Institutional vs Economic development in Georgia

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Abstract

Institutional development is an actual topic as developed as developing parts of the world. Institutional change process is more sensitive for developing economies. Georgia is post-transition developing economy with low incomes.

Twenty five years have completed after the collapse of the Soviet Union, but economy of Georgia has not yet returned to the incomes level of the 90s. Besides successful institutional and economic reforms and years of high economic growth rates, GDP per capita in Georgia is lower than in other eastern European EU member countries. Post-Communist Georgia was characterized by both institutional and economic backwardness, while some post-Soviet economies have completed integration process into European economic and political structures.

Keywords: Institutional development, Economic development, Transition**.**

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1. Introduction

After the dissolution of the Soviet Union, institutional problems faced to the Georgian economy divide into three main groups:

• To establish new institutions required for independent Country (for example: The Central Bank and other governing bodies);

• The transformation/replace of existing institutions, institutions founded in planned economy need adaptation/modification in the market economy

• To develop institutions at level of institutions like developed economies.

It should be said that the first task was successfully solved and nowadays Georgia have successful independent economic institutions. The second issue is mostly solved, but problems still remains due to slow transformation of informal institutions. What can be said about third issue; over the past years - Georgia have shown important institutional growth not only between other post-Communist European economies, but also the other developed countries. Still, there are still important issues where major institutional reforms are required, especially through global background of rapid institutional changes.

2. Body of Paper

In our article we will use two institutional distinction (both individually and combined). First is given this distinction between institutions is given from Nobel Prize laureate American economist Douglas Cecil North - formal vs informal institutions. What are characteristics of formal or informal norms? Informal institutions defined by codes of conduct, norms of behavior and conventions. They come from socially transmitted information and are a part of heritage that we call a culture. Unlike informal one, formal institutions are written; they include political (and judicial) rules, from constitutions, to statue and common laws, to specific bylaws, and finally to individual contracts defines constraints, from general rules to particular specifications (North,1991)., The second theoretical group is internal and external institutions. Such a group is one of the first mention of the German economist Ludwig Lahmann in 1973. Other institutional distinction can be defined by not it is written or not, but about who is responsible for sanctioning when a rule has been reneged upon. Firstly, similar distinction was made by Ludwig Lachman in 1973 and it was answered question how institutions came about. (Lachman, 1973). German economist Stefan Voigt suggests two dimensional institutional structure (formal and informal, external and internal) where external and internal institutions are described as, if the state sanctions rule-breaking, the enforcement is external to society, if rule-breaking is sanctioned by members of society, institution is internal (Voigt, 2016).

Stefan Vogt, a modern German economist, offers a simultaneous use of both of these two approaches to the two-dimensional institutional structure of the 4 group. If we combine them, we can get four groups (types) of institutions each with two institutional dimension. These groups are: Formal internal (FI), Formal external (FE), Informal internal (II) and Informal external (IE). Sum of these institutions should give us total institutional space. By theoretical foundations of both distinction each institutional groups should be shortly described as: Formal external institutions - laws and official regulations which is controlled by state.

Formal internal institutions- formal rules controlled by society and business.

Informal external institutions – effectiveness and public trust in state policies.

Informal Internal institutions – unwritten norms in the society, such as ethics.

To measure institutional types indicated above is required several steps: find suitable indicators, sort and group them by their differences and then to calculate new scores. Measuring of institutions is one of the main problem in the institutional economics, because most of variables are not quantitate. Most suitable for this 2 dimension model should be "Global Competiveness Index" which is provided by World Economic Forum on its "Global Competitiveness Report". Global Competiveness Index include 12 pillar about competitiveness landscape of countries. It includes data about 140 economies and providing insight into the drivers of their productivity and prosperity.

From the 12 pillar for our research is interesting only 1st pillar of index which name is "Institutions". Pillar "Institutions" includes 7 sub-indexes and 21 indicators. Source of institutional indicators is executive opinion survey of World Economic Forum.

To sort and group indexes we must make attention to both dimension separately: Does index characterize formal institutions or informal ones? Does state sanctions institutions determined by this index (external institutions) or sanctions by society (internal institutions)? Data from this pillar A is used in our research. Pillar "Institutions" is grouped by A - Public Institutions and B - Private Institutions. Public institutions we can present as external type and private institutions as internal type.

Second dimension (formal vs informal) should be determine by specified characteristics of sub-indexes. To determine formal and informal institutions is used only sub-indexes, because coefficients in the one sub-index belongs to the same type of institutions. Scores for each type should be calculate as simple average of sub-indexes as they have equal weights in the total GCI index calculation.

Let's, group the GCI sub-indexes into the two dimensional matrix. Every type includes at least one sub-index. Coefficients in every group is listed above.

Formal external institutions:

• Property Rights (incl. coefficients: property rights, intellectual property protection);

• Public Sector Performance (Wastefulness of government spending, Burden of government regulation, Efficiency of legal framework in settling disputes, Efficiency of legal framework in challenging regulations, Transparency of government policymaking).

Informal external institutions:

• Ethics and Corruption (Diversion of public funds, Public trust in politicians, Irregular payments and bribes);

• Undue Influence (Judicial independence, Favoritism in decisions of government officials);

• Security (Business costs of terrorism, Business costs of crime and violence, Organized crime, Reliability of police services).

Formal internal institutions:

• Accountability (Strength of auditing and reporting standards, Efficacy of corporate boards, Protection of minority shareholders' interests, Strength of investor protection).

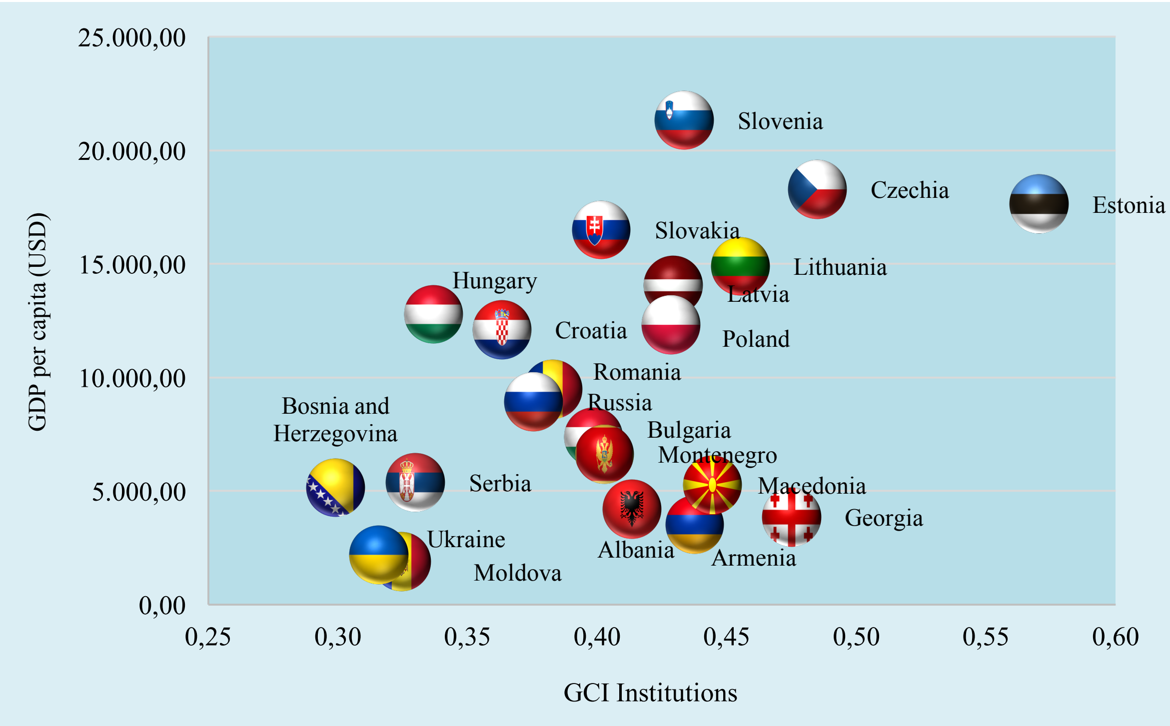
Informal internal institutions:

• Corporate Ethics (Ethical behavior of firms).

In the 2016-2017 global competitiveness report, score of Georgia is 4.2 (1-7) and is ranked 66th among 140 countries. The score of the institutional index is higher - 4.4 (1-7), including indices -state institutions - 4.4 and private institutions - 4.3.

In order to assess institutional and economic deprivation, we compare institutional and economic indicators of Georgia to other post-communist republics in the region (Central and Eastern Europe): Albania, Armenia, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Latvia, Lithuania, Macedonia , Moldova, Montenegro, Poland, Romania I., Russia, Serbia, Slovakia, Slovenia and Ukraine. In the subsequent part of the article this group is referred as “other post-communist countries”.

Figure 1: Economic vs Institutional level



Source: World Bank and World Economic Forum (2016)

Figure 1 contains economies arranged by two factor: global competitiveness institutional index and gross domestic product per capita (2016). There is a positive dependence between these two variables across countries. In the case of Georgia, however the country has one of the highest rates about institutional level, but there is a significant economic backwardness among most countries.

It is possible to calculate correlation coefficients between the two variables for country group in 2007-2016 years (Table 1). The strongest correlation between economic and institutional development was observed in 2007 - 0.81. In later years, correlation has been weakening through rapid institutional development of low income economies. Since 2012 coefficient still continued to grow. Correlation coefficient was 0.49 in 2016.

Table 1: Correlation coefficients between GDP per capita and GCI institutional index (pillar 1) in post-communist economies, (2007-2017)

Year	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Coefficient	0,81	0,65	0,59	0,46	0,31	0,29	0,32	0,37	0,46	0,49

Source: Authors calculations from World Bank and World Economic Forum (2016)

We also have calculated same coefficients between economic variables and institutional groups.
Correlation coefficients between GDP per capita and institutional groups (One-dimensional matrix, calculated by GCI indices):
Formal Institutions - 0.49
Informal Institutions - 0.49
External Institutions- 0.49
Internal Institutions -0.47

Correlation coefficients are almost same, because all indices are in two groups. But if to use more detailed distinction we get different results.
Correlation coefficients between GDP per capita and institutional groups (Two-dimensional matrix, calculated by GCI indices):
Formal External Institutions - 0.43
Formal Internal Institutions - 0.60
Informal External Institutions– 0.52
Informal Internal Institutions - 0.30

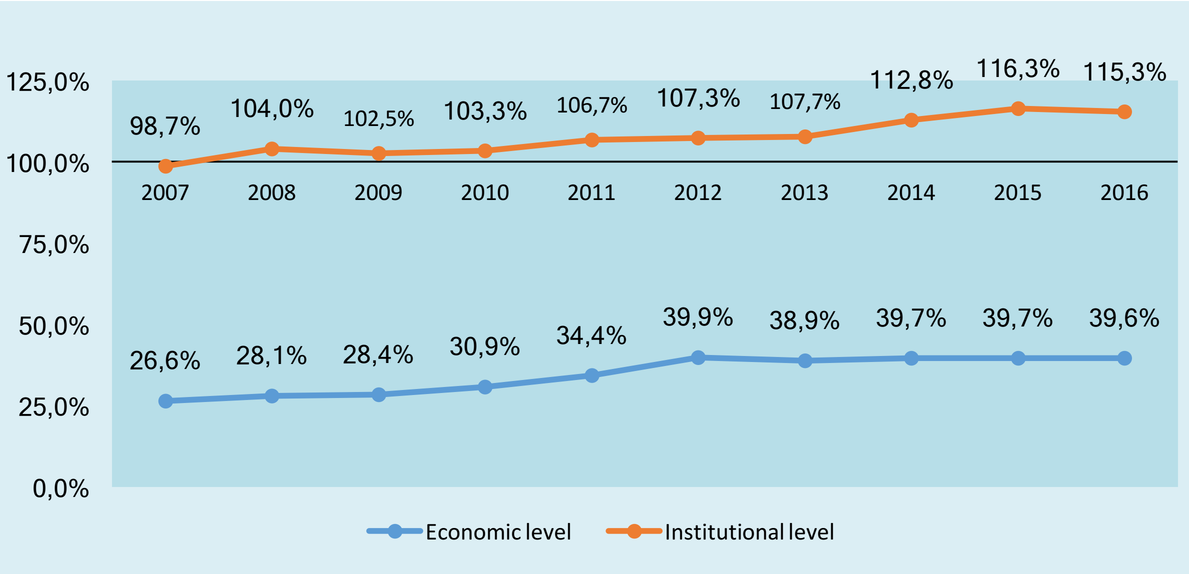
Economies with high economic development characterized by relatively strong formal internal institutions (0.60), while the least developed economies are incompatible with informal internal institutions as unwritten laws working in the society.

After assessing the relationship between economic and institutional factors, evaluate economic and institutional backwardness of the economy of Georgia compared to other post-communist countries. During the economic recession of the 1990s, Georgian economy decreased by 5 times in real prices (before 90s, Georgia was one of the wealthiest country in Soviet Union). To economic and institutional levels, economic development – GDP per capita, Institutional development – GCI institutional index. 100% horizontal line corresponds average rates of all post-Communist European Countries for the relevant year. In 2007, the economic development of Georgia was only 26.6% of the above-mentioned countries (deep economic backwardness). In the last decade, Georgian economy was growing faster than the rest of countries. In 2016, the indicator was increased to 39.6%. As institutional side, level of institutional development of Georgia was almost equal to the level of average post-communist economies (98.7%) in 2007, after successful institutional reforms, Georgia became one of the institutional reformator in the post-communist world (indicator grew to 115.3%, 15% increase of index between 2007-2016).

3. Conclusion

It is clear that Georgia has successfully managed to eliminate backwardness for both - institutional and economic sides. Across countries, informal internal institutions group has weakest dependence to economic growth. Between 2007-2016 years, institutional development level grew by 11.3 percentage point and economic development level by 13.0 percentage point compare to average of other post-communist economies. But, it is evident that incomes in Georgia is still low and rapid economic growth remains as a major economic challenge for counrty.

Figure 2: Economic vs Institutional level (100% = Average of post-communist economies)



Source: Authors calculations from World Bank and World Economic Forum (2016)

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