REFORMS
IN THE PROCESS OF TRANSITION
TO MARKET ECONOMY

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> *Designing reforms requires* high professionalism, resourcefulness and deep knowledge. Meanwhile reforms are often a result of collective "creativeness" of semi-literate officials, politicians and lobbyists that have hard time clearly formulating *even their own self-serving goals.*

During a meeting with the leadership of the Central Bank on April 4, 2014, Armenian president Serzh Sargsyan answered to a question regarding the new cabinet: «*...I think the government must be able to ensure economic growth, continuity of reforms. The new government should restore our people's trust towards reforms and its activities."*

It is thus quite relevant to elucidate *the processes of targeted change of economic institutions*, i.e. *the reforms*. For this objective we shall mainly use the works of Douglass Cecil North, 1993 winner of the Nobel Prize in Economics *"for having renewed research in economic history by applying economic theory and quantitative*

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methods in order to explain economic and institutional change"[1], Victor Polterovich, an author of over two dozen publications and monographs devoted to reforms theory, Member of Russian Academy of Sciences, and Joseph Stiglitz, American neo-Keynesian economist, 2001 winner of the Nobel Prize in Economics "*for analyses of markets with asymmetric information*".

The reforming processes have intensified around world. However, the new concepts slowly adsorb in practice, and *typical mistakes continue getting repeated from reform to reform*. This is the case for example, with the idea that the reforms should be prepared through a dialogue with representatives of all civic groups, so as to form positive institutional expectations and not the opposite.

The Latin verb *reformo* means "to bring back to the original state." The current meaning of the word "reform" – "transformation for the better" – now dominates as connotation. Below the extended definition of reform is provided, though it has to be noted that there would be some terms, the meaning of which will be explained afterwards.

Reform – is the process of building an institutional trajectory that meets certain requirements during a targeted change of institutions, which implies existence of agents in the economic system who develop and implement the transformation plan.

Reforms may be viewed as the opposite to *spontaneous evolution*, whereby the role of the government is limited to formal acknowledgement of the formed behavior standards. The simplest idea underlying many reforms was *transplantation (borrowing) of institutions* from advanced countries. The attempts of such transplantation have often

[1] Institutional economics – a branch of economics that studies economic relationships inside and between public institutions.

failed. The large-scale reforms in 1990s in the countries of the former socialist camp[1], as well as those in some African and Latin American countries were a spectacular failure.

As V.M. Polterovich reasonably notes, the results of the "reforms decade" can be characterized as one of the most *massive economic catastrophes of the 20th century*. In seven years starting from 1991 the 26 reforming countries of Eastern Europe and former Soviet Union *lost over 25% of their GDP in aggregate*.

Never before the forecasts of the "majority" of experts in economy have been so far from reality: the science of economics suffered the greatest defeat ever for its whole history of existence[2]. Russia, Armenia and some other countries of the former Eastern bloc represented especially a bitter lesson. *Transformations in these countries in all main directions led to effects that were never predicted by experts*.

Liberalization of prices brought about a significantly faster and long-term inflation than predicted. Efforts to stabilize the prices at any cost resulted in mechanism of payment defaults and use of barter exchange. Attempts to reform the taxing system prompted development of shadow economy. Weakened government control over the flows of resources in order to create competitive environment produced corruption so widespread that was unseen before. The "shock therapy" privatization that was supposed to establish efficient private owners, instead resulted in ineffective organization forms. All these metamorphoses were accompanied by extraordinarily deep and unpredicted fall in production.

[1] The article is focused on reviewing models that describe transformation of institutions in Russia and Armenia.

[2] See, for example, the articles of renowned Western and Russian economists assembled at http://www.r-reforms.ru/indexzop.htm

Meanwhile, many of the above mentioned phenomena have already been observed during large-scale reforms in other countries, in particular, in the process of modernizing economic systems of some Latin American and South Asian countries. This experience was essentially neglected both in Russia and Armenia.

The first attempt to consolidate this experience, the so-called Washington Consensus, turned unsuccessful. This requires a new look on general patterns of the reforming process.

1) Why reforms often get delayed despite an agreement reached in the society that they are necessary?
2) Is it better to rely on "shock therapy" or use gradual strategy?
3) What should be the sequence of reform measures?
4) Is the fall of production inevitable in the first phase of reforms?
5) Should the reforms be carried out despite resistance of a substantial part of population, or should an overall support be achieved?
We shall discuss these questions by interpreting the results of work by D. North, V.M. Polterovich and J. Stiglitz in the area of reforms in institutional environment of economy.

V.M. Polterovich believes the main problem is to learn how to find rational strategies for transformation of various institutions under specific circumstances, for which he suggests and substantiates relying on the *evolutionary institutional theory*.

Seeking guidance for reformers

In studying reforms, special importance is attached to large-scale institutional transformations, which are based on *radical concepts on balance between government and market* developed by economists and embraced by a number of countries, such as building socialism since 1917 to 1980s and transition to market (*building capitalism*) in 1990s.

Till 1970s not only in the USSR, but also a substantial number of western economists believed that the government should be the chief organizer of economic growth. *The governments played a decisive role in overcoming the crisis in 1930s*; the government intervention supporters found rationale in the theory of J.M. Keynes and ideas of Polish economist Oscar Lange.

After the World War II France and Japan created quite successful systems of *indicative planning* (also extensively used by Spain and Portugal). Indicative plans not only coordinated efforts of entrepreneurs in various industries, but also established a basis for organizing a dialogue and reaching consensus between government, business and society, something that is very important currently for Armenia.

In Japan, South Korea, Taiwan, Singapore the governments conducted *active industrial policy*, which allowed these countries maintaining annual growth rates of 8-10% for two decades. *However, in many countries of Africa and Latin America the government attempts to "direct" economy failed.*

By mid-1970s indicative planning exhausted itself in developed countries, as the well balanced market did not need it anymore. The Socialist camp countries failed to decentralize the system of economic management and the growth slowed down. It became apparent that the Socialist systems lose the competition to the market ones. Zero unemployment and price stability, the two main advantages of the Soviet planned economy, were achieved due to ineffective use of resources and total deficit [1].

Hence, a new, simple and evident formula for transformation of developing and centralized economies appeared: "*create market institutions and ensure their effective functioning*," which was as fallacious as the recipe of capitalism's radical reform recipe ("*create a good plan and make sure it's implemented*"). By 1990s the ideological victory of neoliberalism in reforming economies assigned a secondary role to the government.

Staring late 1990s a reverse process have been observed. More and more economists focus on the role of the government. In his works (*in period of 1998-2003*) J. Stiglitz devoted many pages to the critique of the Washington Consensus and reform strategies imposed by the Western experts on the developing countries [2]. The advantages of gradual approach, crucial role of social and industrial policies in the process of reforms are emphasized in the works of Dani Rodrik of Harvard University [3].

Works of Austrian economists, the founders of libertarian philosophy Ludwig von Mises and Friedrich August von Hayek, significantly influenced the discussions on the government's role in economic development and contributed to the victory of neoliberal views over socialist ones. The notion of *"extended order"* (*"spontaneous order"*) is central to F. Hayek's concept, in opposite to the organized order "artificially" created by people. The extended order is maintained by norms that stem from economic development experience of many centuries. Denying the "evolutionary ethics", Hayek however, states (*later than L. Mises*) that although imperfect and often inefficient, the extended order is patently better than any other organization of economic process designed by humans.

One of the difficulties that the spontaneous order concept encounters is that it *actually offers no guidance for economic action, but rather, only suggests minimizing government intervention in economy* – so in essence, it underestimates market failures.

The idea of extended order incarnated in the Washington Consensus influenced considerably the ideology of liberal reforms that were implemented in Eastern European countries and some CIS countries (*particularly, in Russia and Armenia*) during the 1990s. Even now there are still some adepts of the idea that *it is sufficient to just free the market of restrictions, and it will spontaneously develop* selecting the most effective development directions and creating effective institutions.

In 1989 John Williamson, an American economist delivered a keynote at a conference devoted to reforms in Latin American countries. His keynote was titled *What Washington Means by Policy Reform* and referred to the so-called *Washington Consensus* – a list of nine recommendations regarding reform implementation. However, characteristically, the *Latin American specifics in no way was reflected in recommendations* of the Washington Consensus, and in 1990s it actually served as guidance for economic reforms in not only Latin American, but also Eastern European countries. It was approved by prestigious institutions and highly regarded persons, and it was expected that *any country which follows these recommendations will receive generous assistance from IMF and World Bank*.

So what is this "Washington Consensus":

1. *Fiscal policy discipline*; The budget deficit should be small enough so that no inflation taxing is applied to cover it.
2. *Public Expenditure Priorities*; Reform of public spending to reduce spending on administration, defense, indiscriminate subsidies

and large costly projects. The savings should be redirected toward services like primary health care, education, and infrastructure investment.

3. *Tax Reform*; broadening the tax base and adopting moderate marginal tax rates.
4. *Financial Liberalization*; with ultimate goal of interest rates that are market determined.
5. *The Exchange Rates*; unified exchange rates maintained at a sufficiently competitive level to induce a rapid growth in nontraditional exports and managed in a way to keep exporters' confidence that the rate will remain sufficiently competitive in the future to justify investment in potential export industries.
6. *Trade Liberalization*: Quantitative trade restrictions should be rapidly replaced by tariffs, and these should be progressively reduced until a uniform low rate of 10 percent is achieved.
7. *Inward foreign direct investment*: Barriers impeding the entry of foreign direct investment should be abolished.
8. *Privatization*: State-owned enterprises should be privatized.
9. *Deregulation:* Abolition of regulations that impede the entry of new firms or restrict competition.
10. *Property rights*: The legal system should provide secure property rights.

At a first glance one may agree with the contents of this document. However, it was often adopted by international experts and reformers in its simplistic form. *The emphasis was placed on stabilization, liberalization and decentralization, while social policies and property rights protection were pushed to sidelines in many cases.*

Table 1

The GDP pattern in transition economies, 1980, 1989-2004
(indices, GDP for 1989 is assigned 100)

	1980	1989	1990	1991	1994	1996	1999	2000	2004
Eastern Europe	**88,7**	**100**	**93,2**	**82,9**	**82,1**	**90,2**	**95,6**	**99,1**	**118.8**
Baltic countries	**67,8**	**100**	**97,8**	**89,9**	**55,2**	**58,8**	**65,6**	**69,2**	
CIS countries	**77,5**	**100**	**96,8**	**90,9**	**60,3**	**55,0**	**56,4**	**61,1**	**80.2**
Azerbaijan	79,6	100	88,3	87,7	41,9	37,4	46,8	52,0	77.3
Armenia	**73,5**	**100**	**94,5**	**83,4**	**46,7**	**52,8**	**60,5**	**64,1**	**101.5**
Belarus	65,7	100	98,1	96,9	70,8	65,2	81,4	86,1	113.4
Georgia	79,4	100	84,9	67,0	23,4	26,7	31,2	31,9	41.5
Kazakhstan	87,0	100	99,0	88,2	66,2	61,1	62,6	68,7	102.4
Kyrgyzstan	69,1	100	104,8	96,5	56,2	56,9	66,2	69,8	84.2
Moldova	72,1	100	97,6	80,5	39,0	36,2	33,2	34,0	44.4
Russia	78,1	100	97,0	92,2	62,8	58,2	58,8	64,1	82.5
Tajikistan	80,8	100	102,2	91,7	40,9	29,8	33,1	35,9	52.8
Turkmenistan	80,7	100	101,8	97,0	69,2	68,5	76,0	89,4	90.2
Uzbekistan	76,0	100	99,2	98,7	81,2	81,9	93,9	97,6	119.5
Ukraine	75,0	100	96,4	88,0	52,4	41,4	39,3	41,6	58.8
All countries	**80,3**	**100**	**95,9**	**88,8**	**65,9**	**64,3**	**66,9**	**71,2**	
Former USSR	77,3	100	96,8	90,9	60,2	55,1	55,9	60,1	

Source: Economic Survey of Europe

In a number of Latin American countries reforms implemented according to the Washington Consensus recipes, and after haphazard and not well thought through deregulation of financial markets, dire financial crises occurred in these countries. GDP per capita in Latin American and Caribbean countries in 1980s was dropping annually by

0.8% in average, whereas in 1990s the growth hardly reached 1.5% annually.

As for the Washington Consensus application results in transition economies, these were daunting indeed[1]. The GDP decline in Russia and Armenia was lasting and deep. For instance, by 2000 the Russian Federation lost 38% of its GDP, Ukraine – 58%, Armenia – 35%. The former Soviet republics that suffered the least were those where reforms were implemented slowly: Uzbekistan, Turkmenistan and Belarus. For 26 transition economies average *decline of the GDP per capita in 1990s constituted 30%*.

As the enterprises were deprived of their working capitals due to drastic price inflation, they stopped buying the necessary equipment. Investments in capital assets shrunk by 40% in the first year of reforms: in 1998 they comprised mere 25% compared to the level of 1991.

Table 2

Reforms in Russia and Armenia in 1992-1998: select economic parameters

No	Parameter	Russia 98/91	Armenia 98/91
1	GDP, %	61	61
2	Industrial production, %	50	46
3	Retail trade volume, %	98	60
4	Investments in capital assets, %	25	
5	Real wages, %	43	
6	Real income of population, %	53	
7	Employment, %	87	84.1
8	Consumer price index, times	4500	over 10000

[1] In one of his speeches Yegor Gaidar said that Washington Consensus had no significant impact on the Russian reforms.

Actually, the true scale of impoverishment of the main mass of people is "hidden" under these numbers, because the *reforms caused a large-scale leap of inequality*. In Armenia the purchasing power of population in 1997 had fallen tenfold compared to that 1990.

Table 3

Reforms in Russia and Armenia in 1990-2002: income disparity

Index	Russia		Armenia	
	1993	2002	1992	2002
Ratio of the average income of the richest 10% of the population to the poorest 10% (*R/P 10%*)	4.4	14.0	4	30.9
Gini index	0.48	0.36	0.44	0.357

For comparison, in 1998 the Gini index and R/P 10% ratio for Hungary were 0.244 and 5.0 respectively. For the most of the developed countries R/P 10% ratio is lower than 10. Latin American and African countries are characterized by high degree of income disparity.

It has to be added that the reforms in post-Soviet countries were accompanied by *scores of other devastating cataclysms.* Examples of those for Russia and Armenia are provided below.

At the beginning of the reforms both Russian reformers and *Western experts predicted price inflation increase of 2.5-3.5 times*. However, already in the first year of reforms it increased *26 times*. During the reforms the ruble strengthened. This was a conscious policy by the Central Bank, which hindered exports and facilitated imports, thus contributing to the decline of domestic production. The real wages in 1998 comprised 43% of the 1991 level. Such dramatic fall of wages demotivated people from working in the enterprises and forced them to seek alternative sources of income, mostly through redistribution activities.

The unemployment rose dramatically – in Russia it reached 13.3%. The default crises shocked Russian economy during the five years of reforms. Barter exchange became unusually widespread: in 1998 the share of barters between industrial enterprises comprised 50%. Rapid privatization was supposed to increase productivity. Instead, it resulted in a drastic drop in productivity.

In the initial period of the reforms in Armenia the situation was more than dire. In fact, Armenia stayed in the ruble zone till November, 1993, even when in the summer of the same year Russia announced that ruble will not be serviced outside Russia. Inflation, or more precisely, hyperinflation reached 5273.4%. The price levels in April 1994 were 13440 times higher compared to December 1991 [4]. unlike the other post-Soviet countries, Armenia was least prepared to introduction of national currency, if not unprepared at all.

Washington Consensus: where are the mistakes? In essence, the Western advisers that recommended shock therapy methods, acted as Bolsheviks in 1917. Russian academician D. S. Lvov wrote: *"The ideology of the Washington Consensus is characterized by extreme simplification of the Russian economic policy objectives and reduces those to three postulates: liberalization, privatization and stabilization…"* [5].

It is hard to disagree with this critique. However, the Washington Consensus deserves a fuller review. After all, this list of ten recommendations was the *first ever attempt to develop a guide for reformers, something so badly needed for many experts and developing countries*.

The supporters of the Washington Consensus are ready to make corrections in it. However, V. M. Polterovich believes Washington Consensus is impossible to correct, because *its underlying methodology is inherently faulty*. For example, referring to the IMF position in requiring liberalization of capital markets in the reforming countries, J. Stiglitz wrote *"… it is certainly clear now, that the position was maintained either as a matter of ideology or of special interests, and not on the basis of careful analysis of theory, historical experience or a wealth of econometric studies*" [12], and this hits hard the economies with weak financial sectors.

Two myths that brought most damage to economies of many countries deserve a special attention: a) the teaching about absolute advantages of centralized economy; and b) the faith in spontaneous development of an effective market. *Radical economic solutions in case of reforms should be based on thorough study of possible compromises, but not on a basic postulate*.

The main notions and structure of institutional trajectories: a review

Many studies indicate that institutions and civic culture are fundamental factors of economic development [7-11]. Hereby the attention is focused on the *development pattern (evolution) of institutions (the institutional dynamic) caused by reforms*. For this purpose, following the thoughts of D. North, we introduce the concept of the *"local structure" of institutional trajectories*: i.e. the sequences of interim institutions in the "*institutional space*" that connect the original institution with the desired, more effective one, or worded differently, sequences of "*states*" in the relevant "*institutional space*", each member of which describes the combination of institutions at a given moment of time[1]. In this, a

[1] In economic-mathematical modeling of reforms another idea that seems promising is combining the institutional trajectory and phase trajectory *(the curve in phase-space [geometrical image represented by a multitude of various possible states of a physical system, which have a natural notion of proximity], which is comprised of points representing the states of a dynamic system in sequential moments of time during the whole period of evolution*).

systematic review of reform mistakes is a principal feature.

Norm is a rule followed by large groups of people. *Institute is usually understood as a combination of norms forming a certain entirety*.

As V.M. Polterovich writes, various factors influencing the process of norms formation can be divided in three large groups: *fundamental, organizational and social*. Also, many *formal* and *informal* norms seem absolutely natural, with no alternative, although they are a result of a *long-lasting evolution*.

At the times of Aristotle the Athenians believed that being involved in crafts is not appropriate for freeborn men. In Middle Ages usury was banned in many countries. As recent as in 18th century the commercial ethics was decisively against competitive behaviors. Today we believe that no work is to be looked down upon, that charging interest for a credit is necessary and fair, and that competition is the foundation of an efficient economy.

Undoubtedly, the systems of economic institutions formed in the most developed countries ensure efficient functioning of their economies. Yet many other countries are unable to build an effective economic mechanism for decades.

The changes of economic institutions in the 20th century to a substantial degree occurred due to reforms, which implies *targeted measures of various scales* undertaken in accordance to a certain plan. The reforms generate a stream of *institutional innovations*, some of which turn out capable of developing in their intended scenarios, while others are implemented in shapes hardly resembling the original project, and still others die out quickly. In late 1980s and early 1990s *about 30 countries almost simultaneously commenced a transition from centralized economy to market economy*. This allows uncovering a *number of con-*

sistent patterns that characterize the evolution process of institutions as they are reformed. While reviewing some of the common notions, let us discuss these patterns.

Natural selection and reforms

The evolution of reforms is reviewed based on the notion of institutional trajectory. In this regard, there are two issues focal to the theory of institutional dynamic:

1. What forces and mechanisms determine the system's movement along one or another trajectory?
2. *How to find and carry out an institutional trajectory which would be optimal or at least acceptable in one or another respect?*

The main objective of the reforms theory is to answer the second question. Two principally different mechanisms of creating trajectories for institutional change have to be differentiated. The *first* one can be called *local search*. As a rule, it is performed by small (*local*) institutional innovations, where long-term goals play an insignificant role. If an innovation is viable, it gets affixed; otherwise it is corrected. The *second* type of trajectory emerges as a result of a purposeful institutional buildup and is typical for the *reforms implemented by government*. According to Karl P. Polanyi[1], during the whole history of capitalism, the governments played a decisive role in selecting the directions of institutional development.

In practice, combinations of the described two "*pure*" strategies are implemented, whereby the *natural selection and reforms* supplement each other.

[1] American and Canadian economist, anthropologist, sociologist and political philosopher, one of the founders of the economic anthropology.

The design, transplantation, institutional experimentation.

A reformer sets a goal to build an institution (or system of institutions) of one or another type and to achieve it, selects an institutional trajectory.

The two principally different ways to generate both end-purpose and interim institutions need to be distinguished: *design*, i.e. creation of fundamentally new institutions, and *transplantation*, i.e. borrowing institutions from other, usually more advanced systems. In practice, a combination of both is used. In traditional societies new institutions initially emerge as informal ones, and only later, after having spread around sufficiently, they are legalized.

Institutional experimentation is an important method for selection of institutional innovations, applied both for design and transplantation. The objective of the institutional experiment is to reduce the potential costs. Institutional experiment is conducted in real conditions, Regional institutional experimentation has been widely used during the reforms of the Chinese economy.

In the design of institutional trajectories one of the approaches plays an important role, which can be called *displacement method*. This means a new and potentially more efficient institution has to be introduced without eliminating the old one and at the same time, without limiting oneself to the hope that the competition between institutions would ensure an effective solution.

Transitional rent and redistribution activity

Redistribution activity is understood as activities aimed at changing the proportions of a product's appropriation without improving its quality or increasing its produced quantities.

In a developed society there are many formal and informal organizations the objective of which is to appropriate the already distributed resources or to change the rules of their distribution. Mancur Olson calls them distributional coalitions (Mancur Olson, *The Rise and Decline of Nations*). Olson showed that activities of distributional coalitions hamper innovation in mature economies and thus, slow down economic growth. However, redistribution activity is not necessarily bad, if the coalition defends the interests of low-income groups or future generations.

Redistribution activity is often equalized to rent seeking. The difference between privileged income and "normal" income under same expenditures is called *rent*, and the activity aimed at acquiring privileges is called *rent seeking*. The *rent* related to institutional transformation is termed as *transitional*. The struggle for rent distracts human and material resources from production process and leads to formation of institutional traps. Intensification of redistribution activities (*lobbying, corruption*, etc.) causes institutional dysfunctions.

Transaction costs

The main components of transaction costs are search for information, bargaining process, control of the partner, formulating and protecting the contract, i.e. the costs related to the activities of agents within the frameworks of various institutions. *Comparing institutions during the stage of their introduction requires consideration of transaction costs of all agents, including the government.*

Institutional transformation costs

The costs related to switching from one institution to another are called *transformation costs*. During large-scale reforms the transformation costs are borne both by the state budget and economic agents. For analysis, it is useful to consider three generalized processes that cause transformation costs:

1) *direct costs for financing the institutions – Diversion of resources from traditional directions of investments towards creation of new institutions.* Privatization, establishment of a new banking or pension system, forming a market for short-term government bonds, etc., are all related to diversion of resources from traditional areas of investments. *Adaptation of the system to the new institution* is also part of this bunch.

One example to consider in this respect is the voucher privatization in Armenia during 1994-1997. There is no clear evidence of increased efficiency stemming from privatization. Haphazard privatization of the industry only deepened the economic crisis in the country. To date 90% of privatized industrial enterprises are idle.

2) *indirect costs of creating institutions – Disorganization costs.* Disorganization has two aspects. *First*, during a reform destruction of the old system frequently happens earlier than the new one is able to display any efficiency. *Second,* the discord in actions of different agents including the government, in the process of moving to a new equilibrium. This dynamic aspect has been *considerably underestimated by the reformers*.

In the price liberalization programs implemented by the former planned economies in early 1990s it was tacitly implied that after liberalization the prices will come to a new equilibrium in a rather short period. As it turned out, the *transition takes years*.

3) *indirect costs of creating institutions – Costs of intensified redistribution activities.* At the moment of economy liberalization some economic agents have an opportunity to get additional income – the transitional rent – exclusively due to the positions they occupy at the time. One of the arguments for liberalization of prices and foreign trade was that as soon as domestic prices became equal to the world market prices, the rent income would cease to exist [13]. *The mistake was that the transition regime was not accounted for.* This mistake caused colossal losses to Russia, Armenia and some other countries.

Driving forces of institutional change

The "*demand*" for institutions by groups of population is often accompanied by resistance to introduction of an institution by some other groups. Referring to the "*supply of institutions*" one has to distinguish the existing and newly created institutions.

The development of production, technological changes require establishment of new institutions. Changing quantities and proportions of resources, technology or human resources may create conditions for institutional development. Due to technological changes the price ratios change, and so do the ratios of transaction costs and institutional transformation costs.

The changes in tastes, preferences and ideology (*civil culture changes*) are one of the most important causes of institutional development. With increased wealth, education levels and civil culture, the demand for participation in governance increases, thus creating a basis for establishment of representative democracy institutions.

Every so often institutional changes occur only because lobbying coalitions aspire establishing new social roles or administrative positions, with a purpose to extract transition rent or strengthen their administrative power. *This motive plays an important role in carrying out virtually any reform*.

Mechanisms of stabilizing the norms of behavior

For a behavioral norm to be stable there should be *a mechanism of a negative feedback*. Another option is legally stipulated or tradition-based sanctions for breaking a norm. The third stabilizing mechanism is based on the *coordination effect*, secured by externalities[1], hereinafter referred to as supporting. Coordination of actions by agents decreases the transaction costs of those who abides by the adopted norm, and thus the deviation from it becomes unbeneficial. The fourth mechanism is *cultural inertia*, which denotes agents' reluctance to revise the behavioral stereotypes that have already proven viable in the past. The fifth mechanism of stabilization can be called *lobbying mechanism*: it works through creation of pressure groups in the parliament or government bodies. Other behavioral norm-fixing mechanisms include the *learning effect* (*a prevailing norm gets affixed over time as the participants learn how to fulfil it more efficiently*) and *linkage effect* (*an emerged norm turns out to be linked with a multitude of other rules and its non-observance leads to high transformation costs*)

The coordination effect plays a decisive role in emergence of institutional traps. Other effects (*learning, linkage, cultural inertia and lobbying*) tend to affix the emerged norm.

[1] *Externality* occurs whenever a preferences and technological capabilities of a given agent are directly affected by the other participant agents'.

Institutional trap and hysteresis

If an efficient norm prevailed in the system, under a strong perturbation it may fall into an institutional trap, which remains even if the disturbance disappeared. This the so-called *hysteresis* effect which is a form of a system's dependence on its former trajectory of development (*path dependence*). Once fallen in an institutional trap, the system appears on an *inefficient trajectory*. Its further development depends on how quickly an escape from the institutional trap could be found.

Dysfunctions of institutions

Frequently a new institution turns out *dysfunctional*, "*does not work*" in the existing institutional or cultural medium. There could be several reasons for this.

Atrophy and metamorphosis of institute. The institute turns out unnecessary (*atrophy*) if its use is incompatible with the cultural traditions or institutional structure of the country. Atrophied institution often becomes a source of a more serious dysfunction.

Transplantation of the institute of bankruptcy in Russia and Armenia with adoption of the law on bankruptcy, instead of working as an instrument for increasing efficiency turned into a mechanism of seizing property.

Activation of alternative institutions and rejection. This is usually related to activation of alternative institutions, often unexpected for the reform initiators.

The postwar American administration in Japan forcibly dismantled large Japanese zaibatsu Mitsui and Mitsubishi into 213 separate entities in an attempt to de-monopolize the Japanese market. However, later these autonomous entities gradually re-coalesced and after five years out of the 213 companies formed together two corporations. During these five years the ties between them were maintained through an *alternative institution – informal relations*.

It also has to be noted that activation of alternative institutions often leads to creation of institutional traps.

Institutional conflict. One of the profound reasons for ineffectiveness of market institutions in many transition economies is the lack of full description for most of the real institutions. Hence, an attempt of transplantation understood as imitation of formal rules may lead to emergence of an institute, which although might be viable, but significantly differs from the intended one and is possibly ineffective. Such dysfunction is called *institutional conflict*.

The privatization of fishing business and introduction of fish auctions in Russia resulted in large-scale poaching. The signs of institutional conflict, as well as activation of alternative institutions and rejection are evident in this case.

Institutional traps

It was explained above why in the process of reforms aimed at increasing the efficiency of the economic system, stable *ineffective* institutions or behavior norms emerge, which include the *"institutional traps*". This concerns a special case when different institutions coexist (multiplicity of equilibria) under the same conditions. Which institution will persist, depends on the prior history of the institution[1].

Review of the prior history requires reproducing the institutional trajectory from the original state of the system (*determined by the equilibrium point)* to the observed one. In case of a multiplicity of equilib-

[1] There are substantial volumes of literature also on *poverty traps*.

ria, they can be compared and some of them turn out to be inefficient. The described approach explains why under the same external conditions different institutions may coexist and thus an accurate interpretation of "*path dependence*" is given. *Stable ineffective equilibriums* are exactly institutional traps.

Institutional trap emerges due to a change of external factors and continues to exist when these factors return back to their previous states. The hysteresis effect is characteristic to the traps. As a matter of fact, using the term "trap" is justified because of that.

Avoiding institutional traps is one of the most important tasks for reformers.

Examples of institutional traps.

1. Barter. Liberalization of prices in January, 1992 followed by an inflationary shock resulted in negative institutional changes and generated the *barter trap*. The share of barter transactions in sales of industrial enterprises exceeded 50%. Under high inflation, the transaction costs of settlements by money transfer were enormous. In contrary, the transaction costs of barters and transformation costs of switching to barter were relatively low, because at the time the old "*direct ties*" between suppliers and customers were still strong.

Transaction costs of barter decrease as the number of enterprises involved in barter deals increases, because it becomes easier to find partners (*coordination effect*). Intermediaries emerge, who facilitate building long chains of exchange (*learning effect*) and are interested in further development of bartering (*lobbying effect*). Due to bartering the control of trade becomes harder and thus, establishment of shadow economy is facilitated (*linkage effect*). Having gotten used to bartering, the managers no longer seek credits to carry out monetary settlements (*cultural inertia*). With all these circumstances in place the volume of barter deals may not decrease even if inflation stops (*hysteresis*). All these phenomena were observed in 1992-1998.

2. Payment defaults. In Russia, Armenia and some other post-Soviet countries the 1992 inflationary shock caused by price liberalization deprived the enterprises of their money on accounts. Consequently, most of the enterprises found out that they cannot expect full payments from their customers, though they also may only partially pay for the resources supplied to them [10]. Stopping the delivery of unpaid for products made no sense, as the enterprise could lose their customers altogether. The *coordination effect* that thus occurred, stabilized the "*payment defaults trap*."

3. Tax evasion. For the people not to evade taxes, they should believe that the taxes will be spent on increase of their welfare. In selection of tax collecting strategy the organizational factor is more important, i.e. coercion system that forms expectations of the harm caused by tax evasion.

If the taxes are too high, and the system of tax payment coercion is inefficient (*in the beginning of the radical reforms the tax authorities had not been formed yet and the means of control were very limited*), then tax evasion becomes profitable for many economic agents. For an agent, exiting the shadow economy is related to high transformation costs. The hysteresis effect manifests itself fully in this case.

4. Corruption. In mid- (short-) term run a *corrupt system may turn out more effective than a non-corrupt one*. The larger the scale of corruption, the smaller are the chances for a bribe-taker to be caught and convicted. This externality dependence is based on the coordination effect, which makes the corrupt system more stable. Perfecting itself it creates *linkage* with the mechanisms of shadow economy and part of the government officials resist adoption of effective anti-corruption measures (*lobbying effect*).

5. Dissertation trap. In mid-1990s the practice became widespread in Russia and Armenia whereby business people and politicians who actually were *not involved* in any scientific activities, defended PhD and doctoral dissertations. The process of "*manufacturing dissertations*" required creation of a relevant "infrastructure" [14]. It has to be emphasized that the growth of dissertation market was boosted by a number of fundamental, organizational and societal factors that *appeared due to the reforms*.

6. Partial reform trap. At every step of change the planned gradualist programs of reforms may turn unbeneficial for one or another group of agents [15]. If they are able to obstruct further changes, then the system will remain in an ineffective equilibrium, which would be appropriate to call a *partial reform trap*. In this case the lobbying is the main mechanism. As with the other institutional traps, the partial reform trap occurs due to not well enough thought through reforms strategy. One the main threats to reform success is turning the transitional norms into permanent ones, which are ineffective in the long-run.

Protectionist policies that are necessary a certain stage, could produce an inefficient uncompetitive structure which is supported by a respective lobby.

The need to prevent the partial reform trap imposes certain limits on the character, and possibly also the pace of institutional transformations, but in no way determines its shockwave nature.

Shadow economy trap. A significant shadow segment existed in the Soviet economy. Virtually in all transition economies of the Eastern

Europe and former Soviet Union countries the share of shadow economy increased dramatically. In Armenia it still remains quite large. Two circumstances played a role in this. On the one hand, the government control over the flow of resources weakened in result of disorganization, and on the other hand, the role of the government implementing privatization enlarged. The main motive for emergence of a new shadow economy was tax evasion.

Escaping institutional traps. It has been mentioned hereinabove that five mechanisms contribute to *formation and stabilization* of institutional traps: coordination effect, learning effect, linkage effect, cultural inertia and lobbying. For a number of institutional traps the transition rent also plays an important role.

The processes of *forming and dismantling* institutional traps are based on the notions of transaction and transformation costs and classification of norm-stabilizing mechanisms. Institutional traps often expose stability only in the mid-term and the economic systems gradually develop mechanisms that help exiting inefficient equilibria. In order to escape a trap it is necessary to achieve a *sufficient scale* changes of one of the three types: a) increase the transaction costs of the inefficient norm; b) decrease transaction costs of the alternative efficient norm; c) decrease transformation costs for shifting to the alternative norm.

Frequently a coordination of efforts is required to escape an institutional trap, which implies establishment of additional institutions that would contribute to dismantling it (*e.g. institutions of civil society*). Often a trap exists not because the shift to a more efficient institute is too costly for the society, but because due to a multitude of externalities and imperfections of market institutions the *benefit from such shift to may not be reaped by those who are able to carry it out.*

Let us review the micro- and macroeconomic measures that could be taken by the government, as well as the spontaneous trends that sometimes help escaping institutional traps.

- *Microeconomic measures. A. Sanctions.* The simplest recipe to increase transaction costs of an inefficient norm is introduction of relevant penalties*. B. Reputation mechanisms* is another way to increase transaction costs of corruption, payment defaults, tax evasion, etc., which simultaneously decrease transaction costs of efficient behavior. *C. Amnesty*, the "*instrument of forgetting the past,*" helps reducing transaction costs of the efficient norm, which is related to its history "before the shift". However, it is not always successful.
- *Quick economic growth*. A number of institutional traps (*e.g. corruption trap or the shadow economy trap*) are related to one or another form of rent-seeking behavior. Exit from an institutional trap may become likely if the economy starts to grow fast. In such case investments of part of the agents in production might become preferable that investment in capturing the rent (*as the experience of "economic miracle" countries show*). The industrial policy may contribute to improving the quality of institutions.
- *Evolution of civic culture*. Deviation from an inefficient norm is not beneficial for a separate agent, but in case of a coordinated action it improves the situation for each of them. The agents' ability of rational coordination depends on civic culture and the extent to which the civil society is developed. The USA history of 19th century demonstrates well how the development of civil society results an escaping the *"corruption trap"* [10].

- *Systemic crisis*. In some cases a systemic crisis facilitates the country's exit from an institutional trap [16]. A crisis drastically changes the most important system parameters and destroys the mechanisms supporting the trap, so that an economy may find itself outside the "attraction zone" of the inefficient norm. The evolution of barter system in Russia is a remarkable illustration of this. The barter trap that seemed indestructible was broken in 1998 due to the financial crisis.

The institutional traps are serious barriers for economic development of many countries. The main cause for institutional traps is *lack of coordination*. There are three primary mechanisms that ensure coordination behavior – market, government policies and institutes of civil society.

In the next publication we shall study the reform strategies and provide recommendation for their implementation.

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