Denisova, Irina

Article

Institutions and the support for market reforms

IZA World of Labor

Provided in Cooperation with:
IZA – Institute of Labor Economics

Suggested Citation: Denisova, Irina (2016) : Institutions and the support for market reforms, IZA World of Labor, ISSN 2054-9571, Institute for the Study of Labor (IZA), Bonn, https://doi.org/10.15185/izawol.258

This Version is available at:
https://hdl.handle.net/10419/148483

IRINA DENISOVA
New Economic School and CEFIR, Russian Federation

I Z A
World of Labor
Evidence-based policy making

Institutions and the support for market reforms

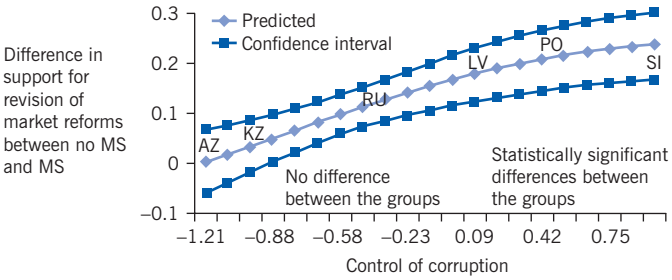
A combination of individual self-interest and good institutions determines the level of public support for market reforms

Keywords: public opinion, market reforms, privatization revision, legitimacy of property rights, transition countries

ELEVATOR PITCH

Economic self-interest and social considerations are the key determinants of public support for market reforms in transition countries. However, political strategies that rely mainly on public support for pushing through economic reforms have limited relevance if the prevailing institutional environment is weak or corrupt. Poor governance and under-developed democracy significantly reduce the level of support. A good institutional framework allows the potential gains from reforms to be realized in a beneficial way, while corruption and poor governance deny the prospect of gains for individuals and for society.

Weak institutions erode the difference in support for the revision of reforms



Note: "MS" = market skills. "Control of corruption" = extent to which public power is exercised for private gain as well as "capture" of the state by elites and private interests; higher values = better governance.

Source: Based on data from [1].

I Z A
World of Labor

KEY FINDINGS

Pros

- Individual, economic self-interest is the key driver of support for market reforms.
- "Market-friendly" institutions increase the support for market reforms.
- Attitudes towards market reforms can change from opposition to support if there is a framework of good governance and well-developed democratic institutions.
- Public support for market reforms has converged between the Commonwealth of Independent States and the Baltic and Central Europe Countries over time, due to economic growth, less income inequality, and improved governance.

Cons

- The prevailing conditions at the time reforms are introduced can increase the degree of political constraints and hinder the development of democratic institutions.
- Opposition to reforms is largely defined by concerns about the legitimacy of those reforms.
- When market institutions are not developed, public attitudes toward market reforms are generally uniformly negative.
- Higher inflation, unemployment, and income inequality increase the opposition to market reforms.

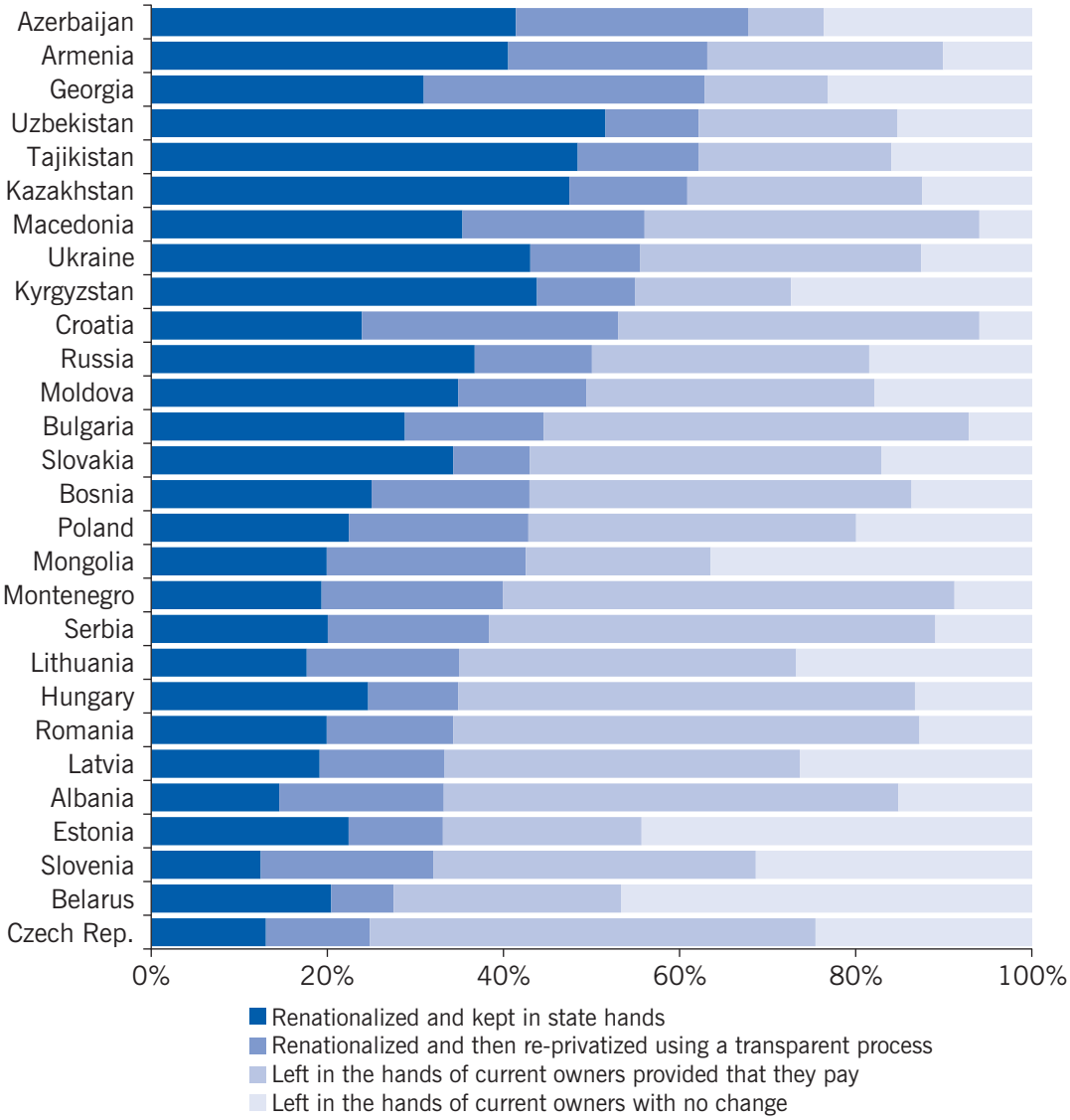
AUTHOR'S MAIN MESSAGE

Evidence from transition countries reveals the importance of both individual and institutional determinants in shaping public opinion toward market reforms. In countries with autocratic and poor governance, both the potential winners and losers from reforms are equally negative about their possible benefits. As the quality of governance and democracy improves, however, support for market reforms increases and the supporters distance themselves from other groups of citizens. In addition to economic self-interest, public perceptions of the legitimacy of reforms are equally important for generating support.

MOTIVATION

One of the puzzles of the transition from planned to market economies, in almost all of the transition countries, is the very high level of public opposition to some key market reforms, such as privatization. This is in spite of the evidence that the social benefits of market reforms outweigh the costs. On average, the support for the status quo with respect to privatized public enterprises in 28 transition countries was less than 20% in 2006. The figures varied from 7% in Bulgaria and 10% in Armenia, to 44% in Estonia, and 46% in Belarus (Figure 1). This low level of public support for reforms has also been witnessed in other regions of the world. For example, survey results from 17 Latin American countries in 2003 found that almost two-thirds of respondents believed that privatization was "not beneficial" [2].

Figure 1. Public support for revising privatization across 28 transition countries, 2006



Note: The graph is based on the following question from the 2006 Life in Transition Survey: In your opinion, what should be done with most privatized companies? They should be: (1) left in the hands of current owners with no change; (2) left in the hands of current owners provided they pay privatized assets' worth; (3) renationalized and kept in state hands; (4) renationalized and then reprivatized again using a more transparent process.

Source: Denisova, I., M. Eller, Timothy F., and E. Zhuravskaya. "Who wants to revise privatization? The complementarity of market skills and institutions." *American Political Science Review* 103:2 (2009): 284–304 [1]. Reprinted with permission.

I Z A
World of Labor

Why do some people oppose and others support reforms, such as privatization, or their revisions? Why do the levels of support and opposition for market reform vary across countries? The answers to these questions are crucial to understand the public support (or lack of it) for the policies adopted, and thus also to understand the political conflicts that may undermine the long-term sustainability of those reforms.

DISCUSSION OF PROS AND CONS

The political economy of transition

According to indicators of the success of reforms provided by the World Bank and the European Bank for Reconstruction and Development, public support for market reforms has a significant effect on the economic, social, and political progress made in transition countries. The effect is even stronger in more democratic countries.

The theory of the political economy of reforms stresses the importance of ex ante (before the reform) and ex post (as a result of the reform) political constraints in shaping the speed and sequencing of market reforms. Ex ante and ex post political constraints differ due to the uncertainty about the economy-wide effects of reforms, the composition of winners and losers, and the extent of the potential costs of reversing the reforms.

Strategies to overcome potential political constraints include partial and incremental implementation of reforms as well as adding in compensation agreements. Such measures are designed to diminish the initial opposition to reforms and as a means of making them more difficult to reverse [3].

Reformist governments, however, are not free to set the menu and sequencing of reforms, as the prevailing economic, social, and political conditions (broadly defined) limit the affordability of many reforms [3]. There is a positive correlation between the progress of reforms in post-communist countries and the breadth of the reformist coalition, and a negative correlation between the progress of reforms and the strength of the executive branch of the government [4]. This implies that broad reformist coalitions foster economic reforms, while strong executive branches hinder them. This is in contrast to the evidence from other parts of the world, particularly Latin America [5]. Empirical evidence supports the view that in transition countries initial conditions when reforms are introduced, such as the strength of non-communist elites and the initial public support for reforms, define the intensity of the political constraints. As a result, the initial choice of policies and political institutions are endogenous to the transition process [3].

Moreover, the institutional inertia that results from historical precedence and experience has a prolonged impact on policy choices. For example, conflicts resulting from the implementation of land privatization in the Russian Empire a century ago are positively correlated with greater public opposition to modern privatization. The reasons behind the opposition are favoring state ownership and the belief in the illegitimacy of privatization [6].

As a result, the design and outcomes of seemingly similar market reforms vary across countries. For example, privatization policies, types of privatization schemes, and their outcomes, have seen enormous variation in transition countries. In some countries, a major effect of privatization is asset stripping (i.e. the selling-off of individual assets), the formation of large financial industrial groups, increases in rent-seeking or exploitative activities, and political instability [3].

Individual determinants of public support for reforms

Individual experience of reforms and expectations about their economic consequences are the most important determinants of public attitudes to market reforms.

Individual economic self-interest is the key determinant of support or opposition to the changes planned or introduced by reforms. Individuals expecting their personal welfare to increase tend to support the new policy, while those who expect losses would rather oppose it. Skills and socio-economic status are the personal characteristics often found to be shaping attitudes toward market liberalization. Wage decompression during the transition from planned to market economies shows in increased returns to market-relevant skills and, in particular, in returns to entrepreneurial skills. At the same time, work experience obtained under the planned system is often regarded as obsolete within the new economy.

The major trade-off between economic efficiency and income inequality is another reason for differences in the individual assessment of many reforms. This could originate from self-interest, but could also reflect the view that more redistributive policies improve collective well-being. In addition, perceptions on the fairness and legitimacy of reforms significantly influence individual attitudes toward them.

Which individual traits increase support for reforms?

The empirical literature on public attitudes toward economic reforms in transition countries originates from studies of support for transition to a free market in the former Soviet Union. These studies stress the crucial role of the negative assessment of the pre-reform economic performance in support for the market reforms. In one study, the developing free-market culture, reinforced by democratic values, was identified as being the most important determinant of individual support for market reforms [7]. The concern raised in this study is that it is not clear at the outset of the reforms whether the positive attitudes would survive economic hardships and, hence, how sustainable support for the reform would be. If there is weak fundamental support and there are no deep roots of free-market culture or democratic values in the country, then a restoration of the old order is very probable.

These concerns were well founded, as support for reforms vanished following the period of economic and social hardships in the region. Indeed, individuals with negative experiences of transition-related hardships, such as those who faced wage cuts or wage arrears, or had to sell assets or cut down on basic food consumption, were challenging the reforms more frequently than those with no such negative experiences [1].

The study of attitudes toward privatization in 28 transition countries highlights the role of relevant market skills for the post-reform economy as being another key determinant for the support of reforms [1]. Market-relevant skills are defined as entrepreneurial skills or high (senior professional) skills utilized by the market economy, e.g. if an individual moved to entrepreneurship or is employed at a senior level in top occupational groups. Individuals with market-relevant skills reveal a higher support for market reforms, while people with obsolete skills or skills that are less relevant for the market economy, show greater opposition to market reforms. The overall size of the effect is approximately nine percentage points. Earning a salary in senior professional occupations diminishes opposition to privatization by 4.1 percentage points, on average. Being an entrepreneur decreases the probability of an individual demanding the revision of privatization policies by 5.1 percentage points [1].

In line with this argument, longer experience of working in the state sector increases the probability of an individual opposing market reforms. Furthermore, older individuals oppose market reforms more often than younger individuals, other things being equal. At the same time, older workers with skills suitable to a market economy are less likely to oppose market reforms than older workers with non-suitable skills. The result, which emphasizes the importance of skills as being a determinant of attitude to market reforms, highlights the role of retraining programs in diminishing the opposition to reforms.

Finally, there are no conclusive results with respect to education level. In some studies, education is statistically insignificant, while in others low-educated people are likely to oppose market reforms as compared to highly-educated people, though there is no simple linearity to this. This finding is in line with the studies on Latin America, which are also inconclusive with respect to the influence of education. Nevertheless, it seems that a better income and upward changes to an individual's income position tend to increase support and decrease opposition to market reforms.

Reasons behind support for revision: Self-interest and social concerns

It is important to not only identify the observable characteristics of individuals in favor of or against market reforms, but also to understand the motives behind the expressed support or opposition.

The two main motives are economic self-interest and social considerations, i.e. concerns about the effects of the reforms on social welfare in general, and on the position of disadvantaged groups in particular. Empirical studies on transition countries confirm the importance of both, and some even attempt to disentangle the mix [8], [9].

In particular, one study uses the design of a question on public attitudes toward the results of the privatization of previously state-owned enterprises as a means of distinguishing between two groups of motives: first, the preference for state or private property, and second, the perception of privatization, its results and process, as being legitimate or illegitimate [9]. We should not assume, however, that those who prefer state versus private property (or vice versa) do so only on the grounds of their perceived self-interest. Some might prefer private property, either because they expect to obtain a higher return to their specific market skills, or because they have an ideological preference for private property. Still, at least a portion of the support for private or state property is defined by economic self-interest.

In fact, the authors of the study find that the preference for private property is the main reason why entrepreneurs and those employed in high-skilled occupations, oppose revising the privatization reform. The rationale for this is, probably, that they expect their own skills to receive a higher reward in the post-reform context. The authors conclude that support for reforms is motivated, in these cases, predominantly by economic self-interest. In fact, in neither group did the authors observe a concern about the possible lack of legitimacy of the process of privatization.

In contrast, those with a longer work experience in the state sector challenge the results of privatization, as they perceive privatization as being illegitimate. The same holds for individuals with less than secondary-school education.

The picture is more complicated for individuals with higher education. They reveal a preference for private property, but at the same time also strong concerns about the legitimacy of

privatization. These opposing attitudes balance each other out almost exactly, so that the "net effect" of this group's attitude toward the reform is not significantly different from zero. Also, those who have previously worked in the private sector for long periods express similar, ambivalent concerns.

Economic reforms in Latin America during the same period (the 1990s) generated a large number of studies of public attitudes in the region. Interestingly, the studies also pointed to the importance of evaluations based on grounds other than pure self-interest. For instance, a study on Mexico found that political loyalty to the ruling party and the president explained the major bulk of variation and outweighed pure self-interest, while difference in social background had only limited influence [10].

Those who experienced pronounced hardships during the period of transition (such as wage cuts and reductions in spending) opposed the reform, both due to preferences for state property and the perception of privatization as being illegitimate. Wealthier individuals—other things being equal—quite intuitively supported privatization due to their preference for private property.

Hence, both supporters and opponents of privatization seemed to be motivated in part by their own self-interest and, in part, by social and/or ideological concerns.

Market-friendly institutions increase support for market reforms

Recently collected data from household surveys in 28 transition countries under the Life in Transition Survey project, allowed a statistical analysis to be undertaken of the correlation between the quality of the institutions in each country and popular attitudes in those countries toward market reforms. In particular, one study looked at how public attitudes to the revision of privatization results vary according to the quality of governance and the development of democratic institutions [1].

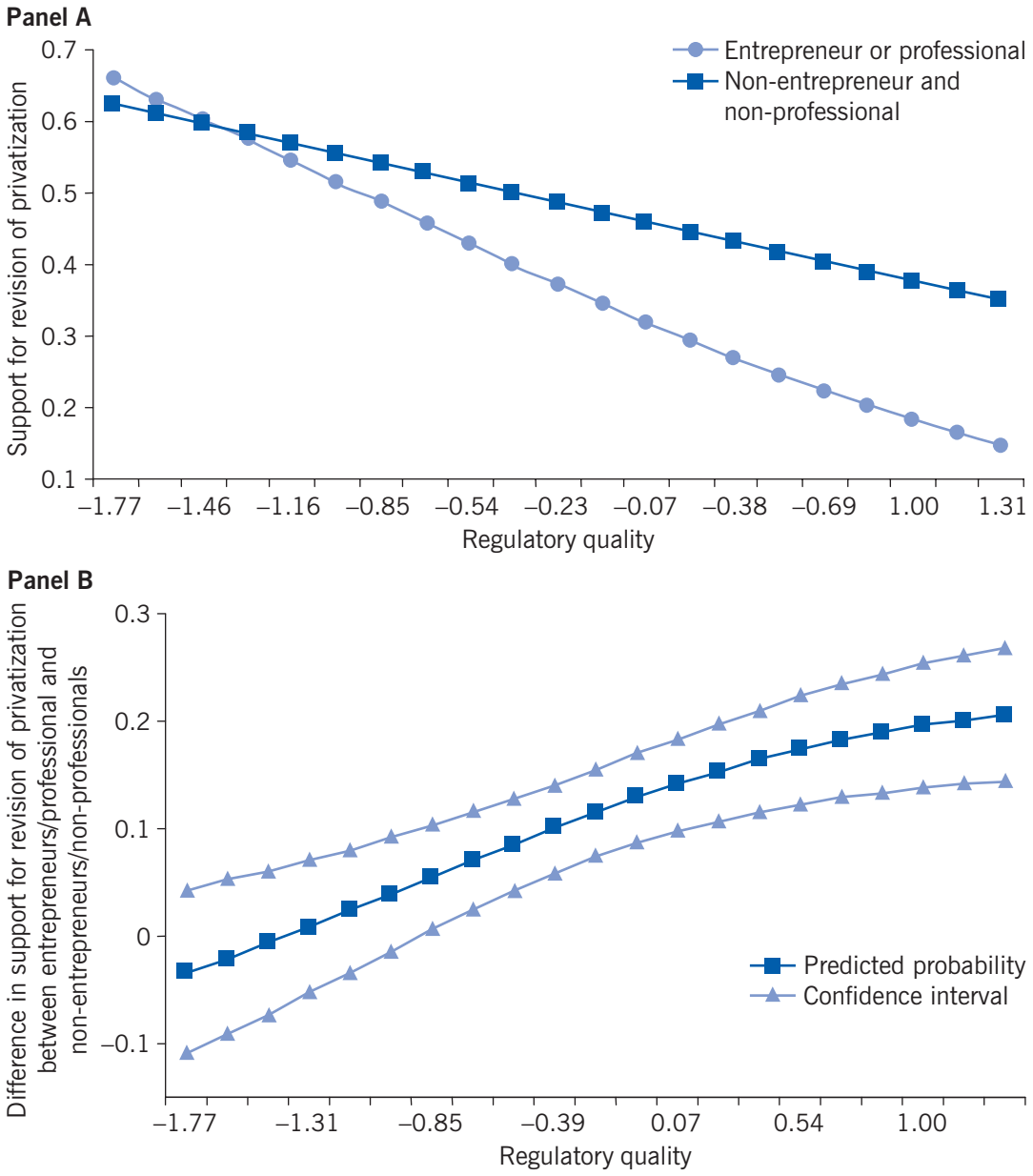
Figure 1 shows the difference in the average attitudes across the countries. The averages, however, conceal the source of this variation. It could be that the composition of individual traits varies across countries, which would explain the variation in the averages. Alternatively, it could be that the individual characteristics of the populations in the two countries are similar, but institutional development is not. Or it could be both. The level of institutional development in the 28 transition countries can be measured by specific indicators [11]. These show a considerable variability among this group of countries. For example, the index of control of corruption varies from –1.2 in Tajikistan to 0.96 in Slovenia, while the index on regulatory quality varies from –1.8 in Belarus to 1.3 in Estonia.

Taking into account the differences in individual characteristics, it becomes apparent that the level of public opposition to market reforms is higher in countries with poor governance and undeveloped democratic institutions. The negative relationship is illustrated in Panel A of Figure 2.

The interaction of individual traits and institutions

Do institutions amplify or diminish the effects of individual traits? Both situations could exist, or, in technical terms, institutions and individual traits could be complements or substitutes.

Figure 2. Difference in support for the revision of privatization, with and without market skills at different levels of institutions (regulatory quality index)



Note: The difference in support to revision of privatization is measured by the difference in predicted probabilities.

Source: Denisova, I., M. Eller, Timothy F., and E. Zhuravskaya. "Who wants to revise privatization? The complementarity of market skills and institutions." *American Political Science Review* 103:2 (2009): 284–304 [1]. Reprinted with permission.

I Z A
World of Labor

When democracy and good governance are envisioned mainly as a means of constraining country leaders in their tendency to change rules and/or extract rents, one could expect a positive association between market-relevant skills and institutions, i.e. complementarity. The intuition behind this is that good institutions would allow potential beneficiaries of the reforms to realize their gains, while poor institutions would take back the potential gains.

Alternatively, when democracy and good governance are envisioned mainly as a means to motivate and effectively engage in the redistribution of wealth, one could expect a negative

association between reform-relevant skills and institutions, i.e., substitutability. The intuition here is that democracy increases the demand for redistribution to groups that are harmed by the reforms, and good governance increases the capacity to implement the redistribution.

Which of the two effects dominate is an empirical question. Life in Transition Survey data allowed the study of 28 transition countries and confirms the complementarity of market skills and institutions in shaping support and opposition to the key market reform, privatization [1]. In particular, support for market reforms from individuals with market-relevant skills varies with the quality of governance and the development of democracy in a country. It is lower in countries with poor governance and undeveloped democracy and higher in countries with good governance and developed democratic institutions. Figure 2 illustrates the effects in terms of a "regulatory quality" index. The regulatory quality index measures the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development. It is an index combining up to 15 different assessments and surveys [11]. Higher values of the index correspond to better governance outcomes. The index ranges from –1.8 to 1.3 in the sample of transition countries. (For democracy measures consult similar graphs in [1].)

Panel A shows that at the low levels of the regulatory quality index, there is almost no difference in the opposition to privatization between those with and without market-relevant skills. As the quality of institutions improves, the difference in the desire to revise privatization between the two groups becomes larger. Panel B, which depicts the difference in opposition between the two groups, together with the statistical confidence interval, shows that already at the level of regulatory quality index of –0.85 (the level of Azerbaijan), the difference in opposition to the reform between the two groups becomes statistically significant. The difference amounts to seven percentage points in Georgia (regulatory quality index of –0.69) and 18 percentage points in the Slovak Republic (regulatory quality index of 0.66).

In absolute figures, in Estonia (which has the highest index of regulatory quality in the group of the countries) the level of opposition to privatization is 35% among individuals without market skills and only 15% among those with market skills. There is no difference in the opposition to privatization between the two groups in countries with poor institutions up to the level of regulatory quality in Azerbaijan, with the share of opponents in countries with poor institutions being as high as 50–65%.

Thus, good governance and developed democratic institutions not only diminish opposition to market reforms, but are necessary to observe the difference in public attitudes between potential supporters and opponents of market reforms. The difference in attitudes disappears when market-friendly institutions are not developed. Whether it is the quality of institutions per se that defines public attitudes, or rather the quality of reforms, as proxied by institutional indices, is to be further studied.

The macroeconomic situation matters

Studies of the determinants of voting behavior in several transition countries show that high unemployment and a higher share of pension-age population and of blue-collar and agricultural workers are negatively correlated with votes for reformist political parties. On the other hand, a larger private sector, with a higher share of white-collar workers and people with university degrees, increases support for reformist parties [12].

Studies of public support for market reforms measured with a Eurobarometer survey confirm this positive correlation between support for market reform and economic stability, and a negative correlation with increased income inequality and inflation [13].

Do things look better over time?

Public support for market reforms tends to improve over time: starting from 1999, public support for market reforms has converged in 12 transition countries. In particular, the difference in public support for market reforms between the Commonwealth of Independent States (which started with much lower public support) and the Baltic and Central and Eastern Europe countries has narrowed [8]. Economic growth, less income inequality, and improved quality of governance are the key macro-level contributors to the increased public support. At the level of the individual, the increased support is registered predominantly through higher support for economic and political reforms from the young cohort and those with higher education or higher incomes, and from less negative attitudes of the 30–39 age group [8].

LIMITATIONS AND GAPS

The empirical evidence to date has studied public attitudes to some key market reforms, including liberalization, privatization, and the movement from a planned to a market economy. However, there are no studies based on the empirical evidence from transition countries on many other types of reforms, the most important of which being reforms in labor market regulation and social insurance, for example, as well as many others. The challenge here lies in being able to measure public attitudes to reforms that are not that clear to the public.

There are examples of important reforms that are well understood by the public, such as labor market reforms, which could also be of particular interest for public policy in transition economies. Additionally, reforms on the regulation of immigration are already studied intensively in many other regions of the world.

The correlation of the quality of governance and democracy with the quality of reforms undertaken in transition countries should be further disentangled. But there are still problems in measuring the quality of reforms, which is a considerable limitation in the literature.

Additionally, more studies are needed to better understand the motives behind individual attitudes to reforms.

SUMMARY AND POLICY ADVICE

The existing evidence suggests that there is large variation in public attitudes to market reforms in transition countries. This variation is due to many factors: differences in the affordable menu and sequencing of market reforms; prevailing macroeconomic conditions; the composition of individual traits and preferences; and the economic and social "returns" to those individual traits and preferences.

Variation in the severity of political constraints at the start and during the period of reforms defines the initial choice of policies and political institutions, which makes them endogenous to the transition process. The confirmed observation from transition countries is that the level of public opposition to market reforms is higher in countries with poor governance and

undeveloped democratic institutions. Conversely, democracy and good governance diminish opposition to market reforms, possibly also because democracy and good governance contribute to the adoption of better-functioning market reforms.

Good governance and developed democratic institutions are also necessary to observe the difference in public attitudes between potential supporters and opponents of market reforms. The differences in attitudes toward market reforms between potential supporters and opponents are not apparent when market-friendly institutions are not developed.

Both economic self-interest and social concerns shape the composition of supporters and opponents to market reforms, with the influence varying across groups. The results are important for future reforms. First, different coalitions, formal and informal, may be needed to advance economic reform under weak and strong institutions. Second, if the motive that shapes the opposition to reform is mainly one of economic self-interest (e.g., a lack of the skills in demand in the post-reform period), then a redistributive transfer to the potentially disadvantaged, either in monetary terms or in terms of publicly-provided training, would diminish the opposition to reform. If, however, the major concern is the legitimacy, or fairness, of the reform, then a simple redistributive transfer may not be sufficient and some revision of the reform could be inevitable.

Consequently, policymakers should note that not only economic self-interest and social outcomes are important, but also that public perceptions of the legitimacy of market reforms are equally vital for generating public support.

Acknowledgments

The author thanks two anonymous referees and the IZA World of Labor editors for many helpful suggestions on earlier drafts. Previous works of the author contain a larger number of background references for the material presented here and have been used intensively in all major parts of this article [1], [9].

Competing interests

The IZA World of Labor project is committed to the *IZA Guiding Principles of Research Integrity*. The author declares to have observed these principles.

REFERENCES

Further reading

Estrin, S., J. Hanousek, E. Kocenda, and J. Svejnar. "The effects of privatization and ownership in transition economies." *Journal of Economics Literature* 47:3 (2009): 699–728.

Stokes, S. (ed.). *Public Support for Market Reforms in New Democracies*. New York: Cambridge University Press, 2001.

Key references

[1] Denisova, I., M. Eller, T. Frye, and E. Zhuravskaya. "Who wants to revise privatization? The complementarity of market skills and institutions." *American Political Science Review* 103:2 (2009): 284–304.

[2] Lora, E., and U. Panizza. "The future of structural reform." *Journal of Democracy* 14:2 (2003): 123–137.

[3] Roland, G. "The political economy of transition." *The Journal of Economic Perspectives* 16:1 (2002): 29–50.

[4] European Bank for Reconstruction and Development. *Transition Report 1999: Ten Years of Transition*. London: European Bank for Reconstruction and Development, 1999.

[5] Roubini, N., and J. Sachs. "Political and economic determinants of budget deficits in the industrial democracies." *European Economic Review* 33:5 (1989): 903–933.

[6] Dower, P. C., and A. Markevich. "A history of resistance to privatization in Russia." *Journal of Comparative Economics* 42:4 (2014): 855–873.

[7] Duch, R. M. "Tolerating economic reform: Popular support for transition to a free market in the former Soviet Union." *American Political Science Review* 87:3 (1993): 590–608.

[8] Rovelli, R., and A. Zaiceva. "Did support for economic and political reforms increase during the post-communist transition, and if so, why?" *Economics of Transition* 21:2 (2013): 193–240.

[9] Denisova, I., M. Eller, T. Frye, and E. Zhuravskaya. "Everyone hates privatization, but why? Survey evidence from 28 post-communist countries." *Journal of Comparative Economics* 40:1 (2012): 44–61.

[10] Kaufman, R. R., and L. Zuckermann. "Attitudes toward economic reform in Mexico: The role of political orientations." *American Political Science Review* 92:2 (1998): 359–375.

[11] Kaufmann, D., A. Kraay, and M. Mastruzzi. 2006. *Governance Matters V: Updated Indicators for 1996–2005*. World Bank Institute Working Paper.

[12] Fidrmuc, J. 2000. "Political support for reforms: Economics of voting in transition countries." *European Economic Review* 44:8 (2000): 1491–1513.

[13] Golinelli, R., and R. Rovelli. "Did growth and reforms increase citizens' support for the transition?" *European Journal of Political Economy* 30 (2013): 112–137.

Online extras

The **full reference list** for this article is available from:
http://wol.iza.org/articles/institutions-and-support-for-market-reforms

View the **evidence map** for this article:
http://wol.iza.org/articles/institutions-and-support-for-market-reforms/map