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**INITIATING INSTITUTIONAL REFORM FOR ENTERING A
SUSTAINABLE GROWTH PATH: THE CASE OF FINANCIAL
VOCATIONAL TRAINING IN ARMENIA**

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Abstract

The current discussion addresses the quality of institution as a crucial factor for the efficiency of delivering developing aid. Within the framework of New Institutional economics we analyze institutional reforms achieving a fit between formal and informal rules as the discretionary process for raising the quality of institutions, allowing entering long-term sustainable growth paths. Because restructuring costs of institutions in a competitive global market place differ, countries inevitable enter separate paths of value creation.

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New institutional economics and institutional reforms

Since the beginning of the 90-ies, the discussion about aid delivery addresses the quality of institutions and governance. According to this understanding, reasons of underdevelopment are less linked with the lack of resources, but with a nation's ability to utilize existing growth opportunities through the quality of its institutions. As empirically and theoretical research prove, neither internal resources such as oil, gas or diamond nor outside resources like development aid or remittances are able to ensure that a country enters a long-term sustainable growth path [Sachs, 1995]. Absorptive capacity, the quality of institution, good governance and regulatory framework makes a difference. Developing nations are less able to control their economies and to deal with factors like volatility in terms of currency fluctuation, commodity pricing, exchange and interest rates. Government revenue amounts to an average of only 27% of GDP in emerging economies (compared with 44% in rich economies) as a result of inefficient tax systems and bigger black economies [IMF]. Asset accumulation as an internal source of investment and finance is much less widespread in the developing world [SOTO].

Indeed, the difference between the developed and the developing world lays in the problem solving abilities of the institutions of developed nations. "The source of increasing return in our modern World can be attributed to an institutional infrastructure that encourages problem-solving" [Popper, 64]. The developed world has higher developed institutions because they are more "adaptable, complex, coherent and autonomous" [Huntington].

But how institutions become good, high quality, problem-solving, resilient to shocks and capable of ensuring an increasing level of value creation? What is the specificity of institutional development as an underlying mechanism for growth and development?

The New institutional economics analyzes institutions as the formal or informal rules governing peoples' and organizations' behavior and describing the 'the rules of the game' [North]. While formal institutions are often more amenable to reform and radical change (through revolution, presidential edict, government policy changes or new laws, for example), informal institutions are deeply embedded in culture, adjust more slowly and may pull in opposite directions to (and undermine) changes in formal institutions. In a changing environment, institutions transform in a discretionary ways, through reforms, opening or not opening long-term growth path through lowering transactions costs of "new rules of the game". Perez describes successful reforms and institutional restructuring as turning points, changing existing techno-economic paradigms as sets of best practice. When a crucial amount of new experience, values and beliefs is accumulated, reforms changes the formal structure of a society, reroute the system, overcome obstacle to growth and give way to new practices, trends and value-creation on a large-scale way [Perez, 52-53]. This way, in order to succeed in a fast-changing environment, successful reforms should achieve a "fit" between formal and informal institutions, subsequently entering new "rules of the game", reflected accumulated new behavior and values and moving along the growth perspectives of the new paradigm.

Different problem-solving capabilities in achieving the fit between a nation's institutions and a permanent changing environment might offer an explanation for stable pattern of ongoing or even increasing differences between poor and rich nations

parallel with the huge and ongoing overall increase in global well-being since capitalism took off. If all nations compete for innovation and an acceleration of the pace of change, it is just natural that some nations succeed while other nations, at least relatively, remain stagnant. Whether the initial triggers for differences are institutional [Acemoglu] or geographic [Sachs 2001], the market mechanism has the embedded tendency to increase differentiation. Other conditions equal we might assume that the higher the value creation of a nation is in relation to others, the higher is its ability to absorb stress and shocks imposed from other nations, but also to impose them on others. The “winners-take-all-markets”, well described with the recent introduction of new information and communication technologies, addresses the open extreme of the continuum of outcomes from innovation and restructuring.

Even if new technologies emerge and disseminate on a local base, they immediately influence the perception about future cash flows from existing assets of all players on a global base, change expectations, influence relative prices, redistribute investment and request new behavior and activities. While the new growth opportunities might favor some institutional arrangement, others will “shocked” or even not be able to adapt to them, making restructuring necessary. The switch to new “rules of the game” with low transaction costs will be a task, they are less able to fulfill.

Considering differences in restructuring costs might explain real-world phenomena. According to the theory of comparative advantages, two countries always win if they are engaged in additional trade. But increased welfare does not take into account possible different costs of restructuring the economy to achieve a new equilibrium. In the extreme, the institutions of a country might not be ready to integrate the additional trade, lose its political stability and subsequently enter a path of negative value creation till a new institutional arrangement, which might be lower than before. For example, the agriculture policy of the European Union has a long history of limiting access to its markets from developing nations and also a long tradition of providing developing aid to the same group of countries. For Europe, the potential increase in welfare by importing agriculture goods is huge, but inevitable major restructuring in the market place will occur. Upcoming changes should be compensated and smoothed through reforms, but these reforms are confronted with political resistance. Depending on determination, power, organization, but also tradition and national values, opposition to change might threaten political instability, increasing restructuring costs significantly. As the European Union has a more powerful enforcement mechanism than developed countries, it ensures that political stability is supported and the existing level of well-being is not at risk. It will limit market access and postpone reforms in order to win time for gaining political support and lowering the costs of change. It might even provide aid to ensure political stability in developing nations. If other factors are not taken into consideration, restructuring costs of the huge European agricultural sector should fall to the expected increase in welfare of the free market access before the opening of the market is economically efficient and the welfare gains of trade might occur.

Transition economies are full of examples, where high transaction cost due to the lack of an appropriate market infrastructure do not allow that effective restructuring of enterprises takes place, such as in the coal industry [World Bank]. Postponing

restructuring and lowering transaction costs is social efficient, but not economically. The resulting growth path generates lower value.

Maybe, development aid, which started to occur after World war II might be understood as the infant tendencies towards a global welfare system, providing a permanent contribution to the GDP of selected countries (for Armenia negative value creation is a double digit figure) till these countries are able to integrate into the World economy on their without outside assistance.

We want to analyze on the example of Armenia's educational system, and vocational banking training particularly the factors contributing or hampering an institutional reform process for entering a sustainable growth path within the concrete historical circumstances of the Armenia's transition economy. Based on personal consultancy efforts during 1997 – 2003 we describe drivers and outcomes of institutional reforms, reshaping the educational landscape in financial vocational training.

Historical roots of Armenia's educational institutional infrastructure

As path dependency in institutional development matters, we have first to understand the history of current institutions. Armenia's educational and vocational training system has its roots in the Soviet Union. But the distantness of this society was itself a result of a major institutional innovation, the communist rule, denying the growth mechanism of a market economy. Factors for the emerging of this unique institutional design lay in the peculiarities of economic and social development of Russia and the prevailing global growth factors at the beginning of the last century. Fast industrialization and growth in Russia provided a small, but crucial input in practice, experience and values of the new industrial age. But the Czarist monarchy was unable to bridge the gap between these emerging new growth opportunities and the mainly agricultural country. After a revolution and civil war it was overruled by the communists. They introduced a planned economy. This new institutional arrangement capitalized on the growth potential between highly developed and underdeveloped sectors of the economy and entered an extensive growth path through adding efficiently new resources into the process of industrialization. Additional, it accessed an additional source of internal accumulation by neglecting further investment in the institutional framework of a market economy such as independent judicial system, property rights, the rule of law, but also democracy and individual freedom of its citizen. By "shortcutting" history, a record of technological accomplishment was achieved. Despite persistent low value creation, the system was advancing in politically sensitive technologies such as defense, and in technologies, where economies of scale and state determination were crucial success factors, such as conquering the space. The "sputnik" shock of the 60-ies of last century describes the ability to influence the outside world within the logic of the Cold War.

But the reasons for success became causes for dramatic failure. After peaking in the 60-ies of last century, growth rates and return of investment diminished fast. The systemic

inability to structural reforms and institutional innovations proved to be more and more a burden for growth, further challenged by the emerging of post-industrial societies at the second half of the last century. The integration of new communication and information despite all efforts failed; the planned economy just could not find an appropriate institutional response. Eventually, after 74 years, the political pressure for changes became crucial and socialism in the Soviet Union and Eastern Europe imploded. The initial gap at the start of Russia's industrialization was closed, but due to the inability for institutional innovation the system failed miserably in comparison with the ongoing global increase in well-being. In terms of global competitiveness and value creation the region had not only lost relatively, but had also to overcome the underinvestment in the neglected basic institutional infrastructure of a market economy. It comes as no surprise that these necessary costs proved to be a heavy burden. As a consequence, the region fall further behind during the 90-ies. Today there are only several states which were even able to achieve the level of economic development of the end of communist rule.

Fractal-like, the educational system mirrored the monolith structure of the planned economy and was an integrated part of it. The system of vocational educational training (VET) was established in Soviet system during the 30-ies of the last century. Its main objective was to serve the qualification needs of preliminary industrialization in huge state-owned enterprises, and to integrate and to socialize a mainly agricultural labor force. Within the conception of "one factory" a pyramidal structure of VET emerged and a strong command-and-control mechanism with extensive, differentiated and sophisticated infrastructure was established. For example, large scientific institutes were engaged in prescribing in detail what should be taught how. The system was optimized to its extreme in providing a maximum amount of theoretical knowledge for functional skills within a teach-centered Fordist assembly-line educational model.

Challenges for Armenia's educational system since independence

Since independence, Armenia moved from a high-tech centre of the world's second superpower to a landlocked country in one of the poorest and politically most fragile regions of the world. Collapsing industrial output, war and an ongoing blockade had challenged the survival of the state itself.

While Armenia's exceptional economic and scientific development after World War II is closely linked with being a part of the Soviet empire, the Socialist model of postponed industrialization and autarky has lost its attractiveness. Armenia inherited an extensive and expensive, but inflexible educational infrastructure, which is designed to meet the demands of an economy that does not exist any more. The labor force, produced by this educational sector, is too expensive educated for low skill jobs but it does not meet the demands of new industries and transnational companies, because the conditions for foreign direct investment are not met. Today's two world's growth countries, China and USA, combining more than 50% of global economic growth of

the last years¹, demonstrate this dilemma: China integrates into the world markets by offering its supply of cheap labor, the US through the development of new technologies.

It is obvious that Armenia's educational sector must change fundamental to reflect these changes in the environment. It is also not difficult to describe in abstract terms the necessary change by comparing the features of the Soviet system with the modern understanding of the educational process: From the Fordist assembly-line learning style to a "case management" learning style, with a focus on critical thinking capacities, communication, analytical and decision-making skills. The transfer should include the transition from a teacher-centered (didactic) to a learner-centered education system, where the focus of education is less on obtaining preliminary defined theoretical knowledge but assumes the active participate of the learner and the development of practical problem-solving capabilities. The future employee should take responsibility in a permanent changing environment using project management and teamwork, facilitation and moderation skills, including self-directed learning. For the education system, the responsibilities and independence of VET schools should be increased sufficiently while state institutions will have a major role in providing service to them, regulating the market place and facilitating the communication process with business and institutions.

The challenge is to enter an institutional reform path under the specific condition of Armenia's transition economy, capitalizing on institutional path dependency and the cultural embedment of learning. Copying other countries' solution might be unavoidable, but it offers only a growth path of limited value creation. Just obtaining similar institution as Western countries will not help to overcome underdevelopment. Chang remarks that the "now developed countries were institutionally much less advanced in those time than the currently developing countries are at similar stage of development [Chang, p. 120]

Performance of Armenia's educational system since independence

Armenia's independence marks the opening and liberalization of the economy. This process puts sever stress on existing institutions, the education system and VET particularly.

First, due to large-scale deindustrialization, vocational training lost its traditional clients, state-owned enterprises. Second, the state was not able any more to finance VET. Even during 1998 – 2003 the amount spend on VET halved from .27 of GDP to .12 of GDP [Statistics]. A systemic collapse was avoided by switching to fee-based training. Third, with new sources of finance VET liberalized and openly a market mechanism started to function. But without regulation, academic standards deteriorated fast. Fourth, demand switched to higher education. The differences in costs of obtaining a diploma in higher education or vocational training are low. With unemployment high,

¹ The Economist, November 15th – 21st 2003, p. 71

the markets give preferences for higher education even for low-skilled jobs [UNDP, 33].

As a result of these modernization shocks, the system of vocational training lost its efficiencies in providing qualification, needed in the world of business. It started an almost parallel life to the emerging labor market. From an integrated part of the monolith structure of the planned economy, it became a disintegrated, fractured element of the institutional landscape, unable to transform the modernization impulses of the outside world in value creation.

All stakeholders of VET were unprepared for systemic reforms. This lack of experience and capabilities increases transaction costs towards a new equilibrium. Furthermore, neither on the level of VET institutions nor on the level of the ministry or other VET stakeholder management capabilities existed which could lead the necessary change process. Losing social status and living standard, state officials, principals and faculty make rational choices when trading off the costs of systemic change with marginal, abstract and uncertain benefits.

Under these circumstances, the roots of the Soviet-style education system remain mainly intact and the value creation and modernization opportunities of a modern educational system could not be fully realized.

As a consequence, the importance of existing assets in generating cash flows increased while the enforcement mechanism of the old system lost legitimacy and partly broke down. Faculty realized that they could charge for examinations and state officials on licensing activities, admission examinations and other academic services, compensating salaries below the official poverty line. Informal business model emerged and a “black economy” became an integrated part of the new equilibrium.

At the same time, the state could avoid an implosion of the educational system despite the external shocks. In people’s perceptions, intact and functioning structures kept legitimacy. They provided orientation, stability, trust, and guarantee of quality, even on a very low level. The image and reputation of a state diploma in Armenia is still high between all stakeholders of the educational process reflecting both new best experiences since independence and accumulated old beliefs, expectations and perception.

The task of systemic reforms in the education sector remains. The challenge is to integrate the different growth and modernization opportunities efficiently through lowering transaction costs. This assignment cannot be reduced, but is mainly defined by the modernization efforts of state institutions, because the effectiveness of a market economy depends on the quality of its regulation. Markets always fail when not supervised appropriately and when transaction costs prevent the internalizing of technological and other non-pecuniary externalities. Therefore, “the freer are the markets, the greater is the burden on the regulatory institutions” [Rodrik, 4].

The role of developing aid in modernizing Armenia's educational system

If a country's absorptive capacity is low, donor projects might add to the fractal characteristics or even accelerate disintegration due to their overwhelming financial and management resources. Institutional reforms are autonomous and innovative processes integrating in a unique way a nation's specific assets. This process cannot be targeted directly by outsiders. It is therefore the challenge of a developing aid to encourage change, create momentum, and provide an atmosphere, where systemic change might take place, without interfering and challenging the ownership of a change process.

In Armenia's higher education, major Greenfield investments took place, such as the setting-up of the American University of Armenia, the Slavic university, the French university and others. They brought much-needed modern knowledge, new training, organizational and management methods and international standards in efficiency in education and training to the market place. But they also put pressure out for reforming national institution in order to meet the demand at the top of the market, such as high-paid jobs for international organization. The new high-quality, high-efficient educational sector is small, heavily subsidized with foreign aid and with limited links with the rest of the economy and other educational institutes. Despite high investment and the use of state-of-the-art training methods and management tools, the return on investment in form of increased economic activity through graduates is much lower than in developed countries. Without appropriate institutional solutions, there is always the danger that integration of the new organizational forms takes place only formally. The differences between a pilot or demonstration project and a fortress of modernity are small.

While bridging the gap between a country's resources and the global environment and providing access to the opportunities and efficiency of modern technologies, the amount, diversity, management capabilities and financial resources of donor projects put also additional stress on initiating and managing systemic reform.

On a different scale than in Armenia, Germany is also faced with the challenges of initiating systemic change for entering a sustainable long-term growth path for the New Bundeslaender. The eastern part of the united Germany could directly use the experience and the capacities of West Germany's institutions. This way many of the problems, usually associated with underdevelopment and low growth rates, could be solved in a fast and efficient manner. Today, the New Bundeslaender have a sophisticated judicial system, efficient property rights and macroeconomic stability. The physical and communication infrastructure is one of the best in the world. On a yearly bases, more than a hundred of billions of Euros are flowing in the form of subsidizes, pensions and transfers. But, besides some islands of performance, overall growth is below expectation and after some catching up, the productivity gap between the two parts of Germany is on the rise again.

Initiating institutional reforms in financial vocational training

How successful institutional reforms in the education system might take place? What is necessary to overcome constraints of donor projects for managing reform efforts? Based on our part-time consultancy experience in financial vocational training during 1997 – 2003 we would like to point to

- Ownership of the reform process: There should be a clear leader and initiator of the change process, who takes the responsibility to push through.
- Network of change agents: Between the initiator of reform and the wider public clear communication channels should be established in order to identify and exercise new solutions, to provide feedback and to accumulate a critical amount of new practices, norms, values and mindsets.
- Creating benefits for stakeholders: the restructuring costs of obtaining new practices and unlearning old habits should be compensated for a crucial amount of stakeholders with an significant amount of increase in welfare
- Creating innovative institutional solutions: new behavior and procedures should be imbedded in institutional arrangements. The new framework should contribute to the dissemination of new practices.

Of course, in comparison with the educational sector financial vocational training is smaller and less complex. Furthermore, financial markets are growing fast and qualification demand is relatively sophisticated. Foreign ownership introduced modern management practice and business approach to the market place. A strong Central Bank and the Association of Banks of Armenia structure and organize the sector. This factors lowered transaction cost for entering a path of systemic change.

We want to describe these drivers of change in more detail.

Ownership of the reform process: In 1998, Central Bank of Armenia, Union of Banks and Ministry of Education created a new local institution, the Financial Banking College, FBC, in order to meet the need in qualified bankers.

Through the German donor, the FBC project has access to modern knowledge and consultancy capacities. This provided stability for the functioning of the institution and covered costs when new innovative behavior was exercised. Having resources, a mission and powerful founders, the FBC was missing demand for its services: the private sector was reluctant to engage in vocational training, the state lacked the resources to finance it and potential students were reserved to believe that a diploma of a new vocational institute would allow them to enter the competitive financial labor market. In order to ensure its survival, the FBC had to change the rule of the game, establish and propagate new behavior, mindsets and norms. Eventually, it became the owner of the institutional change process.

Network of change agents: There is no change process without the involvement of a critical amount of supporters. The FBC could succeed in attracting and maintaining a network of bankers, decision-makers, state officials and other supporters, who could identify themselves with the vision of implementing a modern educational approach in VET in Armenia and who became active propagator of it.

Creating benefits for stakeholders: Requesting new behavior by its stakeholders, the FBC had to offer compensation. The traditional way of a private company is to offer

low prices and a high quality of goods or services. The FBC followed a similar path. It invested in long-term market development and developed a competitive range of services to meet the emerging demand.

Creating appropriate and innovate institutional solutions: Developing and propagating institutional solutions is not a one-off, but an incremental and long-term process. The FBC build momentum by small steps, starting with the creation of an educational standard, recommended for use in the financial sector by Central Bank and the Union of Banks of Armenia in 2000. In May 2003, 17 banks signed a declaration about the establishment of a central examination commission at the Union of Banks of Armenia, expressing emerging new perception, beliefs and expectations of vocational training.

The initiated changes achieved the following results:

- Creating a new market and entering a sustainable growth path of value creation through modern financial VET, further educational services, and Human Resources consultancy with double digit growth rates, exceeding US\$ 100,000 in 2003. This achievement should be related to the amount of state finance of VET (US\$ 2.4 million in 2001), the national average salary of an employee (US \$ 45 USD/months) and the capitalization of the financial sector (US\$ 60 million)
- Establishing an effective mechanism of self-regulation of the market place in financial VET through the integration of transparent and accepted procedures such as: voluntarily establishment of entry criteria for employment based on qualification, new educational standards, dissemination of modern learning methods, and the establishment of an independent national examination board.
- Formalizing best practice of the financial sector in more than 30 training modules, dictionaries and textbooks with a total of 4.000 pages by a team of 30 leading practitioners. For the first time in modern Armenian history, the set reflects both modern requirements for the development of modern training materials and analyzes existing experience and efforts in creating an effective market place.
- Identifying effective institutional arrangement for the involvement of key decision makers and state officials in contributing to training and further training. Practically, all CEO's of Armenia's banks as well as international experts and outstanding representatives of the international community (ambassadors of the US and Germany) are involved in different committees and councils (Board of Trustees, Steering committees, Examination commission), addressing educational and other issues of relevance for the competitiveness of the market place.

Conclusion

On the example of Armenia's educational infrastructures we wanted to show the significance of institution's quality for entering long-term sustainable growth path. We described path dependency and reform as major triggers for institutional development over a period of almost 100 years.

A more detailed analyzes of the evolution of Armenia's educational system since independence confirms the theoretical and practical evidence about the structural imbalance between growth and donor aid. Helping other people to help themselves is an unsolvable conundrum [Ellermann]. "Paradoxically, therefore, program aid is fully effective only when it does not achieve anything – when, that is, no quid pro quo (in the sense of a policy that would not have been undertaken in the absence of aid) is exacted as the price of aid. [Hirschmann 1971, 204]. Institutional restructuring is an autonomous, self-determined process, which, if successful, allows entering a growth path according to a nation's peculiarities in values, mentality and beliefs. Developing aid, independently of the level of economic development and project design, aims on disseminating known approaches and solutions.

Based on practical consultancy efforts in the field of financial vocational education we showed that systemic change might be initiated and facilitated by donor projects, if the above mentioned conditions of "achieving nothing" in the sense of ensuring unconditional local ownership of the change process are met.

As for the foreseeable future developing aid will be a part of Armenia's GDP, the quality of aid delivery matters. We therefore encourage the use of indirect and market-driven forms.

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