
- Initial output fall occurred in all Central and Eastern European countries but how to explain differences in performance after the output fall?

- Poland and Russia did not differ much in their transition strategies but diverged in terms of their output performance.

- Role of institutions, and of law enforcement, in securing private contracts (North, 1990).

- Understanding output fall required looking at level of contracts. Institutional environment of contracts plays an important role.
Deviation of Overall Average Institutional Quality (1997) from the mean of Industrialized countries

- Tajikistan
- Lao People's Dem.
- Turkmenistan
- Uzbekistan
- Bosnia & Herzeg.
- Azerbaijan
- Belarus
- Albania
- Georgia
- Ukraine
- Russian Federation
- Kazakhstan
- Armenia
- Kyrgyz Republic
- Cambodia
- Viet Nam
- Macedonia
- China
- Moldova
- Romania
- Bulgaria
- Croatia
- Mongolia
- Lithuania
- Latvia
- Slovak Republic
- Estonia
- Czech Republic
- Poland
- Slovenia
- Hungary
EBRD legal reform indicators:

Survey among lawyers and legal experts (scores given).

Extensiveness (comprehensiveness) and effectiveness (clarity, absence of contradictions, quality of administration of law)
Figure 3: EBRD Legal System Reform

EBRD Legal System Indicators 1997 and 1999

- Hungary
- Estonia
- Poland
- Croatia
- Czech Republic
- Slovenia
- Bulgaria
- Romania
- Lithuania
- Slovak Republic
- Russia
- Latvia
- Armenia
- FYR Macedonia
- Moldova
- Kazakhstan
- Kyrgyzstan
- Uzbekistan
- Ukraine
- Georgia
- Belarus
- Albania
- Azerbaijan
- Bosnia and Herzegovina

Comparison of legal system indicators for various countries in 1997 and 1999.
EBRD Legal System Indicators

Legal System Effectiveness in 1999

Countries Included:
- Albania
- Belarus
- Bosnia and Herzegovina
- Georgia
- Ukraine
- Uzbekistan
- Azerbaijan
- Czech Republic
- Estonia
- Latvia
- Moldova
- Russia
- Slovenia
- Poland
- Lithuania
- Hungary
- Croatia
- Bulgaria
- Armenia
- FYR Macedonia
- Slovak Republic
- Romania
- Kyrgyzstan
- Kazakhstan
- Estonia
- Czech Republic
- Azerbaijan
- Uzbekistan
- Ukraine
- Georgia
- Bosnia and Herzegovina
- Belarus
- Albania
Legal System Extensiveness in 1999 - Legal System Effectiveness in 1999
- Emphasis on introduction of legal codes is not enough. Russia introduced many US laws but laws were not enforced.

-Mafia phenomenon more developed in Russia and former CIS.

<table>
<thead>
<tr>
<th>% of managers reporting that firms pay Mafia protection</th>
<th>Russia and Ukraine</th>
<th>Poland</th>
<th>Slovakia</th>
<th>Romania</th>
</tr>
</thead>
<tbody>
<tr>
<td>90</td>
<td>8</td>
<td>15</td>
<td>1</td>
<td></td>
</tr>
</tbody>
</table>

Source: Johnson et al., 1999.
- Important coordination problem in law enforcement:

- expectations of weak law enforcement => lower deterrence for unlawful activities including tax evasion => lower production => low tax collection and weak law enforcement.

- expectations of strong law enforcement => higher deterrence for unlawful activities => high productive activity and high tax collection making strong law enforcement possible.
VAT in % of GDP Normalized to 20% Rate 1997 vs. EU Average

Correlation between progress in transition and tax collection. No advanced transition country with low tax collection ability.
The evolution of the unofficial economy as a share of GDP in selected transition countries.

<table>
<thead>
<tr>
<th>Country</th>
<th>1989</th>
<th>1995</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hungary</td>
<td>27</td>
<td>29</td>
</tr>
<tr>
<td>Poland</td>
<td>15.7</td>
<td>12.6</td>
</tr>
<tr>
<td>Czech republic</td>
<td>6</td>
<td>11.3</td>
</tr>
<tr>
<td>Slovakia</td>
<td>6</td>
<td>5.8</td>
</tr>
<tr>
<td>Estonia</td>
<td>12</td>
<td>11.8</td>
</tr>
<tr>
<td>Russia</td>
<td>12</td>
<td>41.6</td>
</tr>
<tr>
<td>Ukraine</td>
<td>12</td>
<td>44.2</td>
</tr>
<tr>
<td>Georgia</td>
<td>12</td>
<td>62.6</td>
</tr>
</tbody>
</table>

Source: Johnson, Kaufmann and Shleifer (1998).
- Countries that started reforms earlier had large unofficial sectors.
- Accession countries have not experienced significant increase in size of unofficial sector.
- FSU countries have seen large increase in size of unofficial sector.
Taxation, regulation, corruption, the legal system and the size of the unofficial sector.

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

Source: Johnson, Kaufmann, Mcmillan and Woodruff (1999).
• Weak law enforcement has an effect on private contracting:

- lock-in of relationships through specific investment to create trust and reduce outside options of other party and create credible stronger sanction
- multilateral sanctions and social exclusion.
- Role of trade associations, wholesalers and intermediaries in keeping information on reputations.

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

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

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

Source: Johnson, McMillan and Woodruff (1999b,c).
Weak law enforcement leads to

- underinvestment (stronger motive than credit constraints in transition economies) because of fear of expropriation.
- weaker developments of markets. Firms trade less distantly, organize in close business groups and trade
How to explain difference in institutional quality in Central Europe vs FSU?

-Difficult question and many possible confounding factors.
- orthodox culture? Absence of renaissance culture?
- Longer communist past?
- absence of rule of law in the past?

- One important factor is that accession acted as an institutional anchor for Central European countries and helps to coordinate expectations.