Institutional Impacts on EU Accession in Central and Eastern Europe

(A position paper)

Abstract: The paper focuses on the impact of three systems of government institutions on enterprises – administrative, judicial and the so called coherence system. The first two systems are examined by all referred studies from either cross-country or cross-industry viewpoint which effectively removes the time dimension from their analyses. The previously unstudied coherence system captures the effect of time changes in institutions on enterprise activity. We favor the position that coherence in government policy matters for explaining the transition results in CEE and propose a model for evaluation the impact of the coherence system for enterprise activity. Enterprise activity is justified as a criterion for a successful economic transition and a criterion for readiness to join the EU.

1. Introduction

Institutional development has been one of the key issues among economists and policy makers in the last 15 years in Central and Eastern Europe (CEE). Institutional development proved to be important in transition, because any interaction between economic agents is impossible outside certain broadly accepted rules – both formal and informal. Institutions are defined on two levels. On the first level we have the rules of economic development (the formal and informal institutions); on the second level are the organizations that implement those rules. While the automatic transfer of the modern rules of the game in CEE has been recognized as relatively easy, the implementation of the formal rules made the difference among the accession countries. Transforming a norm into a workable new institution requires a permanent effort of the implementing agents. Therefore, a relation between economic development and performance of the government bodies which implement the newly adopted laws may be drawn. In particular, the paper will examine the relationship between the performance of three systems of government organizations and the process of European integration. Those three systems are the administrative, the judicial and the *coherence system*. All three systems are influencing transition outcomes through

influencing enterprise activity. More specifically, they influence transaction costs for the enterprises which affect their opportunities for investment and expansion. This leads to different transition outcomes, as enterprise activity is commonly agreed as the most important source of change in transition economies. While there is a lot of literature available on the impact of the administrative and judicial systems on business development and thus on the transition results, the coherence system is a new and unexplored concept.

The paper is developed in three main parts. The first part examines how regulations on the entry and exit of any market affect business activity. The main idea of this part is that less burdensome regulation for enterprises means more resources for investment and growth in the economy. The second part is a logical step further with developing the link between enterprise activity and transition outcomes. Its main implication is that the more vigorous is the enterprise sector, the faster is the process of EU accession. The third part introduces the coherence system. The analysis of the coherence system is a generalization of the argument for the influence of any regulation on business activity. The analysis of the coherence system impact on enterprise activity and on welfare will be the main contribution of the paper.

Before opening the core discussion, it is relevant to introduce several background views in historical perspective on how governments influence business activity. There are five fundamental works in economics that describe the role of entrepreneurs for economic development, and the controversial impact of government institutions on entrepreneurs and thus on economic development. Joseph Schumpeter (1911) was the first who brought the entrepreneur on the stage. His famous concept of *creative destruction* implied that entrepreneurs are the driving force of progress in society because they create new firms and displace the old ones from the market. Almost three decades later Arthur Pigou (1938) employed somewhat different perspective on entrepreneurship. He asserted that stricter regulation of economic activity by the government brings socially superior outcomes to the ones that are stemming from the unregulated market. This is so because more regulation means increased performance of the

public institutions, which are functioning for the benefits of society. The concept presented in this theory is the so called *helping hand theory*. In two independent studies Stigler (1971) and De Soto (1990) present the opposing *grabbing hand view*. Stigler pointed out that regulation benefits only the incumbents to a given industry, and De Soto is famous for enriching this viewpoint – regulations are working for the regulators – bureaucrats and politicians. Thus, no matter what impact the regulations are believed to have, there is no controversy that the political, social, and legal rules establish the basis for production, exchange, and distribution of results of the entrepreneurial activity. This set of rules is defined as the *institutional framework* (Davis and North, 1971), which is the last of the five works.

Any of the influential empirical studies in the last several years has some reference to either of these fundamental theories. In the following part of the paper which analyses critically some of the relevant literature on the institutional impacts on transition, Pigou's theory is found to be outdated, and Stigler's and De Soto's viewpoints are supported by empirical evidence. In addition, the institutional framework for fostering entrepreneurial activity is found to be of great importance for success not only in any developed country, but also in transition economies. Therefore, the institutional impacts on transition are proposed to be channeled through the entrepreneurial activity: the regulations are influencing business activity, and the more active is the enterprise sector in the economy, the smoother is the accession into the EU.

2. Institutional impacts on business activity

There are numerous ways for the government to influence business activity. Two of them are compared in this part of the paper – the influence of the administrative system and the influence of the judicial system. The coherence system will be introduced only after these two are closely examined. The nature of the coherence system calls for a general approach and therefore there is no need to go into greater details like the ones we are going to explore in the part of the paper that follows.

Djankov et al. (2000) and Klapper et al. (2004) limit the scope of their analysis purely to the impact of the administrative system on enterprise activity. More precisely, they analyze the legal requirements before starting up a business, the costs for meeting these requirements for enterprises, and the time for setting up an enterprise in various countries around the world, including transition economies. Both compare the differences in business regulation around the world, focusing on the entry requirements in the market and attempt to explain those differences. In other words, they present a comparative viewpoint on the way the business environment (or, the institutional framework), drives the creation of new firms. Also, they try to assess what types of regulations lead to improved economic performance, and, more generally, what is the scope for governments in facilitating business activity.

The IBRD/World Bank (2004)[1] address the same questions, although they broaden the scope of analysis to a larger number of regulatory parameters. They evaluate not only the work of the administrative system on the market entry in a given country, but also present the differences in regulations for closing up a business and for implementing contracts. Due to the fact that the judicial authorities stand on the exit of a market, the IBRD/WB (2004) study is useful for evaluating the impact of both administrative and judicial systems on enterprise activity, while Djankov et al. (2000) and Klapper et al. (2004) are useful for comparing only the regulatory impact on the entry of market.

Djankov et al. find that for an entrepreneur, legal entry is burdensome, time-consuming, and expensive in most countries around the world. They reach the conclusion that rich countries regulate entry less than poor countries. Similarly, the IBRD/WB (2004) find out that rich countries have smaller number of procedures, and the time to register a company in richer countries is shorter. In addition, they find that the lighter is the regulation of entry, the higher is the productivity and the lower is unemployment in a given country (p.87).

Using somewhat different approach, Klapper et al. (2004) corroborate these results and enrich the conclusions. The difference in the approach is the

[1] Referred from now on as IBRD/WB (2004)

following: instead of comparing the regulation of entry across countries, they evaluate the entry procedures in a given industry around the world. They find out that there are differences across industries as to what is the "natural entry rate" into that industry – what is the share of the new companies compared to the number of the incumbents. They group the industries into high-entry and low-entry ones, and it is only then they bring the regulatory procedures into the analysis. Klapper et al. reveal that more burdensome regulatory procedures inhibit entry and reach the conclusion that "'naturally high-entry' industries have relatively lower entry in countries that have more onerous bureaucratic entry regulations" (p.3). Also, similarly to the previous two sources, they confirm that growth of productivity in high-entry industries in those countries is lower.

However, the different approach used by Klapper et al. leads to somewhat richer conclusions than Djankov et al. and the IBRD/WB (2004) study. They find out that there are industries where the regulations are beneficial for the market entry. Specifically, those industries are with high value added and with high human capital input (e.g. patents). When governments do not protect effectively the intellectual property rights by imposing various procedures, the entry levels are lower. Although IBRD/WB (2004) stresses the importance of the property rights for economic development, it does not draw the relation between the property rights and entry levels in industries or in countries around the world. Djankov et al. do not analyze the property rights protection mechanisms as they are deemed to be outside the scope of their analysis.

The wider scope of IBRD/WB (2004) study extends the aforementioned conclusions to the judicial systems around the world. Judicial systems can influence business activity mainly through two channels – market exit procedures and transaction costs. The latter are the costs that appear before, in due course, or after a given contract has come into force. If there are problems for a given company to execute the stipulations in a contract, then the judicial system is the one that can make the company execute the contract by settling a dispute between the two sides. Also, if a company is in the position to go bankrupt, it is in the interest of the entrepreneur to go bankrupt faster and start over faster. If

the judicial system is functioning poorly, then contracts are not fully implemented and economic activity is suffering; in addition, fewer new companies are created because the old ones cannot go bankrupt. IBRD/WB (2004) finds that richer countries have fewer procedures to resolve disputes among companies and faster bankrupt procedures (p.44). Faster court procedures mean increased time resources for companies, therefore less alternative costs and more investment into the economy.

Thus, Pigou's theory is rejected by empirical evidence presented in all the three sources above. This is exemplified in the following conclusion: "Heavier regulation is generally associated with more inefficiency in public institutions – longer delays and higher cost – and more unemployed people, corruption, less productivity and investment, but not with better quality of private or public goods." (IBRD/WB 2004, p.xiv). In addition, all of the above sources support the opposing theory, introduced by Stigler (1971) and De Soto (1990). Countries with less government regulations are richer because the enterprise sector is left with more resources for pure business development rather than allocating those resources for dealing with redundant regulation both on the entry and on the exit of the market.

The argumentation about how administrative and judicial systems influence enterprises can be generalized to any other system of government institutions. The generalization is made when examining the nature of the coherence system. For the purposes of the current analysis, understanding how administrative and judicial systems work is indicative of the influence of any other government system on enterprise activity. The main outcome of the above discussion related to enterprise activity is that government institutions are influencing transition outcomes because they influence transaction costs of the enterprises. Next section of the paper shows why enterprise activity can be used as a criterion for a successful transition.

3. Business activity, transition outcomes and EU membership

While regulations on the entry and exit, and as we will shortly see, any other regulations, influence the vigorousness of the enterprise sector, there are

several studies that focus on the way enterprise activity influences transition outcomes. The major question they are trying to address is can we relate the enterprise activity with the differences in transition outcomes in CEE? The answer given by Smallbone et al. (2003) and IBRD/World Bank (2002)[2] is positive. The differences in enterprise activity during transition are the key to understanding the different transitions in CEE.

Smallbone et al. (2003) discuss the institutional framework that is adequate for the development of entrepreneurship. However, they discuss the institutional environment and its importance in general, without entering a detailed discussion of its impact neither on transition, nor on enterprises. This limits the empirical and the theoretical power of their analysis. They also stress the importance of entrepreneurship for successful transition in general. Applying slightly different angle, IBRD/WB (2002) evaluate the policies for economic growth in transition economies, especially related to enterprise development. Contrary to Smallbone, they apply empirical approach and corroborate the widely accepted view that institutions are important for development of enterprises. Their main subject is the policies for enhancing economic growth in transition economies, how they differ from country to country and how knowledge about the variance in these policies can explain differences in transition outcomes. This approach leads to more powerful analytical outcomes and sets some implications even for economic theory of transition, namely, the role small and medium enterprises (SMEs) play in any given transition economy may be used as a criterion for maturity of transition. More specifically, the higher the share of SMEs is in employment and in gross domestic product, the more successful the country is in its transition.

This conclusion is also stated in a more general form in Smallbone et al., namely, countries with inadequate institutional framework for small enterprises lag behind in their transition results. However, this does not tell much about the necessary changes to the institutional environment in order to foster entrepreneurial activity. Therefore, the IBRD/WB (2002) extension to this result

[2] Referred hereafter as IBRD/WB (2002)

is more than adequate. It reveals that new enterprises that are by default SMEs are important for growth and development in a specific way. They are more productive, export more, hire more people and invest more into transition economies than the old enterprises (p. 26). Also, small and medium sized enterprises (SMEs) after they entered the market are important for success in transition – employment and value added in SMEs accounts for more than 50% in successful transition economies and between 20-30% in the economies that lag behind in EU integration (p. 41).

This is the right place to combine the analysis. The regulations of entry hamper setting up of new companies and the regulations of the market exit impede effective resource allocation for setting up new companies and increase transaction costs. At the same time, new companies which are predominantly small ones are vital for successful transition. Thus, the institutional impacts on EU accession are running through the enterprise activity – the better the institutions, the more vivid the enterprise sector, and the more successful outcomes of transition.

4. Coherent enterprise policy and transition outcomes

As was highlighted above, the government induces the way enterprises adapt to the business environment through various regulations (which economic theory refers to as institutions). It was stated that there exists an inverse relationship between the costs these institutions impose on enterprises at a certain moment in time and the vigorousness of the enterprise sector. The enterprise activity impacted by the institutions served as a criterion for a successful transition.

Let us complicate the matter a little and consider the case when these institutions are not stable over time so that we cannot compare them at a given moment. All analyses of the impact of business regulations on enterprises cited above include only cross-country or cross-industry database analysis: Djankov et al. (2000); Klapper et al. (2004); IBRD/WB (2004). However, unstable institutional environments over time are observable in all countries in transition, since every new government imposes new business regulations and also

regulations are changed during a given mandate of any government. Moreover, new regulations are naturally adopted due to the process of European integration. Adopting any new regulation, including the common European legislation, means increasing the information and compliance costs for the local enterprises. By their nature, these costs are transaction costs. Although the aforementioned sources examine the effect of regulations on transaction costs, they do not analyze this impact as time changes. As shown below, the time dimension of institutional impacts on enterprises also matters for successful transition. This is so, because time changes in institutions influence the opportunities for investment and growth of enterprises in transition economies. Naturally, changes in institutions over time are made by the elites that have the power and resources to change them. A growing number of literature sources explain the relationships between the choices political elites make and economic performance.[3] The relevant conclusions of these sources to our present work are that timing and sequencing of reform matters (Pierson, 2000) and that if for some reason the elites prefer inefficient policies at a given time, these policies transfer to inefficient economic institutions (Acemoglu, 2006). The section that follows explains how these inefficient economic institutions influence transition outcomes.

As pointed above, the higher level of activity of the enterprise sector which is achieved through reduced transaction costs brings success to the economic transition faster than with higher transaction costs. In order to keep the transaction costs low through every period in time, the enterprises in the local economy require certain coherence in the way the regulations are adopted and implemented. Therefore, the economy needs coherence in the enterprise policy in order to reduce transaction costs. Reducing transaction costs means increased opportunities for the local enterprises to invest and expand. Thus, the coherence in the enterprise policy fosters the enterprise activity in a way that the economy

[3] For further reference, see for example: North, Douglass (1994); Acemoglu D., Robinson J. [(2000), (2001)]; Pierson, (2000); Acemoglu D., Johnson S., Robinson J. (2005); Acemoglu, (2006).

is able to cope more successfully with the competitive pressure of the market forces in the EU (European Commission 2005(a), p.25; EC 2005(b), p.29). Since the executive bodies of the government are the ones that design and implement the new coherent or incoherent laws, we call the system in charge of the design and implementation of new laws with the term *coherence system*. Some of the sources stated above (e.g. Pierson, 2000 and North, 1994) discuss the importance of the coherence system for the success in transition, although they never label it with the term coherence system. However, neither of the above sources discusses the impact of a coherent economic policy on the vigorousness of the enterprise sector in particular. This discussion follows below.

The coherence system serves to improve the performance of the regulations, as well as the performance of the systems that implement the regulations (e.g. administrative and judicial ones). The more frequent are the changes in a given regulation, the more often enterprises are forced to change their way of communication with the government bodies, as well as the way they make contracts between themselves. Therefore, a relationship between the consistency in the legislation over time and potential investment in a transition economy can be drawn. Similarly, the loss of potential investment for the economy because of incoherent system can be analyzed through the occurrence of transaction costs for the enterprises due to new and incoherent legislation. The potential loss of investment for the economy (L) is thus given by:

$L = \mu \sum_{i=1}^{N} TC_i - \sum_{i=1}^{N} CG_i$, where:

μ – marginal propensity to invest in the given economy;

TC_i – transaction costs that occur in line with amending i^{th} institution; N is the number of existing institutions;

CG_i – the costs for amending and implementing the ith institution towards increased policy coherence, faced by the government.

Had they never existed, these transaction costs would have been an income for the entrepreneurs. This income goes to investment with a factor, given by the marginal propensity to invest. Because of their existence, the

transaction costs occurring in line with amending a given institution induce a loss of investment for the economy, given by L. However, the lost investment is not the only loss for the economy. Existence of transaction costs means also lost consumption for the entrepreneurs. Investment (which is transferred to savings) and consumption constitute the income for the entrepreneurs. Since part of this non-existent income would have been saved and part of it - consumed, then the total loss of welfare for the economy due to existence of these transaction costs is given by:

$$L_1 = (\chi + \varsigma)\sum_{i=1}^{N} TC_i - \sum_{i=1}^{N} CG_i = \sum_{i=1}^{N}(TC_i - CG_i),$$ where:

χ – marginal propensity to consume in the given economy;

ς – marginal propensity to save;

TC_i – transaction costs that occur in line with amending i^{th} institution; N is the number of existing institutions;

CG_i – the costs for amending and implementing the ith institution towards increased policy coherence, faced by the government.

Therefore, the importance of the coherence system may be calculated in terms of either forfeited investment (L) or sacrificed welfare (L_1) for the economy. This importance is further exemplified with the straightforward conclusion that policies reducing or eliminating transaction costs lead to increase in investment by L or overall increase in welfare by L_1.[4]

However, there are cases in which amending a given institution will not bring the desired social benefits. This is so because the process of amendment is time consuming itself in the first place, and secondly, because implementing the new laws may turn out to be even more costly than amending the old ones. Thus, incoherent policies are better than coherent ones from a social point of view, if the costs for making the policies coherent ($\sum_{i=1}^{N} CG_i$) are higher than the

[4] It is not in the scope of this position paper to discuss whether the transaction costs for a given economy can or cannot be calculated, and if they can, how exactly it can be done.

entrepreneurial gain from existence of coherence ($\sum_{i=1}^{N} TC_i$). In this situation the social benefit from incoherent policies is positive.

Although positive social benefits from incoherent policies might occur, it is natural to assume that if a given institutional amendment benefits the majority of enterprises in a given economy, then the costs of these reforms would be only a fraction of the benefits for the entire economy. Examples of such large-scale reforms include simplifying market entry and exit regimes, or introducing e-government services for tax-payers. Therefore, an increase in investment and welfare from a coherent economic policy is a natural prediction of the model. The more coherent is the enterprise policy and the more coherent is its implementation, the more resources are left to the enterprises in the transition economy to invest, expand, and export. As we have seen from the previous parts of the paper, growth of enterprises is the key for fostering growth and convergence with EU for transition economies.

5. Conclusion

The common knowledge that the diversity of various institutions in transition countries is important for generating diverse transition outcomes is insufficient for answering a number of important questions, addressed in transitology.[5] These questions are: which institutions are important for economic transition, which are the government bodies that represent those institutions,

[5] In political science, **transitology** is the name for the area that studies the process of change from one political regime to another, mainly from authoritarian regimes to democracies. Pls. refer to Transitology. (2005, September 2). *Wikipedia, The Free Encyclopedia*. Retrieved 19:10, December 7, 2005 from http://en.wikipedia.org/w/index.php?title=Transitology&oldid=22397368 . In a somewhat broader context, transitology may be defined as an interdisciplinary branch of political science on the border between political science and economics used for explaining the rapid economic and political changes in various regions around the world during the last 30-40 years. [Definition coined by the author for the purposes of the paper]

which are the channels for influencing transition outcomes, and most importantly, how institutional impacts are channeled into those outcomes. The list of systems of institutions that influence transition, although by no means exhaustive, includes the administrative and the judicial systems. Understanding how these two systems are affecting transition is vital for understanding the influence of any other institution on any transition economy. More specifically, these systems are working through influencing transaction costs that enterprises face during transition. We have seen that enterprises are the main channel for generating institutional impacts on transition outcomes and we have also agreed with previous studies that their performance is probably the most important criteria for evaluating success in transition. In addition, we have shown that comparing institutions in a snap-shot way is also not sufficient for explaining differences in transition. We have shown that changes of institutions through time are also important for enterprises. Therefore we attempted to reveal analytically that the time-dimension of institutions is working through the opportunity costs of investing and expanding for entrepreneurs, namely, through the same transaction costs that appeared in the analysis of the administrative and judicial systems. The system that can influence these opportunity costs is the coherence system. The better the coherence system is performing, the more favorable are the results from the transition in CEE, which is also acknowledged by EU authorities responsible for evaluating the preparedness of a given country to enter the common EU market.

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