

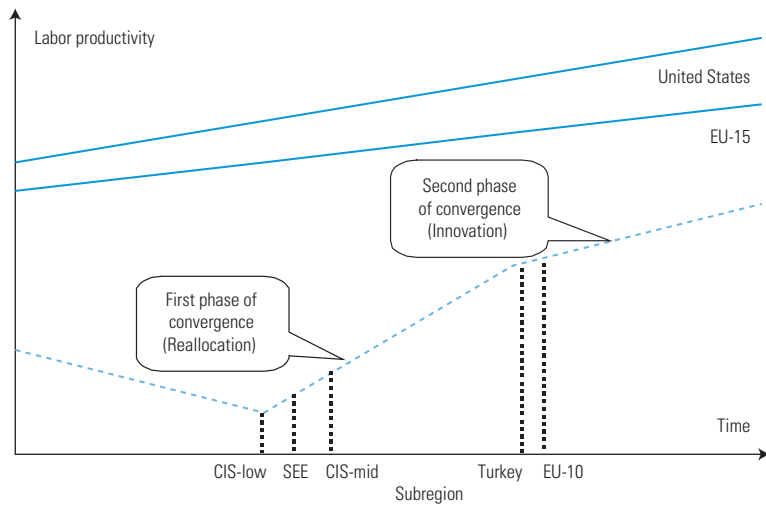
## The Future Role of Public Policy

Accelerated and sustained productivity growth is essential if the countries in the Region are to improve incomes and move rapidly toward convergence with the advanced market economies. The growing and vibrant private sector in many of these countries will drive productivity enhancements, but public policies should promote these enhancements. The barriers to and the sources of productivity growth are, of course, different in each country and will require a differentiated mix of public policies. That mix is best developed at the national level by taking into account country-specific initial conditions and institutions. How successful countries will be in moving forward on the path of prosperity will depend on how well they are able to design and implement public policies and compete among themselves to unleash the creativity of private markets.

### **Sustained Productivity Growth Will Accelerate the Convergence toward Advanced Economies**

The productivity differentials among the countries of the Region and between them and the more advanced market economies suggest that accelerated and sustained productivity growth is essential for higher

**FIGURE 4.1**  
**A Path toward Convergence**



Source: Adapted by the authors from Piatkowski (2004).

living standards. Figure 4.1 suggests a conceptual view of the levels and growth of labor productivity in the Region. The countries of the Region (except Turkey) have embarked on a major economic transformation characterized by economic decline and a deep recession at the outset, followed by a strong surge in growth and productivity driven by domestic and globalizing factors. The EU-10 and Turkey are at a more advanced stage of economic transformation and incomes. The countries of the CIS and SEE have a longer road to travel even though they have shown more rapid growth rates in recent years. If these growth rates are sustained, even accelerated, then the future will be bright for the peoples of these countries.

### **Fostering Productivity Growth Requires a Differentiated Policy Agenda across Countries**

While perseverance in reform is important for all countries, the relative importance of particular public policies in any country depends on where the country is located along the development path. Of course, the pursuit of sound economic policies is a prerequisite for growth. These policies include prudent monetary and fiscal policies (reflected, for instance, in a moderate-sized government and low inflation), an investment climate conducive to private sector growth, a relatively well-developed financial system, and an open trading system. However,

beyond these broad issues, the diagnosis in this report points to a diverse set of challenges for the various groups of countries in the Region. Thus, the primary challenge for the CIS and SEE is to address the unfinished legacy of transition, while the main challenge for the EU-10 and Turkey is to sustain productivity growth and foster innovation (table 4.1). Specifically:

- For the late reformers (the CIS and SEE countries), the greater initial misallocation of resources and the slower path of transition suggest that productivity gains must still be tapped by facilitating firm restructuring, promoting the net entry of firms, easing access to credit, and taking advantage of gains in trade and greater openness by simplifying behind-the-border trade practices. While only a few of the SEE countries may have a realistic prospect of EU accession, all countries in the CIS and SEE have the opportunity to achieve greater integration with the EU and the world economies, along with the attendant benefits in productivity enhancement, new markets, and growth. The development of policies that may help maximize national benefits from regional and global opportunities needs to be a key objective of national governments.
- For the early reformers (EU-10 countries and Turkey), which have largely addressed the legacy of transition issues, gains will still accrue from efficient reallocation and firm churning, such as in even the most advanced economies. But the bulk of the productivity gains are likely to be tapped through within-firm productivity growth as

TABLE 4.1

### Late Reformers Must Complete the Transition; Early Reformers Must Sustain Productivity Growth and Foster Innovation

Stage	Reforms
First phase of convergence: late reformers in which the initial level of misallocation was greater and transition reforms proceeded slowly	<p>Address the transition legacy:</p> <ul style="list-style-type: none"> <li>• Facilitate firm entries, restructuring, and exit by improving the business environment, particularly business licensing, taxation, and legal and judicial reform, and hardening the budget constraints on loss-making public enterprises</li> <li>• Lower the cost of and improve access to credit</li> <li>• Accelerate the behind-the-border agenda to deepen the gains from trade openness, particularly the liberalization of services and the improvement of trade facilitation and logistics such as information technology, infrastructure, port efficiency, and customs regimes</li> </ul>
Second phase of convergence: early reformers in which the misallocation of resources has been substantially corrected relative to their peers, but which are still lagging the EU-15	<p>The second- or third-generation reform agenda: sustain productivity gains and foster innovation as a source of growth by</p> <ul style="list-style-type: none"> <li>• deepening bank and nonbank financial intermediation</li> <li>• adopting competitive product and labor market regulations</li> <li>• improving the quality of human capital (tertiary education)</li> <li>• investing in knowledge (R&amp;D) and in new technologies (ICT)</li> </ul>

Source: Compiled by the authors.

a result of boosts in competition, the fostering of technological imitation and innovation, the absorption of new skills and technologies, and the development of new products and markets. These countries are now entering into the same markets as the more advanced European economies and are catching up with the technological frontier. The success of the EU-10 and Turkey in moving ever closer to the income levels of the EU-15 will largely depend on how able their firms and workers are to advance rapidly into new products and markets and to make their production processes more efficient.

Policies need to address the relative importance of the various channels of productivity growth in a given country. This report has focused on three main channels of productivity growth at the firm level: efficiency gains within firms, reallocation across firms and sectors, and the net entry of new, more-productive firms as older, obsolete firms exit.

Encouraging the growth of new, more-productive firms and strengthening the financial discipline of existing enterprises continue to be important. Many of the former socialist economies still face significant productivity gaps across sectors and across firms. The evidence shows that new firms are typically the most productive, reflecting not only a more efficient use of resources, but also a greater capacity to innovate, adopt new technologies and business practices, and introduce new products to expand the country's set of production goods and services.

As the transition process matures and the more-advanced countries in the Region come to resemble countries with more typical economic structures, within-firm productivity growth will become more important. This channel of productivity growth is not new to Turkey, but it represents a paradigm shift in transition: the shift from reallocation and net entry to within-firm factors as the primary driver of productivity growth. As discussed earlier, this shift is not sudden and discontinuous, but a movement along a spectrum whereby reallocation issues are relatively more important in the CIS and SEE, and within-firm issues are more important in more advanced EU-10 countries and Turkey. The sources of within-firm productivity growth are likely to differ among countries at various points along the spectrum; defensive restructuring (such as labor shedding and the utilization of excess capacity) is the main driver in lagging reformers, and more strategic, market-oriented restructuring, competition, and innovation are the main drivers in the advanced reformers.

Are policies aimed at within-firm productivity growth and policies aimed at encouraging reallocation and net entry mutually exclusive?

While many policies, such as the maintenance of low inflation, trade openness, and predictable tax rates, will strengthen each of these channels, other policies, such as the enforcement of bankruptcy procedures may be more important for reallocation and net entry, while support for integration in global production networks and the development of advanced market skills may be more relevant to within-firm productivity growth.

Building on the findings of this report and the empirical literature on microlevel productivity, we may group policy measures under four broad categories: (a) governance and macroeconomic stability, (b) competition and market entry, (c) labor, infrastructure, and technology development and (d) financial development. These areas are the staple of development policies for ECA countries.

## **Governance and Macroeconomic Stability**

The transition economies have moved a long way toward stability since the early years of the macroeconomic turbulence that eventually exploded into the financial crisis of 1998. Key aspects of the improved macroeconomic environment are the openness to trade and investment and the more rapid economic growth that has been the result. GDP is estimated to have increased 6 percent over 1999–2006. In the CIS, GDP grew even more quickly and at a higher rate, 7 percent, which makes the subregion one of the most rapidly growing in the world. Many factors have helped to accelerate output among countries in the Region: healthier growth in high-income Europe, improved private sector confidence and capital inflows (tied to EU accession for some), lower real interest rates, and massive gains in the terms of trade from increases in energy prices and other export-commodity prices, which have generated more disposable income. However, growth may yet slow down because of several factors, including declines in global energy prices, gradual increases in world interest rates, economic slowdown in the advanced economies, and capacity constraints (World Bank 2007).

While inflation decelerated from an average 9.2 percent in 1999 to 6.6 percent in 2006, inflationary and external pressures are building again as a result of the past few years of rapid growth, credit expansion, and higher energy and food prices. Several countries have inflation rates in excess of 10 percent. For several new EU member countries, achieving inflation rates in line with the Maastricht criteria remains a challenge, especially for countries seeking to

adopt the euro at an early date. Current account deficits increased from an average 5.4 to 7.2 percent of GDP between 1999 and 2006.

The excess demand pressures in many countries—reflected in both external and internal disequilibriums—have generated concern over macroeconomic vulnerability. The pressures are largely caused because the open economies are experiencing strong capital inflows, extremely rapid domestic credit expansion, and, in some cases, a loose fiscal policy stance. While capital inflows are expected to remain strong, particularly those motivated by investment opportunities associated with EU accession, economic disequilibrium makes these countries sensitive to a change in investor sentiment. Even as some countries must contend with large current account deficits, the oil-rich countries, such as Russia, are facing a problem of plenty; they are running significant fiscal surpluses, accumulating large external reserves, and seeing their currencies appreciate. The challenge for them is to find a way to manage the newfound wealth so as to strengthen the productive capacity of the economy and improve economic efficiency, while limiting the erosion of potential gains from inflation and declining competitiveness.

Such risks must be addressed, especially in the middle-income countries, so as to sustain growth momentum. To this end, prudent fiscal and monetary policies must be pursued that target low and stable inflation; strong banking and corporate sector governance; effective banking supervision; sound competition policies; and prudent economic policies that permit rapid policy adjustments in response to shocks.

Moreover, as countries emerge from the transitional recession, they will need to manage the normal economic cycle. How should the structural budget deficit be managed? How might budgeting be carried out in a countercyclical manner? What is the desirable level of fluctuation in short-term interest rates over the cycle? How should government policy offset the possible negative consequences of recessions for firm investment, especially in innovative technologies? These are new questions for the emerging transition economies, that need to be addressed so as to ensure the proper management of economic cycles in a way consistent with the goal of maximizing long-term productivity growth.

## **Competition and Market Entry**

Since the start of transition, a focus of public policy has been the promotion of the entry of new, more-productive firms and the exit

of old, less-productive firms. This development has been considered a key driver of economic transformation. The approach has been based on the premise that the low productivity of obsolete firms is a drag on economic growth, with the consequence that obsolete firms either needed to be restructured to promote more rapid growth or needed to give way to new firms. (World Bank 2002 provides a fuller discussion of the policies to encourage new and discipline obsolete enterprises.)

The entry of new firms has been most effectively promoted through the development of a positive investment climate, while the exit of old firms has been best accomplished through the imposition of market discipline. A healthy investment climate provides a level playing field to attract new investment and firm growth. This requires low and stable marginal tax rates, simple regulatory procedures, secure property rights, and adequate basic infrastructure. The imposition of market discipline forces obsolete firms to restructure and become more productive and compete; otherwise, they must face closure. This discipline—for example, through the hardening of budget constraints, the introduction of market competition, the enforcement of bankruptcy procedures, and better performance measurement—forces obsolete firms to release assets and labor that can then be used by new and growing firms or to divest noncommercial operations, such as housing and other social services, and focus on creating economic value.

Policies for within-firm growth are evident from the experience of the countries of the EU-10. EU integration has provided a strong incentive to openness and competition, and this has helped industries in these countries catch up with the technological frontier. Competition policies in this context involve fostering integration with global production networks, strengthening the regulatory framework for service sector competition, and integrating domestic factor and product markets. Furthermore, as the evidence from the EU suggests, firms are more likely to innovate in the presence of competition (Aghion and others 2006).

An important new aspect of policies to promote firm-level growth is the establishment of links between upstream production and downstream services. The analysis in this report demonstrates that these links are a key factor in the shifts in sectoral patterns and a sign of the growing integration of economic sectors. While general reforms that improve the investment climate may stimulate productivity in downstream agriculture and create off-farm employment, the evidence also suggests that stronger competition in services may also boost farm profitability and productivity growth.

## Labor, Infrastructure, and Technology Development

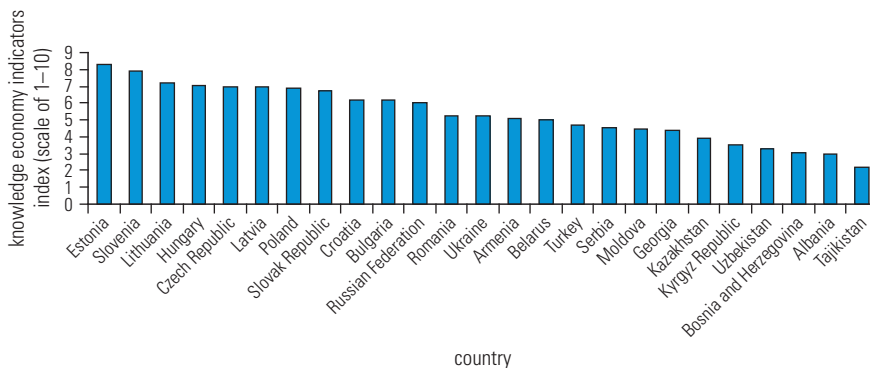
Globalizing forces provide a great opportunity for countries to acquire labor skills and technology through FDI, licensing, and imports of capital goods. A primary challenge during transition has been the shortage of skills required for a market economy. All transition economies have a positive legacy of high attainment rates in tertiary education. This suggests that these countries possess a major advantage, but, in reality, the skilled labor is often limited because of the content of that education and the lack of relevance of skills to the absorption and diffusion of the new technologies essential for the competitiveness of new market economies.

Infrastructure upgrading is necessary for within-firm and within-farm productivity growth because it enhances market access and reduces transaction costs. Infrastructure quality has suffered heavily in most transition economies through underinvestment and lack of maintenance and repairs. If firms and farms are to benefit from globalizing and domestic forces, they need high-quality infrastructure that links them with domestic and foreign markets.

Progress in innovation, as demonstrated through investments in R&D and the commercialization of technology, remains low and uneven in the Region. Average spending on R&D is now under 1 percent of GDP, well below the EU target of 3 percent. Furthermore, around two-thirds of this spending is public spending, whereas, in Western Europe, 65–70 percent of research spending is provided by the private sector. Increases in expenditure are unlikely to improve the situation until the private sector plays a bigger role (for example, see World Bank 2002; Desai and Goldberg 2007). While the new EU member states are doing fairly well in terms of knowledge economy indicators (an aggregate measure of economic incentives, the institutional regime, education, innovation systems, and information infrastructure), the rankings of other countries in the Region reveal a range of weaknesses (figure 4.2). Turkey, which has a GDP per capita that is similar to that of Lithuania and the Slovak Republic, is ranked behind these countries on the knowledge economy indicators index primarily because of low scores on education.

The Region still needs to exploit fully its fairly high human capital stock and well-developed research institutions to provide ideas for commercial applications that will lead to private sector growth. Translating R&D into commercial success is key to achieving sustained, long-term economic growth and will only occur if incentives are provided so that researchers and businesses work together. Such incentives include

**FIGURE 4.2**  
**Early Reformers Exhibit a Higher Absorptive Capacity for Innovation, 2006**



Source: World Development Indicators Database 2007.

broad public access to computers and the Internet, as well as the enforcement of rules to protect intellectual property rights.

### Financial Development

Transition countries have made tremendous progress in the establishment of banks and capital markets, but the contribution of the financial sector to productivity and growth has been uneven. The financial sector in many countries remains underdeveloped relative to the financial sector in other countries at the same level of income. Financial market indicators, such as the ratio of private credit to GDP, the share of domestic credit supplied by depository banks to the private sector, the capitalization of the stock market, the level of total banking assets, and the extent of financial intermediation, are all narrow relative to per capita income (EBRD 2004). More recently, across the Region, there has been rapid growth in bank credit, much of which is highly skewed toward consumer lending. The firm lending that is taking place is concentrated among large firms. In the face of weaknesses in banking supervision and consumer risk assessment, these trends have raised concerns over potential macroeconomic risks, even as private small and medium enterprises are being starved for the credit they require to grow (World Bank 2007; EBRD 2006). Indeed, little credit has flowed to new or existing private enterprises, even though the experience of EU-10 countries and Turkey suggests that financial deepening and the development of sources of credit outside the firm are essential in promoting expansion and economies of scale

within firms (Aghion and others 2006). Indeed, financial development facilitates post-entry growth, especially in sectors that are intrinsically more dependent on external financing. Financial credit for rural enterprises and farm growth is even scarcer.

A multipronged agenda needs to be followed to boost the role of the financial sector in growth. Such an agenda, which, of course, needs to be tailored to specific country situations, should cover the privatization of state banks, the strengthening of the prudential framework for bank and nonbank intermediation, the improvement of bank supervision, progress in financial reporting, greater transparency of bank ownership, and enhancement of credit information systems and collateral regimes.

*Complementary policies.* To support the above reforms, especially with respect to firm restructuring, adequate social safety nets that protect displaced workers are essential (see, e.g., World Bank 2002, 2005). With the transition to a market economy, the guaranteed employment, retirement security, and consumer subsidies of the socialist systems have become obsolete. In many instances, these were fiscally unaffordable as countries sought to balance expenditure demands with revenues. The best way to protect the most vulnerable workers is twofold: by removing any barriers to the entry of new enterprises, thereby creating additional employment opportunities, and by targeting social assistance to those whose skills and experience make them less likely to become employed in new enterprises.

In the CIS, where the challenge of restructuring is still relevant and poverty and inequality remain significant concerns, providing adequate levels of social assistance must be a policy priority. Where resources are limited, this needs to be accomplished through better targeting, through the use of proxy means testing, geographical criteria, or even self-targeting through public works schemes. There remains considerable scope for improving the targeting of utility and housing subsidies through, for instance, a broader expansion of life-line tariffs, whereby utility consumption is metered and the price subsidy is restricted to the initial block of basic needs consumption. The decentralization of social assistance, as in Russia, provides another channel by delegating decisions on both the levels and targeting of social assistance to lower layers of government. In principle, this may improve targeting and move the decisions closer to the preferences of communities. But this needs to be complemented by resources to ensure horizontal equity across regions.

In the EU-10, which may afford a more generous safety net, formal unemployment insurance schemes are becoming more common and represent the best way to protect those displaced by

enterprise restructuring. However, in each country, the gains from the more generous provision of benefits should be carefully assessed against the potential costs not only as a structural fiscal burden, but also as a disincentive for work.

## **Conclusions**

How well countries are able to adapt policies to boost productivity and suit their own situations and how effectively they might implement those policies will determine their way forward on the path to prosperity. The productivity differentials among the countries of the Region and between them and the more advanced market economies suggest that accelerated and sustained productivity growth is essential in achieving higher living standards. Although reforms must continue in all countries of the Region, the relative importance of particular public policies in any country depends on where the country is located along the development path. The emphasis on policies to promote reallocation and net entry is still necessary, especially in the late reformers (CIS, SEE countries), in which the legacy of transition remains pervasive, but, for the early reformers (EU-10 and Turkey), greater productivity growth is likely to derive from within-firm improvements, much as in advanced market economies.