TRANSITION AND LONG-TERM GROWTH: CONVENTIONAL VERSUS NON-CONVENTIONAL DETERMINANTS

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Introduction

Contrary to widespread optimistic expectations, the transition to the market economy has brought about an unexpected, large and lasting recession in most of Eastern Europe and the former Soviet Union. The transition has also been characterized by considerable cross-country variations in both policy approaches and outcomes. In this paper we discuss the causes of these differences in outcomes, prospects for long-term growth for groups of economies in transition, and possible policy responses for the future.

So far, most analyses of transition performance have focused on macroeconomic and financial criteria. Most studies have attributed the observed variation in performance to three sets of causes: (i) approaches in the field of macroeconomic stabilization and liberalization (gradualism, shock therapy, procrastination, slow-fast privatization and so on); (ii) differences in initial macroeconomic conditions; and (iii) availability of external finance. While these analyses have served their purpose during the stabilization phase of the transition, their present usefulness is limited. This approach does not explain why apparently different strategies have produced similar results over the medium-term (compare, for instance, the cases of gradualism in China and shock therapy in Vietnam; or that of Hungary with that of the Czech Republic), or why better results were achieved under supposedly inferior approaches (compare Uzbekistan with Kyrgyzstan). This approach is thus unable to explain much of the observed variation in economic performance, nor the medium term impact of the initial policy changes, or the considerable structural differences emerging among the economies in transition. Explanation of the success in containing the transformational recession, re-starting growth and developing appropriate economic structures must therefore be sought elsewhere.

In this paper we attempt to fill, however partially and imperfectly, these gaps. The main findings of the analysis are that differences in output performance are explained by variations in initial 'structural' and 'institutional' conditions and, even more so, by policy-related factors such as the preservation of adequate institutional capability of the state, export promotion, the establishment of competitive markets, the expansion of the 'new private sector' and the introduction of adequate microeconomic incentives. In contrast, factors such as the speed of liberalization or the level of

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inflation (below a given threshold), do not matter much, or the evidence on their impact is not conclusive.

1. Neglected factors in the explanation of the transformational recession

The conventional wisdom, as summarised for instance in the 1996 World Development Report, suggests that differences in economic performance are associated mostly with progress in liberalization and macroeconomic stabilization (see also de Melo et al. 1996, Breton et al. 1997). While this may well be true, the devil is in the details, which often do not fit into this generalisation and make the whole explanation look trivial. Take the example of Vietnam and China, two countries that shared a lot of similarities in initial conditions and achieved similar results (immediate growth without transformational recession) despite different reform strategies. While the Chinese reforms are normally treated as a classical example of gradualism, the Vietnamese reformers introduced Polish-style shock therapy in 1989 but also managed to avoid a slump in output. Or, take the differing performance of FSU states. The champions of liberalization and stabilization in the region are the Baltic states (with a 1995 EBRD cumulative liberalization index ranging between 2.4 and 2.9), whereas Uzbekistan (with an index of 1.1) is commonly perceived to be one of the worst procrastinators. However, in Uzbekistan output fell by only 18 per cent over 1990-95 and growth resumed in 1996, while in the Baltics output fell in the early 1990s by 36 to 60 per cent and in 1996, two years after bottoming out, was still 31 to 58 per cent below its pre-recession peak.

Overall, attempts to link differences in output performance during the transition to the cumulative liberalization index and the stabilization of inflation have not yielded satisfactory results. It appears that dummies, such as membership in the rouble zone and war, explain a much greater share of variance than the liberalization index or inflation (Åslund et al. 1996). Other factors, reviewed hereafter, appear to have played also an important role:

1.1 *Initial 'structural' and 'institutional' conditions*

The different size of the highly distorted industrial sector inherited from the centrally planned economy is a relevant factor in explaining output performance. These economies differed considerably among each other in terms of the importance of the military sector, extent of over-industrialization, underdevelopment of the service sector, 'under-openness' of the economy, and share of exports to the Soviet republics and other socialist countries. The greater these structural distortions, the more pronounced the reduction of GDP during the transition.

This explanation – which emphasizes the difficulties faced in restructuring the supply-side of the economy – underscores the fact that market imperfections hamper the reallocation of resources across sectors, causing in this way a temporary loss of

output (Kornai 1994). Thus, the decline in the production of non-competitive industries is not offset immediately by an increase in the production of competitive industries because of barriers to capital and labour mobility, little developed financial markets, uncertain property rights, lack of easily enforceable and commonly accepted bankruptcy and liquidation procedures, the underdevelopment of markets for land, housing and labour, and so on.

Under these conditions, a low level of economic development (in particular, lower capital/output ratios) may have represented a comparative advantage, as the resources to be reallocated from the declining to the expanding sectors of the economy were substantially smaller. According to this explanation, the Chinese reformers were less penalized by the legacy of socialism because of the relatively modest weight of a distorted industrial and agricultural infrastructure. The Chinese communes had little fixed capital stock and proved to be much more amenable to reform than the Soviet and East European state farms with a huge and highly centralised infrastructure poorly suited to family farming.

In contrast to China and Vietnam (and, to some extent, Albania and Mongolia), the East European, Baltic and the CIS states entered the transition with huge investments in fixed capital stock and were thus doomed to experience a more pronounced transformational recession. Even in China, large state enterprises in heavy industry have proven to be an important bottleneck in the whole reform process: indeed, there seems to be a correlation between the share of large state enterprises in total output and the rate of economic growth by province: the larger the share of state enterprises in total provincial output, the lower the rate of growth.

1.2 *The limited impact of traditional macroeconomic policies*

Attempts at separating non-policy from policy factors by means of regression analysis (Table 1) suggest that while there is a positive relationship between the extent of the output decline on the one hand and the liberalization index and inflation on the other ($R^2 = 0.65$), this relation weakens or even disappears completely once variables that characterise objective conditions are factored in[1]. It is noteworthy that nearly 70 per cent of the variations in the decline of output is explained by two dummy variables accounting for membership in the FSU and for wars (Åslund et al. 1996). It is remarkable that the addition of the liberalization index and of the rate of inflation to the equation increases the correlation coefficient by only 5 points. In addition, the coefficient of the liberalization index is not significant and has a negative sign. These results suggest that linking the better performance, especially of the Central European countries, to faster liberalization and lower inflation can be misleading.

The FSU-dummy may be better approximated by variables reflecting initial structural conditions (pre-transition level of development and extent of distortion of

the trade and industrial structure) and the impact of war. To avoid multicollinearity problems, we constructed an aggregate indicator of distortions by combining all the distortions mentioned above, expressed as a per centage of GDP. There is a fairly strong correlation between the extent of structural distortions before the transition and the subsequent GDP decline (Table 1). Among countries with modest structural

Table 1 - COEFFICIENTS OF THE REGRESSION OF CHANGE IN GDP (THE LOG OF THE 1996 GDP EXPRESSED AS A PER CENTAGE OF 1989 GDP) ON NON-POLICY AND POLICY-RELATED FACTORS [d, e]

Equations	1	2	3	4	5	6	7	8	9	10
No. of observations	28	28	28	28	28	28	28	28	17	17
Variables										
Constant	3.66	5.37	5.44	5.23	4.96	5.55	5.71	4.82	5.91	6.07
Initial Structural Distortions,[a]			-0.01	-.01	-.01	-.01	-.01	-.01	-.00	-.00
Initial Level of Development (1987 PPP GDP per capita in % of the US level)			-0.01	-.01	-.02	-.01	-.01	-.01	-.02	-.01
War dummy[b]			-0.24	-.63	-.58	-.40	-.40	-.38	0.26[c]	0.27[c]
Decline in tax/GDP ratio between 1989-91 to 1993-96				-.01	-.01	-.01	-.01	-.01		
Liberalization index	0.21	(0.00)	(0.03)		(.07)		(-0.4)			(-.05)
Log of inflation rate (1990-5 geometric average)		-0.23	-0.14			-.12	-.14	-.10	-.12	-.14
Log of (1996 export as a % of 1992)								(.13)[c]		
Share of shadow economy in GDP, 1994									-.02	-.02
Adjusted R²	0.28	0.65	0.78	0.75	0.75	0.85	0.84	0.86	0.92	0.91

Source: authors' calculations on data indicated in footnote 1.

Note: [a] cumulative measure of distortions expressed as a per centage of GDP. It is equal to the sum of defence expenditure (minus 3% regarded as the 'normal' level), deviations in industrial structure and trade openness from the 'normal' level, the share of heavily distorted trade (among the FSU republics) and lightly distorted trade (with socialist countries). Each of these three distortions is attributed a weight of 0.33. [b] Equals 1 for Armenia. Azerbaijan. Croatia. Georgia. Macedonia. and Tajikistan and 0 for all other countries. [c] Significant at the 13 per cent level. [d] all coefficients are significant at the 5 per cent level except those in brackets. [e] For China, all indicators refer to 1979-86 or similar period.

distortions (less than 30 per cent of GDP) one finds Slovenia, Croatia, Macedonia, the Czech and Slovak republics, Hungary, China and Vietnam. All these countries, with the exception of war-affected Macedonia, have performed better than most other transitional economies. On the other hand, among countries with aggregate distortions of over 50 per cent of GDP we find all the former Soviet republics except Russia (where aggregate distortions amounted to 39 per cent of GDP). The R^2 of regression including only the initial distortions (not shown in Table 1) shows that aggregate distortions alone may explain 32 per cent of output variation during the transition and about 50 per cent if the economies affected by war are excluded. All in all, one finds that about 60 per cent of the variation in growth performance is explained by the level of development, aggregate distortions, and the war dummy variable.

Addition of a 'FSU dummy' to the equation renders the aggregate distortion variable non-significant (as these two variables are highly correlated), while the impact of the level of economic development and war remains significant. Adding inflation as an explanatory variable allows to improve the results, but the inclusion of liberalization index deteriorates the T-statistics and does not increase the explanatory power of the regression. To put it differently, the observed differences in performance may be explained in good part by the differences in initial structural conditions, while the role of traditional 'good policy' factors appears quite limited.

However, the exact measurement of the impact of initial structural conditions and policy variables is complicated by multicollinearity, since distortions, liberalization index and inflation are correlated with each other. Hence, it would be wrong to conclude that liberalization does not matter. However, it is natural to control for differences in initial structural conditions before evaluating the impact of subsequent policy changes. And if the regression results, after factoring in distortions, can not be improved substantially by adding the liberalization and inflation variables, it means that the impact of these policy factors remains uncertain. While these conclusions are only preliminary (not least because of the limitations imposed by a small number of degrees of freedom) they highlight an often neglected aspect in the policy debate.

This does not imply that traditional policies do not affect performance, but to admit that progress in liberalization and stabilization accounts for only part of the observed variation in performance. Obviously, as the literature in this area has shown, inflation rates of above 40 per cent a year do represent a serious obstacle to growth. Yet, evidence about the supposed negative relation between inflation rates of less than 20-30 per cent and growth is very weak at best (Stiglitz 1998).

1.3 *The decline of institutional capabilities*

If the regression equation discussed above accounting for initial structural distortions are used to predict GDP performance, it turns out that China and Vietnam

did better than expected, Central Europe and Baltic states somewhat better than expected, and most CIS states worse than expected. The decline of the state capacity to implement consistent economic policies has possibly contributed a great deal to Russia's and CIS's worse than expected performance.

The efficiency of state and non-state institutions is however not easily measurable. In most CIS and Balkan countries, the collapse of state and market institutions is reflected by: the dramatic increase in the share of the shadow economy; the fall of revenue/GDP ratios; the inability of the state to deliver basic public goods or set up an appropriate regulatory framework; the accumulation of tax, trade, wage and bank arrears; the demonetisation, dollarization and barterization of the economy; the decline of bank financing as a proportion of GDP; poor enforcement of property rights, bankruptcies, contracts and law and order; the increase in crime rates; and so on. Most of these phenomena can be defined quantitatively. However, the construction of the aggregate index of institutional capacity of the state is problematic as there is no clear rationale for weighing its various components.

A partial measure of the efficiency of the state is given by the trust placed by businesses and individuals in its institutions. If this approach is followed, the CIS states rank much lower than the Central and Eastern European countries in all analyses. In a recent survey about the credibility of state institutions in 69 countries, the CIS states had the lowest score, lower than that of Sub-Saharan Africa (World Bank 1997a, pp. 5, 35). Especially striking was the gap between Central and Eastern Europe and CIS countries.

Another proxy of the institutional capacity of the state is the revenue/GDP ratio. Though past analyses have rightly emphasized the excessive role played by the state during the socialist era, the recent downsizing of the state in most CIS states has most likely gone too far. During the transition, tax/GDP ratio decreased in all former socialist economies. However, the Central European countries and Estonia soon managed to arrest the decline, while Russia (together with Lithuania, Latvia, and several Southeast Europe and Central Asian states) experienced far greater reductions. In contrast, in Vietnam the tax/GDP ratio grew by 1.5 times over 1989-93. As planned, the revenue of the Chinese central government fell markedly as a percentage of GDP with the introduction of the fiscal decentralisation of the late 1970s, but this was compensated by an increase in the revenue and quasi-revenue of regional government institutions.

In most CIS states the reduction of government expenditure proceeded without any coherent plan and did not involve the reassessment of government commitments. Instead of discontinuing some government programmes and concentrating the limited revenue collected on a few priority programmes, the governments decided for cuts across-the-board which kept all public activities half-alive, half-financed and barely working. This process has led to a gradual but substantial decay of public education,

health care, infrastructure, law and order, basic R&D and so on. The ensuing numerous cases of government failure – and the slow emergence of alternative private and semi-private substitutes – further undermined the credibility of the state.

Low tax/GDP ratios, and the ensuing weak capacity of the state to deliver essential programs, are also influenced by the spread of the shadow economy (Figure 1).

To be sure, the expansion of the shadow economy renders revenue collection more complicated. At the same time, weak administration and regulation act by themselves as a potent stimulus to the development of unregistered, untaxed and unregulated businesses. Whatever way the causation runs (most probably it runs both ways), there is preliminary evidence that 1 per centage point reduction in the share of tax/GDP ratio is associated with an equal increase in the share of the shadow economy. In turn, there is evidence (discussed in greater detail below) that the larger the decline in government revenues, the greater the chances of poor performance (Figure 2).

Introducing the fall in tax/GDP ratio in the regression already including the initial level of development, aggregate distortions and a war dummy), increases to 75 per cent the explanatory power of the regression while the t-statistics remain satisfactory (Table 1).

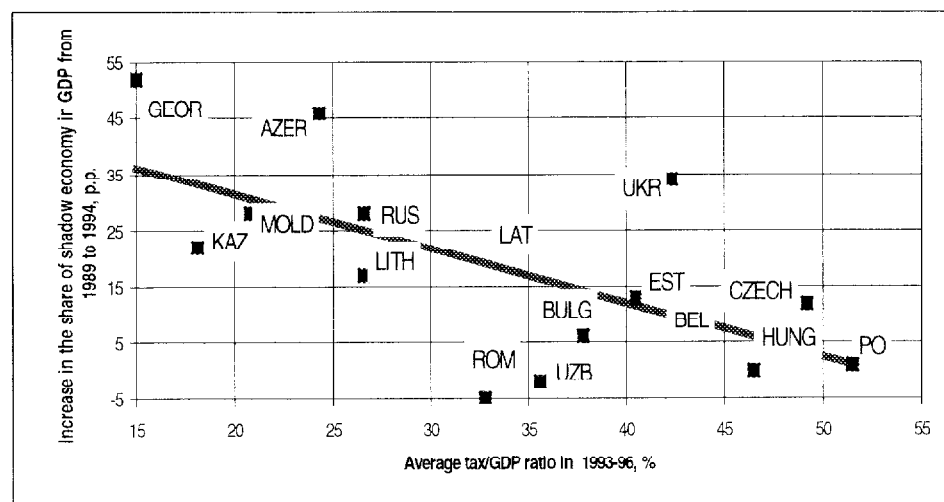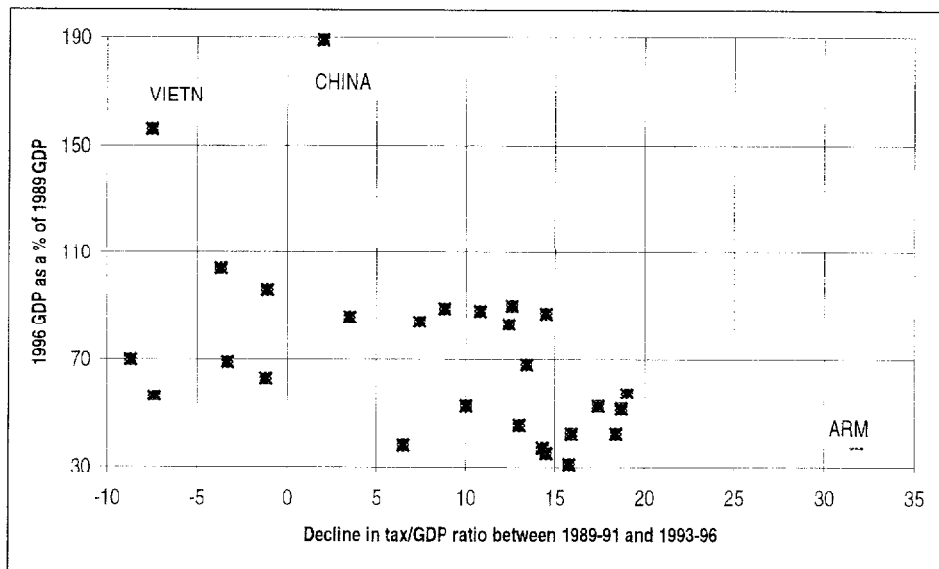Figure 1 - TAX/GDP RATIO AND SHARE OF SHADOW ECONOMY IN GDP

Figure 2 - RELATION BETWEEN TAX/GDP RATIO AND ECONOMIC PERFORMANCE

1.4 *Investment behaviour*

Another neglected topic in the transition debate concerns the dynamics of investment behaviour, and its short and long-term impact (see also EBRD 1995 and Cornia et al., this issue). Among the countries exhibiting growing or stable investment/GDP ratios one finds not only fast-rising China and Vietnam, but also countries such as Belarus, Ukraine and Azerbaijan which have suffered large losses of output. Investment rates are comparatively high also in the Czech and Slovak republics, which are thought to lag behind other Central European nations in terms of industrial restructuring, whereas in Poland – the best performing transition economy of Europe – investment rates remain paradoxically low.

Regression analysis helps in explaining these apparent inconsistencies (Popov 1997): despite widespread beliefs, investment performance is not closely linked to the dynamics of output, progress in liberalization and privatization, and inflation. Except for inflation, the regression coefficients of these variables have unexpected and implausible signs, suggesting, for instance, that the greater the progress in liberalization and privatization, or the higher the growth of output, the lower the investment rate (Table 2).

Liberalization per se should not lead to an immediate increase or slower decrease in investment/GDP ratios, as in the centrally planned economies investment rates were abnormally high. Similarly, privatization per se cannot be expected to improve

corporate governance and the investment behaviour of firms. A number of microeconomic studies show that indicators of investment performance are not linked to the type of property rights and control at the firm level (Blasi et al. 1996, Blasi 1997; Jones 1997).

Table 2 - REGRESSION OF THE LOG OF THE INVESTMENT/GDP RATIO IN 1993-96 (EXPRESSED AS A PER CENTAGE OF ITS 1989-90 VALUE) ON SELECTED POLICY AND NON-POLICY FACTORS[a,b]

| Equations	1	2	3	4	5	6	7	8
No. of observations	28	28	27	27	27	27	24	28
Variables								
Constant	3.134	3.768	3.660	3.832	3.787	3.744	3.385	4.402
Current account in 1993-95, % of GDP			-.070	-.080	-.066	-.071	-.057	-.0500
Budget deficit in 1993-95, % of GDP[c]		.023	.032	.038	.027	.033	.024	
Tax/GDP ratio in 1993-96	.034	.023	.023	.028	.020	.023	.033	
Change in the share of tax/GDP ratio from 1989-91 to 1993-96	-.016	-.0256	-.018	-.021	(-.017)[d]	-.019	(-.011)	
Log of 1996 GDP in % of its 1989 level						(-.020)		
Inflation rate in % (geometric average over 1990-95)				(-.000)				-.0008
Liberalization index				(-.128)				
Share of private sector in GDP in 1995							(-.004)	
Adjusted R^2	0.42	0.48	0.64	0.65	0.64	0.63	0.62	0.41

Source: same as for Table 1.
Note: [a] all coefficients are significant at the 5 per cent level except those in brackets; [b] For China, all indicators refer to 1979-86 or similar period; [c] expressed with a negative sign; [d] Significant at the 6 per cent level.

The factors that really seem to matter the most for investment performance are the institutional capacity of the state (measured by the level and changes in the tax/GDP ratio), the size of the government deficit, and the magnitude of external financing (measured by the deficit of the current account balance). Changes in

tax/GDP ratio alone may explain over 40 per cent of all changes in investment and their explanatory power rises to nearly 50 per cent, once the government deficit is added (Table 2, see also Figure 3).

In the words of the UN Economic Commission for Europe 'continuing downward trend of investment in most CIS countries, as well as the lack of a stable recovery in some of the south-east European countries, seems to indicate something more than just the problems of "transformational adjustment". There does appear to be a more serious lack of progress in these countries in establishing the necessary economic and institutional environment required to encourage investment: macroeconomic and political stability, transparency and predictability of laws and their enforcement, in effect, the minimum set of institutions required to support efficient. market based economic activity' (UN ECE 1997).

Figure 3 - INVESTMENT AND GOVERNMENT REVENUES IN 1989-96
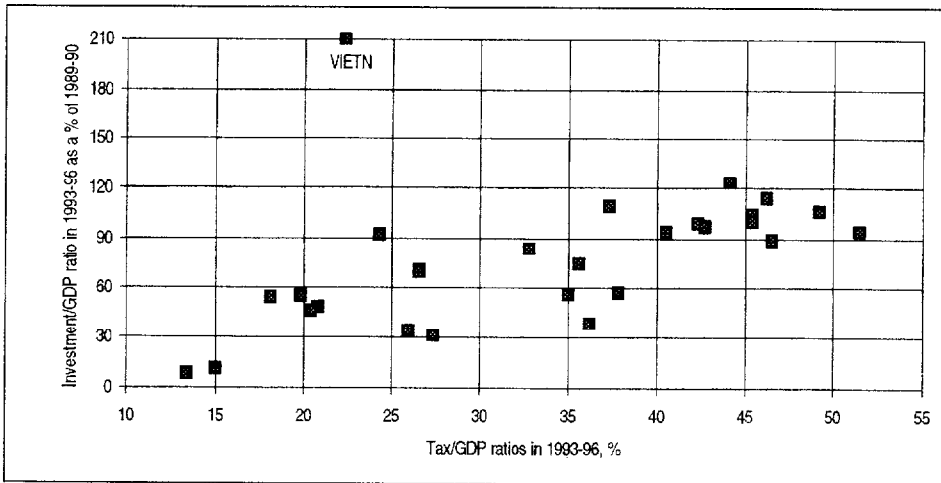
It is by no means a coincidence that countries that managed to increase investment/GDP ratios during transition – Vietnam, Belarus, Slovenia, China, Czech and Slovak republics – maintained high level of revenues during the reform period (Vietnam even managed to increase the share of state revenues in GDP from 15 per cent in 1989 to 22 per cent in 1993). In China, state revenues (including off-budget funds) remained at a level of 30-35 per cent until 1993 and only recently fell to below 20 per cent. Even with the exclusion of off-budget funds, expenditure for 'ordinary government', i.e. current expenditure to finance traditional government functions. remained stable (Naughton 1997).

Public investment seems to be an important factor in the performance of the overall investment/GDP ratio. Available evidence suggests that public investment does not

crowd out private investment one to one, but that it causes a decline in private investment by $0.25 to $0.50 for every dollar of public investment (Schmidt-Hebbel et al. 1996). Thus, an autonomous increase in public investment tends to increase overall investment. Unfortunately, in most transition economies public investment declined faster than investment from other sources, and its level is now in most cases closer to that of the OECD countries rather than to that of emerging market economies. Only in 4 Eastern European countries – Albania, Czech Republic, Hungary and Romania – public investment reached 5 per cent or more of GDP in 1992-95 (EBRD 1995; UN 1996), and these are exactly the countries that managed to sustain relatively high overall investment rates. In contrast, the Baltic states, Russia, Bulgaria and Poland overall investment rates fell. In China public investment decreased from over 50 per cent to 5 per cent of total government expenditure between 1978 and 1994. However, public investment exceeded 5 of GDP until the end of the 1980s, and its decline was preceded by a rise of investment from non-state sources, whereas in most other countries cuts in public investments preceded that by other economic agents.

From the above discussion, it follows that support to public investment might be necessary until investment from other sources picks up. China's policy of gradual reduction of public investment looks preferable to that followed in many European transitional economies which opted for cuts in public investment in order to make room for private investment. In most cases these goals were not achieved.

2. Emerging archetypes of post-Soviet economies

An area completely neglected by the transition debate concerns the models of economies which are emerging from the policy reform process of the last nine years or so. Far from moving all along a unique path leading to a single model of market economy, many of the former socialist economies are evolving into very different economic structures with vastly different growth potentials, abilities to participate to the world trade, degree of openness to foreign investment, and so on.

From an historical perspective, the transition has lasted too little time to give rise to new, stable economic models. Yet, a variety of different archetypes of economies are gradually emerging in the region. To analyse the typology of post-soviet economies, and to analyze their long-term growth potential, we tentatively use the following four structural criteria:

Changes in property rights regime. From a purely theoretical perspective, it is not always true – as it is frequently mentioned – that the private property regime is necessarily superior to all others due to the non-existence or incompleteness of markets (for credit, insurance and assets) and institutions. In addition, the efficiency of private property varies considerably depending on the form this takes: for instance, strong incentives and lower monitoring costs are typical of the small scale private sector but not of the large private enterprises which tend to suffer from governance

and incentive problems. Empirical evidence about the alleged greater efficiency of private property is mixed. Stiglitz (1994, p.12) notes that '... there is a large and growing literature showing how, in varying contexts, local communities have avoided the Tragedy of the Commons by a variety of regulatory devices.' Workers' collectives and co-operatives at times also are more efficient than private companies. In contrast, new private firms have most often been observed to be more efficient than SOEs.

After only a comparatively short transition, the former socialist countries already exhibit considerable variation in terms of prevailing property rights regimes. On the one side, in Azerbaijan, Belarus, Tajikistan and Turkmenistan and, to a lesser extent, in Bulgaria, Ukraine and Uzbekistan, the state still controls most of the means of production (over 50 per cent). This group includes also Vietnam which, however, mainly relied on the commercialisation of SOEs (by introducing a hard budget constraint and avoiding the political appointment of managers) and the creation of joint ventures between SOEs and MNCs. A second group, including China and most CIS states, has developed a large 'quasi co-operative sector' (workers' collectives and TVEs). In contrast, in Central Europe, a large chunk of SOEs has been transferred to the private sector, though also in this case there are differences between the complete privatization of Hungary and the more gradual approach followed in Poland.

Changes in trade and financial openness, and industrial policy. In the import-substituting-industrialization paradigm, trade restrictions and subsidies to domestic industry/agriculture tend to give rise to an economy which is considerably more diversified, possibly less competitive and with greater emphasis on the capital-goods sector than in the case of export-led growth. In this model, portfolio flows are restricted, FDI regulated, and imports funded by the export of the primary sector. In contrast, in an open economy model (with no quotas, low and uniform tariffs, slightly undervalued exchange rate, considerable openness to international financial flows, and a neutral industrial policy), the economy tends to specialise and to be more competitive. However, it is important to note with Rodrik (1996, p.17) that fast export growth can be achieved in different ways, including by delaying import liberalization.

Considerable divergence has already developed in this area. Countries such as Turkmenistan, Belarus and Ukraine have adopted autarkic trade regimes characterised by the exclusion of competing imports and overvalued exchange rates. A watered down version of this approach is observable in Russia (Popov 1996) where average tariffs are comparatively low (15 per cent), but where, at 70 per cent of its PPP level, the exchange rate is relatively overvalued in relation to the 50 per cent PPP level prevailing in Central Europe, and where declining sectors such as machinery and agriculture still receive substantial subsidies. This approach is sustained by the export of gas, oil and other primary commodities (which account for 75 per cent of Russia's export basket). The long-term impact of this approach is unlikely to be positive. The literature indicates that availability of skilled labour, an open trade regime and a neutral or moderately developmental industrial policy favour

the diversification of exports and promote growth, while focusing on primary commodity exports hampers long-term growth and the diversification of exports (Mayer 1997). In Central Europe, in contrast, one finds open economies, following a kind of export-led growth model. Industrial policy is mildly developmental, trade protection low, the PPP exchange rate substantially undervalued, financial liberalization advanced (or even excessive), and production subsidies modest.

Changes in income inequality. While a closer relation between human capital, effort and rewards is desirable, a large increase in inequality is not, and may lead to slow growth. There are three sets of theoretical arguments supporting this view. Microeconomic analysis emphasizes that high asset and income concentration may lead to poor work incentives, and high labour-shirking and monitoring costs. In turn, high income inequality may also be the source of macroeconomic problems: for instance, reaching a given poverty alleviation target under conditions of high inequality requires faster growth rates of output than under conditions of greater equality. Faster growth, however, may be difficult to achieve because of the shortage of foreign exchange and/or savings, or due to inflationary pressures. Finally, there are several political economic arguments suggesting that high inequality might be detrimental to growth: under democratic rule, countries characterised by a high degree of asset and income concentration are expected to experience greater demands for redistribution, higher taxation, lower investment and slower growth than countries with lower income concentration. High inequality countries are also expected to experience greater capital flights and difficulties in servicing their external debt (Alesina and Rodrik 1993, Alesina and Perotti 1995).

Recent trends in income and asset inequality among transitional economies point to clearly diverging patterns of income distribution (Cornia 1996, Milanovic 1998). On the one side, the economies of Central Europe (the Czech Republic, Hungary, Slovakia and Poland) experienced increases of 3-6 points in the Gini coefficient of the distribution of household income, thus broadly catching up with the level of inequality typical of the Western European market economies (which have Gini coefficients of 27-32). On the other, Bulgaria and most of the countries part of the former Soviet Union experienced increases in Gini coefficients of 10-20 points, thus reaching levels of the Gini coefficients of 38-45 points. The pattern of inequality in these countries is evolving towards that observed in most Latin American and African nations. In China, income inequality has remained comparatively low until 1990, but it has risen rapidly since then (Zhang Ping). An important part of this increase was due to rising regional inequality.

Role of the state. In the best of all possible worlds, an efficient state is expected to provide public goods (rules and norms, law and order, contract enforcement, defence, R&D, and so on), goods with large externalities (education and health care) as well as basic social transfers. Rough comparisons of the size and effectiveness of the state in fulfilling these obligations among transitional economies reveals

pronounced differences in terms of expenditure levels, their efficiency and changes over time for both.

The development of formal rules-regulations and their effective enforcement determine whether the transitional economies operate within the context of a 'wild-minimalistic capitalist state' (reminiscent of the Myrdalian soft state) or a 'Western developmental state' (which combines the pro-active aspects of the Asian model with a strong intervention in the social sector). The former model prevails in Russia, while the latter is generally taking root in Central Europe. In contrast, an unreformed post-Soviet state, with many of the functions it had during the socialist era, is dominant in countries such as Belarus and Ukraine. The role and size of the state is influenced also by the population structure and the choice of tax and social security regime. Countries with ageing populations and Western-type welfare systems generally exhibit a 'big state' (except in the FSU where, despite an ageing population, a minimalistic welfare system sharply reduces the role of the state). In contrast, the size of the state in countries with young populations and 'minimalistic-heterogeneous' welfare systems ought to suffer less from this problem.

A multivariate distribution of countries according to the above criteria permits to identify four broad clusters of transitional economies corresponding to highly different economic models which have vastly dissimilar potentials for growth, poverty eradication and active participation in the world economy.

2.1 *Privatised democratic states with open market economies*

This model resembles the West European mixed economy model and includes mainly the Central European countries, and to a lesser extent Estonia. These are characterised by widespread private ownership, considerable trade openness, a weak industrial and export promotion policy, moderate-medium inequality and an extensive institutional and social role for the state. These economies share also some of the features of the post-industrial Western economies, e.g. high unemployment, an ageing population, a costly Western-type pension and social protection systems, stagnant investment and, with the exception of Poland, moderate growth. Several of the conditions for faster growth are however already met.

2.2 *Inward-looking unreformed post-soviet economies*

(Azerbaijan, Bulgaria, Belarus, Ukraine, some Central Asian Republics etc.) characterised by liberalized prices and emerging markets, but also by a pervasive role of state institutions, state control of most assets and a few key prices, modest commercialisation of SOEs, limited role of the private sector, stagnant investment, limited international openness, very high income inequality and limited institutional and social protection. These economies are likely to continue stagnating and being ignored by world trade and financial flows.

2.3 *Inward-looking, semi-reformed, weak state dualistic economies*

(Russia, Kazakstan, and Moldova) featuring a Myrdalian 'soft state', very high inequality, limited and poorly functioning social protection system, a market dominated by protected insider-privatised monopolies little regulated by modern institutional arrangements, limited 'new entries', growth strategy dominated by the export of raw material and protection of domestic industry. There are strong similarities with the dualistic Latin American import-substituting economies of the 1960s and 1970s, which faced considerable long-term growth problems.

2.4 *Authoritarian state export-oriented economies*

China, Vietnam and to some extent Uzbekistan are generally cautious liberalizers. While they have moved slowly in the field of privatization and liberalization (with the exception of Vietnam), they have been able to introduce new and efficient ownership and governance structures incorporating strong microeconomic incentives. Despite the problems met in the initial reform phases, these countries have been able to contain the rise of inequality within reasonable limits and provide a minimum of social services and social protection at fairly low cost and through a variety of approaches. By managing to preserve the institutional capacities of the state, they avoided the negative consequences of its collapse which, in most CIS countries, outweighed the positive impact of liberalization. On the other hand, these countries have adopted a strong export promotion strategy, supported by an appropriately undervalued exchange rate, which greatly contributed to growth. As in the case of the Asian tigers, export liberalization was not accompanied by a simultaneous import and, later on, capital account liberalization.

3. Possible elements of a successful transition strategy

According to the 'Washington consensus' an optimal transition strategy should include immediate price and trade liberalization, subsidies removal, unified and competitive exchange rate, rapid privatization of state-owned enterprises, elimination of barriers to FDI and portfolio investments, small state, the development of the financial sector, and reform of the social sector and taxation. The evidence presented in section 2 and in the literature indicates however that these measures might not be sufficient to ensure success, and that other essential factors have been neglected. In addition, the Washington consensus does not spell out an explicit strategy in terms of engines of growth, incentives, leading sectors, key actors, role of the state, and so on. It focuses on some conditions (e.g. stabilization) but does not say much about other necessary conditions (Eatwell et al. 1995, Stiglitz 1998). Hereafter we review some of the key ingredients of a successful strategy to the transition. While the factors illustrated below do not necessarily add up to a new paradigm, they nevertheless constitute important elements of a 'post-Washington consensus' to the transition.

3.1 *Macroeconomic approach*

3.1.1 *Macroeconomic stabilization and inflation control*

There is clear evidence that high inflation affects negatively economic performance. However, there is no indication that inflation rates below 40 per cent a year damage growth, while there is even some evidence that inflation rates below 20 per cent may be even beneficial (Bruno and Easterly 1995; Bruno 1995; Kolodko and Nuti 1997; Stiglitz 1998). Though we did not specifically examine the 'threshold' below which inflation leaves growth unaffected in transitional economies, it may be argued that in these countries structural rigidities push this threshold at a higher level than in other emerging economies. In Poland and Uzbekistan, two of the most successful reformers, inflation never fell below 20 per cent a year during the first 5 years of transition, while in China the rate of inflation exceeded 20 per cent a year in 1988-89 and in 1993-95 with only modest effects on growth.

3.1.2 *Exchange rate policy*

Economists and policymakers tend to disagree on what kind of exchange rate policy is best for economies in transition. While some stress the importance of using the nominal exchange rate as an anchor to fight inflation, others claim that it is the real exchange rate that should be kept stable – so as to ensure that the actual rate remains below the PPP rate and stimulates export and growth. The Czech Republic, Estonia, Latvia, Mongolia in 1991-94 and, more recently, Russia, tried to maintain a stable nominal exchange rate despite high rates of inflation, thus allowing the real exchange rate to appreciate. In contrast, in Poland, Romania, Slovakia, Slovenia, Croatia, Ukraine and Belarus the real exchange rate was more or less stable during the same period, while the nominal exchange rate depreciated considerably.

Each of these two approaches has its own advantages. While the first approach may be advisable to reduce rapidly high inflation during the initial stages of macroeconomic stabilization, the desirability of continuing such policy after stabilization is broadly achieved is questionable because of its negative effects in terms of export performance, interest rates and accumulation of foreign debt. With an appropriate monetary policy (partial sterilization of the increases in the money supply caused by the build up foreign exchange reserves) the inflationary pressures arising from this policy can be controlled, as proven by the example of many emerging market economies. Though some authors favour exchange rate-based stabilization (Bofinger et al. 1997), others find that money-based stabilization was successful in quite a number of countries (Albania, Slovenia, Croatia, FYR Macedonia) and that there is no evidence that it is an inferior strategy to pegging the exchange rate (Zettermeyer and Citrin 1995).

Yet, the exchange rate is too important a tool to be used only for the control of inflation. Indeed, we argue that a policy of managed real exchange rate, aiming at the

stability of the real rate at a parity substantially below the PPP rate is better suited for promoting economic recovery and facilitating the transfer of resources from the domestic demand to exports.

Figure 4 - GOVERNMENT EXPENDITURE, % OF GDP
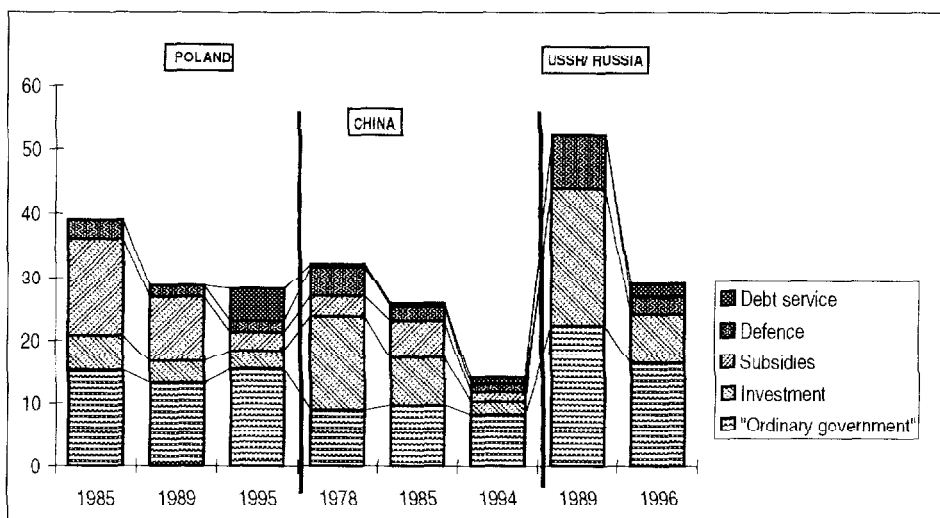
3.1.3 *Government revenues and expenditure*

The analysis in section 2 has shown that maintaining the share of government revenues in GDP at an adequate level is essential for output growth. Three patterns of change in the public expenditure/GDP ratio, illustrating three major models of transition, are presented in Figure 4. In China, cuts in government expenditure focused on defence, subsidies and public investment, while expenditure for 'ordinary government' as a per centage of GDP remained largely unchanged. In Poland, public expenditure, including for 'ordinary government', declined in the pre-transition period, but increased modestly during the transition itself. Finally, in Russia, the reduction in overall public expenditure affected not only defence, public investment and subsidies, but also 'ordinary government', a fact which undermined investment, social cohesion, capital productivity and growth.

While in China total public expenditure and expenditure on 'ordinary government' remained lower than in Russia and Poland, they were sufficient to preserve the functioning of key state institutions and activities, as the financing of social safety net by the central government was traditionally low, and as, after 1978, local government was transferred some of the functions of the centre. Besides, due to the fast growth of GDP, during the first 7 years of the reforms the absolute level of expenditure for 'ordinary government' in China doubled. In Russia, in contrast,

though expenditure for ordinary government seem to be not that much lower than in Poland, its rate of decline during the transition exceeded that of GDP. To put it differently, while in Poland real public expenditure on 'ordinary government' grew by about one third over 1989-95/6, in Russia it fell by about 3 times.

3.2 *Microeconomic, institutional and industrial policies*

3.2.1 *Creating competitive markets*

The first and most important task of economic policy is to create effective competition in each market, regardless of the prevailing property rights regime. Establishing a competitive environment and avoiding monopolistic or oligopolistic behaviour should thus take precedence over any other policy objective, including privatization. In the absence of competition, de-monopolisation and antitrust legislation, privatization can lead to worse economic outcomes than during socialism, mainly because of lack of control and co-ordination failures. In a sense, the emphasis on competition is consistent with the emerging 'post-Washington consensus' (Stiglitz 1998) which emphasizes that, for instance, China has managed to sustain double-digit growth by extending the scope of competition, without privatising state-owned enterprises.

One way to achieve competition is allowing free trade. But, as noted by Stiglitz (1994, p.256) 'there might be cases where there is sufficient internal competition and where, apart from political economic concern, ...a convincing 'infant industry' case for protection can be made. Thus .... this needs to be taken into account in the process of privatization or reorganising of state enterprises, as well as in the laws allowing the formation of firms, co-operatives and partnership. The government must take action to minimise barriers to *entry* (emphasis added).' Another way to create a competitive market environment is to allow for *exit* through bankruptcy, liquidation and consolidation of non-performing enterprises. This approach can be staggered over a fixed schedule, so as to give the 'ageing industry' the time to adjust. In addition, competition requires the creation efficient markets for asset, credit and insurance. This will avoid that only those with cash can bid on occasion of the privatization of SOEs, will help allocating assets to the most efficient producers and will help reduce risk aversion.

3.2.2 *Investment and export growth*

Our analysis supports the hypothesis that public investment has a favourable impact on total investment. The growth of investment per se, however, does not guarantee good growth performance. Though there is evidence that higher investment rates facilitate the restructuring of activities at the aggregate level (allowing, for instance, an increase in the share of services in GDP; EBRD 1995, UN 1996), it is not obvious that – in the absence of a rapid expansion of exports – greater

restructuring automatically leads to higher capital productivity and better growth performance. Similarly, neither a reduction in the share of defence expenditure in GDP, nor increase in the share of services, guarantee per se greater investment efficiency and good performance.

In transitional economies, the argument in favour of export-oriented growth is particularly compelling. Their long isolation from the world market led to the emergence of perverted industrial structures doomed to collapse once exposed to the international competition. The convertibility of national currencies and lowering of trade barriers made it impossible to continue relying on the previous model of collective import substitution. Thus, the only way to outweigh the fast or slow, but unavoidable, decline of the traditional domestic sector and the fall in domestic demand is through a rapid expansion of exports. Penetration of export markets requires considerable efficiency improvements and does require appropriate policy support. While support to this sector may pay off, aid to the non-competitive industries does not.

It is not an accident that, so far, in all fast growing transitional economies the export sector was an important contributor to growth (Figure 5). Countries with industrial policy designed to promote export and favouring export-oriented industries (China and Vietnam) were more successful than those which did not adopt an explicit industrial policy (the Central European and Baltic countries), and far more successful than those (the CIS countries) that continued subsidizing non-competitive industries. Table 1 in section 2, suggests that even after controlling for differences in initial structural conditions, changes in the institutional capacity of the state and war, export performance is positively correlated to output growth.

FIGURE 5 - EXPORT/GDP RATIOS AND ECONOMIC PERFORMANCE
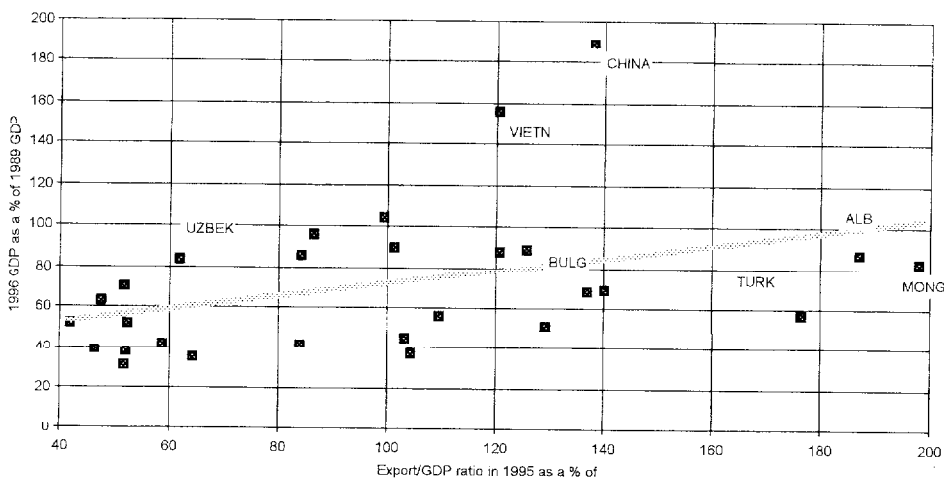
3.2.3 *Privatization of SOEs and the development of the 'new private sector' (NPS), competition and privatization*

Much of the discussion about the privatization of the economy has focused on privatizing SOEs. Yet, it now appears that effective privatization, an equitable distribution of assets and growth may depend more crucially from an expansion of the 'new private sector'. Successful transitional economies (China and Poland for instance) are those which have experienced a vigorous expansion of the 'new private sector' while Russia and other CIS countries have not. Theoretically, the NPS presents a series of advantages in relation to the SOEs and privatised SOEs. First of all, NPS firms generally exhibit better incentive structures for both managers and workers than SOEs. In addition, supervision costs are lower, there is no 'path dependence' vis-à-vis old work habits which are difficult to eradicate as in the state-owned enterprises, even after their privatization, and the risk of adverse selection of management and governance problems are lower. In many cases, managers and owners are the same people. In others, their small size better allows the owner to persuade the managers to act in the best interest of the firm, to monitor their performance, and to remove them if necessary. Third, some of these advantages (lower cost of supervision, incentives, etc.) are further strengthened by the smaller size of the NPS in relation to that of the privatised SOEs. The risk of monopoly behaviour is therefore smaller and the inclination to compete (rather than seek rents) higher. Finally, NPS firms have generally higher total factor productivity and lower capital/worker ratios than the state-owned enterprises and privatised SOEs. Their expansion might thus improve the allocative efficiency of the scarce investable funds available. As the development literature shows, however, these new enterprises may face greater costs or tighter rationing in some input markets (e.g. credit), and greater difficulties in the penetration of export markets. However, experience from several economies shows that there are successful policy responses to these problems.

It is important to underscore that without an expansion of the NPS it might be difficult to privatise-restructure the SOEs. As shown by favourable policy experience of the Czech Republic (Nesporova 1997), an increase in the number of NPS firms can facilitate the absorption of labour and assets shed by the restructuring of privatised SOEs. Failure to absorb the labour made redundant by the restructuring SOEs will either slow the restructuring process, or increase the volume of transfer payments on account of unemployment benefits of early retirement schemes (possibly crowding out public investment and employment creation over the long-term), or generate large political costs which may be politically destabilising.

3.2.4 *Microeconomic incentives*

Lack of work incentives was certainly one the major problems faced by the socialist economies. Currently, it is often believed that privatization will take care of this problem by itself. Yet, microeconomic efficiency crucially depends on the

existence of adequate incentives/sanctions for all stakeholders (managers, local authorities, national government, owners and workers). As several studies now show (Jones 1997; Sun, this issue) hard budget constraints and appropriate incentives at the micro level prove to be more important for restructuring and performance than forms of ownership and control.

At the enterprises level, careful attention must thus be paid to the design of compensation packages, whether wage-based or piece-rate-based (as in the case of Vietnam), the participation to profits and bonuses by managers and workers, the rules on the dismissal of management and labour, and so on. As noted, these measures maximise reward to effort, minimise labour-shirking and free-riding, and maintain the cost of supervision within acceptable limits.

It is also essential to establish clear and certain property rights, of whatever nature they are, to keep transaction and enforcement costs low, and, in the case of SOEs, to establish transparent corporate governance structures (so as to avoid the political appointment of managers, exert control over the managers and respect minority rights). SOEs and TVEs necessitate the introduction of the hard budget constraint and the removal of subsidies (including of 'hidden subsidies' such as tax and inter-enterprise arrears). This helps facilitate restructuring and the acceptance of enterprise risk.

3.2.5 *Privatization approaches, property rights regimes and efficiency*

Do efficiency and growth depend on the form of privatization chosen, and on the new property rights regimes introduced? It is too soon to say, not least because most privatization efforts have been influenced by the simultaneous attempt to achieve also political objectives.

Yet, from a purely theoretical perspective, it could be argued that insider-privatization (by which assets are obtained by ascription and asymmetric access to information) leads to adverse selection, and to a dilution of the incentives to make fructify assets which have been acquired at no or low cost. Indeed insider privatization may encourage firm cannibalism and asset stripping. While it is argued (Raiser 1997) that the range of feasible privatization approaches was sharply restricted by the implicit distribution of property rights existing before the transition, the problems caused by insider privatization remain. In turn, the sale of SOEs to foreign investors (who allegedly have the ability to restructure/supervise/modernize) is often mentioned as the best way to enhance efficiency. However, this approach may be politically unfeasible (as, in its extreme form, it may create a brand of dependent capitalism), and lead to a stagnation of domestic investments due to the large social transfers needed to support the labour shed by the new foreign-owned companies.

Empirical evidence on the relation between privatization and microeconomic efficiency is highly preliminary (World Bank 1997, Jones 1997). Before-after

efficiency studies of privatised SOEs are inconclusive (as privatization might not always given rise to restructuring). Other studies confirm what was discussed above in theoretical terms, i.e. new firms are more efficient than TVEs and co-operatives which, in turn, perform better than SOEs, whether privatised or not. Finally, a few studies show that auction-privatised firms are generally more efficient than insider-privatised firms, though no one knows whether this is due to causation or self-selection, and that privatization by direct restitution (frequent in the case of land) creates disincentives, because of the unclear property rights and high litigation costs this approach often entails (World Bank 1996).

Our analysis suggests also that quick privatization is generally inferior to a more cautious approach, both in terms of raising economic efficiency and of containing the surge in inequality and poverty. Fast give-away privatization is now perceived as less efficient as it provides little revenue, and can create negative incentives and governance problems, which can be very costly over the long-term. Direct sales through auctions may provide revenue to the state budget but limited domestic savings reduce local buying ability, while a glut on the asset market may reduce privatization proceeds (Kolodko and Nuti 1997). So the form of privatization matters, while privatization per se (or at any cost) no. The idea that 'any privatization is better than no privatization' should thus be rejected. In most cases marketization is more essential.

3.3 *Politico-economic and institutional factors*

3.3.1 *Stable leadership, institutional continuity*

In democratic and authoritarian regimes alike, good performance appears to be related to stable leadership, institutional continuity and the capacity of the state to guide the transition process over the medium-term (see Klugman, this issue). Such capacity ensures policy stability and predictability, the prioritization of reform measures, the optimization of choices over a longer time horizon (beyond the immediate interests of the lobbies), and, as result of all this, greater policy credibility, which is key to attract FDI and access international financial markets at rates reflecting low country risk premia.

Thus the most important thing is not the speed of implementation of the reforms but the fact that these will not be reversed and will be sustained in the foreseeable future. The administrative, regulatory and policy-making capacity of the state must therefore be preserved and strengthened, for instance, through the reform of the civil service. And so must its ability to initiate new investment in infrastructure and to retrain the human capital inherited from the socialist regimes. Recent trends in this area are not encouraging: 'human capital flight' is common, while shortages of skilled workers are now evident in many industries.

Commitment to reform and policy continuity (for instance in the area of social protection, preservation of human capital and equity) can be observed in countries with different political regimes, the Czech Republic and Hungary on the one side, and Uzbekistan on the other. The same can be said for lack of commitment, which is observed in both democratic and autocratic regimes. An area in which policy commitment is key is that of equity and social cohesion. Excessive inequality (e.g. when Gini coefficients exceed 38-40) is likely to reduce incentives, increase the demand for public transfers, erode support for the reforms and, possibly, lead to an increase in crimes motivated by material reasons. As a result, uncertainty and capital flights rise sharply and investment rates fall.

3.3.2 *Formal and informal institutions*

During the last few years the transition debate has rightly emphasised the role of the legal, administrative and regulatory framework (EBRD 1995). Increasingly, attention is also being paid to the problems of enforcement of such rules. Less attention has been placed, however, on the relation between enforcement of formal rules and the deterioration of informal institutions, and on the (differential) long-term impact on individual behaviours and economic efficiency of the evolution of informal institutions (North 1990). In all centrally planned economies, the communist Moloch had weakened relations of solidarity within the family and society, instilled a strong sense of dependence on the state, suppressed entrepreneurship, and eroded the relations of trust and co-operation among microeconomic agents. These relations are crucial to keep transaction cost low and increase the enforceability of contracts. Recent work (Poznanski 1996 and 1997) underscores that there were considerable differences in this area among the former socialist countries. If this analysis is correct, the comparatively superior performance of Poland, can be explained also by the better 'initial institutional conditions', in particular, by the ability of her citizens to play the market, take risks, behave according to the rules of parliamentary democracy, maintain co-operative behaviour and so on. A better understanding of informal institutions is thus essential for the proper design of formal institutions.

Analytically, it is therefore essential to look at the status and recent changes of informal institutions, and to their relation to microeconomic efficiency, implementation of formal rules, and so on. As the case of the Chinese TVEs has shown (Sun, this issue, Raiser 1997), relations of trust and co-operation among economic agents are key to the successful development of a sophisticated system of incentives linking managers, workers, and administrators. Similarly, the stability-cohesiveness of the extended family (as in the Caucasus or rural China) and the strength of the organisations of civil society such as trade unions, neighbourhood associations, churches, etc. have been shown to affect favourably economic performance and welfare.

Note

[1] Data on output and liberalization index are from: World Bank (1996a); de Melo et al. (1996); EBRD (1995 and 1996). Data on industrial structure and trade patterns are from: de Melo et al. (1995); EBRD (1995, 1996); Goskomstat-USSR; Goskomstat-Russia; World Bank (1995a); IMF (1991); PlanEcon (various issues); Vietnam General Statistical Office (1996); UNDP (1997); World Bank (1995b); World Bank (1996a); World Bank (1996b); Comecon (1990). Data on investment are from: EBRD (1995, 1996, 1997); IMF (1996-97); World Bank (1995a); de Melo et al. (1995); World Bank (1996b, 1997b); ECE (1996, 1997); Asian Development Bank (1997); IMF (1996); Vietnam General Statistical Office (1996). Data on Ukraine are from: World Bank (1995a) and ECE (1997). Data on government revenues are from: EBRD (1995, 1996, 1997); Economic Systems (Vol. 19 No.2 June 1995, P.103); Goskomstat; de Melo et al. (1995); World Bank (1996b); China Statistical Yearbook (1995); Warsaw School of Economics (1997). Data on China do not include revenues from fiscal off-budget funds nor enterprise extrabudgetary funds. Data on shadow economy are from: *Transition* (World Bank 1997). Data on inflation, current account and budget deficits are from: EBRD (1995, 1996, 1997); World Bank (1996b, 1997b); IMF (1996); Asian Development Bank (1997); International Finance Corporation (1997).

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