

# Growth, Initial Conditions, Law and Speed of Privatization in Transition Countries: 11 Years Later

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August 4, 2004

## Abstract

This paper examines alternative hypotheses concerning the determinants of success in the transition from Communism to the market. In particular, we look at whether speed of privatization, legal institutions or initial conditions are more important in explaining the growth of the transition countries in the years since the end of the Cold War. In the mid 90s a large empirical literature attempted to relate growth to policy measures. A standard conclusion of this literature was the faster countries privatized and liberalized, the better. We now have more data, so we can check whether these conclusions are still valid six years later. Furthermore, much of the earlier work was flawed since it did not adequately treat problems of endogeneity, confused issues of speed and level of privatization, and did not face up to the problems of multicollinearity. Our results suggest that, contrary to the earlier literature, the speed of privatization is negatively associated with growth, but it confirms the result of the few earlier studies that have found that legal institutions are very important. Other variables, which seemed to play a large role in the earlier literature, appear to have at most a marginal positive effect.

## 1. Introduction

The end of the communist era brought much optimism over the growth possibilities of the economies that are now referred to as the transition countries. An inefficient system, rife with distortions and without incentives, was to be replaced by the market. Privatization, liberalization, and decentralization would bring unprecedented prosperity. To be sure, there were some worries about a short transition recession. But the only real issue was how best to secure the transition.

Two schools of thought developed, one advocating shock therapy <sup>[1]</sup> and the other supporting gradual change. The former contended that the faster these countries achieved an economic structure similar to market economies the better off the population would be, and that the best way of doing so was to liberalize and privatize as quickly as possible. This school tended either not to emphasize the importance of institutions, including the legal and financial infrastructure, or to argue that the best way to achieve the requisite institutions was to privatize quickly in order to create a political and economic demand for these institutions. The gradualists worried that without the institutional infrastructure, which could only be gradually created, privatization might lead to asset stripping rather than wealth creation. They also were concerned that not only would monopolies undermine the dynamics of the economy, but might use their wealth to advance political institutions and policies which would maintain their wealth and monopoly. Today, the record of those economies that pursued shock therapy has been at best mixed; several countries have shown a dismal growth performance (see Table A1 in Appendix A).

The most successful transition economies by far have been China and Vietnam<sup>[2]</sup>, both of which pursued gradualist policies. There are, however, some major problems in interpreting these experiences. First, each of the countries in transition differs from the others in initial conditions. Some<sup>[3]</sup> argue, for instance, that China and Vietnam have an advantage because they are *less* developed. But the least developed countries have, in general, not done well over the past twenty years; it is not obvious why compounding one difficult problem, development, with another, transition, should make life easier. Moreover, the countries of the FSU (Former Soviet Union) that were the least developed, like Kyrgyz Republic, did not fare particularly well<sup>[4]</sup>. Secondly, there are many aspects of economic policy that might, in principle, affect success—not just privatization and liberalization, but also, for instance, inflation and macro-stability. Moreover, different aspects of initial conditions—institutional initial conditions and economic institutions conditions—might affect success differently. Cross sectional statistical studies hold out the prospect of sorting out the relative importance of these various potential strands.

In the mid 90s, such studies attempted to sort out the relative importance of policies<sup>[5]</sup> and initial conditions<sup>[6]</sup> in determining the success in transition. Many of the studies concluded that policies, in particular, fast liberalization and privatization, combined with macro-stability were the key to success. But as in Aesop's fable, the tortoise may have overtaken the hare. Countries like Poland and Slovenia that pursued gradualist policies appear far more successful than those under shock therapy. In some cases, they may have even advanced further in privatization or liberalization. With the additional data of five years—doubling the span of time of the earlier studies—we can at last begin ask the question, does speed help. Of two countries, both by 2001 have privatized most of their enterprises, did the country that did so rapidly outperform the country that did so more gradually? The results confirm casual impressions: shock therapy was not conducive to success.

In answering this question, as well as identifying the relative role of initial conditions, policies, and institutions, we should be clear: cross section analysis can at best be only suggestive. We do not have a full set of data that would enable us, for instance, to quantify precisely all of the relevant initial conditions, which would include not only the level of per capita income (a measure of development), and the economic structure (e.g. the fraction of the economy in agriculture. The fraction of output in commodities which are easily marketed internationally), but also the implicit tax or subsidy leveled on the country as a whole by Russia (e.g. when the prices they received for their sales were below international prices, or the prices they paid for say oil were below international prices), or the degree of dependence on Russia (determining the extent to which the country's decline was related to the decline in the Russian economy). Those countries that were nearer Western Europe might not only have greater access to Western European markets, but also be more influenced by Western European ideas.

Moreover, with so many variables, and only a limited number of countries, it is not easy to sort out the relative role played by each factor. Making matters worse, there is a high level of multicollinearity. As we have noted, the countries of Western Europe had a geographical advantage *and* a difference in history. Furthermore, the prospect of accession to the EU provided some spur for faster institutional change. Policies and institutions may both be endogenous.<sup>[7]</sup> Most of the earlier studies not only ignored the problem of endogeneity and pay insufficient attention to multicollinearity but they also lumped institutional and economic initial conditions together in a single index. In this paper, we not only look at what insights the past half-decade can provide on the transition, but also try to deal explicitly with each of these other problems.

This paper is organized as follows. The next section covers the literature review. Section 3 describes the data

and methodology used in this paper. Section 4 describes the results using both Ordinary Least Squares (OLS) and Two-Stage Least Square (TSLS) regressions. Section 5 presents our conclusions.

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## 2. Literature Review

Our paper relates to the cross-country empirical literature on growth in transition countries, trying to sort out the roles of,

- a) Policies, more specifically, liberalization and privatization, and the speed with which they were implemented (including using instrumental variables to correct for endogeneity of policy indexes).
- b) Initial conditions as a “burden” left by the Communist era.
- c) Institutions and, more specifically, legal institutions.

### 2.1. Liberalization Policies

De Melo, Denizer and Gelb (1996) first identified the positive relationship between indexes of liberalization and economic growth for (26) countries in transition. They calculated annual indexes of liberalization. They employed a cumulative measure the Cumulative Index of Liberalization (CLI) [\[9\]](#). Controlling for initial income per capita and a dummy for regional tensions, they found that the liberalization index has a positive significant effect on 1989-1994 average growth.

Subsequently, Selowsky and Martin (1997) used indexes from De Melo, Denizer and Gelb (1996) for a panel data of 25 transition economies. They attempted to adjust growth rates for underreporting and to control for “war” using a war dummy. They also obtained results similar to De Melo, Denizer and Gelb (1996). Sachs (1996) provided a similar regression analysis for 1989-1995 average growth without controlling for any other variables and obtained a similar positive relationship [\[10\]](#).

Fischer, Sahay and Vegh (1996a, 1996b) performed Generalized Least Square on a pooled panel data of 25 transition countries for 1992-1994 growth rates and De Melo, Denizer and Gelb (1996) liberalization indexes, controlling for country effects. In the first paper they included as controlling variables inflation, fiscal deficit as percentage of GDP and official external aid as percentage of GDP. In their second paper they only controlled for fiscal deficit and a dummy for fixed/flexible exchange rate. In both cases, they found a positive relationship between growth and liberalization policies.

Aslund, Boone and Johnson (1996) also used CLI for explaining cross sectional 1989-1995 cumulative growth rate of 24 transition countries. In addition, they included a dummy for ruble zone and war-torn countries. When these variables are added to the regression, the effect of CLI vanished. Fidrmuc (2001) pointed out that these authors interpreted the significance of these variables as distinctive negative legacy inherited from the communist regime. In this sense, former Soviet Union countries received a worse legacy than Eastern European countries. This issue of legacy draws attention to a different and competitive explanation for explaining the cross sectional growth of transition countries, that is, initial conditions related to the “burden” left by the communist era.

### 2.2. Role of initial conditions and instrumental variables

De Melo et al (1997) provided the first comprehensive analysis of the effect of initial conditions on growth in 28 transition countries. Moreover, they introduced the principal components methodology to this literature. We use this technique in this paper. They included in their estimation the two first principal components of eleven initial conditions [\[11\]](#) [\[12\]](#). Based on a panel data growth regression, they concluded that both liberalization policies and initial conditions are important to explaining growth. However, in their cross-sectional regression the liberalization index had a negative but insignificant coefficient.

Popov (2000) found that after controlling for initial conditions, the liberalization index becomes insignificant. This author ran several regressions using 1990-1996 growth rates and 1990-1998 growth rates for a cross section of 28 transition countries. In his regressions he included an aggregate measure of distortions <sup>[13]</sup>, a FSU (Former Soviet Union republic) dummy, a War dummy, 1987 Purchasing Power Parity (PPP) GDP per capita as a percentage of the US level and log of average inflation. He found that the CLI is insignificant for both cases of growth rates. In a second step he replaced the FSU dummy with the fall of government revenues as a percentage of GDP and shadow economy as a percentage of GDP in 1994, finding again that CLI was insignificant. Finally and more important for our paper, he included a measure of rule of law, which is marginally significant.

Krueger and Ciolko (1998) found results similar to that of De Melo et al (1997). This paper applied an instrumental variables approach in order to make the CLI endogenous. The dependent variable is a cross section of output growth from 1989-1995 for 18 transition countries. The instruments used are share of export in 1989 Gross National Product and 1988 GNP per capita <sup>[14]</sup>. These authors ran first a regression of CLI on the instrument and obtained a predicted CLI. In the second regression (growth regression) the coefficient on predicted CLI was negative but not very significant (In addition, they employed as controls a tension dummy and FSU dummy in the growth regression. see Regression 5 on Table 2, page 725).

While this paper is the first attempt in the literature to make CLI endogenous, it has one problem. The estimators of the coefficients in the second equation are inconsistent. The mistake is that in the first regression of this two-step procedure it is necessary to include all the (exogenous) variables and not only the instruments <sup>[15]</sup>. In our work we correct for this mistake by including all the other (exogenous) variables in the estimation of the first equation.

Heybey and Murrel (1999) also make endogenous the liberalization indexes. They performed a three-stage least square on growth rate for 26 transition countries and they found that their initial conditions are significant but the coefficient of speed of liberalization and the coefficient of policy level are insignificant.

Moreover, Heybey and Murrel (1999) dealt with several significant methodological issues existing in the cross-country empirical literature on growth in transition countries. They are the following:

- 1) The failure to include some key initial conditions causes an omitted variable bias.
- 2) The use of cumulative liberalization indexes or annual indexes does not allow distinguishing between the effect of the *level* of the policy variable and the *speed* with which it was implemented.
- 3) Speed of reform may be an endogenous variable.
- 4) Using the same calendar years for calculating growth rate and liberalization indexes for different countries implies that different phases of the post-communist cycle are included. Following the suggestion of these authors, we experiment with growth rate and speed for different starting points of the transition in our regressions. The results are very similar to those using the same starting point.

### 2.3. Role of Institutions

Until recently, strength of legal institutions as a possible explanation for dissimilar growth performance was largely ignored in the empirical literature on transition countries, probably because of a lack of data for the first half of the decade. Since 1997 several organizations started to collect data. In addition, Campos (1999) <sup>[16]</sup> calculated data for institutional variables from 1989 to 1997.

Brunetti, Kisunko and Weder (1997) were the first to estimate OLS regressions using legal and political institutional variables as explanatory variables. These variables were obtained from a survey that quantified *perceptions* of companies in different countries around the world.<sup>[17]</sup> They considered only variables pertaining to 20 transition countries and ran regressions using 1990-1995 per capita growth rates for those countries as dependent variables<sup>[18]</sup>. They found that these institutional measures affect positively cross sectional growth. In addition, they used instrumental variables for correcting some endogeneity problems of these institutional variables and showed that their results stand.

Moers (1999) and Grogan and Moers (2001) ran four cross sectional growth regressions for 25 transition countries in 1990-1995 using four institutional measures<sup>[19]</sup> and two controlling variables (inflation and war dummy). They found that in all cases these measures are positively associated with growth but are not very significant. In addition, they checked for endogeneity of the institutional measures and they found similar results to the OLS results.

Havrylyshyn and Rooden (2000) ran the same panel data that De Melo et al (1997) but only for 25 transition countries. They employed the same measures of initial conditions and liberalization indexes, but they included lagged values of the latter measure. Moreover, they included the inflation rate and, more importantly, institutional variables. These consisted of the first principal component of nine institutional variables from diverse sources. In addition, they split them in legal and political variables. They found a significant positive relation between growth and liberalization indexes. They also found a significant positive relation between growth and the principal components of institutional variables; this relationship is especially strong for legal variables.

Stiglitz (2001) provides another attempt to include an institutional variable in explaining cross sectional growth among transition countries. He ran an OLS regression on 1990-1998 growth rate of 25 countries. The explanatory variables are 1997 EBRD index of privatization of large and small-scale enterprises (policy measure), 1997 EBRD index of governance and enterprise restructuring (institutional measure) and a variable that measure the interaction of the two former variables. He found that the privatization index is insignificant, but the index of governance and enterprise restructuring and the interaction variable are highly significant<sup>[20]</sup>.

### 3. Data Description

In this section we describe the variables used in our empirical analysis. The tables in Appendix A show the complete data exploited in this paper. We employ as dependent variable the total growth rate for 1990 through 2001 for 23 transition countries [21]. Despite the fact that this sample seems small, it is standard to use this kind of “small” sample in this literature. Because the variability among countries growth rates is relatively high [22] there is some hope of identifying critical determinants of growth. Still, the small number of countries and the large number of possible explanatory variables suggests that the task of cleanly defining the relative importance of different variables may not be easy.

We measure the strength of legal institutions employing data from a survey conducted by the World Bank and EBRD. They surveyed more than 4000 firms on 23 transition countries on several areas such as business environment, corruption and legal system. Specifically, we consider positive answers related to the strength of the legal system and enforcement of property rights (see Table 1: Panel 1) [23]. The expected sign of this variable in the growth regressions is positive.

The effect of policy on growth is quantified by two different variables. In order to measure the effect of policy speed we use the absolute difference between 1991 and 2000 EBRD small-scale and large-scale privatization indexes (see Table 1: Panel 1). The effect of policy level is captured by the 2000 observation of the same index.

As Heybey and Murrell (1999) so forcefully explained, it is important to discriminate the effect of policy *level* from policy change on growth. Overall, the empirical literature has used empirical results suggesting a positive effect of the level of privatization to argue for fast privatization. The two schools of thought on transition differ strongly on their prior beliefs about the coefficient of the *speed* of privatization. The shock therapists believe that, ten years out, the countries that privatized most quickly would be ahead of the game—their growth rates would be higher. The gradualists argue that the coefficient on the speed variable should be negative.

The initial conditions are gauged by a set of institutional variables, using principal component analysis [24]. This analysis provides two important outputs that give some intuition as to what exactly the components are measuring. They are the correlation between the principal components and the original variables and the percentage of variance explained by  $i^{\text{th}}$  principal component. The latter measure is computed by dividing the eigenvalue associated to the corresponding principal component by the total sum of the eigenvalues. Intuitively, the first output tells us about the nature of the component and possible interpretation of it. The second output gives a sense of the importance of the component in terms of the variability of the original variables.

Initial conditions are calculated using the 1989 observation of institutional variables for East European countries and the 1991 observation for FSU countries from Campos (1999) [25]. Table 1: Panel 2 explains the nature of these data. We employed the 1991 observation for the former Soviet Union republics because the actual transition started approximately that year. In the case of East European countries the transition began after the Berlin Wall fall that occurred in 1989.

Table 2 shows that the first principal component is strongly correlated with each of these variables. In addition, this component explains a good portion of the variability of the original variables. In consequence, this component corresponds to the initial institutional strength and, thus, its expected sign is positive in the

growth regressions (the higher the score in these indexes the better the institutions.)

Finally, Table 1: Panel 3 shows the detail of the instruments used in the two-stage least square regressions. These instruments are selected based on the two traditional econometric criteria used for choosing instrumental variables.

First, our instruments are clearly correlated with our measures of policy since speed and final level of privatization are certainly related to pre-existing level of reform. This level is captured with our instruments because they reflect the amount of distortions left by the communist policies.

For instance, the variable that captures years under the communist rule reflects the fact that East European countries were communist for a much shorter span than FSU countries, except for the Baltic countries and Moldova. The black market foreign exchange premium reflects the fact that, generally speaking, East European official rates were closer to market exchange rates. Defense spending, industrial structure and trade distortions are also lower on average for East European countries than for former Soviet Union republics. Moreover, our instruments also reflect an important variability within two groups of countries. For example, in the case of industrial structure and trade distortions, former Yugoslav countries were much less distorted than other East European countries.

Second, the other important criterion for selecting instruments is that these instruments, like the dependent variables, are exogenous in the growth regressions. To be sure, we ran the test of overidentifying restrictions and we found that they are effectively uncorrelated with the errors of the growth regressions.

**Table 1: Data Description**

<b>Panel 1: Regressions Data</b>		
<b>Variable</b>	<b>Definition</b>	<b>Source</b>
Growth	Logarithm of the ratio of 2001 GDP and 1989 GDP	United Nations Economic Commission for Europe Common Database
Enf	Proportion of firms in the countries of the sample that agree in 1997 to the following question: To what degree do you agree that the legal system will uphold contract and property rights?	Business Environment and Enterprise Performance Survey, World Bank and the European Bank for Reconstruction and Development (EBRD).
Dp00p91	One tenth of the difference between the 2000 average of the indexes of Small-scale and Large-scale privatization and the 1991 average of the same indexes.	EBRD
Privi00	2000 average of indexes of Small-scale and Large-scale privatization.	EBRD
PC1inst	First principal component of the institutional initial conditions	Based on variables obtained from Campos (1999).
<b>Panel 2: Institutional Initial Conditions</b>		
<b>Variable</b>	<b>Definition</b>	<b>Source</b>
Transacc8991	Indicator from 0 to 10 that measures both transparency of policy-making and accountability of the executive.	Campos (1999)
Rulelaw8991	Indicator from 0 to 10 that measures both quality of law enforcement and "substance" of law itself.	Campos (1999)
Buroqual8991	Indicator from 0 to 10 that measures the quality of local bureaucracy.	Campos (1999)
Civsoc8991	Indicator from 0 to 10 that measures civil liberties, political rights and influence of civic organizations.	Campos (1999)
Note: For East European countries we used the 1989 score and for former Soviet Union republics we used the 1991 score.		
<b>Panel 3: Instruments</b>		
<b>Variable</b>	<b>Definition</b>	<b>Source</b>
Years	Years under communist rule.	De Melo et al. (1997)
Blkpr	1990 percent difference between black market exchange rate and official exchange rate.	De Melo et al. (1997)
Def	Late 1980s defense expenditure as percentage of GDP.	Popov (2000)
Indst	Late 1980s sum of the absolute value of deviations of the share in GDP of each three sector (agriculture, industry, service) from the "normal" level. "Normal" was defined as the average for the group of market economies with comparable PPP GDP per capita. These values are 1990.	Popov (2000)
Trdist	Late 1980s sum of the three trade distortion measures calculated by Popov (2000). These are the following: trade openness, which is the "normal" share of external trade in GDP (defined in a similar way than before) minus the actual share; external trade within FSU as share of GDP; and external trade with socialist countries as share of GDP. These values are 1990.	Popov (2000)

**Table 2: Principal Component Analysis**

<b>Principal Component of the Institutional Initial Conditions</b>			
<b>Correlations</b>		<b>Percentage of Variance Explained</b>	
	<b>IPC</b>		
Transacc8991	0.8021	1PC	0.4908
Rulelaw8991	0.8844	2PC	0.2874
Buroqual8991	0.6398	3PC	0.1206
Civsoc8991	0.3117	4PC	0.1013

## 4. Econometric Analysis

### 4.1. Ordinary Least Square Regressions

We estimated Ordinary Least Square regressions using the variables described in the previous section. The R square is reasonably high considering the size of the sample.

The first regression is a simple regression with the property rights enforcement variable described before (see Table 3). The coefficient has the expected sign (positive) and is highly significant. The adjusted R square is also fairly high, above 40%, which shows that this variable is highly correlated with growth rate.

In the second regression we only include the variables that measure policy level and policy speed. The adjusted R square is also high. The coefficient for policy speed (Dp00p91) is significant and negative. The coefficient of level of policy (Priv00) is positive and significant [\[26\]](#).

In the third regression we put together the former variables. The privatization speed preserves its significant negative effect. The privatization level maintains its sign but decreases its significance to only 10%. The property rights enforcement still has a positive and significant effect on cross sectional growth. In addition, the adjusted R square has a noticeable increase, from 35% to 56%. [\[27\]](#)

In the fourth and final regression we add the principal component that captures the institutional initial conditions. It has the expected sign but it is not significant. Other authors [\[28\]](#) have found that these variables are very significant in explaining growth among transition countries. Therefore, our results suggest that initial conditions have decreased its importance since the beginning of the transition.

In summary, first, consistent with earlier literature, property rights enforcement has a positive and very significant effect. Second, in contrast to earlier literature, privatization speed has a negative effect on growth. This earlier literature, however, systematically confused privatization *speed* with the level. Third, the coefficient of level of privatization is positive but only marginally significant. Finally, initial conditions seem to have little effect on growth after ten years of transition [\[29\]](#). In the next section, we will see whether these “new” facts are able to stand the check for endogeneity.

Table 3: OLS Regressions  
 (Dependent variable is the 1990-2001 GDP growth rate)

Variable	Reg. 1		Reg. 2		Reg. 3		Reg. 4	
	Beta	Tstat	Beta	Tstat	Beta	Tstat	Beta	Tstat
Constant	-0.91	-5.57	-0.78	-2.15	-1.00	-3.20	-1.33	-3.42
Enf	1.44	4.23			1.10	3.04	1.14	3.22
Dp00p91			-4.34	-3.06	-2.72	-2.08	-3.00	-2.32
Privi00			0.42	2.96	0.24	1.81	0.27	2.07
PC1inst							0.03	1.37
R-Squared		46.0%		35.1%		56.4%		60.5%
Adj R-Squared		43.5%		28.6%		49.5%		51.7%
N		23		23		23		23

## 4.2. Two-Stage Least Square Regressions

In this section we perform a simultaneous equation approach. We suspect that both policy measures (speed and level) are not exogenous to economic growth <sup>[30]</sup>. One explanation is that in successful countries it is possible to build political support for reforms such as privatization and, thus, they have been able to privatize more and faster. (Another possible reason is that successful countries can afford to hire more experts in privatization so they can speed up their privatization process.) Finally, *ceteris paribus*, countries with faster growth collect more taxes so they can privatize more and faster without facing budgetary problems.

Table 4 provides the OLS and TSLS regressions. In the first regression we only include the property rights enforcement and policy variables. The most noticeable difference between the OLS and TSLS estimation is that the coefficient of the variable that measures level of privatization becomes insignificant though it is still positive. The sign and significance of the coefficient on the property rights enforcement and speed variables is unchanged. In addition the R-squares are practically the same. The results obtained from the previous section are still valid.

In the second regression we add the institutional initial conditions variable. Again, there is not much difference between the OLS and TSLS regressions. The only change is a decrease in the significance of coefficient for the level of privatization (which is now significant only at the 10% level.). This regression allows us to summarize the above conclusions. First, in the TSLS and OLS estimation the positive effect on cross sectional growth of property rights variable is strong. Second, the speed of privatization variable maintains its negative sign and significance under the two-stage least square estimation. Moreover, according to our result, policy level tends to have only a marginal effect on growth. Finally, initial conditions have an insignificant effect on growth.

Table 4: TSLS Regressions  
(Dependent variable is the 1990-2001 GDP growth rate)

	OLS		TSLS		OLS		TSLS	
	Beta	Tstat	Beta	Tstat	Beta	Tstat	Beta	Tstat
Constant	-1.00	-3.20	-0.95	-2.30	-1.33	-3.42	-1.33	-2.79
Enf	1.10	3.04	1.07	2.87	1.14	3.22	1.13	3.12
Dp00p91	-2.72	-2.08	-3.12	-2.05	-3.00	-2.32	-3.10	-2.09
Privi00	0.24	1.81	0.25	1.64	0.27	2.07	0.28	1.82
PClinst					0.03	1.37	0.03	1.38
R-Squared		56.4%		56.1%		60.5%		60.5%
Adj R-Squared		49.5%		49.2%		51.7%		51.7%
N		23		23		23		23

Instruments: Years, Blkpr, Indst, Def and Trdist.

## 5. Conclusions

At the beginning of the 90s the Eastern European and for Soviet Union countries started a massive process of political and economic reform. The hope was that they would achieve life standards similar to developed countries.

Two answers were offered. On the one hand, the process of liberalization and privatization should be done as quickly as possible [31]. In order to complete this process soon, the advocates of this position believed not only that the faster a transition country would become a market economy, in particular, the faster it privatized, the quicker this country would be able to avail oneself of the growth opportunities that the market provided [32]. On the other hand, others proposed a more gradual process of reform. The sale of government assets needed to be done slower and the economy has to be liberalized more gradually. Our results tend to support this position.

At mid nineties a growing empirical literature started to develop in support of the “faster” position. This literature claimed that the evidence supported the view that the faster transition countries liberalize and privatize the more they would grow. This important conclusion started to be attacked in several directions, in terms of model specification and econometrics. First, the above assertion disregarded the role of initial conditions. Second, important questions were raised about the exogeneity of these policies. Third, institutional differences could also be important in explaining the uneven performance of transition countries. Fourth, this literature did not measure correctly the *speed* variable [33].

In this paper we consider all three concerns in our estimations. Our results can be summarized as follows. First, the most striking (though perhaps not surprising) result is the importance of our measure of institutional strength. This result is similar to what other author have found. Secondly, what surely will be the most controversial result of this paper is the finding that privatization speed has a negative effect on growth, reinforcing the growing anecdotal support for the gradualists and against shock therapy. Third, we found that initial conditions have an insignificant effect on cross sectional growth. One possible explanation for the insignificance of initial conditions (which previous studies have emphasized) is that we are using a longer time series.

While we believe our paper has made some advances over earlier literature in untangling the various factors affecting success in transition, much remains to be done.

First, it is important to disentangle the effect of privatization itself from related policy decisions that also influence long-term growth. For instance, the method chosen for privatized state owned enterprises is an important policy decision that actually differed greatly across transition countries. Each country used basically some distinctive combination of three privatization methods: direct sale (sometimes to foreigners), mass privatization programs (often through vouchers) and management-employee buy-outs. These choices certainly affected the ownership structure, corporate governance and restructuring process of the privatized companies [34]. The impact of privatization (including the speed of privatization) almost surely depended on the form of privatization [35].

Regulatory and competition policies are other important policies that help to determine how privatization would affect the country growth performance [36]. A country that simultaneously privatized and established a regulatory framework that promotes competition and free entry boosts its growth potential compared to a

country that only privatizes and leaves unchanged the old business environment. As Stiglitz (2000) emphasized, the legal framework affecting corporate governance too can be an important determinant of the success of privatization. Policies that affect the development of the financial sector can also be critical, not only in determining overall growth (e.g. as a result of the creation of new enterprises), but also in the success of privatization. Without access to finance, those who obtain the privatized assets are more likely to engage in asset stripping. But the development of the financial sector may itself be endogenous to privatization (both the extent of privatization and its form.) For instance, if privatized companies' securities are traded publicly they can be the backbone for a more sophisticated financial market [\[37\]](#).

Moreover, even the legal structure could be viewed as endogenous, as Hoff and Stiglitz (2002) points out. Policies that affected the desirability of asset stripping versus wealth creation (macro-policies, liberalization policies, such as those relating to capital outflows, and financial policies) affect the likelihood of the development of the "rule of law," of institutional variables that are critical for success in growth.

One challenge is to find good proxies for many of these potentially important variables (e.g. privatization method, ownership structure, corporate governance, and quality of regulation and competition policies) that go beyond the traditional indexes used in the literature on country cross sectional growth.

Given the relatively limited number of countries, the high collinearity among many of the important variables and the complex interdependencies among them, cross section empirical studies may never be able to resolve fully some of the critical controversies. Would it, for instance, have been possible that fast privatization would have had less adverse effects had alternative privatization methods been employed, if monetary policy had been less tight, or if greater efforts had been made to create domestic financial institutions providing credit to the newly privatized companies? To what extent should we blame some of these policies for the failure of appropriate legal institutions to develop?

This paper has at least helps to resolve one controversy: there is no evidence that, controlling for other relevant variables, fast privatization contributed to medium term growth (that is, over a ten year period). On the contrary, the weight of evidence—both the cross section study reported here as well as more detailed anecdotal evidence concerning the successful countries—appears to support the worries of the critics of shock therapy: fast privatization adversely affected decadal growth.

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**Appendix A: Data**  
**Table A1**  
**Regressions Data**

Countries	Growth	Enf	Dp00p91	Privi00	PClinst
Albania	0.0908	0.358	0.15	3	10.6
Armenia	-0.3524	0.512	0.215	3.15	9.6
Azerbaijan	-0.5604	0.449	0.15	2.5	11.5
Belarus	-0.1098	0.413	0.05	1.5	7.5
Bulgaria	-0.2446	0.512	0.27	3.7	9.1
Croatia	-0.1720	0.627	0.165	3.65	9.4
Czech Republic	0.0218	0.401	0.215	4.15	8.6
Estonia	-0.1076	0.614	0.315	4.15	9.2
Georgia	-1.0996	0.305	0.265	3.65	5.3
Hungary	0.0797	0.772	0.265	4.15	5.6
Kazakhstan	-0.2510	0.32	0.25	3.5	11.7
Kyrgyz Republic	-0.3079	0.295	0.25	3.5	11.3
Latvia	-0.3696	0.354	0.265	3.65	10.4
Lithuania	-0.3581	0.333	0.265	3.65	8.9
Macedonia	-0.2459	0.485	0.15	3.5	8.1
Moldova	-1.0217	0.181	0.215	3.15	6.6
Poland	0.2476	0.617	0.13	3.8	6.2
Romania	-0.1803	0.432	0.2	3.35	7.4
Russia	-0.3960	0.208	0.265	3.65	4.8
Slovak Republic	0.0602	0.558	0.215	4.15	5.1
Slovenia	0.1284	0.634	0.18	3.8	5.1
Ukraine	-0.7897	0.254	0.2	3	5.4
Uzbekistan	0.0198	0.744	0.185	2.85	5.4

Note: For definitions and sources see Table 1 in the text.

**Table A2**  
**Institutional Initial Conditions**

<b>Countries</b>	<b>transacc8991</b>	<b>rulelaw8991</b>	<b>buroqual8991</b>	<b>civsoc8991</b>
Albania	8.00	7.00	3.33	0.00
Armenia	7.70	7.00	1.67	0.00
Azerbaijan	7.50	7.00	5.00	1.67
Belarus	5.00	7.00	0.83	0.00
Bulgaria	6.50	6.67	2.50	0.00
Croatia	6.00	6.00	3.33	3.33
Czech Republic	7.50	4.00	3.33	0.00
Estonia	8.00	3.00	5.00	0.00
Georgia	4.50	3.00	1.67	0.00
Hungary	6.50	2.00	0.83	0.00
Kazakhstan	7.70	8.33	2.50	5.00
Kyrgyz Republic	7.70	8.33	1.67	5.00
Latvia	7.70	6.70	1.67	5.00
Lithuania	7.00	6.70	0.83	1.67
Macedonia	6.75	5.00	0.83	3.33
Moldova	5.00	4.17	1.67	1.67
Poland	5.00	4.17	0.83	1.67
Romania	8.00	3.00	0.83	1.67
Russia	5.25	2.00	0.83	0.00
Slovak Republic	5.25	2.00	0.83	1.67
Slovenia	5.25	2.00	0.83	1.67
Ukraine	5.25	2.00	0.83	3.33
Uzbekistan	5.25	2.00	0.83	3.33

Note: For definitions and sources see Table 1 in the text.

**Table A3**  
**Instruments**

<b>Countries</b>	<b>Years under Central Planning</b>	<b>Defense Spending (percentage of GDP)</b>	<b>Industrial Structure Distortion</b>	<b>Trade Distortions</b>	<b>Black Market Premium</b>
Albania	47	5.3	12.3	27.3	43.4
Armenia	71	14.6	23.3	42.8	182.8
Azerbaijan	70	4.3	23.3	25.2	182.8
Belarus	72	11.2	28.3	24.2	182.8
Bulgaria	43	14.1	27.3	13	92.1
Croatia	46	3.7	12.3	19.5	2.7
Czech Republic	42	8.2	19.2	8.5	18.5
Estonia	51	1.9	21.3	52.8	182.8
Georgia	70	4.1	6.1	33.2	182.8
Hungary	42	7.2	7.3	2.6	4.67
Kazakhstan	71	5.2	20.3	28.8	182.8
Kyrgyz Republic	71	8.9	19.4	33	182.8
Latvia	51	9.5	21.3	41.4	182.8
Lithuania	51	7.5	23.9	42	182.8
Macedonia	47	3.7	12.3	7.5	2.7
Moldova	51	4.4	26.3	42.2	182.8
Poland	41	8.1	22.3	20.8	27.7
Romania	42	4.5	30.3	16.1	72.8
Russia	74	15.3	14.9	17.8	182.8
Slovak Republic	42	8.2	19.2	36.3	18.5
Slovenia	46	3.7	4.2	17.3	2.7
Ukraine	74	14.8	22.3	29.7	182.8
Uzbekistan	71	5.6	21.4	28.7	182.8

Note: For definitions and sources see Table 1 in the text.

## Appendix B: Three-Stage Least Squares Estimates

The results of three-stage least squares estimations for our model are the following,

**Table B1: THSLS Regressions**

Panel 1: Dependent variable is Gr					
	Constant	Enf	Dp00p91	Privi00	PC1inst
<b>Beta</b>	-1.3291	1.0959	-3.1961	0.2920	0.0307
<b>Tstat</b>	-3.86	3.50	-2.80	2.52	1.49
R-Squared	0.6044				
Adj R-Squared	0.5164				

  

Panel 2: Dependent variable is Dp00p91								
	Constant	Gr	Privi00	Years	Blkpr	Def	Indst	Trdist
<b>Beta</b>	-0.1255	-0.0069	0.1004	-0.0012	0.0008	0.0004	-0.0008	-0.0010
<b>Tstat</b>	-2.20	-0.46	13.97	-1.64	5.32	0.39	-0.96	-2.20
R-Squared	0.8985							
Adj R-Squared	0.8511							

  

Panel 3: Dependent variable is Priv00								
	Constant	Gr	Dp00p91	Years	Blkpr	Def	Indst	Trdist
<b>Beta</b>	1.3183	0.0713	9.8275	0.0108	-0.0079	-0.0038	0.0073	0.0103
<b>Tstat</b>	2.65	0.49	13.97	1.45	-4.62	-0.33	0.84	2.20
R-Squared	0.8985							
Adj R-Squared	0.8511							

  

Panel 4: Correlation Matrix of Errors of the Above Regressions			
	Gr-reg	Dp00p91-reg	Privi00-reg
<b>Gr-reg</b>	1		
<b>Dp00p91-reg</b>	0.0726	1	
<b>Privi00-reg</b>	-0.0776	-0.8897	1

[1] Shock therapy referred both to policies attempting to rapidly bring down the hyperinflation that afflicted many of the countries (especially after they engaged in “shock” liberalization) and to the policies attempting to change rapidly the structure of the economy through privatization and liberalization. In this paper, we focus on the latter. Poland, for instance, engaged in shock therapy to bring inflation under control (though it did not bring inflation down to single digit levels rapidly) but employed a gradualist strategy for privatization. In our taxonomy, Poland is a gradualist.

[2] Interestingly, the World Bank (1996) and most of the other studies of the economies in transition do not include China and Vietnam, even though they represent more than 75% of the people making the transition. The obvious suggestion is that the results would have been markedly different were these to have been included (in an appropriately weighted way) in the statistical analyses. To make our results comparable to the earlier studies, we too exclude China and Vietnam.

[3] See, for instance, Sachs and Woo (1997).

[4] Some economists (Blanchard (1997)) have suggested that the transition would be easier for agricultural economies than for industrial economies, because of the lower degree of complexity and interdependence. Again, the empirical evidence in support of this hypothesis is underwhelming: the agricultural sector in many of the countries, including Russia, showed the largest decline; Moldova, a largely agricultural country, has been among those in the FSU with the worst performance.

[5] See e.g. De Melo, Denizer and Gelb (1996), Sach (1996) and Fischer, Sahay and Vegh (1996b). We talk more about these papers and others when we review this literature in Section 2.

[6] See, for instance, De Melo et al (1997) and Krueger and Ciolko (1998). More generally, economic historians like North (1990) have also emphasized the importance of institutions.

[7] Krueger and Ciolko (1998) and Heybey and Murrel (1999) also explore the issue of endogeneity. Fidrmuc (2002) performed an instrumental variable analysis in order to consider the possibility of endogeneity and also included an institutional variable (a democracy index). However, his methodology had important pitfalls. See more on this in Section 2.

[8] This literature has been reviewed in several other papers. See, by example, Campos and Coricelli (2002) and World Bank (2001), pages 16-20. Therefore, it is not our intention to go over the whole literature again. Instead we plan to review the papers that, based on our judgment, have been more influential in shaping or misshaping the perceptions on the lessons that can be obtained from the cross-country empirical studies on growth in transition countries. We also do not touch the country-specific studies (see e.g. Berkowitz and DeJong (2001)).

[9] This index is a weighted average of liberalization in three areas: internal markets, external markets and private sector entry.

[10] Sachs (1996) employed liberalization indexes calculated by the European Bank for Reconstruction and Development. These indexes are an extended version of Melo, Denizer and Gelb (1996) indexes. The European Bank for Reconstruction and Development (EBRD) expanded these indexes in both policy areas and years covered. Sachs (1996), Sachs and Woo (1997), Fidrmuc (2001) and others have used the EBRD extended version of these indexes. We employ these indexes in this paper and explained more about them in Section 3.

[11] They are the following:

1. Location (measured using a dummy and not distance from somewhere, usually some city in Western Europe, see Fidrmuc (2001))
2. Previous economic growth rates
3. Categorical variable for differentiating states that were independent or not before 1989
4. Richness of natural resources (Dummy)
5. Over-industrialization
6. Urbanization
7. 1989 PPP income per capita
8. Repressed inflation
9. Trade dependence among Communist area
10. Black market exchange rate premium
11. Number of years under Communism

These variables capture mostly economic, structural and indirect institutional conditions and not direct measures of institutional variables. In our estimation we employ variables that gauge direct initial institutional weaknesses. In addition, we use the last two variables as instruments in our two-stage least square estimations.

[12] In addition, they performed a simultaneous equation approach but they asserted that there is no difference with the OLS approach so they stayed with OLS.

[13] We use more disaggregated measures of distortions in our empirical analysis as instruments in our two-stage least square estimation. See Section 3.

[14] We also believe that it is necessary to be cautious when using these instruments. The possibility of these instruments being endogenous in the growth regression cannot be ignored. Nonetheless, we tried to include these instruments in our estimations using data provided by these authors. However, there were four observations (countries) missing in their data. This would imply a substantial shrinkage of our sample and this made the exercise not worthwhile.

[15] See Wooldridge (2002), Chapter 5 for an econometric explanation why these estimators are not consistent. Interestingly, Fidrmuc (2002) had the same pitfall.

[16] We use in our estimation the data on these indexes as a measure of initial institutional conditions.

[17] Perception variables play an important role in much of this literature. They have to be used with caution. It is possible, for instance, that when the economy is performing poorly, individuals would *perceive* institutional failures as more serious than when the economy is performing well, even though more objective measures show little difference.

[18] Their control variables are 1992 GNP per capita, trade openness (sum of export and import over GDP), secondary enrollment rate in the initial year, average rate of government consumption, and average rate of inflation. They used these variables once a time and they do not try to explore the fact these variables measured different kinds of initial conditions.

[19] These variables are obtained from The Wall Street Journal Europe's Central European Economic Review, Nation in Transit 1997 and Euromoney.

[20] There is a related literature that tried to measure the empirical influence of social culture institutions on cross sectional growth among transition countries. See Raiser et al (2001) and Katchanovski (2000).

[21] These countries are Albania, Armenia, Azerbaijan, Belarus, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Macedonia, Moldova, Poland, Romania, Russia, Slovak Republic, Slovenia, Ukraine and Uzbekistan.

[22] The simple mean growth rate is  $-26\%$  and the standard deviation was  $34\%$ .

[23] For details on this survey see the website of the World Bank:

<http://info.worldbank.org/governance/beps>.

[24] The principal component analysis is a statistical method used frequently for reducing the dimensionality of a given data set of correlated variables while maintaining as much of the variables' variability as possible. This efficient reduction of the number of variables is achieved by obtaining orthogonal linear combinations of the original variables -the so-called principal components. Furthermore, the first principal component preserves most of the variability existing in the original variables, the second component preserves the second most variability existing in the original variables, and so on. Each component is a linear combination of the eigenvector of the variance-covariance matrix of the original variables. For details about the principal component analysis see Flury (1988) and Jolliffe, I. T., (2000). In addition, see Fuentes and Godoy (2003) for a more abridged but more economic discussion of principal component analysis. In order to obtain these components we normally need to use the variance-covariance matrix of the original variables. However, this procedure has an important pitfall, that is, it is extremely sensitive to the units in which the original variables are measured. In order to avoid this problem we calculate the components using the correlation matrix of the original variables. This method allows us to obtain principal components that are independent of the unit of measure of the original variables. See Jolliffe (2000) (Chapter 2) for an extensive discussion about the different advantages and disadvantages of either method. Fuentes and Godoy (2003) also provide a brief discussion about these issues.

[25] This author was very kind in providing these data.

[26] Heybey and Murrell (1999) found that speed has positive sign but insignificant. This difference in sign can be attributed to the fact that their measure of growth is shorter (only first four years of transition), that they do not control for institutional variables and that they used De Melo et al. (1996) liberalization measures. In addition, their measure of policy level is not significant.

[27] It is possible to argue that since (1) we are controlling for the end point and (2) there are higher growth countries with higher level of privatization index in 1991 (mostly East European countries), the coefficient of speed should be negative. In order to address this concern we ran two additional regressions: first, we only include speed of privatization and second, we add to the third regression in Table 3 the level of privatization in 1991 and we replace the final level of privatization with the level in 1995. This last variable is a compromise between being a good proxy for final level privatization (the correlation is  $76.67\%$ ) and avoiding the problem of colinearity (including the variables that measure level of privatization closer in time to 2000 makes all coefficient insignificant because of colinearity). The results are the following:

	Constant	Dp00p91
<b>Beta</b>	0.06	-1.49
<b>Tstat</b>	(0.21)	(-1.22)
R-Squared	0.0664	
Adj R-Squared	0.0220	

	Constant	Enf	Dp00p91	Priv91	Priv95
<b>Beta</b>	-0.925	1.073	-2.177	0.005	0.214
<b>Tstat</b>	(-3.17)	(3.21)	(-1.73)	(0.03)	(2.04)
R-Squared	0.6458				
Adj R-Squared	0.5671				

In the first regression the coefficient of speed is still negative. This shows that the variable that measure speed of privatization has a negative sign without controlling for the end point. In the second regression the coefficient of initial level of privatization is insignificant and the other variables essentially maintain their signs and significance. In the subsequent analysis we do not include the level of privatization in 1991. We attempted other ways of identifying the role of speed, e.g. looking effectively at the fraction of the change that occurred in the first five years. The results are consistent with those reported here: the countries that privatized faster did more poorly.

[28] De Melo et al (1997), Krueger and Ciolko (1998) and Havrylyshyn and Rooden (2000).

[29] An additional important variable that we include in our analysis as a proxy of macroeconomic stability is inflation (see Popov (2000) for another paper using a similar variable). We specifically use the logarithm of accumulated change in Consumer Price Index between 1990 and 1994. We exclude later years to minimize the obvious possibility of endogeneity of this variable. The results are the following,

Regression where Dependent Variable is Gr

	Constant	Inf9094
<b>Beta</b>	-0.14	-0.02
<b>Tstat</b>	(-0.95)	(-0.92)
R-Squared	0.0391	
Adj R-Squared	-0.0067	

	Constant	Enf	Dp00p91	Privi00	PC1inst	Inf9094
<b>Beta</b>	-1.24	1.11	-2.90	0.28	0.02	-0.01
<b>Tstat</b>	(-2.66)	2.99	(-2.14)	2.05	0.73	(-0.38)
R-Squared	0.6084					
Adj R-Squared	0.4933					

The coefficient on the inflation variable is insignificant so we exclude it from the regression analysis. (The result implies that those countries that were more successful in quickly bringing down inflation in the early years of the transition fared no better over the long run than those that did not.)

[30] Heybey and Murrell (1999) mentioned a second possible channel of endogeneity between policy variables (speed and level) and growth rate. There is a chance that there are extra variables omitted in the estimation that drive both variables. For example, distance to Brussels is an interesting possible omitted variable. Countries closer to Brussels might be reforming faster and growing faster because they have a better chance to become member of the European Union (this accession to the E.U. indeed happened for some of countries included in our sample). In order to avoid this problem, it is necessary to perform three-stage least square estimations (THSLS). These estimations are shown in Appendix B.

Based on these results, we find no evidence of this source of endogeneity. In both policy speed and policy level regressions the coefficient of growth is insignificant (see Panel 2 and 3 of Table B1 in Appendix B). In addition, the THSLS estimators of the growth regression are extremely similar to OLS and TSLS counterparts (compare Table B1: Panel 1 with Tables 3 and 4 in the text). Moreover, the correlation among the errors of the Growth regressions and Dp00p91 and Privi00 regressions (policy variables) are very low (see Table B1: Panel 4 in Appendix B). A strong correlation among the errors is certainly a symptom of an omitted third variable problem. Incidentally, the correlation among the errors of Dp00p91 and Privi00 regressions is high only because of the way these variables are constructed.

Finally, our results seem to differ from those of Heybey and Murrell (1999) results. They found that correlation among the errors was high and coefficient of growth variable is significant in the policy variable regression. As we explained before, this difference can be attributed to a shorter sample, to their no control for institutional variables and to their use of De Melo et al. (1996) liberalization measures.

[31] There were, of course, also political arguments (on both sides); advocates of shock therapy worried that unless privatization was done quickly, there might be backsliding. Critics argued that, because quick privatization was more likely to be done poorly, quick privatization would lead to an undermining of support for reform. The recent election in Russia, in which the reform parties were resoundingly defeated, partly because of the almost universal feeling that privatization was done poorly, lends support to the gradualist critique.

[32] Shock therapy would also undermine the domestic opposition to reform. Because of entrenched interests, slow privatization was likely (in this perspective) to lead to (close to) no privatization.

[33] In our opinion, Heybey and Murrell (1999) are the only ones that so far have measured policy speed correctly.

[34] Another complicated issue in the transition countries' privatizations was the participation of private investment funds. See Cadogan Financial (2003) and Castater (2002).

[35] For details on privatization methods see Castater (2002) and his references. In addition, Castater (2002) provides some preliminary results on the effect on growth rate of the different privatization methods. Stiglitz (2001) provided a review of the corporate governance and restructuring issues in transition countries. Dutz and Vagliasindi (2001) related corporate governance and restructuring with privatization methods.

[36] See Vickers and Yarrow (1995).

[37] Thus, privatization can influence growth not only through expected efficiency gains within private companies but also through other channels. We have already noted one such channel: encouraging financial market development. Another indirect channel through which privatization may affect growth is the fact that privatization may possibly release physical and human assets that can be employed in *de novo* companies. See Earle and Estrin (1997) and Havrylyshyn and McGettigan (1999). In many economies in transition, however, there is extensive disguised unemployment, both for skilled and unskilled labor. The absence of opportunity is evidenced by massive emigration. Thus, in these countries, there is little reason to believe that this channel plays an important role.