INSTITUTIONAL APPROA CH TO TRANSITION:
INVESTMENT CLIMATE A ND GROWTH IN UKRAINE.

by

Volodymyr Lugovskyy

A thesis submitted in partial fulfillment of the requirements for
the degree of

MA in Economics

Economic Education and Research Consortium at the National
University of Kiev-Mohyla Academy

1999

Approved by _____
                              Chairperson of Supervisory Committee

                    _____

                    _____

                    _____

Program Authorized
to Offer Degree _____

Date _____

ABSTRACT

This paper is focused on the features of institutional environment (defined by me as investment climate) in transition economies (with emphasis on Ukraine), which are crucial for economic growth. Since equilibrium is a key point of neoclassical approach and transition economies are by definition in the process of transition, I did not use this approach despite the fact that issues of investments and growth are extensively researched by Neoclassicals. Instead I choose institutional and transaction costs approaches for defining the criteria of favorableness [quality] of investment climate. These criteria are:

1. **Speed** of innovation, which influences the quantity of investment trials and depends on transaction costs.

2. Level of political and economic **decentralization**, which influences the quality of investments by determining whether the evolution is only "within" or also "among" constraints and which also determines the structure of organizations.

By both criteria Ukraine is experiencing bad indications:

1. Because of different speed of development of formal and informal institutions, the Ukrainian society became polarized to such degree, that the dominant political group was not formed. On the macroeconomic level it led to the inefficient short-run macroeconomic management and to the undeveloped strategy for the long-run development. On the microeconomic level the polarization has resulted in wide spread and unsystematic corruption, which has increased the transaction costs and so reduced the speed of innovation.

2. Due to the excessive regulatory power of many autonomous government agencies, business property was converted to the common property with open access for government agents. This externality is being internalized only for the firms, which are able to cover at least high fixed costs of internalization. Consequently, mostly large companies are being internalized and a monopolistic structure of economy and society is stimulated.

Table of content.

Definition of Organizations and Formal and Informal Institutions

Since I often use words "institution" and "organization" in my paper and in different publications I met different interpretations of this concept, I decided to make clear what meaning of these words I use in this paper:

"Institutions are the constraints that human beings impose in human interaction. They consist of **formal** rules (constitutions, statute law, common law, regulations) and **informal** constraints (conventions, norms and self enforced codes of conduct) and their enforcement characteristics. Those constraints define (together with the standard constraints of economics) the opportunity set in the economy"[1].

"Organizations consist of groups of individuals bound together by some common objectives. Firms, trade unions, cooperatives are examples of economic organization; political parties, the Senate, regulatory agencies illustrate political organizations; religious bodies, clubs are examples of social organizations."[2]

---

[1] Douglass North: "Five Propositions About Institutional Change", p. 1.
[2] *Ibid*

[1], "the society that permits the maximum generation of trials is the one that has the best likelihood of solving problems through time, as Hayek has persuasively argued"[2]. In other words "innovations" is "the main engine of growth"[1]. In the context of long run growth in transition economies, under "innovations" I mean not only the technological

---

[1] Douglass C. North :"Privatization, Incentives and Economic Growth", p1
[2] *Ibid.*

improvements (although these innovations are also important). What is more important here, are the reforms of government and social structures: in other words rather "organizational" than "technical" innovations are crucial for the growth I transition societies. These organizational innovations are not necessary to be new for the world, the transition economies may use the society self-organizational models and experience of other countries. The use of word "innovation" in this case is justified because the process of reform and adoption of very new or already developed and used organizational model is new and original for each particular transition society. What features of institutional environment are important for these growth stimulating innovations to appear and to work and how the transition process affects these features? This is the main question, the theoretical part of the paper is trying to answer. The empirical section is providing the reader with evidences from Ukrainian economy, which support the theoretical assumptions and conclusions.

Section 2. Literature review.

There is a big variety of possible directions when researching the topic investments or investment climate. That is why I would like to specify from the very beginning that my goal is to learn what kind of institutional environment (which I call the investment climate) will stimulate the long run economic growth. That is why such directions as CAPM and Portfolio theory, influence of fiscal and monetary pollicies on investments, investments in physical and human capital are beyond the scope of this research.

Since I am discussing investments and growth, it would be impossible not to mention the classical Solow-Swan model. Solow-Swan model states that "long-run growth is

---

[1] Szyrmer (1998), p.6.

likely to be independent of the investment rate, because the returns to accumulable factors are probably sufficiently diminishing for this to be true."[1] J. Temple(1993, p.137), although agreeing with diminishing returns to physical capital[2], is strictly negative about the independence of investments and long-run growth. His argument is that Solow-Swan model "does not rule out externalities to investment", like, for example, technology transfer effect researched by De Long and Summers (1991). Externalities from foreign direct investment (FDI) are especially important for developing and transition economies. Additionally to new technologies, externalities consist of growing competitiveness in host countries (OECD, 1998, p.17), "better corporate governance, managerial expertise and skills" (Ishaq, 1997, p.1) the higher degree of openness of the economy, which is especially important for transition economies[3]. Thus, at least some economists consider investments as important factor of growth. At the same time the numerous failures to implement the "quasi"[4] Harrod-Domar model (Domar, 1946)[1] in developing countries give us a strong empirical evidence that investments itself is not a sufficient criterion for long run growth. (See the detailed argumentation about this issue in William Easterly, 1997).

Then, what are these necessary for sufficiency conditions, which would make the investments to cause the economic growth? Mancur Olson (1996) and Douglass North

---

[1] J. Temple (1999), p.137

[2] He names the papers of Benhabib and Spiegel (1994), King and Levine (1994) in support of this statement.

[3] The empirical evidences and theoretical of positive relationship between openness and growth is presented by Sebastian Edwards (1993). J. Temple (1999) gives brief review of theoretical arguments and literature review on this topic and Janusz Szyrmer (1997) stresses the importance of openness for transition economies and indicates the weak performance of Ukraine in this direction.

[4] I use the word "quasi" here, because the author has researched the relationship only between investments and short-run growth. Later, because of "Cold War" political reasons, the theoretical arguments, that this model was not developed for the long run growth were neglected and huge amounts of money were given to the developing economies (see more in William Easterly, 1997)

(1997) stress the importance of institutions for the evolution path of economic and social development of any society. In the framework of North's theory institutions, which are the rules of the game, form the structure, goals and methods of performance of organizations, which are the players. These features of organizations are in its turn crucial for the path of society development. Mancur Olson's point supported by cross-country comparisons is that it is institutional matrix, which determines, whether the individual rationality transfers into social rationality or not. In case when it does, the society is successfully developing, if not it will remain poor. The prosperity of society and the rate of its growth according to Olson do not depend significantly on initial endowment of resources or on the level of technology, as the Neoclassicals would predict.

What is then wrong with the Neoclassical theory? Janusz Szyrmer (1998) gives the detailed answer on this question. Szyrmer states, that Neoclassicals assume the economy in the close to equilibrium stage with given well-developed institutions. However, these assumptions are not hold in all countries and the transition economies (which are in the process of reorganization by definition) are the vivid example of non-equilibrium stage and rapid institutional transformation. Instead of Neoclassical focus on inputs volume and combination as the determinants of production function and growth, Szyrmer names "innovations" as "the main engine of growth"[2]. In this paper I am trying to estimate what institutional factors are the most important criteria for innovations to work in transition economies and particularly in Ukraine.

---

[1] later extended by Rostow's "takeoff into self-sustained growth" theory (Rostow 1960) and supported by Kuznets's historical evidences (1963).
[2] Szyrmer (1998), p.6.

Section 3. Methodology

Most theories, which deal with investments, use two characteristics in order to evaluate an investment: risk and expected returns. Expected returns and risk are simple evaluation criteria when one firm is under consideration: higher expected returns with the same risks are preferred. However, for the whole country very high average expected returns with the same level of risk as in other countries can provide evidence about high monopolization of the economy and/or closeness of the economy or lack of the capital in it. Thus, conditions favorable for one particular investor may be unfavorable for all others. (The appearing of very wealthy people in stagnating economies of Russia and Ukraine may serve as example of such contradiction). Based on these considerations, I used other than risk and expected returns criteria for the evaluation of investment climate. These criteria are the **speed** of the innovation's implementation and the level of political and economic **decentralization**[1]**.** These criteria are focused not on the investment attractiveness of a country, but on the potential ability of society to provide the organizational and governance innovations and reforms. Since the poor performance of government in many transition economies is admitted by many experts as the key obstacle for physical investments[2], the investment attractiveness of the country is then strongly dependent on the favorableness of society for organizational innovations.

In economic literature, the topic "Investment Climate"[3] is closely related to attracting foreign investments in the economy[4]. This research area is very popular in

---

[1] All details about these factors in the subsection 4.1. "Definition and Features of Favourable investment

[2] See Moellers (1998), table 3, Ishaq (1997) and other surveys indicated in Bibliography.

[3] Sometimes instead of "climate" the word "environment" or other synonyms may be used.

[4] J. Hardt, F. Kaiser (1995), see also papers in bibliography in section "Papers on Investment Climate"

developing and transition economies, since the decision-makers from both government's[1] and foreign investors'[2] sides may benefit even in the short-run from implementation of conclusions of these papers[3]. The authors of such papers often use surveys of foreign investors. In this way, they find out what features of the host country are attractive and what are forbidding for investors. Then they usually suggest what the authorities can do for improving the investment climate. In my paper I am also using the results of several surveys, but mainly as supporting evidences for testing my hypotheses. The reason why I am cautious with surveys in theoretical considerations is that each individual investor, when given his answer, takes care primarily about his own interests, which do not necessarily coincide with the conditions of the country's long run growth[4].

The comparison of investment climates of transition economies and other developing or developed countries is also broadly used (Ishaq (1997), Möllers(1998), Pittman (1995)) Using the cross sectional data or subjective evaluations of investors, the researches try to determine the importance of different factors (like legal framework, market volume and potential, level of corruption, tax rates, production inputs costs) on investment climate. Then having determined the priority of factors the authors concentrate on policy recommendations in most important according to their mind directions. I have also used this approach, comparing Ukraine with some transition

---

[1] The governments can raise additional taxes, increase employment or borrow money from the foreign portfolio investors.
[2] Foreign investors are interested in new market shares or in comparative advantages offered by host countries
[3] There are also other groups, which may benefit from FDI, but their influence on policy making and investors' decisions is mostly indirect and insignificant.
[4] The "Daewoo" case in Ukraine is one of the most vivid illustrations of such contradiction. The creation of new trade obstacles in automobile industry was beneficial for "Daewoo" and some other local producer's but the Ukrainian economy has lost many "trade openness" advantages, which are named as very important for the long-run growth generally (Edwards (1993)) and especially for transition economies (Szyrmer (1998, 2))

economies and with fast growing Asian countries, although some of my conclusions are made on one country sample. (this country is Ukraine)

Section 4. Theoretical issues.

4.1.   Definition and Features of the "Favorable Investment Climate".

Following the argumentation of previous sections, I am defining an economic growth as a function of Innovations

Growth = F (Innovations)

Innovations in its turn is not an exogenous variable, but it is dependent on Investment Climate. Investment Climate can be defined here as an institutional environment, which determines the intentions of players toward the volume and pattern of innovations:

Growth = F [Innovations (Investment Climate)]

Among many possible features of Investment Climate, I would like to distinguish and analyze two, which are extremely important for the society's ability to provide both technological and organizational[1] innovations:

- The **speed** of the innovation's implementation (measured by the time from the appearing of the idea or technology until the moment of its real action). This speed depends on the quantity of transactions needed, on the price of these transactions and on the money/time convertibility rate: how many additional units of money should be paid for accelerating the implementation by one unit of time. First Coase (1937) and then a number of other economists suggested to analyze efficiency, organizational structure, property rights and many other aspects of economic and

---

[1] the extreme importance of which for transition societies is described in introduction.

social development using the approach of transaction[1] costs. Wallis and North (1986) prove the increasing importance of transactions by empirical evidences:

> In the United States, for example, the labor force grew from 29 million to 80 million between 1900 and 1970; during that period production workers grew from 10 million to 29 million, while white collar workers (the great majority of whom are engaged in transacting) increased from 5 million to 38 million. The transaction sector (that part of transaction costs that goes through the market and therefore can be measured) in the United States in 1970 made up 45 percent of GNP[2].

- According to D. North[3] the level of **decentralization** of both political and economic decision making is crucial. Since "the organizational failure may be not only probabilistic but systematic", so that improving change may consist of "generation of organizational trials", it is "decentralized decision making process that will allow societies to explore many alternative ways to solve the problem."[4] In other words decentralization allows the society to speed up evolutionary making "choices among

[5]. A decentralized system is also the best one for the functioning of the competition both in political and economic decision making. The best response of organizations to the competitive institutional structure of society will be investing in skills and knowledge, which would improve efficiency and so guarantee the survival. On the contrary, "when the competition is "muted"…organizations will have less incentive to invest in new knowledge…, so that stable [stagnant] institutional

[6] Absence of competition leads to the development of organizational structure with "large scale hierarchies", which "produces the familiar

---

[1] Transaction here is not a narrow banking term, but it is defined in broad economic sense.
[2] Douglass C. North: "Institutions, Transaction Costs, and Productivity in the Long Run", p.4
[3] Douglass C. North :"Privatization, Incentives and Economic Perfomance", p. 1
[4] *Ibid*
[5] James Buchanan (1992) in Janusz Szyrmer (1998) p.7
[6] Douglass C. North :, "Five Propositions About Institutional C

problems of bureaucracy" and "results… in the loss of flexibility essential to adaptive

[1]

4.2. Impact on Investment Climate due to Increase in Contradiction Between Formal and Informal Institutions Resulting From the Rapid Changes in Transition Countries.

The new status of a sovereign country and adoption of a new constitution in all transition countries have drastically changed the formal institutions over a very short period of time. Responding to this, organizations are changing (some of them have already changed) their structures and methods of performance.[2] Rapid evolution in formal institutions and organizations affects informal institutions as well. There are several points about this interaction, which I would like to point out:

1. It takes time for informal institutions to change in the process of adaptation to new conditions (Mancur Olson (1996)). During the process of radical change of formal institutions the probability of adopting wrong formal institutions (which will never be satisfactory to informal institutions and in the future might be changed) increases. Because of these two factors, we can expect a temporary increase in confrontation between formal and informal institutions after the rapid change in formal institutions. An increase in confrontation between formal and informal institutions creates a number of new challenges. One of them is an increase in corruption. Corruption in this sense can be explained as a strategic behavior of organizations and individuals operating according to informal institutions even in cases when the formal institutions are in conflict with informal ones.

---

[1] Douglass C. North :"Privatization, Incentives and Economic Perfomance", p. 6
[2] "Organizations are a response to the institutional structure of societies" - Douglass C. North:

2. The path of change of informal institutions may be different for diverse social, age, or professional groups (we can distinguish these groups based on many other criteria as well). It happens because of different mentality and different effects of change in formal institutions and organizations on these groups. It may increase the polarization in understanding and in behavioral response of different individuals and organizations to the changes in the bundle of formal and informal institutions.

The polarization of society makes the political agreement and adoption of sustain and consistent formal institutions very difficult. It creates extreme problems for the countries without dominant interest group: in these countries several groups determine the policy, but no one of them has enough power to provide one mainstream. So, in general, there is a kind of anarchy when new formal institutions are induced by different interest groups: many of these institutions are not integrated in the general framework. That is why the pattern of transition depends on level of polarization and on the inclinations of the most influential groups.

Let me illustrate the process of polarization using the simplest framework of the game theory analysis. I am making the simplifying assumptions for my model:

(I)   There are only two main groups:

1. market reform **supporters**

2. market and democracy reform **opponents**

(II)   Each group has only two strategies in its dispose

1. to cooperate with another group

2. to fight with another group

Payoff distribution is the following:

---

1. In case one group chooses to cooperate and another to fight, the "fighting" group's goal will be reached (for supporters the goal is "reform", for op

2. In case when both groups are cooperating, no one's goal is achieved, but the government is capable to solve the current problems successfully, so there are no economic and political shocks and the country is experiencing short-run welfare. Why only short-run welfare? Because the groups are cooperating only on current operational issues, while the long-term strategy ("reform" or "no reform") is not agreed.

3. When both groups are fighting, neither the short run problems are solved, nor the long run general path is determined. In the pay off matrix I would call this situation "instability". Therefore, the normal form of the game can be described in the following way.

		Supporters	
		Cooperate	Fight
Opponents	Cooperate	Short-Run Welfare Short-Run Welfare	Reform Reform
	Fight	No reform No reform	Instability Instability

Thus for each player there are four possible outcomes, which depend on his and another player's strategies.

3. "Short-Run Welfare" is equally acceptable for both groups, but is less desirable for each of them than the best possible outcome. So I assign "+5" for each group for this outcome.

4. "Instability" case is equally undesirable for both groups, but it is better than the worst possible payoff (which is the victory of another group). Therefore, the assigned number for this outcome is "-5" for each group.

Now the normal form of the game can be redrawn as following

		Supporters	
		Cooperate	Fight
Opponents	Cooperate	+5 +5	+10 -10
	Fight	-10 +10	-5 -5

With such payoffs matrix the game converges to the classical prisoner's dilemma with

ht-fight" box. For the country it means "Instability", when

neither the short run problems are solved, nor the long run general path is determined.

Thus the country is operating poor now and the basis for the future growth is not created

in such countries.

Thus in the short-run absence of dominant group leads to the worst economic

performance. In order to support this statement let me compare the real GDP growth in

"polarized" countries and countries with dominant groups.

Country with dominant group		Polarized country
Market and democracy orientation	Authoritarian	
Estonia, Hungary, Latvia, Lithuania, Poland	Belarus, Kazakhstan, Uzbekistan	Ukraine, Russia

Source: The differentiation of selected countries on different groups was made with a help of "Przeworski Democracy Coding" and Ted Gurr's "Polity Democracy[1]

---

[1] Now I cannot provide the complete data on these sources in my paper.

Institutional Approach to Transition: Investment Climate and Growth in Ukraine.

From this diagram we can see that counties with dominant groups (both in direction to democratic reforms and to the authoritariaty perform better than polarized societies (Russian and Ukrainian growth curves are under all other countries' curves). Although in the long-run the polarized countries may have better chances for successful development than the authoritarian societies, the short-run macroeconomic management seems to be more solid in authoritarian societies than in polarized countries.

Additionally to the problems caused by polarization on macro level there is also negative impact on micro level. Because of the polarization in understanding and strategic behavior, there are no systematic strict rules, which could describe confrontation between formal and informal institutions and arising from it corruption. Instead they vary in many different ways. It makes the process of corruption extremely inefficient: the transaction costs for determining the pattern of corruption are very high for both bribe givers and bribe takers. So the main damage of corruption in these countries is not an additional cost to the sum of investment, but an increase in transaction costs (whom, how much and how to pay).

The main conclusions of this part are:

The rapid change in formal institutions causes the increase in contradiction in formal and informal institutions, since the informal institutions alter much slower than the formal do. Additionally to the possible increase in corruption this process may cause the polarization of society due to different speed and path of evolution of informal institutions among different social groups. When despite polarization the society has a dominant group the short-run macroeconomic management seems to be better in such country than in the country without dominant group. Except the problems on macro level,

the polarization may increase the micro level inefficiency, since it makes corruption unsystematic and so more costly.

4.3. Conversion of Businessmen's Revenues into Common Property and Impact of this Process on Investment Climate.

The system under which the state monopolized the ownership over the vast majority of the property in the country is currently being replaced in most former Soviet block countries. At the same time in transition societies, the government agents still tend to have an excessive amount of regulatory and controlling power over the economic activity. There are two reasons for it:

1. The Soviet Era inertia[1].

2. Such system satisfies short-term interests of both central government and local level bureaucrats.

The excess of rights owned by government agents is usually accompanied by underdevelopment of those organizations and formal institutions, which could effectively defend the business activities from the harmful (from the efficiency point of view) interventions of government agents. Thus, there are many government agents, which have enough power to destroy one's business[2]. On the other hand, although each particular government agency has its own hierarchical structure, there is lack of coordination and hierarchy between agencies.[3] That is why, even if some government agents want to

---

[1] Under inertia I mean that such perception remains as informal institution among many government bureaucrats and so they may act according to this principle not (or not only) because of their self interest or rent seeking, but also because they are convinced that it is the most fair and legitimate one.

[2] It can be done in many ways:
- Ordering big penalties because of imperfect law system;
- Permanent time wasting inspections;
- Not giving needed certifications or permissions because of artificial or no reason.

[3] So, for example in Ukraine, according to Szyrmer (1999) "their [government agencies] autonomy is quite enough, not to coordinate their activities with each other"

patronize certain firm and to defend it from other agents and agencies, in most cases they are not able to do it, since they can secure this firm only from segmental narrow risks (for example, only from the agents of the same agency). In other words for the government agents it is easy to destroy, but difficult to defend any particular business. Such a system sets up an incentive structure, which stimulates the government agents to make profits on destroying the business (either by collecting fines, which increase their salaries, or by taking bribes for not collecting fines). No wonder that in transition economies where the evolution of state bureaucracy was similar to the above described, the government agents are very good destroyers[1].

The "destroying" incentive matrix can be described by the economic concept of common property with open access, where the businessmen's property is open for government agents' consumption. Both static and dynamic inefficiency of the common property with open access is described by Demsetz (1967) and Dnes (1997) as well as by other economists[2].

- From the static point of view "common property rights cause over-exploitation of a resource"[3] since each user ignores his impact on all other users. (the more detailed illustration of this is given in Appendix 2. "Fishing Example").

- According to dynamic long-run perspective there is no incentive to invest in the common property, since the investor can not secure the returns resulting from his investments. There are also no incentives and mechanism to prevent the common property from complete depletion even when the individual rationality predicts that in

---

[1] So, for example in Ukraine during 9 months of 1997, 88.8% of taxes were collected by repressive actions of the State Tax Administration (see more in empirical part, section 5.2.1)
[2] Dnes names Gordon (1954), Furubton and Pejovich (1972).
[3] Dnes (1997), p.11

the future every one will be worse off.

Demsetz (1967) developing the property rights paradigm states, that common property with open access is an externality. This externality is to be internalized by creating and enforcing property rights in the case when the gains from its internalization exceed the costs. Let us see how this concept can help when analyzing the "government agents – businessmen's property" externality. The internalization in this case would mean that there is a certain group of government agents, which defends a particular firm from all other government agents. Since in transition economies there are often many independent government agencies and each of them is a powerful risk source[1], the patronizing group should deal with all of these agencies, that makes the fixed cost of internalization rather high. It would be reasonable to assume, that for the risk securing the group of agents-internalizers will require from the firm an amount, which exceeds the cost of internalization. Thus the firm, which wants to be internalized, should be large enough for being able to cover at least the fixed costs of internalization.

In dynamic perspective this circumstance will result in tendency to internalize mostly big companies, with the remaining externality of common property for small and medium-size firms, thus creating the monopolistic structure of the economy.

Summarizing the argumentation of this subsection, I would like to highlight the following points:

In transition economies, where the effective mechanisms of property rights securing are not created and transformation of Soviet style governance mechanism results in appearing of many autonomous government agencies, the institution matrix stimulates the development of the monopolized structure of economy and oppresses the development of

small and medium size businesses. Thus, the paradoxical feature of such transition is that the lack of centralization in state governance[2] creates the institutional matrix, which stimulates the monopolized structure of economy, so making the institutions rigid and fostering the evolution of economy (and through economy of the whole society) more "within constraints" than "among constraints."

5. Testing the Theoretical Hypotheses on the Example of Ukraine.
5.1. Increase in confrontation.

5.1.1. Facts supporting an assumption about rapid change of formal institutions:

The adoption of the new Constitution of Ukraine (1996) can be referred as a kind of revolution in formal institutions. Additional factor in support of my assumption about rapid change in formal institutions is constant amendments to the laws. So, for example, "during the one year after the VAT law was adopted (on April 4 1997), there were almost 200 amendments, additions and adjustments made to it".[3] Another example is that "Principal Law on Business has been changed for more than 20 times since its adoption"[4]

5.1.2. Evidences in support of hypothesis about polarization and absence of dominant group in Ukraine:

Although my "Reforms Supporters versus Reform Opponents" example assumes only two main groups, in reality it can be many interest groups competing for the political and economic power. The key factor here is "dominant group". When there is a dominant group, which may consist from one party or from the coalition of several parties and

---

[1] In Ukraine, for example, there are at least 8 of such agencies (for more details see appendices 1 and 3)
[2] Under the lack of centralization in state governance I mean the lack of coordination between the autonomous government agencies, each of which pursues its own goals, without taking care about the state interests.
[3] V. Moursov (1998)
[4] Yurij Kuz'min (1999), p64

groups, the long-run policy is determined and polarization, which to some extent is present in all societies, plays rather insignificant role for the country's development. The absence of dominant group in its turn leads to the "instability " consequences described in theoretical partAs a direct indicator I am presenting the results of the last Parliament elections (Spring 1998, mixed 50% proportional and 50% majoritarian voting system), which evidence about big dispersion in populations' support of different political parties:

Parties	Seats, total	Party list	Single mandate constituencies
Communist Party	123	84	39
Rukh	46	32	14
Socialist/Peasant Parties	32	29	3
People's Democratic Party	28	17	11
Hromada (community)	23	16	7
Green Party19	19	19	-
Progressive Socialist Party	16	14	2
Social Democratic Party (United)	16	14	2
Agrarian Party	8	-	8
Reforms and Order Party	3	-	3
Christian Democratic Party	3	-	3
National Front Block	3	-	3
Other Parties	18	-	18
Independent Candidates (not the members of any of parties)	114	-	-

Source: Ukrainian News agency, Financial Week 13, March 30-April 5, 1998.

The absence or presence of dominant group is difficult to illustrate only by some direct statistics, although such a big quantity of parties and groups reduces the possibility of formation of one dominant group. That is why I am adding some indirect arguments, in order to support my hypothesis. As indirect indicator of polarization I would call a big number of contradictions in legal environment (marked by Moellers (1998), Ishaq (1997)) and ever lasting amendments to the new laws (see Section 3.1.1., 2). These facts evidence about the chaotic decision making, one of the reasons for which is the absence

of dominant group, which would be able to provide consistent adoption and execution of formal institutions.

5.1.3. Evidences on quantitative increase of corruption and its extremly damaging impact in Ukraine.

Both in comparative[1] and absolute[2] measurement corruption has reached all fields of economic activity in Ukraine. The concrete forms of corruption and its scale in Ukraine are described in details by Daniel Kaufmann, the former head of the World Bank's Kyiv (Ukraine) office (Kaufmann 1997), who consider the corruption as a very seiorious obstacle for the growth of Ukrainian economy. So, for example, additionally to many other negative impacts on economy, corruption increases transaction costs of business:

> Senior management in the new private enterprises must spend a lot of time with public officials "securing" licenses and permits and "negotiating" taxes and penalties. In 1995, they spent about 30 percent of their working hours with officials and almost 40 percent in 1996[3].

As it was stated in the theoretical part, the polarization of society causes not only quantitative increase in corruption, but also results in its unsystematic nature, thus creating even more inefficiency. So, for example, according to statistics, corruption in Ukraine (as well as in some other transition economies) is a much more serious obstacle for the investments and economic growth than in other (for example East Asia) countries with about the same level of corruption:

---

[1] According to Transparency International's 1998 Corruption Perceptions Index Ukraine's cross country corruption rank is 69 (where 1 is the least corrupted).
[2] See survey made by the national weekly "Buisiness" (Appendix 1).
[3] Daniel Kaufmann (1997)

Country	Country Rank	1998 CPI	Annual GDI	Annual FDI	GDI as	Average annual
	(out of 85), 1998	Score	per capita (USD)	per capita (USD)	share of GDP	GDP growth
	1=the lowest corruption		1997	1997	1997	1987-97
South Corea	43	4.2	3442	-36	35.0%	6.5%
China	52	3.5	291	36	38.2%	10.1%
Philippines	55	3.3	278	17	24.8%	3.2%
Thailand	61	3	890 in 96	39	35.0%	8.7%
Ukraine	**69**	**2.8**	**238**	**12**	**20.1%**	**-10.2%**
Indonesia	80	2	344	40	32.1%	7.8%
Sources:	*Transparency International's 1998 Corruption Perceptions Index*					
	http://www.worldbank.org/data/countrydata/countrydata.html:					
		World Bank : "China at Glance", 1/28/99				
		World Bank : "Indonesia at Glance", 9/17/98				
		World Bank : "Thailand at Glance", 1/01/99				
		World Bank : "Philippines at Glance", 9/30/98				
		World Bank : "Korea at Glance", 9/11/98				
		World Bank : "Ukraine at Glance", 9/16/98				

5.2. Common Property.

5.2.1. Facts supporting the hypothesis about excessive amount of regulatory and controlling power over the economic activity:

In Ukraine there are at least 8 government agencies, which are making regular revisions of each firm. The names of these agencies and the frequency of revisions (on average more than 40 per year) is given in Appendix 3. Most of these government agencies and many other have the right of creating their own formal institutions, which are not necessary agreed with each other. To be more specific, "business activities are regulated by as many as 32 laws about 30 presidential decrees, and over 80 resolutions of

the government. Furthermore, 32 ministries and departments have the right to issue licenses for various activities."[1]

The hypothesis about incentive matrix, which stimulates the business destroying actions of government agents, can be supported by the discriminative character of Ukrainian tax collecting statistics: during 9 months of 1997, 88.8% of taxes were collected by repressive actions of the STA[2], and this tendency does not change for better.

Since excessive regulatory power serves to the interests of each particular government agency, they are trying to obtain even more monitoring and regulatory power. So, for example, "on July 2, the State tax Administration and the National Bank of Ukraine signed an agreement, under which the NBU is to inform the tax administration about any transactions with values greater than UAH 50,000 [less than 25 thousand USD at that moment]"[3]

These and many other evidences indicate the excessive regulatory power of government agencies in Ukraine and the deficiency of centralization of government power, which results in lack of coordination between different government agencies. This, in its turn leads to the business destroying incentive matrix for the government agents.

5.2.2. Destructive influence of the open access on small business and monopolizing of the economy.

According to the arguments in theoretical part, the autonomy of several powerful government agencies and unprotected property rights lead to the externality of common

---

[1] Inna Pidluska (1998)
[2] O. Nikolaychuk (1997)
[3] Ukrainian News, Financial Week '26, June 29-July 5, 1998

property with open excess for government agents. Section 4.3 discusses several negative

impacts of this externality, one of which is the decrease of incentive to invest, due to the

inability to secure the future revenues for investor. The Ukrainian statistics, which

demonstrates a decrease in net investments since 1995 both in absolute and in relative

terms of measurement, is in full agreement with this hypothesis:

Year	Net investments in Ukraine	
	In bln hryvna (Ukr. Currency)	As % of GDP
1995	2736	5.02%
1996	2189	2.69%
1997	966	1.04%

Source: Statistics Committee of Ukraine
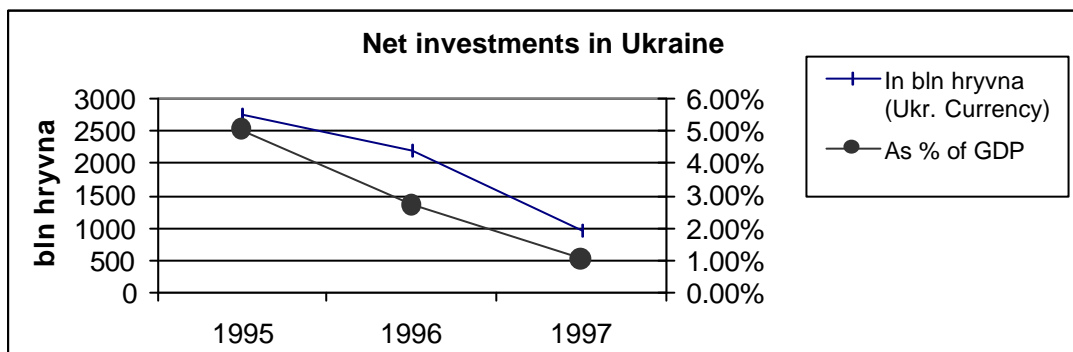
Source: Statistics Committee of Ukraine

The destructive influence of de facto common property with open access to small and

medium size business can be confirmed in Ukraine by empirical evidences:

during 1996 the number of small enterprises decreased by more than 6 thousand units (-
6.6%); the number of employed workers there decreased by 6.1%, respectively. In 1992 the
rate of actually working small enterprises over their total amount was 49.4% of those
registered, in 1994- 37.3%, in 1996 less than one-third of the registered small enterprises
was working (32.6%).[1]

The hypothesis about the development of monopolistic structure seems to be

supported by empirical evidences in Ukraine, which illustrate the size and dynamics of

the monopolizing process in the economy:

A total of 372 enterprises with monopolies in 579 commodity markets had been registered in Ukraine as of January 1, 1999 compared with 352 enterprises as of January 1, 1988, Antimonopoly Committee Chairman Oleksandr Zavada said on March 5 [2]

The monopolization of economy stimulates the monopolization of the government power (for interrelations between economic and political power structures the causality, actually, seems to be true in both directions). So according to Sherman Garnett, Senior Associate Carnegie Endowment for International Peace: "Ukraine … continues to be threatened by the concentration of economic and political power in the hands of a few and by the slow progress toward market reforms"[1]

6. Conclusions.

6.1. Summary

The paper is using the institutional approach for detailed analysis of important features of transition process, which are closely related to the investment climate and growth in transition economies. Having discussed several possible theoretical approaches to the issue of growth, I have determined the growth in transition economies as a function of innovations. For transition countries the emphasis is made not on technological, but on organizational innovations, which push the society in the direction of government reforms, so reforming the institutional environment and improving the attractiveness of the country also for physical investments.

According to my model, there are two factors, which are determining the ability of society for organizational and technological innovations:

1. **Speed** of innovation, which influences the quantity of investment trials and depends on transaction costs.

---

[1] K. Maydanyk (1998)
[2] *Ukrainian News*, March 1-7, 1999, p.9

2. Level of political and economic **decentralization**, which influences the quality of investments by determining whether the evolution is only "within" or also "among" constraints and which also determines the structure of organizations.

For the analysis of what factors affect these criteria I have researched some particularities of institutional development of transition economies and, particularly, of Ukraine. Ukraine as all other transition countries is experiencing the rapid change of formal institutions. Because of different speed of development of formal and informal institutions the confrontation arises among them. One effect of the confrontation between the formal and informal institutions is the increased and unsystematic corruption in Ukraine, which has raised transaction costs and so reduced the speed of innovation. Additionally, dissimilar perception of new formal institutions by different social groups has resulted in polarization of society. The transition societies, where the polarization was very deep, the dominant political groups were not formed. The absence of dominant group complicates the adoption of formal institutions in one mainstream and leads to the extreme inefficiency of the short–run macroeconomic management. Consequently, the transition countries without dominant group have worse economic indicators than countries with both pro market and democracy and authoritarian dominant groups. Thus the "speed of innovations" may be significantly reduced by increased transaction costs due to the absence of dominant group in society.

The "decentralization" criterion is also negatively affected in some transaction economies. In the process of transition the government traditionally has excessive regulatory power over the economy, while the private property defending formal institutions and/or the mechanisms of their execution are not yet developed in many

[1] Sherman Garnett (1998)

transition economies. Additionally, the absence of dominant group and some other factors result in the lack of coordination between different autonomous government agencies. These factors lead to the business destroying incentive matrix, which in the economic theory is described by the concept of common property externality. Due to the high fixed costs of internalization, this externality it is being internalized only for the large companies, where it has negative static and dynamic influences on small and medium-size business. Thus the monopolistic structure of economy and society is stimulated, which leads to the rigidity of institutions and to the lowering the quality of organizational innovations, reducing the choice "among constraints" to the possibility to develop only 'within' constraint.

I hope, that the presented in the paper approach and conclusions may be helpful when developing the policy recommendations thus increasing the probability of successful economic development in Ukraine, as well as in the other transition economies.

6.2. Possible extending of the research

I would like to highlight two possible directions of research extending:

1. To include more empirical data on other transition economies and to test the presented theoretical hypotheses using the panel data.

2. To develop the policy recommendations for the improvement of investment climate using the conclusions and approach of this paper.

Appendices.

Appendix 1: Survey "Do you know the cases, when a problem was solved with a help of bribe in any kind in any of the following governmental structures?"

Structure	Number of cases					average score	
	0	at least 1	2–3	more than 3	many	by	by
	% from the surveyed					surveyed	experts
Tax administration	5	12	11	12	59	4,1	3,7
Customs service	6	14	10	8	62	4,1	4,1
Tax police	9	18	7	13	53	3,8	_
sanitarian-epidemic inspection	7	28	9	11	45	3,6	3,5
city government etc.	5	26	13	15	40	3,6	3,3

372 readers of the weekly "Buisiness" were surveyed.
Sourse: *Áèçíåñ* ¹17,1998, p. 10-11.

Appendix 2. Fishing comparison.

For a better illustration of the relationship between the inspectors and businessmen the example of fishing (Dnes A., 1996, p. 12-13) seems appropriate to me:

> The fish population will adjust to the total revenue (yield) levels shown as fishing is varied on the horizontal axis. Increases in effort reduce the underlying population. The total revenue curve shows the usual bell-shaped relationship that is used as a starting point in models of fisheries management (Clark, 1976). At first, increasing fishing effort increases the yield, as a smaller fish population puts less demand on its food sources and breeding and growth of the fish stock shows greater gains. However, past point M, the falling fish population implies that fish experience increasing difficulty in locating partners for breeding so that yield falls. Hence, the derived total-revenue curve has a bell shape, giving a maximum at point M.
>
> Assuming a constant unit cost of fishing effort gives the linear total cost function. A private owner of the fishery would expand fishing effort to point E in Figure 3.1 where profit is maximized. With common rights, people enter the fishery as long as there is any profit to be had in excess of the (normal) profit they could earn on their investments elsewhere in the economy. If we assume that the fishermen's costs include an element of required normal profit, open access gives a level of effort shown by point A. the entire surplus on the fishery is dissipated by open access. The lack of private property rights leads to overfishing. If we could reduce fishing effort from A to E, we could release inputs for use elsewhere in the economy and increase the catch in the fishery.
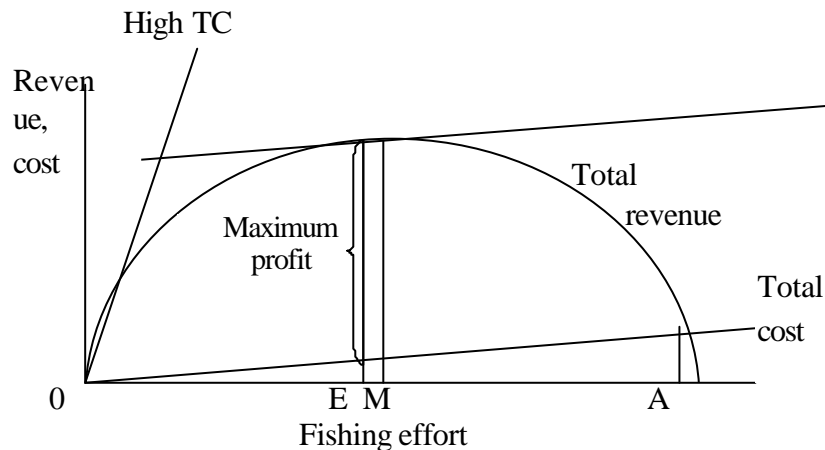

Figure 3.1 The fishery
E = point of maximum profit;
M = point after which fish yield falls;
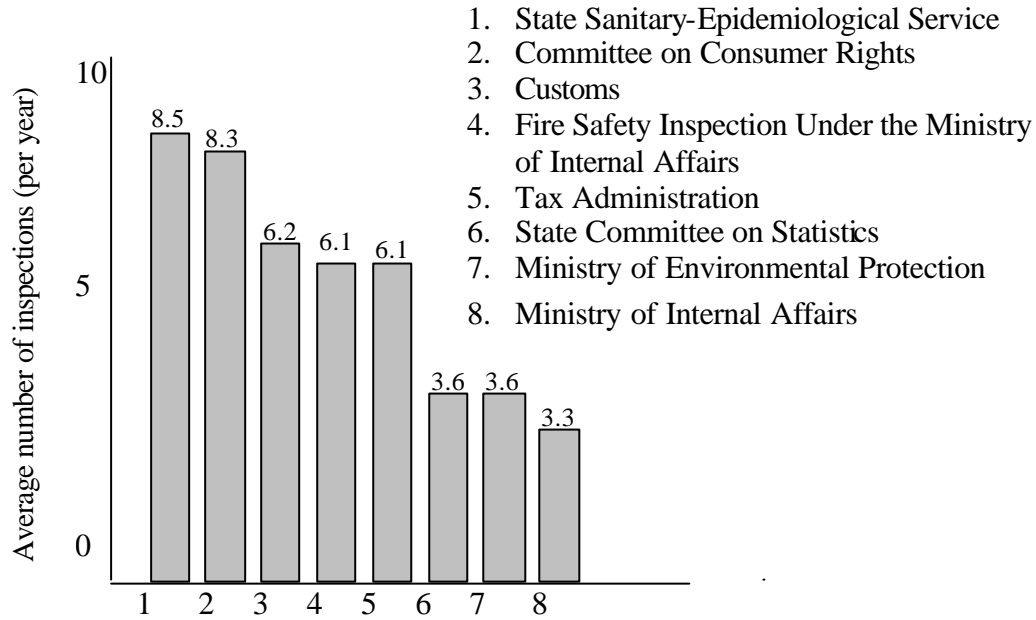A = level of effort given by open access

Now if to replace the fish with the revenues of the businessmen and the fishermen by the government inspectors the previous analysis can be used for the description of the

relationships between the businessmen and inspectors in Ukraine. Low total cost in this case is associated with getting revenues from small and medium size firms with less ability to "fight", high total costs are associated with big firms, which have strong connections and for which the externality of the open access is internalized.

Some comments about this substitution:

- The bell shape of the total revenues curve has a biological explanation for the fish. At the moment I have no data to confirm such a shape for the economic process. To some extent the assumption about the bell shape can be supported by the Laffer curve but I realize that this confirmation is not strong enough. That is why the appropriateness of such substitution is questionable and I consider it just as an assumption.

- One can argue that the revenues of the businessmen are not the common property with open access, since they belong to these businessmen. My argument is that the life of fish is its own property, but the only way to save it is to fight against being caught in the fisherman's net. Unfortunately in Ukraine the private property rights are not guaranteed by the state and only the ability to "fight" (which reflects the costs for inspectors) let the businessmen keep at least a part of their revenues.

Appendix 3. Inspections by Government Agencies

1. State Sanitary-Epidemiological Service
2. Committee on Consumer Rights
3. Customs
4. Fire Safety Inspection Under the Ministry of Internal Affairs
5. Tax Administration
6. State Committee on Statistics
7. Ministry of Environmental Protection
8. Ministry of Internal Affairs

Source: IFC –Ukraine, 1997

Appendix 4. Data on the GDP Growth in 10 Transition Economies, 1992-1998.

Country	1992	1993	1994	1995	1996	1997	1998
Estonia	-14.2	-9	-2	4.3	4	11.4	5
Hungary	-3.1	-0.6	2.9	1.5	1.3	4.4	4.6
Latvia	-34.9	-14.9	0.6	-0.8	3.3	6.5	4
Lithuania	-21.3	-16.2	-9.8	3.3	4.7	5.7	3
Poland	2.6	3.8	5.2	7	6.1	6.9	5.2
Russia	-14.5	-8.7	-12.7	-4.1	-3.5	0.8	-5
Ukraine	-13.7	-14.2	-23	-12.2	-10	-3.2	0
Belarus	-9.6	-7.6	-12.6	-10.4	2.8	10.4	5
Kazakhstan	-19	-16	-20	-5.4	7.1	6.5	4
Uzbekistan	-11.3	-2.3	-4.2	-0.9	1.6	2.4	2

Source: EBRD Transition Report 1998
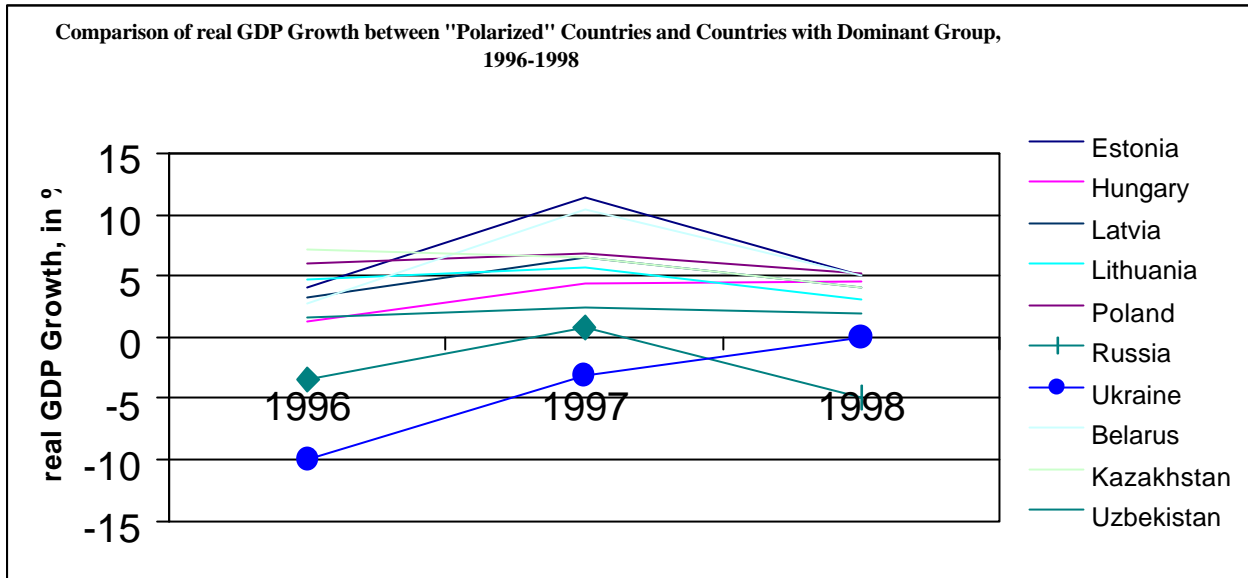
Bibliography.

Theoretical Papers.

1. Benhabib, Jess and Mark M. Spiegel. 1994. "The Role of Human Capital in Economic Development: Evidence from Aggregate Cross-Country Data," J. Monet. Econ., 34:2, pp. 143-73

2. Ronald Coase (1937): "The Nature of the Firm", *Economica*, 4, pp.386-405

3. Ronald Coase (1960): "The Problem of Social Cost", *J.Law & Economics*, 3, pp. 1-44

4. Demsetz, H (1967): "Towards a Theory of Property Rights", *American Economic Review Papers and Proceedings*, 57, pp.347-59

5. Dnes, A (1996): "The Economics of Law", International Thomson Publishing Business Press, London

6. Domar, Evsey. "Capital Expansion, Rate of Growth and Employmen *Econometrica*, Vol.14, (April, 1946), pp.137-47

7. Easterly, William; 1997, "The Ghost of Financing Gap. How the Harrod-Domar Growth Model Still Haunts Development Economics"; *The World Bank Development Research Group.*

8. Edwards, Sebastian. 1993. "Openness, Trade Liberalization, and Growth in Developing Countries," J. Econ. Lit., 31:3, pp. 1358-93

9. King, Robert G. and Levine Ross. 1994. "Capital Fundamentalism, Economic Development and Economic Growth," Carnegie-Rochester Conf. Ser. Public Policy 40, pp.259-92.

10. Kuznets, Simon, "Notes on the Takeoff", in W.W. Rostow, ed., *The Economics of Takeoff into Self-Sustained Growth*, MacMillan Ltd. (London: 1963)

11. De Long, J. Bradford and Lawrence H. Summers, 1991. "Equipment Investment and rt. J. Econ., 106:2, pp. 445-502

12. Douglass C. North : "Five Propositions About Institutional Change", Washington University St. Louis
http://econwpa.wustl.edu:8089/eps/eh/papers/9309/9309001.pdf

13. Douglass C. North: " INSTITUTIONAL COMPETITION", Washington University St. Louis
http://econwpa.wustl.edu:8089/eps/eh/papers/9411/9411001.pdf

Fragile Stabilization to Financial Crisis", CASE #158, Warsaw 1999, p64

4. I. Maskalevich: "These Legendary Investments", Financial Consultation, #15, 1998, p.74
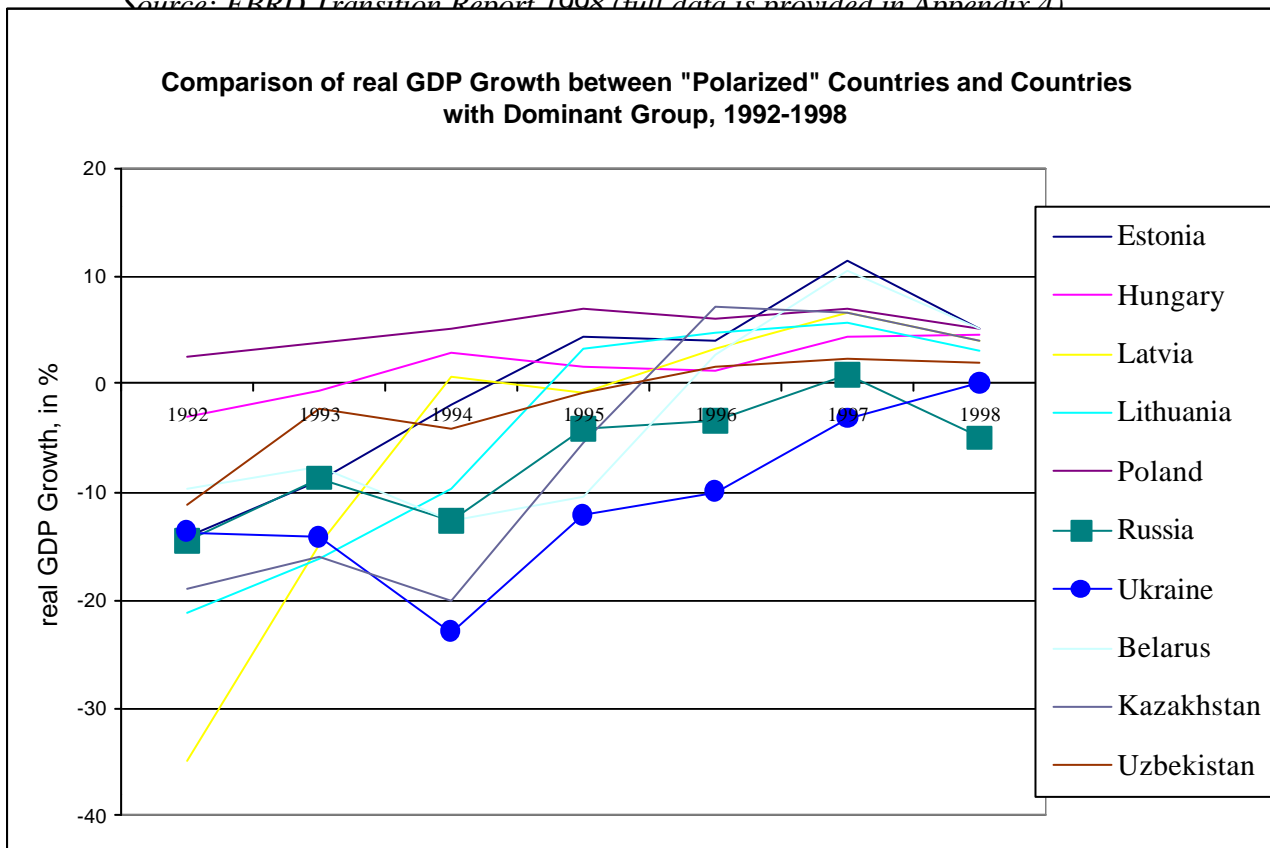(È. Ìàñêàëåâè÷ "Ýòè ëåãåíäàðíûå èíâåñòèöèè", *Ôèíàíñîâàÿ êîíñóëüòàöèÿ*, ¹ 15, 1998ã, ñ.74)

5. . Moursov "Akzyzny sbor" Finansovaya Consultatsia #15, 1998 p.54

Real Life Expierence" in Axel Siedenberg, Lutz Hoffmann (1998): "Ukraine at the Crossroads: Economic Reforms in International Perspective", Physica, A Springer-Verlag Company, Berlin, New-York.

5. Russell Pittman (1995): "Competition Policy in Ukraine and the United States: The Ukrainian Competition Law and American Expierence", Peru White Paper no.95-002, Kiev: Peru, mimeo.

6. T. Tkachenko (1998): "The Tax on Profit and Foreign Direct Investments in the Economy of Ukraine", *Economy of Ukraine*, 1998, #3

Comparison of real GDP Growth between "Polarized" Countries and Countries with Dominant Group, 1996-1998

Source: EBRD Transition Report 1998 (full data is provided in Appendix 4)

Comparison of real GDP Growth between "Polarized" Countries and Countries with Dominant Group, 1992-1998

Appendix 4.Data on the GDP Growth in 10 Transition Economies, 1992-1998.

Country	1992	1993	1994	1995	1996	1997	1998
Estonia	-14.2	-9	-2	4.3	4	11.4	5
Hungary	-3.1	-0.6	2.9	1.5	1.3	4.4	4.6
Latvia	-34.9	-14.9	0.6	-0.8	3.3	6.5	4
Lithuania	-21.3	-16.2	-9.8	3.3	4.7	5.7	3
Poland	2.6	3.8	5.2	7	6.1	6.9	5.2
Russia	-14.5	-8.7	-12.7	-4.1	-3.5	0.8	-5
Ukraine	-13.7	-14.2	-23	-12.2	-10	-3.2	0
Belarus	-9.6	-7.6	-12.6	-10.4	2.8	10.4	5
Kazakhstan	-19	-16	-20	-5.4	7.1	6.5	4
Uzbekistan	-11.3	-2.3	-4.2	-0.9	1.6	2.4	2

Source: EBRD Transition Report 1998