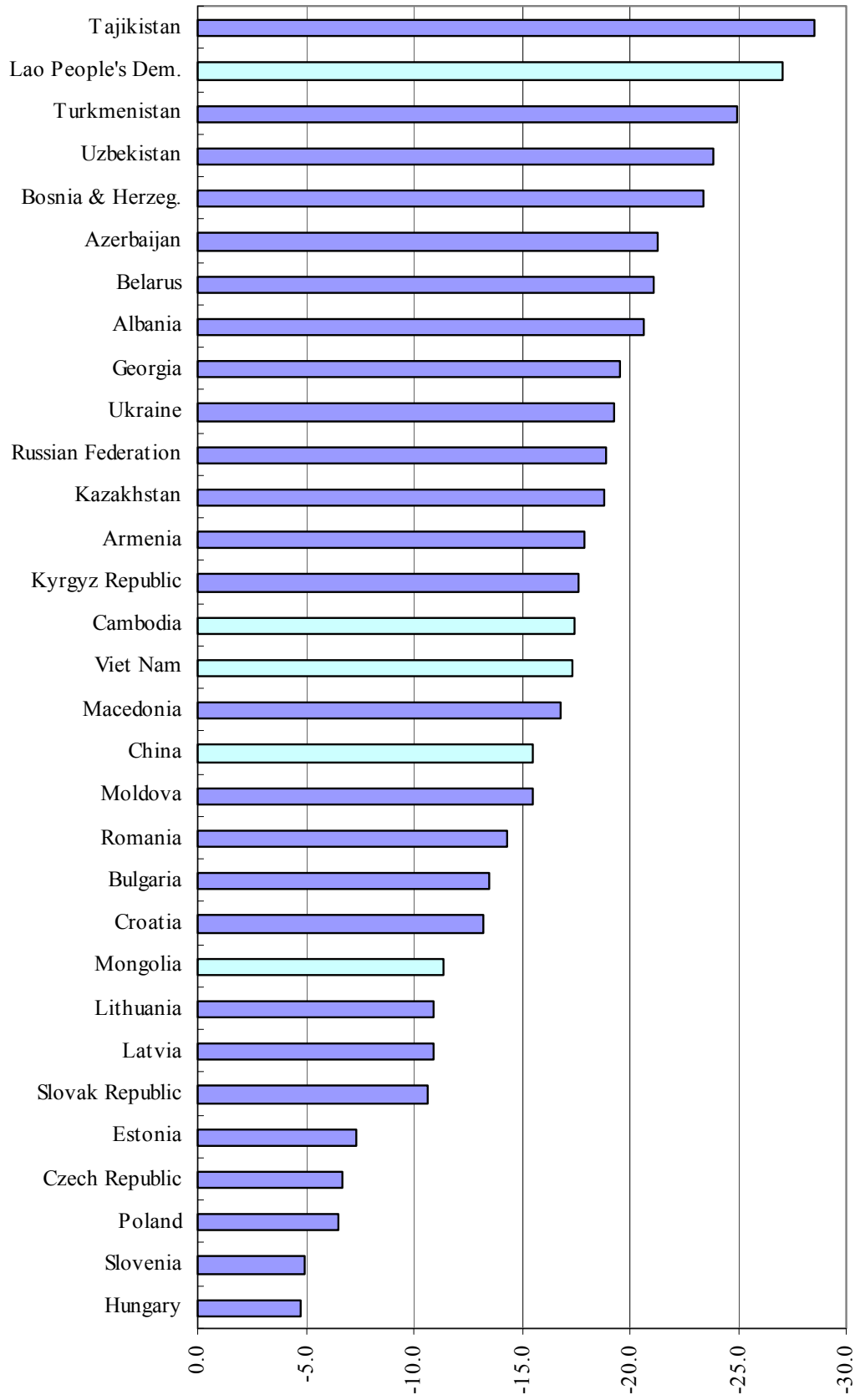


## 6. Institutions and differences in performance.

- Initial output fall occurred in all Central and Eastern European countries but how to explain differences in performance after the output fall?
- Poland and Russia did not differ much in their transition strategies but diverged in terms of their output performance.
- Role of institutions, and of law enforcement, in securing private contracts (North, 1990).
- Understanding output fall required looking at level of contracts. Institutional environment of contracts plays an important role.

# Deviation of Overall Average Institutional Quality (1997) from the mean of Industrialized countries

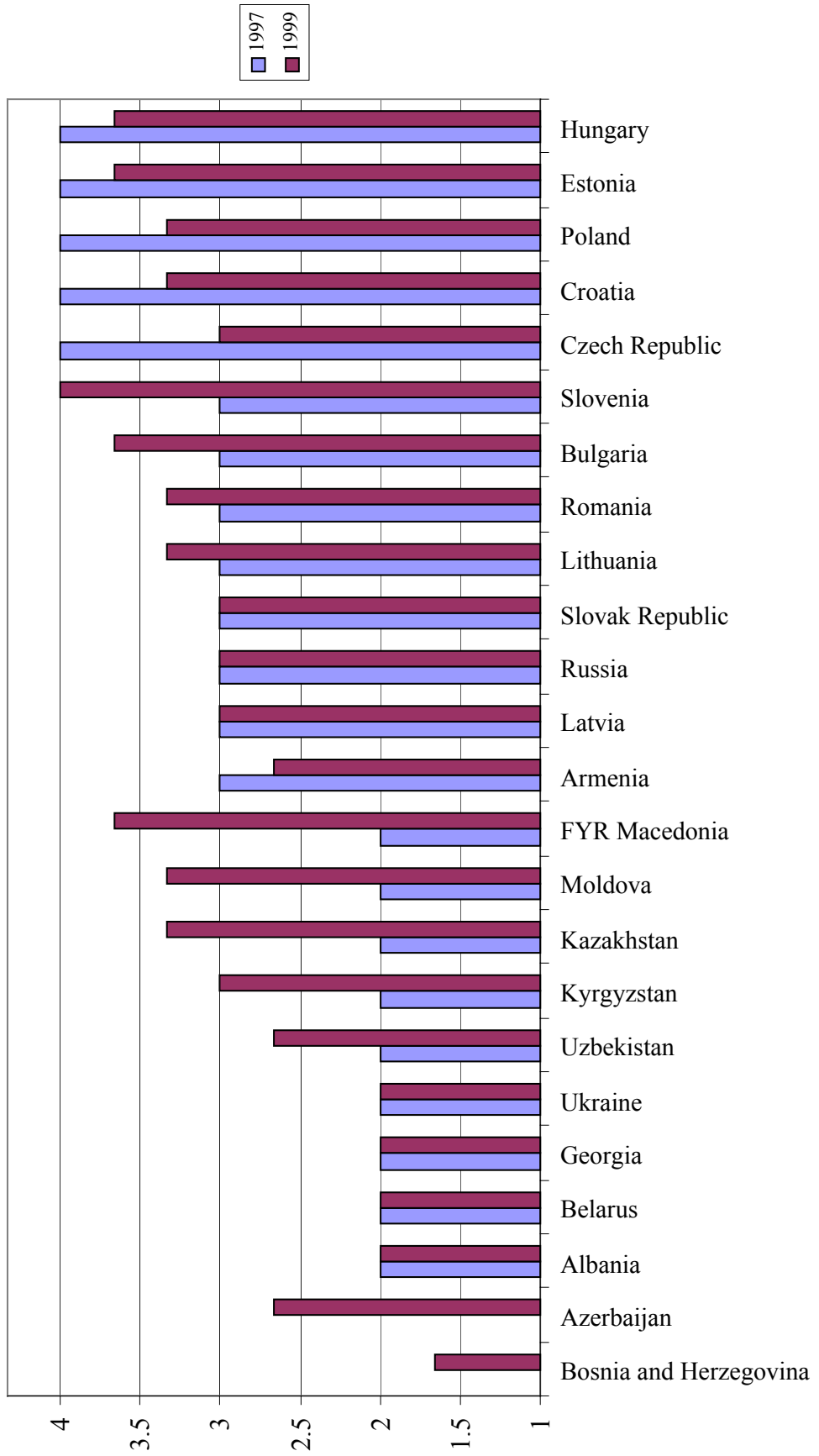


EBRD legal reform indicators:

Survey among lawyers and legal experts (scores given).

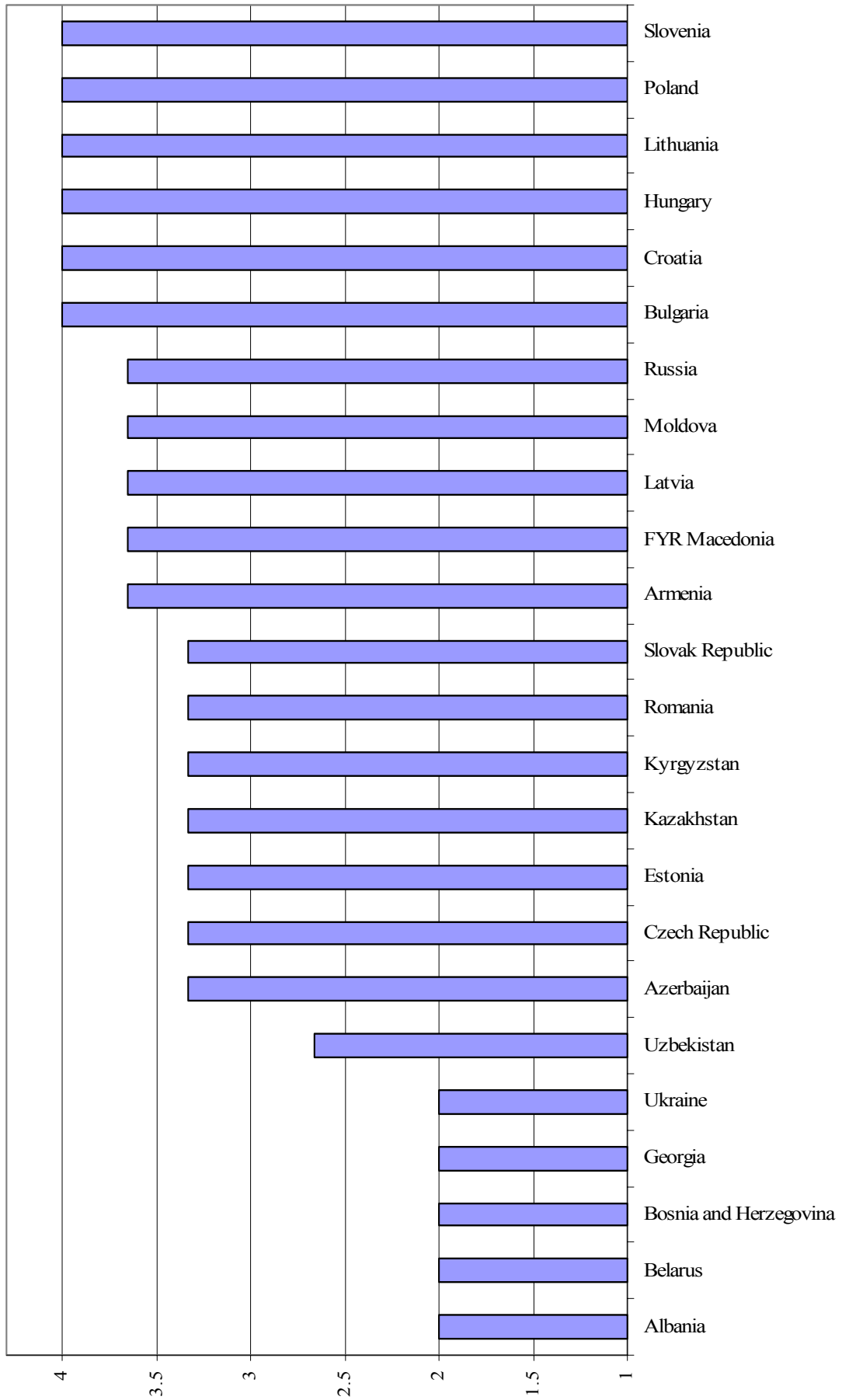
Extensiveness (comprehensiveness) and effectiveness  
(clarity, absence of contradictions, quality of administration of law)

# EBRD Legal System Indicators 1997 and 1999

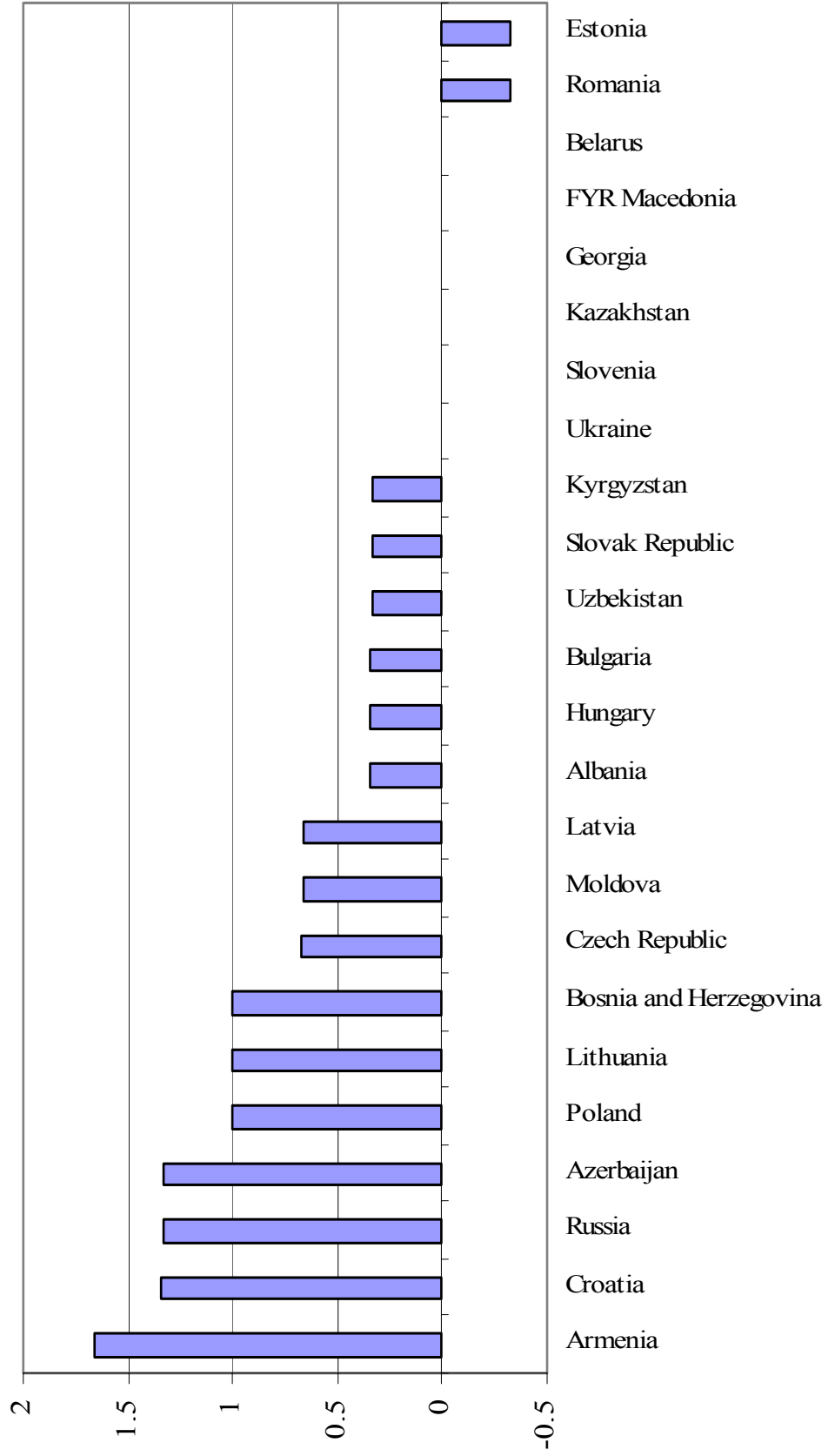


# Legal System Effectiveness in 1999

## EBRD Legal System Indicators



# Legal System Extensiveness in 1999 - Legal System Effectiveness in 1999



- Emphasis on introduction of legal codes is not enough. Russia introduced many US laws but laws were not enforced.

-Mafia phenomenon more developed in Russia and former CIS.

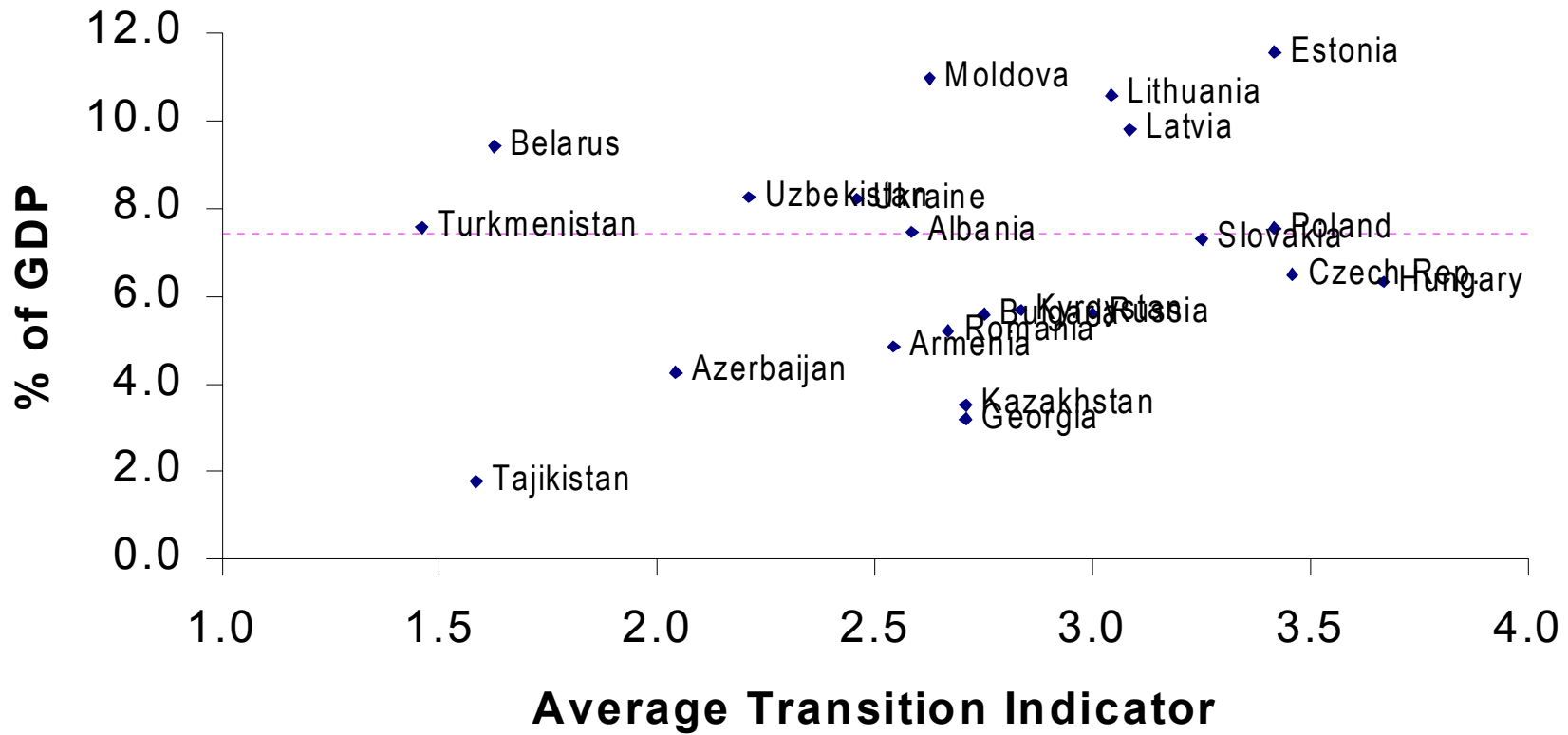
	Russia and Ukraine	Poland	Slovakia	Romania
% of managers reporting that firms pay Mafia protection	90	8	15	1

Source: Johnson et al. , 1999.

- Important coordination problem in law enforcement:
- expectations of weak law enforcement => lower deterrence for unlawful activities including tax evasion => lower production => low tax collection and weak law enforcement.
- expectations of strong law enforcement => higher deterrence for unlawful activities => high productive activity and high tax collection making strong law enforcement possible.



## VAT in % of GDP Normalized to 20% Rate 1997 vs. EU Average



Correlation between progress in transition and tax collection. No advanced transition country with low tax collection ability.

The evolution of the unofficial economy as a share of GDP in selected transition countries.

Country	1989	1995
Hungary	27	29
Poland	15.7	12.6
Czech republic	6	11.3
Slovakia	6	5.8
Estonia	12	11.8
Russia	12	41.6
Ukraine	12	44.2
Georgia	12	62.6

Source: Johnson, Kaufmann and Shleifer (1998).

- Countries that started reforms earlier had large unofficial sectors.
- Accession countries have not experienced significant increase in size of unofficial sector.
- FSU countries have seen large increase in size of unofficial sector.

Taxation, regulation, corruption, the legal system and the size of the unofficial sector.

	Poland	Slovakia	Romania	Russia	Ukraine
Percentage of sales not reported	5.4	7.4	5.7	28.9	41.2
Taxes as % of sales	15.5	16.4	17.2	23.9	24.2
Percent who think firms make extralegal payments for government services	20	38	20	91	87
Percent of firms saying that firms pay for mafia protection	8	14.9	0.6	92.9	88.8
Percent of firms saying courts can be used to enforce an agreement	72.9	67.9	86.9	58.4	54.7

Source: Johnson, Kaufmann, Mcmillan and Woodruff (1999).

- Weak law enforcement has an effect on private contracting:
  - lock-in of relationships through specific investment to create trust and reduce outside options of other party and create credible stronger sanction
  - multilateral sanctions and social exclusion.
  - Role of trade associations, wholesalers and intermediaries in keeping information on reputations.

BUT:

- Lock-in and closed networks good at imposing sanctions reduce competition and limit opportunities.
- use of private protection undermines rule of law and creates opportunities for organized crime to hold up business firms.

Trust and relational contracting.

	Poland	Slovakia	Romania	Russia	Ukraine	Vietnam
Percentage participating in trade associations providing information on suppliers and customers	20.8	23.4	44.2	60	64.1	26
Percentage of bill paid after delivery	83.5	69.7	48.1	11.8	37.5	38
Percentage having customer managed by family or friend	6.4	13.4	30.5	22.2	18.7	14.6
Percentage that would buy from new supplier at price 10% lower than current supplier	42.5	48.4	62.5	1.4	7.9	29

Source: McMillan and Woodruff (1999), Johnson, McMillan and Woodruff (1999a).

Development of Property rights and Market infrastructure.

	Poland	Slovakia	Romania	Russia	Ukraine
Percentage of managers who would not invest 100\$ now to receive 200\$ in 2 years	22.1	24.6	16.2	98.9	99.3
Percentage of a firm's sales going through a wholesale	26	19	7	5	4
Percentage of firm's sales going to different cities or countries	64.7	67.6	53.8	23.3	30.5
Percentage of sales not to SOE's or spinoffs	61.3	55.5	67.7	38.1	36.3

Source: Johnson, McMillan and Woodruff (1999b,c).

Weak law enforcement leads to

- underinvestment (stronger motive than credit constraints in transition economies) because of fear of expropriation.
- weaker developments of markets. Firms trade less distantly, organize in close business groups and trade



## How to explain difference in institutional quality in Central Europe vs FSU?

- Difficult question and many possible confounding factors.
- orthodox culture? Absence of renaissance culture?
- Longer communist past?
- absence of rule of law in the past?
  
- One important factor is that accession acted as an institutional anchor for Central European countries and helps to coordinate expectations.