The Eurasian Growth Paradox

Anders Åslund
Institute for International Economics
Email: aaslund@iie.com

Nazgul Jenish
University of Maryland at College Park
Email: jenish@econ.umd.edu
Abstract

In the first decade of transition, multiple growth regressions showed that the more radical and comprehensive market economic reform was, the earlier a country returned to economic growth and the more vigorous its growth, and Central Europe took the lead. Since 2000, however, the CIS countries have had more than four percentage points higher annual growth than the Central European countries. A regression analysis for 20 postcommunist countries shows with strong significance that a reduction of public expenditures has most effectively stimulated economic growth. As expected, oil exports are also positive and significant. The distance from the EU is also positive and significant, that is, the further from the EU, the higher economic growth. The effect of corruption is negative for growth but only marginally significant. Neither the laggard effect nor investment reveal any significant effect. The conclusion is that more emphasis should be given to the need to reduce public expenditures to boost economic growth.
Since the collapse of communism in 1989 economic output in different regions of the former socialist camp has developed in starkly contrasting fashions. Initially, output fell sharply all over.\(^1\) From 1992, however, Poland recorded growth, and then one country after the other followed, though Ukraine and Moldova remained in the doldrums as late as 1999.

The lesson from 1989-98 was that economic reform worked. The more radical and the earlier the economic reform efforts were, the sooner a country would return to economic growth and the greater the upturn would be. Central Europe and the Baltics shone, while the countries of the Commonwealth of the Independent States (CIS) underperformed badly. Yet even the growth rates of the leaders were mediocre. We shall discuss these lessons in detail in a first section.

Strangely, everything was turned upside down from 1999 on. From 1999 to 2004, eleven CIS countries had an average annual growth of 7.8 percent,\(^2\) while the four Central European Visegrad countries (Poland, the Czech Republic, Slovakia and Hungary) recorded an average annual growth of only 3.6 percent. The three Baltic countries came closer to the first group with 7.1 percent growth, and Romania and Bulgaria closer to the Central Europeans with 5.4 percent (see graph 1). We limit our investigation to these twenty countries.

[Graph 1 approximately here]

\(^1\) We have benefited greatly from the excellent research assistance of Mathew Gibson.

\(^2\) Russia, Ukraine, Belarus, Moldova, Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan. Turkmenistan is excluded because of its extremely poor and unreliable statistics. All averages used here are unweighted, because we are interested in the comparative performance of the different countries. If weighted averages would be used, we would be preoccupied with the relative performance of Poland versus Russia since these economies dominate in their respective regions.
How can this growth paradox be explained? Why did the pioneers of market reforms so quickly become the laggards in growth? This paper seeks to answer that question. In the second section, we investigate the facts and suggest variables that warrant further exploration. In the third section, we undertake a regression with the most interesting variables.

**Lessons from 1989 to 1998: Transition to a Market Economy Works**

When the transition to a market economy started, recorded output plummeted in all countries, though the Soviet economy had already been in free fall. In 1990, only Poland and Hungary launched their transitions. The sudden declines in their registered production caused a shock, and their relative economic performance set the stage of the early debate. When other countries in Central and South-East Europe entered the transition in 1991, their output plummeted even more, but these falls were nothing in comparison with the CIS countries, several of which saw real collapse.

Not only were the declines in output huge, but they lasted for years. Poland took an early lead by returning to growth in 1992. By 1994, the whole of Central Europe and South-East Europe registered growth, and three of the most vigorous reformers in the former Soviet Union had also arrived at growth – Armenia, Lithuania and Latvia. In 1995, they were followed by other reformers, namely Estonia, Georgia and Kyrgyzstan. However, several former Soviet republics experienced prolonged decline followed by stagnation, in particular Russia, Ukraine, Moldova and Kazakhstan. Only at the end of the decade did they return to economic growth.
The total fall in output was staggering. According to official statistics, the aggregate decline in GDP was 19 percent in Central Europe and 29 percent in South-East Europe. In the former Soviet Union, the collapse was truly stunning with 44 percent in the Baltics and 53 percent in the CIS (UNECE 2000).

No doubt, these figures are exaggerated. Perhaps half of the decline can be discarded as the result of statistical misrepresentation (Åslund 2002, chapter 4). The old system exaggerated output for the sake of fulfilling plan targets, while the new system stimulated underreporting for tax evasion. The inherited socialist statistical systems could not capture new decentralized enterprise development, and the underground economy mushroomed, especially in partially reformed countries (Berg 1994; Johnson et al. 1997). Terms of trade or implicit trade subsidies changed sharply, and substantial Soviet subsidies to Central Asia were abolished (Orlowski 1993, 1995; Tarr 1994; Rosati 1995). Shortages soon disappeared; quality improved greatly; and the structural changes were huge. Therefore, the statistical problems are substantial. In fact, many of the initial output declines have been reduced in later statistical revisions, which have succeeded in capturing more of real output. For our purposes, however, we have little choice but to use the official statistics, making the assumption that the later growth rates have been less distorted, though like most we dismiss Turkmenistan’s statistics as sheer fiction.

Soon, a huge literature on the causes of output changes evolved. By and large, it concluded: the more radical and comprehensive the market economic reform was, the

\[^{3} \text{Åslund, Boone and Johnson (1996), Berg (1994), Berg, Borensztein, Sahay and Zettelmeyer (1999), Christoffersen and Doyle (2000), De Melo, Denizer and Gelb}\]
earlier a country returned to economic growth and the more vigorous its growth. The three foci of the transition were macroeconomic stabilization, deregulation and privatization. As convinced reformers usually pursued all three aims in parallel, it is statistically difficult to disentangle these effects because of co-variation.

Almost all transition countries started out with high inflation, and output continued to fall until inflation had been brought under control. Fischer, et al (1996b, p. 89) concluded: “The simple – but essential – message that emerges…is that real GDP rebounds following inflation stabilization, which in turn appears highly correlated with the improvement in the public finances.” In a broader international regression, Michael Bruno and William Easterly (1998) found the critical threshold was relatively high, 40 percent inflation a year. In addition, Christoffersen and Doyle (2000, p. 439) established: “There is no evidence that disinflation necessarily incurs significant output costs, even at moderate inflation rates.” Moderate inflation did not impede growth significantly.

Deregulation was the basis for the formation of a market economy, and over time regression analysis shows the rising importance of deregulation for growth (Berg et al. 1999). Privatization was always more controversial, but the regressions that included the share of GDP arising from the private sector showed that privatization had a clear positive impact on growth (Berg et al. 1999; De Melo et al. 1997a; EBRD 1999).
The standard causes of long-term economic growth (Barro and Sala-i-Martín 2004) were of little or no importance. Surprisingly, Andrei Illarionov showed that the investment ratio in GDP was *negatively correlated* with economic growth, that is, the less a country invested the higher its growth (see graph 2). The explanation is probably that high investment reflected the maintenance of a soft budget constraint, a large public sector, wasteful public investment, and outright theft. Human capital was ample and underemployed, so there is little reason even to investigate it. Overall technology, research, and development appeared similarly irrelevant. Sensibly, nobody paid much attention to these factors. The issue was rather how to utilize the existing physical capital and import foreign technology to ease bottlenecks (Åslund 2002, pp. 153-156).

[Graph 2 approximately here]

Apart from the transition indicators, growth was correlated with the expansion of exports. Imports took off slightly later. The countries that were about to join the EU benefited from privileged access to the large EU market. As a result, the share of their exports to the EU of 15 members rose from half in 1989 to two-thirds in 2000. The CIS countries, by contrast, suffered from severe discrimination by the EU, and the share of their exports to the EU stayed constant around one-third (Åslund and Warner 2004). Co-variation made it difficult to ascertain whether this was really a positive effect of market access or whether it was a result of the EU accession countries adopting many of the systemic features of the EU countries. A corollary was that the closer a country was to Brussels, the higher its economic growth.

With regard to politics, the 1990s evidenced a strong positive correlation between democracy, comprehensive market reforms and economic growth (Berg et al. 1999;
EBRD 1999; Åslund 2002), because in the early transition, the threat against successful market reforms did not come from the many losers, but from the few winners who engaged in rampant rent seeking (Hellman 1998). A corollary of the prior observations was that corruption was negatively correlated with economic growth (EBRD 1999).

In conclusion, radical market reform, macroeconomic stabilization, privatization, EU accession, export expansion, democracy and reasonable governance all went together. Analytically, one problem was that the co-variance was overwhelming. Another problem was that the growth rates remained anemic, and only Poland had convincingly exceeded its economic level of 1989. A third problem was that the comparative standard – the CIS countries – were performing truly miserably. Thus, although one decade had passed, we could not really say all that much about the causes of economic growth, apart from the obvious point that a critical mass of market economic elements was vital. In particular Russia, Ukraine, Kazakhstan and Moldova appeared stuck in an under-reform trap (Åslund, Boone and Johnson 2001).

**A World of Opposites, 1999-2004: The Winners Are the Prior Losers**

Strangely, whatever had been true until 1998 was false from that year. The starkest contrast evolved between the four Central European countries and the eleven CIS countries.⁴ The latter group grew more than twice as fast as the former year after year (see graph 1). This could not be explained by sheer chance.

The dividing event was the Russian financial crash of August 1998, which had many repercussions for the whole CIS region. International financing dried up and the international financial institutions became much stricter, so the CIS governments were

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⁴ Ignoring Turkmenistan.
compelled to minimize their budget deficits. This prompted them to halt all kinds of rent-seeking schemes, such as barter and other forms of enterprise subsidies, which sharply hardened enterprises’ budget constraints. Both governments and publics got such a fright that reductions of social benefits that had been politically impossible were swiftly undertaken. The playing field became more level for enterprises. Many former state managers who had seized control over their old enterprises but did not know how to run them under capitalism were persuaded to sell them to new entrepreneurs in order not to lose everything.

In hindsight, the Russian financial crash can be considered the crucial event that rendered the CIS countries full-fledged market economies. Their fiscal systems were put in reasonable order, and ever since inflation has been moderate. Most CIS countries derived at least 60 percent of GDP from their private sectors. Markets, albeit encumbered, drove their economies. A critical mass of market economy and private enterprise had been achieved, although the CIS countries continue to lag behind the EU accession countries, according to the EBRD transition indicators, which have changed little since 1998, recording only a light convergence (see graph 3). Their minimal movement amidst major structural changes suggests that these transition indicators might not be very relevant as a measurement of actual structural developments.

[Graph 3 approximately here]

The Russian financial crash of 1998 was followed by dramatic external developments. Russia devalued the ruble by three-quarters in 1998, and most other CIS countries subsequently devalued their currencies by about 50 percent, which benefited exporters. Soon afterwards a commodity boom started, driven by Chinese imports of
commodities, allowing the CIS countries to boost their exports in spite of stagnant EU markets and EU protectionism. The expansion was driven by supply rather than demand, as evident from the failure of all forecasts based on demand failed to predict the CIS resurgence. Although only four of twelve CIS economies were significant energy exporters (Russia, Kazakhstan, Azerbaijan and Turkmenistan), growth rates across the CIS were similarly strong. Commodity-poor Armenia has registered the highest growth rate. Nonetheless, to check the effect of major energy exports, we introduce a dummy for the three major energy exporters in our sample (Russia, Kazakhstan, and Azerbaijan).

The export boom has been followed by increased investment, as would be expected, which has further reinforced the economic growth. Much of the growth in Azerbaijan and Kazakhstan has been spurred by extremely high foreign direct investment (FDI), which has been motivated by potential oil production.

It is generally acknowledged that countries with a lower level of economic development *ceteris paribus* grow faster than wealthier countries. Thus, one would expect the CIS countries to grow faster than the Central Europeans after they have caught up somewhat with regard to transition reforms. However, this “laggard effect” would hardly explain a difference of more than 1-2 percent annual growth between these two groups of countries (Åslund and Warner 2004). The laggard effect measured against GDP per capita in purchasing power parities (PPP) must be assessed.

Clearly, additional factors are needed to explain a steady difference in economic growth of over four percentage points each year for half a decade. One possibility is that this is simply recovery growth, and that the main explanation is the huge unused capacity
in many post-Soviet economies after an official decline in output of about half of GDP, as especially Yegor Gaidar (2005) has argued.

However, striking systemic differences have developed in recent years. Most conspicuously, the CIS countries have drastically cut their public expenditures to about one-fifth less as a share of GDP than in Central Europe. This implies that economic freedom has increased in the CIS countries in a fashion that is not captured by the EBRD transition indicators. A simple plot of growth against government expenditure as a share of GDP points to a negative correlation between these variables (see graph 4). Although, care should be exercised when interpreting this type of graphs, more accurate regression analysis below confirms the strong negative association between growth and government spending. Thus, public expenditures appear a plausible explanation of the observed differences in economic growth between Central European and CIS economies.

[Graph 4 approximately here]

Similarly, the CIS has adopted a low-tax regime, while Central Europe has only taken limited steps in that direction as yet. Low and flat taxes are proliferating in the East, while most of Central Europe still has comparatively high and progressive income taxes. Russia has had a flat income tax of 13 percent since 2000, and Ukraine since 2004. Admittedly, Slovakia chose a flat income tax of 19 percent in 2004 and Romania one of 16 percent in 2005, as tax competition stings, but Poland has still progressive taxes peaking at 40 percent. Corporate profit taxes are declining in the whole region, but payroll taxes are being reduced much more in the CIS than in Central Europe.

In addition, Central Europe has developed a habit of running budget deficits of about 6 percent of GDP, while the CIS countries have nearly balanced budgets, with an
average budget deficit of barely 1 percent of GDP for the last half decade (EBRD 2004, p. 41).

The CIS countries also have de facto freer labor markets than the Central European countries. Unfortunately, no easy measure is at hand, and this is another aspect of economic freedom in the CIS countries that the EBRD transition indicators ignore. The same could be said about agricultural policies.

While growth and democracy were nicely correlated in the 1990s, we see an opposite picture after 1998. A graph of growth against a Freedom House democracy index suggests a negative correlation between these two indicators (see graph 5). The CIS countries, which are by and large authoritarian, have grown faster than the democratic countries in Central Europe. But what lies behind this? Have the Central Europeans just relaxed, while the CIS governments were shaken up by the Russian financial crash of 1998? The EU is most probably part of the explanation. The first parts of the common legislation, the acquis communitaire, were undoubtedly useful, helping to build market institutions, while the last parts included new regulations such as the Common Agricultural Policy. It is also possible that the old idea of authoritarian advantage has some relevance when the main risk to economic development becomes popular pressures for regulation of labor markets in favor of insiders and excessive taxes on the rich to the benefit of social transfers for the majority. The dominant risk during the first decade was rent seeking by elites, which was best checked by democracy.

As before, neither human capital nor technology are likely to have had much impact on growth, as free resources have remained ample.
Regression Analysis, 1999-2004

Specification

To investigate more accurately the relative contribution of the major factors, discussed above, to the differences in growth between the CEE and CIS countries, we estimate the following panel data model:

\[
y_i = \alpha + \beta_1 \left( \frac{G_i}{GDP_i} \right) + \beta_2 GDP_{i,t-1} + \beta_3 \left( \frac{I_i}{GDP_i} \right) + \gamma_1 Oil_i + \gamma_2 Corrup_i + \gamma_3 CIS_i + \lambda_i + u_i;
\]

where the dependent variable, \( y_i \), is annual GDP growth rate for country \( i \) in year \( t \). The explanatory variables comprise:

1. \( (G/GDP)_i \), government expenditure as a share of GDP;
2. \( GDP_{i,t-1} \), lagged per capita GDP (in logs), to control for the "catch up" effect;
3. \( (I/GDP)_i \), fixed investment as a share of GDP, measure of the physical capital;
4. \( Oil \), oil producing country dummy, to account for the effect of surging energy exports;
5. \( Corrup_i \), corruption index, proxy for the quality of the political institutions; and
6. \( CIS \) regional dummy.

The CIS dummy serves as a proxy for the distance from the European Union and stands in for other time-invariant, structural factors that differ between the CEE and CIS regions, such as labor market regulation. We control for common shocks reflecting global and regional economic conditions by including fixed year effects, \( \lambda_i \). The error term is
composed of two parts: $\mu_i$ - unobserved individual effect, and $\nu_i$ - idiosyncratic component.

Unlike the standard growth literature, our regression does not include any measures of human capital since all post-communist countries enjoy relatively high levels of education, which do not vary considerably across countries and over the sample period, and hence, cannot explain the observed variation in growth. Nor does it contain specific labor market indicators since the data, even when it is available, is plagued with severe measurement errors.

Moreover, as it is now recognized in the econometric literature, simply increasing the number of right hand side variables in growth regressions is unlikely to take away the omitted variables bias problem. Therefore, we do not here strive for the maximum generality and completeness of explanatory variables but rather focus on a few principal variables and robust ways of evaluating their impact.

The error-component specification is well suited for this purpose. It allows to exploit variation both across countries and over time, as well as to reduce the omitted variables bias. For instance, any differences in human capital across countries are captured by country-specific effects.

Data

Our sample consists of observations for 20 transition economies -- 11 CIS countries, 3 Baltic states, and 6 CE and SEE countries – over the period from 1999 to 2004. The GDP per capita (PPP) data comes from the World Bank's 2005 WDI report. The annual GDP growth rate and government expenditure data are drawn from the 2004 EBRD Transition
Report. Investment figures are from the UNECE databases. Finally, we use the corruption perception index scores constructed by Transparency International. Higher scores correspond to lower levels of perceived corruption. The indicator displays little variation over time, and therefore, the period averages, rather than individual year estimates, enter the regression. All the data are expressed in terms of ratios obviating the need to control for population and country sizes.

*Estimation Procedure*

There are two major possible sources of estimation bias: first, is that lagged GDP per capita, investment and government spending are likely to be correlated with the unobserved individual effects, and the other is the potential endogeneity of investment and government spending, i.e., investment and government spending may be correlated with the contemporaneous idiosyncratic error term.

We first estimate the model with the fixed effects procedure, commonly used in panel data regressions. This technique is robust to the presence of correlation between regressors and unobserved individual effects as it removes the country-specific effects by subtracting time averages before applying the OLS procedure. However, it does not take care of the second problem. Another shortcoming of the method is that it cannot consistently estimate coefficients on time-invariant regressors such as Oil, CIS and Corruption. Nevertheless, it provides a useful benchmark for the time-varying regressors.

An alternative strategy that addresses both estimation concerns is to difference the regression and then estimate jointly the transformed equation and the equation in levels with the two-step efficient general method of moments (GMM) procedure proposed by
Arellano and Bover (1995). In this procedure, investment and government spending are instrumented with their second lags. The GMM estimator is consistent, asymptotically normal and invariant to the choice of transformation.

Results

Overall, the regression results support our main predictions: government spending and energy exports are the key to explaining the differences in growth in the transition countries, economic regulation and corruption seem to have moderate impact, while the laggard effect and investment seem to play a negligible role.

Table 1 summarizes the findings. The first column reports the fixed effects method estimates. The second column presents the GMM estimates. We carried out a series of sensitivity checks using different right hand side variables. One of them incorporates potential spillovers from neighboring countries. We re-run the GMM regression by adding the weighted average of the log per capita GDP for a country's neighbors and big trading partners. The results are shown in column 3.

Throughout all the regressions, the coefficient on the government expenditures is negative and strongly significant. It is significant at 1 per cent level in the fixed effects and GMM regressions, shown the columns 1 and 2, and is significant at 5 per cent in the regression with spillovers. Not only does it have the predicted sign but it has also the largest effect, in terms of magnitude, among all the variables entering the regression. The estimate implies that a one-percent-of-GDP reduction in government spending, everything else equal, gives rise to about 0.14 percent increase in the GDP growth rate.
The coefficient on corruption, which proxies for the quality of institutions, is positive and marginally significant, indicating that low levels of corruption are associated with higher growth. This is consistent with the preceding finding about a negative correlation between government spending and growth since high government spending, as a rule, goes hand in hand with high corruption.

As anticipated, energy exports boost growth. The coefficient on $Oil$ is positive and significant at 5 percent level. The distance from the EU seems also to have a positive effect on growth, as suggested by a positive coefficient on $CIS$.

The laggard effect does not appear to be a major factor accounting for the big gap in the growth rates. The coefficient on lagged GDP per capita has a negative sign, but it is not statistically significant.

Nor do these regressions reveal a significant relationship between investment and growth, though the estimated coefficient is positive. One possible explanation is that most postcommunist countries started transition with high initial levels of physical capital. Therefore, the marginal effect of additional investment is small. Another explanation is that it takes time for improvements in investment to translate into growth, and the time series is simply too short to detect any stable relationship between the two variables. However, some previous studies (Barro and Sala-i-Martin 2004) using longer series for a larger country sample also obtained insignificant estimates.

The effect of spillovers from neighboring economies turns out to be statistically insignificant. The weights are constructed based on geographic distances between countries. Though not perfect, this weighting system accounts reasonably well for economic linkages between countries, such as trade and the costs of transporting goods.
Table 1. Regression for GDP growth rate

<table>
<thead>
<tr>
<th>Explanatory variable</th>
<th>Fixed effects (1)</th>
<th>No spillovers (2)</th>
<th>Spillovers (3)</th>
</tr>
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<tbody>
<tr>
<td>Constant</td>
<td>--</td>
<td>0.089</td>
<td>0.084</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.065)</td>
<td>(0.133)</td>
</tr>
<tr>
<td>G/GDP</td>
<td>-0.229*</td>
<td>-0.136*</td>
<td>-0.138*</td>
</tr>
<tr>
<td></td>
<td>(0.087)</td>
<td>(0.044)</td>
<td>(0.058)</td>
</tr>
<tr>
<td>Lagged GDP per capita</td>
<td>-0.165</td>
<td>-0.009</td>
<td>-0.007</td>
</tr>
<tr>
<td></td>
<td>(0.112)</td>
<td>(0.017)</td>
<td>(0.017)</td>
</tr>
<tr>
<td>I/GDP</td>
<td>0.075</td>
<td>0.047</td>
<td>0.042</td>
</tr>
<tr>
<td></td>
<td>(0.068)</td>
<td>(0.057)</td>
<td>(0.057)</td>
</tr>
<tr>
<td>Oil</td>
<td>--</td>
<td>0.024*</td>
<td>0.025*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.012)</td>
<td>(0.012)</td>
</tr>
<tr>
<td>Corruption</td>
<td>--</td>
<td>0.008</td>
<td>0.008</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.005)</td>
<td>(0.005)</td>
</tr>
<tr>
<td>CIS</td>
<td>--</td>
<td>0.015</td>
<td>0.015</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.015)</td>
<td>(0.015)</td>
</tr>
<tr>
<td>Year 2000</td>
<td>-0.010</td>
<td>-0.004</td>
<td>-0.004</td>
</tr>
<tr>
<td></td>
<td>(0.006)</td>
<td>(0.004)</td>
<td>(0.004)</td>
</tr>
<tr>
<td>Year 2001</td>
<td>0.000</td>
<td>0.002</td>
<td>0.002</td>
</tr>
<tr>
<td></td>
<td>(0.005)</td>
<td>(0.004)</td>
<td>(0.003)</td>
</tr>
<tr>
<td>Year 2002</td>
<td>0.003</td>
<td>0.001</td>
<td>0.001</td>
</tr>
<tr>
<td></td>
<td>(0.005)</td>
<td>(0.005)</td>
<td>(0.004)</td>
</tr>
<tr>
<td>Year 2003</td>
<td>0.019*</td>
<td>0.014*</td>
<td>0.014*</td>
</tr>
<tr>
<td></td>
<td>(0.006)</td>
<td>(0.004)</td>
<td>(0.004)</td>
</tr>
<tr>
<td>Year 2004</td>
<td>0.029*</td>
<td>0.019*</td>
<td>0.019*</td>
</tr>
<tr>
<td></td>
<td>(0.008)</td>
<td>(0.005)</td>
<td>(0.005)</td>
</tr>
<tr>
<td>Spillovers</td>
<td></td>
<td>0.001</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.034)</td>
<td></td>
</tr>
</tbody>
</table>

$R^2$: 0.69 0.51 0.51

Notes: Robust standard errors are shown in parentheses. Sample size is 120.
*- significant at 5% level.
Conclusions

The main conclusion arising from our analysis of economic growth in the postcommunist region since 1999 is that it has been spurred by a sharp reduction in public spending and budget deficits in most CIS countries.

Naturally, growth has also been boosted by the commodity boom on world markets. The impact of the laggard effect is not conclusive from our regression. The coefficient on the lagged per capita GDP is negative, but statistically insignificant.

Our evidence also suggests that a long distance from Brussels has been good for economic growth among the postcommunist countries since 1999. It can be argued that a small and weak state might be less harmful to economic growth than the rigid and excessive regulation of EU states, notably of labor markets and agriculture. Given that growth has been tepid in the European Union, while China and India have been the foremost growth engines of the world, it is naturally better to be closer to growing markets than to stagnating ones.

In effect, the CIS countries have adopted the highly-successful East Asian growth model lock, stock and barrel, while the less dynamic Central European countries have adopted the EU model, which has not been conducive to high economic growth, even if some countries, mainly Ireland, the three Baltic countries and Slovakia, have managed to go against the current. That one model is generally superior does not mean that all its parts are superior. Ironically, the CIS countries that have generated impressive growth figures are largely authoritarian.

International institutions designed to promote growth in the postcommunist world, notably the World Bank and the EBRD, cannot turn a blind eye to these observations, but
need to incorporate them in their advice. For years, the EBRD has shown how Central Europe has scaled its transition indicators, but it fails to explain why Central Europe has only achieved a growth rate of 3-4 percent in recent years. By contrast, Janos Kornai (1992) noticed that the Central European states have developed a premature West European social welfare system. This has turned out to be a social welfare trap with West European tax rates, social transfers and labor market regulations. These countries’ membership in the EU has reinforced these negative features and reduced their inclination to reform, and they are even ignoring the Maastricht restriction that is supposed to limit budget deficits to 3 percent of GDP, maintaining steady budget deficits on the order of 6 percent of GDP. Nor can the EBRD explain the high growth rates of the CIS countries apart from the laggard effect, which our regression deemed statistically insignificant, and the international commodity boom (EBRD 2005).

The obvious conclusion is instead that high public expenditures and taxes are bad for economic growth. The overall conclusion is that a liberal economic policy or greater economic freedom does promote economic growth, which should be conventional wisdom rather than controversial. Conversely, international financial institutions should advocate cuts in public expenditures in postcommunist countries with poor growth.
References


Fischer, Stanley, and Ratna Sahay, “The Transition Economies after Ten Years,”


Graph 1
GDP Growth Rates in CE-4, Baltic-3, CIS-11
1998-2004

Source: World Bank Development Indicators 2005, UNECE Online Statistics
Graph 2
Investment Rate as a Proportion of GDP vs. GDP Growth Rate in Russia, 1993-2004

Source: UNECE Online Statistics
Graph 3
Composite Transition Index for CE-4 and CIS-9, 1990-2003

Sources: De Melo et al. (1997); Havrylyshyn and Wolf (1999), p. 34; Åslund (2002); EBRD 2001, pp. 12, 14; EBRD 2002, p. 20; EBRD 2003, p. 16.
Graph 4
Public Expenditure and Growth in CIS-11, CE-4, Baltic-3
1999-2004

[Graph depicting the relationship between public expenditure (% of GDP) and GDP growth (%).]
Graph 5
Democracy Rating vs. GDP Growth in CE-4 and CIS-9
2003

Average of Freedom House political rights and civil liberties ratings (lower figure indicates greater freedom)

Sources: Freedom House, 2004; Table 1