

# Conclusions—and the Unfinished Agenda

Transition economies have made great strides in liberalizing their domestic markets and foreign trade regimes and in freeing up entry into private business. Many are trying to define property rights more clearly and to privatize, to create or renew essential institutions to support efficient markets, and to reshape social services and the social safety net to conform to the needs of a market system. Taken together, these measures constitute the economics of transition, but transition has had profound social, political, and strategic implications as well.

This chapter draws out the key messages from the analysis of the preceding chapters. What can these countries learn from each other? What does the experience of transition to date suggest for the many other countries grappling with similar issues of economic reform? What are the implications for external assistance—and for the reform priorities in the countries themselves?

## Lessons of experience

*Consistent policies, combining liberalization of markets, trade, and new business entry with reasonable price stability, can achieve a great deal—even in countries lacking clear property rights and strong market institutions.*

Policies of liberalization and stabilization have been the major factor shaping the adjustment process in CEE and the NIS and have been vital to China's and Vietnam's rapid growth. In the first two regions there has been a strong link between consistent and credible reform and economic recovery: growth has typically resumed about three years after the determined application of such reforms, including stabilization programs. Less consistent reformers have recovered more slowly and, on average, have performed less well. Recovery has involved rapid

growth in previously repressed sectors (services in particular) and the penetration of new export markets.

The turnaround in the more successful reformers has included substantial adjustment, even by state enterprises. Governments have succeeded in imposing tight budget constraints on enterprises, spurring a highly decentralized process of deep cost cutting and restructuring by firms themselves, the breakup of some, the introduction of new products, and the acquisition of new capabilities, including marketing and financial management, not required under the old system. Just saying no to enterprises' requests for more resources produces positive results—at least for a time. The next stage of China's reforms will also involve redirecting savings away from unprofitable state firms and exposing them to greater competition.

A striking lesson from the experience of all transition economies is the importance of new entry in response to the lifting of restrictions on business. In China the new entrants were at first primarily the new township and village enterprises (TVEs); more recently new private firms and joint ventures constitute China's most dynamic sources of growth, employment, and exports. In Vietnam the protected state sector continues to generate growth, but it is the private sector that is producing new jobs. In CEE and the NIS new private firms, often using old assets carved out from the state sector—a process greatly encouraged by harder budgets—have clearly led the recovery. If it is to be widespread and effective, entry must be cheap and administratively easy. And new firms cannot flourish without access to broad markets for their products and inputs.

Market economies perform very poorly when inflation rises above a moderate level. The same appears to hold for transition economies. Liberalization at first causes prices to rise. This is painful, but in CEE and the NIS the freeing of prices was needed to sever the link between governments and enterprises and allow subsidies to be cut, thereby making stabilization possible.

*Differences between countries are very important, both in setting the feasible range of policy choice and in determining the response to reforms.*

Which works best, rapid or gradual reform? This question, the one most often asked in the study of transition, has no single or simple answer. Economic reform in CEE and the NIS was begun in the context of a fundamental dismantling of repressive political systems that had been, in many cases, propped up from without. These countries set out with severe macroeconomic imbalances and structural distortions created by central planning, as well as huge declines in trade as the previous system was dismantled. They have not been able to generate the savings necessary to sustain gradual adjustment of the greatly overbuilt state sectors. They therefore face a choice between rapid systemic reforms, entailing deep and often painful structural adjustment, and efforts aimed at prolonging the status quo. Although the latter course may appear less painful at the outset, its result is persisting inflation and economic disarray.

The differences between leading and lagging reformers have largely reflected how they approached this very difficult choice. Dedicated and audacious leaders have mattered a great deal, but transition is not just a matter of intelligent leaders choosing the right policy package or seizing the moment. Countries' characteristics—their unique advantages and disadvantages—influence what policies can be chosen and what leaders can accomplish. Important advantages include strong government administrative capacity, proximity to market economies, greater societal memory of market processes, and a strong desire to integrate into Western Europe. All of these have helped sustain the pace and scope of reform in the advanced reformers. Differences in the abruptness and timing of political change have also been reflected in the thrust of economic reform. Nevertheless, for the bulk of these economies, the answer to the question is now clear: faster and more consistent reform is better.

China, on the other hand, is both a successful reformer and a gradual one, although its first major reform, the shift from collective to household farming, involved a sharp change from the previous regime of agricultural collectivism. China embarked on its transition with a large, repressed rural economy. This allowed rapid productivity gains and growth of a nonstate sector using rural labor. Effective macroeconomic management encouraged a high rate of saving. With a reform program that skillfully took advantage of China's initial conditions, including strong government capacity and the ability to impose direct controls, the Chinese government was able to liberalize along a dual-track process without seriously undermining macroeconomic balance. The political fundamentals were

also quite different from those in CEE and the NIS, as China's transition has involved progressively greater weight on economic performance as a legitimating factor for an ongoing government.

Hungary and Vietnam offer another contrast illustrating the importance of initial conditions for the outcome of reform. Despite embarking on transition with a relatively liberalized economy, and despite postponing sharp macroeconomic adjustment until 1995, Hungary has not been able to avoid a deep transformational recession. Vietnam, on the other hand, had a large rural sector and a smaller state sector, and it sustained strong growth through a period of relatively rapid reform. Its restrictive macroeconomic policies included layoffs of a full third of state enterprise employees, but they were absorbed by the resurgent rural sector and the newly unleashed private sector.

*An efficient response to market processes requires clearly defined property rights—and this will eventually require widespread private ownership.*

The political economy of privatization plays out differently in different countries, and differently for each of the major types of asset (industrial firms, farms, real estate). Experience everywhere reveals a severe and politically charged tension between promoting efficiency and rewarding existing stakeholders. None of the methods used to privatize large firms—sales, management-employee buyouts, or equal-access voucher privatization—is without drawbacks in a transition setting, in terms of either the effectiveness of corporate governance, speed, fiscal impact, access to investment capital, or fairness.

Nevertheless, privatization is important. Initial privatization helps depoliticize economic restructuring and creates incentives to support change required at the firm level. Governments cannot manage and finance such restructuring on a wide scale. Privatization also frees government to focus on those few key areas of the economy—such as infrastructure and, perhaps, key natural resources—where its regulatory and ownership roles are most essential.

Is there an alternative to formal privatization? In theory, yes. But the experience of many CEE countries and the NIS suggests that in practice the alternative is often an ownership vacuum with fuzzy property rights, leading to informal and nontransparent privatization, either of the assets themselves or of the income streams they generate. China and Vietnam have so far been able to prevent wholesale and egregious asset stripping, but there are signs of similar processes at work there also. Informal privatization often precedes the legitimization of a private economy, but it accelerates thereafter. An ownership vacuum delays the restructuring of drifting firms, for which nobody is fully responsible and which cannot tap external

resources. It can create or prolong macroeconomic problems, because it produces strong incentives for enterprise managers to show poor financial performance and then snap up their firms (or additional shares) at an artificially low price. It can also be inequitable and induce corruption, which can undermine the authority of government.

An initial assignment of property rights is only the first step. The broader goal is to develop an efficient secondary trading process in which ownership claims can be reorganized smoothly. All transition economies need such a process, particularly because many of the governance structures emerging during transition are themselves likely to be transitional. For example, in CEE and the NIS control of many firms will need to shift from insiders to outsiders if they are to attract the investments and skills needed to survive in a market economy. Agricultural reorganization will require moving from corporate to individual property rights to enable new, viable farms to emerge. Further clarification of property rights in China's TVEs is essential for their further development, including the ability to raise finance from outside the community. Countries need to beware of dead ends in the evolution of ownership: some transitional arrangements, such as the closed joint-stock corporations in Ukraine or the highly dispersed individual ownership seen in Mongolia, promise to become obstacles to reorganization, essentially because they entrench incumbent workers and managers. In contrast, besides sales (where feasible), the Czech approach, which creates strong external institutional investors and stimulates trading among them, appears to have many advantages.

*Major changes in social policies must complement the move to the market—to focus on relieving poverty, to cope with increased mobility, and to counter the adverse intergenerational effects of reform.*

Transition sets in motion vast social change. Much of this change is positive: it increases individual liberties and choice and gives broad access to information formerly available only to a privileged few. The negatives include greater economic uncertainty and, in some countries, a dramatic growth in crime.

Transition requires a major reorientation in the social role of the state, away from paternalistic, poorly targeted benefits conveyed largely through extensive cross-subsidies, and toward addressing poverty. Market-determined wages and employment are vital to achieving deep restructuring, but initial conditions in transition economies make increased income inequality an inevitable consequence of reform. Until this impact is offset by renewed growth—the indispensable element in any antipoverty policy—an increase in poverty is unavoidable.

How to target benefits to the poor—whether through income-tested assistance, locally organized relief, targeting based on indicators of poverty (one rationale behind, for example, child allowances), or self-targeting (such as in public works employment)—is a complex matter that depends on the administrative capacity of government agencies. The large informal sectors and limited capacity of many transition economies suggest that targeting by poverty indicators is perhaps the most realistic option in the short run. In urban China and much of the NIS, delinking of social services from enterprises will eliminate a serious impediment to restructuring.

In many countries the largest problem, both politically and in terms of demand on public resources, is state pensions. Generous access to pensions is one way of cushioning the impact of transition on a generation that was prevented from accumulating wealth in the previous system and has no opportunity to save in the new market system. But it is important to distinguish such transitional issues from longer-run policies. Retirement ages need to be raised and equalized for men and women. Private pensions are desirable for a variety of reasons but are no substitute for directly addressing the problem of excessive spending in the state sector. In China pensions need to be delinked from enterprise finances, and the continued expansion of the nonstate sector and rising labor mobility argue for extension of a formal social safety net beyond the state sector.

*Institutions that support markets arise both by design and from demand.*

Institutional development—of legal and financial systems and of a retooled government—normally takes years, if not decades. It therefore trails early macroeconomic reforms and formal ownership changes. Institutional reform is now high on the reform agenda in all transition economies. Reform is particularly badly needed because existing institutions were adapted to the needs of a very different economic system and because inadequate institutions impose high economic costs.

- To be effective, legislation must be well designed and well implemented. In addition, the state must itself be ruled by law and trusted by the private sector to do what it says it will do. Yet governments are particularly susceptible to corruption during the phase when the state retains both vast assets and extensive powers to intervene in a growing private economy. Liberalization, demonopolization, and—if transparent—rapid privatization are key steps to reducing these two sources of huge economic rents and to strengthen demand for the rule of law. So are serious efforts to publicize and

punish high-level corruption. Like corruption, organized crime thrives when property rights are unclear, legal procedures ineffective, and risks low. Effective action against organized crime also requires that the state be reasonably free of internal corruption.

- Financial sector reforms cannot proceed in isolation from macroeconomic and enterprise reform. For many countries the best approach involves a mixed strategy, restricting the scope of state banks while a new financial system develops. Both the entry of new institutions and the rehabilitation of old ones pose risks, requiring strong complementary policies.
- Transition means less government involvement in the economy, but where it remains involved—in setting the rules of the game, assisting the development of institutions, and providing social protection—it must become more effective. Far-reaching reforms are needed, especially to strengthen tax systems (reduce exemptions, lower rates, and tighten administration), improve expenditure control (eliminate government arrears), and build transparent intergovernmental relations.

In all these areas and many others, governments need to take an active, central role. However, the degree of institutional change is also closely related to the comprehensiveness and duration of macroeconomic and ownership reforms. Market-oriented reforms create demand for market-supporting institutions and for their associated skills. Experience shows that institutional development cannot proceed far in a vacuum or when the economic system makes it irrelevant or unwanted. Parties will have a strong incentive to abide by legal responsibilities only to the extent that they depend on the market—and their reputations in it—for survival. For example, manager-owners in private firms will be tempted to ignore minority shareholders' rights unless their access to capital depends on their reputation, and banks will not develop the capabilities necessary to function in a market system if they expect to be bailed out by government whenever crises occur.

*Sustaining the human capital base for economic growth requires considerable reengineering of education and health delivery systems.*

Relative to other countries at comparable income levels, people in centrally planned economies were often healthy and well educated. Today, broad access to health and education services needs to be protected in China. Such systems in CEE and the NIS require extensive restructuring to improve their effectiveness. In many respects these systems share the weaknesses of industrial enterprises under central planning, being input-intensive rather than responsive to

changing needs. The decline in health status in this region relative to Western Europe, observable even before transition, emphasizes that the objective ought to be improved health, not simply more health care. This argues for a shift to include health promotion programs—including encouragement of healthy lifestyles—that maintain previous achievements while improving incentives for efficiency.

Transition requires major reforms of education and training, particularly in the NIS and parts of CEE, to enable it to provide the skills needed in a changing market economy. Incorporating private provision of education services, particularly in higher and adult education, and providing education vouchers as part of retraining assistance could help introduce demand-led restructuring.

*International integration can help lock in successful reforms.*

International integration is vital for successful reform in transition countries, especially considering their history of autarky. Imports help make their markets competitive. Exports provide a source of growth and learning. In some areas foreign direct investment is the only way of acquiring vital skills, markets, and finance. Institutional integration is also vital. Joining the World Trade Organization (WTO) would enhance market access and provide some protection against the arbitrary imposition of trade barriers. Equally important, quick access to the WTO will strengthen the political feasibility of maintaining a liberal trade regime in transition economies themselves.

The integration of transition economies into the global trading system will benefit the world economy. The countries of the Organization for Economic Cooperation and Development, especially, have a strong interest in encouraging transition by keeping their doors open. The costs of absorbing the transition economies into world trade are manageable. Enlargement of the European Union to include some of the transition economies may involve more concentrated adjustment costs, but even there the adjustment to trade flows is a less important issue than the budgetary effects.

### **The agenda for donors . . .**

What should be the timing and composition of foreign assistance to transition economies? A first observation is that although only the poorer transition economies require long-term financial assistance, all but a very few could benefit from extended technical assistance to support the building of institutions. This process can take decades, as some aspects of institutional reform involve rebuilding entire professions and require massive training programs. Many countries will also require long-term support, from official sources, nongovernmental organiza-

tions, and the private sector, to help build the institutions of civil society.

Second, macroeconomic stress often strengthens incentives for reform. Aid programs in transition economies therefore require particular care in their design—to walk the narrow path between facilitating reform and diminishing its urgency—and should lock in reforms through setting strict conditions on aid provided. This involves creating the critical institutions, such as independent central banks and property rights, that make reforms more effective and harder to reverse. Because of the great importance of new entry for growth, assistance should also be conditioned on reforms to reduce barriers to new businesses.

Third, in addition to short-term support for stabilization programs, a case can sometimes be made for temporarily plugging a public finance gap while tax systems and budget management are overhauled. Marginal tax rates are high in many countries, encouraging informalization of the economy. Some governments now exceed reasonable size limits, but others lack revenues for essential functions. Public investment has virtually disappeared in many countries, and the maintenance backlog is large and growing. Transition involves costs, with economic decline in some regions and large losses for the banking sector, and it may be necessary—and desirable—to cushion the impact on certain groups. However, support needs to target these transitional issues and losses carefully.

Finally, business advice and financial support to the private (and privatized) sector should mainly come from the private sector itself, that is, from private business services, investors in equity, and private lenders of working and investment capital. These services and suppliers exist in embryo in some transition countries, but not at all in many others. Donor agencies can assist reform in the financial system to speed the creation of prudent and capable lenders and investors and can usefully provide hands-on training and technical assistance to managers and entrepreneurs to overcome the effects of years of isolation from market forces. Simply financing investment through government restructuring agencies should be avoided.

### **. . . And for the reformers**

What reforms are most urgently needed to sustain transition? The answer differs for each country according to the stage it has reached.

With macroeconomic stabilization and liberalization largely accomplished, institutional reform and managing the realignment of the state are now priority areas for the leading reformers in CEE. Public finance has emerged as a critical focus. On the spending side this involves, in particular, reforming costly social programs, especially pensions and health. Action here will assist reform of currently very distortionary tax systems; in particular it should allow high

payroll taxes to be cut. More broadly, improving public accountability and strengthening the influence of civil, democratic society as a counterweight to government are also important. Another priority is continuing reform in the legal and regulatory systems, especially in areas relating to the financial sector, property rights and competition, better enforcement of contracts and regulations, and harmonization with EU standards in anticipation of accession. Addressing the problems associated with residual state ownership is a third important task. For these countries external financial assistance is progressively less important than technical assistance and institution building, which are important roles for bilateral and multilateral agencies.

Fiscal reforms are vital in the less advanced reformers as well. Improved tax administration is essential. So is the need to reduce subsidies through improved cost recovery, to gain fiscal elbow room for maintenance of and modest additions to public investments, and for clearing government's own arrears. But these countries also need to consolidate financial discipline both in banks and in large enterprises and to restore confidence in financial institutions. Tighter discipline, together with privatization, is also necessary to sustain pressure for more effective ownership. Some of these countries also face serious problems of crime, both economic and general. Addressing this and the associated issue of corruption is another very high priority, and indeed is essential for rapid growth. In most of these countries, including Russia, little progress has been made in the overhaul of social programs. Reforms are urgent if deep, intergenerational poverty is not to become institutionalized. Foreign assistance to these countries can usefully include transitional budgetary support, especially for maintenance and to buffer the human cost of transition. Extensive technical assistance, massive specialized training, and broad economic education are all desperately needed.

The next stage of reforms in the East Asian countries will be more complex and difficult than their past efforts, as they tackle reform of the core of their state sectors and the institutional underpinnings of their economies. Maintaining growth and improving the distribution of its rewards are central goals, because these are still poor countries, and also to sustain support for reform. This requires improving the efficiency with which savings are allocated and, in parallel, developing better indirect tools of macroeconomic management. Continuing fiscal reform, including recentralization of the budget in China, is one priority. So are raising capacity in the banking and legal systems and anticipating the need to deal with the many problem clients that will emerge as banks become more commercial and policies shift away from subsidizing credit. A clear definition of the role and scope of the state sector is called for, and this will almost certainly involve reducing its size. Also important are mechanisms to encourage effective corpo-

rate governance and accountability in state, nonstate, and private firms and to avoid an ownership vacuum. Social policy reforms should focus on sustaining broad access to key social services and improving their quality, both for increasingly mobile populations and in poor areas. Disentangling of social benefits from state enterprises is needed to unlock the door to further reforms.

With sustained reforms, transition countries have the potential to achieve strong growth. CEE can exploit the catch-up effect from its favorable location close to large, high-income markets. The NIS can look to major gains from far more efficient use of its natural resource and human capital endowments, and the East Asian reformers

combine abundant labor, a tradition of high rates of saving, and large opportunities to increase the efficiency with which these resources are allocated. A successful transition therefore promises long-term growth rates considerably above world averages.

And what of the risk of failure? The chances of a return to the planned economy may be small, but long-term stagnation and rising poverty—likely outcomes of inconsistent and unstable policies—cannot be ruled out for some countries. In the last analysis, transition's reforms will not bear fruit unless they are underpinned by a broad political and social consensus. Developing this is perhaps the highest priority of all.