The State of Transition Economics

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Much has been done in the post-Communist economies in East-Central Europe and the former Soviet Union, but much has also failed. On the positive side, rudimentary market economies have been established, inflation has finally been brought under control, and most economies in the region have become predominantly privately owned. Many of the worst fears never materialized, notably starvation and mass migration. Social unrest has been surprisingly limited.

On the negative side, the decline in output has been great and it still continues in some countries, at least in Ukraine, Turkmenistan, and Tajikistan. The large decline in output is connected with long-lasting high inflation and persistent state regulation, causing severe corruption. Privatization has, not surprisingly, been immersed in controversy. The key problems of the post-Communist transition have been rent-seeking, the exploitation by a small elite of cheap state financing, and remaining state regulations of prices and foreign trade. The main riches come from two sources: cheap credits and raw materials, bought at low state-controlled prices and exported to a free world market. Natural consequences have been sharply rising income differentials and increasing poverty. Characteristically, income differentials and poverty have been mitigated with the demise of exorbitant rent-seeking, and other social indicators have improved as well.

In hindsight, the lesson of the transition is clear: an early and radical reform is the best. The sooner financial stabilization takes place, the earlier economic growth returns. The showcase is Poland, which returned to growth as early as 1992. Sadly, Poland is the only country to have reached high sustained growth of over 5 percent for three years, and even there the growth rate is declining from 7.0 percent in 1995 to a forecast 5.0 to 5.7 percent this year. Poland is also alone in having exceeded the output of 1989. Visions of East Asian tigers have faded from the horizon. After all, Ireland is currently growing faster than Poland.

The more far-reaching the initial deregulation has been, the more likely it is to hold, and the better for growth as well as financial stabilization. Both speedy privatization of existing enterprises and the development of new private enter-

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prises are positive forces, and there is no natural choice between one or the other. Not surprisingly, the more radical reforms that have occurred, the more institutional reforms appear to take place, although they are more difficult to measure. Hence, positive complementarities dominate in the empirical evidence to date. It is not a question of what reform to start with, but rather to build as much as possible of each pillar as early as possible.

The literature on transition economics is huge. A World Bank bibliography contains over 5,000 titles. The serious literature can be crudely divided into three categories: first, a prescriptive literature arose about what should be done; second, a more formal literature of economic models was elaborated somewhat later; third, a broad empirical literature has been produced.

Most of the prescriptive literature was written in the years 1989–1992, and it was strongly influenced by the dominant economic thinking at the time, which has been coined the "Washington consensus" by John Williamson. In essence, the term means conservative fiscal and monetary policies, far-reaching liberalization of the economy, and privatization. Jeffrey D. Sachs emerged as both the dominant and most radical advocate of a swift market economic transformation, and Poland became his showcase. Other prominent proponents of similar policies were Michael Bruno, William Easterly, Stanley Fischer, Janos Kornai, Richard Layard, David Lipton, and Lawrence Summers in the Western academic establishment, and economic politicians in the regions, such as Leszek Balcerowicz, Václav Klaus, Yegor Gaidar, Vladimir Dlouhy, and Marek Dabrowski. The Washington consensus included many prominent Western economists as well as the U.S. government, the IMF, and the World Bank.

Most of this radical reform model was not particularly original, but there were important novelties. Notably, Jeffrey Sachs's conviction that a currency could be made convertible instantly proved right, while ideas of payment unions were soon disbanded. The swift Polish deregulation heralded by Balcerowicz and Sachs proved to be an extraordinary success and discredited ideas of more gradual liberalization of prices, domestic trade, and foreign trade, proposed particularly by Ronald McKinnon.

Exchange rate policy has caused a great deal of experimentation and debate. All kinds of models have been tried, but no consensus has emerged. In order to support their attempts at financial stabilization, some countries introduced very rigid exchange rate regimes. Poland and Czechoslovakia started off with a pegged exchange rate supported by internationally financed stabilization funds, while Estonia pioneered a currency board in the region, which has been perceived as the answer for small open economies with no credibility. Its architects were Jeffrey Sachs and Ardo Hansson. Lithuania followed, and Bulgaria and Bosnia are about to opt for currency boards. The rigid regime has turned out to be effective in controlling inflation. However, as time passes by, the original exchange rate might become inappropriate, and it has proved difficult to alter the exchange rate regime. Hungary and Slovenia were equally successful with floating exchange rates, although most of the unsuccessful states had floating rates as well.

As is usual in academic debates, however, a reaction evolved instantly against this dominant school of thought. Some of the resistance was political and can be broadly labeled social democratic. However, most of the theoretical models on transition assume the existence of negative trade-offs or externalities. Their essence was that radical reforms would cause more negative effects than gradual reforms. Prominent protagonists of such ideas were Philippe Aghion, Simon Commander, Fabrizio Coricelli, Mathias Dewatripont, Peter Murrell, and Gerard Roland. Olivier Blanchard has been primarily on this side of the debate. A large number of less theoretically inclined social scientists, such as Alice Amsden, Mario Nuti, Adam Przeworski, and Lance Taylor, have also taken this stand, more on political grounds.

An early idea was that a more radical reform would lead to a greater decline in output, and some added the assumption that there was an absolute limit to how large a decline the population would accept. Otherwise, serious social unrest could erupt. In fact, evidence suggests the opposite: the more radical the reform, the less the decline in output has been. Little popular discontent has materialized in radical reform countries, while the tardy reformers Romania, Bulgaria, and Yugoslavia have faced serious social unrest.

Another related argument has been that unemployment would increase more with radical reform, but that assertion has not proven correct either. The Czech Republic all along has had minimal unemployment in spite of radical reforms, while cautious Hungary has had continuous large unemployment. Both Romania and Bulgaria have suffered from large unemployment. Still, the former Soviet Union has less unemployment than East-Central Europe, as there is little or no correlation between the decline in output and the rise in unemployment, and the problem is poverty rather than unemployment.

Similarly, it has been argued that fast privatization would have negative social effects, and a trade-off between the speed of privatization of state enterprises and the creation of new private enterprises has been suggested, but neither assertion is supported by the empirical evidence. On the contrary, the faster the privatization of state enterprises, the more new enterprises are likely to be created because many of them arise from sales of assets from existing enterprises; privatization gives rise to a market in premises, which is a bottle-neck for the development of new enterprises; the larger the private sector as a whole, the better the enterprise environment.

A final argument for gradual reforms has been that institutional development should be given priority and that the necessary new laws should be adopted before liberalization and stabilization are launched. However, that has not happened anywhere, and the more there are other reforms, the more institutional reforms take place, which is logical, for a demand for legislation regulating the market economy is being generated by market economic reforms. Why regulate something that does not exist? In short, the negative externalities of radical reforms that many have been looking for have not materialized. Instead, positive complementarities appear overwhelming, as is brought out by much of the empirical literature. The state of the art is reasonably reflected in the *World Bank World Development Report 1996: From Plan to Market.* The gradualist literature critical of radical reforms largely can be discarded as flawed and irrelevant to the actual reform experience.

The discussion over radical or gradual reform has focused mainly on deregulation and financial stabilization, both of which can be undertaken swiftly. Privatization is a much more complicated matter. Initially, standard investment bankers took the lead in Poland and Hungary with the idea that privatization required meticulously prepared ordinary sales as in the West. However, even before the transition started, ideas of mass privatization surfaced. The Czech Republic took the lead with its voucher privatization, and Russia followed with its voucher scheme. In both countries, each citizen was entitled to vouchers with which he or she could bid for shares in voucher auctions. Most post-Communist countries have adopted some form of voucher privatization. An extensive body of literature has appeared concerning privatization in Poland, the Czech Republic, Hungary, and Russia, spearheaded by Roman Frydman and Andrzej Rapaczynski, and in Russia by government advisors Maxim Boycko, Andrei Shleifer, and Robert Vishny. They are all very positive about swift privatization and voucher schemes. However, the quality of the slower privatization in Poland and Hungary appears to have been higher. Later, some literature on corporate governance and enterprise restructuring appeared, focusing on how slow the adjustment process at the enterprises actually has been. Here, much remains to be done, both empirically and theoretically.

Much of Poland's success is widely ascribed to its fortuitous new start-ups, and the irony remains that Polish privatization of large enterprises has been more limited than in many other countries. However, it is not obvious how the current Polish success should be explained. There are many alternative explanations. Polish state enterprises were exposed to hard budget constraints early because of the strict financial stabilization; liberalization was much more radical in Poland than elsewhere; Poland did have a much larger private sector before the end of communism, as well as a stronger civil society and institutions of all kinds. Yet, the weight of different explanations varies over time.

Hungary was the star of the early transition and widely expected to become the leader of the post-Communist countries. It has done so in one regard, namely, in attracting foreign direct investment. The growth rate, however, has been disappointing. The obvious explanation is that Hungary maintained as large a budget deficit as it could afford until 1995, when it faced up to an accumulated financial burden. The lesson is that an early radical financial adjustment and more limited budget deficits are of vital economic importance, which is the orthodox economic gospel.

The recent lapse in the Czech economic development is more interesting, as the Czech Republic previously was perceived as a success. Now, the attention has turned to previously known shortcomings in the Czech model, such as the absence of bankruptcies, poor regulation of financial markets, and the dominance of state banks over investment funds. The deep crises of the Bulgarian and Romanian economies in 1996 and 1997 underline the dangers of lacking determination in the reform efforts.

Much of the literature has focused on Hungary, the Czech Republic, Poland, and Russia. However, there are no less than twenty-seven transition countries in the region, and this limitation hides the fact that the great divide runs between the four Visegrad countries and the Commonwealth of Independent States (CIS), with the Balkans and the Baltics as intermediary cases. In the Visegrad region, the current GDP is almost as high as it was in 1989. In the CIS, however, the real GDP has probably fallen to about half of the level in 1989. For several years, the issue in the Visegrad region has been how much growth, while some CIS countries still struggle to accomplish growth at all. For the future, the distinction between these two groups will hopefully be much more emphasized, so that we are saved from a discussion about Russian particularism, when the whole CIS is characterized by the same features.

The Visegrad countries have been described by Janos Kornai as premature West European social welfare states. They have public expenditures of about 50 percent of GDP and almost as large public revenues, which implies a very substantial tax burden. About half of these public expenditures are spent on social transfers, pensions as well as unemployment benefits, family allowances, and social security. The worry is that the high taxes and the palpable social transfers will hamper economic growth, as indeed seems to be the case. Yet, financial stabilization was secured early on, and reasonably free market economies have been established. In many regards, their economic agenda is more similar to that of Western Europe than that of the CIS. To a considerable extent, we can declare the post-Communist transition to be over in the Visegrad countries.

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In the CIS, we encounter a completely different world, still in the depths of post-Communist transformation. There, public revenues have fallen to about 20 percent of GDP on average, although Russia and Ukraine still collect much more. Rather than trying to raise public revenues, the CIS countries will have to accept a level of 20 to 25 percent of real GDP. More taxes cannot be collected, and if attempts are made, the effect appears to be continued decline of output. In spite of having achieved financial stabilization, Russia saw its GDP fall by 6 percent last year, and Ukraine by no less than 10 percent. After having seen how the tax collection takes place, this is hardly surprising. The tax authorities focus on the richest enterprises and try to collect as much as possible from them in total contempt of the law as well as economic sense, severely harming economic growth.

It is not only the tax authorities that are awful in the former Soviet Union. Whatever the authorities do tends to be more harmful than useful. They have not even carried out elementary deregulation. A variety of indexes on economic freedom show that the East-Central European countries do not rank particularly high, and the CIS countries are characterized as some of the most regulated countries in the world. Part of the problem is that much legislative work remains to be done to promulgate basic market economic laws. A more difficult issue, however, is that the government, both centrally and regionally, maintains and introduces a plethora of regulations that appear to have little purpose but to increase corruption. The same authorities that reap the revenues from unnecessary regulations tend to introduce them. The whole post-Soviet government appears to be more a machinery of rent-seeking than an instrument of public interest. To date, the only solution appears to be to minimize government to reduce the damage it causes, but that cannot be the long-term solution. A major task for the CIS is to figure out how to reinvent the state and effective government.

One particular effect of the poor enterprise environment is that little entrepreneurial renewal has taken place in the CIS. While most of East-Central Europe has seen an explosion of new small enterprises, their number remains small by any standard throughout the CIS. What are the negative repercussions, and can substantial economic recovery really happen under these circumstances? Apart from in Russia, little research has as yet been undertaken on small enterprises in the CIS.

The most obvious consequence of the poorly functioning government is socially ineffective public expenditures. The problems are manifold. First, a lot of public expenditures are directed to purposes that are not warranted at all, for instance, subsidies to old enterprises that are not doing anything to change the fact that the money tends to go to the managers rather than the workers. Originally, large amounts of public money were wasted on sheer rents to the richest, such as subsidized credits, implicit export subsidies, and import subsidies. Part of it was budgeted but most of it was not. The social expenditures that do exist tend to be geared toward social transfers to the well-off rather than targeted to the poor. Significantly, pensions to certain privileged categories and subsidized holidays are given priority over unemployment benefits and family allowances—which remain tiny. Targeted social welfare barely exists. If the budgets adopted are bad, the execution is even worse, reflecting the strength of various interest groups rather than social needs. While these problems exist elsewhere as well, they have taken on almost absurd proportions in some of the CIS countries.

In particular, four public service systems need to be restored. The first is key, namely, the legal system. Its weakest part is probably the court system. A judge remains effectively subordinate to a prosecutor. Three other public systems in dire need of fundamental reform are the health care system, the education system, and the military. In general, they are all characterized by overmanning and too large premises, while they have too little equipment and materials of all kinds. The necessary downscaling and modernization have not taken place.

In most of these regards, the CIS countries are reminiscent of many Latin American countries, and increasingly the CIS countries appear to have more to learn from Latin America than from the Visegrad countries. Hence, the choice stands between very liberal solutions or corruption. One example of this is that several CIS countries appear to be on the verge of adopting pension systems based on individual savings and private, fully funded pension schemes. Because of the crisis of their states, they have to opt for more radical solutions than those of both West and East Europeans.

The many shortcomings of the functioning of the state are also reflected at enterprise level. Surveys led by Joseph Blasi in Russia show that enterprise restructuring has been very tardy, and the situation is even worse in countries with even slower reforms, such as Ukraine. Moreover, agriculture is lagging behind industry, as less privatization has occurred in agriculture. Privatization and macroeconomic stabilization are necessary preconditions of enterprise restructuring, but they are clearly not enough. Badly run enterprises must face an effective threat of bankruptcy; enterprises must be given sufficient freedom to function; capital markets must evolve further, so that more incumbent managers face an effective threat of ouster; the tax system remains arbitrary on the verge of confiscatory and needs a fundamental reform.

Financial markets and corporate governance are raising many unanswered questions and offer a rich field of future research. One of the big issues is how financial intermediation will take place. Will savings be channeled through the banks from households to enterprises as in Germany or to a greater extent through the stock market as in the United States? Russia has seen a tremendous rise in its stock market, and Hungary and Poland have also benefited from buoyant stock markets, while little has happened in the other countries to date. The bank systems have survived to a comparatively great extent in the Visegrad countries, while the CIS has seen a totally new banking structure emerge, but it remains rudimentary, providing a minimum of finance to enterprises and hardly any for investment. An alternative idea is that large financial-industrial groups will take the lead in financial intermediation and that neither the stock market nor banks will do the job. In Russia, the discussion centers around the Korean system of large conglomerates or the German system of strong banks, while few believe in the Anglo-American model with dominant stock markets. The question remains wide open, and it still means a lot to the nature of these economic systems.

In East-Central Europe it turned out to be surprisingly easy to liberalize the foreign trade system, and exports grew sharply. In the CIS the countries are finding it difficult to liberalize mutual trade, and the lack of orderly trade relations has resulted in a long-lasting and profound decline in inter–CIS trade. One reason for the poor institutional setting is that not one single former Soviet republic has been admitted to the World Trade Organization as of yet. Regional trade issues are largely left to conservative bureaucrats, and a minimum of research has been devoted to these issues to date.

In the end, the obvious question is why the Visegrad countries and the CIS have turned out to be so different. Two simple explanations are the differences in multiple preconditions and the varying reform strategies, while the emphasis on each explanation depends on the observer. The Soviet legacy is, not surprisingly, proving to be a heavy burden to carry, and it is evident that more radical and comprehensive reform policies have worked best. The opportunity to undertake reform is often presented by political chance and can hardly be chosen, but when it does occur there is usually quite a wide choice of alternative policies. Hence, many questions of political economy remain unanswered. Why do various countries reform as they do? What can be done to reinforce the political support for socially beneficial economic reforms?

When the history of post-Communist economic transformation is written, I do think that Jeffrey Sachs will be the hero, and his brand of radical deregulation and financial stabilization is likely to be the widely accepted model. Privatization is more complicated, and the answer is not yet obvious, even if it is clear that speedy privatization is vital. The key problem was the rent-seeking, and the social costs of rent-seeking have been far higher than the structural adjustment costs. The central question for political economy is how the rent-seeking can be minimized. Enterprise restructuring and the formation of financial markets and systems leave many intricate questions unanswered. The very collapse of the state is a crucial concern in the CIS. The decline in public revenues must be accepted, and the tax system should be adjusted accordingly. The next concern is to limit the damage of the defunct post-Soviet state on society and the economy. Finally, however, the state must be rebuilt, and the fundamental functions of a state reinstated, which is one of the great tasks of the future.