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The Pitfalls of Transition: Crowding Out the "National Virtues"

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„What was expected, what we observed,

the lessons learned."

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Abstract

In this paper a view is advanced that explains why the transition to markets did not always lead to the outcomes predicted by the Washington Consensus type strategies. Institutional portfolio theory is used to define a myriad of interests and goals of a transition economy. A model is developed in which external intervention and increased external monitoring are shown to lead to lessening of the intrinsic motivation within transition economies to pursue the reforms as prescribed by Washington Consensus sometimes resulting in very slow growth rates or even a decline of the GDP.

JEL: P21, O43

Key Words: external monitoring; institutional change; intrinsic motivation; portfolio theory; Washington consensus

The Pitfalls of Transition: Crowding Out the "National Virtues"

1. Introduction

Following the dissolution of the Soviet Union and the fall of the Berlin Wall, former socialist Central and Eastern European states (CEES) and newly independent states (NIS) embarked on the transition towards markets. While that transition turned out to be anything but smooth for almost all the countries of the region, some countries were much more successful in that process than the others (Rodrik 2006). Most countries followed the well-known prescription to first stabilize the economy, then to privatize it, and finally to liberalize it. This "recipe" was most transparently codified in the Washington Consensus (Williamson 1990). Ten recommendations in the original Washington Consensus were the fiscal discipline, reorientation of public expenditures, tax reform, financial liberalization, unified and competitive exchange rates, trade liberalization, openness to direct foreign investments, privatization, deregulation, and securing the property rights. These were the policies strongly advised and promoted by the World Bank and the International Monetary Fund (IMF).

Many of the transition economies, in particular several NIS states formerly republics of Yugoslavia or the Soviet Union, could not manage to reach the levels of their 1990 GDP even ten or fifteen years after they started the transition process (IMF 2006). There are a few explanations for this phenomenon but one seemed to have been dominant until recently. Predominantly it was suggested that the Washington Consensus-type policy reforms are a great path to follow and only the lack of total commitment to these policies or "too little reform" may be responsible for prolonged transition characterized with serious recession (*e.g.*, Collier and Dollar 2001; Krueger 2004). Indeed, this view implies that the nature of the reforms should not be questioned but their success is dependent solely on the thorough implementation of these policies. Another view championed by Sachs (*e.g.*, Sachs *et al.* 2004) and illustrated in the *U.N. Millennium*

Project (2005) puts the emphasis on the availability of foreign aid as a necessary condition for the success of the reforms. Admittedly, this approach is more pertinent to the reforms in the less developed countries (LDCs) rather than in the CEES or NIS region.

An alternative view has emerged recently, surprisingly in the World Bank (2005) and was published in their report titled *Economic Growth in the 1990s: Learning from a Decade of Reform*. For the first time, it has been acknowledged that different countries may need to follow different paths in their transition to markets and thus policy diversity, selective and modest reforms, and experimentation, rather than the uniform cook-book type of policies, are needed in guiding the process. While this seems to be a fairly obvious proposition to a non-economist, it complicates the lives of a number of the western-trained economists, business and economics practitioners, and western economic advisors, both independent and those operating within the World Bank, the IMF, a variety of government agencies, or other commercial or think-tank entities.

The complexity arises due to several reasons. First, different CEES and NIS nations have different cultural, historical, political, and economic heritage. Second, different nations have a different vision of where they want to go in their future and how they are to arrive there. In other words, most nations have multiple objectives in both short- and long-run strategies of their national development. Creating a market economy may be only one of the objectives, often in direct conflict with some other objectives. Third, developed market economies have their own agenda and set of goals into which they are trying to fit the actions of the CEES and the NIS economies. Fourth, most existing international financial, trade, political, economic, or military organizations have been clearly designed with the interest of the current member-countries in mind. In other words, for potential member-countries it is necessary to either significantly adjust their development programs to fit the views and the visions of these organizations if they are to become a part of them, or these organizations must exhibit a great deal of flexibility and change the way they operate, to some extent, in order to ease and accommodate joining of the potentially new member-countries.

In this paper, a view is advanced and a simple model is developed that explains why the transition to markets in some of the CEES and NIS countries did not always lead to the outcomes predicted by the Washington Consensus-type policies. Indeed, the involvement of the international organizations and promoting of the joining of the various economic and political entities such as the European Union (EU), the World Trade Organization (WTO), NATO, etc., as the ultimate goal for the transition, economies may have impeded the progress of the reforms in these countries and ultimately their economic growth. Organizational portfolio theory is used in its modified form, called the institutional portfolio, to define a myriad of interests and goals that a transition country normally has in its development program. Then, a model is developed in which external intervention and increased external monitoring may lead to lessening of the intrinsic motivation within transition economies to pursue the reforms as prescribed by Washington Consensus. This sometimes results in very slow growth rates or even a decline of the GDP and conditions under which this situation may occur are identified. Finally, implications of this model are discussed.

2. National Interests, Institutional Changes, and the Organizational Portfolio Theory

Organizational portfolio theory represents a relatively new theory that treats the organization as a portfolio of causes of organizational performance (Donaldson, 1999, 2000). This theory is designed to explain the performance-driven organizational change at the firm level. Miljkovic (2006) extended the theory to fit the international non-profit membership organizations in which the members are independent and sovereign nations (or regions) with very diverse interests.

Organizational portfolio theory begins with a premise that there are various internal and external causes that affect organizational performance. Organizational performance, in turn, feeds back to drive organizational change such that the organization moves into fit with its situation. Organization theorists argue that organizational performance has to become low so there is a crisis before it triggers adaptive organizational change. Adaptive organizational change will not occur if there is only a decline of organizational performance from the maximum level. This is because organizations have a tendency to satisfice rather than maximize (Simon 1976). There exists a satisficing level of performance, substantially below the maximum level, that the organization strives to maintain. The satisficing level is that level of performance that the managers of the organization consider to be satisfactory or acceptable. Organizations satisfice rather than maximize because of bounded rationality. In other words, there are limits on the decision-making capacity of managers given inadequacies, such as in their knowledge (March and Simon 1958). Managers solve problems to restore performance so as to regain the satisficing level. Since the satisficing is a property of managerial decision making in general, it follows that adaptive organizational change of any kind should occur only when organizational performance falls below the satisficing level, because all adaptive organizational changes result from managerial decisions. Empirical research supports satisficing theory, in that low organizational performance is the trigger for adaptive organizational change in organizational strategy and structure (e.g., Cibin and Grant 1996; Donaldson, 1994, 1987; Smith *et al.*, 1990). Specifically, low levels of sales, profit, and earnings per share produce the needed adaptive structural change among large corporations (Donaldson 1987).

A key question is then *why does the crisis or low performance of an organization occur*? According to the organizational portfolio theory (Donaldson 2000), we need to consider that the causes of organizational performance form a portfolio, and each cause is termed a factor in the organizational portfolio. These organizational portfolio factors include causes of organizational performance inside the organization and outside it. Each organizational portfolio factor has a risk, defined as the variation over time in organizational performance that results from that factor. Each organizational portfolio factor is also correlated to some degree, positively or negatively, with each other organizational portfolio factor. Thus, each organizational portfolio factor becomes a trigger of change when, either, it reaches a particular threshold, or interacts with another factor, stimulating threshold levels that trigger change. The greater (lower) the risk of each organizational portfolio factor and the higher their positive (negative) correlation with each other, the higher (lower) the organizational risk, defined as the variation over time in organizational performance. Moreover, each organizational portfolio factor is correlated to some degree, positively or negatively, with organizational misfit, which can be interpreted as the moderating variable. The higher the risk of each organizational portfolio factor and the more it is positively correlated with organizational fit, the greater

the probability that organizational performance fluctuates down to a low level when the organization is in misfit, because both the portfolio factor and misfit are simultaneously depressing performance.

Therefore, considering the whole portfolio, the higher the risk of the organizational portfolio factors and (or) the more they are positively correlated with organizational fit, the greater the probability that organizational performance fluctuates down below the satisficing level, so that the adaptive organizational change occurs. The opposite holds as well: the lower the risk of the organizational portfolio factors and (or) the more they are negatively correlated with organizational fit, the lower the probability that organizational performance fluctuates down below the satisficing level, so that the adaptive organizational change is less likely to occur. An organization in this position will continue to have satisfactory performance but will fail to make needed adaptive changes, so its performance will fall below its potential over time. Therefore, in analyzing each organizational portfolio factor, we need to understand its risk and whether it is positively or negatively correlated with organizational misfit. Where the depressing effect on organizational performance of organizational misfit is counteracted by some other portfolio factor buoying performance, this can be termed a portfolio effect.

Independent nations are much more complex entities than individual firms, or national and international organizations. Most firms or organizations are first created and then later evaluated based on a single goal or a small set of goals they set out for themselves. The complexity of a nation's existence arises primarily due to number and diversity of its constituting elements starting with its citizens, followed by a large number of internal political, social, economic, legal, business, cultural, and many other types of institutions and organizations. Each of these constituting elements has their own goals. Many external factors including global or regional political, economic, natural, and other environments add to that complexity. Yet the basic idea of the organizational portfolio theory can be modified and applied to the operating of a nation. There are many internal and external factors that affect economic development and performance of a nation. Economic performance of a nation provides a feedback in order to drive institutional changes within the society such that the nation moves into fit with its situation.

The CEES and the NIS countries differ from other established nations in two basic respects: (1) many of them are completely new entities that need to form and develop their institutions from scratch, and/or (2) they are trying to get rid of existing institutions and accept a set of new ones before fully understanding the implications that this change may have on every aspect of their existence as a nation. In their process of transition, the CEES and the NIS countries have many different and often conflicting objectives. For instance, many of these countries are experiencing complete independence for the first time, *i.e.,* for the first time ever they are sovereign nations, and are trying to learn about their place and role in the global and regional environments. Economic growth and development are often priorities implying a strong emphasis on changing economic or financial institutions. At the same time, many of these countries (*e.g.*, all former Yugoslav republics except Slovenia; most former Soviet republics) are trying to create and establish their national identity. Some of them went through the period of civil war with the primary goal of gaining independence. Being a member of a union called, for instance, the Soviet Union or Yugoslavia for 70 years may discourage some of these countries from being enthusiastic about immediately joining another union

– even if it is called the European Union – before they could enjoy their independence or understand how the rest of the world perceives their independence. Thus, economic or political integration with the developed western nations through joining their political, trade, financial, or military organizations or alliances, however important, may not be perceived by leaders and citizens of some of the CEES and the NIS nations as their priority. If this is coupled with strong historical and traditional heritage that is considerably different from western practices,[1] odds are that any external pressure on these countries to speed up their political and economic transition may instead considerably slow down the transition process and the transformation of traditional domestic institutions into western-like institutions. Another thing that can undermine the effect of external pressures on the extent of institutional changes is the success that some of the formerly communist economies such as China enjoyed in their transition by following a very different path from one prescribed by the Washington Consensus. China's integration into the world's economy and the rate of economic growth has been unprecedented during the last 10 to15 years. Yet all that happened without undertaking the radical institutional changes prescribed by the Washington Consensus and its proponents (Rodrik 2006).

National interest goals in transition economies are many, but it seems reasonable to assume that they can be generalized and summarized as the following. Each country would like to ensure its political and economic stability along with the high economic growth rate that would improve the welfare of its citizens. The institutional portfolio factors that determine the level of performance of this transition process may be reduced to internal and external factors in order to simplify the analysis. The internal factors are under control of domestic institutions and citizens and include, but are not limited to, internal processes and mechanisms that enable the operating or change of the existing institutions in the country; a diversity of internal goals among different agents in the economy; strengthening the notion of national identity and sovereignty; desire to preserve national, historic, and cultural heritage; resistance to change; or the ability to adopt new goals. External factors are not under control of domestic institutions and citizens and for the purposes of this model they include the pressures and the influence of foreign countries and international economic, financial, trade, military or political organizations or alliances to pursue a certain model of transition to a market economy such as the Washington Consensus. Indeed, many foreign countries and international organizations offer "free" advice and expertise in how to proceed with the transition process. A "stick and carrot" approach is often used in this "independent" advisory process with an array of incentives promised to the followers and punishments outlined for those who chose a different path.

Internal and external factors in the institutional portfolio may interact in different ways and affect the performance of a transition economy with respect to its goals defined as the achievement of political and economic stability coupled with the welfare-improving economic growth rate. The next section outlines the model which explains under what circumstances the external factors would lead to a slow down or decline in performance of a transition economy.

3. The Model – The Hidden Costs of Control and Reward

The idea behind the model developed here is that too much external control or monitoring of institutional change in a transition economy may lead to a slow down in economic growth and in institutional changes. There is not a similar model developed so far, to the best of our knowledge, dealing with the processes of institutional change in transition economies. However, the idea of the hidden costs of control and reward are not new in labor economics. In particular, there is rapidly developing literature in the field of experimental economics with applications to labor issues with regard to measuring the consequences of control on motivation of workers. Most experimental studies are developed as a principal-agent game (*e.g.*, Gneezy and Rustichini 2000; Benabou and Tirole 2003; Fehr and List 2004; Falk and Kosfeld 2006). Yet theoretical models are few in this field and most notable ones include, among others, Frey (1993, 1997) or Osterloh and Frey (2004). Finally, there are a few empirical applications based on these models (*e.g.*, Frey and Oberholzer-Gee 1996; Frey, Oberholzer-Gee, and Eichenberger 1996). Our model of institutional transformation in a transition economy follows closely Frey (1993, 1997) but focuses on the effect and the interaction between internal and external factors on institutional transformation as the *conditio sine qua non* for achieving the political and economic stability along with the high economic growth rate.

If one is to consider this problem in the principal-agent framework, the "international community" may be considered the principal while the transition economy may be considered an agent. According to this theory, the principal has a set of goals for the agent to achieve which coincide with its own goals. Also, the principal has a set of policy instruments (*e.g.,* economic, financial, military) at its disposal that should ensure the agent's compliance with a set of actions proposed or designed by the principal for the agent to follow in order to accomplish the goals. We will show that even when the agent has the same set of goals as the principal, too much external control and monitoring by the principal is likely to slow down or even to reverse the agent's effort and performance.

Three types of psychological processes are assumed in this model. First, when a psychological contract exists between principals (the international community institutions) and agents (the transition economies), the agents may perceive increased monitoring or external involvement as an indication of distrust, and this may induce them to reduce or slow down the institutional change leading to a slow down in economic growth. Second, if transition countries perceive the external intervention as controlling so the extent to which they can determine actions independently is significantly reduced, intrinsic motivation is substituted by external control, *i.e.*, the locus of control moves from the inside to the outside of the transition country itself. In other words, countries which are forced to behave in a specific way by outside intervention are likely to rationally reduce the motivational factors under their control, *i.e.*, the intrinsic motivation. Third, an extensive external monitoring may undermine the transition country's intrinsic motivation since it may be interpreted by the transition country how its intrinsic motivation and competence are not appreciated. This may further lead to either impaired national self-esteem or to resentment towards the international community resulting finally in an impeded institutional transformation and a reduced economic growth rate.

Based on the above psychological processes, the hidden costs of control and reward in the case of a transition economy can be generalized as the following: (1) all external intervention including both control and reward can affect the transition

economy's intrinsic motivation; and (2) external intervention crowds-out intrinsic motivation if it is perceived to be controlling; it crowds-in intrinsic motivation if it is perceived to be supporting.

It is important to emphasize at this point that the psychological crowding theory relates only to the effect on motivation since that, rather than behavior, is what psychologists are interested in. However, one can simultaneously account for the external control effect on institutional change which in turn determines the level of performance of the economy be it measured as the economic growth or social welfare. This kind of problem concerns economists and can be best modeled in the principal-agent setting.

A transition economy (an agent) adjusts its performance and institutional change P considering both benefits B and costs C incurred during the transition to markets process. Benefits and costs are also influenced by the principal's (international community's) external intervention or pressure, E, both directly and indirectly, via the effect on the operating of internal (domestic) institutions and process, I, that are already in place and in operation. This model can be presented with the following two equations:

$$B = B[P(I(E), E)], \quad (1)$$

$$C = C[P(I(E), E)]. \quad (2)$$

Both benefits and costs increase in performance, $\partial B/\partial P \equiv B_p > 0$ and $\partial C/\partial P \equiv C_p > 0$. It is assumed furthermore that the transition economy rationally chooses the level of performance and institutional change P^* that maximizes net benefits $(B – C)$. This yields the first order condition:

$$B_p = B_p. \quad (3)$$

Differentiating further, this economic growth - social welfare maximizing condition with respect to E will show how the transition economy's optimal performance P^* is affected when the international community changes the extent of external pressure:

$$dP^*/dE = (B_{PE}C_{PI} - B_{PI}C_{PE}) / (C_{PI} - B_{PI}) . \quad (4)$$

The second-order partial derivatives are signed as following.

a) $C_{PE} < 0$ implies that, based on the standard principal-agent theory, external intervention raises performance by imposing higher marginal cost on shirking, *i.e.*, by lowering the marginal cost of performing.
b) $C_{PI} < 0$ implies lower marginal cost of performing due to internal institutional adjustment made, based on intrinsic motivation of citizen and domestic/internal organizations and institutions.
c) $B_{PI} > 0$ implies increasing marginal benefits of performance due to more efficient internally adjusted domestic institutions.
d) B_{PE} is the crowding effect and can be positive, zero, or negative. $B_{PE} > 0$ is called the crowding-in effect and implies that the external pressure or intervention bolsters intrinsic motivation. $B_{PE} = 0$ implies that the crowding effect is neglected or, in other words, the change in external pressure does not affect the marginal level of performance. Finally, the crowding-out effect, $B_{PE} < 0$, implies that the external pressure or intervention subdues the intrinsic motivation.

It is clear that the sign of the dP^*/dE will depend on the nature of the crowding effect. The external pressure will always lower the performance in the presence of the crowding-out effect or when the crowding effect is assumed zero (neglected). Moreover, even if we have crowding-in effect in play, that is still not a guarantee that the external

intervention will for sure result in higher level performance of the transition economy. Thus, the crowding-in effect of the increased external pressure or intervention is necessary but not a sufficient condition for the increased level of performance of the transition economy.

The crowding effect is in reality the response of individuals in transition society to external pressures. What benefits external pressure to make quick and sweeping institutional changes will yield to a transition society is a matter of perceptions of individuals in that society. In other words, following Wicksell (p. 79), "… whether the benefits of the proposed activity to the individual citizens would be greater than its cost to them, no one can judge this better than the individuals themselves."

4. Implications of External Pressures on Institutional Changes and Economic Growth in a Transition Economy

Based on the above model, it is clear that external pressures may slow down economic growth due to the completely halted process of institutional change in a transition economy or even when some institutional changes are made based on external recommendations or recipes. If this is to be put in the context of the organizational, or in this case the institutional portfolio theory, external factors in the institutional portfolio may lead in multiple ways to a lower level of economic performance of a transition economy. Figure 1 contains the algorithm showing the paths towards improvement or decline in economic performance of a transition economy under the set of assumptions employed in this scenario.

(INSERT FIGURE 1 HERE)

Internal (domestic) factors in this model are assumed to lead to a high performance level of the economy with a little need for further institutional change. They ultimately lead towards long-term success in terms of goals such as sustainable economic growth and increasing social welfare. This may not be a far-fetched assumption for many countries that recognized quickly what it is that they need to change in their existing institutions in order to be successful in their transition toward market economy. Indeed, when the motivation for changing the political and economic system was intrinsic and know-how was there (*e.g.*, such as in Hungary or in the Czech Republic), such economies needed little external guidance in order to succeed.

The impact of the external factors (pressure) on the economic performance of a transition economy is ambiguous. The external pressures leading to a crowding-out effect or to the lack of crowding effect always result in a decline in economic performance of the transition economy. Indeed, perceived distrust of the international organizations and institutions regarding the abilities or intentions of the internal institutions is likely to lead to "too much controlling" and to adversely impact the intrinsic motivation within the transition economy. The external pressures leading to crowding-in effect may lead under certain circumstances toward long-term success (*i.e.*, sustainable high economic growth rate and improved social welfare). That is likely to happen when additional external pressures coincide with internal policies and institutional changes. An already high performance level of the economy may be just reinforced by the external approval of the internal-domestic management of the transition process. Minimal or no further institutional changes are needed to maintain the prospect of the long-term success under these circumstances. A crowding-in effect, however, may

lead to the moderate economic performance level as well. This can happen when current internal institutions are not suited to deal with proposed transition programs and initial external pressure and assistance have only marginal impact on the economic performance. If additional external pressures are constructive, internal (domestic) institutions may adapt to fit the circumstances and both domestic and external environments. In turn, this institutional adaptation is likely to lead towards much improved economic performance in the long run. On the other hand, if external pressures are perceived as threats and/or if there is a lack of understanding and ability on how to make adjustments in internal institutions, the economy is likely to follow the path of gradual decline illustrated in declining economic growth rates and lower welfare of its citizens.

Our model in its essence is consistent with basic public choice premises. Individuals within transition economies are aware of the choice environment. That this assumption is actually reasonable has been recently documented in Mueller (2005) in his analysis of constitutional institutions in transition economies of Europe. Furthermore, there is clearly institutional barrier between the revealed expression of preference and direct satisfaction of individuals' goals in the form of external pressure (or assistance) to follow a very specific (and possibly different) path of development and institutional change. The failure in the transformation of a centrally planned to market economy emerges, to follow the language of Buchanan (1987, p. 247), "…not in the translation of individual preferences into outcomes, but in the possible presentation of some choosers with alternatives that do not correspond to those faced by others in the exchange nexus." In other words, external players with their independent set of goals pressure the transition economy to follow a very specific path towards markets without considering the possibilities individuals within transition economies perceive as the alternatives for their future. The process of institutional changes is political while its consequences are both political and economic in their nature. Transition countries offer a unique opportunity to analyze electoral participation in the institutional changes during the early years of democratic development. These countries can be regarded as "new democracies", with few people having actual memories of voting in democratic elections and thus experience of liberty of choosing the path of development. Many of the parties themselves are also new and have had relatively little time to establish a voter awareness to enable them to be used as an effective signal. There are also a larger number of political parties than is typically the case in western democracies. Hence there are reasons to suppose that the transactions costs of electoral participation are high relative to those of established democracies. But as against this the recent memory of a non-democratic past may enhance civic duty (Orviska, Caplanova, and Hudson 2001). In turn this leads to relatively larger number of potential strategies a country may pursue in its transition and voters can chose from. Thus a great potential for crowding-out effect of any particular strategy that has been forwarded (externally) onto voters too forcefully exists.

One can see from the above analysis that the use of external pressure, interference, or assistance to modify internal transition processes and institutions must be carefully planned by the principal to fit the circumstances and characteristics of a specific transition economy. Hence, our model is consistent with the World Bank's latest assessment of how the international community must accept the multiplicity of paths leading to successful and operational market economies. This all is true only if the

principal has genuinely positive intentions to help the transitioning country to succeed in creating the economy compatible with the currently prevailing set of institutions within market economies. However, when the principal's interests differ from the interest of the transition economy, more complex strategic gaming is likely to capture their relationship more accurately. This is the topic that deserves serious attention in future research.

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Institutional Portfolio Factors	Performance Risks	Performance Level	Institutional Change	Economic Performance Outcome

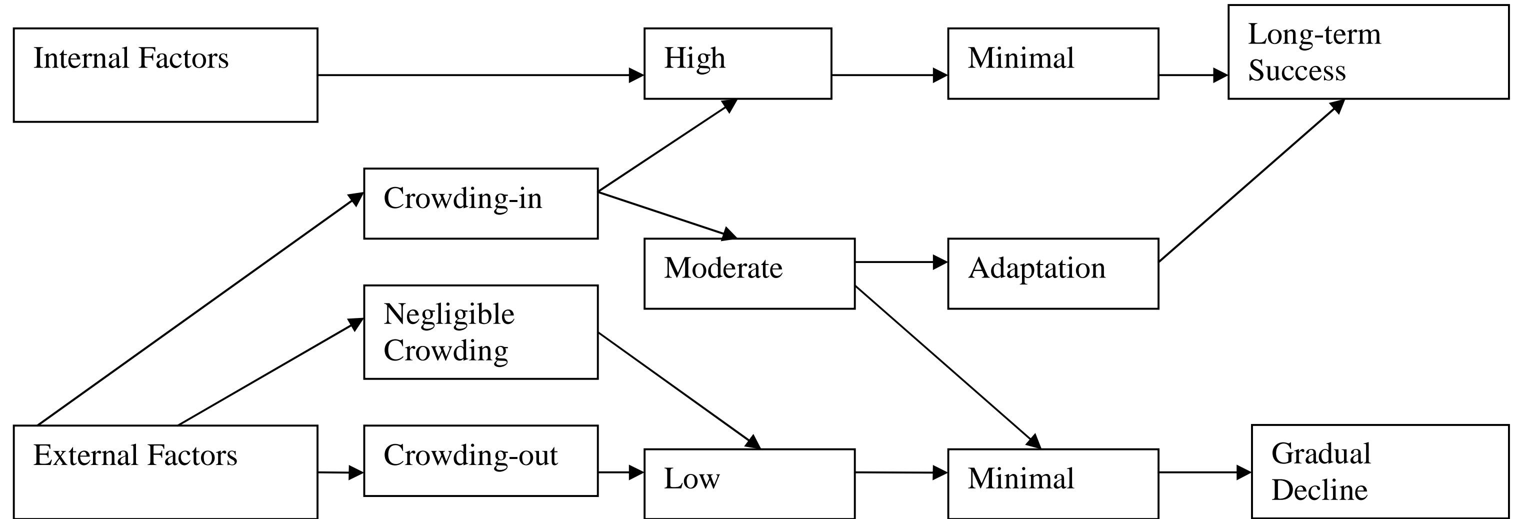

Figure 1. Institutional Portfolio Factors as Causes of Performance Risk, Performance Level, and Institutional Change in a Transition Economy

Footnotes

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[1] Notable exceptions would be a few countries in Central Europe such as Hungary, the Czech Republic, or Poland which have a very rich history and a sense of national identity. Some of these countries have been among leading capitalist economies in the pre-World War II Europe. Transition to market economy for these countries is, in many ways, going back to where they used to be several decades ago and market institutions are not a mysterious unknown to them. On the other hand, some countries made a leap from feudal or quasi-feudal society to communism directly, and the way a market economy of capitalism operates is likely somewhat of a mystery to them.