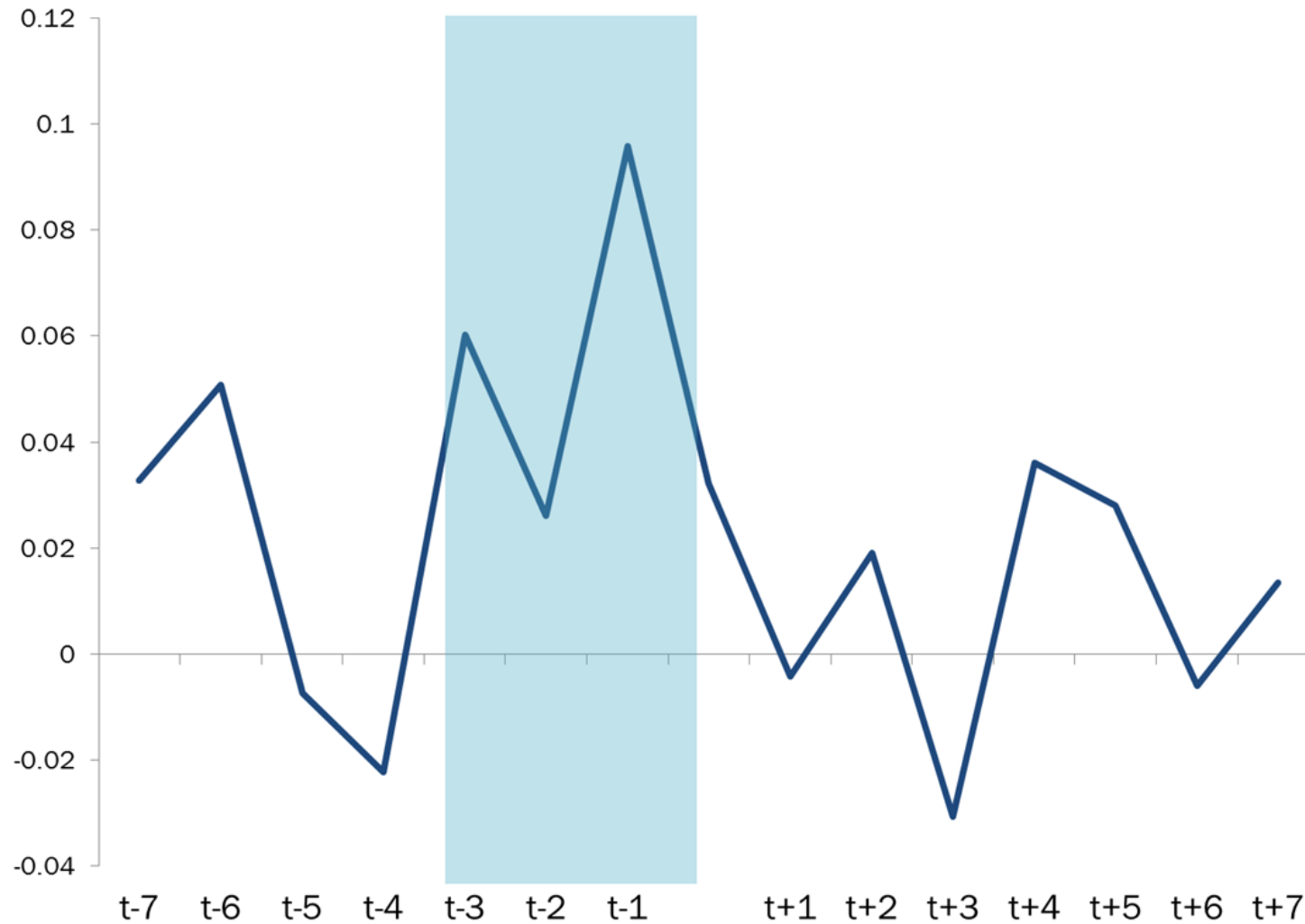
Dependent Variable:	Average of 4 World Governance Indicators		
	Panel OLS	Panel OLS	GMM
Polity2	0.0164*** (0.0059)	0.0126** (0.00632)	0.000123 (0.0109)
Natural Resources	-0.630*** (0.133)	-0.588*** (0.143)	-0.526** (0.221)
Trade Openness	0.16 (0.101)	0.122 (0.108)	0.00992 (0.0805)
Financial Openness	0.360*** (0.0804)	0.295*** (0.0857)	0.08 (0.0724)
Income	0.319*** (0.0599)		0.168** (0.0776)
Ethnic fractionalisation	-0.0169 (0.163)	-0.320* (0.165)	
Distance from the equator	-0.0173*** (0.00184)	-0.0135*** (0.00479)	
Landlocked	-0.0221 (0.0609)	-0.0481 (0.0655)	
Ruggedness	-0.0323 (0.0248)	-0.0362 (0.0268)	
State antiquity index	0.00114 (0.000653)	0.00224 (0.00142)	
EU membership	0.424*** (0.0951)	0.765*** (0.0762)	
Observations	172	172	143
Countries	36	36	36
R-squared	0.814	0.784	
Adjusted R-squared	0.7984	0.7631	
F-value	0	0	

# Crucial factor for institutional quality in EBRD countries is EU membership, income and democracy



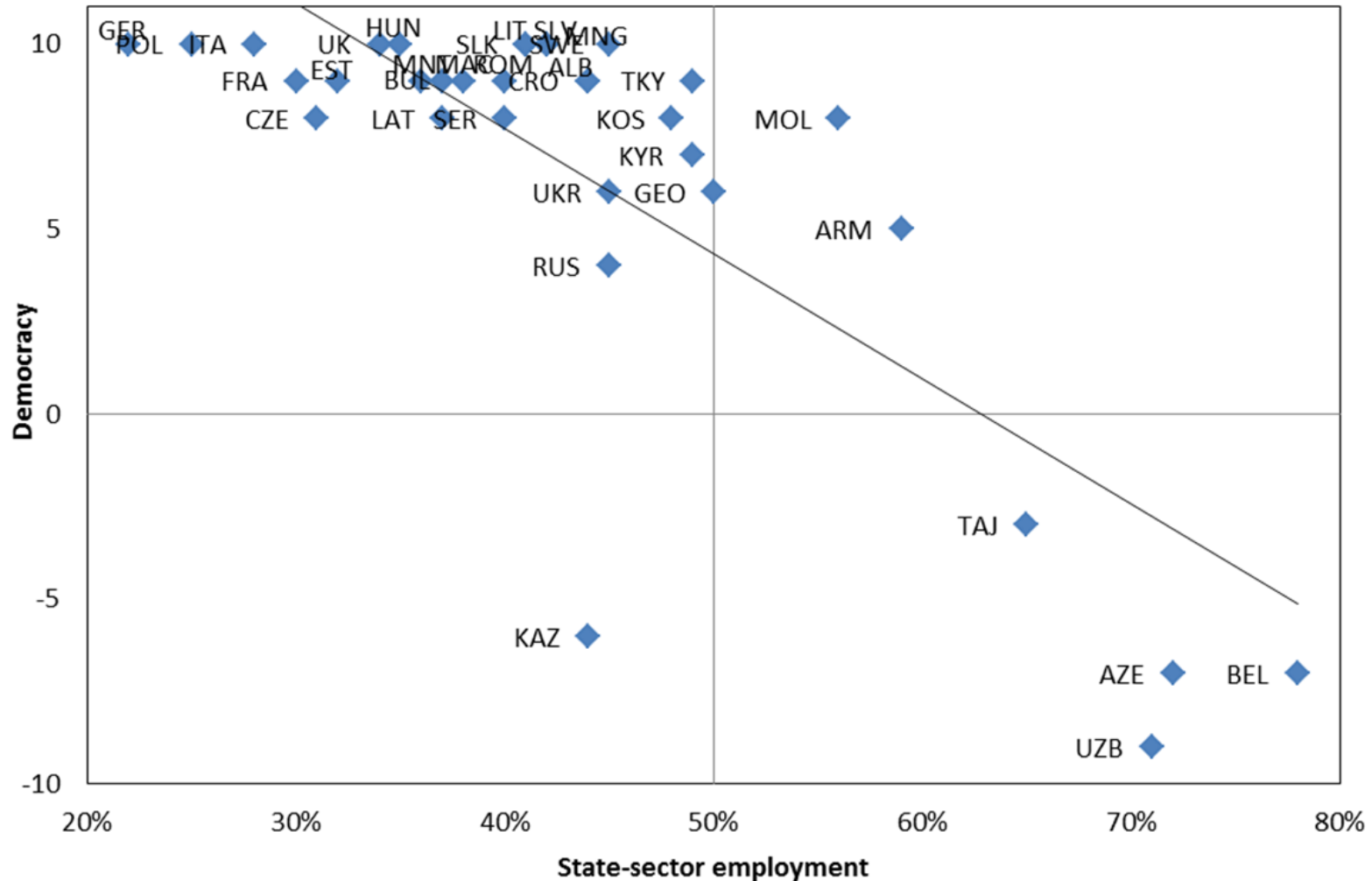
# EU accession played an important role – but a weaker anchor post-accession

Average annual change in governance indicators in EU-10 relative to accession year





# Stronger democratic institutions have also been associated with lower state share of employment



# People strongly support trade if they benefit from it

- High-skilled individuals support their government if skill-intensive exports increase and skill-intensive imports decrease
- Opposite effect for the low-skilled

Outcome is →	Approval of the leader	Confidence in national government
TertiaryEduc*HighSkillExports	0.0303*** (0.0078)	0.0393*** (0.0071)
TertiaryEduc*HighSkillImports	-0.0769*** (0.0166)	-0.0930*** (0.0192)
R-squared	0.132	0.139
N	416994	441415

Source: Gallup World Poll 2006-16, authors' calculations.

Controls: year dummies, country-specific linear time trends, country and individual level characteristics.

Robust standard errors clustered at the country level.



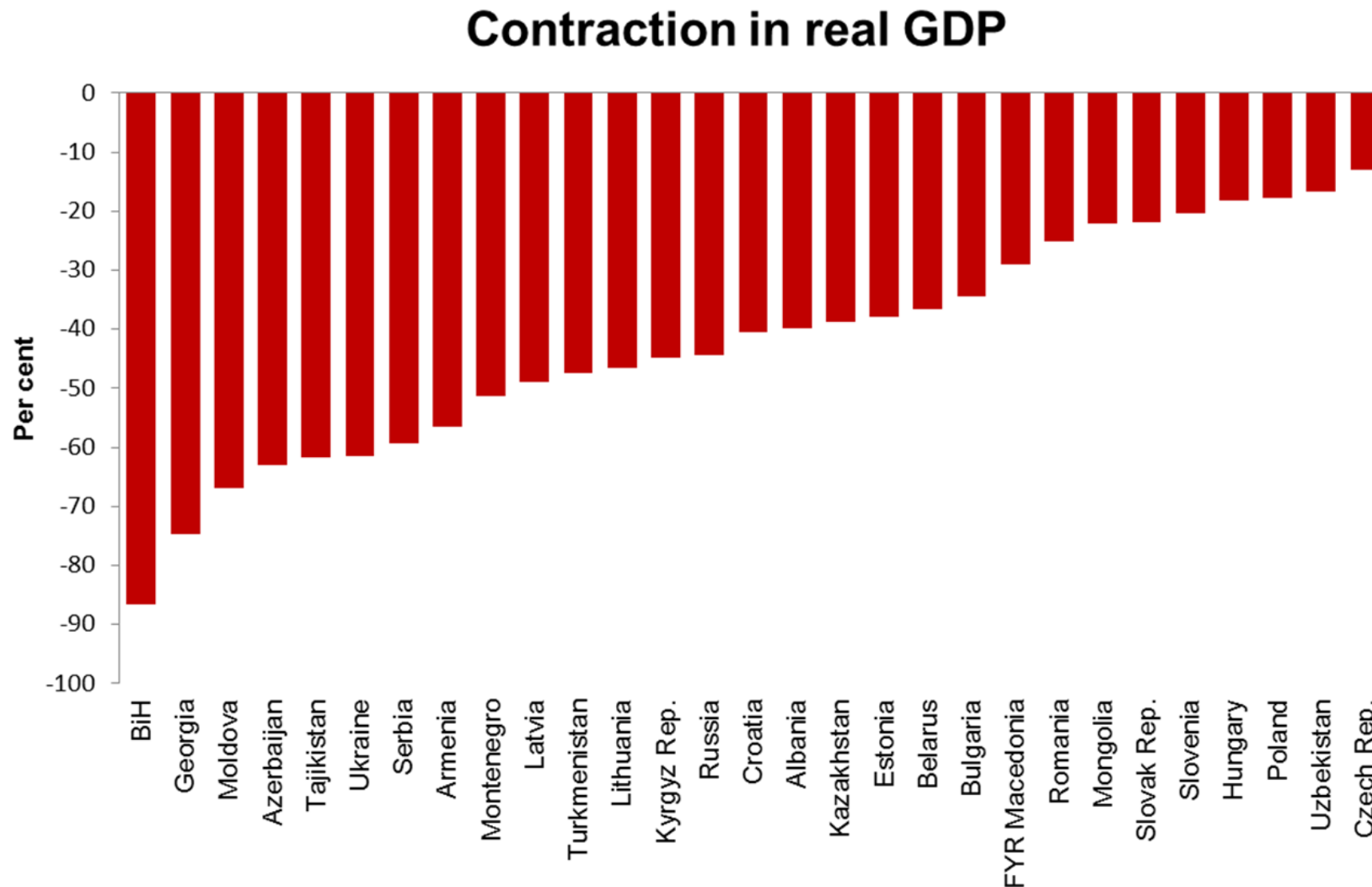
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# Uneven distribution of the pain of reforms

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# Reforms coincided with deep transition recession (-10% Czech to -60%+ in Ukraine / Bosnia)

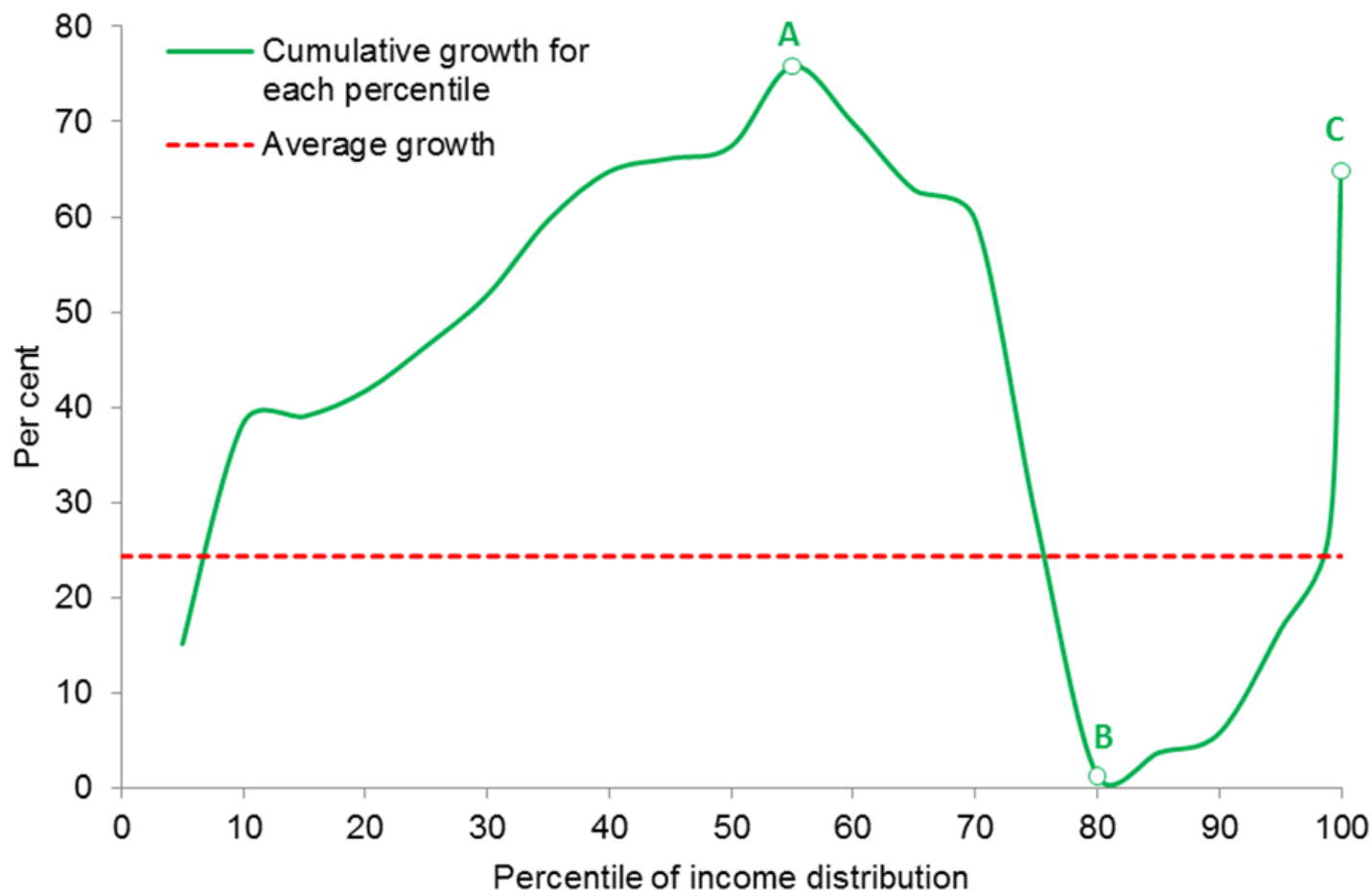


# Who paid the cost of early reforms?

- **Distributional impact of the reforms:**
  - **Milanovic's "elephant" curve:**  
income growth for different deciles of income distribution
- **Result: reforms have mostly benefitted the rich/skilled**
  - **Especially true for the early reform years**
    - **Bottom 80-90% experience substantial declines in incomes**

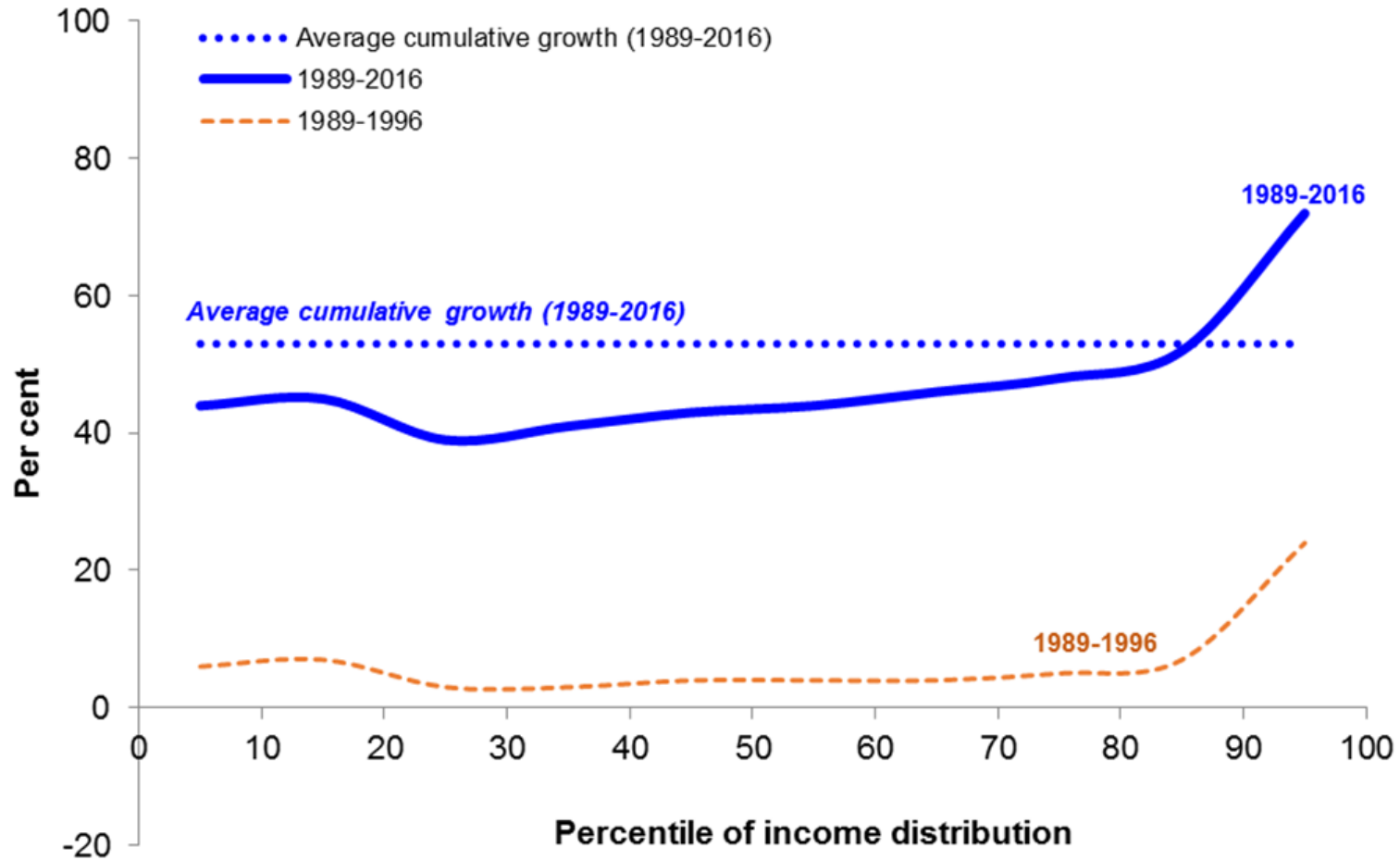
# Global experience – Milanovic’s “elephant curve” – Lower middle class in advanced economies losing out

Relative gain in real per capita income by global income level, 1988-2008



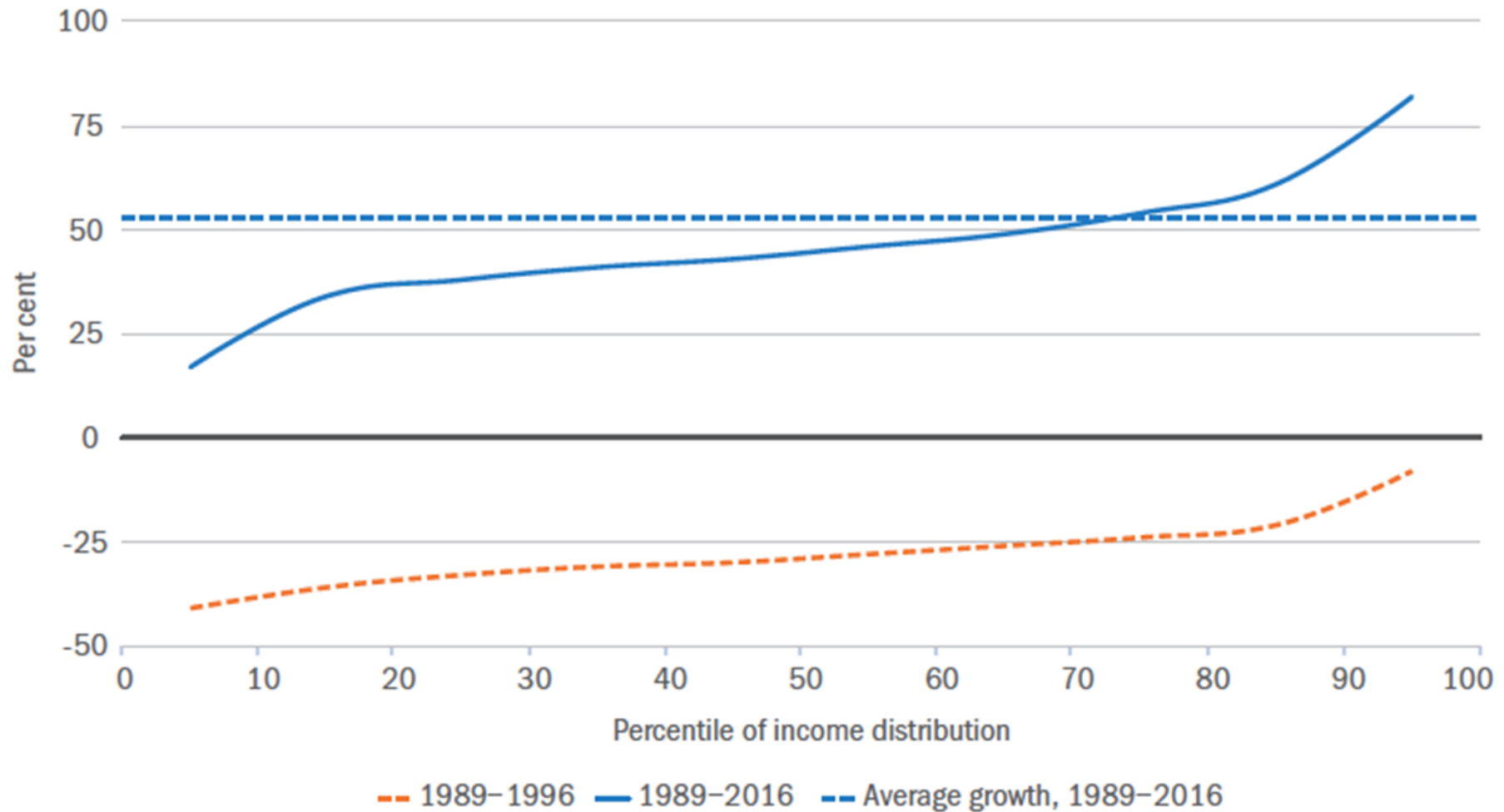
# “Elephant curve” for the US

USA: Cumulative income growth since 1989 by income decile



# In post-communist countries: winners are in the upper deciles

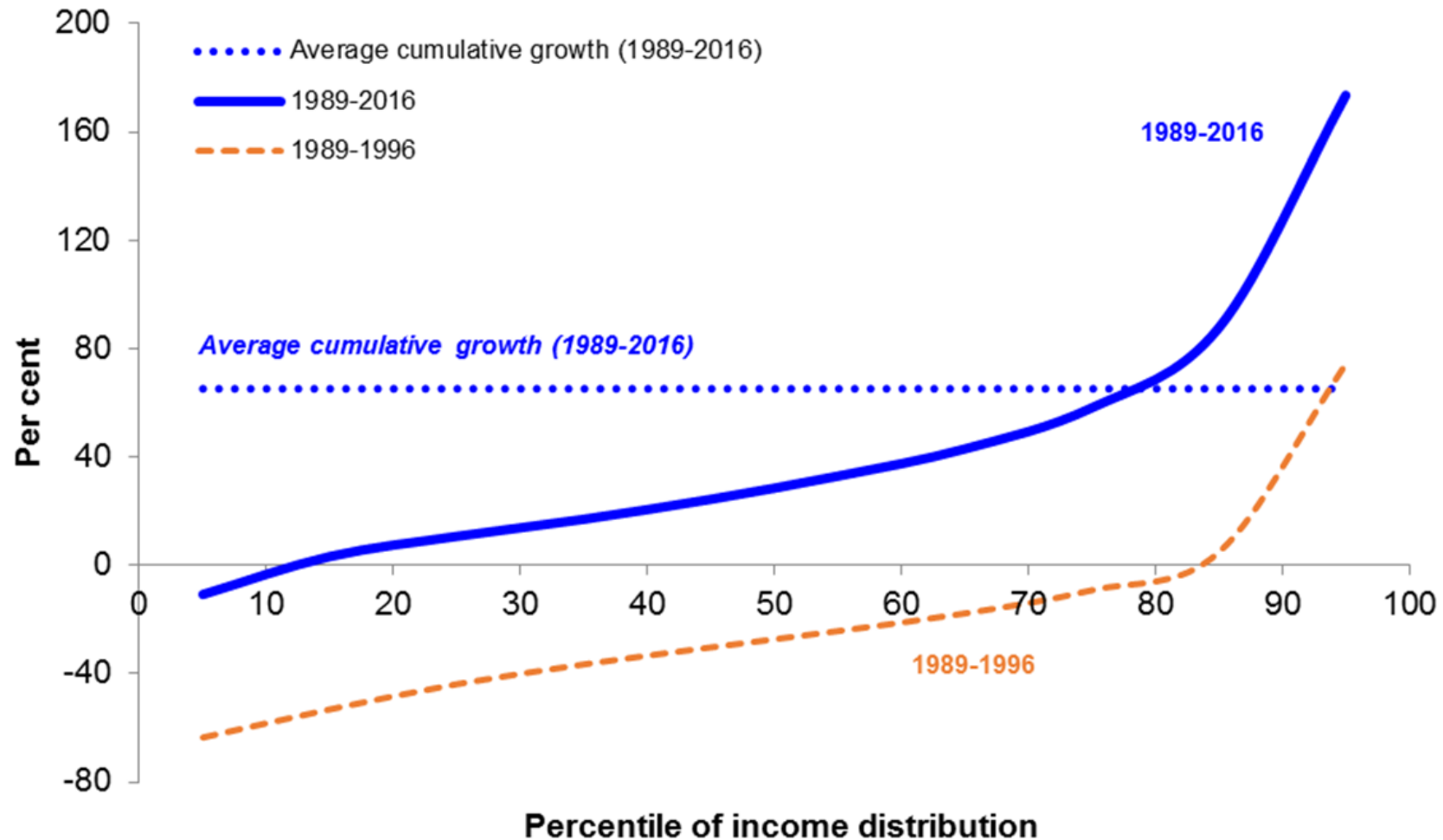
Post-communist countries: Cumulative growth in income since 1989 depending on initial income





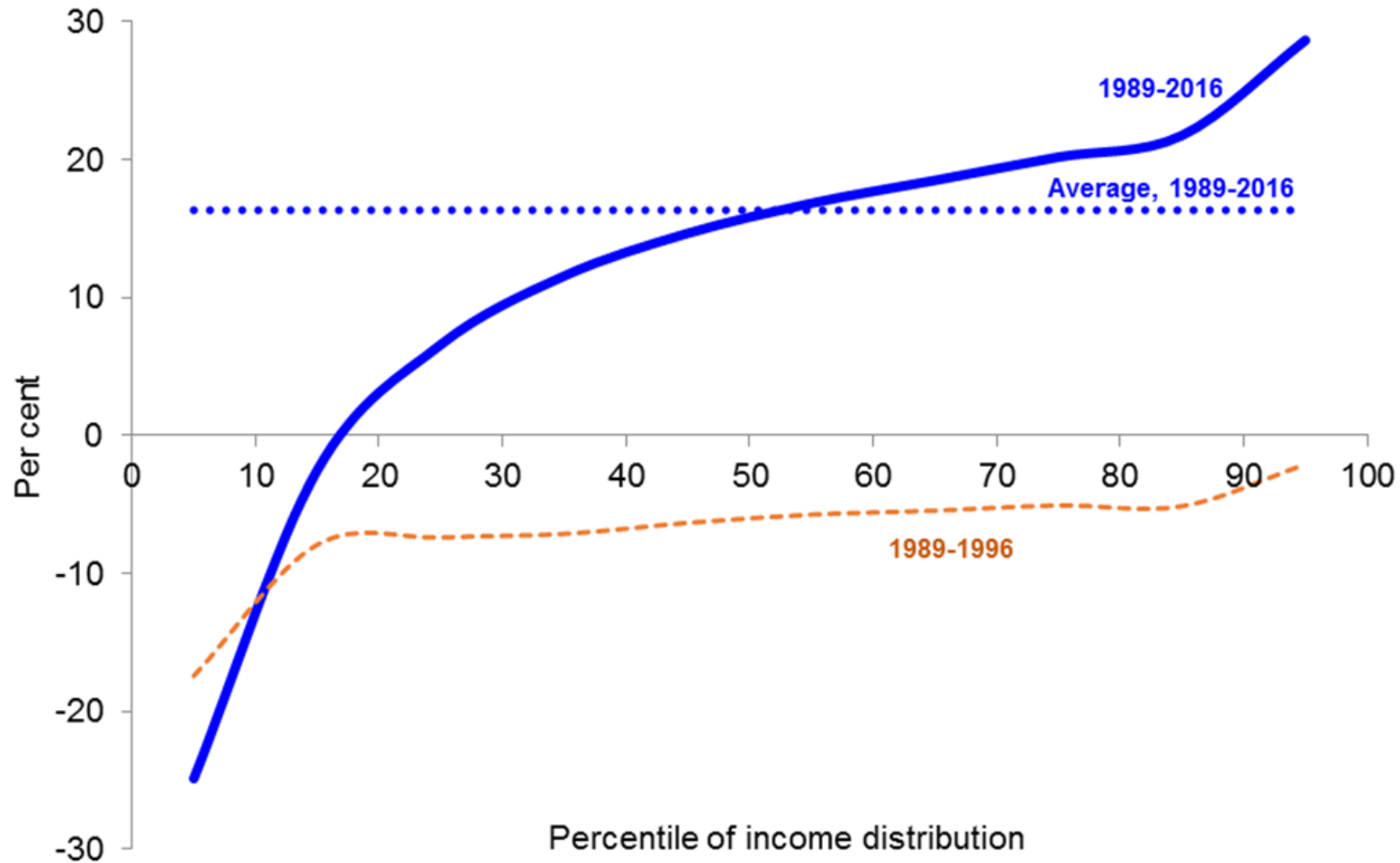
# Within countries: Impressive income growth on average – but gains depend on one’s place on the income ladder

Post-communist countries: Cumulative growth in income since 1989 depending on initial income



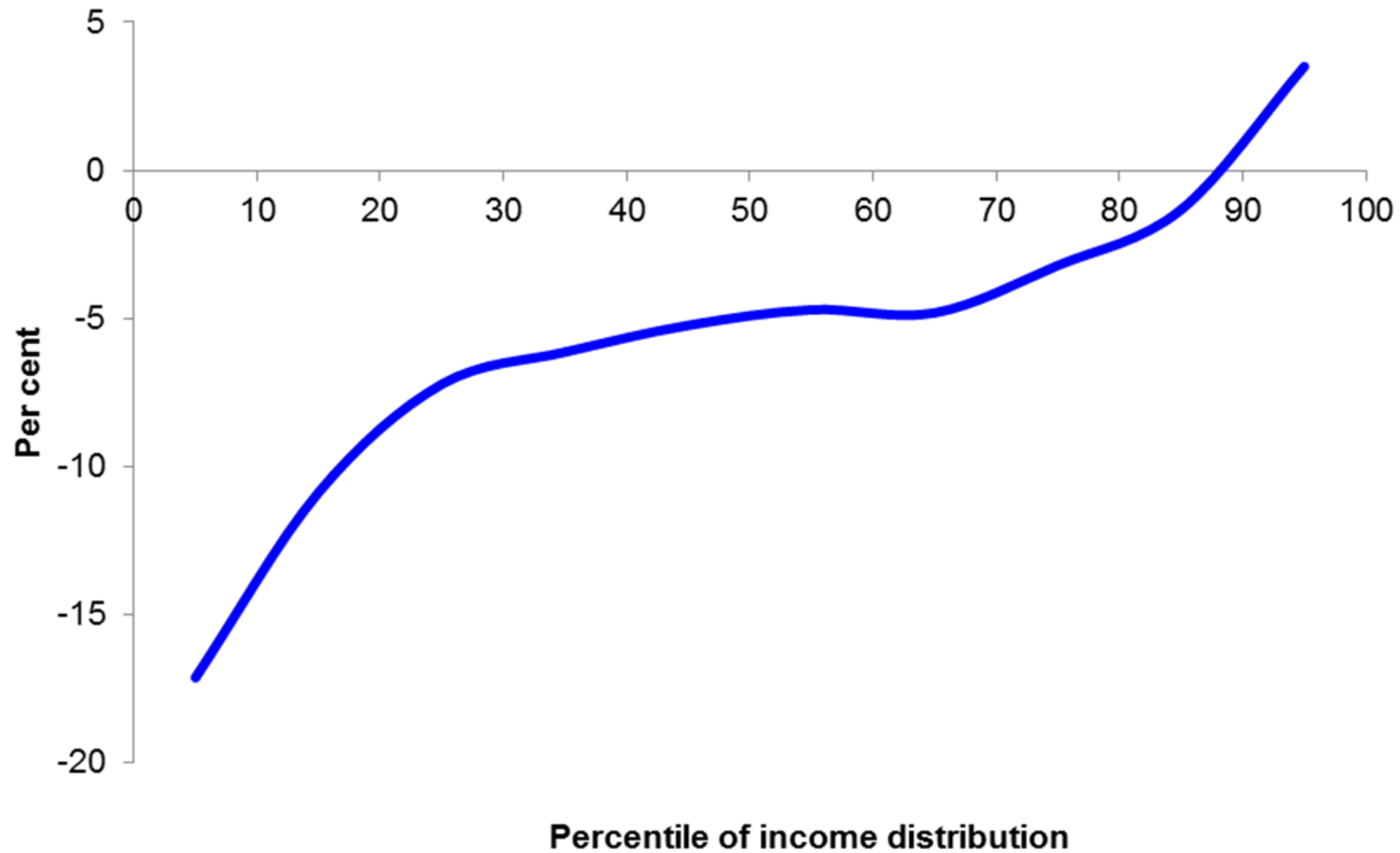
# A similar pattern in Hungary

Post-communist countries: Cumulative growth in income since 1989 depending on initial income



# A similar pattern during the Great Recession

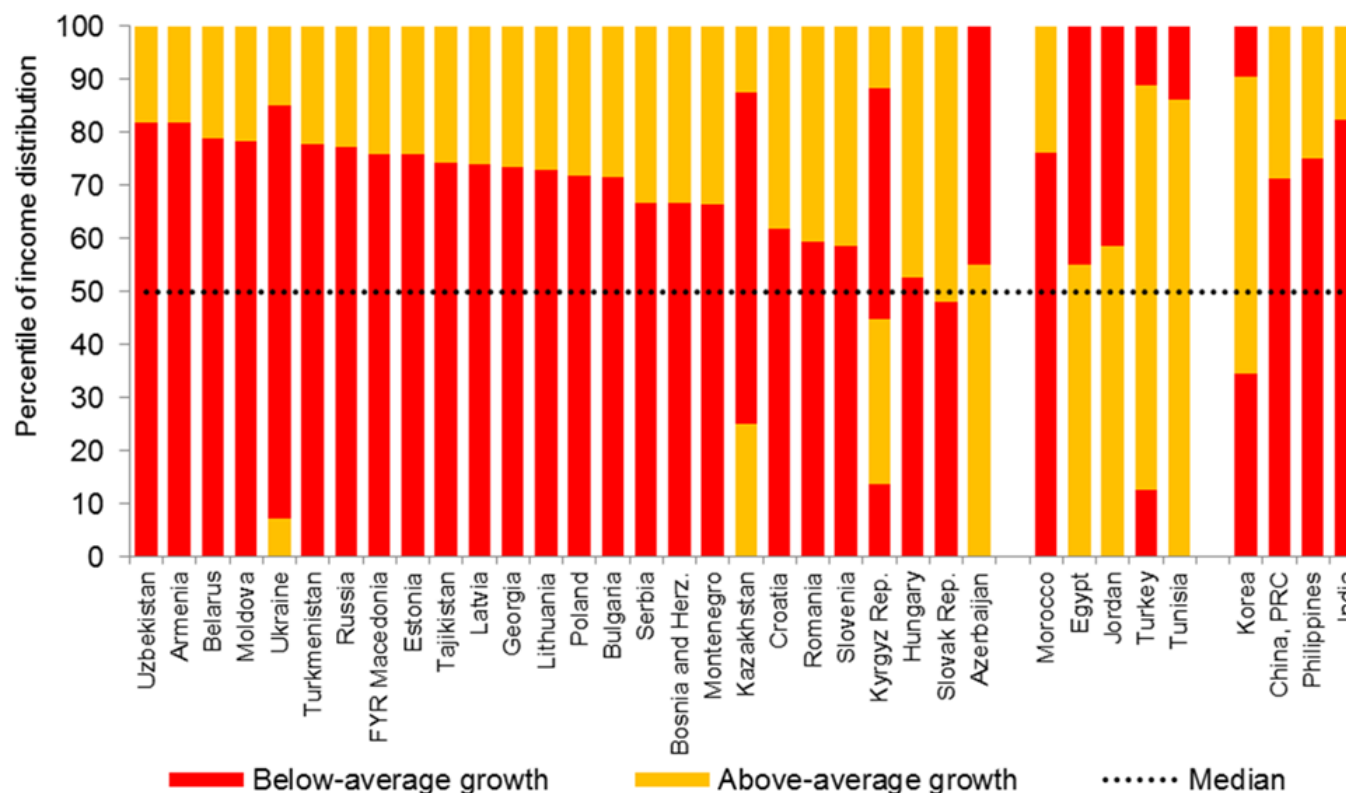
Post-communist countries: Cumulative growth in income since 1989 depending on initial income



# In most countries, only top 20-30 percent have experienced “faster-than-average” income growth

- Headline growth in the region corresponds to the experience of someone at around 75th percentile of income distribution
- Hence  $\frac{3}{4}$  (and the median voter) experienced much slower growth

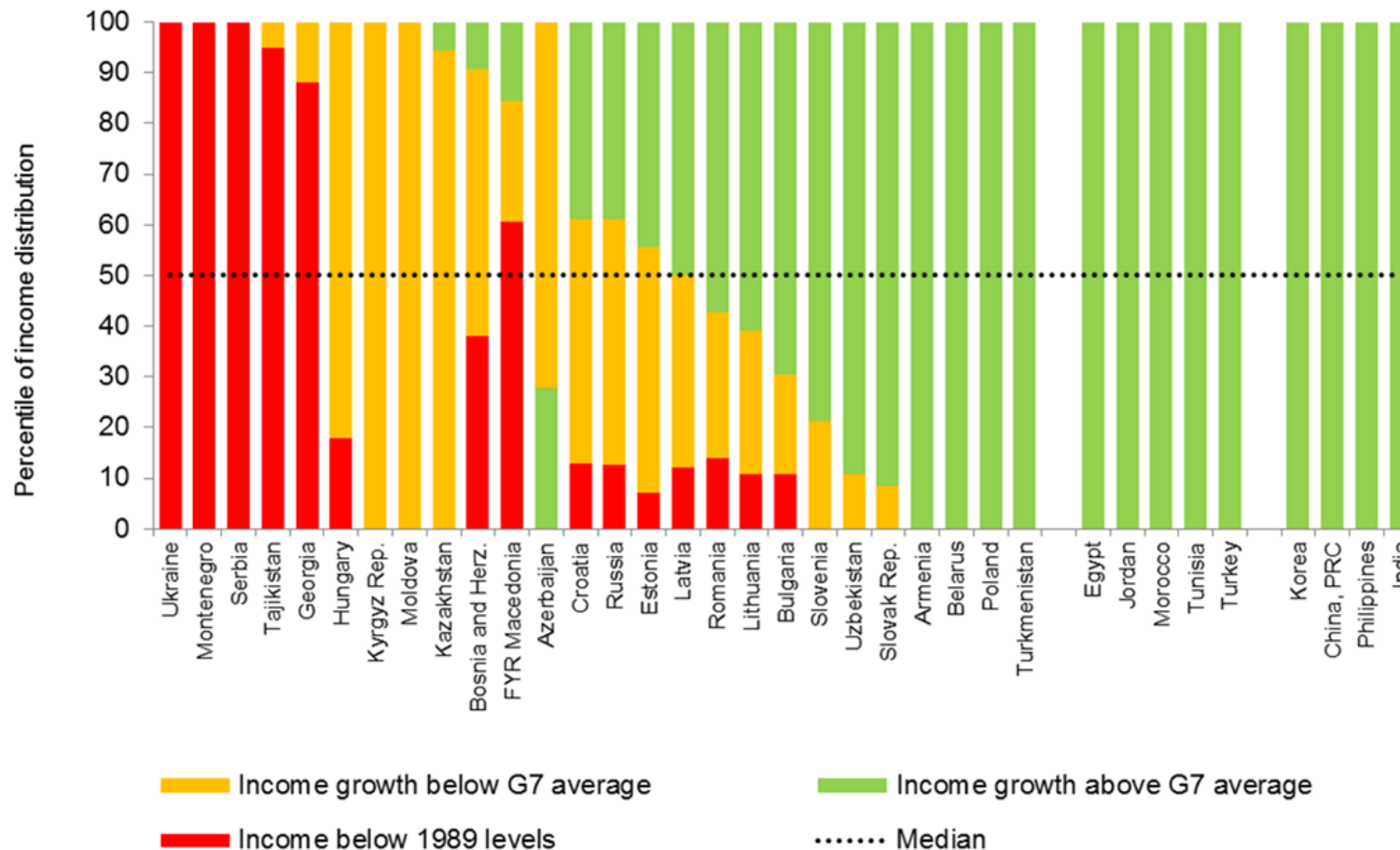
## Percentiles of population with below-average income growth (1989-2016)



# Majority have not experienced long-term income convergence with advanced economies – unlike in other EMs

- Income growth above G7 average only for 44%

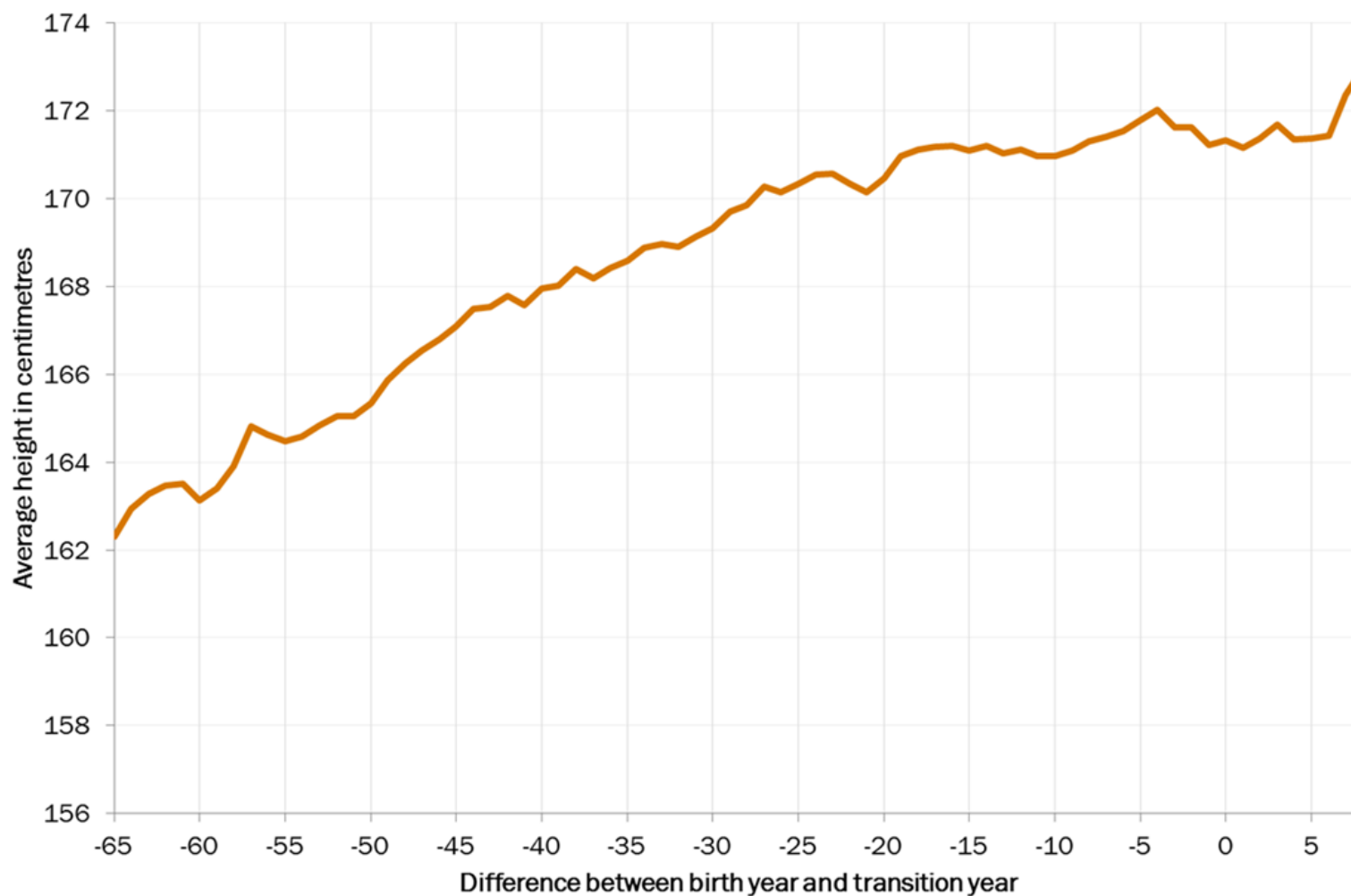
Share of the population with income growth above/below the G7 average, 1989-2016



- **Analysis of income distribution does not provide a complete picture**
  - **Pre-reform income distribution was not fully informative due to regulated prices and shortages**
- **Need to study other indicators of well-being**
  - **Height**
    - **People born in hardship grow up shorter**
  - **Self-reported subjective well-being (“happiness”)**

# Structural shifts accompanying price liberalisation caused significant economic hardship

People born around the year of price liberalisation are 1cm shorter



# The 1 cm effect is statistically significant controlling for individual characteristics, country-specific trends etc.

The fall in GDP alone does not explain the decrease in height.

	Born in transition year	Born or one in transition year	Born in transition year	Born or one in transition year
Born in transition	-1.057*** (0.398)	-0.768*** (0.282)	-0.777* (0.409)	-0.544* (0.292)
Average of log GDP per capita			1.129*** (0.215)	1.190*** (0.221)
No. of observations	42,853	42,853	40,854	40,887
R <sup>2</sup>	0.382	0.382	0.384	0.384

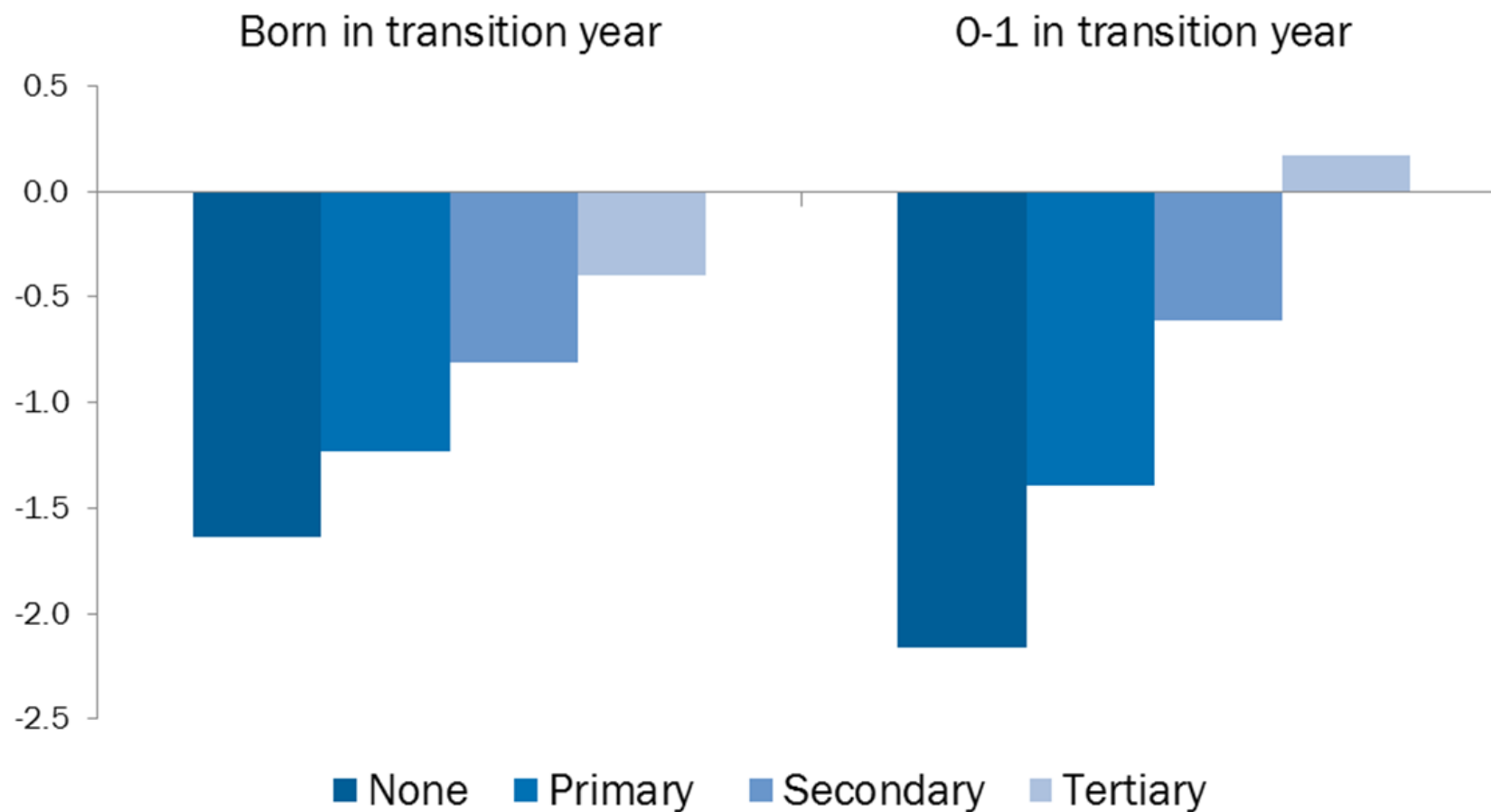


# Results confirmed when using continuous measures of speed of market reforms

	Born in transition year	Born or one in transition year	Born in transition year	Born or one in transition year
Change in price liberalisation	-0.565*** (0.194)	-0.343*** (0.114)	-0.466** (0.204)	-0.274** (0.119)
Average of log GDP per capita			1.267*** (0.229)	1.323*** (0.233)
No. of observations	36,507	36,507	34,660	34,693
R <sup>2</sup>	0.373	0.373	0.375	0.375

# People from less-educated households affected most severely

Effect of transition on height, cm, by mother's level of education

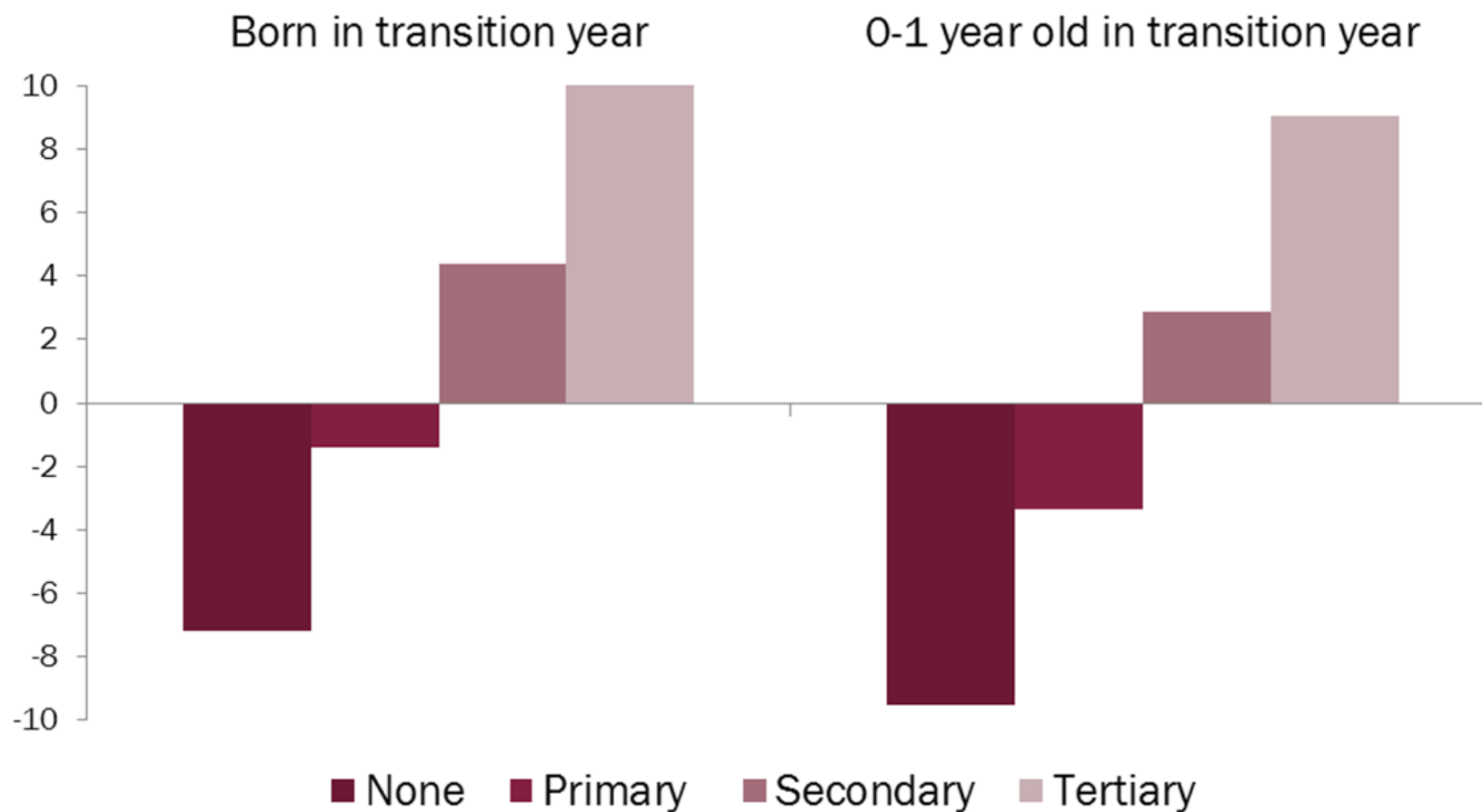


# Yet cohorts born at the start of transition are more satisfied with life than their peers

	Satisfied with life (0/1)		Satisfaction with life (1/5)	
	Born in transition year	Born or one in transition year	Born in transition year	Born or one in transition year
Born in transition	0.141* (0.079)	0.104* (0.056)	0.148*** (0.057)	0.094** (0.041)
No. of observations	47,059	47,059	47,059	47,059

# Except for those from less-educated households

Effect of transition on life satisfaction, percentage points, by mother's level of education



- **Early reforms: time of major socio-economic hardship**
  - **Especially for less-skilled households**
  - **Effect is not explained by economic recession alone, also related to deterioration of public goods**
- **But generation born in transition has benefitted from opportunities due to market reforms**
  - **Similar income, employment and marital outcomes as other cohorts**
  - **Higher education and higher subjective well-being**



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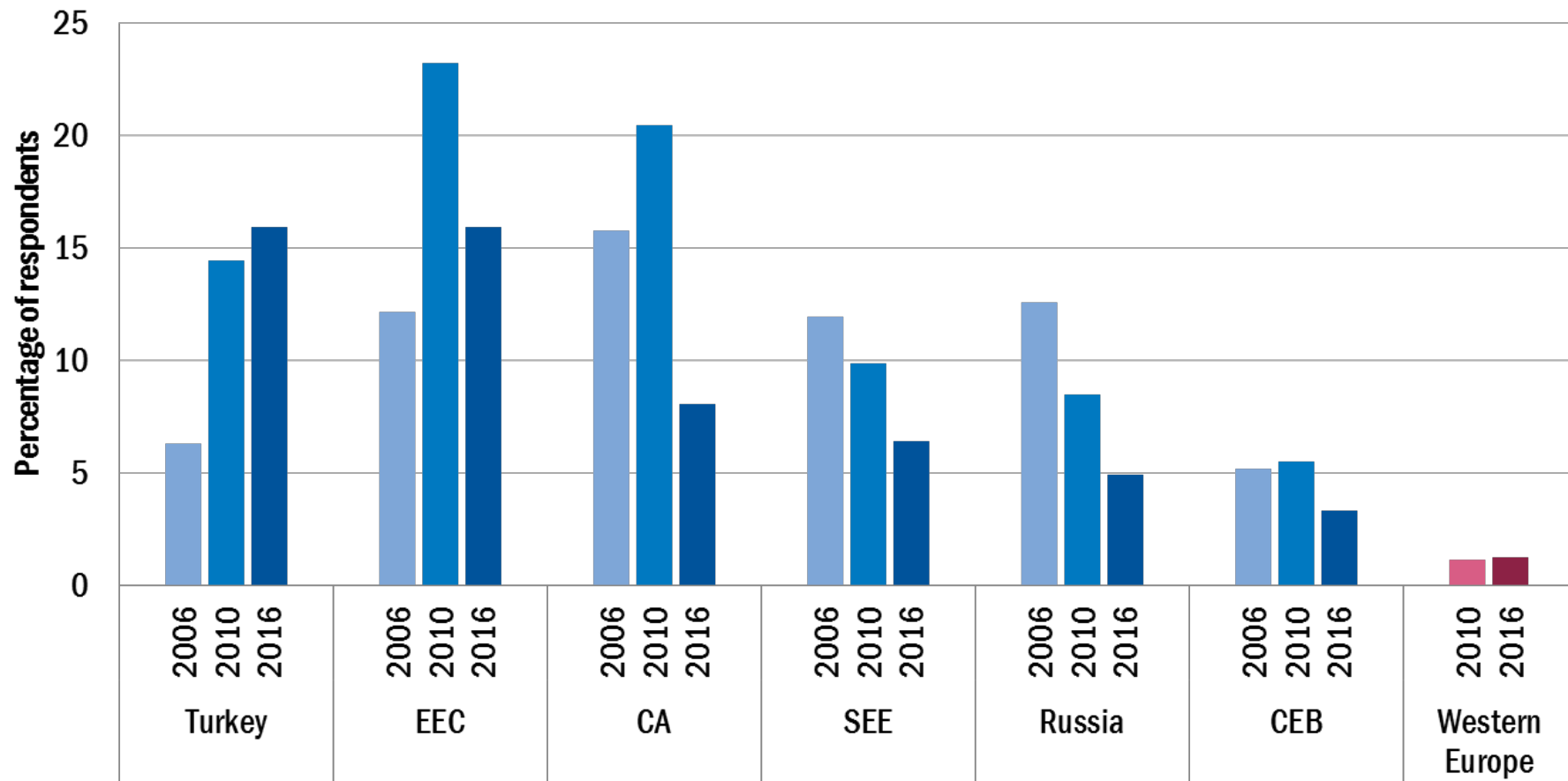
# Corruption, support for reforms and confidence in institutions

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- **Corruption remains prevalent in the region and continues to dominate reform debates**
- **Life in Transition Survey shows that “corruption experience” is a more reliable measure of corruption than “perceived incidence of corruption”**
  - **Possibly due to media bias**
- **Corruption undermines economic development and trust in institutions**
  - **Results based on a panel of 1500 locations in LITS 2010 and LITS 2016**

# Over the past decade, perceived incidence of corruption in the region has declined...

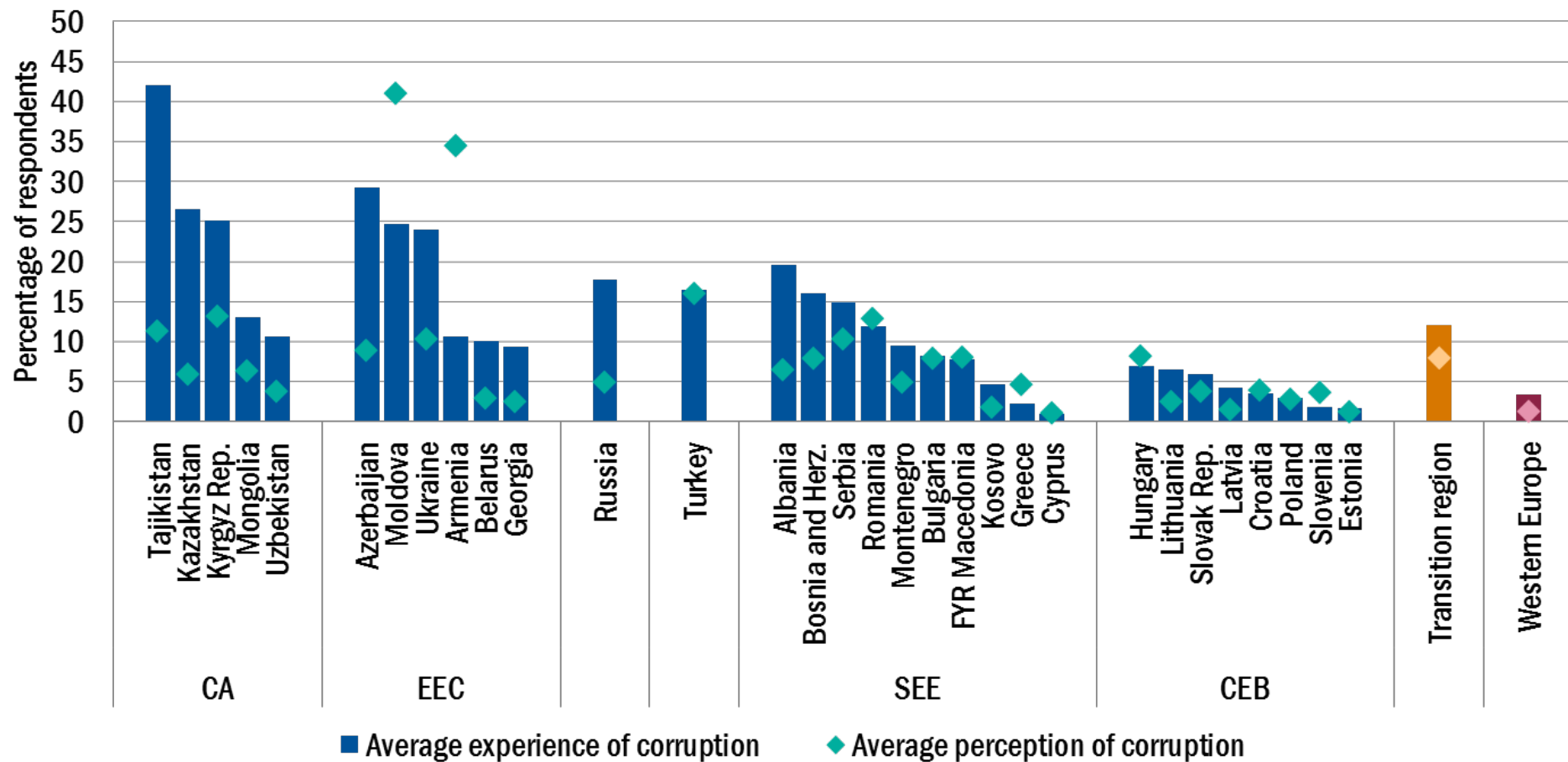
Perceived corruption in 2006, 2010 and 2016 by region



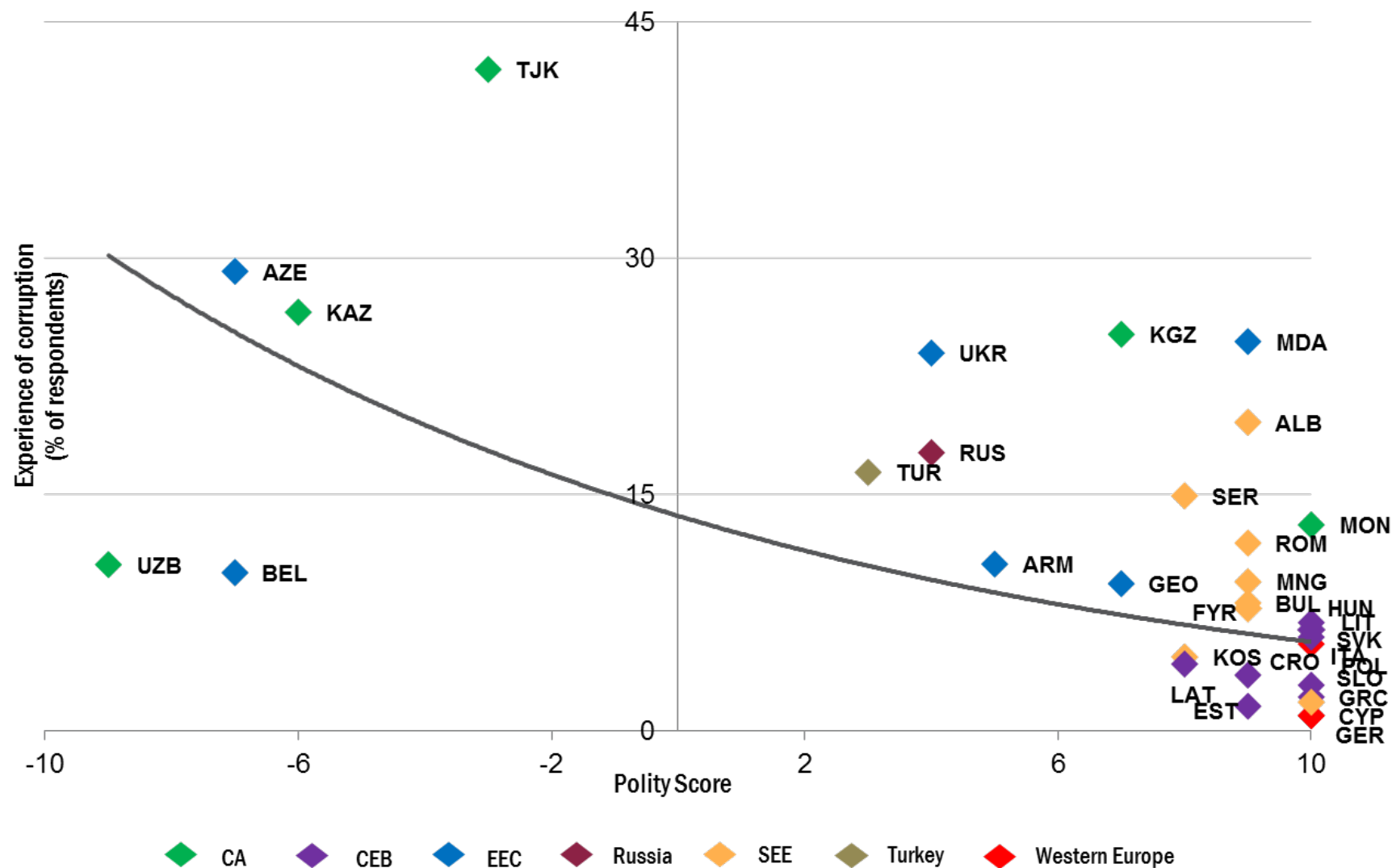


# ...but people tend to experience more corruption than is reflected in perceptions, particularly in Eastern Europe

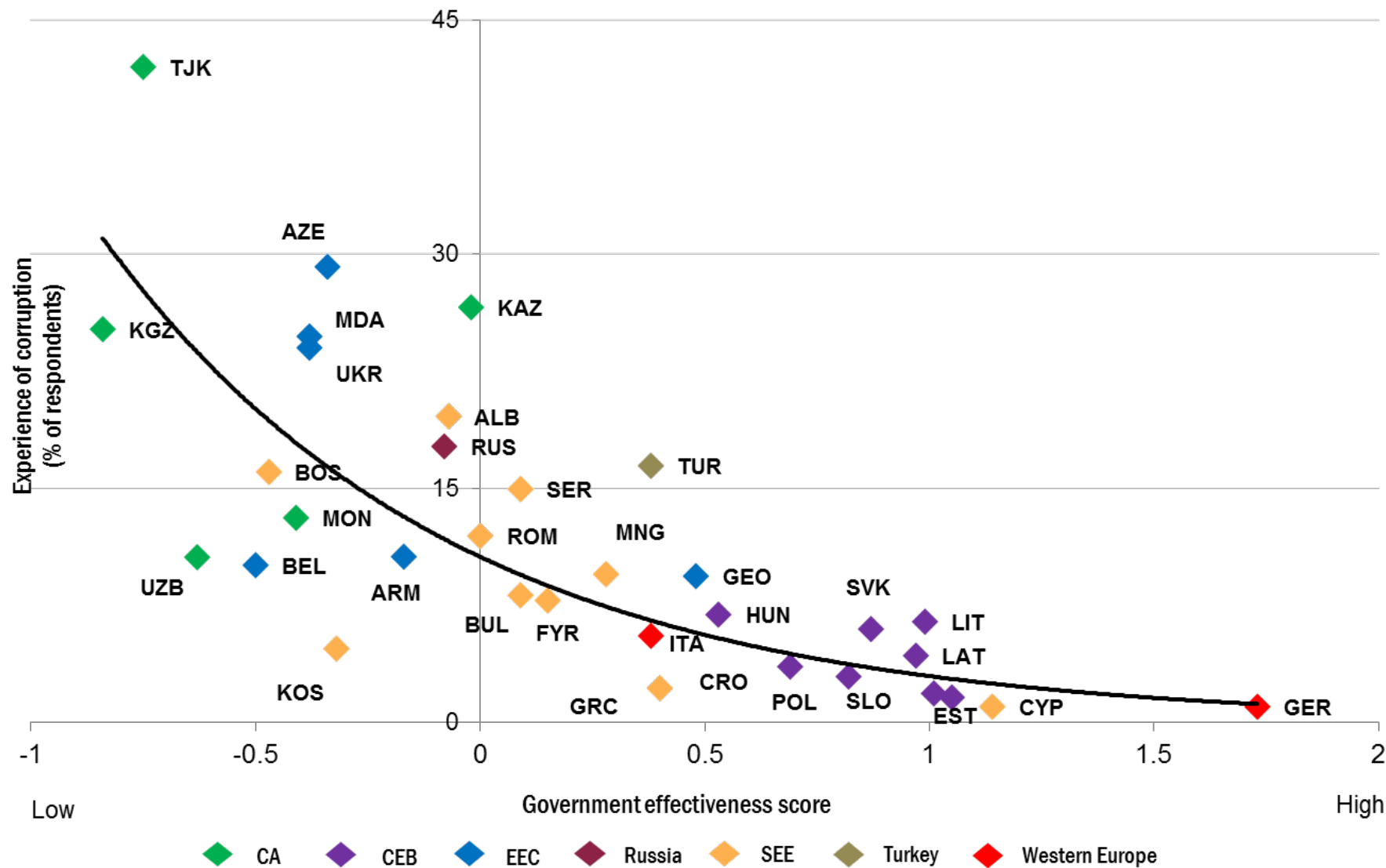
Experience versus perception of corruption in 2016 by country



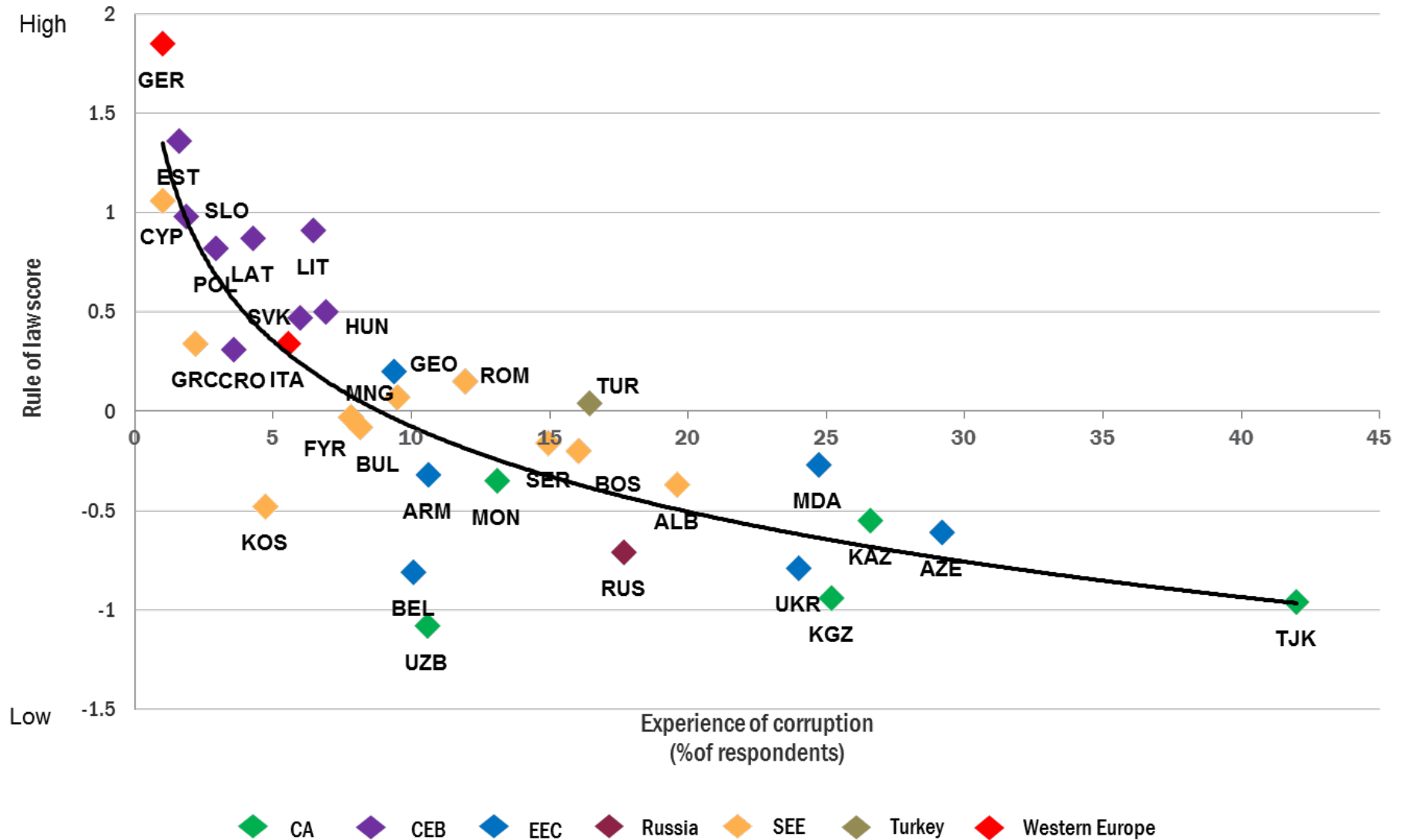
# Democracy tends to go hand in hand with greater transparency and lower corruption



# People in countries with more effective governments are less likely to experience corruption

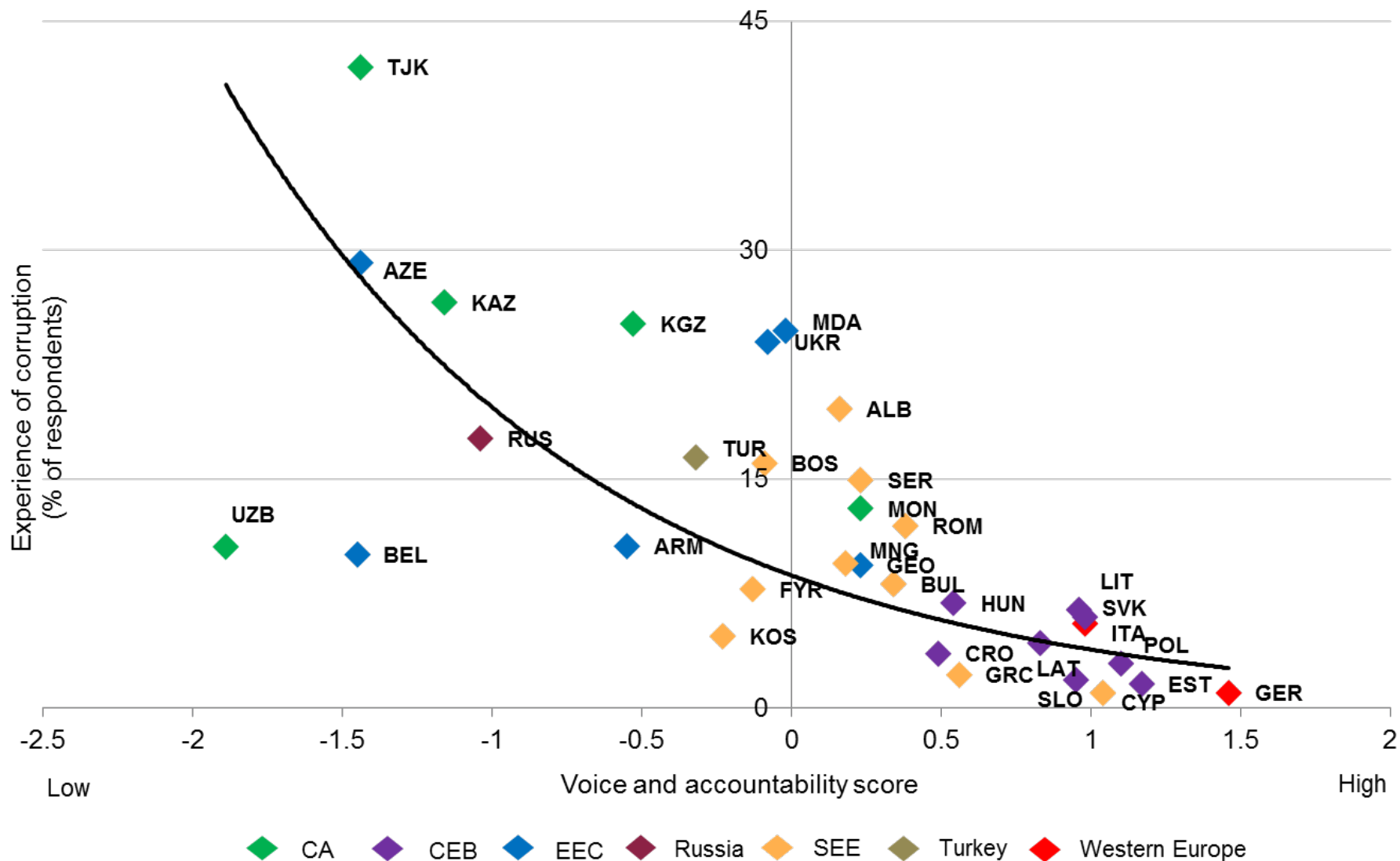


# Corruption within the law enforcement and justice is correlated with weaker rule of law

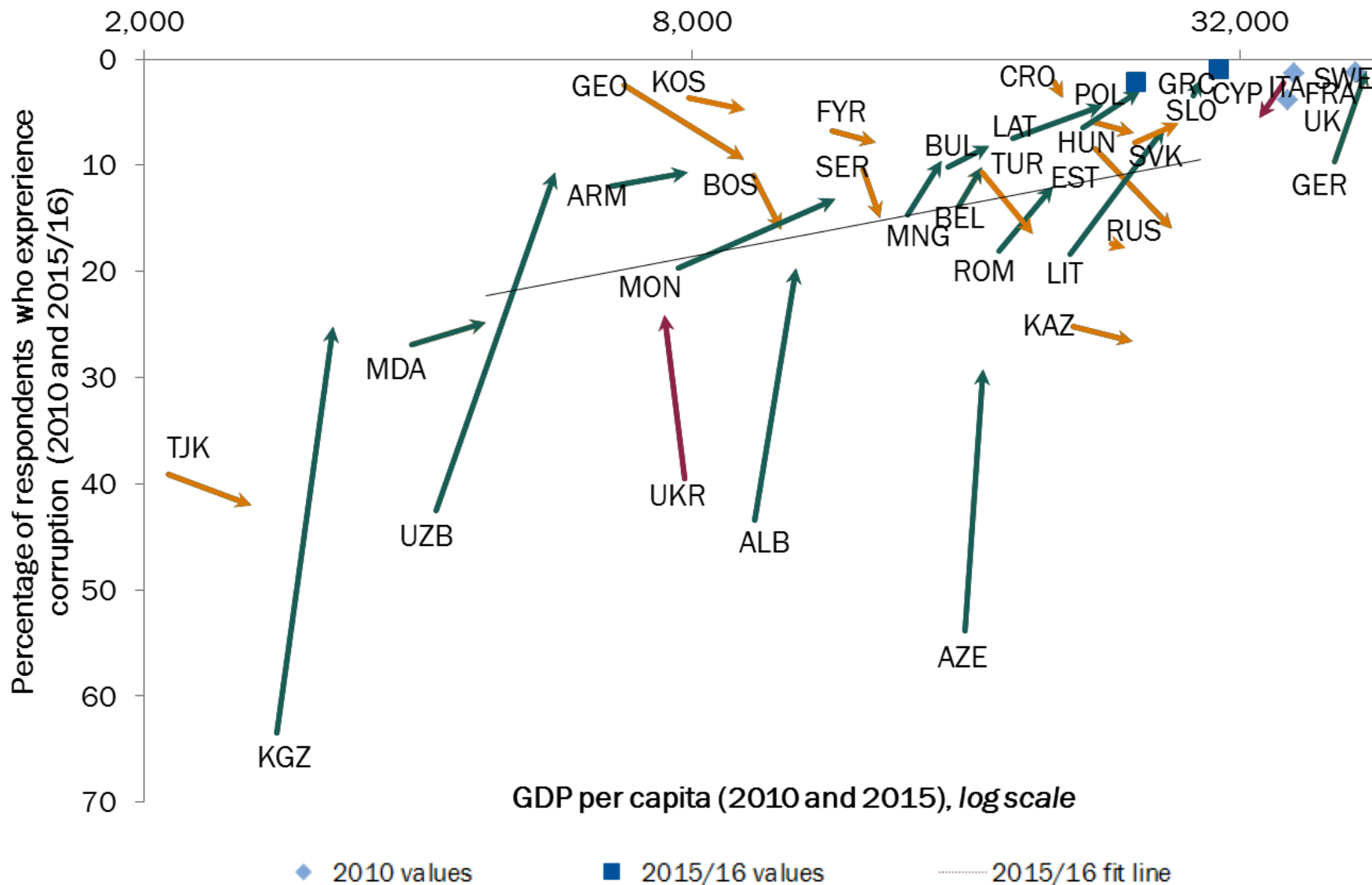


Source: LiTS III, World Governance Indicators (2015), authors' calculations.

# People in countries with more accountable institutions are less likely to experience corruption



# Low experience of corruption and income growth tend to go hand in hand



# Better educated and those who support democracy and markets are more likely to stand up to corruption

Outcome is →	Ordinary people cannot do anything	Refuse to pay bribes	Report corruption when you experience it
Age	0.127*** (0.031)	-0.040*** (0.010)	-0.069*** (0.019)
Male	-0.013*** (0.004)	0.009** (0.004)	0.020*** (0.004)
Married	-0.009** (0.004)	0.015*** (0.004)	0.001 (0.004)
Tertiary education	-0.049*** (0.005)	0.045*** (0.005)	0.031*** (0.005)
Support democracy	-0.007 (0.005)	0.046*** (0.005)	0.012*** (0.004)
Support market economy	-0.008 (0.005)	0.029*** (0.005)	0.005 (0.005)
R-squared	0.05	0.03	0.04
N	42278	42278	42278

# Trust in government rises where people believe corruption is falling

Outcome is →	Trust in president	Trust in government	Trust in parliament
There is less corruption now than 4 years ago	0.178*** (0.016)	0.200*** (0.017)	0.194*** (0.020)
Unemployment	-0.029* (0.017)	-0.019 (0.013)	-0.012 (0.009)
Log income	0.025 (0.016)	0.007 (0.012)	-0.005 (0.007)
R-squared	0.38	0.39	0.40
N	13544	13779	13636
Number of PSUs	1489	1489	1489



# Experience of corruption makes people less likely to believe government is improving

Outcome is →	Local government has improved over the last 4 years	Regional government has improved over the last 4 years	National government has improved over the last 4 years
Corruption experience	-0.065*** (0.018)	-0.071*** (0.015)	-0.040** (0.017)
Unemployment	-0.035*** (0.010)	-0.016 (0.014)	-0.030*** (0.009)
Log income	0.006 (0.007)	0.022** (0.008)	0.017** (0.008)
R-squared	0.29	0.39	0.37
N	14060	11219	13479
Number of PSUs	1489	1489	1489

# Satisfaction with local government positively affects attitudes toward democracy and market economy

Outcome is →	Support for democratic regime	Support for authoritarian regime	Support for market economy
Satisfied with local government	0.030*** (0.010)	-0.005 (0.006)	0.034** (0.012)
Unemployment	-0.022 (0.013)	0.001 (0.008)	-0.037*** (0.011)
Log income	0.032*** (0.009)	-0.003 (0.005)	0.025*** (0.007)
R-squared	0.28	0.22	0.26
N	14487	14487	14487
Number of PSUs	1489	1489	1489



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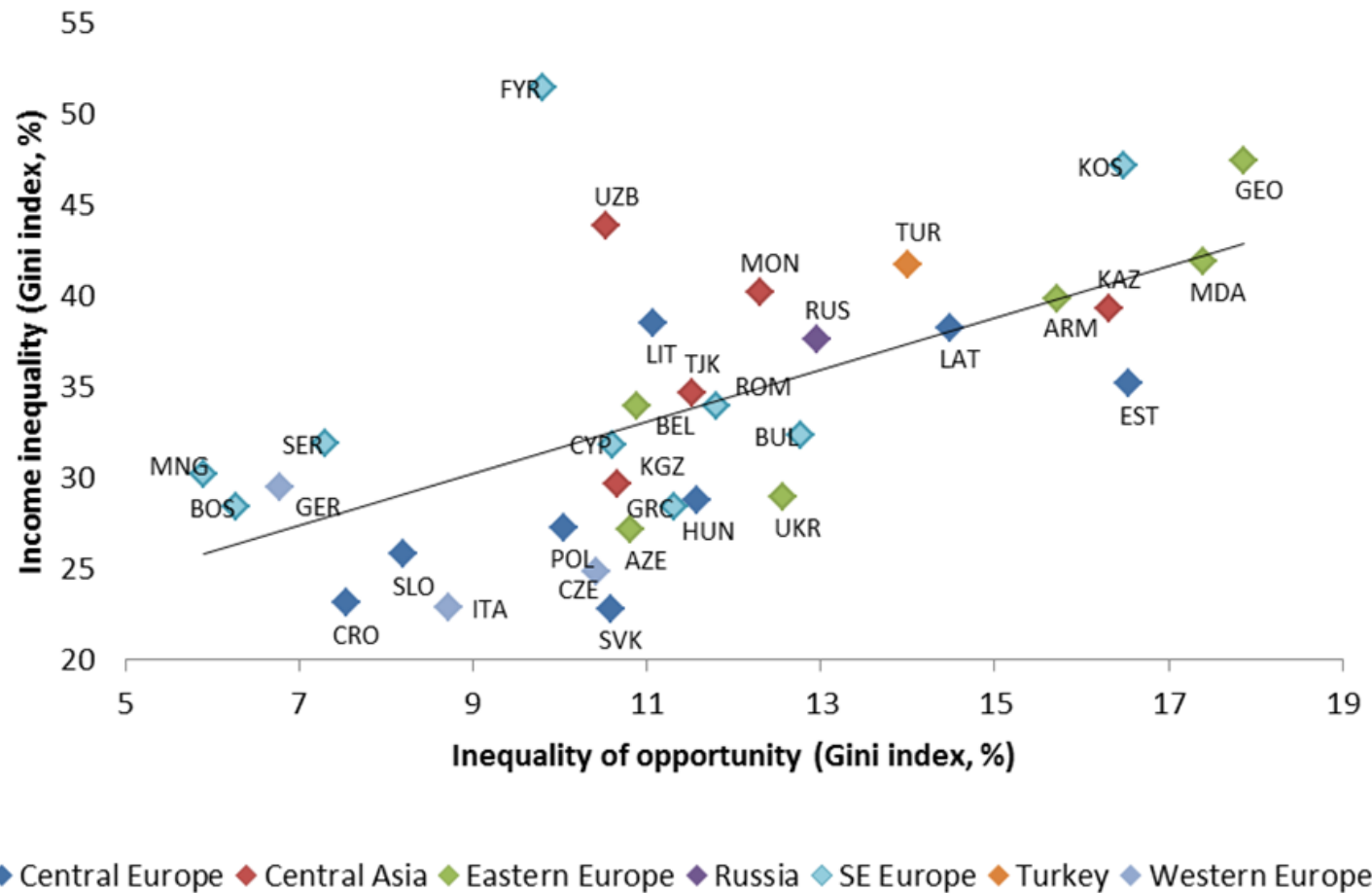
# Fairness and equality of opportunity

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- Opportunity to have education, good job, income should not be limited by circumstances
  - In practice, gender, race, place of birth, and / or parental background have an impact
- Inequality of opportunity is inefficient:
  - prevents people from making the best use of their skills or from realising their entrepreneurial ideas
- Inequality of opportunity is unfair:
  - may lead to the loss of confidence in the key economic and political institutions that underpin societies and a market-based economic system

# 20% to 50% of income inequality in the EBRD region is due to circumstances at birth

Higher than in western Europe but modest compared with other emerging markets and the US



# Inequality of opportunity and support for the reform

- We decompose inequality into
  - “unfair” inequality of opportunity (explained by gender, race, place of birth, and parental background) and
  - “fair” inequality (residual, explained by effort)
- It turns out that support for market economy is negatively correlated only with the inequality of opportunity
- The “fair” component of inequality is positively correlated with support for markets and economy
  - Consistent with Starmans et al. (2017) – people prefer fair inequality to unfair equality

# Inequality of opportunity reduces support for markets and democracy – unlike the “fair” component of inequality

	Support for markets			Support for democracy		
	1	2	3 (LPM)	4	5	6 (LPM)
<b>Direct channels</b>						
Inequality of opportunity: income	-4.508* (2.112)	-4.169* (2.085)	-1.093* (0.480)	-1.899 (3.042)	-1.783 (3.034)	-0.314 (0.687)
<b>Indirect channel</b>						
Perception of relative economic wellbeing		0.077*** (0.022)			0.033 (0.022)	
<b>Controls</b>						
Income decile	0.042*** (0.011)	0.035** (0.011)	0.010*** (0.003)	0.040*** (0.011)	0.037*** (0.011)	0.009*** (0.002)
“Fair” income inequality	4.424** (1.587)	4.516** (1.600)	1.046** (0.354)	5.218** (1.832)	5.228** (1.828)	1.061** (0.374)
Level of democracy (polity2)	0.058** (0.020)	0.061** (0.019)	0.014** (0.004)	0.064** (0.022)	0.064** (0.022)	0.014** (0.005)
Additional individual, region and country controls	Yes	Yes	Yes	Yes	Yes	Yes
Observations	12,258	12,185	12,258	12,514	12,433	12,514



**European Bank**  
for Reconstruction and Development

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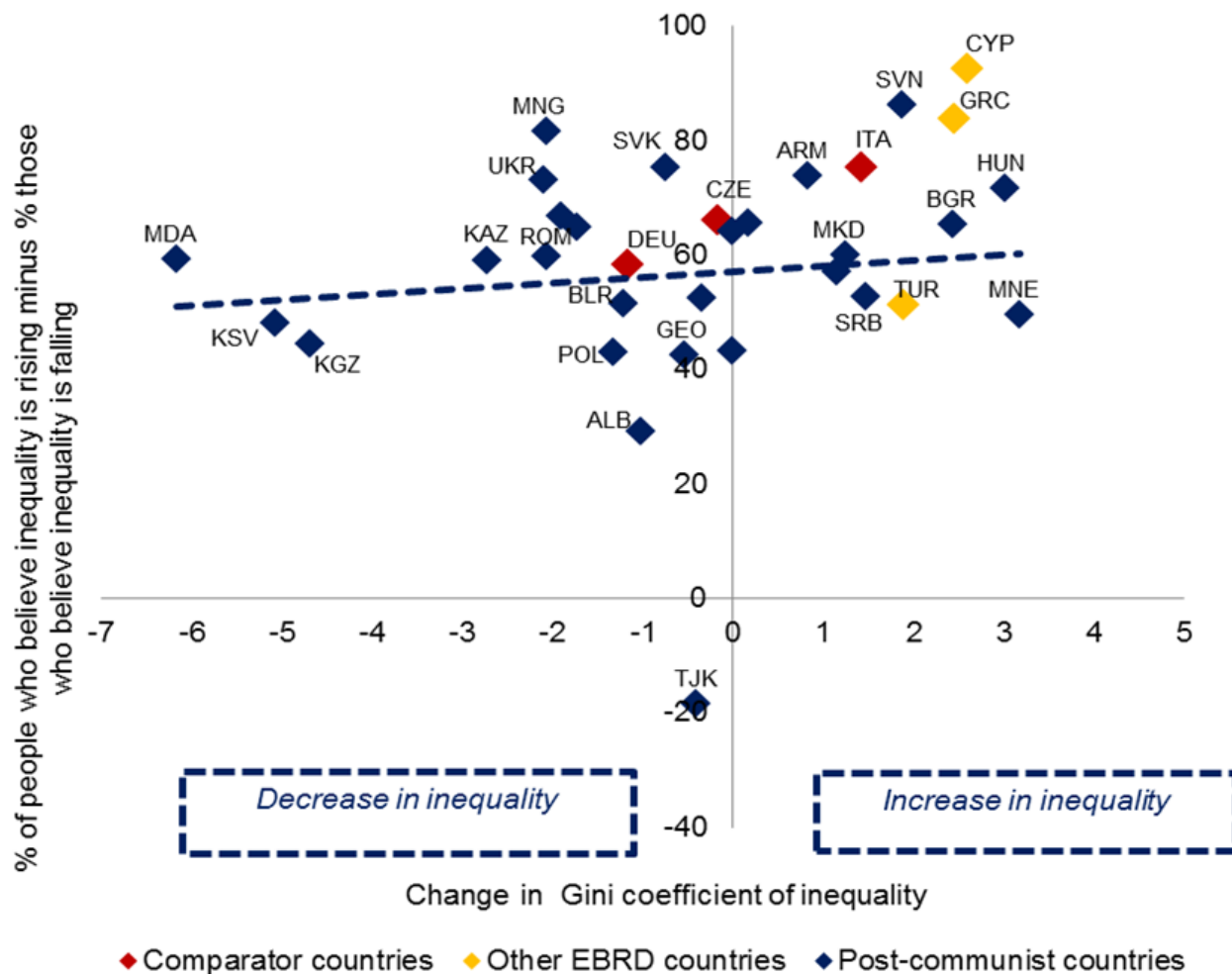
# Emergence of oligarchs

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# Perceptions of change in income inequality: very different from the household survey data

Changes in inequality: measured and perceived



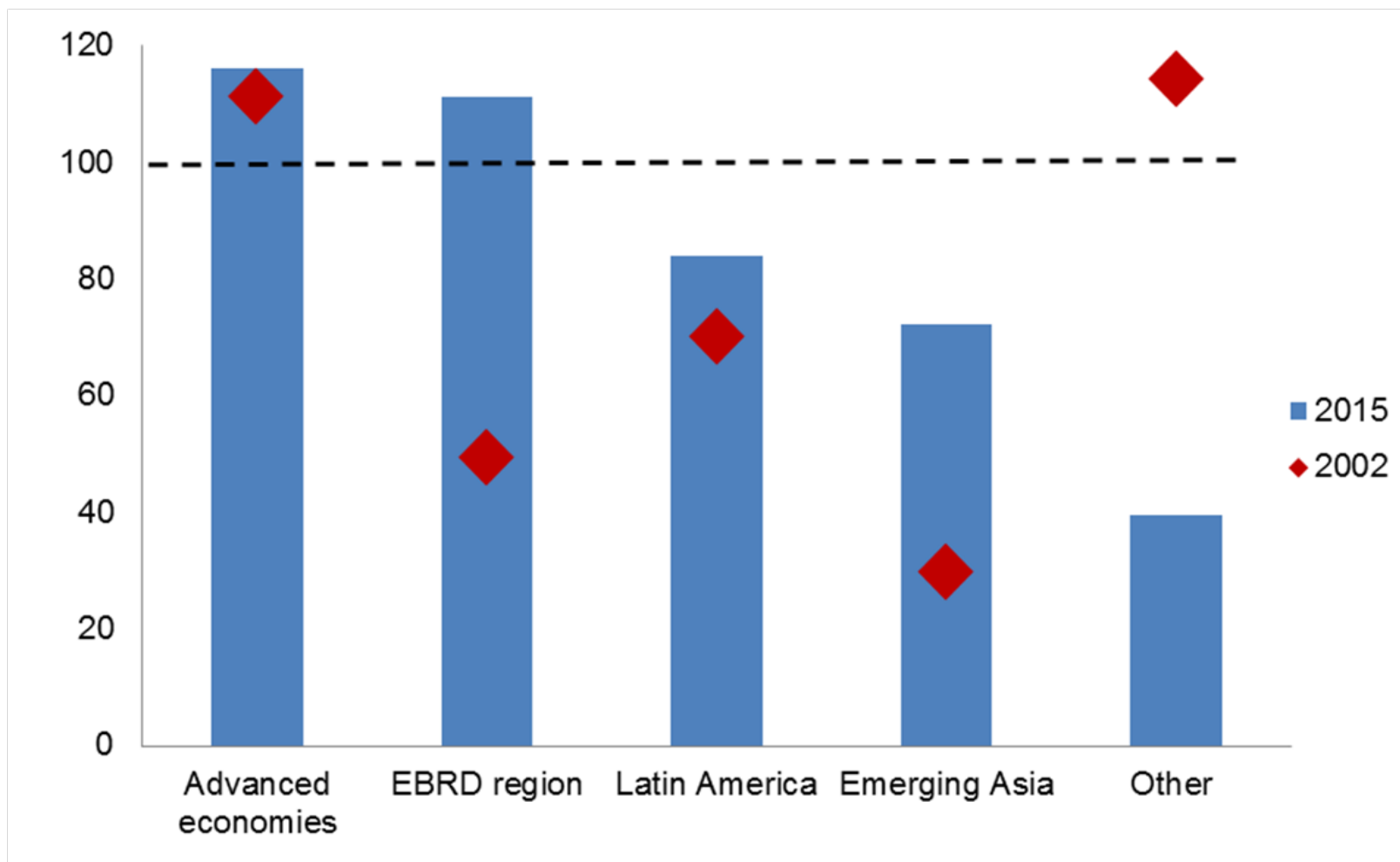
# Why perceptions of inequality differ from the household survey data?

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- Household data do not capture the very poor and the very rich
- In post-communist countries, there is a disproportional presence of the super-rich
  - Their wealth is mostly coming from natural resource rents
  - In other countries, the resources rents are taxed away by the state

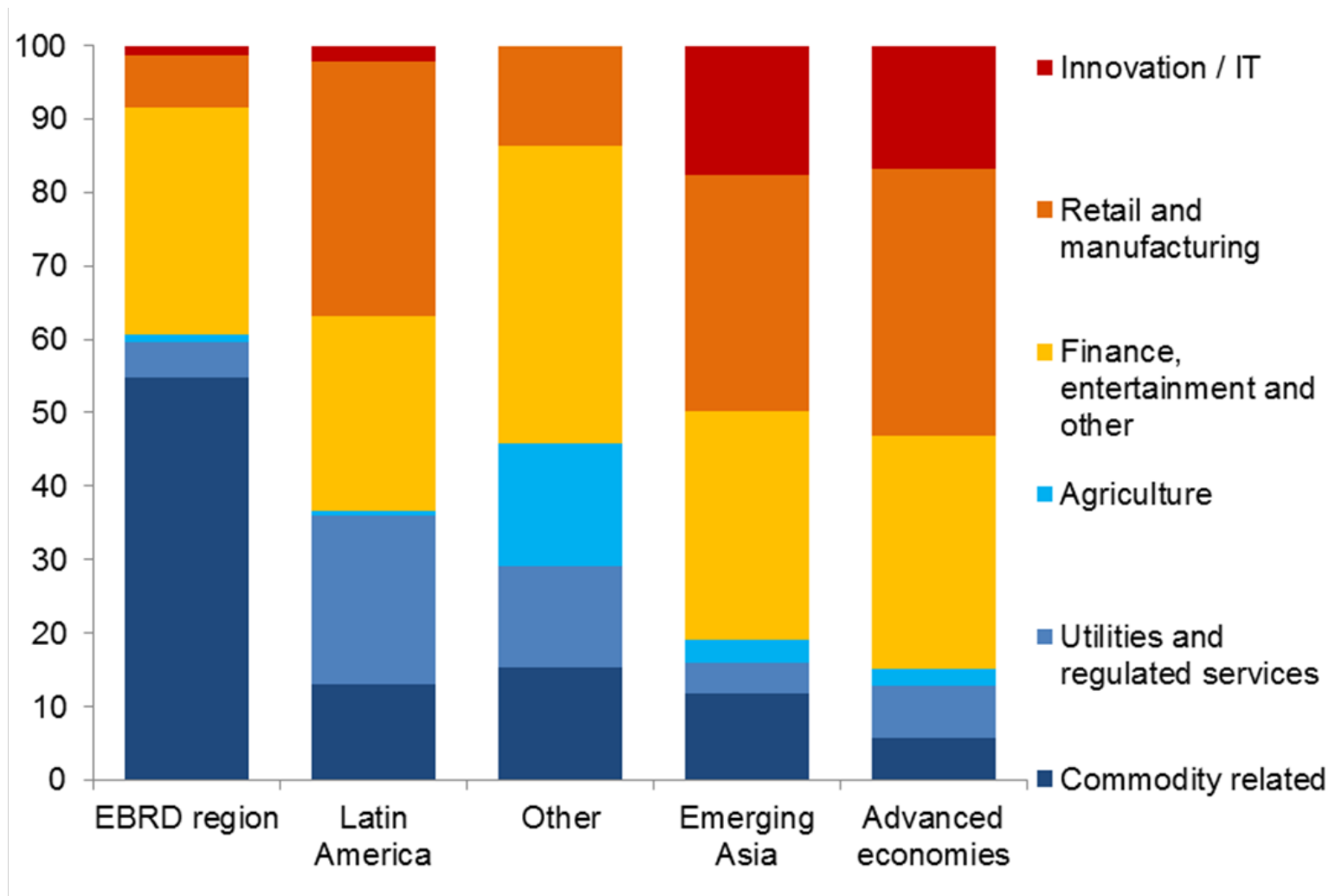
# Concentration of wealth at the top is high by international standards

Regional share of global billionaire wealth in % of regional share of global GDP



# And driven mostly by commodity rents, rather than innovation or competitive manufacturing

Sources of billionaires' wealth, % of total



## Guriev and Rachinsky (2005)

- In Russia 2002, 22 business groups control about 40% sales and employment
  - Mostly present in natural resources industries
- Outperform state-owned enterprises and other private firms
- At par with foreign-owned firms

## Guriev and Treisman (2016)

- **Modern autocrats use money and information rather than ideology/repression**
  - **Remain “popular” rather than feared**
    - **Convince the public that the leader is “competent”**
  - **Treat differently the informed elites (who can judge the quality of the leader) and the uninformed masses**
    - **Use propaganda for masses**
    - **Bribe or censor elites**
    - **Those who choose to be bribed become the regime’s cronies**

# Informational autocracies: empirical analysis

- Gallup World Poll data, 100+ countries, 2006-2016, one million observations
- Analyze approval of national government and perception of media freedom
  - By definition, censorship censors information on the presence of censorship
- Use tertiary education as a proxy for “elite” (understanding the quality of the leader)

## Results

- In democracies, educated are more likely to approve the government
  - As they are better-off today and have brighter future
- In non-democracies, educated are less likely to approve the government
  - Despite being better-off
- Media freedom: self-reported perceptions vs. “objective” Freedom House score
  - Censorship only works for the non-educated – they are convinced there is no censorship
  - For educated, there is no gap between perceived and objective scores