

Transition

The First Ten Years

*Analysis and Lessons for Eastern Europe
and the Former Soviet Union*

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and the Former Soviet Union*



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Foreword

This study looks at lessons to be drawn from the ten-year experience of the transition countries in Eastern Europe and the former Soviet Union in the period 1991 to 2000. The World Bank's *World Development Report 1996: From Plan to Market* focused on the transition process during the first half of this period. It recognized that while initial conditions are critical, decisive and sustained reforms are important for recovery of growth and should be accompanied by social policies designed to protect the most vulnerable groups until growth takes hold. It highlighted the need to create institutions in support of markets, and it emphasized that investing in people is a key to growth.

Today we have more evidence and data on the transition experience. The variability in growth performance across countries has intensified. Poverty and income inequality in some countries have increased to levels not foreseen earlier. In many countries, reform efforts that started in the early 1990s have been interrupted and in some cases even stalled. As a result, output recovery in some of the transition countries was sharply reversed during the second half of the 1990s.

Many of the prescriptions of the 1996 *World Development Report* continue to be valid today. At the most general level, the present study confirms that while initial conditions were critical for explaining the output decline at the start of transition, the intensity of reform policies explains the variability in the recovery of output thereafter. Beyond this, important new lessons highlight some key tradeoffs facing countries in transition that can be translated into priorities for policy.

First, this study highlights the key role of the entry and growth of new firms, particularly small- and medium-size enterprises, in generating economic growth and in creating employment. The growth of new firms depends in part on direct policies to encourage entry—what this report calls the *encouragement* strategy. Does this mean that policymakers can focus on encouraging the new sector while postponing the pain of liquidating and restructuring the old sector to a later time when a cushion has been put in place? Not so. The report shows that to succeed the encouragement strategy needs to be accompanied by a strategy of *discipline*; that is, policies that impose hard budget constraints on the old-large enterprises that remain from pretransition days. Soft budget constraints that allow these enterprises to not pay their taxes, social security contributions, and bank debts undermine the level playing field between different kinds of enterprises and have also been at the root of explosive fiscal and banking crises.

The combined encouragement-and-discipline strategy that this study proposes is crucial to re-allocate assets to more productive uses and to provide economic space for new emerging firms. This perspective of encouragement and discipline allows the report to shed light on issues such as privatization and fiscal policy, which have been major elements of economic reform in transition countries. Privatization is important to the extent that it facilitates hard budget constraints on old enterprises and creates incentives for production and innovation rather than asset stripping and rent seeking in new enterprises.

A second lesson concerns the need to develop or strengthen legal and regulatory institutions to oversee the management and governance of enterprises, both those in the new private sector and those remaining under state ownership. In countries where direct sales of assets to strategic investors—a preferred method of privatization—was unavailable, policymakers were confronted with the often difficult choice between privatization to ineffective owners in a context of weak corporate governance on the one hand and continued state ownership until strategic investors could be found on the other. However, continued state ownership does not lead to efficient stewardship of enterprise assets unless there is a political commitment to transparent privatization outcomes and a minimum institutional capacity to prevent asset stripping by managers during the intervening period. In either event, rules to protect minority shareholders; rules against insider deals and conflicts of interest; adequate accounting, auditing, and disclosure standards; and takeover, insolvency, and collateral legislation, together with development of enforcement capacity, are key to preventing asset stripping that reduces the true long-term value and competitiveness of a firm.

A third lesson involves the recognition that winners from the early stages of reforms such as liberalization and privatization may oppose subsequent reform steps when these reduce their initially substantial, but potentially temporary benefits or rents. These winners will tend to resist reforms such as further trade liberalization; entry of new competitors, including foreign direct investment; and legislation protecting minority shareholders and creditors to the extent they reduce such rents. Furthermore, if the rents are large as a fraction of total gross domestic product, which is usually the case in natural resource- and energy-rich countries, these early winners may capture the state and force the economy into a trap of a low-level reform equilibrium. Understanding how such reform traps arise and how to break out of them is an important area of inquiry addressed by this study. To the extent underlying political economy considerations permit a reform-minded team room to maneuver, fiscal policy can play an important role here, by redirecting support away from ailing enterprises and toward worker training and severance payments; by divesting social assets such as housing, child care, and health facilities from enterprises to governments; and by maintaining the high levels of human capital with which countries entered transition.

The experience of transition from centrally planned to a market economy is an historically unprecedented process, and one that is by no means finished in many countries in Eastern Europe and the former Soviet Union. We hope that this study will encourage further discussion among policymakers and think tanks in the transition countries and will assist their dialogue with external donors and advisers on how to better support the transition process.

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Overview

A dozen years have elapsed since the world witnessed the euphoria greeting the fall of the Berlin wall. Ten years ago last summer, Boris Yeltsin claimed his place in history by climbing atop a tank in the streets of Moscow in defiance of the last defenders of an imploding Soviet Union. Thus did the march from plan to market capture the world's imagination. In those heady days, famously dubbed a time of “extraordinary politics” by a leading reformer from the region, everything seemed possible (Balcerowicz 1995).

At the beginning of the new millennium, a profound divide lies between Central and Southeastern Europe and the Baltics (CSB) and the Commonwealth of Independent States (CIS).¹ In the CSB, officially measured gross domestic product (GDP) bounced back from a transition recession, recovered to its 1990 level by 1998, and exceeded that level by 6 percent in 2000. However, in the CIS GDP in 2000 stood at only 63 percent of its 1990 level. While GDP in Poland, the most populous country in the CSB, increased by more than 40 percent between 1990 and 1999, it shrank by 40 percent during the same period in the Russian Federation, the most populous country in the CIS.^{2, 3}

In 1998 one in five people in the region survived on less than US\$2.15 a day, a standard poverty line.⁴ A decade before fewer than one in 25 lived in such absolute poverty. While absolute income deprivation at those levels is virtually nonexistent in many Central European countries, its incidence is as high as 68 percent in Tajikistan, 50 percent in the Kyrgyz Republic, and 40 percent in Armenia. Inequality, which has just barely increased in Central Europe since the onset of transition, has increased so much in CIS countries such as Armenia, the Kyrgyz Republic, and Russia that they have come to rival the most unequal countries in the world (box 1).

A similar divide runs across the political landscape as well. Competitive democracies—underpinned by widespread political rights to participate in multiparty elections and an extensive range of civil liberties—have taken root in nearly all of Central Europe and the Baltics. In contrast, limitations on rights to participate in elections and constraints on civil liberties during at least some period of the transition have concentrated political power in many countries in the CIS and in Southeastern Europe. Nevertheless, this concentration has been associated with diminished state capacity to provide public goods needed for the market economy as a result of corruption, weak public sector management, and in some cases war

Box 1.

Increased Inequality

The countries of Europe and Central Asia started the transition with some of the lowest levels of inequality in the world. Since then, however, inequality has increased steadily in all transition economies and dramatically in some of them (see figure A). Countries such as Armenia, the Kyrgyz Republic, Moldova, and Russia are now among the most unequal in the world, with Gini coefficients (a standard measure of inequality) nearly twice their pretransition levels.

It is tempting to attribute increasing inequality to reforms and liberalization. But this is only part of the story. While inequality has increased almost everywhere, the more advanced reformers show much more equal, rather than more unequal, outcomes, compared with less advanced reformers. This difference cannot be solely explained by different conditions across the countries at the start of transition.

Rather, a recent World Bank study (2000b) shows that positive developments largely explain the rise in inequality in the CSB: rising returns to education, decompressing wages, and emerging returns to risktaking and entrepreneurship. These forces are welcome despite the increase in inequality, because they signal that the market is now rewarding skills and effort, as in more mature market economies. In the CSB, moreover, strong social transfers and redistribution mechanisms have dampened the rise in education premiums and wage dispersion, in line with the demands these societies have placed on their governments for such measures.

The experience of the CIS is very different. Rising education premiums and wage dispersion explain very little of the rise in inequality. In Armenia, Georgia, the Kyrgyz Republic, Moldova, and Russia income differences linked to educational achievement explain less than 5 percent of inequality, compared with 20 percent in Slovenia and 15 percent in Hungary and Poland. The causes of the huge rise in inequality lie:

- In the prevalence of widespread corruption and rent seeking. There is a strong correlation between higher corruption and higher inequality (and higher poverty) in the region. The poor are disproportionately affected by corruption (World Bank 2000c).
- In the capture of the state by narrow vested interests, which have modified policy to their advantage, often at a high social cost. These interests have been able to limit competition and concentrate their economic power through such mechanisms as special licenses and monopolies. They have undermined state institutions and blocked reforms that would serve the public good.
- In the resulting collapse of formal wages and income opportunities. Wages at old jobs have collapsed or are not paid, while new formal job opportunities are stifled by the lack of competitive markets and by the pervasiveness of corruption. People, except for a privileged few, are largely stuck in their low-paying (and sometimes nonpaying) jobs. To make ends meet they supplement their incomes with diverse forms of self-employment, much of it subsistence agriculture in small household plots. Throughout the CIS, earnings from such small plots account for 40–70 percent of total household earnings. Access to connections and informal networks and an ability to pay are key to finding a job and getting ahead. This has led to highly unequal outcomes.

FIGURE A.

Changes in Income Inequality in Selected Transition Economies



Source: World Bank (2000b).

and civil strife. Outside Central Europe and the Baltics the optimism pervading the beginning of transition has been tempered by the harsh economic realities of its first decade.

However, the starkness of this binary picture needs to be softened; growth outcomes have varied significantly even within the two broad groups of countries. Furthermore, all countries went through the transitional recession, which caused real GDP to dip from its 1990 levels by nearly 15 percent in the CSB and by more than 40 percent in the CIS.

Of the CSB countries, Hungary, Latvia, Poland, Slovenia, and to some extent Estonia and Lithuania have enjoyed several years of uninterrupted growth. By contrast, growth in Bulgaria and Romania was sharply interrupted by serious macroeconomic crises brought on by insufficient structural reform in the mid-1990s, and GDP in 2000 stood at four-fifths its 1990 level. The Czech Republic had a similar but less severe experience; GDP declined during 1997-99 because of a macroeconomic crisis with structural origins. In fact, the Czech Republic was the only country in Central Europe that had not reached its 1990 GDP level by 2000.

In the CIS such early reformers as Armenia, Georgia, and the Kyrgyz Republic, whose GDP fell steeply, and such nonreformers as Belarus and Uzbekistan, where the decline in GDP was smaller, have been growing in the past five years. But Russia, barring a short-lived upturn in 1997, did not begin to grow until 1999, while Ukraine did not return to growth until 2000.

The wide variation in transition across the region raises questions:

- Why has the growth of some transition economies been better than that of others? To what extent can these differences be ascribed to economic policy choices rather than circumstances at the start of transition or external economic shocks?
- Do the policy lessons from the countries that enjoyed several years of rapid growth continue to be relevant for the CIS and South-eastern Europe, which have made less progress with the transition? Do transition

economies have some common characteristics that make those lessons applicable today?

- If the advantages of economic reform are so obvious, why do countries mired in a no man's land between centrally planned and market economies not adopt them? How might political support for reform be built in those countries?
- In what key respects should policy advice to transition economies be modified to reflect experience from the first decade and the new conditions prevailing today?

This report seeks answers to these questions.

The Quest for Growth: Promoting Discipline and Encouragement

The focus on economic growth needs to be put into a broader perspective. For much of the CIS and Southeastern Europe the restoration of sustained growth is a key priority. Without it these countries will not generate income-earning opportunities for households. Nor will they have the resources needed to provide basic public goods such as legal and judicial systems, secure property rights, and basic infrastructure; maintain essential investments in education and health; or set up social safety nets targeted to the most vulnerable. In this respect transition economies are no different from other economies.

Continued growth is also important for the leading reformers in Central Europe and the Baltics. While all the Central European countries except the Czech Republic had surpassed their 1990 GDP by 2000, per capita incomes in the three wealthiest countries aspiring to European Union accession were still only 68 percent of the European Union average for Slovenia, 59 percent for the Czech Republic, and 49 percent for Hungary. However, an exclusive focus on growth, while providing basic public goods and protecting the most vulnerable, is not enough for them. They need to consolidate the gains of the first decade of transition and address "second generation" reform issues. They have to secure control over quasi-fiscal and contingent liabilities. They have to undertake reforms in

labor and financial markets to allow the benefits of growth to be more widely shared. They also have to restructure social expenditures to make them fiscally more affordable without impairing the effectiveness of the social safety net. Several of these reforms overlap with those required to join the European Union.⁵

This report is primarily about economic growth. But the focus is not meant to be exclusive. Two companion reports on poverty and inequality and on anticorruption deal with issues particularly important in the transition (World Bank 2000b, c).

The common heritage of socialism implied that all countries in the region began their transition with a production system adapted not to a competitive environment but to the exigencies of a command economy. External liberalization at the beginning of transition generated significant productivity differences across sectors and enterprises in a production system based on cheap energy and subsidized transport. For example, energy intensity, measured as the amount of energy used per unit of GDP, was 0.95 tons of oil equivalent per US\$1,000 of GDP in the Soviet Union in 1985, compared with 0.50 tons of oil per US\$1,000 of GDP in OECD countries (IMF and others 1991). In April 1992, after Russia had adjusted the price of oil several times, its domestic price was still only 3 percent of the world price (Tarr 1994). Many sectors and enterprises were not viable after price liberalization.

Two challenges had to be confronted:

- First, the imposition of market discipline on inherited enterprises so that they would face the incentive to restructure and, in so doing, become more productive and able to compete at the new prices. Failure to do so should lead to closure.
- Second, encouragement of the creation of new enterprises willing and able to compete in the marketplace without seeking special favors from the state.

Economic growth reflects the interplay between old enterprises in need of state support, which reduce growth by absorbing more

resources than they produce, and restructured and new enterprises, which increase growth. The fall in growth is initially dominated by the drag of old enterprises, which leads to a period of decline. With time, if the business environment favors production and innovation rather than rent seeking, restructured and new enterprises gain the critical mass to overcome the negative effects of old enterprises, leading to recovery and economywide growth.

The initial conditions of geography, history, and price and output distortions at the start of transition and the external economic shocks arising from the breakup of the Soviet Union, war, and civil strife were of course important. However, analysis done for this report shows that initial conditions were significant factors during the initial period of output decline (1990-94), rather than throughout the full ten years of transition, even after accounting for differences across countries in policy reform and the impact of external economic shocks. That analysis also demonstrates that policy reforms have been significant factors in differences among countries in the speed of economic recovery, once due account is taken of differences among countries in initial conditions and the impact of external economic shocks. Furthermore, market-oriented policy reform not only speeded up economic recovery and promoted growth in the medium term, but it also mitigated the effects of the transitional recession in the short term. How effective policies have been in disciplining the old sector and encouraging the new therefore holds the key to understanding why growth has been better in some transition economies than in others.

Discipline forces old enterprises to release assets and labor, which are then potentially available to restructured and new enterprises. It does this by hardening budget constraints, introducing competition in product markets, providing exit mechanisms, and monitoring managerial behavior to generate incentives for production and innovation (rather than for asset stripping and theft).⁶ Discipline also pushes old enterprises to divest themselves of such social assets as housing, health clinics, and kindergartens to local governments, shifting the

locus of social protection away from enterprises to governments. The social safety net then needs to be strengthened to ensure that labor shed by contracting enterprises and other losers from reform do not fall into poverty, while not eroding these workers' incentives to find employment in new enterprises.

Encouragement entails policies to create an attractive and competitive investment climate in which restructured and new enterprises have incentives to absorb labor and assets rendered inexpensive by the downsizing and to invest in expansion. These policies include reducing excessively high marginal tax rates, simplifying regulatory procedures, establishing secure property rights, and providing basic infrastructure, while maintaining a level playing field among old, restructured, and new enterprises. At the same time the policy environment must provide incentives for wealth creation rather than rent seeking and asset stripping by new enterprises. This mode of adjustment broadly corresponds to the experience to date of economies in Central Europe and the Baltics.

The Flipside: Protection and Discouragement

The disposition of assets among old, restructured, and new enterprises also provides a useful perspective on the experience of many of the CIS countries and, to some extent, South-eastern Europe. These countries have tended to protect rather than discipline old enterprises through subsidies granted through the budget, energy consumption, and the banking sectors. Where institutions of public and corporate governance are not strong enough, asset stripping, theft, and other violations of property and shareholder rights become widespread. Entry of new enterprises is discouraged—or, at best, only selectively encouraged—because of opposition from entrenched interests that would lose from further liberalization of entry. Furthermore, because of a poor investment climate where tax rates are high, licensing and registration procedures are open to abuse, and the legal and judicial system is weak, corruption becomes a serious obstacle to the growth of new enterprises.

Support for the old sector is ultimately financed through taxes on households, new enterprises, and enterprises that have restructured successfully to survive the market test. The social safety net is unable to prevent people from moving into subsistence and low-productivity activities to ensure their survival. Such a protect-and-discourage strategy creates an environment where resource transfers tend to flow in a direction opposite to that in a discipline-and-encourage environment. Transfers from efficient to inefficient enterprises and sectors undermine the credibility of government policy, with detrimental consequences for the economy.

The logic of discipline and encouragement is intended to apply broadly to the production of goods. But it may also be applied, with some modification, to the banking system, an important part of the investment climate required to attract new enterprises. Hard budget constraints on state banks and a credible threat of exit for failed banks are essential to discipline banks and enterprises alike. However, encouragement does not always imply free entry of new banks. Free entry could help make the banking sector competitive, but potential entrants must satisfy prudential norms, such as those for minimum capital requirements and capital adequacy. It is also important that expansion of the banking system not outpace the capacity for effective supervision and growth in the number of creditworthy borrowers.

Shading the Classification

The juxtaposition of discipline-and-encouragement and protection-and-discouragement highlights two contrasting modes of adjustment. In reality, country outcomes span a range of intermediate possibilities, depending on whether liberalization was implemented, hard budget constraints imposed, and an enabling business environment promoted and in what order and how vigorously.

- The discipline of hard budget constraints and institutions of corporate governance to monitor managerial behavior and encouragement

through liberalization and a climate hospitable to domestic and foreign investment are perhaps seen most clearly in Estonia, Hungary, and Poland.

- Even in the broad category of discipline and encouragement, however, softer budget constraints and hence less discipline prevailed for a long time in the Czech Republic, Lithuania, and the Slovak Republic.
- Bulgaria, the Kyrgyz Republic, Moldova, Romania, Russia, and Ukraine liberalized their economies, but for a long time failed to maintain discipline through hard budget constraints. They were also unable to contain tunneling, the expropriation of assets and income belonging to minority shareholders, and theft through either rule of law or administrative control. Though many of these countries did encourage new entry early in the transition, the capture of the state by a narrow set of vested enterprises—old enterprises and well-connected early entrants—discouraged further entry and created a poor investment climate, resulting in a pattern of protection and selective encouragement.
- Belarus, Turkmenistan, and Uzbekistan, which have undertaken some liberalization, but have not imposed hard budget constraints, strongly discourage new entry. Policies such as access to foreign exchange and credit on special terms soften budget constraints for state enterprises. But continuing reliance on centralized political power and mechanisms of administrative control inherited from the command economy did limit extensive asset stripping and other forms of theft at the enterprise level. That led to a situation incorporating some elements of discipline in an otherwise strongly protective stance, together with discouragement of entry.

New Enterprises Spur Economic Growth

The growth-enhancing effects of new enterprises and the growth-restraining effects of the old broadly suggest that new enterprises in transition economies are more productive than old enterprises. This is supported by data from 10 transition economies covering both the

leading and lagging reformers in the region, drawn from the World Bank's database on small and medium-size enterprises (SMEs). It is also supported by a comparison between old and new enterprises in the Business Environment and Enterprise Performance Survey, conducted jointly by the European Bank for Reconstruction and Development and the World Bank in 1999 (see box 3.1). The survey finds that new enterprises outperform old enterprises in sales, exports, investment, and employment (chapter 3). Thus a transfer of resources from old enterprises to new can be a source of growth. Whether that potential is realized depends on the discipline imposed on old enterprises to shed resources and the encouragement extended to new enterprises to absorb them.

The interaction between old and new enterprises is key to economic growth. The share of total employment and value added accounted for by small enterprises (defined as employing fewer than 50 workers) as a proxy for new enterprises divides transition economies into two groups.⁷ In the Czech Republic, Hungary, Lithuania, and Poland, new enterprises grew very rapidly. They now account for 50 percent or more of employment, the average for the European Union, and for between 55 and 65 percent of value added. But in Kazakhstan, Russia, and Ukraine, which have seen modest or no growth in new enterprises, the share of employment has stayed at or below 20 percent and the share of value added has stayed between 20 and 30 percent.

Hungary and Poland saw a sharp and early decline in employment and a rapid demise of the old sector, which initially made resources available cheaply to the new sector. Such discipline is important but insufficient; encouragement is also needed. Growth takes off only when the new sector evolves from a passive receptacle for absorbing resources into an active competitor, rapidly increasing its share of employment and attracting the most qualified workers. The evidence suggests that new enterprises must reach a threshold of around 40 percent in their contribution to employment before they can become an engine of growth. In Russia and Ukraine, where the contribution of the new sector to employment is well below the threshold, a large proportion of the labor force remains mired in old,

unrestructured enterprises not generating increases in productivity. The new sector has not emerged as a source of growth.

New enterprises are more productive than old ones, but productivity differences diminish with transition. The difference is greater in Kazakhstan, Russia, and Ukraine than in the Czech Republic, Hungary, Latvia, Lithuania, and Poland. Why? It is because closure and restructuring can raise the productivity of factors in the old sector and because fast growth of enterprises and employment can reduce the productivity of factors in the new sectors. Thus a comparison of labor productivity shows a difference in favor of new enterprises of more than 100 percent in Ukraine, where the contribution of the new sector to total employment is 17 percent. That difference narrows to just more than 40 percent in Hungary, where the contribution of the new sector to total employment is 55 percent.⁸

Creating a policy environment that disciplines low-productivity old enterprises into releasing resources and encourages high-productivity new enterprises to absorb those resources and to undertake new investment, without tilting the playing field in favor of any particular type of enterprise and while strengthening the social safety net to protect the most vulnerable, is central to economic growth in transition economies. This is the main lesson from the successful reformers in Central Europe and the Baltics.

When Is Transition Over?

Do transition economies at different levels of gross national income per capita (ranging in purchasing power parity terms from US\$2,100 in Moldova in 1999 to US\$16,050 in Slovenia in 2000 [World Bank 2001]) have anything in common that would make lessons from economies in the region leading in reform applicable to those lagging in reform? The wide dispersion in the productivity of labor and capital across types of enterprises at the onset of transition and the erosion of those differences between old and new sectors during reform provide a natural definition of the end of transition.

Enterprises in a typical transition economy can be distinguished by history: are they new,

restructured, or old? They can also be distinguished by economic performance: are they productive? Furthermore, history and performance are related. New enterprises are expected to be more productive than restructured enterprises, which are expected to be more productive than old enterprises. As markets develop and resources are allowed to flow to their most valued uses, the role of history progressively weakens, and differences in productivity arising from membership in any of the categories tends to disappear, consistent with the evidence on the behavior of differences in productivity.

This is not to suggest that differences in productivity across enterprises will disappear altogether. These differences always exist as a result of technical innovation and new export market penetration, among other factors. However, the variation in productivity could not be systematically attributed to the enterprises' historically determined categories: old, restructured, and new. When that distinguishing characteristic is lost in a country, the transition can be taken to be over. At that point, the economic issues and problems policymakers must deal with are no longer specific to transition. At what level of per capita income will this occur? The answer depends on the success of disciplining the old sector and encouraging the new one. It also depends on the success of the business environment in attracting investment.

Do Central Europe and the Baltics Point the Way Forward?

The striking diversity in challenges and circumstances among countries that have not proceeded far in the transition—in particular, countries in the CIS and Southeastern Europe—raises the question of whether 10 years after the dissolution of the Soviet Union these countries can learn from the successful reforms in Central Europe and the Baltics.

Countries in the CIS and Southeastern Europe continue to face significant productivity differences across old, restructured, and new enterprises characteristic of the transition and are therefore a long way from the end of transition. Hence, the framework of discipline and

encouragement and its associated policy and institutional implications remain relevant for understanding what needs to be done to restore growth and protect the most vulnerable in these economies (the policy and institutional reforms associated with discipline and encouragement are summarized in annex 1).

However, the political context for pursuing reform policies has changed greatly in a decade. At the beginning of transition, implementing reforms focused on overcoming the resistance of the *nomenklatura*, whose political and economic privileges fueled support for the prevailing economic system, and on building support for reform among the newly mobilized public. But in the past decade power over economic resources has shifted, often in a highly concentrated pattern, from state bureaucrats to the private sector, even in much of the CIS and in Southeastern Europe. That has made it easier for narrow special interests to capture the state and block further reforms that may undermine short-term rents.

Other problems, specific to individual countries or subgroups of countries, have little to do with the transition but demand urgent resolution. Securing peace and inaugurating the painstaking task of nation building in the South Caucasus and the Balkans, wracked by war and civil strife, are priorities. So is controlling the spread of tuberculosis and HIV/AIDS, which threaten millions of lives. But these challenges are outside the scope of this report.

Can We Have It Both Ways: Encouragement without Discipline?

The implementation of policies associated with both discipline and encouragement presents a challenge. Is it possible to downsize the old sector slowly while encouraging the new sector and thus to avoid the pain of liquidation and restructuring until a cushion has been put in place? Encouragement without discipline will not work if old enterprises absorb resources that would otherwise flow to new enterprises. For example:

- Protection of state-owned enterprises and farm collectives through the banking sector in Bulgaria and Romania led to a sharp increase in

nonperforming loans as a share of total banking sector loans in the 1990s (in Romania, 34 percent in 1998). These loans prevented the expansion of bank credit to new, small, and politically less-connected enterprises. They also triggered banking and macroeconomic crises that called for stabilization and a tightening of credit, hurting new enterprises.

- Protection of the old industrial sector in Belarus and Uzbekistan through specially favorable foreign exchange regimes, directed credit, and high trade protection has meant that whatever credit and foreign exchange remain are available only to new smaller enterprises at prices several times higher than what would have been paid in unified markets. In Uzbekistan small enterprises have to pay three times more for foreign exchange to finance their imports than do large state enterprises.
- Protection through tax and utility arrears in countries such as Georgia, the Kyrgyz Republic, Moldova, Russia, Romania, and Ukraine meant that new and more energy-efficient enterprises were charged more to compensate for revenue losses from nonpayment by old, less energy-efficient enterprises to utilities in the energy sector. Tax exemptions for large enterprises and agricultural collectives in Ukraine, negotiated offsets to pay taxes in Russia, and tax avoidance in exchange for bribes by large enterprises in Georgia typically worked to the disadvantage of new and smaller enterprises, which ended up paying higher prices and bribes as a proportion of their annual revenue.

The lack of a vibrant emerging private sector, because of a policy of discouragement, limits the outside options available to those in old enterprises. These limited private sector job options increase the social cost of restructuring the old enterprises, resulting in the need for additional protection for the old sector. The complementary relationship between discipline and encouragement also sheds light on why a relaxation in discipline—brought about, for example, by special treatment for powerful lobbies—is associated with selective rather than complete encouragement. It also helps explain why policy reform

must cover both discipline and encouragement, thus proceeding along an ambitiously broad front, and therefore why there are no magic bullets in transition.

Learning from China?

The success of encouraging entry of new enterprises in China (where GDP per capita grew 8 percent per year from 1978 to 1995, lifting 200 million people out of absolute poverty) without imposing significant discipline on state enterprises raises a question of the applicability of China's reform to the transition economies of Eastern Europe and the former Soviet Union. Through different channels China modulated the tradeoff between encouraging new enterprises and not imposing hard budget constraints on existing state enterprises. The country reaped spectacular gains from liberalizing repressed sectors such as agriculture, which had surplus labor, and rural industries and from a massive inflow of foreign direct investment.

Part of these gains, helped by a high savings rate, could be transferred through the banking system to finance loss-making state enterprises, which were far less important in China than in most countries in Eastern Europe and the former Soviet Union. For example, only 19 percent of the Chinese labor force worked in the state sector and were thus entitled to a range of social benefits, compared with 90 percent in Russia. Furthermore, tight political control over asset stripping, arbitraging between controlled and market prices for private gain and corruption, together with some state capacity to manage public assets allowed China to move its loss-making state enterprises more slowly to market conditions at the same time that explosive growth of new enterprises took place. If a substantial inflow of resources, for example, from liberalizing a previously repressed sector or from foreign direct investment, and state capacity to manage the process allow a country to follow such a phased transition, it is less likely to experience a period of contraction in output.

These conditions were largely absent in most transition economies covered by this report. But the costs of soft budget constraints on China's

state enterprises remain to be fully recognized. The share of nonperforming loans in the banking system, which served as a conduit for assistance to state enterprises, is between 30 and 40 percent of annual GDP. Addressing this problem is likely to pose a major fiscal challenge. In sum, the transition economies of Eastern Europe and the former Soviet Union did not have the resources for a phased transition for state enterprises, but they would be well advised to draw from China's experience the importance of encouraging new enterprises as a basis for wealth creation and economic growth.

Institutions Are Important, but So Are Policies

Early on, Fischer and Gelb (1991) flagged the role of institutional reforms in the transition. Given that it is now argued that a key deficiency of the transition has been insufficient attention to building a market-friendly institutional framework, reflecting on the experience of East Germany's unification with West Germany in 1990 is instructive. It illustrates, among other things, how inappropriate policy choices can undermine performance even in the most favorable of institutional environments. East Germany was able to adopt all the institutions of West Germany without delay. It also received massive financial transfers, which averaged between 40 and 60 percent of East Germany's GDP over the period 1991 to 1997, and which continue at levels exceeding 4 percent of West Germany's GDP per year. Furthermore, German reunification conferred on East Germany automatic membership in the European Union.

Despite these considerable advantages, East Germany suffered an initial decline in GDP that was deeper than its transition economy neighbors' declines, and it has experienced one of the slowest GDP growth rates in Europe, disappointing expectations that it would catch up rapidly with West Germany. This occurred, first, because the one-to-one conversion rate between West German and East German marks led to a substantial overvaluation of the East German currency and, second, because attempts to bring East German wages in line with West German wages, in the face of much lower labor productivity in

the East, undermined East Germany’s competitiveness. As a result, a much larger part of the inherited capital stock was rendered unproductive than would have been the case had more appropriate macroeconomic policies been chosen. Thus, while institutional change is important, so too is policy reform, and it is essential that they proceed hand in hand.

The Political Economy of Discipline and Encouragement

Many transition economies outside Central Europe and the Baltics are stuck in a no man’s land between plan and market. If the advantages of economic reforms are so obvious, why doesn’t every country adopt them? Can economic policy choices be systematically related to particular institutional characteristics of political systems in transition?

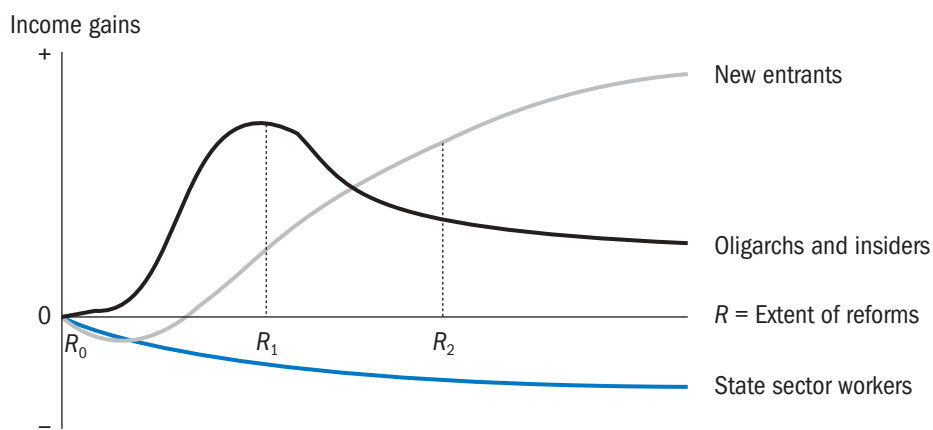
The political economy of reform within the framework of discipline and encouragement can be expressed graphically by tracing the paths of winners and losers from the transition. Figure 1 depicts the gains and losses in income ac-

cruing to three different constituencies at different doses of reform in a typical transition economy.

- *State sector workers*, employed in state enterprises and lacking the skills to become new entrants in the competitive market, face a sharp drop in income as discipline calls for downsizing the sector, with little hope of any substantial recovery with the intensification of reform.
- *Potential new entrants*, workers in state enterprises and new entrepreneurs with skills to become new entrants in the competitive market, have a classic J-curve pattern of income. They face significant adjustment costs at low levels of reform as they exit the state sector. In addition, they realize gains only when enough progress has been made with policy and institutional reforms to promote and support new entry into the competitive market.
- *Oligarchs and insiders* begin the transition with substantial de facto control rights over state assets and close ties with the political elite inherited from the previous command

FIGURE 1.

Winners and Losers from Reform



Note: R_0 = no reforms; R_1 = point at which income gains of oligarchs and insiders are maximized; R_2 = level of reforms that allows the winners of reforms beyond R_1 (new entrants) to compensate for or exercise enough political pressure to neutralize the resistance of oligarchs, insiders, and state sector workers.

Source: Authors.

system. However, because of limited skills to compete in the market economy, they face an inverted U-curve of income gains. They are the immediate beneficiaries of liberalization and privatization, as de facto control rights over state assets can be converted into de jure control and cash flow rights. They reap concentrated gains in the early stages of reform from the opportunities for arbitrage, rent seeking, and tunneling that arise if liberalization and privatization are not combined with discipline and encouragement. But these gains dissipate as further reforms lead to increasing competition and market entry.

Given these patterns of gains and losses, each constituency prefers a different combination of reforms. State sector workers prefer the status quo R_0 and reject all reforms. Oligarchs and insiders prefer a partial reform and sustain the reform process through R_1 , the point where their gains are maximized and beyond which further implementation of policies of discipline and encouragement threaten to undermine gains from rent seeking and tunneling. For potential new entrants, the reform process offers sacrifices at the beginning for the promise of gains when the reforms are further advanced.

Where the risk of oligarchs and insiders blocking anything more than partial reform is high, potential new entrants and state workers will either reject reform or support only partial reform, because the latter, by limiting the downsizing of the state sector and maintaining the flow of subsidies, imposes lower adjustment costs. Yet it is precisely such partial reforms—liberalization without discipline and with selective encouragement—that make capture of the state by oligarchs and insiders a self-fulfilling prophecy. This has led to a so-called partial reform paradox in many transition economies in which governments lack credibility and are highly susceptible to state capture. This leads potential new entrants at the outset of transition to discount substantially the potential gains from any proposed radical reforms and instead support partial reforms that offer lower costs early in the reform process, even though they are more likely

to lead to barriers to entry. Public support for radical reforms therefore depends on perceptions of government credibility in its commitment to follow through with such reforms.

The risk of “getting stuck” at a low level of reform (R_1) characterized by liberalization without discipline and limited encouragement of new entry is high. As both insiders and state sector workers face declining incomes after R_1 , these groups have a strong incentive to join forces to oppose further economic reforms. It is only when reforms reach a critical threshold (R_2) that the added gains to new entrants are enough to allow these winners to either compensate the losses of the other groups or to generate enough political pressure to neutralize opposition to continued reform.

By recognizing that different combinations of reforms produce different configurations of winners and losers, the framework of discipline and encouragement suggests two political challenges in promoting economic reform:

- Securing the support of potential new entrants for comprehensive reforms until wider efficiency gains from discipline and encouragement are realized.
- Preventing the early winners from liberalization and privatization from undermining further reforms that would impose discipline and encourage new entry and competition and thus reduce their rents.

To meet these challenges, governments must appear credible to potential new entrants in its commitments to follow through with the long and difficult process of economic reform. Governments must also be able to constrain oligarchs and insiders from using their initial advantages in the reform process to derail further reforms that would create a more competitive market economy.

Credibility and constraint are rooted in political institutions shaped by the cultural and historical legacies that guided the exit from communism. In many countries in the CIS and Southeastern Europe, where the state has been captured by narrow private interests, the collapse of communism was rooted in a contest among competing elites rather than in any broad social

movement. The new political arrangements in these “concentrated political regimes” were designed by incumbent leaders, often as a way to consolidate their power. They lacked the credibility to build and sustain broad popular support for a comprehensive reform program.

As a result, these countries embarked on transition without a broad social consensus on the goals of reform and without a way of organizing the public behind these goals. Instead, incumbent politicians sought alliances with powerful incumbent enterprises. In addition, the politicians continued partial liberalization and privatization in the context of soft budgets and barriers to entry that created tremendous opportunities for rent seeking by old and new enterprises, especially in economies rich in natural resources. Countervailing pressures from competing groups were weak and the disaffection and apathy of the “losers” minimized the direct costs to politicians of poor policy choices. As a result, countries with concentrated political regimes have tended to languish in an equilibrium trap of partial economic reforms. Political and economic power has been used to preserve market distortions that benefit narrow vested interests at considerable social cost.

This partial reform equilibrium can be contrasted with the situation in the “competitive democracies” prevailing in Central Europe and the Baltics. In the aftermath of popular revolutions against communist rule, political institutions in most of these countries emerged from roundtable negotiations among broadly representative popular fronts and a wide range of other organized interests. This, together with the close ties of these countries to Western and Northern Europe and the pull of potential European Union accession, contributed to a wider social consensus on the main directions of reform and broad public support for comprehensive reform programs in the early stages of transition.

New governments in competitive democracies tended to focus first on promoting new constituencies of “winners” by removing entry barriers, quickly tackling severe macroeconomic instability (with its high costs to the public), and using social protection to support the “losers” from the dislocations of reform. A legacy of

strong public administration allowed for greater security of property and contract rights and better public infrastructure, important preconditions for promoting new entry. As reform progressed to promote entry and improve the enabling environment, constituencies with a stake in advancing reform grew stronger, and the emergence of powerful insiders and oligarchs diminished. This combination allowed these countries to implement and sustain comprehensive reforms.

Political developments and economic reforms are closely interrelated. Political systems affect the incentives of politicians to make certain economic policy choices; reform choices shape the configuration of social groups and the distribution of power, which affects the structure and functioning of the political system. For example, economic reforms that facilitate new entry also strengthen the constituency of SMEs, which build support for increasing political competition.

Nevertheless, given the sharp break with communism and the disintegration of the Soviet Union, choices about the structure of political systems in the transition economies were generally made before decisions about the nature and pace of economic reform. Moreover, in all but a couple of countries—Croatia and the Slovak Republic—the nature of the political regime has not changed much since the start of transition. This suggests that while the pace and direction of economic reforms may have reinforced initial choices about the structure of the political system, they do not appear to have decisively shifted the course of political transition. As a result, a stronger case can be made for identifying the direction of causation from political choices to economic choices, thus providing part of the explanation for why some countries have been unable to move beyond partial reform.

Shifting Policy Priorities to Account for Experience and New Conditions

Much economic policymaking is endogenous from the broader perspective of political economy. Designing effective reform strategies must therefore take into account the political incentives and constraints that block progress in transition. But although initial

conditions and political institutions influence reform paths, these factors cannot wholly predetermine outcomes in a process as complex and multifaceted as transition. Experience from across the world demonstrates that talented political leaders can maneuver countries out of so-called reform traps. Critical elections or external shocks can break long-term stalemates on reform. New leaders can mobilize alternative coalitions and spark collective action that tips the balance of power between the potential winners and losers from further economic reforms. Clever winners can devise win-win strategies that co-opt their opponents to build support for reform.

In what ways should policy advice during these extraordinary opportunities for reform reflect the experience of the past decade and today's conditions? Three broad areas can be identified.

From Privatization and Restructuring to Promoting Entry

Policy needs to shift its emphasis from privatization and restructuring of assets to creating wealth through new enterprises. The early emphasis on rapid privatization entailed removing ownership of enterprises from the state, creating a constituency for private ownership to help guarantee the irreversibility of reform, and stopping abuses such as asset stripping by enterprise managers and other forms of "spontaneous privatization." Although much remains to be done, particularly in privatizing medium-sized and large enterprises, these past concerns weigh less heavily on policymakers today. To this must be added the suggestion from the empirical literature that privatization has promoted restructuring in the CSB, but not in the CIS (see Djankov and Murrell 2000 and chapter 7 in this volume).

New enterprises are important to promoting growth. In both the leading and lagging reformers, new enterprises enjoy a productivity advantage over old enterprises. So transferring resources from old enterprises to new ones is a source of growth. Although causality cannot be inferred from the evidence, countries that have returned to sustained growth have relied on a vibrant new sector to absorb labor and other resources released by the downsizing of the old

sector and to provide a major share of employment (50 percent) and value added (55–65 percent) in the economy. By contrast, in countries where restoring sustained growth has proved more elusive, new enterprises account for a low share of employment (10–20 percent) and value added (10–20 percent).

That is why encouraging an investment climate attractive for new entrants and meeting the policy and institutional challenges of encouragement should be the highest priorities for policymakers in transition economies. Remember, though, that encouragement cannot go very far without discipline. Therefore, the emphasis on encouragement is more effective the more it is accompanied by hard budget constraints, exit mechanisms, product market competition, and stronger institutions for monitoring managerial behavior.

From Depoliticizing Enterprises to Monitoring Managers

The lack of restructuring in privatized enterprises in the CIS, together with tunneling and theft, renew interest in the question of what institutions are needed to encourage managers to become effective stewards of enterprise assets. Although developing these institutions of corporate governance has been on the reform agenda since the start of transition, the difficulty of doing so in countries without recent market experience was probably underestimated.

International experience suggests that without effective legal protection, suppliers of finance do not enter into contracts with enterprises to ensure that they get a return on their investment—the essence of the corporate governance problem—even if such arrangements are in the interest of both parties. Concentrated ownership, by providing enhanced monitoring of managers by shareholders, can overcome some of the corporate governance problems that plague transition economies lacking such legal protection. But the type of concentrated ownership matters as well. Enterprises controlled by strategic investors, particularly if they are foreign, have performed much better than those controlled by holding companies or other financial institutions.

The selection of strategic investors matters too. Enterprises sold through transparent tenders or auctions have generally attracted better owners, outperforming enterprises sold directly to politically connected parties, frequently at highly subsidized prices. Without such safeguards, concentrated ownership does not avoid the risk of expropriation of assets and income belonging to minority shareholders.

In countries where the preferred method of privatization—direct sales through transparent tenders or auctions to strategic investors—was unavailable, the relevant comparison in assessing privatization is not between the actual method chosen and the ideal method, but between the actual method and continued state ownership until strategic investors were found. Countries where mass privatization using vouchers originally dispersed ownership and where secondary trading has not led to transparent consolidation of shares witnessed expropriation of assets and income of minority shareholders by those that were able to gain control over the enterprise in the first stages of the privatization program. But the success of continued state ownership is not assured unless there is a political commitment to transparent privatization outcomes and a minimum institutional capacity to prevent asset stripping by enterprise managers in the interim period. Indeed, navigating between continued state ownership with eroding control rights on the one hand and a transfer to ineffective new private owners with an inadequate institutional framework on the other hand was one of the most difficult challenges confronting policymakers in charge of privatization. Irrespective of the alternative chosen, governments need to enshrine investor protection in the legal system and supplement it with a system of regulation for financial intermediaries, such as investment funds and brokers (Johnson and Shleifer 2001).

Developing laws and institutions to protect investors and monitor managerial behavior and thus facilitate the development of bank and non-bank financial intermediation in countries with no recent market experience is far more difficult when opposed by early winners from transition. Further reforms would dissipate the rents

accruing to the early winners. In Russia, for example, powerful insiders with a stake in weak corporate governance have frequently hampered the work and enforcement efforts of the Securities and Exchange Commission. In environments of high state capture, privatization has not created enough demand for the enforcement of property rights. Indeed, quite the opposite is true. While privatization is positively associated with public governance (the latter summarizing the state's capacity to provide key public goods) in low-capture environments, the association is negative in high-capture environments (EBRD 1999).

Several of these issues were not foreseen at the beginning of the transition. One was the apparent stability of such partial reform equilibriums. Another was the unexpectedly perverse relationship between privatization and the quality of governance in such environments. That increased the challenge of enhancing creditors' and shareholders' rights; promoting internationally recognized accounting and auditing standards; and enforcing takeover, insolvency, and collateral legislation in the face of opposition from a narrow set of entrenched private interests.

The need to strengthen corporate governance, despite opposition from oligarchs and insiders, is an important lesson from the first decade of transition. This is, however, a time-consuming process, during which policymakers still need to make choices about the appropriate stewardship of state assets, including privatization. The following broad principles should guide a program of privatization:

- Privatization should be part of an overall strategy of discipline and encouragement.
- Small enterprises still owned by the state should be sold directly to new owners through an open and competitive auction and without restrictions on who may bid for the shares.
- In general, medium-size and large enterprises should be privatized to strategic outside investors, who, with a concentrated controlling stake, will best use enterprise assets. Although several transaction methods may be used, including negotiated sales, the evidence suggests

this can be brought about most effectively through competitive case-by-case methods, which are more deliberative than voucher schemes or rapid, small auctions. They use independent financial advisors who both prepare the enterprise for sale and act as sales agents on behalf of the state. Rapid privatization to insiders or through mass privatization should be avoided. In countries such as Belarus, Turkmenistan, and Uzbekistan, each of which has a substantially unfinished agenda of privatization of medium-sized and large enterprises, but where the state retains the capacity to provide public goods, the state should use its administrative capacity to control the disposition of public assets as transparently as possible, while developing institutions of corporate governance. Transparency would be enhanced, for example, if decisions regarding public assets were to be reviewed by independent boards of directors and accompanied by public disclosure.

- Privatization should be accompanied by increasing competition in the market for the products sold by the enterprise in question and vigorously enforced by the competition policy authority. This can help discipline managers when corporate governance is weak.
- Divestiture of enterprises in sectors characterized by a natural monopoly or oligopoly (becoming rarer with advances in technology) must proceed with caution, if at all. Establishing an efficient regulatory regime is a prerequisite to protect the public interest, lest divestiture transform an inefficient public monopoly into a poorly regulated or unregulated private monopoly.
- The state's property and cash flow rights should be clarified and strengthened in enterprises in which the state continues to hold a stake.

Mobilizing the Winners from Further Reform

Breaking the political economy equilibrium underlying partial reforms is the most important and difficult challenge in advancing transition in many countries of the region, particularly in the CIS. Where the state is already susceptible to influence

by powerful vested interests in the new private sector, granting extraordinary decree-making powers to the executive branch to dissipate rents and level the playing field has not won against strong opposition from insiders and oligarchs.

What is needed instead is to mobilize through greater political inclusion and coordination all constituencies that lose from partial reform and that stand to gain from further progress toward a more competitive market economy. For example, given the wide and generally regressive impact of high inflation, political parties in several transition economies mobilized enough electoral support for macroeconomic stabilization to overcome the opposition of powerful commercial banks and other actors that gained from economic volatility. Similarly, banking crises in Bulgaria, the Czech Republic, and Hungary sparked electoral appeals to disgruntled savers that helped break the stalemate over such issues as banking privatization and regulatory reform.

Business associations could serve as vehicles of collective action by SMEs, new enterprises, and “second-tier” enterprises that suffer from an unlevel playing field, discretionary taxation and regulation, and anticompetitive barriers. In countries with concentrated political regimes, such associations are weaker than those in the competitive democracies of Central Europe, which have more voice. So political parties have yet to seek strategic alliances with such actors as an alternative base of support and funding.

Overcoming the coordination dilemmas of mobilizing the highly dispersed winners of further reform is not easy. A major challenge for the reformist team that comes to power during a period of extraordinary politics in countries with concentrated political regimes is to make clear the links between rents from partial reform and the direct costs to society. Tax arrears, tax and duty exemptions for high-profile conglomerates, and nonpayments need to be linked in the public mind to delayed public sector wages and pensions and the poor provision of social services. The complex web of nontransparent subsidies to powerful businesses needs to be uncovered, revealing that such subsidies tend to benefit incumbent managers rather than workers.

To advance reforms, governments should focus on smoothing the curves of the winners and losers at the initial stages of reform (see figure 1). This means lowering the adjustment costs for potential new entrants and reducing the high concentration of gains to oligarchs and insiders. One way to do this is by strengthening the provision of basic public goods, such as secure property rights and a legal and judicial system. Another way is by reducing excessively high marginal tax rates and broadening the tax base that promotes entry of enterprises from the unofficial to the official economy. This can break the vicious cycle of informalization, lower tax revenue, and further intensification of tax rates on a shrinking base. Developing a rule-based tax administration to enforce efficient taxation of the new private sector is also important.

To align the incentives of local governments to identify with small business and increase entry, taxes on small enterprises should be allocated to local government. Simplifying entry and licensing arrangements for new enterprises is critical. These measures, by encouraging the emergence of new enterprises, offer a stable outside option to state workers, creating opportunities for them to become potential entrants into the burgeoning sector of new enterprises and lessening their opposition to reform.

As entry occurs gradually at the margin, these actors become an effective constituency demanding reforms to remove weaknesses in the investment climate over the long run. Furthermore, a gradual reallocation of public expenditures from nontransparent and discretionary subsidies to worker training, severance payments, and grants for improving services in communities affected by downsizing can create further momentum for reform. More broadly, strengthening the social safety net and divesting such social assets as housing, child care, and health facilities shifts the burden of social protection from enterprises to governments, thus facilitating the restructuring that will foster a return to growth. Fiscal policy therefore has the potential to smooth the curves described in figure 1 and redistribute a part of the reform dividend to those who would otherwise bear its costs. It is thus a key element in supporting comprehensive reform.

Conclusions

Analysis of the first ten years of transition in Eastern Europe and the former Soviet Union highlights the following lessons, which could be applied in future to economies that have made limited progress with reform.

- While the initial conditions that prevailed at the beginning of transition were critical for explaining the output decline that occurred initially in all countries, market-oriented policy reforms have played a significant role in promoting subsequent economic growth. Creating an environment that disciplines old enterprises into releasing assets and labor and encourages new enterprises to absorb those resources and undertake new investment, without tilting the playing field in favor of any particular type of enterprise, is central to economic growth.
- Policymakers cannot postpone the pain of liquidating and restructuring the old sector until the cushion provided by new enterprises is in place. The success of the encouragement strategy requires simultaneous application of discipline, because a lack of discipline undermines the level playing field between different kinds of enterprises. Furthermore, the practice of allowing old and large enterprises to avoid paying taxes and social security contributions and to avoid repaying bank debts has been at the root of macroeconomic crises.
- Developing legal and regulatory institutions to oversee enterprise management, though time-consuming, is important. In the meanwhile, where direct sales of state assets to strategic investors—a preferred method of privatization—is not feasible, policymakers face a difficult choice between (i) privatization to ineffective owners in a context of weak corporate governance, with the risk of expropriation of assets and income of minority shareholders by those who gained control over the enterprise, and (ii) continued state ownership in the face of inadequate political commitment to transparent privatization outcomes and limited institutional capacity to prevent asset stripping by incumbent enterprise managers.

- Breaking out of low-level equilibrium traps in which the immediate beneficiaries of liberalization and privatization have captured the state and oppose measures of encouragement such as competition and free entry that would reduce their rents requires mobilizing small, medium-sized, and new enterprises and second-tier businesses that suffer as a result of the uneven playing field and stand to gain from further reform. Fiscal policy has an important role to play here, by redirecting support away from ailing enterprises and toward worker training and severance payments, and by divesting social assets such as housing, child care, and health facilities from enterprises to governments.
- Controlling fiscal risks arising from implicit and contingent liabilities on account of state-owned enterprises, banks and pension systems, guarantees for projects and balance sheets of special purpose agencies, and the fiscal stance of subnational governments.
- Implementing bankruptcy laws to facilitate exit through a formal process and to create incentives for closure through informal mechanisms.
- Reforming the budget process so the state can meet its expenditure obligations in cash and on time, with a view to eliminating arrears and noncash payments.

Monitoring and influencing managerial behavior requires:

Annex 1. Discipline and Encouragement: The Reform Agenda

What policy and institutional reforms are needed to create an environment favorable to discipline and encouragement? While no individual policy can be assigned to a single outcome in an interrelated system, it helps to think of policy packages as those primarily directed at disciplining the old sector and those primarily directed at encouraging the new sector without tilting the playing field in favor of any particular type of enterprise.

Discipline

In an environment of price and trade liberalization, discipline requires imposing hard budget constraints on enterprises, providing exit mechanisms for insolvent enterprises, monitoring and influencing managerial behavior to reward efficient stewardship of assets and to discourage tunneling and theft, increasing product market competition, transferring social assets from enterprises to local governments, and using the social safety net as a cushion for displaced workers and other losers from reform.

Imposing hard budget constraints requires:

- Eliminating tax exemptions, fiscal and financial subsidies, budget and tax offsets, and directed credits.

- In reforming economies, where the bulk of assets are in private hands, improving institutions of corporate governance by strengthening legal protection for minority shareholders and creditors, bringing in management by concentrated owners or strategic investors, promoting internationally recognized accounting and auditing standards, and working, as capital markets grow, to develop a market in corporate control.
- In nonreforming economies, where assets remain largely in the public sector and where the state retains the capacity to provide public goods, the state should use its administrative capacity to control asset disposition as transparently as possible, while developing institutions of corporate governance.

Promoting competition in product markets is an important ingredient of discipline, especially because of competition's effect on the behavior of enterprise managers. In the CIS, for example, competition can compensate to some extent for weak monitoring of managers by shareholders and creditors. This requires:

- Opening markets and promoting free entry, including trade liberalization
- Enforcing competition laws through a government agency vested with the requisite authority.

Transferring responsibility for social assets such as housing, utilities, clinics, and kindergartens from

enterprises to local governments will allow enterprise restructuring to proceed in countries that have relied heavily on enterprises as instruments of social policy. This requires:

- Clarifying the roles and responsibilities of subnational governments
- Giving those governments resources to fulfill their assigned responsibilities
- Reforming communal services (including central heating and gas) and moving tariffs to cost-recovery levels
- Replacing across-the-board housing and utility subsidies with targeted social assistance to the poorest households, sometimes combined with lifeline tariffs.

Social insurance programs that cover pensions and unemployment insurance and social assistance programs make it more feasible to discipline old enterprises into shedding labor and to help create a constituency for discipline. Reform of social insurance programs requires:

- Moving pension reform in Central Europe and the Baltics to multipillar systems, with a minimum poverty-based benefit. Because structural unemployment is falling in these countries, they can implement unemployment insurance programs.
- Reforming pay-as-you-go systems in Bulgaria, Romania, Russia, and Ukraine to put them on a firmer fiscal footing, with a minimum poverty-based benefit. Unemployment insurance might involve a flat benefit or severance payment.
- Moving to a flat benefit structure in the resource-constrained, low-income countries of the CIS, to protect the poorest elderly.

The reform of social assistance programs requires:

- Moving to a means-tested cash benefit assistance program in Central Europe and the Baltics
- Moving to categorical cash benefits, either universal or targeted by category, in Bulgaria, Romania, Russia, and Ukraine and using means-tested benefits only where local institutions are strong

- Improving targeting of limited cash benefits in the low-income CIS countries through geographical targeting, community-based identification, or self-targeting through some form of public works scheme.

Encouragement

In addition to liberalizing prices and trade, improving the investment climate for domestic and foreign investors is key to encouraging new enterprises. This requires establishing secure property and contract rights and providing basic infrastructure, reducing excessive marginal tax rates, simplifying regulatory and licensing procedures, and developing a competitive and efficient banking system.

Ensuring the adoption of laws best suited to securing property rights and contracts requires emphasis on two areas:

- The process for drafting laws: enterprises should have input in their design and be informed beforehand of changes in rules that will affect their operations
- The effectiveness of the judiciary: its fairness (bias, honesty, and consistency) and the likelihood of enforcement.

Tax reform should:

- Raise the turnover threshold for becoming a value-added taxpayer high enough to exclude small enterprises, which should instead be subject to a small-enterprise tax regime. This regime should be simple enough to lighten the administrative and reporting burden on taxpayers and reduce interactions between the taxpayer and the tax authority.
- Allocate small business taxes and property taxes to subnational governments to help them identify with new emerging enterprises, which are typically a source of job creation, rather than with large, bankrupt enterprises to save jobs that should be cut.

Streamlining the business licensing and registration requirements that govern entry of new enterprises is a high priority. Addressing these issues requires:

- Simplifying and making transparent entry and licensing procedures
- Reducing the scope for arbitrary decision-making and abuse of power.

Insecure property rights are more of a constraint on investment for new enterprises than the availability of bank finance, particularly in the CIS, which is less far along in the transition (Johnson, McMillan, and Woodruff 2000). But as the transition proceeds and legal and judicial reforms strengthen property rights, financial deepening and development will be essential to support the growth of a private sector led by new enterprises.

Developing a competitive banking sector requires a strategy to deal with the exit of failed banks, the entry of new banks, and bank privatization and restructuring. Strengthening the regulatory authority for bank supervision is extremely important for performing these activities effectively. This will require:

- The resolution of failed banks, which dominate the banking system in transition economies and have large interbank exposures and loans to loss-making enterprises, therefore poses special problems. Liquidation and restructuring options should be assessed carefully in the event of systemic risks to the financial sector and the need to impose hard budget constraints on banks and enterprises.
- The fostering of a competitive and efficient banking system requires encouraging the entry of new banks that satisfy prudential criteria for minimum capital requirements and capital adequacy. Because supervisory responsibility resides mainly with the home country regulatory authority, entry by foreign banks and acquisition of stakes in existing banks by foreign banks is a quick way of importing managerial and governance expertise and improving bank regulation in a transition economy. In any event, the expansion of the banking system should occur only in line with the growing capacity for bank regulation and growth in the number of creditworthy borrowers.
- The privatization of banks to strategic investors whenever possible. If foreign, they

can help upgrade managerial and supervisory standards. The alternative—privatizing banks to concentrated owners—should occur only if there is a clear separation between shareholders and borrowers. The pace of privatization should not outrun the development of adequate supervision authority.

Notes

1. The CSB comprises Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, the former Yugoslav Republic of Macedonia, Poland, Romania, the Slovak Republic, and Slovenia. The Federal Republic of Yugoslavia is not included in the aggregates for the CSB countries because no data are available before 1998. The CIS comprises Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, the Russian Federation, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.
2. The terms “Russia” and “Russian Federation” are used interchangeably and refer to the same country.
3. Conceptual and measurement problems plague the GDP data (see box 1.1). However, these problems do not modify the qualitative thrust of the statements presented here.
4. These estimates are based on 1993 purchasing power parity rates (World Bank 2000a).
5. The agenda of accession to the European Union looms large for countries in Central and Eastern Europe. The World Bank has been engaged in a major project that examines country-specific and subregional issues arising from European Union accession. The principal outputs of the project are listed in the bibliographic guide; therefore, that subject will not be covered in this report.
6. Kornai (1986) introduced the term soft budget constraint (the opposite of a hard budget constraint) to characterize the environment faced by state enterprises in Hungary in the 1980s.
7. The analysis is based on the assumption that data for small enterprises can be used to approximate new enterprises. The approximation is not accurate inasmuch as the set of small enterprises includes small old enterprises. Annex 4.1 presents an upper bound for the error committed by this assumption in the CSB countries. While the estimate for the upper bound is substantial in 1995, it shrinks significantly under reasonable assumptions about the mortality rate of enterprises by 1998, the year for most of the data in this report. The terms “new enterprises” and “small enterprises” are henceforth used interchangeably.

8. Annex 4.2 describes the circumstances under which comparisons based on labor productivity (for which data are available) correspond to comparisons based on total factor productivity, which is the relevant concept for this report.