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Commitment Devices, Opportunity Windows, and Institution Building in Central Asia

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Commitment Devices, Opportunity Windows, and Institution Building in Central Asia*

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Abstract

This paper studies the institutional reform process in Central Asia from 1995 to 2006. I compare the institutional reform processes of Central Asian countries to those conducted in their neighbouring countries of Central and (South) Eastern Europe, and the Middle East. The paper identifies contemporaneous factors responsible for the persistence of poor institutional arrangements. Second, the paper identifies factors that have acted as commitment devices in order to achieve and sustain institutional change over the last decade. It is argued that deficiencies in the education system, and preferences of individuals and politicians are responsible for the persistence of poor institutional arrangements. External factors such as real and financial openness, fixed exchange rates, and international agreements have provided a disciplining effect for policy makers to improve institutional arrangements in Central Asia, despite poor initial conditions. Finally, there is some evidence that large external shocks may help to shift preferences towards more reliable institutional settings.

JEL Classifications: H11, O10, P20.
Keywords: Economic institutions, reforms, Central Asia.

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1. Introduction

Sound economic institutions have been found to be an essential factor in developing a country's wealth and long-run growth. Reliable institutions reduce uncertainty and transaction costs and thereby fostering investment and economic growth (cf. Hall and Jones, 1999; Acemoglu et al., 2005).

This paper analyses the institutional reform process in Central Asia from 1995 to 2006. I compare the reform processes in Central Asian economies with those conducted in emerging market economies in Central and (South) Eastern European countries (CEEC), and the Middle Eastern and North African (MENA) economies, in order to identify factors that have helped Central Asian countries with their transition process and institutional reforms.[1] CEEC and MENA economies share several similarities, as well as important differences, in terms of history, economic structure and culture. This set-up provides a natural experiment that allows us to identify potential drivers of the reform process. First, each of these countries can be considered as emerging markets with a large fraction of external trade, whereas CEEC and Central Asian economies are former socialistic states, while the MENA economies are mostly former colonies of European countries. Second, both Central Asian and MENA economies have large shares of commodity exports, as opposed to the resource scarce CEEC, which have a large fraction of commodity imports. Third, all three regions have cooperation agreements with the European Union (EU) at varying levels of intensity, ranging from EU Accession Country status to very loose agreements regarding technical assistance and economic and cultural exchange (such as Technical Assistance for the Commonwealth of Independent States (TACIS)-programme).

There is a vast literature on the determinants of economic institutions and political change. Most papers focus on historical and exogenous factors, such as the abundance of natural resources or colonial and legal origins (cf. Peters, 1996; Acemoglu et al., 2001; Beck and Laeven, 2006). This

1 The terms CEEC and MENA are used very loosely in this study. The group of CEEC countries are defined as all Central and (South) Eastern European countries and the Baltic states that had a (potential) EU candidate status in 2006. The group of the MENA economies is restricted to MENA countries that are part of the Barcelona Process. For a detailed description of the country groups see Appendix.

paper argues that institutional arrangements, first and foremost, are subject to a political decision-making process in which politicians are responsible for setting-up institutional arrangements, regardless of the actual political system. Exogenous factors, by definition, cannot be changed in order to achieve better institutional settings and thus, offer little for policy recommendations. Looking at institutions from a choice perspective allows for the identification of factors that can be subject to change and can therefore lead to institutional reforms.

In short, the paper looks at two types of factors. First, the paper identifies factors that may have hindered institutional reforms in Central Asia and argues that the lack of reforms in Central Asia is the result of a lack of incentives for policy makers and individuals. Second, the paper provides stylised evidence on endogenous external factors that have helped Central Asian economies, in the past decade, to overcome reform inertia and revise existing institutional arrangements. Based on the findings, it is argued that deficiencies in the education system and preferences about institutional reforms are an important factor for the persistence of institutional settings in Central Asia. Both preferences and the education received under the old socialistic system are two important channels through which historical factors affect current institutional arrangements and provide an obstacle for implementing more efficient, market-based institutions. Second, external factors such as real and financial openness, combined with fixed exchange rates, have constrained policy making towards better institutional arrangements. A high degree of trade and financial openness provides an incentive to reform institutional settings, as countries have a larger share of revenues per gross domestic product (GDP) from external trade and a larger share of foreign investment in total investment. Therefore, opportunity costs in terms of forgone business opportunities as a result of bad governance provide an incentive to improve the institutional set-up. Third, financial openness provides an incentive to remedy deficiencies in regulatory frameworks, thereby making the economy less prone to sudden capital outflows which may result in financial turmoil and painful economic recessions. Pegging the exchange rate, in combination with financial openness, can have the same effect and amplifies the effect of financial openness, as undesirable domestic policy measures may result in speculative attacks against the currency regime. Forth, the TACIS-programme has likely contributed positively as well, as it explicitly aims for institutional change and more market-oriented institutions which are essential for closer ties with the EU and better access to EU goods and financial markets. Lastly, the role of economic shocks, such as a domestic economic crisis, may speed up the process of institutional change as it may shift preferences of politicians and individuals towards a better institutional framework.

The remainder of the paper is organised as follows. Section 2 discusses the sources of persistence of institutional arrangements. Section 3 discusses the external factors that have helped Central Asian countries to overcome persistence in the reform process and the mechanisms behind them. Section 4 concludes.

2. Persistence of Institutional Arrangements

Since the breakdown of the socialistic systems in the early 1990s, transition economies in Central Asia have faced the problem of rearranging their institutional framework and finding strategies to steer economic growth in order to smoothen the structural adjustment process towards a market economy.

Figure 1 compares the quality of economic institutions in Central Asian economies against an unweighted average of the EU-15, CEEC, MENA economies, and Russia as benchmarks using the Economic Freedom Index provided by the Heritage Foundation (2008).[2] The index is a *de facto* measure of institutional quality and defines institutions as mechanisms to ensure property rights and efficient public bodies, in order to provide public goods in an efficient way and reduce transaction costs. Institutional quality is measured using 10 different sub-categories, namely business and investment regulations; trade and financial sector regulations; monetary and fiscal institutions; property rights protection and corruption; and labour market institutions. Each of the 10 categories is

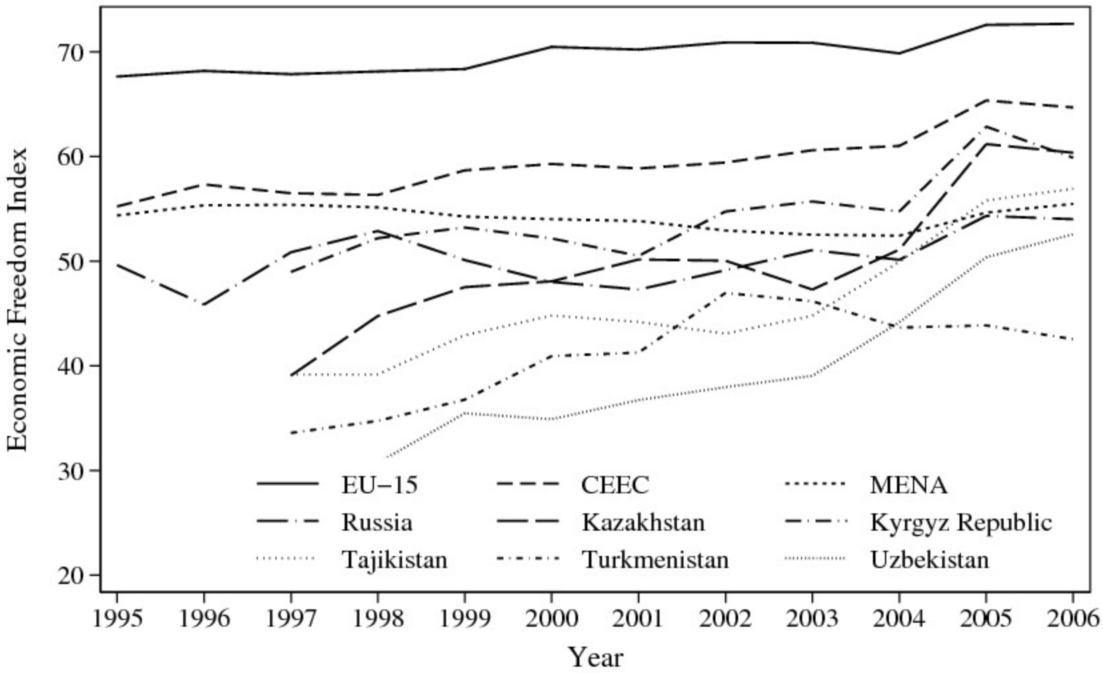
2 Throughout the paper unweighted averages are used for the CEEC, MENA, and EU-15 countries in the graphs in order to compare policies without distorting size effects of countries. While, the primary focus is on the comparison between the small open economies in the three regions, Russia and the EU-15 are added to the analysis as both countries represent important hegemonic states with quite opposing institutional set-ups that exert considerable influence on Central Asian economies.

graded on a continuous scale from 0 to 100, with 100 representing a minimum of distortions and costs associated with the existing arrangements and 0 a maximum. Figure 1 reveals that the institutional reform process in Central Asia, CEEC and the MENA economies has been heterogeneous. Although Figure 1 suggests that institutional settings in all countries are quite persistent, the transition economies in CEEC and, lately, Central Asia appear to be relatively successful in reforming their institutional arrangements. While Central Asian economies started from a low level in the early and mid-1990s, they have caught up with their neighbours in the MENA region in recent years, despite poorer starting conditions. Some Central Asian countries, namely Kazakhstan and the Kyrgyz Republic, have even come close to CEEC levels, even though CEEC started off at a much higher level of institutional quality in the mid-1990s. Particularly, the Kyrgyz Republic, Tajikistan, and Kazakhstan show a significant upward trend after the Russian debt crisis in 2001 and became the most dynamic reformers in the group, while Turkmenistan and Uzbekistan are still lagging behind. Leaving aside Turkmenistan, all Central Asian countries show some co-movements with Russia and their surrounding countries in Central and Eastern Europe.[3] This may suggest that there are factors that are common to either Central Asia and Russia, or Central Asia and CEEC, which may have driven the reform process in the region.

Although most Central Asian countries show signs of institutional change in recent years according to Figure 1, it is important to understand the factors that cause the persistence of lumpy institutions, in order to ensure that the reform process will be continued and not be reversed.

3 In recent years, China's influence on Central Asian countries has grown considerably through, for example, the establishment of the Shanghai Cooperation Organisation in 1996 as well as through economic ties. For simplicity and historical reasons, Russia is chosen as a counter-benchmark to the EU. But in the future, the Chinese influence in the region should be monitored.

Figure 1: Institutional Quality 1995–2006

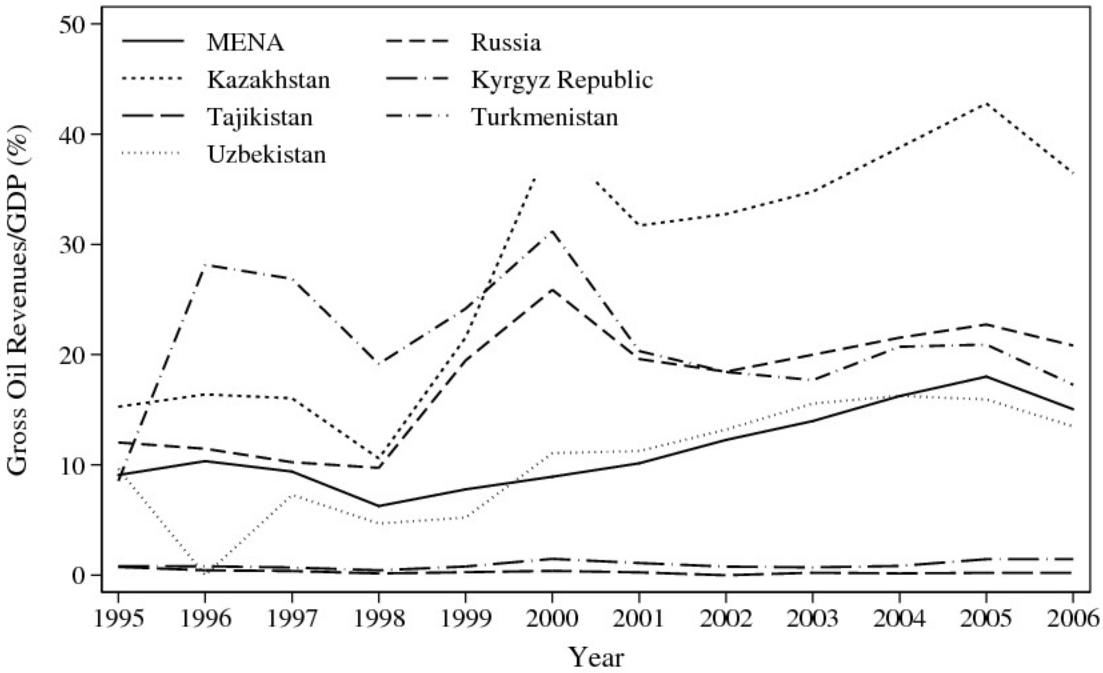


Source: Heritage Foundation (2008). Note: No data available for Central Asian countries prior to 1997.

Several authors have discussed factors behind the persistence of institutional arrangements (cf. International Monetary Fund (IMF, 2005) for an overview). The most prominent argument as to why bad policies persist is that the political elite has control over economic rents from natural resources, such as crude oil (cf. Sachs and Warner, 2001; Ross, 2001; Sala-i-Martin and Subramanian, 2003; Ramsay, 2006). Access to these rents pose a disincentive for political and economic elites to reform institutions, as (tax) earnings from other economic sectors, which would need sound institutional frameworks and property rights protection for their development, pale in insignificance (Rajan and Zingales, 2006; Congdon Fors and Olsson, 2007). Moreover, poor property rights protection can be used to block the introduction of new technologies that may reduce the elites' future political and economic power (Rajan and Zingales, 2006; Acemoglu and Robinson, 2006).

Figure 2 shows the share of oil related GDP as a share of total GDP as a measure of resource dependence in Central Asia. Oil related GDP ratios in Central Asia are compared to an unweighted MENA average. From the graph, it is apparent that Kazakhstan and the Kyrgyz Republic have the highest share of oil related GDP of any of the Central Asian states. All three countries are well above the average MENA country, whereas Uzbekistan is roughly at the same level and Turkmenistan and Tajikistan are below the MENA average.

Figure 2: Oil related GDP 1995–2006



Source: International Energy Agency (2008), IMF (2008).

Comparing this graph to Figure 1, it appears to be the case that no clear relationship between resource dependence and institutions exists in Central Asia. Kazakhstan and the Kyrgyz Republic are the countries with the highest fraction of oil related GDP, as well as the best institutions among Central Asian economies. At the same time, the countries with the poorest institutions in the Central Asian group are also the ones with the lowest degree of resource dependence according to our measure. While this does not necessarily reject the theory of a resource curse for Central Asia, it might indicate that other factors have mitigated the effects of the easy-rents sector on institutional settings.

Another argument proposed in the literature is that being a former colony, or having a legal system that roots in the European legal tradition, has a positive long-term effect on institutional arrangements (Acemoglu et al., 2001; Kuran, 2004; La Porta et al., 2008). Once modern, market-based institutions were implemented during colonial times, they have not been reversed after the end of the colonial rule. Similarly, Beck and Laeven (2006) find that the CEEC were better reformers when compared to their Central Asian counterparts, because they have spent less time under a socialistic regime with a non-market based institutional framework. In this case, individuals find it costly to adjust to a new set of rules, such that the old ones stay in place. Looking at Figure 1, these factors seem to explain initial values in the graph for Central Asia, CEEC, and the MENA economies. But they do not appear to explain the changes in the reform process over time. MENA economies show higher values at the beginning of the sample when compared to Central Asian countries possibly due to a different legal system implemented during colonial times. But despite more favourable starting conditions MENA countries showed little change throughout the following years and did not manage to catch up with the EU. Moreover, it does not explain why several Central Asian countries have overtaken MENA economies.

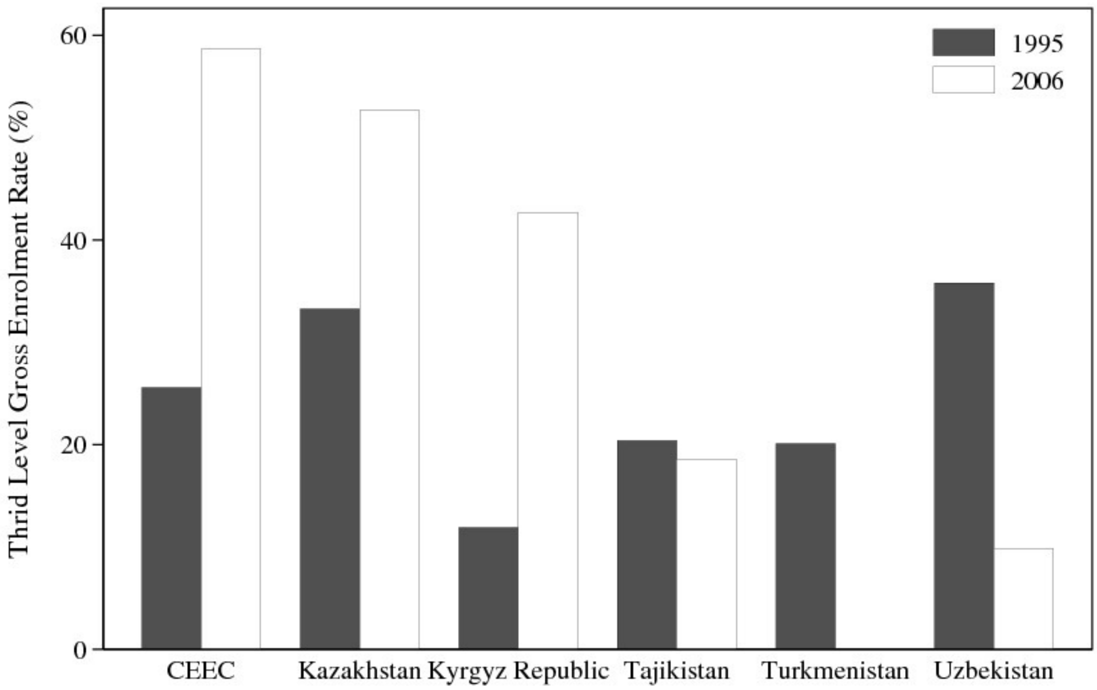
As neither history nor geographical factors can be undone, it is important to understand the transmission channels trough which historical factors affect current choices. Social norms, habits, or costs arising from adjusting to a new set of rules are likely reasons why agents prefer a status quo or gradual changes rather than a quick adjustment, even if it would be socially desirable. Moreover, economic and institutional reforms are often not Pareto-optimal, such that certain groups in the population will be confronted with utility losses due to these reforms. Even though reforms may be socially optimal on a global scale, the non-existence of a political Coase-Theorem, such that winners cannot credibly commit themselves to compensate the losers of the reforms, makes reforms less likely (Acemoglu, 2003; Hoff and Stiglitz, 2008). Continuing with a reform path that is but sub-optimal for a strategically important group of the voting population or special interest groups bears the risk for politicians of loosing their incumbency (Acemoglu and Robinson, 2006).

In a similar fashion, individuals' risk preferences may yield a similar effect. Uncertainty about the outcome of reforms, due to interdependence of different institutions, may also prevent reform efforts or even worsen existing arrangements unintentionally. Hence, the effect of uncertainty on the individual's utility may provoke risk averse agents to prefer keeping their status quo, rather then voting for reforms (Fernandez and Rodrik, 1991). As a result, risk averse policy makers then lack the willingness to reform. Moreover, individuals may have preferences about the way institutions actually should be designed. It is obvious that these preferences are shaped by either the former institutional system or severe economic shocks and that historically shaped preferences do have an effect on current political outcomes. De Grauwe (2007), for example, argues that historical events explain the differences between the French and German inflation target prior to the introduction of the European Monetary System (EMS). Severe inflationary crises in the German history and painful deflationary episodes in France have shaped preferences among politicians and citizens in favour of more stability-oriented, or lax monetary policy, respectively. Similarly, Alesina and Fuchs-Schuendeln (2007) provide evidence on how persistent preferences about institutions are after a regime change by using the division of Germany as a natural experiment. In their paper, Alesina and Fuchs-Schuendeln (2007) find that East Germans, who grew up under the socialistic regime, are more in favour of redistribution and state intervention than West Germans. This effect is particularly strong for older cohorts, which have spent more time under the Communist regime compared to younger cohorts. From their results, they estimate that it takes approximately 30 years until preferences between east and west converge.

The education system is another important factor causing persistence of institutions in Central Asia that may be responsible for persistent institutions. Sound property rights protection and well-functioning factor markets are essential preconditions for developing a knowledge-based economy and economic growth driven by ideas. However, having a well developed property rights protection alone does not ensure production ideas, as it requires a certain level of education among the work force to develop innovations.

Figure 3 shows third level education enrolment rates for Central Asia and the CEEC. As shown by the graph, there appears to be no relationship between education and institutions around 1995. Kazakhstan and Uzbekistan lead the figures, followed by the CEEC, Turkmenistan, Tajikistan, and the Kyrgyz Republic in the last spot. But third level education enrolment rates roughly mirror the ranking of institutional quality in Figure 1, when looking at 2006 figures. CEEC have the highest share of population with third level education in 2006, followed by Kazakhstan and the Kyrgyz Republic as the countries with the highest share of third level education among Central Asian countries, whereas Turkmenistan and Uzbekistan have the lowest fraction. Hence, education did not seem to matter much in the early and mid-1990s. But education of the labour force seem to be associated with the reform process in recent years, such that investing in education and human capital increases the preference for property rights protection and more market-based institutional arrangements, in order to ensure that individuals can benefit from their human capital accumulation.

Figure 3: Third Level Education Enrolment Rates 1995–2006



Source: World Bank (2008). Note: No data available for Turkmenistan after 1997.

A second factor related to education which can be linked to persistence of institutional settings is the quality of education. Although the quality of an education system is hard to measure, a large number of public and private employees in Central Asia, still in key positions after the breakdown of the socialistic regime, were educated under the socialistic system. It is obvious that a curriculum in socialistic book-keeping, banking supervision, and legal treatment of property rights differed remarkably from what a market-based economy demands. In this case, persistence may simply arise from the complexity of setting-up market based institutions and policy makers' lack of knowledge about how to implement and execute certain institutional arrangements. The accumulated knowledge of these employees, therefore, does not assist them in executing their tasks and probably makes redesigning institutions impossible.[4]

3. Openness, Commitment, and Economic Reforms

So far, preferences of individuals and politicians, alongside the deficiencies in the education system, appear to be major obstacles in the reform process in Central Asia, whereas the resource curse does not seem to apply to Central Asian countries. Reforming the education system might help the reform process. But educational reform efforts are subject to the same problem as institutional reforms themselves, namely a lack of willingness to reform. Because educational reforms will only pay off in the long-run, politicians are likely to favour reform projects that will pay off in the short-run. Moreover, changing the domestic demand for better institutions does not ensure that better institutions will be introduced, as the political and economic elite may want to block these reforms.

In this section, I argue that economic openness and factors that are related to it, have played an essential part in reforming institutions in Central Asia since the breakdown of the socialistic systems and are also the reason for why CEEC economies have been even more successful reformers in the past.

Alesina and Fuchs-Schuendeln (2007) argue that preferences about institutions in East and West Germany will converge over time as a result of cultural and economic exchange within a highly integrated economy. While there certainly is an effect on preferences due to economic exchange between Central Asian countries and the rest of the world, I focus more on the disciplining effect external factors have on the policy agenda in small open economies and thereby help to overcome

4 Vaclav Klaus (1990) summarised this as "When we want to play chess, we must know how to play."

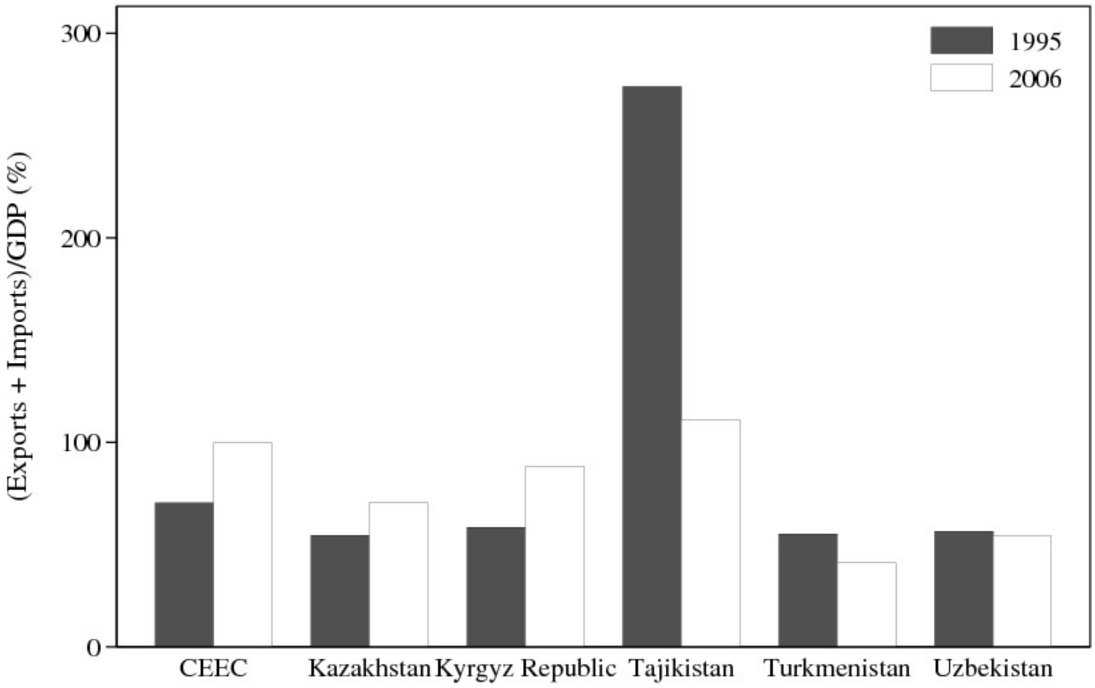
reform-unwillingness. A number of papers have underscored the importance of commitment devices in order to cope with time-inconsistency and credibility problems in individual decisions and policy making (Schelling, 1960; Barro and Gordon, 1983; Kydland and Prescott, 1997; Benjamin and Liabson, 2003). Commitment devices can work twofold: first, they encourage policy makers not to sacrifice reform efforts that would be beneficial in the long-run for short-term policy objectives. Second, they also signal that already conducted reforms will not be reversed.

Countries with a high degree of openness have a larger share of revenues per GDP from external trade and a larger share of foreign investment in total investment. Therefore, opportunity costs in terms of forgone business opportunities as a result of bad governance provide an incentive to improve institutional arrangements.

Figure 4 shows the degree of trade openness measured as total imports and exports in goods and services as a percentage of GDP in Central Asia and CEEC. Figure 4 shows that CEEC, Kazakhstan, and the Kyrgyz Republic have gradually opened up over time, while trade as a share of GDP has declined in Turkmenistan, Uzbekistan, and especially in Tajikistan. Comparing the changes over time rather than absolute levels in 1995 and 2006, this reflects approximately the ranking in Figure 1.

A similar argument can be made with regard to financial openness. Lane and Milesi-Ferretti (2006) report that, in the early 1990s, the CEEC have gradually liberalised their capital accounts, which has led to a number of reforms that strengthened financial sector development in these countries. The disciplining effect of financial openness stems from the fact that financial openness not only improves access to international capital markets and foreign investment, but it also comes at the risk of sudden stops and sudden reversals in international capital flows and thus, painful economic crises. Therefore, it provides an incentive to improve the regulatory framework in order to avoid recessions, as well as reducing sovereign risk and borrowing costs abroad.

Figure 4: Trade Openness 1995–2006

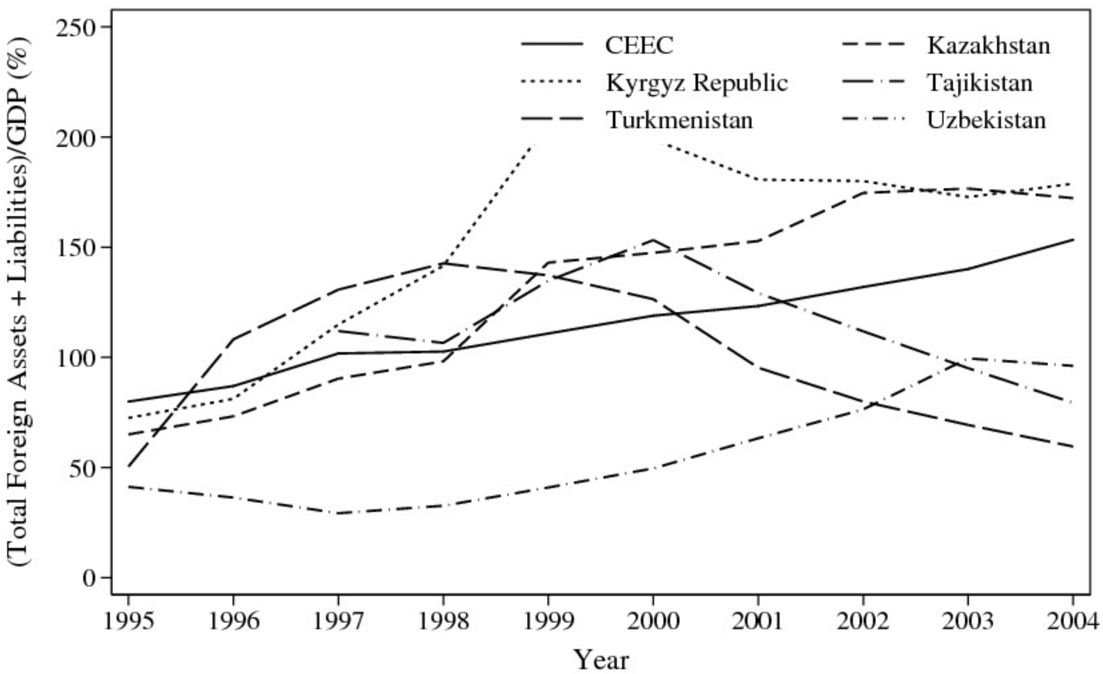


Source: IMF (2008).

Figure 5 shows financial openness measures for Central Asian economies and the CEEC as a benchmark from 1995 to 2004. Estimated stocks of total foreign assets plus liabilities as a share of GDP is provided by Lane and Milesi-Ferretti (2007). The data is adjusted for exchange rate and valuation effects in order to provide a clean measure of exposure to international financial markets. Figure 5 shows that the CEECs and Central Asian countries had similar levels of financial integration around 1995, except for Turkmenistan and Uzbekistan. The CEEC show a constant upward trend over the 1990s and early 2000s, similar to Kazakhstan and the Kyrgyz Republic. While all Central Asian countries, except for Uzbekistan, overtook CEEC for a short period in the following years, only Kazakhstan and the Kyrgyz Republic sustained high levels of financial openness similar to the CEEC after the year 2001, which coincides with the changes documented in Figure 1. Both Kazakhstan and the Kyrgyz Republic already had a higher level of institutional quality when compared to their peers in Central Asia. But they also continued to improve over the following years (Figure 1). In contrast to this, Turkmenistan stopped in particular improving institutions (see Figure 1), which went hand in hand with financial disintegration (see Figure 5).

Financial openness, per se, presumably does not provide an incentive to improve regulatory frameworks. Giavazzi and Pagano (1988) have argued that fixed exchange rate rates, as opposed to flexible ones, also have a disciplining effect on the policy agenda in small open economies. Fixed exchange rates are often a necessity in transition countries, because of the inability to borrow in domestic currency and to hedge the exchange rate risk due to underdeveloped capital markets, as well as the inability to conduct stability-oriented monetary policy autonomously (Calvo and Reinhart, 2002).

Figure 5: Financial Openness 1995−2006



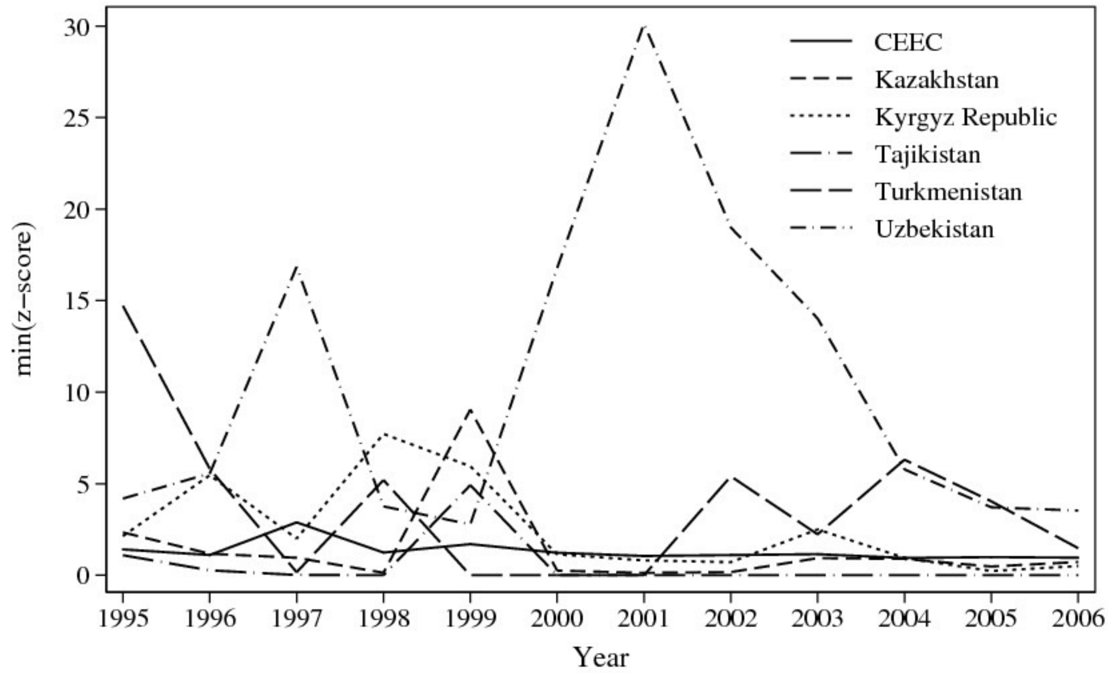
Source: Lane and Milesi−Ferretti (2007) , IMF (2008). Note: No data available for Tajikistan before 1997.

On the other hand, fixed exchange rates provide a target for speculative attacks. In the event that agents expect undesirable policies, they are likely to speculate against the country’s currency, which may force monetary authorities to abandon the peg. As a result, a rapid devaluation will trigger a default of the government and firms on foreign currency loans which, in the medium and long-run, will have negative consequences on the government's and firms' ability to refinance on international markets. Thus, tying the government's hands by fixing the exchange rate is likely to change priorities on the policy agenda in favour of reforms towards more market-based institutions, such as sound financial regulation and property rights protection, in order avoid speculative attacks on the exchange rate regime.

Figure 6 shows average annual exchange rate volatilities of national currencies from 1995 to 2006 against the US dollar (USD), the euro, and the German Mark (DM) prior to the introduction of the euro. Exchange rate volatilities are calculated as Z-Scores, as proposed by Ghosh et al. (2002). This allows us to summarise the de-facto exchange rate regime regardless, of the actual anchor currency. For each country, the volatility measure z_{jt} against the *j-th* foreign currency at time *t* is calculated as $z_{jt} = \min(\sqrt{\mu^2{}_{\Delta ejt} + \sigma^2{}_{\Delta ejt}})$, whereas $\mu_{\Delta e}$ and $\sigma_{\Delta e}$ represent the mean and the standard deviation of the currency returns against the *j-th* currency (USD or euro/DM) in year *t* respectively. The minimum volatility is chosen in order to identify the manipulated and policy relevant exchange rate. Annual figures are calculated from monthly data for each year.

Figure 6 shows that the CEECs have constantly kept exchange rate volatility at very low levels while most Central Asian countries show significantly higher volatility between 1995 and the year 2000 but appear to be on a downward trend. Following the year 2000, Kazakhstan, the Kyrgyz Republic, and Tajikistan have converged to CEEC volatility levels. In contrast to this, Turkmenistan and especially Uzbekistan still show significantly higher levels of exchange rate volatility, which peaks in the aftermath of the Russian debt crisis in 2001. One conclusion that can be drawn from Figure 6 is that the countries with the lowest levels of institutional quality according to Figure 1, Turkmenistan and Uzbekistan, were also those who seemed to suffer the most from contagion effects in the aftermath of the Asian and the Russian crisis in 1997 and 2000. Uzbekistan, in particular, had severe problems in bringing exchange rate volatility back down to pre-crisis levels. Other Central Asian economies that were already closer to the CEEC, in terms of institutional quality, did not have to abandon their exchange rate pegs. Moreover, once the reform process seemed to have speeded up, Uzbekistan was able to contain exchange rate volatility and bring it back to pre-crisis levels.

Figure 6: Exchange Rate Volatility 1995–2006



Source: IMF (2008).

Even though other Central Asian economies did not have to abandon their exchange rate regimes during the Russian debt crisis in 2001, which also hit other countries in the Region and the CEEC, Figure 1 shows that there were increased reform efforts in Central Asia after 2001. While the incentive of financial openness, in combination with fixed exchange rate regimes, assists in preventing an economic crisis, as shown in the Uzbek case, economic crises themselves can have a positive effect in the long-run, despite painful short-run effects. As already pointed out in the previous section, preferences are often shaped by historical events. Periods of systematic instability can shift preferences in favour of better regulations among the population and policy makers and open a window of opportunity for reforms as they reveal weaknesses in institutional arrangements (Acemoglu and Robinson, 2001; Brueckner and Ciccone, 2011). In the aftermath of the crisis, agents have a higher willingness to reform and prefer better institutions, in order to avoid future costly recessions.

Beside these market factors, international agreements that specifically target economic improvement may provide a form of commitment as well. A significant amount of studies find that

IMF and World Bank programmes that specifically target political and social change have negative effects on institutions and economic growth (cf. Przeworski and Vreeland, 2000; Dreher and Rupprecht, 2007). In contrast to this, Di Tomasso et al (2007) find a positive effect of EU or NATO membership on institutional development. The main difference between the two findings can be attributed to the different types of conditionality that apply when it comes to membership and assistance. In the former case, assistance is given in exchange for the promise of political change. In the latter, becoming a member of either NATO or the EU requires political change first and the reward in form of external security and access to European markets comes second.

The CEEC have been the most successful reformers among the former communist economies. A major difference between CEEC and other emerging markets at the EU periphery is that the countries in Eastern Europe have a reasonable prospect of entering the EU at some point in the future. There is evidence that the prospect of an EU membership has become an anchor for domestic economic policy-making in many CEEC (Babetskii et al., 2004). A (prospective) EU membership imposes important constraints on national fiscal and monetary policy, as well as on other policy areas such as governance, as compliance with the *Acquis Communitaire* is a key requirement for entering the EU (European Commission (EC), 2007). Thus, the prospect of entering the EU is likely to explain the transition observed in the CEEC. Although weaker, other forms of cooperation between the EU and countries at the periphery may also provide a disciplining effect on institutional reforms. Economies in Central Asia (as well as Russia) are part of the TACIS-programme. The EU has underscored the strategic importance of its neighbours in Central Asia and has already become an important export market for members of the TACIS-programme (European Commission (EC), 2007). Although the TACIS-programme is not a political agreement in the first place and resembles more an IMF-type programmes, it has become the corner stone of economic and political integration between the EU and Central Asia (EC, 2007). Giving full access to European markets constitutes a strong economic incentive for Central Asian economies to give in to certain political demands from the EU. Danne (2011) provides empirical evidence that the TACIS has helped the institutional transformation process in Central Asia. While there is no direct incentive, as there is in the case of a (prospective) EU membership, there is some evidence that regional non-trade related agreements with a regional hegemon in the centre are an important channel through which institutional arrangements diffuse to neighbouring countries (Danne, 2011).

4. Conclusion

This paper compares the institutional reform processes in Central Asian economies to those of their neighbouring countries in CEEC and MENA economies. The paper identifies shortcomings in education and preferences about reforms of individuals and policy makers as some the main obstacles in the reform process. Based on this, I identify external factors that have acted as commitment devices for Central Asian economies over the past 15 years to reform existing institutional arrangements. Stylised evidence is provided that external factors, such as real and financial openness and factors that are related to both, provide an incentive for policy makers to sustain institutional change. Real and financial openness, fixed exchange rates, and non-trade related international agreements have disciplined governments to conduct institutional reforms. This results from the fact that small open economies, by definition, are more exposed to external shocks and international capital and trade flows. A high degree of trade and financial openness may provide an incentive to reform institutional settings as small and open countries have a larger share of revenues per GDP from external trade and a larger share of foreign investment in total investment. Therefore, opportunity costs in terms of forgone business opportunities as a result of bad governance provide incentives to improve the institutional set-up. Similarly, financial openness provides an incentive to remedy deficiencies in the regulatory framework, thereby making the economy less prone to sudden capital outflows that may result in financial turmoil and painful economic recessions. Pegging the exchange rate, in combination with financial openness, has the same effect as undesirable domestic policy measures and may result in speculative attacks against the currency regime. External agreements, such as the TACIS-programme are also likely to act as an incentive for Central Asian countries, as institutional reforms towards more market-oriented institutions are essential for closer ties with the EU. Lastly, there is also some evidence that external shocks, such as an economic crisis may shift preferences of individuals and politicians towards better institutional arrangements.

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Appendix

Table A. Definitions of Country Groups

Central Asia Kazakhstan Kyrgyz Republic Tajikistan Turkmenistan Uzbekistan
CEEC Albania Bulgaria Croatia Czech Republic Estonia Hungary Latvia Lithuania Macedonia Poland Romania Slovakia
EU-15 Austria Belgium Denmark Finland France Germany Greece Ireland Italy Luxembourg Netherlands Portugal Spain Sweden United Kingdom
MENA Algeria Egypt Israel Jordan Lebanon Libya Morocco Syria Tunisia

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