

Macedonia: The Road of Transition to Prosperity

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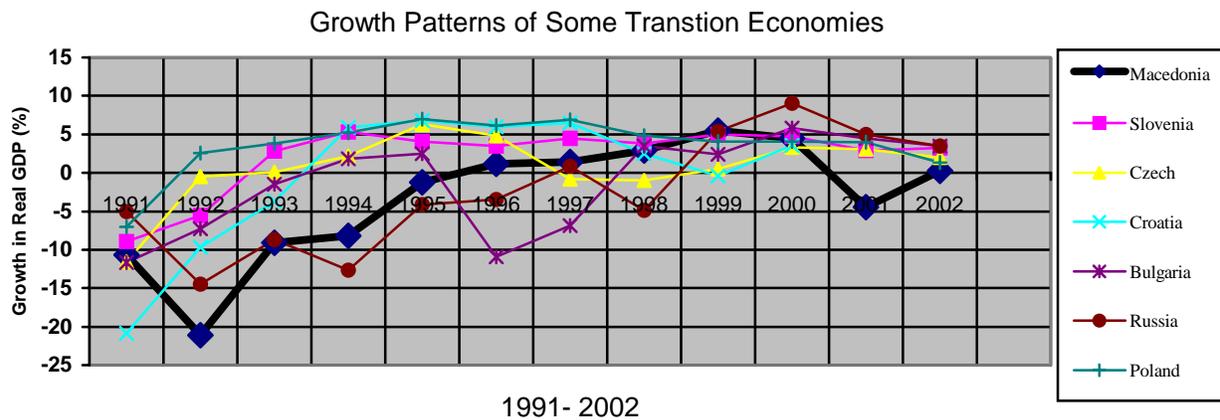
Abstract:

This paper tests which policies play a significant role in explaining growth in transition economies by using data from twenty-five Eastern European countries in transition. The regression shows that initial conditions, stabilization, liberalization, human development, geography and institutions are all important in explaining the growth of the countries in transition. The results of the regression are then applied to the case of Macedonia in order to assess what might be the reason behind the low economic growth of the country. The data shows that weak institutions have the biggest negative impact on the growth rate of Macedonia, followed by the amount of foreign direct investment.

1. Introduction

After the demise of the socialist order in the countries of Eastern Europe, large gaps have been observed in terms of the extent to which the countries in transitions were able to raise real income and therefore the standard of living of their people. Once part of the prosperous Republic of Yugoslavia, Macedonia has been among the countries experiencing very turbulent and unstable economic growth. Namely, since the beginning of the transition period for Macedonia in 1991, the country has accumulated foreign outstanding debt of 43.5 % of the country's GDP. Macedonia's government has not been able to decrease the unemployment rate, which averages 35.5% over the period from 1990-2003. Furthermore, poverty rates, which are estimated at 30 percent of the total population for 2003, continue to grow.

In Graph 1, which compares the growth rates in real GDP of some transition economies of Eastern Europe, the low economic growth of Macedonia is even more evident. Unlike most of the countries in the graph, Macedonia's compound growth has been negative, with a current income per capita of approximately -5 % from its pre transition level. In general, Macedonia has been stuck at performing below its potential level.



The negative average economic growth of Macedonia in the period since the country's independence raises questions about which specific factors have impeded the economic growth of the country. In this paper, I will examine which factors are significant at explaining the economic growth of the transition economies. Then, I will apply these results in the case of Macedonia and I will look at the deviation of the indicators of the Macedonian economy from the average in order to evaluate which aspects of the Macedonian policies and institutions are hindering its economic growth.

This paper is organized as follows. I begin by presenting an overview of the literature written about the economic and social problems that economists believe to be most significant in explaining the different economic growth of the countries. Next, I draft a simple model that tests the correlations between growth and macro and microeconomic factors, and well as

human and capital endowments. I do this by regressing the data on growth rates and other economic and social indicators of 25 Eastern European economies in transition in the period from 1991 to 2000. Then, I present the results of the regression, and I compare the predicted growth of Macedonia to the “average” transition economy. I also look at the residual for Macedonia to see which factors are most impeding to the growth of the country. I finish this paper with concluding remarks on what could be the basis for future research and by giving suggestions about possible solutions to the Macedonian problem.

2. Literature Overview

What lies behind the low economic growth of some transition economies? Is it the degree of liberalization, income inequality, and low investment in human and physical capital or black markets? While many economists have agreed that all of the above factors have some influence on economic growth, there has been a divergence of opinion as to which factors are most important to growth. Based on this opinion, different theories are presented as to which reform should be a priority of the governments of the transition countries in order to spur growth.

The “Washington Consensus” economists believe that there is a positive correlation between monetary stability and economic growth in transition economies, and because of such relationship, the governments should focus on macroeconomic stabilization policies [Fisher et al (1998) and Gelb and Gray (1991)]. Fisher, Sahay and Vegh, for example, argue that output declines have stopped and growth has resumed in all countries that have stabilized. The regression that they present in their model seeks to account for the differences in performance

among countries; they find a positive relationship between growth and stabilization by studying the behavior of growth and inflation in 26 transition economies during the 1992-1995 period. They conclude that “[stabilization] policies will make all the difference” in future growth of the countries. Gelb and Gray, on the other hand, analyze country-specific indicators over the transition period in order to find which of them are mostly correlated to growth and which reforms should be undertaken in a transition economy. They conclude that although the exact reforms would differ by country, macroeconomic stabilization is a prerequisite for any kind of subsequent structural reforms in each country.

The arguments that point to stabilization policies as a reform priority have been challenged by economists like Winkler (2000) and Roland (2000), who argue that stabilization can be discounted as a likely cause of the difference in economic performance of the transition economies. These economists offer another explanation for the low growth by hypothesizing that adequate corporate governance solutions and stable privatization policies might be the key to increasing growth. Winkler, for example, analyzes indicators of the stabilization policies, private sector and financial system in Macedonia. He concludes that although the country has implemented conventional stabilization policies, the growth performance has not improved because of the inadequate corporate governance in the country. He claims that his model is applicable to all transition economies.

Roland, on the other side, discusses the relation between corporate governance and economic efficiency in transition economies. His model examines the consequences of the various privatization policies on corporate governance and enterprise restructuring. Roland concludes that from the point of view of corporate governance, the privatization policies play a crucial role not only in determining restructuring outcomes but also in determining the

economy-wide performance. Both Winkler and Roland suggest that governments should focus on gradual and strong privatization policies accompanied with adequate corporate governance in order to spur the economic growth in the countries.

In addition to the theories that emphasize the importance of stabilization, privatization and corporate governance policies are the neo-classical theories of economic growth of the countries in transition. In these theories, the neo-classical economists focus on the importance of human and physical capital, as well as foreign and domestic investment. Rizov and Swinnen (2003), for instance, analyze the importance of the establishment of new enterprises in the economies in transition and stress that the lack of resources causes boundaries for improving the human and physical in these countries. In their paper, they draw their model from an overview of the development of individual farming in Romania, but apply it to the development of the industrial sector as well. They determine the factors that influence the decisions of people to start a business, and conclude that those decisions will be mostly influenced by human and capital factor endowments, as well as access to capital. They further argue that due to capital market imperfections, potential entrepreneurs might find it hard obtain resources to start a business, and that access to physical capital goods and external financing is imperial to economic growth. Consequently, Rizov and Swinnen suggest that foreign direct investment is imperative to the economic growth of a transition economy.

Further studies which support the idea that increasing foreign direct investment (FDI) is what ultimately will help the transition economies grow, have also shown that foreign investors have been more successful than domestic owners in restructuring the former state-owned enterprises (EBRD, 1999). In general, economists, who argue that the transition economies' lack of resources is impeding to growth, believe it is imperative that the governments prioritize

selling public enterprises to foreign investors, because domestic firms are otherwise unable to raise the required amount of capital to modernize and increase productivity.

While macroeconomic policies are positively correlated with economic growth, the argument that prioritize such policies do not seem to explain the more direct reason behind the low economic growth of some transition countries. In terms of stabilization policies, empirical data on inflation and growth rates for the Eastern European transition economies inspire some doubt regarding the arguments on stabilization policies. Namely, in the last five years, the countries with growth rate averages of above four percent are the countries that have had relatively high levels of inflation of around eight to ten percent (USAID, 2002, p.23).¹ In terms of the private sector, there is not a trend which illustrates that the higher degree of privatization causes higher growth (World Bank online databases). These empirical observations suggest that while macroeconomic policies are important for the growth of the transition economies, they might not be the key.

Regarding the arguments on the essentiality for increased domestic and foreign investment, what causes low investment, and what should governments do to spur it? Altomonte and Guagliano (2003) find that in general, the Mediterranean region, to which Macedonia belongs, displays lower potential in attracting foreign direct investment compared to Central and Eastern Europe because of the presence of social unrest. If we believe that social unrest/conflict generates economic uncertainty and increases the redistributing activities [Rodrik (1999)], then making attempts to solve each ethnic and social conflict should be the utmost importance of the governments of countries in the Mediterranean region.

¹ Here I am more specifically referring to Slovenia, Slovakia, Poland, Bulgaria and Hungary. All of the countries have had

And this is what neo-institutional economies suggest. According to the neo-institutional theories, institutions that would tame social conflict and would define property laws are crucial to the economic prosperity of the countries in transition. The IMF, for example, suggests that strengthening the judiciary system should be a priority for the transition economies. In the 2003 country report of Macedonia, IMF economists analyze the correlation among sectors and indicators in the country, and conclude that there is a high rate of rent seeking activities correlated with a weak judiciary system. For that reason, these economists suggested that creating well-defined judiciary system with enforcement ability should be a priority for the executive branch of the government of Macedonia (IMF, 2003).

A study done by Murphy et. al (1993) adds “further substance to [the] recently renewed concern about the effect of poor property rights on economic development” (Murphy et. al, 415).² Namely, they argue that rent seeking activities enabled by the poor protection of property rights, are in various ways harmful to growth. They present a mathematical model which shows that rent-seeking activities attack innovation and causes people to shift from cash crop production to rent seeking activities or subsistence production.

In yet another study done on the importance of institutions, Cheikbossian (2003) analyzes the macroeconomic consequences of rent seeking activities in the transition economies. He concludes that the distribution of property rights is critical to the macroeconomic outcomes. He warns that rent seeking can be harmful for the modernization and increase in productivity of the enterprises in transition economies, and that it may also affect the relative benefits and outcomes of different privatization programs.

² Arye Hillmann (2003) conducts another study on the importance of institutions, in which he associates rent seeking with a government that is responsive to private rent seeking behavior, and whose administrative officers themselves engage in such behavior. He suggests that the reforms should be primarily made in the government itself, so it will be more conducive to working ethics, and less prone to indulging in corruption activities.

Another reason for why institutions are extremely important to growth is the informal sector. Whereas Winkler (2000, p. 265) believes that the existence of an informal sector in the transition countries is good for the economy in the longer run because “it more often than not cushions the output decline and provides outlet for entrepreneurial talent,” other economists have argued that the informal sector is a result of malfunctioning in different sectors of the economy, and are warning governments to decrease the informal sector. Rosser, Rosser and Ahmed (2000) believe that income inequality is positively (and possibly causally) correlated with the size of the informal sector of the economies of the countries in transition. To prove this hypothesis, they use empirical data for 16 countries in transition in the periods from 1987 to 1989 and from 1993 to 1994. They point out that a significant informal sector results in a decrease in the tax revenue, which would result in a decrease in the official safety nets and a decrease in the long run growth of the countries.

As one can see, economists cannot agree on which factor is most significantly related to economic growth. To find which factor is crucial for growth, in the next section I test the significance of all of the factors mentioned as being “responsible” for economic growth of transition economies.

3. The Model

In this section I test empirically the validity and the relative importance of the different explanations given for the difference in economic growth of the transition economies by regressing them against growth. My empirical analysis focuses on the differences in economic growth rates of twenty-five Eastern European transition countries in the period from 1991 to

2000. I start with 1991 because this is the year by which all of the former socialist countries that were not in war had officially declared independence. Since my primary objective in this paper is to find explanation about the low growth of Macedonia, I exclude data for 2001 (and after) because this is the year of ethnic tensions and conflict in Macedonia and the year of 9 percent net decline of real GDP.³ I exclude this from the regression in order to avoid the possible high collinearity between the war and the other variables during and after the war conflict. In addition, I exclude the countries with war incidents longer than six months from the regression because my purpose is to examine the factors affecting economic growth other than warfare.⁴

The dependent variable in the regression is the average compound growth of the observed transition economies. The independent variables in the regression and their definitions are presented in Table 1.⁵ All of them are proxies/measures for the arguments presented in the literature review, and are included in the regression in order to test the significance of the arguments that explain growth in the transition economies. Income, enrollment and domestic investment are all variables from the Solow growth model. I include the initial real GDP per capita in order to control for the divergence in income levels of the countries in the time before the transition to capitalist market economies. I use enrollment as a

³ More specifically, the growth rate of Macedonia dropped down from 4.5% in 2000 to -4.5% in 2001 (UNECE).

⁴ The countries excluded are Bosnia and Serbia and Montenegro.

⁵ In my earlier versions of the regression, I included the variable bank credit (bank credit to private investors as a share of GDP) as a proxy for investment, savings and financial supply in the formal sector. I was initially including it as a proxy for the stability of the financial sector in order to test the Winkle's argument (mentioned in the previous section) that the inadequate corporate governance is a problem for economies in transition. In Macedonia, poor corporate governance caused past incidents in the financial sector, such as bankruptcy of private and public banks (which decreased public saving in the financial institutions) and high number of non-performing loans (which decreased the willingness of the banks to give credit to private investors). Bank credit was supposed to control for these kind of occurrences. Nevertheless, since it was very statistically insignificant, I used the share of domestic investment instead.

Table 1: List of the independent variables used in the regression and their definitions

Independent Variable	Definition
EXPSHR	Exports as share of Real GDP (GDP (UN, World Bank, EBRD and USAID online databases))
FDI	Foreign direct investment as share of Real GDP (UN, World Bank, EBRD and USAID online databases)
LNINFL	Average rate of inflation. (World Bank and USAID online databases)
ININC91	Per capita GDP in 1991 [IMF, (www.imf.com)]
LGTD	Longitude of the capital city of each transition economy. ⁶
SCENRLRT	Net secondary enrollment ratio as percent of enrolled children of the official age for the education level indicated to the total population of that age. [UNDP (2003)]
CORIDX	Assessment of the level at which corruption is perceived by businessmen as impacting on commercial life (1-least corrupt; 10-most corrupt) (Transparency International, www.transparency.org)
PUBXCOR	A product of the public sector as share of GDP and the Corruption Perception Index. World Bank (www.worldbank.org/ecspf)
DOMINV	Domestic Investment as a share of Real GDP [World Bank (1996, 1999, www.worldbank.org)] ⁷
INFSCTR	Estimates of the Informal Sector as a share of Real GDP. Rosser et. al (2000, 2003); several official government sites. ⁸

proxy for human development, whereas domestic investment is included to test the significance of investment in generating economic growth.⁹ All of the three variables are included to test the arguments of economists like Rizov and Swinnen. Furthermore, exports and FDI are proxies for openness to capital flows, and are used to test the arguments that favor liberalization.¹⁰ Inflation and corrupted public sector are included as measures for the

⁶ The longitude for each country's capital was found from the various sources (mostly encyclopedias) on the internet.

⁷ The values for this variable are taken from several World Bank databases.

⁸ The measure on the size of the informal sector is the only data for which I several official government sites of the transition economies. The standard deviation of the measure of the informal sector share is very high, which indicates that these variables might be a subject to some measurement error. In terms of the data for the other variables, it is taken from measurements done reliable international organizations; however, it still might be subject to some measurement error.

⁹ Primarily, I intended to use the share of private investment as a percent of GDP. However, since I could not find a uniform measure of the data, I used domestic investment instead.

¹⁰ Initially, I used total trade as a share of GDP as a proxy for the degree of liberalization of the transition economies. This variable showed as being negatively related to growth and statistically insignificant at standard in

arguments about stabilization and privatization respectively. Longitude is included in the regression as a proxy for few other variables that might have an influence on the growth of the transition economies: the proximity to the west, the memory of capitalism, and cultural influence of the west. This variable might also pick up the influence of the institutions of the western economies. Finally, corruption and the informal sector are used as proxies for quality of institutions and are used to test the arguments favoring institution reforms, where as the corrupted public sector is used as an interaction term to test if corruption matters in the non-privatized economy.

Table 2. Explaining the low growth in some transition economies.

Dependent Variable: Average Compound growth of Real GDP Per Capita Growth 1990-2000

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	4.007	1.583		2.531	.024
	EXPSHR *	-.017	.007	-.339	-2.360	.033
	FDI *	.186	.086	.237	2.148	.050
	LNINFL *	-.189	.108	-.298	-1.746	.103
	ININC91 *	.000	.000	-.473	-3.363	.005
	LGTD *	-.009	.005	-.198	-1.659	.119
	SCENRLRT *	.020	.010	.359	2.023	.063
	CORIDX *	-.415	.209	-.536	-1.989	.067
	PUBXCOR	.066	.168	.100	.390	.702
	DOMINV	-.021	.016	-.183	-1.259	.229
	INFORSCT	.002	.007	.033	.262	.797

N 25

the regression. Initially, this was a rather shocking finding, but after examining the data on export and import separately for each country, it was evident that for the countries experiencing low economic growth, the share of imports to GDP was significantly higher than the share of exports. In addition, the imports were mainly in manufactured products, whereas the exports were primarily in agricultural products and natural resources. Since the high level of imports in the stagnant transition economies are driving up the percentage of total trade to GDP, I use exports as a share of GDP to control for liberalization instead.

Table 2 displays the results of the regression, which indicate that the regression explains 90.9 percent of the variation in growth among the countries in transition. All but three of the independent variables used in the regression are statistically significant in explaining different growth rates among the countries in transition. The three variables that are not statistically significant are the measures for domestic investment, informal sector and the corruption in the public sector.

In the regression, we find support for two of the three theories of the neo-classical economists. Initial income and enrollment both turn out statistically significant and inversely correlated with growth of the transition economies.¹¹ This is not surprising because the initial income is a proxy for the initial socio-economic conditions in the country, which are important for the subsequent growth, whereas the human capital determines the productivity growth of the countries at any point after the transition.

The regression also proves the validity of the theories, which state that liberalization is very important in explaining the difference in growth rates among the transition countries. The variables used as measurements for the liberalization of trade and capital flows, exports and foreign direct investment, are both statistically significant. FDI is positively correlated to growth, thereby supporting the argument of Rizov and Swinnen that the foreign direct investment increases the human and physical capital in the countries. However, the exports

¹¹ Domestic investment, which is the third Solow variable, is not statistically significant. This is an odd result, but a good topic for future research.

come out to be negatively correlated with growth in this regression, which was a surprising result at first.

In order to find explanation of why this might be the case, I reviewed the export commodities of the countries that are subject to my observation. I found that the Commonwealth of Independent States (CIS) countries, which exhibit the lowest growth rates from the observed twenty-five countries, have very high export ratios.¹² I concluded that it is possible that the export components in addition to export volume might have an effect on the sign of the export variable.

Table 3: Major export components of some CIS countries

<u>Country</u>	<u>Export components</u>
Kazakhstan	Oil and oil products (58%), ferrous metals (24%), chemicals and coal
Russia	Oil and oil products, natural gas, wood, metals
Tajikistan	Aluminum, electricity, oil
Turkmenistan	Natural gas (57%), oil (26%)
Uzbekistan	Natural gas, gold, energy products, ferrous metals, mineral fertilizers

Source: CIA (2003)

Table 3 presents the main export components of few of the CIS countries. It is evident that these countries mainly export natural resources, which might result in the negative correlation of exports and growth, and in turn influence the sign of the export variable. A theory presented by Sachs and Warner (2001) provides support for this idea. According to Sachs and Warner (2001), natural resource abundance is correlated with slow growth and inefficient industrialization. They present a very convincing model based on regressions,

¹² The CIS countries are most of the countries that were part of the Soviet Union before 1989. The CIS group consists of: Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Republic of Moldova, the Russian Federation, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

empirical evidence and studies done by other professionals in the field. Since the exports of many of the transition economies of Central and Eastern Europe consist of natural resources, the Sachs and Warner's theory might explain the negative correlation between exports and growth as depicted by the regression.

In addition to the fact that the regression supports the theories that liberalization is important for economic growth, it also supports the theories that argue that stabilization is conducive to economic growth. The inflation variable in the regression is both inversely related to growth and statistically significant, which means that stabilization is important in explaining the growth of the transition economies.

The regression also supports the hypothesis of the neo-institutional economists, who believe that the difference in the nature and strength of institutions is the most important factors of economic growth for the transition economies. Both variables included in the regression as proxies for institutions (longitude and corruption) are statistically significant and negatively related to growth. This means that institutions that are market oriented and decrease rent-seeking activities are very important for the growth of the transition economies.

In conclusion, the regression presented in this section has a very high explanatory power in explaining the different growth experience of the transition economies. It shows that stabilization, liberalization, human capital, FDI, and institutions are all significant in explaining the growth of the transition economies, and are therefore necessary ingredients for stimulating growth.

4. **Applying the regression**

In this section, I will compare the predicted value for the growth of Macedonia to the predicted value for the growth of the “average” transition economy, in order to compare the performance of Macedonia relative to the “average” performance of the observed transition economies. Next, I will find the residual for Macedonia in order to determine which variables are mostly contributing to the growth performance of Macedonia.

Table 4: Predicted values and residual for Macedonia

Hypothesis	Independent Variables	Predicted Values		Residual for Macedonia		
		Macedonia	"Average" economy	$V_{mac} - V_{avg}^{13}$	Beta	
Solow variables	Initial income	0	0	-706.12	0	0
	Enrollment	1.214	1.28	-3.3	0.02	-0.066
	Investment	-0.399	0.42504	-1.24	-0.021	0.026
Liberalization	Exports	-0.688	-0.81345	-7.37	-0.017	0.125
	FDI	0.186	0.29016	-0.56	0.186	-0.104
Stabilization	Inflation	-1.05651	-1.01304	0.23	-0.189	-0.043
Western influence	Longitude	-0.19	-0.31032	-13.2	-0.009	0.118
Institutions	Corruption	-3.6105	-3.1955	1	-0.415	-0.415
	Corruption in private sector	0.37356	0.33264	0.62	0.066	0.04
	Informal Sector	0.07	-0.059	5.5	0.002	0.011
	Predicted growth	-4.10045	-3.06347			

Table 4 presents the results of the calculations of the predicted growth of Macedonia, the “average” transition economy and the residual for Macedonia. The predicted growth of Macedonia is -4.1 percent, whereas the predicted growth for the “average” transition economy is approximately -3.06. This means that Macedonia is expected to perform worse compared to the performance of the average transition economy.

¹³ This is the value of the independent variable of Macedonia minus the value of the same variable of the “average” economy.

Furthermore, the residual for Macedonia shows that the variables mostly responsible for the lower growth of Macedonia are corruption and FDI. In fact, according to the results in the regression, if the country manages to lower the corruption by one, its growth should increase by .41 percent per year. In addition, if every 1 percent increase of FDI in the country would result in a .104 percent increase in the annual growth rate. Enrollment also lowers growth, although its impact is not as much (one percent increase in the net secondary enrollment rate should result in a .06 increase in the annual growth rate of the country).

These results are not surprising for those familiar with the Macedonian economy. Macedonia ranks as the fifth most corrupt country from the twenty-five countries in the observation group. Its Corruption Perception Index (on a scale from 1 to 10, 1 being least corrupt) is 8.7 (Transparency International, www.transparency.org). Also, the fact that the property rights are not well defined, nor enforced, in Macedonia might be a partial explanation of the low rate of FDI in the country.

The above results of the predicted growth of Macedonia and the variables that affect its growth the most suggest that the country needs to undergo reforms of the legal system that would decrease the expropriatory activities in the country. Since corruption, as a form of rent seeking activity, is a result of inefficient legal system, then regression supports the idea that institutional reforms in Macedonia should be a priority of the government.

4. Concluding Remarks

Macedonia has been experiencing a decline in the public trust of the government and a

continuous social unrest. There have been constant court filings by the employees against managers of companies, who caused the bankruptcy of major public enterprises by laundering the company money and stealing significant amounts of the corporate inventory, whatever it might be (www.a1.com.mk). In the last incident, for example, the Secretary for Defense of Macedonia was arrested after asking for and receiving \$60,000 bribery for choosing one offer for purchase of army property over another (Lupevska, www.a1.com.mk). To put this in perspective, the GDP per capita for 2001 in the country is \$1,586 (UNSD, www.unstats.un.org). Needless to say, the courts have ruled in favor of the people, but have been unable to expropriate the stolen funding back to the stockholders and employers.

Since property rights and their enforcement have a big impact on economic outcomes (Yeager, 1999, 33), and since formal institutions are the “written rules of the game,” then formal institutions have a big impact on economic outcomes. If property rights are not clear, and not easy to enforce, which is the case in Macedonia, this is a detrimental effect to growth. According to Yeager (1999, 33), the institutional framework of a nation ultimately determines the transaction costs, and therefore the degree to which an economy reaches its production and income potential.

According to evaluation of the legal system in Macedonia done by IMF (IMF, 2003), the country does not have an adequate legal system to effectively enforce contracts. Consequently, big part of the economic decline in Macedonia is due to improper and corrupt privatization and limiting liberalization reforms, which increase the amount of rent-seeking activities and create a vicious cycle of politically powerful elite - a concept explained by Krueger (1999).

As we can see from the regression, corruption plays a big role in explaining the economic growth of the transition economies, and as observed in the data on Macedonia during the transition period, the country has to be having the biggest problems with corruption. Since corruption is a rent seeking activity, which is a result from poorly defined property rights and non-efficient legal system, which as a branch is not separated from the executive branch, then the primary reforms made in Macedonia should be in the institution sector. Macedonia needs a well-defined constitution, and better enforcement ability. We are left to see if this is achievable at all, especially since the government, which needs to administer these changes, is at the same time the most corrupt sector.

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