nadel

Nachdiplomstudium für Entwicklungsländer
Postgraduate Course on Developing Countries

Ivan Pavletic

Political Competition, Economic Reform and Growth: Theory and Evidence from Transition Countries

OPEN ACCESS – erhältlich als eBook zum freien Download
DOI-Nr. 10.3218/3311-3
ISBN 978-3-7281-3311-3 (open access)
ISBN 978-3-7281-3296-3 (Printversion)
www.vdf.ethz.ch

vdf

nadel

Nachdiplomstudium für Entwicklungsländer
Postgraduate Course on Developing Countries

Ivan Pavletic

Political Competition, Economic Reform and Growth: Theory and Evidence from Transition Countries

Bibliografische Information der Deutschen Nationalbibliothek
Die Deutsche Nationalbibliothek verzeichnet diese Publikation in der Deutschen Nationalbibliografie; detaillierte bibliografische Daten sind im Internet unter http://dnb.d-nb.de abrufbar.

ISBN 978-3-7281-3311-3 (open access)
ISBN 978-3-7281-3296-3 (Printversion)
DOI 10.3218/ 3311-3

Download open access:
www.vdf.ethz.ch

Dieses Werk ist gedruckt unter www.vdf.ethz.ch erhältlich.

Contents

List of Figures vii

List of Tables ix

Nomenclature xi

Acknowledgements xv

Introduction 1

1 Fighting Poverty in Transition Countries 7

- 1.1 Causal Links between Poverty, Inequality and Growth . . . 7
  - 1.1.1 The Promising Link Between Poverty and Growth . . . 10
  - 1.1.2 The Capricious Link Between Inequality and Growth . . . 11
- 1.2 The Policy Agenda . . . 14
  - 1.2.1 Macroeconomic Adjustment . . . 16
  - 1.2.2 Openness To Trade . . . 17
  - 1.2.3 Privatization and Market Regulation . . . 19
  - 1.2.4 Institutional Quality and Effective Governance . . . 20
- 1.3 Conclusion . . . 21

2 The Political Economy of Reform 23

- 2.1 Introduction . . . 23
- 2.2 The Reform Model . . . 25
  - 2.2.1 Model Assumptions . . . 25
  - 2.2.2 The Political Market . . . 26
  - 2.2.3 Reform Decision . . . 27
  - 2.2.4 Reform Design . . . 33
  - 2.2.5 Reform Implementation . . . 34
- 2.3 Model Discussion . . . 36
  - 2.3.1 State Capacity . . . 37
  - 2.3.2 The Collective Action Problem . . . 42
  - 2.3.3 The Agency Problem . . . 47
  - 2.3.4 Competition . . . 52

2.4 Methodological Observations 55
2.4.1 Cross-Country vs. Case Studies 55
2.4.2 The Scientific Validity of Case Studies 56
2.4.3 Case Selection 57
2.5 Conclusion 61

3 The Process of Endogenous Simultaneous Transition 63
3.1 Introduction 63
3.2 Competition and Performance 65
3.3 Empirical Analysis 68
3.3.1 Sample and Variables 68
3.3.2 A Model of Endogenous Simultaneous Transitions 69
3.3.3 Estimation 71
3.3.4 Results 72
3.4 Simulation 79
3.5 Conclusion 83

4 Comparative Case Study 85
4.1 Introduction 85
4.2 Bulgaria 86
4.2.1 Initial Conditions 86
4.2.2 Muddling Through Transition 88
4.2.3 The Return to the Path of Economic Growth 94
4.2.4 The Path to EU Accession 98
4.3 Romania 102
4.3.1 Initial Conditions 102
4.3.2 Yet Another Case of Muddling Through 103
4.3.3 Breaking the Logjam 107
4.3.4 The Path to EU Accession 111
4.4 Albania 118
4.4.1 Initial Conditions 118
4.4.2 Shaking Off the Legacy of the Past 120
4.4.3 The Continuing Trouble with Governance 125
4.4.4 The Rocky Road to EU Accession 129
4.5 Bosnia and Herzegovina 134
4.5.1 Initial Conditions 134
4.5.2 The Travails of Reconstruction 136
4.5.3 The Limits of External Intervention 138
4.5.4 The (Not So) Tempting Bait of European Membership 145

4.6 Past Achievements and Future Reform Challenges . . . 150
4.6.1 Macroeconomic Adjustment . . . 152
4.6.2 Trade . . . 155
4.6.3 Privatization and Market Regulation . . . 156
4.6.4 Education . . . 168
4.6.5 Institutional Quality and Effective Governance . . . 170
4.7 Ex Post Reform Forecast . . . 174
4.7.1 Political Markets at the Beginning of Transition . . . 174
4.7.2 Political Markets at a Turning Point . . . 183
4.8 Conclusion . . . 193
5 Conclusion 197
Data Sources and Definitions 201
Bibliography 203

List of Figures

1.1 GDP Index Across Regions from 1989–2006 10
1.2 The Growth-Inequality-Poverty Diamond 22

2.1 The Reform Process 28
2.2 The Relationship Between Voice and Exit 30

3.1 The Process of Endogenous Simultaneous Transition 67
3.2 Marginal Effect of a 1 Percent Decrease in GDP 73

4.1 GDP Index 1990–2006 151
4.2 Consumer Price Index 1990–2006 153
4.3 General Government Balance 1990–2006 153
4.4 Government Expenditure 1990–2006 154
4.5 Current Account 1990–2006 154
4.6 Trade 1990–2006 156
4.7 EBRD Large Scale Privatization Index 1990–2006 157
4.8 EBRD Banking Sector Reform Index 1990–2006 157
4.9 EBRD Price Liberalization Index 1990–2006 158
4.10 EBRD Infrastructure Reform Index 1990–2006 158
4.11 Private Sector Share in GDP 1990–2006 159
4.12 Private Sector Share in Employment 1990–2006 159
4.13 Sectoral Share in GDP and Employment 1991–2005 160
4.14 EBRD Enterprise Restructuring Index 1990–2006 161
4.15 Labor Force Indicators 1990–2006 162
4.16 Starting a Business 2003–2006 163
4.17 Enforcing Contracts 2003–2006 163
4.18 Closing a Business 2003–2006 165
4.19 Employment Regulation 2003–2006 165
4.20 CPI-Deflated Wage Index 1998–2006 167
4.21 Gross Upper Secondary Enrollment 1990–2006 169
4.22 Public Expenditure on Education 1990–2006 169
4.23 Governance Indicators 1996-2006 173

List of Tables

1.1 Poverty Rates in Transition Countries 9

2.1 Living Standards at the Beginning of Transition 59
2.2 Economic Indicators at the Beginning of Transition 60

3.1 Estimates for Reform Equation 76
3.2 Estimates for Growth Equation 77
3.3 Estimates for Political Equation 78
3.4 Unsuccessful Transition Dynamics (Scenario 1) 80
3.5 Partially Successful Transition Dynamics (Scenario 2) 81
3.6 Successful Transition Dynamics (Scenario 3) 82

4.1 Gross Average Monthly Wages (in US$) in SEE 1998–2006 167
4.2 Political Market Conditions between 1990–1992 178
4.3 Political Competition between 1990–1992 183
4.4 Political Market Conditions between 1996–1997 188
4.5 Political Competition between 1996–1997 192

Nomenclature

ACER	Albanian Center for Economic Research
APL	Albanian Party of Labor
AR1	First-order autoregressive specification
BiH	Bosnia and Herzegovina
BSP	Bulgarian Socialist Party
CEEB	Central Eastern Europe and the Baltic States
CIS	Commonwealth of Independent States
CISE	Eastern Commonwealth of Independent States
CISW	Western Commonwealth of Independent States
DNSF	Democratic National Salvation Front
DPA	Democratic Party of Albania
EBRD	European Bank for Reconstruction and Development
ESI	European Stability Initiative
EU	European Union
FBiH	Federation of Bosnia and Herzegovina
FDI	Foreign direct investment
FRY	Federal Republic of Yugoslavia
GDP	Gross domestic product
GDPPC	Per capita gross domestic product
GMM	Generalized method of moments
GNI	Gross national income

HDZ	Croatian Democratic Party
IDA	International Development Agency
IMF	International Monetary Fund
ITA	Indirect Taxation Authority
LAOUL	Law on Agricultural Ownership and Use of Land
MEBO	Management and Employee Buy-out
MRF	Movement for Rights and Freedoms
NAP	National Agency for Privatization
NSF	National Salvation Front
NSSED	National Strategy for Socio-Economic Development
OECD	Organisation for Economic Co-operation and Development
OED	Operations Evaluation Department (of the World Bank)
OLS	Ordinary least squares
OPPG	Operationalizing Pro-Poor Growth
PH1	Poverty headcount ratio at US$ 2.15 a day (PPP)
PH2	Poverty headcount ratio at US$ 4.30 a day (PPP)
PIC	Peace Implementation Council
PPP	Purchasing power parity
PSDR	Party of Social Democracy of Romania
RAS	Romanian Academic Society
RDC	Romanian Democratic Convention
RS	Republika Srpska
SAA	Stabilization and Association Agreement
SAp	Stabilization and Association Process
SDA	Bosniak Party for Democratic Action
SDP	Social Democratic Party
SDPBH	Social Democratic Party of Bosnia and Herzegovina

SDS	Serbian Democratic Party
SEE	South Eastern Europe
SGMM	System generalized method of moments
SMEs	Small and medium-sized enterprises
SNM	Simeon II National Movement
SNSD	Party of Independent Social Democrats
SOE	State-owned enterprise or socially-owned enterprise
SPA	Socialist Party of Albania
UDF	Union of Democratic Forces
UN	United Nations
UNDP	United Nations Development Programme
UNECE	United Nations Economic Commission for Europe
VAT	Value added tax

Acknowledgements

This thesis is the result of my research at the NADEL (Postgraduate Program in Development Studies) at ETH Zurich. Many people have supported me in my work and contributed to the completion of the thesis. I would like to offer special recognition and deep gratitude to my thesis advisor, Rolf Kappel, for his support during my years of study and investigation. I would also wish to thank Henner Kleinewefers for sharing his vast scientific knowledge and for always providing pertinent and timely feedback. The thesis would not have been possible without their invaluable contributions. Further thanks go to Thomas Sattler, with whom I co-authored the Chapter "The Process of Endogenous Simultaneous Transition" in this thesis. Collaborating with him has been professionally and personally very rewarding. Peter Beez and Anne Lugon-Moulin, who supported me throughout various stages of this project, provided me with extremely worthy input and insight. The Swiss National Science Foundation financially supported my stay at the London School of Economics, which is greatly acknowledged. I am also indebted to Sandra di Domenico and Brooke Walters for editing the thesis. I would further like to thank the NADEL team for the stimulating conversations during our famous coffee breaks, lunches and parties. Finally, I wish to express my deep love and gratitude to my friend and companion, Ursina Tones, and my family for their devoted support, understanding, and encouragement during the entire course of the study.

Introduction

Understanding the process of policy reform has become the challenge of several generations of academicians. Scholars from various scientific backgrounds have identified factors that promote or hinder the adoption and implementation of reform policies. However, a quick look at the literature reveals that research on the dynamics of economic and political change remains in its early stages. What still lacks is a comprehensive, systematic analysis of the political and institutional prerequisites to implement reform policies.

The reason for the lack of a comprehensive, systematic analysis is that political and economic change is a complex undertaking. Policy reform is a process that involves many actors through many stages of the political process. It calls for specific actions from economic and social agents, and requires forms of cooperation that guarantee the sustainability of the reform effort. The trade-offs among country-specific needs and capacities, interests and political benefits are still not yet fully understood. Moreover, a universal set of right policy measures does not exist since policies are contingent responses to existing political, social and economic constraints. A reform might succeed at one point in time in a given country, but fail in a different place or in the same place at a different time. There is also good reason to question some governments' commitment to implement reform policies. This complexity explains why so many reform efforts in the past have not achieved their intended outcome. In order to improve the likelihood of success it is important to better understand the politics of reform. This study aims at contributing to this understanding by providing a systematic analysis of the political and institutional forces that shape the reform process.

Particular attention is drawn to reform policies that have been identified as being good for the poor. During the past two decades of intense reform efforts in developing and transition economies, the inadequate consideration given to the fate of poor people has raised many concerns. This has set off a lively debate about the necessity of taking poverty into account when implementing reform measures. As a result, economists have explored at length the impact of various reforms on poverty. It has been acknowledged that economic growth and inequality play an important role in this relationship. Growth raises income levels and improves the well-being of people living in poverty. Evidence suggests that poverty falls most sharply in countries that grow rapidly, implying that faster growth leads to faster poverty reduction. Although the relationship between poverty and inequality is somewhat more complicated, recent findings clearly indicate that the impact of a given growth rate on poverty is related to the initial level of inequality—with high initial inequality making poverty reduction efforts more difficult in the future.

Research has also established a set of policy measures that strengthen the capabilities of poor people and facilitate their active participation in the growth process. Some policies are relatively undisputed. For instance, it is now widely accepted that poor people greatly benefit from macroeconomic stability. Evidence even suggests that the poor disproportionally benefit from low levels of inflation. Other policies, such as market liberalization, are more controversial. While a coherent microeconomic liberalization is a *conditio sine qua non* for functioning factor and product markets, the specific design of liberalization policies and their impact on poverty is still subject to dispute. For example, does trade openness in combination with complementary reforms such as tariff reductions automatically generate faster growth? Not necessarily. Without collateral policies and institutions on the domestic side, import liberalization could bring about a sharp increase in imports (benefiting consumers) without a corresponding healthy supply response on the export side (which is necessary to benefit workers). But coupled with improvements in the investment climate and human development, openness to trade can be a powerful driver of growth and poverty reduction. Similar observations can be made with respect to labor market liberalization, or capital market and financial sector liberalization.

The poverty agenda is not confined to economic stability and liberalization alone. All these measures are more likely to show positive results in the presence of a reliable institutional environment that regulates the interactions between public and private agents. Evidence clearly shows that a good institutional environment and good governance are closely linked with development outcomes. The problem is that it is easier to enumerate the functions institutions should perform than it is to tell what these institutions have to look like in practice.

Textbooks tell us that good institutions provide secure property rights, enforce contracts, guarantee political and economic stability, foster integration in the world economy, stimulate entrepreneurship, and enhance voice and accountability. The extensive research on institutions in recent years has shown that growth and development are not confined to specific institutional arrangements. Therefore, we should not be overly formal in our understanding of the institutional environment. Some institutions work in one place, but do not work in another. What is possible often depends on local constraints and opportunities. To quote Rodrik (2004, 13), the best a consultant can do is to make "institutional prescriptions that are contingent on the prevailing characteristics of the local economy."

While some of the aforementioned prescriptions are clear, others often remain vague and subject to debate. Ambiguous prescriptions generally complicate matters, because they increase the level of uncertainty inherent to the reform process and leave room for political manipulation. However, ambiguity also gives policy makers the opportunity to become political *entrepreneurs* in the Schumpeterian sense. As entrepreneurs, they engage in a risky process of creative destruction, dismantling the existing order of economic activity and creating a new one. This process highlights the experimental character of reform politics, where trial and error determine success. The new order may work or it may not. What matters in the end is that the political market facilitates and enables the process of trial and error, learning, and innovation (Hayek, 1978).

The ability to adapt to a changing environment is a key determinant of competitive advantage. The radical changes taking place in the countries of Eastern Europe and the former Soviet Union offer an exceptional opportunity to study this process of adaptation. These countries had to overcome the legacy of communism and authoritarianism in a relatively short period of time.

The transition to democracy and market economy started in 1989–1990 for most countries of Eastern Europe. After the collapse of the Soviet empire in 1991, other countries began their transition to a market-based economy. Major programs of macroeconomic stabilization and complex market restructuring were introduced at the end of 1989 in Poland and the former Yugoslav Federation. Czechoslovakia, Bulgaria, and Slovenia launched their reform programs a year later. Albania started the transition process in 1991, while Estonia, Latvia, Lithuania and Russia joined the group of reformers in 1992. In Croatia, Macedonia, Moldova, and the Kyrgyz Republic, serious reform efforts were made only in 1993, and it took at least another year until Armenia, Georgia, Azerbaijan, and Kazakhstan started to reform. Hungary, being more advanced in building market mechanisms and having a moderate level of inflation, pursued an explicitly gradual reform strategy. Romania also adopted a gradual approach, however with much worse results. Several countries, including Belarus, Turkmenistan, and Uzbekistan never developed nor adopted a viable approach to achieve a full-scale transition to a market economy.

The outcome of economic transition is mixed and distributed according to a regional pattern. After a relatively short period of output decline, Central Eastern Europe and the Baltic states (CEEB) have achieved sustainable growth by maintaining inflation at a low and relatively stable level, balancing the fiscal budget, and making serious progress in building basic market institutions. With closed ties to the European market, they have managed to build a relatively healthy and modern financial sector, attract significant inflows of foreign investment, and create a healthy entrepreneurial climate for small and medium-sized enterprises (SMEs).

Countries within the Commonwealth of Independent States (CIS) present a mixed picture. In general, they are less advanced in their reform efforts than the CEEB countries. Their transition process was characterized by a deep and long lasting economic decline. Not until the end of the 1990's did the economies embark on the path of growth, mainly thanks to rising oil and commodity prices. Macroeconomic stability was fragile due to direct and indirect enterprise subsidies, low levels of tax collection, and the chronic fiscal imbalances resulting from the inadequate restructuring of the public sector. Liberalization efforts were not implemented firmly enough, so that basic market institutions remained weak and immature. Serious impediments to business activity hampered the development of SMEs and the inflow of foreign investment. In many CIS countries, the financial sector suffered from irregularities and pathologies such as asset stripping, abuse of shareholders rights, and connected lending. Old trade patterns were maintained, while non-transparent regulations and high barriers to trade protected the economies from unwanted outside competition. Belarus, Turkmenistan and Uzbekistan deliberately preserved significant components of the command system.

The situation in South Eastern Europe (SEE) is situated somewhere in between these two extremes. Although reforms started relatively early in some countries, a resolute implementation was slowed down by periodic outbursts of violence in the region. Albania was the only country to make serious attempts to stabilize the economy from an early stage. Even in countries not directly affected by wars, such as Romania and Bulgaria, it took several years until a critical reform mass was achieved. Major political changes at the end of the century gave new impetus to the process of transition, and allowed the South Eastern part of Europe to progress toward reform.

The differences in the reform trajectories produced different outcomes. Countries benefiting from the initial momentum in favor of radical reforms made serious progress in creating a new political and economic system in a relatively short period of time. New elites were committed to democratic institutions and market structures and opposed any attempts to reverse the transition process. Old elites underwent a serious transformation and began to accept the new rules. At the same time, the consolidation of checks and balances, such as a free mass media and burgeoning civil society organizations, prevented the restoration of authoritarian regimes. Finally, for countries near the European Union (EU) border, the tenacious focus on EU accession was a clear commitment to the process of both political and economic reforms.

Early macroeconomic stabilization and market liberalization limited the magnitude of recession and contributed to sustain the output recovery. Encouraging the development of new private enterprises, these policy measures prepared the ground for a broader and more equal access to new entrepreneurial and employment opportunities. A firm and coherent reform implementation was probably the most effective way to cope with the social costs of transition. It allowed governments to avoid impoverishment due to long periods of uncertainty and high inflation. Institutional progress, political predictability and the prospect of EU integration attracted important inflows of foreign investment, increasing income per capita and strengthening the constituencies of reform.

Countries adopting an initially cautious attitude towards reform lost momentum and found themselves trapped in a situation characterized by extended periods of economic instability and negligible market structure improvements. In addition, distorted political institutions deprived social forces of the opportunity to hold policy makers accountable. Old and new elites captured public institutions and engaged in rent extraction activities, while administrative red tape and corruption hindered the rest of the society from participating in economic life. The uncertainty arising from political and economic distortions seriously deteriorated economic prospects, engendered impoverishment of large parts of the society, and undermined the legitimacy of state institutions. The benefits from political and economic insecurity mostly accrued to the elites. The costs were borne by the population. Accordingly, the elites had little interest in supporting reforms that would eventually dislodge them from their privileged positions. In many countries, this situation engendered frustration and political apathy within the population and prepared the ground for political manipulation and populism. The result was a perpetuation of misguided political choices and flawed institutions.

In some cases, this negative trend was overcome. For example, a severe financial crisis in Bulgaria during the winter of 1996–1997 led to early elections and a change of government. The new government seized its window of opportunity and implemented radical policy reforms. Other countries, like Ukraine and Serbia, are still struggling to shed the remains of their authoritarian past in order to embark on the path of democracy and market economy. Together, the diverse reform trajectories of the transition economies offer an exceptional test case for studying the process of political and economic change.

In order to examine the various reform trajectories, this study mixes two methods of analysis. A multivariate regression analysis that includes data from 26 countries over the period 1991–2006 tests a number of reform hypotheses the empirical transition literature has proposed in recent years. However, there are several problems related to this method. Aside from the standard reservations about the quality and comparability of data for a large number of countries, econometric issues loom large: measurement errors, endogeneity of independent variables, or biases due to omitted variables are inevitable. Even when we control for these problems, doubts remain whether we really unearth an adequate and satisfactory causal explanation. A more general problem is that cross-country studies are rarely able to give us good insights into the *mechanisms* of reform politics. While they do point out important regularities in cross-country experiences, they are of little help when it comes to understand what is shaping the dynamics that lie beneath the process of change.

From an empirical standpoint, processes of change require breaking up the aggregated indicators typically used in cross-country regressions. This means that research must integrate political and economic institutions, income distribution, and growth into more detailed qualitative comparative-historical analyses to understand the underlying mechanisms that determine reform processes. Therefore, a comparative country analysis will be conducted, including the countries of Albania, Bosnia and Herzegovina (BiH or Bosnia), Bulgaria, and Romania. It is true that it is more difficult to make generalizations based upon an individual country's experience, but comparative country analysis—when done properly—can provide us with useful lessons about the mechanisms and processes at work. There is no doubt that "for quite a long time to come both methods will have to be utilized, with full consciousness of the limitations of either." Bardhan (2005, 31) Efforts to bridge these two methods can yield critical insights into the nature of the reform process.

Readers may find it useful to have a brief synopsis of this study. Chapter 1 describes the various dimensions of poverty within the context of transition. Economic growth and inequality are identified as the proximate causes for changes in poverty. The chapter then reviews a number of growth-enhancing policies and discusses their effect on poverty and inequality. The chapter closes by asking what incentives motivate policy makers to implement such policies.

In Chapter 2, the theoretical basis of the political economy framework is laid down. The chapter presents an intuitive reform model that is used as an analytical device in the comparative case study in Chapter 4. By applying the market analogy to the political arena, the model reduces the complexity of the reform process and enables us to perform a systematic evaluation of the mechanisms at work. Three underlying problems of the reform process are then discussed in more detail: state capacity, collective action, and the agency problem. It is argued that political competition within an accepted and respected institutional environment mitigates these problems, and thus increases the likelihood of successful reform.

Chapter 3 presents an empirical model that explicitly accounts for the dynamic process of political and economic liberalization in post-communist countries. Simulation results based on this model reflect the diverging transition paths of these countries, which include quick democratic consolidation, political stagnation and reversals, and the collapse of the transition mechanism. Which path a country takes depends on the constellations in the political and economic arena at the outset of the transition process. Successful endogenous simultaneous transition requires that a considerable degree of political competition exists.

Chapter 4 examines the reform processes in Bulgaria, Romania, Albania and Bosnia on a case by case basis to evaluate whether political competition had an effect on economic reforms and possibly on economic performance. After a description of the political and economic reform trajectories in each country, reform achievements and future challenges are assessed. The comparative analysis at the end of the chapter finds evidence that the extent of economic reform has been contingent on the level of competition in the political markets studied. Chapter 5 concludes.

Chapter 1

Fighting Poverty in Transition Countries

This chapter first gives a description of the many dimensions of poverty in transition countries, as well as how they are influenced by growth and inequality. While both growth and inequality matter, it is difficult to change inequality patterns. The focus of reform should thus be laid on promoting growth. The impact of a number of growth policies on poverty is then evaluated, before concluding with a list of policy measures that have been identified as being particularly good for the poor.

1.1 Causal Links between Poverty, Inequality and Growth

The multidimensional view of poverty is now so broadly accepted that reemphasizing it is most certainly redundant. Therefore, the observations made here will be kept simple and brief.

Although poverty displays considerable variation across socio-demographic, regional, economic and institutional structures, common patterns do exist. Countries with a high dependency ratio—i.e., the ratio measuring the portion of the population which is either too young or too old to work relative to the productive part of the population—are more likely to be poor. Geographical variation in poverty is also quite marked, with rural areas being particularly afflicted by high poverty levels. The poor depend heavily on agriculture and often lack access to product and factor markets, education, and health services.

Poverty correlates strongly with bad labor market outcomes, such as the loss of a paying job, or insufficient income because of a lack of skills. The non- and semi-skilled suffer the most from poverty, regardless of their regional location. Casual wage employment is an important correlate of poverty. Poor people are often concentrated in microfirms and individual entrepreneurship in the informal sector. Finally, certain population groups—whether differentiated by ethnicity, race, religion, gender, or health condition—suffer a much higher risk of poverty than others (Lipton et al., eds, 1995; World Bank, 2000).

The poor in transition countries and the poor in the rest of the world share many attributes: they are short of assets, lack access to resources and basic services, and their standard of living is generally low. However, the region's socialist past and its profound economic upheaval in the last decade have made post-socialist poverty special in several respects.

What most notably distinguishes transition countries the most from other regions in the world is the increase in poverty levels experienced in the last decade. Between 1988 and 1998, absolute poverty has climbed from 2 percent to 21 percent (at US$ 2.15 in 1993 purchasing power parity (PPP) terms) in this region. Economic recovery at the end of the decade has reduced poverty to approximately 12 percent of the population (World Bank, 2000, 2005b).

In terms of poverty levels, the region can be split into four subgroups (see Table 1.1). In CEEB the levels of poverty are generally low, at less than 5 percent of the population. Poverty in SEE is around 5 percent to 20 percent, although with Albania the region comprises one of the poorest countries in Europe. Poverty levels in the Western Commonwealth of Independent States (CISW) are similar to those in SEE. Meanwhile, the Eastern Commonwealth of Independent States (CISE) displays very high levels of poverty. On the whole, poverty tends to be deeper in CIS countries than in CEEB and SEE countries (World Bank, 2000).

Despite the rise in poverty, living conditions of the population in the region are good compared to the conditions in countries of similar income levels. During the socialist era governments made strong investments in infrastructure and public services. Many of the poor in transition countries are literate and well-educated. The high level of education is one of the most important legacies of communism. School enrollment continues to be effectively universal in most of the countries. Even in the poorest countries in the region, primary enrollment rates now exceed 85 percent. Access to piped water, electricity, and central heating is generally assured, although the economic collapse in the 1990s has forced many governments to reduce public investments, so that the quality of these services has seriously deteriorated. The same is true for the health sector, where indicators are generally better than in countries of similar incomes. Maternal mortality rates are low, increases in child mortality have largely been contained, and even in the poorest countries, most children continue to be immunized despite reductions in public health spending (World Bank, 2000).

Notwithstanding these positive indicators, universal access to infrastructure and public services is being undermined by the inability of people to afford the expenses that are now being levied by many public institutions.

While conditions have deteriorated for the poor population in general, some groups are particularly vulnerable. Comprehensive studies on poverty have found that the unemployed, the less well-educated, the rural population, and children are the subgroups with the highest incidence of poverty in transition countries (World Bank, 2000, 2005b).

In recent years, many proximate and distant causes of poverty have been identified. In a narrow sense, two major factors contribute to the perpetuation of poverty: severe inequality and the lack of economic growth. Together, these factors make it difficult for

Table 1.1: Poverty Rates in Transition Countries

Country	Year	GDPPC	PH1	PH2	Gini
CEEB					
Estonia	2003	12’790	5	26	33
Hungary	2002	13’391	0	12	25
Latvia	2003	9’702	3	17	35
Lithuania	2003	11’055	4	24	32.5
Poland	2002	11’917	3	27	32
SEE					
Albania	2002	4’113	24	71	31.9
BiH	2004	6’267	4	35	29.5
Bulgaria	2003	7’304	4	33	27.7
Macedonia	2003	6’419	4	24	37.3
Romania	2003	6’875	12	58	28.8
Serbia and Montenegro	2002	na	6	42	29.2
CISW					
Armenia	2003	3’468	50	93	28.5
Azerbaijan	2003	3’417	4	70	18.2
Belarus	2002	5’331	2	21	29.2
Georgia	2003	2’445	52	85	39.1
Moldova	2003	1’426	43	85	32.8
Russia	2002	7’993	9	41	33.8
Ukraine	2003	5’188	1	22	26.8
CISE					
Kazakhstan	2003	6’302	21	66	31.8
Kyrgyz Republic	2003	1’654	70	96	27.6
Tajikistan	2003	1’045	74	96	32.7
Uzbekistan	2003	1’648	47	86	35.5

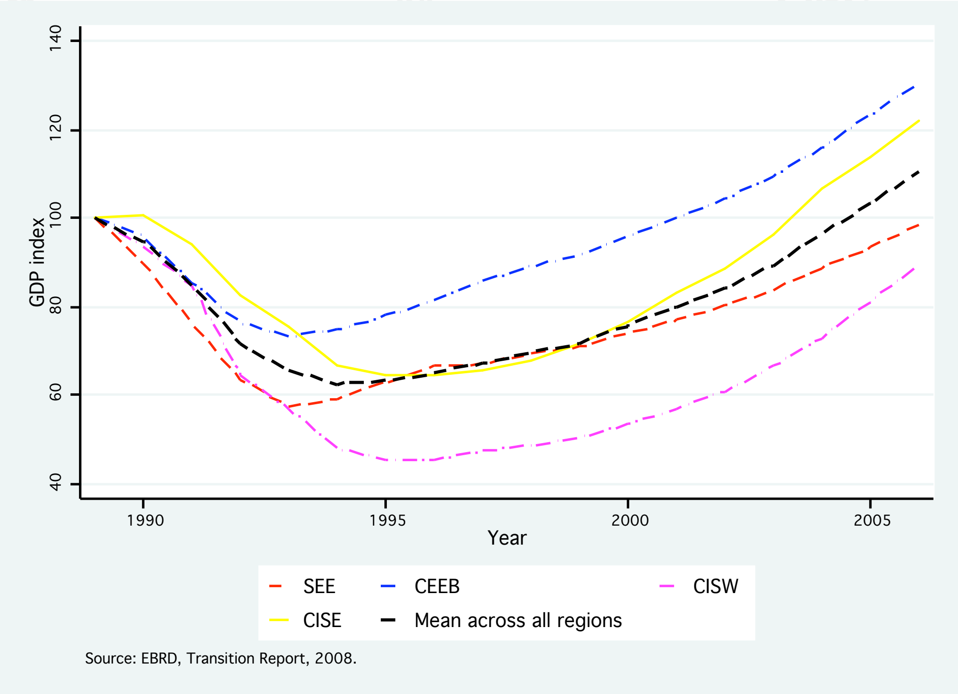
Notes: *GDPPC* lists the per capita income levels by PPP in constant 2005 dollars; *Gini* is the Gini index; *PH1* is the poverty headcount ratio at US$ 2.15 a day (PPP) in percent of the population; *PH2* is the poverty headcount ratio at US$ 4.30 a day (PPP) in percent of the population. PH2 is used to capture the notion of economic vulnerability.

Source: World Bank (2005b).

the poor to access and accumulate all kinds of assets, like human capital (capacity for basic labor, skills, good health), natural and physical assets (e.g., land, infrastructure), and social assets (e.g., networks of contacts and political influence over resources).

The same causal factors underlie the increase in poverty in transition countries. Here, the major source of poverty has been the economic downturn associated with transition and the subsequent collapse in output. As one can see from Figure 1.1, the cumulative output declined almost 50 percent in the CIS countries, and many countries have still not reached the GDP level they had at the beginning of the transition.[1] In CEEB and SEE, the output decline was less severe and the economies started to recover earlier. In addition, the level of inequality increased dramatically during the 1990s. Today, income inequality varies considerably in the region. While CEEB and SEE countries remain relatively egalitarian by world standards, there is concern about overly high levels of inequality in some CIS countries (see Table 1.1). These regional differences are striking, because income inequality was comparable across countries at the outset of the transition process.

Figure 1.1: GDP Index Across Regions from 1989–2006



Why did the collapse in output have such different effects on poverty across the region? What is necessary to reduce poverty in the future? How do the differences in inequality affect future efforts that aim to cut down poverty levels? These questions have spawned an extensive research literature on the mechanisms that regulate the relationship between poverty, growth and inequality, to which we will turn now.

1.1.1 The Promising Link Between Poverty and Growth

There is little doubt today that growth is the most important engine for poverty reduction. Evidence suggests that poverty falls most sharply in countries that grow rapidly.

[1]Note that the regional means reported in Figure 1.1 are unweighted averages.

Therefore, faster growth means faster poverty reduction. Empirical cross-country evidence suggests that, as average income rises, the income of the poorest fifth of the population rises proportionately. Over long time periods, between 66 percent and 90 percent of the reduction in poverty can be explained by changes in average income (Dollar and Kraay, 2002). On average, every one percent increase in the mean income decreases the poverty rate by 2.5 percent (Ravallion, 2001).

This is not to say that growth always benefits poor people equally. Countries and regions with similar per capita income can have quite different outcomes in both the income and the non-income dimension. These variations result from differences in initial inequality, the effectiveness of public interventions, and the level of development. In some countries growth clearly benefits the poor, while in others it does not appear to do so. However, the large majority of growth episodes raises poor peoples' absolute income. Moreover, growth also contributes to the progress of social dimensions of poverty, even though less strongly and consistently than it does to the progress on income poverty (World Bank, 2000).

1.1.2 The Capricious Link Between Inequality and Growth

Despite numerous studies, there is little evidence of a clear impact of growth on inequality. As a matter of fact, a consensus has emerged claiming that there is no definite relationship of distributional change during growth periods. On average, periods of growth are not accompanied by any predictable change of the income distribution (Bruno et al., 1999). In other words, increasing inequality may go hand in hand with positive or negative growth rates. The same goes for decreasing inequality.

An important reason for the lack of association between growth and inequality is the fact that inequality variations are the outcome of a wide and complex range of disparate factors. Changing inequality at a given rate of growth may stem from many possible sources, such as varying policies or institutions or differences in the regional and sectoral composition of growth. For instance, if growth does not find its way to poor regions and poor people cannot easily migrate to other regions, growth is likely to increase inequality. On the other hand, if growth occurs in sectors from which poor people derive their income, such as agriculture, growth is likely to decrease inequality.

Country analyses draw a more nuanced picture, highlighting the importance of changes in the distribution of growth and the return to education, labor market choices, and demographic changes. Those changes result from:

- market forces, such as a change in the demand for labor;
- policies, such as public investment in the education or health sector;
- social forces, such as higher participation of women in the labor force or changes in practices discriminating against ethnic minorities; or
- institutional forces, such as a change in legal restrictions.[2]

[2] See World Bank (2000/2001, 54).

Finding no clear distributional impact of growth does not mean that inequality should be neglected. While income growth is a necessary condition for poverty reduction, its distributional pattern also matters. The effectiveness of growth in reducing poverty depends on the initial inequality in income distribution and on the change in inequality (Ravallion, 2001). Inequality matters in so far as it influences the degree of poverty reduction generated by growth. An increase in inequality is detrimental to poverty reduction, because it tends to make poverty reduction efforts more difficult in the future.

In transition countries, inequality has undeniably increased since 1989. The rise in inequality was to some extent expected, because the transition from a planned to a market economy entails that wages and incomes progressively reflect individual productivity and effort. What was not expected, however, was the large difference in distributional outcomes. Countries with high levels of inequality will have more difficulties in pulling people out of poverty than countries with low levels of inequality. Nevertheless, inequality should not be considered harmful if:

- the number of poor people falls;
- the income at the bottom rises or at least does not fall;
- the development process expands opportunities for all; or if
- the observed trends are not the result of dysfunctional forces such as discrimination.[3]

But the relationship between inequality and growth is not linear. Using data on 73 countries, Cornia (2004) finds evidence for an inverted U-shaped relationship between initial income inequality and economic growth in subsequent periods. This implies that both a too low and a too high level of inequality can have negative repercussions on growth. Incentive traps, free riding, and high supervision costs put a brake on economic development when inequality is very low. The move along the curve towards higher levels of inequality increases the growth potential as levels of incentives go up. The result is higher incomes for particular groups and potentially more savings, which in turn stimulates investment. However, beyond a certain level, inequality is no longer positively associated with growth. Past that level the relationship sharply turns negative.

Why do high initial levels of inequality discourage development and growth? There are several hypotheses to answer this question. High inequality, independently of other factors, is a large and statistically significant barrier for the development of institutions and human capital on which successful economic development depends (Easterly, 2002). High initial inequality levels hinder the implementation of sensible macroeconomic strategies, impede the development of pro-poor trade policies, limit the growth of human capital stocks, raise social discontent, and limit the degree of political participation (Justino et al., 2003).

High levels of inequality imply that a section of the population has little or no assets with which to acquire credit. This means that poor people are excluded de facto from

[3] See World Bank (2000/2001, 54f.).

credit markets. Poor credit applicants with high-expected rate of return projects have less access to credit than rich applicants with the same quality or worse quality projects. The higher the initial inequality, the lower the number of people with access to credit markets. This bars many potentially good projects from funding and leads to lower economic growth (Bruno et al., 1999; Birdsall, 2002).

High inequality also hinders poor people from investing in their human capital. They are not only evicted from credit markets, they also have higher rates of time preference and higher opportunity costs for attending schools. The greater the share of poor people in the total population, the more depressed human capital development is, which in turn has negative spillover effects for the whole society (Bruno et al., 1999). Overall growth rates are reduced as they are positively correlated to the stock of human capital (Birdsall, 2002).

The unequal distribution of resources can become a source of political tension and social conflict, which increases the insecurity of property rights. Potential investors may expect conflicts to erupt, which places a lid on domestic and foreign direct investment (FDI), and discourages the accumulation of assets and the process of production (Perotti, 1996; Keefer and Knack, 2002). In unequal non-democratic or semi-democratic societies, the elites expect that democratization will entail widespread redistribution. Therefore, they have an incentive to shift their wealth offshore. In countries where the bulk of the elites' wealth is fixed (e.g., land), opposition by the elite against democratization is much more pronounced and the likelihood of civil conflict and coups much greater, with devastating effects on growth and human development (Acemoglu and Robinson, 2005). However, Acemoglu and Robinson (2005) also show that the negative relationship between inequality and political stability is not linear. Very high levels of income inequality reflect large discrepancies in political power and collective action-resources in a society. Inequality is then associated with more, not less stability, as the disadvantaged layers of society have no means to stage any effective political challenge against the elites.

As the literature suggests, high initial inequality adversely affects subsequent growth. However, the proposed channels that transmit inequality into an obstacle to growth are not always clear. For instance, several studies argue that high inequality may cause social conflicts, which in turn dampen growth and development. Intuitively, the argument is appealing, but there is no conclusive evidence that inequality increases the prospect of social conflict. Empirical evidence proves to be sensitive to model specification, to the particular measure of social conflict, and to the inclusion of suspect observations referring to inequality. For instance, Keefer and Knack (2002) find no link between inequality and violence. Instead, they suggest that inequality interacts with insecurity of property rights, e.g., the risk of expropriation, the risk of repudiation of contracts by government, and corruption in government. In the same way, sustainable poverty patterns are more likely to result from deficient institutional and governance structures.

The suggestions derived from the literature can be summarized as follows: it is not necessarily economic inequality per se that dampens growth. Instead, inequality may encourage types of distortions that reduce economic performance. Birdsall (2006, 5) reaches similar conclusions when she argues that:

> [Income] inequality in developing countries matters for at least three (instrumental) reasons:
>
> - Where markets are underdeveloped, inequality inhibits growth through economic mechanisms;
> - Where the institutions of government are weak, inequality exacerbates the problem of creating and maintaining accountable government, increasing the probability of economic and social policies that inhibit growth and poverty reduction;
> - Where social institutions are fragile, inequality further discourages the civic and social life that undergirds the effective collective decision-making that is necessary to the functioning of healthy societies.
>
> (...) in all three cases, it is not inequality itself that is the problem but the interaction of inequality with weak markets or with unaccountable or incompetent governments (...).

What conclusions can we derive from this discussion? A clear message for poverty alleviation is that, on average, economic growth reduces poverty, or, in now familiar words, *growth is good for the poor*. Moreover, the higher and the more sustained the rate of growth, the faster the process of poverty reduction. Equally accepted is the fact that inequality in opportunities is harmful to poor people. Inspite of a couple of sound and appealing arguments and some empirical evidence on the negative effects of inequality on growth, the relationship between the two components still remains somewhat obscure. What we do know is that high initial inequality is an obstacle for subsequent poverty reduction through growth, with implications for how growth translates into poverty reduction. On the other hand, the effect of growth on inequality is erratic. Last but not least, it is important to remember that although growth and inequality explain much of the existing levels of poverty, these two factors are in some sense just proximate causes, behind which lies a complex interaction of economic, social, and political processes.

1.2 The Policy Agenda

Based upon the foregoing discussion on the links among poverty, growth and inequality, we can expect that poverty falls fastest in countries where average income is growing quickly, where initial inequality is low, and where income growth lowers income inequality (Bourguignon et al., 2003). What policy conclusions can be derived from these findings? Should one concentrate on growth alone, or should poverty reduction strategies also be concerned with containing, respectively lowering inequality?

Opinions diverge on the question of when growth can be considered as being pro-poor and how the problem of inequality should be handled. Kakwani and Pernia (2001) suggest that growth is pro-poor only if the income growth rate of the poor exceeds the average growth rate. According to this definition, growth should be biased in favor of the poor, so that the poor benefit disproportionately from growth and inequality between the poor and the non-poor decreases. This is the relative definition of pro-poor growth. The concern with this definition is that growth coming with large absolute gains to the poor, even if inequality is rising, is not deemed to be pro-poor (Klasen, 2004).

To this relative definition Klasen (2005) opposes two absolute definitions. The first considers growth as pro-poor if the absolute income gain of the poor is larger than the average absolute income gain. This would be *strong absolute pro-poor growth.* White and Anderson (2001) show that this requirement is—to say the least—difficult to meet, since the growth rate of the poor would have to be biased a lot more in favor of the poor than proposed by the relative definition. The second absolute definition adopts an entirely different position. It considers growth as being pro-poor if the growth rate of the poor is positive (Chen and Ravallion, 2003). Klasen (2005) calls this *weak absolute pro-poor growth.* The main argument supporting this view is that what matters in the end is that the income of the poor grows as fast as possible, and not how growth compares to the growth of the non-poor.

Klasen (2005) is right to point out that from a policy point of view, it is not very helpful to attach too much importance to these definitional issues. Instead, the operational approach should be aligned to the policy goals regarding poverty reduction. The author proposes that if the goal is to reduce poverty, the rate of income growth among the poor should be maximized. Where such a choice is available, one would certainly prefer growth benefiting the poor, but in any case growth must be generated, because it is the only known solution to benefit the poor in the long run (Kraay, 2006).

Important as income may be for an individual to shape his life, poverty should not be understood only as a lack of financial resources but also as a lack of capabilities across a range of dimensions (Sen, 1999). Growth promoting policies must be understood from a similar perspective. The purpose of such policies is to improve living standards. This implies that we must leave aside the relatively narrow focus on income to include education, health, and social and political participation into the growth agenda (Stern et al., 2005).

In fostering the growth process, one must bear in mind that the appropriate framework in transition countries is not an economy on the technological frontier, but one well inside it. Improvements in productivity are for the most part driven by better organization and management and by a public administration aimed toward overcoming obstacles to economic activity. Therefore, restoring growth requires changes in the organization of production, in the allocation of production factors, in infrastructure, and governance. It also calls for profound changes in behavior, some of which are beyond the scope of government policy. The growth agenda is a function of several elements that can be grouped under four broad headings:

- Macroeconomic adjustment
- Openness to trade
- Market regulation
- Institutional quality and effective governance

A stable macroeconomic environment promotes clarity, reduces risk, and provides reliable economic signals with respect to value and scarcity. Openness to trade encourages competition and provides incentives for innovation and entrepreneurship. A sound market regulation promotes competition, aligns the incentives of producers with the needs of consumers, and ensures independent regulation of quality, price, and service coverage. The fourth area—institutional quality and effective governance—comprises many dimensions, such as the legal framework for property and contracts, the availability and delivery of health, education, and social protection etc. (Stern et al., 2005). For transition economies, one of the most important factors for output recovery and poverty reduction has been the scope and quality of these reforms. This section briefly reviews the growth policy agenda and its impact on inequality and poverty.

1.2.1 Macroeconomic Adjustment

Macroeconomic adjustment is necessary to generate growth. Low inflation, limited volatility in prices and production, and policies promoting savings and investments have a stimulating and sustaining effect on growth. Markets cannot perform their proper function if price signals are distorted by inflationary tendencies. Empirical evidence indicates that monetary stability not only leads to sustained growth, but that it is also an inequality-reducing measure (Dollar and Kraay, 2002; Easterly and Fischer, 2000).

Dollar and Kraay (2002) estimate the influence of inflation on the mean income of the poor in 80 countries. They separate two different effects: the *growth effect* shows the direct effect of inflation on the poor people's income; the *distribution effect* captures the indirect effect of rising price levels on income of the poor through its influence on income distribution. The authors find that monetary stabilization is a *super pro-poor* policy since both effects of its implementation are negative: inflation is not only detrimental to growth, but it also leads to a deterioration of income distribution.

This consistent is consistent with empirical evidence that the poor are more likely to rate inflation as a top national concern (Easterly and Fischer, 2000). Datt and Ravallion (1998) come across evidence of a negative effect of inflation on poverty in Indian states. According to Romer and Romer (1998), the income share of the lowest quintile is inversely related to inflation. The reason behind this pattern is that the rich, unlike the poor, have access to sophisticated financial market instruments and do not have to expose themselves to the risks of inflation.

In transition economies, it became clear very early that large price adjustments were necessary to allow markets to function effectively. In the wake of price deregulation, large price increases took place in CIS countries. In the CEEB and SEE countries, the increases were less dramatic, because the initial level of price distortions was lower. To mitigate the adverse effects of higher prices on the poor, governments introduced various subsidy schemes targeted at low-income households, but with varying results.

Macroeconomic adjustment also calls for fiscal reforms. The goal of fiscal reform is to sustain fiscal deficits in a way that is compatible with moderate levels of inflation and public debt. Fiscal discipline entails efforts to enhance revenues and cut expenditures. Low and stable levels of taxation are essential to maintain growth in the long run (Schuknecht and Tanzi, 2005). De Ferranti et al. (2003) show that whenever fiscal reforms have led to price stabilization, a reduction in inequality has resulted.

Transition saw the reduction of the overall level of tax collection, the introduction of income taxes and indirect taxes. In most transition economies, the regressive character of the value added tax was mitigated through exemptions for basic commodities and reasonable income tax thresholds. Equity considerations also dictated the implementation of a progressive income tax system, but weaknesses in tax administration have undermined its realization in many countries (World Bank, 2000). As a consequence, efforts have shifted towards establishing a simple and transparent tax system. As early as in 1994, Estonia adopted a flat rate tax regime, which has since then spread all over the region. The implementation of the flat rate tax regime has generally attracted FDI, encouraged the legalization of the shadow economy, increased fiscal revenues, and reduced tax evasion.

The severe recession at the beginning of the transition engendered large declines in government revenues throughout the region. For many countries, the independence from the Soviet Union also led to the loss of large fiscal transfers and thus to painful reductions in government revenues. The extent to which fiscal revenues were affected by the economic collapse determined the governments' ability to mitigate the social impact of the transition. Many countries did not have the fiscal space to sustain their expenditures. Especially in CIS and SEE countries, health and education spending was significantly reduced. The resulting surge in informal payments hurt particularly the poor. Moreover, poor budget management and implementation engendered large and persistent arrears in public sector payments, wages, and pensions, pulling large parts of the middle class into poverty. In CEEB countries, expenditures were maintained at relatively high levels, which might have had negative effects on growth and employment creation. Yet, the high levels of social spending helped to protect the poor and made reforms socially acceptable (World Bank, 2000). At present, the challenge for these countries is to improve the cost-effectiveness of public spending, and to ensure a transparent and efficient resource allocation, without hurting those in need.

Macroeconomic adjustments do not affect growth and distribution equally. Some developments, such as stabilization, are critical to restore growth and have positive distributional outcomes. In other cases, there might be trade-offs. For example, cuts in government spending may be needed to reduce fiscal deficits and sustain growth, although they bring along negative distributional effects, especially for the poor. In most countries, social spending is the most pressing concern over the short run, but this concern must always be balanced against the need to restore economic growth and to sustain it in the long run.

1.2.2 Openness To Trade

International trade theory perceives the potential of static and dynamic gains from opening the economy to the global market. Static gains emanate from the more intensive use of the abundant production factor, which in many developing and transition countries is labor. Trade participation has the potential to increase employment opportunities and to spread the benefits of increased growth evenly across society. Dynamic advantages arise from technological spillover effects and increased access to foreign capital. Evidence shows that long-term growth rates are higher in countries that adopt export-oriented trade policies rather than a more inward-looking strategy. The World Bank's study

The East Asian Miracle offers persuasive evidence supporting the argument that open economies are more innovative, dynamic, and more able to sustain accelerated growth over long periods (World Bank, 1993). Export-led economies record higher and more equally distributed income growth than inward-oriented economies. Warr (2006) finds that the more open economies have the highest growth-elasticity of poverty reduction, whereas closed economies exhibit the lowest ones.

However, openness to trade is not a panacea for economic progress, distributional equality, and poverty reduction. The success of an outward-looking policy strategy depends on several factors. Therefore, caution needs to be exercised when interpreting empirical findings. Dollar and Kraay (2002) find that openness to trade has a positive growth effect, yet the effect on income distribution is not significant. The poor thus benefit from overall economic growth, but their income share is not affected. The findings of Lundberg and Squire (2003) indicate the opposite effect: they offer evidence that openness has a dampening effect on income growth of the bottom quintile. However, their data set is smaller and their openness measure does not only include exports plus imports relative to GDP, but also a wide range of policy and institutional factors. When Dollar and Kraay (2002) use this broad indicator they also find that openness decreases the mean income of the poor, even though the effect is not statistically significant. All in all, the evidence on the effects of openness on income distribution remains inconclusive.

Existing research on the relationship between trade and poverty suggests that greater openness and faster growth in labor-intensive exports is associated with poverty reduction (Winters et al., 2004). However, the realization of the effect depends on many factors such as the flexibility of factor markets, the educational level of the labor force, the quality of public administration, and the innovative capacity of the private sector. Trade liberalization has to be part of a comprehensive development strategy to have a positive effect on growth and poverty reduction. If introduced in isolation from complementary improvements in domestic institutions and policies, it is likely to work as an external shock with uncertain consequences for long-term growth (Rodrik et al., 2004).

Transition economies have displayed disparate trade performances. CEEB countries were most successful in moving into the production and export of more technologically sophisticated, higher-value-added goods, while SEE countries have generally specialized in low-skill, low-value-added goods. CIS countries were particularly slow in adapting their external sector. Many of them remain highly dependent on trade with the Russian Federation, although the rise in world energy consumption has spurred their natural resource exports towards other regions of the world.

It appears that the integration of transition economies into the international division of labor is taking different forms in different countries. FDI is integrating the more advanced economies into multinational production networks, while in the region's less advanced economies, integration into the world economy lags behind. These countries generally have less opportunity for investment in human capital, employment of skilled labor, and local research and development.

1.2.3 Privatization and Market Regulation

Privatization and market liberalization generally increase market efficiency, encourage private initiative, and accelerate economic growth. Productive efforts become more appealing while rent seeking opportunities decrease.

Deregulating the markets for factors, goods and services generally stimulates growth. Blanchard and Giavazzi (2003) show that overregulation redistributes rents, protects the privileged and hinders the disadvantaged. Heavy business licensing and market entry regulation generally shields vested interests from competition of start-ups. The high fixed costs of regulation imposed on small firms push them into the informal sector (Besley and Burgess, 2002). Removing market constraints allows private entrepreneurs to expand their activities, thereby increasing employment opportunities for low-income groups (Djankov et al., 2002). The removal of market distortions and operative restrictions is particularly important in the agricultural sector, since a disproportionate share of poor households in transition countries lives and works in rural areas (Rozelle and Swinnen, 2004; Macours and Swinnen, 2007).

The ability to provide unskilled labor is the poor's most valuable asset. The poor benefit from market deregulation as deregulation increases the demand for unskilled labor. The extent of labor increase greatly depends on the flexibility of labor markets. In most transition countries, these markets are still heavily regulated. It is common wisdom that market interventions such as minimum wage regulations, severance payments, and job reservations mainly shelter those who already have a job in the formal sector. These interventions tend to reinforce inequality because they protect the interests of formal sector workers at the expense of informal workers and the unemployed. They discourage higher labor absorption, and discriminate against the unemployed and those who are employed in the informal sector. Holding everything else equal, labor market deregulation increases labor intensity of growth and the income of poor people, if we were to assume that the unemployed and informally employed comprise a portion of the poor population (De Ferranti et al., 2003).

The empirical evidence on market deregulation in transition economies is mixed. CEEB countries have encouraged market competition by promoting the entry of new and productive firms and the exit of old, less productive state-owned enterprises (SOEs). Firm entry has been encouraged through the creation of a positive investment climate, while the exit of old firms has been achieved through the imposition of market discipline, i.e., the hardening of budget constraints, the enforcement of bankruptcy procedures, and privatizations. These efforts have significantly improved economic growth. In contrast, excessive regulation of factor and product markets is still an important obstacle for growth in many CIS countries. Overregulation has also been witnessed in many SEE countries. For a long time, privatization and restructuring of loss-making SOEs was delayed owing to the prevalence of vested interests. However, the prospect of EU accession has encouraged many countries in the region to open and deregulate their markets, as well as to divest state-owned assets (World Bank, 2008).

The evaluation of the effects of market deregulation on inequality and poverty in transition economies is not easy. Divergences in the effects of market liberalization often arise from interactions among the countries' initial conditions, their institutions, their policy choices, and the external shocks they receive (De Melo et al., 2001; Falcetti et al., 2002, 2006). Existing evidence suggests that inequality has increased less in those countries that have created well-functioning product and factor markets. Where market reforms have lagged behind, rent seeking, corruption, wage arrears and wage contract violations have been prevalent, increasing inequality and reducing the prospects for growth (World Bank, 2005b).

1.2.4 Institutional Quality and Effective Governance

Much of the growth literature has attempted to identify institutions that explain significant portions of the observed differences in living standards across countries (e.g., Londregan and Poole, 1996; Przeworski and Limongi, 1997; Barro, 1999; Epstein et al., 2006; Acemoglu et al., 2008). The state plays a critical role in this relationship by providing the appropriate environment for entrepreneurship and innovation. Basic political economy theory suggests that the activities of the state should focus on health, education, infrastructure, and the protection of property rights. Moreover, a social safety net legitimizes a market economy because it renders it compatible with social stability and social cohesion. However, the welfare state can also generate a number of apparent economic and social costs, such as mounting fiscal expenditures and disincentives to work. Finding the balance between these costs and benefits is an ongoing challenge. Healthy societies also have a range of institutions that mitigate social conflicts and increase citizens' will to cooperate. Social conflicts are harmful, because they divert resources from economically productive activities and because they generate uncertainty. The rule of law, a high-quality judiciary, representative political institutions, and free elections are examples of such institutions (De Soto, 2000; Besley and Burgess, 2002; Rodrik, 2000, 2004; Stern et al., 2005).

However, institutional functions generally do not translate into unique institutional forms. What is possible depends on local constraints and opportunities. Where institutions serve a general purpose, it is possible to import and adopt available institutions from more advanced economies. But when institutions are highly specific to local conditions and contain a high degree of discreteness, importing outside models is not an option since institutions need to be developed at the local level and need to be base upon local knowledge, experience, and experimentation (Rodrik, 2004, 2008).

Two major obstacles exist when one attempts to assess the impact of institutions on growth. The first obstacle is that the concept of institutional quality is vague. The most commonly-used indices rely on surveys of foreign and domestic investors—such as the World Bank's *Governance Matters* indicators (see Kaufman et al., 2008) or the Freedom House index—measuring how institutional quality in a given country is perceived. The problem is that perceptions can be influenced not just by the current operation of the institutional environment, but also by other aspects, such as the current state of the economy. Also, the outcome of these surveys does not indicate what specific rules, legislations, or institutional patterns lie beneath the measured outcome (see, e.g., Dethier et al., 1999; Rodrik, 2004).

The second obstacle in assessing the impact of a particular institution on growth is that institutional quality is as endogenous to growth of income levels as anything can possibly be. The possibility of disentangling the web of causality between these two elements is heavily constrained. Przeworski's observation illustrates the problem well:

> The embarrassingly obvious observation is that if endogeneity is strong, then institutions cannot have a causal efficacy of their own. Imagine that only those institutions that generate some specific outcomes, say those that perpetuate the power of the otherwise powerful, are viable under the given conditions. Then institutions have no autonomous role to play. Conditions shape institutions and institutions only transmit the causal effects of these conditions. The question, thus, is how to distinguish effects of institutions from those of the conditions that give rise to them. (...) And if they are endogenous, if history does not randomize institutions with regard to conditions, then to tell whether institutions matter we must be able to isolate their effect from that of the conditions under which they function. This is the difficulty we face (Przeworski, 2004, 527ff.).

In transition economies, many institutions inherited from the socialist legacy had to be dismantled. Some of the new institutions were established on the basis of existing communist state structures, such as civil service laws or existing labor codes. Other institutions, such as the market regulatory system, monetary and fiscal institutions, a functioning and independent judiciary, had to be built almost from scratch (Grzymala-Busse, 2007). Although the size and role of the state has considerably diminished, states continue to play an important role in promoting growth (World Bank, 2000, 2008).

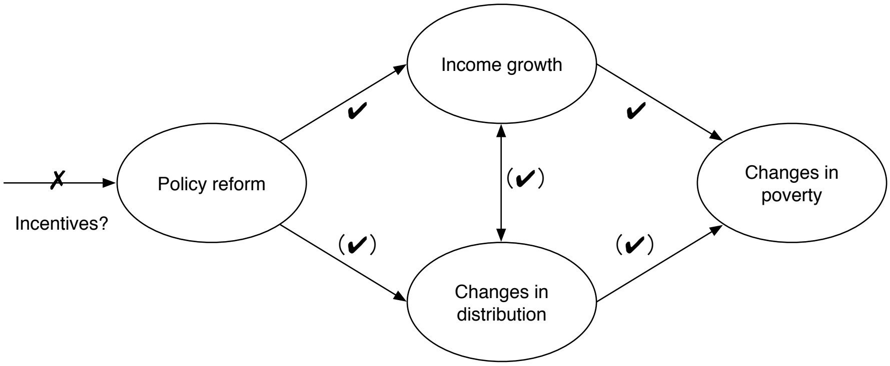
Nonetheless, in many countries the state remains part of the problem, not part of the solution. Particularly in the CIS and the SEE regions, states continue to suffer from inefficient institutions and weak governance. They are beset by governmental harassment of citizens and business, feeble public services and infrastructure, and poor policy design and implementation. The legal system is neither effective nor predictable, contracts are weakly enforced, and crime is pervasive. In sum, these countries have not been able to create an environment in which predictable and impartial rules constitute the foundation of economic and social interactions. These developments threaten to complicate future poverty reduction efforts as policies which are good for the poor require stable and predictable institutions to ensure their success.

1.3 Conclusion

The increase in poverty during the transition can be attributed to two distinctive factors: the drop in economic output and changes in its distribution. Although the economic decline and the surge in income inequality account for much of the increase in poverty, these two factors are in some sense mere proximate causes. Behind these proximate sources of poverty lies a complex interaction of economic, social, and political processes (World Bank, 2000).

Evidence across countries seems to confirm that most of the aforementioned reform measures primarily reduce poverty by growth stimulation, while their effect via an improved income distribution is ambiguous. However, average results tend to provide an incomplete picture of the various effects reforms had in different countries. Often, only detailed case studies reveal the complexity of reform, showing that the costs and benefits of past reforms have been unevenly distributed over time and regions. Hence, it is sometimes difficult to retain a universal message on whether the reforms discussed are generally positive or negative for the poor. In some cases they benefit the poor, while they may hurt them in others (OPPG, 2005).

Figure 1.2: The Growth-Inequality-Poverty Diamond



Source: Adapted from Lopez (2004).

Research has made considerable progress in finding ways by which the poor contribute to and benefit from growth. As illustrated in Figure 1.2, there is a relatively broad consensus about which policies need to be implemented in order to spur growth and reduce poverty. The problem today is thus not one of not knowing the right set of growth-enhancing and poverty-reducing policies, but one of not knowing how to motivate politically and economically influential actors to consider and promote the interests of poor people. The *World Development Report 1991* describes the dilemma in the following terms:

> (...) Policies to reduce poverty involve a trade-off. This trade-off is not, in the main, between growth and the reduction of poverty. Switching to an efficient, labor-intensive pattern of development and investing more in the human capital of the poor are not only consistent with faster long-term growth; they contribute to it. Since these actions mean that a larger share of income and more public spending will go to the poor, the principal trade-off, especially in the short run, is between the interests of the poor and those of the non-poor. The two-part strategy is, therefore, more likely to be adopted in countries where the poor have a say in political and economic decision-making (World Bank, 1990, 2).

What political and institutional factors trigger reforms that enable the poor to participate in the growth process? How can the incentives of policy makers be influenced in order to achieve such a dynamic? These are the questions this study addresses and attempts to resolve.

Chapter 2

The Political Economy of Reform

2.1 Introduction

This study examines the process by which governments decide, plan, and implement growth-enhancing and poverty-reducing reforms. These reforms are considered to arise from the policy-making process, and are treated as endogenous. It may be admitted that the task is a difficult one as the reality behind reform politics is complex. One cannot consider reforms to be a sequence of discrete policy changes. Reforms result from the interactive and ongoing process of decision-making by political actors in response to actual or anticipated demands from groups and individuals in strategic positions. The content of these demands and the subjects to which they relate are extremely diverse. Reforms are highly technical as they involve individuals, goals, incentives, perceptions, decisions, rules, resources, and actions at different state levels. To further complicate the matter, reforms are dynamic: therefore the factors influencing them vary in time. Uncertainty and ignorance, along with luck and coincidence are inextricably related to the multi-faceted reform process.

The exact definition of reform politics is difficult to formulate due to its complex reality. Accordingly, existing definitions are relatively vague. Grindle (2004, 2) defines reform politics as “deliberate efforts to make changes in policies.” But the general character of this definition probably applies to the political process as a whole and makes it difficult to draw a clear distinction between a particular reform effort and ‘politics as usual’. According to Alesina et al. (2006, 2), the concept of reform “generally refers to a major change in policy that goes beyond day-to-day policy management.” This definition refers to the idea that the process of reform always accompanies a moment of extraordinary politics. However, this is not necessarily true since reforms can very well occur under circumstances that are not so extraordinary at all (Williamson, 1994). If we consider economic policy as an equilibrium outcome of the political process, a reform can be defined as a political adaptation or alteration aiming to improve the existing status quo. This is the definition adopted in this study.

The problem that we face today is that we do not have a coherent and encompassing theory of reform. We rather have to cope with a great number of hypotheses or partial theories on various aspects of reform policy. Three generations of reform models can be distinguished (Brinkerhoff and Crosby, 2002). First generation reform models sought first-best solutions that maximize socio-economic welfare for the greatest number of citizens. The focus was on the content of reform programs. No one questioned whether or not governments were committed to maximizing public welfare or if they had sufficient administrative capacity to effectively carry out their duties.

The gap between reform prescriptions and real-world applications led to a critical re-examination of these assumptions (Krueger, 1974; Bates and Krueger, eds, 1993). Scholars and practitioners turned their focus on the context of reform programs. The role and capacity of the state were put under scrutiny in particular. One strand of this positive-economics approach was directed toward the social, economic, and political consequences of different reform policies (reforms as *explanans*). The other strand directed its focus toward the explanation of how reform policies occur (reform as *explanandum*). Politics and institutions were included as categories of inquiry in reform analysis and design. These second generation models sought for ways of rearranging the interplay between state, market, and civil society in order to improve the outcome of reform efforts. At this stage, it was recognized that institutions and politics matter, and that building capacity is necessary to maximize the likelihood of reform success (Grindle, 1996).

Third generation models concentrated on the technical and strategic aspects of reform, such as speed, timing and sequencing of implementation, or the interactions among the various components of macroeconomic, sectoral, and governance reforms (Haggard and Webb, 1993; Williamson, 1994; Balcerowicz, 1995). Policy reforms were at last considered as a complex and dynamic process in which the outcome could only imperfectly be predicted or controlled. Brinkerhoff and Crosby (2002, 5f.) note that:

> The process perspective calls for an additional set of tools that incorporates social and institutional factors more centrally into technical policy alternatives. (...) A major implication is that if policy is a process, then successful policy outcomes depend not simply upon designing good policies but upon managing their implementation. Instead of identifying ideal solutions up front and top down, policy implementers need to iteratively develop second- or third-best answers that collaborating agencies and stakeholders can agree upon. The best technical solution cannot be achieved unless there is cooperation, which means making modifications to accommodate the views and needs of the various parties involved.

The positive-economics approach has generated a rich theoretical and empirical literature in recent years. At one end of the spectrum, research has consisted of inductive, comparative case studies, providing a survey of reform triggers, interest group dynamics, and other political and institutional forces that influence the process of reform. At the other end, it has generated deductive models that provided valuable insights on why some reforms are adopted while others are not.

Today, the challenge is to assess the relative importance of the various stimulating factors that lead to reforms. Research is now submitting the hypotheses raised by country studies and theoretical models to empirical econometric testing. Thus far this strand of research has not been able to mitigate the ambiguous and to some extent contradictory findings of previous research. Hence, the outcome of the existing reform literature genuinely reflects the multifaceted nature of reform.

The purpose of this chapter is to prepare the ground for the empirical analysis. The first section introduces the reference model, which reflects the decision, planning, and implementation stages of the reform process. The next section discusses the reform model in the light of the recent political economy literature. In the final section, some issues with respect to the methodological approaches are discussed.

2.2 The Reform Model

The reform model was first elaborated by Beez and Mäder (1997), and was slightly rearranged for the purpose of this study. The logic underlying the reform model consists of applying the analogy from the economic market to the political market. The political arena is conceived as a bargaining place, where alternative policies are demanded, supplied, and exchanged. The structure of the model is kept simple in order to facilitate its practical application. The loss of detail is largely offset by the benefit of the possibility of explaining a rich variety of political phenomena with a relatively simple theoretical structure.

2.2.1 Model Assumptions

The model rests on three common assumptions in economic theory, all of them related to the concept of *homo economicus*. The homo economicus attempts to achieve the highest possible payoff given the existing information about opportunities and restrictions on his ability to achieve a predetermined goal. Adjustments in human behavior occur as a reaction to shifts in these restrictions. The assumptions can be summarized as follows:

- methodological individualism;
- constancy of preferences; and
- rational pursuit of self-interest.

Methodological individualism is a fundamental element of modern neoclassical economics. It places the individual and the relations among individuals at the center of the analysis. All social phenomena,"especially the functioning of all social institutions, should always be understood as resulting from the decisions, actions, attitudes, etc., of human individuals." (Popper, 1945, 89ff.) From this perspective, collective action must be attributed to, and explained by actions of individuals.

The reform model further assumes the preferences of individuals to be constant over time in order to facilitate the making of inferences about causal relationships. Frey (1999, 6) observes that

> Incentives are produced by preferences and constraints which are strictly distinguished. Changes in human behaviour are attributed (as far as possible) to observable and measurable changes of the opportunity set determined by the constraints. Behavioural changes are thus not attributed to non-observable and non-measurable preferences changes. This procedure enables us to develop theoretical hypotheses and to test them empirically.

The third assumption states that individuals rationally pursue their self-interest and attempt to maximize their utility under given constraints by continually evaluating the costs and benefits of their actions. This evaluation includes comparisons with utility gains from pursuing other goals and activities. Self-interest can encompass both material and ideal motivation. In the end, the comparative evaluation of the pros and cons determines the decision of individuals to which extent they follow the prescription.

But individuals cannot conform to the ideal of full rationality. Full rationality requires unrestricted cognitive capabilities, something human individuals are not able to achieve in the very near future. Individuals are bound by habits, they are subject to informational limitations, and often operate under time pressure. These natural restrictions limit an individual's capacity to choose the best option among a set of given alternatives.

Hence, it is plausible to assume that on average individuals react systematically to incentives that arise from existing restrictions. This in turn enables us to predict the likelihood of occurrence of individual and collective behavior in a setting of changing constraints. With this set of assumptions, the economic analysis can be applied to the political market.

2.2.2 The Political Market

In political markets, individuals organize and express their demand of policies. This usually reflects a wide range of partial and conflicting interests in society. Theoretically, the number of interest groups involved in the reform process can be narrowed to those supporting policy adjustment and those opposing it. Both groups have an interest in defining the state of the future political equilibrium. But they are likely to have conflicting views on the set of policies to be adopted. As a result, a bargaining process will take place to determine the future political equilibrium.

Bargaining is a process of exchange in which the negotiators try to reach an agreement on a mutually beneficial trade even though they have conflicting interests over the exact terms of trade (Muthoo, 2000). The bargaining process is time consuming, because the negotiating parties have to agree over the exact partition of the costs and benefits associated with the future political equilibrium. The negotiators will attempt to reach an agreement that is as favorable to them as possible. Offers and counter-offers will be made until an agreement is struck.

Bargaining does no only take place between supporters and opponents of reform alone. It also occurs between demand and supply groups. Evaluating the potential costs and benefits associated with the demands in the political market, the supply side, typically the government in office, satisfies those demands that maximize its utility. The delivered policies can be considered as market goods: the money that buys the marketed good is political support for those who supply it.

Reform policies can thus be considered as an explicit agreement between potentially conflicting political actors with bargaining power. Although explicit, the agreement is incomplete. The imperfections of the political market make it difficult for negotiating parties to monitor each other and to prevent political opportunism, especially where transactions occur at different points in time.

One way to reduce uncertainty arising from market imperfections is by creating rules, or, in other words, institutions. Institutions, organizations, rules, customs, norms and habits influence the cost of the negotiation process. They affect the incentives of political actors and their capacity to exert pressure. Institutions also affect the nature of the reform policy.

The reform process can be divided into three distinct, but interdependent stages. The first stage pertains to the bargaining for or against reforms. Once the decision in favor of reforms is taken, a suitable program must be designed. This is the second stage of the process. In the third stage, the reform program has to be implemented. In the following sections, each reform stage is discussed in more detail.

2.2.3 Reform Decision

The stage of reform decision is characterized by the bargaining process among interest groups on the demand and supply side. This process is schematically illustrated in Figure 2.1.

The Demand Side of the Market

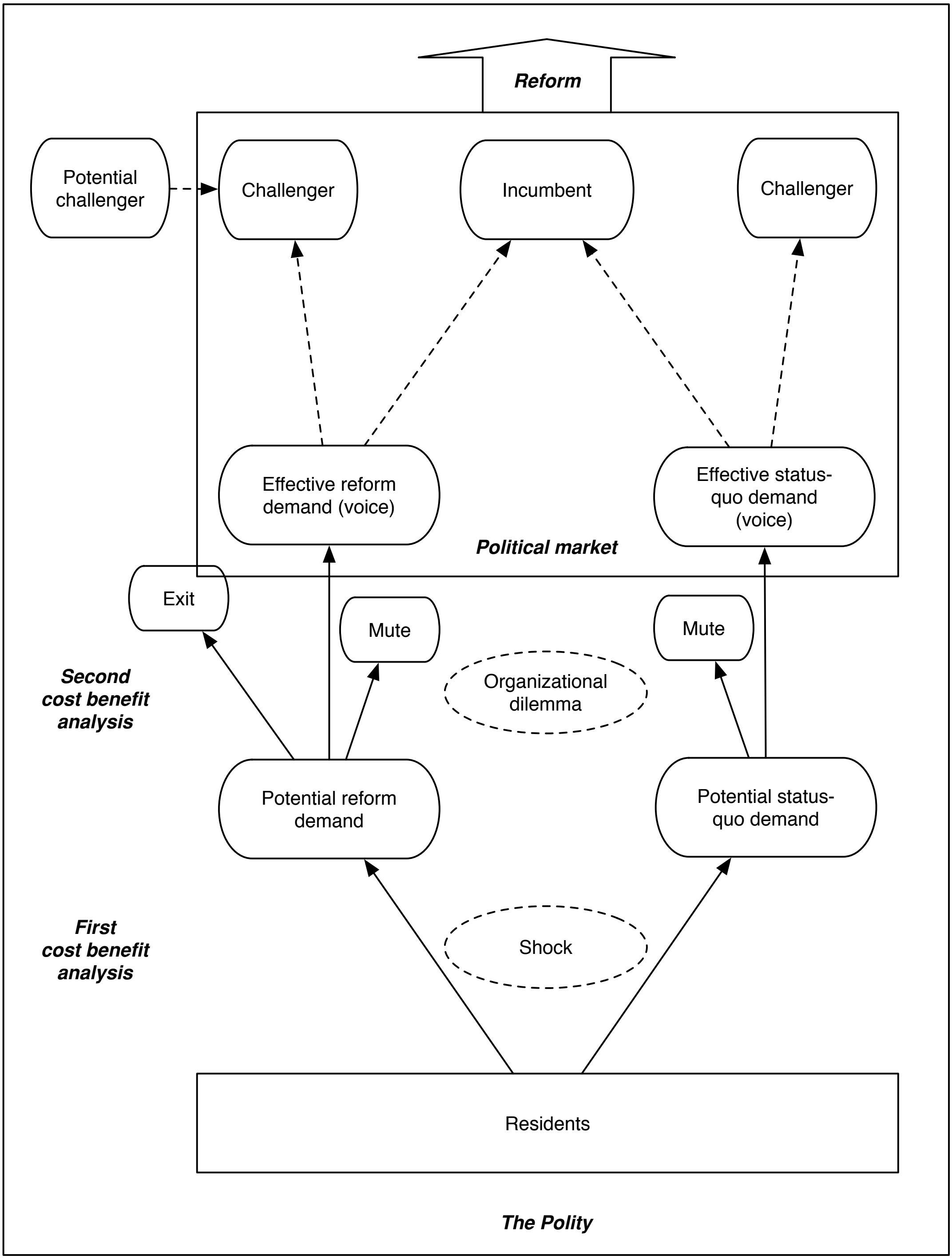
Suppose that a given bias toward status quo keeps the existing political equilibrium among vested interests intact. The reform process starts when a major shift (or shock) takes place in the prevailing set of constraints.

The shock encourages people to evaluate the expected payoff from a given reform proposal relative to other proposed policy measures or maintaining the status quo. Those who are negatively affected by the shock will support the implementation of adjustment policies. Their claims will inevitably face opposition from those actors who continue to derive more benefits from the current political equilibrium than from a reformed one. The outcome of this *first cost-benefit evaluation* shapes people's preferences and leads in the aggregate to a potential demand for maintaining the status quo or to a potential demand for reforms.

Individuals with a preference for the status quo have two options: they can either express their demand on the political market (*voice*), in which case the demand becomes effective, or they can remain silent (*mute*). Members in the potential reform demand group face an additional option: they can *exit* and move to another political market. Cost and utility of each of these alternatives depends on the means being used to implement them, and the effectiveness of their execution.

The decision to join the status quo or the reform group is subject to people's *second cost-benefit evaluation*. The bargaining power of the respective demand groups influences this decision. The bargaining power is increasing in the size of the interest group expressing the demand, its organization, and its economic power. However, the larger the group, the more difficult it will be to give it an effective organization. A stronger bargaining power has obviously better chances to be satisfied.

Figure 2.1: The Reform Process



Source: Adapted from Beez and Mäder (1997).

When people choose to express their demand or to exit the political market, they incur transaction costs. The level and nature of these costs depend on the prevailing institutional arrangement and on people's ability to minimize these costs. The utility of the respective alternatives depends on the individuals' subjective evaluation of the expected payoff, as well as on the timing and the likelihood of its occurrence. Finally, people's time horizon and risk attitude also influence the second cost-benefit evaluation.

The utility of being in the effective demand group is derived from mainly two factors. First, members of the effective demand can elect their respective political supplier. Second, they can themselves become political suppliers.

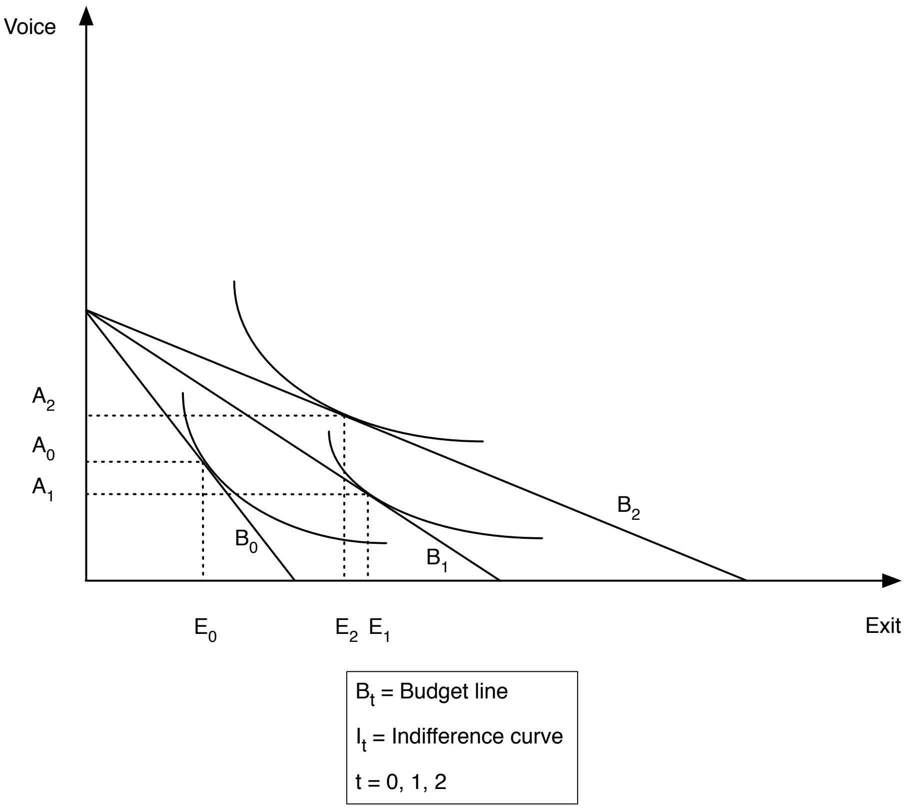
One function of political institutions is to sort out the subset of people who possesses the characteristics required for membership in the effective demand. Polities have more or less formalized mechanisms that allow some people to join the effective demand. Those who do not possess the required characteristics can in principle still express their demands. However, they face higher institutional entry barriers to the political market and thus higher transaction costs. The public of a polity can then be separated along a critical dimension: those who are part of the effective demand and those who are not. The latter are, at least temporarily, disenfranchised because they are either unable or unwilling to express their preference for a policy in the political market.

The effective status quo and reform demand groups compete to improve their welfare. The balance of pressure among these groups determines the political equilibrium. The equilibrium depends on each group's ability to voice its demands. The group's ability to voice its demands determines to what extent a group's interests will be considered by the supply side. A group's voice can be expressed via votes and elections, but also through battle and riot. Efficiency in producing voice is determined by the cost of controlling free riding and rent seeking among members (Becker, 1983). In other words, interest groups will have to solve the collective action and the agency problem to improve efficiency. But efficiency in producing voice also depends on the institutional setting: a political system that institutionalizes the means of expression by establishing and maintaining civil and political rights considerably reduces bargaining costs. On the other hand, arbitrary state coercion generally increases transaction costs.

Both voice and exit are imperfect public goods, or so-called 'club goods', since people can be excluded from their consumption (Buchanan, 1965). In fact, it is possible and sometimes reasonable for members in the effective demand group to restrict entry to other people. Typically the demand group restricts entry to others when its bargaining power is strong enough to impose its policy choice in the political market. The inclusion of additional member would unnecessarily increase competition for potential rents arising from a political intervention. Similarly, it may be reasonable for a government in office to increase exit barriers in order to prevent people from moving to other political markets if emigration reduces its rent extraction opportunities.

Voice and exit are interdependent. Individuals who exit the domestic political market can still express their demand from an outside market. Moreover, the mere fact that people choose to exit can have a signaling effect on the cost-benefit evaluation of those who remain in the political market. Let us illustrate this relationship with an example.

Figure 2.2: The Relationship Between Voice and Exit



Source: Beez and Mäder (1997).

Voice and exit can be thought of as substitutive goods. Suppose, for the sake of convenience, that the available income of the public to purchase both goods is constant. In such a case, different consumption bundles of exit and voice can be consumed.

Figure 2.2 illustrates the relationship between voice and exit. Based on the assumption of decreasing marginal utility of consumption, the negative slope of the indifference curve indicates the marginal rate of substitution between the alternative consumption bundles. All else being equal, a change in the relative price of voice and/or exit will affect the demand for both goods. If the bundle A_0E_0 is consumed in time t_0, a decrease in the cost of exit will induce people to consume more exit in t_1, so that the consumption bundle will adjust to A_1E_1. This is the *substitution effect.* A very strong reduction in the exit costs, as in A_2E_2, will increase the consumption of both goods. Not only are there more people exiting the political market, there are also more people consuming voice. This is the so-called *income effect.*

In the presence of low exit barriers, the interdependence between voice and exit encourages competition between domestic and outside political markets. Increasing political competition has two beneficial effects. It reduces private rents available in political markets and encourages policy suppliers to act in the interest of the demand groups.

The Supply Side of the Market

Every political market has one or more suppliers with the authority to raise revenue and allocate resources. Political suppliers behave rationally and maximize their utility under a given set of restrictions. Restrictions usually arise from organizational and institutional constraints, political challengers in and outside the market, and the respective claims on the demand side.

In the political market, the incumbent supplier competes with challengers for the leadership position within the limits of existing institutional arrangements. The primary problem the incumbent faces is to figure out how to prevent being replaced by a challenger. The extent of competition in the political market depends on the degree of market openness. Openness allows challengers to enter the market in order to supply their goods. In general, political competition lowers the incumbent's window of opportunity.

A good organization improves a supplier's position and bargaining power in the market. But creating and running a network requires financial, social and human capital to meet the related investment, operation, and time costs. Growing experience generally reduces transaction costs through economies of scale and scope, and vested interests usually derive some important advantages out of already existing organizational structures.

Once the supplier is elected he picks out people from the effective demand to form a winning coalition. This winning coalition must endow the political supplier with sufficient bargaining power at the cheapest possible price. Members of the winning coalition are rewarded with private goods, on top of the public goods available to the public at large (Bueno de Mesquita et al., 2005).

Whether the winning coalition includes more reform or status quo forces depends on which of the respective groups provides the incumbent supplier with more bargaining power. A winning coalition may consist exclusively of reform or status quo forces, or it may be a mix of both. The likelihood of reform then depends on the political weight of the reform demand forces within the coalition: greater bargaining power of the reform demand makes reforms more likely.

Efficiency and Distribution in Reform Bargaining Arrangements

The outcome of the reform bargaining process can be assessed in terms of efficiency and distribution (see Muthoo, 2000, for a detailed discussion). Efficiency refers to the extent to which transaction costs can be kept low. Distribution refers to the issue of how exactly the gains from the bargaining arrangement are divided.

Transaction costs critically determine the bargaining process. In practice, several factors influence the negotiators' transaction costs. One factor is the time preference of political actors. All else being equal, political actors prefer to reach an agreement sooner than later. However, the more patient a negotiating party is relative to another, the more power it wields.

The time preference of political actors depends on the existence of alternative options available to them. In game theory, a distinction is drawn between outside and inside options. An outside option is the payoff a player gets if there is no agreement at all. The player's outside options increase his bargaining power. Inside options are the payoffs a player accrues during the bargaining process while the negotiating parties are in temporary disagreement. If the outside options of each player are small, only the inside options matter. The player with better inside options suffers less from uncooperative behavior. Consequently, the player will be more patient during the process and will attain additional bargaining power. However, if one of the players enjoys a viable outside option, inside options may become secondary. For example, if the payoff from the existing political equilibrium is large, the defendants of the status quo have little interest in striking a new deal with reform advocates. Their inside option is simply too lucrative to disregard. However, if those in favor of reform have the possibility to leave the domestic political market for a better outside market, their bargaining power considerably increases.

Another factor influencing transaction costs is the availability of information. People usually have less than full information about the political options available to them. If a political actor enjoys an informational advantage, his future bargaining payoff is likely to increase. If the other parties involved in the bargaining process are aware of this possibility, they may refuse to consent to an agreement, even if it were mutually beneficial. Incomplete information thus increases the likelihood that negotiations result in inefficient outcomes, i.e., outcomes with disagreements, costly delays, or with no exchange at all. In such cases, costly commitment devices—i.e., institutional arrangements—are necessary to credibly enforce bargaining agreements (Alesina and Drazen, 1991; Fernandez and Rodrik, 1991; Rodrik, 1996).

Institutions also play a crucial role in determining how the gains from a possible reform agreement are divided among political actors. For instance, the fact that reform forces prevail in the bargaining process does not necessarily mean that the provision of public goods (such as macroeconomic stabilization, market liberalization, or public service provision) will increase.

An accepted and respected institutional framework encouraging competition among political actors is more likely to provide public goods. According to Bueno de Mesquita et al. (2005), there is a natural tension between the provision of public goods and the size of the winning coalition: if the size of the winning coalition is small and the size of the effective demand is particularly large, coalition members can be replaced easily, and the incumbent is less likely to need the support of any particular individual. Hence, a small ratio between the size of the winning coalition and the size of the effective demand increases the loyalty of the coalition towards the incumbent. Where the ratio between the size of the winning coalition and the size of the effective demand is high, members of the coalition enjoy more independence vis-à-vis the incumbent. The size of the winning coalition thus affects policy provision along two dimensions: first, the larger the coalition, the weaker the loyalty of its members towards the incumbent. In order to maintain loyalty, the incumbent must dedicate a greater quantity of resources to maintaining the coalition. Second, as the coalition gets larger, the incumbent moves towards the frontier of his budget constraint and a greater part of the budget expenditures must be dedicated to providing public goods rather than private ones.

2.2.4 Reform Design

When a political supplier has been charged with the mandate to reform, he is granted with considerable discretionary power over the subsequent design and implementation process because the mandate is frequently vague about the operational details of reform. The mandate is necessarily incomplete, because some contingencies are unforeseeable or because too many exist to be specified. However, the supplier must carefully examine the impact of any policy measure on his future bargaining power before adopting it.

Successful reform outcomes depend not only on the design of the program but also on managing its implementation. The fact that the political market is dominated by pro-reform forces does not necessarily indicate that people agree on the various technical issues involved in this process. In order to ensure political backing, reform suppliers may have to develop second-best solutions on which stakeholders and implementing agencies can agree upon instead of identifying ideal solutions up front. The best technical solution is ineffective if it faces stiff resistance from veto players. In order to manage policy implementation strategically, reform suppliers must acknowledge the nature of the policies they are implementing, the context of the new policy, and the way the policy alters the status quo. Hence, reform suppliers have to consider a number of questions at the onset of the design stage: how are reforms to be designed, implemented, and sequenced? Is there a trade-off between policy objectives, and what determines this trade-off? What are the effects of specific changes in public policy? How do changes in the policy affect poor people? How can policy implementation be monitored and improved? Can the burden of reform on poor people be reduced?

Policy reforms require paying attention both to the effects they have on the public and to bureaucratic implementation constraints. The particular policy features determine the relative importance of each and the dynamics of the implementation process. Policies differ in their administrative complexity, their speed of implementation, and the reaction they generate in the public and bureaucratic arena. For example, education reforms normally require considerable administrative changes. However, they do not have an immediate impact on the public, which is why they may generate more opposition from the bureaucracy than from the public. In contrast, a number of political decisions, such as macroeconomic stabilization or the removal of trade restrictions, can be implemented relatively easily by a ministerial 'stroke of the pen'. However, their impact on the public can be enormous, which is why they may generate considerable opposition in the public arena.

The initiation of reform policies entails both planning and execution strategies: concrete action plans must be prepared, and performance targets and standards have to be clarified before activities take place. The executive authorities need adequate administrative, material, and human resources, since capacity bottlenecks critically affect the implementation stage of reform. One must also account for the existing institutional environment and its influence on the incentive structure of those whose consent is essential to the reform process. If potential veto players (e.g., ministries drafting the legislation, the legislative and judicial bodies, service providers, final recipients) do not perceive the benefits of the reform effort, they will neither modify their behavior nor commit to the reform program.

An obstacle that political suppliers face is that they generally only have limited time to design a reform program. The suppliers can mitigate the potential problems that arise from time constraints by outsourcing parts or the entirety of the reform design. Indeed, designing a reform program has much in common with a make-or-buy decision of a firm: the suppliers can put together the program by themselves or leave the task to a third party. Outsourcing implies that the policy suppliers place themselves on the demand side of the political market, while a variety of actors on the supply side offer policy proposals.

Those most actively involved in the formulation of policy changes tend to be technocrats. In political markets where the level of appropriate knowledge and human capital within the effective demand and/or the winning coalition is low, importing human capital from outside political markets is possible. However, the incumbent political supplier remains the sole awarding authority.

A critical issue faced by political suppliers is the length of time it takes to complete the reform process. Reforms involving institutional change, such as complex and multi-component social reforms in health or education, usually take several years to fully accomplish their objectives. The government may change during the process, implying that different decision-makers and interest groups will seek to intervene and influence the reform outcome. The fact that reform implementation extends beyond a single political cycle is a crucial issue to be dealt with. A strategic outlook must ensure that existing institutions and constituencies are capable of keeping reforms on track.

Depending on their complexity, the implementation of reforms can take several years. The longer it takes, the more likely are deviations from the initial plan. Adjustments are inevitable and planning should be flexible enough to account for possible contingent outcomes. However, there is a trade-off between stability and the adaptability of a reform program that may affect the credibility of the executive authority. Balancing these two factors is thus crucial to guarantee the sustainability and success of the reform (Lupia and McCubbins, 1998b; Cox and McCubbins, 2000; Haggard and McCubbins, 2000).

2.2.5 Reform Implementation

The implementation of reforms is a political and technical challenge: it is multidirectional, incremental, and to some extent unpredictable. Policy implementation requires the concerted efforts of many executive agencies within and outside the government.

Even if one of the agencies assumes the leading role in the implementation process, consensus-building remains a difficult task as responsibility for implementation is likely to be dispersed among various actors. As a result of the difficulty in building consensus, transaction costs increase (Brinkerhoff and Crosby, 2002).

To return to the market analogy, the process of reform implementation is similar to promoting an innovative technology, with all its risks and uncertainties. To discover one's production potential requires considerable investments on the part of the innovator as he must first acquire the knowledge, materials and the means of production. The benefits of the discovery may not be fully appropriated by the innovator since competitors will be induced to exploit the innovation without having to bear the initial sunk cost of implementation. Finally, while innovations typically add value to the society at large, they may also have a negative or destructive effect on existing producers as new developments clear away or change old organizational forms and practices. As such, they are likely to be opposed by those groups in the society who suffer from their implementation (Schumpeter, 1975; Aghion and Howitt, 1992).

On the supply side, the enforceability of the innovation depends on the market position of the political entrepreneur, the nature of the innovation, its promotion, and its cost.

The supplier's market position lies on a continuum between perfect competition and monopoly. The higher the entry barriers to the political market, the lower the level of competition. High entry barriers provide the supplier with a monopolistic position, in which case the incentive to innovate is low. When entry barriers are low, the presence of other potential suppliers in the political market compel the incumbent to innovate in order to be reelected.[1]

The nature of the innovation also impacts the likelihood that it will be implemented. Key stakeholders must acknowledge the legitimacy of the proposed innovation. To acquire legitimacy, the innovation must be marketed and promoted. Advertising, legal bindings, and coercion are possible means of promotion. Legitimacy opens the door to developing ownership for the adaptation. The more contentious the innovation and the more it departs from past practice, the more the legitimization process influences whether or not it is adopted (Brinkerhoff and Crosby, 2002).

Constituency-building complements and facilitates the legitimization process. Constituents are those who will benefit from the innovation in some way, such as consumers, providers of inputs, or people within the implementing agency who find their position enhanced by the innovation. The aim of constituency-building is to increase acceptance for the innovation.

[1] There are situations in which competition might deter innovation. Equally, there are situations in which a monopolistic market structure might promote innovation. This is because the political supplier faces a trade-off between innovating and keeping his position secure (by not innovating). For instance, in a monopolistic market in which the risk of losing power is minimal, security considerations are secondary to some extent. In this situation the incumbent may be inclined to promote innovations. In contrast, in an arena where political competition is fierce, however, the destabilizing effects of innovation may deter the supplier from reforming. See Acemoglu and Robinson (2005) for details.

In general, the supplier bears the cost of innovation at the onset of the process, while benefiting only slowly once the adjustment has been implemented. Not only do the benefits need time to materialize, but the costs of innovation are likely to spread over groups favored by the status quo. These groups are usually well-organized, occupy influential positions, and have a common interest in blocking potentially harmful innovations (Przeworski, 1991). Innovations are thus subject to a time inconsistency problem as discussed in Kydland and Prescott (1977). To overcome these barriers to innovation, a gradual approach can reduce uncertainty with respect to future payoffs and persuade interest groups to move forward step by step (Dewatripont and Roland, 1992, 1995; Wei, 1997).

In situations in which the benefits of innovation arise up front, the early winners may tend to freeze the implementation process at the point where it is most beneficial to them. Thus these groups may have an incentive to block future innovations in order to secure their market position and their bargaining power. In such a case, a fast and comprehensive implementation strategy is adequate because a gradual approach would disrupt the stability of the existing market system without generating the efficiency gains that are expected from an innovation (Hellman, 1998; Chang, 2002).

On the demand side, the enforceability of the innovation is determined by the relative position of the reform and status quo groups in the market, their size and bargaining power, and the homogeneity of their preferences. As on the supply side, the market position of interest groups on the demand side is located on a continuum between monopsony and perfect competition. A group holding a dominant position (i.e, close to monopsony) in the market has more bargaining power and therefore more clout in its interactions with the supply side. As the number of powerful demand groups grows, competition for the favor of the political supplier increases. Groups have to engage in bargaining procedures to reach consensus, a process which inflates transaction costs.

The problem of increasing transaction costs is somewhat mitigated if interest groups have homogeneous preferences. In a political market where repeated social and political interactions take place, enduring patterns of mutual trust can develop, improving the possibility of collective action (Spiller and Tommasi, 2003).

While ensuring broad and continuous participation is in general necessary to increase the legitimacy of innovations, it raises serious management problems since political suppliers have limited capacity to deal with and to satisfy a wide range of demands. Because additional groups will condition their support based upon the concessions they receive for their claims, the supplier will evaluate whether expanded participation is necessary and affordable. The cost of satisfying new demands must be balanced against improved prospects of implementation and political survival.

2.3 Model Discussion

In implementing reforms, transition countries face political, administrative, economic, and informational constraints. The lack of material, human, and organizational capital limits administrative capacity. Economic constraints come in form of complex institutional market failures. Uncertainty about the impact of a proposed reform program may prevent people from embarking on a reform path. However, political barriers are the biggest impediment to reform efforts. To be successful, reforms must have sufficient support from politically decisive groups at the three stages of reform. But reform measures involve a basic trade-off for those in strong positions in societies. Although a policy change may increase their economic payoff, it is also likely to affect their political power by enabling new groups to become politically effective and to demand, or insist on, more opportunities or resources. The opposition of vested interests, whether political or economic, thus represents the largest obstacle to changes in policies and institutions, "for he who innovates will have for his enemies all those who are well off under the existing order of things, and only lukewarm supporters in those who might be better off under the new." (Machiavelli, 1992, 13) Those groups who benefit from the status quo will fight tenaciously to retain it. The success of reform hinges on understanding these dynamics and the interests pursued by the actors involved.

Two questions particularly interest us here: Do decisive actors have the *ability* to decide, design, and implement reforms, and what are the determinants of this ability? The second aspect is whether and under what conditions these actors have an *incentive* to implement reforms. Both aspects are interrelated and point to three major problems inherent to the reform process. The first problem concerns the capacity of the state to develop and implement policies necessary to foster growth and reduce poverty. The second problem consists of overcoming barriers to collective action. Finally, the delegation problem must be solved. These problems can occur at different stages of the reform process. In this study it is argued that a sufficient level of political competition is the best way to mitigate the potential problems raised by these issues.

2.3.1 State Capacity

Integral to the success of the reform process is the state's capacity to act as a catalyst and coordinator in that process. Capacity refers to the ability of state actors to engender, design, implement and assess policies, which depends upon the government's policy expertise and its ability to manage complex administrative organizations. It also refers to the ability of state administrations to regulate economic activity, enforce the rule of law, and deliver services (Rius and van de Walle, 2003). State capacity critically affects all three stages of reform.

Broadly speaking, state capacity is determined by good governance and economic prosperity. A crucial role of the state is to provide an environment in which the economy can prosper. Over the long run, development objectives cannot be achieved without a favorable investment climate. The state needs markets as much as markets need the state. What capacity does a government need to have to ensure a favorable investment climate? Four factors play a role, each of which will be briefly discussed below.

- Good governance and public sector management
- Institutional framework for markets

- Physical and financial infrastructure
- Organization of the provision of basic services

Huge spillover effects exist between good governance and economic prosperity. Good governance improves the investment climate. A good investment climate generates prosperity and expands economic opportunities, so that investments become more productive and the economy attracts more investment. Improvements in the investment climate and the ensuing economic growth in turn increase the state's capacity to regulate economic activity and to adapt it when necessary.

In countries with poor institutions and governance, citizens tend to suffer from government harassment, bad public services, and weak policy design and implementation. The legal system is ineffective and unpredictable, contracts are only weakly enforced, and crime is pervasive. Public officials embezzle public funds, receive bribes, grant privileged access to public goods and services, and hand out administrative positions to their supporters. The quality of governance also affects the business sector. If economic actors are exposed to bureaucratic discrimination, it does not only lower their productivity, it also signals to them that competing for political favors is more beneficial than competing for profits in the economic market. As a result, these countries are beset with an environment that not only lacks predictable and equitable rules, but also the basic public services for productive economic and social activity.

Good governance—understood as a good political organization and administrative competence of the government—has been widely recognized as fundamental to growth and development. Governance is neither easy to define nor can it be measured with precision. Governance generally refers to:

- the processes by which political actors are selected, controlled, and replaced;
- the government's capacity to devise and put into practice sound policies; and
- the respect for the institutions that govern economic and social interactions.

Although good governance means that the state is well run, it involves more than just the state. It also refers to how power is exercised. Institutions that protect the property rights of the entire society and constrain the power of policy makers improve the economic climate. By contrast, institutions that generate political instability, concentrate political power in the hands of a powerful minority, and deny basic rights to the broad population adversely impact economic development because they discourage investment in physical capital, human capital, and technology (Stern et al., 2005; Kaufman et al., 2008).

Political stability—defined as the absence of episodes of social conflict or the absence of chronic government changes—is an important aspect of governance. A certain amount of political stability is necessary to achieve economic growth. Political instability has a negative effect on economic performance because it increases uncertainty (Collier and Hoeffler, 2004). Uncertainty in turn affects many private economic decisions, such as those pertaining to investments and savings. Evidence also suggests that political instability retards economic reforms (Alesina and Perotti, 1996).

The implementation of reform policies requires that the government and administrative agencies adapt to new tasks. New organizations may have to be created. How these agencies work and what they produce is the outcome of an agreement among interested parties about what and whose needs should be satisfied. Administrative procedures and routines are institutionalized around such agreements. Changes can be implemented, but the process is neither simple nor quick. Most administrations try to maintain as much independent control over inputs, outputs, and operations as possible. Reforms can pose substantial threats to these administrations if they entail changes in how resources are allocated. These threats are increased in situations in which stakeholder interests are diverse and resources are scarce (Brinkerhoff and Crosby, 2002).

Many transition countries experience a fragile governance environment. While the number of democracies has increased in the region, political regimes with a mix of democratic and autocratic features are not uncommon. These regimes are highly unstable and vulnerable to social conflict. Inconsistencies in governance are also widespread. For example, countries may hold competitive elections for the legislative chamber even if the chamber does not exercise effective control over the executive branch. Countries may allow open political competition among some social groups while restricting access to others.

At the core of a good investment climate are institutions that define and enforce property rights. Where property rights are protected, individuals have incentives to invest or innovate because they can expect to receive the benefits from these activities (De Soto, 2000). Formal enforcement institutions, such as courts, accelerated enforcement proceedings, simplified judicial procedures, or automated court administration records have positive effects on business activity (Stern et al., 2005).

Property rights also influence reform implementation. When the set of property rights is not at stake, it is likely that reform measures are implemented more easily. Unfortunately, this is rarely the case since reform policies often rearrange the existing set of property rights. For example, in transition countries the state was generally the legal owner of manufacturing firms. In reality, however, the right of *usus fructus* largely belonged to the employees of these firms and to government officials. These groups enjoyed considerable discretionary power over the firm's management and the distribution of the firm's assets. It comes as no surprise that measures aiming at transferring property rights to private economic actors encountered massive opposition from these groups.

In many transition economies excessive regulation of factor and product markets restricts the right of usus fructus of many firms, and thus constitutes an important obstacle for existing firms. Moreover, many transition countries lack the necessary capacity and the checks and balances in regulatory agencies to enforce existing regulation. Overregulation then easily becomes a profitable source of rent extraction and a disincentive to private investment. Instead of channeling economic activity, regulation then protects the privileged and discourages the disadvantaged (Blanchard and Giavazzi, 2003; Djankov et al., 2002). While a certain level of regulation is indispensable, the challenge is to eliminate the wrong kind of regulation and to establish the right kind. In the presence of doubt, simplicity should be favored over complexity. Stern et al. (2005) propose the following institutional measures to improve the investment climate directly and generate pressure for reform:

- Simple business and tax regulation increase transparency and reduce bureaucratic discretion.
- Strong legal institutions for businesses and households improve contract enforcement and conflict resolution.
- Impact statements reveal the costs and benefits about existing regulation.
- Align the incentives between public agencies and their clients by automating registration procedures and reducing opportunities for arbitrary behavior.

To improve information and transparency, they propose the following measures:

- Provide information and points of contact between businesses and regulatory agencies.
- Benchmark and publicize business climate indicators.
- Promote education institutions for business and include business issues in more general education.

State capacity is also directly linked to the availability of physical and financial infrastructure. Fiscal stability, low inflation, sound monetary and exchange rate policies improve the investment climate by reducing risk, providing sound economic signals, and promoting transparency (Dollar and Kraay, 2002). Open trade regimes promote competition and increase incentives for innovation and entrepreneurship.

External financial flows can also contribute to state capacity by increasing capital mobility and easing capital account restrictions. FDI is particularly important. FDI provides access to technology, management techniques, and standards from developed countries' markets. Other financial resources may play a role. Worker remittances, for instance, represent an increasing part of the financial flows to transition economies. Foreign assistance may also contribute to a positive investment climate. The success of foreign assistance depends on whether local ownership, local involvement, and adaptation to local conditions are given (Rodrik, 2000). Foreign assistance can be a significant support to governments that are genuinely motivated to reform, but the stimulus to reform has to come from within the country (Ellerman, 2005).

The contribution of foreign assistance to economic growth and poverty reduction is better in countries with good policies and institutions. Assistance is also more successful if the donor country favors assistance for those countries with a proven record of successful reforms rather than those who have simply promised reforms. The traditional conditionality clauses imposed by the assisting country typically fail to provide adequate incentives to engage in reform. Effective policy reform hinges on domestic political consensus. Imposed conditionality tends to complicate political consensus building. Having recognized this problem, donors have shifted toward ex post conditionality, i.e., assistance based on jointly monitored results rather than promises (Devarajan et al., eds, 2001; Collier and Dollar, 2002).

State capacity also includes the organization of the provision of basic services. Increasing public spending on basic services is typically not enough to improve capacity. Evidence shows that the link between public spending and policy outcomes is weak (Filmer et al., 2000). Organizational factors also matter. A service delivery chain is only as strong as its weakest link.

The budget is the main tool to make sure that public spending is consistent and sustainable. In the long term, government expenditures have to be covered by equivalent revenues, because sustained budget deficits affect economic performance. But fiscal constraints often make it difficult to foster growth and to encourage poor people's participation in it; therefore expenditure allocations and levels therefore have to be carefully chosen. When the level of government spending is determined, the costs and difficulties with regard to taxation have to be accounted for as well. Spending decisions cannot be made independently of revenue decisions. In some cases, external resources may cover a portion of what will be needed, but gathering sufficient resources usually entails cutting those directed to old policies. The result is that competition for limited resources will increase (Stern et al., 2005).

Budget allocations must translate into steady resource flows for the policy to be effective. To ensure a steady flow of resources, a medium-term perspective is usually taken to assess the effects of current and future expenditure. This entails the establishment of a medium-term macroeconomic framework to align government spending with economic performance. The productivity of public expenditures must be continually evaluated (Stern et al., 2005).

Increased public spending fails to improve the provision of basic services if governments misallocate budgets. Budget misallocation results from inadequate information and knowledge about appropriate policy interventions. But political incentives also play a role. Political pressure can divert public spending in favor of influential groups, thereby reducing investment in public goods that benefit the society at large. Even when budgets are correctly allocated, they may fail to reach their intended recipient if organizational and incentive problems in public institutions cause misappropriation or theft. A further problem is that providers may have insufficient incentives or capacities to deliver services effectively. Ineffective service delivery can be traced back to insufficient monitoring of providers and weak incentives for good performance, such as unattractive working conditions or low remuneration (World Bank, 2003c).

Tracking public expenditure increases transparency and reveals how public resources are being used. To increase the sustainability of public expenditures and to make sure that public resources are not misused, three factors have to be in place: verification of expenditures, functioning control and audit institutions, and punishment of those who infringe the law (Stern et al., 2005).

From this short discussion, it can be easily noted that the elements of state capacity are at the same time goals of achieving economic development and poverty reduction.

To solve the seemingly paradoxical situation, governance plays an essential role since it is hardly probable that market institutions, infrastructure, and provision of basic services will create themselves. However, individuals in the political market interested in promoting reform face two problems: how to mobilize public support and how to prevent deviant behavior. Both problems will be addressed now.

2.3.2 The Collective Action Problem

One important dimension of public policy-making is that it attempts to solve problems of *collective action*. Collective action problems arise when it comes to the provision of public goods. Since public goods are non-excludable and non-rival in consumption, it is rational for individuals to wait until someone else contributes to their production. However, if private benefits do not compensate for the costs, nobody will be willing to contribute to the public good independently and hence no provision will take place.

People interested in the provision of public goods tend to form associations based upon shared perceptions regarding the value of the anticipated benefits of collective action. The most effective groups will be those that are small and comprised of individuals with homogeneous interests. Small group size increases the expected per capita benefit to group membership and increases the members' incentives to contribute to the group's success. Small groups thus have a comparative advantage over their larger competitors because their members will supply more effort on the group's behalf. Small groups also face lower costs of monitoring and controlling free riding, since deviant behavior is easier to detect and sanctions are easier to impose. Moreover, it is easier for small groups to agree on a common goal, an advantage reinforced by homogeneity of members' preferences. Once a group is organized, the cost of directing the group's efforts to the political market is relatively low. The start-up costs have already been borne in the process of organization. Political lobbying then becomes a relatively inexpensive byproduct of being organized. Large and uncoordinated groups are therefore likely to succumb to the 'tyranny of the minority' (Olson, 1965, 1982).

A key issue in the literature of collective action is whether individuals can be motivated to join interest groups and to participate in the effort to support the group's political activities. Lobbying, after all, is itself a public good and free riding is likely to undermine its provision.

In order to mobilize people and to minimize the risk of free riding, selective incentives can be provided to the members of the group. For instance, a group can supply private goods or services to its members that cannot be purchased elsewhere. By tying this good or service to membership and monopolistically pricing it above cost, the group can attract new members and thus finance its lobbying activities.

In the context of policy reform, collective action problems loom large. Lobbying for reform or status quo is itself a public good. The reform might not be provided, because it is rational for individuals to wait until someone else accepts to bear the cost of provision. Moreover, small decisive groups might resist reform at the expense of society at large because they benefit from the existing status quo.

Uncertainty about the future distribution of costs and benefits can exacerbate collective action problems. Suppose that a conflict between interest groups over the distribution of costs connected to a reform program leads to implementation delays. Each group is looking for ways to charge a larger fraction of the costs to the adversary. Given asymmetric information about the alternative (inside and outside) options available to each group, it is rational to wait and see whether the adversary will concede first. The group with less attractive options will have to bear higher costs and is thus more likely to give in. In the meantime, the disagreement leaves most people in society worse off, because a superior political equilibrium could in principle have been achieved (Alesina and Drazen, 1991; Alesina et al., 2006).

Even if everybody is aware that the majority of the society will be better off after reforms are implemented, reforms may be blocked. The problem is that individual uncertainty about who will eventually belong to the group of beneficiaries makes people risk-averse. Those who expect to find themselves among the losers of reform will oppose it. Uncertainty with respect to reform outcomes can thus create a bias toward maintaining the policy status quo (Fernandez and Rodrik, 1991).

This sort of collective action problem was regularly observed in countries confronted with the extremely difficult situation of the manufacturing industry at the beginning of the transition process. Privatization, the imposition of hard budget constraints, and restructuring were among the most urgent and fundamental reforms faced by policy makers at that time. However, many governments were unable to implement these reforms because workers and managers of SOEs constantly exerted pressure for interventionist measures in support of ailing firms. Both groups had well-established organizations with close ties to political parties. Although they could expect to be better off once the necessary reforms were executed, the individual-specific uncertainty about the impact of these measures generated political opposition among SOE employees.

Collective action is even more difficult in (socially, ethnically, or confessionally) polarized environments. Evidence shows that an individual's propensity to join groups, participate in social activities, or cooperate in the provision of public goods and services is negatively related to the degree of polarization in a society (Bardhan, 2004; Baland et al., eds, 2006). This finding suggests that inefficiency and polarization may frequently go together. Polarization increases uncertainty. To overcome uncertainty, trust relationships must be established. However, building trust relationships involves transaction costs. If interest groups are unable or unwilling to bear these costs, opportunities for cooperative problem-solving may be foregone. Collective action problems related to polarization have been frequent in transition countries. In Bosnia, for instance, ethnic polarization has mired the country in political stalemate for several years. The legislative and executive bodies have been unable to agree on common goals. Accordingly most of the reform decisions have been made by the High Representative for Bosnia, the executive arm of the countries involved in the Dayton Peace Agreement.

How can the problem of collective action be solved? In other words, what incentives do interest groups have to support reform measures? The reform literature has focused on two explanatory factors. First, crises help to generate a constituency for reform if the costs related to the status quo exceed the benefits of the decisive groups. Second, political strategies can motivate interest groups to accept potentially painful reforms. The following passages examine how these factors impact the interest groups' incentives to carry out reform measures.

The term 'crisis' refers to a sudden deterioration of the political equilibrium caused by an exogenous or endogenous shock. The shock can destabilize cooperation between interest groups by changing the balance of bargaining power or by increasing the cost of the status quo political equilibrium. Such a disruption can motivate interest groups to adapt their policy preferences and to approve reforms (Tornell, 1998; Drazen and Easterly, 2001).

The crisis hypothesis goes back to Olson (1982) who argued that societies have an automatic tendency to become sclerotic. A society that faces no crises experiences an increase in the power of vested interests and a subsequent decline in flexibility. A crisis can open the door to policy reform in that it destroys existing coalitions and creates room for new actors.

For some people, the crisis hypothesis has become orthodox thinking, while others argue that it is nothing else than a tautology. For instance, Rodrik (1996, 27) argues that "reform naturally becomes an issue only when policies are perceived not to be working. A crisis is just an extreme case of policy failure. That reform should follow crisis, then is no more surprising than smoke following fire." The fact remains that crises can induce interest groups to adapt to the new political equilibrium.

A crisis can take many forms. In the literature, the sources of crisis vary from changes in global interest rates to leverage exercised by international financial institutions or environmental catastrophes. But crisis can also follow the endogenous evolution of state variables, such as the formation of a new government or the slow deterioration of state services (Krueger, 1992; Williamson, 1994).

Perception and the availability of information play a critical role in how a crisis affects vested interests. Crises lead to a re-examination of prior beliefs of individuals, making them more likely to overcome ideological skepticism and accept proposed policy changes (Harberger, 1993). Perception is most likely to provide the link between crisis and reform when individuals agree on what is needed to improve the situation. Hyperinflation, for instance, is easily perceptible. Once people agree (upon the measures) to curb it, the issue is easily resolved. For a widespread perception of social inequality, however, open conflicts often have to arise first. And even if the problem is recognized, the question of how to correct it is probably more difficult to solve (Drazen and Easterly, 2001).

Similarly, hyperinflation and financial crises are perceived as immediate threats by the public as they affect almost everyone; however, fewer people perceive a deterioration in education and health services as the deterioration in services often varies according to region and class. Where these services have always been weak, most people do not even consider the resulting problems as a crisis. "Therefore, the political costs of delaying improvements in health care delivery or education quality are far lower than the costs of failing to cope promptly with spiraling inflation or rapidly dwindling foreign exchange reserves." (Kaufman and Nelson, eds, 2004, 13).

The ambiguous effects of crisis on reform can also be observed in transition countries. For example, hyperinflation at the beginning of transition induced many governments to stabilize money supply rapidly and to enforce hard budget constraints. Others, such as Bulgaria, took a much more easy going approach, which resulted in continued deterioration until a deep recession in 1996 forced the government to enact radical and painful reforms. Another example of the ambiguous effects of crisis on reform is the widespread problem of underfunding or non-funding of school maintenance, a reality that has created an education infrastructure crisis in many countries. In Albania some schools are in such a bad condition that safety is a major concern (World Bank, 2000). Although the problem is long recognized, measures to improve the status quo have yet to materialize. Both examples indicate that those who bear the costs of inaction (i.e., the population, school children and teaching staff, respectively) lack sufficient voice to raise pressure for reform. Since these groups are unable to raise pressure, the political costs for decision-makers are negligible.

In sum, a strong crisis is often necessary to generate support for reform. However, crisis alone is not a sufficient condition for reform implementation. This is because crises do not translate unambiguously into political behaviors and attitudes. Moreover, it is a priori unclear how severe a crisis has to be to unleash reforms. The effect of crises generally depends on:

- what groups are affected by crisis;
- how badly politically decisive groups are affected;
- the possibilities to avoid the negative effects of crisis (for instance, through attractive inside or outside options);
- the kind of reform under consideration; and
- the degree of consensus on what needs to be done to overcome the crisis.

If permitting stark deterioration of services is not a viable option to create wide acceptance for reform, strategic measures may be needed to overcome the problem of collective action. Research has focused on whether or not the way reform packages are designed can secure the sustainability of political support over time. The broad lines of inquiry include reform speed and sequencing. Speed refers to whether any particular reform should be introduced rapidly or gradually. Sequencing refers to whether it is better to implement reforms all at once in the form of a comprehensive program or whether they should be introduced in some particular order.

The pros and cons of rapid and comprehensive as opposed to gradual and sequenced reform have generated long and lively discussions. Supporters of speed and comprehensiveness point out that where reform implementation is rapidly undertaken, the return to growth is generally faster and political support for reform is broader (Lipton et al., 1990). Fast reforms shorten the period of transitory vacuum characterized by high political and economic uncertainty. A rapid and comprehensive implementation of reforms also has an important signaling and credibility effect. If uncertainty among investors about the intentions of the government is high, 'big bang' reforms can be used to reveal a true reformist identity and thus generate stronger support (Rodrik, 1996).

Because most reform measures are socially painful at the onset, they are usually highly unpopular and meet strong resistance. But in the transition context, the collapse of the socialist regime and political enthusiasm for democracy and freedom increased people's willingness to bear the cost of transition. This window of opportunity could not last indefinitely and it was important to act rapidly in order to achieve a critical mass of political and economic reforms (Balcerowicz, 1995).

Supporters of gradual and sequenced reforms point out that proceeding step by step may be the only viable approach in a context where high uncertainty about the distributive effects of reform leads to political deadlock (Przeworski, 1991; Dewatripont and Roland, 1992, 1995). Uncertainty makes comprehensive reforms difficult to initiate. Gradualism makes consensus finding easier. If the first wave of reform is successful, interest groups will support further measures, even if uncertainty persists. Gradualism can then generate pressure for further reform.

Critics point out that the gradual approach usually generates lower efficiency gains. It takes a long time for the economy to recover (World Bank, 2000). Early reform winners have an incentive to capture the government and freeze the state of reform at the point where it is most beneficial to them, thereby reducing support for further reforms (Rodrik, 1996; Hellman, 1998). Indeed, there is strong empirical evidence in the transition literature that early and rapid reformers achieved better economic and social outcomes than their slower counterparts (EBRD, 1999, 2000; World Bank, 2000)

Many other strategies have been proposed to ease collective action constraints (for a good recent overview, see Arroyo, 2008). One approach is to compensate reform losers (Roland, 2002). However, this approach is difficult to enact, because compensations have to be financed by increasing tax revenue and because the government might be unable to commit to a continuous flow of transfers to reform losers. Haggard and Kaufman (1995) suggest that it may be necessary to temporarily insulate reformers from the influence of vested interests until reform support is large enough to sustain the process. They recommend the delegation of power to technocrats in order to achieve a sustainable reform level. In contrast, Hellman (1998) argues that the government should remain open to public demands in order to prevent rent seeking activities and state capture.

It is not necessary to extend the list of strategic measures here because the topic is only indirectly related to the research question. Finding appropriate strategies can help us to understand how to motivate interest groups to agree upon necessary reforms, but it does not tell us what incentives exist to encourage policy makers to apply those strategies. Instead, it is assumed a priori that a social planner is interested in promoting policy reform; there is no explanation as to the source of that motivation. Hence, the focus on strategic measures is only of limited use for the research goal of this study.

In contrast, the crisis hypothesis is important, because it indicates that a change in the political equilibrium can alter the cost-benefit evaluation of individuals, inducing them to take into consideration the possibility of political change. If the discounted private benefit connected to political reform is higher than the associated discounted cost, individuals will tend to accept political change. If the private benefit is large enough, individuals might even be willing to solve or tolerate some free riding, create a lobby group with equal-minded people, and eventually provide the public (reform) good. In reality, a crisis does not have to occur. Individuals are forward-looking and try as best they can to anticipate the future. If individuals in decisive groups anticipate that a crisis could affect them negatively in the future, they will attempt to avoid it by informing, motivating, or forcing other interest groups to act. Their chances of success increase if:

- their group is small and has homogeneous preferences;
- their group is well-organized and able to control free riding among its members; and
- their group faces low opposition from other well-organized groups in the political market.

A final remark concerns a more general problem of the collective action literature. This literature tends to exaggerate the relative importance of demand-side pressure in the process of reform. The supply side of the political market is typically ignored. Political representatives are primarily considered as brokers whose impact on reform mainly depends on the support they receive from their economic constituencies (Haggard and McCubbins, 2000). This shortcoming is being addressed by the agency literature, which is covered in the next section.

2.3.3 The Agency Problem

It is argued above that uncertainty poses a major obstacle to reform implementation. One way to reduce uncertainty is to improve the relationship between the actors on the demand and the supply side of the political market. Indeed, only a subset of individuals in the respective demand groups is directly involved in the official process of reform bargaining and implementation. This subset generally includes elected or otherwise designated officials. These policy makers constitute the 'supply side' of the political market. They place policy issues on the agenda of government decision-making, and provide initiative, orientation, and expertise to major policy issues.

In an ideal world the public would be able to designate benevolent, omniscient, and omnipotent policy makers, thereby ensuring the implementation of policies that maximize public welfare. Uncertainty with regard to the quality of political representatives would disappear. Unfortunately, the selection of political representatives is inherently afflicted with uncertainty as the public does not or cannot know who among its members is best suitable to represent their interests in the bargaining process, since individuals can conceal their 'type'. An individual's type is a summary of the personal characteristics about which other individuals are uncertain. This can include personal attributes and goals, ideological predispositions, professional expertise and experience, position and power resources, political and institutional commitments. The type of a policy maker matters, because there is reason to believe that the quality of policy choices depends among others on the quality of the political representative (Besley, 2006). After all, some individuals can carry out policy reforms more efficiently than others, because they have more knowledge, experience, power, or insight into what works. Therefore, the public must ensure that those who represent it in the political market are competent, accountable, and responsive. Accountability enables the public to identify who is responsible for policy decisions. Responsiveness guarantees that policy makers react to changes in the public's preferences. But since the types and the actions of policy makers cannot be fully observed, the public suffers from an informational gap that policy makers can use to their advantage.

This situation corresponds to a typical *agency* problem, where the principal (the public) delegates authority to an agent (the policy maker) to complete a task. The information asymmetry between the principal and the agent generates problems of moral hazard because agents generally seek to pursue their own preferences. Incongruity of preferences between the principal and the agent increases the agent's incentive to withhold information.

To ensure that the agent completes the task at the lowest possible cost, the principal incurs transaction costs. These costs arise from selecting appropriate agents, monitoring them, and gaining information to set performance standards. The magnitude of the transaction costs depends on the principal's ability to design an incentive scheme that rewards or sanctions the agent according to the payoff achieved. The better the incentive scheme, the lower the principal's transaction costs, and the more successful delegation is likely to be. The better the information provided by past agents, the more effective the principal's performance standards will be.

The political market is characterized by *multiple agency* relationships. Multiple agency relationships arise where many agents are controlled by many principals. If the objectives of the principals differ, it will be more difficult offering incentive compatible tasks to the agents. Moreover, the lack of transparency in multiple agency settings enables malevolent and incompetent policy makers to pool with benevolent and competent ones. Therefore, multiple agency situations make monitoring more difficult and outcomes more uncertain, increasing the transaction costs of each principal (Laffont and Tirole, 1991).

Agency problems explain a great deal of existing distortions and manipulations in the political market. In the decision and implementation stages of reform, these problems are particularly difficult to avoid.

The multiple agency relationships in the political market make it difficult for the public to assess the specific contributions of political agents. Furthermore, the complex characteristics of some public goods and services render it difficult for individuals to assess a policy maker's task contribution. For example, education and health services are complex and transaction-intensive: allocated financial resources are first turned into education inputs, which then contribute to student learning or patient health. But the output—in terms of literacy or good health—is likely to vary not only according to student and patient characteristics, but also according to the characteristics of the respective service provider. The day-to-day behavior of these providers plays an important role for the quality of the service (World Bank, 2003c). Moreover, the benefits of education and health services takes several years to emerge, long after the policy action has been taken. Therefore, it is not easy for the public to identify the sources of potential outcome failures. Is it because policy makers have reneged on their promises? Was the amount of financial resources channeled toward the provision of these services adequate? Are the outcome failures due to particularly difficult circumstances or to unresponsive service providers? In short, it is often difficult for individuals to trace back who is responsible for failures in the provision of public goods (Keefer and Khemani, 2005).

This concrete case of multiple agency hints to another problem: not only is it difficult for the public to identify an agent's particular task contribution, it is also difficult for the agent to make credible concessions (Keefer and Vlaicu, 2005). For example, after several years of stagnation, a reform-minded government was appointed at the end of 1996 to implement radical economic reforms in Romania. However, being under constant attack from opposition parties and unable to overcome bureaucratic inertia, the record of the reform program was disappointing, which led to the resignation of the government in early 1998. Although the new government was believed to be in favor of reform policies, it could not overcome the powerful political and administrative veto points in the political market. Instead, everybody was accusing everybody else of incapacity, stealing, and cheating. In such a context, particular policy programs become irrelevant for the public, because political agents are unable to promise a better political alternative with any credibility.

In multiple agency settings, it is difficult for the public to sanction policy makers on the basis of reliable criteria. Poor people are particularly disadvantaged, because seclusion, illiteracy, poor health, or restricted mobility hinder their access to information. The larger the fraction of the public who is uninformed about the type of political agents, the greater are the agents' incentives to rely on narrow political constituencies to mobilize the public in return for targeted favors (Grossman and Helpman, 1996). Agency problems thus adversely affect a decision-maker's policy choice.

To see this, let us first differentiate between agency relationships of first and second order. The first-order agency relationship refers to the link between the policy maker and the narrow political constituency to which she belongs. The second-order agency relationship refers to the link between the policy maker and the public at large. This differentiation corresponds to the distinction previously made between the *effective demand* and the *potential demand*. Since the members of the effective demand are better organized, they generally have more information about the agent's type, even more so if the agency relationship is based on a history of repeated interaction. They are also better placed to monitor her actions. Therefore, policy makers will first and foremost be responsive to their political constituencies rather than to the public at large. *Clientelism* as this phenomenon is called is an inevitable outcome when credibility of policy makers is limited (Keefer and Vlaicu, 2005; Rius and van de Walle, 2003). Clientelism is more likely to arise in political markets characterized by high social, ethnic, or confessional polarization.

In clientelistic political markets, agents have no incentive to provide universal public goods as this would lower their political benefit. Instead, specific promises of pork become the currency of trade.[2] Pork can be targeted to small groups of the population. It is a visible sign that policy makers have kept their promises. By concentrating on targeted promises to their narrow constituency, agents can gain and preserve political power over time. In contrast, universal access to or quality improvements in public goods are not easily targeted. Not only do they spread throughout the system, but they are also difficult for the public to attribute to particular policy makers. In a clientelistic environment, it is thus easier for constituents to give credit to policy makers for public goods exclusively targeted to them rather than for public goods that are universal. Policies may be adopted to address desirable public goals, such as providing employment or reducing poverty, but the way they are implemented will basically follow clientelistic objectives (Rius and van de Walle, 2003).

There is ample evidence showing that clientelistic governments have a strong preference for the provision of targeted goods at the expense of universal public goods. The larger the number of clients, the greater is the focus of government expenditure on items targeted to specific groups, and the less is spent on public goods (Keefer and Khemani, 2005). The performance of young democracies in the provision of public goods is systematically worse than the performance of older democracies (Keefer, 2005). The low performance of young democracies is related to the inability of policy makers to make credible promises. Political agents in older democracies have had greater opportunity to build policy reputations. They are thus better able to make credible promises about providing universal public goods. However, the formation of policy reputations is far from inevitable as democracies age (Keefer and Khemani, 2005).

Policy makers in clientelistic political markets thus behave like monopolistic suppliers in a niche market. Because individuals tend to select political agents largely on the basis of partisanship and regardless of their performance and policy record, the existence of clientelism restricts the political choice of the public. These circumstances can lead to absurd situations. For example, even if clients were to suffer from the policy choices of their agent, they may not want to remove him from power because they prefer to stay with the devil they know than with a devil they do not know. Choosing another agent would put at risk their 'privileged' position in the effective demand. As a result, the public loses its ability to hold politicians accountable for bad policy choices (Acemoglu et al., 2003; Bueno de Mesquita et al., 2005).

Monitoring and transparency are the devised mechanisms through which responsiveness and accountability of public agents can be increased. Monitoring may occur after the consequences of the agent's actions are known (*ex post monitoring*), or prior to the agent taking action (*ex ante monitoring*). Both types of monitoring ultimately rely on rewards and sanctions for their effectiveness. Ex post monitoring leaves the agent

[2] Pork refers to geographically targetable public spending whose incidence follows a political rather than an economic logic. Pork may still qualify as public goods, but the fact that it is derived from political interests signifies that it may not be the least costly means of providing these goods to the society. On the other hand, pork refers to rents, including a wide range of subsidies, special tax provisions, or regulatory exceptions that are extracted from the government (Cox and McCubbins, 2000).

relatively free to determine how best to satisfy the demand schedule. Ex ante monitoring, by contrast, defines behavioral standards that the agent has to follow. Where task output is homogeneous and easy to control, ex post monitoring is more effective. In contrast, where the output is heterogeneous and hard to control, ex ante monitoring is more appropriate (World Bank, 2003c).

Monitoring and evaluation of reform progress by means of process indicators facilitates learning and error correction. Ideally, one would like to assess economic and social policies ex ante and control them ex post for their impact, particularly in terms of their effects on poor people. Ex ante evaluation entails using quantitative techniques to predict the likely effects on different groups of a policy reform prior to its implementation. After the reform implementation, it is crucial to evaluate the effective impact of a policy and to compare it with the ex ante predictions. Systematic deviations between ex ante predictions and ex post realizations can then point to persistent capacity or agency problems within the chain of reform. Such information can improve the accountability of policy managers and implementing agencies. One example of reform chain evaluation are Public Expenditure Tracking surveys, where service delivery at a particular facility is linked upstream to government agencies and downstream to the household level. These links then allow a comprehensive analysis of supply and demand factors, as well as explicit analysis of political economy factors (Stern et al., 2005).

Monitoring can be provided by a variety of actors. Because reform implementation affects multiple agencies, it is sometimes problematic to determine who monitors and reports on a comprehensive scale of overall reform impacts. Monitoring and evaluation reports and results can be used for reward and punishment, and tensions and conflicts can appear when monitoring responsibilities are allocated. Thus, external monitoring plays an important role in assuring accountability and responsiveness of policy makers and administrative agencies (Brinkerhoff and Crosby, 2002).

In sum, the agents' responsiveness and accountability to the principal critically depend on the availability of information. Responsiveness and accountability generally improve if:

- the task is clear and easy to implement;
- the incentives of the principal and the agent are aligned;
- good monitoring technologies are available, so that the agent's actions and output can be easily observed;
- the agent's short run payoff from deviation is low;
- the number of political actors is relatively small, so that the agency relationship remains simple; and
- the principal can recourse to alternative or previously established performance standards.

2.3.4 Competition

In this study it is argued that the problems discussed so far—i.e., capacity, collective action, and agency—are generally better handled by governments in competitive markets than by governments in monopolistic markets. Put differently, this means that political competition within an accepted and respected institutional framework increases the likelihood of successful reform implementation. But how is political competition defined and when are political markets competitive?

Political competition is a complex process, too complex to be apprehended holistically. To make this process more tractable, existing analyses generally focus on discrete elements of political competition, such as party competition, checks and balances between government branches, or the set of constitutional rules. The reform model presented in this study takes a more systemic approach by taking into account the interaction between:

- potential states of the world, one of which is the status quo, the other being reform;
- the set of constitutional rules that determines legitimate actions of individuals;
- a decision-making process that determines the likelihood that alternative potential states of the world will be realized in the future;
- effective demand groups with preferences about the relative desirability of potential states of the world;
- a set of political suppliers who compete with each other for selection to constitutionally privileged positions in the decision-making process; and
- existing alternative political markets.

The role of competition is to provide information, increase political choice, promote competence, and good behavior. The availability of a set of views about potential states of the world enriches the existing pool of knowledge and increases the set of alternative strategies of citizens about how to shape their future. This aspect of competition can ease capacity constraints of the state.

Access to and exit from the political market is crucial for competition. Extensive formal or informal market regulation as well as existing agreements among market actors complicate market entry or exit. Low entry barriers make it easier for individuals to organize and express their demand. Individuals may also be better able to choose among existing political alternatives. This aspect of competition mitigates the collective action problem by reducing transaction costs and increasing the allocative efficiency of the market.

The intensity of competition further increases when political authority is distributed among a large number of actors. It is a sufficient level of competition among effective demand groups and policy suppliers that gives citizens the opportunity to make an informed choice regarding their political representatives and to reduce the risk of adverse selection. When the public has increased opportunity to replace deviant incumbents with challengers, competition among political agents is fiercer. Competition in this sense is inter-temporal: it influences the behavior of the incumbent political agent via the threat of dismissal. Since incumbents have an interest in maintaining political power, their incentive to respond to the public's preferences is stronger when the public can remove them from power more easily. "Simply put, the public holds more bargaining power when it holds a tighter leash on incumbents." (Bardhan and Yang, 2004, 3) All else being equal, a policy maker's risk of being removed from power is higher in competitive markets. In this way competition can alleviate existing agency problems by forcing incumbents to heed the public's demands for reform.

Two scenarios exist in which political competition can increase the motivation of political agents to promote reforms that might eventually reduce their political power. The first scenario is straightforward: the political supplier implements reform in order to remain in power. If the bargaining power of the reform group is strong enough, an unresponsive political agent will be removed from office. Hence, the incumbent initiates reforms. In the second scenario policy makers may prefer to reduce uncertainty about future choices, particularly those made by other agents. To preclude successors from revoking their policy decisions in the future, incumbent politicians may be willing to restrict their power by reforming (Olson, 1993). Thus, in this sense, the creation of institutions is a way of maximizing individual preferences for an extended period of time. The creation of institutions implies commitment to reform and convinces other market actors that policy choices will remain impervious to short-term needs. Reforms thus represent strategic decisions made by political agents. In both scenarios political agents make sure that their legacy will remain in place. In the first case, they remain in power to defend their policy; in the second case, institutional devices guarantee policy continuity. For example, in a politically stable environment, the elite may be inclined to encourage human capital promotion to improve the productivity of their capital assets. This strategy would allow the elite to benefit from higher economic growth while social conditions improve (World Bank, 1990, 2000/2001). The mechanisms developed are valid for any economic reform that increases the economic payoff to powerful political groups by spurring growth while simultaneously reducing their political power by enabling new interest groups of society to become politically active.

Nonetheless, an optimal level of political competition may exist; too much competition can have negative effects on policy outcomes (Acemoglu and Robinson, 2005; Besley and Ghatak, 2005; Besley, 2006). Persson et al. (1997) show that the public's ability to sack officeholders can backfire if the threat of public sanction is too strong. If political competition makes re-election sufficiently unlikely, the incumbent may be induced to extract private rents during his remaining time in office. The overt threat of dismissal can thus generate a shift in political incentives towards the short term.

Competition also arises from outside political markets. International political economy draws attention to the relationship between the dynamics of globalization and various types of domestic economic policies. In particular, research has focused on how globalization, in interaction with various domestic variables, affects institutional changes, such as monetary and fiscal policies, or public welfare (Rodrik, 1998; Geoffrey, 2001; Mosley, 2003). The question is whether, and to what extent, globalization dynamics have taken over domestic forces in the process of national policy-making. One hypothesis states that international and domestic institutions and economic policies converge over time, leading to common economic structures that increase market efficiency. The rational behind the convergence hypothesis is that the global mobility of factors of production puts competitive pressure on countries inducing them to produce more business-friendly policies and institutions in order to attract foreign investment (Rodrik, 1997).

Simmons and Elkins (2004) argue that a country's policy decision alters the costs and benefits of the policy for other countries, either through direct economic competition or through the subjective pressure of prevailing global norms. A governments' reform efforts will then depend on the efforts of their most important foreign economic competitors (Abiad and Mody, 2005). Cao (2008) suggests that competing countries are connected to the same external markets and sources of finance, and thus occupy similar positions in the global network. Similarity in network positions leads to competition among peers because they become easily substitutable. Competition among substitutable peers induces them to engage in similar moves by increasing their incentives to adopt efficiency-mandated economic policies and enabling institutions to gain advantages over their competitors. In the end, the argument goes, competition leads to the convergence of the institutional environment within the group of competitors.

Similarity among countries might also give rise to policy diffusion because it encourages policy learning and emulation. Policy makers require information about the nature and consequences of certain policies before they can make a decision. In order to engage in systematic and intensive evaluation of a policy, they must have adequate information about the policy. Therefore they choose those policies for which they have readily accessible information. The source of information regarding the policy determines its persuasiveness. Information gathered from similar countries is often more convincing than information received from other countries. Group membership involves the identification of peers. The identification process is characterized by long-term interactions within different dimensions. It is not only economic interactions, but also social and cultural ones, that create common affinities and trust between countries. In the face of conflicting information about certain policies and/or when the amount of policy alternatives exceeds the cognitive limits of policy makers, i.e., when uncertainty is high and the decision is hard to make, policy makers are more likely to emulate the policy choice of their self-identified peers, even if they cannot anticipate if the choice reflects their best interests. Neighboring countries often enjoy a higher chance of interaction. Interaction in turn facilitates learning and emulation, stimulating the diffusion of ideas and practices. The nearer the national economies, the more similar they are in terms of their domestic economic policies (Simmons et al., 2006).

Learning may promote reform by revealing information that causes reassessment of the costs and benefits of the policy regime. It can alleviate deadlock that stems from uncertainty regarding the identity of winners. The concept of 'learning' encompasses both discovery and the consequent realignments in relationships. Domestic learning may be supplemented by international diffusion as countries converge to global or regional norms to compete for international capital. The assumption here is that most states in the world do not discover economic policies on their own. They rather tend to 'copy-shuffle-paste' policies that have been successfully adopted in peer economies (Simmons and Elkins, 2004).

Access to global markets subjects the government to outside discipline because external actors can respond quickly to actual and expected policy failures by withdrawing their investments. Policy makers consider this adverse outcome and adapt their behavior accordingly. From this perspective, global integration increases the cost of pursuing divergent policy objectives. Therefore, external economic and political markets become a constraining condition that systematically limit policy makers by rewarding good and punishing bad behavior.

Accounting for these factors, the political market is considered to be competitive when:

- various views about potential states of the world compete with each other;
- the set of constitutional rules grants individuals access to and exit from the political market;
- there is more than one effective demand group in the political market;
- there is more than one political supplier competing for selection to constitutionally privileged positions; and
- it faces competition from alternative political markets.

2.4 Methodological Observations

In order to assess the relative importance of various determinants of reform in transition economies, this study adopts two methodological approaches. The first approach—a multivariate regression analysis—estimates the relationship between political competition, market liberalization, and economic growth in 26 transition countries during the period from 1991 to 2006. The second approach—a comparative country analysis including Bulgaria, Romania, Albania, and Bosnia—analyzes the underlying mechanisms that determine the reform process.

2.4.1 Cross-Country vs. Case Studies

The application of econometric methods has become so widespread that their limits are sometimes overlooked. The panel data analysis in this study shares some familiar technical shortcomings with other cross-country regression studies. First, since it is impossible to include all factors that determine reforms and economic performance, it is difficult to avoid some degree of omitted variable bias. Although country-fixed effects can mitigate the impact of this problem, the complex dynamics involved in the transition process are likely to bias the estimates of the parameters that are included. Second, endogeneity and reverse causality weaken the validity of the estimation. This problem can be addressed using appropriate models and controls. However, in the face of the relatively short length of the time series, compounded with the existence of shocks and volatility in the data, the possibility to introduce suitable corrective factors is sometimes restricted. Third, the presence of multicollinearity can make it difficult to untangle the respective impacts of certain independent variables. The existence of correlated independent variables in the model is likely to distort standard errors. Consequently, it becomes difficult to make inferences about the effects of particular independent variables.

In general, these shortcomings do not undermine the general validity of econometric results. Nonetheless, uncertainty remains as to whether or not a satisfactory causal explanation exists the variables under scrutiny.

The latter argument points to a more general problem: cross-country studies are rarely able to give us good valuable insights into the *mechanisms* of reform politics. Regression analyses can reveal interesting regularities in cross-country experiences, but their ability to unravel the various factors that shape the process of change is relatively constrained. To achieve an understanding of this complex process it is necessary to break up the aggregated indicators typically used in cross-country regressions. Research must integrate political and economic institutions, growth, and income distribution into more detailed qualitative comparative analyses to understand the underlying mechanisms that determine reform processes. Comparative studies can provide us with valuable insights into the mechanisms and processes of transition. However, the scientific value of case studies has time and again been questioned, allegedly because it is difficult to generalize from an individual country's experience. The next section therefore discusses the scientific validity of case studies.

2.4.2 The Scientific Validity of Case Studies

In comparative social science, there is a long tradition of studying empirically-related countries conceived as comparable cases. The comparative method is generally employed to test the validity of general empirical propositions when econometric methods cannot be applied. Econometric methods require a sufficiently large amount of quantitative data drawn from a sufficiently large number of cases so as to make statistical manipulation possible. Where quantitative data is restricted, research is often restricted to the analysis of the behavior of qualitative variables in a small number of cases.

This problem is also encountered in studies of political processes. The dynamics and mechanisms involved in politics are difficult to apprehend with conventional econometric methods. Part of the difficulty derives from the complexity of the policy-making process. The process involves a variety of actors—executives, parties, legislators, judges, bureaucrats, interest groups, the media, etc.—who come together in formal as well as informal meetings to engage in political exchanges. Sometimes these exchanges take place right away, while at other times present actions or resources are exchanged for promises of future actions or resources (Stein et al., 2006). The behavior of these actors and the nature of the exchanges in which they are engaged in depend on the actors' preferences, their incentives, and the constraints they face (North, 1990). Factors like credibility and the capacity to enforce political agreements are vital in this respect (e.g., Lupia and McCubbins, 1998a; Keefer and Khemani, 2005).

Because of the complexities that characterize the policy-making process, it is impossible to understand political processes by concentrating solely on a few statistical aggregates commonly used in econometric works. For example, to estimate the impact of political competition on reform efforts, the multivariate regression analysis in Chapter 3 makes use of the Freedom House political rights index. The index specifies, among others, whether it is possible to vote freely for distinct alternatives in legitimate elections, compete for public office, join political associations, and elect representatives. However, the Freedom House index is inevitably imprecise, because it is unclear whether it considers the quality of institutions, the political participation process, or individual attitudes towards public authorities (Dethier et al., 1999). If such ambiguities are to be transcended, the institutional and procedural environment must be understood in a systemic way. Such a systemic approach can be achieved by means of qualitative case studies, which allow for a variety of institutions, actors, historical and cultural legacies to be considered.

Case studies are useful for both generating and testing hypotheses, but the testing of hypotheses is dependent upon whether or not an individual country's experience can be generalized. The view that it is not possible to make generalizations from an individual country's experience is usually considered to be devastating to the case study methodology. But this assertion is not necessarily an accurate one. Sometimes it is more valuable to shed light on the deeper causes behind a given problem and its potential consequences than to describe the symptoms of the problem and the frequency with which they occur. Moreover, the 'generalizability' depends on the case examined and on how it is chosen (Flyvbjerg, 2006).

The generalizability of case studies can be increased by the strategic selection of cases (Geddes, 2003; Flyvbjerg, 2006). Where the objective consists of achieving the greatest possible amount of information on a given problem, a representative case is not the most appropriate strategy because the *average* case does not usually provide a broad range of information. Atypical cases often reveal more information because they activate more basic mechanisms in the context studied.

When considering the difficulties posed by generalizing case studies, the question that arises is how cases should be selected. Comparative case analysis attempts to explain behavior within a group of countries that are similar, but it can analyze contrasting cases that differ in numerous ways. Either focus of comparison—explaining similarities or differences—can tell us a lot about the dynamics of the policy-making process (Peters, 1998).

2.4.3 Case Selection

The comparative approach in this study utilizes aspects of both approaches. The four countries under consideration share some common features. The Balkan countries of Bulgaria, Romania, Albania, and Bosnia share a historical legacy characterized by centuries of Ottoman rule and rich cultural diversity. Following World War II, these countries adopted socialist regimes. However, with the exception of Bulgaria, they maintained a relatively loose relationship with the Soviet empire. Gradually the political regimes of the countries transformed into personal dictatorships. In Albania, Enver Hoxha's attempts to introduce Marxism-Leninism led the country into a state of isolation. In contrast, Josip Broz Tito installed a relatively open economic regime in the Federal Republic of Yugoslavia (FRY), while similar attempts by Nicolae Ceaucescu to liberalize the economy proved unsuccessful in Romania. By 1989, Todor Shivkov had distinguished himself as the longest-serving communist leader and a steadfast Soviet ally who attempted to turn Bulgaria into a major economic and military regional power within SEE. The authoritarian and personalized structure of power established and consolidated during the communist era eventually played an important role in the aftermath of the collapse of the regimes.

Bulgaria, Romania, Albania, and Bosnia have also followed a similar trajectory toward democracy and market economy. The main reason for reforms in these countries at the outset of the transition was the crisis of the planned economy system. In the early 1980s, it was common knowledge that the socialist political and economic system had become increasingly ineffective and in need of urgent corrective measures. However, because groups interested in the preservation of the status quo were politically stronger than those advocating reforms, much needed technological changes and economic liberalization programs were either postponed or blocked. In all countries under examination, some piece-meal reforms were introduced in the 1980s, but the effect of these measures was negligible.

The lack of reform led to an accumulation of macroeconomic inefficiencies, which found their expression in growing fiscal deficits and severely repressed inflation rates. The resulting systemic crisis strengthened the stance of reformers who called for the implementation of macroeconomic and structural reforms. In the FRY the first reform steps took place as early as 1988. Bulgaria and Romania initiated reforms after the disintegration of the socialist regimes in 1990; Albania followed suite a year later. The break-up of the FRY and the ensuing war postponed reforms in Bosnia until 1996.

These Southeast European countries also displayed notable differences at the beginning of the transition process. Compared to its neighbors, the political regime in the former FRY was relatively open and independent from the Soviet Union. The federal constituencies enjoyed considerable autonomy, which encouraged a slight degree of political debate within the country. However, while these countries did experience some political openness, it was not enough to prevent the disintegration of the federal state in 1990. The antagonistic forces at work in Bosnia plunged the country into a bloody civil war. At the beginning of the transition process the country was placed under a de facto EU protectorate, and the international community increasingly assumed the role of a social planner. In contrast, strong central governments in Albania, Bulgaria, and Romania hindered the emergence of dissident political groups during the communist era. Accordingly, there were no important opposition parties in these countries at the beginning of the transition. In all three countries, the majority of the former communist elite were able to reintegrate into political and/or economic life.

Table 2.1: Living Standards at the Beginning of Transition

	Bulgaria 1990	Romania 1990	Albania 1991	BiH 1996
Population				
Population (in millions)	8.718	23.207	3.293	3.401
Rural population	33.6	45.7	63.1	58.5
Living Standard				
GDPPC (in const. 2000 US$)	1'720.3	1'895.5	708.3	873.5
Life expectancy (years)	71.6	69.7	71.9	72.1
Under 5 IMR (per 1'000)	18.7	35.7	44.5	12.9[a]
Fertility rate (births/woman)	1.8	1.8	2.8	1.7
Literacy rate	98.2[b]	96.7[d]	98.7[b]	96.6[c]
Inequality				
Gini	30.8[d]	25.5[d]	29.1[e]	35.8[f]
Poverty				
PH1	2[g]	2[g]	2[e]	..
PH2	2	2[g]	11.3[e]	2[g]

Notes: Indicators are in percent, unless otherwise indicated. *IMR* is the infant mortality rate; *GDPPC* lists the per capita income levels by PPP in constant 2000 dollars; *PH1* is the poverty headcount ratio at US$ 1 a day (PPP) in percent of the population; *PH2* is the poverty headcount ratio at US$ 2 a day (PPP) in percent of the population; *Gini* is the Gini index; *a* data for 1998; *b* data for 2001; *c* data for 2000; *d* data for 1992; *e* data for 1997; *f* data for 2005; *g* data for 1989; *h* data for 2002.

Sources: World Bank, World Development Indicators, 2008; European Bank for Reconstruction and Development (EBRD), Transition Report, 2008.

Significant differences also existed in the economic structure and the living standards across countries. Tables 2.1 and 2.2 provide some summary economic and social indicators at the beginning of the transition.[3]

With the exception of Romania, all countries were small in demographic terms. A large fraction of the population lived in rural areas. In Albania and Bosnia, the majority of people lived in the countryside. Both countries had low levels of income, with GDP per capita of US$ 708.3 and US$ 873.5, respectively. Income levels in Romania and Bulgaria were slightly higher, placing them in the group of lower middle-income countries.

Life expectancy and literacy rates were similar to those of Western industrial countries, reflecting the positive legacy of socialist rule. However, the relatively high rates of

[3]The tables point to a general methodological problem, namely the scope and quality of the data. The problem is most severe at the beginning of transition, mainly because of measurement errors and underreporting. In later years, the data improved; consequently it can be considered more reliable. Data issues have been discussed in detail in EBRD (1999, 2000); Falcetti et al. (2002, 2006) and Rusinova (2007).

infant mortality point to the states' limited capacity in providing health services to the entire population. The rural population was most neglected in this respect. The rates of income inequality and poverty were low in all countries when compared to developing countries, but in comparison to European standards, poverty rates were high, especially in Albania.

Table 2.2: Economic Indicators at the Beginning of Transition

	Bulgaria 1990	Romania 1990	Albania 1991	BiH 1996
Macroeconomy				
GDP (const 2000 US$, billion)	14.997	43.99	2.332	2.971
Current account/GDP	−8.2	−9.6	−29.1[a]	−24
External debt/GDP	48.2	16.5[b]	66	116.4
External debt/exports	143.9	64.9[b]	498.1[a]	550.2
Share of trade in GDP	65.3	39.2	95.3[b]	71.3
Economic Structure				
Private sector share in GDP	10	15	5	35[c]
Share of industry in GDP	39.8[d]	49.9	32.1	21.4
Share of agriculture in GDP	15.4[d]	23.7	42.5	20.5
Labor Force and Employment				
Labor force (percent of population)	75	69.1	74.7	71.9
Employment in agriculture	18.5	29.1	67.2[e]	..
Employment in industry	44.2	43.5	11[e]	..
Private sector employment	5.9	34[d]	1.8	..

Notes: Indicators are in percent, unless otherwise indicated. *a* data for 1993; *b* data for 1992; *c* data for 1998; *d* data for 1991; *e* data for 1994.

Sources: World Bank, World Development Indicators, 2008; EBRD, Transition Report, 2008.

There was also considerable variance in the economic structure of the four country cases. Albania and Bosnia had very low levels of GDP at the outset of the transition process. In the case of Bosnia, the level of GDP was estimated to be at 20 percent of its pre-war level in 1991 (IMF, 2000a; World Bank, 2004b). The relatively large current account deficits in Albania and Bosnia can be attributed primarily to the discrepancies between exports and imports. In both countries, the reconstruction efforts of that time can explain the overhang of imports. Since the industrial park of these countries was either depleted or destroyed, goods and services had to be brought in from abroad. Both countries were thus highly dependent on external markets. This outside dependency led to a rapid increase in foreign debt.

In Bulgaria and Romania, trade and current account balances were less distorted. Especially in the case of Romania, the low levels of imports and exports respective to GDP indicate that industrial production was directed primarily toward the internal market. Simply put, the goods and services produced were not competitive in external markets. Following Gorbachev's *perestroika* during the mid-1980s, Bulgaria experienced a low level of trade with respect to GDP due to the loss of the country's preferential access to the Soviet market. Hence, both countries were in a phase in which they had to reconsider their trade strategies. Compared to Albania and Bosnia, Bulgaria and Romania had relatively low levels of external debt. During the 1980s, Romania made Herculean efforts to pay off international lenders, which in turn rendered her incapable of modernizing her depreciated industrial assets.

All countries had relatively low levels of private sector share, except for Bosnia, where forms of small private enterprises existed on a larger scale. Private employment was moderate in all countries. What remains noteworthy is the size of the agricultural sector in these economies. In Albania, a large share of the population lived by means of subsistence agriculture, with more than 60 percent of total employment concentrated in the agricultural sector.

As we can see, the selected cases vary across many dimensions and lend themselves for the purpose of a qualitative comparative case study. One might object that there is danger of selecting cases in such way that they confirm the researcher's preconceived notions, thereby shedding scientific doubt on the value of the study. Apart from the fact that this kind of selection bias can occur with other methods too, one can counter such criticism by stating that case studies have their own rigor. While the rigor may be of a different nature, it is no less strict than the rigor of quantitative methods.

In order to meet the standards of scientific rigor, this study analyzes the transition process in Bulgaria, Romania, Albania, and Bosnia according to the reform model described in Section 2.2. It remains to be said that although the model appears sensible in theory, in practice it is sometimes difficult to implement it verbatim. Therefore, the model should be understood as a flexible signpost rather than a rigid prescription.

2.5 Conclusion

The purpose of this chapter was to expose the theoretical and methodological foundation for the analysis of reform processes. The presentation of the reform model showed that by applying the market analogy to the political arena, the complexity of the reform process could be reduced so as to enable a systematic evaluation of the mechanisms at work. Three underlying problems of the reform process, i.e., state capacity, collective action, and agency, were subsequently discussed in more detail. The goal of the discussion regarding the potentials and limits of cross-country versus case studies was to show that combining both methods can yield fruitful results to aid in understanding the mechanisms of reform.

To what extent does the discussion help us to address the questions stated at the end of Chapter 1? Is it possible to identify political and institutional factors that trigger reforms and enable the poor to participate in the growth process? Furthermore, how can incentives for the non-poor be manipulated in order to achieve such a dynamic?

The argument proposed here is that the factors affecting the state's ability to decide upon and adopt reform policies are: good governance and public sector management, the institutional framework for markets and physical and financial infrastructure, and effective organization for the provision of basic services. State capacity, or the lack thereof, also influences the willingness of political actors to implement reforms. Good governance plays a critical role since it is the only factor that can change independently of the others. However, the recommendation of good governance does not include a ready-made recipe on how to create a good political and institutional environment. This is a logical conclusion as institutional functions do not translate into unique institutional forms. What is possible depends on local constraints and opportunities. Trial, error, and innovation are integral elements of this discovery process.

To participate in the growth process, the poor must solve the problems related to collective action and agency. It was shown that their chances of success increase if:

- their group is 'small' and has homogeneous preferences;
- their group is well-organized and able to control free riding among its members;
- their group faces low opposition from other well-organized groups in the political market;
- the political task is clear and easy to implement;
- the incentives of the principal and the agent are aligned;
- good monitoring technologies are available so that the agent's actions and output can be easily observed;
- the agent's short run payoff from deviation is low;
- the number of political actors is small so that the agency relationship remains simple;
- the principal can recourse to alternative or previously established performance standards.

Finally, it is hypothesized that competition in the political market seems the best known way to influence the incentives of the non-poor to initiate and sustain the growth process. In the next two chapters, this hypothesis is submitted to empirical testing. Chapter 3 models the dynamic relationship that exists among political reform, economic liberalization and economic performance in order to understand the causal transition mechanisms in post-communist countries. The model will shown that a median degree of political competition is required for successful democratic and economic transition. In Chapter 4, the reform processes in Bulgaria, Romania, Albania and Bosnia are described and subsequently analyzed according to the reform model proposed in Section 2.2.

Chapter 3

The Process of Endogenous Simultaneous Transition

3.1 Introduction

The primary argument of this chapter is that successful economic transition depends on the breadth of political competition within a given country. A sufficient level of political competition generates an endogenous, self-enforcing reform process that strengthens democratic institutions and stimulates economic growth.

Research suggests that the political outcomes that ensued after the collapse of post-communist regimes have determined the fortunes of these countries for a very long time. Countries that did not take the opportunity to establish free institutions at the onset of the transition phase subsequently may not be able to reform their political and economic institutions. In contrast, countries that established political competition in the early 1990s have experienced quick economic liberalization and democratic consolidation. In a third group of countries, however, transition has followed a more complex path. The transition process in these countries includes stagnation or authoritarian reversals, which sometimes are overcome, but also may endanger the democratization process.

Conventional empirical analyses do not account explicitly for the transition *mechanism*, which leads to the aforementioned divergent transition paths. This is because existing empirical models only focus on one of the following relevant aspects of simultaneous transitions. They examine the determinants of political competition, economic liberalization or economic performance independently of one another. These separate analyses do not study how political and economic institutions jointly evolve, or whether they reinforce or constrain each other over time. They ignore feedback from one part of the political economy to the other, which is important to understand how transition failures, political stagnation and reversals, or democratic consolidation emerge endogenously.

We present an empirical model that combines the research on economic reform, democratization and economic performance in post-communist transition countries. In this structural model, changes in one part of the political economy can have repercussions throughout the system. For instance, political reforms may induce economic liberalization, which then has a positive influence on political competition in subsequent periods. Similarly, a lower degree of political competition can lead to a lower degree of economic liberalization, which may in turn have a negative effect on economic growth. The model is used for a sequence of simulations that show how different constellations in the political and economic arena lead to distinct long-term political and economic trajectories.

The simulation results reflect the diverging transition paths of many post-communist countries since the early 1990s. Contrary to static empirical analyses, they also isolate explicitly the mechanism that leads to self-enforcing (consolidated) democratic institutions (Weingast, 2008). The results show that the initial level of political competition is crucial for transition dynamics in the long run. In countries with a sufficient degree of political competition, citizens respond to economic crises by demanding more economic liberalization. The findings also reveal a strong complementary relationship between political and economic reforms. Economic liberalization encourages political liberalization and activates a dynamic, self-enforcing reform cycle. The cycle continues until fully liberalized economic and consolidated democratic institutions are established.

In the absence of political competition, citizens are constrained in their ability to lobby for economic liberalization as they face costly and sometimes prohibitive barriers to political participation. Thus when confronted with an economic downturn, governments face less pressure to initiate economic reforms. The lack of government responsiveness disrupts the transmission mechanism between economic and political liberalization, and a dynamic, self-enforcing reform cycle fails to emerge.

Unlike in previous empirical studies, political stagnation and reversals follow endogenously from the dynamic relationship between political and economic reforms. Promising initial reforms may be reversed if economic and political competition diverge from their common, long-term time path. Specifically, delays in economic reforms can halt progress in political liberalization. If, for instance, a government only lifts political restrictions, but does not simultaneously increase economic competition, the country will experience political setbacks before it embarks on a transition path towards a democracy with a market economy. This result provides an explanation for the occurrence of political instability and slow democratic progress in some transition countries.

Our study yields implications about the long-term consequences of the 'colored revolutions', i.e., the waves of public protest during the last decade in some post-communist countries. Greater political competition, which arose after public protest provoked the resignation of the authoritarian governments, may activate the self-enforcing endogenous reform mechanism, but democratic consolidation in these countries can only occur if economic competition is established as well. As described in the previous paragraph, a lack of economic liberalization is likely to impede democratization at least temporarily. Political stagnation or reversals can occur until economic liberalization strengthens democratic forces since fortified democratic forces have the power to overcome the resistance from reactionary groups. If this is the case, the protests are not necessarily a 'one-shot deal' (Tucker, 2007b). They may have lasting effects, although the developments that have followed protests suggest otherwise.

3.2 Competition and Performance

Empirical research has shown that the impact of diverging initial conditions across countries at the outset of the transition process diminishes over time, as the effect of the accumulated stock of reforms grows in importance (Heybey and Murrell, 1999; De Melo et al., 2001; Falcetti et al., 2002; Fischer and Sahay, 2004). The resurgence of growth in many post-communist transition economies demonstrates that many governments were able to implement market reform policies successfully and establish institutions that spurred long-term development. At the same time, incomplete reforms and inadequate institutional arrangements in many countries have undermined economic development and have led to state capture, lawlessness, and a poor investment climate.

How can these differences in transition paths and outcomes be explained? Existing studies usually focus on only one of the following three relevant aspects of simultaneous transitions. They either examine the determinants of economic liberalization; analyze what affects political reform; or study how political and economic institutions affect economic performance in transition countries.[1] We combine these three parts of a political economy to derive a model that captures the causal mechanisms leading to diverging transition paths in post-communist countries.

In many transition countries, the lack of economic reforms can be traced back to the existence of lucrative rent seeking opportunities that typically deter political decision-makers from developing market institutions. Such institutions erode their privileges and allow for a more equal distribution of opportunities and income (Hellman, 1998). The quality of the institutional framework, and, in particular, the extent of political competition determines the states' susceptibility to being held hostage by partial interests. Countries with more political competition are less likely to suffer from political capture because they develop channels of political contestability that keep vested interests in check. Empirical research has found a positive relationship between competitive political institutions and economic reforms in post-communist countries (Dethier et al., 1999; De Melo et al., 2001; Slantchev, 2005).[2]

According to the reform literature, economic reforms also are more likely to occur during economic crises (Haggard and Kaufman, 1995; Drazen and Easterly, 2001). The idea behind this presumption is that good economic performance generates public support, regardless of the regime type. Politicians have no incentive to introduce far-reaching market reforms when the economy is doing well. When the economy fares poorly, however, public pressure for market liberalization increases. The pressure from the electorate and from political competitors induces policy makers to introduce market reforms; otherwise they are replaced by someone who will respond to voters' demands.

[1] The relevant studies are classified along these lines below.

[2] Other research has also presented a number of arguments for why political competition may have a negative impact on reform efforts (Alesina et al., 2006; Przeworski, 1991; Haggard, 1990). Empirical evidence for post-communist countries suggests that in these countries, a positive relationship between inclusive political systems and economic reforms exists (Slantchev 2005; for a world-wide analysis, see Giavazzi and Tabellini, 2005).

The economic competition that follows successful economic reforms provides feedback on political institutions. Strong evidence exists that the relationship between political competition and economic liberalization is reciprocal. Comprehensive economic reform dissociates economic power from political power and encourages the two to balance each other. The logic behind this reasoning is that economic liberalization fosters individual and group independence, thereby strengthening people's incentives and ability to resist arbitrary state actions and to call for more political openness. Economic liberalization thus encourages political reforms which promote political competition (Acemoglu and Robinson, 2005; Fish and Choudhry, 2007).

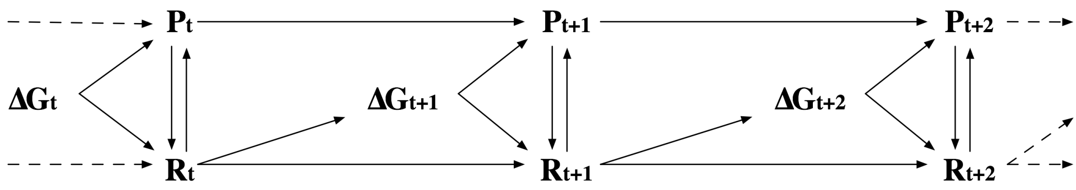
Finally, market liberalization and possibly political reform have a positive effect on economic growth. The importance of market liberalization for economic performance is well-established (see, e.g., Falcetti et al., 2006). Empirical findings on the relationship between political competition and growth remain inconclusive (Alesina and Rodrik, 1994; Barro and Sala-i-Martin, 1995; Burkhart and Lewis-Beck, 1994; Fidrmuc, 2003; Keefer and Knack, 1997; Persson and Tabellini, 1994; Rodrik, 2000; Satyanath and Subramanian, 2004, 2007). While the direct impact of political competition on economic performance may be unclear, the literature suggests that at the very least, political institutions have an indirect impact on growth through their effect on market liberalization.

The aforementioned research has established the reciprocal relationships among political competition, economic liberalization, and economic performance. Political competition and economic crises induce economic liberalization; economic liberalization and growth promote political competition; and economic and possibly political competition shape economic performance. However, the focus of empirical research has usually been limited to identifying these relationships separately without trying to orchestrate the dynamic interaction between them. By combining these relationships, it is possible to establish the conditions under which an endogenous, simultaneous transition process occurs, functions, and fails.

The three parts of a simultaneous transition process imply that the level of political competition at the beginning of the transition is crucial. In countries with a sufficient degree of political competition, citizens can manifest their discontent when they face an economic downturn and vote out elected officials who are believed to be unable or unwilling to implement potentially beneficial reforms. In the absence of political competition, the public lacks the means to force officeholders to act. The latter have few incentives to encourage reforms that are likely to reduce their control over the economy and destabilize their political power in the future (Acemoglu and Robinson, 2005).

Figure 3.1 illustrates the process of endogenous simultaneous transition. Economic performance (ΔG_t) may lead to economic reforms (R_t) in more inclusive political systems, but not in closed polities. In more open political systems, economic liberalization then leads to more political rights (P_t), which reinforces the effect of economic decline on economic reforms, which in turn leads to more political participation, and so on. The three parts therefore evolve together, and reinforce or constrain each other over time.

Figure 3.1: The Process of Endogenous Simultaneous Transition



Different scenarios about the trajectory of the transition path follow from these causal linkages within the political economy.

In one scenario, a reform process is initiated and sustained endogenously. This requires that citizens have the possibility to voice their concerns and build political pressure, at least to some degree. The existence of political rights in this scenario is established by some exogenous event, e.g., when citizens pressure the old elite to step down at the collapse of an old, authoritarian regime. This partial political openness eventually leads to demands for economic reforms, particularly during economically difficult times. The subsequent economic reforms then may initiate a gradual, dynamic reform process because political and economic reforms are complementary and positively influence each other over time. If it is not disturbed by exogenous factors, this endogenous reform cycle continues until fully liberalized economic and consolidated democratic institutions are established.

This does not mean that the endogenous transitions path necessarily progresses smoothly without the possibility of temporary backlash. Stagnation, or even reversals, may occur if political and economic institutions at the outset of the transition path diverge from their common, long-term time path. As a consequence, reform delay in one area has a negative impact on the other. If, for instance a median degree of political participation exists, but hardly any economic competition is present, the beneficiaries of state capture will try to prevent economic reforms by attempting to restrict the political influence of their (potential) competitors. The consequence may be political stagnation or even reversal until the democratic forces overcome the resistance from reactionary groups.

In a different scenario, the reform process collapses because there is no possibility for political participation. In exclusive polities, there is no or little opportunity to demand economic reforms that would allow broader segments of society to participate in economic competition. Without efforts to reform the economy, there will be no endogenous political reforms because the absence of economic competition prevents the formation of new entrepreneurs who can challenge the old elite, or at least demand more political participation. Instead, incumbent policy makers and their allies will defend their privileges and ensure that political participation remains restricted.

3.3 Empirical Analysis

3.3.1 Sample and Variables

The data set covers 26 transition economies between 1991 and 2006, yielding a total of 416 observations.[3] The data were gathered from a variety of sources. Table 1 in Appendix A provides an overview of the variables used, the sources, and some descriptive statistics. The major data source is the indicators published annually by the EBRD.

To measure economic reforms, $R_{i,t}$, we rely on an average of nine reform indices provided by the EBRD. These indices broadly cover 'first generation' and 'second generation' reforms. The first group comprises price liberalization, trade and foreign exchange liberalization, and small-scale privatization. Second-generation reforms include large-scale privatization, governance and enterprise reform, competition policy, banking reform and interest-rate liberalization, and non-bank financial institutions. The latter usually need more time, effort, and resources to be implemented. We also add the EBRD overall infrastructure reform index, which measures progress in the telecommunication, electricity, roads, and water and waste-water sectors. The indices are based on the assessment of an expert team of the EBRD. A score of 0 indicates no major change relative to the planned economy. The maximum score 3.3 corresponds to an advanced market economy (EBRD, 2000).[4]

Political competition, $P_{i,t}$, is measured using the Freedom House political rights index. It indicates whether it is possible to vote freely for distinct alternatives in legitimate elections, compete for public office, join political associations, and elect representatives. The values of the original index have been reversed so that it takes values from 0 (no freedom) to 6 (complete freedom).[5]

In order to account for economic performance, we use the log of an index of real GDP, $G_{i,t}$. To measure economic performance as measured by the annual percentage change in real GDP, we compute the difference in this index $\Delta G_{i,t}$. To account for initial conditions, $IC_{i,t}$, we use different composite indicators constructed in De Melo et al. (2001), Fischer and Sahay (2004), and Falcetti et al. (2006). The indicators capture the degree of macroeconomic distortions and unfamiliarity with market processes in society, as well as the overall level of economic development in terms of industrialization, pre-reform GDP, and degree of urbanization. Obtaining very similar results across the various specifications, we decide to retain the approach used in Falcetti et al. (2006).

[3] The countries include Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic, and Slovenia (CEEB); Bulgaria, Croatia, Romania, Albania, and FYR Macedonia (SEE); Armenia, Azerbaijan, Belarus, Georgia, Moldova, Russian Federation, and Ukraine (CISW); and Kazakhstan, the Kyrgyz Republic, Mongolia, Tajikistan, Turkmenistan, and Uzbekistan (CISE). Bosnia and Herzegovina, Montenegro and Serbia were excluded on grounds of data availability and comparability.

[4] The values of the original EBRD index have been transformed. See Table 1 in Appendix A for details.

[5] Since early data are missing for the former Soviet and Yugoslav republics, we replace the index with values for the Soviet Union and Yugoslavia as appropriate. Other indicators, such as the Governance Indicators of the World Bank, may be useful alternative measures, but are available only from 1996 onward, and with much missing data in the early years.

Most of the remaining control variables are standard in the literature. The general government fiscal balance, $F_{i,t}$, represents the government's attitude toward macroeconomic stabilization. The impact of resource prices, $O_{i,t}$, on economic performance is represented by the net export of oil, divided by GDP. In order to control whether growth is influenced by external demand, we include a weighted average of real GDP growth in the five most important trading countries, where the weights are the share of total exports to each country, $T_{i,t}$. Finally, two spatial variables account for the influence of neighboring countries and regional incentives to implement political and economic reforms. Distance to the regional reform leader, $C_{i,t}$, is the gap between the maximum level of market liberalization realized in the region and the level of a country's state of liberalization. It measures the extent to which reforms may be influenced by international diffusion, as suggested by Simmons and Elkins (2004) and others. Distance to the EU, D_i, reflects a country's incentives to implement political reforms in order to meet the requirements for EU membership.

3.3.2 A Model of Endogenous Simultaneous Transitions

To empirically analyze the transition dynamics of post-communist countries over time, a dynamic model is required. Many conventional empirical analyses, however, are static and do not account for the internal dynamic process that leads to successful transition. Moreover, existing research generally uses reduced-form (single-equation) models to examine the different aspects of transition separately. This approach does not allow for feedback between political competition, economic liberalization, and economic outcomes, which is an essential part of simultaneous transitions and long-run dynamics in transition countries.

We combine previous models (e.g., Abiad and Mody, 2005; Slantchev, 2005; Falcetti et al., 2006; Fish and Choudhry, 2007) to construct a structural, three-equation model in order to examine the causal mechanisms connecting political competition, market liberalization, and economic performance. The reform equation captures the effects of growth and political competition on market liberalization. The growth equation examines how the benefits derived from economic liberalization feed back into the economy and influence aggregate income of a transition country. The political equation reflects to what extent economic reforms and economic development affect citizens' rights to participate in political decision-making.

Following Abiad and Mody (2005), the baseline model reflects the idea that economic reform efforts diminish, the more liberalized the economy is at a specific point in time. The same logic applies to political reforms: countries with a low level of political competition can reform more than countries that have already reached a high level of competition. This consideration leads to a first-order autoregressive (AR(1)) specification for the political and economic reform equations:

$$\Delta y_{i,t} = \beta_0 + \beta_1 y_{i,t-1} + \ldots + v_{i,t} \tag{3.1}$$

where $y_{i,t}$ corresponds to the level of political (economic) liberalization in country i at time t, and $v_{i,t}$ is the error term.[6] $\Delta y_{i,t}$ is the change in the political (economic) index and reflects the progress in political (economic) liberalization in country i between t and $t-1$. Since the size of reforms should decrease with greater levels of liberalization, we expect that the coefficient on $y_{i,t-1}$, β_1, is negative. Equation (3.1) can also be written as

$$y_{i,t} = \beta_0 + (\beta_1 + 1) y_{i,t-1} + \ldots + v_{i,t} \tag{3.2}$$

which facilitates the integration of the reform equations in the system of equation and its subsequent estimation, as we will see below. Our theoretical expectation that β_1 is negative implies that the AR(1) coefficient in equation (3.2) is smaller than 1 and, thus, that the process does not have a unit root.

As suggested previously, market liberalization is more likely to take place in periods of economic decline. When the economy performs poorly, citizens in politically open countries can put governments under increasing pressure to reform. In countries with a low degree of political competition, citizens do not enjoy this possibility. The intervening effect of political competition can be captured by adding an interaction term between the political variable and economic growth to the reform equation. We further assume that political competition does not influence economic performance directly, at least not in the short run. However, political competition has an indirect effect on growth that works through its impact on economic reforms and the subsequent influence of economic reforms on growth.

An important issue for the design of the structural model is the lag structure. We assume that economic growth and the degree of political competition have a contemporaneous effect on reforms, while reforms have a delayed influence on growth. This assumption is reasonable when we consider that it takes some time for economic actors to adjust to the new environment in which they operate.[7] Empirical tests with different lags confirm that the structure chosen is most appropriate.

[6] Once the maximum level of economic (political) liberalization is reached, the country corresponds to a typical market economy (democracy), and the reform pressure decreases. The AR(1) model is similar to Abiad and Mody (2005)'s benchmark specification of economic reform. Unlike these authors, we do not use a nonlinear benchmark specification. Our tests indicate that the nonlinear relationship does not have additional explanatory power in the transition context.

[7] Previous research suggests that economic reforms have a negative contemporaneous effect on economic performance (Falcetti et al., 2002). When we control for this effect, we find a negative relationship between contemporaneous economic reforms and growth in OLS and fixed-effects regressions, but not in system GMM regression. We also test for the possibility that the effect of contemporaneous and lagged reform on growth is jointly equal to zero. The test is rejected at the 5 percent level.

Based on these considerations, our endogenous, simultaneous transition model can be represented by the following three-equation system:

$$\begin{bmatrix} 1 & -\alpha_{1,1} & -\alpha_{1,2} \\ 0 & 1 & 0 \\ -\alpha_{3,1} & -\alpha_{3,2} & 1 \end{bmatrix} \begin{bmatrix} R_{i,t} \\ \Delta G_{i,t} \\ P_{i,t} \end{bmatrix} = \begin{bmatrix} \alpha_{1,0} \\ \alpha_{2,0} \\ \alpha_{3,0} \end{bmatrix} + \begin{bmatrix} \alpha_{1,3} & 0 & 0 \\ \alpha_{2,1} & \alpha_{2,2} & 0 \\ 0 & 0 & \alpha_{3,3} \end{bmatrix} \begin{bmatrix} R_{i,t-1} \\ \Delta G_{i,t-1} \\ P_{i,t-1} \end{bmatrix}$$

$$+ \begin{bmatrix} \alpha_{1,4} \\ 0 \\ 0 \end{bmatrix} P_{i,t} * \Delta G_{i,t} + \begin{bmatrix} \boldsymbol{\alpha_1} & \boldsymbol{\alpha_2} & \boldsymbol{\alpha_3} \end{bmatrix}' \begin{bmatrix} X_{1i,t} \\ \vdots \\ X_{ji,t} \end{bmatrix} + \begin{bmatrix} \epsilon_{1i,t} \\ \epsilon_{2i,t} \\ \epsilon_{3i,t} \end{bmatrix} \tag{3.3}$$

where $R_{i,t}$ is the level of economic liberalization; $\Delta G_{i,t}$ is economic growth; $P_{i,t,}$ is the degree of political competition in country i; $X_{1i,t}$ through $X_{ji,t}$ are control variables, and $\epsilon_{1i,t}$ through $\epsilon_{3i,t}$ are error terms.

Thus, we get a model, where each row represents an equation, with the economic reform equation in the top row, the growth equation in the middle row and the political reform equation at the bottom of (3.3). In other words, the first and last rows are economic and political reaction functions. They indicate how the government responds to changes in the economy, and how the two reaction functions are interrelated. The second row shows the growth equation commonly used in the transition literature.

3.3.3 Estimation

We estimate (3.3) equation-by-equation using system GMM following Arellano and Bover (1995) and Blundell and Bond (1998). This choice is appropriate for three reasons. First, the hypothesized contemporaneous relationships that exist among economic growth, market liberalization and political reform imply that an instrumental-variables approach is needed to avoid simultaneity bias. Second, even in the absence of a contemporaneous relationship, the lagged dependent variables in the model give rise to a dynamic panel bias, violating the assumption of strict exogeneity underlying standard panel methods (Wooldridge, 2002, 299-314). Third, system GMM is more appropriate than the related difference GMM (Arellano and Bond, 1991) when the time series are persistent, which is the case in our system (Bond et al., 2001; Blundell and Bond, 2000).

To keep the number of instruments low, the estimations are based on 'collapsed' sets of instruments, where each lag of an endogenous or predetermined variable represents a single instrument (instead of sets with separate instruments per lag and time period of a lagged variable; see Roodman, forthcoming, esp. 16-20, for details).[8] Furthermore,

[8] A high number of instruments can be problematic because too many instruments may overfit endogenous variables. Many instruments also produce weak Hansen tests of instrument validity (Roodman, forthcoming). For the 'standard' difference and system GMM procedures, the instrument matrix includes a separate column (instrument) per lag and period. This means that the number of instruments increases quadratically in the number of time periods. In the collapsed instrument matrix, each lag corresponds to one instrument, independent of the number of periods.

the number of lags used as instruments is kept small, varying between two and five.[9] We also report OLS and fixed-effects (FE) estimates for comparison, because OLS over- and FE underestimates the size of the AR(1) coefficient. These two models thus provide reference points for validity checks of the GMM estimates (Bond, 2002, 4-6).

All variables are transformed into deviations from time means, which is equivalent to including time dummies. These time-fixed effects help to remove common, time-related shocks and thus correlations in errors across countries.[10] Since the system GMM model includes both a first-difference and a level equation, it takes into account country-fixed effects through the differenced equation. The two-step GMM estimates are robust to heteroskedasticity and serial correlation. Downward-biased standard errors from two-step estimation are corrected as suggested by Windmeijer (2005).

3.3.4 Results

Our key results are presented in the multi-equation system (3.4). The estimates shown correspond to the free parameters in (3.3). Robust standard errors for each coefficient are in parentheses below the parameters. More detailed estimation results for different models and the control variables are provided in Tables 3.1, 3.2, and 3.3 at the end of this section. The estimates presented here are from the system GMM regressions.

$$\begin{bmatrix} 1 & \begin{matrix}0.034\\(0.012)\end{matrix} & \begin{matrix}-0.065\\(0.033)\end{matrix} \\ 0 & 1 & 0 \\ \begin{matrix}-0.499\\(0.291)\end{matrix} & \begin{matrix}-0.002\\(0.013)\end{matrix} & 1 \end{bmatrix} \begin{bmatrix} R_{i,t} \\ \Delta G_{i,t} \\ P_{i,t} \end{bmatrix} = \begin{bmatrix} 0.002 \\ (0.01) \\ -0.537 \\ (0.529) \\ 0.004 \\ (0.071) \end{bmatrix} + \begin{bmatrix} \begin{matrix}0.899\\(0.117)\end{matrix} & 0 & 0 \\ \begin{matrix}5.077\\(2.271)\end{matrix} & \begin{matrix}0.418\\(0.118)\end{matrix} & 0 \\ 0 & 0 & \begin{matrix}0.799\\(0.093)\end{matrix} \end{bmatrix} \begin{bmatrix} R_{i,t-1} \\ \Delta G_{i,t-1} \\ P_{i,t-1} \end{bmatrix}$$

$$+ \begin{bmatrix} \begin{matrix}-0.006\\(0.002)\end{matrix} \\ 0 \\ 0 \end{bmatrix} P_{i,t} * \Delta G_{i,t} + \ldots + \begin{bmatrix} \epsilon_{1i,t} \\ \epsilon_{2i,t} \\ \epsilon_{3i,t} \end{bmatrix} \tag{3.4}$$

We conduct several robustness checks and specification tests. The Hansen test indicates that we cannot reject the null hypothesis of valid instruments. Similarly, the Difference-in-Hansen test, which evaluates the validity of subsets of instruments, shows that the additional instruments used by system GMM (compared to difference GMM) are valid. The Arellano-Bond (1991) test confirms that there is no serial correlation in the residuals, which would invalidate the use of (certain) lagged values of endogenous

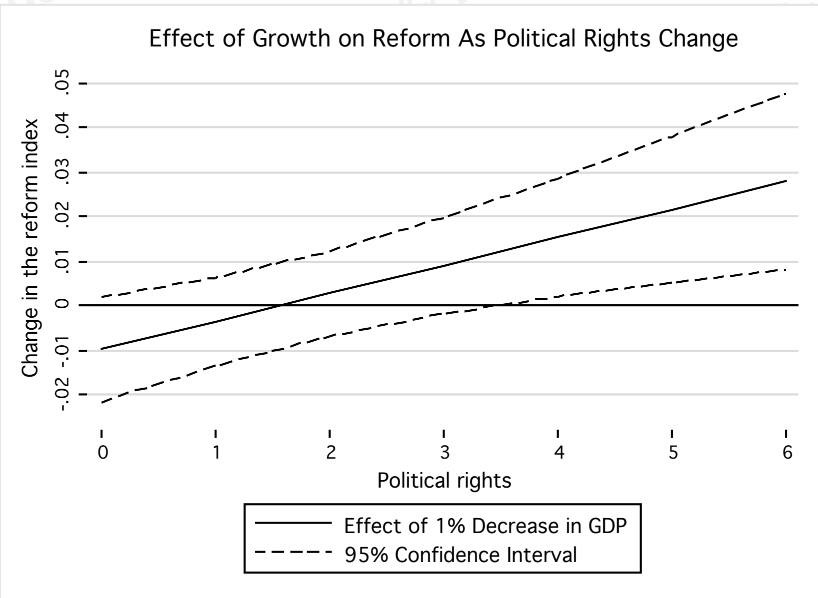
[9] We follow Wooldridge's (2002) recommendation to use "a couple of lags rather than lags back to $t = 1$" (p. 305).

[10] See Bond (2002, 4). The Arellano-Bond (1991) test for autocorrelation used as additional specification test requires that there is no contemporaneous correlation in the residuals across countries.

and pre-determined variables as instruments. Finally, the estimated AR(1) coefficients from system GMM generally lie within the desired range, i.e., above (respectively below) the FE (respectively OLS) estimates, which confirms once more that our results are reliable.

The results show that a dynamic mechanism among economic performance, market liberalization and political reforms exists. A crucial component of this mechanism is the link between growth and economic reforms, which is conditional on the level of political competition. This relationship is captured in the equation in the first row of the system (3.4). It shows that economic reforms are implemented in response to bad economic performance as measured by a decline in aggregate GDP. This effect, however, only exists in countries where citizens have the possibility to articulate their political opinions and to participate in the policy decison-making process. Figure 3.2 illustrates this conditional effect of negative growth. The y-axis of the figure shows how much the economic reform index changes when GDP falls by one percentage point, i.e., when the economy is in a recession. The x-axis shows how this effect of growth changes as political competition increases from 0 to 6.

Figure 3.2: Marginal Effect of a 1 Percent Decrease in GDP



When the level of political competition is very low, recessions do not have an effect on government efforts to reform the economy. Although the impact of a percentage point decrease in GDP on market liberalization is slightly negative, the 95 percent confidence interval spans the zero line, implying that this effect is not statistically significant. When political competition increases, the effect of negative growth on economic reforms becomes positive. The effect becomes statistically significant for countries with a score of 4 and more on the political rights index. Furthermore the increase in economic liberalization during a recession is greater when citizens are more involved in the political decision-making process because they can put pressure on governments to implement economic reforms.

The conditional effect of negative growth on economic reforms in open and inclusive political systems is substantial: a decrease of one percent in GDP leads to an increase of approximately 0.03 points in the market liberalization index. Taking into account that transition economies have experienced periods of deep and extended recessions, this effect is nontrivial. A note of caution is appropriate here: our results do not imply that reforms are reversed when the economy is doing well. There are only very few instances in our dataset where reforms are revoked and the achieved liberalization level decreases.[11] The relationship between growth and reforms thus results from the positive impact of recessions on reform efforts rather than from a negative impact of economic boom phases.

Since we used time-demeaned variables, this conditional effect is unlikely to depend on extreme contractions in economic output at the outset of the transition process. The time-demeaned growth variable accounts for changes in growth relative to the time mean, i.e., average growth in all other post-communist countries, and has the same effect as the inclusion of time dummies. Nonetheless, we test to what extent the results depend on a few extreme recessions that occurred in the early 1990s in some countries. The results are identical if we exclude extreme slumps in growth relative to other countries, i.e., when GDP of a country drops by more than 20 percent (4 observations) or more than 10 percent (25 observations) compared to average growth in that period. If, in addition, we exclude countries with exceptionally high relative growth, we still get the same result.[12]

We include two additional variables in the reform equation to control whether or not initial conditions or spatial factors influence the progress of market liberalization. Initial conditions in terms of macroeconomic imbalances appear to have no effect on market reform. The positive coefficient of $C_{i,t}$ indicates that the higher the gap between the regional reform leader and country i, the greater are the incentives to catch up to the regional benchmark. However, the coefficient is statistically significant only in the OLS regression.

The growth equation, which is in the second row of system (3.4), shows the feedback effect of market liberalization on economic growth. Liberalization has a strong and positive effect on economic performance. A one-point increase in the liberalization index raises the average growth rate by approximately 4.7 percent. Although this effect appears to be large, one must take into account the high variation of economic performance in

[11] There are seventeen cases of reform reversal in our dataset, compared to 399 cases of reform progress or maintenance of status quo. These reform reversals are small and concentrated in the CIS region. The only exception is Russia, whose liberalization index dropped by 0.41 points following the financial crisis in 1998.

[12] The excluded observations are clustered in the first few years of the period of analysis, specifically from 1991 to 1995, and include a wide range of countries, including CEEB countries like Hungary, Poland or Latvia and CISE countries like Tajikistan or Azerbaijan.

transition economies.[13] Moreover, the average progress in market liberalization is only 0.11 points per year.[14]

We do not exclude the possibility that countries that do not implement reforms can experience economic growth. Other factors, such as positive developments in the world economy or favorable natural resource prices, can lead to growth in a non-reformed economy. We control for these factors and find that both external growth and increases in natural resource prices have a positive and significant effect on growth. We also find that improvements in the fiscal balance favorably influence growth. Yet our findings indicate that in the long run, liberalized economies have better premises to spur growth internally and are less dependent on favorable external conditions.

This result underlines the importance of political conditions for long-term economic development. Although we follow the presumption that there is no direct effect of political competition on economic performance, our result points to the strong, indirect effect that works through market liberalization. Economic reforms in open political regimes have a positive feedback on economic performance by spurring growth and increasing aggregate income. In countries where political competition is weak, no economic reforms are implemented, with negative effects on average growth and citizens' incomes.

The last row of system (3.4) connects market liberalization and political reforms. The results show that the economic transition usually goes hand in hand with political reforms, resulting in a higher degree of political competition. The relationship between economic and political reforms is quite strong. Countries with an additional point on the market liberalization index are associated with an additional 0.49 points on the political competition index. In other words, if a government continuously reforms the economy and moves from, e.g., 0 to 2 on the market liberalization index over time, the expected increase in political competition is about one point on the Freedom House scale. We also find that in our sample of transition countries, economic performance does not directly influence political consolidation. While the coefficient for growth is positive, the effect is small and statistically insignificant. Similarly, we find that the proximity to the EU has a positive, but statistically insignificant impact on political reforms.[15]

[13] As an illustration, our dataset includes 51 country-years (observations) with GDP growth rates of -10 percent or lower. Similarly, 164 observations show growth rates of +5 percent or more.

[14] We also estimate models with levels of log of GDP, which corresponds to a standard Solow growth model where growth converges to zero as the country approaches the steady state. The results for this model, however, indicate that the process for GDP levels may contain a unit root for our data because the AR(1) coefficient generally is around 0.99 or higher with a standard error greater than 0.05. Thus we use primarily the specification for growth in equation (3.4). The results for both models are similar and correspond to the findings by previous research (Falcetti et al., 2006).

[15] We only discuss immediate (same-period) effects of the variables in this section. Changes in an explanatory variable also affect the dependent variable in subsequent periods through the AR(1) term. These gradual effects are captured in the simulation that we present in the next section.

Table 3.1: Estimates for Reform Equation

	OLS	FE	SGMM
R_{t-1}	0.998	0.635	0.899
	(0.028)	(0.092)	(0.117)
ΔG_t	-0.012	-0.004	-0.034
	(0.003)	(0.003)	(0.012)
P_t	0.028	0.030	0.065
	(0.007)	(0.015)	(0.033)
$P_t * \Delta G_t$	-0.002	-0.000	-0.006
	(0.001)	(0.001)	(0.002)
C_t	0.079	-0.047	-0.061
	(0.036)	(0.078)	(0.127)
$IC * t$	0.002	0.012	0.006
	(0.001)	(0.004)	(0.003)
$IC * t^2$	-0.000	-0.001	-0.000
	(0.000)	(0.000)	(0.000)
Constant	-0.000	-0.000	0.002
	(0.006)	(0.000)	(0.01)
N	416	416	416
χ^2	1987.89	43.36	11.16
$Pr < \chi^2$	0.000	0.000	0.048
Instruments	–	–	18
Hansen test	–	–	0.21
Diff-in-Hansen	–	–	0.35

Notes: Robust standard errors in parentheses. Estimates are from OLS, fixed-effects (FE) and System GMM (Arellano and Bover, 1995; Blundell and Bond, 1998). Hansen test are p-values for the null hypothesis of valid instruments. Difference in Hansen tests the additional instruments used by the system GMM. Arellano-Bond tests fail to reject the null of no second-order (or higher) autocorrelation in first-difference residuals.

Table 3.2: Estimates for Growth Equation

	OLS	FE	SGMM	OLS	FE	SGMM
ΔG_{t-1}	0.437	0.347	0.445	0.424	0.300	0.418
	(0.057)	(0.045)	(0.082)	(0.063)	(0.046)	(0.118)
R_{t-1}	1.815	5.758	7.648	1.113	2.286	5.077
	(0.591)	(1.221)	(3.079)	(0.555)	(1.384)	(2.271)
$IC * t$	-0.056	0.349	0.151	-0.028	0.425	0.191
	(0.050)	(0.104)	(0.135)	(0.054)	(0.125)	(0.124)
$IC * t^2$	0.009	-0.010	-0.001	0.005	-0.018	-0.011
	(0.004)	(0.006)	(0.007)	(0.004)	(0.006)	(0.007)
O_t				0.331	1.997	1.409
				(0.260)	(0.636)	(0.868)
T_t				0.189	0.200	0.278
				(0.133)	(0.098)	(0.184)
F_t				0.240	0.272	0.470
				(0.100)	(0.072)	(0.196)
Constant	0.000	-0.000	-0.097	-0.002	-0.003	-0.537
	(0.261)	(0.252)	(0.787)	(0.244)	(0.233)	(0.529)
N	416	416	416	382	382	382
χ^2	38.56	45.30	10.99	24.66	35.06	179.22
$Pr < \chi^2$	0.000	0.000	0.004	0.000	0.000	0.000
Instruments	–	–	17	–	–	18
Hansen test	–	–	0.240	–	–	0.377
Diff in Hansen	–	–	0.508	–	–	0.847

Notes: Robust standard errors in parentheses. Estimates are from OLS, fixed-effects (FE) and System GMM (Arellano and Bover, 1995; Blundell and Bond, 1998). Hansen test are p-values for the null hypothesis of valid instruments. Difference in Hansen tests the additional instruments used by the system GMM. Arellano-Bond tests fail to reject the null of no second-order (or higher) autocorrelation in first-difference residuals.

Table 3.3: Estimates for Political Equation

	OLS	FE	SGMM
P_{t-1}	0.871	0.569	0.799
	(0.031)	(0.057)	(0.093)
R_t	0.333	0.219	0.499
	(0.087)	(0.201)	(0.291)
ΔG_t	-0.004	-0.003	0.002
	(0.007)	(0.005)	(0.013)
D_t	-0.062		-0.088
	(0.027)		(0.114)
Constant	0.000	0.000	0.004
	(0.029)	(0.000)	(0.071)
N	416	416	416
χ^2	2831.12	35.60	3.23
$Pr < \chi^2$	0.000	0.000	0.199
Instruments	–	–	20
Hansen test	–	–	0.11
Diff-in-Hansen	–	–	0.21

Notes: Robust standard errors in parentheses. Estimates are from OLS, fixed-effects (FE) and System GMM (Arellano and Bover, 1995; Blundell and Bond, 1998). Hansen test are p-values for the null hypothesis of valid instruments. Difference in Hansen tests the additional instruments used by the system GMM. Arellano-Bond tests fail to reject the null of no second-order (or higher) autocorrelation in first-difference residuals.

3.4 Simulation

To illustrate the implications of our results, this section presents simulations of the transition dynamics after the breakdown of the communist system in three possible scenarios. These simulations can be viewed as theoretically relevant counterfactual analyses. They show how economic and political developments in a country would have differed if it had embarked on the transition path under different political conditions. Each scenario gives rise to a distinct transition path, and each path leads to different outcomes with respect to speed and success of the simultaneous transition.

In the first scenario, there is no political or economic liberalization after the collapse of the old system. In such a case, the country will not be able to establish liberal political and economic institutions unless an exogenous political shock lifts political competition to a median level. In the second scenario, some political competition is established at the beginning of the transition process, but there is no market liberalization. After some initial setbacks in political liberalization, this country embarks on a transition path that eventually leads to full political openness and economic freedom. In the third scenario, the collapse is followed by a partial political *and* economic liberalization. In this case, the country experiences a quick consolidation of liberal political and economic institutions.

To model the different transition trajectories, we choose different sets of starting values of the relevant variables, political reforms and market liberalization. In the first scenario, we set the starting value of market liberalization and political competition to zero, i.e., $R_0 = 0$ and $P_0 = 0$. The starting values in the second situation are a low market liberalization score of zero and a median political competition score of three, i.e., $R_0 = 0$ and $P_0 = 3$. For the third set of starting values, we set both liberalization scores at their middle values, i.e., $R_0 = 1.5$ and $P_0 = 3$.

Tables 3.4 through 3.6 show the evolution of these scenarios over a period of 15 years. Each row lists the the predicted value of one of the three variables in the columns for different points in time. The predicted values are computed using the coefficient estimates from the multi-equation system in (3.4).[16] The 95 percent confidence intervals in brackets below the predicted values are computed by bootstrapping.[17]

[16]The predicted values for period t are computed using the reduced form of (3.4). Rewriting the structural system in matrix form gives

$$A_0 y_{i,t} = A_1 + A_2 y_{i,t-1} + A_3 P_{i,t} * \Delta G_{i,t} + A_4 X_{i,t} + \epsilon_{i,t} \tag{3.5}$$

where y_t is the vector with the three endogenous variables, political and economic liberalization, and economic growth; the A's are matrices or vectors with coefficients; $X_{i,t}$ is a matrix with the exogenous variables; and $\epsilon_{i,t}$ is a vector with the error terms. The reduced form then is

$$y_{i,t} = B_1 + B_2 y_{i,t-1} + B_3 P_{i,t} * \Delta G_{i,t} + B_4 X_{i,t} + v_{i,t} \tag{3.6}$$

where $B_j = A_0^{-1} A_j$, $v_{i,t} = A_0^{-1} \epsilon_{i,t}$, $j = 1, 2, 3, 4$. To compute the predicted values, we start with the growth equation because growth does not depend on contemporaneous values of the other two endogenous variables in the reduced form. The second step consists in computing the predicted value of political competition, which, in the reduced form, depends on contemporaneous growth through the interaction term, but not on contemporaneous economic reforms. Using the predicted values of growth and political freedom, the predicted value for economic reforms follows automatically.

[17]The bootstrapped confidence intervals are based on 10'000 draws from the distribution of the co-

Table 3.4: Unsuccessful Transition Dynamics (Scenario 1)
Starting values: $R_0 = 0$; $P_0 = 0$; $\Delta G_0 = -15$

	$t = 1$	$t = 5$	$t = 10$	$t = 15$
R_t	0.00 [0.00, 0.01]	0.00 [0.00, 0.09]	0.00 [0.00, 0.32]	0.00 [0.00, 0.80]
ΔG_t	-7.12 [-10.01, -4.21]	-0.66 [-2.64, 0.71]	-0.36 [-1.71, 2.46]	-0.35 [-1.60, 6.05]
P_t	0.00 [0.00, 0.14]	0.00 [0.00, 0.47]	0.01 [0.00, 1.00]	0.01 [0.00, 1.95]

Notes: Rows show the predicted values for variables listed on the left. Columns are different time periods as indicated on top. The values in brackets indicate the corresponding 95 percent confidence interval.

Table 3.4 shows how the country evolves over time when the transformation is unsuccessful, i.e., when political competition and economic freedom fail to take root after the collapse of the old system. The results are straightforward: If the transformation fails, there is no improvement in political and economic liberalization during the whole period, with negative consequences for economic growth. The economic liberalization index, R_t, which takes a starting value of zero, remains at that level for the remainder of the simulation period. Similarly, the degree of political competition, P_t, which also starts from zero, does not change at all. After 15 time periods, citizens are still excluded from the political process. Failure to implement political and economic reforms adversely affects economic welfare. Economic growth remains negative and hardly improves.

This scenario resembles the developments in Turkmenistan and some other post-Soviet countries. This country never managed to establish a reasonable level of political competition after the collapse of the Soviet Union. Accordingly, hardly any dynamics leading to internally motivated reform in the political or economic realm have been present since then. The political and economic policy outcomes in Turkmenistan thus closely resemble the dynamics predicted by our model, given the starting values of this country. The recent actual growth rates in Turkmenistan, however, have been higher than the predicted rates. This is because the simulation only accounts for endogenously generated changes in growth due to economic reforms. Actual growth can be higher because of positive exogenous shocks or favorable developments in the world economy.

Table 3.5 shows the reform dynamics for the second scenario. The only difference compared to the first case is the starting value for political competition, which now takes a value of three. The transition dynamics are very different from the previous case. Economic liberalization increases immediately because recessions in countries with some

efficients. For each draw, we compute the predicted values for the 15 time periods according to the procedure described in the previous footnote. The bounds of the 95 percent confidence interval correspond to the 2.5 to the 97.5 percentiles of the simulated values. Naturally, uncertainty about the prediction and therefore the confidence interval increases with additional time periods.

Table 3.5: Partially Successful Transition Dynamics (Scenario 2)
Starting values: $R_0 = 0$; $P_0 = 3$; $\Delta G_0 = -15$

	$t = 1$	$t = 5$	$t = 10$	$t = 15$
R_t	0.21 [0.05, 0.39]	0.63 [0.12, 1.24]	1.03 [0.12, 2.88]	1.53 [0.06, 3.00]
ΔG_t	-7.12 [-10.01, -4.21]	3.28 [-1.11, 8.76]	7.30 [-0.32, 23.71]	11.25 [-0.36 37.45]
P_t	2.49 [2.00, 2.96]	1.76 [0.60, 3.36]	2.05 [0.14, 5.41]	2.82 [0.00, 6.00]

Notes: Rows show the predicted values for variables listed on the left. Columns are different time periods as indicated on top. The values in brackets indicate the corresponding 95 percent confidence interval.

political competition encourage economic reforms. The market liberalization index rises up to a level of 1.5 during 15 periods. This overall increase in economic liberalization is considerable when we take into account that these reforms are generated solely by endogenous dynamics, without any potential support or incentives from outside the country. Economic reforms have a positive feedback on GDP growth, which increases substantially.

The development of political competition is more complex. The political index *decreases* at the beginning, reaches its minimum after six periods, and then increases again. The reason for this is that at the beginning of this scenario, political and economic liberalization are in a 'disequilibrium'.[18] In other words, the starting values of economic and political liberalization are inconsistent with each other because, on the long-term equilibrium path, low (high) values of economic liberalization are associated with low (high) values of political competition. If the two diverge too much, they first converge towards the equilibrium path. In our example, this means that the lower economic index increases while the higher political index decreases. Once the two series equilibrate after six time periods, they move together on the equilibrium path towards a democracy with a market economy. This scenario corresponds to the developments in countries of SEE, such as Bulgaria or Macedonia. These countries managed to establish a sufficient level of political competition at the outset of transition. By contrast, economic liberalization lagged behind political reforms. Hence, both countries have experienced a period of political instability before embarking on the transition path towards democracy and the free market.

The experience of Bulgaria illustrates the workings of these mechanisms. Until 1997, the Bulgarian transition to a market economy was devoid of a clear strategy and featured a stop-and-go course. After the financial crisis in that year, a new government implemented stabilization measures and restructured the economy with broad public support.

[18] The term 'equilibrium' here has the same meaning as in time series analysis, i.e., in this context, it refers to the joint long-term time path of the three interdependent variables.

Table 3.6: Successful Transition Dynamics (Scenario 3)
Starting values: $R_0 = 1.5$; $P_0 = 3$; $\Delta G_0 = -15$

	$t = 1$	$t = 5$	$t = 10$	$t = 15$
R_t	1.56 [1.40, 1.85]	2.14 [1.14, 3.00]	3.00 [0.85, 3.00]	3.00 [0.58, 3.00]
ΔG_t	-0.08 [-6.39, 6.01]	15.37 [2.79, 35.02]	23.04 [3.00, 45.89]	25.72 [2.21, 48.09]
P_t	3.18 [2.61, 3.80]	3.88 [1.64, 6.00]	5.09 [0.87, 6.00]	5.87 [0.37, 6.00]

Notes: Rows show the predicted values for variables listed on the left. Columns are different time periods as indicated on top. The values in brackets indicate the corresponding 95 percent confidence interval.

But the government's popularity eroded as allegations became public that officials gave unjustified private benefits to their key political friends through favorable privatization deals, public procurements, and business permits. A newly founded party with a broad electoral base—including members of the new business elite—took office in 2001 and promoted a highly eclectic program combining liberal ideas and populist pledges. In response to pressure from the business community, the government dropped the populist pledges made during the electoral campaign and continued the reform agenda initiated by the previous government. The Bulgarian case thus not only confirms the importance of political competition and economic crises for economic reforms, it also demonstrates that economic liberalization and the emergence of a new business elite is an important part of democratization and democratic consolidation.

Finally, Table 3.6 shows the results for the third scenario, representing a successful transformation. At their middle values of 3 and 1.5 for the political and economic indices, respectively, the two series are already on their common equilibrium path, which means that they both increase simultaneously from the beginning. Both market liberalization and political competition converge towards their maximum levels within approximately 15 periods. This scenario corresponds to the experience of many Central European countries, such as Poland or the Czech Republic. The quick initial implementation of political openness and economic freedom have generated a positive self-enforcing dynamic of change, which enabled these countries to consolidate their liberal political and economic institutions.[19]

[19]The predicted growth rates appear fairly high in this scenario, mainly for two reasons. First, the growth rates in post-communist countries are more extreme than in other countries, which is reflected in the estimation results. Second, unlike in a standard Solow growth model, predicted long-run growth does not converge towards zero in the AR(1) growth model used here. We rely on the latter model because results from the former (using levels of (log) GDP) indicate that the process is likely to have a unit root and is not stationary. Overall, however, the estimated impact of economic reforms on growth largely corresponds to the estimation results in previous studies (e.g., Falcetti et al., 2006). We also redo the simulation with a specification for GDP levels that yields point estimates for the AR(1) term slightly below one. As expected, in these simulations predicted growth rates converge towards zero.

The results yield some important implications. The outcome of the initial political transformation after the collapse of the old system is important for the long-term success or failure of an endogenous, simultaneous transition process. Countries with a reasonable degree of political competition at the beginning of the transition process are more likely to establish democracy and free market institutions. By contrast, countries that do not establish a median level of political competition after the collapse of the old regime are trapped in a vicious cycle that does not yield (endogenously motivated) improvement in any aspect.

This does not mean that the latter countries will be trapped in this cycle forever. But to set off the positive transition dynamics, a political or economic shock leading to an upward shift in political competition is necessary, as in the case of Serbia in 2000. Serbia's experience illustrates that when the opposition manages to coordinate its activities, it may engender sufficient political pressure to increase political competition. Such pressure can have various roots. An example is public protest in many post-communist countries during the last decade, which emerged after the government committed electoral fraud (Tucker, 2007a). Other possibilities are foreign interventions or positive incentives, such as the possibility to join the EU, which can help to lay the foundations necessary for a self-enforcing transition path.

External factors, however, can also seriously disturb the endogenous reform cycle. Interventions from neighboring countries may interfere with the transition mechanism. The simulations presented in this section capture the endogenous transition dynamics that occur or do not occur holding everything else constant. When and why external conditions are likely to foster or undermine the endogenous mechanism depends on factors that are emphasized by complementary models, such as those focusing on spatial effects (Gleditsch and Ward, 2006; Kopstein and Reilly, 2000).

3.5 Conclusion

We combine the literature on democratic and economic transitions to develop a model that allows us to analyze the mechanism which leads to institutional modernization or deadlock in post-communist countries. The diverging transition trajectories of post-communist countries, which include quick democratic consolidation, political stagnation and reversals, and the collapse of the transition process, emerge endogenously from this model. The path a country takes depends on the constellations in the political and economic arena, especially the degree of political competition at the outset of the transition process.

What implications can we derive from these findings? The results suggest that "democracy is [not] simply an entailment of a high level of social and economic development" (Londregan and Poole, 1996, 1). Instead, our results indicate that some level of political competition is essential to start an endogenous simultaneous transition process towards self-sustaining, i.e., consolidated, democratic institutions and liberal

More importantly, the simulation results for economic and political liberalization are almost identical to those presented in Tables 3.4 through 3.6. Our substantive conclusions thus remain the same.

market structures. Political competition, therefore, not only is a goal of its own, but also is crucial for sustainable transition and liberalization in other areas of the political economy. Only if both democratic and economic transitions succeed, the danger of authoritarian reversal is minimized, and the survival of democracy is not contingent on favorable circumstances (Svolik, 2008).

The results to some extent match the predictions by theoretical research that distinguishes between de facto and de jure political rights (Acemoglu and Robinson, 2008). As predicted by these models, our simulation shows that economic reforms do not follow immediately from the establishment of de jure political rights. If political and economic reforms are not implemented simultaneously, the elite will try to consolidate de facto power, and substantial economic liberalization becomes a difficult and lengthy process. Only when new, pro-market elites emerge that also have the resources to challenge those holding de facto political power, substantial economic reforms will follow. This process can take a very long time after de jure political rights are established. It has to be kept in mind, however, that due to its complexity, the model and its implications are specifically tailored to post-communist countries; not all conclusions drawn here necessarily apply to other transitions.

The simulation results also imply that post-communist countries, which do not establish political freedom at the outset of the transition process, are not necessarily trapped forever in an authoritarian setting. A political shock that leads to greater political participation may offset the endogenous reform cycle at any time, especially during economic recessions. Such a political shock could come from inside a country when political protest forces the government to grant citizens greater political rights, e.g., as in Serbia in 2000 or the Ukraine in 2004. Similarly, foreign threats or interventions can distort endogenous institutional modernization when they give an incentive to policy makers to decrease participation, e.g., in pretense of increasing national security, like in Georgia after the war with Russia in 2008.

Finally, our study confirms that institutional persistence has important welfare effects. Political competition helps to initiate market reforms, which have a strong and positive effect on economic performance. Our simulations show that post-communist countries that reach a higher level of economic liberalization experience significantly higher growth than those that fail to reform the economy. Since political and economic competition are strongly complementary and reinforce each other, there is a substantial, indirect effect of democracy on aggregate income.

Chapter 4

Comparative Case Study

4.1 Introduction

At this point it is worthwhile to briefly recapitulate what has been said so far. In Chapter 1 it was argued that macroeconomic stabilization, openness to trade, market regulation, institutional quality and effective governance foster growth and poverty alleviation. In countries where these policies have been actively pursued, such as in the CEEB region, they have raised growth and reduced poverty. In SEE and in the CIS, where the policy agenda has not been consistently implemented, the reform outcome in terms of economic growth and sustainable poverty reduction has been less successful. The chapter closed by arguing that while research has provided important insights into how policies affect growth and poverty, evidence on the dynamics of political change remains scarce.

Chapter 2 presented a model that applies the analogy of the economic market to the political market. The model distinguishes three reform stages. The first stage of reform describes the process of decision-making in which reform supporters and opponents bargain over which reforms are to be implemented and how. The group with more bargaining power sets the terms of the political agenda and mandates a political entrepreneur to implement it at the lowest possible cost. This does not mean that the policies implemented will correspond exactly to those included in the political agenda. During the second and third stage of the reform process, in which the reform agenda is designed and implemented, a number of obstacles can prevent the political entrepreneur from supplying the policies at the theoretically lowest possible price. These obstacles include, among others, a supplier's weak position in the political market, insufficient political support, organizational problems, lack of competence, weak state capacity. The existence of these obstacles makes it difficult for the demand side to evaluate the political supplier's performance.

In the ensuing discussion it was argued that political competition within an accepted and respected institutional framework increases the likelihood of successful reform implementation, because it brings information and knowledge into the political market and confronts individuals with alternative solutions for achieving policy ends. Political competition thus provides information about best practices and possible benchmarks.

Moreover, the presence of more than one political supplier in the political arena provides individuals on the demand side the possibility to make a choice and to reduce the risk of adverse selection. This is a strong incentive for political entrepreneurs to look out for policy innovations and/or implement a given reform agenda. Finally, the presence of political competition provides the necessary checks and balances to constrain the ability of a political supplier to pursue policies that are not in the interest of the public. From this perspective, political competition is likely to improve the chances of growth and poverty-reducing reforms being implemented.

The empirical evidence on the dynamic interactions between political competition, economic reforms and economic performance presented in Chapter 3 provided support for the working hypothesis. The findings suggest that when the economy fares poorly, public pressure for economic liberalization increases in political markets with a sufficient level of political competition. Removing distortions in the distribution of economic resources increases economic efficiency and raises public welfare. It also allows individuals previously excluded from economic activity to enter the markets at the expense of vested interests. Due to their newly gained economic clout, these individuals ask for more participation in the political process. Simulations suggest that the resulting endogenous simultaneous transition process continues until fully liberalized economic and consolidated democratic institutions are established. Such a process does not occur in uncompetitive political markets.

The present chapter examines the transition processes in Bulgaria, Romania, Albania, and Bosnia to gauge the effect of political competition on economic reform. After a detailed description of the political and economic reform trajectory in each country, the achievements and future challenges in terms of macroeconomic stabilization, trade openness, market regulation, institutional quality and effective governance will be assessed. The various transition paths will then be evaluated according to the reform model established in Chapter 2.

The comparative study pursues two interrelated goals. The first goal is to assess whether the initial level of political competition can tell us something about the subsequent reform trajectories in the countries under examination. The second goal is to find out whether the reform model can help us predict reform outcomes on the basis of some easily available and accessible information on political market conditions.

4.2 Bulgaria

4.2.1 Initial Conditions

Bulgaria's development prior to 1989 was to a large degree shaped by its leader Todor Zhivkov who ruled the country for 33 years. During this period, the economy underwent agricultural collectivization and heavy industrialization. While the agricultural sector performed relatively well, the products of the industrial sector were generally uncompetitive outside the Council for Mutual Economic Assistance market. On the political side, the communist rule was characterized by a combination of severe political repression at home and an extreme loyalty to the Soviet Union.

The political and economic overhaul in the Soviet Union in the 1980s resulted in the elimination of existing economic privileges that Bulgaria once enjoyed. The repercussions were two-fold: Bulgaria suffered a substantial decline of net capital grants from Moscow. Moreover, the country was placed on equal footing with other communist countries in its trade relations with the Soviet Union. The loss of protected markets led to a sharp decline in the demand for Bulgarian products.

While the changes in the external environment would have required major economic adjustments, the communist regime opted for a less painful strategy: it resorted to printing and borrowing money which was subsequently used to keep the ailing state sector alive. As a consequence, the country's gross foreign debt increased from US$ 2.9 billion to US$ 10.7 billion between 1984 and 1989, while the monetary overhang generated by the sustained expansion of money supply added to the problem of suppressed inflation. As a result, by the end of the decade, severe internal and external imbalances had become apparent (Nikolov et al., 2004).

In the face of growing economic and political instability, leading figures of the Bulgarian Politburo forced Todor Zhivkov out of office on 10 November 1989, the day after the fall of the Berlin wall. The Union of Democratic Forces (UDF), an umbrella organization consisting of anti-regime groupings, was formed shortly thereafter. It organized massive demonstrations to drive the communists out of power. Under increasing pressure from the street protestors, the communists relinquished their constitutional monopoly on political power, renamed themselves the Bulgarian Socialist Party (BSP), and, after consultations with the opposition, agreed to hold democratic multiparty elections in June 1990 (Nikolov et al., 2004).

In their electoral campaign, the UDF and the BSP promoted similar goals—the restoration of economic stability and the encouragement of political and economic freedom. Disagreement existed on how to implement these goals. While the BSP advocated a gradual approach, the UDF favored a more radical economic transition. However, the UDF's desire to submit the economy to a shock therapy aroused suspicion among rural people, pensioners, and state employees who feared the loss of their rents and jobs. The UDF also faced dissent within its own ranks. In fact, the wide political spectrum of the UDF included (mostly urban) radical, christian-democrat, liberal, social-democrat, environmental, and agrarian tendencies. These groups, although united in their opposition against the BSP, had diverse and even conflicting political goals. By contrast, the organizational structure and ideological basis of the BSP were still intact, and the party continued to enjoy unwavering support from industrial workers, the administration, farmers, and pensioners. As a result, the BSP won the first democratic elections since 1946 and secured a comfortable majority in the parliament with 53 percent of the votes. The outcome indicated that the disenchantment with the communist regime had not yet reached its peak (Ruzicic and Spacek, 2000).

The UDF refused to accept the victory of the BSP on the grounds that the electoral process had not been entirely fair and resumed street demonstrations. In the face of ongoing extra-parliamentary pressure from the opposition the BSP-led government proved unable to rule. A coherent reform strategy was missing. Instead, policies were ad hoc, ambiguous, and poorly implemented. A law on market liberalization and denationalization of state property was being prepared, but it never progressed past the design stage. A unilateral moratorium on foreign debt payments was declared without prior consultations with the creditors. In the background, the BSP was busy transforming its political influence into economic power by placing cronies on the management boards of public companies. Soon economic hardship increased and, on a wave of popular discontent, the socialist government stepped down in November 1990 (Nikolov et al., 2004).

4.2.2 Muddling Through Transition

The early stage of transition in Bulgaria was characterized by frequent government changes which impeded the development and implementation of adequate economic reforms. In December 1990, an interim multiparty coalition government was appointed to calm the political atmosphere. First attempts were made to stabilize the economy. Following the abrupt announcement of a moratorium on foreign debt, Bulgaria faced severe balance of payments restrictions and approached the International Monetary Fund (IMF) for assistance. The IMF designed a reform agenda which represented the most comprehensive reform package initiated in the early phase of transition. The program, launched in February 1991, included price and trade liberalization, current account convertibility and liberalization of the exchange rate, fiscal and budgetary reform, and the privatization and restructuring of SOEs (Nikolov et al., 2004).

The practical implementation of the IMF reform agenda was inadequate and slow. Political instability and corruption impeded the implementation of many policy measures. Price and trade regimes were partly liberalized. Prices consequently increased dramatically, but goods began to reappear in the stores.

A number of structural reforms were implemented in the banking sector. A two-tier banking system with a formally independent central bank and a system of commercial banks was established. However, prudential regulations were either flawed or missing. As a result, supervision mechanisms were inadequate to monitor the working of the system. The independence of the central bank was frequently disregarded while state-owned commercial banks were used to finance unprofitable SOEs—a practice that created huge quasi-fiscal liabilities for the government. Moreover, a system of granting licenses and low start-up capital requirements ensured easy entry into the banking sector. New and inexperienced commercial banks inundated the market, raising the number of private banks from 2 in 1990 to 81 in 1992. Bad management and interrelated lending resulted in nearly all banks accumulating significant losses. Hence, political intervention together with weak supervision contributed to the general weakening of the financial system, which further threatened the economic stability of the country (European Commission, 2003a).

No progress was made in privatizing and restructuring the state sector, except for land restitution. Following the urging of the UDF, the Law on Agricultural Ownership and Use of Land (LAOUL) was adopted in February 1991. The law regulated the restitution of land to its former owners or their heirs and the privatization of agricultural assets. However, its implementation proved to be difficult as it triggered considerable political controversy and legal issues concerning the definition of ownership (Hanisch and Boevski, 1999; Gorzynski et al., 2000).

Overall, the outcome of the coalition government was bleak. The polarized structure of the political market held back the reform process and enabled public officials to pursue their private agendas. Moreover, the implementation process was affected by problems of ownership. Since the program was almost entirely designed by the IMF, its implementation was largely perceived as a policy prescription imposed from the outside. As a result, public officials, who were already struggling to understand the transmission channels through which policy actions translate into economic performance, showed little commitment to implement the program (Nikolov et al., 2004).

Another reason for the poor outcome of economic reforms was that the initial phase of transition was dominated by the consultations between former communists and newly emerging political groupings—the so-called 'Roundtable Talks'. During these consultations it was decided to charge the parliament with the mission to elaborate a new constitution. Political efforts thus revolved around the constitutional debate, while other transition countries went ahead with macroeconomic and structural reforms. After long and contentious discussions, a new constitution was formally adopted in July 1991, providing for a multiparty system, free elections on the basis of a universal adult franchise, and the protection of human and civil rights. However, the domination of the parliament by the BSP somewhat tainted the legitimacy of the constitution (Stone, 2002; Nikolov et al., 2004).

New elections were held in October 1991. The UDF emerged as the largest party with 34 percent of the votes, leaving it short of an outright majority. A minority government was formed with the support of the Movement for Rights and Freedoms (MRF), a liberal Turkish minority party which had secured 7.5 percent of the votes. The new government had a broadly liberal orientation and was committed to implement the IMF reform agenda. It worked out a package of tax laws and tax procedures. It also managed to curtail inflation through a restrictive wage policy. Prices and interest rates were further liberalized.

The government also took steps towards restructuring the economy. In May 1992, the adoption of the Privatization Act heralded the start of state demonopolization. The act outlined the methods of privatizing state-owned companies and named the agencies in charge of the process. The responsibility was split between branch ministries, the municipalities, and a newly created privatization agency. While the latter was in charge of privatizing large enterprises, the other two primarily dealt with small and medium-size ownership transfers. The inclusion of all theoretically possible methods of privatization into the law mirrored the apparent absence of a core consensus about the model of privatization. While the BSP favored mass privatization, the UDF leaned towards direct sales and Management and Employee Buy-outs (MEBOs). The lack of agreement about privatization strategies delayed the privatization process for several years (Nikolov et al., 2004).

The process of land restitution was also delayed by political disagreements. The UDF-led government had successfully amended the LAOUL to clarify property right issues and to enable the dismantling of collective farms. However, the law had serious disadvantages for its political ally, the MRF, because the majority of the Turkish population was quasi-exempt from the restitution program. The frustrated MRF-electorate began to express harsh criticism towards the government. In July 1992, the rigid position of the government brought the informal alliance between the UDF and the MRF to an end (Hanisch and Boevski, 1999).

The escalation of tensions within the UDF aggravated and culminated in the party's split. A right-wing hard core gradually took the lead of the party while the left-wingers disintegrated or departed. Confronted with mounting pressure and isolation, the UDF government called for a vote of confidence and lost. At the end of October 1992, it stepped down after barely one year in office. The early fall of the government prevented its leaders from implementing their ambitious reform goals.

A non-partisan government came to power in December 1992. It drew its support from an informal coalition between the BSP, the MRF, and a small left-wing breakaway faction of the UDF. However, in the absence of genuine political backing and legitimacy, the new government failed to initiate any major reform or to carry forward previously mandated policies. Despite political rhetoric, the efforts toward privatization, restructuring and deregulation were crushed. With the exception of concluding a debt rescheduling agreement with Bulgaria's external creditors, no progress was made in achieving macroeconomic stabilization (Crampton, 2008).

On the contrary, in order to support unsustainable economic structures, the government continued to channel subsidies into loss-making state companies via the banking sector, despite the dubious quality of these loans. The lending operations resulted in a sharp deterioration of bank portfolios in 1993. In 1991 and 1992 two special bond issues had already covered part of the non-performing pre-1990 loans incurred by commercial banks. The Bad Loans Act adopted in 1993 covered the remainder of these loans—a total of US$ 3 billion or about a third of the Bulgarian GDP in that year (Gorzynski et al., 2000; European Commission, 2003a).

However, the introduction of the Bad Loans Act was insufficient to prevent the banking system from deteriorating since state banks and enterprises were spared the effort of restructuring themselves. The partial financial bailout sent the wrong signal to these companies as it encouraged them to maintain unprofitable business activities at the expense of current and future taxpayers. Meanwhile, leading members of the Bulgarian political and economic elite reaped enormous financial benefits by placing private companies up front and back-end of SOEs. This strategy enabled them to sell input products above and to buy output products below market prices, thereby gradually stripping state companies of their assets (Boevsky and Kramer, 1998).

While such illicit activities were expanding rapidly and wreaking havoc on the economy, they were not appropriately dealt with. The judiciary was increasingly captured by special political and economic interests. The public administration was in a state of permanent reshuffle as each new government carried out sweeping layoffs and brought in its own cronies. The lack of stability and transparency in the working of the public administration engendered apathy and corruption. Political responsibility and ownership of the reform program were quasi-inexistent. The weakness of the institutional environment was a key factor for the proliferation of financial indiscipline and the escalation of economic problems.

The unbalanced course and incoherent nature of the reform process had grave consequences for Bulgaria's economic performance. The country experienced one of the most severe transformational recessions among Europe's transition economies. GDP declined by more than 27 percent from 1989 to 1994. Inflation hit a record high in 1991 with more than 330 percent and remained at a high level thereafter. Gross industrial output fell by more than 45 percent between 1989 and 1994. Almost a million jobs were lost in this period, although no major policy-induced dismissals had taken place. The rate of unemployment reached 18.6 percent in 1994.

Bulgaria's economic situation was further affected by the sanctions against the FRY following the war in Bosnia. Officially Bulgaria was strict in its application of sanctions, despite the fact they caused severe disruption to Bulgaria's trade. According to some estimates, the total losses to the Bulgarian economy amounted to US$ 1.3 billion between January and June 1993. The sanctions also increased the incidence of crime as huge fortunes could be made through border smuggling. Organized groups which did so were suspected to have collaborators within the administration and the police (Crampton, 2008).

The deterioration of Bulgaria's economic performance had a dramatic impact on the living standards of the population. Per capita GDP dropped from US$ 5'238 in 1989 to US$ 1'152 in 1994, despite a reduction of almost 10 percent of the population owing to declining birth rates, increasing mortality rates, and emigration. The sharp output decline together with high inflation eroded the real value of both current income and of monetary assets held in domestic currency. Following a generous wage adjustment to inflation in 1992, real wages fell by more than 30 percent from 1993 to 1994.

Governments attempted to redress the rapid degradation of living standards by broadening the eligibility to pension schemes and social assistance programs. Many state employees were sent into early retirement. With a general retirement age of 60 for men and 55 for women, the ratio of pensioners to employed rose to more than 70 percent in 1994. Pension and social benefits were mainly financed through payroll taxes. Although they were frequently adjusted to correct for the increase in the consumer price index, their real value declined considerably over this period. Moreover, revenues from social contributions were generally insufficient to cover social expenditures, and the remainder had to be covered by the central government budget. Although general government spending declined from 55.3 percent of GDP in 1989 to 45.7 percent in 1994, Bulgaria's fiscal balance registered excessive deficits, with an average of 5.5 percent of GDP per year. The introduction of the value added tax (VAT) in April 1994 did not fundamentally alter this situation (Ackrill et al., 2002).

The decline in living standards generated recurrent open social unrest. These protests often acted as a deterrent in the policy process, causing reversals in some policies or preventing the adoption of others. In the summer of 1994, the BSP withdrew its support to the government in the hope to gain the upper hand in the forthcoming elections.

Deprived of political support, the government resigned in September, and a caretaker government took office to prepare parliamentary elections. The elections in December returned a solid majority for the BSP and its allies. The party had run its electoral campaign on a populist program, promising to restore economic order and to halt the deterioration of living standards (Stone, 2002; Nikolov et al., 2004).

When the BSP came to power in January 1995, it announced an economic program, which was a union of contradictory reform measures including lower inflation, cuts in unemployment, a comprehensive industrial and agricultural reform, and an acceleration of privatization. The government refused to implement the painful measures the IMF and parts of the opposition proposed, i.e., the imposition of hard budget constraints, the liquidation of banks and SOEs with weak balance sheets, and the reduction of the fiscal deficit. Instead, it adopted a program based on extensive state intervention, reintroducing price regulations, increasing state-control over the financial and industrial sectors, and pouring money into the economy to protect SOEs from the consequences of inefficiency (Nikolov et al., 2004).

The government also reversed previously adopted legal decisions regarding the restitution of agricultural land. The restitution process was already seriously delayed by difficulties in determining and distributing land titles. In spring 1995, the government enacted amendments to the LAOUL which further complicated the process, reduced the amount of land available for restitution and diluted existing ownership rights. The amendments also restricted sales of land and thus blocked the evolution of land markets. The possibility to revise legal decisions about land titles and assets already handed out eventually deadlocked the whole process. Under these institutional arrangements, the incentive of investing in private farming became extremely weak. The agricultural sector meanwhile suffered from the worst crisis ever. The control of farm-gate prices at levels far below world prices, the sluggish progress of restitution, the insecurity of property rights, as well as the resistance of the rural population to the breakup of farm collectives led to a severe decline in agricultural production (Hanisch and Boevski, 1999).

The developments in the financial sector eventually brought Bulgaria into serious trouble. By the end of 1995 the negative liabilities in the bank portfolios amounted to 10 percent of GDP, with 70 percent of the volume of loans classified as non-performing and 25 percent as non-collectable. Public confidence in the banking system started to erode when some banks experienced liquidity problems. The panic progressively escalated and took the form of a full-scale run on the banking system following the closure of several banks in the first half of 1996. The government attempted to avert a crisis by prohibiting lending to loss-making SOEs and amending the Law on Banks. Legal procedures for bank bankruptcy were introduced, and insolvency proceedings were initiated against defaulting banks (European Commission, 2003a).

In a desperate move, the central bank raised the basic interest rate to 280 percent, but continuing monetary injections neutralized the effect of the interest rate hikes and annihilated all of what was left of the government's credibility. At the end of 1996, bankruptcy procedures were initiated against 15 state-owned and private commercial banks, and bad loans to enterprises were again converted into state bonds. Meanwhile, the increase in short-term debt raised interest expenditures to 19.7 percent of GDP (Nikolov et al., 2004).

With a critical need to find extra fiscal revenues, the government substantially increased the VAT and introduced import duties. It also launched the sale of a number of large state enterprises. Moreover, a mass privatization scheme, which had been in preparation for more than two years, was initiated at the end of 1996. However, the impact of mass privatization on the disposal of state-owned assets was relatively limited, with only 14.6 percent of the total volume of state's assets divested (Gorzynski et al., 2000; Crampton, 2008).

The policy course of the BSP government had devastating consequences for the Bulgarian economy. The cumulative drop in GDP from 1996 to 1997 amounted to 15 percent. The seigniorage financing of deficits threw the country into hyperinflation in 1997, which resulted in significant financial losses for a great number of people. The biggest losers were low and middle-income classes who held assets and savings in domestic currency. The crisis resulted in a dramatic increase in poverty. Between 1995 and 1997, the poverty rate increased from 5.5 percent to 36 percent (World Bank, 2002).

The strategy of taming inflation with price controls struck back with a vengeance as basic commodities disappeared from store shelves during the winter of 1996–1997. Rising prices and food shortages provoked massive demonstrations. After a brief outbreak of violence around the parliament building in Sofia at the beginning of 1997, a wave of peaceful protests, strikes and blockades of major roads spread around the country inducing the BSP to accept early parliamentary elections in June 1997 (Stone, 2002).

A UDF caretaker government took office in February 1997. It successfully stabilized the Bulgarian currency, which had depreciated six-fold between the end of 1996 and early February 1997. It also rapidly reduced inflation, reached an agreement with the IMF, launched a campaign against corruption, and purged the bureaucracy. The decisive approach of the government boosted the popularity of the UDF. As a result, the party gained a comfortable majority in the parliamentary elections while the socialists suffered a devastating defeat.

The crisis induced the BSP to reform itself. Its former leaders were ousted from the top positions and reformist members took control of the party. The BSP performed an ideological volte-face by embracing the course of market reforms and advocating a rapid accession to the EU (Nikolov et al., 2004).

In sum, Bulgaria's transition to a market economy until 1997 was devoid of a clear strategy and featured a stop-and-go course. Everything was done on an ad hoc basis. Many reforms remained unfinished while others were not initiated at all. The failure to reach a consensus—both within the society and among existing political forces—regarding the general direction of the reform process led to frequent changes of governments, and shortened the time horizon of political actors. The result was that none of the governments in office demonstrated a full commitment to implement and realize a comprehensive economic reform program.

4.2.3 The Return to the Path of Economic Growth

The new government inherited a bankrupted country. The economy was in a deep recession. Inflation exceeded 1'000 percent in 1997. The general government debt stood at about 320 percent of GDP. More than 50 percent of the goods and services within the consumer price index were administered by the state. Trade was hampered by import tariffs, export taxes, non-tariff barriers, trading licenses, and administrative regimes. Only 24 percent of state assets were privatized. 60 percent of all employees in the country were employed in the public sector. The financial system was in ruins while state companies continued to incur substantial losses.

The crisis gave rise to broad public support for a radical change in the course of economic transition. The UDF advocated a break with the previous previous trend of chronic delays and unfulfilled commitments and promised to rapidly introduce a comprehensive reform program. The UDF committed fully to implementing multilateral recommendations for stabilizing and restructuring the economy. By the time of the elections the main reform program was ready to be implemented. During its term in office, the government successfully stabilized the economy and privatized much of Bulgarian agriculture and industry (Nikolov et al., 2004).

The centerpiece of the stabilization program was a currency board arrangement imposed by the IMF as a non-negotiable prerequisite for new funding. The IMF's intention was to deploy a disciplining mechanism in macroeconomic policy. The nominal exchange rate was fixed against the German mark (and subsequently to the euro) with unlimited convertibility of base money, depriving domestic authorities of a sovereign monetary policy. The currency board arrangement also limited the government's fiscal sovereignty following the IMF's insistence on establishing a medium-term fiscal framework which would guarantee long-term fiscal sustainability (Dobrinsky, 2001).

The introduction of the currency board arrangement quickly yielded positive outcomes. The annual average inflation declined dramatically from 1'082 percent in 1997 to 22.2 percent in 1998 and 0.7 percent in 1999. The basic interest rate was reduced from 180 percent in 1996 to 6.7 percent in 1997. The fiscal deficit was brought down to sustainable levels. Despite the inhospitable external environment characterized by the global financial crisis in 1998 and the Kosovo conflict in 1999, the currency board arrangement was effective in maintaining macroeconomic stability. General government debt was brought down to 80 percent of GDP at the end of 1999, with short-term liabilities declining significantly.

A major tax reform was initiated with the twin objective to improve tax collection (by establishing a Unified Revenue Agency), and to lower the tax burden (by simplifying the system of income and corporate taxation). Extra-budgetary funds were closed down. These measures significantly increased fiscal revenues and curbed tax evasion and underreporting in the following years (Nikolov et al., 2004; EBRD, 2000).

Prices were gradually, but swiftly liberalized. The Law on Prices, which was introduced by the previous government and formed the legal basis for state intervention in price setting, was abolished in July 1999. The prices of coal, electricity, central heating, telephone, postal services, and gas remained administered for some time as a collateral social policy measure. They were progressively adapted in the following years to ensure cost recovery (EBRD, 2000).

The reform program did not only consist of stabilizing and liberalizing the economy, it also addressed the root causes of the reform failures during the first phase of transition. One of the first priorities was to rehabilitate the banks that survived the crisis. Important institutional safeguards were adopted in order to tighten the prudential banking regulations and increase the efficacy of banking supervision. New criteria regulating risky exposition, capital adequacy conditions, and bank reporting were introduced. Another measure designed to stabilize the economy consisted of cutting the flow of bank credit to unviable SOEs. For this purpose, the largest loss-making state companies were placed in financial isolation, forcing them to fundamentally restructure their operations. The implementation of the financial isolation program lasted several years and helped to improve the operational and financial performance of many targeted enterprises. Insolvent companies were liquidated (Nikolov et al., 2004; EBRD, 2000).

Bank privatization was initiated and vigorously pursued. By 2004 all state-owned banks were privatized. By that year, the number of foreign-owned banks had increased to 24, from 7 in 1997. These banks held 81.6 percent of all bank assets in the country. Bank assets in state hands were reduced to 2.3 percent.

Another key element of the reform program was the rapid privatization of SOEs. The government declared that sales to strategic investors would have the highest priority. The period with the most intensive ownership transfer was between 1997 and 1999. By 2000, almost 80 percent of SOE assets available for privatization had been sold, mainly through public sales.

Land restitution was also forcefully implemented, and by the end of 2000 the process was largely complete. However, some major obstacles impeded the creation of a functioning land market. The process of land titling was delayed by a slow and corrupt local public administration. Only 40 percent of the land subject to restitution had been titled by 2000. The lack of progress in land titling hindered the process of land consolidation, which was essential to create a viable land market, since agricultural plots were generally small. The land market was further constrained by the lack of access to financial markets, depriving landholders of the possibility to acquire credit. Finally, foreign ownership of land was prohibited, which prevented the transfer of capital and technology from outside. These obstacles significantly curbed the growth of agricultural productivity (EBRD, 2000, 2001; Dudwick et al., 2007).

The year 1998 saw the implementation of a major public service reform program which aimed to improve the financial sustainability of the pension, social welfare, education, and health care systems. After a decade of economic decline, the financial situation in these areas had become untenable. Following mounting pressure from international donors and the public, the government took decisive steps to reverse the negative trends.

Public pensions were provided through a traditional pay-as-you-go system, which was mainly financed via payroll taxes. But the system was increasingly out of line with the demographic and macroeconomic reality. Early retirement schemes had produced over 2.3 million pensioners—which was half of Bulgaria's working-age population. The ratio of pensioners to the officially employed was 75.7 percent in 1998. Moreover, high contribution rates encouraged informal working arrangements and under-reporting of income. This situation put the pension system under severe financial stress, and deficits had to be increasingly covered by allocations from the government budget. However, as fiscal constraints ruled out further social security deficits, the authorities had no choice but to allow the real value of pensions to erode. This erosion in turn generated strong social and political pressure for pensions to increase (IMF, 2000b; UN, 2000).

An ambitious reform was launched to improve the financial viability of the public pension scheme. The introduction of a modern three-pillar pension system, including a public pay-as-you-go system, a mandatory privately-managed second pillar, and a voluntary third pillar was prepared. Legislation for the voluntary pillar was passed in 1999, and regulated private pension funds started operating at the end of that year. A reformed pay-as-you-go system, including a higher minimum retirement age and fewer early retirement categories, was implemented in 2000. The efficiency and long-term viability of the pension system greatly improved in the following years (IMF, 2000b, 2004b; UN, 2000).

The government also took measures to improve the provision of social assistance. Until then, social assistance consisted of a large number of poorly-targeted programs which were spread across various institutions. The main poverty alleviation program consisted of a monthly income support. The adoption of a new Social Welfare Law in 1998 improved the eligibility criteria by establishing a single, better-targeted, income guarantee scheme. It also defined the respective roles of central and local authorities in providing social assistance. The effectiveness of social assistance programs subsequently improved, with the cash benefit program having a high incidence among the poor. In 2001 about 68 percent of its resources were channeled to the bottom quintile (IMF, 1999c; World Bank, 2002).

The government also presented a cautiously formulated, yet comprehensive reform plan to modernize the educational system. After a decade of declining expenditures, Bulgarian schools began to show obvious signs of decay. Capital spending had been low during transition so that school buildings were deteriorating and material was missing. Attendance rates were in decline and about 45'000 children dropped out of school each year. Attendance rates of minorities were significantly lower than those of ethnic Bulgarians across educational levels. For instance, secondary enrollments for Roma were in the single digits, while the national level was around 46 percent. Massive failures of children in primary school cast doubt upon the competence of teachers, teacher training, and teaching methods (UN, 2000; Dainov, 2005; EBRD, 2006).

Legislative regulations were adopted to determine the parameters for curriculum standards and student achievements. Secondary educational cycles were elevated to European standards and schools were given greater freedom in defining their plans for implementing the curriculum. Steps were also taken to decentralize the management of the educational system. However, the legislative acts were only partially implemented in the following years as they were met with public suspicion and strong resistance from the administrative staff (Dainov, 2005).

Health care reforms became urgent as the sector suffered from serious institutional deficiencies. During much of the 1990s, priority was given to the costly hospital sector at the expense of primary health care and preventive medicine. Excess capacity, old technologies, poor maintenance, and inefficient utilization of resources were inherent characteristics of the system. In theory, health care was financed by general fiscal revenues and access was free. In practice, patients were required to contribute directly to service provision by paying informal fees. As a result, vulnerable groups were excluded from basic health care. In order to remove existing deficiencies, the government adopted the Health Insurance Act and the Law on Health Establishments in 1998 and 1999, respectively. The laws were oriented towards increasing efficiency and financial stability of the health system, as well as improving the quality of the services provided (Georgieva et al., 2007).

Similar to the reforms in the education sector, reform implementation was met with resistance by the administration, the staff, the public, and the media. In both cases, part of the problem was that reformers were unable to convince the public of the importance of these reforms. The main problem, however, was the stakeholders' unwillingness to relinquish existing resources and privileges.

These obstacles notwithstanding, the outpatient care and the primary healthcare provision by family doctors were successfully reorganized. In addition, ownership of health care facilities below the national level was transferred to municipalities. However, problems of coverage, quality and access continued to afflict the health care system. Some municipalities lacked the financial resources and the management capacities to maintain appropriate quality standards. Moreover, in the absence of a functioning health market and given the impossibility to close down insolvent hospitals, incentives for good hospital management remained weak and public funds continued to be channeled to loss-making facilities. Ultimately the reform did not succeed in eradicating informal payments for health services so that vulnerable groups still experienced difficulties in accessing health care (Georgieva et al., 2007; Pashev, 2006).

As a result of the macroeconomic and structural reforms—and in spite of negative external economic and political trends—Bulgaria's GDP registered an average yearly growth rate of about 4 percent between 1998 and 2001 and thus reversed the negative trend of previous years. The economic upturn was mainly driven by the service sector. The manufacturing industry was negatively affected by the ongoing restructuring, and gross industrial output resumed only in 2000, following an upturn in FDI. The sustained economic recovery contributed to an improvement in living standards, although at a very low level. Between 1997 and 2001 per capita GDP increased from US$ 1'257 to US$ 1'723. During the same period, real wages increased by more than a third (IMF, 2002a).

The authorities' efforts notwithstanding, the reform dividend was relatively slow in coming. A series of adverse shocks kept GDP relatively flat. Exports suffered from an economic slowdown in partner countries as a result of the global financial crisis. In 1999, the Kosovo conflict led to further export losses. Moreover, the intensive privatization and restructuring of large inefficient enterprises produced high levels of unemployment. Having declined to 14.5 percent in 1997, unemployment rose substantially and reached

19.5 percent in 2001. Although headcount rates fell to 12.8 percent in 2001, poverty remained widespread, especially in less developed rural regions (World Bank, 2002).

The decisive political effort to push forward necessary and painful economic reforms triggered a positive response by several important external actors. In 1997, a three-year agreement was concluded with the IMF, and financial support was extended following the government's determined implementation of macroeconomic and structural reforms.

In December 1999, Bulgaria was invited to start EU accession negotiations. The invitation was recognition of the country's reform achievements thus far. In the following years, the process of EU accession was to become the impetus of market reforms. While the post-crisis reforms inspired by the IMF and the World Bank mostly sought to establish functioning market institutions, the preparation for EU accession implied a considerable broadening and deepening of the reform process. On the one hand, the EU decision to accept Bulgaria's candidacy had tangible benefits including greater material and technical support as well as policy stability. On the other hand, Bulgaria had to accept the EU's active role in designing and monitoring the reform process.

The domestic scene looked quite different from the international one. Although the UDF government stayed popular for over two years, support began to dwindle as the public became concerned about stagnating living standards. The government's popularity was further eroded by ongoing corruption allegations against senior public officials. The latter were suspected of providing unjustified private benefits to their key political friends through favorable privatization deals, public procurements, and business permits.

The unexpected appearance of the former king of Bulgaria, Simeon Saxe-Coburg, turned the political scene upside down. His newly-created party—the Simeon II National Movement (SNM)—won half the seats in parliament in the June 2001 elections. The broad electoral base of the SNM—including members of the business elite as well as disappointed former BSP and UDF voters—mirrored the party's highly eclectic electoral program that combined liberal ideas and populist pledges. A coalition was formed with the MRF, and in July 2001 the new government was inaugurated.

4.2.4 The Path to EU Accession

Following pressures from the IMF and the business community, the government dropped the populist pledges made during the electoral campaign and pursued the reform agenda initiated by the previous government. This volte-face led to a remarkable degree of continuity in the policy course.

The macroeconomic policy framework was maintained, and the currency board arrangement remained firmly in place. Fiscal policy was prudent under the medium-term fiscal framework. The 2001 Budget Law reduced the tax burden to support job creation and the development of the private sector. Considerable efforts were made to improve tax collection. In July 2002, the government approved the creation of a National Revenue Agency to administer the collection of public receivables. In the following years, fiscal revenues continuously increased and contributed to a surplus in the consolidated fiscal balance. Strong economic growth and active debt management policies reduced the ratio of total public debt to GDP to below 50 percent in 2003.

There was also continuity in institutional reforms, a condition Bulgaria had to meet in order to integrate into the EU. In its 2002 report on Bulgaria's progress towards accession, the European Commission observed that the country fulfilled the political criteria for accession. It also estimated that Bulgaria was close to being a functioning market economy able to withstand competitive pressure from the EU—provided that it continued to adhere to the reform process. The Commission finally attested that Bulgaria had made good progress in aligning its legislation with the Acquis Communautaire, but that more attention had to be paid to how this was to be implemented and enforced (European Commission, 2002a).

In March 2002, a new Privatization Act was adopted with the objective to increase transparency and compliance with sale contracts, which had been a potential source of corruption in the past. In the following years, significant progress was made in transferring state assets into private hands. By March 2005, the process was complete in large parts of the economy. Significant advances were also registered in the liberalization and restructuring of the energy, transport, and telecommunication sectors. Progress was somewhat slower in areas where EU accession provided weaker reform incentives, such as in improving efficiency of the public sector, enforcing the rule of law, increasing labor market flexibility, and simplifying business licensing (European Commission, 2007b; IMF, 2007b).

Despite the efforts undertaken by the previous government to remove administrative barriers, the paradoxical combination of excessive state control and weak enforcement of the legal framework continued to poison Bulgaria's business climate. In an effort to remove the obstacles faced by investors, the licensing and regulatory regimes were reviewed and simplified. In December 2003, the parliament adopted the Law on the Restriction of Administrative Regulation and Control on Business Activity to facilitate market entry and exit for businesses (EBRD, 2006).

Reforms were also directed towards improving the efficiency of the judicial system. Problems with the judiciary stemmed from the fact that the constitution introduced in 1991 had placed few checks on the judicial branch. The resulting lack of accountability made the judiciary one of the most corrupt institutions in Bulgaria. In September 2003, the constitution was amended to introduce a higher level of transparency and accountability in the judiciary branch. Immunity of magistrates was curtailed. The inner workings of the prosecution process were made more transparent, and accountability mechanisms were improved. A Law on Mediation as an alternative out-of-court procedure for conflict resolution entered into force in December 2004. In April 2005, the parliament adopted a law which unified the registration of businesses and turned it from a legal to a purely administrative procedure (EBRD, 2006).

Despite these efforts, judicial and administrative structures and procedures continued to repel investment because some reforms were delayed while others were not being implemented. Public administration was slow and unresponsive. The judiciary was unable to deliver a satisfying standard of legal certainty. The burden of administrative regulation was still high: market entry and exit as well as contract enforcement were time-consuming and costly, while tax procedures remained complex and were applied inconsistently. Evidence also indicated that the declining trend in corruption reported since the late 1990s could not be sustained in spite of the government's highly promoted anti-corruption strategy. In sum, Bulgaria had come to the point where the adoption of new regulations seemed less urgent than their actual enforcement (European Commission, 2007b; IMF, 2006a).

Limited progress was also made in redressing the health care and education systems, despite the fact that reforms were crucial for the release of scarce public resources needed for high priority spending in these sectors. The education sector was afflicted with severe overstaffing despite a sharp fall in the school-age population. A pool of 110'000 people drew their salaries from educating about 900'000 students. School consolidation and the reduction of staff were urgent reforms needed in order to channel savings toward teacher training, and acquiring materials and equipment. Similarly, health budgets were constrained severely by cost increases and an aging population. Yet the government did very little to improve health financing and implement hard budget constraints at the hospital level. The lack of progress was due primarily to disagreement about the need to consolidate the public service as well as the considerable resistance to change demonstrated by the administrative staff (IMF, 2002b; Dainov, 2005; IMF, 2007b).

While the European Commission acknowledged these deficiencies in its 2004 Progress Report, it nevertheless praised Bulgaria's reform efforts and endorsed the planned date of 2007 for the country's EU accession. In June, Bulgaria officially closed all the chapters of the Acquis Communautaire, and the accession treaty was signed in early 2005 (European Commission, 2004a; EBRD, 2006; Crampton, 2008).

During the SNM government's term in office, Bulgaria enjoyed strong economic performance. Real GDP growth averaged about 5.6 percent between 2002 and 2005. Industrial gross output recovered and registered double-digit growth rates in 2003 and 2004. Inflation pressures remained limited. Despite these favorable macroeconomic developments, Bulgaria's vulnerability somewhat increased as the current account deficit widened from 2 percent of GDP in 2002 to 12 percent of GDP in 2005. Much of the increase was due to the buoyancy of domestic investment and consumption. At the request of the IMF, the increase in domestic demand was partially offset by a prudent fiscal policy. While the general government budget was on balance between 2002 and 2003, it slightly increased in the following years (IMF, 2007b).

The favorable economic performance had a positive effect on the living standard of Bulgaria's population. Per capita GDP increased from 1'988.4 in 2002 to 3'522.7 in 2005. Poverty continued to decrease, although less sharply than between 1997 and 2001. The poverty rate fell by 2.1 percent between 2001 and 2003, to 10.7 percent. Indicators of the depth and severity of poverty also improved. Extreme poverty was at 4.8 percent (Gotcheva, 2007).

The economic environment also had a positive impact on the labor market. Employment grew on average 3 percent per year. The employment rate reached 56 percent in 2005 while unemployment dropped from 16.8 percent in 2002 to 10 percent. Yet both indicators were far from being satisfactory and mirrored the government's limited success in removing structural labor market restrictions. While emigration and employment growth generated increasing constraints in certain segments of the labor market, significant parts of the labor force were excluded from the formal job market. Bulgaria's Labor Code was rigid and left little room for implementing more flexible working arrangements.

Despite its many positive achievements, the SNM's time in office disenchanted Bulgaria's electorate. Public frustration stemmed from the high level of crime and corruption in the administrative sector and the inadequacy of public service provision. The decisive factor, however, was that the improvements in living standards, although important, did not match the inflated expectations set by the 2001 election campaign.

The result was a revival of the BSP's chances. The latter emerged as the biggest party in the June 2005 elections, but failed to win a majority in the parliament. After almost two months of difficult bargaining, a broad coalition including the BSP, the SNM and the MRF was formed. In spite of being an uneasy alliance, conflicts were suppressed to ensure Bulgaria's EU accession in 2007.

The new coalition government continued to follow a stability-oriented macroeconomic policy. However, Bulgaria's strong economic performance was accompanied by growing external imbalances. High FDI inflows coupled with strong domestic demand triggered substantial increases in imports, which led to a widening trade deficit. As a result, the current account deficit further increased and attained 17.9 percent in 2006. In order to reduce the country's vulnerability to external shocks, gross reserves were increased to above 100 percent of short-term debt. Despite the IMF's insistence, the government did not keep the fiscal budget in check, and thus the deficit widened to reach 3 percent in 2006 (IMF, 2007b).

Implementing institutional reforms also proved more difficult in the face of fragile party politics and entrenched special interests. European standards were achieved in areas where the EU accession process tended to enforce legal homogeneity. Prices, trade, and the capital account were fully liberalized; so were the financial, telecommunications and energy markets. The long-awaited establishment of the National Revenue Agency centralized the collection of taxes and social security contributions previously spread over several institutions (EBRD, 2006).

Other reforms proved more difficult to carry out. Bulgaria's Labor Code was amended in May 2006 to allow for greater flexibility in the labor market, but the amendments were not completely implemented. Similarly, the law transforming business registration from a judicial to a purely administrative procedure, while approved in March 2006, was delayed. Reforms aimed at alleviating the regulatory burden and improving the functioning of the judicial and administrative systems remained irresolute and slow. The government introduced a new anti-corruption strategy and performed a number of symbolic actions demonstrating support for it, but it never acted decisively in its implementation. (EBRD, 2006).

The overwhelming structural problems burdening the public sector were acknowledged, but no significant action was taken to ameliorate them. Pension contributions were lowered to reduce payroll taxes and create incentives for job creation in the formal sector. Further reforms of the pension system were planned, but no details were provided on the timetable. In the health sector, the financing of hospitals was centralized at the National Health Insurance Fund, but the measure had no visible effect on financial discipline of hospitals. In the meantime, the accumulation of arrears in the hospital sector continued to burden the central government budget. In the education sector, a comprehensive reform aimed at improving the quality of school education as well as the efficiency of spending was in preparation, and implementation was to start in 2007. Finally, cautious attempts were made to give municipalities greater powers in setting local taxes and fees and managing their own budgets with the adoption of a Law on Fiscal Decentralization in November 2006. But the law was not fully operational and required additional legislation (European Commission, 2007b).

The slow progress of institutional reforms and the unwillingness of successive administrations to take firm action against corruption raised concerns among EU officials about Bulgaria's readiness to join the EU. In May 2006, the EU postponed until October its final decision on whether Bulgaria should be given access to the EU in January 2007. In September, the original date was confirmed. However, the European Commission was granted the authority to verify the progress in reforms and to reduce financial support whenever targets were not met (Crampton, 2008).

4.3 Romania

4.3.1 Initial Conditions

In December 1989, public manifestations in Romania culminated in the violent overthrow of Nicolae Ceausescu who had ruled the country for over 24 years. At that time, Romania's social and economic situation was dismal. On the one hand, the country was clear of debt as almost all sovereign borrowings had been repaid by April 1989. The downside of this seeming bonanza was that the repayment had imposed severe privation on Romania's population. Poverty had become widespread, especially in rural areas and amongst the elderly and children. The repayment had also contributed to the decline of infrastructure and industry. The economy was characterized by an obsolete and energy-intensive industrial park, an agricultural sector burdened by huge and inefficient farms, and a penury of basic goods. The over-centralized planning system had created a very rigid economic structure, marred by serious misallocation of resources, huge internal macroeconomic imbalances, and a lack of market-economy infrastructure. Private sector activity was marginal.

The fall of Ceausescu paved the way for those within the communist party who had fallen out of favor with the dictator. Under the umbrella of the National Salvation Front (NSF), they took the reins of power, reversed some of Ceausescu's most unpopular policies, and pursued expansionary fiscal and monetary policies through most of 1990 in order to win popular support (Demekas and Khan, 1991).

Multiparty elections were scheduled for May 1990. The NSF's electoral program was based on populist promises of improved social provision and gradual economic reforms that would avoid the rigors of rapid price adjustment and enterprise restructuring. These promises appealed to industrial workers, pensioners, state bureaucrats, and managers of

SOEs who were most likely to suffer from systematic structural reforms. In rural areas, the NSF appealed for electoral support by holding out the prospect of land restitution (Maniu et al., 2001). This strategy helped the NSF to win a solid mandate at the May elections.

Despite its clarity, the legitimacy of the electoral outcome was put into doubt by members of the opposition who accused the NSF of exploiting its dominant stance in the political market and using Romania's widely feared secret police—the Securitate—to continue some of its old practices of political infiltration and harassment. However, the electoral victory of the NSF primarily mirrored the reluctance of the population to endure the impact of another radical economic transformation after a decade of extreme austerity. Voters feared that the opposition's commitment to radical change would further reduce their standard of living. Moreover, the opposition was not considered to have the capacity to assume political power. The quarrels within the opposition were not useful in allaying these fears. Noisy electoral competition was unsettling, and people felt more secure with the NSF's paternalism (Carothers, 1997; Gallagher, 2008).

4.3.2 Yet Another Case of Muddling Through

After the elections, the new government continued to pursue an economic policy without consideration for fiscal and monetary constraints. Restrictions on household consumption were eased by removing import barriers and maintaining price controls on basic commodities. The resulting boom in private consumption led to a sharp increase in the level of imports at the expense of domestic industrial production. Subsidies were poured into loss-making state companies in order to keep them afloat. These measures were financed by depleting the country's remaining foreign exchange reserves. The demonopolization of the state sector and the introduction of market mechanisms were delayed. Together with the general output decline, this strategy aggravated domestic imbalances and resulted in a serious deterioration of the balance of payments (Stan, 1995).

The growing economic instability at the end of 1990 induced the government to implement a stabilization program which had been designed and approved by the IMF. Decisive steps were taken to liberalize prices and to cut subsidies for basic consumer goods. Imports were drastically cut back. The share of administered prices in the consumer price index was reduced to 47 percent in two consecutive rounds between November 1990 and April 1991. Wages were only partially indexed to inflation. The Romanian currency was devalued and in November 1991, internal convertibility for current account transactions was introduced. The government also established a two-tier banking system and initiated a number of reforms in the public administration (Demekas and Khan, 1991; Stan, 1995; Osiatynski, 1997).

Efforts were also undertaken to transfer state assets into private hands. Small-scale privatization was initiated in November 1990. The privatization of large and medium-sized enterprises began with the adoption of the Privatization Act in July 1991. The law laid down the rules for the transfer of state companies to multiple owners. The State Ownership Fund was charged with implementing the privatization of some 6'381 companies. However, the legislation provided little guidance as to how to achieve this goal. The methods of privatization were not clearly specified and much confusion existed about the structure of property rights. These uncertainties tended to enhance mismanagement of assets (Osiatynski, 1997; Earle and Telegdy, 2002).

The adoption of the Land Fund Act in February 1991 marked the beginning of land privatization. The reform was aimed at restituting land held by cooperative farms to the households that had ceded it during collectivization. Cooperative farms accounted for 65 percent of total agricultural land in the country, the remaining being in the possession of state (28 percent) or private farms (7 percent). The enactment of the Land Fund Act was preceded by the government's refusal to restitute land to the former owners. Instead, the government attempted to distribute small plots of land to all rural residents. However, increasing political pressure from former landowners eventually convinced the government to enact the restitution law (Cartwright, 2001; Sabates-Wheeler, 2005).

The restitution of collective farm land was quickly implemented. The size of restored properties was limited to 10 hectares. By 1994, more than 80 percent of the land belonging to collective farms had been handed over to about 4.2 million owners or their heirs. The restitution of state farm land, tangled in politics, was considerably slower and did not start before 2000 (Csaki and Kray, 2005; Sabates-Wheeler, 2005).

The imposed size limit on restored properties led to an extreme fragmentation of agricultural land, with 99 percent of farms being individual smallholdings. The consolidation of agricultural land, necessary to increase productivity in the long run, was blocked by the absence of a functioning land market. A formal market failed to develop because the Land Fund Act explicitly prohibited land sales. Moreover, the issuance of formal land titles was considerably slowed down due to administrative difficulties and corruption at the local level. By October 1995, less than half of the land owners were in possession of updated land titles (Osiatynski, 1997). As a result, the agricultural sector remained undercapitalized and grew more labor-intensive. Subsistence and semi-subsistence farming became the dominant mode of production.

Economic hardship, together with the government's effort to impose hard budget constraints, provoked public hostility and led to violent demonstrations in Bucharest in September 1991. The demonstrators enjoyed the tacit support of those in the NSF who favored a more gradual reform approach. In the face of external pressure and fading internal support, the government stepped down at the beginning of October.

The demise of the government considerably slowed down Romania's reform efforts. The new administration carried on with the restitution process and small-scale privatization, but stopped the planned mass privatization scheme, which intended to transfer 30 percent of total state assets to Romanian citizens. Fiscal constraints were relaxed. Instead of weeding out inefficient SOEs, the government injected funds to cover their losses (Osiatynski, 1997).

A new constitution was adopted by public referendum in December 1991 in spite of the opposition's refusal to accept the final draft. Much of the criticism was directed at the insufficient separation of powers between the executive, the legislature, and the judiciary. Moreover, it was argued that the constitution provided the head of the state with too much discretionary powers. In the end, however, the rejection was due to the fact that the opposition had been marginalized during the process of drafting the new constitution (Gallagher, 2008).

A new round of general elections was scheduled for September 1992. During the electoral campaign, mounting frictions within the NSF led to a split of the party. Its reformist wing retained the original name, while the more powerful conservative wing formed the Democratic National Salvation Front (DNSF), which subsequently became the Party of Social Democracy of Romania (PSDR).

The February 1992 local elections resulted in a number of opposition victories in Romania's cities, reflecting its growing strength in urban areas. However, the opposition was too heterogeneous, dissipated and unorganized to represent a real threat for the DNSF. Consequently, the latter again carried the general elections. This time, however, the DNSF secured only 28 percent of votes. The main opposition group, an electoral alliance of center-right parties known as the Romanian Democratic Convention (RDC), significantly strengthened its position by securing 20 percent of the votes. The NSF came as a distant third with 10 percent. The PSDR formed a minority government with the support of ultra-nationalist and neo-communist parties that were broadly opposed to rapid market reforms (Maniu et al., 2001).

Romania fell into a pathological stagnation, with no clear reform direction. The new government proved politically weak, uninspired, and ineffective in restoring macroeconomic stability or creating market institutions. The reforms initiated by previous governments were definitely replaced by interventionist and redistributive policies. Financial indiscipline and chronic public deficits maintained pressure on inflation which reached 256.1 percent in 1993. By mid-1993, Romania saw its gradual approach to economic stabilization and restructuring shattered. Between 1989–1993, GDP declined by almost 32 percent. Industrial gross output even dropped by 72.4 percent. The official unemployment rate increased to 10.4 percent, even in the absence of any major policy-induced layoffs. As imports began to rise again, the trade balance became negative. The resulting deficit in the current account was covered by short-term credits (IMF, 1998). The government's lack of reform commitment brought it into conflict with the IMF and resulted in the break-up of the existing stand-by agreement.

The parliament failed to exercise its constitutional role of oversight and promotion of accountability, enforcing the public's tendency to view policy makers with serious distrust. Corruption among state officials became another major reason for public dissatisfaction.

Public discontent over deteriorating economic and social conditions together with the loss of IMF financial support forced the government to come up with a new stabilization program at the end of 1993. Nominal interest rates were increased to reach positive real values. The Romanian currency was devalued once more, and money supply was put under strict control. The inflation rate subsequently fell to 32.3 percent. Budgetary subsidies and transfers to unproductive activities were cut from 23.5 percent in 1992 to 14.4 percent in 1994. In the same period, government spending was reduced from 42 percent to 33.4 percent. In April 1994, the foreign exchange market was fully liberalized and price controls were partially removed. These measures were supported by a new stand-by agreement with the IMF in May 1994 (Osiatynski, 1997). Economic growth, which had started at 1.5 percent in 1993, accelerated to 3.9 percent in 1994 and 7.1 percent in 1995.

No attempts were made to liberalize market structures, leaving intact many impediments to private sector activity—such as licensing, registration procedures and taxation policies as well as various protectionist measures for the SOEs. Neither did the government increase efforts to revive the privatization process. By the end of 1994, the private sector share in Romania barely reached 40 percent. Only about 1'500 mainly small SOEs out of the planned 6'381 had been privatized. 80 percent of the industrial sector still remained in state hands. It was only at the beginning of 1996 that the mass privatization scheme—that had been put on the shelf for five years—was implemented. Some 30 percent of equity in all commercial companies was distributed to Romania's citizens, and the private sector share in GDP increased to 55 percent (Osiatynski, 1997; IMF, 2003b).

Moreover, the restructuring of state companies as required by the agreement signed with the IMF was not being decisively addressed. The government was unable—and very often unwilling—to impose hard budget constraints. Instead, the enterprise sector continued to receive substantial implicit and explicit subsidies, particularly in foreign exchange.

The softening of budget constraints delayed the necessary restructuring of inefficient production facilities and undermined the entire stabilization program. At the end of 1995, unmistakable signs of economic deterioration reappeared. The share of nonperforming loans of state commercial banks climbed from 18.5 percent in 1994 to 56.5 percent in 1996. External debt as a share of GDP increased from 21.3 percent in 1994 to 25.6 percent in 1996. Particularly worrisome was the rapid increase in short-term liabilities.

With the general elections approaching in November 1996, the government attempted to spend its way out by expanding domestic demand. Wages in the public sector and social welfare spending were substantially increased. However, the effort was ephemeral. After yet another acceleration of inflation in 1996—followed by the reintroduction of price and foreign exchange controls—the IMF suspended its stand-by agreement (Osiatynski, 1997). By that time, it had become obvious that the PSDR's approach to market reform had failed.

The deterioration of economic conditions strongly affected Romania's population. Per capita GDP contracted from US$ 2'319.1 in 1989 to US$ 1'562.9 in 1996, despite a shrinking population. The contraction was worst in 1992, with per capita GDP falling to US$ 859.1. About a third of the population was estimated to live with less than three dollars per day. About 17 percent of the population lived on less than one dollar per day and person.[1] The long-term unemployed, families with many children living on low wages, pensioners in rural areas, as well as the Roma minority were most affected

[1]The poverty rates reported for this period vary significantly according to different sources (see for instance Milanovic, 1998; Sahn, 2001). The data must therefore be apprehended with caution. The figures reported here represent the lower bound.

by the economic deterioration. The economic and social situation in rural areas was systematically worse than that in urban areas (UN, 1997).

The decline in the standard of living reflected Romania's weak economic performance and slow progress in macroeconomic and structural reforms. The general elections of November 1996 thus coincided with widespread hopes of change, despite the fact that in terms of candidates and parties the elections were similar to those of 1992. The most promising candidates to the presidential office, all of them former members of the Romanian communist party, were the same as in the previous elections. Except for some small changes, the configuration of political parties and coalitions had also remained the same. In contrast to 1992, the underlying bases of support had somewhat changed. The PSDR still drew its support from the rural population, the pensioners, and the bureaucracy, but many industrial workers who had supported the party in 1992 had turned their back on it because of its daunting record of incompetence in restoring economic order. The RDC coalition mainly drew its support from educated voters in urban areas (Carothers, 1997).

The loss of the worker vote weakened the PSDR and resulted in the victory of the opposition. However, the transfer of power to the RDC constituted more a rejection of the former regime rather than the endorsement for the opposition. No clear and comprehensive reform plan had been presented in advance. While the opposition was better organized than in the last elections, it still represented a heterogeneous and ill-suited combination of anti-communists and former communist-reformists united in their desire to breach the political monopoly of the PSDR (Gallagher, 2008).

4.3.3 Breaking the Logjam

At first, the replacement of the PSDR by a center-right coalition government seemed to mark a shift in Romania's economic policy. In February 1997, the new administration started a radical reform program, established with the assistance of the IMF. The program included the removal of price controls and the tightening of monetary and fiscal policies. Ambitious objectives were set regarding the privatization of the industry and the banking sector, the restructuring of public utilities, and agricultural reform. However, partly due to the economic conditions inherited from the previous government and partly due to the governing coalition's weak implementation capacity, the task of carrying out these overdue reforms was more difficult than projected (Maniu et al., 2001).

A number of important structural reforms were initiated. The external debt that accrued under the previous administration was rapidly repaid. The foreign-exchange market was liberalized, which led to a sharp devaluation of the Romanian currency. The removal of price controls in the agricultural and energy sector improved the allocation of resources, but released repressed inflationary pressure and resulted in an annual inflation rate of 154.8 percent in 1997 (IMF, 2000c).

These policies substantially reduced real incomes in Romania. By July 1997, real wages had fallen by a third. Income inequality widened and a large number of workers slipped into poverty as their salaries did not keep up with the price increases for basic goods. In 1997 real GDP dropped by 6.1 percent while industrial output decreased by

5.6 percent. On the one hand, the decline was due to the restructuring and closure of ailing industries. On the other hand, it resulted from reductions in real wages, which affected private consumption (IMF, 2001).

The severity of the economic decline and its impact on Romania's society generated disagreements within the coalition over the pace and direction of further reforms. Despite the adoption of important legal acts to accelerate the process of privatization and restructuring, the closure of unprofitable SOEs was subsequently delayed and the process fell behind schedule (Smith, 2006).

Efforts to enforce financial discipline in the state sector were not sustained. Government employment increased and attempts to reduce remuneration proved unsustainable. Soft budget constraints and weak corporate governance contributed to the resurgence of wage inflation in 1998. Wages in the state sector were almost twice as high as the economy-wide average wage of US$ 110. Public workers with high-wage, low-productivity jobs faced high opportunity costs from moving to higher-productivity, lower-wage jobs and therefore had strong incentives to resist restructuring (IMF, 2001).

Another manifestation of financial indiscipline was inter-enterprise and fiscal arrears. Total enterprise payment arrears amounted to a third of GDP in 1997, with a tendency to rise in the following years. The tolerance of fiscal arrears threatened Romania's fiscal stability and induced the IMF and other creditors to withhold financial support. By April 1998, the disagreements within the governing coalition over the pace of reform had become irreconcilable and resulted in the replacement of the prime minister and his cabinet (Gallagher, 2008).

The new administration drafted a new set of reform proposals in order to accelerate the privatization and restructuring of ailing enterprises, but failed to provide a new impetus to the process. The government closed down a number of large loss-making SOEs in spite of the resurgence of violent demonstrations, but these measures did not go far enough to iron out systemic deficiencies. Meanwhile, banks continued to provide soft credits to loss-making firms. The banking system remained dominated by state-owned banks, none of which had yet been privatized. In early 1999, the accumulation of non-performing loans led to the bankruptcy of a major state bank, followed by the downfall of some smaller banks.

Confronted with the threat of a full-blown banking crisis, the authorities took over some five percent of GDP in additional debt for the purpose of partially recapitalizing the banking system. Funding by the IMF was resumed under a new stand-by agreement signed in April 1999. The capital injection strengthened the banks' financial position (IMF, 2001).

The privatization of two banks and the closure of another one drastically altered the ownership structure of the banking system. At the end of 1999, private banks held more than half of the total banking sector assets in Romania. Enhanced supervision and stricter rules and regulations helped to improve the quality of banks' loan portfolios in the following years (IMF, 2001).

Under the pressure from the IMF, the authorities renewed their effort to implement a fiscal adjustment program that included cuts in primary expenditure and increases in revenue. The initial focus on expenditure cuts—concentrated on wages, pensions and capital—was partially rolled back under strong political pressure from interest groups in the public sector.

The focus subsequently shifted towards addressing the efficiency of the tax system. Income and wage taxes were lowered to reduce distortions and incentives for rent seeking activities. At the same time, broader-based indirect taxes were raised. Efforts to increase the efficiency of the corporate tax were impeded by ad hoc and frequently changing decisions on tax exemptions. Far from benefiting investment and employment, these measures destabilized the tax regime and undermined the government's credibility. It was only at the beginning of 2000 that tax exemptions and investment-incentive legislation were repealed and the corporate tax rate was reduced, bringing Romania's tax regime in line with the regional standard (IMF, 2001).

As a result of these measures, government revenues increased by more than 4 percent of GDP between 1996 and 1999. However, due to the increase in interest expenditures, the overall government deficit declined by only 1 percent during the same period. Moreover, the beneficial effect of the reduction in income and wage taxes was largely offset by increases in social security contributions. In the health sector, the financing mechanism based on general taxation was replaced with a mandatory health insurance paid concurrently by the employer and the employee. In the pension sector, contributions were substantially raised due to growing financial imbalances (IMF, 2001; Sava and Menon, 2007).

As was the case in Bulgaria, Romania had entered the transition process with an already unsustainable pay-as-you-go pension system. The financial health of the system was further endangered by the introduction of generous early retirement provisions and the expansion of the number of pensioners. In the absence of a comprehensive pension reform, the current government had no choice but to raise contribution rates. The attendant increase in non-wage labor costs led to a decline in the effective contribution rate by generating unemployment and tax evasion. With lacking enforcement of financial discipline, firms—particularly in the state sector—started to default on the employer contributions (IMF, 2001).

Notable progress was made in the rapprochement with the EU. In 1998 the European Commission decided that potential EU accession candidates would receive a disproportionately large share of financial support in order to catch up with more advanced candidates. Romania thus increased efforts to improve its political relationships with EU members. Following the clear pro-Western position adopted during the Kosovo crisis, Romania was invited in December 1999 to begin accession negotiations with the EU. In turn Romania had to accept that the EU would play an active role in supervising the formulation and implementation of reform measures (IMF, 2001; Gallagher, 2008).

Yet in spite of this political success, Romania's cabinet was replaced following internal political quarrels at the end of 1999. While cabinets were regularly dissolved, Romania's problems were not. Public sector companies remained a major source of financial indiscipline. The level of enterprise arrears climbed from 33.6 percent of GDP in 1997 to 40.7 percent in 2000. Inter-enterprise arrears accounted for about a half of total arrears, of which about 40 percent were owed to energy suppliers. Arrears to the central budget and social security funds accounted for about a third of the total. State-owned companies were responsible for more than a half of total arrears. The new government proved unable to restore the position as a tough creditor. The tolerance of fiscal arrears perpetuated the problem of soft budget constraints and represented a strong disincentive for restructuring (RAS, 2002; IMF, 2004c).

After three consecutive years of decline, the economy recovered in 2000. The hesitant recovery largely reflected the influence of external market conditions rather than the administration's reform effort. The government's time in office produced a mixed outcome. Controls on the price, trade, and exchange systems had been largely removed. The process of privatization had been carried on, although at a relatively slow pace. A number of enterprises in socially and politically sensitive areas had been closed down. Privatization in the banking sector had been initiated, and financial market supervision had been strengthened. Government finances improved to some extent as a result of fiscal adjustments and a reduction of the general government debt.

In contrast, Romania's economic performance declined by almost 10 percent between 1997 and 2000. Government spending and inflation remained high throughout the period. The private sector share of GDP merely increased by 5 percent, from 60.6 percent in 1997 to 65.6 percent in 2000, and many large SOEs remained in the portfolio of Romania's State Ownership Fund. Public utilities continued to operate as monopolists in their market. Soft budget constraints and weak corporate governance discouraged financial discipline and periodically threatened macroeconomic stability. Substantial resources were channeled to unproductive sectors and to a highly redistributional welfare system. The high level of recurrent expenditure, arising from a growing wage bill in the public sector, was maintained at the expense of capital investments in infrastructure, health, and education. No progress had been made in reforming the public administration and the judiciary, and legal and administrative barriers continued to impair the functioning of factor and product markets.

The deterioration of the economic environment affected people's lives, especially the poor. Between 1997 and 2000, real wages stagnated and poverty substantially increased. 30.8 percent of the population was estimated to live in poverty in 1998. 11.3 percent of the population suffered severe poverty. In 2000, these figures increased to 35.9 percent and 13.8 percent, respectively (UNDP, 2007).

The overall disappointing economic and social outcome was partly due to the disastrous economic legacy of the PSDR administration. The harsh external economic environment in 1998 and 1999 put further strains on the government. These difficulties notwithstanding, the RDC coalition fell short of achieving its ambitious reform goals. The lack of leadership and ongoing internal conflicts weakened the government's cohesion and made it susceptible to outside pressure. The result was an ad hoc and selective stop-and-go approach dictated by short-term political considerations rather than a decisive and comprehensive reform. The failure to match rhetoric with deeds eroded confidence in the government and eventually undermined its credibility as a reform party.

The deterioration of living standards contributed to the growing unpopularity of the government. Its decision to increase social welfare payments and wages for state-sector personnel in the running up to the November 2000 general elections failed to mobilize electoral support. Instead, the attendant increase in the fiscal deficit brought the government into renewed conflict with the IMF. Both the IMF and the EU expressed concern about the lack of progress made in restructuring the economy and the high level of government spending (Smith, 2003).

While the RDC progressively disintegrated, the PSDR strove to rid itself of its anti-Western image. It tried to appeal to the young and urban electorate by committing itself to prepare Romania for EU membership. But former communist apparatchiks continued to hold the reins of power in the party, raising suspicion among younger voters. Hence, the PSDR won the November 2000 general elections mainly by mobilizing its traditional constituency—rural, poorly educated and elderly voters. The party did not succeed in broadening its appeal to a younger, urban, and middle-class electorate whose social weight and political influence was on the rise. Following the merger with a smaller socialist party, the PSDR took the name of Social Democratic Party (SDP) (Gallagher, 2008).

4.3.4 The Path to EU Accession

Euro-Atlantic integration became the major objective of the new administration. A year earlier, in March 2000, the main political parties, in association with civil society organizations had started a dialogue from which emerged a consensus about the future political and economic development of Romania. A Medium-Term Economic Strategy was elaborated that called for the establishment of a functioning market economy compatible with EU institutions and policies. Four broad intermediate objectives were put forward: the clarification of ownership rights, the adoption of missing economic regulations, the improvement of financial discipline, and the reduction of the informal sector (IMF, 2001).

Together with the EU, the IMF, and the World Bank the government worked out a program designed to tighten monetary and fiscal policy and accelerate structural reforms. In October 2001, a new stand-by agreement was concluded with the IMF. The agreement encompassed measures to reduce budgetary deficits and inflation, tighten controls on state sector wages, eliminate enterprise arrears, and to privatize—and if necessary—to close ailing industries. Finally, it was convened that the government would have to restructure the financial sector, privatize commercial banks in state hands, and further improve bank supervision and regulation (Smith, 2003).

The SDP government was more successful than its predecessors in adopting the legislation needed to implement economic reforms and restructuring the institutions associated with such reform. In contrast to its predecessors, the SDP enjoyed the backing of the majority in the parliament and the control over bureaucracy and SOEs. Moreover, the opposition was divided and weakened by its electoral defeat. This favorable configuration allowed the government to enact legislative acts relatively swiftly. The SDP's connections with trade unions, the media, and the security apparatus also made sure that public opinion rallied to the issue of painful economic measures. As a consequence, the government met the macroeoconomic targets contained in the stand-by agreement. Monetary policy contributed to disinflation by reducing the rate of crawl and maintaining high interest rates. The inflation rate gradually fell from 45.7 percent in 2000 to 22.5 percent in 2002. The budgetary deficit was reduced to 2 percent of GDP in 2001, and remained low in the following years (IMF, 2004e; RAS, 2004).

By the end of 2002, most SMEs were privatized. To speed up the privatization of large SOEs, the government replaced the inefficient State Ownership Fund with the State Assets Resolution Agency, and put it under direct government control. The new agency followed a strategy of accelerated privatization. State companies were sold on advantageous terms, conditional on maintaining employment and activity. Although the strings attached to ownership transfer deterred some investors, the agency's approach registered some success. In the financial sector, the State Assets Resolution Agency divested some of the country's largest banks. The soundness of the banking system improved, mainly thanks to the regulatory framework introduced by the previous administration. The telecommunication sector was also liberalized, allowing foreign companies to enter the market (Smith, 2003).

The SDP administration became Romania's first post-communist government to complete a stand-by agreement with the IMF, following five failed attempts in the 1990s. Yet, not all targets included in the agreement were easily met. The large-scale losses of state industries, the caps on energy prices, the fiscal arrears to the state budget and to public utilities, as well as the high level of wages and overstaffing in the public sector continued to hamper Romania's growth performance. The government failed to address these issues adequately in its first years in office (IMF, 2004d).

The EU's assessment on Romania's reform progress, published in October 2002, acknowledged that the country had made considerable progress towards accession, but concluded that Romania did not yet satisfy the economic criteria for entry into the EU. Notwithstanding this conclusion, Romania was offered the possibility to join the EU in 2007 on condition of satisfying a stringent set of political and economic requirements. The requirements were similar to those agreed with the IMF, but also encompassed tax, financial, and public sector reforms. The report also stressed the necessity of fighting corruption (European Commission, 2002b).

The government took measures both to increase the level of revenues and to reduce the level of current expenditures. In 2002, a comprehensive reform of the VAT and profit tax legislation eliminated fiscal distortions and contributed to improving the business climate. Moreover, the government reduced Romania's aggregate social insurance contributions by 3 percent in 2002 and by another 5 percent in January 2003. However, at nearly 50 percent of gross wages, the Romanian workforce was still heavily taxed. These charges not only narrowed Romania's tax base, they also contributed to labor market rigidities and high unemployment rates. Finally, they were partly responsible for the significant share of Romania's informal sector, which was estimated at 30 percent at that time. Nevertheless, tax reforms and improvements in tax administration considerably strengthened revenue collection in absolute terms despite the reduction of social security contribution rates. However, revenue collection as a share of GDP declined from 31.2 percent in 2000 to 28.7 percent in 2004, mainly as a result of Romania's strong growth performance (IMF, 2004d).

The authorities also took steps to curb current expenditures. Interest payments were drastically reduced. Employment in the state-sector decreased in absolute and relative terms, and public sector wages were reduced as a share of GDP. In order to fulfill the EU-IMF targets, education, health, and social welfare spending was also reduced. The resulting financial shortages repeatedly brought these sectors to the edge of collapse. Although these measures helped to reduce the fiscal deficit as a share of GDP to 1.5 percent in 2003, they were implemented in the absence of any serious effort to improve the financial sustainability of the public sector.

As a matter of fact, the public sector remained unorganized, overcrowded, and inefficient. Service delivery was compromised by the weaknesses in funding arrangements. Government funds continued to be channeled into recurrent expenditure at the expense of capital investment. However, wages were too low to provide an incentive to meet the needs of the population. Corruption and informal payments were widespread, giving rise to problems of access and equity (World Bank, 2006g).

The absence of a comprehensive public sector reform was partly due to the fact that the government's actions were predetermined by existing agreements, which mainly focused on stabilization and market restructuring. However, as in many other transition economies, the lack of reform also reflected the government's reluctance to address a delicate sector which would risk alienation of the staff, trade unions and the public.

Informal political interference in the administration and the judiciary increased under the SDP government. Facing pressure from the EU, the authorities established an anti-corruption agency in 2002 to eradicate political, administrative, and judicial abuses of power. However, the agency exclusively targeted low-level corruption, while senior public officials continued to amass excessive personal fortunes. The agency also turned a blind eye to the blatant misuse of power at the local level. The majority of local governments were in the hands of SDP mayors, who exercised almost absolute control over regional courts, elected bodies, the police, and the economy. These mayors also dominated the regional development agencies through which the EU channeled its funding, thereby raising concerns of EU officials about the misuse of funds (Gallagher, 2008).

The EU also expressed concern about human rights and the treatment of minorities in Romania. Consequently, the authorities amended Romania's constitution to bring it in line with EU legislation. In a referendum held in October 2003 the electorate accepted the new constitution which provided better protection of property rights and improved legal safeguards for ethnic minorities (Gallagher, 2008).

The process of privatization and market deregulation gained momentum in 2003. A number of large companies in the heavy industry and the energy sector were split up and sold for nominal sums. The plants were large-scale employers and had proved difficult to privatize in previous years. As a result, the private sector share of GDP exceeded 70 percent in 2004. Another important measure was the adjustment of energy prices to their cost recovery levels. To facilitate market entry, lengthy administrative procedures and red tape were reduced by establishing one-stop shops for registering and authorizing firms and by implementing a silent approval procedure for the issuance of public licenses. However, complex procedures, insufficient administrative capacity and uneven application of the legislation adversely affected the business environment. Similarly, the weak application of the newly amended bankruptcy framework continued to encourage financial indiscipline (European Commission, 2004d; EBRD, 2004).

At the end of 2003, the EU acknowledged in its annual report that Romania had achieved the status of a functioning market economy, but it underlined the necessity of continued and decisive implementation of structural reforms to enable the Romanian economy to cope with competitive pressure in the EU (European Commission, 2004d).

In the wake of elections, the SDP attempted to capitalize on the EU's positive decision and on the country's robust economic performance. The average growth rate between 2001 and 2004 was 6.1 percent per year. In 2004, inflation was brought down to 12 percent, the fiscal deficit was at 1.2 percent of GDP, and government debt stood at a comfortable level of 18.8 percent of GDP. Living standards also improved during the SDP's term in office. Per capita GDP increased from US$ 1'793.1 in 2001 to US$ 3'484.5 in 2004. In the same timespan, economy-wide real wages increased by more than a third. Unemployment remained moderate due to growth in private sector employment, which mitigated the effect from dismissals prompted by the restructuring of state companies. However, the low unemployment rate also indicated that restructuring was not yet accomplished. The absolute poverty rate decreased from 30.6 percent in 2001 to 18.8 percent in 2004, while the rate of severe poverty fell from 11.4 percent to 5.9 percent. However, inequality had increased and the widening gap between those who had benefited in one way or another from the privatization of state property and those living in modest conditions became a reason for strong public dissatisfaction.

Prior to the November 2004 general elections, civil society organizations formed a Coalition for a Clean Parliament and published a document relating the cases of 222 parliamentary candidates from Romania's major parties who were deemed ineligible because of powerful allegations of corruption. The image of the SDP was particularly affected by these allegations as it was revealed that senior party officials had interfered with the judiciary, and that considerable EU funds had been diverted (Freedom House, 2008b).

While the SDP rejected the allegations, parts of the opposition withdrew their accused candidates. This move strengthened the opposition's credibility in the eyes of the voters. Opposition parties further improved their electoral position by forming the Justice and Truth Alliance in August 2003. Running on an anti-corruption platform, the Justice and Truth Alliance carried the general elections and came to power in December 2004. At the same moment, the EU agreed to sign the accession treaty with Romania, preparing the way for membership in 2007.

The reform agenda of the new administration was basically the continuation of the former government's economic policies. The agenda was largely dictated by the requirements associated to EU accession and included policies such as deregulation and privatization, the reduction of direct taxes, the simplification of the tax system, the dismemberment of state monopolies, the abolition of government subsidies, and the reduction of inflation to EU levels (Smith, 2007).

The government's first move was to replace the progressive income tax with a 16 percent flat rate tax on personal income and profits by January 2005. The objective was to simplify the process of tax collection and to reduce the incidence of corruption and tax evasion. The introduction of the flat tax led to a loss in tax collections of about 1 percent of GDP. The loss was compensated by higher indirect tax collections due to strong consumption demand. Hence, the revenue-to-GDP ratio remained constant. No progress was made in reforming expenditures (European Commission, 2006; IMF, 2006b).

As part of its preparations for entry into the European Monetary System, the central bank removed all remaining controls on capital movements. The full liberalization of the capital account and the adoption of inflation targeting complicated monetary policy and increased the economy's vulnerability as significant inflows of capital put upward pressure on the currency, creating problems of competitiveness for export industries and contributing to a boom in imports. The subsequent reduction in interest rates generated a boom in household credit, the majority of which was denominated in foreign currencies. Together with increases in real wages and the pro-cyclical effect of the tax reform, the credit boom led to a sharp increase in private consumption and put renewed pressure on Romania's current account (IMF, 2006b).

In contrast to Bulgaria, Romania did not follow the IMF's prescription to pursue a counter-cyclical fiscal policy so as to remove pressure from the current account. On the contrary, substantial increases in public sector wages generated large overruns in the wage bill and made it necessary to cut down capital investment. The decision to increase wages was made after massive strikes against the underfunding of the public sector had paralyzed the country. Further pressure on government spending arose from the recalculation of pensions, the clearance of fiscal arrears, and capital injections into the banking system. The lax fiscal policy brought the government into renewed conflict with the IMF which suspended its precautionary stand-by agreement by the end of 2005 (IMF, 2006b).

The government continued to move ahead with the process of privatization. The divestment strategy in the energy sector was successfully accomplished. The country's largest privatization involving the sale of a majority stake in the largest Romanian bank was also concluded. By the end of 2006, the majority of shares in the telecommunications sector, the financial sector, the pharmaceutical, the metallurgical, and automotive industries were privatized. However, the State Assets Resolution Agency still held shares of over 1'000 enterprises, of which more than a half was unfit for privatization. Against this background, the liquidation of insolvent enterprises was inevitable. But the authorities continued to show some reluctance in the use of bankruptcy procedures to foster market exit. Instead, it was decided to shift the date for accomplishing the privatization process from end-2006 to end-2007 (European Commission, 2006; Smith, 2007).

Facing increasing pressure from the EU, the government also carried out a program for agricultural and rural development, including the completion of land restitution. Up to that point, the restitution process had failed to improve the commercial viability of agricultural farms. Romania had more than four million farming units, with an average farm size of 3.1 hectares. A large proportion of those who had received land were lacking the skills, experience, physical capacity, and financial means to engage in farming. Subsistence and semi-subsistence farming continued to be the dominant forms of production. The integration with the agro-markets was inadequate, capital and land markets were shallow, and the rural labor market was rigid. As a result, agricultural productivity was extremely low (Csaki and Kray, 2005).

Legislative packages were adopted to cut subsidies to state farms, facilitate the legal transfer of land, and to speed up the pending cases related to restitution. Moreover, measures were taken to encourage land consolidation. However, the outcome of these policies was limited. More than half of the state farms in the State Assets Resolution Agency portfolio were considered insolvent. The divestment of these farms was being delayed by an incoherent strategy and pending ownership disputes. State farms continued, meanwhile, to accumulate losses as fiscal budget constraints remained relaxed (Csaki and Kray, 2005).

The consolidation of small farms failed to progress in the absence of a functioning market for land transactions. Legal disputes, bureaucratic delays and local corruption in the distribution of land titles continued to impede the establishment of a functioning land market. By the end of 2006, less than one-third of the claims filed by former owners dispossessed by the communist regime had received any attention. The prevalence of pensioners among rural landowners also hampered the consolidation in the agricultural sector. According to some estimates, pensioners owned more than 60 percent of land in rural areas. The government's proposition to offer a life annuity for old farmers in return for their land failed to attract much interest. The lack of non-agricultural employment opportunities in rural areas also discouraged people from selling or leasing their land. Hence, the restructuring process in the agricultural sector remained at a standstill (Csaki and Kray, 2005).

Following lengthy consultations in the parliament, legislation aiming at transposing the Acquis Communautaire on Romania's labor code was enacted in March 2006. The amendments provided the legal basis for the use of short-term contracts, the extension of the probation period, more flexible working hours, and the employer's right to reduce labor for economic reasons. However, the main sources of labor market rigidity, such as the high level of social insurance charges and the complicated hiring and firing practices, remained unchanged. Accordingly, labor markets showed little improvement. Over 40 percent of the effective working population was still formally excluded from the labor force. While the unemployment rate remained relatively stable at 7.7 percent in 2005, both youth unemployment and long-term unemployment reached 23.8 percent and 4.4 percent, respectively (European Commission, 2006; Kotzeva and Pauna, 2006).

Firm action was taken to address the problem of corruption in the judicial system. The legal and financial independence of the judiciary was strengthened by substantially increasing both its budget and personnel. Competition for leading positions and a more rapid promotion scheme were introduced. Last but not least, a national anti-corruption department was established with the objective to investigate all cases of high-level corruption, economic fraud, and tax evasion (OECD, 2006).

The resolute application of these reforms alarmed the political establishment and induced members of the Justice and Truth Alliance to side with the opposition in order to obstruct the anti-corruption campaign. The decisiveness of the minister of justice was increasingly considered as a threat to informally established arrangements, whereby policy makers enjoyed control over the justice system and immunity from some of its laws. While the minister of justice enjoyed the support of the public and the EU, her actions increasingly divided the ruling party coalition (Gallagher, 2007).

The government also increased efforts to enhance the quality of administration. A medium-term fiscal framework was established to improve the process of fiscal planning. However, its development was rudimentary, and the planning and budgeting processes remained disconnected and opaque, while spending targets were unrealistic. Legal decentralization progressed, but the effects of poor implementation of past measures became increasingly evident. The tasks already transferred to local authorities were not systematically evaluated, and the blatant lack of management skills at the local level was not sufficiently accounted for. Civil service legislation was adopted to comply with the EU standards on recruitment, promotion, civil service classification, and political neutrality. However, merely amending legislation without increasing capacity was not sufficient to improve the quality of a public sector characterized by weak professionalism and a high level of politicization (World Bank, 2006g).

The poor quality of Romania's administration raised concerns among EU officials about the country's capacity to responsibly use future EU structural and cohesion funds. Romania's track record in this respect was less than encouraging. For instance, a large part of the funds allocated for agricultural and rural development in 2004 and 2005 were in danger of remaining unused because the administration was not able to cope with the complex rules attached to them. As a consequence, the funds were hastily allocated at the beginning of 2006, making it more than doubtful that the recovery of agriculture would be accelerated by such improvisation. The country's inability to absorb EU structural and cohesion funds increased the risk that Romania would become a net contributor to the EU budget (World Bank, 2006g; Gallagher, 2007).

The government's attempts to accelerate institutional development were hampered by increasing political infighting over the anti-corruption strategy of the ministry of justice. Decisions were repeatedly delayed by the government's inability to summon a majority in the parliament. Maintained by only a few seats, the government coalition majority lacked discipline and, on many occasions, collapsed. In April 2006, senior members of the Justice and Truth Alliance even put into doubt the future of the coalition. Nevertheless, a split was avoided in order not to endanger the EU accession process. While legislative acts were still being adopted, their institutional implementation fell behind schedule. In practice, this involved that little was done to upgrade the bureaucracy and ensure that public officials were prepared for the task of drawing up projects, budgeting for them, and preparing a timetable for their implementation (Freedom House, 2008b).

Despite concerns about the fragile macroeconomic situation, the poor quality of the administration, and the prevalence of corruption, the European Commission announced in September 2006 that Romania had made sufficient progress to proceed with EU accession in January 2007. Yet the EU reserved the right to exercise safeguard measures, granting the European Commission the authority to verify the progress in reforms.

4.4 Albania

4.4.1 Initial Conditions

In his attempt to establish an autarchic state based on Marxist-Leninist principles, Albania's long-time ruler Enver Hoxha plunged the country into a deep economic crisis. The regime's isolationist policy and rigid central planning left the country with a highly distorted economic structure, unprecedented macroeconomic imbalances, and widespread social hardship. At Hoxha's death in 1985, Albania ranked among the poorest countries in Europe. Economic stagnation, coupled with a growing population, forced Hoxha's successors to make cautious attempts at political and economic liberalization. However, these steps were not sufficient to halt economic deterioration.

The continuing decline in Albania's economic and social conditions, together with the collapse of communist regimes in neighboring countries, stimulated internal pressure for reform and forced the Central Committee of the Albanian Party of Labor (APL) to embark on a mildly reformist path at the beginning of 1990. While continuing to declare its commitment to Marxism-Leninism, the Central Committee agreed on a program of selective economic and political reforms. A package of legislation was passed to liberalize the criminal code, reform the court system, guarantee the right to travel abroad, and allow producers to sell some of their surplus on the open market. In this connection, private markets were authorized, and some producers were permitted to set their own prices. Despite mounting social pressure, the Central Committee continued to reject the idea of a multiparty democracy (Kaser and Tahiraj, 2007; Bartlett, 2008).

Popular discontent intensified when a drought in the summer 1990 exacerbated food shortages already strained by inefficiencies in agricultural production. Masses of people began to invade Western embassies in Tirana in order to escape hunger and misery. Others chose to flee to neighboring countries. Worries over popular insurrection induced the government to pursue a policy of soft budget constraints. In August, the monopoly on foreign trade was abandoned, and the import of basic food items was sharply increased. In the face of declining state revenues, the government lifted the constitutional ban on foreign credit to finance the increase in imports. At the same time, Albania's state bank was printing money to enable state companies to meet payrolls and to avoid layoffs. In September, the government issued a decree to make sure that workers who were temporarily unemployed by the shortage of raw materials and spare parts were still entitled to 80 percent of their nominal wage. However, at US$ 20 per month, the average worker pay was not much of an incentive to prevent a growing wave of absenteeism in the state sector (Pashko, 1993; Kaser and Tahiraj, 2007; Bartlett, 2008).

The government's measures were too limited and disorganized to bring about fundamental improvements in the functioning of the economy. If anything, they disrupted economic activity, bred corruption, and further increased political instability. Although state subsidies increased from 6.6 to 13.8 percent of GDP between 1989 and 1990, agricultural and industrial output dropped by 5.4 percent and 14.2 percent, respectively. Real GDP declined by 10 percent, and the official rate of unemployment rose to 9.5 percent. In the absence of fiscal constraints, the budget deficit reached 15 percent of GDP. In less than two years after removing the ban on foreign credits, Albania managed to amass a foreign debt of 66 percent of GDP (Pashko, 1993).

In early December 1990, students organized mass protests in Tirana, calling for an end of the dictatorship and the introduction of a multiparty system. As state institutions had ceased to function, and economic activity had come to a virtual halt, the communist regime was unable to withstand popular demands for more political rights, and agreed to hold multiparty elections in March 1991. The formation of non-communist political parties was approved, and soon after Albania's first legal anti-communist opposition party—the Democratic Party of Albania (DPA)—was founded. The DPA and the APL were to become the main adversaries of Albania's political scene in the following years. Both parties acknowledged that progress would only be possible through a market economy, but they disagreed on the speed and scope of such a transformation. The APL proposed a policy of gradual economic reform. The DPA advocated membership of the European Community, rapid privatization of property, and the disbandment of agricultural collectives. It also promised Western financial aid, and jobs in foreign enterprises for the unemployed (Ammann and Sguaitamatti, 2000).

The elections took place peacefully and gave the APL a two-thirds majority in the 250-member parliament. The opposition secured the urban constituencies. Support for the APL came mainly from the rural population. Many people in rural areas voted for the APL because they lacked reliable information about existing alternatives. They drew their information from the state media, which were still under the control of the communist party. Moreover, the newly formed opposition parties did not have enough time to organize and extend their electoral campaign to rural areas. Finally, many rural voters working in state farms had been influenced by farm directors who remained powerful supporters of the incumbent regime.

The new APL government announced a reform program, which included measures aimed at stabilizing the economy, liberalizing trade, and privatizing SOEs. It also formally endorsed political pluralism and market economics, the right to private property, and the right to strike and demonstrate. The right to emigrate was also reiterated. However, the opposition did not recognize the election results, claiming that they had failed to meet democratic standards. Frustration over the electoral defeat provoked riots and looting in many urban areas. Strikes and demonstrations continued throughout the months of April and May, and plunged the country deeper into chaos. The period was characterized by widespread devastation and theft of public property. The consequences were a large-scale deterioration of economic conditions, a huge decline in national output, increasing pauperization, and serious shortages of food. The newly formed government was unable to reestablish order and resigned on 6 June 1991. A few days later, the APL renamed itself Socialist Party of Albania (SPA), renounced Marxist ideology, and officially adopted the principles of a market economy (Pearson, 2007; Vickers, 2007).

4.4.2 Shaking Off the Legacy of the Past

An interim cross-party coalition government was formed to prepare for new elections, scheduled for March 1992. In the following months, the political situation began to improve slightly. Although there were further strikes and demonstrations, the interim government was at least able to initiate a number of fundamental economic reforms (Vickers, 2007; Bartlett, 2008).

A reform program was designed to be executed during the period of September 1991 through March 1992. It included measures of strict fiscal and monetary policy, price and exchange rate liberalization, market deregulation, and privatization. The monthly budget deficit was reduced to around 2 percent of GDP through major cuts in administrative spending and the introduction of a simple, flat-rate corporate tax system. A package of laws was designed to fulfill the requirement of legal separation between Albania's central bank and its newly created commercial banks. It was also decided that the central bank should focus on monetary policy alone, and no longer cover government budget deficits. The Lek was gradually devalued, and in November the official exchange rate was 25 percent lower than the free market rate. However, the devaluation was of limited use because administrative prices were only partially liberalized (Pashko, 1993).

A Law on Privatization was adopted with the objective to prepare SOEs for divestiture and increase their responsiveness to market signals. Companies became largely independent from ministries, and management boards were free to negotiate input prices, hire and fire workers, and adjust output prices. A National Agency for Privatization (NAP) was established in order to implement and supervise the process of ownership transformation. The law also specified the methods of privatization. Large-scale privatization was scheduled for the second half of 1992 (Pashko, 1993).

Small-scale privatization was initiated in September 1991. By January 1992 almost 75 percent of retail trade and small services were sold or leased. The preparations for land reform were made during the summer 1991. Change of land ownership was expected to have a significant effect on the economy since the agricultural sector contributed over a third to Albania's GDP and employed half of the country's workforce. Cooperatives, which held about 73 percent of Albania's cultivable area, were dismantled. The land was distributed to peasants on an equal per capita basis. In order not to delay the process, the claims of former owners were ignored and no scheme of compensation was set up. As a consequence, the privatization of agricultural cooperatives proceeded very rapidly. By the end of 1993 almost 94 percent of the agricultural land formerly within the cooperative system had been distributed to approximately 450'000 families, with an average of 1.4 hectares per family. State farms, which held about 24 percent of Albania's agricultural area, were excluded from the first round of land distribution because the government met with stiff resistance from farm directors. Nevertheless, the change in land ownership was one of the most effective achievements of the early reform stage (Pashko, 1993; Hashi and Xhillari, 1999).

In the face of forthcoming elections, disagreements between coalition partners over the reform direction became more intense and eventually led to the dissolution of the government in December 1991. The new administration was busy preparing the country for the upcoming elections, which made it impossible to further advance the reform agenda. The change of government thus left many aspects of the reform process unfinished. A law for the privatization of housing had been prepared but not adopted. Similarly, a strategy to privatize medium- and large-scale SOEs was shelved at the planning stage. A Social Assistance Law, designed to regulate the provision of unemployment benefits, had been approved in parliament in November but was never implemented. The Banking Law was only enacted in June 1992 (Pashko, 1993).

Not only were reforms being interrupted, but some of the measures were later repealed. Fiscal constraints were relaxed, and government spending rose despite a sharp decline in tax revenues. Food aid provided by donors was being sold to cover government expenditures. The central bank continued to pour money into loss-making state companies. Meanwhile, economic activity plummeted. GDP declined by 28 percent in 1991. Industrial and agricultural output fell by 42 percent and 17.4 percent, respectively. Inflation rose and peaked at more than 300 percent in the first quarter of 1992, while industrial unemployment reached 50 percent (Pashko, 1993).

In the March 1992 elections the DPA carried an overwhelming victory, winning 92 out of 140 seats in the Albanian parliament. The inexperienced administration was confronted with a range of serious problems, the most pressing of which was the continuing shortage of food, which made Albania's population heavily dependent on foreign aid. The decline in industrial production generated alarmingly high levels of unemployment. Last but not least, the continuing popular protests, attended by looting and violence, had eroded state authority and led to a dramatic increase in crime (Vickers, 2007).

The new government drew up a reform program in collaboration with the IMF to stabilize the economy. A stand-by arrangement was signed in August 1992. Several monetary policies were quickly adopted to curtail inflation. The interest rate was raised to 40 percent, full current-account convertibility was introduced, and prices were liberalized, except for a basket of basic commodities. Fiscal measures aimed to increase the level of tax revenue by extending the corporate tax base and introducing a personal income tax. On the expenditure side, the government imposed strict credit ceilings, and reduced enterprise subsidies from 13.2 percent in the first half of 1992 to 4.5 percent of GDP in the second half. In spite of these measures the fiscal deficit reached 23.1 percent of GDP in 1992, which was mainly due to the budgetary ease at the beginning of the year. The government successfully reduced inflation to 14.4 percent in the last quarter of 1992. End-year inflation stood at 236.6 percent, much lower than expected (Pashko, 1993).

The privatization strategy of the previous government was maintained. Small-scale privatization, land ownership transfer, and privatization of housing were decisively implemented. In July 1992 the Agency for Restructuring and Privatization of Agricultural

State Farms was established to manage the sale of state farm assets. Former employees were given preferential treatment. Difficulties in evaluating farm assets and the inability of new owners to pay in cash initially slowed down the process. After removing these obstacles, state farm land was rapidly distributed. The process was virtually complete by the end of 1993. Privatization of housing in urban areas also proceeded at great speed. Launched in May 1993, the process was accomplished by November of the same year. The privatization of housing had a substantial income effect for the urban population since new owners were now able to use their flats as collateral in obtaining bank credits (Hashi and Xhillari, 1999).

By contrast, the privatization of state companies proceeded at a much slower pace. Not only did the shortage of financial resources prevent most of the population from participating in the process, but the NAP, with a staff of only 13 employees, was ill-equipped to prepare SOEs for privatization and to implement the relevant directives with sufficient speed. In May 1993 the government unblocked the process by transferring the responsibility of privatizing SMEs to each of Albania's 36 districts, allowing 482 enterprises to change owners by 1995. In the absence of any notable interest from foreign capital, MEBOs were the most commonly used method of privatization. However, the government faced harsh criticism as local privatization boards were accused of manipulating the sales. The issue became particularly controversial in the electoral campaign of 1996, inducing the government to reduce the role of local privatization boards (Hashi and Xhillari, 1999).

The divestiture of large state companies was slow and encountered resistance from managers and employees who preferred the status quo. Confronted with an unemployment rate of 29 percent in 1993, the government was understandably reluctant to press ahead with restructuring and privatization of non-competitive and unprofitable enterprises. Instead of expediting the unpopular but necessary reform, the government reestablished control over SOEs. It was not until May 1995 that a mass privatization scheme was approved, entailing the divestiture of about 800 SOEs. However, the process was hampered by serious administrative obstacles, conflicting rules, and lengthy procedures. Privatization plans were prepared by the enterprises themselves. These plans were then processed by different ministries, and submitted to the NAP for final approval. This procedure was complicated and produced unnecessary delays. The number of units available for mass privatization was subsequently revised downward, and by 1996 only 97 companies had been transferred into private ownership. The May 1996 elections eventually brought the mass privatization scheme to a halt (Hashi and Xhillari, 1999).

In the meantime macroeconomic outcomes improved as structural reforms started to bear fruit. Between 1993 and 1995, the economy grew on average by 10.4 percent annually. The favorable economic performance was mainly driven by a rise in productivity following the implementation of small-scale privatization in the agricultural and service sectors. In spite of delays in completing large-scale privatization, the private sector share accounted for about 60 percent of GDP and 75 percent of employment in 1995. Government spending was reduced from 40.4 percent in 1993 to 33.4 percent in

1995. While public wage expenditures were maintained, enterprise subsidies, capital expenditure, and social benefits were reduced. Tax revenues remained low due to weak tax collection and a narrow tax base. The decline in government spending helped bring the fiscal deficit down to 10.1 percent in 1995. In the same year, the government also successfully curbed inflation to single-digit levels.

Many issues remained unresolved, however. With an average growth rate of 12.6 percent per year between 1992 and 1995, the agricultural sector provided the boost to Albania's early period recovery. However, further expansion was being held back by small land sizes, weak processing capacity, poor infrastructure, and low market access. Moreover, a formal land market did not develop because the sale of land was prohibited by law. When the prohibition was removed in 1995, the land market was slow to develop as land transactions could only take place when all the land in a village area was registered. Since land commissions were slow in resolving land disputes and registering land titles, the initial success of agricultural reform was threatened (Ammann and Sguaitamatti, 2000; World Bank, 2006e; Stahl et al., 2007).

Despite strong economic growth, social conditions remained dire and repeatedly threatened Albania's stability. Instances of disorder and lawlessness were legion in the early period of transition. Many schools and health centers were destroyed, and social services deteriorated alarmingly, causing huge humanitarian problems. 64.4 percent of the population was estimated to live on less than two dollars per day in 1996. With an average annual output decline of almost 18.9 percent in industrial output between 1990 and 1995, many people formerly employed in this sector lost their jobs. The official unemployment rate declined from 18.6 percent in 1993 to 10.2 percent in 1995, but this figure masked a high number of people who lost their eligibility to apply for state support. Although unemployment insurance had been introduced in 1993, the flat-rate unemployment benefit hardly provided for a minimum living standard. Many people found work abroad or in the informal sector. By 1995 approximately half a million people were working outside the country. They assumed an important role as a source of remittances to family members left behind. The informal sector began to flourish when sanctions were imposed against the FRY due to the war in Bosnia. Informal activities were estimated to account for over half of Albania's GDP. The removal of sanctions against the FRY in 1995 entailed the loss of lucrative income opportunities, resulting in popular discontent (OECD, 2004b; IMF, 2005a; Bartlett and Xhumari, 2007).

Reform achievements also remained fragile because of serious governance problems. State capacity was weakened by an insufficient tax base, a weak infrastructure, and a rudimentary financial system. Corruption and organized crime were widespread, and increasingly complex links were forged between criminals and high-level public officials. Poor law enforcement, insecure property rights, bureaucratic harassment, and lengthy regulatory procedures posed a considerable hindrance to private business development and labor market performance (IMF, 1999a; World Bank, 2003a).

Instead of improving Albania's state institutions, the DPA administration developed an increasingly authoritarian attitude which threatened to undermine the rule of law. Administrative and judicial positions were filled with party cronies, thereby opening the way to the politicization of the bureaucracy. These connections were then misused to build up back-scratching networks and acquire undue wealth. The authoritarian mentality of the DPA became obvious when former communist leaders were arrested and convicted to several years in prison despite the lack of tangible evidence (Elbasani, 2004; Vickers, 2007).

The government also introduced institutional reforms in order to increase its political power. A new constitution was drawn up in 1993. The draft was controversial because it increased the powers of the president at the expense of the legislature. Following parliamentary rejection in October 1994, the government circumvented the legislative process by arranging a referendum. The rejection of the referendum in November 1994 reflected the DPA's decreasing popularity among the general population and further weakened the party's position in the political market (Elbasani, 2004; Vickers, 2007).

The government's response was to introduce a number of laws with the objective of excluding the opposition from participation. The law against genocide under the communist rule, adopted in September 1995, excluded anyone who occupied a position of power before March 1991 from holding a public office. By the time of the May 1996 elections, the law had banned more than a quarter of the incumbent SPA deputies. The DPA government also made an unsuccessful attempt to raise the minimum threshold of representation from four to ten percent to deter small parties from competing. The plan provoked harsh criticism from Western countries, forcing the government to retract the proposal (Elbasani, 2004; Vickers, 2007).

The authoritarian attitude of the government added to the already bitter hostility between the DPA and the SPA. As a result, the electoral campaign was held in a climate of tension. Running on a populist ticket, the SPA was advocating a larger role for government in the economy and increased social assistance spending for reducing poverty. However, the party was deeply divided between conservative communists and liberal Europhiles, and the latter split in March 1996 to create a new party. Yet the divisions within the opposition did not appease the DPA's fear of losing the elections. The government relaxed fiscal discipline by removing credit ceilings for state banks and raising public sector wages. In addition, the government resorted to manipulation and intimidation. Opposition parties were banned from holding rallies in town centers. There were allegations of intimidation and pressure on opposition supporters during the campaign process. These irregularities induced all but one opposition party to boycott the elections, and the DPA consequently won 122 out of 140 seats. Although the majority of electoral observers agreed that serious irregularities had occurred, the DPA declared itself the winner. Appeals from Western governments to re-run the elections fell upon deaf ears. The SPA refused to recognize the results and subsequently boycotted parliamentary sessions in protest (Ammann and Sguaitamatti, 2000).

The depth of Albania's governance problems was revealed in January 1997 when several fraudulent pyramid schemes collapsed. Financial companies had attracted the savings of more than half of the population by offering extraordinary high returns. About US$ 2 billion had been placed in these schemes, which was the equivalent of Albania's GDP at that time. Violent protests by angry investors erupted throughout the country and led to the breakdown of law and order (Ammann and Sguaitamatti, 2000).

The protesters' anger was not only directed at the pyramid scheme companies, but also toward the government. The government was blamed for letting these companies operate without controls. Indeed, financial reforms had been very limited so far, and Albania's financial sector remained largely unregulated. When people began to deposit their savings in the schemes at the beginning of 1996, the government refused to intervene in spite of repeated warnings from Albania's central bank, the IMF and the World Bank. Instead, senior public officials appeared at company functions, and even as the pyramid schemes began to crumble at the end of 1996, the companies were praised as safe investment opportunities (Jarvis, 2000).

The crisis led Albania to the brink of civil war. Protesters called for the government to step down and for restitution of their savings. Unable to resist the increasing pressure, the government resigned in March 1997. A multinational protection force entered the country and restored some semblance of order. It was agreed that elections would take place by the end of June. Following a number of violent incidents during the electoral campaign, the SPA-led coalition secured an overwhelming two-thirds majority in the new parliament.

Albania was deeply affected by these tragic events. More than 2'000 people were killed during the uprising. Many thousands escaped to the neighboring countries. The number of people living on less than two dollars per day fell from 64.4 percent in 1996 to 46.6 percent in 1998. However, the decline was accompanied by a significant increase in the number of people living on less than one dollar per day, from 12.3 percent in 1996 to 17.4 percent in 1998. The economy was also severely affected. GDP fell by 10.9 percent in 1997, while inflation resurged to 33.2 percent. The budget deficit increased to 12.4 percent of GDP while government debt spiraled to 77.1 percent, from 55.2 percent of GDP in 1996. The collapse of the political and economic order was aggravated by widespread vandalism, destruction and theft of public property (IMF, 2005a).

4.4.3 The Continuing Trouble with Governance

The new SPA-led government took office in July 1997. With the assistance of the IMF and the World Bank, economic stability was rapidly restored through a tight monetary and fiscal policy. Inflation was brought down to 20.6 percent in 1998, and to a negligible 0.4 percent in 1999. The exchange rate was allowed to float. Overseas remittances led to a rapid appreciation of the rate and made a major contribution to stabilizing the economy. The government limited public spending and introduced a broad-based VAT with a rate of 20 percent to contain the fiscal deficit. The current account deficit was also substantially reduced, and foreign exchange reserves rose to a comfortable level. In the following years, monetary and fiscal policy remained prudent under successive IMF agreements (IMF, 1999b).

The regulatory weaknesses in the banking sector were also addressed. The disorder left behind by the pyramid schemes was cleared up, and steps were taken to consolidate the financial system. One major state-owned bank was liquidated while the two remaining ones, which together accounted for over 70 percent of total banking assets, were restructured, recapitalized, and offered for privatization. The supervisory capacity of Albania's central bank was strengthened. In July 1998 the Banking System Law was enacted, which along with the Law on the Bank of Albania passed in 1997 provided the legal framework for banks to operate effectively and for supervisors to perform their responsibilities. Banks with a ratio of non-performing loans exceeding 20 percent were prevented from lending. A functioning Deposit Insurance Agency was created to guarantee deposits of up to US$ 5'000, covering almost 60 percent of the deposits. Although not all regulations were fully implemented, the improvements boosted confidence in the banking system and led to a spectacular rise of the share of domestic currency deposits in total deposits in the following years (IMF, 1999b, 2003a; EBRD, 2002).

To reduce the state's control over the economy, the process of privatizing about 520 SMEs was rapidly completed through sales or liquidations. A new Privatization Law, adopted in March 1998, signaled a change in the government's privatization strategy for large state companies. The emphasis was directed towards finding strategic investors while the use of vouchers was limited to a maximum of 20 percent of the value of each company. However, the implementation of the new strategy was hampered by the lack of interest among foreign investors (IMF, 1999b; EBRD, 2002).

In the key agricultural sector, the land-registration program was accelerated in 1998 as a condition of the IMF's stand-by agreement. Only a small share of real estate had been properly registered thus far. By March 1999, registration was completed in about 40 percent of the country's cadastral zones. By the end of 2000, 96 percent of land titles had been issued to their lawful owners. The swift advance of the registration process led to an increase in property sales, with more than 40'000 transactions reported between 1998 and 2000. However, the program slowed down in subsequent years, and unclear land ownership in major urban and coastal areas continued to hinder economic development (EBRD, 2003).

Despite these notable improvements, Albania was far from achieving a process of self-sustained economic development. The state budget continued to depend on concessional financing of international donors. The public administration suffered from inadequate human, technical and material resources. The informal sector threatened the viability of officially registered businesses, while the inadequate functioning of the judiciary opened the door to widespread fraud and corruption. These shortcomings not only affected the government's capacity to enforce laws and implement reforms, they also undermined the quality of the rule of law, public service delivery, and the effectiveness of public control.

In the early stage of transition, relatively little attention had been paid to these institutional shortcomings. The crisis of 1997 pushed governance issues into the limelight, and showed that macroeconomic and structural measures were not sufficient to bring about sustainable development. As a result, the inadequacy of state structures and the lack of political accountability caught the attention of international assistance programs. Strengthening governance thus became the main concern of the international community.

Under considerable international pressure to reverse the pattern of weak institution-building, a parliamentary commission was established in September 1997 to draft a new constitution. The commission benefited from substantial international assistance in all stages of the drafting process.

In spite of international efforts to address governance issues, Albania remained entrenched in divisive and confrontational politics. The new government was dominated by the conservative fraction of the SPA which had a tendency to maintain the authoritarian governing style of the previous administration, both towards its intra-party rivals as well as towards the opposition. The government persisted in excluding the opposition from the political debate and the negotiation of critical institutional decisions, such as the constitution. In response to this, the DPA boycotted the parliament during a crucial moment of institutional transformation. In the following years, the opposition adopted a disruptive extra-parliamentary strategy by boycotting state institutions, organizing anti-government rallies, and calling for civil disobedience. Albania was thus far away from leaving behind the politics of partisanship and adopting a peaceful framework for competitive politics.

In line with the previous administration, the SPA also tightened its grip over the public sector by undertaking a campaign of political dismissals and appointing political and personal supporters. The politicization of the public sector further undermined any efforts to strengthen Albania's weak state institutions.

The urgent need for governance reform was once more revealed in September 1998, when a prominent DPA member was assassinated at the headquarters of the DPA in Tirana. The assassination triggered violent protests by several thousand DPA supporters during which the parliament, the government building and the national television were occupied. After days of lawlessness, looting, and vandalism, the government succeeded in restoring order. In response to these events, a new government was formed, led by the young and reformist wing of the SPA that wished to see a freer exchange of ideas across political boundaries.

The new administration successfully pushed forward the constitutional reform. The final document, which was adopted by a referendum in November 1998, provided better separation of power between the executive, the legislature, and the judiciary, and fulfilled the requirements for a model European constitution. Although the enactment of the constitution represented an important symbolic victory for the SPA, the party's triumph was tarnished by the ongoing parliamentary boycott of the opposition.

The adoption of a new constitution could obviously not prevent governance malpractices from happening. Many judges continued to be appointed for political reasons while parliamentary deputies faced difficulties in exercising legislative oversight and fulfilling representational functions. Empirical surveys provided evidence that many public officials did not understand their role and responsibilities, and lacked the necessary knowledge about the issues they were supposed to deal with. The surveys further highlighted the high level of corruption in public life. Customs, the courts, and tax offices were identified as the three most corrupt sectors. The underlying causes of corruption were attributed to political interference, lack of trained personnel, low salaries, and poor management procedures (EBRD and World Bank, 1999; ACER, 2002).

In order to overcome these deficiencies, the government initiated a public administration reform with the support of the international community. The goal of the reform was to establish a modern legal framework for the civil service, modernize personnel management, and increase the flexibility of the wage structure. In parallel to these efforts, an anti-corruption strategy was elaborated. In the following years, a cascade of legal and institutional mechanisms were decided with the objective to depoliticize public employment, increase professionalism in the public sector, and crack down on fraud and corruption (IMF, 1999b; ACER, 2002).

However, in 1999 the reform momentum was considerably slowed by the conflict in the FRY and the influx of about half a million refugees from neighboring Kosovo. Although the government successfully led Albania through this difficult period, the crisis further exacerbated political uncertainty and deterred foreign capital from deeper engagement in the country. Political uncertainty was further aggravated by the volatile nature of Albanian politics. Continuing power struggles between conservatives and reformists within the SPA led the prime minister to resign in October 1999. Although the reformist camp succeeded in placing its candidate in the chair of the prime minister, conflicts of power weakened the government's ability to implement reforms.

Efforts were maintained to improve the system of public finance. On the revenue side, an income and corporate tax system was implemented with the objective to strengthen Albania's revenue base and improve the efficiency of tax administration. A new Customs Code was adopted in April 1999 to combat fraud and corruption in the customs area, which generated about 60 percent of Albania's tax revenues. The code imposed significant fines for smuggling and provided the basis for creating an anti-smuggling unit. The code also included measures to apply when corruption of customs officials was detected. On the expenditure side, the introduction of a medium-term fiscal framework in 2000 paved the way for a more strategic and policy-focused budget process. The framework addressed existing shortcomings in the management of budget preparation, coordination between line ministries, budget monitoring and implementation, which had been to some extent responsible for the low levels of public spending on key social services and the depreciation of existing capital assets in the past (IMF, 1999b, 2003a; OECD, 2004a).

Public finances improved somewhat in subsequent years. Total tax revenues increased by a quarter in 2000 compared to 1999, reaching 19.3 percent of GDP. This was the highest ratio of government revenue to GDP reached since 1994. The increase in tax revenues resulted mainly from the implementation of the VAT and the recovery in economic activity. The general government deficit decreased from 12.1 percent of GDP in 1999 to 6.9 percent in 2001. Yet the ineffectual and discretionary application of tax laws and government regulations remained a serious problem in subsequent years, and the resulting tax evasion threatened the continuation of the country's recovery as persistent shortfalls in tax revenue affected investments in basic infrastructure, health, and education (IMF, 1999b, 2003a; OECD, 2004a).

After insistent urges from the international community, the government transferred more political power from the central to the local level in order to improve democratic control, increase citizen's involvement, and bring public services closer to local communities. In 2000, a decentralization strategy was outlined. In a first stage, a package of laws on local financing, physical assets, and local public enterprises was introduced to improve the allocative efficiency of public expenditures, as well as governance and accountability mechanisms. The existing 36 district councils were reorganized into 12 regions so as to downsize and consolidate local administrative units. A National Committee for Decentralization was set up to deliberate on the implementation of the decentralization strategy. However, partly due to the nature of the proposed changes and partly due to resistance from the central government, progress on decentralization was slow (ACER, 2002; OECD, 2004a; World Bank, 2004a).

4.4.4 The Rocky Road to EU Accession

Following the crisis in Kosovo, the European Commission proposed to open a Stabilization and Association Process (SAp) for several countries in the Western Balkans, including Albania. The candidate countries were required to liberalize and restructure their economy, consolidate democracy, implement the rule of law, and undertake comprehensive institutional reforms. In exchange, they were offered access to EU markets, as well as financial and technical assistance. The process also involved the conclusion of a Stabilization and Association Agreement (SAA), which explicitly included provisions for future EU membership. While the EU officially endorsed the SAp in November 2000, Albania was not yet considered to be sufficiently prepared for the process. A joint Steering Group was thus set up to accelerate the pace of integration (Elbasani, 2004).

In June 2001, the SPA carried the parliamentary elections, obtaining 73 seats in the legislature. The Union of Victory, an electoral alliance led by the DPA, only secured 46 seats. Although international observers declared the elections to be free and fair, the Union of Victory rejected the result and announced that it would continue to boycott the parliament.

The electoral victory of the SPA resulted from the strong social and economic recovery Albania was experiencing after the pyramid scheme disaster in 1997. Indeed, the cumulative GDP growth rate was 35.4 percent between 1998 and 2001. During this period, industrial and agricultural output increased by 58.2 and 21 percent, respectively, while average monthly gross wages increased by almost 40 percent. Although Albania's level of employment was still alarmingly low, private sector employment was expanding fast. Moreover, poverty was reduced substantially during this period. The government's achievements in developing closer ties with the EU further boosted support for the SPA. Finally, the electorate still remembered the DPA's implication in the 1997 crisis (IMF, 2005a).

The smooth conduct of the electoral process induced the European Commission to invite Albania to negotiate for an SAA. The decision was made mainly for political reasons since Albania's institutional reform progress did not justify such a step. However, according to the Commission, the perspective of opening SAA negotiations was the best way to maintain the momentum of political and economic reform (European Commission, 2001).

In collaboration with external actors, the government drew up a National Strategy for Socio-Economic Development (NSSED) in November 2001 with the objective to address poverty through a systemic and multidimensional reform. According to the NSSED, one-quarter of the Albanian population, or close to 780'000 individuals, fell below the national poverty line. Poverty was higher in rural areas. About 35 percent of the rural population was estimated to be poor, with 5.2 percent living in extreme poverty. Poverty incidence among younger people was above the national average. Almost half of the country's poor were younger than 21. In rural areas, almost every second child under the age of 5 lived in poverty (Council of Ministers of the Republic of Albania, 2001; World Bank, 2003a).

The NSSED emphasized the necessity to create employment opportunities for the poor, improve quality and access to public services, and empower the poor through stronger public accountability. Specific objectives were to reduce the percentage of the population living on less than two dollars per day from 25 percent in 2002 to 20 percent in 2006. The percentage of the population living on less than one dollar per day was to be reduced from 5 percent to 3 percent. Further goals were to increase real GDP by 25 percent by 2004 and to improve the quality of and access to infrastructure and public services. Government spending allocation for health and education was scheduled to reach 3.2 percent of GDP and 3.7 percent of GDP, respectively by 2004 (Council of Ministers of the Republic of Albania, 2001; World Bank, 2003a).

The implementation of the NSSED was delayed by the resurgence of internal struggles in the ruling party. At the beginning of 2002, the government was forced to step down due to fierce public attacks by senior conservative SPA party members on issues of corruption, electoral fraud, and abuse of power. The ensuing fight for leadership seriously affected government stability and almost led the country to fresh elections. However, a power sharing agreement between the SPA's reformist and conservative wing prevented this from happening.

A new government with a balanced representation of both fractions was formed in February 2002. Under the leadership of a prime minister from the reformist camp, the government succeeded in bringing the DPA back into parliament, electing a consensual president, and cooperating with the opposition in different parliamentary committees.

The focus of the new government was on implementing the NSSED. To this end, the authorities concluded a Poverty Reduction and Growth Facility arrangement with the IMF in June 2002. The specific objectives of the arrangement were to strengthen the integrity and competence of the public sector (particularly the tax administration), improve the business environment, and reform Albania's ailing energy sector. Also in June 2002, the World Bank adopted its Country Assistance Strategy for Albania, which focused on strengthening public institutions, promoting private sector growth, upgrading the infrastructure, and foster human development (European Commission, 2004b).

Despite these notable achievements, the government was forced to resign in July 2002 after severe pressure from inside the party, at which moment conservative members of the SPA definitely took on government leadership. Hopes that this step would end the bitter feuding within the governing party proved vain as power struggles continued throughout the party's term in office. The DPA failed to benefit from the turmoil within the SPA and remained on the margins of political debate (Vickers, 2007).

Albania's difficulties in maintaining political stability and implementing reforms delayed official negotiations for an SAA until the end of January 2003. Regardless of the prospect of signing an SAA, the government's performance in implementing institutional reforms remained lackluster. While reasonable monetary and fiscal discipline was maintained and structural reforms were globally on track with the IMF program (despite some delays in implementation), institutional reforms were limited to amending legislation without substantially improving the quality of the public sector. Organized crime and corruption remained deeply rooted in key areas such as the judicial system, customs and police. The government attempted establishing a series of anti-corruption strategies, but they were largely ineffectual due to strong political interference and weak state capacity (European Commission, 2004b).

The administration carried out a number of measures to improve the business climate. An agency for foreign investment promotion was established in 2002 to improve market access for foreign investors. This measure was followed by the enactment of a Bankruptcy Law and a Competition Law in 2002 and 2003, respectively to ensure the alignment of Albania's legal framework with the EU acquis. However, a serious boost of investments was hampered by the persisting deficiencies of the business-related administrations. The presence of the large informal sector continued to affect the development of a fully fledged market economy. Indeed, formal private sector activity was discouraged by inadequate tax enforcement, excessive permit and licensing requirements, and weak public infrastructure. The weak enforcement of laws and regulations also created a strong breeding ground for informal labor. Widespread use of informal labor contracts and systematic evasion of social security contributions resulted in weaker protection and lower social benefits for the employees. High levels of informality in the Albanian economy further gave rise to a complex system of non-transparent business practices which deterred foreign investors from entering the market (European Commission, 2004b; EBRD, 2004).

In 2002, the government introduced an action plan to address the energy crisis that had erupted in 2000. While the communist regime had made Albania a net energy exporter, the exclusive reliance on hydroelectricity left the country vulnerable to the effects of prolonged drought. Despite expensive imports of energy equivalent to domestic generation, power outages were regularly imposed. The causes at the root of the energy crisis were all directly or indirectly related to Albania's state-owned energy company, KESH. Poor infrastructure led to important technical losses and widespread electricity theft, while weaknesses at the management level encouraged uncontrolled consumption and low bill collection. Energy shortages, disruptions of production, as well as expensive imports of energy represented a serious threat to Albania's social and economic development and put an additional strain on the government budget (Kaser and Tahiraj, 2007).

The government's action plan proposed to increase generating capacity, reduce excessive demand, improve the financial situation of KESH, and eliminate budgetary subsidies by the end of 2004. However, delays in meeting targets were reported as soon as in May 2002, owing to the non-payment of arrears to KESH by water companies. Between 2003 and 2004 the action plan was frequently updated and prices for electricity rose. However, little progress was made on reducing losses by theft, non-payment and technical factors, which continued to cost the company in excess of one-third of its production. Despite strong international involvement, the restructuring of KESH and efforts to attract foreign capital and technology into the electricity sector yielded little tangible results (Kaser and Tahiraj, 2007).

In 2004, the government initiated a series of public service sector reforms which were needed to stop the process of disintegration. Public facilities were old and deteriorating. Many had been severely damaged and looted during the riots between 1991 and 1997. The delivery of public service was poor and unreliable mainly because of the low skill level of the workforce, the lack of supplies and equipment, and poor infrastructure. The lack of standards and effective control mechanisms resulted in low productivity and a waste of resources. The quality of service provision was determined primarily by the amount of money the client was willing to pay. Out-of-pocket payments at the point of service delivery were significant. The public sector also suffered from an inadequate financing system. Service providers were not financially autonomous. They were dependent on conditional grants from line ministries and had no budget to fund even minor expenses. The dependence on external funds resulted in a general lack of accountability for performance and led to stark disparities between poor and wealthy localities (Palomba and Vodopivec, 2001; ACER, 2002; World Bank, 2006a; IMF, 2008a).

In order to improve the quality of public services, the government devised a national education strategy. The strategy focused on strengthening the management and financing capacity of public schools, improving the quality of teaching, and increasing participation of the population. In the health sector, a basic Health Care Law was adopted in 2004, transferring competences and financial responsibility for health care services to the regional level and granting more autonomy to hospitals. However, the implementation of the legal framework was much slower than planned, and public spending in both sectors remained well below the targets specified in the NSSED (Republic of Albania - Ministry of Finance, 2005; World Bank, 2003a, 2006b).

In parallel to these measures, some progress was registered in decentralizing Albania's state structure. Conditional transfers were partially replaced by an unconditional grant distribution mechanism. Moreover, local governments were allowed to levy taxes to fund service provision. Both measures expanded local government revenue and expenditure autonomy. However, full implementation of decentralization remained a challenge due to under-qualified personnel and the lack of proper financial resources (ACER, 2002; OECD, 2004a; World Bank, 2004a).

During the SPA's term in office, the process of institutional reform was slow and many projects remained at a preliminary stage. Albania was far from completing the design of political, administrative and fiscal maturity necessary for EU integration. The implementation of the legal framework was generally uneven because of weak state capacity and opposition to deregulation both at the political and bureaucratic level. Not all ministries were open to the various policy strategies developed in collaboration with outside actors. Where attempts were made to implement institutional reforms, poor coordination between levels of government created conflicting authorities, duplications and inefficiencies. While the government demonstrated its capacity to set up plans and specific institutions, its declarations of intent were usually not followed by concrete actions (OECD, 2004a; World Bank, 2004a, 2006b; Bogdani and Loughlin, 2007).

In spite of these shortcomings, Albania maintained a stable macroeconomic framework with high economic growth and low levels of inflation. The cumulative GDP growth rate between 2001 and 2005 reached 28.5 percent. In the same period, industrial output registered an increase of 55.8 percent. The cumulative growth in agricultural output slowed down to 14.9 percent. Per capita GDP doubled from US$ 1'297 to US$ 2'594.9. Good economic performance was accompanied by a substantial reduction in poverty. The fraction of the population whose real per capita monthly consumption was below the basic consumption basket fell from 25.4 percent in 2002 to 18.5 percent in 2005, lifting approximately 235'000 individuals out of poverty. Extreme poverty decreased from 5.2 percent to 3.5 percent. Health indicators, such as disease incidence and infant mortality, improved and secondary school enrollment increased from 48.4 percent in 2001 to 68 percent in 2006. The improvement in social and economic conditions resulted from the favorable international market developments, the remittances from Albanians working abroad, the stability of the economy, and the good performance of Albania's small private sector (World Bank, 2006e).

In July 2005 parliamentary elections were held. The political credibility of Albania's main political parties had considerably diminished due to the lack of progress in institutional reforms and the high level of corruption in the public sector. Hopes that voters might turn away from the incumbent parties to support reformist candidates who had recently split from the SPA and the DPA did not materialize. The DPA and its allies won 80 seats in the parliament, while the SPA and its allies secured the remaining 60 seats. The new DPA-led coalition government declared Albania's integration into the EU and the fight against corruption as its highest priorities (Vickers, 2007).

The EU considered the parliamentary elections of July 2005 a decisive test in determining Albania's ability to conduct elections conforming to international standards. Although the EU had acknowledged that the elections were generally free and fair, and despite the fact that the SAA negotiations were practically complete, EU officials wanted to assess the new government before definitely concluding the SAA with Albania.

The new government maintained macroeconomic stability in a continuing favorable economic environment characterized by rapid growth, price stability, and large remittances from abroad. The authorities also implemented tax policy reforms which considerably improved government revenues. Tax revenues increased by more than 10 percent in the first half of 2006, and the fiscal deficit was brought down to 3.3 percent of GDP compared with 5.1 percent in 2004. The higher than expected revenues prompted the government to reduce the fiscal burden on business. The corporate tax for small businesses was halved from 3 percent to 1.5 percent. Fees for registering small businesses were also considerably reduced. Customs tariffs on machinery and equipment were eliminated, and social security contributions were cut from 29 percent to 20 percent. Moreover, commercial registration was simplified so that the time scale for registering declined from about 30 days in 2005 to eight days in 2006. Finally, it was decided that registering fees would be equal for foreign and domestic investors (EBRD, 2006).

While these measures improved the business climate, governance problems continued to deter foreign investors. The fight against corruption was led without due regard for constitutional rights and freedoms. Senior officials in the tax, customs and civil service administration were laid off without consideration for their legally protected status of civil servants under the pretext of cutting down administrative operational costs. Despite judicial orders for their reinstatement, accruing vacancies were filled with DPA supporters. Such practices not only caused delays in reform implementation, but also frustration among international partners as they challenged the effectiveness of previous reform measures and raised doubt about Albania's ability to accomplish much needed governance reforms in the near future (Freedom House, 2008a).

Nevertheless, the European Commission decided to conclude the SAA negotiations. The agreement was officially signed on 12 June 2006, and on 1st December 2006 its trade related provisions entered into force. The agreement required Albania to increase its efforts to implement political and economic reforms in order to meet the conditions for future entry into the EU.

4.5 Bosnia and Herzegovina

4.5.1 Initial Conditions

Economic reforms in Bosnia and Herzegovina began as early as 1988. External and internal imbalances as well as unsustainable structural deficiencies induced the government of the Socialist FRY to implement a radical reform program to stabilize and restructure the economy. The program included a restrictive fiscal and monetary policy, the liberalization of foreign trade, the legalization of private companies, and the privatization of SOEs.

The move toward a market economy occurred alongside major political transformations. In the late fall of 1989, the League of Communists of Yugoslavia disintegrated into its republican components, and non-communist parties were legalized. These events encouraged the proliferation of political parties, many of which embraced an explicitly nationalist ideology. The parliamentary elections held in November 1990 were carried out separately in each republic. This fragmentation of the electoral process sealed the end of the central political authority of the FRY.

The disintegration of the federal state strengthened the anti-reform forces in Bosnia and induced them to block the reform measures adopted by the federal government. The parliamentary elections in November brought to power three parties representing each of Bosnia's main ethnic constituencies: the Bosniak Party for Democratic Action (SDA), the Serbian Democratic Party (SDS), and the Croatian Democratic Party (HDZ). A referendum on the independence from the FRY in February 1992 obtained massive support from Bosniak and Croatian voters, and was followed by international recognition (Palmer, 2007).

SDS leaders refused to accept the outcome of the referendum and proclaimed the creation of a Serbian Republic of Bosnia in March 1992. Already in November 1991, Bosnian Serbs had voted in a referendum to remain within the FRY if Bosnia was to seek independence. They armed themselves, and the remnants of the Yugoslav People's Army supported them in their belligerent eagerness to remain part of the federation. The desire to remain within the federal system reflected powerful economic interests. SOEs in the Serbian-dominated parts of Bosnia benefited from generous subsidies from the federal budget; many of them would not have survived if not for this government support. The proclamation of independence and the initiation of war enabled Serbian political and economic decision-makers not only to consolidate their grip on these companies, but also to maintain their political power. The aspirations of the Croatian minority to join the nascent Croatian state followed a similar logic (Gagnon, 2004).

The war broke out in April 1992. The conflict lasted for three and a half years and left the country in ruins. Out of a population of over 4 million, an estimated 250'000 persons were missing or dead at the end of the war in November 1995. More than a million lived as refugees abroad. Over two million people had been internally displaced during the conflict. The war caused widespread damage to infrastructure and productive capacity. One-fifth of the housing stock, two-fifths of hospitals, three-quarters of school buildings and half of the industrial park had been destroyed (World Bank, 2004b).

Before the war, Bosnia's production structure was fairly diversified and closely integrated into the Yugoslav economy. Dominated by heavy industry, the Bosnian economy supplied raw materials and semi-finished products for processing industries in other federal republics. Agriculture represented about 10 percent of GDP. International trade was important, with exports and imports accounting for about 24 percent of GDP and 19 percent of GDP, respectively (IMF, 2000a; World Bank, 2004b).

By the end of the war, the country's economic activity had contracted by about 80 percent from its pre-war level. The annual per capita GDP had shrunk to just about US$ 500, from US$ 2'446 in 1990. Bosnia's physical infrastructure was largely destroyed. War-related disruptions left plants and machinery severely outdated. Enterprises found themselves isolated and without traditional local and international markets. Know-how was lost through emigration and internal displacement of the labor force. Consequently, the industrial output fell to 5–10 percent of its pre-war level. Agricultural activity practically came to a standstill. The rate of unemployment was estimated at 70–80 percent (IMF, 2000a; World Bank, 2004b).

The signing of the Dayton Peace Agreement in December 1995 officially brought the war to an end. The constitution adopted as part of the Dayton agreement gave the state a highly decentralized governmental structure. Bosnia remained a single state within its internationally recognized borders, but was internally reorganized into two entities: the Republika Srpska (RS) and the Federation of Bosnia and Herzegovina (FBiH). The RS had a relatively centralized government structure in terms of both revenue and expenditure assignments. By contrast, the FBiH had a decentralized structure, with the responsibility for public services devolved to 10 cantons and 82 municipalities. The responsibilities of the central government were constrained in many areas, from monetary and exchange rate policy, external borrowing and debt service, to foreign trade and customs tariff policy. Functions not explicitly assigned to the central government, including those for defense, resided with the country's two constituent entities or their sub-units (IMF, 2000a).

The institutional framework established by the Dayton Peace Agreement was not conducive to the development of a market economy. The constitutional set-up divided the country into a loose system of highly-autonomous regions and accomplished the process of political, economic, and ethnic fragmentation which had taken shape during the war. This fragmentation was to dominate policy-making in Bosnia in subsequent years. Moreover, since the economy was almost under exclusive administrative control of the respective jurisdictions, the lack of appropriate checks and balances encouraged the misuse of public resources, nepotism, and corruption. No other country in SEE had to begin market reforms under initial political conditions as complex as those in Bosnia.

4.5.2 The Travails of Reconstruction

Bosnia's development priorities in the immediate post-war period were determined primarily by the requirements of reconstruction. The establishment of a market economy was identified as a medium-term priority to be implemented once the basic infrastructure and institutional prerequisites for the normalization of economic activity were in place (Bojicic-Dzelilovic et al., 2004).

The international community launched a reconstruction program to restore basic public services and rebuild damaged housing units, energy supply systems, and transport and water infrastructure. To this end, approximately US$ 5.1 billion was disbursed between 1996 and 1999. The inflow of multilateral and bilateral financial assistance considerably improved the economic situation in Bosnia. By 1999 the reconstruction program had repaired a third of the housing. Most urban infrastructure had been restored to pre-war levels, from telephone lines to electric power generation, from water services to schools and health centers. As a result of the international involvement, the initial post-war growth rate was very high at 86 percent in 1996 and 37 percent in 1997, before falling to more normal levels in 1999. The pickup in economic activity was stronger in the FBiH than in the RS, owing mainly to the Federation's greater access to foreign aid. Assistance had been initially withheld from the RS due to the government's involvement with indicted war criminals. Despite significant economic improvements, Bosnia's GDP level in 1999 was only at about half of what it had been in 1990 (Cox, 2001; World Bank, 2004c).

Despite its overall satisfactory record, the reconstruction program also had its drawbacks. Bosnia's reconstruction was an operational challenge for the international community. For as long as the central state structures remained weak, international agencies had no choice but to cooperate with nationalist leaders who continued to dominate the political market in sub-national jurisdictions to ensure a rapid and uncomplicated delivery of assistance. Governance concerns were relegated to the background. Nationalist leaders were given control over significant financial and material resources without having to implement the constitutional provisions stated in the Dayton Peace Agreement. Nationalist parties thus benefited economically by providing goods and services to international agencies. They also benefited politically by selecting the beneficiaries of international aid. This way of proceeding tended to consolidate Bosnia's political and economic fragmentation (ESI, 1999, 2000).

As long as existing ethnically-based power structures were not affected, Bosnia's main political parties were willing to work with the international community. But as soon as objectives were placed on the reform agenda that could weaken their political and economic power, international efforts were met with strong domestic resistance. As a result, confrontations became more frequent as the goals of the international community broadened to include the return of minorities, the implementation of economic reforms, or the establishment of stronger state institutions (Cox, 2001).

In contrast to the expectations of the international community, the short 2-year electoral cycle did not bring about the anticipated political change. Instead, the elections consistently returned nationalist wartime leaders to power. These actors were largely independent from formal constitutional authority. They had direct control over political parties, intelligence services, security forces, and management boards in public utilities and SOEs, giving them access to various sources of political and economic power. Each of the ethnic groups maintained separate public finances, public utilities, pension funds, armies and police forces. Monetary policy was fragmented into three regional arrangements, operating with the Bosnian dinar, the Croatian kuna, and the Yugoslav dinar. Complex systems of bureaucratic licensing ensured that political contacts were needed for any commercial activity. Pensions, social benefits and the distribution of humanitarian aid were all subject to more or less overt political manipulation. Against this background, nationalist leaders had every incentive to oppose policies and institutions which they could not be sure of controlling (IMF, 2000a; Cox, 2001).

The international community gradually extended its mandate beyond the use of traditional diplomatic techniques in response to the nationalist parties' unwillingness to engage in a constructive political dialogue. At a meeting in Bonn in December 1997, the Peace Implementation Council (PIC), which was responsible of overseeing the implementation of the Dayton Peace Agreement, granted extraordinary powers to its executive arm in Bosnia, the High Representative. These powers, often referred to as the 'Bonn powers', resulted in the domination of Bosnian politics by the High Representative (Bartlett, 2008).

The adoption of the Bonn powers gave the High Representative unlimited authority to dismiss obstructive public officials and to impose laws at any constitutional level. These powers were routinely and increasingly used to promote legal and economic goals, and to overcome sources of political obstruction. Most of the important decisions in the Bosnian transition process can be traced back to the use of the Bonn powers, or the threat thereof. Out of a total of 815 decisions taken by the High Representative from 1997 to 2006, 262 were related to constitutional, state-level, or judicial issues. 89 decisions were related to the economic field, while in 170 cases public officials or political parties were either dismissed or reinstated. While the High Representative imposed on average four decisions per month between 1997 and 1999, this figure more than tripled between 1999 and 2006. The growing willingness to decide on behalf of Bosnia's elected public officials reflected the High Representative's fading hopes of being able to hand over the political and economic reform agenda to local policy makers in the near future.

4.5.3 The Limits of External Intervention

In June 1997, the state parliament endorsed a set of economic laws on the central bank, the fiscal budget, external debt, trade, and customs tariff policies. This so-called 'Quick-Start Package' was implemented only after long delays, owing to a political crisis that emerged in the RS in the summer 1997.

The crisis was the outcome of a power struggle between radical and moderate forces within the SDS, more specifically between the first elected president of the RS, Radovan Karadzic, and his successor and protégée Biljana Plavsic. Pressure from the international community forced Karadzic, who had been indicted for war crimes, to resign his post in July 1996. Plavsic, who took over the presidency, soon turned against her mentor whose supporters were responsible for blocking the implementation of the Dayton treaty. Important economic interests were at stake as the clique around Karadzic had created a profitable contraband network that was put at risk by the implementation of the Dayton agreement. The crisis lasted throughout the summer and autumn of 1997.

Parliamentary elections in the RS were held in November 1997 to resolve the crisis. The elections brought to power a new coalition government, led by the relatively moderate Party of Independent Social Democrats (SNSD), which agreed to implement economic reforms. The SDS was subsequently isolated by the High Representative through sanctions and pressure. This enabled the authorities to adopt a country-wide economic program, based on the observance of cautious macroeconomic policies, the rebuilding of public administration, and market-oriented structural reforms (IMF, 2000a; Bartlett, 2008).

Following the resolution of this crisis, inter-entity cooperation and the functioning of central state institutions somewhat improved. Having experienced wartime hyperinflation, both entities made monetary stability their main priority. In May 1998, an ambitious macroeconomic reform program was adopted, supported by an IMF stand-by arrangement. The centerpiece of the program was a currency board arrangement, as mandated under the Dayton treaty. The choice of a currency board arrangement for the immediate post-war period was motivated by the necessity to restore trust, to allay concerns about the lack of administrative capacity, and to promote the role that transparency played in improving fiscal discipline. For these reasons also, the central bank was placed under international control. In June 1998, the central bank issued a new domestic currency, the convertible mark, to replace the Bosnian dinar. The convertible mark was pegged to the German mark at a fixed exchange rate. In September 1999, the convertible mark became the only legal means of payment in both cash and non-cash transactions (IMF, 1998, 2000a; Bartlett, 2008).

The central bank's monetary policy throughout the transition period remained prudent. Consumer price inflation in the Federation dropped from 5.1 percent in 1998 to -0.9 percent in 1999, and remained low thereafter. In the RS, consumer price inflation remained in the double digits until 2000, but decreased markedly in the following years.

The adoption of the currency board system was backed by a comprehensive reform of Bosnia's financial system. Unlike in other transition countries, the implementation of financial sector reforms did not meet any major obstacles.

Bosnia's financial sector had so far been dominated by the payments bureaus that had a monopoly on clearing banking payments, collecting and processing tax revenues, and maintaining public sector accounts. The presence of payments bureaus impeded the development of a banking sector capable of financial intermediation. Since the payments bureaus were capable of creating credit, they also threatened to undermine the currency board arrangement (ESI, 1999).

The lack of public confidence following failures of some banks in the post-war period further constrained development of the banking sector. There were about 60 banks operating in Bosnia in 1998. Assets were heavily concentrated in a small number of majority-owned state banks. Many of these banks were in a weak financial condition, burdened with bad loans and foreign currency-denominated liabilities that could not be serviced or repaid. Non-performing loans accounted for almost 80 percent of total loans in 1998. Bosnia's private banks, which had been established during or after the war, were too small and undercapitalized to meet the deposit and lending requirements of a recovering economy (IMF, 2000a; Bojicic-Dzelilovic et al., 2004).

To address these problems, the reform strategy prepared by the authorities in collaboration with the international community consisted of dismantling the payments bureaus and replacing them with a sound private banking system. To this end, the existing banking sector had to be strengthened through liquidations of insolvent banks, privatization of state banks, improvements in the regulatory framework, as well as enhanced bank supervision. The reforms were to be implemented separately in each entity (IMF, 2000a).

A number of institutional and regulatory reforms were rapidly enacted to create the legal basis for banking operations and bank privatization. Supervising agencies were established in both entities in order to monitor the banking sector, while special privatization units carried out the privatization program. Banks had to be declared solvent on the basis of their audited balance sheets in order to qualify for privatization. The privatization plans had to be approved by the privatization units and the respective ministries of finance. Insolvent banks had their banking license revoked, while solvent ones were prepared for privatization (IMF, 2000a).

Both entities made good progress in payments system reform, and by 2000, the payments bureaus had been dismantled. In contrast, progress in bank privatization was relatively slow in the beginning. The opening of balance sheets to the bank privatization unit and completion of the solvency tests were delayed in both entities. Consequently, the sale of banks, scheduled to begin during the fall of 1999, only started in 2000. Nevertheless, about 94 percent of total asset shares in Bosnia were in private hands by 2002. 76.7 percent of total assets were held by foreign banks. Strengthening control and supervision of banking operations initiated a process of consolidation, and by 2002, the number of banks had been reduced to 40 (EBRD, 2003, 2006).

The high number of private foreign-owned banks significantly increased competition in the banking sector. Competition was further encouraged by allowing banks from one entity to open branches in the other, with the result that interest rates steadily decreased over the following years. Confidence in the banking system was increased by establishing a state level deposit insurance agency in August 2002, followed by the introduction of mandatory deposit insurance for all banks in 2003. Bosnia's financial sector remained robust and stable in the following years, sparing the population from the disastrous consequences of a banking crisis as experienced in Albania or Bulgaria (EBRD, 2003).

Efforts to liberalize the trade regime in the Federation had started as early as 1996, when quotas, taxes, tariffs and special licenses for exports were gradually removed. In the RS, export and import quotas and taxes remained in place until the Foreign Trade Law was adopted by the state parliament in 1998. The law introduced a liberal trade regime and ensured free movement of exports and imports without quantitative restrictions (Bojicic-Dzelilovic et al., 2004).

The impact of the law on Bosnia's business environment was modest. While exports picked up in the following years, the increase was relatively small. Imports, on the other hand, surged and contributed to the huge trade and current account deficits that Bosnia was experiencing throughout the transition process. The country's current account deficit had been around 25 percent of GDP before falling to 8.5 percent of GDP in 1998. In 2000, the deficit rose to 16.4 percent and remained at a high level in subsequent years. The deficits were covered by grants from the international community (Bojicic-Dzelilovic et al., 2004).

Bosnia's weak export performance reflected the country's deep structural constraints that impeded economic development. Structural deficiencies affected all areas of the economy. The state lacked a unified economic space, a harmonized legal environment, clear administrative procedures for new investments, such as labor and tax regulations, and an efficient judicial system. Instead, discretionary administrative intervention in the economy limited the development of the private sector and encouraged corruption. Hence, the challenge facing the authorities was to press ahead with structural reforms so as to promote a sound business environment and private sector-led development (EBRD and World Bank, 1999; Fries et al., 2003).

The establishment of a new fiscal system was at the core of the reform priorities. Bosnia's fiscal system was a direct outcome of the model of political organization the Dayton Peace Agreement had created. Revenue rising powers resided with the entities while the central government and municipalities largely depended on entity transfers. The assignment of revenue sources and expenditure responsibilities was mismatched and caused inefficiency, policy incoherence, and competition for resources. Separate tax administrations and non-harmonized tax legislations made fiscal policy coordination between the two entities difficult, and resulted in opportunities for tax distortions. These distortions destabilized the structure of domestic taxes and impeded the development of a unified domestic market (IMF, 2000a; ESI, 2001).

Bosnia's federal structure represented a major source of fiscal pressure. Expenditures as percentage of GDP exceeded 55 percent in 1998 and 1999. Public spending was concentrated on defense, veteran and disability benefits, and public-sector wages. Bosnia's extremely high social fund expenditures reflected the country's unfavorable post-war demographic structure, as a large proportion of the working-age population had left the country and a large share of the population had become disabled. Sustained high unemployment further contributed to the outflow of young people, placing substantial pressure on the pension, health, and unemployment funds. While the disproportionately high level of government transfers to war invalids reflected the large number of war victims, entitlements for these groups were also particularly generous compared with those of other vulnerable groups. Public sector spending, such as health and education, was low, owing mainly to substantial off-budget donor assistance in these areas (IMF, 2000a).

High levels of government spending imposed an oppressive tax burden on the country's economy. In 1998, tax revenues accounted for 92 percent of Bosnia's consolidated government revenue. The largest revenue items were sales taxes and excises, accounting for 37 percent and 17 percent of total tax revenue, respectively. The high level of and the complicated administration of sales taxes had a negative effect on taxpayer compliance. Income tax revenues were relatively small, accounting for about 17 percent of total revenue. In both entities, the main source of income tax revenue was the wage tax. The cumulative tax burden on an average worker's gross income was about 55 percent, the bulk of which was due to social insurance contributions. The high tax rate on labor entailed great incentives for tax evasion, thereby eroding the contribution base for the social insurance funds. All in all, the fiscal burden gave rise to a large informal economy and undermined private investment (IMF, 2000a).

Aware that these developments were detrimental to the business climate, the entity governments requested international assistance to develop a simple and transparent tax system. The fiscal reform strategy envisaged to rationalize and lower taxes and social contributions, reduce spending on defense, and streamline the complex government structure. Also, the harmonization of economic policies, such as tax and labor regulation, in the two entities was considered crucial for the establishment a unified economic space (IMF, 2000a).

The first attempts to reform Bosnia's fiscal system occurred in 1999. A unified tariff policy at the state level was enforced, and sales taxes between entities were partially harmonized. An agreement was reached on aligning excise rates between entities and between imported and domestically produced goods. In the Federation, tax policies of the Croat and Bosniak areas were unified, and corporate income tax and social insurance contribution rates were reduced (IMF, 2000a; Bojicic-Dzelilovic et al., 2004).

In spite of these measures, the tax system remained complex and arbitrarily enforced. The fiscal system continued to suffer from high tax burden on labor income, remaining inter-entity tax differentials, a narrow tax base, and low compliance. General government spending in Bosnia remained high by regional standards and fiscal imbalances continued to threaten the sustainability of growth.

Privatization of SOEs was identified as a priority for reducing government spending and improving the business environment. Some privatization had already occurred under the SFRY Law on Socially Owned Capital, but the process was stopped by Bosnia's authorities at the beginning of the war (Gagnon, 2004; Bartlett, 2008).

Bosnia's corporate sector was dominated by a small number of large SOEs. Although less than 10 percent of enterprises in Bosnia were publicly owned, SOEs accounted for about 65 percent of total output. Similar to other transition countries, public ownership had led to a situation in which management boards had more incentives to maximize wages and company indebtedness than to generate profits. This type of economic environment was not conducive to a vibrant private sector (IMF, 2000a).

While initial conditions were unfavorable, policy choices in the post-war period exacerbated the situation further by treating SOEs as a social safety net. Following the demobilization of military forces in 1996, state companies were pressed to rehire their former employees. Alongside, labor regulations required employers to grant generous wage and benefit packages to their employees. Since SOEs were operating at a fraction of their original capacity, they were unable to bear the associated increase in labor costs. By further requiring SOEs to clear all unpaid wage and social insurance contribution arrears prior to dismissal, labor regulations effectively prevented SOEs from laying off labor (IMF, 2005b).

While privatization laws had been in preparation since 1996, political opposition at the entity level delayed their implementation. After long delays, the High Representative forced through a state-level Privatization Law in August 1998. The entity parliaments subsequently adopted a number of laws that established a sound legislative and institutional privatization framework. Privatization Agencies were established on entity and cantonal levels (IMF, 2000a).

Privatization was based on the distribution of vouchers to the population. The objective of this approach was to settle the large outstanding debts of the respective entity governments against their citizens. The vouchers covered claims related to frozen foreign currency deposits, unpaid wages of soldiers, unpaid pensions, and restitution of property. The vouchers could be used to acquire shares in companies or to buy state-owned apartments, or they could be invested in Privatization Investment Funds which were allowed to invest in enterprises. SOEs could also be sold by public tender to the employees as an insider privatization, or to foreign investors (IMF, 2000a; Bartlett, 2007).

The results of the privatization process were modest. Small-scale privatization started in 1999, and by the end of 2003 about 78 percent of the companies in the Federation, and 55 percent in the RS, had been privatized. The outcome of large-scale privatization, and in particular the sale of strategic enterprises, was even more disappointing. Out of a total of 108 strategic companies, only 19 had been sold by 2003. No significant progress was made in subsequent years. All in all, Bosnia's private sector share in GDP was estimated at about 50-55 percent. Obstruction by vested interests, disagreements between foreign experts providing technical assistance, as well as the lack of knowledge of local actors led to substantial delays. Many tenders were subject to interference from line ministries. When tenders failed, it was not uncommon for the entity authorities to engage into one-on-one negotiations with potential investors. Anticipating this, investors tended to wait until the tenders failed to enter the process of negotiation. This way of proceeding encouraged corruption and undermined the whole privatization process (EBRD, 2003; IMF, 2005b).

Privatization did not achieve the twin goal of easing the fiscal burden of the state and developing a market economy based on private property. Governments retained control over privatized companies through shares that had been transferred to state funds. There was little political will to enforce hard budget constraints, and private investment funds were ill-equipped to carry out corporate restructuring. Bankruptcy procedures were ineffective in the Federation, and non-existent in the RS. This led to a build-up of arrears and encouraged a barter system of trading among enterprises. Unconditional debt write-offs and re-schedulings prolonged the life expectancy of unprofitable companies and reduced the profitability of others. As a result, large enterprises remaining in state hands failed to restructure while privatized ones continued to suffer from poor corporate governance (IMF, 2005b).

Efforts to remove systemic barriers to employment were limited. The labor laws applying in Bosnia reflected the legacy of the former socialist system, with generous benefits, high payroll taxes, and significant rigidities in hiring and firing procedures. On the initiative of the World Bank, a number of new labor laws were prepared by the state parliament at the beginning of 2000. The package included the reduction of severance costs, more flexible provisions on fixed-term contracts, and less restrictive provisions on canceling employment contracts. Implementation was delayed, however, because the specified severance payment was too high for the majority of enterprises. Due to the inability of the entity parliaments to come to a decision, the High Representative imposed the laws in late 2000. However, the high level of labor taxation, the lack of harmonization among pension and health insurance systems, and the limited portability of benefits across entities and cantons continued to discourage employment creation and labor mobility (IMF, 2005b).

International actors also undertook considerable efforts to improve the quality and financial sustainability of health care provision. Health care reform was initiated with the adoption of the Health Care Law and a Health Insurance Law in 1997 and in 1999 in the Federation and the RS, respectively. A Strategic Plan for a comprehensive health system reform was developed to allow better exploitation of economies of scale in the delivery, financing, and administration of service provision. Health insurance funds were established in both entities. The funds were financed by a portion of the social contribution tax levied on payrolls. An inter-entity and inter-cantonal agreement was signed in December 2001, allowing the population to access health services at the place of residency regardless of the source of contribution. Moreover, a health information system was developed, providing the authorities with information about revenues, sources and application of funds, and health expenditures (Cain et al., 2002).

Although reforms in the health sector made some progress, social insurance contributions were not sufficient to cover health care expenditure. The payroll base remained narrow due to several factors including the under-collection from formal public and private enterprises, a high exemption rate, and the fact that the government could not define a working tax base for rural workers. Harmonization and coordination within the sector remained insufficient. The health information system and system of supervision did not provide reliable data and were thus of little use (IMF, 2007a).

With the exception of the health sector, no major efforts were made to improve the quality and financial sustainability of public services. Overall, the quality of the public sector remained low. As the responsibility of public service provision was shared among different jurisdictions, often without any clear financing and coordination arrangements, the resulting institutional and functional overlaps generated an inconsistent service delivery, high overall administrative costs, and confusion over the size of public spending. The public sector was so opaque and fragmented by narrow national interests that it was impossible for service users to find out whom to hold responsible for problems of access, provision, and quality of outcome. The administrative fragmentation thus opened the door to corruption and political patronage. Informal payments for supposedly free services were widespread. Fragmentation also led to significant disparities in the resources available for public services. Variations of 200–300 percent in real public service expenditures were registered between administrative units. These disparities were not addressed as there was no equalization mechanism by which poorer areas of the country could receive funding transfers from areas that were economically better off. This situation was particularly serious for the estimated 19 percent of the population that were living below the country's poverty line in 2001 (World Bank, 2003b; UN, 2004).

The overall outcome of the transition process was relatively disappointing up to this point. The international community's financial engagement was not matched by a similar commitment to reform by the authorities. Hopes that elections would produce a fully integrated, multi-ethnic democracy were dashed. The dominant nationalist parties continued to obstruct and delay the international community's efforts to build a functioning state.

Since any form of government above the local level required cooperation between highly antagonistic interest groups, finding a common denominator was complex if not impossible. Consensus building was further complicated by the excessively decentralized structure of the Bosnian state, the proliferation of weak institutions, complex decision-making procedures, and the incentives for nationalist leaders to build purely ethnic constituencies. This was not a political system where a single party commanding a majority in the parliament took on executive power until the next elections, consigning all other parties to embrace the role of loyal opposition (ESI, 2002).

Instead, the three nationalist parties—the SDA, the HDZ, and the SDS—maintained authoritarian power structures in their respective territories through their monopoly on violence and their control of the informal economic activity. They had an intrinsic interest in preserving the conditions on which their power was based: deep ethnic division, fear and insecurity among the population, absence of the rule of law and democratic accountability, and personalized control over public institutions (ESI, 1999).

Consequently, the Croatian and Serbian populations retained an enclave mentality and a high degree of homogeneity. With the exception of the 1997 elections in the RS, there had been no serious challenge to the authority of nationalist parties. Although the division of the war-time political establishment in the RS resulted in shifting coalitions and recurring crises, political leaders were still able to present a high degree of unanimity when they came to deal with external actors.

By contrast, the Bosniak power structures were more fragmented. Its war history and its strategic interests had led the SDA to commit to a unitary state of Bosnia and to cooperate more closely with the international community. The SDA also displayed a greater diversity of opinion within its ranks, including supportive and opposing views regarding the implementation of the Dayton Peace Agreement. The isolation of Bosniak pockets from each other during the war had created localized power structures which were formally part of the SDA, but acted with a high degree of autonomy. Although the fragmentation of the SDA encouraged political pluralism, it also tended to promote the development of authoritarian power structures at the local level (ESI, 2001).

The lack of domestic consensus on the goals of the political and economic reform process thus consistently ended in a deadlock. Pressing problems, such as severe fiscal deficiencies, high unemployment, inability to meet social obligations, were remarkably absent from the domestic political debate. As international financial assistance was expected to drop in the following years, the Bosnian public grew increasingly concerned about the question of economic security (ESI, 2001, 2002).

While the extension of political powers enabled the High Representative to resolve the impasse in several areas, the frequent use of these powers did not encourage the establishment of a self-sustainable, democratic state. Instead, it created an unhealthy form of symbiosis in which political parties became accustomed to outsourcing politically sensitive decisions to the Office of the High Representative. Yet when it came to implementing the new policies and procedures, the common experience of the High Representative was often one of powerlessness. As local acceptance on reform issues was often gained by resorting to pressure tactics, the subsequent implementation process was characterized by its slow pace and the lack of genuine local commitment.

4.5.4 The (Not So) Tempting Bait of European Membership

Optimism about reform prospects was raised by a number of political changes that took place in 2000. Following the electoral defeat of its sister party in the Croatian general elections in January, the HDZ abruptly lost the political and financial support of the Croatian government for its hardline nationalist policies. Similarly, the deposition of the Milosevic regime in Belgrade in October somewhat weakened the position of the hardliners in the RS. These events laid the ground for the victory of the Alliance for Change coalition at the state level in the November 2000 general elections. The coalition of ten moderate parties was led by the non-ethnically based Social Democratic Party of Bosnia and Herzegovina (SDPBH) that pledged to rebuild the country as an integrated, multi-ethnic state (European Commission, 2003b; Palmer, 2007).

The attempts of the international community to bring about a new era of cooperation with the moderate political forces were undermined by ongoing clashes with the nationalist-led entity governments. In 2001, the HDZ attempted a forced take over of the civil administration and the Croatian component of the Federation army in Croatian-held cantons. The Office of the High Representative responded vigorously to this attempt by removing several senior HDZ members from power. In the RS, the November 2000 elections had given the majority to the SDS. The moderate SNSD had suffered a devastating defeat despite considerable international support. Although the SDS claimed that it had reformed and that it would respect the Dayton accords, the international community insisted that aid to the RS was conditional on the SDS's exclusion from the entity government. A minority government was formed in January 2001 with the informal support of the SDS, helping the party to maintain control over government organs and state-owned companies (Palmer, 2007).

The efforts of the Alliance for Change to improve the functioning of common institutions at the state level met with only limited success due to the opposition from the entities. In response to the lack of progress towards greater national reintegration, the High Representative imposed constitutional amendments in April 2002 to ensure that all Bosnians, regardless of ethnicity, would be represented at all levels of government and public administration in both entities (Palmer, 2007).

The hope for change was definitely dashed when moderate Bosnian authorities suffered a reverse in the October 2002 elections. With the Alliance for Change weakened by internal conflicts, the SDP emerged from the elections with reduced support. In turn, the SDA, the HDZ, and the SDS regained the upper hand in Bosnia's legislatures. Despite their pledges to work alongside the international community in implementing the reform agenda, nationalist leaders continued to engage in obstructive and delaying tactics. The main impetus for reform thus came from external actors (Palmer, 2007).

As the post-war reconstruction program was coming to an end, the international agenda shifted towards meeting the requirements for Bosnia's integration into the EU. In May 1999, Bosnia had obtained the promise of being included in the SAp, along with other countries in the Western Balkan. The SAp offered financial and economic assistance, a preferential access to the EU market, cooperation in the area of judiciary and home affairs, and a new type of contractual relations—the SAA, giving the country a potential candidate status. In return, Bosnia had to follow an agenda focusing on a limited number of relevant reforms covering political, economic and democracy-related areas. In 2000, the EU 'Road Map' had identified the first concrete political measures on this journey. The goal of these reforms was to strengthen Bosnia's central state institutions in order to improve government decision-making. Although the adoption of the proposed amendments was not a formal condition for the completion of an SAA, EU officials clearly stated that they considered constitutional change necessary if the authorities wished to finalize the agreement. A joint consultative task force was charged with monitoring the fulfillment of the reform measures set out in the Road Map. As the Road Map seemed to enjoy wide support among Bosnian authorities, its implementation was thought to be a short-term exercise. However, completion of the Road Map was only achieved in September 2002—more than one year behind schedule (European Commission, 2003b; Solioz, 2007).

Following the completion of the Road Map, international pressure increased to adopt reforms to strengthen the state authorities at the expense of the two entities. Despite strong opposition from Serbian parties, the High Representative increased the powers of the state council of ministers as a real executive authority in December 2002. The next steps of the reform agenda consisted of satisfying the requirements imposed by the

European Commission in November 2003, which had to be fulfilled before negotiations opened over an SAA. These requirements entailed an adjustment of the Dayton constitutional framework so as to enable Bosnia's institutions to function more effectively (European Commission, 2004c).

With pressure on them mounting, the nationalist parties were compelled to allow SAA reforms to progress. A key priority was defense reform, which involved bringing the entities' armed forces under state control. Following increased pressure from the High Representative in spring 2003, Serbian policy makers, who had vigorously opposed the merger of the entity armies, reluctantly agreed to a state-level, civilian-controlled command structure for the armed forces. In December, a new state-level defense ministry was established, and Bosnia's collective presidency was designated as the country's supreme military commander. A number of legislative acts were approved in March 2004, which provided for a state-level intelligence and security agency. In August 2005, a single, unified armed force replaced the entity-level armed forces—but only after heavy international pressure had been exercised (Palmer, 2007).

The reluctance of Serbian authorities to take action against war criminals and implement police reforms caused a great deal of contention. Due to the uncooperative attitude of the Serbian authorities, SDS bank accounts were frozen in April 2004. In the following months around 80 Serbian officials, mostly from the SDS, were removed from public positions due to their alleged assistance to war criminals, albeit with little tangible success (Palmer, 2007).

As with defense reforms, the motivation of the international community in insisting on police reform was to strengthen the authority of the central government. Failure to move forward with the police reform became the major stumbling block for opening the negotiations on the SAA. The RS authorities had rejected international drafts on police reform in May and September 2005. In October, after the reform proposals had been approved by other prominent parties in the RS, the SDS-led government was forced to cave in. The SDS's acceptance of the reform draft was achieved only after the party's bank accounts had been frozen again, and fraud investigations had been opened against leading party members. Later in October, the state parliament approved the police reform, which allowed negotiations on an SAA to be opened in November 2005 (Palmer, 2007; Solioz, 2007).

Prospects for meeting the conditions for EU integration faded during 2006 owing to mounting political instability. After several of its members had been removed in 2004, the SDS government had managed to mobilize political support from a number of smaller parties in the RS parliament. However, the coalition was weak and unstable. In January 2006, the coalition collapsed following a vote of confidence. The SDS's defeat reflected the party's decreasing popularity as its leaders were considered to be too subservient to the international community. Enthusiasm among international officials about the SDS's defeat rapidly diminished as the moderate SNSD used increasingly hard-line rhetoric regarding RS sovereignty in an attempt to improve its chances in the run-up to the October 2006 general elections. A number of incidents in the months prior to the elections rekindled inter-ethnic tensions, and contributed to one of the most incendiary electoral campaigns since the end of the war. The political tension dashed the PIC's plans to close the Office of the High Representative by mid-2007. Together with the delay in the implementation of political and economic reforms, it also considerably lowered Bosnia's prospects for meeting the requirements for EU integration. In November 2006 the European Commission issued a critical report, listing a number of political and economic shortcomings that had to be fixed before an SAA could be signed (European Commission, 2007a).

The international community's focus on state-building relegated economic reforms to the background. Bosnia's ownership of economic reform thus remained limited. In the areas where progress was achieved, international initiative, input and pressure was crucial. The international community was responsible for pushing forward the adoption and implementation of reforms, notably by drafting the majority of laws—usually with only minimal participation by Bosnian officials. Inadequate domestic political will and capacity inevitably had an adverse impact on the outcome of adopted reforms.

The most positive outcome was achieved in the area of macroeconomic stabilization. The authorities maintained price stability and achieved considerable fiscal consolidation under successive IMF stand-by arrangements. The currency board arrangement, which was initially scheduled to last until 2003, was extended due to ongoing political tensions (European Commission, 2004c).

In 2000 and 2001 entities experienced serious fiscal imbalances as the authorities allowed public sector wage and pension arrears to build up. A crisis was avoided by yet another intervention of the international community. With the technical assistance provided by the IMF and the World Bank, the authorities established a modern treasury system in both entities. Government spending was drastically cut, and the annual rate of government expenditure as a share of GDP fell from 54.4 percent in 2000 to 39.9 percent in 2003. This level was maintained in subsequent years. The reduction was achieved mainly by reducing pension entitlements to affordable levels, thereby ending the accumulation of pension arrears. A start was also made in clearing pension arrears accumulated in the past (IMF, 2005b; Werner et al., 2006).

Improvements were also registered in tax collection. Responsibility for indirect taxation was transferred from the entities to the state in order to make central institutions financially independent. This resulted in the establishment of the Indirect Taxation Authority (ITA) in 2003. The ITA incorporated a unified customs structure and worked in close cooperation with European officials on the implementation of the VAT, scheduled for 2006. The establishment of the ITA was an important step in strengthening the country's fiscal coordinating mechanisms. The introduction of the VAT at the beginning of 2006 contributed to increasing government receivables to around 45 percent of GDP in 2006. As a consequence of these measures, the overall fiscal balance moved from a deficit of 4.2 percent of GDP in 2002 to a surplus of 2.6 percent in 2006 (Werner et al., 2006).

Despite these achievements, ongoing conflicts over the allocation of tax revenues revealed the ineffectiveness of Bosnia's fiscal coordination mechanisms. The country lacked a central institution able to set, execute and monitor a sound and coherent fiscal policy.

Existing institutional gaps were filled by the IMF. In 2005, a consensus was reached on the establishment of the National Fiscal Council, charged with the coordination of tax matters over the medium- to long-term. However, due to resistance against further centralizing fiscal policy functions, the National Fiscal Council Law was not enacted for several years (IMF, 2004a, 2005b; European Commission, 2007a).

Despite some improvement in macroeconomic performance, Bosnia's productive capacity remained weak. Real GDP growth averaged 5 percent between 2002 and 2006, mainly reflecting a favorable external environment. In the same period, industrial output expanded by 34.4 percent, driven by increasing export volumes and high international prices for metals. However, the increase in exports could not compensate for the high level of imports. The average current account deficit thus remained stubbornly high at 18 percent of GDP between 2002 and 2005, as FDI and remittances were not sufficient to compensate for large trade deficits. The current account deficit was reduced to 8.5 percent of GDP only in 2006.

Nevertheless, the lack of structural reforms and the strong influence of the nationalist parties on the economy hindered the efficient allocation of resources through market mechanisms. In 2003, under the pressure from the High Representative, the entity governments pledged to revive the privatization process, but limited progress was recorded in subsequent years. As a result, the private sector's share in GDP remained at around 55 percent in 2006. In that year, the first, hesitant measures were taken to liberalize infrastructure, energy, and telecommunications networks (European Commission, 2007a).

In November 2002, the High Representative launched an initiative to improve Bosnia's business environment. A 'bulldozer committee' was established to identify specific laws and regulations that impeded job creation and business expansion. The committee made some progress towards removing administrative and bureaucratic obstacles to business and investment. Following its initiative, the state parliament adopted a law enabling the introduction of a uniform, simplified and significantly shorter procedure for registering new business. However, in 2006 the business registration system was still not fully operational. Meanwhile, the business environment continued to discourage firm entry because of costly and lengthy business registration and problems with the recognition of administrative documents across jurisdictions (European Commission, 2007a).

New legislation to strengthen bankruptcy procedures came into force in 2003, following strong resistance by domestic parties and trade unions. The new laws were designed to streamline and accelerate the process of liquidation of unprofitable companies. Similar to other legislative amendments, the laws were being implemented only slowly. The judiciary continued to suffer from slow court proceedings, poor case management, and a backlog of unresolved cases. Political interference was not uncommon. These circumstances undermined the effective enforcement of creditor and property rights, and further delayed the process of corporate restructuring (European Commission, 2007a).

No progress was made in improving Bosnia's labor market, which continued to suffer from significant structural rigidities in terms of wage setting mechanisms and high taxation of labor. The labor legislation remained fragmented. No uniform social security system existed on the state level, and social benefits differed across the jurisdictions.

The lack of portability of pension and health benefits across entity and cantonal borders severely limited labor mobility. No measures were taken at the state level to address the pressing problem of unemployment, which stood at 31 percent in 2006. Youth unemployment exceeded 60 percent, and the majority of unemployed were long-term unemployed (European Commission, 2007a).

In autumn 2004, Bosnian authorities presented a comprehensive, country-wide public administration reform strategy aimed at strengthening the quality of the public sector, reducing the burden of public employment, and eliminating administrative duplications. However, the reform strategy was not properly implemented as the public sector continued to suffer from substantial deficiencies in terms of delegation and cooperation mechanisms, distribution and exercise of powers, and planning capacity. There were insufficient safeguards against political interference, and the delivery of public services remained conditional on ethnic identity and party membership. The duplications arising from the fragmented administrative structure generated high costs with the result that the public sector continued to depend on foreign assistance (UN, 2004; IMF, 2007a; European Commission, 2007a).

Overall, Bosnia was far from achieving the objective of self-sustaining economic and social development which had been set by the international community. While many governments in SEE seized the opportunity to implement long-due structural reforms, taking advantage of the favorable international economic conditions which prevailed after 2001, no consensus on a common economic policy emerged in Bosnia. Instead, nationalist parties remained slaves of their enclave mentality and blocked every reform proposal that could destabilize their power. The fragmentation of the political market into local monopolies encouraged the development of authoritarian power structures and spared public officials the hassle of public accountability. As a consequence, while social and economic conditions significantly improved in SEE between 2000 and 2006, they remained relatively poor in Bosnia. The lack of progress in poverty reduction illustrates this: The most recent poverty estimates show that 17.8 percent of the population were poor in 2004, compared to 19.5 percent in 2001 (IMF, 2007a).

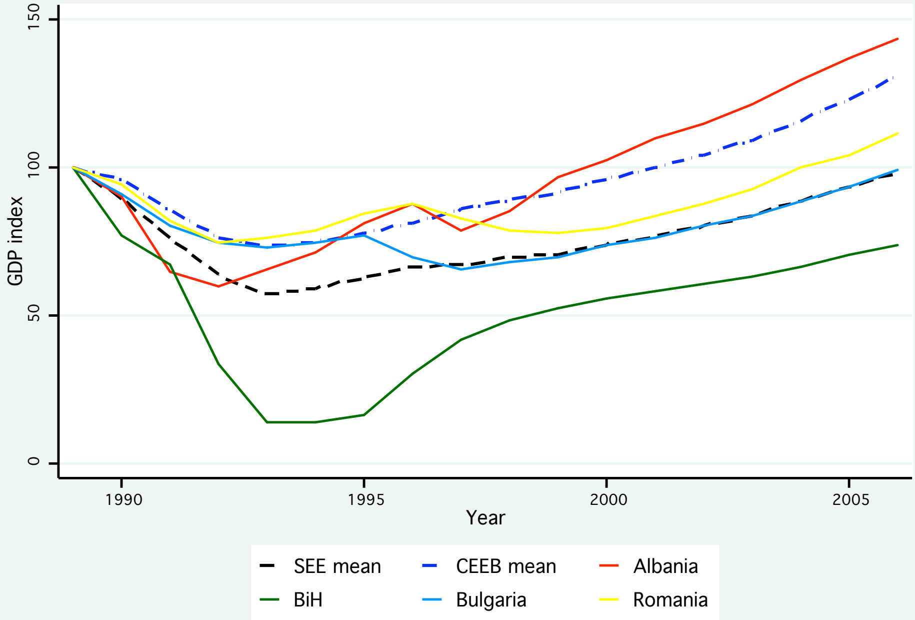
4.6 Past Achievements and Future Reform Challenges

This section examines whether and to what extent the countries under review have been able to accomplish the elements of the growth agenda discussed in Section 1.2.

During the 1990s, Bulgaria, Romania, Albania and Bosnia considerably lagged behind the economic performance of the CEEB region but are now experiencing many of the same trends, with rising living standards, strong consumption and investment growth, and significant declines in poverty rates. The recent progress in stabilizing the economy, liberalizing trade, developing functioning markets, and the prospect of EU accession have played a crucial role in this upward trend. As a result, average growth reached the level in CEEB at about 5.5 percent per year between 2000 and 2006. As illustrated in Figure 4.1, all countries except Bosnia have attained the GDP level of the period before transition.[2]

[2] Note that the regional means reported in the figures and table of this section are unweighted averages.

Figure 4.1: GDP Index 1990–2006



Source: EBRD, Transition Report, 2008.

Despite considerable reform achievements in recent years, the evidence presented in the case studies reveals that structural and institutional reforms are far from being achieved. The current reform program must therefore focus on:

- reducing the regulatory complexity in order to improve competition in domestic markets,
- implementing labor market reforms that improve labor adjustment and encourage the creation of employment,
- improving the quality and quantity of human capital accumulation, and
- enhancing governance and public administration performance.

Implementing these reforms is particularly important as the productivity gains from resource reallocation typical of the first phase of transition are beginning to decrease. The future pace of economic development will thus depend on the vigor with which these reforms are pursued.

The SEE mean does not only include Bulgaria, Romania, Albania, and Bosnia, but also Croatia, FYR Macedonia, Serbia and Montenegro.

4.6.1 Macroeconomic Adjustment

The case countries have made significant progress in restoring macroeconomic stability, but the process was neither quick nor easy. Albania's macroeconomic performance stands out by both regional and international standards. Following the collapse of the pyramid banking schemes, Albania has experienced average annual growth rates of 7 percent between 1998 and 2006, the highest among transition economies. The favorable economic performance has been accompanied by progressive declines in poverty.

Successful macroeconomic management has been an important contributor to economic growth, leading to sizable reductions in the overall fiscal deficit and inflationary pressure. The fiscal deficit has been reduced from 12.4 percent of GDP in 1997 to 3.2 percent of GDP in 2006 through spending cuts and revenue increases. The level of government spending has decreased from 34.1 percent of GDP in 1998 to 28.4 of GDP in 2006 and is now among the lowest in Europe. During the same period, fiscal revenues have increased from 17.5 percent of GDP to 23 percent of GDP. However, the level of fiscal revenues remains low and puts a considerable strain on Albania's debt service capacity and social expenditures. Despite a dramatic reduction since the crisis in 1997, the debt level remains relatively high at 56.6 percent of GDP (see Figures 4.2 through 4.4).

Following a failed transition which culminated in a deep crisis in 1996–1997, Bulgaria has managed to establish macroeconomic stability by prudent fiscal policies anchored in the currency board arrangement. Fiscal consolidation was achieved through drastic cuts in government spending, reducing the overall budget deficit from 10.3 percent of GDP in 1996 to 0.3 percent in 1997. In the following years, the Bulgarian government has maintained a balanced budget, while cutting its public debt from 319.8 percent of GDP in 1996 to 22.7 percent of GDP in 2006. As a result of these policies, inflation has declined from hyperinflation levels to single digits.

Between 1998 and 2006, Bulgaria's economy has experienced growth rates averaging 4.7 percent per year. Yet despite robust economic growth, social indicators remain a cause of concern. The country's economic performance, while strong, has not contributed as much as was expected to improving living standards and eradicating poverty.

In Romania, serious efforts to consolidate the economy began only in 1998, encouraged by the EU membership process. The delay in reforms contributed to the contraction of the economy and to a substantial increase in poverty. Between 1999 and 2005 expenditure as a share of GDP was reduced by more than 4 percentage points. Spending cuts went hand in hand with the resumption of economic growth which enabled the government to bring the overall budget deficit down to 1.9 percent of GDP in 2006, from 4.6 percent of GDP in 2000. Fiscal consolidation strengthened the disinflation process during this period and allowed for the partial containment of the aggregate demand expansion.

Bosnia has achieved monetary stability by establishing a currency board system in 1998. However, while Bosnia's fiscal position has improved since the end of the war, the country has not yet achieved fiscal stability. The overall budget deficit narrowed from 6.4 percent of GDP in 1999 to near balance over the last several years, but government

Figure 4.2: Consumer Price Index 1990–2006

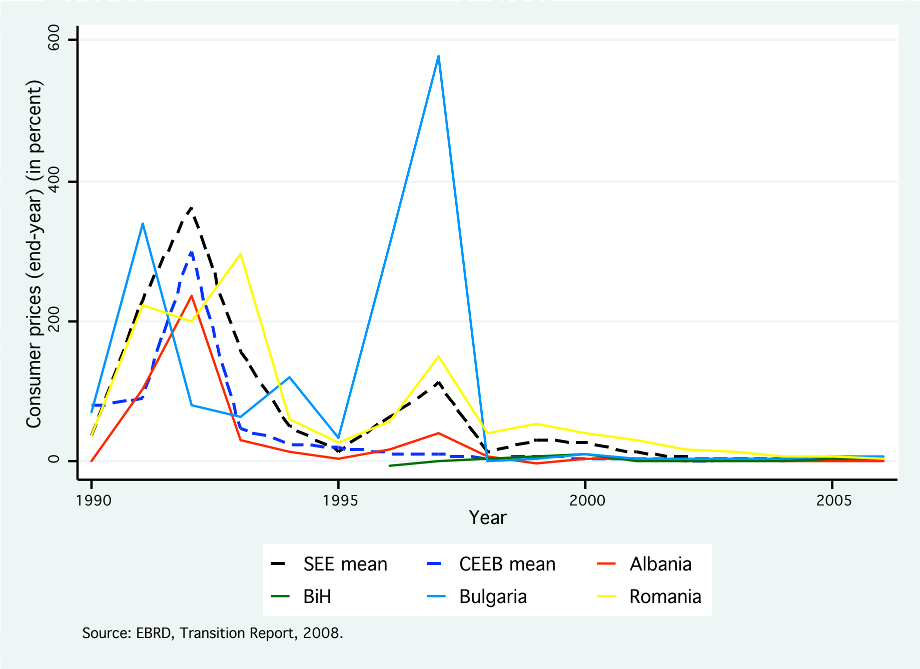


Figure 4.3: General Government Balance 1990–2006

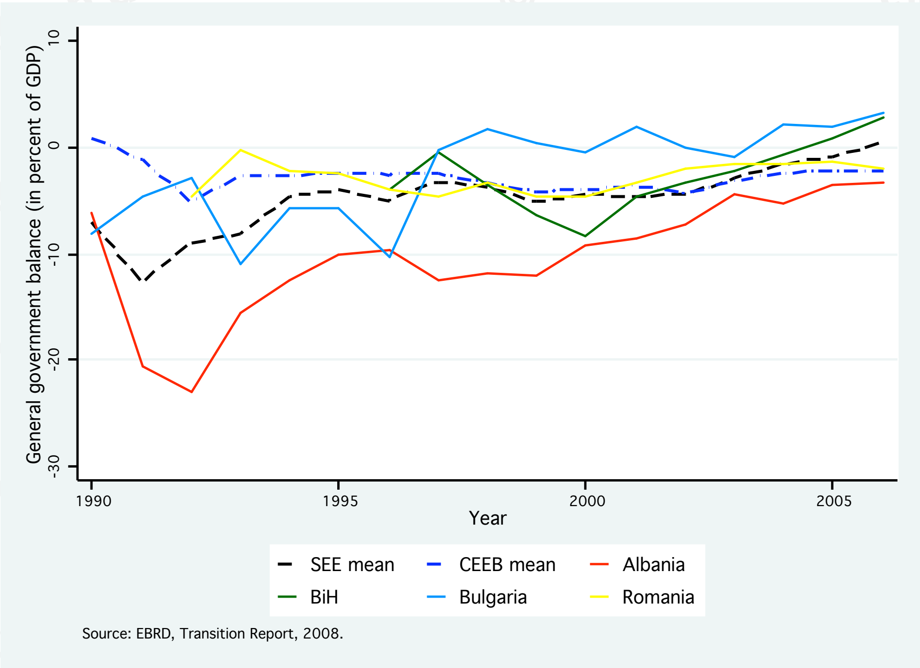
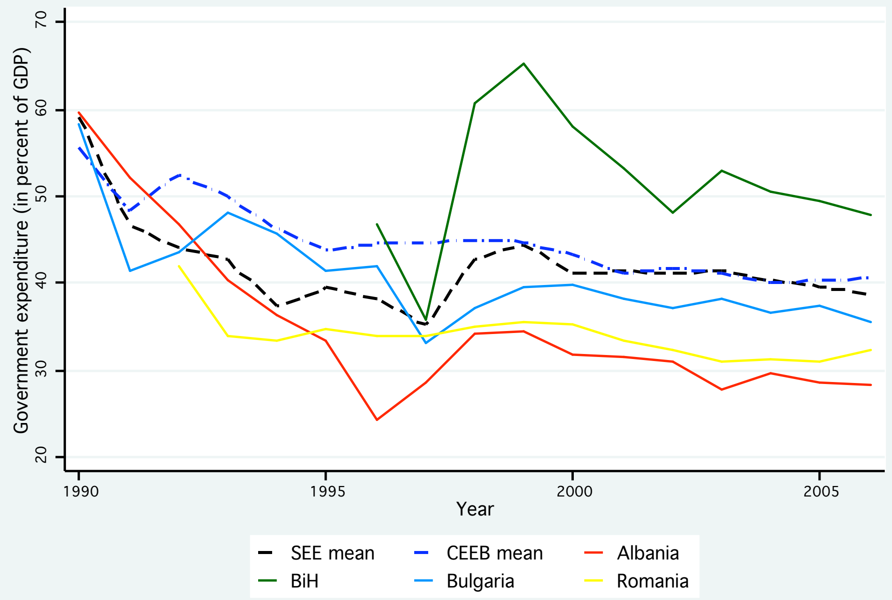
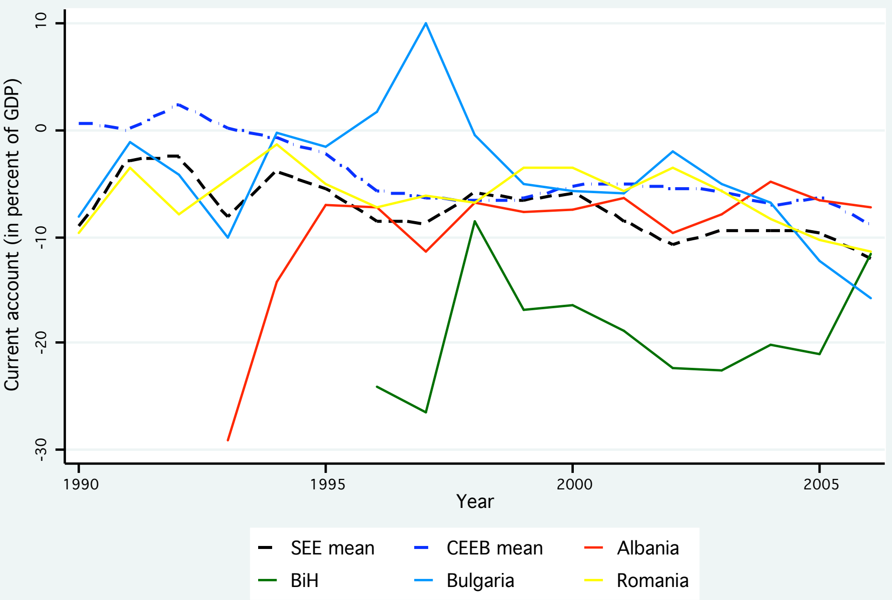


Figure 4.4: Government Expenditure 1990–2006



Source: EBRD, Transition Report, 2008.

Figure 4.5: Current Account 1990–2006



Source: EBRD, Transition Report, 2008.

spending, at 47.9 percent of GDP in 2006, is about 10 percentage points higher than average of the countries in SEE. In the meantime, the outcome of government spending is substantially poorer than in other countries in the region. Nonetheless, economic activity has remained robust despite a slowdown of reform implementation. However, the favorable economic performance has brought no substantial improvements in living conditions over the last couple of years.

As can be seen in Figure 4.5, the large current account imbalances remain a key macroeconomic challenge in the countries analyzed in this study. In 2006, all countries except Albania had current account deficits in the double digits. If these deficit levels are maintained, the external financial liabilities and future external repayment obligations will eventually become unsustainable.

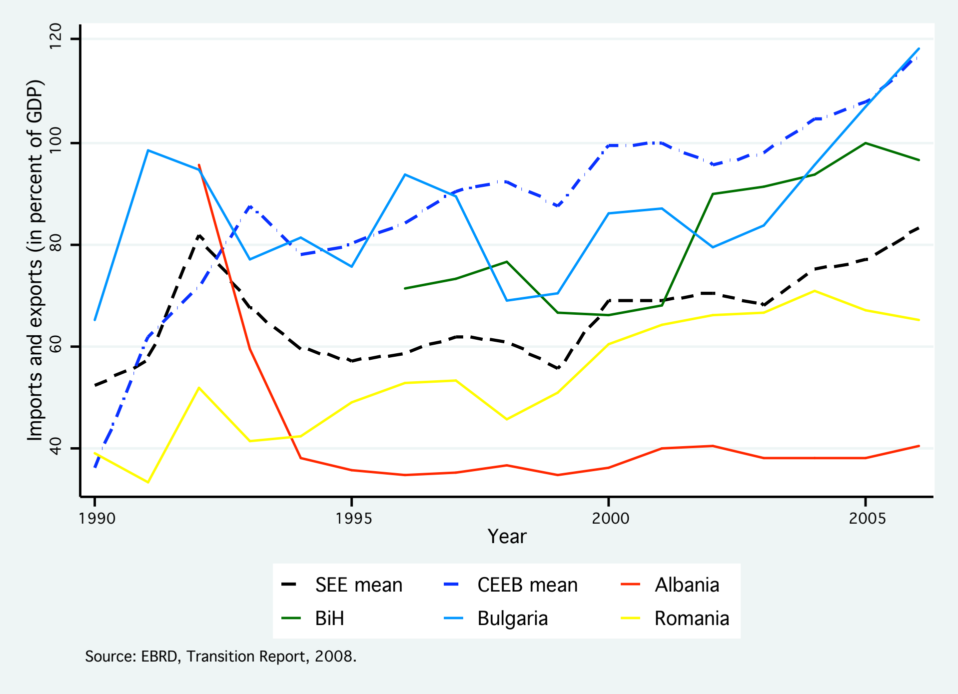
4.6.2 Trade

The widening external imbalance reflects a dearth of savings and the buoyancy of imports of investment and consumer goods. Strong consumption growth has been partly financed by rapid increases in bank credit to the private sector. The sustained increase in imports has further coincided with massive inflows of FDI. In the run-up to EU accession, Bulgaria and Romania in particular have turned into recipients of massive capital inflows, which have triggered an absorption boom and led to a strong increase in foreign exchange reserves. Notwithstanding significant real exchange rate appreciation, exports have been growing steadily.

The increase in imports and exports reflects the region's progressive integration with external markets. SEE's average trade in goods and services relative to GDP increased from 55 percent in 1999 to 83 percent in 2006. However, SEE economies are significantly less integrated with international markets than their neighbors in CEEB where the average trade in goods and services amounted to 117 percent of GDP in 2006. Moreover, there are substantial variations among case countries as shown in Figure 4.6. In Bulgaria, for instance, trade as a share of GDP equaled about 120 percent of GDP in 2006, while in Albania it barely reached 40 percent of GDP.

A pattern that is common to all countries is that growth in exports has not kept pace with growth in imports, resulting in huge trade deficits over the years. While in Bulgaria and Romania the value of imports surpassed the value of exports by about a third in 2006, Albania's and Bosnia's import-export ratios were about 6 to 1 and 3 to 1, respectively. The large sustained trade deficits reveal the weaknesses in the structure of manufacturing industry and agriculture, two sectors that are not yet able to respond to the changing demands of domestic and foreign markets. The slow pace of agricultural and industrial restructuring in the 1990s has left the economies with a relatively narrow export base that is largely dependent on low value added labor- and resource-intensive goods. The invisible elements of the current account have not been enough to offset the trade deficits and, as a result, external imbalances have increased.

Figure 4.6: Trade 1990–2006



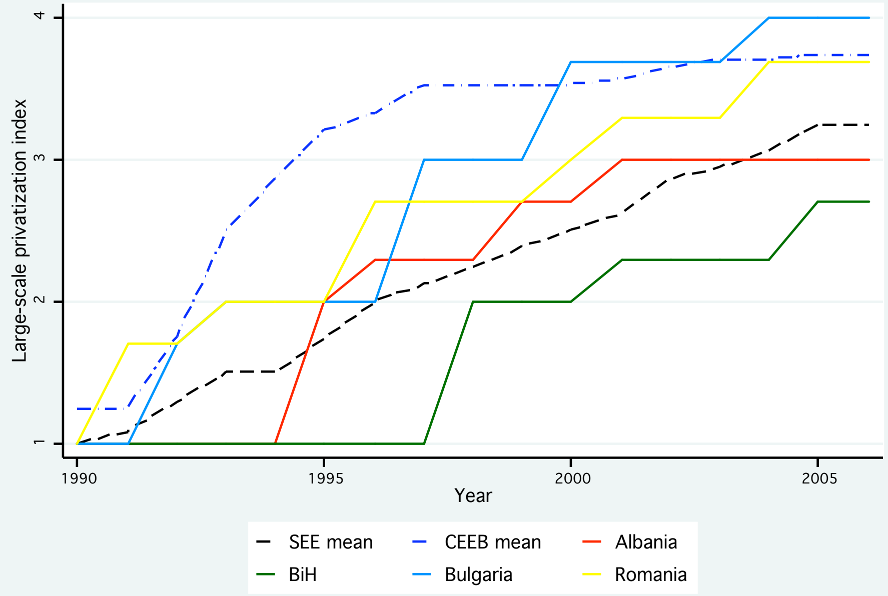
4.6.3 Privatization and Market Regulation

Progress on the structural front is crucial to reduce external imbalances and ensure long-term productivity-driven growth. At a first glance it appears that structural policy reforms together with a favorable international economic environment have generally contributed to solid economic performance. Following the economic crises in 1996–1997, the prospect of EU accession changed the political economy in the case countries and accelerated the long-overdue process of economic restructuring.

Most of the non-infrastructure enterprises and banks in the region were privatized or liquidated between 1998 and 2004. Banking supervision was strengthened. Prices were freed from administrative regulation. In the run-up to EU accession, Bulgaria and Romania completed the privatization and liberalization of the energy and telecommunications markets, and adopted new legislation, regulations, and management systems to improve the public sector. In Bosnia, and to a lesser extent in Albania, the implementation of these reforms lagged behind the pace set by Bulgaria and Romania. Nevertheless, economic growth in SEE is now led by the private sector which accounts for 65 percent of GDP and 68 percent of total employment (see Figures 4.7 through 4.12).[3]

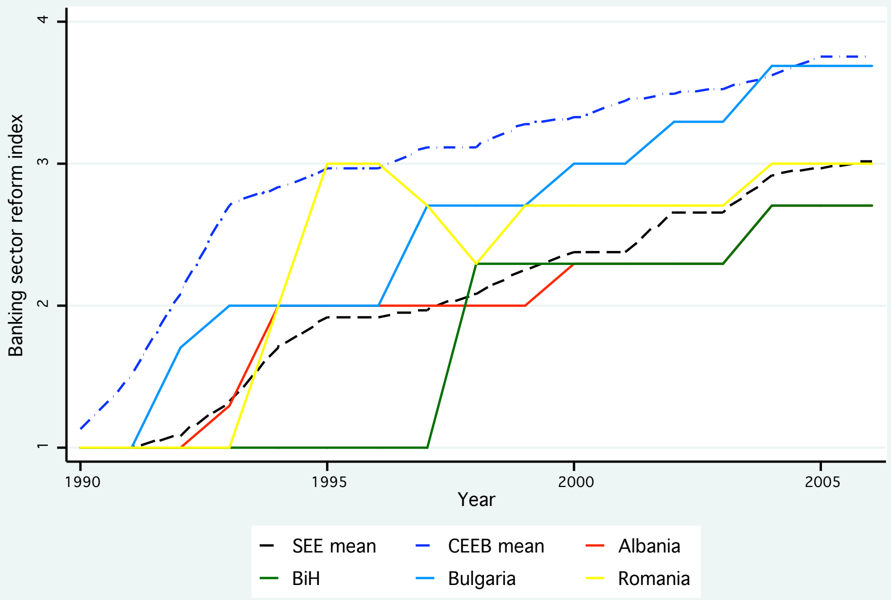
[3]The reform indices represented in Figures 4.7 to 4.10 are based on the assessment of an expert team of the EBRD. A score of 1 indicates no major change relative to the planned economy and the maximum score 4.3 corresponds to an advanced market economy (EBRD, 2000). See Table 1 in Appendix A for details.

Figure 4.7: EBRD Large Scale Privatization Index 1990–2006



Source: EBRD, Transition Report, 2008.

Figure 4.8: EBRD Banking Sector Reform Index 1990–2006



Source: EBRD, Transition Report, 2008.

Figure 4.9: EBRD Price Liberalization Index 1990–2006

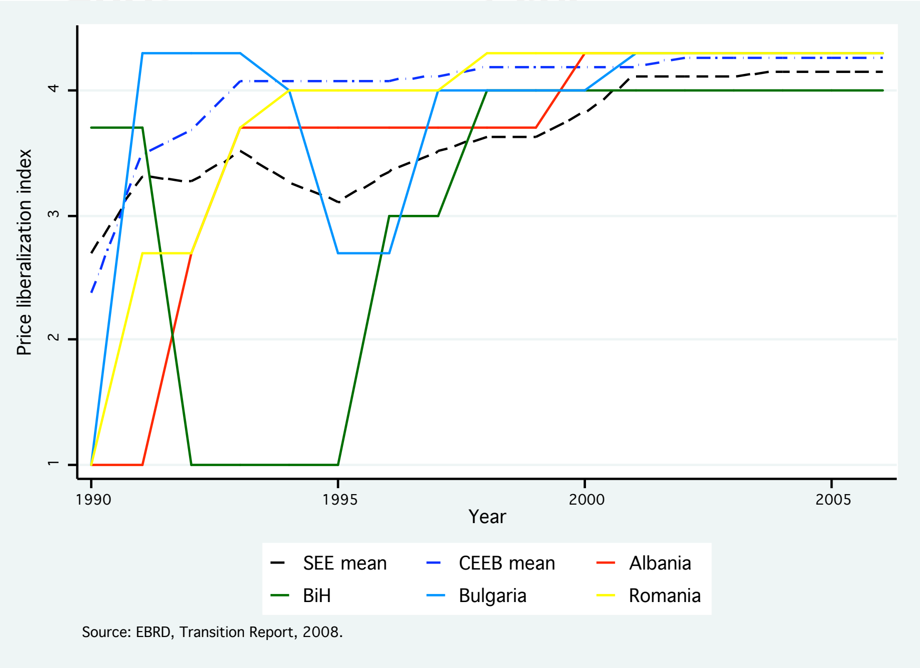


Figure 4.10: EBRD Infrastructure Reform Index 1990–2006

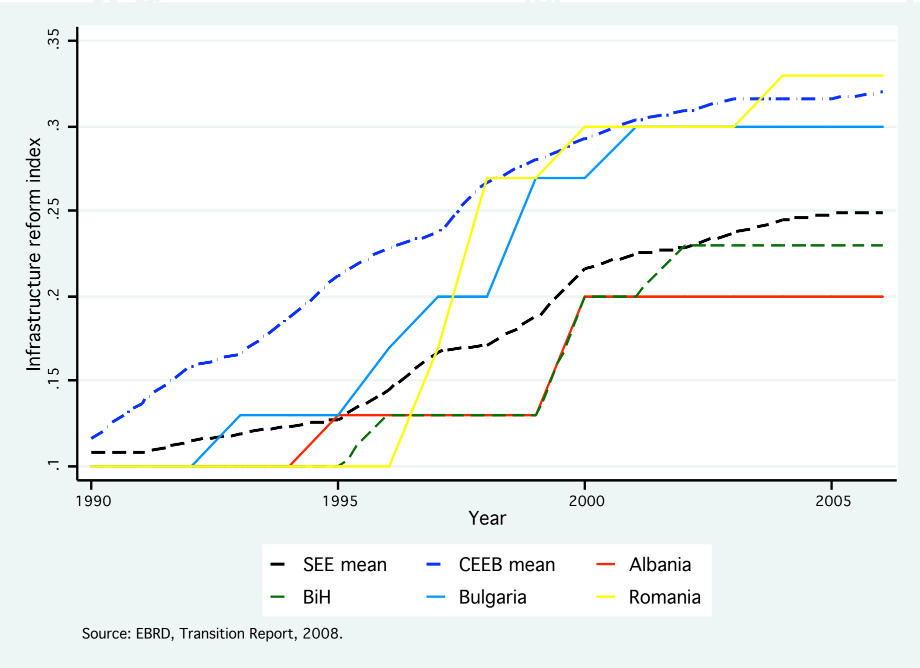
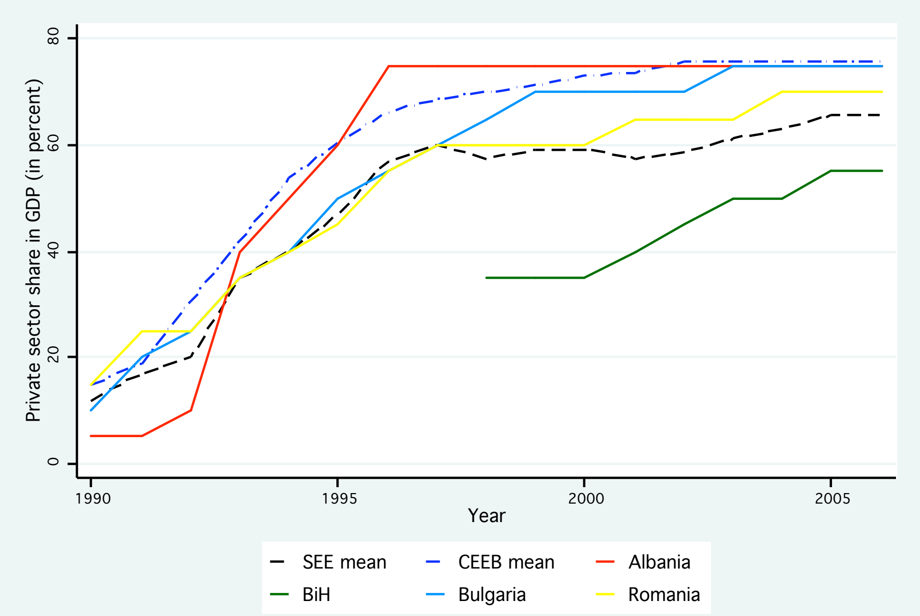
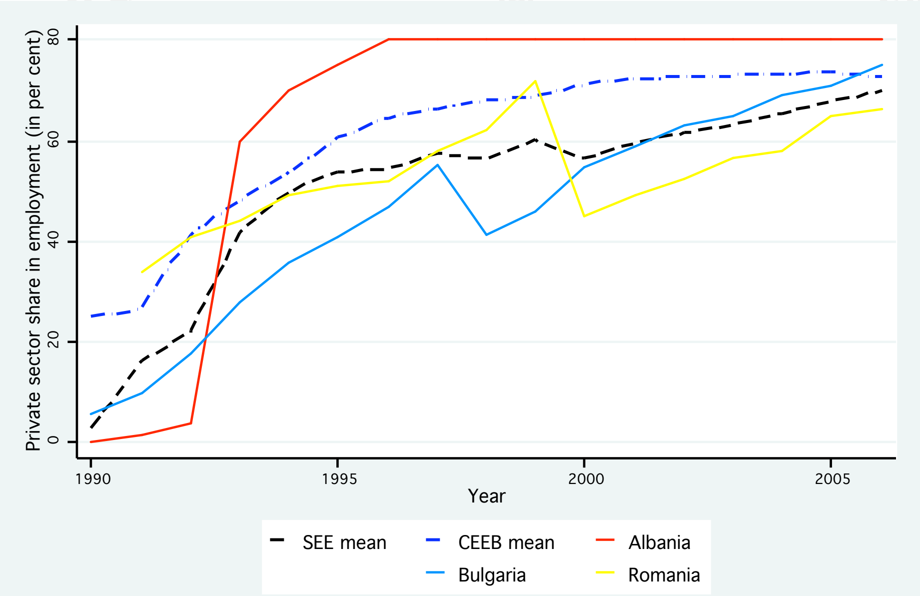


Figure 4.11: Private Sector Share in GDP 1990–2006



Source: EBRD, Transition Report, 2008.

Figure 4.12: Private Sector Share in Employment 1990–2006

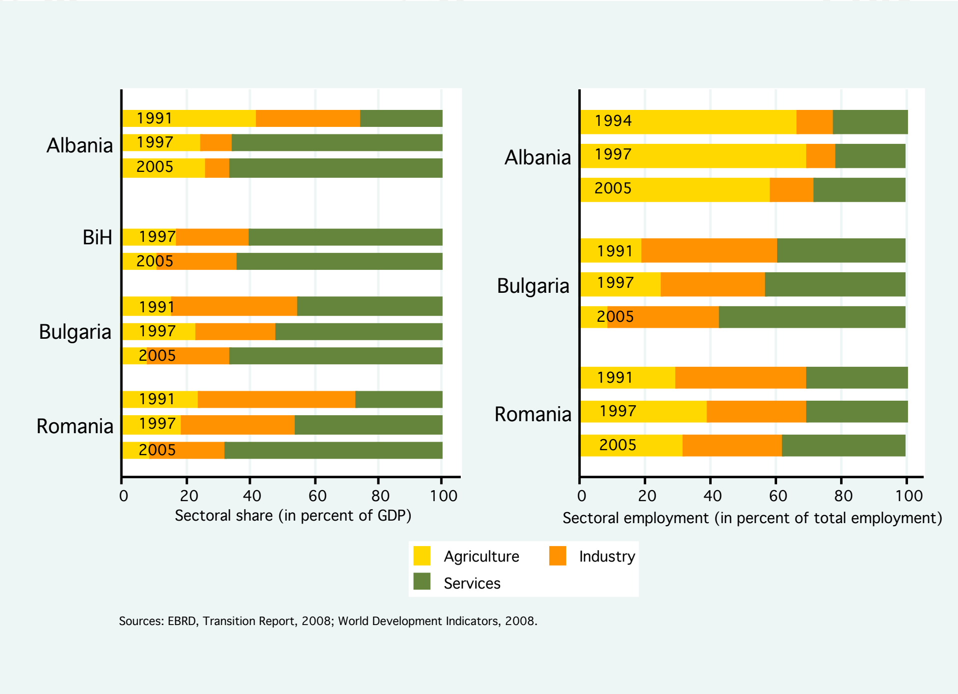


Source: EBRD, Transition Report, 2008.
Notes: Data for Bosnia not available.

Yet the economies are still constrained by a number of structural weaknesses, the removal of which is a pre-condition for lasting growth and living standard improvements. One of the key challenges facing the authorities in SEE is to stimulate the competitiveness and labor productivity of domestic producers and to create new employment opportunities for the workforce.

A common problem in SEE is that a large share of the labor force is locked in sectors with low and declining productivity. As can be seen in Figure 4.13, the relative shares of agriculture and industry in the case countries have generally declined after 1997, while the service economy has become an increasingly important source of income. Despite significant shifts in the sectoral composition of output, agriculture still accounts for a significant share of GDP and employment. In Albania, the agricultural sector is the largest employer, accounting for about 58 percent of total employment in 2005. In that year, the share of agriculture in GDP amounted to 26.4 percent. In Romania, agricultural employment accounted for 32 percent of total employment, while the sector's contribution to GDP was 8.5 percent. The situation is similar in Bulgaria, where the agricultural sector employed 25.8 percent of the labor force in 2002, but generated 10.7 percent of gross value added.[4]

Figure 4.13: Sectoral Share in GDP and Employment 1991–2005

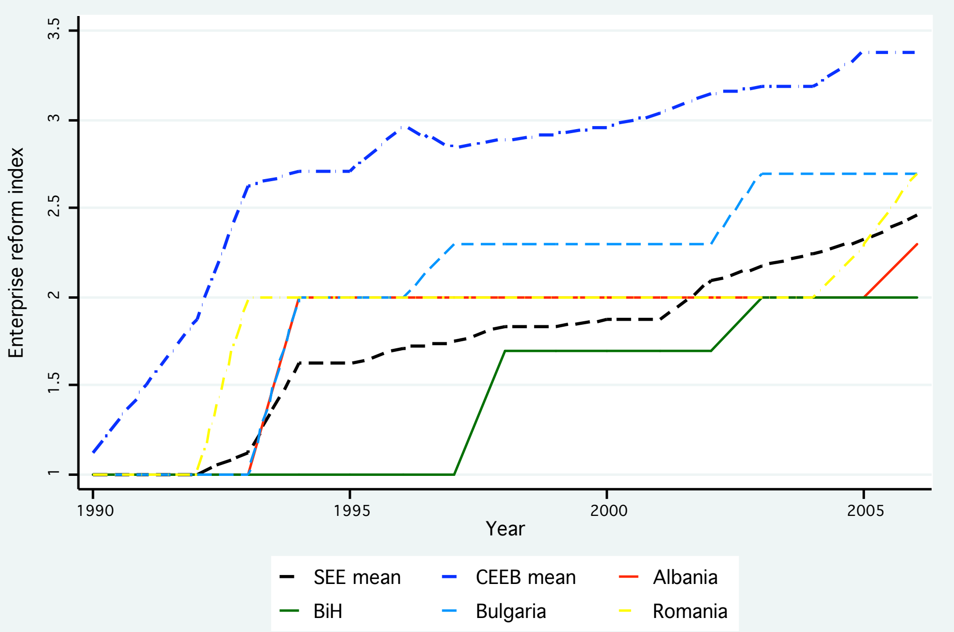


[4]The rapid decrease in Bulgaria's agricultural employment between 2002 and 2005 is due to statistical adjustments rather than to fundamental changes in the economy. In 2003, about 15 percent of total employment formerly assigned to the agricultural sector were attributed to the service sector.

The potential of agriculture for rural development, living standard improvement, and poverty eradication remains untapped. To varying degrees, the agricultural sector has absorbed displaced labor from urban industries and played the role of a social safety net for the unemployed and pensioners. As such, most agricultural activity remains labor intensive and technologically backward. Moreover, the sector suffers from land fragmentation, a lack of systemic investment, and access to product markets. As a result, productivity and incomes in agriculture are significantly lower than the average.

The high share of employment in the manufacturing industry also indicates that the reallocation of workers from less productive to more productive activities is not yet accomplished. While a relatively small number of large companies, many of which are foreign owned, has generally grown rapidly and generated high levels of productivity in recent years, empirical evidence indicates that the bulk of SMEs in the region has not yet completed the restructuring process and still depends on labor intensive and simple technologies (see Figure 4.14). Moreover, weak vertical linkages between large companies and SMEs entail that technological spillovers remain fairly limited. The majority of SMEs thus continues to exhibit low levels of productivity (World Bank, 2007a).

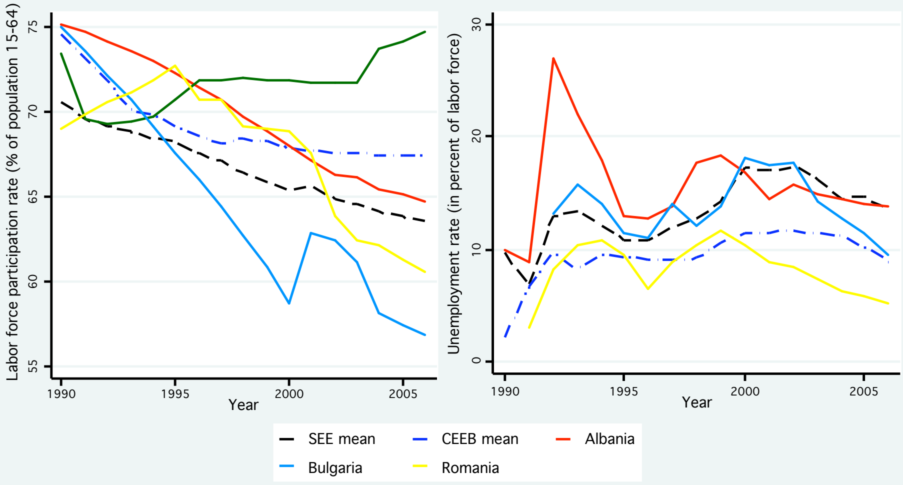
Figure 4.14: EBRD Enterprise Restructuring Index 1990–2006



Source: EBRD, Transition Report, 2008.

While a large share of workers is trapped in low-productivity jobs, others are excluded from the labor market altogether. During the transition process, productivity increases in the agricultural and manufacturing sectors have been driven primarily by shedding labor and adopting cost-cutting strategies (World Bank, 2008). The restructuring process has inevitably resulted in a dramatic decline in labor force participation

Figure 4.15: Labor Force Indicators 1990–2006



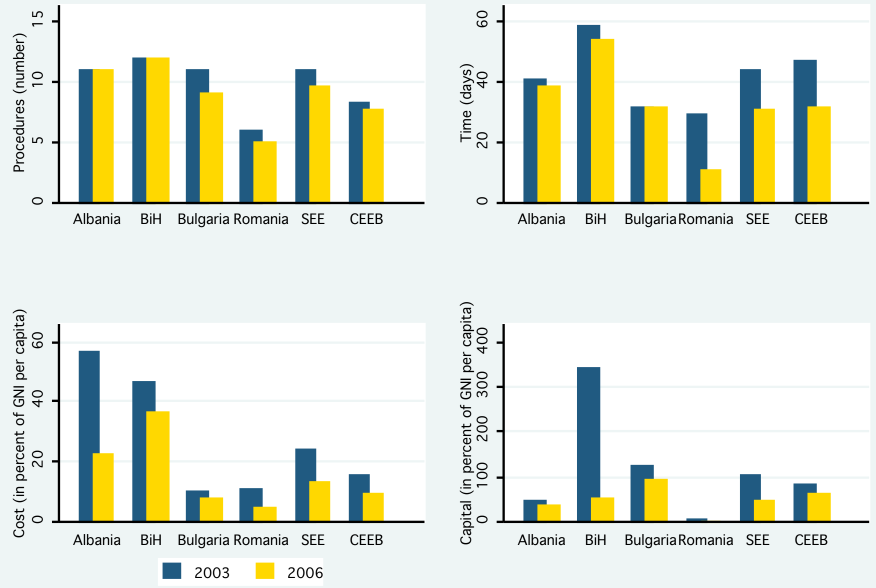
Sources: World Bank, World Development Indicators, 2008; UNICEF Innocenti Research Center, TransMONEE Database, 2008.
Notes: Data for Bosnia not available.

and high unemployment (see Figure 4.15). The employment losses gave way to renewed growth, but employment stagnated or continued to fall. Although the nascent private sector generated new jobs, it was not enough to absorb the excess labor supply. Limited employment opportunities have pushed people out of the formal labor market into subsistence agriculture and the informal sector. Moreover, new jobs typically required a different set of skills, complicating the transition of many unemployed whose skills were not longer in demand.

Although unemployment rates decreased in recent years, labor force participation in SEE remains low. Notwithstanding the progress made in simplifying the regulatory framework in recent years, domestic markets in SEE remain constrained by overly complex business and labor market regulations. The existing regulatory framework discourages higher labor absorption and discriminates against the unemployed and those who are employed in the informal sector. It imposes high fixed costs on market actors and pushes them into the informal sector, while shielding vested interests from competition. Heavy regulations also increase opportunities for administrative graft and corruption.

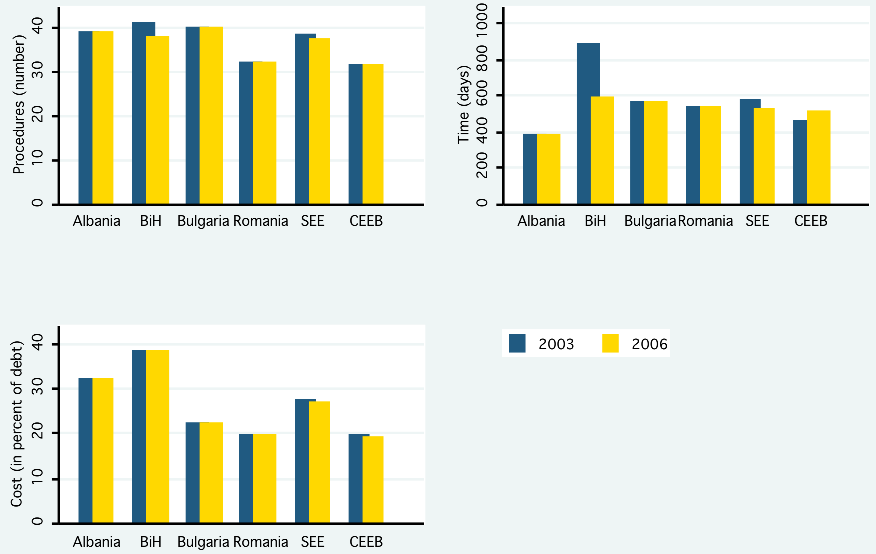
Figure 4.16 shows that market entry is still a cumbersome process in SEE. In Bulgaria, it took 9 procedures and about 288 days to complete the registration process in 2006. The total cost of creating a new firm amounted to 71.1 percent of per capita gross national income (GNI). With 91.3 percent of per capita GNI, Bulgaria had the highest minimum capital requirement in the region. In Albania and Bosnia, opening a business was even more time consuming and expensive. In Albania, 39 days were needed on av-

Figure 4.16: Starting a Business 2003–2006



Source: Doing Business Database, 2008.

Figure 4.17: Enforcing Contracts 2003–2006



Source: Doing Business Database, 2008.

erage in 2006 to complete one of the necessary eleven procedures, making a total of 429 days. With 22.4 percent of per capita GNI and procedure, the cost of the process was twice as high as the CEEB average. In Bosnia, it took almost two years and 435.6 percent of per capita GNI to register a new firm. Such unfavorable market conditions generate opportunities for rent seeking, and they channel resources into inefficient activities. By contrast, Romania's experience proves that it is possible to reduce administrative red tape within a short period of time. In 2006, it took only 5 procedures to register a new firm. The average time spent during each procedure was 11 days, compared to 30 days in 2003. The official cost of each procedure was 4.4 percent of per capita GNI, while the minimum capital requirement amounted to 1.6 percent of per capita GNI.

As shown in Figure 4.17, procedures for contract enforcement are also complex and expensive. The average number of procedures that had to be passed in 2006 to see a contract enforced was 37.4 for SEE countries and 31.8 for CEEB countries. In both regions, it took about 520 days to resolve a contract dispute. The cost in court and attorney fees, expressed as a percentage of the debt value, were 26.8 percent in SEE, compared to 19.3 percent in CEEB. Albania and Bosnia stand out as the business environments where contract enforcement is most expensive, with costs reaching 31.8 percent and 38.4 percent of debt value, respectively. The complexity and inefficiency in enforcing contracts requires business owners in these countries to rely more heavily on cash transactions than on more efficient and contract-intensive forms of payment.

Market exit is also difficult and lengthy, as illustrated in Figure 4.18. The average time needed to execute insolvency in SEE increased from 3.5 years to 3.8 years between 2003 and 2006. The insolvency process was especially slow in Albania and Romania, with 4 years and 4.6 years, respectively. Albania also had the most expensive bankruptcy proceedings in the region. In 2006, it took on average 38 percent of the estate's value to close down business, compared with approximately 10 percent in the other countries. Figure 4.18 also shows that the share claimants recover from an insolvent firm is much smaller in SEE than in CEEB. In 2006, claimants in SEE recovered on average 24 cents per dollar, whereas claimants in CEEB recovered on average 38.1 cents per dollar.

The pace of reallocation of factors of production from less- to more-productive uses could be significantly accelerated by simplifying and lowering the costs of these business regulations. By increasing market contestability, low entry and exit barriers raise pressure on market actors to perform more effectively. Better contract enforcement mechanisms reduce uncertainty and considerably simplify market transactions. To boost competitiveness and stimulate investment, it is thus crucial to eliminate existing regulatory constraints.

The low levels of labor force participation and the relatively high unemployment rates point to serious shortcomings in the functioning of the labor markets. The employment indices illustrated in Figure 4.19 suggest that inflexible employment regulations represent a major constraint to an optimal allocation of labor resources.[5]

[5]The indices measure the difficulty of hiring, nonstandard work schedules and paid annual leave, as well as the costs and rules governing redundancy termination. Each index assigns values between 0 and 100. Higher index values indicate more rigid regulations.

Figure 4.18: Closing a Business 2003–2006

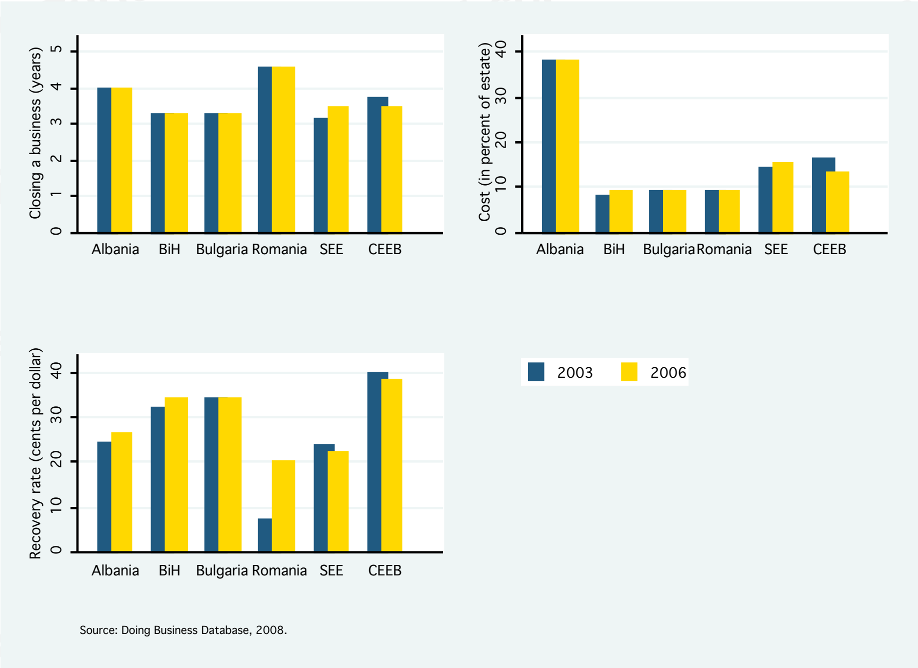
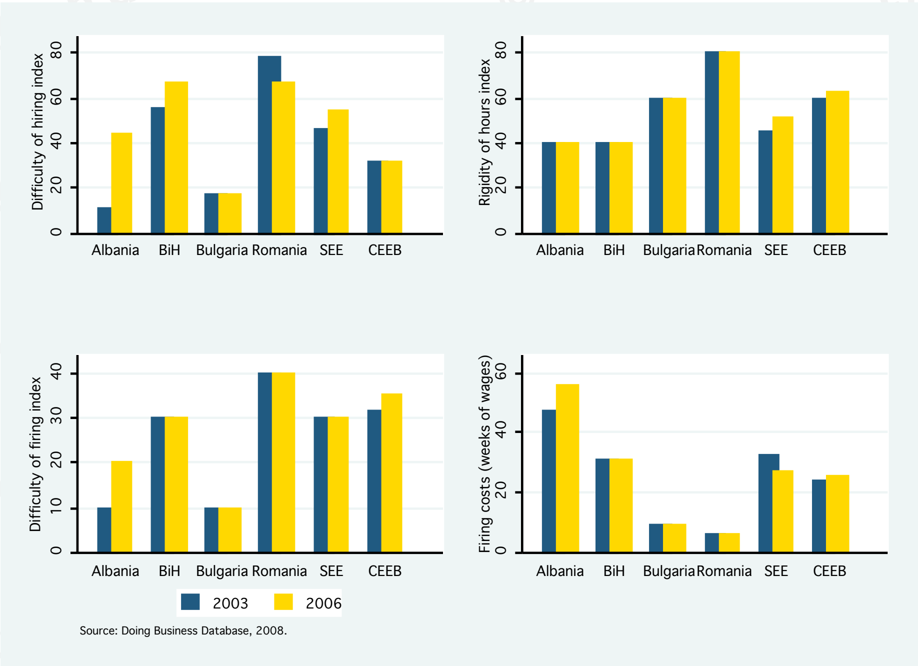


Figure 4.19: Employment Regulation 2003–2006



In Bulgaria, the main problems lie in the rigidity of working hours. Flexibility in these parameters is especially important for SMEs, which tend to be labor intensive, and are thus an important source of employment creation. Moreover, there is room for enhanced flexibility in procedures for dismissals, use of fixed-term contracts, and overtime pay and wage adjustments (World Bank, 2007a).

In Romania, the labor code introduced in 2003 was widely criticized for introducing significant rigidities in the labor market, thereby adversely affecting job creation and labor costs. Term contracts can only be used in exceptional circumstances. The employer's rights to labor retrenchment for economic reasons are severely restricted. Moreover, mandatory extension of industry-wide collective labor agreements push small firms out of business or into the informal sector. Romania has implemented several changes in the labor code to correct some of the imbalances, but the aforementioned rigidities have not been removed (Kotzeva and Pauna, 2006). As a result, Romania's rigidity of employment indices are the highest in the region.

In Bosnia more formal sector jobs could be created if the deficiencies arising from delayed restructuring and privatization were addressed, but rigid employment regulations are also responsible for poor labor market outcomes. As is the case in Romania, industry-wide collective labor agreements increase hiring costs of employers and make hiring of new personnel less attractive. Moreover, shedding labor is complicated and costly. Bosnia's labor legislation has no provisions for layoffs that can help companies respond to economic shocks in order to recover and meet their financial obligations. Instead, labor adjustment generally takes the form of excess workers stopping work, while remaining nominally employed. Consequently, enterprises accumulate wage and social insurance arrears (World Bank, 2005a).

Albania's employment protection rules are relatively moderate when compared to other countries in the region. However, rigidities have increased between 2003 and 2006 following the introduction of more stringent labor regulations. Compared to the CEEB benchmark, Albania's rules were somewhat more restrictive on hiring but relatively flexible with respect to firing. However, feedback from enterprises suggests that labor market regulation is not a major constraint on job creation in Albania. Rules are not too restrictive and their impact is further weakened by low compliance (World Bank, 2006c).

Simplifying labor market regulations, while important, is not enough to create new job opportunities. Non-wage labor costs in SEE countries tend to be the highest in Europe. There are indications that high payroll taxes in the countries studied significantly increase labor market distortions and create a disincentive to job creation in the formal economy.

As indicated in Table 4.1, wages in SEE appear to have grown significantly in recent years, but they are still low compared to the CEEB average. Albania had the lowest wages in the region in 1998. Since then, gross salaries have been rising on average by 16 percent per year to reach US$ 293.8 in 2006. In real terms wages have more than doubled during this period (see Figure 4.20). Still, in 2006, gross average monthly salaries in Albania were lower than in all other countries except Bulgaria. In the other

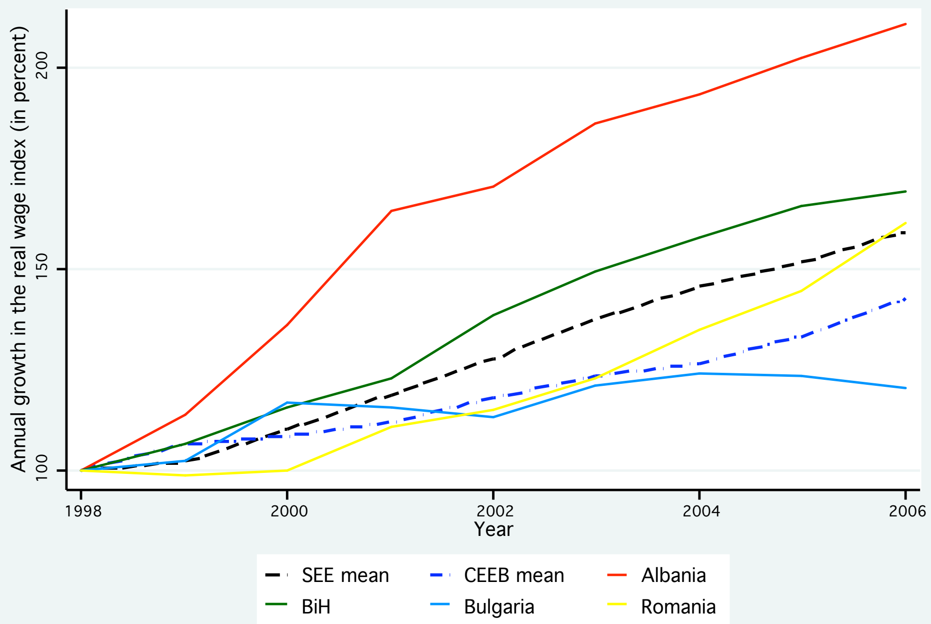
Table 4.1: Gross Average Monthly Wages (in US$) in SEE 1998–2006

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Bulgaria	104.3	109.5	106.4	110.3	125	158.4	186	206.1	231.1
Romania	148	125.3	131.7	145.4	160.9	200	251.3	332.6	408.1
Albania	76.4	92.3	104.1	120	140.3	175	237.3	268.4	293.8
BiH	287.7	300	294.9	298.2	341.6	444.9	498.1	522	569
SEE	239.2	247.9	222.7	239	279	347.8	413	364.4	417.3
CEEB	390.1	392.6	376.7	404.2	469.5	488.3	575.3	645.6	726.9

Source: UNECE Statistical Division Database, 2008.

countries, both nominal and real wage increases have been less pronounced than in Albania. Despite these increases, the wage levels in SEE remain low, reflecting the low productivity of the labor force in the region.

Figure 4.20: CPI-Deflated Wage Index 1998–2006



Source: EBRD, Transition Report, 2008.

While labor costs in SEE are relatively low, payroll taxes are not. In Bulgaria the non-wage labor costs of employers and employees added together were about 42 percent in 2006. In the same year, Albania's payroll contributions were estimated to be between 42 percent and 49 percent, depending on the source. Despite efforts of the Romanian government to reduce non-wage labor costs, combined employer-employee social insurance contributions still exceeded 45 percent of the gross wage in 2006. In

Bosnia, payroll deductions amounted to 47.3 percent and 52 percent of the gross wage in the Federation and in the RS, respectively (World Bank, 2005a, 2006c,h).

When the costs associated with formal employment are high, employers tend to avoid or minimize these costs by non- or partial compliance. This is especially possible where public administration capacity is limited and enforcement is weak. In the countries analyzed, non-compliance appears to be a common strategy. The strongest indication is the existence of a widespread informal sector. The development of the informal economy can be considered as a testimony to the resilience of the private sector in the face of structural impediments. Therefore, options for reducing payroll taxes should be considered as another means for improving formal-sector job creation. However, since reducing payroll taxes has significant implications for the public finances, changes must be considered within the broader context to ensure that their impact on the budget can be absorbed without compromising the financial position of the social security system.

Heavy business and labor market regulations constrain the demand for labor, but evidence suggests that several factors on the supply side also delay the reallocation of factors of production from less to more productive activities. High unemployment rates among the young, high levels of long-term unemployment and tight labor markets for skilled and educated workers indicate a mismatch between the skills the education system provides and the labor market demand (World Bank, 2005a, 2006d, 2007a,b). Since the level of education of the labor force is positively correlated with value added and hence with the overall competitiveness of an economy, it is crucial to improve the quality of the labor force.

4.6.4 Education

Despite recent improvements in school enrollments, the stock, flow, and quality of human capital in SEE are still inadequate. As shown in Figure 4.21, enrollment rates at the secondary level remain alarmingly low at a time at which the economy increasingly needs a more sophisticated labor force equipped with knowledge and workplace skills that cannot be developed through primary or basic education alone. In Albania and Bosnia, enrollment rates in 2006 were 68.1 and 62.4 percent, respectively. In Albania enrollments have steadily increased since 1995, whereas in Bosnia they continue to fall. In Bulgaria and Romania, enrollment rates were significantly higher, but still lag behind the average CEEB rate.

To improve quality and efficiency of the education system, the level and composition of government spending need to be adjusted. With the exception of Bosnia, education systems in SEE have been severely underfunded during transition. As indicated in Figure 4.22, average education spending in SEE has hovered between 3 percent and 4 percent of GDP—which is much lower than average public spending on education in CEEB countries.

At more than 6 percent of GDP, Bosnia spends more on education than most countries in the broader region. This is mainly due to its institutionally complex structure that encourages duplications even at the local level. Inefficient spending has resulted in unacceptably poor education outcomes. Moreover, institutional fragmentation has en-

Figure 4.21: Gross Upper Secondary Enrollment 1990–2006

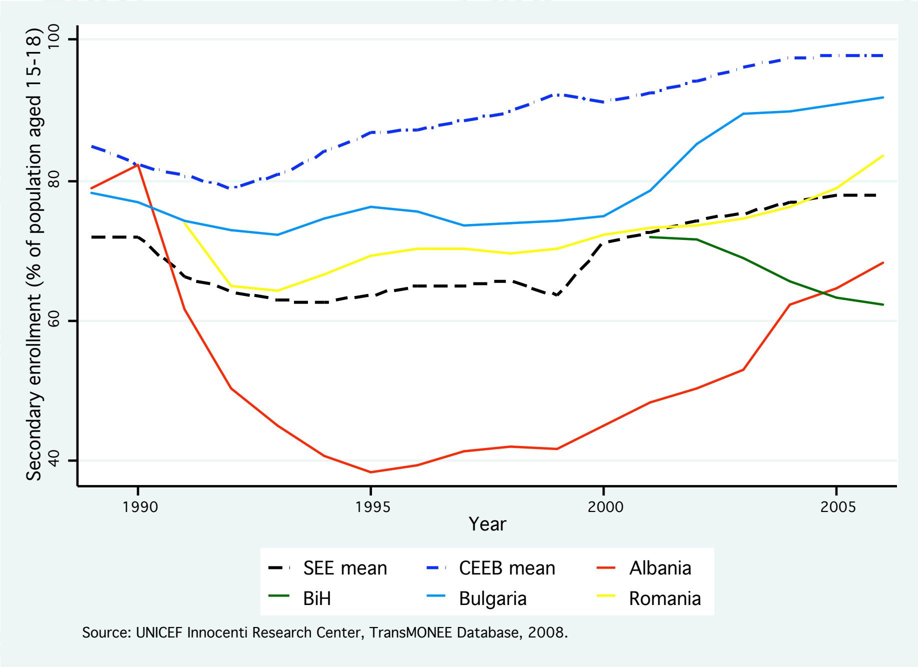
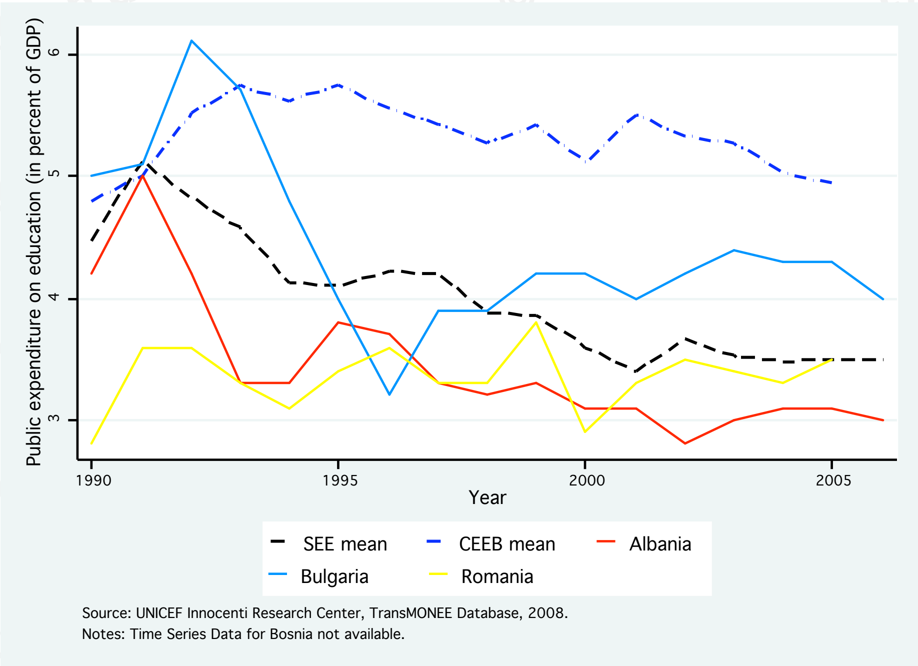


Figure 4.22: Public Expenditure on Education 1990–2006



shrined significant regional differences in spending and educational achievements, raising concerns of widening inequalities among cantons (World Bank, 2005a). Overall, increases in funding are warranted, but more resources are unlikely to improve education outcomes unless the factors underlying the inefficiencies are corrected.

Although the case of Bosnia is the most dramatic one, institutional and organizational inefficiencies also affect the quality of education systems in the other countries analyzed. Greater flexibility in the funding system is needed to make appropriate adjustments in the allocation of spending within the sector. Spending is generally skewed away from primary and secondary schooling. In Romania, the share of education spending going to tertiary education is among the highest in the world, while basic education gets less than 40 percent of total education spending, just 1.2 percent of GDP. Moreover, a common problem is that under-funding of complementary inputs undermines the quality of the services. Only a marginal rate of current spending is available for instructional materials and maintenance despite severe shortages of materials and poorly maintained equipment. These critical lacks result in low quality of service delivery and an associated reduction in demand (World Bank, 2007b).

In sum, future reforms have to improve the efficiency of spending and streamline the organization and financing of education. Part of the savings can then be devoted to improving education outcomes through the acquisition of textbooks and materials, teacher training and an incentive program that encourages school attendance for children from the poorest households.

4.6.5 Institutional Quality and Effective Governance

The deficiencies in the education sector reflect a poor governance environment in general, and weak public administrations in particular. Public administrations in SEE remain slow and unresponsive to the needs of people and businesses. They are characterized by a considerable degree of politicization, weak capacity, and low standards of professionalism. Efforts with a focus on enhancing the general business environment and upgrading human capital are needed to improve the governance in the public sector.

In the early years of transition, public administrations generally lacked the capacity to deal with rising social and economic problems. While public officials were involved in rent seeking activities, governing parties deliberately delayed the implementation of regulation and oversight of state assets, and made little effort to transform the public administration into a more rational-bureaucratic organization. Administrative capacity was further weakened as each new government initiated sweeping layoffs to bring in its political cronies. The formation of clientelistic networks, the lack of stable rules and the absence of transparency in the working of the public administration bred incompetence, apathy and endemic corruption.

Little was done to reform public administration until 1998, after the EU made improved state administration a condition of accession. Under increased pressure from the international community, SEE countries made progress on several key dimensions of public administration reform. New civil service laws aimed at improving the functioning of the public sector and adopting EU standards were implemented between 1999 and 2003.

Secondary laws were enacted to regulate processes such as recruitment and selection, performance evaluation, and avoidance of conflict of interest. In Bulgaria and Albania, and to a lesser extent in Romania, progress was also made in developing a medium term expenditure framework.

Some improvement in these processes has already been registered. Regular training of state officials has fostered competence and proficiency. However, weak professionalism is still a cause of concern, especially at the lower levels of the state structure where policies are implemented. Local authorities are still lacking the adequate administrative, technical and financial capacity to carry out their functions. Also, whilst regulations on promoting integrity of civil servants have improved, they continue to be lax when it comes to policy makers. As political appointees at the administrative level mistrust the public administration, they continue to use patronage and politicized appointment processes to promote their agenda. In the face of low salaries, corruption continues to be a major problem in the public administration. Low salaries also deter people from entering the public administration so that institutions increasingly face problems of recruitment.

Among the four countries under analysis, Bulgaria's public administration has undergone the deepest transformation in recent years. A large number of laws and regulations aimed at improving administrative capacity and quality have been adopted. The National Revenue Agency was established in 2006, centralizing the collection of taxes and social security contributions previously spread over several institutions. Progress was also made in developing the medium term expenditure framework (European Commission, 2007b).

Future reforms should focus on accomplishing the implementation of the new legislative and regulatory framework. This involves streamlining the public sector, extending the budgeting procedures to the entire administration, and strengthening auditing procedures. The resulting fiscal savings could be used to fund public services in rural areas, which are chronically short of resources. Reducing the tax and social contributions burden on the economy would be another viable alternative. Moreover, the implementation of both the merit criteria for hiring and transparent and competitive procurement for public tenders would do much to depoliticize the civil service.

Although the political system in Romania is highly centralized, weak cooperation between different ministries and levels of government affects the transparency and effectiveness in the public sector and reduces the quality and efficiency of local service delivery. Due to the abundance of largely uncoordinated administrative processes and procedures, a comprehensive and consistent political strategy is missing. This lack of clear strategic direction is a major constraint in Romania's governance system. It implies that the country's policy decisions are often driven by short-term political objectives, with little consideration for the effects on the functioning of the economy and the long-run sustainability of government finances. Confusion over responsibilities, lack of transparency due to weak monitoring and reporting mechanisms, high frequency of budget revisions, pronounced end-year surge in public spending, and underprovision of essential public services are symptomatic of poor governance structures (World Bank, 2006g; IMF, 2008b).

The high degree of centralization also leads to problems of governance at the local level. Local authorities have relatively few areas of responsibility, weak resource bases, and are often staffed by persons with low levels of technical competence. Interactions between local and central authorities are slow, uncooperative and highly opaque, enabling policy makers in some less developed counties to act as oligarchs.

As in the case of Bulgaria, Romania has introduced several administrative laws and regulations in recent years to fulfill the requirements for EU accession. Romania, like Bulgaria, also needs to apply the legal and regulatory framework it has adopted in order to improve the functioning of the public sector. Particularly important is the strengthening of fiscal institutions, including technical capacity building and improved transparency in fiscal policy, the implementation and resolute application of the medium term fiscal framework, and the development of independent auditing procedures (World Bank, 2006g).

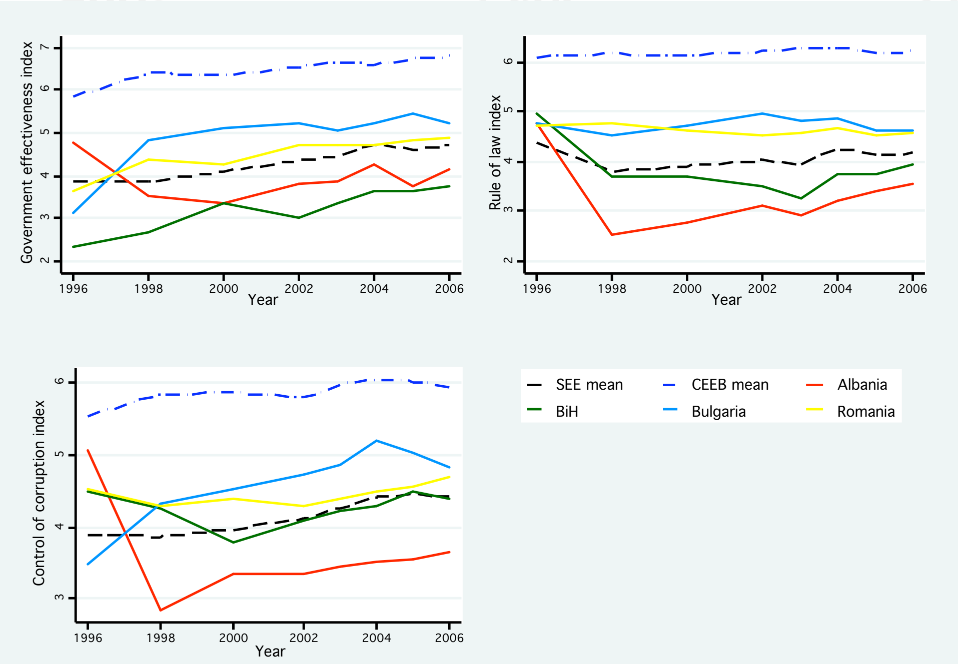
In Bosnia the state structure is too fragmented to be effective and efficient. The Dayton peace agreement has established protected administrative monopolies that seriously impair public accountability and make coordination difficult. Whilst satisfying the requirements of ethnic parity, the public sector leaves much to be desired in terms of setting up an environment conducive for development and improved administrative performance. Inappropriate fiscal decentralization creates overlapping responsibilities between levels of government, fiscal imbalances, and inefficient mechanisms for financing and delivering services. Given the substantial over-employment in police, defense, the judiciary and education, as well as the duplications resulting from administrative fragmentation, the size of the core public administration is small. Lack of transparency and accountability imply that civil servants are generally selected on political patronage rather than on competence and organizational requirements. Last but not least, unclear working procedures, insufficient independent auditing, the absence of monitoring mechanisms, and non-transparent budgets facilitate corruption and appropriation of public resources (UN, 2004; World Bank, 2006f).

Improving the functioning of public administration thus remains a crucial challenge for Bosnia. Substantial administrative savings could be made if state structures were rationalized and streamlined. Moreover, future public financial stability will depend on improvements of budget accountability and fiscal management (World Bank, 2006f). However, the internal drive for harmonization is quasi non-existent.

The need for public sector reform is probably most acute in Albania. This becomes obvious when looking at Figure 4.23 which shows three dimensions of governance: government effectiveness, rule of law, and control of corruption.[6] The figure indicates that

[6]The indicators reflect the responses given by a large number of survey respondents on the quality of governance (see Kaufman et al. (2008) for more detail). The first dimension, government effectiveness, assesses the capacity of the civil service and its independence from political pressure, the quality of public services, and the quality of policy formulation. The second dimension, rule of law, measures the extent to which agents have confidence in the legislative and regulatory framework of the country, such as the property rights, the police, and the courts. The last dimension, control of corruption, measures the extent to which public power is exercised for private gain. The original governance indicators are measured in units ranging from -2.5 to 2.5, with higher values corresponding to better governance

Figure 4.23: Governance Indicators 1996–2006



Source: Kaufmann D., A. Kraay, and M. Mastruzzi: Governance Matters VII: Governance Indicators for 1996-2007, 2008.

Albania considerably lags behind Bulgaria and Romania in terms of government effectiveness, rule of law and control of corruption. Although the country has made good progress in reducing the size of the public sector as well as streamlining its structure, the persistent low quality of Albania's bureaucracy, the inadequate functioning of the judiciary, widespread fraud and corruption, poor infrastructure, and limited technical means are still cause of concern as they seriously hamper the country's EU accession process (World Bank, 2006d). The policy measures proposed to deal with these issues are broadly similar to those recommended in the other countries and do not need to be reiterated here.

Regulatory and governance reforms have taken a prominent place on the reform agenda in recent years. The progress made to date has been rather slow and laborious, corroborating the hypothesis made in Chapter 3 that delays in economic reforms at the beginning of transition slow down progress in political reforms or stop it altogether. The fact that significant institutional changes have occurred in recent years in Bulgaria, Romania, and Albania without major political setbacks suggests that the period of political instability is coming to an end, and that the region is embarking on a simultaneous transition path towards a democracy with a market economy. By contrast, the lack of economic liberalization in Bosnia is likely to impede democratization for some time to come.

outcomes. The values of the original indicators have been transformed so that they assume values from 0 (poor governance outcomes) to 10 (excellent governance outcomes).

4.7 Ex Post Reform Forecast

The present section compares the political markets of Bulgaria, Romania, Albania and Bosnia during the transition process. The reform model developed in Section 2.2 is used to facilitate comparison across countries. As explained in that chapter, reforms are considered as arising from the policy-making process, and are treated as endogenous. In contrast to Chapter 3, the focus here is exclusively on one of the three relevant aspects of simultaneous transitions, namely the relationship between political reforms, P_t, and economic reforms, R_t. By applying the market analogy to the political arena, the model reduces the complexity of the reform process and simplifies the evaluation of the underlying mechanisms.

Based on the narrative description in the Sections 4.2 to 4.6, two ex post forecasts will be carried out. Predictions about the likelihood of reform will be made based on the conditions prevailing in the political market at a particular moment in time. With the wisdom of hindsight, the results can then be 'back tested' by comparing them to de facto reform outcomes. The first ex post forecast covers the period between 1990 and 1996 during which the countries under study attempted more or less successfully to stabilize their economies and free them from state control. The second ex post forecast covers the period after 1996, when the EU became an important political force in the region and encouraged governments to complete macroeconomic and regulatory reforms and remove obstacles to effective governance. The ex post forecasts performed here are, to some extent, similar to the counterfactual analysis in Chapter 3. In contrast to these, however, they rely mostly on the narrative description made above.

The comparative study pursues two interrelated goals. The first goal is to ascertain if the initial level of political competition had an effect on economic reform. The intensity of political competition will be determined based on the definition in Section 2.3.4. The second goal is to find out whether the reform model can help us predict reform outcomes on the basis of some easily available and accessible information on political market conditions. If this is the case, the model can be used as a simple analytical device to evaluate the chances of reform success.

4.7.1 Political Markets at the Beginning of Transition

The economic crisis that engulfed the communist bloc in the 1980s led to drastic declines in living standards and brought incumbent communist regimes into discredit. The large social and economic discrepancies between Western and Eastern Europe became an open secret even in countries where information about the outside world was scarce, such as in Albania and Romania. The public was thus growing increasingly aware of the costs associated to the maintenance of a corrupt and ineffective political and economic system. The perceived costs of the crisis contributed to the establishment of a potential reform demand. When the wave of political liberalization swept through Central Europe in 1989, societies in SEE were encouraged to challenge the communist rule.

Yet there were considerable differences in the magnitude of crises across countries. Social and economic deprivation was most prevalent in Albania, where the economy was ruined by years of self-inflicted autarky. The overwhelming state sector was not able to provide regular salaries to its employees. People were starving and desperate to move out of the country. In Romania the population also suffered enormously following Ceausescu's forced repayment of external debt. In contrast, material hardship was less severe in Bulgaria, where the preferential relationship with Moscow had enabled the government to maintain reasonable living standards. Following the removal of the privileges in the mid-1980s, the policy of soft budget constraints preserved jobs and wages, but aggravated the country's debt problem. The situation was similar in Bosnia, where living standards, while in decline, were still relatively high compared to the regional peers.

The brunt of the crisis was borne by those in society who lived in poverty and destitution. The communist elites, on the other hand, continued to enjoy a life of relative wealth and even luxury. Yet evidence from the case countries suggests that economic deterioration threatened the welfare of the mid-level hierarchical positions of the elite, encouraging them to defy their superiors by openly questioning the political status quo.

Taking these factors into consideration, it can be assumed with confidence that the potential demand for economic reforms exceeded the potential demand for status quo in each of the countries studied. The question is whether reform supporters were able to transform their potential demand into effective demand.

Despite the obviousness of change in political conditions, the question is all but trivial. Although the demise of communist regimes brought to life new interest groups and political forces in all countries, former communist party members managed to preserve considerable political power, and thus continued to play a crucial role in the political agenda-setting process. While some of them formed a non-reform wing that advocated the maintenance of old economic and political structures, the majority was in favor of a gradual implementation of social market economy. In reality, both groups used the window of opportunity during the relatively long political transition to turn their administrative resources and political power into economic clout. Their main goal was thus not to establish a market economy, but to assert control over the transition process. Reform gradualism was selected as a strategy to buy time to better promote this goal. For this, they relied on the organizational structure and network of the communist party, which remained intact and powerful even after the party's transformation into a social democratic party. Therefore, although they pretended to support reforms, the former communist elites were mainly interested in protecting their economic turf.

In Bosnia, the situation was different in that the reformed communists rapidly lost political influence and support due to the growing wave of nationalism. Nationalist parties took control over political and economic resources in their respective regions, and presented themselves as the natural defenders of their ethnic group. Threats posed by other ethnicities were exaggerated to mobilize public support, enhance group solidarity, and impede the development of organized political opposition. In such a climate characterized by fear and insecurity, the development of political pluralism was strangled. Voices that called for a liberalization of political and economic life were marginalized.

These status quo forces were joined by the group of state employees. Managers and workers in public enterprises had strong vested interests in maintaining the status quo, because many enterprises were unable to survive under market conditions. A similar reasoning applies to bureaucrats. A comprehensive reform would have required the restructuring and modernization of the public administration, which was characterized by a lack of professionalism, accountability, scrutiny and transparency. Bureaucrats were reluctant to embrace any change that threatened to undermine their position. The size, the homogeneity of interests, and the organizational strength gave state employees significant bargaining power vis-à-vis other demand groups in the political market. For instance, the support of state employees was one reason why the Albanian communist party was able to remain in power until mid-1991. Support also came from rural areas which accounted for almost two-thirds of the country's population. People working in state farms were heavily influenced by farm directors who remained powerful supporters of the incumbent regime.

After the ban of political activities was lifted, reform-minded political groups emerged rapidly in the region. However, these groups were too immature to challenge existing status quo forces. The majority among them was small, unorganized, and lacked political and economic experience. Efforts were undertaken to unite the reform forces, but the heterogeneity among them was so pronounced that a common reform strategy could not be defined.

The fact that public agencies and enterprises remained under the control of the former communist nomenclature limited the opposition's economic power. In regions with only one industry or farm, employees were particularly reluctant to vote for the opposition out of fear of losing their jobs. In the absence of adequate economic resources, reform-minded opposition groups were unable to organize and develop powerful political voice. Hence, these groups failed to rally much popular support as they were not considered to have the capacity to assume political power.

The powerlessness of reform-minded opposition groups reflected the weakness of the civil societies in the region. One of the reasons for this weakness was of course the historic repressiveness of communist regimes. The legacy of the communist experience had engendered, to say the least, the desire to avoid involvement in political life. Another reason was that in the face of a full-blown social and economic crisis, survival became the main objective in people's lives. People were concerned about preserving what little they had left, and this made mobilization for collective action and civic engagement very difficult (Howard, 2002; Mungiu-Pippidi, 2002).

Opposition parties also faced considerable institutional barriers. For instance, they only had restricted access to media broadcasting which made it difficult for them to promote their political agendas. This made it virtually impossible to mobilize the population, which continued to be heavily influenced by state propaganda. Propaganda in turn painted liberal reformers as a grave threat to the nation. The parties in power discredited privatization schemes by suggesting that market reforms implied selling the country off to foreigners. In Romania, opposition movements were even subject to political harassment by the secret police and rampaging workers. These workers came mainly from heavy industrial sectors, such as the steel, coal mining, and other metallurgical enterprises, which were threatened with disbandment by many of the new organizations (Stevenson Murer, 2002).

Finally, the general population was ignorant in terms of understanding how a market economy functions. The lack of knowledge boosted idealistic expectations as well as end times prophecies, which made it difficult for the public to get a realistic picture of what to expect from market reforms. In the absence of a similar comparator, it was impossible for individuals to assess the economic and social impact of transition. The developments in Central Europe could hardly mitigate existing uncertainties. On the contrary, the serious difficulties these countries were experiencing following the rapid implementation of economic reforms were unsettling to many people in SEE. Within this context of dissipated opposition, ideological confusion and fear of change that was still deeply rooted in the minds of the population, it was not difficult for former communists to set the direction of political action (Maniu et al., 2001).

The political developments in Bulgaria and Albania somewhat diverged from the general pattern sketched above. In both countries, the former communist elite managed to win the first parliamentary elections, but was forced out of office after massive extra-parliamentary pressure from opposition forces.

In Bulgaria, opposition forces were determined to avoid any major struggle among them and united under the umbrella of the UDF. This coalition represented a wide range of political movements that stressed their anti-communist stance and painted the former communists as the enemies of the Bulgarian nation. The most effectively organized groups within the UDF were those who called for the restitution of property titles held by their ancestors. The convergence of their interests enabled them to overcome the problem of collective action and to set the priorities in the UDF's political agenda. The pooling of interests enabled the UDF to win the second parliamentary elections held in October 1991.

In Albania, the DPA played a decisive role in promoting a radical program of political and economic reform. The party drew its initial support from young, urban groups coming from academic circles. The young generation had missed the glorious days of Albanian communism and grew up at a time of rapidly deteriorating living standards. Young people were generally well-informed about the outside world, as the communist regime had been unable to restrict access to Italian media. They were aware of the opportunity costs they incurred by remaining in the political status quo and were united in their desire to reach the living standards of Western countries. Being young, they had a long time horizon and were more inclined to take risks. Moreover, because of their academic affiliation, these groups were relatively well-organized, allowing them to mobilize a great number of people in a short period of time.

Students protested against the presence of former communists in the other countries as well, but these protests were not nearly as massive as in Albania, where the median age of the population was about 23.8 years in 1990, compared to 36.6 years and 32.6 years in Bulgaria and Romania. The DPA gained considerable bargaining power in the political market with the support of these groups. The DPA also managed to gather support from state employees and farmers as it became apparent that the economic crisis deepened and state institutions disintegrated.

Albania's catastrophic economic situation also encouraged individuals in the potential demand to opt for the exit strategy. Masses of people invaded Western embassies or escaped to neighboring countries to find work and a better place to live. Albania is a good example of how the combined effect of voice and exit increases pressure on the government to introduce reform policies. Although there were relatively large emigration outflows from Bulgaria, Romania and Bosnia, they did not have a major impact on the reform process in their respective countries.

Table 4.2: Political Market Conditions between 1990–1992

	Bulgaria	Romania	Albania	BiH
Reform decision				
Crisis	+	+	+	+
Potential reform demand	+	+	+	+
Expected benefit from exit	0	0	+	0
Expected benefit from voice	+	-	+	-
Effective reform demand				
Market position	+	-	+	-
Group cohesion	0	-	+	0
Economic power	0	-	0	-
Knowledge and experience	-	-	-	0
Relative bargaining power of the effective reform demand	0	-	+	-
Reform design and implementation				
Effective reform supply				
Market position	0	-	+	..
Resolution of organizational problems	-	-	+	..
Competence	-	-	-	..
Relative bargaining power of the effective reform supply	-	-	+	..
External support	0	0	+	..
State capacity	-	-	-	..
Rule of law	-	-	-	..
Accountability	-	-	-	..
Reform intensity (ex post forecast)	low	low	medium	none

Notes: A positive sign indicates a hypothesized positive effect of the variable on reform, and a negative sign indicates a negative effect. 0 indicates that there is no effect at all.

The first part of Table 4.2 illustrates the situation on the demand side in the respective political markets. While strong potential reform demand groups existed in all four countries, not all of them were able to effectively channel their claims and resources into the political process. The lack of economic power and the absence of coordinated effort weakened reformist forces in Romania and Bosnia and made it difficult for them to rally enough support for their political agenda. In contrast, in Bulgaria, a consensus arose on the need to reform the economy. However, the consensus was fragile as each group involved sought reform for divergent reasons. Hence, the effective demand had relatively weak bargaining power. In Albania, the reform demand groups managed to resolve temporarily their organizational and collective action problems and to emerge as a strong demand group in the political market.

As illustrated in the second part of Table 4.2, the varying degrees of intensity in effective reform demand translated into varying degrees of effective reform supply. In Bosnia, the rise of nationalist parties brought the ongoing economic reforms to a premature end. The growing divergences about the future status of the country heralded the process of state disintegration. Nationalist parties gained the monopoly on violence in their respective territories and took control over economic activity. The beginning of the war in April 1992 sealed Bosnia's fate as it became clear that a political solution to the conflict had receded into the distance.

The war enabled nationalist leaders to consolidate their grip over political and economic resources. Accordingly, they had a strong interest in maintaining the conditions on which their power depended: ethnic homogenization, personalized control structures over state institutions, and the absence of democratic accountability and rule of law (ESI, 1999). As long as the established power structures remained in place, economic reforms were highly unlikely to be resumed.

In the other political markets, the reform-minded forces on the supply side were in a difficult position as well. In Bulgaria the multiparty coalition government appointed in December 1990 triggered a number of reforms, but the strong polarization between political forces contributed negatively to their outcome. Political responsibility was ambiguous, so that none of the antagonistic political forces took ownership of the reform process. In the absence of adequate mechanisms of accountability, the various suppliers pursued their particularistic agendas at the expense of the public at large. The implementation of a comprehensive economic reform program was abandoned as a policy priority, despite political rhetoric to the contrary.

The victory of the UDF in the October 1991 elections was expected to jumpstart the reform process as the coalition had a liberal orientation and an affirmed commitment to economic reforms. Upon closer examination, however, the new government's position in the political market was fragile as demonstrated by the fact it never achieved a consensus on the direction of reform. The wide political spectrum characteristic of the members of the UDF and the relative dominance of those who demanded restitution of property titles soon led to internal disagreements. These disagreements eroded the UDF's credibility and weakened its ability to defend the contentious reform package vis-à-vis alternative suppliers in the political market.

For instance, the political agenda of the UDF's informal coalition partner—the MRF—was mainly focused on promoting the political and economic rights of the Turkish minority engaged in tobacco growing and processing in Southern Bulgaria. The implementation of economic reforms was of secondary importance. Representing an electorate with homogeneous political, social and economic interests, the MRF was a tough political partner to deal with. Also, since the BSP continued to enjoy strong support from employees in the public administration, the government's implementation capacity was severely compromised—despite sweeping layoffs of senior staff members and their replacement by political appointees.

In Romania, the bargaining process between reformist and status quo forces mainly took place within the NSF due to the party's monopolistic position in the political market. The reformist wing of the NSF contributed to what little reform impetus existed in the party by establishing a legal framework for a transition to a market economy. However, the status quo forces, clustered around the president, shied away from any real reform commitment. Their agenda relied on populist promises of stability and gradual economic change, thereby appealing to state employees who were most likely to be affected by economic reforms. As the economic pain resulting from the imposition of market reforms mounted over time, they took advantage of the situation and called for a stop of reforms. As a result, the NSF's cohesion started to wane. The party's split in the run-up to the September 1992 general elections consolidated the political power and cohesion of the status quo forces.

The elections did not substantially change this situation. The reformist opposition groups managed to strengthen their ranks by carrying a number of victories in the country's major urban centers. However, the heterogeneity of their composition posed major organizational issues and reduced their effectiveness in the role of political opposition. The status quo forces, by contrast, derived considerable power from control over state institutions and support of state employees, making it impossible for potential reform suppliers to win over the majority of the electorate.

As was the case in Bulgaria, a multiparty coalition assumed executive power in Albania's political market after the forced resignation of the APL. The coalition included some strong supporters of exhaustive economic reform, with the result that some early stabilization successes were achieved. However, with parliamentary elections approaching, politicians pandered to populist passions and interrupted their reform efforts. Disagreements over the reform direction eventually led to the dissolution of the interim government in December 1991.

Although the DPA won the parliamentary elections, the party's market position was considerably weakened by the SPA's victory in the local elections three months later (Pashko, 1993). The DPA's refusal to recognize the socialists as a legitimate political interlocutor worked against the emergence of a political consensus on policy reform and brought the new government's commitment to democracy into question. The conflictive relationship between the two parties raised the likelihood of political instability and threatened to undermine the reform process.

In order to compensate for the loss in bargaining power, the DPA carried out sweeping layoffs in the public sector, replacing SPA administrators and managers with its own political appointees. The DPA leadership also rapidly consolidated its own ranks for the sake of internal party cohesion. During this process, the leadership grew increasingly authoritarian, inducing party members—among which prominent representatives of the young and reform-friendly generation—to defect. Although these measures strengthened the DPA's internal cohesion, they deepened the party's alienation from the electorate and weakened its commitment to reform.

The low level of managerial and technical competence in the political markets studied was a serious obstacle to the successful implementation of economic reforms. Political suppliers had no practical experience of a modern market economy, nor did they display any knowledge of democratic principles. In a period requiring innovative solutions, suppliers lacked the appropriate skills to tackle complex technical and political challenges.

Due to the shortage of domestic skills and experience, foreign experts played a dominant role in working out the reform agendas. However, the over-reliance on foreign expertise made reforms prone to error as external advisors failed to capture the countries' political and economic idiosyncrasies. Moreover, as domestic suppliers had no clear understanding of how policy actions translated into actual economic performance, they struggled to adjust the reform agendas to the needs of the country. This is likely to have reduced their commitment to embrace genuine political and economic change. As a result, little was done to communicate the basic components and goals of the reform agenda to the public so that it was impossible to achieve wide ownership of reforms. Instead, political suppliers had a tendency to give in to the temptations of populism and nationalism, and to use external advisors as scapegoats to mask their own incompetence (Mungiu-Pippidi, 2002; Nikolov et al., 2004).

Nevertheless, external actors did not confine themselves to supplying information and technical assistance. Control over important financial resources provided them with considerable bargaining power to promote their reform agendas in the respective political markets. Their leverage was generally greater in countries where alternative credit sources were not readily available, such as in Albania and Bulgaria.

The lack of skills and experience on the supply side of the political market was further exacerbated by weak state structures. The reason for this weakness was that the collapse of communism was accompanied by the dismantling of state institutions which had lost legitimacy among citizens. As the speed of institutional destruction by far exceeded the speed of institution-building, state capacity was significantly undermined. The slow progress in capacity-building reflected the suppliers' reluctance to transform the public sector into a market-supporting institution. Instead, the public sector was used as a source of patronage, thereby causing problems of politicization, inefficiency and corruption. Consequently, the state lacked the capacity to address the vast array of political and technical reform challenges (Nikolov et al., 2004; Grzymala-Busse, 2007).

Among the most affected were the institutions of law and order. Judicial systems, which had been cut off from the development of modern legislation, were ill-equipped to implement new laws once they were adopted. Nontransparent lawmaking processes at the beginning of the transition overburdened courts, lawyers, and regulatory bodies charged with implementation. The inefficiency of state institutions and the general absence of rule of law was a breeding ground for illegal activities and corrupt practices in- and outside the public sector (Anderson et al., 2005).

Public confidence in democratic institutions deteriorated rapidly once it became clear that political markets were suffering from weak, or even missing, controls and a lack of accountability. Once seated in office, political suppliers were considered as being responsive to particularistic constituencies on the demand side rather than to the public at large. State bureaucracies were not accountable to the people, but to the party in power. Parliaments were ineffective and operated at a very low level of transparency, exacerbating the public's tendency to regard political suppliers with distrust. All in all, there were no formally established institutional linkages between the supply and the demand side of the political market that would have enabled both sides to find effective mechanisms to communicate with each other on a regular basis. Hence, the agency problem remained unresolved. The lack of appropriate accountability mechanisms was an important restriction for an effective implementation of reforms.

In light of the presented evidence, the political markets under examination cannot be considered as competitive, as none of them meets the definitional criteria of political competition proposed at the end of Chapter 2. Alternative views to the existing status quo were present in all polities, perhaps with the exception of Bosnia, where the vague of nationalism and separatism swept diverging views aside. However, myths and misconceptions about political and economic liberalization abounded, and reliable and convincing information was hard to find. Because of this uncertainty, reform supporters found it difficult to convince risk-averse individuals to bear sacrifice and hardship in the short term for the lure of a better future.

Evidence also suggests that demand groups faced considerable barriers of access to political markets despite the formal introduction of democratic institutions. Especially in Romania and Bosnia, the lack of resources and the presence of institutional barriers crippled the capacity of many potential reform demand groups to organize and develop effective voice. Status quo forces thus enjoyed a quasi-monopsonistic position on the demand side of the political market.

Once in office, political suppliers had a tendency to consolidate their political domination, either through tactical distributions of favors to political supporters or through outright threats and intimidation. The existence of such tactics indicates the absence or inadequacy of existing checks and balances in the system of government.

Finally, there was considerable competition from external political markets in Albania, as evidenced by the large emigration in the early stage of transition. Moreover, the overwhelming desire of the population to reach Western living standards induced political suppliers to follow the economic prescriptions of external advisors. In Bulgaria, by contrast, many dominant political figures remained oriented towards the Soviet Union, while Romanian and Bosnian political suppliers were either disoriented or absorbed by nationalism. Hence, in these countries, competition from outside political markets seemed to be limited. Table 4.3 summarizes the different aspects of political competition for each country according to the definition proposed at the end of Chapter 2.

Based on the analysis of the political markets and the evaluation of their respective level of competition, the reform intensity is estimated ex post to be fairly strong in Albania and low in Bulgaria and Romania. In Bosnia, reform is highly unlikely due to the complete absence of political competition. When we review Section 4.6, which contains a detailed report on present conditions in these countries, we can conclude that

Table 4.3: Political Competition between 1990–1992

	Bulgaria	Romania	Albania	BiH
Alternative political views	$\surd$	$\surd$	$\surd$	$\times$
Access to political markets	$\times$	$\times$	$\times$	$\times$
Alternative effective demand forces	$\surd$	$\times$	$\surd$	$\times$
Alternative effective supply forces	$\times$	$\times$	$\surd$	$\times$
Alternative political markets	$\times$	$\times$	$\surd$	$\times$

Notes: $\surd$ and $\times$ indicate whether the criteria is satisfied or not.

these general predictions closely match actual observations. In Bosnia, economic reforms came to a halt as soon as status quo forces came to power. Governments in Bulgaria and Romania made some early progress in liberalizing markets, but the reform effort collapsed rapidly for lack of support from well-connected and well-organized status quo groups. These countries never achieved sustainable macroeconomic stabilization. In contrast, Albania managed to stabilize its economy and to implement some structural reforms at an early stage.

4.7.2 Political Markets at a Turning Point

Previous literature has identified the years 1996–1997 as a turning point in the development of many transition countries (see Nikolov et al., 2004; Rusinova, 2007). While the period prior to 1996–1997 was characterized by weak economic performance, the period after it was marked by sustained economic recovery. It is thus worthwhile to investigate the potential for changes in the political market, especially those related to the level of political competition, to improve economic outcomes.

The generally low level of political competition, and the resulting lack of checks and balances, induced incumbent suppliers in the region to abuse their dominant market position during the early phase of transition. In the absence of adequate accountability mechanisms, they tended to behave much like their communist predecessors. Control over the selection processes in all major state institutions allowed incumbents to insulate themselves from political challenge and to block the channels of political change. Dissident voices were excluded from influential leadership positions to increase party loyalty and discipline. This led to the resurrection of a party-directed state apparatus, which clearly violated the constitutional separation of powers and contributed to public disenchantment with the democratic process.

Incumbent suppliers not only prevented political liberalization, they also delayed the establishment of oversight and regulatory agencies. These delays enabled them to exercise near monopolistic control over public companies, including utilities, transportation networks, and industrial enterprises. They utilized the considerable economic and political power derived from control over these companies to consolidate the regime. Where economic reforms were implemented, political suppliers generally politicized the process and distributed state assets for their own benefit.

The incumbents continued to rally support from a large number of individuals on the demand side of the political market despite public disenchantment with political patronage and corruption. They accomplished this by exploiting the uncertainty about the political and economic future and creating a general atmosphere of doubt and fear. As a result, security issues tended to prevail over concerns for political and economic liberalization.

The result was that many reforms in Bulgaria, Romania, and to a lesser extent in Albania remained unfinished while others were not initiated at all. This had grave consequences for the countries' social and economic performance. The situation in Bosnia was even worse. After three and a half years of war, the country lay in ruins, the economy was devastated, and hundreds of thousands of people were displaced. Growing frustration over the massive declines in living standards and a commensurate rise in poverty led to a renewed demand surge for political and economic change. The demands intensified as the successful transition processes in several neighboring Central European countries revealed the benefits foregone by not reforming.

The large flows of emigration during the early years of transition also increased pressure for change. The economic crisis together with rigid labor regulations had excluded a generation of young workers from domestic labor markets, encouraging them to opt for the exit strategy in order to find jobs in more prosperous countries. Although the emigrants sent remittances to their families to alleviate economic hardship, they also left behind a demoralized and unproductive workforce that was ill-suited to meet the challenges of transition. The loss of young and productive manpower and the continuing decline in tax revenues made it increasingly difficult for the remaining population to afford the costs associated to the status quo.

In Bulgaria and Romania, parts of the rural population, the elderly, and the bureaucracy—lured by promises of well-paid jobs, higher rents and subsidies—continued to support incumbent suppliers in their respective political markets. SOE managers, whose tenures were closely tied to those of the incumbent regimes, also remained opposed to any change in the status quo. However, even among these groups there were many who had lost confidence in political leadership and abstained from actively supporting incumbent suppliers. In Bulgaria, for instance, the catastrophic agricultural policy of the BSP contributed significantly to the alienation of a large part of the rural population.

As a result, status quo forces gradually lost their bargaining power to the growing category of relatively wealthy and well-educated private entrepreneurs and property owners, most of whom were located in urban areas. Having a strong interest in a stable and predictable economic environment, this emerging class of businessmen became involved in the political process to demand the implementation of political and economic reforms. They were joined by workers from public companies who grew increasingly reluctant to support political incompetence and corruption while experiencing huge declines in real income. These groups were actively supported by the independent media.

The international community also came to play an important role in the political markets. Through the years, international financial institutions had acquired valuable experience in dealing with transition-specific economic problems. After several years of involvement in the region, they had a better understanding of local institutional and political contexts and the specific problems of the economies. However, Bulgaria's and Romania's poor record of compliance with IMF and World Bank conditionality during the initial phase of transition suggests that the leverage of these organizations was limited in the absence of genuine domestic support for reform.

The crises that shook the region in 1996–1997 led to a political consensus, characterized by policy convergence on areas such as macroeconomic stability and structural reforms. Particularly in Bulgaria, the financial situation was such that the authorities were no longer in a position to maintain their current operations. The main interest groups realized that past policies had been ineffectual, and that foreign support would be necessary to sustain policy change.

Concomitantly with this change in attitudes, European integration became a key objective of many groups on the demand side of the respective political markets. Until then, neither Bulgaria nor Romania had a clear European orientation. The elections that took place in 1996 and 1997 initiated a broad dialogue from which a consensus emerged about the goal of EU membership. Likewise, the EU had a strategic interest in Bulgaria's and Romania's European integration. From this point forward, it took a prominent role on the demand side of the political markets and provided tangible benefits, including greater financial, material and technical support. In return, domestic political actors indicated their willingness to accept its active role in designing, monitoring, and implementing reform measures. The prospect of EU membership and the disciplining role of accession negotiations promised to be an important vehicle for pushing through a comprehensive reform agenda.

In Bulgaria, the UDF coalition was the political symbol of change. It managed to strengthen the cohesion among the various reform demand groups and to rally their support for a rapid implementation of economic reforms. After the fall of the first UDF government in October 1992, the coalition successfully consolidated its position at the center of the political spectrum and improved cooperation with other non-communist groups. It also established a solid reformist reputation by defending IMF policies during its time in opposition. In the electoral campaign, the UDF was therefore credible in its commitment to carry out free-market reforms and other changes required to meet the rigid conditions of the IMF. In its domestic policy agenda, the UDF also pledged to crack down on corruption and organized crime; its foreign policy agenda was oriented towards full membership in Euro-Atlantic institutions. On polling day in April 1997, the center-right coalition thus swept to an absolute majority.

In Romania, the reform demand forces were grouped under the RDC umbrella. Although the coalition was better organized than in the 1992 elections, it still represented a heterogeneous crew of anti-communists and former communist reformists who were only united by their desire to breach the political monopoly of the PSDR. In comparison to Bulgaria, the coalition clearly suffered from a lack of internal cohesion.

RDC members led an aggressive electoral campaign, criticizing what they perceived as an autocratic and corrupt governing style of the president. They resorted to populist rhetoric, promising rapid economic recovery, the eradication of corruption, an overhaul of the judicial system, and a firm pro-Western foreign policy orientation. However, they failed to develop a clear and coherent reform framework. Nevertheless, the disastrous economic legacy of the PSDR administration convinced voters that the RDC could better deal with the challenges of transition. Its victory in the November 1996 parliamentary elections spelled the end of PSDR's uninterrupted rule.

In contrast to Bulgaria and Romania, Albania's DPA-led government had followed macroeconomic policies in accordance with IMF requirements. The consistent implementation of stability-enhancing fiscal and monetary policies increased the government's credibility vis-à-vis international credit institutions and foreign governments on which Albania depended for its economic recovery. Despite some delays in structural reforms and widespread allegations of corruption, the government enjoyed the support of the international community. On the home front, however, the government's legitimacy waned as Albania's dynamic economic growth did not translate into improved living standards for the population. The government's legitimacy was further eroded by the DPA's excessively authoritarian political style. As coalition partners began to pull out of the government, the DPA failed to garner the required two-thirds majority in the parliament to enact a new constitution. Consequently, the country was governed on the basis of a package of interim constitutional provisions.

In the absence of a formally accepted and respected institutional framework, informal institutions became increasingly important. The clan system and the 'Kanun'—Albania's customary law—were revived in many of the country's areas to regulate social life. Clans controlled economic resources and exercised power in their respective area of influence.

To be effective, political parties used the clan system as their basis of organization. As a result, the main parties had a clearly defined regional support base. The poorer, mountainous areas in the northern part of Albania supported the DPA, while the SPA mainly drew its support from the South (Gerxhani and Schram, 2008). However, support for the SPA was not uniform. The rural population and the elderly tended to back the conservative forces within the party, while the moderates enjoyed the support of the young and urban voters. The latter also managed to gain international credit by endorsing and promoting a social liberal agenda centered on EU accession.

The traditional and rigidly hierarchical clan system stifled the development of political competition as the exercise of voice depended to a great extent on family ties and wealth. This enabled political suppliers to behave like monopolists in their respective territories, because citizens on the demand side selected their representatives on the basis of partisanship rather than on their performance and policy record.

The strong polarization of Albania's political market made consensual policy-making impossible. Although a consensus existed on the necessity and the general direction of economic reforms, the dominating forces in the political market were engaged in bitter feuds with each other. Instead of looking for compromise solutions, they used state institutions to weaken each other and to consolidate their hold on power. The dominating forces' utilization of state institutions to achieve particularistic goals further undermined state capacity and legitimacy.

The culmination of this negative development was the DPA's controversial victory in the May 1996 elections. The elections had been preceded and followed by partisan violence, fueled by politicians' inflammatory statements. The DPA had worked actively to subvert the electoral process and to weaken political opposition. Opposition forces had also complained about tight government control and inadequate coverage of opposition party activities. Finally, DPA supporters, often with official connivance, disrupted opposition meetings and harassed SPA supporters.

Confronted with these political and institutional barriers, the opposition had been unable to voice its demands and fully exercise its rights in the political market. It was only after the pyramid scandal re-plunged Albania into a deep crisis that the SPA was able to mobilize sufficient support to remove the DPA from power in June 1997.

In Bosnia, competition on the demand side was restricted by the continuing fragmentation of the political market into local monopolies in which nationalist leaders maintained their control over political institutions and economic resources. Although intra-party disagreements surfaced with regularity, there was no serious challenge to the authority of nationalist parties. The public was generally consumed by the hardship of everyday life, and possessed neither the energy nor the capacity to challenge authoritarian power structures. Weak cooperation, a lack of advocacy, and a poor understanding of public policies further limited people's incentives to voice their demand in the political market. Political apathy prevailed. If anything there was potential support of the status quo among some sections of the population, such as SOE workers, bureaucrats, pensioners and war veterans. Although it generally took months until they received their salaries and pensions, these groups preferred to cling on to the privileges they were entitled to by law. Despite the desolate economic and social situation, voters thus continued to cast their votes according to ethnic lines rather than pressing economic and social issues.

Despite its considerable power and influence in the immediate post-war period, the international community confined its political activities to attempts to convince political suppliers of the benefits of political and economic reforms. Apart these efforts, it remained a relatively passive observer on the demand side of the political market. On the one hand, the cautious position of the international community reflected its hopes that reform demand would arise from endogenous forces. On the other hand, it also reflected the international community's inner diversity. The international community included a multiplicity of private and public organizations and actors, each with its own agenda, constituency, and source of authority. In the face of this diversity, the coordination and organization of a joint political position proved difficult. It is thus not surprising that nationalist parties managed to maintain a high degree of unanimity when bargaining with external actors (ESI, 2000).

Frustration over the uncooperative stance of nationalist parties eventually convinced the international community to take a more active role in Bosnia's political market. The adoption of the Bonn powers in December 1997 gave the High Representative the authority to dismiss obstructive public officials and to impose legislation. With this decision, the High Representative was provided with a quasi monopolistic position on the supply side of Bosnia's political market.

The conditions on the demand side of the political market are summarized in Table 4.4. With the exception of Bosnia, a strong potential reform demand developed in all countries following an economic crisis. Bulgaria's reform demand group was able to effectively channel its claims and resources into the political process. In a coordinated effort, it worked hard to rally broad support for its reform agenda. In contrast, Albania's and Romania's reform demand forces were relatively weak, mainly because of their heterogeneous and disorganized nature. Although a consensus existed on the necessity of economic reforms, their implementation was likely to be delayed by power struggles and disagreements over the reform direction. In Bosnia, the bargaining power of the international community provided the reform demand group with a strong position in the political market. However, the absence of support at the grassroots level raised serious concerns about their legitimacy, and likely affected the success of reform implementation.

Table 4.4: Political Market Conditions between 1996–1997

	Bulgaria	Romania	Albania	BiH
Reform decision				
Crisis	+	+	+	+
Potential reform demand	+	+	+	0
Expected benefit from exit	+	+	+	-
Expected benefit from voice	+	+	+	-
Effective reform demand				
Market position	+	+	+	0
Group cohesion	+	0	0	-
Economic power	+	+	0	+
Knowledge and experience	0	0	-	+
Relative bargaining power of the effective reform demand	+	+	0	+
Reform design and implementation				
Effective reform supply				
Market position	+	0	+	+
Resolution of organizational problems	+	-	-	-
Competence	+	0	-	+
Relative bargaining power of the effective reform supply	+	0	-	+
External support	+	+	+	+
State capacity	0	0	-	-
Rule of law	-	-	-	-
Accountability	0	-	-	-
Reform intensity (ex post forecast)	high	low	low	medium

Notes: A positive sign indicates a hypothesized positive effect of the variable on reform, and a negative sign indicates a negative effect. 0 indicates that there is no effect at all.

The second part of Table 4.4 assesses the supply side of the respective political markets. In Bulgaria, the UDF was eager to demonstrate its competence in reforming the economy. The party had already worked out a comprehensive reform program in collaboration with the IMF during the crisis. Economic reforms were thus ready to be implemented by the time the party came to power. Immediately after taking office in June 1997, the Bulgarian government reaffirmed its commitment to prudent economic management by adopting a currency board arrangement.

Despite the liberal nature of the reform program, the UDF managed to secure the support of traditional left-wing bastions that had suffered under the policies of the previous government. Their support provided the UDF with a comfortable parliamentary majority. To further strengthen its position in the political market, the UDF transformed from a coalition to a single party with a christian-democratic orientation. Hence, for the first time after the fall of communism, Bulgaria had a strong government with full control over its reform agenda.

The crushing defeat in the legislative elections also induced the socialists to carry out a major internal reorganization. The status quo forces were removed from the leadership positions and reform-minded policy makers took control of the party. They produced a major change in the party's policy orientation by embracing the course of market reforms and advocating a rapid accession to the EU.

The political agenda was now backed by all major suppliers in Bulgaria's political market. While the reform priorities varied to some extent, the overall reform direction enjoyed wide political support. The broad bipartisan consensus ensured political stability and enabled the government to take timely and aggressive action to reform the economy. These developments reflected Bulgaria's growing political maturity, and increased the likelihood of successful reform implementation.

In Romania, the PSDR's electoral defeat constituted a break with the old order. Consequently, the coming-to-power of the RDC was greeted with euphoria and high expectations. The support from the demand side enabled the RDC to establish itself as a powerful supplier in the political market. However, two factors weakened the RDC's market position. First, the RDC was unable to secure a parliamentary majority on its own, which is why it had to enter into a coalition government with a number of small parties. Second, the socialists maintained a relatively strong market position, enabling them to play an effective role as an opposition party.

When the new government took office at the beginning of 1997, it was committed to radical changes in order to promote economic stability and growth, but that commitment rapidly disintegrated in the face of considerable ideological differences between coalition partners. These differences were exacerbated by personal animosities that weakened the government's cohesion and undermined its credibility. The heterogeneous and centrifugal nature of the ruling coalition significantly reduced its bargaining power and made it prone to particularistic demands from its constituents.

The growing internal divisions also revealed the lack of competence and organization of the governing team. In contrast to Bulgaria, Romania's coalition partners had not developed a joint reform agenda in advance. The result was that political action was dictated by short-term political considerations with little regard for long-term economic consequences. This became evident at the latest when the first RDC-led government failed to implement its reform program due to the lack of support from within the coalition. Given the weak bargaining power of Romania's government, reforms were unlikely to get off the drawing board.

In Albania, the DPA's involvement in the pyramid banking schemes resulted in an overwhelming parliamentary victory for the SPA-led coalition. The SPA by itself secured more than half of the total votes. Together with a coalition of like-minded parties, it took control of two-thirds of the seats in parliament, relegating the DPA to the role of passive spectator.

The solid mandate of the SPA was primarily due to the discredit in which the people held the DPA. But the party's popularity also stemmed from the populist promises made during the electoral campaign. These included, among others, the rapid reconstruction of public facilities destroyed during the riots, an increase in social assistance spending, and—last but not least—the compensation for the losses incurred in the pyramid scandal. Given Albania's lack of domestic financial reserves and the unwillingness of foreign donors to step into the breach, it was clear that these promises could not be fulfilled. Under pressure from international financial institutions, the new government rapidly dropped its promises and restored economic stability through a tight monetary and fiscal policy.

Despite its strong electoral mandate, the new government struggled to articulate and implement a coherent reform program. Some of the difficulty arose from the internal conflicts over leadership positions. The government was dominated by the conservative wing of the SPA which had a tendency to maintain the authoritarian governing style of the previous administration. This, however, did not discourage the younger generation within the SPA from challenging its leadership. These power struggles resulted in frequent reshuffles in the government and threatened the fragile political stability of the country.

Reform was further hampered by the lack of competence, as senior officials were not appointed on the basis of merit and performance but rather on the logic of clan politics. Consequently, many officials were unable to effectively manage the reform process. They used their political power for rent seeking purposes instead. Where reforms were implemented successfully, political and technical inputs mainly came from external sources (Reid, 2007).

When the young and reform-friendly generation of the SPA took over government affairs in September 1997, reform prospects improved not because the new team was more competent, but rather because it was more willing to follow the prescriptions of external advisors. Yet their lack of political experience and authority made it difficult for them to assert themselves against the conservative forces which continued to pull the strings behind the curtain (Reid, 2007). The fact that the real balance of power within the government did not rely on transparent rules but on personal influence and informal political control, compromised the reform process and made it prone to failure.

In Bosnia, the PIC's decision to grant the High Representative a monopolistic position in the political market enabled the latter to resolve the reform deadlock caused by the nationalists' refusal to cooperate. In the absence of domestic competence and expertise, the High Representative drew on the knowledge, experience and guidance of international financial institutions, which allowed him to frame the reform agenda and influence the legislative process. Nationalist parties did not actively participate in the design of reform strategies.

The High Representative had much less influence on the implementation process as nationalist parties refused to take ownership of a reform agenda which threatened to undermine their power and authority. Moreover, the institutional framework established by the Dayton Peace Agreement was too burdensome and complicated for undertaking ambitious reforms. Bosnia simply lacked the mechanisms to ensure that the legal framework underpinning the reforms was implemented consistently throughout the state and its constituent entities.

In such a context, it was unlikely that negative conditionality would induce domestic political suppliers to commit to a foreign-driven reform agenda. Early reform efforts tended to confirm this view as even under coercion powerful vested interests continued to block economic reforms. In the absence of genuine local commitment, reforms were likely to face strong opposition from nationalist elites.

All countries continued to suffer from serious governance-related constraints that affected their capacity to enforce laws and implement reforms. No progress had been made in establishing a modern public administration capable of providing adequate support to a functioning market economy. State institutions were inefficient, highly politicized and suffered from inadequate human, technical and material resources. Remuneration systems did not provide incentives for good practice, but rather tended to encourage fraud and corruption.

The weakness of state institutions reflected the prevailing tendency among governments to neglect state building. The crises that shook the region in 1996–1997 brought to light the inadequacies of state institutions, the absence of rule of law and political accountability. This raised the awareness that governance issues had to be addressed for macroeconomic and structural reforms to be successful. Governance thus became a main concern of the international community.

The awareness of the necessity to improve governance increased the prospects for economic reform. However, as discussed in Chapters 1 and 2, it is notoriously difficult to get governance reforms to achieve their underlying goals. A major difficulty lies in the fact that such reforms seek to alter entrenched patterns of organizational behavior. Since such behavior relies on a complex combination of mutually-reinforcing expectations, norms and incentives, changing formal rules is generally not sufficient to induce behavioral change. For governance reforms to succeed, they must be accompanied by changes in these mutually-reinforcing expectations, behavioral norms and incentives. However, such changes usually take time to develop. Since the discrepancy between formal and informal rules was relatively large in all countries under examination, governance was likely to remain a bottleneck for reform implementation for some time to come.

Although the examined political markets were still far from being fully competitive, the analysis presented here has shown that the conditions for political competition generally improved in the case countries from 1996 onwards, with the exception of Albania and Bosnia. Table 4.5 summarizes the different aspects of political competition for each country according to the definition proposed at the end of Chapter 2.

Table 4.5: Political Competition between 1996–1997

	Bulgaria	Romania	Albania	BiH
Alternative political views	$\surd$	$\surd$	$\surd$	$\times$
Access to political markets	$\surd$	$\surd$	$\times$	$\times$
Alternative effective demand forces	$\surd$	$\surd$	$\times$	$\times$
Alternative effective supply forces	$\surd$	$\times$	$\times$	$\times$
Alternative political markets	$\surd$	$\surd$	$\surd$	$\surd$

Notes: $\surd$ and $\times$ indicate whether the criteria is satisfied or not.

Alternative solutions to the existing status quo existed in all countries. However, where the dominant political parties controlled the media, such as in Bosnia and partly in Albania, it was difficult for citizens to obtain independent and reliable information. Moreover, access to independent media was generally limited outside urban areas, which, to some extent, explains why some of the incumbent regimes continued to enjoy strong political support among the rural population.

Evidence also suggests that apart from external donors, demand groups faced considerable formal and informal barriers of access to political markets in Albania and Bosnia. In these countries, opposition parties also lacked the necessary resources to organize and develop effective voice. By contrast, access to the political market considerably improved in Bulgaria, as evidenced by the peaceful change of government in 1997.

The new government established itself as a valuable alternative political supplier to Bulgaria's socialist party. Although supply side competition improved in Romania, the bargaining power of political suppliers was seriously limited by their lack of competence and organization. In Bosnia, the monopolistic position of the High Representative significantly undermined the conditions for effective market competition.

Finally, all political markets had to cope with considerable pressure from outside, as the successful transition in CEEB countries caused people to reassess the costs and benefits associated with the status quo. This cost-benefit evaluation encouraged some of them to join the reform demand, while others—in particular the educated and skilled members of the labor force—preferred to emigrate.

Based on the analysis of the political markets and the evaluation of their respective level of competition, the reform intensity is estimated ex post to be high in Bulgaria and medium high in Bosnia. Due to the absence of effective reform suppliers and the weakness of governance institutions, the chances of reform success and sustainability in Albania and Romania are considered to be low.

Again, comparison of model predictions with the observations in Section 4.6 shows that the model does relatively well. Macroeconomic and structural reforms were vigorously pursued in Bulgaria, where political competition began to take shape. In Bosnia, economic reforms progressed even in the complete absence of political competition. This is mainly because of the High Representative's strong hand in directing the reform process. The case of Bosnia illustrates that political competition is not a necessary condition for the success of economic reforms. However, the case also reveals that the influence of a benevolent dictator is relatively weak in the face of strong status quo demand forces. As predicted, the implementation of economic reform in Albania and Romania was significantly slowed by disagreements in the ruling coalition government. In Albania, structural and governance reforms were generally limited to adopting new laws and regulations without changing underlying patterns of non-enforcement. In Romania, it was only after the EU became actively involved in the political market that competition reached a sufficient level to boost economic reform.

Overall, and in accordance with the findings in Chapter 3, the case study shows that countries that have not yet attained a reasonable degree of political competition tend to experience a period of political instability before embarking on the transition path towards democracy and the free market. The findings also confirm that countries, which do not establish political freedom at the outset of the transition process, are not necessarily trapped in an authoritarian setting forever. A political shock, such as the involvement of the EU in the political market, can offset the endogenous reform cycle at any time, especially during economic recessions.

4.8 Conclusion

The chapter started with a narrative description of the transition processes in Bulgaria, Romania, Albania, and Bosnia. Apart from Albania, where early stabilization policies were successfully implemented, the countries struggled to reform their economies. The gradual approach adopted by the governments in Bulgaria and Romania resulted in a deep economic and social crisis, whereas the unwillingness of political leaders to agree upon a commonly accepted modus vivendi plunged Bosnia into a devastating civil war.

The second transition crisis in 1996–1997 spurred the demand for economic reform. New political forces with a strong interest in a stable and predictable economic environment emerged and called for a change in policy direction. In Bulgaria, Romania, and to a lesser extent Albania, these political forces came from inside the country. In Bosnia, this role was mainly taken up by the international community. Yet these new political forces were not always effective in voicing their claims in the political market. In Bulgaria, macroeconomic and structural reforms were rapidly and successfully implemented. Albania and Bosnia were able to restore economic stability, but suffered serious delays in completing structural reforms. In Romania, the whole reform process was delayed until the country was invited to begin accession negotiations with the EU. Reform efforts increased significantly as the involvement of the EU intensified in the region. By implementing tight monetary and fiscal policies along with structural reforms, all governments considerably strengthened their economies. Today, the challenge lies in maintaining the momentum for structural and governance reforms, such as the reinforcement of public expenditure management, the completion of public enterprise restructuring, the improvement of public service delivery, and the systematic application of anti-corruption laws.

The comparative analysis at the end of the chapter has attributed the initial failure to reform to the low level of political competition and the absence of an accepted and respected institutional framework in the polities studied. The resulting lack of checks and balances encouraged widespread fraud and abuse at all levels of government, contributing to the disintegration of state institutions. The emergence of new political forces during the crisis in 1996–1997 generally improved political market competition, even though competition was still not embedded in an accepted and respected institutional framework. It was not before the EU became actively involved in the political markets of the region that the acceptance of and respect for the rule of law was markedly advanced. The appearance of the EU laid the groundwork for effective and healthy political competition, and thereby facilitated the implementation of economic reforms. The exception to this general trend is Bosnia, where to date no competitive political market has emerged.

This leaves us with the question of whether the reform model can help predict reform outcomes based on some easily available and accessible information on political market conditions. Considering the comparative analysis performed in this chapter, I would like to answer in the affirmative, but not without a note of caution. The two forecasts in this study were carried out ex post, with good knowledge about subsequent historical developments. This allowed us to back test predictions by comparing them to de facto reform outcomes. However, since hindsight is always easier than foresight, one has to be careful not to give the predictions more credit than they really deserve. The process of reform is complex and depends on many internal and external contingencies. Unforeseeable shocks can occur at any time. Such shocks can fundamentally and persistently alter the political conditions for economic reform. The occurrence of these shocks inevitably increases uncertainty, and the reform model cannot account for that. Attempts to make ex ante predictions on the likelihood of reform success have to take this restriction into account.

The study has taken a systemic approach that covers all aspects of the political market, i.e., the interaction between alternative views about potential states of the world, between different actors on the demand and the supply side of the political market, between different political markets and their underlying institutional arrangements. Given the abstract nature of the concept of political competition, the comparative analysis remained descriptive and formulated in relatively general terms. Other studies generally focus on discrete elements of political competition—such as party competition, checks and balances between government branches, or the set of constitutional rules—with the result that they fail to grasp the full complexity of the phenomenon. Finding appropriate measures for the various aspects of political competition could improve the predictive validity of the reform model. Keeping these restrictions in mind, the reform model can be used, for the time being, as a simple analytical device to identify the relevant political and institutional constraints that impede the effective and efficient implementation of economic reforms.

Chapter 5

Conclusion

In this study it has been shown that political competition within an accepted and respected institutional environment has been a driving force in shaping the direction and success of economic reforms in transition countries. In the theoretical discussion, it has been argued that the positive effect of political competition on economic reform can result from several factors. Competition can add to society's pool of knowledge and provide alternative strategies to overcome capacity, collective action, and agency problems. In terms of low entry and exit barriers to the political market, competition also makes it easier for citizens to organize and express their demand. Competition further influences the behavior of political suppliers via the threat of dismissal. Since political suppliers have an interest in maintaining power, their incentive to act in the public's best interest is generally stronger when they face effective sanctions. As such, political competition can increase the motivation of political suppliers to promote economic reforms.

The panel data analysis, which includes the evaluation of 26 transition economies from 1991 to 2006, has revealed a strong complementary relationship between political and economic liberalization. In a series of simulations based on observational data, it has been shown that in countries with a sufficient degree of political competition, citizens respond to economic crises by calling for economic liberalization. The implementation of these reforms removes existing distortions, increases economic efficiency and raises public welfare. Economic liberalization allows individuals previously excluded from economic activity to enter the markets at the expense of vested interests. Due to their newly gained economic clout, these individuals ask for more participation in the political process. This activates a dynamic, self-enforcing reform cycle that encourages full political and economic liberalization. This scenario corresponds to the experience of many Central European countries.

In the absence of political competition, individuals are constrained in their ability to lobby for economic reforms as they face costly barriers to political participation. When confronted with an economic shock, governments face less pressure to initiate economic reforms. The lack of government responsiveness disrupts the transmission mechanism between economic and political reforms, so that the endogenous simultaneous transition process fails to emerge. This scenario resembles the developments in many CIS countries.

Countries, where some political competition is established at the beginning of the transition process but where no efforts are made to liberalize the economy, usually experience some initial setbacks in political liberalization. This is because the trends in political and economic liberalization first have to converge towards a common equilibrium before embarking on an endogenous simultaneous transition path. This scenario corresponds best to the developments in countries of SEE. These countries managed to establish some political competition at the outset of transition. However, due to the delays in economic liberalization, they experienced a period of political instability before embarking on the equilibrium transition path towards democracy and the free market.

The comparative study on Bulgaria, Romania, Albania, and Bosnia has corroborated the positive reciprocal relationship between political competition, economic reform and economic performance. In particular, the study has shown that the initial level of political competition in the countries under examination was not sufficient to trigger the process chain described above. As a result, the countries experienced a period of chronic political crisis and a lack of economic reforms. The second crisis, coupled with the appearance of the EU as an active player in the domestic political markets, has laid the basis for a comprehensive implementation of political and economic reforms. Bosnia is the only country not to have followed this trend.

These results indicate that some level of political competition is essential to start an endogenous simultaneous transition process towards self-sustaining democratic institutions and liberal market structures. Political competition is thus not only a goal of its own, but is also crucial for sustainable economic liberalization. Since the conclusions drawn here are based on a region-specific data set, they do not necessarily apply to other countries. Future research is needed to determine whether the endogenous simultaneous transition process can also be observed in other developing or transition countries.

In order to find out what incentives motivate political suppliers to adopt growth-enhancing and poverty-reducing policies, the comparative analysis in this study was restricted to the national level. This makes sense for at least two reasons. First, at the outset of transition, the political markets examined were highly centralized, so that all major policy decisions were made at the state level. Second, because of the government's inability and/or unwillingness to enforce economic reforms, poverty increased and became a mass phenomenon in the mid-1990s. Hence, to achieve the research objectives it was deemed appropriate to take a macro perspective.

In the meantime, the face of poverty in transition countries has changed. Mass poverty has disappeared, indicating that it was a transient phenomenon that resulted from poor policy or implementation performance. Today's poverty is concentrated among specific groups such as children, unemployed people, the rural population and ethnic minorities. The comparative analysis has revealed that these groups still lack access to assets and basic services, such as land, education and health services. Owing to limited voice, the interests of these groups are often ignored or downplayed in the political process.

While central authorities still play an important role in enabling the poor to participate in growth-oriented activities, the country studies have shown that many of the aforementioned deficiencies can be traced back to the unwillingness and ineffectiveness of sub-national authorities and their service providers to account for the needs of the poor. Local authorities have weak resource bases and are often staffed by persons with low levels of technical competence. Moreover, the absence of adequate accountability mechanisms enables political suppliers at the local level to exercise almost absolute control over political markets, administrative structures, and economic resources. Unless the governance problems at the local level are addressed, the problems related to policy implementation—and hence poverty alleviation—will remain unresolved.

These changes point to the need for an alternative approach. Future political economy research may gain from focusing on political and institutional bottlenecks in local political markets. The reform model presented in this study could be easily adapted to take the specificities of local political markets into account. This may give us further insight into the interplay between political competition, policy reform, and economic performance.

Data Sources and Definitions

Variable Name	Source	Definition	Descriptive Statistics
Reform (R)	EBRD rating from 1 (no reform) to 4.3 (standard market economy).	R is the simple average of reform ratings for the following nine indicators: price liberalization, trade liberalization, small-scale privatization, large-scale privatization, corporate governance and enterprise reform, competition policy, banking reform and interest rate liberalization, securities markets and other non-bank financial institutions, and overall infrastructure reform. See EBRD (2004) for details. In Chapter 4 the values of the original index have been transformed so that it assumes values from 0 (no reform) to 3.3 (standard market economy).	Observations = 416 Mean = 2.587 Standard deviation = 0.76 Minimum = 1 Maximum = 3.956
GDP growth (G)	EBRD database. See Transition Reports for details on each country.	Annual growth rate of GDP in country i and year t, in percent.	Observations = 416 Mean = 1.287 Standard deviation = 9.177 Minimum = -44.8 Maximum = 26.4
GDP level (GL)	EBRD database. See Transition Reports for details on each country.	Log level of the GDP index with 1989 equal to 100 based on annual growth rates of GDP in country i and year t.	Observations = 416 Mean = 4.337 Standard deviation = 0.351 Minimum = 3.234 Maximum = 5.178
External growth (T)	IMF Direction of Trade Statistics, World Bank.	A weighted average of real GDP growth in the five most important trading countries, where the weights are the share of total exports to each country.	Observations = 394 Mean = 1.893 Standard deviation = 3.926 Minimum = -11.77 Maximum = 16.856
Net oil export (O)	Energy Information Administrations – Official Energy Statistics from the U.S. Government.	Annual net exports of oil in US dollar, divided by GDP.	Observations = 394 Mean = -0.0166 Standard deviation = 0.101 Minimum = -0.262 Maximum = 0.624
Fiscal balance (F)	EBRD database.	Consolidated balance of the general government, in percent of GDP.	Observations = 389 Mean = -3.975 Standard deviation = 5.255 Minimum = -31.2 Maximum = 8.4

continued on next page

Variable Name	Source	Definition	Descriptive Statistics
Political Competition (P)	Freedom House rating from 1 (free) to 7 (not free).	The Freedom House index includes the right to vote freely for distinct alternatives in legitimate elections, compete for public office, join political associations, and elect representatives. The more specific list of rights considered vary over the years. The values of the original index have been transformed so that it assumes values from 0 (non competitive) to 6 (fully competitive).	Observations = 416 Mean = 3.61 Standard deviation = 2.026 Minimum = 0 Maximum = 6
Initial conditions (IC)	EBRD staff calculations based on data in De Melo et al. (2001). See EBRD (1999) for details.	Initial country conditions are calculated according to the first principal component of a factor analysis over 11 indicators (GDP per capita in 1989; pre-transition growth rate; trade dependence on the Council for Mutual Economic Assistance; degree of over-industrialization; urbanization rate; natural resources dummy; years spent under central planning; distance to EU; dummy for pre-transition existence as a sovereign state; repressed inflation; black market premium). The indicator is normalized to have a mean of zero.	Observations = 416 Mean = -0.023 Standard deviation = 2.253 Minimum = -3.53 Maximum = 3.425
Distance from Regional Reform Leader (C)	EBRD database.	Gap between the maximum level of market liberalization achieved in the region and the level of a country i's state of liberalization at year t. We distinguish four regions: Central Eastern Europe and Baltic States (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic, Slovenia), South Eastern Europe (Bulgaria, Croatia, Romania, Albania, FYR Macedonia), Commonwealth of Independent States West (Armenia, Azerbaijan, Belarus, Georgia, Moldova, Russian Federation, Ukraine), Commonwealth of Independent States East and Mongolia (Kazakhstan, Kyrgyz Republic, Mongolia, Tajikistan, Turkmenistan, Uzbekistan).	Observations = 416 Mean = 0.374 Standard deviation = 0.368 Minimum = 0 Maximum = 1.622
Distance to the EU (Bruxelles) (D)	www.daftlogic.com	Distance/1000	Observations = 416 Mean = 2.531 Standard deviation = 1.642 Minimum = 0.721 Maximum = 6.789
Transition time (t)		The variable determines the length of transition period and is set to 1 in 1991.	Observations = 416 Mean = 8.5 Standard deviation = 4.615 Minimum = 1 Maximum = 16

Bibliography

Abiad, Abdul and Ashoka Mody, "Financial Reform: What Shakes It? What Shapes It?," *American Economic Review*, March 2005, *95* (1), 66–88.

Acemoglu, Daron and James A. Robinson, *Economic Origins of Dictatorship and Democracy*, Cambridge: Cambridge University Press, 2005.

_ and _, "Persistence of Power, Elites, and Institutions," *American Economic Review*, 2008, *98* (1), 267–293.

_ , _ , and Thierry Verdier, "Kleptocracy and Divide-and-Rule: A Model of Personal Rule," *CEPR Discussion Paper No. 4059*, September 2003.

_ , Simon Johnson, James A. Robinson, and Pierre Yared, "Income and Democracy," *American Economic Review*, June 2008, *98* (3), 808–842.

ACER, *Albania: Common Country Assessment*, UNDP, 2002.

Ackrill, Robert, Rumen Dobrinski, Nikolay Markov, and Stephen Pudney, "Social Security, Poverty and Economic Transition: An Analysis for Bulgaria 1992–96," *Economics of Planning*, 2002, *35* (1), 19–46.

Aghion, Philippe and Peter Howitt, "A Model of Growth through Creative Destruction," *Econometrica*, March 1992, *60* (2), 323–351.

Alesina, Alberto and Allan Drazen, "Why are Stabilizations Delayed?," *American Economic Review*, December 1991, *81* (5), 1170–1188.

_ and Dani Rodrik, "Distributive Politics and Economic Growth," *The Quarterly Journal of Economics*, May 1994, *109* (2), 465–490.

_ and Roberto Perotti, "Income Distribution, Political Instability, and Investment," *European Economic Review*, June 1996, *40* (6), 1203–1228.

_ , Ardagna Silvia, and Francesco Trebbi, "Who Adjusts and When? The Political Economy of Reforms," *IMF Staff Papers*, 2006, *53, Special Issue.*

Ammann, Natalie and Lorenzo Sguaitamatti, "Albanien – Schlusslicht im osteuropäischen Transformationsprozess," in Carsten Goehrke and Gilly Seraina, eds., *Transformation und historisches Erbe in den Staaten des europäischen Ostens*, Frankfurt am Main: Lang, 2000.

Anderson, James H., David S. Bernstein, and Cheryl W. Gray, *Judicial Systems in Transition Economies: Assessing the Past, Looking to the Future*, Washington D.C.: The World Bank, 2005.

Arellano, Manuel and Olympia Bover, "Another Look at the Instrumental Variable Estimation of Error-Components Models," *Journal of Econometrics*, 1995, *68* (1), 29–51.

_ **and Stephen Bond**, "Some Specification Tests for Panel Data Methods: Monte Carlo Evidence and an Application to Employment Equations," *Review of Economic Studies*, 1991, *58* (277–298).

Arroyo, Dennis, "The Political Economy of Successful Reform: Asian Strategems," *Stanford Center for International Development Working Paper No. 356*, 2008.

Baland, Jean-Marie, Pranab K. Bardhan, and Samuel Bowles, eds, *Inequality, Cooperation, and Environmental Sustainability*, Princeton University Press, 2006.

Balcerowicz, Leszek, *Socialism, Capitalism, Transformation*, Central European University Press, 1995.

Bardhan, Pranab K., *Scarcity, Conflicts and Cooperation: Essays in Political and Institutional Economics of Development*, MIT Press, 2004.

_ , "Institutions Matter, but which ones?," *Economics of Transition*, July 2005, *13* (3), 499–532.

_ **and Tsung-Tao Yang**, "Political Competition in Economic Perspective," *BREAD Working Paper*, July 2004.

Barro, Robert J., "Determinants of Democracy," *Journal of Political Economy*, December 1999, *107* (6), 158–183.

_ **and Xavier Sala-i-Martin**, *Economic Growth*, New York: McGraw-Hill, 1995.

Bartlett, William, "Bosnia and Herzegovina: Economy," in Taylor and Francis Group, eds., *Central and South-Eastern Europe 2008*, Routledge, London and New York, 2007, 102–107.

_ , *Europe's Troubled Region: Economic Development, Institutional Reform, and Social Welfare in the Western Balkans*, Routledge, London and New York, 2008.

_ **and Merita Xhumari**, "Social Security Policy and Pension Reforms in the Western Balkans," *European Journal of Social Security*, December 2007, *9* (4), 297–323.

Bates, Robert and Anne O. Krueger, eds, *Political and Economic Interactions in Economic Policy Reform*, Oxford: Basil Blackwell, 1993.

Becker, Gary S., "A Theory of Competition among Pressure Groups for Political Influence," *The Quarterly Journal of Economics*, August 1983, *98* (3), 371–400.

Beez, Peter and Niklaus Mäder, "Wie kommt es zu erfolgreichen Volkswirtschaftlichen Reformen? Vorschlag eines ökonomischen Rasters," *Working Paper, University of Fribourg*, 1997.

Besley, Timothy, *Principled Agents? The Political Economy of Good Government*, Oxford University Press, 2006.

_ **and Maitreesh Ghatak**, "Competition and Incentives with Motivated Agents," *American Economic Review*, June 2005, *95* (3), 616–636.

_ **and Robin Burgess**, "The Political Economy of Government Responsiveness: Theory and Evidence from India," *The Quarterly Journal of Economics*, November 2002, *117* (4), 1415–51.

Birdsall, Nancy, "Asymmetric Globalization: Global Markets Require Good Global Politics," *Center for Global Development Working Paper No. 12*, 2002.

_ , "The World is not Flat: Inequality and Injustice in our Global Economy," *WIDER Annual Lecture 9*, 2006.

Blanchard, Olivier and Francesco Giavazzi, "Macroeconomic Effects of Regulation and Deregulation in Goods and Labor Markets," *The Quarterly Journal of Economics*, August 2003, *118* (3), 879–907.

Blundell, Richard and Stephen Bond, "Initial Conditions and Moment Restrictions in Dynamic Panel Data Models," *Journal of Econometrics*, 1998, *87* (1), 115–143.

_ **and** _ , "GMM Estimation with Persistent Panel Data: An Application to Production Functions," *Econometric Reviews*, 2000, *19* (3), 321–340.

Boevsky, Ivan and Jost W. Kramer, "Transformation und Genossenschaftswesen in Bulgarien – Jüngste Entwicklungen," *Südosteuropa*, 1998, *47* (3–4), 149–167.

Bogdani, Mirela and John Loughlin, *Albania and the European Union: the Tumultuous Journey Towards Integration and Association*, London: I.B. Taurus, 2007.

Bojicic-Dzelilovic, Vesna, Fikret Causevic, and Rajko Tomas, "Bosnia and Herzegovina: Problems, Obstacles and Outcome of the Reforms," *European Balkan Observer*, June 2004, *2* (4).

Bond, Stephen, "Dynamic Panel Data Models: A Guide to Micro Data Methods and Practice," *CEMMAP Working Paper 09/02*, 2002.

__ , Anke Hoeffler, and Jonathan Temple, “GMM Estimation of Empirical Growth Models,” *CEPR Discussion Paper*, *3048*, 2001.

Bourguignon, François, Francisco H.G. Ferreira, and Marta Menéndez, “Inequality of Outcomes and Inequality of Opportunities in Brazil,” *William Davidson Institute Working Paper No. 630; World Bank Working Paper No. 3174*, 2003.

Brinkerhoff, Derick and Benjamin L. Crosby, *Managing Policy Reform: Concepts and Tools for Decision-Makers in Developing and Transitioning Countries*, Kumarian Press, Connecticut, 2002.

Bruno, Michael, Martin Ravallion, and Lyn Squire, “Equity and Growth in Development Countries: Old and New Perspectives on the Policy Issues,” *World Bank Policy Research Working Paper No. 1563*, November 1999.

Buchanan, James M., “An Economic Theory of Clubs,” *Economica*, February 1965, *32* (125), 1–14.

Bueno de Mesquita, Bruce, Alastair Smith, Randolph M. Siverson, and James D. Morrow, *The Logic of Political Survival*, Cambridge, MA: MIT University Press, 2005.

Burkhart, Ross E. and Michael S. Lewis-Beck, “Comparative Democracy: The Economic Development Thesis,” *American Political Science Review*, December 1994, *88* (4), 903–910.

Cain, Jennifer, Antonio Duran, Amya Fortis, and Elke Jakubowski, *Health Care Systems in Transition: Bosnia and Herzegovina*, World Health Organization, 2002.

Cao, Xun, “Convergence, Divergence, and Networks in International Political Economy: A Social Network Analysis Approach,” *Working Paper*, 2008.

Carothers, Thomas, “Romania: the Political Background,” in Leo Tindemans, ed., *Democracy in Romania*, International IDEA, 1997.

Cartwright, Andrew, “Avoiding Collectivisation: Land Reform in Romania 1990–92,” *Working Paper No. 50 Rural Transition Series*, 2001.

Chang, Ha-Joon, *Kicking Away the Ladder: Development Strategy in Historical Perspective*, London: Anthem Press, 2002.

Chen, Shaohua and Martin Ravallion, “Measuring Pro-Poor Growth,” *Economic Letters*, January 2003, *78* (1), 93–99.

Collier, Paul and Anke Hoeffler, “Greed and Grievance in Civil War,” *Oxford Economic Papers*, October 2004, *56* (4), 563–595.

_ **and David R. Dollar**, "Aid Allocation and Poverty Reduction," *European Economic Review*, September 2002, *46* (8), 1475–1500.

Cornia, Giovanni A., *Inequality, Growth and Poverty in an Era of Liberalization and Globalization*, Oxford: Oxford University Press, 2004.

Council of Ministers of the Republic of Albania, *National Strategy for Socio-Economic Development*, Republic of Albania-Council of Ministers, 2001.

Cox, Gary W. and Mathew D. McCubbins, *The Institutional Determinants of Economic Policy Outcomes*, Cambridge University Press, 2000.

Cox, Marcus, "State Building and Post-Conflict Reconstruction: Lessons from Bosnia," *Working Paper*, 2001.

Crampton, Richard J., "Bulgaria: History," in Taylor and Francis Group, eds., *Central and South-Eastern Europe 2009*, Routledge, London and New York, 2008.

Csaki, Csaba and Holger Kray, "Romanian Food and Agriculture from a European Perspective," *ECSSD Working Paper No. 39*, June 2005.

Dainov, Evgenii, "Education Reform in Bulgaria," *Working Paper*, 2005.

Datt, Gauvrav and Martin Ravallion, "Why Have Some Indian States Done Better than Others at Reducing Rural Poverty?," *Economica*, 1998, *65* (257), 17–38.

Demekas, Dimitri G. and Mohsin S. Khan, "The Romanian Economic Reform Program," *IMF Working Paper No. 91/80*, 1991.

Dethier, Jean-Jacques, Hafez Ghanem, and Edda Zoli, "Does Democracy Facilitate the Economic Transition? An Empirical Study of Central and Eastern Europe and the Former Soviet Union," *World Bank Policy Research Working Paper No. 2194*, October 1999.

Devarajan, Shantayanan, David R. Dollar, and Torgny Holmgren, eds, *Aid and Reform in Africa: Lessons from Ten Case Studies*, Washington D.C.: The World Bank, 2001.

Dewatripont, Mathias and Gérard Roland, "Economic Reform and Dynamic Political Constraints," *Review of Economic Studies*, October 1992, *53* (4), 703–730.

_ **and** _ , "The Design of Reform Packages Under Uncertainty," *The American Economic Review*, December 1995, *85* (5), 1207–1223.

Djankov, Simeon, Rafael La Porta, Florencio Lopez-De-Silanes, and Andrei Shleifer, "The Regulation of Entry," *Quarterly Journal of Economics*, February 2002, *117* (1), 1–37.

Dobrinsky, Rumen, "Fiscal Policy under a Currency Board Arrangement: Bulgaria's Post-Crisis Policy Dilemmas," *Russian and East European Finance and Trade*, 2001, *37* (2), 36–77.

Dollar, David and Aart Kraay, "Growth is Good for the Poor," *Journal of Economic Growth*, 2002, *7* (3), 195–225.

Drazen, Allan and William Easterly, "Do Crises Induce Reform? Simple Empirical Tests of Conventional Wisdom," *Economics and Politics*, July 2001, *13* (2), 129–158.

Dudwick, Nora, Karin Fock, and David Sedik, "Land Reform and Farm Restructuring in Transition Countries – The Experience of Bulgaria, Moldova, Azerbaijan, and Kazakhstan," *World Bank Working Paper No. 104*, 2007.

Earle, John S. and Almos Telegdy, "Privatization Methods and Productivity Effects in Romanian Industrial Enterprises," *Journal of Comparative Economics*, December 2002, *30* (4), 657–682.

Easterly, William, "Inequality Does Cause Underdevelopment: New Evidence," *Center for Global Development Working Paper No. 1*, June 2002.

_ **and Stanley Fischer**, "Inflation and the Poor," *World Bank Policy Research Working Paper No. 2335*, May 2000.

EBRD, *Transition Report 1999: Ten Years of Transition*, EBRD, London, 1999.

_ , *Transition Report 2000: Employment, Skills and Transition*, EBRD, London, 2000.

_ , *Transition Report 2001: Energy in Transition*, EBRD, London, 2001.

_ , *Transition Report 2002: Agriculture and Rural Transition*, London: EBRD, 2002.

_ , *Transition Report 2003: Integration and Regional Cooperation*, EBRD, London, November 2003.

_ , *Transition Report 2004: Infrastructure*, EBRD, London, 2004.

_ , *Transition Report 2006: Finance in Transition*, London: EBRD, 2006.

EBRD and World Bank, *Business Environment and Enterprise Performance Survey (BEEPS)*, EBRD and World Bank, 1999.

Elbasani, Arola, "Albania in Transition: Manipulation or Appropriation of International Norms?," *Southeast European Politics*, June 2004, *V* (1), 24–44.

Ellerman, David, *Helping People Help Themselves: From the World Bank to an Alternative Philosophy of Development Assistance*, Ann Arbor: University of Michigan Press, 2005.

Epstein, David L., Robert Bates, Jack Goldstone, Ida Kristensen, and Sharyn O'Halloran, "Democratic Transitions," *American Journal of Political Science*, July 2006, *50* (3), 551–569.

ESI, "Reshaping International Priorities in Bosnia and Herzegovina – Part One: Bosnian Power Structures," *ESI Discussion Paper*, October 1999.

_ , "Reshaping International Priorities in Bosnia and Herzegovina – Part Two: International Power in Bosnia," *ESI Discussion Paper*, October 2000.

_ , "In Search of Politics: the Evolving International Role in Bosnia and Herzegovina," *ESI Discussion Paper*, November 2001.

_ , "Imposing Constitutional Reform? The Case For Ownership," *ESI Discussion Paper*, March 2002.

European Commission, "Report from the Commission to the Council On the Work of the EU/Albania High Level Steering Group, in Preparation for the Negotiation of a Stabilization and Association Agreement with Albania," *Brussels: European Commission, COM 0300 final*, 2001.

_ , "Regular Report on Bulgaria's Progress towards Accession 2002," *Commission Report*, 2002.

_ , "Regular Report on Romania's Progress towards Accession," *Commission Report*, 2002.

_ , "The Financial Sector in Bulgaria," *Enlargement Papers*, September 2003.

_ , "Report from the Commission to the Council on the Preparedness of Bosnia and Herzegovina to Negotiate a Stabilisation and Association Agreement with the European Union," *Commission Staff Working Paper COM2003 692 final*, 2003.

_ , "2004 Regular Report on Bulgaria's Progress towards Accession," *Commission Report*, 2004.

_ , "Albania Stabilisation and Association Report 2004," *Commission Staff Working Paper COM2004 203 final*, 2004.

_ , "Bosnia and Herzegovina: Stabilisation and Association Report 2004," *Commission Staff Working Paper COM2004 205*, 2004.

_ , "Regular Report on Romania's Progress towards Accession," *Commission Report*, 2004.

_ , "Romania – May 2006 Monitoring Report," *Commission Staff Working Document*, March 2006.

_ , "Bosnia and Herzegovina 2007 Progress Report," *Commission Staff Working Document COM2007 663 final*, 2007.

_ , "Economic Assessment of the Convergence Programme of Bulgaria," *ECFIN/50976/07-EN*, 2007.

Falcetti, Elisabetta, Martin Raiser, and Peter Sanfey, "Defying the Odds: Initial Conditions, Reforms, and Growth in the First Decade of Transition," *Journal of Comparative Economics*, June 2002, *30* (2), 229–250.

_ **, Tatiana Lysenko, and Peter Sanfey**, "Reforms and Growth in Transition: Re-Examining the Evidence," *Journal of Comparative Economics*, September 2006, *34* (3), 421–445.

Fernandez, Rachel and Dani Rodrik, "Resistance to Reform: Status Quo Bias in the Presence of Individual-Specific Uncertainty," *American Economic Review*, December 1991, *81* (5), 1146–1155.

Ferranti, David De, Guillermo Perry, Indermit Gill, J. Luis Guasch, William Maloney, Carolina Sanchez-Paramo, and Norbert Schady, *Closing the Gap in Education and Technology*, Washington D.C.: The World Bank, 2003.

Fidrmuc, Jan, "Economic Reform, Democracy and Growth During Post-Communist Transition," *European Journal of Political Economy*, 2003, *19*, 583–604.

Filmer, Deon, Jeffrey S. Hammer, and Lant H. Pritchett, "Weak Links in the Chain: A Diagnosis of Health Policy in Poor Countries," *World Bank Research Observer. August*, 2000, *15* (2), 199–224.

Fischer, Stanley and Ratna Sahay, "Transition Economies: The Role of Institutions and Initial Conditions," *Paper presented at the Conference in Honor of Guillermo A. Calvo, Washington*, April 2004.

Fish, M. Steven and Omar Choudhry, "Democratization and Economic Liberalization in the Post-Communist World," *Comparative Political Studies*, 2007, *40* (3), 254–282.

Flyvbjerg, Bent, "Five Misunderstandings About Case-Study Research," *Qualitative Inquiry*, April 2006, *12* (2), 219–245.

Freedom House, "Albania: Country Report," 2008.

_ , "Romania: Country Report," 2008.

Frey, Bruno S., *Economics as a Science of Human Behaviour. Towards a New Social Science Paradigm.*, Kluwer Academic Publishers, Boston/Dordrecht/London, 1999.

Fries, Steven, Tatiana Lysenko, and Saso Polenac, "The 2002 Business Environment and Enterprise Performance Survey," *Working Paper*, November 2003.

Gagnon, Valère Philip, *The Myth of Ethnic War: Serbia and Croatia in the 1990s*, Ithaca: Cornell University Press, 2004.

Gallagher, Tom, "Romania: History," in Taylor and Francis Group, eds., *Central and South-Eastern Europe 2008*, Routledge, London and New York, 2007.

_ , *Modern Romania: The End of Communism, the Failure of Democratic Reform, and the Theft of a Nation*, New York University Press, 2008.

Geddes, Barbara, *Paradigms and Sand Castles: Theory Building and Research Design in Comparative Politics*, Ann Arbor: University of Michigan Press, 2003.

Geoffrey, Garrett, "Globalization and Government Spending around the World," *Studies in Comparative International Development*, February 2001, *35* (4), 3–29.

Georgieva, Lidia, Petko Salchev, Rostislava Dimitrova, and Antoniya Olga Avdeeva Dimova, "Bulgaria: Health System Review," *Health Systems in Transition*, 2007, *9* (1), 1–156.

Gerxhani, Klarita and Arthur Schram, "Clan-based Polarized Voting: Empirical Evidence," *Working Paper*, 2008.

Giavazzi, Francesco and Guido Tabellini, "Economic and Political Liberalizations," *Journal of Monetary Economics*, 2005, *52* (7), 1297–1330.

Gleditsch, Kristian S. and Michael D. Ward, "Diffusion and the International Context of Democratization," *International Organization*, 2006, *60* (4), 911–933.

Gorzynski, Michal, Krassen Stanchev, Georgi Stoev, Julian Pankow, Mateusz Walewski, and Assenka Yonkova, "Fiscal Effects From Privatization: Cases of Bulgaria and Poland," *IME-Sofia, CASE-Warsaw*, 2000.

Gotcheva, Boryana, "The Poverty Mapping Exercise in Bulgaria," in Tara Bedi, Aline Coudouel, and Kenneth Simler, eds., *More than a Pretty Picture: Using Poverty Maps to Design Better Policies and Interventions*, The World Bank, Washington, 2007.

Grindle, Merilee S., *Challenging the State: Crises and Innovation in Latin America and Africa*, Cambridge University Press, New York, 1996.

_ , *Despite the Odds: The Contentious Politics of Education Reform*, Princeton University Press, Princeton and Oxford, 2004.

Grossman, Gene M. and Elhanan Helpman, "Electoral Competition and Special Interest Politics," *Review of Economic Studies*, April 1996, *63* (2), 265–286.

Grzymala-Busse, Anna Maria, *Rebuilding Leviathan – Party Competition and State Exploitation in Post-communist Democracies*, Cambridge University Press, 2007.

Haggard, Stephen, *Pathways from the Periphery: The Politics of Growth in the Newly Industrializing Countries*, Cornell University Press, 1990.

_ **and Mathew D. McCubbins**, *Political Institutions and the Determinants of Public Policy*, Cambridge University Press, 2000.

_ **and Robert Kaufman**, *The Political Economy of Democratic Transitions*, Princeton University Press, 1995.

_ **and Steven B. Webb**, “What Do We Know About the Political Economy of Economic Policy Reform?,” *World Bank Research Observer*, July 1993, *8* (2), 143–168.

Hanisch, Markus and Ivan Boevski, “Political, Institutional and Structural Developments Accompanying Land Reform and Privatization in Bulgarian Agriculture,” *Südosteuropa*, 1999, *48* (7-8), 446–464.

Harberger, Arnold C., “Secrets of Success: A Handful of Heroes,” *The American Economic Review*, May 1993, *83* (2), 343–350.

Hashi, Iraj and Lindita Xhillari, “Privatisation and Transition in Albania,” *Post-Communist Economies*, 1999, *11* (1), 99–125.

Hellman, Joel S., “Winners Take All: The Politics of Partial Reform in Postcommunist Transitions,” *World Politics*, January 1998, *50* (2), 203–234.

Heybey, Berta and Peter Murrell, “The Relationship between Economic Growth and the Speed of Liberalization During Transition,” *Journal of Policy Reform*, 1999, *3* (2), 121–137.

Howard, Marc M., “The Weakness of Postcommunist Civil Society,” *Journal of Democracy*, January 2002, *13* (1), 157–169.

IMF, “Bosnia and Herzegovina: Selected Issues,” *Country Report No. 98/69*, 1998.

_ , “Albania: Article IV Consultation,” *IMF Country Report No. 99/50*, 1999.

_ , “Albania: Recent Economic Developments and Statistical Appendix,” *Country Report No. 99/69*, 1999.

_ , “Bulgaria: Selected Issues and Statistical Appendix,” *Country Report No. 99/26*, 1999.

_ , “Bosnia and Herzegovina: Selected Issues and Statistical Appendix,” *Country Report No. 00/77*, 2000.

_ , “Bulgaria: Selected Issues and Statistical Appendix,” *Country Report No. 00/54*, 2000.

_ , “Romania: Article IV Consultation,” *Country Report No. 00/159*, 2000.

_ , "Romania: Selected Issues and Statistical Appendix," *Country Report No. 01/16*, 2001.

_ , "Bulgaria: Selected Issues and Statistical Appendix," *Country Report No. 02/173*, 2002.

_ , "Bulgaria: Selected Issues and Statistical Appendix," *Country Report No. 02/173*, 2002.

_ , "Albania: Article IV Consultation," *Country Report No. 03/63*, 2003.

_ , "Romania: Selected Issues and Statistical Appendix," *Country Report No. 03/12*, 2003.

_ , "Bosnia and Herzegovina: Selected Economic Issues," *Country Report No. 04/54*, 2004.

_ , "Bulgaria: Selected Issues and Statistical Appendix," *Country Report No. 04/177*, 2004.

_ , "Romania: Selected Issues and Statistical Appendix," *Country Report No. 04/220*, 2004.

_ , "Romania: Selected Issues and Statistical Appendix," *Country Report No. 04/220*, 2004.

_ , "Romania's Performance under Past Fund-Supported Programs," *Public Information Notice No. 04/44*, 2004.

_ , "Albania: Selected Issues and Statistical Appendix," *Country Report No. 05/90*, 2005.

_ , "Bosnia and Herzegovina: Selected Economic Issues," *Country Report No. 05/198*, 2005.

_ , "Bulgaria: Selected Issues and Statistical Appendix," *Country Report No. 06/299*, 2006.

_ , "Romania: Article IV Consultation," *IMF Country Report No. 06/168*, 2006.

_ , "Bosnia and Herzegovina: Poverty Reduction Strategy Progress Report," *Country Report No. 40052*, 2007.

_ , "Bulgaria: Selected Issues," *Country Report No. 07/390*, 2007.

_ , "Albania: Poverty Reduction Strategy Paper," *Country Report No. 08/270*, 2008.

_ , "Romania: Selected Issues," *Country Report No. 08/210*, 2008.

Jarvis, Christopher, "The Rise and Fall of the Pyramid Schemes in Albania," *Finance and Development*, March 2000, *37* (1), 46–49.

Justino, Patricia, Julie Litchfield, and Laurence Whitehead, "The Impact of Inequality in Latin America," *PRUS Working Papers 21*, 2003.

Kakwani, Nanak and Ernesto M. Pernia, "What is Pro-Poor Growth?," *Asian Development Review*, 2001, *18* (1), 1–16.

Kaser, Michael and Enkeleida Tahiraj, "Albania: Economy," in Taylor and Francis Group, eds., *Central and South-Eastern Europe 2008*, Routledge, London and New York, 2007.

Kaufman, Daniel, Aart Kraay, and Massimo Mastruzzi, "Governance Matters VII: Aggregate and Individual Governance Indicators, 1996-2007," *World Bank Policy Research Working Paper No. 4654*, June 2008.

Kaufman, Robert and Joan M. Nelson, eds, *Crucial Needs, Weak Incentives: Social Sector Reform, Democratization, and Globalization in Latin America*, Johns Hopkins University Press, 2004.

Keefer, Philip, "Democratization and Clientelism: Why Are Young Democracies Badly Governed?," *Policy Research Working Paper No. 3594*, 2005.

_ **and Razvan Vlaicu**, "Democracy, Credibility and Clientelism," *Policy Research Working Paper No. 3472*, 2005.

_ **and Stephen Knack**, "Does Inequality Harm Growth Only in Democracies? A Replication and Extension," *American Journal of Political Science*, January 1997, *41* (1), 323–332.

_ **and** _ , "Polarization, Politics and Property Rights: Links between Inequality and Growth," *Public Choice*, March 2002, *111* (1–2), 127–54.

_ **and Stuti Khemani**, "Democracy, Public Expenditures and the Poor," *The World Bank Research Observer*, 2005, *20* (1), 1–27.

Klasen, Stephan, "In Search of the Holy Grail: How to Achieve Pro-Poor Growth?," in The World Bank, ed., *Annual World Bank Conference on Development Economics –Europe 2003: Toward Pro-Poor Policies: Aid, Institutions, and Globalization*, Washington D.C.: The World Bank, 2004, 69–93.

_ , "Economic Growth and Poverty Reduction: Measurement and Policy Issues," *OECD Development Centre Working Paper No. 246*, September 2005.

Kopstein, Jeffrey S. and David A. Reilly, "Geographic Diffusion and the Transformation of the Postcommunist World," *World Politics*, 2000, *53* (1), 1–37.

Kotzeva, Mariana and Bianca Pauna, “Labour Market Dynamics and Characteristics in Bulgaria and Romania – Challenges for a Successful Integration in the European Union,” *GDP Working Paper*, July 2006.

Kraay, Aart, “When Is Growth Pro-Poor? Evidence from a Panel of Countries,” *Journal of Development Economics*, June 2006, *80* (1), 198–227.

Krueger, Anne O., “The Political Economy of the Rent-Seeking Society,” *American Economic Review*, June 1974, *64* (3), 291–303.

_ , *Economic Policy Reform in Developing Countries*, Cambridge, MA: Blackwell, 1992.

Kydland, Finn E. and Edward C. Prescott, “Rules Rather than Discretion: The Inconsistency of Optimal Plans,” *Journal of Political Economy*, June 1977, *85* (3), 473–491.

Laffont, Jean-Jaques and Jean Tirole, “Privatization and Incentives,” *Journal of Law, Economics and Organization*, 1991, *7*, 84–106.

Lipton, David, Jeffrey Sachs, Stanley Fischer, and Janos Kornai, “Creating a Market Economy in Eastern Europe: The Case of Poland,” *Brookings Papers on Economic Activity*, 1990, *1990* (1), 75–147.

Lipton, Michael, Martin Ravallion, Hollis Chenery, and T. N. Srinivasan, eds, *Poverty and Policy*, Elsevier, 1995.

Londregan, John B. and Keith T. Poole, “Does High Income Promote Democracy?,” *World Politics*, October 1996, *49* (1), 1–30.

Lopez, J. Humberto, “Pro-Poor Growth: A Review of What We Know (and of What We Don’t),” *Paper Prepared in the Context of the "Pro-poor Growth" Program of the the World Bank’s PREM Poverty Group*, 2004.

Lundberg, Mattias and Lyn Squire, “The Simultaneous Evolution of Growth and Inequality,” *Economic Journal*, 2003, *113* (487), 326–344.

Lupia, Arthur and Mathew D. McCubbins, *The Democratic Dilemma: Can Citizens Learn What They Need to Know?*, New York: Cambridge University Press, 1998.

_ **and** _ , “Political Credibility and Economic Reform,” *Paper Prepared for the World Bank*, 1998.

Machiavelli, Niccolò, *The Prince (originally published in 1513)*, Dover Publications, 1992.

Macours, Karen and Johan F. M. Swinnen, “Rural Poverty in Transition Countries,” *LICOS Discussion Papers 169/2007*, March 2007.

Maniu, Mircea T., Ella Kallai, and Dana Popa, "Explaining Growth. Country Report: Romania (1990-2000)," *Global Development Network Working Paper*, 2001.

Melo, Martha De, Cevdet Denizer, Allan Gelb, and Stoyan Tenev, "Circumstances and Choice: The Role of Initial Conditions and Policies in Transition Economies," *World Bank Economic Review*, September 2001, *15* (1), 1–31.

Milanovic, Branko, *Income, Inequality and Poverty during the Transition from Planned to Market Economy*, The World Bank, Washington, 1998.

Mosley, Layna, *Global Capital and National Governments*, Cambridge: Cambridge University Press, 2003.

Mungiu-Pippidi, Alina, "The Romanian Postcommunist Parties," in Andras Bozoki and John T. Ishiyama, eds., *The Communist Successor Parties of Central and Eastern Europe*, M.E. Sharpe: Armonk, 2002, 188–205.

Murer, Jeffrey Stevenson, "Mainstreaming Extremism: The Romanian PDSR and the Bulgarian Socialists in Comparative Perspective," in Andras Bozoki and John T. Ishiyama, eds., *The Communist Successor Parties of Central and Eastern Europe*, M.E. Sharpe: Armonk, 2002, 367–396.

Muthoo, Abhinay, "A Non-Technical Introduction to Bargaining Theory," *World Politics*, April-June 2000, *1* (2), 145–166.

Nikolov, Boyko, Nikolay Markov, Nasko Dochev, Dimitar Dimitrov, Rumyana Kolarova, and Rumen Dobrinsky, "Understanding Reform: A Country Study for Bulgaria," *Global Development Network Southeast Europe*, October 2004.

North, Douglass C., *Institutions, Institutional Change, and Economic Performance*, New York: Cambridge University Press, 1990.

OECD, *Balkans Public Administration Reform Assessment Albania*, OECD, 2004.

_, *The Informal Economy in Albania: Analysis and Policy Recommendations*, OECD, 2004.

_, "Romania - Public Service and The Administrative Framework Assessment," *Assessment Report*, March 2006.

Olson, Mancur, *The Logic of Collective Action: Public Goods and the Theory of Groups*, Harvard University Press, 1965.

_, *The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities*, Yale University Press, 1982.

_, "Dictatorship, Democracy, and Development," *American Political Science Review*, September 1993, *87* (3), 567–576.

OPPG, *Pro-Poor Growth in the 1990s: Lessons and Insights from 14 Countries*, Washington D.C.: The World Bank, 2005.

Osiatynski, Jerzy, "Economic Reforms and their Social and Political Implications," in Leo Tindemans, ed., *Democracy in Romania*, International IDEA, 1997.

Palmer, Peter, "Bosnia and Herzegovina: History," in Taylor and Francis Group, eds., *Central and South-Eastern Europe 2008*, Routledge, London and New York, 2007.

Palomba, Geremia and Milan Vodopivec, *Financing, Efficiency, and Equity in Albanian Education*, Washington D.C.: The World Bank, 2001.

Pashev, Konstantin, "Healthcare Reforms in Bulgaria: Towards Diagnosis and Prescription," *Working Paper*, May 2006.

Pashko, Gramoz, "Obstacles to Economic Reform in Albania," *Europe-Asia Studies*, 1993, *45* (5), 907–921.

Pearson, Owen, *Albania in the Twentieth Century, A History: Volume III: Albania as Dictatorship and Democracy, 1945–1999*, I.B. Tauris, 2007.

Perotti, Roberto, "Growth, Income Distribution, and Democracy: What the Data Say," *Journal of Economic Growth*, June 1996, *1* (2), 149–87.

Persson, Torsten and Guido Tabellini, "Is Inequality Harmful for Growth?," *American Economic Review*, June 1994, *84* (3), 600–621.

_ , Gérard Roland, and Guido Tabellini, "Separation of Powers and Political Accountability," *The Quarterly Journal of Economics*, November 1997, *112* (4), 1163–1202.

Peters, B. Guy, *Comparative Politics. Theory and Methods*, New York: New York University Press, 1998.

Popper, Karl, *The Open Society and Its Enemies*, Vol. II, London: Routledge, 1945.

Przeworski, Adam, *Democracy and the Market: Political and Economic Reforms in Eastern Europe and Latin America*, New York: Cambridge University Press, 1991.

_ , "Institutions Matter?," *Government and Opposition*, September 2004, *39* (2), 527–540.

_ and Fernando Limongi, "Modernization: Theories and Facts," *World Politics*, January 1997, *49* (2), 155–183.

RAS, "Arrears Are Still an Unresolved Problem," *Early Warning Report Romania*, January 2002.

_ , "Iliescu Returns with a Vengeance," *Policy Warning and Forecast Report Elections 2004*, November 2004.

Ravallion, Martin, "Growth, Inequality and Poverty: Looking Beyond Averages," *World Development*, 2001, *29* (11), 1803–15.

Reid, Gary J., "The Political Economy of Civil Sector Reform in Albania," *Working Paper*, 2007.

Republic of Albania - Ministry of Finance, *Progress Report on Implementation of the National Strategy for Socio-Economic Development During 2004 – Objectives and Long-Term Vision Priority Action Plan 2005-2008*, Washington D.C.: The International Monetary Fund, 2005.

Rius, Andres and Nicolas van de Walle, "Political Institutions and Economic Policy Reform," *Document presented to the Global Development Network: Understanding Reform*, August 15 2003.

Rodrik, Dani, "Understanding Economic Policy Reform," *Journal of Economic Literature*, March 1996, *34* (1), 9–41.

_ , *Has Globalization Gone Too Far?*, Washington D.C.: Institute for International Economics, 1997.

_ , "Why Do More Open Economies Have Bigger Governments?," *Journal of Political Economy*, 1998, *106* (5), 997–1032.

_ , "Institutions for High-Quality Growth: What They Are and How to Acquire Them," *National Bureau of Economic Research Working Paper No. 7540*, February 2000.

_ , "Getting Institutions Right," *CESifo DICE Report*, 2004, *2.*

_ , "Second-Best Institutions," *Working Paper*, January 2008.

_ **, Arvind Subramanian, and Francesco Trebbi**, "Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development," *Journal of Economic Growth*, 2004, *9* (2), 131–165.

Roland, Gérard, "The Political Economy of Transition," *Journal of Economic Perspectives*, Winter 2002, *16* (1), 29–50.

Romer, Christina D. and David H. Romer, "Monetary Policy and the Well-Being of the Poor," *NBER Working Paper No. W6793*, 1998.

Roodman, David, "A Note on the Theme of Too Many Instruments," *Oxford Bulletin of Economics and Statistics*, forthcoming.

Rozelle, Scott and Johan F. M. Swinnen, "Success and Failure of Reform: Insights from the Transition of Agriculture," *Journal of Economic Literature*, June 2004, *42* (2), 404–456.

Rusinova, Desislava, "Growth in Transition: Reexamining the roles of factor inputs and geography," *Economic Systems*, September 2007, *31* (3), 233–255.

Ruzicic, Zdravko and Igor Spacek, "Bulgarien - Wandel in Etappen," in Carsten Goehrke and Gilly Seraina, eds., *Transformation und Historisches Erbe in den Staaten des Europäischen Ostens*, Bern: Peter Lang, 2000.

Sabates-Wheeler, Rachel, *Cooperation in the Romanian Countryside: an Insight into Post-Soviet Agriculture*, New York: Lexington Books, 2005.

Sahn, David E., "Poverty Profile Without Poverty Lines: Romania, 1994 to 1997," *Cornell Food and Nutrition Policy Program Working Paper No. 118*, 2001.

Satyanath, Shanker and Arvind Subramanian, "What Determines Long-Run Macroeconomic Stability? Democratic Institutions," *IMF Working Paper*, 2004, *215.*

_ and _ , "The Political Economy of Nominal Macroeconomic Pathologies," *IMF Staff Papers*, 2007, *54* (3), 419–453.

Sava, Dan and Rekha Menon, "Romania - Health Sector Policy Note," *Working Paper*, 2007.

Schuknecht, Ludger and Vito Tanzi, "Reforming Public Expenditure in Industrialized Countries – Are There Trade-offs?," *European Central Bank Working Paper Series No. 435*, February 2005.

Schumpeter, Joseph A., *Capitalism, Socialism and Democracy (first published in 1942)*, New York: Harper, 1975.

Sen, Amartya, *Development as Freedom*, Oxford University Press, 1999.

Simmons, Beth A. and Zachary Elkins, "The Globalization of Liberalization: Policy Diffusion in the International Political Economy," *American Political Science Review*, February 2004, *98* (1), 171–189.

_ , Frank Dobbin, and Geoffrey Garrett, "The International Diffusion of Liberalism," *International Organization*, 2006, *60* (4), 781–810.

Slantchev, Branislav L., "The Political Economy of Simultaneous Transitions: An Empirical Test of Two Models," *Policy Research Quarterly*, June 2005, *58* (2), 279–294.

Smith, Alan, "Romania: Economy," in Taylor and Francis Group, eds., *Central and South-Eastern Europe 2004*, Routledge, 2003.

_ , "The Romanian Economy since 1989," in David Phinnemore, ed., *The EU and Romania: Accession and Beyond*, I.B. Tauris, 2006.

— , "Romania: Economy," in Taylor and Francis Group, eds., *Central and South-Eastern Europe 2008*, Routledge, London and New York, 2007.

Solioz, Christophe, *Turning Points in Post-War Bosnia; Ownership Process and European Integration*, Nomos, 2007.

Soto, Hernando De, *The Mystery of Capital – Why Capitalism Triumphs in the West and Fails Everywhere Else*, Basic Books, 2000.

Spiller, Pablo T. and Mariano Tommasi, "The Institutional Foundations of Public Policy: A Transactions Approach with Application to Argentina," *The Journal of Law, Economics, and Organization*, October 2003, *19* (2), 281–306.

Stahl, Johannes, Thomas Sikor, and Stefan Dorondel, "Transparency in Albanian and Romanian Land Administration," *Working Paper*, 2007.

Stan, Lavinia, "Romanian Privatization: Assessment of the First Five Years," *Communist and Post-Communist Studies*, 1995, *28* (4), 427–435.

Stein, Ernesto, Mariano Tommasi, Koldo Echebarria, Lora Eduardo, and Mark Payne, *The Politics of Policies: Economic and Social Progress in Latin America*, Harvard University Press, 2006.

Stern, Nicolas, Jean-Jaques Dethier, and F. Halsey Rogers, *Growth and Empowerment: Making Development Happen*, MIT Press, 2005.

Stone, Randall W., *Lending Credibility: The International Monetary Fund and the Post-Communist Transition*, Princeton University Press, 2002.

Svolik, Milan, "Authoritarian Reversals and Democratic Consolidation," *American Political Science Review*, 2008, *102* (2), 153–168.

Tornell, Aaron, "Reform from Within," *NBER Working Paper No. W6497*, April 1998.

Tucker, Joshua A., "Enough! Electoral Fraud, Collective Action Problems, and Post-Communist Colored Revolutions," *Perspectives on Politics*, 2007, *5* (3), 535–551.

— , "People Power of a One-Shot Deal? The Legacy of the Colored Revolutions Considered from a Collective Action Framework," Manuscript, New York University 2007.

UN, *Romania: Common Country Assessment*, United Nations, 1997.

— , *Bulgaria: Common Country Assessment*, United Nations, 2000.

— , *Bosnia and Herzegovina: Common Country Assessment*, United Nations, 2004.

UNDP, *National Human Development Report Romania 2007: Making EU Accession Work for All*, UNDP, 2007.

Vickers, Miranda, "Albania: History," in Taylor and Francis Group, eds., *Central and South-Eastern Europe 2008*, Routledge, London and New York, 2007.

von Hayek, Friedrich A., "Competition as a Discovery Procedure," in "New Studies in Philosophy, Politics and Economics," Chicago: University of Chicago Press, 1978, 179–190.

Warr, Peter, "Poverty and Growth in Southeast Asia," *ASEAN Economic Bulletin*, December 2006, *23* (3), 279–302.

Wei, Shang-Jin, "Gradualism versus Big Bang: Speed and Sustainability of Reforms," *The Canadian Journal of Economics/Revue Canadienne d'Economie*, November 1997, *30* (4b), 1234–1247.

Weingast, Barry R., "Self-Enforcing Constitutions: With an Application to Democratic Stability in America's First Century," Manuscript, Stanford University 2008.

Werner, Jan, Laurent Guihéry, and Ognjen Djukic, "Fiscal Federalism in Bosnia and Herzegovina: Ten Years after the Dayton Treatment and Still not in a Steady Condition," *Working Paper 01-2006*, January 2006.

White, Howard and Edward Anderson, "Growth versus Distribution: Does the Pattern of Growth Matter?," *Development Policy Review*, September 2001, *19* (3), 267–289.

Williamson, John, *The Political Economy of Policy Reform*, Washington: Institute for International Economics, 1994.

Windmeijer, Frank, "A Finite Sample Correction for the Variance of Linear Efficient Two-Step GMM Estimators," *Journal of Econometrics*, May 2005, *126* (1), 25–51.

Winters, Alan, Neil McCulloch, and Andrew McKay, "Trade Liberalization and Poverty: The Evidence So Far," *Journal of Economic Literature*, March 2004, *42* (1), 72–115.

Wooldridge, Jeffrey M., *Econometric Analysis of Cross Section and Panel Data*, MIT Press, 2002.

World Bank, *World Development Report: Poverty*, Oxford University Press, 1990.

_ , *The East Asian Miracle: Economic Growth and Public Policy. A World Bank Policy Research Report*, Washington D.C.: The World Bank, 1993.

_ , *Making Transition Work for Everyone: Poverty and Inequality in Europe and Central Asia*, Washington D.C.: The World Bank, 2000.

_ , *World Development Report: Attacking Poverty*, Washington D.C.: The World Bank, 2000/2001.

_ , *Bulgaria: Poverty Assessment*, Washington D.C.: The World Bank, 2002.

_ , *Albania: Poverty Assessment*, Washington D.C.: The World Bank, 2003.

_ , "Bosnia and Herzegovina: Poverty Assessment Volume I," *Report No. 25343-BIH*, 2003.

_ , *World Development Report: Making Services Work for the Poor*, Washington D.C.: The World Bank, 2003.

_ , *Albania: Decentralization in Transition*, Vol. I, Washington D.C.: The World Bank, 2004.

_ , *Bosnia and Herzegovina: Country Assistance Evaluation*, Washington D.C.: The World Bank, 2004.

_ , *Bosnia and Herzegovina: Post-Conflict Reconstruction and the Transition to a Market Economy - An OED Evaluation of World Bank Support*, Washington D.C.: The World Bank, 2004.

_ , "Bosnia and Herzegovina: Labor Market Update – the Role of Industrial Relations," *Report No. 32650-BA*, 2005, *December.*

_ , *Growth, Poverty and Inequality: Eastern Europe and the Former Soviet Union*, Washington D.C.: The World Bank, 2005.

_ , *Albania: Health Sector Note*, Washington D.C.: The World Bank, 2006.

_ , *Albania: Health System Modernization*, Washington D.C.: The World Bank, 2006.

_ , "Albania: Labor Market Assessment," *Report No. 34597-AL*, 2006.

_ , "Albania: Public Expenditure and Institutional Review," *Report No. 36453*, 2006.

_ , *Albania: Trends in Poverty and Inequality, 2002–2005*, Washington D.C.: The World Bank, 2006.

_ , "Bosnia and Herzegovina: Addressing Fiscal Challenges and Enhancing Growth Prospects: A Public Expenditure and Institutional Review," *Report No. 32156-BA*, September 2006.

_ , *Romania: Public Expenditure and Institutional Review Volume I*, Washington D.C.: The World Bank, 2006.

_ , "Romania: Social Protection Sector Pensions," *Policy Note*, 2006.

_ , "Bulgaria: Accelerating Bulgaria's Convergence: the Challenge of Raising Productivity," *Report No. 38570*, 2007, *Volume I and II.*

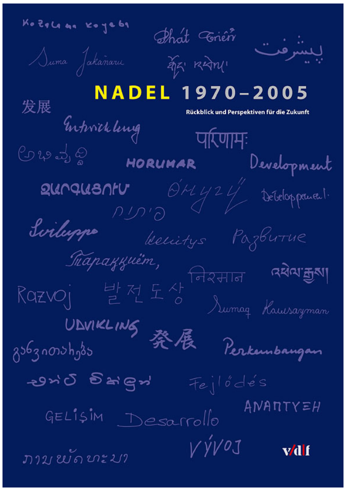
_ , "Romania: Education Policy Note," *Working Paper*, 2007.

_ , *Unleashing Prosperity*, Washington D.C.: The World Bank, 2008.

Rolf Kappel, Ruedi Baumgartner (Hrsg.)

NADEL 1970 – 2005

Rückblick und Perspektiven für die Zukunft



2005, 64 Seiten,
zahlreiche Grafiken und Tabellen,
4-farbig, Format 21 x 29,7 cm, broschiert
ISBN 978-3-7281-3039-6

Das Jahr 2005 markiert das 150-jährige Bestehen der ETH Zürich. Zudem begeht das Nachdiplomstudium für Entwicklungsländer (NADEL) seinen 35sten Geburtstag. Obwohl die Jubiläen den Kontext für dieses Buch liefern, sind sie nicht der Hauptgrund dafür.

Der Hauptanlass ist eine externe Evaluation des NADEL im Jahr 2004, die vom Zentrum für Weiterbildung (ZfW) der ETH Zürich und der Direktion für Entwicklung und Zusammenarbeit (DEZA) in Auftrag gegeben wurde. Das Ziel der Evaluation bestand darin, dem NADEL Material an die Hand zu geben, das für die erfolgreiche Weiterentwicklung der Studienprogramme hilfreich ist. Dieses Buch informiert darüber, was die Evaluation an Ergebnissen gebracht hat und wie das NADEL die Evaluationsresultate verarbeitet.

---

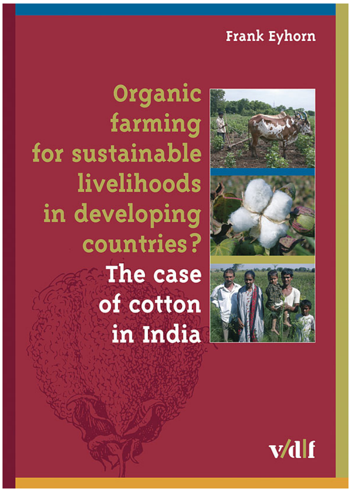
vdf

vdf Hochschulverlag AG an der ETH Zürich, VOB D, Voltastrasse 24, CH-8092 Zürich
Tel. +41 (0)44 632 42 42, Fax +41 (0)44 632 12 32, verlag@vdf.ethz.ch, www.vdf.ethz.ch

Frank Eyhorn

Organic farming for sustainable livelihoods in developing countries?

The case of cotton in India



2007, 224 Seiten,
Format 17 x 24 cm, broschiert
ISBN 978-3-7281-3111-9
auch als eBook erhältlich

Organic farming has experienced considerable growth, not only in industrialized countries. Is it primarily an approach to safeguard consumer health and the environment, or can it also contribute to poverty reduction in developing countries?

Drawing on 3 years of research on organic cotton farms in the Maikaal bioRe® project in central India, this book assesses the potential and the constraints of organic farming for improving rural livelihoods. It further integrates lessons learnt in other organic cotton projects in Asia and Africa, making it the presently most in-depth and comprehensive work on the socio-economic impact of organic farming in a developing country. The research builds on a conceptual frame that allows investigating rural livelihoods in a holistic and interdisciplinary way. The book not only addresses scientists in the fields of rural development and tropical farming systems, but also provides recommendations for practitioners and policy makers.

This publication is also available as e-book.

vdf Hochschulverlag AG an der ETH Zürich, VOB D, Voltastrasse 24, CH-8092 Zürich
Tel. +41 (0)44 632 42 42, Fax +41 (0)44 632 12 32, verlag@vdf.ethz.ch, www.vdf.ethz.ch

nadel
Nachdiplomstudium für Entwicklungsländer
Postgraduate Course on Developing Countries

Ivan Pavletic

Political Competition, Economic Reform and Growth: Theory and Evidence from Transition Countries

Which political and institutional factors trigger reforms that enable the poor to benefit from the process of economic growth? How can the incentives of policy makers be influenced in order to achieve such a dynamic? These are the questions this study seeks to address by examining the transition process in post-communist countries. The author argues that political competition within an accepted and respected institutional environment has been a driving force in shaping the direction and success of transition reforms. Evidence shows that in countries with a sufficient degree of political competition, citizens responded to economic crises by calling for economic liberalization. Economic liberalization removed existing distortions, increased economic efficiency and raised public welfare. This activated a dynamic, self-enforcing reform process that also strengthened the political and economic power of the poor. In the absence of political competition, such a process failed to emerge, thereby contributing to the persistence of poverty. Based on these findings, there is good reason to postulate that some level of political competition is essential for transition reforms to improve economic efficiency and public welfare in a sustainable manner.

9 783728 132963

OPEN ACCESS – erhältlich als eBook zum freien Download
DOI-Nr. 10.3218/3311-3
ISBN 978-3-7281-3311-3 (open access)
ISBN 978-3-7281-3296-3 (Printversion)
www.vdf.ethz.ch