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## The long road to normalcy: Where Russia now stands

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Working Paper No. 2010/13

## **The Long Road to Normalcy**

Where Russia Now Stands

Vladimir Popov\*

February 2010

### **Abstract**

The goal of this study is to reveal the long-term trajectory of Russian economic development and to make predictions for the future. The study starts with a much discussed question: why Russia did worse economically during transition than most other countries in Europe and Asia? It is argued that it was partly caused by objective circumstances before transition (distortions in industrial structure and in trade patterns accumulated during the era of central planning), but mostly by the weakening of the institutional capacity of the state during transition.

Keywords: economic transition, institutional trajectories, Russia, China

JEL classification: O11, O57, P27, P52

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## **1 Introduction**

The goal of this study is to reveal the long-term trajectory of Russian economic development and to make predictions for the future. The study starts with a much discussed question: why Russia did worse economically during transition than most other countries in Europe and Asia? It is argued that it was partly caused by objective circumstances before transition (distortions in industrial structure and in trade patterns accumulated during the era of central planning), but mostly by the weakening of the institutional capacity of the state during transition.

The second argument deals with the reasons for the institutional collapse that was more pronounced in Russia than either in democratic East Europe (EE) or in authoritarian China and Vietnam. Partly these reasons are associated with democratization carried out in a poor rule of law environment (in EE countries the rule of law was stronger, whereas in China and Vietnam democratization was delayed). A possibly more important reason is the long-term trajectory of institutional development; i.e. the historical path from traditional collectivist institutions to the modern individual responsibility type. Whereas East Europe more or less adopted Western institutions, and China preserved the institutional continuity (traditional 'Asian values' institutions), Russia and some other former Soviet Union (FSU) states found themselves in a 'no man's land'—collectivist institutions were destroyed, but Western law and order institutions did not take root.

Russian trajectory of economic development is placed into the comparative context. It is argued that developing regions that preserved institutional continuity (East Asia, Middle East and North Africa (MENA), India) have better conditions for growth than regions where traditional institutions were largely destroyed (sub-Saharan Africa (SSA), Latin America (LA), FSU). If this interpretation is correct, the new growth miracles will happen in MENA countries like Turkey, Iran, Egypt, whereas Russia together with LA and SSA will remain a 'normal' developing country with poor institutions, mediocre and highly volatile growth.

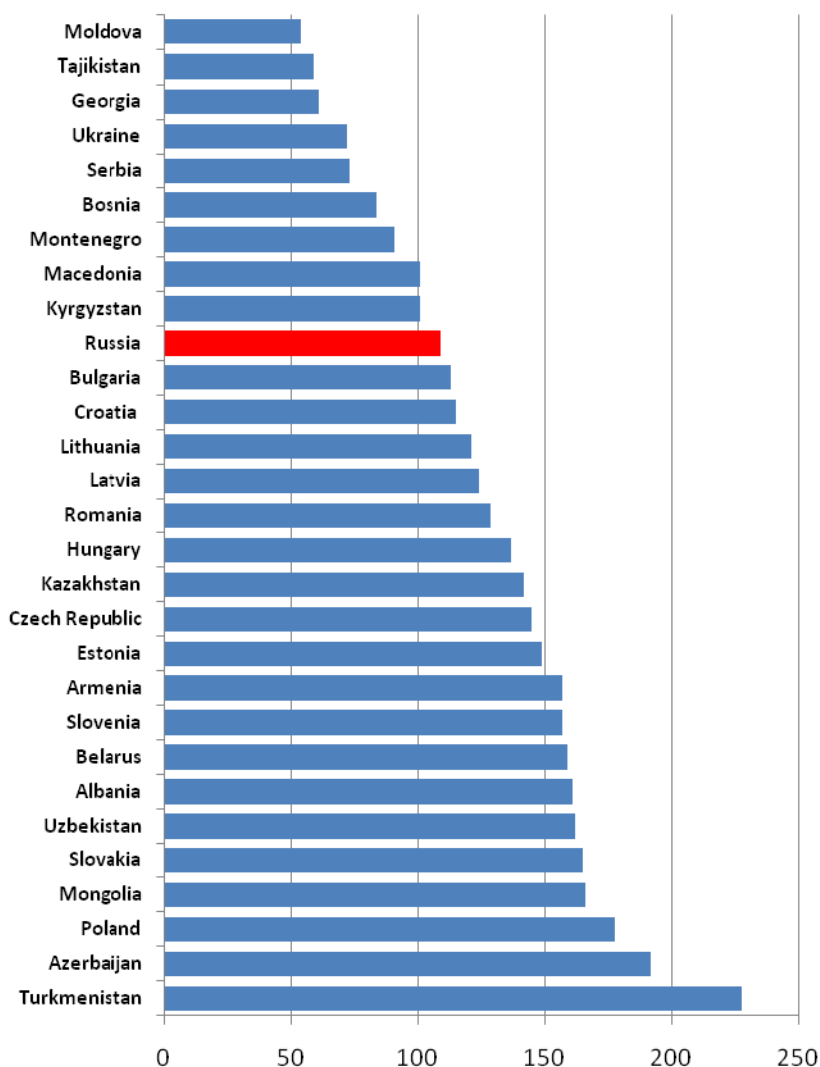
## **2 A 'normal' country?**

The world economic recession of 2008-09 hit Russia harder than other countries. Russia's GDP for 2009 fell by about 9 per cent due to the collapse of oil prices and the outflow of capital caused by world recession—more than USA, European, and Japanese GDP (2, 4, and 5 per cent respectively) and considerably more than the GDP in most emerging market economies that did not experience a recession (China registered growth of 8 per cent, India 6 per cent, Middle East 2 per cent, SSA 2 per cent).

From 1989 to 1998 Russia experienced a transformational recession—GDP fell to 55 per cent of the pre-recession 1989 level. In 1999-2008 Russia's economy was recovering at a rate of about 7 per cent a year and barely reached the pre-recession peak

of 1989; Figures 1 and 2).<sup>1</sup> Now, with some luck, pre-recession 1989 GDP will be surpassed in the period 2011-12. In sum, therefore, for two ‘lost decades’, there has been no increase in output.

Figure 1: 2008 GDP as a % of 1989 level



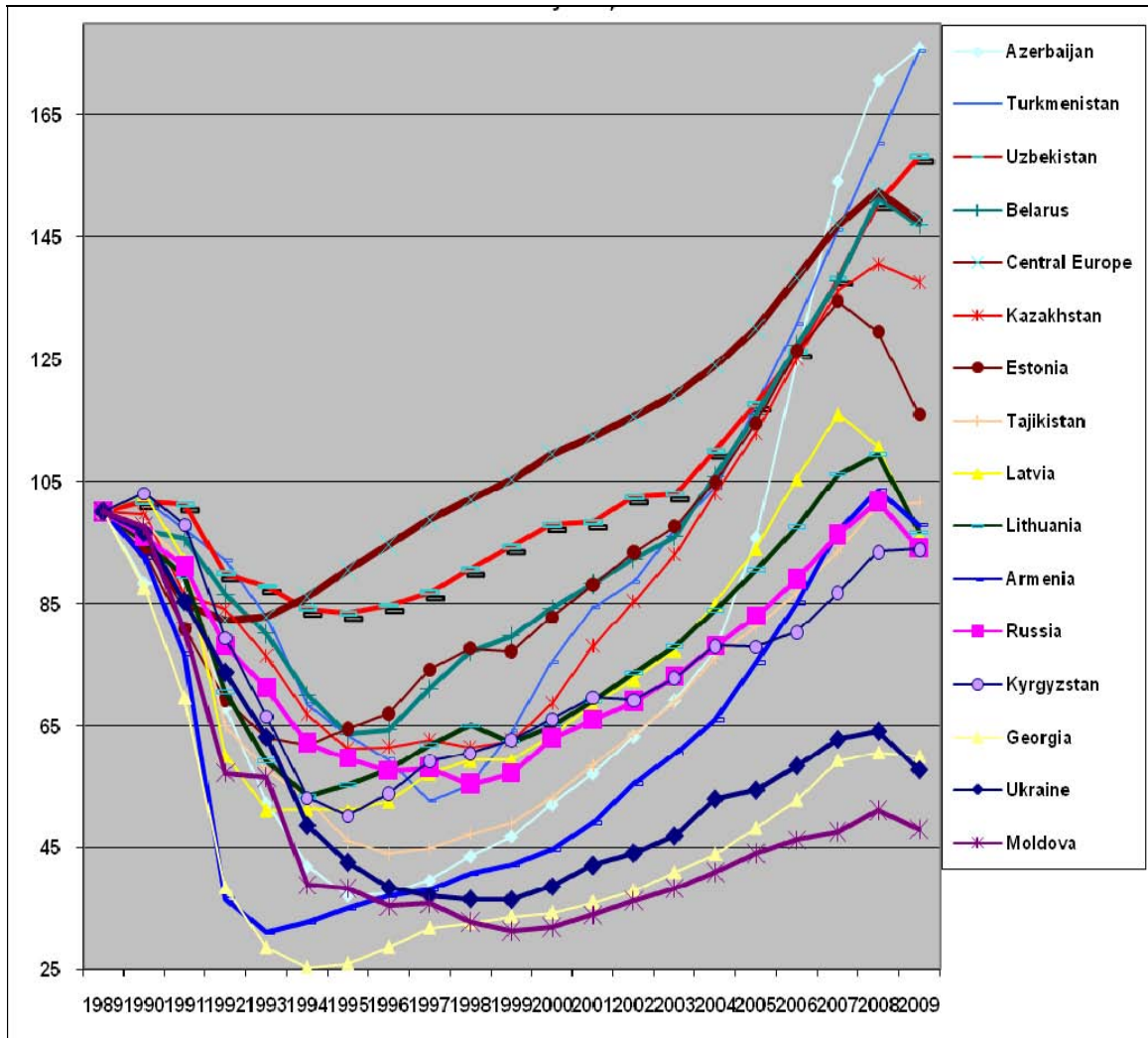
Source: EBRD Transition Report 2009.

In 2005, Andrei Shleifer and Daniel Treisman published an article entitled, ‘A Normal Country: Russia after Communism’ (Shleifer and Treisman 2005). They compared Russia to Brazil, China, India, Turkey and other developing countries, and argued that, in terms of crime, income inequalities, corruption, macroeconomic instability, and other curses typical of the third world, Russia is by far not the worst—indeed, somewhere in the middle of the list, better than Nigeria, although worse than China. In short, Russia is a *normal* developing country.

<sup>1</sup> Figure 1 is based on GDP indices (2008 as a percentage of 1989) reported in the *EBRD Transition Report 2009*, whereas Figure 2 reports chain indices (based on annual growth rates) from the same source. The discrepancies are not that substantial.

The USSR was an *abnormal* developing country. The Soviet Union put the first man into space, had about 20 Nobel Prize winners in science and literature. Out of about 40 living laureates of the Fields Medal (awarded since 1936 and recognized as the ‘Nobel Prize in mathematics’) eight come from former Soviet Union (that had less about 5 per cent of world population). The USSR had universal free healthcare and education (the best among developing countries) low income inequality and relatively low crime and corruption. By 1965, Soviet life expectancy had increased to 70 years—only two years less than in the USA, even though per capita income was only 20-25 per cent of the US level.

Figure 2: GDP change in FSU economies



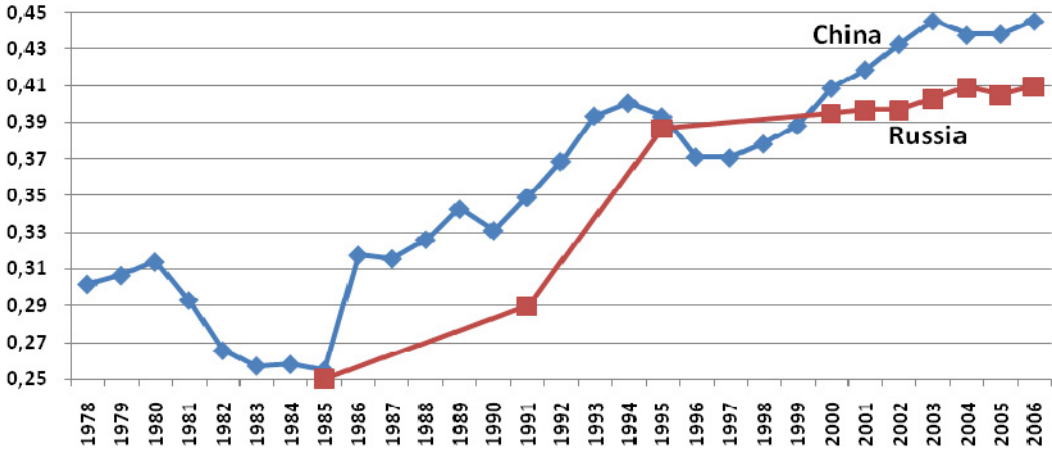
Note: 1989 = 100%.

Source: EBRD Transition Report (various).

The transition to a market economy in the 1990s brought about the dismantling of the Soviet state: the provision of all public goods, from healthcare to law and order, fell dramatically. The shadow economy, which the most generous estimates place at 10 per cent to 15 per cent of the GDP under Brezhnev, grew to 50 per cent of the GDP by the mid 1990s. In 1980-85, the Soviet Union was placed in the middle of a list of 54 countries rated according to their level of corruption, with a bureaucracy cleaner than that of Italy, Greece, Portugal, South Korea and practically all the developing countries.

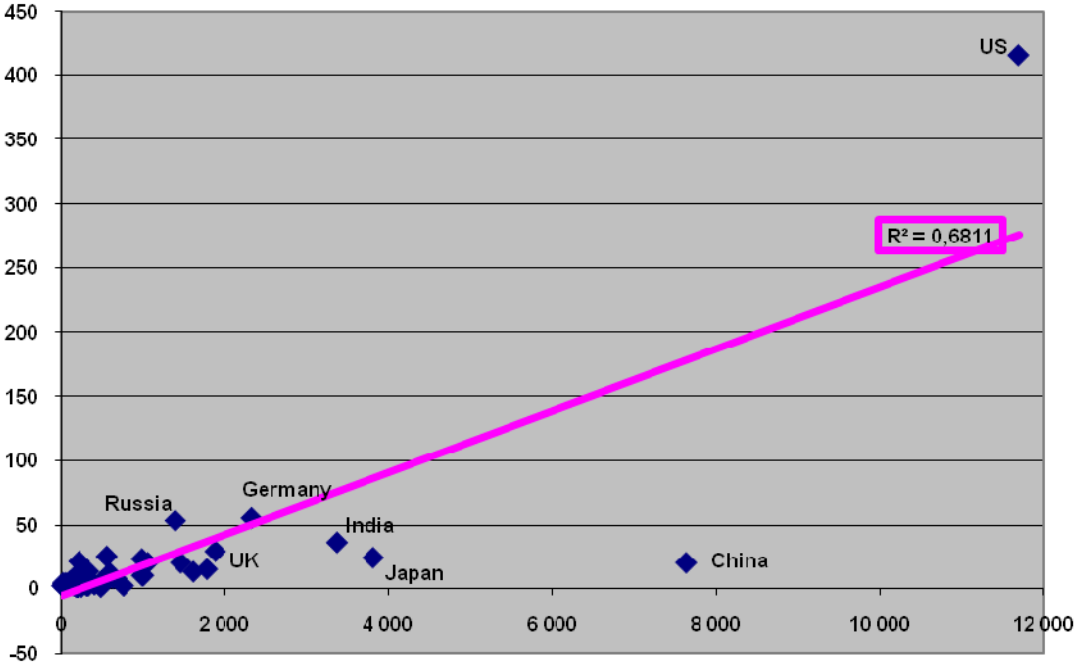
In 1996, after the establishment of a market economy and the victory of democracy, Russia came in 48th in the same 54-country list, between India and Venezuela.

Figure 3: Gini coefficient of income distribution in China and Russia, 1978-2006



Source: Chen et al. (2008); Goskomstat (various).

Figure 4: Number of billionaires in 2007 and PPP GDP in 2005 (billion US\$) by country



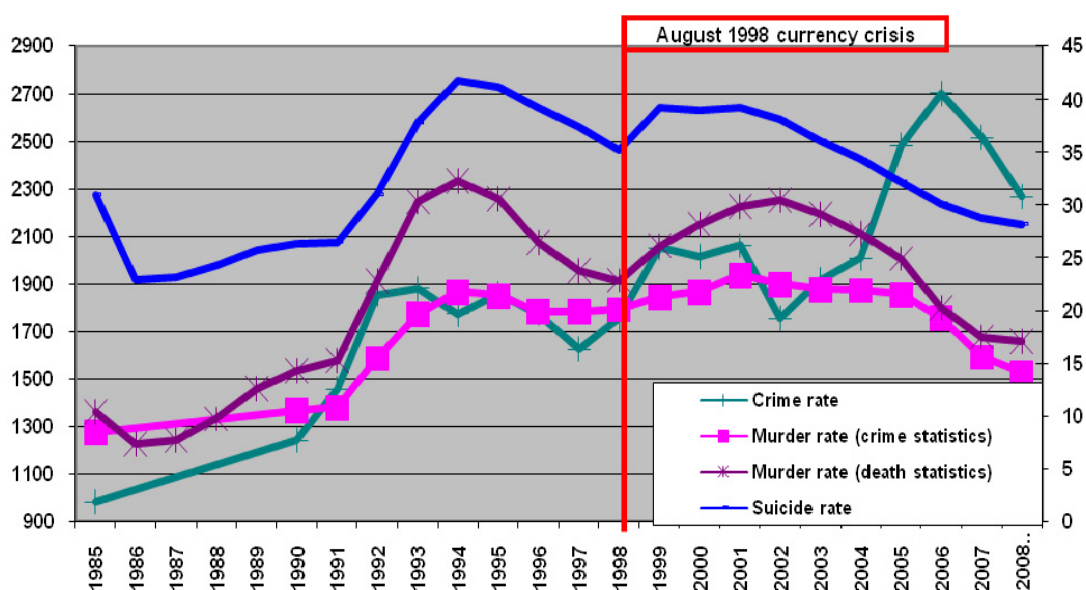
Source: Forbes, <http://www.forbes.com/forbes/2008/0324/080.html>

Income inequalities increased greatly: the Gini coefficient increased from 26 per cent in 1986 to 40 per cent in 2000, and then 42 per cent in 2007. The decile coefficient—the ratio of incomes of the wealthiest 10 per cent of the population to the incomes of the poorest 10 per cent—increased from 8 in 1992 to 14 in 2000, and then to 17 in 2007 (Figure 3). But the inequalities at the very top increased much faster. In 1995, there was no one in Russia worth over US\$1 billion; in 2007, according to *Forbes*, Russia had 53 billionaires (Figure 4), which propelled the country to second or third place in the world

in this regard after the USA (415) and Germany (55). Indeed, Russia had two fewer billionaires than Germany, but Russia's billionaires were worth a total of US\$282 billion (US\$37 billion more than Germany's richest). In 2008, right before the recession, the number of billionaires in Russia increased to 86, with a total worth of over US\$500 billion—a full one-third of national GDP. The Soviet Union was abnormal; there were no billionaires at all and there hardly were even dollar millionaires (perhaps only a dozen in the shadow economy).

Worst of all, the criminalization of the Russian society grew dramatically in the 1990s. Crime had been rising gradually in the Soviet Union since the mid 1960s, but after the collapse of the USSR there was an unprecedented surge—in just a few years in the early 1990s crime and murder rates doubled and reached one of the highest levels in the world (Figure 5). By the mid 1990s, the murder rate stood at over 30 people per 100,000 inhabitants against one to two persons in Western and Eastern Europe, Canada, China, Japan, Mauritius, and Israel. Only two countries in the world (not counting some war-torn, collapsed states in developing countries) had higher murder rates—South Africa and Colombia—whereas in countries like Brazil or Mexico this rate is two times lower. Even the US murder rate, the highest in developed world—six to seven people per 100,000 inhabitants—pales in comparison with the Russian one.

Figure 5: Crime rate (left scale), murder rate and suicide rate (right scale) per 100,000 inhabitants



Source: Goskomstat (various).

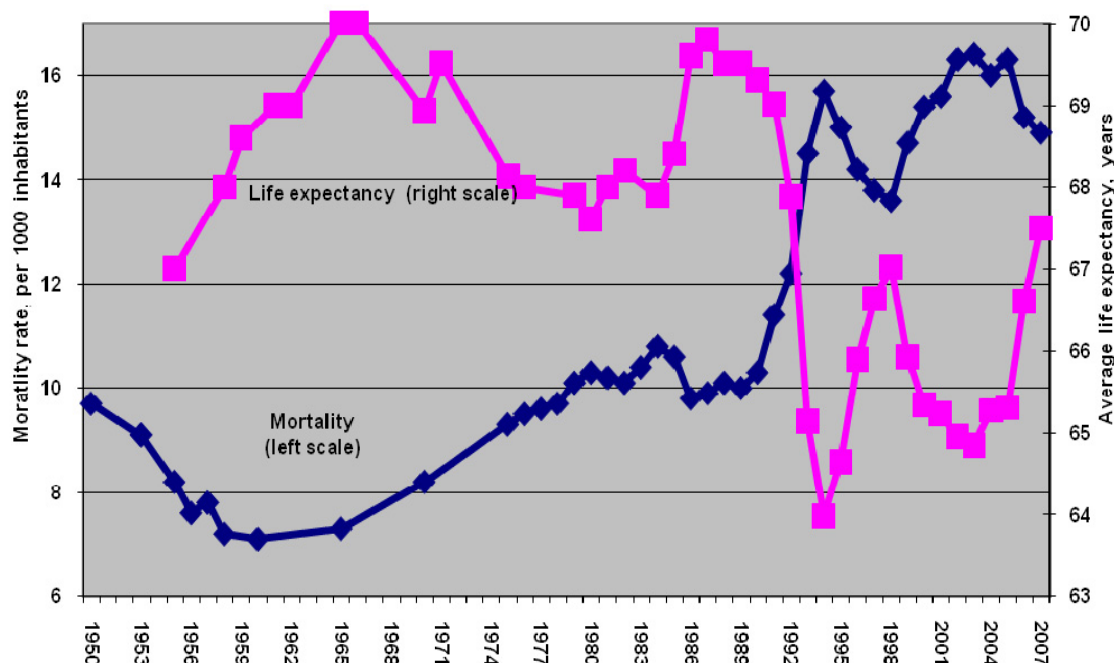
The Russian rate of deaths from external causes (accidents, murders, suicides) had, by the beginning of the twenty-first century, skyrocketed to 245 per 100,000 inhabitants. It was higher than in any of the 187 countries covered by WHO estimates in 2002; equivalent to 2.45 deaths per 1,000 a year, or 159 per 1,000 over 65 years, which was the average life expectancy in Russia in 2002. Put differently, if these rates were to continue to hold, one out of six Russians born in 2002 would have an 'unnatural' death. To be sure, in the 1980s, murder, suicide and accidental death rates were already quite high in Russia, Ukraine, Belarus, Latvia, Estonia, Moldova and Kazakhstan; several



times higher than in other former Soviet republics and in East European countries. However, they were roughly comparable to those of other countries with the same level of development. In the 1990s, these rates rapidly increased, far outstripping those in the rest of the world.

Mortality rate grew from 10 per 1,000 in 1990 to 16 per 1,000 in 1994, and stayed at a level of 14-16 per 1,000 thereafter (Figure 6). This was a true mortality crisis; a unique case in history where mortality rates increased by 60 per cent in just five years without any wars, epidemics, or catastrophic volcanic eruptions. Russia had never, in the post-war period, had mortality rates as high as those in the 1990s. Even in 1950-53, during the last years of the Stalin's regime, with the high death rates in the labour camps and the consequences of the wartime malnutrition and wounds, the mortality rate was only 9-10 per 1,000, as compared to 14-16 in 1994-2008.

Figure 6: Mortality rate (per 1,000, left scale) and average life expectancy (years, right scale)



Source:Goskomstat (various).

Russia became a typical ‘petrostate.’ Few specialists would call the USSR a resource-based economy, but Russia’s industrial structure changed considerably after the transition to the market. For all intents and purpose, the 1990s were the period of rapid deindustrialization and ‘resourcialization’ of the Russian economy, and the growth of world fuel prices since 1999 seems to have reinforced this trend. The share of output of the major resource industries (fuel, energy, metals) in total Russian industrial output increased from about 25 per cent to over 50 per cent by the mid 1990s and stayed at this high level thereafter. This was partly the result of changing price ratios (greater price increases in resource industries), but also due to the fact that the real growth rates of output were lower in the non-resource sector. The share of mineral products, metals and diamonds in Russian exports increased from 52 per cent in 1990 (USSR) to 67 per cent in 1995, and to 81 per cent in 2007, whereas the share of machinery and equipment in

exports fell from 18 per cent in 1990 (USSR) to 10 per cent in 1995, and then to below 6 per cent in 2007.

The share of spending in research and development was 3.5 per cent of GDP in the late 1980s in the USSR. It has fallen to 1.3 per cent in Russia today (compared with: China 1.3 per cent; USA, Korea, and Japan 2-3 per cent; Finland 4 per cent; Israel 5 per cent). So today's Russia really looks like a 'normal' resource-abundant developing country.

To understand Russia today, one has to evaluate the record of the last twenty years. In the late 1980s, during Gorbachev's perestroika, the Soviet Union was aspiring to join the club of rich democratic nations, but instead degraded in the next decade to a position of a normal developing country that is considered neither democratic nor capable of engineering a growth miracle. For some outsiders, a 'normal developing country' may look better than the ominous superpower posing a threat to Western values. But the insiders feel differently. Most Russians want to find a way to modernize the country so as to make it prosperous and democratic. However, they also feel that something went very wrong during the transition—the policies and political leaders of the 1990s are totally discredited.

To understand the popularity of Putin in 2000-08 and now of Putin-Medvedev in tandem, one has to bear in mind that Putin's policy is the de facto denial of across-the-board-liberalization policies of Yeltsin, his predecessor. It is in essence a modernization project intended to put a halt to the degradation of the 1990s. The actual achievements of 2000-08 may be modest, but they are real: nearly a decade of economic growth; increases in government revenues and spending, accumulation of foreign exchange reserves, decreases in mortality, murder, and suicide rates, preventing the disintegration of the country. When Putin was elected president for the first time in 2000, he received 53 per cent of the votes. In 2004 he was elected with 71 per cent of the votes, and over 60 per cent said they would vote for him in September 2007, never mind he was not going to run. Even in 2009, in the midst of economic recession, Putin-Medvedev policy was getting 50 per cent plus approval rate.

### **3 Short-term perspective: why Russia did worse than other post-communist economies during transition**

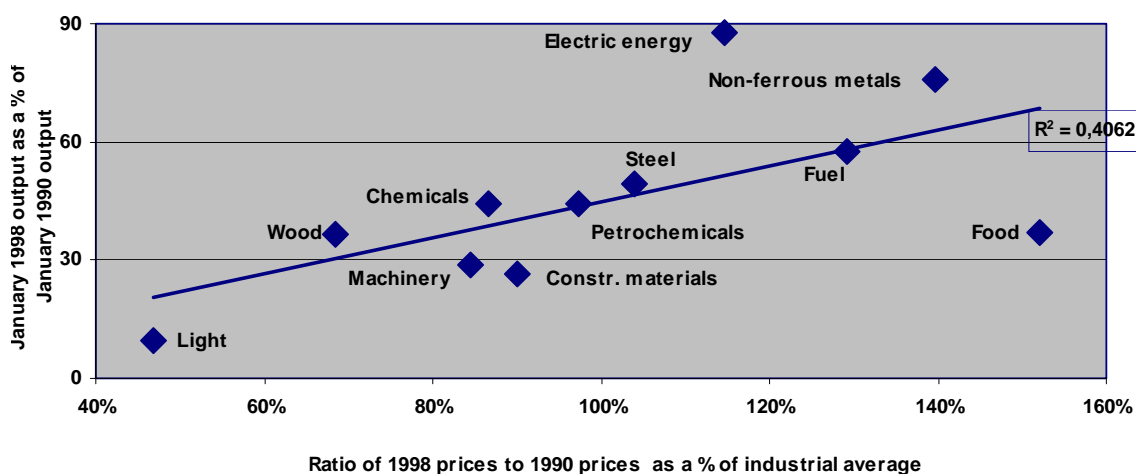
The debates of the 1990s juxtaposed shock therapy strategy to gradualism. The question of why Russia had to pay a greater price for economic transition was answered differently by those who advocated shock therapy and those who supported gradual piecemeal reforms. Shock therapists argued that much of the costs of the reforms should be attributed to inconsistencies of policies followed, namely to slow economic liberalization and to the inability of the governments and the central banks to fight inflation in the first half of the 1990s. On the contrary, the supporters of gradual transition stated exactly the opposite, blaming the attempt to introduce conventional shock therapy package for all the disasters and misfortunes.

In Popov (2000, 2007a) various explanations of the transformational recession are discussed and the alternative explanation is suggested—the collapse of output was caused primarily by several groups of factors. *First*, by greater distortions in the industrial structure and external trade patterns on the eve of the transition. *Second*, by

the collapse of state and non-state institutions which occurred in the late 1980s, early 1990s, and which resulted in chaotic transformation through crisis management instead of organized and manageable transition. And *third*, by poor economic policies, which basically consisted of bad macroeconomic policy and import substitution industrial policy. Finally, *fourth*, the speed of reforms (economic liberalization) affected performance negatively at the stage of the reduction of output because enterprises were forced to restructure faster than they possibly could (due to limited investment potential), but positively at the recovery stage.

(1) In the first approximation, economic recession that occurred in FSU states was associated with the need to reallocate resources in order to correct the inefficiencies in industrial structure inherited from centrally planned economy (CPE). These distortions included over-militarization and over-industrialization, perverted trade flows among former Soviet republics and Comecon countries, excessively large size and poor specialization of industrial enterprises and agricultural farms. In most cases these distortions were more pronounced in Russia than in Eastern Europe—not to speak of China and Vietnam—the larger the distortions, the greater was the reduction of output. The transformational recession, to put it in economic terms, was caused by adverse supply shock similar to the one experienced by Western countries after the oil price hikes in 1973 and 1979, and similar to post-war recessions caused by conversion of the defense industries.

Figure 7: Change in relative prices and output in 1990-98 in Russian industry



Source: Popov (2007a).

As Figure 7 shows, the reduction of output in Russia during the transformational recession was to a large extent structural in nature; industries with the greatest adverse supply shock (deteriorating terms of trade, relative price ratios for outputs and inputs), such as light industry, experienced the largest reduction of output. The evidence for all transition economies is in Table 1; the reduction of output by country is well explained by the indicator of distortions in industrial structure and trade patterns (it remains statistically significant no matter what control variables are added). The magnitude of distortions, in turn, determines the change in relative prices, when they are deregulated.

The nature of the recession was basically an adverse supply shock caused by the change in relative prices. There was a limit to the speed of reallocating capital from non-

competitive to competitive industries, which was determined basically by the net investment/GDP ratio (gross investment minus retirement of capital stock in the competitive industries, since in non-competitive industries the retiring capital stock should not be replaced anyway). It was not reasonable to wipe away output in non-competitive industries faster than capital was being transferred to more efficient industries. Market type reforms in many post-communist economies created exactly this kind of bottleneck. Countries that followed the shock therapy path found themselves in a supply-side recession that is likely to become a textbook example: an excessive speed of change in relative prices required the magnitude of restructuring that was simply non-achievable with the limited pool of investment. Up to half of their economies was made non-competitive overnight, output in these non-competitive industries was falling for several years and fell in some cases to virtually zero, whereas the growth of output in competitive industries was constrained, among other factors, by the limited investment potential and was not enough to compensate for the output loss in the inefficient sectors (Popov 2000, 2007a).

Hence, at least one general conclusion from the study of the experience of transition economies appears to be relevant for the reform process in all countries: provided that reforms create a need for restructuring (reallocation of resources), the *speed* of reforms should be such that the magnitude of required restructuring does not exceed the investment potential of the economy. In short, the speed of adjustment and restructuring in every economy is limited, if only due to the limited investment potential needed to reallocate capital stock. This is the main rationale for *gradual*, rather than instant, phasing out of tariff and non-tariff barriers, of subsidies and other forms of government support of particular sectors (it took nearly ten years for the European Economic Community or for NAFTA to abolish tariffs). This is a powerful argument against shock therapy, especially when reforms involved result in a sizable reallocation of resources. For Western countries with low trade barriers, low subsidies, low degree of price controls, etc., even fast, radical reforms are not likely to require restructuring that would exceed the limit of investment potential. But for less developed countries with a lot of distortions in their economies supported by explicit and implicit subsidies, fast removal of these subsidies could easily result in such a need for restructuring that is beyond the ability of the economy due to investment and other constraints. However, such a reduction of output due to the inability of the economy to adjust rapidly to new price ratios is by no means inevitable, if the deregulation of prices proceeds gradually (or if losses from deteriorating terms of trade for most affected industries are compensated by subsidies). The pace of liberalization has to be no faster than the ability of the economy to move resources from non-competitive (under the new market price ratios) to competitive industries. Therefore, it should be expected that there is a negative relationship between performance and the speed of liberalization. It should also be expected that the larger magnitude of distortions in industrial structure and trade patterns would lead to the greater reduction of output during the transformational recession, but would not have much of an impact on performance during the recovery stage (after the non-competitive sector would be shut down completely).

(2) The additional reason for the extreme depth of the transformational recession was associated with the institutional collapse; here differences between EE countries and FSU are striking. The adverse supply shock in this case came from the inability of the state to perform its traditional functions—to collect taxes and to constrain the shadow economy, to ensure property and contract rights, and law and order in general.

Naturally, poor ability to enforce rules and regulations did not create a business climate conducive to growth and resulted in the increased costs for companies.

The measure of the institutional strength is the dynamics of the government expenditure during transition. This factor seems to have been far more important than the speed of reforms. In Kolodko's (2004: 259) words 'there can be no doubt that *during the early transition there was a causal relationship between the rapid shrinkage in the size of government and the significant fall in output*'. Keeping the government big does not guarantee favorable dynamics of output, since government spending has to be efficient as well. However, the sharp decline in government spending, especially for the 'ordinary government', is a sure recipe to ensure the collapse of institutions and the fall in output accompanied by the growing social inequalities and populist policies.

When real government expenditure falls by 50 per cent and more—as it happened in most CIS and South East European states in the short period of time under discussion—there is practically no chance to compensate the decrease in the volume of financing by the increased efficiency of institutions. As a result, the ability of the state to enforce contracts and property rights, to fight criminalization, and to ensure law and order in general, falls dramatically (Popov 2009a). Thus, the story of the successes and failures of transition is not really the story of consistent shock therapy and inconsistent gradualism. The major plot of the post-socialist transformation 'novel' is the preservation of strong institutions in some countries (from Central Europe and Estonia to China, Uzbekistan, and Belarus)<sup>2</sup> and the collapse of these institutions in others. At least 90 per cent of this story is about the government failure (strength of state institutions), not about the market failure (liberalization).

It is precisely this strong institutional framework that should be held responsible for both—for the success of gradual reforms in China and shock therapy in Vietnam, where strong authoritarian regimes were preserved and CPE institutions were not dismantled before new market institutions were created; and for the relative success of radical reforms in EE countries, especially in Central European countries, where strong democratic regimes and new market institutions emerged quickly. And it is precisely the collapse of the strong state and institutions which began with the USSR in the late 1980s and continued in the successor states in the 1990s that explains the extreme length, if not the extreme depth, of the FSU transformational recession.

To put it differently, Gorbachev reforms of 1985-91 failed not because they were gradual, but due to the weakening of the state institutional capacity leading to the inability of the government to control the flow of events. Similarly, Yeltsin reforms in Russia, as well as economic reforms in most other FSU states, were so costly, not because of the shock therapy, but due to the collapse of the institutions needed to enforce law and order and carry out manageable transition. It turns out that the FSU transition model (with partial exemption of Uzbekistan, Belarus and Estonia) is based

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<sup>2</sup> Countries like Belarus and Uzbekistan fall into the same group with Central European countries and Estonia—with small reduction of state expenditure as a % of GDP during transition, good quality of governance, little bribery, a small shadow economy, and low state capture index (Hellman et al. 2000). In 2005, Belarus and the Slovak Republic were the only two countries out of 25 surveyed in EE and FSU (BEEPS, Business Environment and Economic Performance Survey) where significant improvement was registered in 2002-05 in all seven areas of economic governance (judiciary, fighting crime and corruption, customs and trade, business licensing and permits, labour regulations, tax administration); EBRD (2005).

on a most unfortunate combination of unfavorable initial conditions, institutional degradation, and inefficient economic policies, such as macroeconomic populism and import substitution.

What led to the institutional collapse and could it have been prevented? Using the terminology of political science, it is appropriate to distinguish between strong authoritarian regimes (China and Vietnam, and to an extent, Belarus and Uzbekistan), strong democratic regimes (Central European countries) and weak democratic regimes (most FSU and Balkan states). The former two are politically liberal or liberalizing—i.e., protect individual rights, including those of property and contracts, and create a framework of law and administration—while the latter regimes, though democratic, are politically not so liberal since they lack strong institutions and the ability to enforce law and order (Zakaria 1997). This gives rise to the phenomenon of ‘illiberal democracies’, countries where competitive elections are introduced before the rule of law is established. While East European countries and East Asian countries recently moved from first establishing the rule of law to gradually introducing democratic elections (Hong Kong is the most obvious example of the rule of law without democracy), in Latin America, Africa, and CIS countries, democratic political systems were introduced into societies without the firm rule of law.

Authoritarian regimes (including communist ones), while gradually building property rights and institutions, were filling the vacuum in the rule of law via authoritarian means. After democratization occurred and illiberal democracies emerged, they found themselves deprived of old authoritarian instruments to ensure law and order, but without the newly developed democratic mechanisms needed to guarantee property rights, contracts and law and order in general. No surprise that this had a devastating impact on the investment climate and output. There is a clear relationship between the ratio of rule of law index on the eve of transition to democratization index, on the one hand, and economic performance during transition, on the other. To put it differently, democratization without strong rule of law, whether one likes it or not, usually leads to the collapse of output. There is a price to pay for early democratization; i.e., the introduction of competitive elections of government under conditions when major liberal rights (personal freedom and safety, property, contracts, fair trial in court, etc.) are not well established.

(3) Finally, performance was of course affected by economic policy. Given the weak institutional capacity of the state—i.e., its poor ability to enforce its own regulations—economic policies could hardly be ‘good’. Weak state institutions usually imply populist macroeconomic policies (budget deficits resulting in high indebtedness and/or inflation, overvalued exchange rates), which have devastating impact on output. On the other hand, strong institutional capacity does not lead automatically to responsible economic policies. Examples range from the USSR before it collapsed (periodic outburst of open or hidden inflation) to such post-Soviet states as Uzbekistan and Belarus, which seem to have stronger institutional potential than other FSU states, but do not demonstrate higher macroeconomic stability.

Regressions tracing the impact of all mentioned factors are reported in Table 1 (Popov 2000). Eighty to 90 per cent of the variations in the dynamics of GDP in 1989-96 could be explained by the initial conditions (distortions and initial GDP per capita), institutional capacity of the state (decline in government revenues and rule of law and

democracy indices), and macroeconomic stability (inflation). If the rule of law and democracy indices are included into the basic regression equation, they have predicted signs (positive impact of the rule of law and negative impact of democracy) and are statistically significant (equation 1), which is consistent with the results obtained for larger sample of countries.<sup>3</sup> The best explanatory power, however, is exhibited by the index that is computed as the ratio of the rule of law index to democracy index: 83 per cent of all variations in output can be explained by only three factors: pre-transition distortions, inflation, and rule-of-law-to-democracy index (Table 1, equation 2). If a liberalization variable is added, it turns out to be statistically insignificant and does not improve the goodness of fit (equation 3). At the same time, the ratio of the rule of law to democracy index and the decline in government revenues are not substitutes, but rather complement each other in characterizing the process of the institutional decay. These two variables are not correlated and improve the goodness of fit when included together in the same regression:  $R^2$  increases to 91 per cent (equation 5); a better result than in regressions with either one of these variables. The liberalization index, when added to the same equation, is not statistically significant and has the ‘wrong’ sign.

To test the robustness of the results, another year, 1998, for the end of the transformational recession was chosen so the period considered was 1989-98 (by the end of 1998 the absolute trough was reached in 24 out of 26 countries that experienced the recession). The adjusted  $R^2$  is slightly lower, but the statistical significance of coefficients remains high (with the exception of the initial GDP per capita). The best equation is shown below:

$$\text{Log}(Y_{98/89}) = 5.8 - .006\text{DIST} - 0.005\text{Ycap87} - 0.39\text{WAR} - 0.01\text{GOVREVdecline} - 0.17\text{logINFL} - .003\text{DEM}$$

$$(-2.48) \quad (-0.09) \quad (-3.22) \quad (-2.94) \quad (-4.60) \quad (-1.74)$$

N = 28, adjusted  $R^2$  = 82%, T-statistics in brackets, all variables are shown in the same order as in equation 7 from Table 1 (liberalization variable is omitted).

Once again, if liberalization variable is introduced in this equation, it turns out to be insignificant.

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<sup>3</sup> For a larger sample of countries (all developing and developed countries, not only transition economies), the result is that there is a threshold level of the rule of law index: if it is higher than a certain level, democratization affects growth positively; if lower, democratization impedes growth (Polterovich and Popov 2007). For the regressions reported in Table 1 (to explain changes in output in 1989-96) averages of rule of law and democracy indices were used for the longer period (1989-98) to account for the fact that business agents often anticipate changes in business climate that are captured in experts’ estimates only later.

Table 1: Regression of change in GDP in 1989-96 on initial conditions, policy factors, rule of law and democracy indices (robust estimates)

Equations, number of observations/variables	1, N=28	2, N=28	3, N=28	4, N=28	5, N=28	6, N=28	7, N=28
Constant	5.3***	5.4***	5.2***	5.4***	5.4***	5.5***	5.7***
Distortions, % of GDP <sup>a</sup>	-0.005**	-0.005**	-0.003	-0.006**	-0.007***	-0.007***	-0.007***
1987 PPP GDP per capita, % of the US level	-0.009**	-0.006*	-0.007**	-0.007**	-0.009***	-0.008***	-0.008***
War dummy <sup>b</sup>				-0.19 <sup>c</sup>	-0.36***	-0.37***	-0.45***
Decline in government revenues as a % of GDP from 1989-91 to 1993-96					-0.011***	-0.011***	-0.011***
Liberalization index			0.05			-0.02	0.03
Log (inflation, % a year, 1990-95, geometric average)	-0.16***	-0.20***	-0.18***	-0.17***	-0.13***	-0.13***	-0.14***
Rule of law index, average for 1989-97, %	0.008***						
Democracy index, average for 1990-98, %	-0.005***						-0.003**
Ratio of the rule of law to democracy index		0.07***	0.07***	0.06***	0.05***	0.05***	
Adjusted R <sup>2</sup> %	82	83	83	85	91	91	90

Note: \*, \*\*, \*\*\* significant at 10, 5 and 1% levels, respectively. <sup>a</sup>Cumulative measure of distortions as a % of GDP equal to the sum of defense expenditure (minus 3% regarded as the 'normal' level), deviations in industrial structure and trade openness from the 'normal' level, the share of heavily distorted trade (among the FSU republics) and lightly distorted trade (with socialist countries) taken with a 33% weight; see Popov (2000) for details. <sup>b</sup>equals 1 for Armenia, Azerbaijan, Croatia, Georgia, Macedonia, and Tajikistan, and 0 for all other countries. <sup>c</sup>significant at 13% level. Dependent variable = log (1996 GDP as a % of 1989 GDP). For China, all indicators are for the period of 1979-86 or similar.

Source: Popov (2000).



(4) Finally, to deal with the endogeneity problem (liberalization affects performance, but is also affected by performance; if output falls, liberalization very likely would be halted) the liberalization variable was instrumented with the democracy level variable (Popov 2007a). The results are in Table 2; the main difference from Table 1 is that liberalization now affects performance significantly and negatively.

Table 2: 2SLS robust estimates: regression of change in GDP in 1989-96 on initial conditions, institutional capacity, liberalization, rule of law and democracy indices (liberalization index instrumented with the democracy level variable)

Equations, number of observations/variables	1, N=28	2, N=28	3, N=17	4, N=17
Constant	6.4***	6.3***	6.0***	6.0***
Pre-transition distortions, % of GDP	-0.01***	-0.02***		-0.004
1987 PPP GDP per capita, % of the US level	-0.007**	-0.01***		
War dummy <sup>a</sup>	-0.45***	-0.29 <sup>b</sup>		
Liberalization index in 1995	-0.18**	-0.39*	-0.19***	-0.19***
Decline in government revenues as a % of GDP from 1989-91 to 1993-96	-0.02***	-0.02***		
Log (inflation, % a year, 1990-95, geometric average)	-1.7***	-0.22***	-0.22***	-0.19***
Rule of law index, average for 1989-97, %		-0.01 <sup>c</sup>		
Increase in the share of shadow economy in GDP in 1989-94, pp			-0.02***	-0.015***
R <sup>2</sup> %	86	77	88	90

Note: \*, \*\*, \*\*\* significant at 1, 5, and 10% levels, respectively. <sup>a</sup>equals 1 for Armenia, Azerbaijan, Croatia, Georgia, Macedonia, and Tajikistan and 0 for all other countries. <sup>b</sup>significant at 12% level. <sup>c</sup>significant at 16% level. Dependent variable = Log (1996 GDP as a % of 1989 GDP). For China, all indicators are for the period of 1979-86 or similar.

As argued in Popov (2007a), at the recovery stage (1998-2005), the impact of distortions on performance disappears but the influence of institutions persists, and the impact of the speed of liberalization (increment increase in liberalization index) becomes positive and significant. This is very much in line with the intuition; after the non-competitive sector is eradicated at the stage of transformation recession further liberalization (which inevitably becomes gradual at this point) cannot do much harm, whereas institutional capacity always affects growth.

We end up with the scheme that summarizes factors affecting performance during transition (scheme 1). The FSU in general (there are some exceptions), and Russia in particular, had poor initial conditions—allocation of resources by industries and regions under central planning was very different from market type so when prices were deregulated, and allowed to govern the allocation of capital and labour, sizeable restructuring occurred leading to a recession. To add insult to injury, there was dramatic decline in institutional capacity of the state.

Scheme 1: Initial conditions (distortions) and institutions: classification of countries

Institutional capacity \ Distortions	Low	High
	High	China, Vietnam
Low	Albania, Mongolia	FSU

#### 4 The mystery of the genesis of institutions

The scheme leaves us with a frustrating conclusion that the bulk of the recession of the 1990s was inevitable (initial conditions and institutions are exogenous, given by preceding developments) and economic policy (fast liberalization at early stages of development and poor macroeconomic policy) more often than not aggravated the recession. Besides, today, after the transformational recession, the prospects for the future seem to depend mostly on institutional capacity, which is the binding constraint for growth. With respect to distortions, gradual liberalization should have allowed avoiding the collapse of output. But would it have been possible to preserve strong institutions, as happened in EE and in China?

Manufacturing growth is like cooking a good dish—all the ingredients need to be in the right proportions; if only one is under- or over-represented, the ‘chemistry of growth’ will not happen. Fast economic growth can materialize in practice only if several necessary conditions are met simultaneously. In particular, rapid growth requires a number of crucial inputs: infrastructure, human capital, even land distribution in agrarian countries, strong state institutions, economic stimuli, among other things. Once one of these crucial necessary ingredients is missing, the growth just does not take off. Rodrik et al. (2005) talk about ‘binding constraints’ that hold back economic growth; finding these constraints is the task of ‘growth diagnostics’. In some cases, these constraints are associated with the lack of market liberalization; in others, with the lack of state capacity or human capital or infrastructure.

By the end of the 1970s, China had virtually everything that was needed for growth except liberalization of some markets (a much more easily introduced ingredient than human capital or institutional capacity). But even this seemingly simple task (economic liberalization) required careful management. The USSR was in a similar position in the late 1980s. True, the Soviet system lost its economic and social dynamism, the growth rates in the 1960s-80s were falling, life expectancy was not rising, and crime rates were slowly growing, but institutions were generally strong, human capital was large, which provided good starting conditions for reform. Nevertheless, economic liberalization in China (since 1979) and in the USSR, and later Russia (since 1989), produced markedly different outcomes (Popov 2000, 2007a).

Why did economic liberalization work in Central Europe, but did not work in SSA and LA? The answer, according to the outlined approach, would be that in Central Europe the missing ingredient was economic liberalization, whereas in SSA and LA there was a lack of state capacity, not the lack of market liberalization. Why did liberalization work

in China and Central Europe but not work in the CIS? Because in the CIS it was carried out in such a way as to undermine state capacity—the precious heritage of socialist past—whereas in Central Europe, and even more so in China, the state capacity did not decline substantially during transition. The trick of transition, as is evident post factum, was not to carry out economic liberalization but to carry it out in such a way as to not throw the baby away with the bathwater—not to squander the precious achievements of the previous communist period in the form of strong institutions. China generally did not squander this heritage, even though government spending fell, income inequalities rose and crime rates increased, whereas Russia and most other CIS states did.

Here lies the crucial question: how did some former communist countries retain their strong institutions during reforms, whereas in other countries institutional capacity, even if previously high, deteriorated? Why EE and China managed to preserve relatively strong institutions during economic liberalization, whereas in Russia state institutions collapsed? Part of the answer is the impact of democratization on the quality of institutions. As argued in previous papers (Polterovich and Popov 2007; Polterovich et al. 2007, 2008; Zakaria 1997), democratization carried out in a poor rule of law environment (weak state institutions) is associated with further weakening of institutions and with worsening of macroeconomic policy which has a negative impact on growth and does not allow for the creation of a stable democratic regime, especially in resource rich countries.<sup>4</sup>

This is only part of the answer, however, because there are few examples of fast catch-up development under democratic regimes (Japan after the Second World War, Botswana and Mauritius after gaining independence in the 1960s). Besides, democracy is an institution by itself, and it remains to be explained why some countries adopted it at earlier stages of development whereas other countries stayed authoritarian, or returned to authoritarianism, after short-lived experiments with democracy. And finally, differences in the institutional capacity of the state in countries with authoritarian regimes (say China, USSR, Russia) are huge and need to be explained.

In an important paper by Acemoglu et al. (2001) the authors used an astute indicator for instrumenting the institutions variable; mortality rate among settlers in the colonies of major European states in the nineteenth century. The argument was that, if these mortality rates were very high (Gambia, Mali, Nigeria had mortality rates hundreds times higher than Australia, Bahamas, Canada, Hong Kong, New Zealand, USA), the settlers did not bother to set up good institutions in those countries. It was also claimed that the local population was largely immune to the diseases that were life-threatening for the newcomers, so the settlers' mortality rate did not affect economic growth

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<sup>4</sup> When growth of GDP per capita in 1975-99,  $y$ , is regressed on usual control variables (initial income levels, population growth rates, population density, investment/GDP ratios) and various indicators of institutional quality (share of shadow economy, WB indices of rule of law, government effectiveness, etc., corruption perception indices from Transparency International, investment risk indices) and democratization (increase in democratic ratings from Freedom House), the best result is usually the threshold equation, like the one below:

$$y = \text{CONST.} + \text{CONTR.VAR.} + 0.18\Delta(\mathbf{RL} - 0.72),$$

where  $\Delta$  – democratization (change in index of political rights in 1970-2000),  $\mathbf{RL}$  – rule of law index (one of the indicators of the institutional capacity).

directly, but only via its impact on institutions. That is why this indicator can be used to resolve the endogeneity problem (institutions => growth => institutions) and to properly estimate the impact of institutions on growth. The authors concluded that, after controlling for the impact of institutions, the geographical location does not really have an impact on growth.

An opposite view is advocated by Rodrik et al. (2002) in the article with a self explanatory title 'Institutions Rule'. The authors examine the impact of three basic growth factors: geography (proxied by the distance to the equator and regional dummies); trade openness (the share of trade in GDP); and institutions. The difficulty, of course, is that all three factors are inter-linked and that institutions and trade openness not only influence growth, but depend on growth themselves. To estimate properly the contribution of each factor, they instrument institutions with the settlers' mortality rate, like Acemoglu et al. (2001), and instrument the share of trade in GDP with the predicted share of trade (from gravity models). Then, after giving a 'fair chance' to geographical variable to compete with the instrumented variables of institutions and trade openness, they conclude that 'institutions rule', i.e. the impact of the institutions is most crucial. Institutions are largely, but not totally, determined by geography, and in turn they determine the trade openness and growth. The direct impact of geography on growth (apart from the impact through institutions) turns out to be insignificant.

The difference with the straightforward geographical determinism approach is thus obvious, but there is an important difference with the Acemoglu et al. (2001) approach as well. Rodrik et al. (2002) believe that geography, in particular settlers' mortality rates, is a good predictor of institutional quality but not the major cause of it. The genesis of institutions is a complex process with many determinants and finding an appropriate econometric instrument is not the same as finding the proper explanation. Rodrik (2004) explains the difference with the following example: the variation in GDP per capita in countries that were never colonies is no less substantial than among colonized countries; here Ethiopia and Afghanistan are at the one end of the spectrum and Japan at the other end, with Turkey and Thailand lying somewhere in between. What accounts for the different quality of the institutions in this non-colonized part of the world?

## **5 Long-term perspective: institutional continuity versus transplantation of foreign institution**

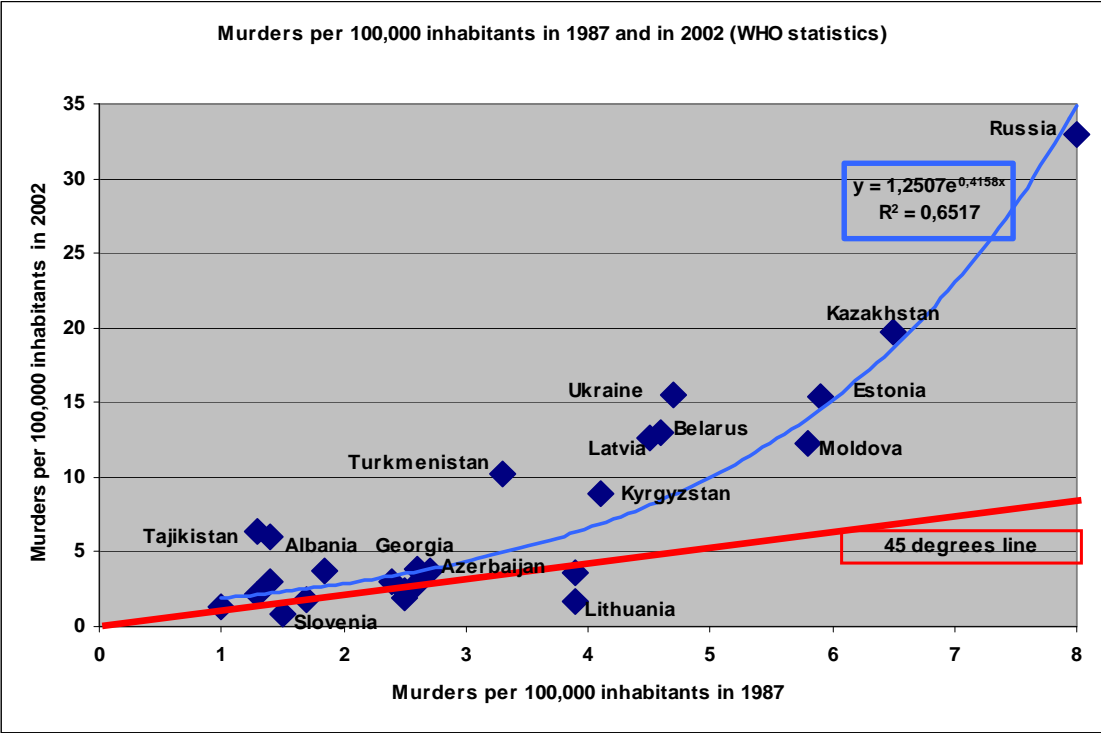
A different interpretation of the genesis of the institutions in colonized and non-colonized countries is the continuity perspective (Popov 2009b). All countries had traditional community structures in the past; everywhere before Reformation, under the Malthusian growth regime, the law of the land was what we now call 'Asian values'—the superiority of the interests of the community over the interests of the individuals.

Colonization of sub-Saharan Africa, South America, and to a lesser extent South Asia, led to complete or near complete destruction of traditional (community) structures that were only partially replaced by the new Western-style institutions. Among large geographical regions, only East Asia, MENA, and to an extent South Asia, managed to retain traditional community institutions despite colonialism. It could be hypothesized

that those countries and regions that preserved traditional institutions in difficult times of colonialism and imposition of Western values retained a better chance for the catch-up development than the less fortunate regions of the world periphery, where the continuity of the traditional structures was interrupted. Transplantation of institutions is a tricky business that works well only when tailored to the local traditions, so that it does not interrupt the institutional continuity (Polterovich 2001). Otherwise it leads either to complete elimination of the local structures (USA, Canada, Australia) or to non-viable mixture of old and new institutions that is not very conducive to growth (SSA, LA).

If institutional capacity of the state is defined as the ability of the government to enforce rules and regulations, one of the natural measurement indicators is the murder rate. Crimes are registered differently in different countries; higher crime rates in developed countries seem to be the result of better registration of crimes. But grave crimes, like murders, appear to be registered pretty accurately even in developing countries, so international comparison of the murder rates is well warranted.

Figure 8: Murder rate before and after transition in EE countries and FSU



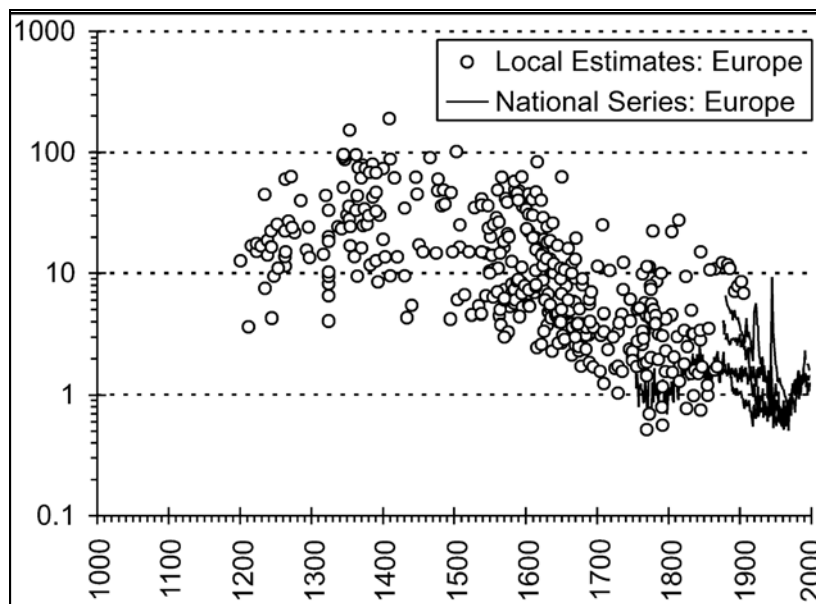
Source: WHO (2004).

Among countries in transition Russia experienced the greatest increase in the murder rate; it quadrupled during 1987-2002, increasing from 8 to 33 per 100,000 inhabitants (Figure 8). In East European countries and most FSU states, the increases were much less pronounced. China during 1979-2009 also managed to better preserve the strong state institutions; the murder rate in China is still below 3 per 100,000 inhabitants as compared to about 30 in Russia in 2002 and about 20 in 2008 (Popov 2007d). The national statistics on murders under Mao regime is not available, but there is data for some provinces. In the 1970s the murder rate in the Shandong province was less than 1 (Shandong 2009), and in 1987 it was estimated at 1.5 for the whole of China (WHO

2004). A two-to-threefold increase in the murder rate during the market reforms is comparable with the Russian increase, but the Chinese levels are nowhere near the Russian levels.

It took Western countries 500 years to bring the murder rates from about a hundred to just a few (1 to 3) per 100,000 inhabitants (Figure 9). Even in the seventeenth century the murder rates in Western Europe were generally exceeding 10 per 100,000 of inhabitants—more than in many developing countries with similar levels of GDP per capita today. In fact among developing countries today we find two major patterns: low murder rates (1-3 per 100,000 inhabitants) in Eastern Europe, China and MENA countries (Figure 10), and high murder rates (15-75 murders per 100,000 inhabitants) in FSU, Latin America, and sub-Saharan Africa (Figure 11). India (5.5), South East Asian countries (about 10, with the exception of Philippines where the rate is 21) fall in between the two groups. The argument is that countries that preserved collectivist institutions (East Asia, MENA countries, India) were able to retain institutional capacity of the state, whereas countries that eliminated these institutions while only partly replacing them with individual responsibility system (FSU, Latin America, and sub-Saharan Africa) paid a high price in terms of diminished institutional capacity. Eastern Europe (with the exception of FSU states) could be the exception that proves the rule; it went through a period of low institutional capacity with high murder rates as did Western Europe between the fifteenth and seventeenth centuries—although direct evidence here is lacking, all observations for Figure 9 are from Western Europe (England, Belgium, Netherlands, Scandinavia, Italy).<sup>5</sup>

Figure 9: Long-term homicide rates in Europe per 100,000 inhabitants<sup>6</sup>

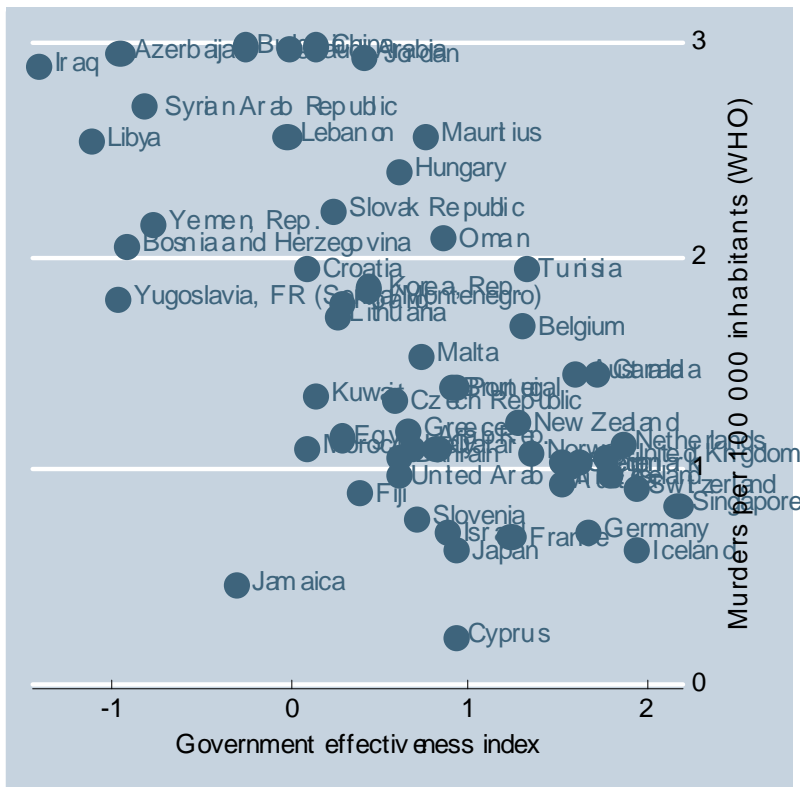


Source: Eisner (2003).

<sup>5</sup> Another anecdotal evidence of the strength of the collective institutions in East Asia, South Asia, MENA countries is the virtual absence of urban slums (Pomeranz 2008) and homeless children, which are found in abundance in LA, SSA, and FSU.

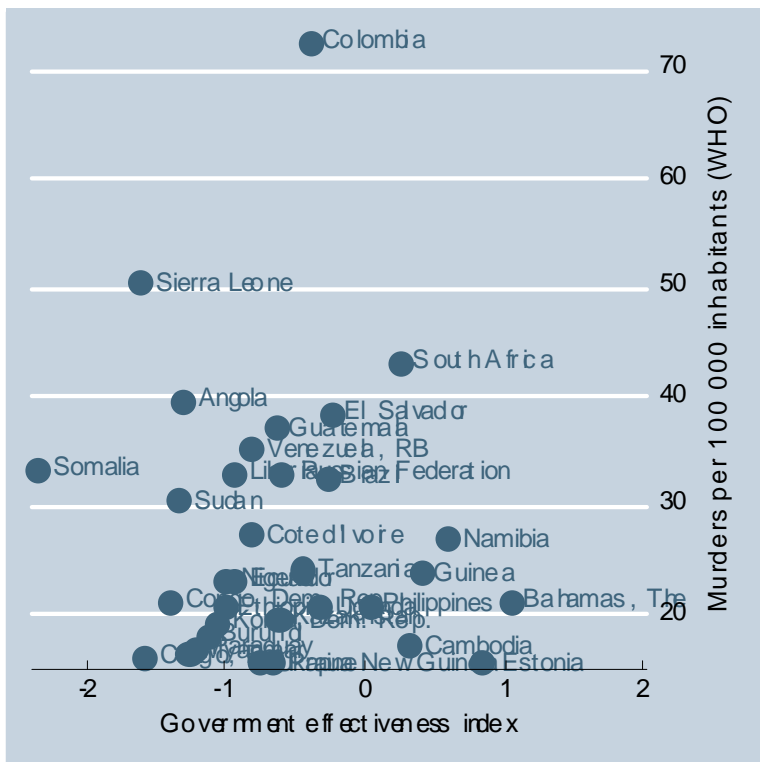
<sup>6</sup> Overall trend in homicide rates, all pre-modern local estimates and four national series. Note: All 398 local estimates from the History of Homicide Database; national series for Sweden, England and Wales, Switzerland, and Italy.

Figure 10: Murders per 100,000 inhabitants and government effectiveness index in 2002: countries with 1 to 3 murders per 100,000 inhabitants



Source: WDI (2005); WHO (2004).

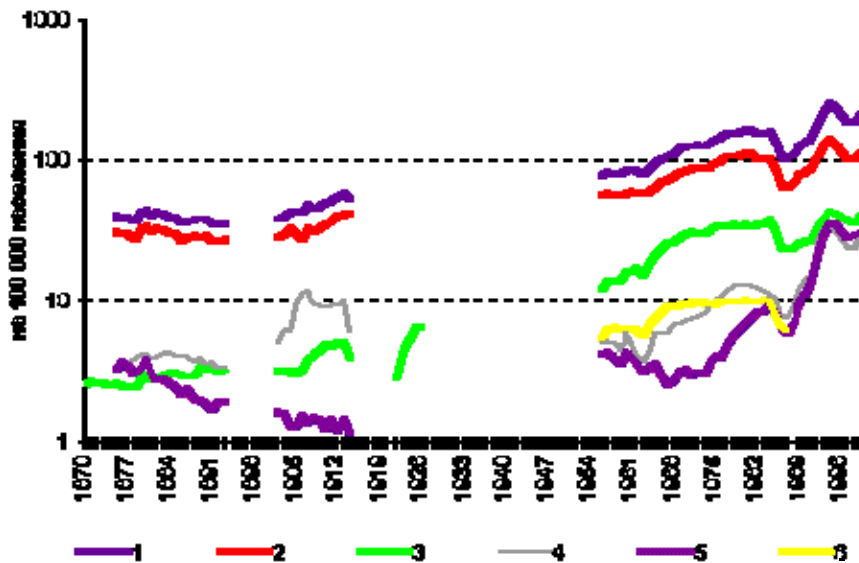
Figure 11: Murders per 100,000 inhabitants and government effectiveness index in 2002: countries with 15 to 75 murders per 100,000 inhabitants



Source: WDI (2005); WHO (2004).

By European standards at the time, Russia had a very high murder rate (up to 10 and over per 100,000 inhabitants) in the beginning of the twentieth century, before first (1905-07) and second (1917) Russian revolutions (Figure 12). By the 1960s, it was down to 5-7 murders per 100,000 of inhabitants, even though mortality from other external causes increased markedly. By the mid 1960s, however, it was on the rise, approaching early twentieth century levels by the mid 1980s at about 10 murders per 100,000 inhabitants (Figure 13).

Figure 12: Death rate from external causes (per 100,000 of inhabitants): Russian Empire, RSFSR, RF, 1870-2000 (log scale)



Note: 1=all external causes; 2=accidents; 3=suicides; 4=murders; 5=unknown; 6=work-related accidents.

Source: Bogoyavlensky (2001).

Another evidence of the cost of breakdown in institutional continuity comes from data on income inequality in pre-modern societies. The destruction of communal, collectivist institutions that was first carried out in Western countries during the sixteenth to nineteenth centuries was accompanied by the increase in income inequalities. The available data (Milanovic et al. 2007) suggest that in England, Holland and Spain in the eighteenth century the Gini coefficient of income distribution was at a level of 50 and even 60 per cent (Figure 14)<sup>7</sup>—an extremely high level according to today’s standards and, most probably, according to the standards of the distant past (about 40 per cent in Rome in the first century and in Byzantine in the eleventh century; Figure 14).<sup>8</sup>

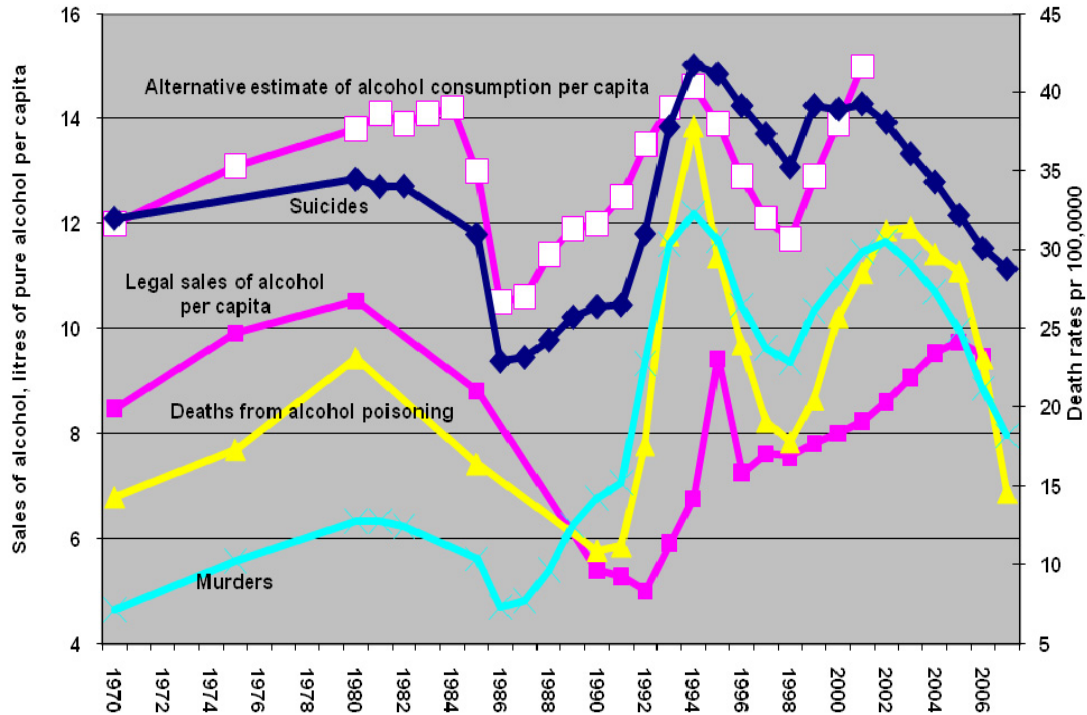
<sup>7</sup> In England and Wales the Gini coefficient increased from 46 per cent in 1688 to 53 per cent in the 1860s (Saito 2009).

<sup>8</sup> Very high income inequalities in low-income countries mean that a lot of people find themselves in extreme poverty, below subsistence level, which leads to high mortality.



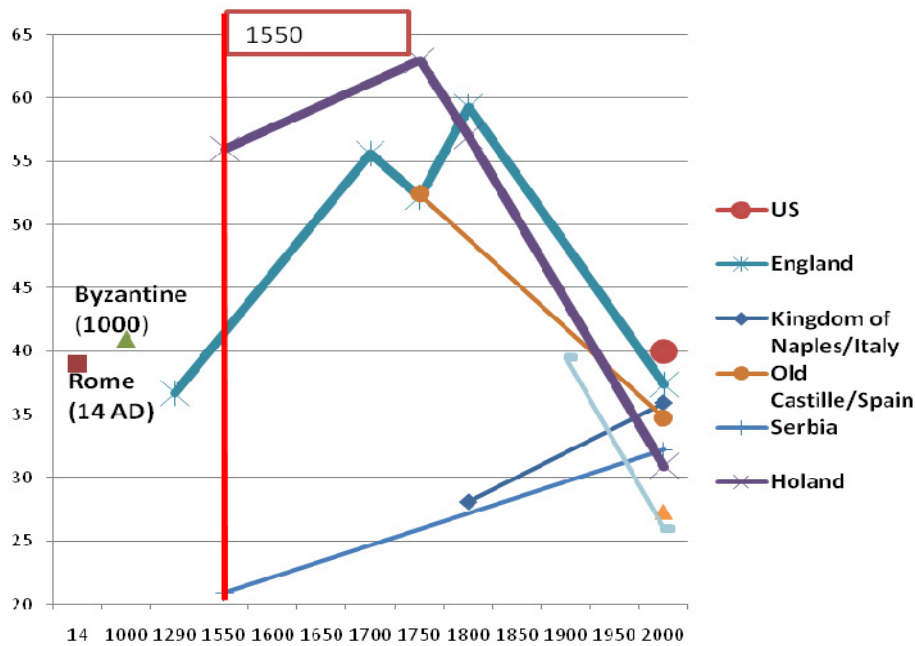
Figure 13: Murders, suicides, deaths from alcohol poisoning and consumption of alcohol in Russia in 1970-2007

Fig. Sales of alcohol, litres of pure alcohol per capita (left scale), death rates per 100,000 from alcohol poisoning, murders and suicides (right scale)



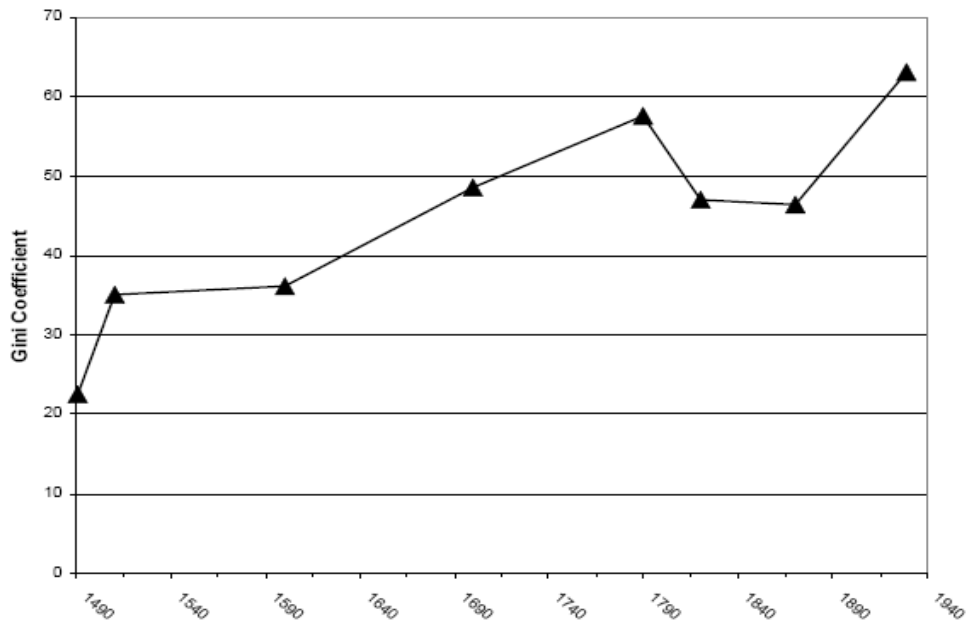
Source: Goskomstat (various years); Nemtsov (2006).

Figure 14: Gini coefficient in developed countries, 1550-2000



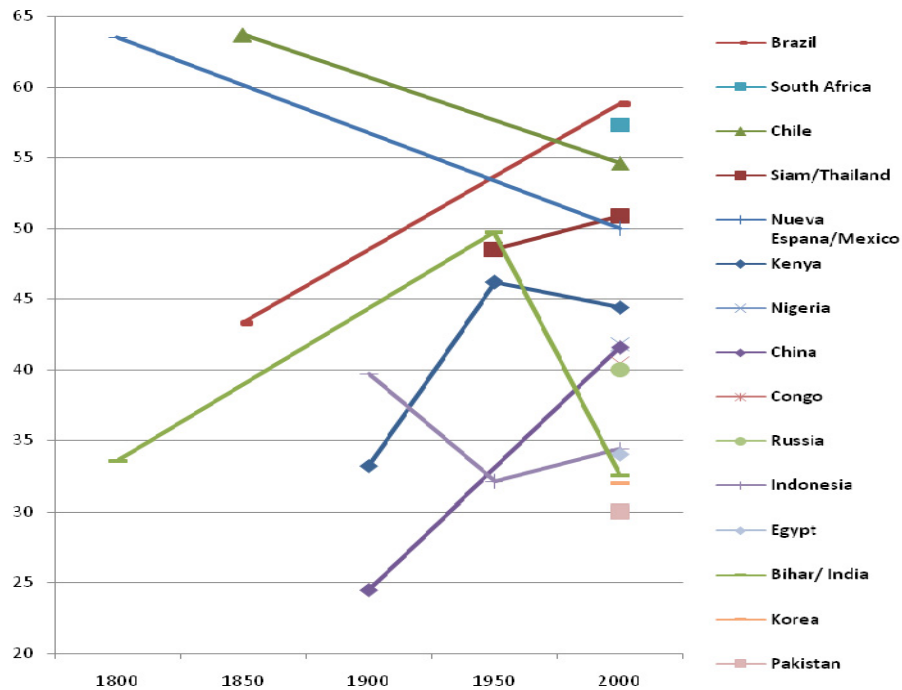
Source: Milanovic et al. (2007).

Figure 15: Predicted inequality in Latin America 1491-1929<sup>9</sup>



Source: Williamson (2009).

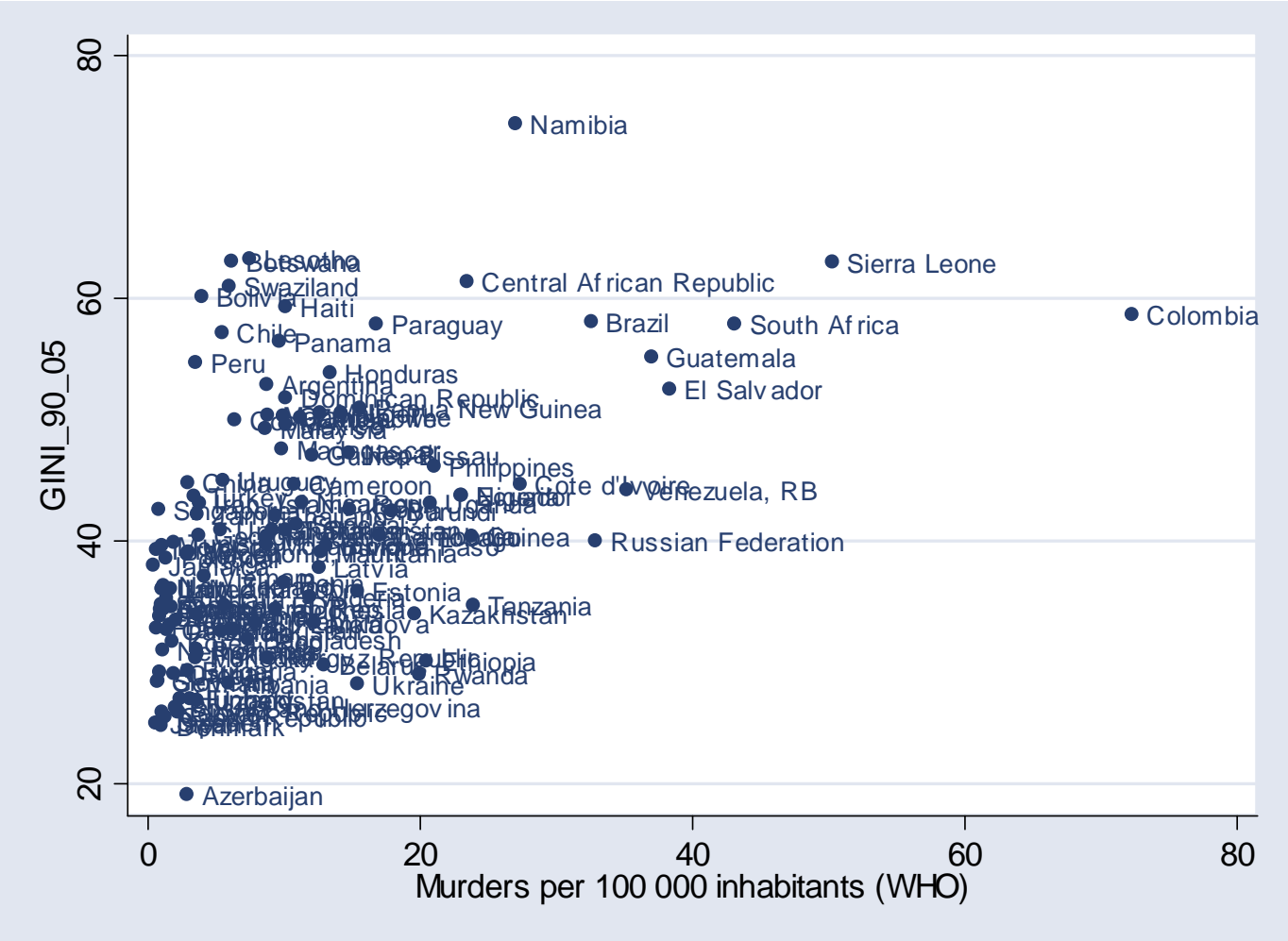
Figure 16: Gini coefficient in developing countries, 1800-2000



Source: Milanovic et al. (2007).

<sup>9</sup> These are not the actual Ginis, but predicted Ginis reconstructed using regression equation mentioned above.

Figure 17: Murder rate in 2002 and income inequalities in 1990-2005



Source: WHO (2004); WDI (2005).

The income inequality story for developing countries is quite consistent with the dynamics of the institutional capacity—in SSA, LA, FSU, where the institutional continuity was interrupted and institutional capacity weakened, inequalities increased and remain high today. Regressions, linking pre-statistical Gini coefficients of income distribution to per capita GDP, population density, urbanization and colonial status (plus some variables to control for different quality of the data) suggest that colonialism increased inequalities greatly: colonies had Ginis nearly 13 percentage points higher than non-colonies (Williamson 2009). In LA as a whole inequalities increased from 22.5 per cent 1491 to over 60 per cent in 1929 (Figure 15). On the contrary, India, China and Japan in the eighteenth and nineteenth centuries had a more balanced income distribution (Figure 16; Pomerantz 2000; Saito 2009).<sup>10</sup> In MENA, EE, India and East Asia (especially until the 1990s) inequalities were noticeably lower (Figure 16). Income inequalities, of course, go together with weak institutional capacity, as measured by the murder rate (Figure 17).

To summarize, there are two ways to escape the Malthusian trap: (1) eliminating collectivist institutions and allowing for the costly increase in income inequalities and savings/investment rate at the very early stage of development at the expense of the consumption of the masses; (2) maintaining collectivist institutions and keeping the income inequalities relatively low until slow technological progress and rise in productivity allows to begin accumulating capital at a pace surpassing population growth rates. The first way was taken by countries that are now called Western and was associated with dramatic social costs between the sixteenth and eighteenth centuries. Moreover, it was imposed on part of the developing world in the nineteenth and twentieth centuries during an era of colonialism. In the developing world this Westernization attempt created an institutional vacuum—traditional, collectivist structures were destroyed, whereas the new modern institutions did not take root, which led to even greater costs than several centuries before in the West.

On the contrary, those developing countries that managed to resist the Westernization of their institutions and to preserve institutional continuity as well as relatively low inequalities (East Asia, MENA countries, India) did not gain much in terms of economic growth before the mid 1900s, but were better positioned to take advantage of growth opportunities as soon as natural increases in productivity allowed exiting the Malthusian trap. The other countries that destroyed their egalitarian institutions prematurely (replicating the Western path) experienced tremendous declines in institutional capacity and rise in inequalities. In India, China, and SSA this path was associated with periodic mass famines, which did not happen before colonialism due to even distribution of limited food resources by the community institutions.<sup>11</sup> In more

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<sup>10</sup> In Japan Gini coefficient allegedly increased from 34 per cent in 1860 to 56% in 1940, but then fell to 30-40 per cent in the 1960-90s (Saito 2009).

<sup>11</sup> ‘... Even before the onset of the Victorian famines, warning signals were in place: C. Walford showed in 1878 that the number of famines in the first century of British rule had already exceeded the total recorded cases in the previous two thousand years. But the grim reality behind claims to ‘good governance’ truly came to light in the very decades that Ferguson trumpets. According to the most reliable estimates, the deaths from the 1876–1878 famine were in the range of *six to eight million*, and in the double-barreled famine of 1896–1897 and 1899–1900, they probably totaled somewhere in the range of *17 to 20 million*. So in the quarter century that marks the pinnacle of colonial good governance, famine deaths average at least a million per year’ (Chibber 2005). In China famines claimed 8,000 lives a year in 1644-1795, 92,000 lives in 1796-1871, 260,000 lives in 1871-1911, and 583,000 lives in 1911-47. The

developed LA countries the growth rates in the twentieth century did not allow narrowing the gap with the West (Argentina, a developed country in between the two world wars, even fell out of the club after the Second World War). In short, premature dismantling of collectivist institutions, even when allowing to overcome the Malthusian trap, did not allow for healthy growth:

The frequent claim that inequality promotes accumulation and growth does not get much support from history. On the contrary, great economic inequality has always been correlated with extreme concentration of political power, and that power has always been used to widen the income gaps through rent-seeking and rent-keeping, forces that demonstrably retard economic growth (Milanovic et al. 2007).

This explains differences in the long-term development trajectory of institutions in China and Russia. The Chinese 1949 Liberation was similar to the Russian 1917 Revolution, not only because communists came to power in both countries but because traditional collectivist institutions, ruined by preceding Westernization, were re-established and strengthened. However, in Russia 1917-91 the communist regime just interrupted the process of transplantation of Western institutions that had been going on since at least the seventeenth century, whereas in China the Liberation of 1949 just returned the country to long-term institutional trajectory that was briefly (and only partly) interrupted after the Opium Wars.

To put it differently, Russia had been already Westernized before 1917, and collectivist institutions that were introduced in Russia by the 1917 Revolution had been largely alien to previous long-term institutional development. China, on the contrary, aborted the unsuccessful Westernization attempt (1840-1949) and returned to collectivist (Asian values) institutions. What was a passing episode and deviation from the trend in Russia was a return to the mainstream development and a restoration of a long-term trend in China. Hence, economic liberalization from 1979 onwards in China, even though accompanied by growing income inequalities and crime and murder rates, has not resulted so far in institutional collapse.

## **6 Conclusions**

After allowing for differing initial conditions, it turns out that the fall in output in transition economies was associated mostly with poor business environment, resulting from institutional collapse. Liberalization alone, when it is not complemented with strong institutions, cannot ensure good performance. Institutional capacities in turn, depend to a large extent on the combination of the rule of law and democracy. The data seem to suggest that both authoritarian and democratic regimes can have strong rule of law and can deliver efficient institutions, whereas under a weak rule of law authoritarian regimes do a better job of maintaining efficient institutions than democracies. To put it in a shorter form, the record of illiberal democracies in ensuring institutional capacities is the worst, which predictably has a devastating impact on output.

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1876-79 famine alone took at least 10 million lives, more than all preceding famines since 1644 (Xia Mingfang calculations cited in Pomerantz 2006).

Why do illiberal democracies emerge? Why did Russia become one of them? It was argued that the group of developing countries that willingly and unwillingly (colonialism) transplanted Western institutions (LA, FSU, SSA) ended up with high income inequalities and apparent lack of institutional capacity. On the contrary, the other group of developing countries—regions that has never really departed from the collectivist institutions and preserved institutional continuity (EA, India, MENA)—succeeded in maintaining low income and wealth inequalities. This second group of countries may have stayed in the Malthusian growth regime longer than others, but once technical progress allowed them to exit from the Malthusian trap, their starting conditions for economic growth in terms of institutional capacity turned out to be better than in the first group. If this interpretation is correct, the next large regions of successful catch up development would be MENA Islamic countries (Turkey, Iran, Egypt, etc.) and South Asia (India), whereas Latin America, sub-Saharan Africa and Russia would fall behind.

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