



Part II

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Growth in transition economies: sources and obstacles

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Most transition economies are now growing. This is in contrast to the position only a few years ago, when many were experiencing extreme upheaval and rapid falls in output (see Chapter 7). In some countries, such as Poland, growth has been sustained for six years whereas in others, such as Azerbaijan, it is just beginning. Increases in output suggest that the transition economies are recovering from the effects of the collapse of central planning and the liberalisation of markets, but these increases may also indicate the start of more sustained economic growth. Because of the brief history of transition, it is not easy to separate these two aspects of emerging growth (initial recovery and sustained expansion). However, the speed and strength of the growth are closely associated with sustained, broad-based market liberalisation and macroeconomic stabilisation (see previous editions of the *Transition Report*). Basic questions for the analysis and formation of economic policy are whether this initial growth will be sustained and what measures will be needed to deliver rapid growth over the medium and long term.

Sustained growth requires investment in new plant and equipment and in new skills, as well as innovation in technology and business management. However, growth does not inevitably result from this, and the state cannot insist on the investment and innovation which will produce growth. Neither do they simply “happen” in an automatic way regardless of the actions of government. It is important to recognise that growth stems from the initiatives of entrepreneurs, managers and workers and that their activities are shaped by an economy’s “institutional infrastructure”. The term “institution” here covers the practices, rules and organisations that guide and govern economic activities. The institutional infrastructure of a market economy includes the way that markets operate, the ease of entry into the market by new firms (the avoidance of bureaucratic obstacles and restrictive procedures) and for the exit of established firms (including bankruptcy procedures), property law and contracts and their judicial enforcement, taxation, the effective regulation of financial and infrastructure services and environmental protection.

In transition economies enormous change has been brought about by liberalisation, privatisation and progress towards the establishment of market-based institutions. However, there are many remaining challenges associated with the way that market forces interact with the economic practices, structures and institutions inherited from central planning. In market economies, rivalry among firms is a driving force for innovation, and the search for competitive advantage and profit opportunities continually leads

to improvements in technologies and business organisation. These market forces have already initiated substantial structural change and restructuring in transition economies and they will bring about future innovation and development.

Growth in transition economies hinges, therefore, on the economic incentives faced by businesses and individuals, on how they operate in the market and on the new and evolving institutions and government policies. This chapter focuses on the factors governing growth, such as the legacies inherited from central planning, the extent of market competition, the organisation and ownership of firms and financial institutions, the capacity of the state and the behaviour of government. This analytical approach is, in essence, a market-driven perspective on the growth process which focuses on innovation (commonly referred to as “Schumpeterian”¹). This is surely the natural approach to growth in the transition, a process which is itself all about markets and change.

The other chapters in Part II of the *Report* expand on the key theme developed in this chapter: the central role of market competition and enterprises in the process of growth. Chapter 4 examines the changes in broad economic structures and in patterns of specialisation in production resulting from the introduction of market mechanisms in transition economies. It also focuses on enterprise performance and restructuring. Chapter 5 assesses what is needed from government for the development of well-functioning markets and well-performing enterprises in transition economies. Particular emphasis is given to exploiting the links between key policies, to harnessing the strength of the state and to strengthening the behaviour of government. The final chapter in this part of the *Report*, Chapter 6, assesses the prospects for growth in the region, drawing on both historical evidence from industrialised and developing market economies and on techniques that allow some weighting of various factors which determine long-term growth in market economies.

Section 3.1 of this chapter summarises some of the main economic theories of growth, which analyse the role of investment in plant and equipment, the acquisition of skills, innovation and institutions. This analysis involves some conceptual analysis of the sources of growth, but it is an unavoidable prerequisite for the identification of the key factors underlying growth and for the assessments of prospects and policies for the future. Section 3.2 discusses how the particular features of transition economies form a unique combination of sources of, and obstacles to, growth. Section 3.3 provides some brief conclusions.

¹ See, in particular, Schumpeter (1932) and (1943). The “Schumpeterian” perspective has a long lineage, dating back at least to Marx’s description of the process of growth under competitive capitalism (see Marx [1867]). Marx understood much about the forces of competition but failed to see how powerful competitive capitalism would be over the long term in creating and sustaining growth and change. The Schumpeterian tradition has been taken forward within modern growth theory, and this recent work informs the discussion which follows.

3.1 An economic perspective on growth

For the output of an economy to grow, at least one of two things must happen. Either the inputs of capital and labour used to produce goods and services must expand or the efficiency with which inputs are used in production must increase. The purpose of this section is to examine the processes in a market economy which determine the level of investments in plant and equipment and the development of a skilled workforce. It also looks at the circumstances that generate innovations in technologies, new products and ways of organising businesses. Market-driven investment and innovation are likely to make significant contributions to growth in transition economies. However, the extent of their contribution will be shaped by the effectiveness of the newly established institutions which determine the incentives and constraints for enterprise investment and innovation. Moreover, the contribution of innovation is likely to be unusually strong because of the unusual circumstance of transition economies. With their legacy from central planning of massive but misallocated investments in both the workplace and the workforce, a priority is to find more effective ways of making use of existing resources, although some plant and equipment has been simply rendered economically obsolete by market reforms.

Early discussions on growth focused on the quantity of physical capital, such as plant and equipment, as the most important factor, treating the growth in labour (population) as determined by other, non-economic factors.² However, it is increasingly recognised that the qualities of both capital and labour (in terms of their potential contributions to output) can vary widely and that improving the quality of both physical capital and individual skills (human capital) is just as important for growth as increasing their quantity. Of similar importance is the way in which different factors and skills are combined in the organisation of production. Investment in new machinery and a skilled workforce must be financed through savings by households, domestic enterprises, foreign investors or government. The achievable rate of growth in output also depends, therefore, on the mobilisation of savings.

Investigations of growth in industrialised and developing market economies find that it is not easy to account for the bulk of long-term growth by simply attributing it to the accumulation of physical and human capital, at least not as typically measured (see Chapter 6).³ The “residual”, the growth in output that cannot be accounted for by the growth of other factors, is sometimes described as “technical progress”. This residual is also sometimes known as growth in total factor productivity. Because technological change is itself an outcome of economic decisions, this finding emphasised the importance to growth of the mechanisms and the economic and institutional conditions that foster innovation.

Box 3.1

Elementary growth theory

A basic building block of growth theory is the relationship $Y = F(K)$, which shows how much output Y can be produced with the aggregate capital stock K , under a given state of knowledge, with a given range of available techniques and with a given set of other non-capital inputs (as embodied in the function F). While investment contributes directly to growth in output through an increase in feasible production, a crucial assumption is that there are diminishing returns to capital. In other words, the marginal productivity of capital decreases as capital accumulates. In a closed economy, moreover, gross capital accumulation (gross investment) must equal aggregate savings. In the models which follow, issues concerning aggregate demand and the process by which savings and investment come into balance are put to one side, with full employment of factors assumed, in order to focus directly on the effects of capital accumulation.

In the basic model introduced by Solow (1956), it is assumed that people save a constant fraction s of their income Y , so that gross capital accumulates at rate sY . If a constant fraction δ of the capital stock disappears each year as a result of depreciation, then the net increase of the capital stock is $\Delta K = sF(K) - \delta K$. In the absence of population growth and/or technological progress, such an economy cannot grow forever at a positive rate. Indeed, because of diminishing returns to capital, national income $F(K)$ does not grow as fast as the capital stock, which means that savings $sF(K)$ cannot grow as fast as depreciation. Eventually depreciation catches up with savings and at that point the capital stock stops rising and the economy stops growing.

The fundamental determinant of long-term growth of income per capita is therefore the rate of technical progress in this framework. Long term here means the steady-state in which output and the capital stock grow at the same constant rate (which may be zero without technological progress). Recall that $F(K)$, the production function, was defined for a given state of knowledge. A higher savings (investment) rate raises the rate of growth temporarily, that is over the medium term. If maintained, it permanently increases the long-term level of per capita income, but the long-term rate of growth does not depend on the savings rate. Of course, the medium term may last for many years, so savings and investment behaviour remain important factors for growth.

Another implication of this model (sometimes called conditional convergence) is that, for two economies characterised by the same technology, savings rate and depreciation rate, the economy that begins with the lower level of income per capita will have a higher growth rate of income per capita because of diminishing returns to capital accumulation. This implies that a relatively low initial level of capital stock raises the medium-term growth rate of an economy, other things being equal. Of course, this does not mean that the levels of income per capita in different countries or regions will converge over time, since those will typically differ in structural characteristics, such as the level of technology, savings rate and other factors.

² This is a simplification of a long and rich history of the theory of economic growth. In some of the earliest systematic discussions of growth (such as by David Ricardo), land was considered an important limiting input and working capital to pay labour ahead of the harvest played a prominent role. However, at least since Marx, physical capital has been at the centre of the discussion of growth in capitalist economies. Nevertheless, for the purposes of this chapter, where the focus is on the economic and institutional framework that fosters the accumulation of private capital and technological change, land and other inputs (natural resources) can be omitted.

³ Measured capital accumulation often does not adequately account for improvements in the quality of such inputs. Jorgenson and Griliches (1967) showed that when capital and labour inputs were carefully adjusted for quality changes, much of the “residual” in post-war US growth could be accounted for by factor accumulation. While later studies have disputed the quantitative findings for the United States and other countries, this work focused attention on the need to make quality adjustments to both measured inputs and outputs, and on the economic mechanisms that generate quality change in an economy.

The findings that much of growth cannot be accounted for by investment alone also underline an important lesson from economic growth theory. While investments in skills, plant and equipment are critical to medium-term growth, they cannot by themselves sustain growth in output per person over the long term. Because additional investment tends to become less productive as the amount of capital per worker increases (which is often referred to as the “diminishing marginal productivity” of capital),⁴ the impact of investment on growth tends to decrease over time. This leaves technical progress as the primary source of sustained growth in output per person over the long term (see Box 3.1).

One way to offset the effect of the diminishing productivity of capital and to boost the growth rate temporarily is to increase the aggregate savings rate and the rate of investment.⁵ This was the approach to boosting faltering growth rates in centrally planned economies of eastern Europe and the former Soviet Union, as their savings and investment rates doubled from 15 per cent of GDP to 30 per cent between the 1950s and 1980s (see Chapter 6 of the 1996 *Transition Report*). The poor growth performance of countries in the region was partly due to the misallocation and poor quality of capital investment (see Chapter 3 of the 1995 *Transition Report*). However, their failure to sustain growth also confirmed the basic lesson of the Schumpeterian growth perspective, which is equally applicable to market economies. Growth which does not embody continued advances in technology cannot be maintained indefinitely. Investments in the workplace and the workforce, particularly that driven by competitive market price signals, are important to raising the level of output per capita. Nevertheless, in order to sustain positive growth in output per capita, there must be continued advances in the form of new goods, new markets, and new ways of organising and conducting business. In other words, there must be technological progress.

Much progress has been made in recent years in formalising the insights associated with Schumpeter and others concerning the process by which technological progress is generated and remunerated in market economies.⁶ The Schumpeterian perspective on economic growth arises from the following set of ideas. Innovations (which lead to the introduction of new production processes, new products, new management methods and new organisation of production activities) are created by self-interested firms, entrepreneurs and researchers who expect to be rewarded in the event that their innovation is successfully implemented.⁷ These rewards are often seen as monopoly rents (profits earned from market

power) in that they result from the special position of a firm which has successfully made an innovation. In general, these rents will eventually be dissipated, as the new processes or products introduced by current “innovators” will become obsolete at some point in time. That is, new innovations will occur in the future which will compete with current innovations and, possibly, drive them out of the market entirely. The Schumpeterian approach to growth is thus based on the notion of “creative destruction”, by which Schumpeter meant the competitive process whereby entrepreneurs are constantly looking for new ideas and for new sources of rents that will render their rivals’ ideas obsolete.

Technological progress involves a whole range of inputs to, and participants in, the production and diffusion of innovations, not just the small part that takes the form of formal research and development (R&D) activities. Innovations are created by a variety of self-interested individuals in the process of trying to solve new production problems, to learn from experience, to find new and better ways of organising and conducting business, to profit from opening new markets, and to adapt methods and processes invented elsewhere to the domestic or local market environment. By focusing explicitly on innovations as an economic activity, distinct from capital accumulation, the Schumpeterian approach to growth enables a deeper understanding of how market structures and imperfections, international trade, technological spillovers, business organisations, financial institutions and the legal framework affect long-term growth through their effects on incentives to engage in knowledge-producing activities. Box 3.2 summarises the key findings of the Schumpeterian perspective on growth.

By focusing on innovative activity and entrepreneurship as key sources of productivity growth, the Schumpeterian perspective provides an important starting point for analysing growth prospects in transition economies. Structural change, enterprise restructuring and significant productivity improvements will constitute a driving force for medium-term growth in transition economies. This growth will arise from the proliferation of new private businesses, from foreign direct investment and the potential technology transfers it generates and from the creative restructuring and reallocation of existing enterprises and capital resources. Key challenges for growth include reforms that facilitate the new entry of enterprises, the selection by market competition and survival of superior projects and firms and the allocation of capital resources to them, and the restructuring of existing activities inherited from the previous regime of central planning.

⁴ With just two factors, capital and labour, constant-returns-to-scale (that is, production conditions where doubling all inputs leads to a doubling of output) necessarily implies the diminishing marginal productivity of each factor.

⁵ Another way in which the effect of the diminishing productivity of capital may be offset permanently is through the benefits of learning associated with investment. While investment by individual firms may be subject to diminishing returns, a by-product of investment is often the collective accumulation of technological and organisational know-how through learning-by-doing and learning-by-watching (demonstration effects). If this effect is sufficiently strong, the diminishing returns to capital at the firm level can in principle be overcome at the level of the economy as a whole. See Frankel (1962) and Romer (1986).

⁶ Earlier growth theory and associated empirical work showed the importance of technological change, but provided only limited formal explanation of how it was produced or remunerated. In fact, under the standard assumption of constant returns to capital and labour, one can show that once these factors of production have been remunerated at their competitive price, there is nothing left to remunerate “technological progress”. Without an incorporation or an explicit analysis of the determinants of technical progress, growth theory was, from a purely formal perspective, equally applicable to centrally planned and market economies. This is not to say, of course, that centrally planned economies were actually successful at producing high-quality investment, technological change and growth. The “Schumpeterian” perspective places greater emphasis on the market mechanisms generating technological progress and thus are particularly relevant to transition and other market economies.

⁷ The Schumpeterian approach is an example of so-called “endogenous growth theory” because it seeks to explain the process of technological change as the consequence of rational decisions and actions of firms and entrepreneurs.

Box 3.2

The main results of the Schumpeterian approach

Technological progress results both from purely innovative activities and also from the diffusion or adaptation of new technologies or products to other sectors or market environments. In Schumpeterian models of economic growth, firms compete by devoting resources to innovation, for which research and development (R&D) is used as a shorthand (see Romer [1990], Aghion and Howitt [1992] and [1997]). The outcome of this effort is uncertain in the sense that, with various probabilities, some experiments succeed and others fail. The probability of success depends positively on the level of R&D. If a firm produces a successful innovation, it earns temporary “monopoly” rents, but these are competed away when other firms (be they incumbent firms or new entrants) generate superior inventions. In addition, the rents may decline as the existing innovations diffuse or spread through the economy – for example, through demonstration effects and learning-by-watching. The rate of growth of the economy depends on the rate of innovation generated by total R&D in the economy.

The long-term rate of growth will therefore depend positively on any factor which increases the probability of successful innovation or the rents accruing to innovation, or which reduces the cost of innovation. Factors that increase the rate of diffusion have ambiguous effects on growth from a theoretical perspective. While these factors increase the use of superior techniques or products and thus raise productivity, greater diffusion normally means less ability of the original innovating firm to capture rents, and thus less incentive to innovate in the first place.

Innovation in the Schumpeterian framework tends to be fostered by:

- a high productivity of R&D – this encourages further R&D and therefore increases the expected number of innovations;
- a large supply of skilled labour – more skilled labour decreases the cost of implementing and diffusing new innovations throughout the economy;
- a large market size – this provides higher rents for successful innovators, indicating a growth-promoting role for trade liberalisation and market enlargement, such as accession to the European Union;
- a legal environment in which property rights on new innovations are adequately enforced;
- a low real interest rate – R&D, like any other investment activity, tends to be discouraged by high real interest rates (hence the need for both macroeconomic stability and financial development);
- low depreciation rates for physical and human capital – the lower these depreciation rates, the higher is the net present value of investing in new vintages of capital goods and/or new skills (hence the importance of education policy);
- flexible labour markets – lower hiring and firing costs facilitate implementation of new technologies by reducing the associated labour costs and mitigating the power of vested conservative interests;
- a strong, market-oriented infrastructure – this facilitates productivity, flexibility and effective markets.

The widespread adaptation of new technology also tends to be fostered by:

- a high degree of mobility of skilled workers across firms and sectors – this speeds up the diffusion of new technologies throughout the economy;
- a high degree of R&D spillovers (learning-by-watching and other activities) across firms, sectors and countries – this directly contributes to technological diffusion. International R&D spillovers are facilitated by trade with technologically more advanced countries (see Coe and Helpman [1995]);
- a high rate of learning-by-doing within particular sectors and of learning across sectors or countries – this is promoted by labour mobility to disseminate information;
- market-oriented infrastructure – this facilitates mobility, spillovers and learning.

There are both positive and negative effects of product market competition on the incentives both to innovate and to adapt. While more product market competition tends to reduce rents (profits from market power) and thereby discourage innovative activities by small entrepreneurial firms, it also reduces managerial slack within large enterprises, forcing them to adopt new innovations and to restructure and reorganise their activities. In addition, product market competition enhances the mobility of workers across sectors which, as was argued above, speeds up the diffusion of new technologies and intensifies learning-by-doing. While the overall effect of competition on growth is ambiguous from a theoretical perspective, recent empirical studies on different countries have found a positive association between product market competition and the rate of productivity growth in manufacturing industries (see Blundell et al. [1995] and Nickell [1996]).

The challenges for growth in transition economies also include measures that improve the environment for business investment. If firms cannot take advantage of the benefits of investment because they are subject to arbitrary losses through corruption and criminality (or the threat thereof), to unpredictable tax regimes and to ineffective judicial enforcement of property rights and contracts, their incentives to invest are blunted and investment is discouraged. Foreign direct investment is particularly sensitive to these risks, since foreign investors are able to look elsewhere and global competition for capital funds is intense. Moreover, both investment and domestic savings are influenced by financial institutions that can provide secure outlets for household and corporate savings and that can channel them into productive, market-oriented investment projects. Even without formal consideration of these aspects, the results summarised in Box 3.2 and above point to the importance of the institutional structures for investment and savings.

Before turning to a detailed consideration of the factors governing growth in transition economies, however, it is useful to examine briefly available evidence on the determinants of growth in industrialised and developing market economies. A number of investigations have attempted to identify key factors which are empirically associated with growth. Despite data and statistical difficulties, the main conclusions from this work support some of the important aspects of the economic perspectives on growth reviewed above. Chapter 6 provides a more detailed analysis of the cross-country evidence regarding the factors governing productivity and growth.

A basic result of the economic perspective of growth is that, if there are diminishing returns to capital, countries with lower levels of per capita income grow more rapidly than those with higher levels of income, other things being equal. There is some evidence that this is the case, which would imply that diminishing returns to capital will lead to a convergence of GDP per capita.⁸ However, this process of catching up has been very slow, and applies only to groups of countries that are relatively similar in terms of other determinants of growth, such as levels of labour skills and institutional arrangements.

There is, in addition, considerable evidence that growth is stimulated by a skilled workforce, adequate institutional and physical infrastructure, political stability, economic openness and absence of market distortions. The importance of skills (measured by school attainment, for example) arises not only from their direct contribution to output but also from their indirect impact on output growth through productivity gains.⁹ These effects are significant both for countries which generate technological changes and for those which rely on adapting technologies from more advanced countries. Aspects of the institutional infrastructure have a significant influence on growth. Indicators of institutional development, such as measures of the rule of law, are significantly and positively associated with long-term growth,¹⁰ and there is evidence that political instability (measured by the frequency of strikes and of coups, for example) is detrimental to growth.¹¹ Economic openness to foreign trade and the absence of significant market distortions (in the form of a black market premium) also contribute significantly to growth in market economies.¹²

An important conclusion to be drawn from available evidence on the determinants of long-term growth in market economies is that an environment supportive of private investment and well-functioning markets is associated with high, sustained rates of growth. Also, a skilled workforce facilitates innovation and the spread of new technology and thus contributes to an increase in growth for countries with relatively low levels of per capita income.

3.2 Factors governing growth

The main factors governing growth are the same for both transition economies and market economies. However, in transition economies certain features have been inherited from the previous centrally planned system that also affect prospects for medium- and long-term growth. Among the most important features are a well-educated workforce, relatively old and economically obsolete plant and equipment, a need for radical reallocation of resources both within and between sectors, an inadequate physical infrastructure, and underdeveloped market-oriented institutions. This chapter examines separately the sources of, and obstacles to, growth in transition economies. There are, however, strong paral-

els between these two elements since any removed obstacle is an additional source of growth.

Consideration is given to four general sources of growth: recovery from the recession that tends to take place at the early stages of transition; structural change and enterprise restructuring; the high level of education of the workforce; and lastly investment and technological change. The first two sources are relevant for only a limited period, albeit important and possibly long lasting, while the others are permanent factors. Chapters 4 and 5 discuss these temporary sources of growth in more detail, while Chapter 6 attempts to quantify the impact of both the temporary and permanent factors governing growth prospects in the region. This section also considers four general obstacles to growth: impediments to competition; weakness or absence of market-oriented institutions; bureaucratic interference, corruption and criminality; and underdeveloped financial sectors.

Sources of growth

Recovery from the transition recession

The magnitude and duration of the slump in the early stages of transition differ sharply across the region, being significantly larger in CIS countries than in central Europe. For example, the measured decline in output from the pre-reform levels to the trough during the transition varied from lows of about 20 per cent in the Czech Republic, Hungary and Poland to much deeper levels in the region of the former Soviet Union, with declines of about 45 per cent in Russia, 50 per cent in the Baltics and 60 per cent in Ukraine. Considerable caution must be exercised in interpreting these figures, however, because of the difficulties in measuring output accurately in transition economies. Among the most serious measurement problems are those associated with the growth of the informal economy, the improvement in the quality and customer-orientation of goods and services, and the growth of the service sector, none of which tends to be captured very accurately in available statistics on output and price indices (for discussions of these issues, see Chapter 4 of this *Report* and Chapters 2 and 11 of the 1995 *Transition Report*). Notwithstanding these limitations, it seems clear that transition has involved greater disruption in the former Soviet Union than in central Europe.

Because of the distorted economic structures and production patterns within enterprises inherited from the central planning of the previous regime, price and trade liberalisation and removal of enterprise subsidies led to a large number of economic activities becoming loss making and non-viable. These changes brought about an initial contraction in output and forced state-owned and privatised enterprises to restructure their activities or to face closure. Moreover, the introduction of markets had the effect of disrupting the traditional trade links and supply chains among

⁸ See, for example, Chapters 11 and 12 of Barro and Sala-i-Martin (1995).

⁹ See Benhabib and Spiegel (1994).

¹⁰ See Knack and Keefer (1995).

¹¹ See Alesina and Rodrik (1994).

¹² See Edwards (1997).

producers, requiring a restructuring of commercial relationships and a search for new customers and supply sources.¹³ The extensive vertical integration and regional specialisation in the organisation of production activities in the former Soviet Union contributed to the more severe drop in output in this region compared with the decline in central Europe. The countries of the former Soviet Union were also severely affected by the extreme macroeconomic instability and trade disruption associated with the collapse of the federal Soviet state.¹⁴ However, market liberalisation is a “one-off” event and the effects of these factors can be expected to fade.

While initial economic conditions at the start of reform and market liberalisation are associated with a decline in output early in the transition, it is important to recognise the central role of these reforms in introducing market forces and thereby promoting growth. There is now considerable evidence that macroeconomic stabilisation and broad-based structural reform stimulate a market-led recovery from the recession in the early stages of transition and lay a foundation for medium-term growth. A number of investigations examine the contribution of market-oriented reforms (as measured by the EBRD’s transition indicators, for example) and of macroeconomic stabilisation (as measured by inflation rates and fiscal deficits) to growth rates in transition economies.¹⁵ The findings of these studies, and the analyses of the previous *Transition Reports*, support the view that stronger growth in transition economies is associated with superior macroeconomic stabilisation and the more effective operation of market forces. These factors explain much of the variation in short-term growth in the region (such as the divergence in growth between central Europe and the CIS). There is also evidence that these factors are associated with increased foreign direct investment (FDI) per capita (see Chapter 7),¹⁶ suggesting that a critical element of growth, namely private investment, is unlocked by these measures.

As with all empirical work, however, these studies are subject to qualifications. Data measurement is extremely difficult (as discussed above in relation to output measures), the liberalisation and structural reform indices are imperfect, and the sample period is too short to draw definitive conclusions about medium-term growth prospects. Despite these problems, the studies all point to the same basic conclusion: macroeconomic policies and market-oriented reforms both generate stability and efficiency and promote output recovery and growth.

Enterprise restructuring, new firms and structural change

Transition countries are operating far below their production potential. This is due to their inheritance of distorted economic structures and inefficient methods of production within enter-

prises, together with the initial upheaval associated with the collapse of the old system. However, to realise this potential from the existing inputs, it is not sufficient to acquire new, market-oriented technology and skills, important though that is. It also requires a radical change in the way that resources such as plant and equipment and the workforce are allocated and used. This involves a market-driven process of searching for new products, processes and organisational arrangements and developing new market-based relationships. This process includes both restructuring of existing enterprises and new business start-ups. Both of these are closely linked to the institutional infrastructure, which shapes the incentives and constraints on firms and on resource mobility more generally.¹⁷

The introduction of market-oriented reforms not only led to a large number of the existing economic activities becoming loss-making (particularly in industry and defence-related sectors) but also it created new profit opportunities (mostly in service sectors and, in some countries, agriculture – see Chapter 4). These new market opportunities in turn should create a strong incentive for existing enterprises to undertake investments aimed at changing existing working methods and to upgrade technologies or improve existing resources in some way. Such investments, together with new management and a more customer-oriented business approach, are at the heart of the process of “deep” restructuring of enterprises (see Chapter 8 of the 1995 *Transition Report*). At the same time, new private businesses (domestic and foreign), if unimpeded by bureaucratic and other obstacles to entry, are likely to develop new market opportunities created by the reforms. Private firms can also challenge the existing state-owned and privatised enterprises in established sectors.

Strengthening product market competition should also reduce the scope for inefficiency within firms and spur innovation in technologies and business organisations. The main ways in which competition has been strengthened in transition economies are economic openness through trade liberalisation and new entry by domestic and foreign producers, with the reduction of bureaucratic and other obstacles to private activity (see Chapter 4). Restructuring in existing firms is being facilitated by developing adequate governance structures through privatisation and mechanisms for corporate control that enable more efficient ownership structures to evolve (such as concentrated outside ownership). The development of well-functioning credit markets should also help these firms make the new investments required for a “deep” restructuring of their activities.

As shown by the recent growth in some transition economies (see Chapter 4) and by the experience of emerging Asian economies

¹³ Blanchard and Kremer (1997) and Roland and Verdier (1997) develop formal models of the output decline based on the “disorganisation” and the search for new suppliers and customers which follows the creation of markets.

¹⁴ See de Melo et al. (1997) on the role of initial conditions in the output decline in transition economies.

¹⁵ See, for example, Aslund et al. (1996), Berg et al. (1997), de Melo et al. (1996), Fischer et al. (1996), Sachs (1996) and Selowsky and Martin (1997).

¹⁶ See Lankes and Venables (1996) and Selowsky and Martin (1997).

¹⁷ See McMillan et al. (1989) for evidence, based on the Chinese experience, that the introduction in 1978 of market-based incentives, and individual rather than collective responsibility and rewards, raised agricultural productivity substantially within a period of only a few years. The scale of the reform was such that, even though it may not have changed the permanent rate of growth of productivity (as opposed to its level), it produced rapid growth in agricultural output over the medium term and made possible other growth-enhancing reforms in the industrial sectors of the Chinese economy.

including China, new private firms are probably the most significant potential source of output recovery and growth. These firms provide a natural channel through which markets can reallocate resources and activities to more cost-efficient and more demand-oriented uses. Such firms are unencumbered by past business decisions, such as those regarding product lines, investment and location, and are able to develop freely new market opportunities. New private firms are also likely to be more responsive and flexible and, therefore, more competitive due to their small size and because the workforce is likely to be more dedicated owing to the close relationship between ownership and managerial control of the firms.

Labour skills

An important feature of transition economies is the high level of education inherited from the socialist era. People are far better educated than in other countries at similar levels of income per capita (see Chapter 2 of the 1995 *Transition Report*).¹⁸ In the former Soviet Union, for example, enrolment in primary and secondary education has been almost universal since the late 1950s. In 1989 over 90 per cent of employees had taken eight or more years of school and university and, in 1989-90 there were more university students relative to the total population in Russia than in most OECD countries. Table 3.1 shows measures of education for all transition economies (primary, secondary and tertiary education enrolment rates) along with comparable measures for high-income (industrialised market) countries and middle-income (developing market) countries. Throughout the region there is extensive access to education at all levels, which in many countries is on a par with that of industrialised market economies.

The mix of skills generated by the previous system of education and training, however, is not well-suited to the requirements of a market economy. Problems include a lack of attention to social sciences, including law, economics and business administration, a strong emphasis on mathematics and science but a weak emphasis on problem-solving, and an excessive allocation of resources to fundamental research at the expense of product development (with the exception of the military sector). These and other features of the education system in post-communist countries call for structural reforms aimed at refocusing programmes and research priorities towards the needs of a market economy while maintaining the positive legacy of education from the previous system.¹⁹

This inheritance of a skilled workforce can promote growth in various ways. Since skilled labour generally adds to the productivity of physical capital, such as plant and equipment, an abundant supply of skilled labour increases the profitability of investment and provides enterprises with an incentive to invest. While this is important, skilled labour plays another more

Table 3.1

Levels of education in transition economies, 1993

(in per cent of relevant age group)

	primary	School enrolment secondary	tertiary
Albania	96	na	10
Armenia	90	85	na
Azerbaijan	89	88	na
Belarus	96	92	44
Bulgaria	92	72	23
Croatia	85	83	27
Czech Republic	103	86	16
Estonia	83	92	38
FYR Macedonia	87	54	16
Hungary	95	81	17
Kazakhstan	86	90	42
Latvia	83	87	39
Lithuania	92	78	39
Moldova	77	69	35
Poland	98	84	26
Romania	95	na	na
Russia	107	88	45
Slovak Republic	101	89	17
Slovenia	97	89	28
Tajikistan	89	100	na
Ukraine	87	80	na
Uzbekistan	80	94	na
Middle-income countries	104	62	20
High-income countries	103	97	55

Source: World Bank, World Development Indicators 1997.

dynamic role in the growth process. To a large extent, education entails learning how to gain knowledge, adapt and react rather than absorbing a particular body of knowledge. These are essential skills in the transition and, indeed, any changing environment. This view is supported by recent evidence which indicates that the contribution of labour to growth is larger in countries where technological change is more dynamic.²⁰ However, this potential contribution can be fully realised only if labour and product markets are reasonably open and flexible. These conditions are needed to ensure that skilled labour can move in search of new opportunities and enter markets with new approaches and ideas. Although centrally planned economies emphasised the importance of developing skills, they promoted general education rather than learning-by-doing and experimentation and largely neglected the role of other factors (learning-by-watching) in the development of new skills.

To make the most effective use of skilled labour resources, it is necessary to improve labour mobility across firms and sectors. This is achieved through improvements in infrastructure (see below), privatisation and development of housing markets, and minimising regulatory barriers. The benefits of greater labour

¹⁸ See also World Bank (1996).

¹⁹ However, educational inputs (including equipment and high-quality teachers) have suffered from absolute cuts in public spending in many countries since the beginning of transition (even though broadly maintained relative to GDP). This, together with the brain-drain of east European and especially Russian scientists (prompted by low pay at home and the removal of emigration restrictions, together with the economic downturn experienced in most countries), raises serious concerns about the ability of transition economies to maintain and improve the quality of their skills base.

²⁰ This hypothesis was proposed and empirically tested by Welch (1972). See Benhabib and Spiegel (1994) for cross-country evidence consistent with this view.

mobility include a better match between skills and technologies and between skills and products, which in turn should encourage both the development of new skills and the implementation of new technologies. It should also lead to a greater distribution of knowledge and learning-by-doing within and across sectors.

Investment and technological advance

Following market liberalisation in transition economies, much of the industrial structure was rendered economically obsolete, raising the opportunity for new investment. Investment returns over the medium term are likely to be particularly high for those investments that facilitate the restructuring of existing enterprises and which enable new private firms to enter the market (see above). Such investment is central to long-term growth, as in mature market economies. Growth will also be assisted by the introduction of new technologies, processes and organisations and their subsequent replication and adaptation.

Growth-enhancing investments in transition economies will rely importantly upon establishing open trade regimes and attracting foreign direct investment, and also upon key structural reforms including: (i) reform of the financial sector and the establishment of a competitive banking system that effectively screens and monitors investment projects; (ii) the impartial enforcement of clear and stable laws and regulatory rules via accountable state institutions; and (iii) investments (such as in infrastructure and housing) that enhance product market competition and labour mobility. In the medium term, transition economies will develop at different rates. The structure of growth will, no doubt, vary across economies, but the form it takes is perhaps less important than the establishment of an institutional framework that will underpin the growth by helping to promote a reallocation of resources according to market forces, the entry into the market of new firms and open competition.

Obstacles to growth

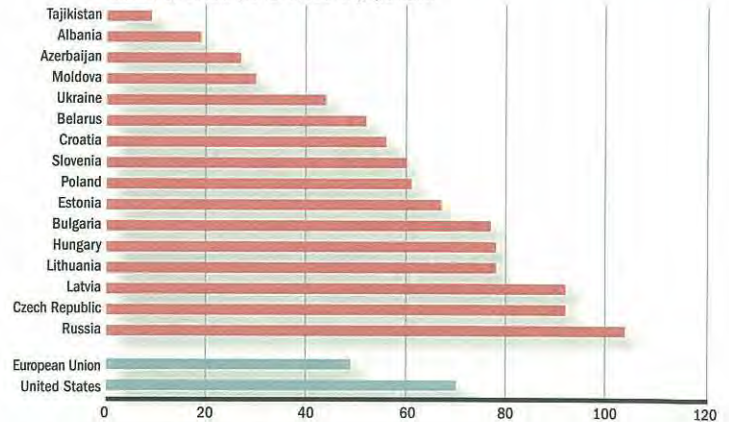
Impediments to competition

The process of improving the allocation and utilisation of resources across firms and sectors must be governed by market forces, and this requires effective competition. However, competition in transition economies remains severely limited by a number of factors. Arbitrary business licensing procedures, regulations and taxation create significant barriers to entry by new private firms (particularly in the CIS), while country-risk factors influence the extent of foreign entry through direct investments (see Chapter 4). The continuation of soft budget constraints for at least some enterprises, particularly by allowing tax and energy tariff arrears and soft bank loans, blunts the operation of market forces in a number of transition economies (see Chapter 5). Also, inherited market structures in transition economies often are concentrated and lack a competitive fringe of small and medium-sized producers. Entry by such firms is limited in a number of countries, particularly in the CIS, by government-related obstacles and by criminality. It is often the case that new firms are “visited” by representatives of organised crime within a few days of setting up and are required to pay substantial protection money.

Chart 3.1

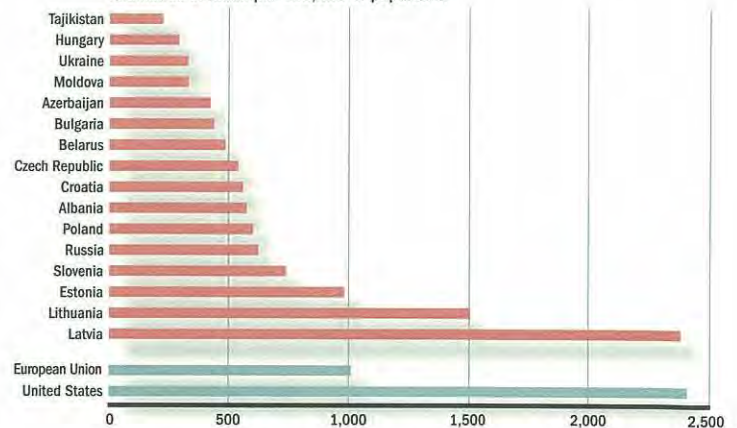
Rail network densities, 1993

Kilometres of rails per 100,000 of population



Road network densities, 1993

Kilometres of roads per 100,000 of population

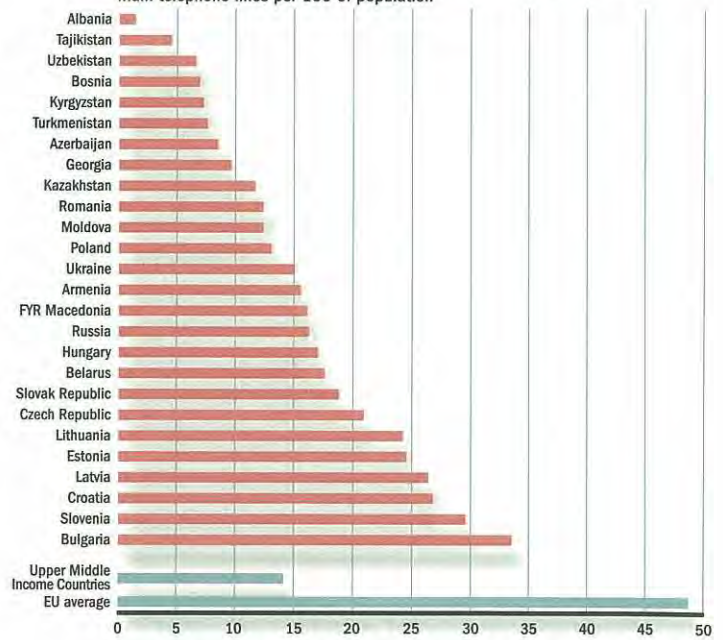


Source: International Road Transport Union (1996).

Chart 3.2

Telecommunications network penetration rates, 1994

Main telephone lines per 100 of population



Source: International Telecommunications Union

The potential for competitive markets is also undermined by inadequate physical (and institutional) infrastructure. This is a key area for determining the level of “transactions costs” in any economy, and therefore its ability to adapt to change. The physical infrastructure (especially roads, railways and telecommunications) inherited from the central planning of the previous regime was designed to meet the needs of a system that was highly vertically integrated (for political and ideological rather than sound economic reasons). Under central planning, there were very few small or medium-sized firms, little horizontal communication between enterprises from different sectors, and relatively limited provision of information to buyers and suppliers. As such, it was unsuited to the needs of a competitive market system. Charts 3.1 and 3.2 illustrate the inherited infrastructure of transition economies and contrast this with the infrastructure of industrialised and developing market economies (see also Chapter 3 of the 1996 *Transition Report*).

The emergence of new networks of production and distribution in the transition requires new investment in infrastructure (particularly in roads and telecommunications networks and other forms of information systems) to facilitate the exchange of goods and services and information among producers and consumers. Such infrastructure can help lower transactions costs (including transportation costs and the search for suppliers and customers) both in vertical relationships among firms (in buying and supplying inputs) and between customers and firms. For example, it can enable firms to search more effectively for low-priced suppliers and to identify and exploit market opportunities more rapidly. By improving access to new markets and market participants, investment in infrastructure can also reduce local market power and stimulate product market competition.²¹ In short, greater market-oriented infrastructure makes a major contribution to a more competitive environment that can weed out both high-cost established firms and weak potential entrants.²²

Lack of market-oriented institutions

The points about the role of physical infrastructure apply equally to the institutional infrastructure, which supports market interaction. This infrastructure includes the legal framework (especially contract and other commercial law and protection of physical and intellectual property), bankruptcy institutions, regulation of financial institutions, competition agencies, tax authorities and other regulatory and licensing bodies. In the same way that restricted access to physical infrastructure weakens competition, “captured” or non-transparent public institutions can distort, confuse and manipulate the rules of the game and thereby undermine the competitive process.

It is possible for firms to find ways of adapting their operating procedures to take account of a poor institutional infrastructure, but this leads to an increase in social costs and distorts competition. For example, studies show that when legal contracts are difficult or expensive to enforce, enterprises find other ways of disciplining customers and suppliers for not complying with a contract. Market transactions tend to be organised at a local level, where the desire to maintain a good reputation enforces good behaviour, or they are restricted to similar ethnic groups where there is mutual trust.²³ This behaviour has the effect of softening competition among established firms and limiting the weeding out of weaker enterprises. It also becomes difficult for new entrants to gain a foothold, partly because customers may be less willing to buy from new firms without legal or other safeguards.

A key requirement of well-functioning, market-oriented institutions is that they enforce transparent, stable rules that facilitate open market processes, particularly for the entry into, and exit from, markets by enterprises. A basic and powerful way to accelerate institution-building in transition economies is to create private sector demand for it by privatisation and other policies to reduce the role of the state in economic life.²⁴ These policies are undoubtedly important in their own right. However, this “demand creates its own supply” view of institutional development runs the risk of creating institutions that are designed to serve, or are “captured” by, particular vested interests. For example, competition authorities are important for enforcing level playing fields for rivalry among producers. However, they can also be misused to protect the established competitors rather than to promote open competition. The same danger exists in other regulatory institutions, tax authorities and even the legal system itself. Regardless of the form it takes, the “capture” of public institutions by private interests undermines sustainable growth because it dilutes the incentives, and the ability, of new firms to compete with those already in place.

The interplay between public officials and enterprises can have a significant influence on the development of state institutions and government policies in transition economies. Privatisation of existing state-owned enterprises, for example, was widely viewed as the most effective way of “depoliticising firms”.²⁵ Although it certainly increased the authority of enterprise managers at the expense of government officials, mass “insider privatisation” (as in Russia) introduced a new source of political pressure and vested interests. It increased the ability of incumbent managers (of large firms and through industrial groupings created from previous branch ministries) to “capture” some aspects of government policy and regulation. In particular, the new-found autonomy and power

²¹ This allows low-cost firms to compete more successfully with high-cost firms (gaining market share), which in turn lowers overall production costs in the economy. Lower transactions costs make it more attractive for low-cost potential competitors to enter the market (compared with high-cost entrants) because they know they will be able to compete more effectively after entry. The intensification of competition also increases the incentives of incumbent firms to reduce their costs by restructuring.

²² For a formal model of some of these mechanisms, see Aghion and Schankerman (1997). Note that these arguments apply to any form of infrastructure that facilitates market interactions. This would include a subset of physical infrastructure – transport and telecommunications but not electricity or water supply – but also many forms of institutional infrastructure.

²³ For an interesting study of Vietnam, see McMillan, Naughton and Woodruff (1996). Similar research is under way on a number of east European and CIS countries. The role of ethnic groups in enforcing commercial contracts and other dealings is particularly prominent in African countries, but may also apply to some ethnically heterogeneous transition countries.

²⁴ See, for example, Boycko et al. (1995) and World Bank (1996).

²⁵ For example, Shleifer and Vishny (1994) argue that while under public ownership the government could use its coercive power to force non-profit maximising decisions on firms’ managers.

of some enterprise managers have been used to lobby government to stifle potential competition, to oppose the introduction and/or enforcement of new tax systems, to prevent new outside owners buying into their firms and to gain additional economic power.

To promote entrepreneurship and growth, public institutions should have the following attributes: independence from the enterprises they “regulate”, accountability, transparency, stability and adaptability. In practice there is some conflict between these elements. For example, adaptability requires some degree of flexibility and discretion in rule-making, which may conflict with stability. As a result, there is some variation between countries in the particular forms that institutions take. In that sense, no specific institutional designs could be described as prerequisites for growth.²⁶ What is critical for growth, however, is that government institutions (including tax and licensing systems) are designed to facilitate the entry of new products, ideas and firms into the market place, a competitive environment and the exit of enterprises that are not commercially viable. It is against these standards that government institutions should be judged.

Corruption and predatory behaviour

A basic public good provided by government in a market economy is the legal and institutional framework to enforce contracts and safeguard property rights and its failure to do so creates a serious obstacle to private activity. In the absence of reliable enforcement of property rights and contracts, private businesses become exposed to risks of state or criminal expropriation of profits and assets, in whole or in part. Anticipating this, private businesses cut back on investments, including those in innovation, or refrain from developing market opportunities altogether (see Chapter 4). The weak capacity of a state to enforce those rights necessary for a well-functioning market economy can lead to corruption by officials and Mafia-type activities as an alternative means of enforcing these rights. Many of these practices are simply criminal, such as protection rackets, and should be combated directly through law and order measures. This takes leadership and courage.

In addition to weak state capacity, the misdirected use of this capacity can also create scope for corruption. Bureaucratic and cumbersome procedures for business registration and regulation can create significant scope for the misuse of power by officials and for corruption. These practices are particularly prevalent at local government level in some transition economies.

The tax system is another important example of how unclear rules, weak institutions and bureaucratic discretion contribute to business uncertainty and corruption and undermine private sector activity. Enterprise surveys from developing and transition countries have shown that it is not so much the average level of

taxation, but rather the unpredictability, haphazard definition of bases, discretionary enforcement and sometimes confiscatory nature of taxes which deters business activity. In response to this government-created uncertainty, businesses tend to invest less in plant and equipment and more in financial assets, accumulate tax arrears, avoid taxes with corrupt payments, or engage in informal economic activity. These business strategies, however, involve social costs, undermine formal private sector activity and reduce the ability of government to raise the tax revenues needed to fund critical expenditures (such as those on law and order, the judiciary, education, health, social security and infrastructure).

Introducing effective monitoring of government officials, and minimising the scope for “insider behaviour” in the broad sense of the term, is necessary to create a more even-handed climate for private business activity. This will require a change in the way government functions, which will not be easy to achieve. Governments must recognise that their primary role in economic affairs is to set and enforce clear and stable rules that maintain a level playing field for competition, to ensure accountability and to exercise a minimum of arbitrary control while giving officials an interest in a well-functioning market economy (see Chapter 5). However, at the same time, the private sector should establish a corporate culture of transparency and accountability, underpinned by strong corporate governance based on outside ownership.

Underdeveloped financial sector

The private investment, entrepreneurship and innovation that drive growth cannot be sustained without well-functioning credit institutions and markets. These include all forms of institutions that mobilise savings and/or channel savings into productive private sector investment projects – banks, equity markets, private pension funds and other large institutional investors as well as less formal sources of credit.²⁷ By providing the external finance needed for new investment projects, these institutions serve as an additional source of project screening and of financial discipline on the governance of enterprises.²⁸ They also help enforce hard budget constraints by increasing the likelihood that new investment projects that turn out to be unprofitable would not be refinanced.²⁹ This is in contrast to the system under central planning, where most projects operated under soft budget constraints. In place of decentralised re-evaluation of projects after approval by the standard of market performance, there was extensive, centralised bureaucratic project review which was confined to decisions prior to approval.³⁰

To promote high-quality investment and growth, however, financial institutions need to be restructured, effectively regulated and subjected to effective governance and competitive pressures. A balance must be struck between stringent prudential regulations

²⁶ See Gershenkron (1968).

²⁷ For discussion of financial markets, see Chapters 5 and 10 of the 1995 *Transition Report*, Chapter 6 of the 1996 *Transition Report* discusses savings in transition economies.

²⁸ See King and Levine (1993) for a formal model of financial intermediation in a Schumpeterian growth model.

²⁹ The idea that a decentralised banking sector is less likely to refinance projects that involve large sunk costs *ex ante* but turn out to be unprofitable *ex post*, was formalised by Dewatripont and Maskin (1995) in a paper on the determinants of hard budget constraints.

³⁰ For discussion in the context of R&D, see Qian and Xu (1997).

to protect the stability and integrity of the financial sector, on the one hand, and sufficient competitive pressure on the other. The approach of essentially unregulated “free entry” into financial markets, adopted by the Baltics and Russia in the early years of transition, led to excessive risk-taking, financial manipulation and instability that can undermine the long-term confidence in the financial sector that is needed for growth. However, competitive pressures within the financial sector are necessary to spur innovation in the form of new financial instruments and services and of increased efficiency in service delivery.

Creating effective financial markets will also require, in most transition economies, a more aggressive policy of restructuring and privatisation of existing state-owned banks. Being traditionally closely connected with large state-owned enterprises, these banks entered transition with portfolios that were both insufficiently diversified and overburdened with non-performing loans. This has had the effect of restricting potential lending to new private firms and inhibiting therefore the creation and expansion of new private sector enterprises, while at the same time contributing to financial sector instability. The reform and privatisation of existing state-owned banks will enhance growth by reducing financial instability and improving access to credit for new private businesses (see Chapter 5). At the same time, it will strengthen the ability of domestic banks to compete effectively when financial markets are open to foreign competition, as is mandated by the Europe Agreements. The strengthening of financial institutions will be a crucial part of the process of accession to the European Union.

3.3 Conclusion

It will be market-oriented innovation that will deliver growth – new products, production techniques and methods, organisational forms and ways of doing business. At the core of this process is entrepreneurship, experimentation and adaptation. It can only work if there are flexible markets, open and effective competition, and adequate institutions and infrastructure. Among the most important institutions is the legal system itself, which must impartially protect private property, enforce contracts and prevent corruption, fraud and other forms of criminality. Without this basic ingredient, it is not possible for other critical public and private institutions to develop and function properly – including licensing and tax authorities, regulatory bodies, and financial institutions and markets.

Less favourable initial conditions, and slower progress in macro-economic stabilisation and in market liberalisation and privatisation, partly account for the delayed and weaker output recovery and growth in CIS countries compared with central Europe. However the analysis in this chapter suggests that further progress in liberalisation and privatisation will not, by itself, produce sustained growth in Russia and other CIS countries. The serious institutional obstacles to entrepreneurship, competition and private investment must be addressed effectively before sustained growth can be achieved in this region. This will not be easy to accomplish, in part because of the strong vested interests that have been reinforced by mass insider privatisations, and the limited ability of government institutions to exert the required authority to levy taxes and to enforce laws. The process of accession to the EU will, for central European countries, bring enhanced access to the market, technical assistance and harmonisation of key institutions. The result may contribute to an increasing divergence in the state of institutional development between countries in central Europe and the CIS. Lastly, the dramatic increase in poverty and income inequality in CIS countries compared with the levels in central Europe may pose serious problems for the maintenance of macro-economic stability and growth in the long run.³¹ All these considerations underline the importance for governments in the CIS to provide and encourage the deep institutional reform which is vital for sustained economic growth.

³¹ See Gavin and Hausman (1996) for detailed cross-country evidence of the detrimental effects of inequality and poverty on stabilisation and growth in Latin America.

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Structural change, restructuring and enterprise performance

4

Growth in transition economies depends on how enterprises adapt to new and changing market conditions and develop innovative ways of doing business (in particular, in terms of products, production processes and business organisations). An important element of this process of adaptation and innovation is the creation and growth of new private enterprises in response to emerging business opportunities. This Schumpeterian perspective on growth, which was discussed in Chapter 3, emphasises the importance of product market competition, including the entry and exit of firms, and its impact on enterprise performance. Market competition and the way that enterprises respond are in effect the microeconomic factors governing growth, shaping the quantity and quality of investment and encouraging innovation. The microeconomic viewpoint adopted here complements macroeconomic analyses focusing on savings and capital accumulation as determinants of growth. Individual decisions drive savings and investment in a market economy, and microeconomic conditions have a vital influence on those decisions. Moreover, this perspective is particularly relevant to transition economies because at the centre of transition is fundamental change in the way enterprises operate.

This chapter analyses the microeconomic sources of growth in transition economies. In particular, it examines the response of enterprises in transition economies to the introduction of market forces and considers key aspects of enterprise performance: how enterprises have adapted their output and use of resources to the introduction of market mechanisms, and how the performance of enterprises, both old and new, is affected by factors such as the extent of product market competition, the policies and practices of government (particularly toward new private firms) and the effectiveness of privatisation and corporate governance.

At an aggregate level, the response of enterprises to market forces is seen through changes in the composition of output and the use of resources. The introduction of market forces into the economic structures inherited from central planning has brought about significant structural change in transition economies, with some sectors contracting and others expanding. Transition economies have also redirected trade away from other countries in transition and towards international markets. One part of this chapter analyses changes in economic structures and in patterns of trade in transition economies in terms of the operation of basic market forces. It is evident from this analysis that market forces have driven many of the changes that have taken place, and that the emerging economic structures are moving towards those of market economies.

A number of factors have a significant impact on enterprise performance according to evidence from industrialised and developing

market economies. These include product market competition, government behaviour and state capacity, and privatisation and effective corporate governance. The other part of this chapter assesses available evidence from transition economies on how these and other related factors influence enterprise performance. The empirical results highlight the parallels that exist between market economies and those in transition, with two aspects deserving particular emphasis. In transition economies, the entry of new private firms plays a particularly crucial role in the process of enterprise sector adjustment and the role of state institutions and government policy is instrumental in fostering development of the new private sector.¹

Section one of this chapter examines the changes in the sectoral structure of transition economies (as reflected in the share of employment in industry, services and agriculture). Section two looks at the pattern of trade specialisation, while the third section builds a bridge between these aggregate analyses of enterprise performance in transition economies and the microeconomic factors for enterprise performance. Section four examines the impact of competition on enterprise performance. The fifth section considers the obstacles to enterprise development resulting from inefficiencies in government behaviour (such as policy uncertainty, arbitrary interventions and corruption) and a weak state. Section six examines how enterprise performance in transition economies is affected by privatisation and various corporate governance arrangements. The seventh section offers some brief conclusions.

4.1 Transition and structural change

Decades of central planning have resulted in distorted economic structures for countries in transition. Industries had become over-extended by the emphasis of central planners on material production, while services were neglected. Much of agriculture was collectivised, limiting private activity and, it was argued, exploiting economies of scale. Transition and the introduction of market-determined prices, competition between producers, and entry and exit of enterprises have brought about large-scale changes in output and employment. Some sectors in transition economies have expanded and others have contracted, sometimes dramatically.

To analyse structural change in transition economies it is useful to start with established patterns of development in market economies. This reveals a systematic relationship between the sectoral composition of economic activity and the overall level of income per person (measured by per capita GNP, for example).² In particular, as economies grow and countries (and individuals) become richer, the allocation of resources and the composition of

¹ The importance of state institutions and the exercise of governance are further explored in Chapters 1 and 2.

² See Chenery and Syrquin (1975) and Syrquin and Chenery (1989).

production shifts away from agriculture and into industry and services.

A number of economic factors help to shape the structural transformation of market economies as they develop. First, as per capita incomes rise, the relative demand for some products tends to decrease (such as food) and to increase for others (such as investment goods). Second, higher rewards typically draw resources towards higher-productivity sectors,³ contributing both to growth in per capita income and to shifts in the share of production between sectors. Third, the comparative advantage of countries in international trade encourages countries to shift away from labour- and low-skill-intensive production and towards more capital- and high-skill-intensive areas, as the accumulation of plant and equipment and the acquisition of skills alters the balance between unskilled and skilled labour and physical capital.

These factors are sources of uniformity in structural change and help to explain the strong historical relationship between changing economic structures and per capita incomes. However, this relationship is not rigid. Foreign trade allows countries to look beyond domestic demand in terms of production and to specialise according to their comparative advantage. The availability of natural resources, such as arable land or mineral resources, and the size of the country can have fundamental and lasting influences on economic structures and patterns of specialisation in individual countries. Similarly, economic policies can have important and lasting effects on resource allocation and hence economic structures, as the previously centrally planned economies amply demonstrate.

In which direction is structural change in transition economies likely to occur? A comparison of the relationship between the structure of economic activity and per capita GNP across countries helps to establish benchmarks against which the economic structures of transition countries can be analysed, both at the start of transition and after several years of progress in market-oriented reforms. In particular, the benchmarks suggest what economic structures would prevail if the transition economies were to approach market economies in their respective patterns of resource allocation.

Benchmarks for assessing structural change

While the structure of a market economy is often expressed in terms of the sectoral composition of output (real GDP), it would be

difficult to apply this approach to transition economies because of measurement problems. Calculating index numbers for prices of goods and services is problematic in all countries, but it is particularly so in transition countries. This is because of the dramatic changes in relative prices and, in many cases, because of the absence of the resource allocation role for prices under the old regime. The analysis here is based, therefore, on the structure of employment rather than output, since changes in the composition of employment can be measured more reliably than those of real GDP.⁴ In particular, this approach avoids reliance on index numbers to measure real quantities, since the number of employees can be recorded directly.⁵ Moreover, the reallocation of employment is central to transition and of interest in its own right.

For this analysis, employment has been broken down into three broad areas: agriculture, industry and services. In view of the importance of services in general and their role in the process of transition in particular, however, the services sector is in turn subdivided into those that are typically provided by the market and those whose provision usually involves a strong role for government. The sectoral classification used is thus as follows:

- Agriculture
- Industry (mining, manufacturing, electricity, gas, water and construction)
- Market-oriented services (trade, transport and communications, and finance)
- Non-market-oriented services (healthcare, education, defence, public administration and other services).⁶

To establish a benchmark for the division of employment between sectors for each transition economy, an examination of the relationship between employment by sector and GNP per capita (at purchasing power parity [PPP] exchange rates) in industrialised and developing market economies is needed. This relationship is estimated using data from 41 countries.⁷ The results are similar to those derived by others using output rather than employment. In particular, the higher a country's per capita income, the lower is its percentage share of employment in agriculture and the larger are its shares of employment in industry and in both market-oriented and non-market-oriented services.

The estimated relationships between each sector's share of total employment and per capita income, therefore, form the bases for

³ In a market economy, resources shift to equalise their marginal productivity across all occupations. This does not preclude substantial differences in average resource productivity between two sectors, such as is evident, for instance, in higher average labour productivity in industry than in services.

⁴ For an analysis of the structure of GDP of several transition countries along the lines of Chenery and Syrquin (1975) and others, see Döhrn and Heilemann (1996).

⁵ Comparing labour inputs across economic activities would in principle require adjustments for hours worked and for the quality of labour. The latter would raise issues of relative price adjustments for different types of labour.

⁶ Other services, including some market-oriented services, are included here because of limitations in the International Standard Industrial Classification (ISIC)-2 employment data. Employment data broken down by ISIC-2 categories do not permit separation of "other services" from non-market services; ISIC-3 does allow this but is available for relatively few market economies.

⁷ The cross-country regressions are of the non-linear form $S = a + b(\ln(Y)) + c(\ln(Y))^2$, where S is the share of a sector in total employment, and $\ln(Y)$ is the log of 1995 GNP per capita at purchasing power parity in 1995 US dollars. The squared term allows for curvature in this relationship. Statistical tests on the joint significance of the estimated coefficients b and c were always highly significant. Country size (population) was not included as an explanatory variable (as is often done in these analyses), because when included it was rarely significant. The data on GNP per capita at purchasing power parity are from the *World Bank Atlas*. The data on employment shares are from various sources (World Bank, International Labour Organisation and national statistical agencies) and, for reasons of data availability, are from a year in the period 1990-95.

calculating benchmark employment shares in each of the broad economic sectors for each of 21 transition countries. These employment share benchmarks are calculated for both the pre-transition period (1989 or 1990) and for 1995 (with the exception of Estonia at 1994).⁸ These calculations yield, for example, a benchmark for the share of employment in agriculture in Poland in 1995: that is, the share of employment that would on average be recorded in a market economy with the same per capita income that Poland had in 1995. Repeating the calculation using Poland's pre-transition per capita GNP in 1989 yields its 1989 benchmark for the share of employment in agriculture.⁹ With employment share benchmarks calculated in this way, comparisons with actual employment shares become possible. Actual and benchmark employment shares of the 21 transition countries included in the sample can also be averaged to yield actual and benchmark shares for an "average" transition country. The average benchmarks can be interpreted as the sectoral shares of employment that would be typical of a lower-middle-income market economy whose GNP per capita was equal to the transition country average.¹⁰

Economic structures before and during transition

Table 4.1 shows pre-transition employment share benchmarks and actual shares for an "average" transition economy. The results are in line with the standard view of the distorted structures of centrally planned economies and with results of earlier analyses.¹¹ The main distortion at the start of transition was a very large share of industrial employment relative to the benchmark. At the start of

transition, the average transition economy had 36 per cent of total employment in industry compared with a benchmark share of 24 per cent. The counterpart to the large employment share in industry was the relatively small share of market-oriented services (notably trade, which showed an actual 9 per cent employment share compared with a benchmark of 17 per cent). Non-market-oriented services and agriculture also accounted for smaller shares of employment than those indicated by the benchmarks.

The comparison of actual and benchmark employment shares at the start of transition would suggest that the introduction of market forces in transition economies would foster a reallocation of labour away from industry and into services, in particular market-oriented services. The position is more complex than this, however, because transition has been accompanied by declines in measured GNP, and hence by changes in the benchmarks; benchmark shares for industry and services are lower than they were pre-transition, while the benchmark share for agriculture is higher. Moreover, estimates of per capita GNP are likely to understate true incomes because of measurement problems,¹² including the omission of informal sector activity, which can be substantial and is typically not evenly distributed across economic sectors (see section 4.5 below).

Table 4.1 also shows the 1995 employment share benchmarks and actual shares for an average transition economy. A comparison between the actual employment shares at the start of transition and

Table 4.1

Benchmark and actual sectoral shares of employment

(in per cent)

	Pre-transition (1989-90)			1995			Change in actual share
	Actual share	Benchmark share	Difference	Actual share	Benchmark share	Difference	
Agriculture	23.8	29.4	-5.5	26.9	41.1	-14.2	3.1
Industry	36.1	23.4	12.8	28.0	20.4	7.7	-8.1
Market-oriented services	21.4	25.8	-4.3	24.0	20.6	3.3	2.5
Trade	8.5	16.7	-8.2	11.6	13.9	-2.2	3.1
Transport and communications	6.8	5.3	1.4	6.2	4.7	1.6	-0.5
Finance	5.3	3.7	1.5	5.6	2.1	3.4	0.3
Non-market-oriented services	19.5	21.5	-2.0	21.6	17.9	3.7	2.2
Average GNP per capita at PPP, 1995 US dollars	5,425	-	-	3,250	-	-	-

Sources:

International Labour Organisation, national sources, World Bank and EBRD calculations.

Notes:

Actual shares (columns 1 and 4) are average shares of sectors in total employment across 21 transition countries. Benchmark shares derive from cross-country regressions of the form $S = a + b(\ln(Y)) + c(\ln(Y))^2$, where S is the share of a sector in total employment and $\ln(Y)$ is the log of 1995 GNP per capita at purchasing power parity in 1995 US dollars, based on a sample of 41 industrialised and developing market economies. Benchmark shares for each of 21 transition countries are calculated using the estimated coefficients a , b , and c and GNP per capita pre-transition (1989 or 1990) or GNP per capita in 1995. The benchmark shares in columns 2 and 4 are average benchmarks for the 21 transition countries. Average GNP per capita (bottom row) derives from the average of log GNP per capita for these countries (logs because the estimating equation is in log form). For more details see main text.

⁸ The transition countries are (pre-transition year in parentheses) Bulgaria, Hungary, Poland and Slovenia (1989) and Armenia, Azerbaijan, Belarus, the Czech Republic, Estonia, Georgia, Kazakhstan, Kyrgyzstan, Latvia, Moldova, Romania, Russia, the Slovak Republic, Tajikistan, Turkmenistan, Ukraine and Uzbekistan (1990).

⁹ The *World Bank Atlas 1997* presents data on GNP per capita in PPP US dollars for 21 transition economies in 1995. To arrive at estimates of pre-transition GNP per capita, real growth rates of GDP were applied backwards, adjusting for US inflation to obtain data in constant 1995 PPP US dollars.

¹⁰ More precisely, GNP per capita derived from the average of log GNP per capita, since the regressions are in log terms.

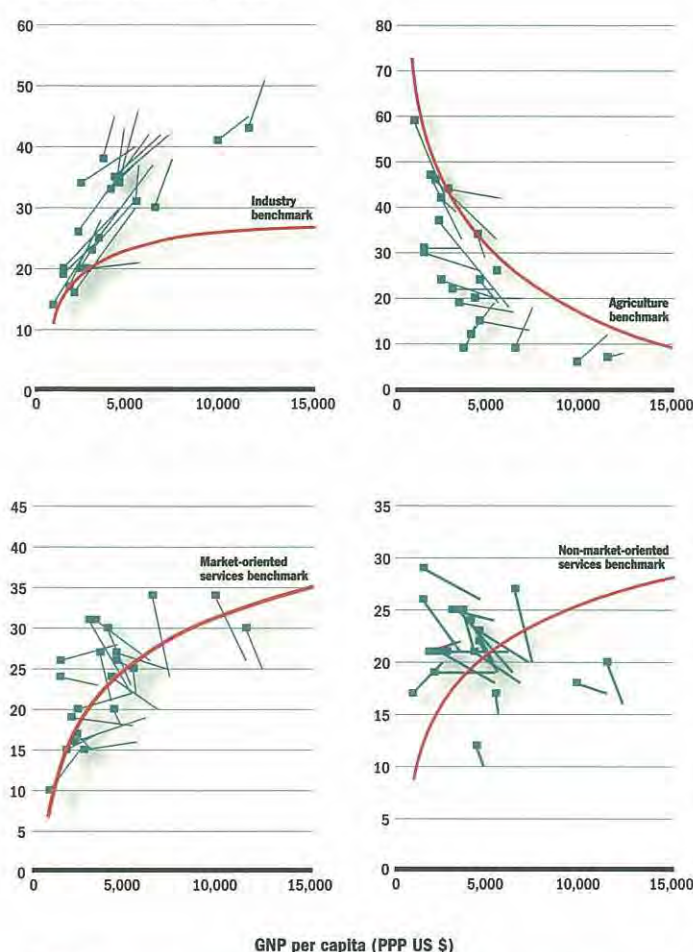
¹¹ See, for example, Winiński (1988).

¹² See Appendix 11.1 of the 1994 *Transition Report* for a detailed methodological discussion.

Chart 4.1

Adjustments towards the benchmarks: structural change in transition, 1989-95

Employment shares, in per cent



Sources:

International Labour Organisation, national sources, World Bank and EBRD staff calculations.

Notes:

On the calculation of the solid benchmark lines, see footnote 4 and the note to Table 4.1. The line extending to each square shows the change for each transition country from its pre-transition (1989 or 1990) actual sectoral employment share and GNP per capita. Each square on the chart shows the actual sectoral employment share and GNP per capita for a transition country in 1995.

in 1995 indicates the direction of change in employment shares in each sector. In most sectors the direction of change is towards the 1995 benchmarks.

While industry in transition economies remains oversized relative to the benchmark, the share of industry in total employment in 1995 was 28 per cent, down from its pre-transition share of 36 per cent (a fall of 8 percentage points). Still further adjustment in industrial employment, though, would be predicted by the 1995 benchmark, which is 20 per cent. The share of employment in agriculture has increased, again towards the 1995 benchmark, although the discrepancy between the benchmark and observed shares is now large. Transition economies have on average 27 per

cent of their labour forces in agriculture, up from 24 per cent at the start of transition, but well below the benchmark of 41 per cent. The share of the trade sector in employment also moved up towards the new benchmark, and the broader category of market-oriented services (including also finance, transport and communications) moved from being below to slightly above the benchmark.

Chart 4.1 presents the results of the exercise in country-by-country detail for the four broad sectors. Each panel of the chart presents for a particular sector: (i) the benchmark employment share for the sector derived from data for 41 industrialised and developing market economies, which is depicted by a single solid line; (ii) the position of each of the 21 transition economies in 1995 denoted by a small square; and (iii) the size of the sectoral adjustment in each transition economy by a line showing the country's income and sectoral share pre-transition and the movement to its current position.

The upper left panel shows that a reduction in the size of the industrial sector has taken place in all 21 transition countries in the sample. Because measured income per capita has also declined, the trajectories of movement in countries' positions are all towards the graph's origin. Moreover, the industrial sector's employment shares in transition economies with low per capita incomes is smaller than in those economies with higher incomes, and indeed these shares are not far from the benchmark. In contrast, transition economies with higher per capita incomes may still have further adjustment to make in their oversized industrial sectors. These countries had, in 1995, industrial employment shares in excess of 30 per cent or even, in the cases of the two wealthiest transition countries, the Czech Republic and Slovenia, 40 per cent, compared with benchmark shares of 20-25 per cent. This conclusion would be unaffected even by large underestimates of income per capita, because the benchmark share of industrial employment is less than 30 per cent even for high-income countries.¹³

The upper right panel reveals a mixed pattern of adjustment in the share of agricultural employment. A number of transition economies with low per capita incomes and with large agricultural sectors at the start of the transition (Moldova, Romania and the Central Asian republics) have witnessed substantial increases in the share of employment in agriculture and hence movements towards the benchmark. Most of the remaining countries have seen little or no increase in the share of employment in agriculture and remain well below the benchmark. Moreover, a handful of countries, most with higher per capita incomes (the Czech Republic, Estonia, Hungary, the Slovak Republic and Slovenia), have seen their shares of employment in agriculture fall further below the benchmark. As with the industry benchmarks, the large gaps between actual and benchmark shares of agricultural employment would exist (except for some of the transition economies with the lowest incomes) even if measured incomes per capita were revised upwards by large margins.

¹³ A country with a per capita income of US\$ 20,000, which would be typical of western Europe and hence far in excess of that observed in the transition countries, would have an industrial employment benchmark of 28%. However, there is substantial variation around the benchmark and some high-income countries have an employment share in industry of up to 40%.

The “overshooting” of market-oriented services is evident in the lower left panel of Chart 4.1, which shows a number of transition economies moving above the benchmark in 1995, having started the transition below it. The average gap is not large, however, and would be further reduced or even eliminated if per capita incomes were adjusted upwards. The fourth panel shows that employment shares of non-market services (primarily the government-provided services of healthcare, education, defence and public administration) also grew substantially in most transition economies.¹⁴ This growth took place despite the fact that non-market services at the start of transition already had high employment shares in most of these economies. Most countries in 1995, therefore, have employment shares of government services which are high for their level of per capita income, with governments possibly absorbing some labour released by other sectors to cushion the impact of structural change on incomes. Available evidence suggests that employment shares in healthcare and education have increased, but that real wages in those sectors have fallen sharply.¹⁵

The pattern of changes in employment shares across countries in transition shows that, for higher per capita income countries, changes in employment shares in agriculture and in market-oriented services are consistent with higher per capita incomes than those that prevailed in 1995. However, employment shares in industry for higher-income transition economies remain well above their benchmarks, and even above the benchmarks for high-income market economies. The explanation for this may partly be that transition countries differ in a number of ways from non-transition countries with comparable levels of income: they are more urbanised, with higher levels of literacy and education, and recently had higher income levels. The low share of employment in agriculture in transition economies compared with the benchmark (and hence indirectly the higher shares of industry and services) may be explained by the level of urbanisation and the large-scale organisation of agriculture in transition economies due to past collectivisation. Underestimation of incomes would also contribute to the adjustment by higher-income transition economies as if their true incomes were higher than their measured incomes.

Many transition economies with lower per capita incomes are also the countries that have implemented market-oriented reforms more gradually. Nevertheless, by 1995 most transition economies had introduced basic reforms, in particular price and trade liberalisation.¹⁶ These measures alone would be sufficient to trigger substantial structural adjustment, even if some of the more demanding aspects of reform, such as restructuring enterprises, building efficient financial intermediation and strengthening the legal framework, were yet to be initiated.

While the benchmarking exercise in this section shows a broad pattern of structural change in transition economies driven by the introduction of market forces, its aggregate nature means that it

ignores the numerous aspects of structural adjustment within sectors and at the enterprise level. The next section looks in more detail at structural change in foreign trade, as one area where market forces and economic reforms can be expected to have a particularly strong impact on patterns of production.

4.2 Specialisation and foreign trade

Factor endowments and trade interact in market economies to produce patterns of specialisation in production which contribute to deviations from the benchmarks characterising the relationship between broad economic structures and development (or per capita GNP). Like industrialised and developing market economies, those in transition also display wide variation in factor endowments and trade policies.¹⁷ This section examines foreign trade in transition economies, relating their trade specialisation to their respective resource endowments.

Transition economies began their reintegration into the world economy with specific comparative advantages, the most significant of which are high levels of formal education and high proportions of skilled workers on relatively low incomes. In addition, some CIS countries have vast natural resources (including in some cases land) which can be expected to have a major impact on patterns of specialisation. One relatively scarce resource in the region, however, is the availability of modern physical capital. There is an abundance of existing fixed assets and structures, but their market values are often negligible after years of investment misallocation and neglect of technological innovations. To benefit from international trade, transition economies might be expected to specialise in production of labour- and skill-intensive goods (and in some cases resource-intensive exports) and import capital-intensive investment goods.

Table 4.2 provides an overview of trade specialisation in transition economies in 1995 by major product categories. The table is based on “mirror data” provided by all countries reporting to the United Nations. These data exclude much of the trade within the CIS and a significant proportion of trade with developing countries. The figures should therefore be interpreted with care, particularly for the CIS countries, whose share of exports to these two country groups accounted for around two-thirds of the total by the mid-1990s. Bearing this in mind, the table confirms expectations. The largest differences in export structures are between resource-rich economies and all others, with the former displaying very high shares of raw materials and fuel exports. In Russia, for example, slightly less than half of total exports are raw materials or fuels. East European and Baltic economies specialise to a greater or lesser degree in exports of manufactured products, albeit with large variations within manufacturing.

An example of variation within manufacturing is the low share of machinery and transport equipment in total exports from CIS

¹⁴ Indeed, employment in government-provided services in 1995 was higher in absolute terms compared with pre-transition in over half the transition countries examined.

¹⁵ See Horton (1996).

¹⁶ See Chapter 2 of the 1995 *Transition Report*.

¹⁷ Chapter 5 examines trade policy in transition economies.

Table 4.2

Structure of foreign trade in transition economies, 1995

Share of total exports, in per cent						
Country	Food, beverages, tobacco, and agricultural products	Raw materials except fuel	Fuels and electric energy	Chemicals and intermediates	Machinery and transport equipment	Other manufactures
Albania	7.8	17.7	0.7	21.0	3.3	49.5
Armenia	0.9	11.0	26.0	42.2	1.7	18.2
Azerbaijan	4.3	53.0	16.7	21.4	2.2	2.4
Belarus	4.1	13.7	7.8	49.1	12.2	12.9
Bosnia and Herzegovina	10.4	10.3	0.6	18.7	15.9	44.0
Bulgaria	13.9	7.5	2.8	50.8	8.2	16.7
Croatia	7.5	7.6	9.5	32.5	9.6	33.3
Czech Republic	4.3	6.9	4.4	40.5	27.2	16.8
Estonia	4.4	20.0	14.3	28.2	13.7	19.4
Georgia	3.5	23.5	7.1	55.8	5.4	4.7
Hungary	13.5	5.1	3.0	27.6	32.9	18.0
Kazakhstan	2.4	20.7	6.2	69.1	0.7	1.0
Kyrgyzstan	0.9	68.0	0.0	29.4	0.9	0.8
Latvia	1.8	26.4	34.6	25.8	2.0	9.5
Lithuania	8.5	19.9	14.7	32.1	8.5	16.3
Moldova	39.7	11.8	1.1	33.6	2.6	11.1
Poland	7.6	5.4	8.0	37.2	19.0	22.9
Romania	5.0	3.4	4.5	40.1	11.2	35.8
Russian Federation	4.6	10.2	34.4	43.0	2.7	5.0
Slovak Republic	4.2	5.5	4.2	50.2	21.7	14.2
Slovenia	2.9	2.6	0.2	38.4	31.5	24.5
Tajikistan	0.2	63.3	0.0	29.0	0.2	7.2
Turkmenistan	2.0	79.9	13.6	2.3	0.7	1.6
Ukraine	6.2	10.9	9.9	63.1	3.2	6.8
Uzbekistan	0.8	77.1	0.0	8.1	0.2	13.9

Share of total imports, in per cent						
Country	Food, beverages, tobacco, and agricultural products	Raw materials except fuel	Fuels and electric energy	Chemicals and intermediates	Machinery and transport equipment	Other manufactures
Albania	26.1	0.8	4.3	27.1	22.2	19.5
Armenia	47.4	5.7	1.0	9.8	10.8	25.2
Azerbaijan	47.6	0.3	0.6	20.5	19.4	11.5
Belarus	22.4	0.6	0.5	26.4	35.4	14.8
Bosnia and Herzegovina	42.4	1.3	4.5	23.8	14.9	13.2
Bulgaria	12.9	4.7	4.8	33.0	31.4	13.2
Croatia	12.4	2.7	6.6	32.9	29.9	15.4
Czech Republic	6.7	2.4	1.8	31.9	42.0	15.2
Estonia	15.9	3.4	5.4	26.8	32.8	15.7
Georgia	49.8	0.4	16.2	10.0	9.1	14.5
Hungary	5.1	2.3	2.1	34.9	40.6	15.0
Kazakhstan	18.1	1.1	0.6	19.4	37.8	23.0
Kyrgyzstan	26.1	0.7	0.3	29.4	24.4	19.0
Latvia	22.1	1.8	8.3	23.1	28.9	15.9
Lithuania	18.1	2.5	1.2	31.0	29.0	18.1
Moldova	23.1	1.8	7.1	28.7	24.9	14.3
Poland	8.7	3.0	3.3	35.5	34.1	15.4
Romania	11.9	3.5	5.1	33.0	31.3	15.3
Russian Federation	26.7	1.8	0.8	17.7	33.6	19.5
Slovak Republic	8.0	3.4	4.1	36.6	36.3	11.6
Slovenia	8.8	5.2	3.4	34.8	34.8	13.0
Tajikistan	39.5	1.3	0.2	10.8	37.7	10.4
Turkmenistan	17.2	0.6	0.4	28.3	40.3	13.2
Ukraine	17.9	2.5	9.2	23.6	31.7	15.1
Uzbekistan	19.5	0.7	0.2	19.3	46.0	14.3

Source:

EBRD staff calculations based on the "mirror data" of the UN Comtrade database.

countries and their high share in exports from more developed east European countries, such as the Czech Republic, Hungary and Slovenia, and to a lesser extent Poland and the Slovak Republic. The higher share of manufacturing production in capital-intensive goods, such as machinery and transport equipment, in higher-income countries of the region reflects the more extensive accumulation of capital, both plant and equipment and acquired skills, by these countries.

In contrast with exports, the structure of imports is relatively uniform across the region, with the high share of machinery and transport equipment in imports reflecting the shortage of capital assets with a positive market value. Most of the region is also a net importer of food and agricultural products. Because the data do not capture most exports from the CIS, imports of raw materials and fuels by east European, Baltic and resource-poor CIS countries are under-reported. However, more complete data would probably not alter the general observation of variation in export patterns across the region in response to differing factor endowments and a much more uniform composition of imports reflecting the common need to upgrade capital stocks.

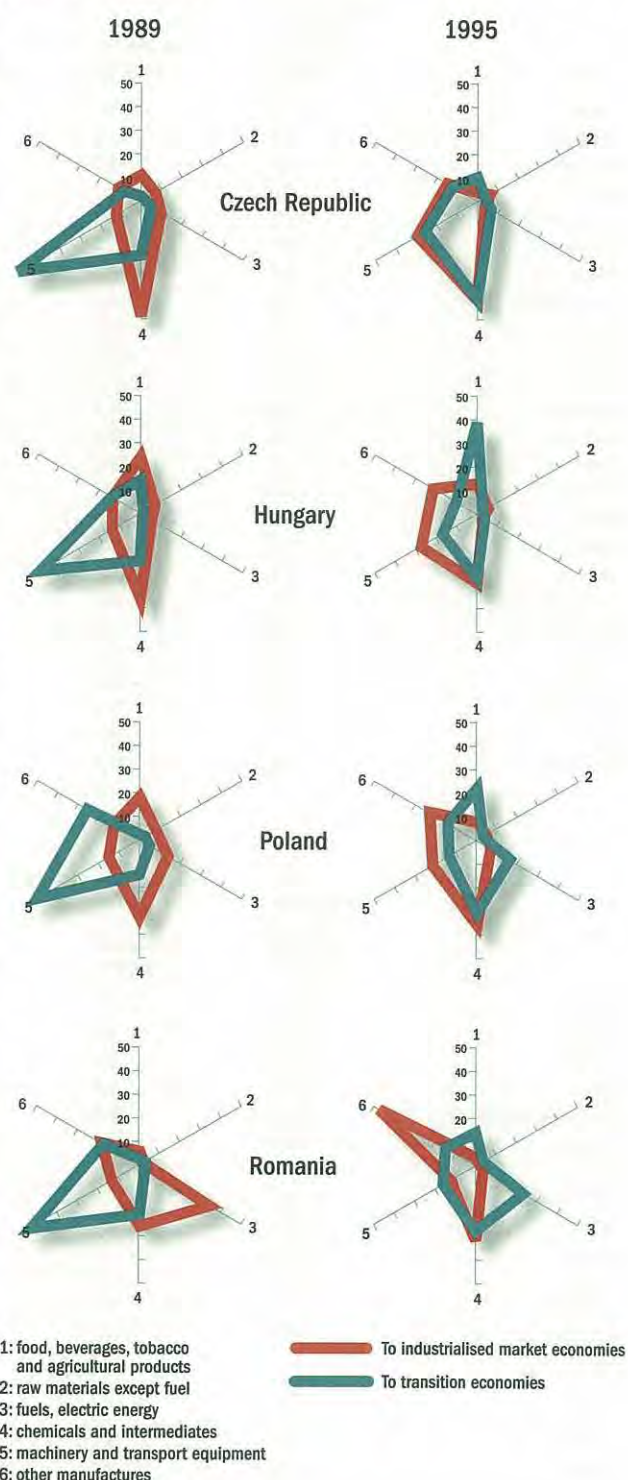
As broad economic structures of transition economies have changed with the introduction of market-oriented reforms, so too has the composition of trade. Chart 4.2 shows the changes in trade for a limited number of countries for which trade data by both product and destination reported by national authorities are available. It compares the structure of exports to industrialised market economies and to other transition economies.

In 1989 exports to industrialised market economies were very different from those to other transition economies. The latter received a substantially higher share of capital goods exports, such as machinery, while those to the industrialised market economies consisted mainly of intermediate goods and agricultural products.¹⁸ By 1995 the type of exports to these two destinations had become far more similar. This was due to two changes. First, liberalisation of trade among former Council of Mutual Economic Assistance (CMEA) members led to a reduction in the export of capital goods to transition economies and an increase in exports that reflected the exporter country's comparative advantage. Second, the type of exports to industrialised market economies changed significantly, particularly as more advanced transition economies increased their exports of machinery and transport equipment.

The narrowing of the difference between export structures and, in particular, the large reduction in the export of capital goods to other transition economies, illustrates the effect of market forces in directing structural change and specialisation in transition economies. Manufactured exports within the Soviet trading bloc were of poor quality and largely uncompetitive in international markets. Typical examples of such past exports are Bulgarian electronic goods, Czech rolling stock, Hungarian buses and Polish

Chart 4.2

The structure of exports to developed market economies and to other transition economies, 1989 and 1995, selected countries



Source:

EBRD staff calculations based on the UN Comtrade database.

Note:

The share of exports of a given SITC category (in per cent) is measured by the distance from the origin. Product categories correspond to the aggregation in Table 4.2.

¹⁸ This dual structure of exports from former socialist economies has been found by others, including Hoekman and Djankov (1996).

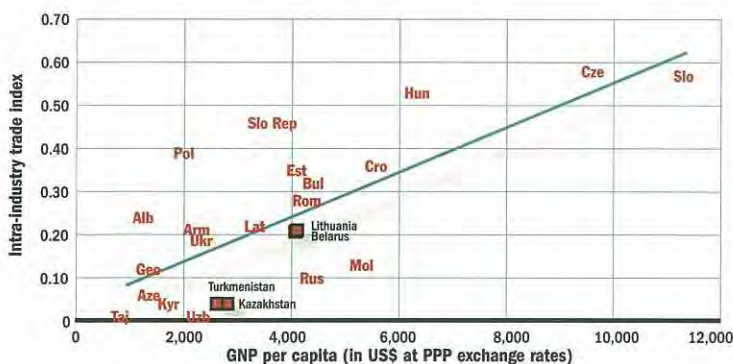
trucks, the production of which has been sharply reduced. However, the gradual increase in the export of capital- and skill-intensive products to industrialised market economies by more advanced transition economies shows how changes to exports are increasingly reflecting these countries' long-term strengths. For example, transport equipment, in particular the assembly of automobiles, is leading the recovery in exports of capital goods, owing in part to substantial foreign direct investment.

Many advanced transition economies have experienced rapid growth in real wages and labour productivity in recent years and, if this trend continues, they are likely to shift increasingly away from labour-intensive sectors.¹⁹ This prospect, however, does not mean that opportunities for trade are being exhausted. Insights from trade theory suggest that countries with relatively similar levels of income per capita tend to have a high proportion of intra-industry trade.²⁰ In addition, some transition economies are attracting substantial foreign direct investment, much of which has been directed at export-oriented manufacturing. These factors suggest that intra-industry trade will gain an increasing share of trade flows between industrialised market economies and those in transition.

Chart 4.3 shows that the proportion of intra-industry trade in the total trade of transition economies with industrialised markets is directly related to their level of income. Moreover, in more advanced transition economies, this proportion has increased significantly in recent years. The largest increases have taken place in countries such as Hungary and Estonia with high levels of

Chart 4.3

Intra-industry trade with developed market economies increases with higher per capita incomes



Sources:

World Bank Atlas 1997; EBRD staff calculations based on the UN Comtrade database.

Notes:

Intra-industry trade is measured by the following formula:

$$1 - \frac{\sum_i |X_i - M_i|}{\sum_i (X_i + M_i)}$$

where: X_i and M_i are a country's exports to and imports from a trading partner in commodity i respectively. An index close to one indicates a large share of intra-industry trade. GNP per capita is calculated at purchasing power parity (PPP) exchange rates. Both GNP per capita and the intra-industry trade index are for 1995.

foreign direct investment. In contrast, intra-industry trade between Russia and industrialised market economies has fallen and is at an extremely low level.

In general, there are two forms of intra-industry trade. Horizontal intra-industry trade exploits preferences for product variety and allows two countries with very similar production structures to benefit from exchanging close substitutes with slightly different attributes. Some German consumers may have a taste for French wine and French cars, while some French consumers may prefer German cars and German beer. Vertical intra-industry trade arises from substantial quality differences among products and from outsourcing of production stages by companies operating internationally. For example, in the assembly of electronic goods, international companies often contract with low-cost manufacturers for those production stages that use low-skilled labour intensively. Intra-industry trade of transition economies with industrialised market economies is largely of the second kind (see Box 4.1).

As suggested by Box 4.1, exports from eastern Europe to the EU are generally of much lower quality than exports from other industrialised market economies and of only marginally better quality than exports from China and India to the EU. This finding highlights the challenge facing transition economies to achieve a level of competitiveness in high-quality and high-price segments of international markets that will enable incomes to rise to EU levels (and ease integration into the EU for those countries invited to join). However, it must be emphasised that quality upgrading is under way in more advanced transition economies. Continuation of this process requires additional investments at the enterprise level not only to replace outdated equipment but also to build skills in marketing and management strategies and to implement financial controls. In other words, enterprise restructuring is central to the emerging patterns of structural change and specialisation in transition economies.

4.3 Structural change, market reforms and enterprise performance

The performance of enterprises is at the heart of structural change and development in market economies. Entrepreneurs use their knowledge and skills to develop economic opportunities and to advance living standards by matching resources to consumers' demands. An important part of this process is the formation of new businesses, to which entrepreneurship makes a vital contribution. Managers in existing enterprises initiate product and process innovations in response to competitive challenges, thereby enhancing their companies' survival and growth. Workers contribute to this process through their effort and skills and through their willingness to adapt. Structural change and new specialisation in production are part of the visible process of economic growth and development. Entrepreneurs, managers and workers are the crucial agents in this process and their actions are shaped by how well markets and enterprises function. However, their activities are concealed below the surface of aggregate statistics.

¹⁹ See Chapter 7.

²⁰ Helpman and Krugman (1985).

Box 4.1

Quality gaps in east European trade with the EU

The quality of exports from eastern Europe is likely to be lower than the quality from industrialised market economies or indeed from middle-income developing countries. The main reason for this is the lack of attention that was paid to product quality under central planning, with the evaluation of enterprise performance almost exclusively in terms of output levels. Other reasons are the lack of customer awareness and of experience in product marketing.

Evidence shows that there are substantial quality gaps between east European and Russian exports and those of market economies (see Landesmann and Burgstaller [1997]). The comparison of unit prices for individual products at the most disaggregated level of trade statistics provides the basis for these findings. At this level, differences in unit prices are likely to result primarily from differences in quality. Based on the price comparisons of east European exports with those from market economies, it is possible to construct an indicator of the average quality gap in a particular industry, using export shares of each product category as weights. The ratio for a particular sector and country is given by:

$$Q^c = \sum (p^c / p^{EU}) s x^c,$$

where p^c is the price per unit at which country c sells exports of the product i on EU markets, p^{EU} is the average price of product i in total exports to the EU and $s x^c$ is the share of product i in country c 's exports to the EU market. The summation is over all i products belonging to industry j .

The table to the right shows the average quality gap for the engineering sector and the textiles, clothing and footwear sector for exports of seven transition countries to the EU in 1988-90 and 1992-94, where the average quality of all such exports to the EU in a given sector takes the value of one. The quality gaps for east European and Russian engineering exports were quite large in the earlier period. However, in the later period, the more advanced east European countries had registered a noticeable improvement to product quality levels more in line with those of middle-income developing countries. In contrast, quality gaps have remained large in Bulgaria, Romania and Russia. The quality gaps in clothing and textiles were smaller in the earlier period than those in engineering, but the general trend of improvement in more advanced transition countries and stagnation further east remains.

Estimation of quality gaps for exports to the European Union, 1988-90, 1992-94, selected sectors and countries

Country	Engineering		Clothing, textiles and footwear	
	1988-90	1992-94	1988-90	1992-94
Bulgaria	0.40	0.24	0.39	0.57
CSFR/Czech Republic	0.41	0.52	0.61	0.79
Hungary	0.38	0.44	0.74	1.03
Poland	0.34	0.42	0.60	0.76
Romania	0.12	0.14	0.53	0.51
Soviet Union/Russia	0.44	0.25	0.40	0.42
Yugoslavia/Slovenia	0.50	0.60	0.89	1.08
China	-	0.35	-	0.60
Greece	0.57	0.51	1.07	1.16
India	0.59	0.45	0.89	0.88
Portugal	0.83	0.90	1.04	1.05
Turkey	0.38	0.48	1.08	1.12

Source:

EBRD staff calculations based on Landesmann and Burgstaller (1997).

Notes:

Quality gaps are calculated as a weighted average of unit prices of exports from each country to the EU, relative to average export prices to the EU, at the lowest level of aggregation (eight-digit combined nomenclature, NACE). Price ratios are then aggregated to the three-digit industry level. The table reports the average quality gap of exports at the three-digit industry level for two particular sectors where the average quality of exports to the EU takes on a value of one.

Market economies share a number of features that enable and indeed require enterprises to exploit their full potential. Product market competition is one such characteristic that promotes both efficiency and innovation. Competition is the primary factor behind the process of market selection and hence the overall performance of the enterprise sector. Aggregate productivity increases when new businesses set up and expand successfully in an industry and when poorly performing enterprises leave the sector. Moreover, market-determined prices reconcile the preferences of consumers with the costs of production. Competitive pressures among existing producers in a market create strong incentives to maintain and improve their market position through efficiency gains and innovation. There are, however, important qualifications to this line of argument. The potential for temporary monopoly rents (profits from market power) is necessary to create an incentive for investments in product and process innovations

and in organisational changes.²¹ Further qualifications arise from market failures related to the provision of public goods, the presence of externalities (such as pollution) and economies of scale in production and the lack of public information. These considerations establish important roles for government in a market economy.²²

An essential public good provided by government in a market economy is the legal and institutional infrastructure for well-functioning markets.²³ For example, laws and their judicial enforcement serve to protect property rights and to implement economic transactions through contracts. Government fosters competition by limiting administrative hurdles for the entry of enterprises, by establishing rules for the exit of those producers no longer able to compete, and by controlling the concentration of market power through an active competition policy. There are also

²¹ These ideas are developed more fully in Chapter 3.

²² Stern and Stiglitz (1997).

²³ North (1990). Additional government activities in market economies include the provision of public goods and a limited range of government services.

a number of important regulatory tasks for government, particularly in the areas of finance, infrastructure and the environment. By establishing a stable and reliable policy and legal environment, government helps to reduce uncertainty, to facilitate economic decision-making and to improve the functioning of markets. Governments also support enterprises by avoiding counterproductive activities, such as arbitrarily favouring some enterprises and discriminating against others. The guiding principles should be a level playing field and an arm's-length relationship between government and all enterprises.

To respond efficiently to profit opportunities provided by well-functioning markets and to react effectively to competitive pressure, however, enterprise managers and workers need appropriate incentives. Private enterprises have systems of corporate governance which help to impart the profit motive of owners to managers as they exercise control over enterprise assets and operations. Apart from owner-managed firms, there is typically a separation between ownership and management. Because individual owners face difficulties in directly monitoring and controlling managers, the latter's incentives must be linked to enterprise performance through the mechanisms of corporate governance. These include managerial reward schemes, boards of directors, proxy contests among management teams and takeovers. Some corporate governance mechanisms also create the potential for new management teams to develop alternative and more valuable uses for enterprise assets.

The transition to a market economy requires progress in reforms in all three areas outlined above: the establishment of competitive markets, the need for government to support effectively markets and enterprises rather than directly provide goods and services, and the development of effective corporate governance mechanisms for private enterprises. International evidence, moreover, reinforces the importance of these market reforms. This evidence supports the view that weak product market competition, misdirected and unpredictable government policies and practices, and inadequate corporate governance mechanisms are detrimental to enterprise performance.²⁴ A central challenge for transition is, therefore, to strengthen the operating environment of enterprises and to harness the knowledge, skills, effort and initiative of entrepreneurs, managers and workers to achieve structural change, new specialisations in production and greater enterprise efficiency.

The remainder of this chapter examines the impact of the market reforms listed above on enterprise performance in transition economies. However, it is necessary first to define what is meant by enterprise performance and to examine how it is measured. Efficiency in production is central to enterprise performance and most performance measures examine the relationship between

input and output quantities. A commonly used performance indicator that captures this relationship is total factor productivity growth, measured as the difference between changes in output produced and changes in the sum of all inputs used, weighted by the respective shares of input payments in total costs. However, in practice there are problems in implementing this measure. Often appropriate data on the quality and price of inputs are missing. Fixed inputs, such as the capital stock, provide a flow of services that are difficult to measure. Alternative measures, such as labour productivity, profitability or asset market valuation, are therefore often used in evaluations of enterprise performance. In the context of transition, it is also useful to include qualitative indicators, such as the reorganisation of production.

4.4 Competition and enterprise performance

In transition economies, the impact of increased competition on enterprise performance can be measured in two ways. The first is to examine adjustments by state-owned enterprises (SOEs) early in the transition in response to price liberalisation, subsidy reductions, greater import competition and organisational changes. In a few countries where a significant new private sector already existed, elimination of legal restrictions on its operation also added some competitive pressures. The second type of analysis focuses on the entry of new private firms, which is becoming an increasingly important aspect of competitive pressures in the region, and an important source of economic growth at the enterprise level.

Competition and restructuring

State-owned and former state-owned enterprises in eastern Europe, the Baltic states and the CIS responded to the abolition of central planning and the liberalisation of prices and trade by undertaking very basic "defensive" restructuring measures. Defensive (or reactive) restructuring is a response to the short-term necessity to cut costs in order to stay in the market and involves such measures as shedding excess labour, containing wage costs and changing the product mix to stop producing unwanted goods and to deliver what customers demand. Enterprise managers often cited market pressure as one of the main reasons for the kind of reactive restructuring described here.²⁵

Several recent investigations highlight the importance of trade to product market competition and to enterprise performance. For example, a study based on a survey of several hundred Russian manufacturing enterprises in the period 1990-94 found a direct relation between measures of import competition (import penetration ratios) and enterprise adjustment indicators, such as labour productivity, change in product lines and total layoffs over the sample period. The study, however, failed to find a positive impact on enterprise performance from domestic product market competi-

²⁴ Nickell (1996) surveys the evidence on the positive relationship between competitive markets and enterprise performance and presents convincing new evidence based on panel data for 147 firms in manufacturing in the United Kingdom. Tybout and Roberts (1996) present a collection of empirical papers on the positive impact of market selection and enterprise turnover on economic growth. Evidence concerning the importance of government behaviour for enterprise performance will be reviewed in the next section. The positive relationship between private ownership, appropriate systems of corporate governance and enterprise performance is the subject of a vast theoretical and empirical literature (See section 6 of this chapter).

²⁵ See for instance Pinto and van Wijnbergen's (1995) survey of managers in 75 Polish SOEs. Heinrich (1995) similarly finds support for the impact of competition on enterprise adjustment in a survey of around 40 SOEs and privatised enterprises each in the Czech Republic and Hungary.

tion, measured by market share and two subjective indicators.²⁶ Another investigation focused on the shift in trade away from other transition economies to international markets as an indication of increased competition faced by Bulgarian enterprises. Trade orientation is found to be positively associated with total factor productivity growth at the enterprise level. In contrast, the share of exports in total sales has no impact on total factor productivity growth.²⁷

The beneficial impact of competition on enterprise performance can also be seen in the way that industrial sectors within a country have undergone different levels of adjustment. In Polish industry, for example, the growth in total factor productivity at the sub-sector level over the 1991-93 period was positively associated with import penetration ratios and negatively associated with sectoral concentration.²⁸ Caution in this interpretation is necessary, however, as competition in contested markets with only very few competitors can still be substantial, and hence competitive pressure might not be adequately measured by industrial concentration.

While available evidence suggests that openness to trade is significantly and positively related to enterprise performance, indicators of openness reveal that, despite significant increases in trade, transition economies remain less open than industrialised market economies. Chart 4.4 shows the levels of import penetration in the region in 1992 and 1995 and compares them with the levels of selected industrialised and developed countries that are roughly similar in size, resource endowments and income. The level of import penetration in most transition economies remains below the typical level in high-income west European economies. Compared with Greece and some developing countries, however, import penetration has already reached similar levels in many transition economies.

The initial high concentration of market structures of many transition economies highlights the importance of import competition as a source of restructuring pressure. Since the start of transition, many large industrial groups have been broken up and the number of enterprises has increased dramatically. The break-up of existing state-owned enterprises and the substantial labour shedding as a result of the recession have led to a smaller average enterprise size in many transition economies. It is hard to gauge, however, whether the resulting process of deconcentration has yet had a positive effect on the performance of the enterprise sector overall.²⁹

Competition and entry

With progress in transition, the entry of new private firms - private firms established *ab initio* - not only provides an increased pressure on state-owned and former state-owned enterprises to change but also furnishes one of the main sources of economic growth. With the abolition of legal barriers to enterprise entry, entrepreneurial activity has flourished in many transition economies, leading to substantial increases in the number of enterprises. By 1995 the Czech Republic and Hungary had reached an enterprise density per 1,000 inhabitants above the European Union average of 43, while Bulgaria, the Slovak Republic and Slovenia were just below that figure.³⁰ A recent study of the size of the *ab initio* private sector in eastern Europe and the CIS found that its share in GDP was highest in Albania, Poland and the Baltic states, and generally higher in eastern Europe than in the countries of the former Soviet Union.³¹ On average, according to these estimates, in 1995 the *ab initio* private sector accounted for 42 per cent of GDP in eastern Europe and the Baltic states against only 23 per cent in the CIS. The sectoral distribution of *ab initio* private firms has also become more diversified. By 1995, 25 per cent of new private firms in the Czech Republic, Poland, the Slovak Republic and Slovenia operated either in manufacturing or construction, representing a shift away from an initial concentration on consumer services.

Poland provides strong direct evidence concerning the contribution of the *ab initio* private sector to aggregate economic performance. In Poland, this sector has been the engine behind the rapid growth of manufacturing since 1992, despite its small size (7 per cent of industrial output) at the start of transition in 1989. Between 1992, when recovery started, and 1995, industrial output in Poland increased by 34 per cent, and the new private sector accounted for approximately two-thirds of this increase.³² In many other countries, the size of the *ab initio* private sector is only now reaching a level where a noticeable contribution to overall economic growth may be expected. In Russia, for instance, employment in new private firms increased from virtually zero to 15 per cent in mid-1996.³³

Together with its initial size, the contribution of the *ab initio* private sector to economic growth also depends on the rate of productivity increases in new private enterprises compared with state-owned or privatised firms. There have been many studies documenting the rapid growth of new private sector firms, and their strong performance compared with state and privatised

²⁶ Earle and Estrin (1997a). As discussed by Nickell (1996), market share may not be an ideal indicator of the degree of competition faced in the product market. The two subjective indicators therefore additionally try to capture the extent of contestability of markets in the Russian sample.

²⁷ Djankov and Hoekman (1996).

²⁸ Falk, Raiser and Brauer (1996). The study uses data for 21 sectors within Polish industry over the period 1991-93.

²⁹ However, at least for the case of the Czech Republic, it has been argued that the large-scale reorganisation of state-owned enterprises through break-ups of large conglomerates had no significant impact on the performance of individual enterprises. See Lizal, Singer and Svejnar (1995).

³⁰ These figures are from a recent comprehensive panel of new private enterprises in eastern Europe and the Baltic states, covering 92,000 recorded enterprises. See Eurostat (1996).

³¹ Johnson, Kaufmann and Shleifer (1997). The study estimates the size of the *ab initio* private sector by subtracting the share of initial private activity from the overall private sector share in GDP and adjusting for the impact of privatisation. While some of these adjustments appear rather ad hoc, the general trend of more private sector dynamism that they describe for eastern Europe would seem to be robust to measurement problems.

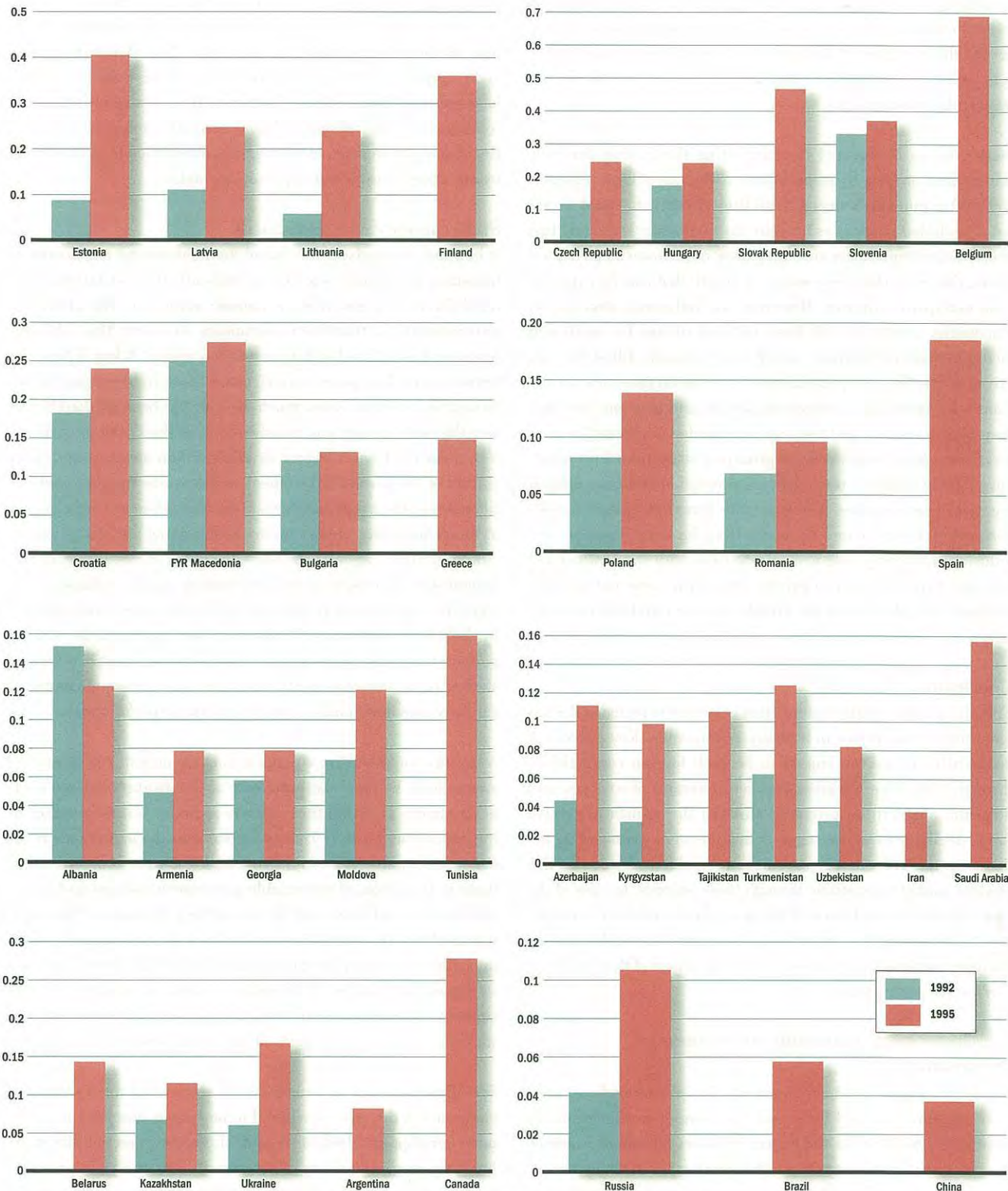
³² Gornulka (1997).

³³ *New Russia Barometer VI* (1996).

Chart 4.4

Import penetration has increased in most transition economies

Ratio of imports to GNP minus net exports



Sources: IMF, World Bank and data provided by national sources.

Note: GNP in US\$ at PPP exchange rates is used to calculate the import penetration ratios.

firms.³⁴ Several factors may explain this strong performance, although actual evidence on their relative importance is still lacking. First, new private firms have good corporate governance arrangements, with private ownership and a small number of owners who are able to monitor the management closely (if they are not the management themselves). Second, they usually represent new combinations of plant and equipment and skills put together by entrepreneurs.

Some caution is required in interpreting the finding that new private firms are very dynamic, however. The rate of turnover (entry and exit) is quite high among small firms, leading to “good firms” being included in samples because they have survived and “bad firms” being omitted because they have not. However, as argued above, this is precisely one source of growth that may be expected from enterprise turnover. Moreover, the industrial structure of communist economies left large unfilled niches for small and medium-sized enterprises, which was naturally filled by new private firms. The entrepreneurs who have started these new private firms have been able to choose the sectors and locations in which they want to operate, and they can be expected to choose the more promising ones. State-owned and privatised enterprises, in contrast, have largely inherited their sectoral orientation and geographical location. Some studies of new private firms have tried to take account of these factors by controlling for size, location and industry when comparing new private firms with state-owned and privatised firms. *Ab initio* private firms still come out as more dynamic, though whether the sample selection problem has been fully addressed in these studies is not clear.

Conclusion

Effective product market competition is central to realising the full potential of enterprises in transition economies. Key sources of competitive pressures appear to be both foreign competition, through trade liberalisation and reorientation of exports, and domestic competition primarily through the growth of private firms. Available evidence suggests that the more advanced transition countries of eastern Europe have been able to foster effective product market competition through these sources. In view of the large potential contribution of the new private sector to economic growth, removing the obstacles to its expansion is a key policy challenge in transition economies, and one aspect of this challenge is reform of government.

4.5 Government behaviour and enterprise performance

The ability of a government to provide the institutional and legal infrastructure required for a well-functioning market economy depends on the financial and human resources it commands and on the capacity of state institutions. The state's capacity to perform its functions is limited and burdened by legacies of legal and other traditions and of established levels of public trust in state institutions. The behaviour of government also depends on leadership and on the incentives of government officials not to misuse public

office for private benefits. Where the probability or level of penalty is low and the culture and tradition of integrity are weak, public officials are more prone to corruption. Moreover, the scope for arbitrary behaviour and hence for “rent-seeking” by public officials increases in line with the level of regulatory distortions and red tape. Reform of government needs to take place alongside market and enterprise reforms, particularly in transition economies which have emerged from systems of paternalistic government-enterprise relationships and of government antipathy towards markets. Enterprise performance in the region is directly affected, therefore, by how much government improves its conduct.

State capacity and investment

It is widely recognised that one of the fundamental challenges in transition economies is to change radically the institutional and legal framework governing economic activities. The ability of governments in transition economies to effect this change, however, has differed widely across the region. A key difference between east European countries and those in the region of the former Soviet Union is how much the state has been affected by the way that state power was transferred from the Communist Party (see Annex 2.1 and Chapter 5). Rather than attempting to gain control of the central government as in eastern Europe, political reformers at the republican level in the Soviet Union sought to gain as much autonomy as possible by undermining the central state's administrative capacity. While successful in breaking up the federal state, a consequence of this strategy was the collapse in the capacity of the state to perform those functions previously fulfilled by the federal authorities. Weakness in the capacity of the state to perform functions essential to a well-functioning market economy, such as protection of property rights and enforcement of contracts, can have profound implications for enterprise performance.

A recent comprehensive attempt to compile an index of subjective assessments by local entrepreneurs of the institutional and legal environment in which they operate includes a large number of transition economies.³⁵ This study confirms the importance in all countries, industrialised and developing market economies and those in transition, of predictable government policies and a reliable institutional framework for enterprise performance. Moreover, it underlines the seriousness of the lack of state capacity as an impediment to enterprise performance in the CIS. These countries as a group rank lowest of all groups in terms of measures of state capacity, reflecting a deep dissatisfaction of local entrepreneurs with several important aspects of the institutional environment.

Specifically, the survey examined five elements of the institutional environment that are considered to be serious obstacles to enterprise development: lack of security of property, unreliability of the judiciary, unpredictability of government laws and policies, instability in government itself, and corruption. Compared with the CIS, the extent of dissatisfaction in eastern Europe and the Baltic states is less on all criteria. The relative disadvantage of the CIS is greatest in respect of unpredictability of policy and level of

³⁴ See, for example, Belka et al. (1995), Johnson and Loveman (1995), Richter and Schaffer (1996) and Bilsen and Konings (1996).

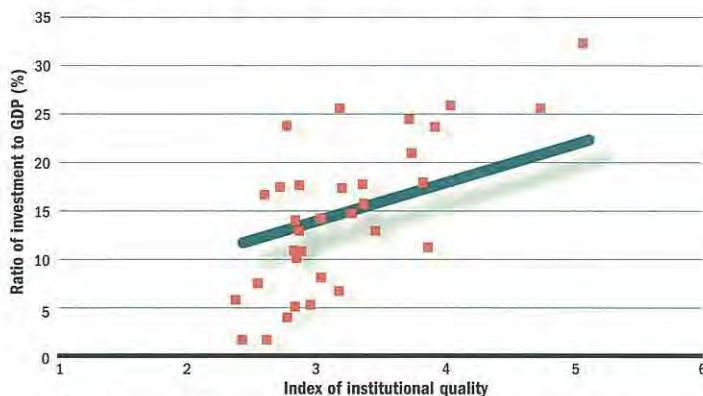
³⁵ World Bank (1997).

corruption. These findings are further substantiated by a recent survey of private shops in Moscow and Warsaw. Russian shop managers felt considerably more vulnerable to legal uncertainty and demands for bribes by public officials than their Polish counterparts did.³⁶

An unpredictable policy environment and an ineffective legal system represent major obstacles to investment and growth. A number of enterprise studies have inquired whether difficulties with implementing an investment project were related more to the cost of regulations or to their arbitrary and haphazard implementation. In a majority of cases, managers have highlighted regulatory uncertainty rather than the cost of regulations as a major impediment to the development of their businesses.³⁷ This point can be graphically illustrated by a partial correlation of an index of the quality of the institutional environment against average investment rates in the sample of countries included in the above-mentioned study (Chart 4.5).³⁸

Chart 4.5

Low institutional quality deters investment



Source:
World Bank (1997), p. 32.

Note:
The chart plots investment rates against an index of institutional quality using data for 33 countries over the 1984-93 period. The solid regression line controls for income per capita, education and policy distortions. The index of institutional quality comprises the following five dimensions: i) predictability of laws and policies, ii) stability of government, iii) security of property rights, iv) reliability of judiciary, v) corruption. The Index of institutional quality was originally called index of political credibility by the World Bank (1997), on which this chart is based.

Government behaviour and the unofficial economy

With implementation of economic reforms, governments in transition economies have begun to create a legal and institutional framework supportive of competitive markets. However, myriad business regulations, arbitrary and incoherent tax regimes, and a prevalence of corruption continue to impose very high costs on existing and, in particular, new private businesses. Governments in many cases do not respect the arm's-length principle in dealing

with the enterprise sector, and privileges extended to state-owned enterprises remain prominent. Where the costs of abiding by the formal laws and regulations are high and where the state's capacity to enforce property rights and contracts is low, enterprises have an incentive to operate in the unofficial economy.³⁹

One way to measure the size of the unofficial economy in transition economies is to compare changes in official GDP with changes in energy consumption (see Box 4.2). Two general results emerge from such an exercise. First, the unofficial economy has increased almost everywhere in the region, pointing to considerable costs imposed on enterprises operating in the formal economy and the limited capacity of the state to provide essential services for well-functioning markets. It is noteworthy, however, that in some countries the estimated share of the unofficial economy in total GDP (including the unofficial economy) has fallen since 1994, notably in the Czech Republic, Estonia, Lithuania, Poland and the Slovak Republic. This may reflect improvements in the operating environment as well as increases in the governments' ability to enforce existing legislation and limit tax evasion. Second, the share of the unofficial economy in GDP is on average higher in the CIS, reflecting at least in part the greater cost of official business due to unpredictable and arbitrary government policies and the lack of state capacity and institutional quality. Given the rather strong assumptions underlying the methodology behind these figures, the observations made here should be viewed as suggestive rather than conclusive, however.

While the estimated share of the unofficial economy in total GDP in many transition countries is substantial, in another important respect the unofficial economy is rather shallow (Box 4.2). A distinctive feature of the informal economy in transition economies is that much of this activity consists of misreported or undeclared economic activities performed by registered enterprises using the same assets that are used to produce output for the formal economy. This part of the unofficial economy is particularly sensitive to changes in relative costs of official and unofficial activities, such as changes in business regulations and taxation, changes in the state's capacity, and changes in the level of bribes required to avoid detection by tax authorities and government regulators.

Survey evidence suggests that the costs for businesses associated with the unofficial economy bear more heavily on new enterprises and the growth of small firms than on activities of the state-owned and former state-owned medium-sized and large enterprises.⁴⁰ Government policies in many transition economies continue to violate the arm's-length principle. The expansion of private businesses without government connections is thereby hindered and the entry of *ab initio* private firms into the official economy discouraged. Chart 4.6 confirms this suggestion by showing that those transition economies with a larger new private sector

³⁶ Frye and Shleifer (1996).

³⁷ World Bank (1997) and Halligan and Teplukhin (1996). See also Chapter 9 of the 1995 *Transition Report*.

³⁸ The World Bank calls this an index of "political credibility". A broader terminology is adopted here to reflect the complementary nature of government policies and the state's capacity in generating an efficient institutional framework.

³⁹ See Borner et al. (1995).

⁴⁰ Kaufmann (1997), Frye and Shleifer (1996) and Johnson, Kaufmann and Shleifer (1997).

Box 4.2

Understanding and measuring the unofficial economy

A recent attempt to measure the unofficial economy across a large number of transition economies was carried out by Kaufmann and Kaliberda (1996). The basic concept was to find a variable that is very closely related with GDP everywhere in the world and to look at the rate of change in this variable compared with the rate of change in official GDP as an indication of the rate of change in the size of the unofficial economy. Kaufmann and Kaliberda suggest that electricity consumption fulfils this role on the basis of international evidence of a rough parallel between demand for electricity consumption and growth in GDP.

Share of the unofficial economy in GDP, 1989-95, selected transition economies

(in per cent)

	1989	1990	1991	1992	1993	1994	1995
Azerbaijan	12.0	21.9	22.7	39.2	51.2	58.0	60.6
Belarus	12.0	15.4	16.6	13.2	11.0	18.9	19.3
Bulgaria	22.8	25.1	23.9	25.0	29.9	29.1	36.2
Czech Republic	6.0	6.7	12.9	16.9	16.9	17.6	11.3
Estonia	12.0	19.9	26.2	25.4	24.1	25.1	11.8
Georgia	12.0	24.9	36.0	52.3	61.0	63.5	62.6
Hungary	27.0	28.0	32.9	30.6	28.5	27.7	29.0
Kazakhstan	12.0	17.0	19.7	24.9	27.2	34.1	34.3
Latvia	12.0	12.8	19.0	34.3	31.0	34.2	35.3
Lithuania	12.0	11.3	21.8	39.2	31.7	28.7	21.6
Moldova	12.0	18.1	27.1	37.3	34.0	39.7	35.7
Poland	15.7	196.0	23.5	19.7	18.5	15.2	12.6
Romania	22.3	13.7	15.7	18.0	16.4	17.4	19.1
Russia	12.0	14.7	23.5	32.8	36.7	40.3	41.6
Slovak Republic	6.0	7.7	15.1	17.6	16.2	14.6	5.8
Ukraine	12.0	16.3	25.6	33.6	38.0	45.7	48.9
Uzbekistan	12.0	11.4	7.8	11.7	10.1	9.5	6.5

Source:

Johnson, Kaufmann and Shleifer (1997).

Notes:

The share of the unofficial economy is defined over total GDP, i.e. correcting official GDP for estimates of the change in the unofficial economy derived from data on electricity consumption. The 1989 data comes from two survey studies conducted in the late 1980s.

There are a number of reasons why this relation between electricity demand and GDP may not hold during transition. Due to price liberalisation, increased energy efficiency and shifts away from energy-intensive sectors, electricity demand may drop during the upswing. At the same time, inefficiencies resulting from higher overheads during capacity under-utilisation, lack of basic maintenance due to shortage of funds, and substitution away from other sources of energy to electricity would tend to push up energy demand. Particularly where recorded output falls have been very large, such as in the CIS, enterprises may be unable to reduce electricity consumption commensurately, even without additional unofficial production. Taking these considerations into account, Kaufmann and Kaliberda adjust the income elasticity of the demand for electricity to 0.9 in all east European countries and to 1.15 in the CIS. The assumption of a unitary elasticity (1.0) is retained for the Baltic states. Note that these assumptions imply a higher estimate of the unofficial economy in eastern Europe and a lower estimate for the CIS than under a simple unitary elasticity scenario.

In order to arrive at the shares of the unofficial economy in GDP for 1990-94, a starting value for the year 1989 is needed. This value is taken from two international studies conducted during the late 1980s and early 1990s. The initial values are particularly high for Hungary, Bulgaria and Romania while very low for the Czech Republic. While level estimates may be distorted by starting points, the rates of change confirm the major message that the unofficial economy has increased considerably more in the CIS than in central and eastern Europe.

The table to the left shows the Kaufmann and Kaliberda estimates of the share of the unofficial economies in GDP for 17 transition economies.

The unofficial economy has also been measured in other ways for individual transition countries. For Hungary, for example, the methodology has relied extensively on household income and expenditure surveys (Arvay and Vertes, 1995). Lifestyle surveys were conducted to derive hidden incomes from a typical consumption pattern. Consumers were also asked to report the number of purchases made without receipts as an indication of undeclared sales. This methodology has found the share of the unofficial economy in Hungary to be around 29 per cent in 1992. This estimate is quite close to that of Kaufmann and Kaliberda.

(i.e. the officially recorded private sector excluding privatised enterprises) as a share of GDP tend to have a smaller unofficial economy as a share of estimated total GDP.

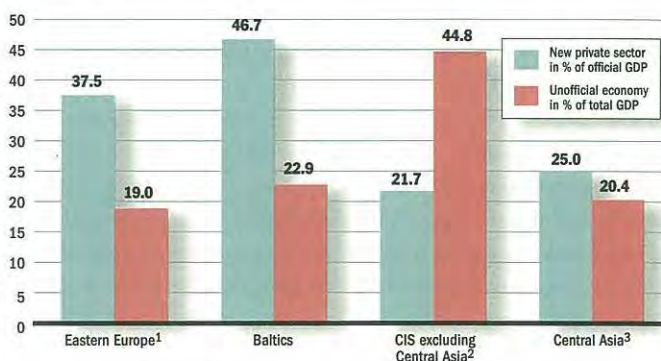
Conclusion

Transition involves a radical reorientation in the relationship between government and enterprises. The role of government shifts from an (in principle) all-powerful coordinator of economic activity to the role of a rule setter and enforcer. Government in most economies also continues to provide basic public services, such as healthcare and education, and to invest in basic infrastructure to complement private investment. As government's regulatory capacity increases, its involvement in the direct provision of these services may also be reduced, opening up new opportunities for government-business partnerships. However, in all its dealings with the private sector, the guiding principle for government must be to maintain an arm's-length relationship with enterprises.

Chart 4.6

Estimated share of the new private sector and the unofficial economy in GDP, 1995

In per cent



Source:

D. Kaufmann et al. (1997).

1 Includes Bulgaria, Czech Republic, Hungary, Poland, Romania and Slovak Republic.

2 Excludes Armenia.

3 Includes Kazakhstan, Uzbekistan.

Government in transition economies has to adapt to this new role against the background of weak state capacity, manifested in a poor ability to enforce contracts, lack of public trust and high levels of corruption. The reliability and quality of the institutional framework is, therefore, low. This and repeated changes to laws and regulations increase uncertainty and depress investment. Moreover, myriad remaining administrative hurdles and policy distortions increase the cost of doing business and lead to the defection of enterprises to the unofficial economy. The development of the new business sector is thereby negatively affected and growth may suffer.

4.6 Privatisation, governance and enterprise performance

While previous sections have focused on factors external to firms and their contribution to enterprise performance and restructuring, this section turns to internal pressures for adjustment resulting from privatisation and corporate governance. The particular focus is on the impact of privatisation and alternative forms of corporate governance on enterprise performance.

Privatisation and enterprise performance

The early transition period was characterised by “defensive” adjustment measures by state-owned and privatised enterprises in response to increased competitive pressures and considerable hardening of budget constraints in most countries of the region. For a sustained improvement in performance, these defensive measures are not enough, however. International evidence from both industrialised and developing market economies suggests that private firms outperform state-owned firms even in competitive industries; the evidence also shows that firm performance improves following privatisation.⁴¹ Comparisons between the performance of state-owned and private firms in transition economies are only now becoming available, but the picture is similar: privatised and new private firms perform better than state-owned firms. Here the discussion focuses on the relationship between privatisation and performance (the new private sector was discussed above).

A useful starting point is a comprehensive study of the impact of privatisation on firm performance using data on over 6,000 enterprises from six east European countries (Bulgaria, the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia) for the period 1992-95.⁴² This study finds that growth in total factor productivity increases substantially after privatisation, by about 5 per cent per year. Various other studies have also shown privatised firms outperforming state-owned firms, or privatised firms improving their performance following privatisation, according to a number of measures of restructuring and performance.⁴³

Studies that seek to identify the effects of privatisation on the performance of firms face a key problem, however. Privatisation is typically not random, and enterprises that are selected for privatisation may simply be better, or potentially better, to begin with. While privatisation can be expected to foster better performance (for the reasons described earlier), it is also possible that better performance (actual or potential) leads to privatisation; when this is the case, the result is a form of sample selection bias. Studies need to establish not simply an association between privatisation and good performance, but that privatisation leads to good performance, and not simply the other way around. This sample selection bias can also exist between alternative forms of privatisation where multiple tracks to private ownership exist.

Management and employee buy-outs in Poland provide a good example of the problem. In this case, the selection bias works in favour of a specific group of owners rather than private versus state ownership in general. Insiders in small and medium-sized firms were given the right to purchase their enterprises from the state (via “liquidation privatisation”) and to borrow from the state to finance the acquisition. Employees were more likely to take up this option if the enterprise was profitable to begin with and, in particular, if it could generate the cash flow needed to service the debt. A survey of 200 Polish manufacturing enterprises found that those privatised to workers were relatively healthy.⁴⁴ However, this result is arguably not because workers are better owners but because workers are more likely to buy profitable enterprises.

A small but growing number of recent studies have tried to address the selection bias problem when analysing the impact of privatisation on firm performance.⁴⁵ These studies have produced the same results as those from the earlier studies and from the analyses of privatisation in market economies: private firms outperform state-owned enterprises across a range of performance and restructuring indicators. Studies of the effects of privatisation on enterprise performance are now turning to how corporate governance is exercised.

Corporate governance and performance

The experience of privatisation has been very diverse across, and within, transition economies, with a wide variety of privatisation methods being employed and a wide variety of ownership structures emerging (see Chapter 5). There have been voucher privatisations directly to the public or via investment privatisation funds, sales or give-aways to insiders (managers and workers) and direct sales to the public, to other firms or to foreign investors. Ownership is sometimes concentrated in a few shareholders, and sometimes it is very diffuse. Moreover, the initial structure of ownership changes following privatisation as share ownership changes hands.

⁴¹ See, for example, Vining and Boardman (1992) and Megginson, Nash and Van Randenborgh (1994).

⁴² Pohl et al. (1997)

⁴³ See, for example, Belka et al. (1995) for Poland, Barberis et al. (1996), Earle and Estrin (1997b) and Filatotchev et al. (1996) for Russia, and Frydman et al. (1997) for a study of the Czech Republic, Hungary and Poland.

⁴⁴ Earle and Estrin (1996).

⁴⁵ Barberis et al. (1996), Earle and Estrin (1997b), Claessens and Djankov (1997) and Frydman et al. (1997) are notable examples.

One of the initial concerns about privatisation programmes resulting in large-scale ownership by insiders was that insiders would prove ineffective owners of larger firms, lacking the incentives to undertake deep restructuring measures which may be painful or expensive in the short term. This is particularly the case in enterprises effectively controlled by workers, where adjustment involves lay-offs of a significant part of the workforce. While the problem might disappear eventually as insiders sell shares to outsiders and firms cease to be insider-owned, this process could be lengthy, especially if the insiders are able to set up obstacles preventing or making it difficult for outsiders to acquire shareholdings and eventually control.

A study of Russian industrial firms in the first years following privatisation presents evidence which suggests that managerial ownership of larger Russian firms is associated with better restructuring and performance, across a wide variety of restructuring measures, compared with both state-owned firms and firms with dominant worker ownership.⁴⁶ Outsider ownership, however, is associated with the most restructuring and the best performance, a finding consistent with the concerns expressed above about insiders delaying restructuring.

As noted above, the need for lay-offs may delay restructuring in worker-controlled firms, but the reasons for management ownership to delay restructuring are less obvious. Indeed, there are competing views as to why privatisation leads to improved performance in firms. Private owners may give the managers of their firms the right incentives to perform (for example bonuses when the firm does well) or the managers may themselves be the owners, claiming the entire residual cash flow. Alternatively, private outside owners may simply choose better managers. Managers of private firms are hired on the basis of their skill at managing the firm, whereas managers of state firms may be hired on other criteria (such as their connections). Managers in insider-dominated firms may similarly benefit from good relations with worker committees or indeed, as a result of a management buy-out, may not be subject to outside monitoring (and hence pressures to leave) at all.⁴⁷

One study of Russian shops following privatisation suggests that privatisation and the introduction of high-powered incentives for managers (such as share ownership) are not enough to cause shops to undertake major restructuring measures (engaging in major renovation, keeping longer hours, changing their suppliers). Instead, what appears to cause major restructuring is managerial turnover, i.e. the introduction of new human capital.⁴⁸ This finding suggests that, to promote enterprise restructuring following privatisation, it is not enough for privatisation programmes to give

management ownership stakes in their firms (and hence high-powered incentives). Programmes should be designed to promote share turnover and to enable new owners to exercise effective corporate governance by being able to replace the existing management (see Chapter 5).

The ability of outside owners to exercise corporate governance increases with the size of their shareholding. It is often argued that some concentration of ownership helps corporate governance. By contrast, diffuse ownership rights spread among many small shareholders will be ineffective. This was a concern of some at the start of the Czech voucher privatisation programme. In the event, investment privatisation funds emerged to take the vouchers which had been distributed to the population, and most individuals ended up investing their vouchers in these funds. The initial ownership structure of privatised Czech firms was already fairly concentrated, and subsequent trading of shares has increased the level of concentration. By 1995, the average listed Czech firm had close to 60 per cent of its shares held by five shareholders, and investment funds accounted for about 50 per cent of all shareholdings.⁴⁹

The natural question is whether increased concentration leads to improved enterprise performance. It has been shown using a sample of 300 listed Czech enterprises that firms with share ownership concentrated in a small number of shareholders, in particular investment funds, tend to have higher operating profits and higher stock market valuations.⁵⁰ Apparently, concentrated ownership leads to better operating performance, and it seems that the market values concentrated ownership. As before, however, care must be taken when interpreting these correlations: it is also possible that investment funds are better informed about firms' prospects and are better at finding good firms in which to invest. The Czech experience suggests also that corporate governance of the financial intermediaries themselves can itself be problematic (see Chapter 5).

Conclusion

The economic reforms introduced at the start of transition throughout most of the region (liberalisation of prices and trade, reduction in subsidies, decentralisation of decision-making to SOE managers) have been successful in generating initial adjustment by SOEs. In the medium term, international evidence and, increasingly, results from the transition economies suggest that private ownership is a crucial factor in improving enterprise performance. In choosing the right privatisation method, policy makers should bear in mind the evidence presented here, which points towards better performance in enterprises owned by a concentrated group of outsiders capable of bringing in new managers.

⁴⁶ Earle and Estrin (1997b).

⁴⁷ Incumbents also have assets that might qualify them for management during the transition. They have developed enterprise-specific human capital, in the form of network capital with other managers, technological knowledge and knowledge about workers' ability, which may all contribute to easing the adjustment at the enterprise level. Whether managerial turnover is decisive for the success of enterprise adjustment ultimately is an empirical matter.

⁴⁸ Barberis et al. (1996).

⁴⁹ Claessens, Djankov and Pohl (1997).

⁵⁰ Claessens et al. (1997).

4.7 Conclusion

This chapter has examined a number of aspects of enterprise performance in transition economies. It started with an analysis of adjustment at the aggregate level, in particular how the composition of output and the use of resources have responded to the introduction of market mechanisms. In general, the analysis found that introducing market forces has advanced the sectoral composition of employment in transition economies closer to market-based benchmarks. The share of industrial employment has declined sharply towards the benchmark, particularly for lower-income transition economies. For upper-income transition economies, considerable further adjustment could be required. The share of agricultural employment has increased towards the market-based benchmark, particularly for lower-income transition economies. The share of market-oriented services has also increased in most transition economies, reflecting the neglect of this sector under central planning. One striking and potentially worrying result, however, is that the proportion of employment in government services (healthcare, education, defence and public administration), those sectors not directly exposed to market forces, has increased well beyond benchmark levels in most transition economies. Nevertheless, the general picture that emerges is that the direction of change is towards those structures that would be expected in market economies with comparable levels of per capita income.

The analysis of foreign trade, moreover, supports the view that the changing composition of output in transition economies reflects the strong influence of market forces. In particular, the composition of trade in 1995, both of exports and imports, was broadly consistent with the comparative advantages of transition economies. The composition of exports varies widely across the region, reflecting differences in endowments of natural resources and in levels of development. Several resource-rich CIS countries export mostly primary products and energy, while most east European and Baltic countries export a variety of manufactured products, with the more developed countries exporting more capital-intensive manufactured goods. Imports throughout the region are dominated by capital-intensive goods, reflecting the need to upgrade the existing, partially obsolete capital stock. In addition, trade structures have become more aligned with comparative advantage, as the composition of trade among transition economies has moved closer to the composition of their trade with the rest of the world. Despite the substantial adjustment effort, however, formidable challenges remain, as shown by the inferior quality of east European exports on west European markets.

While the analysis of structural adjustment illustrates the effects of market forces on the composition of output and the use of resources, it conceals a number of important factors that shape enterprise adjustment and performance. The chapter examined, therefore, the effects of three broad factors on enterprise performance: product market competition; government behaviour and the capacity of the state to perform its functions; and privatisation and corporate governance.

The process of product market competition, of rivalry among producers and of entry and exit by firms into the market, is central to strengthening enterprise performance in transition economies. Available evidence reveals that increased competition from imports in transition economies is often associated with improvements in enterprise performance, such as gains in total factor productivity. There is also substantial evidence that in countries at more advanced stages of transition the entry of new private firms has made a substantial contribution to productivity increases and output growth. Compared with state-owned and privatised enterprises, new private firms register higher output and productivity growth, thereby subjecting existing enterprises to competitive pressures.

Concerning government behaviour and the capacity of the state to perform its functions, this chapter has focused on two issues. The first addresses the impact of limited state capacity and the uncertainty surrounding the formulation and implementation of policy on enterprise performance. Evidence from both market economies and those in transition points to a significant, positive relationship between state capacity and the quality of the institutional environment and investment. The results of a recent international survey of businesses suggest that the transition economies, and CIS countries in particular, have relatively weak states, as reflected in low values for political stability, reliability of state institutions and government policies, and high levels of corruption (see also Annex 2.1). The weakness of the state therefore represents an important obstacle to recovery and growth at least in parts of the region. A second issue concerns the costs imposed on new entrants and existing enterprises by remaining administrative hurdles and policy interventions. One response of businesses to high costs of operation related to government behaviour is to operate in the unofficial economy. This is promoted in countries where the state's capacity is weak, because detection costs faced by firms increase with the strength of state institutions. The evidence from transition economies strongly suggests that private enterprises suffer disproportionately from the costs associated with pervasive government interference and the neglect of the arm's-length principle.

A consistent finding of studies of transition economies is that the sale or transfer of state-owned enterprises into private hands is associated with, and indeed leads to, improved performance, in line with the findings from industrialised and developing market economies. Enterprise performance is also enhanced by effective corporate governance structures, in particular concentrated outside ownership which has both the incentive and means to exercise effective control over enterprise managers.⁵¹

Where this chapter has assembled evidence on how much enterprises have adjusted and on the factors governing enterprise performance, the next chapter addresses a number of policy issues raised by the evidence presented above. In particular, it examines the challenges in radically altering the relationship between governments and enterprises in transition economies, approaches to banking reform, ways of fostering increased product market competition, and implications of privatisation for corporate governance and its evolution in transition economies.

⁵¹ See also the discussion in the 1995 *Transition Report*.

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Enhancing enterprise performance

To improve the performance of enterprises in transition economies, two key aspects of market-oriented reforms are of paramount importance. The first involves altering radically the relationship between government and enterprises and the second requires the establishment of effective mechanisms for privatisation and corporate governance. This chapter examines in depth the past experiences and the future challenges of transition economies in these two areas. The analysis in Chapter 4 of the factors that determine how an enterprise performs in the transition to a market economy underlines the importance of progress in these reform areas. However, this progress varies widely across the region (see Chapter 2). A number of east European and Baltic countries have relatively few problems regarding the relationship between the state and enterprises, but effective institutions of corporate governance have yet to emerge. In contrast, many CIS countries remain severely affected by weaknesses in both areas.

A successful relationship between government and enterprises requires the establishment of predictable, non-arbitrary rules for business activities (such as taxation and business licensing) and the legal enforcement of property rights and contracts. Under the central planning of the previous regime, the state used a variety of measures to suppress private activity. However, in some countries continued bureaucratic interference in business activities and weaknesses in the legal framework have severely diluted the benefits resulting from the removal of prohibitions on private sector activity. In particular, many potential benefits from the development of the new private sector have yet to be realised. Such failures in many CIS countries are well documented¹ and are generally more severe than those in eastern Europe and the Baltic states (see Annex 2.1).

It is crucial to detach enterprises from their dependence on government support and to base their survival on performance in the market place. While many countries have hardened enterprise budget constraints by eliminating budgetary subsidies, this measure has sometimes been compromised by governments' willingness to allow tax and energy tariff arrears or by access to soft loans from banks. Continued government support of enterprises, whatever form it takes, often reflects resistance to the structural change and restructuring that is needed (see Chapter 4). Moreover, if forcing enterprises to rely on their own performance is to lead to enhanced efficiency, enterprises must operate in a competitive environment. Opening the economy to international trade has provided an effective and simple competition policy in many countries. However, active demonopolisation through effective competition policy is sometimes required, particularly in large or relatively closed economies.

Privatisation has launched the private ownership of many medium-sized and large enterprises in transition economies, but the design of privatisation programmes has often compromised the effectiveness of corporate governance in these privatised companies. To improve governance and enterprise performance, it is vital, therefore, to make changes in the initial ownership structures and the arrangements for corporate governance and to impose discipline from outside sources of finance. The budding financial sectors in the region have a central role to play in this process. However, building market-oriented and stable financial sectors has been one of the more challenging aspects of transition.

Government behaviour towards enterprises in transition economies is examined in section one, along with ways of strengthening the role of government. The second section looks at the need for enterprises to move from dependence on government to reliance on the market. While the policies required to implement this shift are widely recognised, this section examines the links between policies, including those aimed at strengthening the role of government, and the effectiveness of the institutions charged with implementing these policies. Particular attention is given to the challenges of financial sector reform and of implementing effective bankruptcy and competition policies. Section three focuses on developing the effectiveness of private institutions, in particular the privatisation and governance of enterprises and the market mechanisms which bring about improvements in corporate governance. The fourth section concludes with an assessment of key challenges ahead in enhancing enterprise performance.

5.1 Government behaviour and enterprise performance

Government behaviour affects enterprise performance and growth in two fundamental ways. The first concerns uncertainty about government policy (such as taxation and tariffs) and unpredictability of actions by the government and judiciary, both of which can lead to the postponement of investment and to short-term horizons for business decisions. The second stems from the state (the government, bureaucracy and judiciary) operating in a highly discretionary manner and thereby generating inefficiencies through the seeking and granting of special privileges and in some cases by stifling entrepreneurship altogether. Both factors inhibit growth because investment in existing enterprises is reduced, entry and growth of new firms is hampered and foreign investment is deterred. Chapters 4 and 6 provide evidence linking the function and behaviour of governments to enterprise performance, including development of the new private sector, and to long-term economic growth. This section examines some of the factors behind the weaknesses in the functioning of the state in transition and ways to strengthen its capacity.

¹ See EBRD (1997).

Weaknesses in the functioning of the state in transition economies

High levels of corruption exist in some of the transition economies. The adverse effect of corruption on enterprise performance and growth depends on the capacity of the state compared with other economic agents (managers, workers and entrepreneurs).² In economies where the state has sufficient capacity, it can protect existing rights at low cost. Corruption in this instance is not necessarily inconsistent with rapid growth. State officials interested in maximising the potential value of bribes have both the power and the incentive to create and protect productive rights. However, in countries where the state lacks the capacity to enforce rights, it becomes uncertain who has particular rights (for example, property rights), which then become highly contested. In this instance, state officials have little interest in the long-term performance of enterprises and are unable to monopolise the protection of rights (with a possible consequence that Mafia-type groups flourish).³

Compared with eastern Europe, the CIS has much higher levels of corruption and of perceived policy instability (see Annex 2.1). This fact and the reasons for corruption suggest that in the CIS the weakness of the state compared with other agents in the economy (such as managers of state-owned enterprises) may be due to the circumstances of the transition in the former Soviet Union.

A key difference between east European countries and those in the region of the former Soviet Union is the way that the transfer of state power from the monopoly of the communist party to new political regimes has affected the capacity of the state. In eastern Europe the opposition movements pursued a transition strategy that focused on gaining control of existing state institutions and on preserving the institutional foundations of state capacity. The political opposition pursued a quite different strategy in the context of the Soviet federal system. Rather than attempting to gain control of the centralised Soviet state, politicians at the republican level pursued a strategy of increasing their political autonomy by undermining the administrative capacity of the Soviet federal state. They did so by offering individual enterprises and organisations in their own republics "as much autonomy from the centre as they could take", to paraphrase a well-known slogan of Boris Yeltsin at the time, with the aim of winning their allegiance in the struggle against the centre. However, a by-product of this transition strategy was the collapse of the capacity of the state to perform the functions previously fulfilled by federal authorities.

The unravelling of the federal system in the Soviet Union has proved difficult to control, especially in Russia, where regional leaders have sought to use the same tactics to weaken the capacity of the Russian federal state. In contrast, the political transition in

the unified states of eastern Europe (with the exception of the Yugoslav federal state) did not entail the same challenge to the capacity of the central state, enabling the key state institutions to continue to function through the transition albeit under different political leadership.

Since the experience of communism and the nature of the political transition lie behind the weakness of the state in CIS countries, a straightforward duplication of the transition path of eastern Europe and the Baltics cannot be predicted for the CIS. This consideration means that listing desirable legal and policy changes is much easier than providing a convincing explanation of how they could be implemented.⁴

Russian tax reform provides an example of the problems of reform in a state with weak capacity (see Chapter 7, Box 7.1).⁵ The existing Russian tax system is deeply problematic because it does not generate enough revenue to finance basic government functions and because it severely distorts business decisions. The rules are ambiguous and contradictory, compliance costs are very high, application of rules is inconsistent and penalties for violation of frequently changing laws are draconian. Many improvements are contained in draft tax codes submitted to the parliament. However, serious obstacles block not only their passage into law but also the establishment of supporting institutions and appropriate incentives for both the private sector and state officials.

An approach to tax reform should recognise that officials will be tempted to engage in corruption and should provide incentives to increase interest in fostering private sector growth.⁶ In this case, the desire to stimulate private investment in new business by keeping tax rates low can be traded off against the need to promote public officials' private interest in the growth of such businesses by establishing them as a source of local tax revenue. The kind of policy that may work (in the context of an overall tax reform) is to allow state-owned and formerly state-owned enterprises to sell property and to levy a property tax, some receipts of which would accrue to local authorities.⁷ Medium-sized and large enterprises typically have excessive land holdings and have an interest in selling them. Such sales would open commercial property to new uses and generate revenue from a property tax, which could strengthen local officials' interest in new business formation.

In addition to altering the incentives of public officials, it is possible to constrain their ability to engage in corrupt practices. For example, cutting back on the state's role where it clearly impedes rather than facilitates the functioning of a market economy (by reducing distortionary trade and foreign exchange controls, arbitrary licensing requirements for new private businesses and

² Khan (1996) and Khan (1997) provide treatments of "rent-seeking" behaviour on which this section draws.

³ Olson (1993) refers to a state as a "stationary bandit" which will be more growth-promoting than an anarchic one characterised by "competing bandits".

⁴ Shleifer (1997) examines the role of political reform and in particular of the importance of local elections in arousing the interest of local politicians in local businesses.

⁵ McDonald and Alexeev (1997) also provide a useful summary of the current system and the proposed reforms.

⁶ Incentive structures are examined by Gordon and Li (1997).

⁷ These issues are discussed in Boycko (1996).

state ownership of enterprises) limits the scope for state officials to intervene arbitrarily in economic activity and for corruption. This reorientation of the state can also help to increase the state's capacity to perform other roles central to a well-functioning market economy. Chart 5.1 shows that in transition economies those countries that have made greater progress in market-oriented reforms tend to have lower levels of corruption, as measured by a survey of regional analysts.

Enterprises can also contribute to the battle against corruption through the adoption of principles, policies and practices designed to deal with this problem. There are important lessons to be learned from experiences of the corporate sector, with case studies being of value in showing what can be done. Indeed, a major international information technology manufacturer operating in Russia has refused all requests for bribes from the start of its operations, making clear that its position is absolute and non-negotiable. Today, its lead product has a large market share. Work in developing case studies of effective business strategies in this area is being supported by the EBRD.⁸

Impediments to developing laws for a market economy

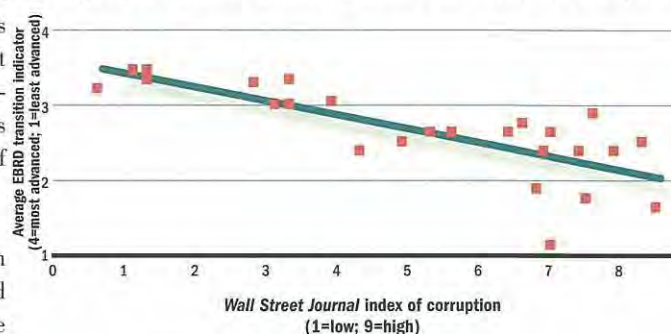
Developing the legal basis for a market economy requires three main ingredients: written laws that have legitimacy among the population; functioning institutions to enforce laws and to generate information needed for their enforcement; and individuals and enterprises with appropriate incentives to demand their implementation. A comparison between Hungary and Russia regarding the way that legal frameworks have developed finds much greater weakness in Russia along these three dimensions (see Chapter 2 for a summary of progress in legal reform in all transition economies).⁹

In Hungary, a new bankruptcy law was introduced in 1992 to facilitate reorganisation and liquidation under the direction of the courts. The law included an automatic trigger which required firms with arrears of more than 90 days to file for reorganisation or liquidation. The fact that thousands of managers did so reflected that they took seriously the penalties attached to failure to file.

Implementation of the Hungarian bankruptcy law overloaded the courts and revealed an inadequate infrastructure to support the processing of cases. In addition, for the law to work properly, creditors needed to be well-informed, as well as an array of accountants, auditors, bank supervisors and trustees to oversee the process and to prevent fraud. While the result was far from the intended outcome, with some debtors and creditors colluding to make use of bankruptcy to privatise assets and socialise liabilities, the episode marked significant progress in developing the rules of the market economy and of the associated law. In addition to the law's enactment, the process of implementation fostered the emergence of professionals, institutions and specialised knowledge

Chart 5.1

Progress in market-oriented reforms and levels of corruption



Source:

EBRD and Wall Street Journal (1995-96).

Note:

Points represent transition economies.

necessary to support a functioning bankruptcy law. This process also pushed forward privatisation of enterprises and thereby the establishment of market-based incentives.

The Russian experience of establishing company law differs in important respects. The task of creating from scratch a legal framework based on private property is enormous. For CIS countries such as Russia, moreover, the need to establish quickly a legal framework to support mass privatisation clashed with the requirement that, for the role of the law in the economy to take root, there must be a process of democratic approval – which can be slow. The priority placed on privatisation meant that company law developed in an ad hoc fashion through various presidential decrees, and at least in the initial stages it lacked the legitimacy gained through parliamentary approval.

While a company law is now in place in Russia, the supporting institutions (well-functioning judiciary) and information (credible financial disclosures) remain largely absent. Moreover, building up a demand for the enforcement and improvement of the law is hampered by insider control of privatised enterprises. Insider control reinforces the importance of personal connections rather than arm's-length business relationships and dampens demand for codified company law.

If Hungary and Russia are typical of eastern Europe and the CIS, the impediments to developing legal frameworks appear more significant in the CIS countries than in those of eastern Europe and the Baltic states. Not only are initial conditions in the CIS less favourable, owing to a lack of historical legal precedents, weaknesses in democratic institutions and fragmentation of the state, but it is also true that current approaches to structural reform, such as heavy reliance on insider privatisation, do not create strong demand for the types of laws required for a well-functioning market economy.

⁸ This work is being carried out by the Kinnerton Research Centre, with the support of the EBRD and the Soros Foundation.

⁹ Chapter 6 of the 1995 *Transition Report* examines the contribution of law to fostering investment. The specific comparison here between the development of legal frameworks in Hungary and Russia is based on Gray and Hendley (1995).

5.2 From dependence on the state to dependence on the market

Both economic analysis and empirical evidence emphasise the importance of competitive markets to enterprise performance. The selection of producers through the process of competitive entry to, and exit from, the market helps to ensure efficient use of assets over time and to spur innovation in the ways of organising businesses and in technologies. Competitive pressures also help to reduce the tendencies of managers to pursue their own interests rather than those of their shareholders, because market discipline leaves limited scope for managerial slack or empire building. Importantly, available evidence also reveals that greater product market competition is associated with higher total factor productivity of enterprises (see Chapter 4 for evidence in transition economies).¹⁰

For markets to become the decisive factor for economic success or failure in transition economies, there must be a dramatic reorientation of enterprises away from their dependence on government to a dependence on markets. This shift requires not only tough tightening of budgetary support for enterprises, but also elimination of off-budget sources of support, such as tax arrears and soft bank loans. Without hard budget constraints, enterprise managers have little incentive to focus on customers and costs. However, the extent of rivalry which emerges among producers facing hard budget constraints depends on a number of factors, including government-created barriers to the entry of domestic and foreign firms, openness to trade and concentration in market structures. Some aspects of inherited industrial structures and relationships can weaken product market competition if left unchecked.

Achieving hard budget constraints

Detaching enterprises from dependence on budgetary subsidies (along with price liberalisation) was one of the least controversial reforms in the transition. Trends in budgetary subsidies as a share of GDP provide a starting point for measuring progress in this aspect of transition.¹¹ Table 5.1 reports available data for most transition economies. In virtually every country, clear downward trends are present. In CIS countries the downward trend began in 1992 or 1993, while in eastern Europe and the Baltic states it began one or two years earlier. Nevertheless, by 1995 there was little variation in the level of subsidies across countries in the region. Indeed, the average level of subsidy in per cent of GDP for CIS countries is on a par with that of east European and Baltic countries.

A narrow focus on budgetary subsidies, however, fails to capture off-budget sources of government support. For example, in Bulgaria, where budgetary subsidies fell from 15 per cent of GDP

in 1989-90 to 1 per cent in 1995-96, off-budget subsidies (such as tax arrears and soft bank loans) remained unchecked for several years (until the recent reform package). Of the east European economies, Bulgaria entered the transition from a particularly difficult starting point, with its greater dependence on trade with and transfers from the former Soviet Union through the CMEA trade arrangements and more severely distorted industrial structure.¹² While slow but apparently steady progress in reform was made in the first half of the 1990s, the economy descended into crisis in 1996 as output collapsed and inflation soared. The roots of this crisis appear to lie in the failure to tackle off-budget sources of softness available to a small number of large loss-making enterprises.¹³

The data on off-budget routes through which subsidies are provided, however, is very incomplete. The remainder of this section examines tax, energy and inter-enterprise arrears, while the following section turns to the issue of soft bank loans.

Table 5.2 presents information on the stock of tax arrears for countries in the region for which data are available over a number of years. For these countries, there is a consistent pattern in which tax arrears rose as budgeted subsidies fell, at least for a while. This observation is in line with enterprise survey evidence that, as enterprises experienced financial distress, they ceased meeting their tax obligations.¹⁴ However, in one country for which data are available (Poland), the rise in the stock of tax arrears (relative to GDP) has peaked and the trend is now downward following increased efforts to collect taxes.

Inter-enterprise arrears are also a potential source of government support. The arrears simply represent claims within the enterprise sector itself. It is therefore only through some form of government intervention that these arrears can become a source of softness. Overdue trade credits have been connected to soft budget constraints in a number of transition countries through two distinct routes, both of which stemmed from misguided government actions.

First, in some cases (such as Romania in 1991 and Russia in 1992), governments have responded to rapid increases in overdue trade credit and associated lobbying by enterprises, with clearing operations. The aim of these operations was to net out, by administrative means and with the injection of credit, the mutual indebtedness of enterprises. Net creditors were paid the value of their receivables net of payables they owed to other enterprises, while net debtors received credit to cover the amount they owed net of the receivables due from other enter-

¹⁰ See Blundell et al. (1994) and Nickell (1996) for evidence from industrialised market economies.

¹¹ The data reported here are for all budgetary subsidies. Until price liberalisation is complete, it is often difficult to distinguish producer from consumer subsidies. Moreover, not all countries report producer and consumer subsidies separately.

¹² Dobrinsky (1997) argues that Bulgaria's degree of integration with the Soviet Union was comparable to that of some of the ex-Soviet republics. Added to this source of disadvantage (relative to other east European economies), Bulgaria was heavily indebted as a sovereign borrower, unlike the former Soviet republics.

¹³ See Claessens and Peters (1997) for an econometric study which provides support for this view. See also Dobrinsky (1997) and Avramov and Sgard (1996).

¹⁴ Schaffer (1995) and Alfandari and Schaffer (1996) report that in Hungary, Poland and Russia tax arrears were concentrated in the weakest firms and were essential for keeping them afloat.

Table 5.1

Budgetary subsidies, 1989-96

(in per cent of GDP)

	1989	1990	1991	1992	1993	1994	1995	1996
Albania ¹	6.6	13.9	17.8	4.3	0.0	0.1	0.0	-
Bulgaria	15.5	14.9	4.2	1.8	2.2	1.4	1.1	0.8
Croatia	-	-	1.7	1.3	1.2	1.6	1.6	-
Czech Republic ²	7.8	-	-	4.9	4.2	3.5	2.4	2.0
FYR Macedonia	-	-	-	-	-	3.4	2.9	2.2
Hungary	-	7.0	5.7	4.0	3.8	4.5	3.8	3.8
Poland	10.2	7.3	5.1	3.2	2.3	3.3	3.0	1.7
Romania	-	7.0	9.1	13.0	6.8	3.8	4.1	4.3
Slovak Republic ²	7.8	-	-	5.3	4.7	4.2	3.7	3.3
Slovenia	-	-	2.8	2.8	2.2	1.6	1.7	0.8
Estonia	-	-	2.8	1.8	1.5	0.9	0.5	-
Latvia	-	-	1.3	0.3	0.0	0.1	0.4	-
Lithuania	-	14.0	5.5	2.1	1.3	1.3	0.9	1.0
Armenia	-	-	-	-	16.7	12.8	0.9	-
Azerbaijan	-	-	-	10.8	3.8	3.8	1.9	2.0
Belarus	-	-	-	9.2	15.0	6.5	3.4	3.7
Georgia ³	-	-	-	-	25.7	12.7	0.2	0.0
Kazakhstan	-	-	-	3.3	2.3	1.7	1.0	-
Moldova	-	-	-	5.2	2.8	2.0	-	-
Russian Federation ⁴	-	-	-	10.4	3.0	1.8	1.3	-
Ukraine	-	-	-	-	11.2	7.0	-	-
Uzbekistan	-	-	-	8.7	6.3	1.6	1.2	-

Sources:

IMF (1996), Halligan et al. (1996), IMF and World Bank.

¹ Budgetary and extrabudgetary subsidies to enterprises.² 1989 refers to the Czech and Slovak Federal Republic.³ 1993 and 1994 include implicit energy subsidies such as for energy imports.⁴ Federal budgetary subsidies and import subsidies to enterprises.

prises.¹⁵ Apart from being inflationary, these clearing operations softened budget constraints, since the credit injected went to net debtors. These schemes also reduced the incentive of enterprises to impose hard budget constraints on each other, since suppliers had less of an interest in ensuring that their customers would pay them.

Second, there are examples of enterprises that do not pay particular bills for extended periods, but which for political reasons continue to be supplied. The most prominent examples are enterprises that do not pay their energy bills. In the latter part of 1996, the stock of energy arrears in Russia exceeded 4 per cent of GDP, while in Latvia they amounted to almost 6 per cent (although the arrears situation there is improving). Other countries, notably Belarus, Lithuania, Moldova and Ukraine, have also been caught in a web of energy-related non-payments. Weak payments discipline and collection efforts by state-owned utilities provide a partial explanation for energy-related arrears. However, policies and practices of governments are also to blame, in particular the failure of governments to pay their own energy bills and the granting of privileges to some strategic energy users which exempt them from full payments.¹⁶ Failure to pay energy bills, of course, shifts the burden elsewhere in the economy.

Table 5.2

Stock of tax arrears, 1990-96

(in per cent of GDP, end of period)

	1990	1991	1992	1993	1994	1995	1996
Bulgaria ¹	4.7	6.7	10.3	10.9	12.2	11.1	13.4
Moldova ²	-	-	-	-	9.6	8.2	10.4
Poland ³	1.1	4.1	4.4	5.3	4.5	3.6	-
Romania ⁴	-	-	0.0	1.5	4.2	4.6	5.1
Russian Federation ⁵	-	-	-	1.7	2.5	3.5	10.0

Sources:

OECD (1996); Agency for Economic Analysis and Forecasting, Sofia; IMF; and Russian European Centre for Economic Policy.

¹ Liabilities of state-owned enterprises to the national budget and social security.² Including tax arrears to the social fund.³ Including arrears on social security contributions.⁴ 1996 refers to June.⁵ The tax arrears figures for 1993-95 exclude those to off-budget funds. The comparable figure for 1996 is 5.7.

¹⁵ The clearing scheme tried in the Czech Republic aimed to net out mutual debts unaccompanied by an injection of bank credit. Probably for this reason, very little mutual inter-enterprise debt was actually cleared in the Czech scheme (OECD 1994).

¹⁶ See Chapter 3 of the 1996 *Transition Report*.

The appropriate policy response to pressures for on- and off-budget subsidies to producers in most cases is, of course, to refuse. However, governments can also take significant steps to reduce the intensity of political pressures for bail-outs emanating from the inevitable financial distress of some enterprises. Perhaps the most important of these measures is to create conditions in which the new private sector can flourish and generate alternative and, in many cases, superior employment opportunities (see Chapter 4). It is either development of the new private sector or the social safety net which reduces resistance to restructuring in the state-enterprise sector; and there are tight fiscal constraints on the latter.¹⁷ The ability of governments to resist pressures for on- and off-budget bail-outs of enterprises can also be reinforced through fiscal policy commitments to international organisations such as the International Monetary Fund.

The removal of all subsidies from declining industries in the short term, however, is not possible because the social costs of closures can be high if a non-viable enterprise or industry is very large and if it is very important for a specific region (as a number are). Nevertheless, it is crucial that the level of subsidy remains highly visible and on-budget. One way to proceed is to transfer ownership of declining enterprises from industrial branch ministries to a finance ministry. As compared with bureaucrats in branch ministries, officials in finance ministries typically do not have close, long-standing connections with enterprise managers but do have a direct interest in the transparency and control of government expenditures. Going beyond reallocation of government responsibilities to establish an arm's-length relationship with non-viable enterprises, the longer-term objective must be to establish a credible commitment to cut industrial capacity within a specific time period. In transition economies with Europe Agreements, the strategic objective of entry to the European Union has influenced the approach of governments to declining industries through a dialogue with the European Commission on state aid.

From passive finance to financial discipline

While passive finance and soft bank loans were inherent features of central planning, a market economy requires financial discipline through application of sound banking principles to function effectively. Achieving this radical re-orientation of finance has been one of the more difficult challenges in the transition, with continuation of directed credits and soft bank loans a major source of cushioning of enterprises from market pressures in the transition (as for example in Bulgaria).

The institutional foundations of financial discipline are weak in transition economies, particularly in early stages of transition but also at more advanced stages. In most countries, state banks and

former state banks remain dominant, while the failure rate among new private banks has been very high. The financial condition of banks has often been impaired both by a stock of loans extended in the pre-reform era, which has been revealed as non-performing in the wake of the economic upheavals of transition, and by a flow of new bad loans due to the failure to apply sound banking principles in post-reform lending. For bank managers to act in ways that raise incrementally the capital value of banks, it is necessary that they have positive capital values. This assumes that the current and/or future compensation of bank managers is related to these capital values, as it should be. In addition, market-based banking skills are often in short supply for both state-owned and private banks.¹⁸ The incentive for managers of enterprises to repay loans is often weak. Mechanisms for bankruptcy (both reorganisation and liquidation) and for execution of collateral function poorly in most countries.

The extent of inherited bad loans and of soft bank lending are evident in the developments in non-performing loans. Table 5.3 reports data on classified bank loans in those transition countries for which data are available. All of these countries show increases in classified loans following the introduction of reform packages, including a reduction in budgetary subsidies to producers. However, some caution is required in interpreting these data. Both the definition of non-performing loans and the scope for discretion in their application can vary substantially, both within a country and across countries. The timing of the initial increase in non-performing loans tends to reflect when prudential standards were tightened more than when the loan losses actually occurred. Indeed, a recorded increase in bad loans often reflects a government's first step in recognising and resolving the problem.¹⁹

A few countries in the region, including Estonia, Hungary, Poland and Slovenia, have managed to achieve sustained reductions in non-performing loans. Also, several CIS countries achieved a significant reduction in non-performing loans in 1996, following the introduction of measures to tighten prudential regulations and to address bank insolvencies. These countries include Armenia, Georgia, Kazakhstan and Kyrgyzstan. Interpreting these trends, however, requires more information about developments in the banking system. For example, the sharp reduction in non-performing loans in Hungary and Slovenia occurred when these loans were transferred to specialised state agencies outside the banking system for resolution.²⁰ There, the extent of financial discipline depends on how these state agencies perform, in particular whether they enforce hard budget constraints on enterprises or whether they become a new source of government accommodation. In the Czech Republic the persistent high level of non-performing loans reflects in part the disadvantageous tax

¹⁷ See Aghlon and Blanchard (1994).

¹⁸ The entry of new private banks has also been inadequately disciplined by licensing and initial capital requirements.

¹⁹ A number of countries have yet to introduce international accounting standards and adequate loan classification and provisioning standards, including Belarus, Tajikistan and Turkmenistan (which are in the early stages of transition) but also Croatia and Russia (where reform started much earlier). Bulgaria introduced adequate loan classification and provisioning standards in 1997.

²⁰ In contrast, the consolidation bank in the Czech Republic is part of the banking system, so the transfers of bad loans to this institution did not result in an immediate reduction in reported non-performing loans.

Table 5.3

Non-performing loans, 1991-96

(In per cent of total loans, end of period)

	1991	1992	1993	1994	1995	1996
Albania	-	-	14	27	-	-
Bulgaria	-	-	7	12	15	16
Czech Republic	2	19	23	38	35	35
Hungary	-	11	29	22	17	13
Poland	16	27	31	29	20	13
Romania	5	5	4	7	12	-
Slovak Republic	-	3	12	30	42	32
Slovenia	-	-	19	15	10	-
Estonia	-	7	7	4	3	2
Latvia	-	-	-	10	19	20
Lithuania	-	-	-	-	-	26
Armenia	-	-	-	32	33	23
Azerbaijan	-	-	-	13	34	-
Belarus	-	-	-	1	10	11
Georgia	-	-	-	24	31	10
Kazakhstan	-	-	-	-	35	18
Kyrgyzstan	-	-	-	62	63	22
Moldova	-	-	-	-	11	13
Russian Federation	-	-	-	-	7	7
Ukraine	-	-	-	5	13	40
Uzbekistan	-	-	-	8	11	-

Sources:

IMF, Central Banks and Borish et al. (1996).

treatment of loan write-offs by banks, giving them an incentive to keep bad loans on their books.

In general, there have been two approaches to resolving effectively the bad loan problem in transition economies: the liquidation of troubled banks and their conditional recapitalisation (see Chapter 10 of the 1995 *Transition Report*). Implementing the first approach is relatively straightforward provided there is a legal framework for suspending licences of banks that fail to meet prudential requirements, including the test of solvency, and for liquidating their assets. However, consideration of the repercussions for other banks of liquidating failed institutions and the political pressures to avoid widespread losses to depositors often constrain the application of this approach. Typically, in transition economies, it is only applied to small, private banks which play minor roles in a banking system and for which there is less political resistance to closure (as in recent cases in Armenia, Georgia, Kazakhstan and Kyrgyzstan). Nevertheless, Estonia and Latvia stand out for having applied this approach to relatively large, private banks and Bulgaria for having recently applied it to large banks, both private and state-owned (albeit after the banking system's near collapse).²¹

The conditional recapitalisation of banks in transition economies is much more difficult to implement successfully than bank liquidations, but this approach has been applied to dominant yet

troubled state banks which emerged from central planning institutions. These banks have tended to be considered too large to fail for the reasons identified above (perceived systemic risks and political pressures). The countries that apparently have implemented this approach with at least partial success include the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia. However, the design of conditional bank recapitalisation schemes is complex, with many potential pitfalls. The challenge is to establish a set of requirements for state banks to meet in order to receive recapitalisation from the government in such a way that this source of government funding does not perpetuate soft budget constraints for enterprises (see Box 5.1).

The unconditional recapitalisation of state banks in transition economies, of course, inevitably perpetuates passive finance and undermines financial discipline. Government bail-outs of state banks without conditions are readily transformed into soft budget constraints for enterprises, because bank managers (anticipating another bail-out) have little incentive to recover on non-performing loans. Recognising this lack of incentive to collect, enterprise managers have little incentive to service their outstanding loans. This unconditional approach to bank recapitalisation was pursued in some countries in their early stages of transition (such as Bulgaria and Romania) with predictable results.

While well-capitalised banks and an approach to insolvent banks that imposes discipline on bank managers and shareholders create incentives for sound banking, bank operations must also be constrained by effective prudential regulations to prevent fraud and other abuses. The scope for abuse arises because of the difficulties that individuals face in evaluating the credit-worthiness of individual institutions and of the trust which depositors must inevitably place in banks. While many countries in the region have made significant progress in enacting prudential banking regulations based on standards in industrialised market economies, the challenge remains in most countries to develop the institutional capacity needed to enforce these rules effectively (see Chapter 10 of the 1995 *Transition Report*).

For banks to become a source of financial discipline, however, they must have both the incentive and the ability to collect on their loans. This ability depends in part on a well-functioning mechanism for bankruptcy of enterprises (both reorganisation and liquidation). However, in most transition economies these mechanisms function poorly. Only a handful of countries at more advanced stages of transition, including the Czech Republic, Hungary and Poland, have bankruptcy procedures operating even at a minimal level.

Table 5.4 reports the number of bankruptcy proceedings initiated and completed in three advanced transition countries. Bankruptcy mechanisms in these countries are still hampered by a number of

²¹ On the Baltic banking crises, see Fleming et al. (1996).

Box 5.1

Conditional bank recapitalisations

The conditions typically applied by governments when recapitalising banks in industrialised market economies are twofold: to dismiss senior management of the failed bank (where poor performance was a key contributing factor to failure) and to write down the value of its shareholders' claims. These sanctions give both bank managers and shareholders incentives for prudence and sound banking. However, these conditions can be effectively applied to many troubled banks in transition economies. The initial post-reform stock of bad loans was typically beyond the control of bank managers, and most banks which have been recapitalised are state-owned. The task of bank recapitalisation in transition economies is further complicated by the absence of accurate information about the true quality of bank loans.

One approach to assessing the extent of loan losses in a troubled banking system is to conduct special portfolio audits, particularly where ongoing prudential supervision is weak. In a number of transition economies, international institutions such as the EBRD and the World Bank have commissioned international auditors to perform in-depth diagnoses of banks' balance sheets, earnings and operating procedures. However, the experience with portfolio audits in eastern Europe reveals that it is difficult to assess accurately the extent of losses in this way. Problems arose in part because accounts of enterprises did not conform to international accounting principles and independent auditing standards. Nevertheless, in Poland, a rough estimate of loan losses from a special portfolio audit provided the basis for the successful recapitalisation of seven state banks.

A possible alternative to special audits is to make bank recapitalisations conditional upon the outcome of bankruptcy (or other specially established) procedures for resolving non-performing loans. The key point here is that bankruptcies, special loan reconciliation procedures

and transfers of non-performing loans to specialised government agencies can serve as alternative ways of establishing the true value of non-performing loans. Whatever method is chosen, the challenge is to provide bank managers with an incentive to pursue recoveries on all non-performing loans or to transfer these loans to a specialised agency (see Aghion, Bolton and Fries [1996]).

Whether banks should be required to resolve their non-performing loans or whether these should be transferred to a specialised government agency remains largely an unresolved issue. The choice between the two approaches rests on a difficult judgement about which type of institution would be more effective in recovering on outstanding loans. An important issue is whether a specialised government agency or state banks are more likely to succumb to pressures from enterprises for special treatment and bail-outs. The experiences of Hungary and Poland, which have pursued bank-based approaches, and of the Czech Republic and Slovenia, which established bank restructuring agencies, suggest that it is possible to implement either approach with at least some effectiveness (on Poland, see Gray and Holle [1997]).

Following recapitalisation of state banks in transition economies, the approaches to creating incentives for prudence and sound banking have centred on commitments to bank privatisation. These commitments serve two purposes. First, they impose commercial objectives and incentives on managers of state banks, which for example can help to motivate recoveries on non-performing loans. Second, implementation of bank privatisation fundamentally changes the circumstances under which any future banking troubles would be resolved. Private shareholders could then be exposed to the risk of losses, and bank managers could then be held accountable for the commercial performance of their institutions. Commitments to bank privatisation were central elements of the recapitalisation programmes in Hungary, Poland and Slovenia, with Hungary having followed through on this commitment to the greatest extent.

difficulties.²² In the Czech Republic, the bankruptcy law is not conducive to financial reorganisations, leading to a predominance of liquidations. Hungary stands out for the sheer scale of its bankruptcy cases, many of which were initiated by an automatic trigger in effect from 1992 to 1993 requiring enterprises in arrears to file for bankruptcy. However, the effectiveness of the process was compromised by banks' weak incentives to monitor the proceedings and the incentives for liquidators to prolong the process. In Poland, bankruptcy legislation has a number of weaknesses in design and implementation, notably low priority given to secured creditors, inadequate provisions for reorganisations and institutional weaknesses in bankruptcy courts. For these reasons, a special out-of-court loan conciliation process was established as part of the bank recapitalisation programme.

Intensifying product market competition

While eliminating soft budget constraints and soft loans from the banking system is a precondition for the functioning of competitive markets, enterprise performance also depends on the intensity of rivalry among producers (see Chapter 4). The extent of product market competition is influenced by a number of factors in transition economies. Entry by new private businesses varies widely across the region. In particular, entry by new domestic firms is sharply curbed in a number of CIS countries by the behaviour of

government. Similarly, entry by foreign producers through direct investment differs enormously, with much investment concentrated in those countries more advanced in transition and macroeconomic stabilisation. There are also tendencies for industries in transition economies to be dominated by relatively few large enterprises and for cooperation among enterprise managers, often through industrial associations formed from former branch ministries.

The main policies used to instil greater product market competition in transition economies (in addition to eliminating government-created barriers to domestic and foreign entry, on- and off-budget subsidies to producers and soft bank lending) are trade liberalisation and competition policy. However, there are significant challenges to implementing both policies.

Liberalisation of trade and foreign exchange payments perform two important roles in transition: enhancing competition in domestic markets and reducing scope for bureaucratic interference in enterprise management. Trade and payments regimes under central planning were characterised by extensive quantitative controls over exports, by state-owned enterprises with sectoral monopolies in foreign trade and by restrictions on access to foreign exchange for trade transactions.²³ Liberalisation of trade and payments in

²² Balcerowicz, Gray and Hashi (1997) provide a recent survey of bankruptcy procedures in the Czech Republic, Hungary and Poland.

²³ Since centrally planned economies tended to be characterised by shortages, most quantitative trade restrictions were applied to exports rather than to imports. Imports were controlled primarily through limited access to foreign exchange.

Table 5.4

Bankruptcies in the Czech Republic, Hungary and Poland, 1990-96

	1990	1991	1992	1993	1994	1995	1996
Czech Republic							
<i>Number of bankruptcies filed</i>	-	-	350	1,098	1,816	2,393	2,990
<i>Number of bankruptcies completed</i>	-	-	5	61	290	482	725
Reorganisations	-	-	0	1	2	2	6
Liquidations	-	-	5	60	288	480	719
Hungary							
<i>Number of bankruptcies filed</i>	-	-	14,060	8,229	5,900	6,461	7,477
Reorganisations	-	-	4,169	987	189	145	80
Liquidations	-	-	9,891	7,242	5,711	6,316	7,397
<i>Number of bankruptcies completed</i>	-	-	1,302	1,650	1,241	2,276	3,007
Reorganisations	-	-	740	510	90	21	9
Liquidations	-	-	562	1,140	1,151	2,255	2,998
Poland							
<i>Number of bankruptcies filed</i>	151	1,327	4,349	5,936	4,825	3,531	3,118
Reorganisations	2	76	688	665	596	465	375
Liquidations	149	1,251	3,661	5,271	4,229	3,066	2,743
<i>Number of bankruptcies completed</i>	29	305	910	1,048	1,030	1,030	984
Reorganisations	1	8	98	179	235	287	173
Liquidations	28	297	812	869	795	743	811

Source:
Balcerowicz et al. (1997).

the region has taken two tracks, with east European and Baltic countries moving relatively rapidly and CIS countries more gradually. The initial steps involved elimination of most quantitative restrictions on trade and abolition of state trading monopolies. In general, east European and Baltic countries adopted these measures at least two years earlier than most CIS countries (see Table 5.5).²⁴ However, a few CIS countries have still not adopted basic reform measures (see Chapter 2).

The difference in timing of trade and payment reforms reflects in part more favourable conditions for liberalisation in eastern Europe and the Baltic states, with these countries benefiting from closer proximity to EU markets, more extensive trade links with industrialised market economies under central planning, and more rapid price liberalisation compared with CIS countries. The central planning legacy of a relatively high degree of industrial specialisation and inter-dependence among CIS countries also makes trade liberalisation more problematic.

While removal of quantitative trade restrictions and state trading monopolies (and state order systems) is the first step in increasing scope for product market competition for tradable goods and services, alternative forms of protection have often emerged in their place. One cushion for producers arose from the widespread under-valuation of exchange rates, as macroeconomic instability

generated a flight from local-currency assets. However, as transition economies gained control over their financial policies, explicit trade protection through tariffs and import surcharges tended to gain in significance. In many east European countries, tariff protection has increased following the initial liberalisation of trade (see Chapter 8 of the 1994 *Transition Report*) and a number of countries have applied import surcharges for balance-of-payments reasons.

The consolidation of trade and payments reforms in transition economies has typically taken place in the context of multilateral negotiations. Again, the east European and Baltic countries have tended to advance more rapidly than those in the CIS. Ten east European and Baltic countries had reached association agreements with the EU by 1995, which established timetables for free trade with the EU within 10 years and prospects of full EU membership. As Table 5.5 reports, eight of these countries have also accepted the Uruguay Round obligations under the GATT and had joined the WTO by the middle of 1997, and eight have accepted the obligation of Article VIII of the IMF Articles of Agreement on current account convertibility.

By the end of 1997 all CIS countries bar one (Tajikistan) will have reached Partnership and Cooperation Agreements with the EU, which call for the mutual granting of most-favoured-nation status,

²⁴ CIS reforms started in earnest only after the break-up of the former Soviet Union in late 1991.

Table 5.5

Trade policy

(Year in which policy benchmarks achieved)

	GATT/WTO membership	IMF Article VIII status	EU Association Agreement	EU Partnership and Coop. Agreements	Substantial removal of trade barriers		
					Quantitative restrictions Imports	Exports	State trading monopoly
Albania	-	-	-	-	1992	1992	1992
Bulgaria	Dec-96	-	Jan-94	-	1991	1991	1991
Croatia	-	May-95	-	-	1991	1991	1991
Czech Republic	Jan-95	Oct-95	Mar-92	-	1991	1991	1991
FYR Macedonia	-	-	-	-	1992	1992	1992
Hungary	Jan-95	Jan-96	Mar-92	-	1989-91	1989-91	1989
Poland	Jul-95	Jun-95	Mar-92	-	1990	1990	1990
Romania	Jan-95	-	Mar-93	-	1992	1992	1990
Slovak Republic	Jan-95	-	Mar-92	-	1991	1991	1991
Slovenia	Jul-95	Sep-95	Jun-95	-	1993	1993	1993
Estonia	Jul-95	Aug-94	Jun-95	-	1992	1992	1992
Latvia	-	Jun-94	Jun-95	-	1992	1993	1992
Lithuania	-	May-94	Jun-95	-	1992	1993	1992
Armenia	-	-	-	Apr-96	1995	1995	1989
Azerbaijan	-	-	-	Apr-96	1995	1995	1994
Belarus	-	-	-	Mar-95	1995	1995	-
Georgia	-	Dec-96	-	Apr-96	1993	1995-96	1993
Kazakhstan	-	Jul-96	-	Jan-95	1995	1995	1994
Kyrgyzstan	-	Mar-95	-	Feb-95	1994	1994	1994
Moldova	-	Jun-95	-	Nov-94	1994	1994-95	1992
Russian Federation	-	Jun-96	-	Jun-94	1992	1994-95	1991
Tajikistan	-	-	-	-	-	-	1995-96
Turkmenistan	-	-	-	Nov-97 ¹	-	-	-
Ukraine	-	May-97	-	Jun-95	1994	1994	1994
Uzbekistan	-	-	-	Jun-96	-	-	-

Sources:

EBRD, IMF, WTO and OECD (1997).

¹ Expected signing date of the Agreement.

the removal of all quantitative trade restrictions and, if progress is made in movement towards market-oriented reforms, establishment of free trade with the EU. While most CIS countries are participating in negotiations over WTO membership, no agreements have been reached. Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia and Ukraine have accepted the obligations of the IMF's Article VIII on current account convertibility.

The pursuit of trade and payments reforms by transition economies through acceptance of multilateral rules and disciplines has the advantage of anchoring these measures in well-established institutions. The commitments related to WTO accession, IMF articles on currency convertibility and EU agreements on regional free trade reduce the likelihood of permanent reversals in trade and payment reforms and add to the transparency and predictability of trade and payment regimes. In particular, these international commitments will help authorities to resist pressures from domestic producers for ad hoc protection, while securing greater access to international markets for exporters.

While trade and payments liberalisation can intensify competitive pressures in some sectors, their impact on competition is limited in scope and intensity by at least two factors. Many services are location-specific (such as retailing and distribution) and trade in

goods is limited by geography and transportation costs. These considerations point to the importance of an effective competition policy to complement liberalisation of trade and foreign exchange payments, particularly in economies that are large in size and geographically remote from major potential trading partners (Russia, Ukraine and some Central Asian republics).

Competition policy establishes a set of rules governing the conduct and transactions of enterprises which are aimed at ensuring rivalry among producers. While the specific rules of competition policy vary from country to country, competition law broadly seeks to control the formation of cartels among producers (so as to prevent the exploitation of market power or the weakening of their competitors), to prevent the abuse of dominant market positions by a single producer and to stop those mergers or acquisitions that create or enhance market power. Enforcement of competition laws is typically vested in an independent yet accountable government agency with the power to stop violations of the law and to impose fines, and with the resources necessary to carry out its responsibilities.

Most countries in eastern Europe, the Baltics and the CIS with competition laws have at least loosely adapted their legislation from that of industrialised market economies, particularly those of the EU. As a result, the laws tend to focus more on preventing and

penalising anti-competitive behaviour and transactions than on changing market structures. This approach relies on the assumption that competitive tendencies are strong and will emerge provided that the law prevents the deliberate suppression of competition.

Significant experience with the application of competition law in transition economies is limited to a handful of countries. The Czech Republic, Hungary, Poland and the Slovak Republic have the most extensive experience in the region, with the number and nature of decisions by these competition offices reported in Table 5.6. A recent assessment of their performance observed that there has been extensive progress in enforcing competition laws in these countries, but cautioned that a majority of cases focused on alleged abuse of dominant market position and that most of these cases involved issues related to price control and vertical relations between enterprises (that is, between firms as both buyers and sellers).²⁵ There appear to be similar tendencies in the implementation of competition policy in Russia and Ukraine, where dominant issues have been implementation of price controls and unfair advertising, respectively.²⁶

The particular circumstances of transition economies, however, call for greater emphasis on implementation of competition policy on cartels (horizontal agreements between firms in the same product market) and abuses of market dominance that restrict entry to, or expansion of, markets. In other words, competition policy should ensure that barriers to entry imposed by incumbent enterprises in an industry are kept to a minimum. This emphasis would contribute directly to changing market structures and concentration, and thereby to reducing the potential to abuse dominant positions and to form and sustain cartels. However, its implementation would require from the competition agencies considerable capacity and independence.

5.3 Privatisation and governance of enterprises

In transition economies, corporate governance issues arise primarily for medium-sized and large privatised enterprises. Small privatised enterprises, small enterprises that were privately owned under central planning and start-up firms are typically not affected by serious governance problems. For these firms, there is usually one owner or a small group of owners who are also engaged in day-to-day management of the firm.²⁷

In industrialised market economies, the running of a medium or large-scale firm is typically delegated by shareholders to management, provided that operating and financial performance is satisfactory. Changes in management tend to occur for two reasons: either because shareholders judge the firm to be performing poorly (for which management is typically held responsible) or because another investor perceives a different, more profitable use for the firm's assets. If the firm is performing poorly, the governance struc-

Table 5.6

Competition policy, 1992-96

(Number and nature of decisions by competition offices) ¹

	Czech Republic ²	Hungary	Poland	Slovak Republic
Abuse of dominant position	109	184	658	111
Violation found	-	40	327	35
No violation found	-	144	331	76
Mergers and acquisitions ³	271	64	349	43
Violation found	-	1	19	16
No violation found	-	63	330	27
Cartels and other agreements	97	29	38	47
Violation found	-	18	17	29
No violation found	-	11	21	18
Total	477	277	1,045	201
Violation found	-	59	363	80
No violation found	-	218	682	121

Sources:

J. Fingleton et al. (1996) and annual reports of competition offices.

¹ Excluding consumer fraud cases.

² The Czech figures on violations exclude 1992 and 1995.

³ Includes mergers allowed subject to certain conditions, but except in the case of the Czech Republic these are very few.

ture should enable owners to press for changes to improve performance, including management turnover. Alternatively, a firm that is performing satisfactorily may be picked out by an investor who can envisage a different use of the firm's resources. The change in use of assets typically comes about through a change in ownership in the capital market.

Transition reveals a large proportion of enterprises to be poorly performing as a consequence both of poor or under-performing managers and of assets combined in ways that are not viable in a market economy. The challenge in transition economies, therefore, is both to establish mechanisms of corporate governance so as to improve managerial performance and to set up methods through which changes in the control of assets can take place. The problem is that these mechanisms have to be set up at a time when the demands on them are heavier than in a well-functioning market economy.

Privatisation of enterprises

Among the many objectives associated with privatisation, two are of particular relevance here. One is disengagement of the state as owner of enterprises, where speed in disengagement is sometimes important. The other is post-privatisation corporate governance and potential for subsequent changes in control. Additional considerations include consistency of privatisation with product market competition and considerations concerning the distribution of wealth. Feasibility is dictated by the balance of power between

²⁵ See Fingleton et al. (1996).

²⁶ See Joskow et al. (1994) and Cornelius (1997).

²⁷ There may be, however, problems with appropriate skills on the part of such owner-managers, which can be reflected in weak responses to new opportunities. The efficient use of assets by small-scale producers would thus be enhanced if entry and therefore competition were promoted and if bankruptcy were enforced.

Table 5.7

Progress and methods of privatisation of medium-sized and large enterprises ¹

	EBRD large-scale privatisation transition indicator score	Sale to outside owners	Voucher privatisation		MEBO ²	Other ³
			Equal access	With significant concessions to insiders		
Albania	2	Primary	-	-	-	-
Bulgaria	3	Primary	Secondary	-	-	-
Croatia	3	-	-	-	Primary	-
Czech Republic	4	Secondary	Primary	-	-	-
FYR Macedonia	3	-	-	-	Primary	-
Hungary	4	Primary	-	-	-	Secondary
Poland	3+	Tertiary	Secondary	-	Primary	-
Romania	3-	Secondary	-	-	Primary	-
Slovak Republic	4	-	Secondary	-	Primary	-
Slovenia	3+	Secondary	-	-	Primary	-
Estonia	4	Primary	-	-	Secondary	-
Latvia	3	Secondary	Primary	-	-	-
Lithuania	3	-	Primary	-	Secondary	-
Armenia	3	-	Primary	Secondary	-	-
Georgia	3+	-	-	Primary	Secondary	-
Kazakhstan	3	Secondary	Primary	-	-	-
Kyrgyzstan	3	-	Primary	-	-	-
Moldova	3	Secondary	-	Primary	-	-
Russian Federation	3+	Secondary	-	Primary	Tertiary	-
Tajikistan	2	-	-	-	Primary	-
Ukraine	2	-	Secondary	-	Primary	-
Uzbekistan	3	-	-	-	Primary	Secondary

Source:
EBRD.

¹ Progress in privatisation of medium-sized and large enterprises is measured by the EBRD's transition indicators. A score of 2 indicates that up to 25% of state-owned enterprise assets have been privatised, a score of 3 that up to 50% of these assets have been privatised, and a score of 4 that more than 50% have been privatised.

A + or - indicates a borderline score. Primary, secondary and tertiary denote the first, second and third most important privatisation methods in a particular country, according to their contribution to privatisation of state-owned enterprise assets.

² Management-employee buy-outs.

³ Includes asset sales through insolvency proceedings and a mass privatisation programme based on preferential credits.

the state, managers and employees, by administrative capability and by electoral politics. The features of privatisation policy implemented in a particular country depend on the weight attached to various objectives and on constraints dictated by feasibility.

Table 5.7 shows the methods of, and progress in, privatisation for most transition economies. For many CIS countries, those in the region of the former Yugoslavia, and Poland, privatisation has primarily benefited insiders either through voucher privatisations with significant concession to insiders or through management-employee buy-outs (MEBOs). Reformers seeking depoliticisation of economic activity (in some cases rapidly), but facing the constraint of de facto or de jure control of enterprises by managers and employees had little choice in privatisation method. Nevertheless, aligning ownership with control rights through insider privatisation provided an opportunity for improvement in efficiency compared with state ownership.

In contrast, a number of east European countries and those in the Baltics benefited from favourable initial conditions because they

were not restricted to insider privatisations by the power of incumbent managers or employees in order to ensure progress. Estonia and Hungary used sales to strategic investors as their primary method and the Czech Republic, Latvia and Lithuania used equal-access voucher methods as their main approach. Equal-access voucher privatisation allocates vouchers to all citizens and does not provide special ownership privileges to enterprise insiders. All of these countries have achieved rapid privatisation of medium-sized and large enterprises.

To the extent that privatisation methods vary within a country, choice of privatisation method for a particular enterprise often reflects whether it is considered to be viable or potentially viable under market conditions. The best enterprises or parts of enterprises have frequently been singled out for sale to strategic investors. This pattern is true of countries with very different primary approaches to privatisation, including Hungary, Poland and the Czech Republic.²⁸ Finding effective owners for good enterprises has the merit of promoting rapid restructuring and signalling success which can elicit investor interest in other firms.

²⁸ The Czech privatisation scheme is often misrepresented as being one of full voucher privatisation. However, just 50% of large-scale privatisation was through vouchers. Available evidence suggests that firms selected for pure voucher privatisation were the weak ones (under-capitalised with weak profits and revenues). See Marcincin and van Wijnbergen (1997).

In contrast, some countries that have undertaken mass sale to insiders as their primary method, such as Russia, have privatised the entire spectrum of enterprises (viable, potentially viable and non-viable) to incumbent management and employees. This lack of differentiation among enterprises is likely to result in some poor managers becoming entrenched in good firms. Not only is the signalling role of successful privatisation and restructuring lost, but the growth of such enterprises will be constrained by the reluctance of poor managers to release control in exchange for access to external finance for investment.

Post-privatisation corporate governance

Privatisation schemes have produced different shareholding structures and approaches to post-privatisation corporate governance, sometimes by design and sometimes through market developments. Six types of dominant shareholders in transition economies can be identified. The sharpest contrast is between (i) strategic investors and (ii) incumbent management and employees. In addition, there are a number of institutional shareholders: (iii) various types of investment fund, (iv) holding companies, (v) banks, and (vi) financial-industrial groups.

Strategic investors

One aim of privatisation is to find an ownership structure in which the owner(s) has the capability to exert control over management and is able to provide access to finance for investment. The problem is that strategic investors with these characteristics are in short supply in transition economies. The two countries that opted for direct sales to strategic investors as their primary method of privatisation, Estonia and Hungary, entered the transition with particularly favourable initial conditions. More than in any other centrally planned economy, Hungarian enterprises were extensively engaged with Western companies by the 1980s and many of these original links formed the basis for subsequent direct sales. Estonia has a small economy, which began the reform period with a very strong, market-oriented government which was prepared to allow extensive foreign ownership. However, even with a small absolute number of enterprises to privatise and with full political support for primacy of direct sales, Estonia was left with some enterprises for which there was no investor interest. Management buy-outs (sometimes at a price of zero) were used to privatise the remaining potentially viable enterprises.

Experience in Hungary illustrates some potential benefits of enterprise control by strategic investors in transition economies. Available evidence reveals that strategic owners of Hungarian firms are more directly involved in management than is the case in the normal operation of a firm in an industrialised market economy.²⁹ New owners have tended to exert direct influence over the running of the firm rather than relying on the formal structures of corporate governance, such as the General Assembly or the Supervisory Board. However, as restructuring takes place and management skills are upgraded (or replaced if necessary), greater delegation by the owner to management and the establishment of a

more “normal” pattern of monitoring through the formal structures of corporate governance can be expected.

The benefits of strategic ownership are clear for transition economies. While sale to strategic investors is not feasible as the primary method of privatisation in most countries, it should be seen as a supplementary method for promising firms which can bring valuable demonstration effects.

Incumbent management and employees

A significant constraint on the design of privatisation programmes in many countries (such as Poland, Russia and the former Yugoslavia) has been the devolution of enterprise control rights to managers and workers under earlier partial reforms to central planning. While privatisation with major concessions to insiders often reflects the constraints imposed by this existing allocation of control rights, the resulting allocation of managers to privatised enterprises tends to preserve the status quo and to limit the scope for selection of new managers. However, in countries using management buy-outs (or management-employee buy-outs) as the main form of insider privatisation, a certain amount of effort by managers is typically required in order to secure ownership. As a result, some selection of managers occurs through the privatisation process. However, in voucher privatisations with concessions to managers and workers, the entrenchment of poor managers becomes more likely.

Two forms of competitive market pressures, however, are likely to influence the performance of insider-controlled enterprises. Faced with new market opportunities, managers can restructure and expand operations to exploit profit potentials. Alternatively, dwindling markets and revenues can force the contraction of operations. If incumbent managers are capable and their enterprises are potentially viable, they will (with the benefit of economic recovery) be able to guide their enterprises over restructuring hurdles, relying in the first instance on internal funds for financing any investments. Where internal funds prove insufficient, a competent manager will normally be willing to sacrifice some measure of control in exchange for access to external finance, and a gradual evolution of ownership structure from insider to outsider can be expected. In this case, potential concerns of managers over loss of control from increased outside ownership are balanced against the prospects of new profit opportunities.

The resistance to, or acceptance of, increased outside ownership by employee-owners is likely to depend on macroeconomic factors, such as the state of the labour market.³⁰ The relationship can be easily explained. If employee-owners are able to cooperate among themselves, they will internalise any cost of unemployment if control shifts to an outsider and restructuring goes ahead. If they cannot coordinate their decisions, an individual employee shareholder will assume that the sale of their stake will have no effect on control and hence on their future employment in the firm. The more depressed the opportunities for alternative employment (and

²⁹ See Török (1995) for details.

³⁰ See Aghion and Blanchard (1996).

the lower unemployment benefits), the greater the incentive of employee-owners to cooperate and the less likely it is that they will sell their shares. However, anonymous trading of shares reduces the chances of employee-owners acting in this way. And in some countries, such as Russia, enterprise managers have sought to control the shares of employees.

It is important to emphasise that, where managers are competent, the evolution of ownership from insiders to outsiders can be expected and has been observed on a small scale. One technique through which this is happening in Russia is via so-called investment tenders. Enterprises receive investment commitments from core investors in exchange for the government's remaining stake in the enterprise.³¹ A number of measures can also nudge insider-owned enterprises towards more outside influence, including the sale of remaining government stakes to outsiders, the enforcement of employee-shareholder protection from management influence and the representation of outsiders on boards.

Hard budget constraints and competitive pressures can severely constrain the prospects of those insider-owned enterprises which have poor managers. In this case, the threat of bankruptcy substitutes for the presence of a value-maximising owner.

Investment funds

While investment funds in industrialised market economies tend to rely on liquidating shareholdings when they are dissatisfied with performance rather than on taking active roles in corporate governance, many investment funds in transition economies behave quite differently – not as portfolio investors but as strategic ones. This observation can be explained by the facts that capital markets in transition economies are relatively illiquid and that most medium-sized and large enterprises have significant corporate governance problems. In some countries in the region, investment funds have participated significantly in corporate governance, although experience varies. A comparison of investment funds in Poland, the Czech Republic and Russia highlights some of the differences.

An integral feature of the voucher privatisation programme in Poland is the priority it placed on creating concentrated outside ownership of enterprises. The objective was to ensure that the investment funds established as part of the programme had both the incentive and the capability to exercise corporate governance over the enterprises in which they had been allocated substantial stakes. Fifteen state-owned investment funds were established as part of the programme, and their management contracts were put out to international tender. Each fund was allocated, by lottery, strategic holdings in 34–35 of the 514 participating enterprises and minority holdings in the rest. Polish citizens were able to buy for a small fee tradable certi-

icates which are exchangeable for shares in the investment funds after their listing on the stock exchange.

Owing in part to its ambitious character in seeking to establish effective control over incumbent managers and employees, the Polish programme was delayed by political opposition for several years (contributing to a deterioration in many participating enterprises). On the positive side, the delay has meant that the Warsaw Stock Exchange is now sufficiently well-developed to enable flotation of shares of the investment funds and of their portfolio enterprises. Despite compromising speed for ensuring effective post-privatisation corporate governance, it is likely that because of its design, the programme will prove a sound method for privatising a large number of enterprises.

In the Czech mass privatisation programme, it was assumed that privately created investment funds would play the useful role of allowing citizens to diversify their portfolios by exchanging voucher points for fund shares. In addition, it was believed that strategic investors would buy up stakes from funds so that effective ownership and control would arise from the operation of an emerging capital market. It was not expected that voucher funds themselves would be effective agents of restructuring.³² Concentration of ownership has in fact followed the two waves of voucher privatisation, and strategic investors have emerged as significant shareholders in voucher privatised firms.³³

The contribution of the Czech funds to capital market development and corporate governance through some “control-oriented” funds has probably exceeded the modest expectations of the scheme's architects. However, some aspects of governance of Czech investment funds raise concerns. These relate in particular to the system of cross-ownership among state-owned banks and investment funds that has developed and that leaves management of these institutions insulated from external control. However, the affiliation of investment funds with banks was instrumental to their marketing and distribution successes, with investment funds attracting over two-thirds of all voucher points. Second, the lack of transparency and disclosure associated with the process by which stakes were concentrated after the privatisation process has deprived minority shareholders of fair value.³⁴

Russian investment funds have played only a very minor role in corporate governance, because privatisation has left insiders firmly in control of enterprises. In the interest of securing insider support for privatisation, initial regulations for the investment funds limited the stake of any one fund to 10 per cent of any enterprise, but a desire to boost the strength of outside owners led to the ceiling being raised to 25 per cent in 1994.³⁵ In contrast to the Czech Republic, where affiliations between banks and investment funds provided the latter with ready distribution channels, the

³¹ See Boycko (1996); however, there are instances of managers seeking to retain control by accepting low tenders from non-threatening investors.

³² This interpretation is supported by Ceška (Deputy Minister for the Administration and Privatisation of National Property) (1996).

³³ For details, see Claessens, Djankov and Pohl (1996).

³⁴ For example, see *Central European Economic Review*, March 1996, pp. 8–11.

³⁵ For details, see Frydman et al. (1996).

Russian investment funds gained less than 10 per cent of the shares of privatised enterprises. Available evidence shows very limited activism by funds in terms of managerial turnover or restructuring behaviour.

Holding companies

Holding companies have emerged as a source of active post-privatisation corporate governance in several transition economies, often through conversion of the legal form of investment funds (the Czech Republic and Lithuania) or of former state trading companies (Poland and the Slovak Republic). There is clear economic rationale for such structures where strong complementarities exist between assets of the constituent parts and where holding structures provide a way to economise on scarce managerial talent.

Two reasons for scepticism about holding companies relate to implications for competition in an industrial sector and to dangers that a holding company will become a vehicle for attracting government subsidies. Particularly in the CIS, a concern is that holding companies can become vehicles for resurrecting or maintaining old patterns of non-market resource allocation in industrial sectors. In the Czech case, a *laissez-faire* attitude by the government allowed investment funds to convert to holding companies for the purpose of evading the more stringent disclosure rules and restrictions on the size of holdings.³⁶

A Lithuanian example highlights the potential merits of a holding company playing the role of a strategic owner. In this country, a holding company provided a way of restoring viability to a group of related enterprises for which former cross-border supply chains had been ruptured. The producers of electronics goods in Lithuania depended heavily on deliveries of supplies from Russian enterprises and most of their output was delivered to Russia.³⁷ Following voucher privatisation in Lithuania, eight large investment funds/holding companies emerged, which tended to concentrate their holdings in particular branches. One of these holding companies dominated the electronics branch and began the task of creating a domestic network of suppliers. Integrated ownership fostered a common strategy for investment and for attracting foreign investment.

Banks

In addition to standard functions of banks in industrialised market economies (financing investment and disciplining enterprise managers through outstanding credits), banks in transition economies are often called on to finance and oversee restructuring. In some industrialised market economies, banks carry out these functions, but only occasionally when a company is in serious difficulties. A small number of German banks have operated in this way. For profitable companies, the supervisory board on which

the bank is represented intervenes little in management. However, if a company is in trouble, banks can become heavily involved in evaluating and replacing management. It is striking that the historical origin of some German banks' holdings of non-financial companies lies in the intervention of the banks when enterprises to which they had made loans were in serious trouble.

Since transition can be viewed as a period when such special circumstances for a market economy of a company in serious difficulties are generalised across the whole economy, more widespread involvement of banks in enterprise restructuring might have been expected. However, expertise in the day-to-day banking functions of evaluating creditworthiness and monitoring loans is very limited in banks in transition economies. In even shorter supply is experience with corporate restructuring and turnarounds. One aim of policy should be to create the incentives for these skills to be acquired. This consideration highlights a potential benefit of delegating to banks the task of renegotiating bad debts with enterprises, as has been done in Poland.

While the evaluation of the Polish bank conciliation programme for enterprise restructuring suggests that the immediate results have been rather disappointing,³⁸ the conclusion to be drawn for other countries is not that this is a poor policy but rather that the scale of the task is enormous. The pay-off from a policy of this kind will come gradually and may not be evident in the early cases.

Financial-industrial groups

The financial-industrial groups (FIGs) established in CIS countries such as Russia and Ukraine share the common characteristic that they are large, multiple-enterprise groupings with activities straddling both industry and finance. In Russia at least two broad types can be distinguished with quite different efficiency characteristics.³⁹

The first type arose from concentrations of private capital originating in trade and finance. These finance-based empires have been built up by new private banks which have bought into industry.⁴⁰ These groups are potentially important sources of challenge to the insider domination of Russian industry and could evolve into effective agents of corporate governance and industrial restructuring. In addition, FIGs can create what is in effect an internal capital market within groups, with the parent company (often a bank or investment fund) allocating capital for investment based on private information about the operating performance of member companies. Depending on the mix of operations within the groups, there can also be the potential for economies of scale and synergies in production.

The second type of FIG was formed from pre-existing structures. One route was the transformation of former branch associations

³⁶ For details, see Canty (1996).

³⁷ See von Hirschhausen and Hui (1995) for details.

³⁸ See Gray and Holle (1996).

³⁹ For a description and analysis of financial-industrial groups, see Starodubrovskaya (1995), Prokop (1995) and Freinkman (1995).

⁴⁰ For an analysis of this type of financial-industrial group, see Freinkman (1995).

into joint-stock companies, which then diversified into finance and trade. Another route was the establishment of regional associations of enterprises through the participation of local authorities and typically including local financial institutions. The most active initiators of such FIGs were the directors of state or former state enterprises, especially in defence industries.

The debates surrounding the presidential decree of 1993 reveal some of the motives for establishing FIGs. Lobbying on behalf of certain enterprises, the State Committee for Industrial Policy and State Committee for the Defence Industry sought to establish a state-driven process of FIG formation through which members would get special privileges, such as tax concessions, guaranteed state orders and protection from anti-monopoly legislation. Opponents of this approach sought to ensure that FIG creation was market-driven and subject to anti-monopoly legislation. The 1993 decree formalised the status of FIGs and granted them privileges, but subjected them to existing monopoly legislation (implementation is weak though because of limited institutional capacity). Their status was further clarified and their promised privileges extended by the November 1995 Law on Financial Industrial Groups.

The 1995 law confers on FIGs a number of privileges.⁴¹ These include: the ability to convert the debt of its members into equity of the parent company; flexibility in the choice of depreciation methods for tax purposes; consolidated taxpayer status; government guarantees for domestic and foreign investors; special treatment of the bank-members of FIGs (lower capital adequacy requirements); and direct government financial support. However, not all provisions of the FIG law are fully effective, owing to conflicts within the tax regime, to lack of implementing legislation or to limited financial resources of the government. There has also been a recent major change in the approach towards FIGs initiated by the government formed in March–April 1997 and aimed at reducing special privileges in the economy.

With the apparent lack of effectiveness of many FIG privileges, the formation of industrial groupings in Russia seems so far to be largely market driven. However, there are at least two pitfalls associated with the remaining potential for government support of FIGs. First, it risks recreating industrial structures which prevailed under central planning (in the form of industrial or regional holdings) and undermining product market competition. In particular, FIG formation (and other industrial groupings) should be disciplined by an effective competition policy. Second, the lack of financial transparency within FIGs impedes their ability to implement internal financial controls and increases the likelihood of connected lending between banks and enterprises within a group. While assessing compliance with bank capital requirements in the absence of financial transparency is virtually impossible, easing capital requirements for banks exposed to pressures for connected lending and, in some cases, to lending concentrated by industrial sector is misdirected.

Evolution of ownership structures and governance

With the possible exception of enterprises sold to strategic investors, the immediate post-privatisation ownership structures and corporate governance arrangements in transition economies are likely to be transitory (see also Chapter 4 of the 1994 *Transition Report*). Moreover, the corporate governance arrangements that ultimately endure are likely to vary widely among countries and even among enterprises within countries. This expectation is based on the observation that a wide variety of corporate governance mechanisms co-exist in industrialised market economies, with no one approach being obviously superior to another.

In view of the diversity of post-privatisation ownership structures, evolution of corporate governance in transition economies cannot be expected to follow a unique path. One path arises from multiple privatisation tracks which lead to differing post-privatisation ownership structures and potentials for change in ownership and control. Poland is perhaps a good example of how to create multiple mechanisms for privatisation. A second path involves the operation of capital markets in which ownership and control rights of enterprises and their assets change hands. The transition economy with the most active market for corporate control is the Czech Republic, with the rapid consolidation of outsider ownership in the so-called “third wave” of privatisation following two distributions of ownership through voucher privatisation. A third path is gradual increase in outside ownership through the provision of outside finance, a process which appears to be taking hold slowly in Russia. Lastly, the threat of bankruptcy arising from the imposition of hard budget constraints and product market competition is in effect a last-resort approach to corporate governance. This mechanism is likely to be important for improving performance where functioning of institutions supportive of effective corporate governance are weak, such as in countries that relied heavily on insider privatisation and that have weak banks and capital markets.

By identifying potential sources of change in ownership and corporate governance, it becomes apparent that corporate governance in transition economies will be shaped by a wide range of factors in addition to how enterprises were initially privatised. Particularly important to this process will be financial sector development. Box 5.2 illustrates some potential interactions among privatisation and capital market development.

⁴¹ See Karlova (1996).

Box 5.2

Privatisation and capital market development

Privatisation methods across the region were rarely influenced in a major way by the objective of developing a modern capital market. The outcome of the varied privatisation policies has been a mixture of approaches to capital market development; some have been government-led and others market-led.

In the Czech Republic and Russia, mass privatisation took place early in the transition, and as a result securities activities started in earnest before there was a comprehensive regulatory and institutional infrastructure. Much of the development of capital markets in these countries has been in response to demands from market participants for improved services and regulation. This is referred to as a market-led approach. In contrast, in countries such as Poland and Romania delays in mass privatisation due to debates related to the scope and form of privatisation have had the consequence that a comprehensive framework for securities activities has been developed well before moving ahead with mass privatisation. Development of the capital market in these cases is referred to as government-led. Other countries have followed paths somewhere between these two approaches, with securities activities and development of the regulatory and institutional infrastructure moving more or less in step.

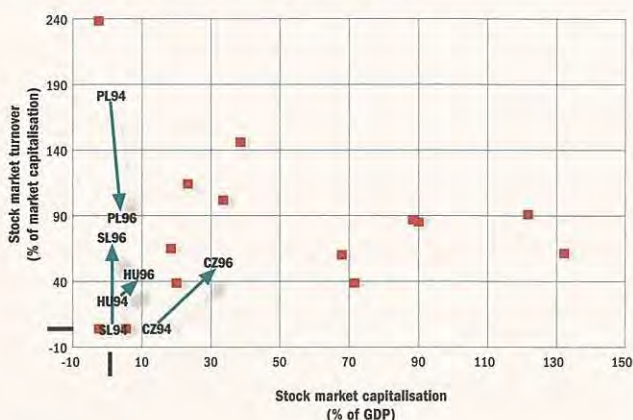
To gauge the impact of the alternative paths on capital market development, it is useful to consider two key indicators of market development. One is total market capitalisation relative to GDP and the other is market turnover relative to market capitalisation. The first is a measure of market size and the second of liquidity. Development of both dimensions is central to a well-functioning capital market.

The chart depicts the different development paths and the process of convergence towards market parameters similar to those of advanced industrialised countries. For example, in 1994 the Czech Republic realised a large stock market capitalisation (relative to other transition economies) through its mass privatisation programme, but only very low rates of market turnover. Essentially, the creation of shares in this case was not disciplined by the process of issuing equities to investors in exchange for cash and, as a result, financial transparency and investor confidence were low, at least initially. In contrast, those countries that developed well-regulated securities markets in advance of mass privatisation achieved initially high rates of market turnover, such as Poland in 1994, but this activity was limited in scope by the small capitalisation of the markets.

By 1996, as indicated on the chart, these paths of capital market development were beginning to converge. Market turnover in the Czech Republic has increased considerably, while market capitalisation in Poland is growing. It received a further, substantial fillip in mid-1997 with the listing of the privatisation investment funds. Those countries pursuing an intermediate approach to capital market development appear to be advancing along a balanced path.

While the various paths of capital market development have their own strengths and weaknesses, it is perhaps most important to identify potential pitfalls. In countries that have pursued a market-led approach,

Indicators of stock market development



Source:

IFC Emerging Markets Factbook 1997.

Note:

Unlabelled points represent selected industrialised and developing market economies (average of 1994 and 1996). CZ94 and CZ96 represent the Czech Republic in 1994 and 1996, HU94 and HU96 represent Hungary, PL94 and PL96 represent Poland and SL94 and SL96 represent Slovenia.

there have been significant problems with both regulation of securities activities and institutional infrastructure.

Largely because of their narrow interpretation of free market principles, the Czech Republic long delayed the creation of an independent regulatory agency for securities markets and institutions. As a result, the Czech stock markets lacked transparency, with most transactions taking place off the exchanges and with no disclosure of trade prices and quantities. This lack of transparency may have contributed to the poor functioning of investment funds associated with the mass privatisation programme. Non-transparent trading appears to have enabled some who managed these funds to engage in hidden transactions that deprived fund shareholders of fair value. In Russia, weaknesses in both the market infrastructure and the legal framework are major impediments to securities activities. However, in 1996 progress was made in the development of a legal framework for protection of shareholders' rights with adoption of laws on joint-stock companies and securities markets and strengthened enforcement powers for the Securities Commission. The capital market infrastructure has also been strengthened with the establishment of independent share registrars and an over-the-counter market, which links brokers in Moscow with those in other cities.

While the shortcomings of a purely market-led approach become apparent through problems within capital markets, the cost of a purely government-led approach is often the absence of some securities activities. For example, establishment of a comprehensive framework for securities activities can delay the issuance and trading of securities and over-regulation by government can suppress economically valuable securities activities.

5.4 Conclusion

Responding to the challenges of enhancing enterprise performance in transition economies will require improving the overall effectiveness of reforms, particularly by exploiting links between them and by strengthening both public and private institutions. Having examined in this chapter the progress in overhauling the relationship between government and enterprises and in strengthening the governance of enterprises, this conclusion identifies key

issues for the period ahead. These focus on altering the behaviour of government towards enterprises, on easing and resisting pressure for continued government support of enterprises, on strengthening competition among enterprises and on improving the effectiveness of privatisation and corporate governance.

As emphasised above and in Chapter 4, a key factor behind the weaker performance of enterprises in the CIS compared with those

in eastern Europe and the Baltic states appears to have been the failure to unlock the potential of the new private sector in the CIS. Constraining this potential is the limited capacity of state institutions in the CIS (reflecting in part the way in which the Soviet federal system unravelled). This constraint is often associated with unpredictable and discretionary actions of government, which are particularly damaging to the new private sector. One way to strengthen the state's capacity and to create a more predictable environment involves incremental policy changes (in tax reform, for example) that have the effect of strengthening the interests of officials in a well-functioning market economy. Another is to limit the ability of state officials to engage in corrupt practices through further market liberalisation and privatisation.

The importance of fostering a buoyant new private sector arises not only from its direct contribution to growth but also from spillovers it creates elsewhere in the enterprise sector. A rapidly growing new private sector facilitates implementation of other necessary reforms, such as hardening enterprise budget constraints, establishing financial discipline and promoting competition. The creation of new employment opportunities by small businesses and entrepreneurs reduces resistance to restructuring state-owned and formerly state-owned enterprises. Pressures for tax and energy arrears and soft bank loans can be mitigated by attractive private sector jobs. Fiscal commitments to international institutions, such as the IMF, can also help in resisting pressures for government support.

Measures aimed at eliminating soft bank lending through liquidation of insolvent banks or their conditional recapitalisation and through effective prudential regulation are inherently difficult and time consuming. The liquidation of banks is constrained by concerns over systemic risks and political pressures to protect depositors, while the recapitalisation of banks by governments risks adding a new financial cushion. Progress in this area has been slow in most countries, and some have yet to begin addressing these issues. Even where progress has been made, the performance of financial institutions themselves remains weak, owing in part to the lack of sound banking and finance skills and adequate capital. International institutions, such as the EBRD, the EU, the IMF and the World Bank, have important roles to play in helping to strengthen the performance of local financial institutions by investing in them, in restructuring some troubled banks and developing regulatory capacities.

To enhance competition in product markets, governments have pursued both liberalisation of trade and foreign exchange payments and development of competition policy. Most transition economies have made significant progress in trade and payments reforms and these are now being anchored by international commitments (with the WTO, the IMF and the EU). However, development of an effective competition policy has been more difficult, even with the adaptation of laws from industrialised market economies (such as those in the EU). Implementation of these measures in order to alter existing market structures and to remove barriers to entry requires well-functioning competition

agencies. While substantial progress in developing this institutional capacity has been made in some more advanced transition economies, significant challenges remain.

Transition economies have pursued a wide variety of privatisation methods, resulting in many different types of ownership structures, reflecting the multiple objectives and constraints on the design of privatisation programmes. These include widespread insider ownership (by managers and employees) and a variety of institutional owners – investment funds, holding companies, banks and financial-industrial groups. Sales directly to strategic investors have been relatively rare. Apart from sales to strategic investors, most forms of privatisation have led to compromises in the effectiveness of post-privatisation corporate governance.

A crucial link exists between the evolution of corporate governance and financial sector development. Instrumental in the improvement of corporate governance will be development of the financial sector to become an effective source of outside finance for investment and a market in which changes in ownership and control can take place. Even if the forms of corporate governance that eventually emerge in transition economies do not rely heavily on the market for corporate control, capital markets will probably play a central role in the evolution of ownership structures and control following many forms of privatisation.

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Prospects for growth in transition economies

6

For an economy's output to grow, either the supply of inputs (primarily capital and labour) must expand or the productivity of these inputs must increase. Therefore, the economic analysis of growth identifies its key elements as investment in physical capital, such as plant and equipment, development of labour skills, and innovations in technology and business organisation. However, it is also important to understand the role of market forces in stimulating innovation, investment in physical capital and the development of skills, in terms of both their quantity and quality. The failure of central planning to yield high and continuing rates of growth despite enormous investment efforts demonstrates the basic importance of market forces for the generation of investment and economic growth. Competition between profit-seeking firms promotes the efficiency of investment and leads to innovation. These factors governing growth are central to the Schumpeterian perspective on growth developed in Chapter 3. In transition economies, it is market-oriented reforms which must create the competitive process which in turn will deliver growth.

Chapters 4 and 5 examine how the newly established market forces operate in transition economies and what measures are required to strengthen their effectiveness. In particular, Chapter 4 demonstrates that the changes in broad economic structures (the balance of economic activities between industry and services, for example) and in patterns of trade specialisation are consistent with the way in which market forces operate in mature market economies. At the level of individual firms, there is also evidence that policies which facilitate or impede enterprise performance have much the same effect as they do in market economies. Chapter 5 examines some of the key policy challenges in improving the functioning of markets and the performance of enterprises in transition economies.

The purpose of this chapter is to carry forward this market-oriented view of the growth process in transition economies and to use it to examine the prospects for growth in the region. Section 6.1 looks at instances of rapid growth and of stagnation in market economies in a way which is useful for assessing growth prospects for transition economies. As might be expected, both investment booms and large gains in productivity are characteristic of periods of rapid growth. Perhaps less obvious is the important contribution made by the more efficient use of existing resources and technologies in some countries, such as in post-war Japan. Moreover, the failure of some countries to grow rapidly can often be attributed to resistance to structural change and restructuring, as the experiences of India and Britain for much of the period since the Second World War illustrate. In countries where extensive investment in machinery and equipment and development of labour skills have been wasted through a distorted economic structure, such as in the transition

economies, structural change and restructuring can produce considerable productivity gains and growth over the medium term.

Section 6.2 draws some key lessons for transition economies from historical episodes in market economies of catching up with and falling behind the advanced countries of that period and in so doing identifies the importance of structural change and restructuring for medium-term growth in transition economies. It also suggests that the post-war recovery in western Europe and Japan provides a conservative estimate of the magnitude and duration of this source of productivity gains and growth that might be achieved in transition economies.

The assessment of long-term growth prospects in transition economies is the focus of Section 6.3, where the emphasis is on investment and innovation. This analysis takes a long-term perspective of 20 to 30 years after the initial period of structural change and restructuring. It also focuses on quantifiable factors governing growth to try to predict how growth will develop. As Chapter 3 emphasises, an important potential source of growth in transition economies is the high level of skills acquired through the priority placed on education under the central planning of the previous regime. Through its ability to adapt and to innovate, a skilled population can play a particularly important role in helping transition economies catch up with technologically more advanced economies. It is the combination of high levels of skills and wide technological deficits which creates the potential for strong medium- and long-term growth in transition economies (with broad estimates for most countries in the range of 4 per cent to 7 per cent per annum). However, this analysis also reveals that the low quality of institutions which support the functioning of a market economy is a key constraint on growth in the long term. Unless there are further advances in the building and reform of institutions, growth in transition economies could fall well below its potential. Yet institutional change is by its very nature a slow and gradual process and, for this reason, it must be a priority if strong and sustainable growth is to be achieved. Furthermore, it must be nurtured carefully if it is to take a form which is genuinely beneficial for strong growth from which the whole community benefits and if the dangers of special privileges and vested interests in slowing and skewing growth are to be avoided.

6.1 Growth in market economies: catching up and falling behind

The distorted allocation of skills and resources, a lack of infrastructure and institutions, and the absence of markets are not entirely new phenomena. The sheer scale of the necessary reorganisation in transition economies may be unprecedented, but the phenomenon itself is not. To "catch up" with the most advanced market economies after the Second World War, western Europe and

Japan had to repair wartime destruction and shift whole economies from military to civil production. In East Asia, large structural shifts in employment took place during industrialisation.

This section investigates the lessons that can be drawn from these past experiences of successful catching-up. It also considers examples of countries which have stagnated, such as India and post-war Britain. A primary cause of their falling behind has been the resistance to necessary structural change and restructuring. To analyse these examples of sustained, rapid growth and of stagnation, a wide range of qualitative and statistical evidence has been drawn upon.

Cross-country overview of growth

Tables 6.1 and 6.2 provide a cross-country overview of the growth performance of many industrialised and developing market economies over the past century or so. These tables reveal that episodes of rapid economic growth, taken as sustained annual rates of growth in GDP per capita above 3 per cent, are relatively rare. In general, these episodes are associated with growth phases in which relatively under-developed countries have caught up with the more advanced economies of the time, including recovery from major dislocation and in particular from the destruction of war. This process typically involves modernisation of relatively backward economies through high rates of investment and significant improvements in productivity. In the absence of “catch-up” growth, real GDP per capita is historically unlikely to exhibit sustained growth of more than about 2.5 per cent per year. Episodes of rapid growth since the late nineteenth century are confined primarily to western Europe and Japan after the Second World War and to East Asian economies in

Table 6.1

Long-run growth rates of real GDP per capita in industrialised market economies

(in average annual per cent)

	1870-1913	1913-50	1950-73	1973-92
Australia	0.9	0.7	2.4	1.4
Austria	1.5	0.2	4.9	2.2
Belgium	1.0	0.7	3.5	1.9
Canada	2.2	1.4	2.9	1.5
Denmark	1.6	1.6	3.1	1.6
Finland	1.4	1.9	4.3	1.6
France	1.5	1.1	4.0	1.7
Germany	1.6	0.3	5.0	2.1
Ireland	1.0	0.7	3.1	2.7
Italy	1.3	0.8	5.0	2.4
Japan	1.4	0.9	8.0	3.0
Netherlands	0.9	1.1	3.4	1.4
New Zealand	1.2	1.3	1.7	0.5
Norway	1.3	2.1	3.2	2.9
Portugal	0.5	1.2	5.7	2.1
Spain	1.2	0.2	5.8	1.9
Sweden	1.5	2.1	3.1	1.2
Switzerland	1.5	2.1	3.1	0.8
UK	1.0	0.8	2.5	1.4
USA	1.8	1.6	2.4	1.4

Source:
Maddison (1995).

Table 6.2

Long-run growth rates of real GDP per capita in developing economies

(in average annual per cent)

	1950-73	1973-92
Africa		
Cote d'Ivoire	3.1	-2.2
Egypt	2.7	3.8
Ethiopia	1.7	-1.7
Ghana	0.2	-1.2
Kenya	1.9	0.6
Morocco	0.1	1.8
Nigeria	3.2	0.1
South Africa	2.4	-0.6
Tanzania	1.9	-0.5
Zaire	0.8	-3.9
Asia		
Bangladesh	-0.6	2.2
Burma	1.8	1.3
China	2.9	5.2
Hong Kong	5.5	5.4
India	1.6	2.4
Indonesia	2.5	3.1
Pakistan	1.8	2.7
Philippines	1.8	0.7
Singapore	4.3	5.9
South Korea	5.2	6.9
Taiwan	6.2	6.2
Thailand	3.2	5.3
Latin America		
Argentina	2.1	-0.2
Brazil	3.8	0.9
Chile	1.2	1.9
Colombia	2.3	1.9
Mexico	3.1	1.1
Peru	2.5	-1.7
Venezuela	1.6	-0.8

Sources:
Maddison (1995) and World Bank (1995).

the recent past. More generally, however, it should be recognised that in many countries opportunities for rapid growth remain unexploited or initial successes are not sustained (see the experiences of Brazil, Cote d'Ivoire, Mexico and Nigeria shown in Table 6.2).

The episodes of rapid growth in western Europe and Japan in the 1950s and 1960s and in East Asia more recently involved not only moving towards the levels of plant and equipment per worker of the leading economies (such as the United States) but also narrowing the gap with those countries in terms of efficiency and technology.¹ At the start of rapid growth in western Europe and Japan and in East Asia, levels of physical capital per worker were low and returns to investment were high. As the investment returns diminished only gradually, the sustained high rates of investment in these periods of rapid growth had a large impact on the growth of both capital stocks and output. The reconstruction and reorganisation of west European economies and Japan after the economic upheaval of the inter-war and wartime years also provided a significant opportunity for rapid improvement in productivity.

¹ See Milbourne (1995).

Components of growth

To understand how rapid growth comes about, it is first necessary to identify and to measure the components of growth. Put simply, growth involves the expansion of aggregate production. Firms generate production through their use of inputs, such as unskilled and skilled labour and plant and equipment, and their application of technologies and organisational methods. Growth, therefore, must come about either through increases in the use of inputs (for example, by investments in plant and equipment) or through improvements in technologies and organisation. In the long run, the latter will be crucial to prevent diminishing returns halting the growth process (see Chapter 3). At the aggregate level of an entire economy, a technique called growth accounting provides a way of presenting data which may, under certain strong assumptions, be interpreted as a breakdown of the sources of growth into various components: population growth, acquisition of skills, investment in plant and equipment, and improvements in technologies and business organisation (see Box 6.1).

Growth-accounting exercises suggest that periods of sustained, rapid growth typically result from high investment combined with strong total factor productivity growth. Table 6.3 reports that during both the "Golden Age" (post-war period) in western Europe and Japan and the "East Asian Miracle" there were strong contributions to growth from both capital accumulation and productivity gains. In fact, both periods witnessed investment booms, with the share of investment expenditure in total GDP exceeding 22 per cent in periods of rapid growth in these countries. Strong total factor productivity growth, which is explored further below, suggests that something was contributing to growth over and above the investment in plant and equipment and skills with given technology and organisation. In these cases, there were improvements in the use of resources (associated with, in particular, changes in the structure of employment, shifts to higher levels of effort and well-functioning processes for entry and exit of firms) together with gains from economies of scale (where relevant) and from innovations based on the successful assimilation and adaptation of foreign technology.

Table 6.3 reveals one important difference, however, between catching-up in East Asia and in western Europe and Japan: the differing contributions made by growth in labour inputs. The much more substantial contribution of labour to growth in East Asian economies arises from two sources: improvements in the quality of labour as a result of better education and training and increases in labour force participation which, unlike in western Europe, have not been offset by a decline in the number of hours worked per person employed.² Overall, it would appear that the fast growth in East Asia was generated much more by the accumulation of capital and expansion of labour than by growth in total factor productivity.

Notwithstanding the importance of increases in capital investment and labour inputs to the recent East Asian growth episode, the growth-accounting estimates reported in Table 6.3 also underline

Box 6.1

Growth accounting

Growth accounting is a technique which seeks to identify the components of growth and to provide a way of describing how (rather than why) growth happens. Contributions to growth are divided into those resulting from extra inputs and those stemming from improvements in the technology which transform inputs into outputs. The latter concept is known as total factor productivity (TFP) growth and measures increases in output after an allowance has been made for any increases in the quantity of each of the factors used in production. Total factor productivity growth is a comprehensive measure of productivity gains which takes into account the change in output allowing for the use of both capital and labour (or other inputs where relevant). The more familiar concept of labour productivity growth is simply the change in output per unit of labour. In growth accounting, inputs are weighted according to their importance in production and, at the level of an entire economy, an approximation (which may be precise when markets are perfect) can be obtained by weighting factors according to their shares in national income (see Oulton and Young [1996]). In measuring the growth of inputs, it is also desirable to include changes in quality as well as quantity. For labour this implies taking account of the education and skills of the labour force.

Growth accounting typically relies on the following identity:

$$\Delta Y/Y = \alpha \Delta K/K + \beta \Delta L/L + \Delta A/A,$$

where $\Delta Y/Y$, $\Delta K/K$, and $\Delta L/L$ are the percentage growth rates of output, capital and labour, respectively, and α and β are the shares of profits and of wages in national income, respectively. It is an identity because $\Delta A/A$ is defined as the growth in output not accounted for by increases in the factors of production, capital and labour. This term is the "residual" after calculating all the other components of the equation. By definition, this residual represents the contribution of TFP growth. This type of analysis was pioneered by Denison (1967).

Measurement issues are fundamental to the application of growth accounting. The technique is best regarded as a useful way of examining the data and not as a model of the growth process. Several points should be kept in mind when considering results from growth-accounting exercises. First, estimates of the growth of input factors and their share in national income are often difficult to form, leaving the residual of total factor productivity growth vulnerable to different techniques, assumptions and errors. Second, studies using this approach may not be strictly comparable because the application of the methodology differs in detail, due in some cases to data limitations. Third, the residual has been famously described as a "measure of our ignorance". In practice, it is likely to reflect a range of factors in addition to technological change, such as general deficiencies in the modelling process, improvements in allocation of resources, more intensive use of existing factors and economies of scale. All components of TFP growth are likely to be influenced by policy choices and the quality of institutions which establish the framework within which investment and resource allocation decisions are made.

the important role played by total factor productivity growth in periods of fast growth, notably in western Europe and Japan in the early post-war period. In considering what rapid growth episodes in market economies can teach us about medium- and long-term growth prospects in transition economies, it is particularly important to ascertain what has generated rapid total factor productivity growth in the past and whether similar conditions now prevail in eastern Europe, the Baltics and the CIS. In fact, the importance of productivity gains in transition economies is suggested by the very

² See Young (1995).

Table 6.3

Composition of output growth in western Europe and East Asia

(in average annual per cent)

	Capital accumulation	Increased hours of labour	Gains in total factor productivity	Output
1950-73				
France	1.6	0.3	3.1	5.0
Germany	2.2	0.5	3.3	6.0
Italy	1.6	0.2	3.2	5.0
Japan	3.1	2.5	3.6	9.2
UK	1.6	0.2	1.2	3.0
1973-92				
France	1.3	0.4	0.6	2.3
Germany	0.9	-0.1	1.5	2.3
Italy	1.0	0.6	1.2	2.8
Japan	2.0	0.6	1.2	3.8
UK	0.9	0.1	0.6	1.6
1966-90				
Hong Kong	3.0	2.0	2.3	7.3
Korea	4.1	4.5	1.7	10.3
Singapore	5.6	2.9	0.2	8.7
Taiwan	3.2	3.6	2.6	9.4
1979-94				
China ¹	4.2	1.2	3.9	9.3

Sources:

Hu and Khan (1996), Maddison (1996), Rossi et al. (1992) and Young (1995).

¹ Chinese labour inputs measured in persons not hours.

high rates of increase in labour productivity in those countries which are at more advanced stages of transition and which are growing rapidly (see Chapter 7).

From the standpoint of the economics of growth, it might seem logical to assume that total factor productivity growth was simply an indication of the contribution of technological progress to growth and that, in the context of catching up with more advanced economies, these improvements reflected primarily how successful economies were in achieving technology transfer from technologically advanced countries. Although it is important, this aspect is only part of the story. Particularly in the context of the modernisation of hitherto backward economies, a large part of productivity growth actually reflects improvements in the allocation of resources, the better use of investment, the elimination of inefficiency and, in some cases, a higher intensity of work. These aspects of productivity gains are essentially transitory in the sense that they cannot produce growth over the indefinite future, but they can have a substantial impact over two decades or more.

A recent study attempts, for four countries featured in Table 6.3, to divide the sources of total factor productivity growth between technological change and improvements in the efficiency with which existing resources and technologies are used.³ Table 6.4 shows these estimates. During the fast growth period 1950-73, the esti-

mated component of total factor productivity growth due to the more efficient use of existing resources and technologies ranges from 44 per cent in France to 83 per cent in Japan. These improvements stemmed from adjusting to trade liberalisation, exploiting opportunities for mass production as larger and better integrated markets emerged and from moving resources out of relatively low-productivity agriculture. As catch-up growth weakened, the absolute magnitude of this component fell markedly, especially in Japan where its contribution to growth fell by 2.2 percentage points per year in the period 1973-92.

Key lessons to be drawn from growth-accounting exercises for industrialised and developing market economies are that both investment in plant and equipment and growth in total factor productivity have made substantial contributions to periods of rapid growth. Moreover, an important, albeit non-permanent, source of productivity growth in the "Golden Age" of western Europe and Japan arose from improvements in the efficiency with which existing resources and technologies were used through trade liberalisation, economies of scale and structural change. The scope for these efficiency improvements arose in part from the collapse of world trade between the two world wars and the militarisation of the economies during the wartime years.

The potential for improving the use of existing resources in transition economies is in all likelihood much greater in these economies than it was in western Europe and Japan in the early post-war period. This potential arises from the heavily distorted economic structures that these countries inherited from central planning, including some vastly over-extended industries, neglected services and wasteful use of energy (see Chapter 4). The opening of these economies to international trade after decades of economic self-sufficiency and the restructuring of enterprises to focus on customers and costs increase the potential for productivity gains. These gains are likely to make a major contribution to growth in the transition economies over the next two to three decades.

Table 6.4

Components of total factor productivity (TFP) growth rates

(in average annual per cent)

	France	Germany	Japan	UK
1950-73				
TFP growth	3.1	3.3	3.6	1.3
Improvements in efficiency ¹	1.3	1.6	3.0	0.6
Residual ²	1.7	1.6	0.6	0.7
1973-92				
TFP growth	0.7	1.5	1.0	0.6
Improvements in efficiency	0.7	0.7	0.8	0.3
Residual	0.0	0.8	0.2	0.3

Source:

Maddison (1996).

¹ Improvements in efficiency is the sum of the separate effects labelled as catch-up, foreign trade, structural and scale.² The residual can be thought of as technological change plus measurement error.³ See Maddison (1996).

Determinants of growth

Role of government

Favourable incentive structures for both private businesses and governments have led to the strong total factor productivity growth and the investment booms characteristic of periods of sustained rapid growth. The ability of investors to realise their investment returns and the competitive pressure leading to increased managerial effort are central to investment, innovation and cost reduction. Government policies and institutional arrangements are, moreover, fundamental to the incentives to which firms respond. With regard to politicians' support of the market economy, key issues are their ability to benefit from the long-term success of business enterprises and their commitments to enforce property rights and not to expropriate profits.

The themes outlined above are commonplace in economic history, which has repeatedly identified the importance of political and institutional structures which permit strong yet restrained and predictable government.⁴ In particular, government needs to be able to protect property rights and enforce contracts but to refrain from expropriation, repudiation of its obligations and capricious behaviour.

The historical example of nineteenth-century American capitalism illustrates the concept more precisely. It is a common misconception that the country blossomed in conditions of lawlessness and corruption rather than by creating high-quality institutions. After all, this was the land of the California gold rush, Tammany Hall and the Wild West. It could be tempting, therefore, to ask whether transition economies could expect to prosper by permitting similarly unethical or dubious practices in political and economic activities.

This interpretation would, however, be a serious misreading of nineteenth-century economic history, even though it does depict a small part of the American experience. Certainly, the period saw the development of substantial political corruption associated with the machine politics of large American cities in the era of mass immigration.⁵ In addition, massive investment in the railway network was notorious for corrupt practices connected with the transfer of land rights to the railway companies, especially the Union Pacific.⁶ There were, however, a number of other important factors.

First, the United States had inherited from the colonial period a settled legal framework based on common law and, therefore, enjoyed from the outset the basic property rights fundamental to a market economy. The importance of this factor is reflected, for example, in the early development of patent protection for inventors⁷ and in the establishment and rapid refinement of mineral rights in some areas.⁸ Second, public land was securely privatised even though the process was often characterised by corruption

and violence. Third, the favours obtained by railway promoters accelerated projects which involved high rates of return, in terms of social benefits, on the enormous investments involved in developing the trans-continental system. Corruption, however, led to a serious misuse of resources. An example of this was the long delay in launching the New York subway system, which threatened the profitability of other transport assets run by the Tammany leaders.⁹

The right message to take from nineteenth-century America is that its strength stemmed from its pro-market institutions. Its rapid development was despite, not because of, the illegal and corrupt behaviour of some cynical and ruthless businessmen and politicians. Where governments are unable to enforce basic property rights and contracts, however, opportunistic behaviour by politicians or Mafia-type activities are likely to have detrimental consequences for growth. In fact, institutional quality (measured in terms of the rule of law, the risk of expropriation or repudiation of contracts by government and the efficiency and honesty of bureaucrats) discriminates well between the fast- and slow-growing countries in East Asia since 1960.¹⁰

The implications for transition economies are clear and already in evidence. As Annex 2.1 and Chapter 4 show, both arbitrary government behaviour and corruption are prevalent in transition economies, particularly in the CIS. There is also evidence that the unpredictable and arbitrary behaviour of government has had a detrimental effect on investment in the region, particularly in business start-ups and the new private sector. Economic history suggests that a high share of market-driven investment in GDP is one of the vital components to sustained high rates of growth.

Restructuring, resistance and growth

While there is a need to establish institutions and incentives that are conducive to investment and innovation, periods of catch-up growth typically involve significant changes in the composition and pattern of economic activity, leaving some economic activities loss-making. An important political dimension to growth is the potential for those who lose from technological change and restructuring to obstruct the process of modernisation.¹¹

Relatively weak total factor productivity performance has frequently been associated with inappropriate policies that sustain inefficient producers and institutions that give rise to "rent-seeking" (lobbying government for hand-outs and trade protection). The result has been a failure to exploit the full potential from the reallocation of resources and new technology. India in the post-war period provides a clear example. Estimates reveal that the ever-increasing distortions associated with the prevalence of import quotas, public utility pricing, investment decisions in nationalised enterprises and capital market controls, and the extensive rent-seeking to which they give rise, reduced total factor

⁴ See Weingast (1995).

⁵ See Benson (1978).

⁶ See Atack and Passel (1994).

⁷ See Sokolof (1988).

⁸ See Libecap (1978).

⁹ See Benson (1978).

¹⁰ See Rodrik (1997).

¹¹ See Abramovitz (1986).

productivity growth from about 3.7 per cent to around 1 per cent per year on average in the period 1950-80.¹² There is also evidence that in Indian manufacturing between 1959 and 1979 total factor productivity growth was negative (-0.2 per cent per year), with the worst performing sectors also the most heavily protected and subsidised.¹³

In the United Kingdom, misdirected intervention and political constraints on the reform of an unfortunate institutional legacy seriously undermined productivity performance. Tables 6.1 and 6.3 show that the United Kingdom was a case of relative economic decline and low total factor productivity growth during the European Golden Age. Table 6.5 extends this picture and shows the build-up of a large gap in manufacturing labour productivity between the United Kingdom and France and Germany up to the end of the 1970s, which was responsible for a substantial part of its poor performance in these years. The table also shows that this gap in productivity shrank substantially in subsequent years.

Following a winter of crippling labour strikes, the government elected in 1979 pursued a series of radical reforms that marked a major break from the supply-side policies of all previous post-war British governments. Key ingredients included privatisation, deregulation, abandonment of industrial policies involving both the subsidy of “lame ducks” and the support of “national champions”, reduction of direct tax rates while relying more on indirect taxation and restraining the growth of government spending as a proportion of GDP, and reforms of industrial relations. Foreign investment, including the take-over of British-owned firms, was encouraged. Increased competitive pressures and a severe recession shifted bargaining power away from workers and facilitated a re-assertion of managerial prerogative. Strikes by powerful groups of public-sector workers were defeated.¹⁴

The most striking result of this policy experiment is the strong industrial productivity growth of the 1980s. To a large extent, this reflected a shake-out associated with the reduction in overstaffing, the exit of inefficient firms and changes in the effort levels of workers in the early 1980s as fears of bankruptcy and unemployment increased.¹⁵ By the end of the 1980s, comparative analysis suggests that British firms had become more efficient than their German counterparts at reducing costs, and the remaining gap in productivity reflected lower investment per worker.¹⁶ Although the implementation of British privatisation was mishandled to some extent, the inefficiencies that it eliminated were substantial.¹⁷

In some rapidly growing economies, however, industrial policy involving subsidies and non-tariff barriers to trade appears to have played a prominent role. Nevertheless, even in successful countries, such as Japan and Korea, the evidence is that, on balance, these policies retarded rather than stimulated growth. An analysis of industrial productivity growth across sectors in Korea during

Table 6.5

Relative productivity in manufacturing ¹

(Index numbers with the United Kingdom set equal to 100 in each year)

	1950	1973	1979	1995
Federal Republic of Germany	97.5	142.0	163.7	116.8 ²
France	90.4	130.6	149.1	122.1
Japan	45.2	90.5	113.8	104.4
United States	245.7	186.6	179.9	143.5

Sources:

Pilat (1996) extended to 1950 and interpolated to 1979 using van Ark (1993). Note that the Pilat figures are comparisons between the other countries and the USA and were originally expressed using the USA as the base country.

¹ Productivity is measured as value-added per hour worked.

² Excludes the area of the Former German Democratic Republic in 1995.

1963-83 finds that tax and financial incentives did not enhance productivity growth, while protectionist policies (especially non-tariff barriers) reduced both capital accumulation and total factor productivity growth.¹⁸ There is also evidence that Japanese industrial policies diverted resources away from high-growth sectors towards declining industries and did not have a positive effect on total factor productivity growth within sectors during the period 1960-90.¹⁹ Rapid growth in these economies, therefore, was despite, not because of, their protectionist policies.

There are three main conclusions that can be drawn from these examples of resistance to restructuring and technological change. First, countries may fail to take full advantage of opportunities for productivity improvement if they do not adopt market-oriented policies. Second, the consequent poor productivity performance often reflects the weak incentives for managers to put effort into cost-reduction and the ability of vested interests to slow down restructuring, the reallocation of resources and the adoption of new technologies. Third, the changes in government policy required to redress these problems are often likely to encounter strong political resistance from those made worse-off by the changes. The ability of governments to withstand potential resistance to these changes is often associated with events during periods of political and economic crisis.

In most transition economies, the initial reforms of rapid price and trade liberalisation, elimination of budgetary subsidies and small-scale privatisation were implemented immediately after the collapses of communist regimes and changes in political power. The challenge in the transition economies has been to consolidate these reforms amid strong resistance, in particular pressure from state enterprises for off-budget bail-outs (tax arrears and energy arrears) and soft bank loans. Importantly, the elimination of impediments to new business start-ups and the growth of the new private sector can ease this resistance to change by creating new employment opportunities (see Chapter 5).

¹² See Hamilton et al. (1988).

¹³ See Ahluwalia (1991).

¹⁴ See Crafts (1991).

¹⁵ See Bean and Symons (1989).

¹⁶ See O'Mahony (1992).

¹⁷ See Newbery and Pollitt (1996), p. 23.

¹⁸ See Lee (1995).

¹⁹ See Beason and Weinstein (1996).

Technology transfer

While making more efficient use of existing resources is a crucial component of total factor productivity growth in periods of catching up, the transfer of technology from more advanced economies is also a major source of productivity gains. However, technology transfer does not simply involve imitation. It is important to recognise that the gains from importing technology vary and that, in successful cases, technology is often adapted and improved during the process of international diffusion. The striking success of East Asian economies reflects in part their unusually strong efforts to improve and develop imported technology.²⁰

Given that substantial application of resources is usually required to implement technology transfer, with foreign direct investment often a key ingredient, this process shares many of the aspects of research and development. As discussed in Chapter 3, productivity gains from technology transfer should be enhanced by wider markets and by the lower costs of acquiring and implementing technical change. Importantly, trade can play a role both in lowering the costs of adapting foreign technology and in expanding markets.²¹ The capability to absorb and adapt foreign technology is also significantly influenced by a recipient country's level of education and the extent of acquired skills.²² However, the adaptation of foreign technology to domestic conditions requires investment, which is unlikely to be undertaken by firms fearing that their profits may be at risk because of a lack of property rights.

The historical evidence tends to support the view outlined above. For example, it is clear that in the "American invasion" during the trade liberalisation of the 1950s and 1960s, the multinational companies which flocked to western Europe brought with them American technology. Europe was able to benefit more from American technology as the costs of technology transfer fell substantially following improvements in education, more research and development activity, lower transport costs and wider markets.²³ Japan also gained greatly from technology transfer in this period. It did so largely through extensive expenditure on reverse engineering and complementary research and development based on a strong initial base of a skilled workforce and stimulated by strong profit incentives.²⁴

Conclusion

Transition economies have much to learn from earlier periods of rapid growth. This section has drawn on both historical accounts and empirical studies of growth in industrialised and developing market economies to provide a clear picture of periods of rapid growth and of relative decline. Several key points emerge from the analysis of these periods. They are summarised below.

- Rapid growth is usually associated with successful advances by economies that are modernising and moving towards the levels of technology, organisation and capital per worker of leading countries.

- Strong advances in growth are typically associated both with investment booms and with rapid growth in total factor productivity, as in western Europe and Japan in the 1950s and 1960s and in East Asia in recent years.
- Large productivity gains associated with periods of rapid growth depend not only on changes in technology (in part through adaptation) but also on improvements in the efficiency with which resources are used. This is a key point from the Japanese experience.
- Rapid growth to catch up with the more advanced economies is not automatic but requires appropriate policies and institutions. For example, it is important that credible property rights are established and contracts are enforced so as to underpin high levels of investment and innovation and that opportunism and rent-seeking are contained. This was fundamental to the growth of the United States in the nineteenth century.
- Political pressure from those groups concerned that a loss of jobs and wealth might result from restructuring and technological change can be an impediment to rapid growth. A period of political and economic crisis has, in some cases, been instrumental in changing perceptions of the costs and benefits from reform and in overcoming this resistance to change, as was the case in the United Kingdom in 1979.
- Technology transfer is a critical component of productivity growth in periods of catching up with more advanced economies. Trade and foreign direct investment often facilitate this process, as post-war experience in western Europe and Japan has illustrated. However, successful transfer requires both the incentive (market opportunities) and the ability (local skills base) to adapt technologies to local conditions.

6.2 Restructuring and growth in transition economies

While the examples of catching up and falling behind in market economies illustrate the importance of adapting to market conditions through structural change and restructuring, this process in transition economies is taking place on an unprecedented scale. Chapters 4 and 5 describe in detail some of the distorted economic structures inherited from central planning and the effects that introducing market forces had on the composition of economic activity and on the performance of enterprises. This analysis illustrates how progress in market-oriented reforms can enhance growth by improving the efficiency with which existing resources and technologies are used.

While the experience of transition is relatively brief and many factors influence developments in these economies, it is becoming apparent how important market-oriented reforms are to growth. There is some evidence that the depth of the initial falls in output in transition economies have been closely associated with the extent of the inherited economic distortions (macroeconomic

²⁰ See Bell and Pavitt (1993).

²¹ See Coe et al. (1997).

²² See Benhabib and Spiegel (1994).

²³ See Nelson and Wright (1994).

²⁴ See Goto (1993).

imbalances and distortions in prices and the composition of output).²⁵ Moreover, the timing and strength of the recovery and growth have been linked to two factors: the successful implementation of macroeconomic stabilisation and of market liberalisation.²⁶ This suggests that over time the legacies from central planning will have less of an effect on growth and that the effectiveness of reforms will become more important. In fact, Chart 6.1 shows that output growth in transition economies after the initial fall in output is positively linked with progress in reform.

The positive relationship between market-oriented reforms and short-term growth in transition economies suggests further potential for growth through more efficient use of existing resources. In this short time span, the effects of investment and innovation are bound to be small relative to the stock of resources and existing technologies, with much of the recovery in the region originating from efficiency gains. While it is difficult to judge the likely intensity and duration of these efficiency gains for transition economies, the post-war recovery in western Europe and Japan provides a possibly conservative estimate of their potential contribution to medium-term growth in transition economies.

The process of transition, however, involves more than just structural change and restructuring. Over time, investment in plant and equipment, the acquisition of market-based skills and the adaptation and development of new technologies will come to dominate the long-term performance of these economies. Indeed, the mix of old and new plant and equipment and of technologies will change gradually. The growth of transition economies over the medium and long term will be determined, therefore, both by structural change and restructuring and by investment in plant and equipment and the introduction of new technologies.²⁷

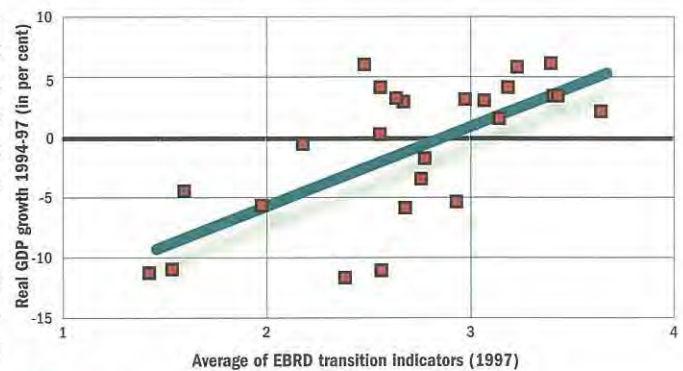
6.3 Long-term growth prospects in transition economies

While the analysis of examples of catching up and falling behind in market economies shows how important structural change and restructuring are to growth, this section considers the potential contribution of investment and innovation to long-term growth. These processes are present in all market economies, and considerable evidence is available for gauging their long-term potential in transition economies. This analysis requires weighting the relative importance of the determining factors for investment and innovation. The process of weighting, however, tends to over-emphasise those factors which are more easily quantified at the expense of those which might be more important but more difficult to measure. Nevertheless, some progress has been made in recent years in quantifying some of the important factors in investment, innovation and growth.

One method for weighting the various factors comes from cross-country growth regressions, which relate statistically a number of factors to cross-country variations in long-term growth performance. This is a way of organising the data to reflect the

Chart 6.1

Growth and market-oriented reforms in transition economies



Source:
EBRD.

Note:
Unlabelled points represent transition economies.

importance of positive and negative attributes of transition economies but it is not a way of delivering precise forecasts for particular economies. In fact, the approach has already been applied to transition economies by first estimating the statistical relationships for large samples of industrial and developing market countries during the 1960s to 1980s and then making growth predictions based on the known variables for transition economies. However, the variables used in these exercises omit the institutional factors identified in the preceding section as key determinants of rapid growth (see Box 6.2).²⁸

Growth projections using cross-country regressions

A typical cross-country growth regression suggests that growth will be positively associated with investment and educational enrolments and negatively with the initial level of income per person, which serves as a measure of the potential for catching up with more advanced economies (see equation [1] in Box 6.2). Table 6.6 shows the results of using these explanatory variables to project long-term growth rates for transition economies. An exercise of this kind is perhaps best suited to analysing growth prospects after the period of extensive structural change and restructuring, which is still many years from completion, and related to average growth over a period of about 20-30 years from that point. Table 6.6 contains some illustrative projections based on the gaps in income with the United States and the investment levels that prevailed in the mid-1990s. Comparable projections are calculated for the west European and East Asian countries that have experienced periods of rapid growth, where these projections are based on values of the explanatory variables at the start of their period of rapid progress in catching up with more advanced economies.

The general picture that emerges can be summarised as follows. First, the more affluent transition economies have income levels (relative to that of the United States) similar to those of southern Europe and East Asia at the start of their periods of rapid growth. However, they are much lower than those of the north European

²⁵ See de Melo et al. (1997).

²⁶ See Fischer et al. (1996) and de Melo et al. (1996).

²⁷ See Rühl and Vinogradov (1996).

²⁸ See IMF (1996) and Fischer et al. (1997).

Box 6.2

Cross-country growth regressions

The last decade has seen a proliferation of analyses which use cross-country data to carry out regressions of growth rates on a selection of variables thought to contribute to growth. However, these approaches to predicting growth must be treated with considerable caution for several reasons (see Stern [1990]). First, the equations describing the growth process are grossly over-simplified. Second, the approach suffers from the problem that growth can influence the variables used to predict growth as well as vice-versa. Third, most of the variables are poorly measured.

Initial analyses tended to link growth to the scope for closing the gap on the most advanced economy (measured by the initial income level relative to that of the most advanced country) and to investment in machinery and to development of skills. A useful overview can be found in Levine and Renelt (1992). These authors scrutinised the work carried out to that point and selected a fairly robust cross-section equation describing the general experience of growth by the expression:

$$(1) \text{ GYP} = -0.83 - 0.35\text{RGDP60} - 0.38\text{GPO} + 3.17\text{SEC} + 17.5\text{INV},$$

where GYP is the average annual growth rate of real GDP per capita for 1960-85, RGDP60 is real income per person in the initial year (1960), GPO is the population growth rate, SEC is the secondary school enrolment rate and INV is the share of GDP devoted to investment. The estimated relationship is for about 100 countries excluding eastern Europe. The numerical co-efficients represent the estimated impact of a unit change in the explanatory variable concerned on the per capita growth rate, holding the other variables on the right-hand side constant. Thus, other factors remaining the same, a rise in the investment rate by 0.01 (1 percentage point of GDP) would be associated with an increase in the growth rate of 0.175 percentage points. The equation finds that, allowing for investment in machinery and development of skills, growth is inversely related to initial income, suggesting that catching up with more advanced countries is part of the growth process.

It is striking that the above equation does not point to any great role for the institutions which shape investment incentives, nor does it reveal anything about the reasons for different investment rates across countries. Nevertheless, using an estimated relationship of this type to infer future growth prospects for transition economies is quite common. Yet such an approach would miss the fundamental question of the role to be played in subsequent growth by the design of appropriate institutions and by incentives to invest and to innovate. It would miss, therefore, much of what may be important in transition economies.

countries in 1950. The less affluent transition economies are more similar to the position of China in 1970. Second, the current secondary school enrolments in transition economies are higher than those in western Europe and Japan in 1950 and in East Asia in 1970 (but are similar in terms of average years of schooling of the labour force). Third, there is a wide range in the investment rates of transition economies, with only the strong performers matching the past investment rates of high-growth countries. Overall, this approach tends to produce reasonably optimistic projections for long-term annual growth rates in transition economies (in the range of 4 per cent to 7 per cent for most countries shown in Table 6.6), largely because of the significant scope for catching up with advanced economies and the high levels of educational enrolment.

Several recent empirical investigations of cross-country growth point to the importance of institutions in the exploitation of opportunities for growth. This has involved both establishing links between growth and factors such as the credibility of property rights and the enforceability of contracts and exploring what kinds of society are likely to create and to sustain good-quality institutions. The work of Knack and Keefer (1995) has been influential in this respect. An equation presented in Knack (1996) typifies this later approach, which is rather more appropriate for the transition economies than the earlier study:

$$(2) \text{ GYP} = -6.602 - 1.308\text{LogRGDP60} + 1.273\text{SEC} + 2.296\text{PRIM} + 12.086\text{INV} + 8.122\text{LFGR} + 0.755\text{PRIC} + 0.058\text{ICRG},$$

where variables are defined as before except that GYP now relates to 1960-89, PRIM is the primary school enrolment rate, LFGR is the labour force growth rate, PRIC captures the impact of changes in international prices (but is statistically insignificant) and ICRG is an index of the security of property rights and contract enforcement published in the International Country Risk Guide by Political Risk Services (a US commercial company). This equation is an extension of the earlier Levine-Renelt approach, with the main difference being the inclusion of the term measuring security of property rights. The positive (and significant) co-efficient implies that countries with better established property rights experience faster growth, allowing for the other variables, and thus that this aspect of institutional capability is important for growth prospects. Note that this leaves out any effect which operates through the share of investment in GDP since this is included elsewhere in the equation.

The ICRG index embodies five components. Two of these, "expropriation risk" and "rule of law" relate directly to the security of property rights. Risk of "repudiation of contracts by government" is a measure of contract enforcement, while "corruption in government" and "quality of the bureaucracy" characterise the general efficiency in provision of government services. The overall index is the sum of the scores of the five components.

The form of the equation illustrates, however, some of the above warnings. In this context, there are two particular omissions relevant to the discussion of historical growth in the preceding section. First, the specification of the regressions does not encompass some of the key messages from growth-accounting studies, in particular the importance of efficiency gains from the reallocation of resources in periods of rapid growth. Second, some aspects of success and failure in growth are overlooked because they cannot be easily quantified. For example, many institutional factors are particularly difficult to quantify.

Projections of growth of the kind shown in Table 6.6 and elsewhere²⁹ are unsatisfactory, however, because they ignore the role of policies and institutions and because of the serious modelling and estimation problems described in Box 6.2. Essentially, closing the gap on advanced economies is viewed as an automatic and mechanical process, which the experience of growth in market economies suggests is far from the case. A refinement of these basic predictions could result from comparing indices of institutional quality and policy design across countries and replacing the basic predictive equation with one that incorporates a measure of this kind. The institutional variable could relate to important aspects of the business environment, in particular those that reflect the ability to appropriate the returns to investment (such as the extent of security of property rights and enforcement of contracts). Both economic experience and theory suggest that these factors have sizeable

²⁹ See IMF (1996) and Fischer et al. (1997).

effects on investment and innovation (including the rate of technology transfer). The basic problems of the technique itself, however, may limit the value of these refinements.

The International Country Risk Guide (ICRG) index of the security of property rights and the enforcement of contracts (published by a commercial company) is available for some (but not all) transition economies, as well as a large number of market economies. A recent cross-country regression that includes this measure of institutional quality (equation [2] in Box 6.2) provides the basis for calculating a second set of growth projections for some transition economies which includes as an explanatory variable a measure of institutional quality. However, the exercise is no more than illustrative because it assumes that current levels of institutional quality are maintained and it uses an index that may flatter the transition economies somewhat. For example, while the ICRG index places the highest ranked transition economies in 1995 (the Czech Republic, Hungary and Poland) on a par with France and Germany in 1984 (the earliest year for which this index is fully available), an alternative index of business risk, compiled by Business Environment Risk Intelligence (BERI), places these

Table 6.6

Comparisons of transition economies with earlier cases of fast growth ¹

(in per cent)

	Per capita income relative to that of the US	Investment share in GDP	Secondary school enrolment rate	Forecast of average annual growth over 25 years
Albania	5.0	16.5	78	4.4
Armenia	8.6	8.8	85	3.2
Azerbaijan	5.6	15.9	88	4.6
Belarus	16.1	25.2	92	6.1
Bulgaria	17.1	20.7	72	4.6
Croatia	21.7	14.0	83	3.7
Czech Republic	37.4	24.7	86	5.3
Estonia	16.1	26.9	92	6.4
FYR Macedonia	8.2	15.4	54	2.8
Hungary	24.5	22.8	81	5.1
Kazakhstan	11.5	22.4	90	5.6
Latvia	12.9	20.8	87	5.2
Lithuania	15.8	19.2	78	4.6
Moldova	7.9	6.7	84	2.8
Poland	20.7	17.0	84	4.3
Romania	16.7	25.7	82	5.8
Russia	17.1	25.0	88	5.9
Slovak Republic	13.8	28.3	89	6.6
Slovenia	43.7	22.5	89	4.8
Tajikistan	3.5	17.4	100	5.3
Uzbekistan	9.1	23.3	94	6.0
Western Europe and Japan ²	49.7	24.7	50	3.8
East Asia ³	16.5	28.0	45	5.2

Sources:

Levine and Renelt (1992), IMF, World Bank and EBRD calculations. Implemented using their dataset and taking US1960=7,380 dollars with other initial income levels calculated using relativities reported in the table.

¹ Explanatory variables for the transition economies are from 1995. The equation used to obtain the growth forecast is the equation in Box 6.1.

² Values of explanatory variables are from 1950.

³ Values of explanatory variables are from 1970.

Table 6.7

Further comparisons of transition economies with earlier cases of fast growth

	Index of institutional quality	Baseline forecast of average annual growth over 29 years (in per cent)	Growth forecast based on an index value of 46 (in per cent)
Albania	36	3.2	3.8
Bulgaria	37	3.5	4.0
Czech Republic	42	4.2	4.5
Hungary	46	4.3	4.3
Poland	44	3.6	3.8
Romania	34	4.1	4.8
Russia	28	4.0	5.1
Slovak Republic	39	5.1	5.5
Western Europe and Japan	44	4.0	na
East Asia	38	4.5	na

Sources:

Knack (1996), Table 6.6 and EBRD calculation.

Note:

Predicted growth rates are based on the equation from Knack (1996) reported in Box 6.2 and where two additional variables have been set to sample means and added to the intercept.

The index 1 has a maximum of 49 and a minimum of 7; for western Europe and East Asia estimates are for 1984, the earliest year with full information. For transition economies the index is for 1995 and is only available for Albania, Bulgaria, the Czech Republic, Hungary, Poland, Romania, Russia and the Slovak Republic.

countries more plausibly on a par with Portugal and Spain in 1972 (the earliest year of this index). Moreover, the ICRG index focuses only on one aspect of institutional quality, the security of property rights and enforcement of contracts, and there may be other institutional factors that have a significant impact on growth prospects in transition economies (such as development of the financial sector and physical infrastructure).

Table 6.7 shows growth projections for eight transition economies based on the cross-country regression given by equation (2) in Box 6.2 and their 1995 ICRG index values. Several points are immediately apparent. First, it is clear that according to these measures transition economies (with the possible exception of the Czech Republic, Hungary and Poland) do not yet have institutional arrangements which match those which prevailed in western Europe and Japan in 1984 (the first year for which the index is available), although most transition countries covered by the index are on a par with East Asia (except for Russia). Second, two countries (Romania and Russia) which seemingly had very good prospects in Table 6.6 appear likely to be constrained to a significantly lower growth rate by low institutional quality. Third, many transition economies not covered by the ICRG index are in the CIS and are likely to have levels of institutional quality at or below that of Russia. Their seemingly good growth prospects reported in Table 6.6 are also likely to be constrained by low institutional quality.

The existence of substantial obstacles to private investment in transition economies, particularly those in the CIS, is borne out by a variety of evidence (see Chapters 4 and 5). These include the

arbitrary and discriminatory enforcement of taxation, weaknesses in basic legal institutions that undermine the enforceability of contracts, and unnecessary business licensing and interference that gives rise to corruption.³⁰ This strongly supports the argument that projections based on equations that ignore institutional quality will be seriously misleading and much too optimistic, particularly for CIS countries such as Russia. At the same time, it also suggests that the rewards for improving institutional quality could be substantial.

Table 6.7 also shows projections of the gains for transition economies if they achieved Hungary's level of institutional quality. These gains are estimated to be between 0.5 and 1 percentage point per year on the growth rate for those countries apart from the most advanced ones. The gains for those countries not covered by the index are likely to be 1 percentage point per year or more. However, it should be remembered that, in normal circumstances, historical experience suggests that major changes in institutional quality are quite unusual. For example, long-term changes in indices of security of property rights like the one used in the calculations reported here tend to be rather modest. In only one country (Chile) out of 36 for which there are long-term data has the cumulative change over 20 years been as large as the gap between Russia and Hungary shown in the table. In the years after a major social upheaval, however, experience suggests that there is often a window of opportunity for rapid change before blocking coalitions re-emerge.³¹ Obviously, in the transition economies that have established high institutional quality, there have been massive strides in a few short years since the collapse of communism.

In fact, the potential gains from improving institutional quality suggested by Table 6.7 are likely to be underestimates, particularly of the medium-term rewards, for three reasons. First, as noted above, the scope for improvement in institutions is probably understated by the ICRG index used in compiling Table 6.7 because of its somewhat flattering view of the transition economies. Second, the estimates do not allow for the indirect effects that would come through raising the investment rate. Related work suggests that a move from 28, the lowest institutional quality score, to 46, the highest score, would raise investment by enough to raise the growth rate by a further 0.5 percentage points per year on top of the direct effect.³² Third, equations of this kind understate the gains from the process of structural change and restructuring, which can be expected to yield significant increases in total factor productivity in transition economies.

Accounting for growth in transition economies

Because of the limitations of growth projections for transition economies based on cross-country regressions, it is important to check on the plausibility of these projections. One such check is to perform a growth-accounting exercise for transition economies. Such an exercise for transition economies basically involves forming quantitative predictions about the future expansion in inputs, physical capital, acquired skills and unskilled labour and

about growth in total factor productivity. As Box 6.1 emphasises, it is primarily a method of quantifying the growth process rather than a forecasting technique.³³ The approach followed here begins with acquired skills (human capital), a valuable and abundant resource in all transition economies.

There are two possible routes through which human capital promotes growth. The first is through the growth in skilled labour inputs, which are directly transformed by technologies and organisations into increased output. The second route is indirect and operates by enhancing an economy's capacity to adjust to opportunities for closing the gap on advanced economies and for raising total factor productivity. Available empirical evidence suggests that this latter channel is likely to be very important.³⁴

The approach followed here takes account of both of these effects and, once again, draws comparisons with western Europe and Japan and with East Asia. Table 6.8 shows estimates of the increases in the quantity of the labour forces and in their quality based on available projections of the growth of the labour force and of increases in schooling. Weighting this input growth in accordance with the growth-accounting formula gives an estimate of the direct effect on growth of changes in the labour force. The table also uses regression estimates which relate productivity growth to years of schooling and the scope for catching up with advanced economies. This shows the indirect effect of the labour force operating through the impact of acquired skills on total factor productivity growth. The table highlights several points. First, the likely contribution of increased labour inputs to growth of per capita output in transition economies is much lower than in East Asia. This difference arises because in many transition countries schooling levels are already high and because demographic trends are much less favourable. However, hours of work are unlikely to fall as they did in western Europe during the post-war period, and the contribution of labour inputs will surely exceed that of those countries. Second, the high stock of acquired skills has a positive effect on total factor productivity growth, and this effect can be a very positive factor in promoting growth, as in East Asia. Indeed, given the large initial shortfall in productivity in transition economies, there may be the potential for a strong impact on growth comparable with that in Japan, Korea or Taiwan in many transition countries. Third, combining the two components would suggest that in general the transition economies are not quite as well placed as their East Asian counterparts.

While Table 6.8 examines potential contributions to growth from a skilled workforce, both directly and indirectly through total factor productivity growth, a more complete growth-accounting exercise requires consideration of investment in plant and equipment and of population growth. For this purpose, growth of the capital stock is assumed to keep pace with the output increases resulting from extra labour inputs and total factor productivity growth, so that the ratio of output to capital remains constant on a "balanced-growth" path. This path is set out as a useful benchmark with which to focus the

³⁰ See EBRD (1997).

³¹ See Olson (1982) and Balcerowicz (1995), Chapter 1.

³² Based on Knack and Keefer (1995, p. 221 using equation [2]).

³³ Indeed, as a formal modelling technique it shows many of the problems embodied in the regression approach.

³⁴ See Benhabib and Spiegel (1994).

Table 6.8

Contributions to growth from extra labour inputs and total factor productivity (TFP) growth¹

(in average annual per cent)

	Growth of labour source	Labour force growth adjusted increase in schooling	Contribution to growth		
			Increased quantity and quality of labour	TFP growth	Combined effect
Azerbaijan	0.9	1.6	1.1	2.5	3.6
Belarus	0.2	0.7	0.5	2.4	2.9
Bulgaria	-0.2	0.3	0.2	1.8	2.0
Czech Republic	-0.1	0.2	0.1	1.5	1.6
Estonia	0.0	0.3	0.2	3.4	3.6
Georgia	0.2	0.9	0.6	2.3	2.9
Hungary	-0.1	0.1	0.0	2.0	2.0
Kazakhstan	0.3	1.0	0.7	2.0	2.7
Latvia	0.1	0.4	0.3	3.2	3.5
Lithuania	0.0	0.3	0.2	3.1	3.3
Moldova	0.2	0.8	0.6	3.4	4.0
Poland	0.1	0.5	0.4	2.4	2.8
Romania	0.2	0.7	0.5	2.4	2.9
Russia	0.2	0.5	0.4	2.2	2.6
Slovak Republic	0.1	0.4	0.3	4.3	4.6
Ukraine	0.1	0.7	0.5	2.3	2.8
Uzbekistan	0.8	1.5	1.0	3.5	4.5
Western Europe and Japan	-0.6	-0.3	-0.2	1.4	1.2
East Asia	1.5	2.3	1.6	2.3	3.9

Sources:

Table 6.6 and, for the transition economies, EBRD projections and calculations based on possible improvements in schooling from the levels reported in UNDP (1993).

- ¹ All estimates assume a standard weight of 0.7 for labour inputs in the growth accounting formula. Contributions to growth from the impact of human capital on TFP growth are based on Benhabib and Spiegel (1994, p.162, equation 5). Estimates for the transition economies are for 1995-2010, for western Europe and Japan are for 1950-73, and for East Asia are for 1966-90.

discussion. It is not intended as a prediction that there will be “steady-state growth” in the sense of a formal growth model in which the capital stock and output grow at the same constant rate.

The projections that result from this growth-accounting approach are set out in Table 6.9, and they have several implications. First, as shown, for the majority of the transition economies, the projections obtained using the basic cross-country regression which ignores institutional quality may be too optimistic in their implied assumptions with regard to the supply-side potential of the transition economies. Second, the growth-accounting projections are broadly similar to those based on the cross-country regression which takes account of the likely impact of institutional quality. However, this comparison only covers those transition economies with relatively high levels of institutional quality. This suggests that in those unrated transition economies with low institutional quality, the need for further institutional reform may well constrain the realisation of growth potentials.

Conclusion

The quantitative predictions for transition economies developed in this section offer only an initial suggestion as to their growth prospects. At first, this analysis might seem to suggest that the transition economies are generally well placed for rapid growth after their initial period of transition because of their high level of acquired skills and the large initial shortfall in productivity. These factors point to long-term average annual growth rates for transition economies in the range of 4 per cent to 7 per cent for most countries.

To realise this potential, however, the establishment of institutions that will create incentives for high investment and rapid TFP growth will be required. If further improvement in institutions does not materialise, the evidence available even for those transition economies with relatively high institutional quality (compared with other transition economies) suggests that long-term growth rates are likely to be reduced by up to 1½ percentage points per year. For many transition economies where the standardised measure of institutional quality is unavailable (in part because their institutional quality is below the level at which foreign investment can be attracted) the constraint of low-quality institutions on growth is likely to be particularly severe.

At present, there is not enough historical evidence to make confident predictions about the introduction of reforms and the future of

Table 6.9

A feasible “balanced growth” path compared with regression projections

(in per cent)

	Forecast of balanced growth	Difference with Table 6.6 forecast ¹	Difference with Table 6.7 forecast ²
Azerbaijan	5.2	0.6	na
Belarus	4.1	-2.0	na
Bulgaria	2.9	-1.7	-0.6
Czech Republic	2.3	-3.0	-2.0
Estonia	5.2	-1.2	na
Hungary	3.0	-2.1	-1.3
Kazakhstan	3.9	-1.7	na
Latvia	5.0	-0.2	na
Lithuania	4.7	0.1	na
Moldova	5.7	2.9	na
Poland	3.9	-0.4	0.3
Romania	4.1	-1.7	0.0
Russia	3.6	-2.3	-0.4
Slovak Republic	6.5	-0.1	1.4
Uzbekistan	6.5	0.5	na

Sources:

Tables 6.6, 6.7, 6.8 and EBRD calculations.

Note:

The balanced growth forecast uses the projections of Table 6.8 plus the population growth rate together with the assumption that capital-output ratio is constant as on a balanced growth path such that $\Delta Y/Y = \Delta L/L + TFP/B$ (using the notation of the growth accounting box). The growth rate is expressed in per capita terms.

- ¹ The second column is the difference between this balanced growth path and the projected growth rate of per capita income using the Levine and Renelt formulation as in Table 6.6.

- ² The third column is the difference between this balanced growth path and the projected growth rate of per capita income using the Knack formulation as in Table 6.7.

institutions. There are striking examples of rapid and radical change even though persistence in existing arrangements may be more usual. A recent survey seeking to identify the political circumstances most conducive to economic reform was largely inconclusive, although the critical importance of crises in precipitating change is often noted (see Box 6.3).³⁵

This analysis, moreover, is no more than a partial view of growth prospects in transition economies and does not take account of several factors that deserve careful consideration. In particular, the measure of institutional quality used here is very narrow, focusing only on the security of property rights and the enforcement of contracts. There are many other aspects of the institutional infrastructure that are important to investment and enterprise performance, including the predictability of tax administration, business licensing procedures, instability in governments and their policies, under-developed financial sectors and distorted physical infrastructure (see Chapters 4 and 5). In addition, these quantitative estimates are unlikely to capture the full medium-term growth potential from structural change and restructuring in transition economies, the scale of which is without historical precedent.

Others have drawn attention to the likely disincentive effects of the taxation necessary to support large government budgets, stressing that some transition economies spend high proportions of GDP on state pensions.³⁶ This is clearly an important area where future policy decisions may influence projected growth rates. It may be unrealistic, however, to suppose that it will be easy for the transition economies to reduce sharply social transfers in general and pensions in particular (whatever the inherent merits or otherwise of this policy). A key influence on patterns of social spending in democratic countries is the age distribution of the population. The available evidence suggests that both the initial age structure and the continuing ageing of the population in the transition economies will produce strong pressures against reductions in government spending on pensions and other aspects of spending on the welfare state.³⁷

6.4 Conclusion

Relative economic backwardness can offer the opportunity for very rapid growth. Recent decades have seen outstanding examples of this in western Europe and Japan in the early post-war period and in East Asia in recent years. These episodes of rapid growth stand in sharp contrast to the many countries in which opportunities for catching up with advanced economies remain unexploited or where initial successes have not been sustained. For those designing policies and building institutions in transition economies, the stakes are clearly high.

There is vast potential for medium-term gains in productivity in transition economies both through more efficient use of existing resources and technologies and through upgrading technology.

Box 6.3

Achieving reforms that improve institutional quality

Changing institutions is often both very costly and fraught with political difficulties. Reforms are often blocked by interest groups consisting of those who fear that change might have an adverse effect on them. To switch from the current set-up involves incurring high fixed costs and having to learn how to operate under the new arrangement. In contrast, conventional patterns of behaviour which are customary, predictable and self-enforcing help to reduce transactions costs. They develop through the accumulation of precedent and, once established, tend to persist. Although chance events may sometimes allow a new start, the process of institutional change usually occurs through small incremental changes and is often dependent on earlier historical events so that early mistakes may be very difficult to overcome (see North [1990]).

Italy is a case in point. Putnam (1993) distinguishes between the regions of Italy in terms of their civic norms and practices and notes that more civic regions have more effective governments, less corruption and a way of life that minimises opportunism and transactions costs. This seems to have been a fundamental reason for the more successful development of north and central Italy compared with the south. What is most striking about Putnam's analysis, however, is his demonstration that the existence of these positive civic attributes on a regional basis largely reflects their presence a century earlier, as measured by an index of civic involvement. While this particular finding is controversial, it suggests that the legacy of the social framework in a region may be more important for subsequent development than its level of resources or acquired skills.

India offers another example where the legacy of history, as emphasised by North, has been important. Bhagwati (1993) sketches the development of a blocking coalition of vested interests among politicians, bureaucrats and producers that was originally spawned by the planning system of the 1950s and 1960s and the controls to which it gave rise. The result has been a democracy which has consistently from the 1970s to the 1990s had its reforms blocked or diluted by the need to pacify important interest groups. This is despite widespread recognition of the inefficiencies of the state sector, the rent-seeking and corruption associated with controlled markets, the technological backwardness of much of Indian industry and the need for foreign direct investment. Even in the 1990s, reform has continued to be cautious and limited, and political constraints imply that this is likely to continue to be the case (see Manor [1995]).

This is in contrast to South Korea, which in the early 1960s was not on a rapid development path. Under the threat of a communist takeover, there was a military coup in 1961, after which the new government saw economic growth as a key requirement to ward off the continuing communist threat (see Reeve [1963]). The 1961 coup was a major turning point for Korea. It led to the establishment of what is now thought of as the Korean model of development based on outwardly oriented policies and predictable, rule-based government intervention reliant on a high-quality bureaucracy (see Root [1996]). The new regime acted quickly to build institutions that managed to limit corruption and channel it into less damaging forms. It also acted to ensure predictable rules and to limit uncertainty for business and to promote investment and innovation. It is possible that the trauma of the end of communism in the transition economies makes the Korean example more relevant than the Indian case.

³⁵ See Haggard and Williamson (1994).

³⁶ See Sachs and Warner (1996).

³⁷ See Lindert (1993).

Some countries have already made significant progress in a market-driven process of structural change and enterprise restructuring. However, sustained progress in reform is required, particularly in the areas of financial sector reform and of competition policy, which will be instrumental in further strengthening enterprise performance. Other transition economies have yet to achieve a strong commercial orientation in the enterprise sector and have yet to implement fundamental reforms, such as hardening budget constraints and privatising state-owned enterprises. The upgrading of technology to catch up with advanced economies typically involves the adaptation of foreign technologies to local conditions. Foreign trade and direct investment play important roles in this process. While countries in transition have made significant progress in opening their economies, considerable challenges remain, particularly in the CIS.

While the reforms required to unlock the medium-term growth potential of transition economies are broadly understood, it is often difficult to overcome the potential resistance from those that stand to lose in the short term from the resulting structural changes and restructuring. This resistance to change is one of the main reasons for slow progress in catching up with advanced economies, as the experiences of India and of post-war Britain illustrate. Evidence of resistance to change is also apparent in transition economies, where these pressures are reflected in rising tax and energy arrears and in soft bank lending in some countries. In this regard, measures that facilitate the growth of the new private sector and the employment opportunities that it creates can help to ease these pressures on transition economies. The most important of these measures are those that reduce the discretionary and arbitrary interventions of government that create large barriers to entry by new private firms.

Over the long term, the transition economies have one advantage and one disadvantage compared with countries that have achieved rapid growth in the past. The combination of a well-educated population and the relatively low productivity levels which exist in parts of the region (see Table 6.6) offers a unique opportunity for rapid productivity growth as transition progresses. This consideration alone would point to relatively robust long-term growth rates in the range of 4 per cent to 7 per cent for most transition economies, although a growth-accounting exercise suggests that these estimates may be optimistic. It must also be recognised that the quality of institutions supporting investment in resources and technological innovation (such as secure property rights and judicially enforced contracts) is low in many transition economies. Available evidence suggests that even for those transition economies with relatively high-quality institutions, this factor would lower long-term growth rates by up to 1½ percentage points in the absence of further reforms. For many transition economies for which no internationally comparable measure of institutional quality is available, the constraint on growth imposed by low-quality institutions is likely to be particularly severe.

This chapter underlines, therefore, the importance both of sustaining progress in market reforms that foster structural change and restructuring and of building the institutions that support investment in resources and innovation to sustained high rates of growth in transition economies. The more advanced reformers are well on the way to succeeding in this regard, and it could be that looking back in 20 years' time some of the world's "tiger" economies will have been found in the region. However, this growth process should not be viewed as in any way mechanical or automatic. Just as the growth potential is large, so is the possibility of becoming trapped by resistance to change.

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