Governance and comparative institutional development in transition countries

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Abstract: *How can we explain the difference in institutional outcomes between transition countries, in particular between new democracies and autocratic states and hybrid variants of the two? This paper outlines the research agenda of developing an extensive model of government which is capable of capturing differences in institutional development. It discusses implications of the commitment problem in autocratic government and the problem of controlling politicians in new democracies with a history of corruption.*

Keywords: *Institutions, property rights, limited commitment, reelection constraint*

1. Introduction

How can we explain the difference in institutional outcomes between different transition countries? The countries of Eastern Europe and the CIS countries all started out with insufficient fiscal capacity and weak property rights protection: Insufficient fiscal capacity is considered a main contributing factor to the shared experience of hyperinflation in the 1990s while the weak protection of property rights by the state gave rise to the emergence of mafia structures in many countries (see, e.g., for Russia: Varese, 2001).

Property rights protection remains weak in the autocracies of Eurasia. Cases of *reiderstvo* have become a common phenomenon in Russia (see Shelley and Dean, 2016): Raiders effectively expropriate business assets using their connections within the state and local administration to exercise pressure on the owners, for example by forcibly closing down businesses for alleged violations of legal rules. Law enforcement agencies—held back by interagency struggles—have an extremely bad record in protecting business property. Moreover, high-profile cases such as the Yukos affair have left observers with the impression that a complex legal system can be tweaked to effectively expropriate members of the elite who have fallen out of favor—a view endorsed by the Permanent Court of Arbitration in The Hague (see FT.com, 2015).

Using contract sensitive money as a proxy, Hartwell (2015) shows that the new democracies of Eastern Europe better protect property rights. At the same time, corruption remains high not only in autocracies but also in new democracies.[2] Empirically, socialist legacy is associated with greater corruption (Svensson, 2005) but in general one would expect democracy to reduce corruption (see e.g. Kubbe and

[2] See Sonin (2016) for an overview of the literature on corruption in transition economies.

Engelbert, 2018): One of the factors associated with less corruption is a free media and, theoretically, electoral control should at least constrain elected officials from corrupt behavior.

The observed persistence of corruption in transition economies is often blamed on an inefficient court system (see e.g. Anderson et al., 2005). Seen from this angle, corruption in new democracies and ineffective enforcement of property rights in autocracies may have the same underlying cause. But they may also serve the same purpose: The procurement process is often corrupted in order to reward supporters (see Toth and Hajdu, 2017) while, as Di Maria et al. (2018) argue, weak property rights in autocracies may be necessary to support personal—implicitly contractual—relations within the regime.

There is no theory that is at the same time sufficiently specific to account for differences in the institutional development of transition countries and general enough to analyze their experiences in a comparative perspective. Accounts either focus on the experience of individual countries or group of countries (see, e.g. Hartwell, 2016), or, if they are general enough to serve as a theory of comparative institutional development, they are too coarse to pick up differences between individual transition countries.[3]

The best candidate to provide such a theory to date is Besley and Persson (2009) who develop a macro-model of institutional development with governments who have to decide over investment into fiscal and legal (i.e. property rights protection) capacity. Yet as we are going to show, their approach is not sufficiently detailed to account for differences in the institutional developments between different transition countries. As Besley and Persson suggest themselves, what is missing from their approach is a structural model of government. In this paper we are going to broadly outline some elements of such a theory.

In section 2 we review the approach of Besley and Persson (B-P). In section 3, we focus on the autocratic state and the implications for institutional development. In section 4, we discuss a model of controlling politicians in new democracies. Section 5 considers hybrid cases. Section 6 concludes.

2. The case for a structural model of government

In the B-P model, governments have to decide over investing into the stock variables fiscal and legal capacity. Besley and Persson assume that interests of government and groups of citizens are broadly aligned, in the sense that governments attach positive weights to the different groups in society, and, hence, each current government values property rights protection in citizen-citizen interaction and the power to tax—although it might not necessarily want to invest into future capacity. Besley and Persson also provide preliminary empirical support: They find that measures of legal capacity such as access to credit or an index of government anti-diversion policies[4] are linked to the prevalence of external conflict as fiscal capacity measured by indicators of the size of tax revenue. This supports their main claim: that investing into one type of state capacity, for example into fiscal capacity as the need arises to provide for the public good "defense," is complementary to investing into the other type of state capacity.

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[3] See for an illustration the theory of Acemoglu, Johnson, and Robinson (2001) based on a country's colonial experience.

[4] The index is taken from the International Country Risk Guide and has been used in the development literature by authors such as Acemoglu, Johnson, and Robinson (2001).

While this theory provides enough detail to distinguish between different histories of transition economies, it falls short of accounting for fundamental differences in the relationship between governments and citizens in these countries.

Historical circumstances have shaped the emergence of the particular set of Western institutions in the 19th century (see, e.g., Acemoglu and Robinson, 2012). At the time, the prior totalitarian order was in decline and the emerging class of industrialists agreed on the need of defensive rights against the state, which notably include safe property rights. Political parties organized themselves around the interests of emerging classes: In the UK, the Whig party represented the interests of the socio-economic class of merchants against the interests of the landed gentry of the Tories. Later, Labour defended the interests of the emerging working class against the established parties. All this was conducive to the formation of parties representing the organized interest of citizens and it is natural to assume some alignment of citizen interest and party position.

While, at first sight, the experience of transition countries in the 1990s is similar—the old socialist order was in decline and a new business class was emerging —things were different at closer inspection: The total collapse of the institutions of the socialist state made property rights that provided a defense against the state less important while the lack of property rights enforcement in the citizen-citizen relationship was a serious and common problem and led to the rise of Mafia structures in many transition countries. While in the new democracies which emerged from the Eastern bloc—in particular those who joined the EU—formal property rights were eventually consolidated, the protection of property rights in autocratically governed transition countries has remained weak. Most new democracies, on the other hand, still suffer from corruption which undermines legal protection and fiscal capacity. Moreover, many transition countries appear to move somewhere between the extremes of autocracy and democracy.

B-P compare a utilitarian benchmark case, where the social planner attaches equal weights to two groups, to the case of "political control" where the political planner attaches a higher weight to her own group. The strength of this "overweighting" may be interpreted as a proxy for political polarization. Yet a focus on differences in representation of different groups in society cannot easily explain the difference in experience: In the new democracies, during the 1990s, the role of parties as a transmission mechanism between citizens' preferences and collective action was weak: Not only did governments frequently change, but parties were often disbanded and new parties coalesced (see, e.g., Kaminsky, 2006). Yet if one were to count these observations as high political turnover and, hence, a proxy for political polarization, fiscal and legal capacity in those countries would be predicted to be relatively low, when in fact it is relatively high. The established autocracies of Eurasia typically produce economic outcomes which favor a part of the elite. But unless they revert to repression, they also have to try to accommodate the interests of a relatively broad coalition of citizens. This is even more striking in comparison to some increasingly polarized new democracies such as Hungary or Poland where the government furthers the interests of an electoral majority while at the same time antagonizing a substantive minority. This argument would suggest that autocracies might be thought of as closer to the social planner model. Clearly, there is also a contest for power in autocracy, but this typically plays out in the longer term.[5] The

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[5] Clague et al. (1996) show that property rights protection increases with the expected length of tenure of the autocrat.

observation that this contest often has the potential to produce more radical shifts in ownership rights cannot in itself be taken as a proxy of greater polarization: It says something about how institutions look in such an environment and is, therefore, part of the explanandum—what needs to be explained—rather than the explanans, i.e. the explanation itself. It also points to the more fundamental problem, as originally stated by Olson (2000), that safe property rights in the state-citizen relationship are—unlike the power to tax—most of all in the interests of the benefited part of the elite because it provides insurance against the consequences of losing political power. From this perspective, the B-P model is silent on the central aspect of our investigation.

In this paper, we argue that a structural model of government is more appropriate for the study of transition countries than a model that summarily assumes that different groups are differently represented in the governments of different countries. Ideally, a structural model of government must be capable of explaining differences in inner-government and citizen-government relations. For this it needs to take account of the motives of the main players, their relative power and how it affects their relationship, and also to specify what is being exchanged between the main players. It also has to be detailed enough to explain how different governance problems apply when development starts from different historical positions.

3. Autocratic states

An autocratic government cannot be bound by legal institutions because, by definition (see Przeworski and Wallerstein, 1988), it can overturn the outcome of the institutional process.[6] Yet it may be able to make credible promises if this is supported in political equilibrium (see Myerson, 2008) or, in simpler terms, if the situation and the purpose of the regime are such that it wants to keep the promise. An example is former Chilean president Augusto Pinochet who, although in the position of autocrat, ceded power after losing an election which was scheduled in accordance with the constitution promoted by the junta. Pinochet was persuaded to step down after his defeat, a move which helped to promulgate the regime's constitution and to solidify its political legacy (see Michalak and Pech, 2013).

The ability of an autocratic government to protect property rights may be analyzed along the same lines as the incentive of a sovereign not to expropriate foreign direct investment. Thomas and Worrall (1994) analyze a setting where a sovereign can sign a renegotiation-proof—and hence credible—contract with a foreign investor. To obtain the result, the government and the investor need an infinite planning horizon, there has to be an advantage to the foreign firm in running the investment project, and the foreign firm has to be able to withdraw and revert to autarky.

This suggests that the ability of the autocratic government to commit not to expropriate is likely to be greater with large multinational companies than with homegrown investors. Yet there are few examples where the government directly expropriates and receives a fiscal windfall—the case considered by Thomas and Worrall. As the *reiderstvo* issue suggests, the problem may be the citizen-citizen relationship as much as the government-citizen relation. Also, better protection of property rights would seem to be a relatively easy way to address the economic stagnation deplored by many governments in transition countries. Hence, if the

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[6] Taking this perspective, the constituting problem in Guriev and Sonin (2009) is that a dictator cannot simultaneously protect oligarchs against property rights violations by each other and against expropriation by himself.

protection of property rights remains unsatisfactory, this must be related to some more fundamental governance problem.

As Shlapentokh (2007) has argued, personal relationships are at the core of the autocratic governance system where political support—or at least the promise of political neutrality—is exchanged for economic advantage. It is inconceivable to make the underlying implicit contract explicit or enforceable in court. [7] Yet enforcement by unilateral termination of the contract implies weak property rights: The government could not have sued Mr. Khodorkovsky for straying into politics. Instead, it kept the factual power to target his assets when everyone concerned understood that there was a violation of the terms of the implicit contract.

Di Maria et al. (2018) have formalized this contractual relationship. The underlying social and economic situation is quite different from an earlier approach by Guriev and Sonin (2009) who have argued that oligarchs may prefer a weak dictator who is unable to protect property rights over a strong dictator who is able to expropriate them. Yet they do not explain the observation of weak property rights in consolidated autocracy.

Focusing on weak property rights as an element of a contractual relationship also helps explain other features of autocratic systems: Because of the lack of commitment not to expropriate, the autocrat's supporters must not be "overpaid." Hence, there is an inherent tendency for supporters-oligarchs to inflate costs in order not to show excessive profits. At the same time, to the extent that supporters need to be bought off so that they refrain from a leadership challenge, the need to compensate them is likely to result in an industry structure that maximizes rents. The reverse of this logic is that if the government has the possibility to commit itself and any successor government not to expropriate some investors, this will also allow it to reduce overall rents in the economy: To the extent that rents cannot be appropriated by a successor government, potential political challengers need not be compensated for refraining from trying to capture those rents.

Applying the argument of Thomas and Worrall to this situation, large international investors—in particular in such industries where they have a natural advantage—are more likely to escape the threat of expropriation and, hence, bringing in such investors is an unambiguous advantage for the economy and quite possibly for the government. A recent initiative by the government of Kazakhstan to open the possibility of international arbitration for international investors (see FT.com, 2014) but also the recent opening of the Uzbek economy are examples of such an approach.

4. New democracies

In new democracies, while property rights are mostly formally safe, corruption affects bureaucracy, judiciary, and the elected government. Our main interest here is the corruption problem at the level of the elected government because an effective electoral constraint is arguably the main distinction between new democracies and autocratic states.

Following Barro (1973), Ferejohn (1986) and Acemoglu, Golosov and Tsyvinski (2008), the electorate may be able to enforce good behavior on the side of the incumbent politician by choosing a retrospective electoral strategy. In an ideal world where preferences, alternatives and ability of the incumbent politician and, also, of the politicians in the pool of reserve candidates are known up to an error term,

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[7] Hence, it has to be analyzed as a relational contract as pioneered by Macleod and Malcomson (1989).

following some retrospective strategy is optimal—and even subgame perfect —because there is no better strategy than to throw a politician who failed to deliver out of office. In the following, we apply the framework of Ferejohn to our situation.

Assume that the public can overcome their coordination problem and set a reelection rule R as follows: Reelect the incumbent if the amount x he grabs does not exceed the threshold R and elect a reserve candidate if $x > R$. The incumbent can choose between grabbing an amount $x > R$ today and being thrown out of office for good and grabbing $x = R$ and being reelected. Politicians and public discount future pay-offs with the discount rate $\delta \in [0,1)$. For each period in office, the incumbent receives a benefit from holding office B. His "physical" grabbing capacity is θ but he may decide only to grab a part $x \leq \theta$ of what he can maximally grab.

A politician's periodic utility is

$v = B + x.$

The periodic utility of a typical member of the public is

$u = -\gamma x$

where $\gamma > 0$ is the degree to which grabbing affects the typical member of the public.[8]

The incumbent can decide between satisfying the reelection constraint and grab at most $x=R$ or choose not to be reelected by grabbing $x > R$, provided that he has the capacity of so doing. The incumbent's total pay-off from staying in office indefinitely is $\delta(R+B)/(1-\delta)$. As he can maximally grab θ, he chooses to be reelected if

$$\delta(R+B)/(1-\delta) \geq \theta. \tag{1}$$

In this case, the public needs to leave to the incumbent at least what he can enforce by grabbing. Therefore, the reelection rule has to satisfy

$R \geq max[\theta, \ \theta (1-\delta)/\delta - B].$

Now consider the case where the public cannot directly observe θ but has to infer it with some uncertainty from some prior observation. Assume that the prior observation is the realization of θ in the previous period. Call this observation e_0 and assume that the current realization of θ is equally distributed on $[e_0 - \frac{1}{2}, \ e_0 + \frac{1}{2}]$.[9]

In this case, citizens want to equate the expected value for the incumbent to stay in office to the expected value of grabbing and accepting defeat. Hence, it is the optimal reelection strategy to set R such that

$$R = max \ [e_0, \ e_0 (1-\delta)/\delta - B]. \tag{2}$$

In a world without reelection constraint, citizens can directly observe the level of corruption. Let $e_0 = \theta$ be the prior realization of θ. So after a history of corruption,

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[8] If the "grabbing game" is zero sum and there are n members of the public, $\gamma = 1/n$.
[9] Ferejohn uses a more general density function but the equal distribution assumption much facilitates the proof of our result on comparative behavior with and without the reelection constraint. See also the discussion in the text below.

citizens will tend to set their reelection rule in accordance with what they have historically observed and will choose a lenient reelection rule. Essentially, as long as citizens believe that politicians are all equally corrupt (with expectation e), it makes no sense to throw out an incumbent who just meets this expectation.

While for a history of corruption under ineffective electoral constraints—as we argued is typical of new democracies—the reelection threshold increases with past corruption, we may ask how this compares to a situation where the reelection constraint was operative in the past. Assume that there is a state where citizens can observe only past grabbing rather than past capacity. To make sense of any such observation, citizens need to hold a prior. Suppose that the prior is identical to the value e_0. In period 1, citizens select their reelection rule in accordance with (2). Assume that $R < e_0$, i.e. on average the reelection rule binds the politician.

Now assume that the incumbent, after observing his true θ, chooses to be reelected. If he realizes $x < R$, citizens can directly infer $\theta < e_0$. If he chooses $x = R$, citizens will conclude that θ is in the range $[R, \theta']$ where θ' is the value of θ for which (1) is binding. If ex ante citizens attach positive probability to θ exceeding θ', then after observing compliance by the incumbent they update their prior e_0 to e_1 with average value $Ee_1 < e_0$. The decisive property for this result—which we prove in the appendix—is that the posterior distribution after an incumbent has been reelected puts greater emphasis on the incumbent having a low capacity for grabbing in comparison to the prior distribution. This result obviously holds for more general density functions than the one considered here.

So citizens who directly observe corruption in a world with no reelection constraint—arguably the case of new democracies directly after transition—will tend to be more lenient towards future performance than citizens who observe compliance with the reelection rule from an incumbent who acts under an operative reelection constraint. Only very corrupt politicians will reveal themselves under a reelection constraint as well as in the absence of a reelection constraint.

5. Hybrid cases

A number of transition countries have moved between the extremes of autocracy and full democracy. For example, Hungary has recently lapsed towards more autocratic rule. Also Russia—considered an imperfect democracy in the 1990s—has become increasingly autocratic. On the other hand, there are countries such as Kyrgyzstan, which have moved from autocratic rule to imperfect democracy.

It is striking that property rights have remained safe in Hungary even with increasingly autocratic rule while the weak property rights regime that was characteristic of Russia of the 1990s has become entrenched with autocratic rule. Hungary has shown elements of personalized relationships at the center of power (FT.com, 2017), but the underlying incentive structure mainly consists of favorable procurement contracts.[10] Arguably, weak property rights and handing out favorable procurement contracts may be interchangeably used for solving the same governance problem.

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[10] See also Toth and Hajdu (2017).

6. Conclusions

This paper has set out to explore the different performances of new democracies and autocracies in terms of institutional outcomes, in particular property rights enforcement. We have argued that the enforcement of the implicit contractual relationship which is meant to secure support in exchange for economic advantages, conflicts with full protection of property rights. The hybrid case of Hungary suggests that where similar contractual relations need to be supported in countries with already fully established property rights protection, the preferred method of supporting such relationships are advantageous public procurement contracts. This particular observation also suggests that at least right-leaning politicians will normally find it costly to overturn an established property-rights order. We also offered a discussion why even with a binding reelection constraint, citizens of countries with a history of corruption and instable government want to implement less constraining reelection strategies. The latter argument suggests that in new democracies with autocratic tendencies there will be some leeway to conduct corrupt practices in public procurement even if voters can theoretically throw out a corrupt government.

Overall, the paper makes the point that extensive models of government behavior in different historical circumstances can contribute to our understanding of how policies are being shaped and how they can be possibly improved. Opening the economy to large international investors may be a reform that is not only economically desirable but also in the interest of the government.

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8. Appendix

Let $L = e_0 - \frac{1}{2}$ and $U = e_0 + \frac{1}{2}$ and observe $R < e_0$. If x falls in the range *[L, R)*, citizens directly observe θ and reelect the incumbent. In the range *(R,θ']*, the incumbent chooses $x = R$ and citizens know the true value is contained in the interval. In the range *(θ', U]* citizens directly observe θ and do not reelect the incumbent.

The expectation of the updated value of e after observing compliance is

$$Ee_1 = \Pr(\theta < R)\frac{R+L}{2} + \Pr(\theta \in [R,\theta'])\frac{\theta'+R}{2}. \tag{A1}$$

The ex ante probabilities given the prior e_0 and the equal distribution on the support *[L, U]* in (A1) are $(R-L)/(\theta'-L)$ and $(\theta'-R)/(\theta'-L)$. The points $(R-L)/2$ and $(\theta'-R)/2$ are at the middle of the respective intervals.

We can rewrite (A1) as

$$Ee_1 = \frac{R-L}{\theta'-L}\frac{R+L}{2} + \frac{\theta'-R}{\theta'-L}\frac{\theta'+R}{2}$$

which, using $\dfrac{R-L}{\theta'-L} + \dfrac{\theta'-R}{\theta'-L} = 1$, simplifies to

$$Ee_1 = \frac{1}{2}R + \frac{1}{2}\frac{(R-L)L + (\theta'-R)\theta'}{\theta'-L}$$

$$= \frac{1}{2}R + \frac{1}{2}\frac{-R(\theta'-L) + \theta'^2 - L^2}{\theta'-L}$$

$$= \frac{1}{2}R + \frac{1}{2}\frac{-R(\theta'-L) + (\theta'-L)(\theta'+L)}{\theta'-L}$$

$$= \frac{1}{2}R + \frac{1}{2}[-R + (\theta'+L)]$$

$$= \frac{\theta'+L}{2} \leq \frac{U+L}{2} = e_0 \text{ with a strict inequality sign for } \theta' < U.$$