

# UNDERSTANDING TRANSITION

## 1.1 LITTLE PRIOR KNOWLEDGE BEFORE TRANSITION

In his essay on economic policy and the political process, Avinash Dixit (1996) quotes Alan Blinder's "Murphy's Law of Economic Policy" (1987, p. 1): "Economists have the least influence on policy where they know the most and most agree; they have the most influence on policy where they know the least and disagree most vehemently."

This statement, its second half at least, seems to be especially valid for the economics of transition. Rarely have economic advisers played such a prominent role in policy debates as has been the case since 1990 in Central and Eastern European economies. Jeffrey Sachs, for example, has attracted worldwide attention for his forceful advocacy of the "big bang" approach to transition. These views were endorsed by one part of the profession and criticized vehemently by another part. Controversies focused very quickly on the speed of transition. Advocates of big bang arguing for a simultaneous and quick introduction of all reforms included Lipton and Sachs (1990a), Åslund (1991), Berg and Sachs (1992), Boycko (1992), Murphy, Shleifer, and Vishny (1992), Sachs (1993), Frydman and Rapaczynski (1994), and Woo (1994). Advocates of gradualism emphasizing the need for a given sequencing of reforms included Svejnar (1989), Portes (1990, 1991), McKinnon (1991), Roland (1991), Dewatripont and Roland (1992a, 1992b, 1995), McMillan and Naughton (1992), Murrell (1992), Aghion and Blanchard (1994), Litwack and Qian (1998), and Wei (1993). Others emphasized the need for big bang along certain dimensions and gradualism along other dimensions. This was the case for Kornai (1990), Blanchard and colleagues (1991), and Fischer and Gelb (1991).<sup>1</sup> This early polarization, along with the surrounding controversy on transition strategies, can surely be seen as a sign of unpreparedness of the economics profession for the tasks of transition.

No preestablished theory of transition existed before the fall of the Berlin Wall. The ratio of theory to policy papers in transition economics has nevertheless been surprisingly low. The early literature on transition was largely verbal in style, aiming essentially

<sup>1</sup> Many other economists remained skeptical about whether economic theory has or should have anything to say at all about the transition from socialism to capitalism.

at giving advice on transition policies. The theories with which Western advisers were probably best-equipped were those concerning macroeconomic stabilization. However, existing theories of stabilization assume a market environment. It was not clear a priori how stabilization policies would work in an initial environment without markets. More importantly, most economists will agree that stabilization is only one of the dimensions of transition. Other very important aspects relate to the necessary large-scale institutional changes: the creation and development of markets, including financial markets, the institution and enforcement of property rights, and other legal and political changes along with enterprise privatization and restructuring. The difficulty of transition is that all these complementary changes need to take place without creating too many economic disturbances, as the economy must continue to function and the various needs of the population must continue to be fulfilled.<sup>2</sup> To make things even more complex, because of the magnitude of the changes implied by transition, political support needs to be continuously maintained during the reform process to avoid policy reversals.

There were no preexisting theories in some of the most crucial areas of transition, such as

- The effects on sectoral reallocation and general output performance of different methods of liberalization in a socialist economy where there were no preexisting markets or market networks, let alone capital and labor markets.
- How to harden budget constraints and achieve efficient restructuring in existing enterprises.
- The effect of political constraints on general reform strategies and specific reform policies.
- How to privatize socialist enterprises.

Even though practice has shown a general inferiority of state firms over private firms, no good theory existed to explain the difference in performance between private and state firms.

## 1.2 SURPRISES OF TRANSITION

Theoretical knowledge on how to achieve the changes listed in the preceding section was scarce before transition. Moreover, the only major experience prior to 1989 was that of China, where the political and economic circumstances differ strongly from those of Europe. Countries like Hungary, Yugoslavia, and Poland had only limited experience of partial reform within the socialist system. In almost every case, the lack of prior knowledge of the transition process has led to surprises.

<sup>2</sup> *An analogy to this difficulty would be the task of changing the engines of a plane while it keeps flying!*

Economists did not expect the huge output fall observed after price liberalization and stabilization. As acknowledged by Kornai (1993), most economists who had been thinking about transition before 1989 did not predict the output fall. Many economists had expected a sluggish supply response to price liberalization. Many others had expected a mild economic slowdown, a “transformational recession” to use the words of Kornai, with the transition from a shortage economy, characterized by a generalized excess demand on most markets, to a market economy, with mostly buyers’ markets (excess supply) rather than sellers’ markets. The observed double-digit output fall was quite unexpected.

Moreover, while most Central European countries were recovering from this important output fall, for most countries of the former Soviet Union, including Russia, transition has led to an abysmal plunge in output that has all the appearances of a huge negative permanent output shock.

The outcome of privatization policies was also unexpected to many. As a rule, privatization of former SOEs benefited mostly the “insiders”—that is, managers, and sometimes also workers, who were inside the firm before transition started. Many, if not most economists, would have expected outsiders (foreign investors and new private entrepreneurs) to play a much bigger role. Indeed, the skills of socialist managers are not necessarily the same as those of managers of capitalist enterprises. Socialist managers had to learn to be good at coping with a shortage economy and dealing with planning agencies. Because of excess demand and planned deliveries, they never had to worry much about selling their products and competing with other firms offering comparable products. Also, in the previously centrally planned economies there was no market for managers, and the allocation of managers to specific firms was not necessarily done on the basis of productive efficiency. One of the objectives of privatization was precisely to achieve a better allocation of managers to assets. The fact that insiders benefited much from privatization raises suspicions about the efficiency of some of the privatization policies followed, especially the policies of mass privatization. Indeed, as we will see later in the book, many studies tend to show that privatized firms, especially firms privatized to insiders, do not perform better than nonprivatized SOEs. At a positive level, the question is raised of why insiders were able to benefit so much from privatization, especially in Russia.

However, there were good surprises of restructuring inside SOEs. Many economists advocated fast privatization, sometimes fast privatization at any cost—that is, at the cost of efficiency—because of the fear that the alternative of no privatization, or slow privatization, would be so much worse. The fear was that managers of SOEs, being in an “endgame situation,” would start dissipating the assets of SOEs to their private benefit, leading to inefficient squandering of productive assets. Privatization was much slower than expected in many countries, Poland being the best example. Nevertheless, doomsday predictions about the effects of slow privatizations did not materialize. Very early in transition, evidence started to be produced that SOEs were restructuring. In a paper published in the *Brookings Papers on Economic Activity* in 1993, Marek Belka, Stefan Krajewski, and Brian Pinto gave evidence of restructuring of SOEs in Poland. At

the same time, privatization did not seem to prevent asset dissipation. A few years after mass privatization, there is increasing evidence of diversion of assets privatized through vouchers in the Czech Republic (Weiss and Nikitin, 1998) and through mass privatization in Russia (Black, Kraakman, and Tarassova, 1999). This massive asset stripping points to the absence of appropriate legal structure, mostly absence of law enforcement and government collapse.

This observation leads us to another surprise of transition: the spectacular growth of organized crime, and especially the so-called Mafia phenomenon in Russia. On the ruins of communist government, organized criminal groups, specializing in racketeering, prostitution, smuggling of drugs and of the spoils of the former Soviet nuclear arsenal, and the like, started to emerge at an amazing speed. The Russian Mafia has become so important that the FBI, Interpol, and other international law enforcement agencies have started monitoring this phenomenon because of the obvious spillover effects outside Russia. This organized crime came as an unpleasant surprise to economists who had predicted the emergence of private enterprise. The Mafia phenomenon obviously has a negative effect on private-sector development because of racketeering in private business, uncertainty related to Mafia wars, the absence of the rule of law, and the general breakdown of government and its replacement by corruption and stealing.

Another big surprise was the breakup of countries. At the beginning of transition, Yugoslavia broke up, followed soon by the USSR and Czechoslovakia. After the fact, many explanations were offered of the inevitability of such breakups, but before they happened, few observers had predicted that there would be so many breakups and that they would happen so fast.

Electoral backlash was also an important surprise to many observers. A few years after the communists had been evicted from power by the democratic revolutions of 1989, former communists came back to power via the ballot box in Lithuania (1992), Poland (1993), Hungary (1994), Bulgaria (1994), and Latvia (1994). In Russia, the Communist Party in 1995 gained 22 percent of votes, giving it a dominant position in the Russian parliament, the Duma. In the case of “accession countries”<sup>3</sup> like Poland and Hungary, the communists had transformed themselves into European-style social democrats, as the Italian communists had done many years before, but this was certainly not the case in Russia. The breakup of Czechoslovakia itself can be seen as a form of political backlash, since there was, at the moment of the breakup, wide divergence of views about how transition should proceed, the big bang approach being more favored in the Czech Republic under Vaclav Klaus, whereas in Slovakia, where there was heavy concentration of former military industry of the Soviet bloc, expectations about transition were much more lukewarm.<sup>4</sup>

Last and not least, the most positive surprise is probably the success of Chinese economic reforms. Between the beginning of its reforms in 1978 and 1998, China’s GDP per capita has more than quadrupled, growing at an average annual rate of 9.5 percent. The transition strategy in China was also very different from the big bang approach advocated in Central and Eastern Europe. The Chinese success came unexpectedly for several reasons. First of all, because of the gradualist approach, partial reforms in some areas co-

<sup>3</sup> Accession countries are countries expected to become members of the European Union in the medium term. In 1998 official negotiations for accession started with Poland, Hungary, the Czech Republic, Slovenia, and Estonia.

<sup>4</sup> However, in many cases, governments led by former communist parties tended to lose the subsequent election, suggesting that Central and Eastern European populations tend to be discontented with all governments, left and right.

existed with the socialist status quo in other areas. Because reforms are complementary, the Chinese approach was criticized for being half-baked and inconsistent (Woo, 1994). However, as stated earlier, the successful development of the nonstate sector, especially the township and village enterprises (TVEs), came as a surprise because of its unclear property right structure. It was not clear whether TVEs were pseudoprivate firms or firms owned by local governments. Price liberalization did not follow the big bang approach either. Prices were liberalized only at the margin with planned production and deliveries frozen at a given level and all output liberalized in excess of those planned obligations. This dual-track system was criticized for creating output diversion. China's successful growth came during a period where SOEs were not the object of restructuring and where privatization was still taboo. Despite important criticisms of the Chinese transition strategy in the 1980s, the Chinese experience appeared to be extremely positive, compared to the transition experience of Eastern Europe. China did not experience an initial output fall, and its continuous growth record appeared impressive compared to the Eastern European situation. Despite the Tiananmen massacres and the lack of democratization, there was no backlash against economic reforms that brought prosperity and increased incomes to hundreds of millions, despite the associated increase in income inequality. Any normative evaluation of the evolution of China cannot ignore that it is the world's largest dictatorship and also one of the few remaining ones. This fact, however, should not distract us from making a sober assessment of Chinese transition and recognizing its huge economic success.

All these surprises show that economists were not really prepared to face the tasks of transition. Our knowledge and understanding of transition processes remain limited and happen mostly "after the fact." In the rest of this chapter, we first give a rough description of the main features of the socialist system before transition and then lay out the objectives and constraints of transition. Against that background, we describe what we think are the main stylized facts of transition so far and what questions these stylized facts have raised that we need to understand.

### 1.3 THE INITIAL SITUATION BEFORE TRANSITION

A large body of knowledge has been generated by several generations of Sovietologists and comparative economists who have been studying the socialist economy. The scholarly knowledge developed by that literature is impressive compared to the caricatural description of socialism that one often finds in the transition literature. Nevertheless, many important questions related to the functioning of the system remain unanswered today. In this section, we only roughly describe the main features of the socialist economy and of partial reforms under socialism and focus essentially on features that are relevant to understanding transition.

**TABLE 1.1** SECTORAL ALLOCATION OF LABOR IN OECD AND CPES  
(PERCENTAGE SHARES)

	Agriculture	Industry	Services
(1) OECD, 1991			
Eight richest countries	5.5	29.8	64.7
Eight middle countries	5.8	30.4	63.9
Eight poorest countries	17.9	29.5	52.6
(2) Centrally planned economies (CPEs, 1989)			
GDR	10	44.1	45.9
Czechoslovakia	11.6	46.8	41.6
Hungary	17.5	36.1	46.4
Poland	27.2	36.3	36.4

Source: *OECD*.

First of all, the price system and markets were completely absent under “classical” socialism. Allocation of goods and services was done by the planning administration that organized production and exchange. Enterprises were told what to produce, from whom to purchase, and to whom to sell. The only existing markets were those of the shadow economy, which were illegal and operated at the margins of the system.

The production structure was distorted compared to market economies. The two most important distortions were (1) a relative overdevelopment of heavy industry and underdevelopment of services and (2) a bias toward big firms and against small firms. This distortion is clear from Tables 1.1 and 1.2. From Table 1.1, it appears that the sectoral bias is relatively independent of the level of development measured in terms of income per capita, since the same conclusion obtains if one compares East European countries with richer or relatively poorer OECD countries. From Table 1.2, one sees that German industry tends to be more concentrated than French and Italian industry, but the comparison between East and West shows clearly a bias toward large firms in the East.

Heavy industry was overdeveloped because of the requirements of the arms race. Before its demise, the Soviet Union was the biggest producer of steel in the world. One reason why services were underdeveloped is that, following Marx, services were viewed as “unproductive”: transforming a good physically was considered to add value, but bringing it to the buyer was not. The bias toward big firms was explained mostly by the fact that it was easier to plan output for a small number of large firms than for a big number of small firms, and also by a desire to exploit economies of scale. Managers of enterprises

**TABLE 1.2 DISTRIBUTION OF EMPLOYMENT IN INDUSTRY BY SIZE OF FIRMS (PERCENTAGE SHARES)**

	0–100	100–500	500 and more
West Germany	14.1	23.9	62
France	22.5	24.9	52.6
Italy	32.3	27.3	40.4
GDR	1	11.1	87.9
Czechoslovakia	0.1	3.4	96.5
Hungary	4.5	16.3	79.3
Poland	1.4	18.2	80.4

Source: OECD. Data for West Germany, France, and Italy are from 1987, for the GDR from 1988, and for the other countries from 1989.

also pushed to increase the size of their enterprise in the expectation that they would then get more attention from central planners. These distorted structures are important to mention because they imply that transition requires important sectoral reallocations and a substantial entry of small firms. In many of the transition debates, there has been an excessive focus on the privatization of the existing large SOEs but insufficient attention to the entry of small firms and the organic development of capitalism from below by the new entrepreneurs. From the point of view of sectoral reallocation, much of the “destruction” must take place among the existing large SOEs, whereas much of the “creation” is the task of newly entered firms.

Enterprise incentives were characterized by large bonuses for fulfillment of the planned output target and smaller bonuses based on a percentage of overfulfillment of the plan. This system led enterprises to distortions in product mix and quality so as to maximize the plan indicators. For example, when glass was planned in tons, it tended to be too heavy. When the measurement of glass output switched to square meters, glass became too thin and fragile (see Nove, 1958). Since managerial rewards depended mostly on these output targets, there were few incentives to save on costs. One plan indicator, the *val* (*valovaia produktsiia*) aggregated enterprise output using prices calculated on a cost-plus basis. This system led enterprises to bias their output mix in a cost-maximizing fashion. Moreover, whenever enterprises lacked the financial means necessary to achieve their output target, they would always be refinanced in order to achieve that goal. This practice is the phenomenon of soft budget constraints conceptualized by Kornai (1980). Because there was no cost consciousness, wages were kept under centralized control to prevent any drift in wages at the enterprise level.

An important fact about socialism is that there was not really a consistent plan at the level of the economy. Consistent plans were developed for a disaggregated nomenclature of between 40 and 200 categories of goods. In reality, the Soviet economy had about 12 million different types of goods. The mathematical planning literature of the 1950s and 1960s attempted to find “decomposition algorithms” that would allow the calculation of consistent plans for a disaggregated nomenclature from the consistent plan of an aggregated nomenclature (Kornai and Liptak, 1965; Malinvaud, 1967; Arrow and Hurwicz, 1960; Weitzman, 1970). Central-planning practice, however, remained very far from those algorithms. Computer capacities were by far insufficient to cope with the complexity of such calculations, as Hayek (1945) had predicted.<sup>5</sup> Already in the early 1960s, Montias (1962) had understood that the method of material balances used to compute plans did not produce consistent plans. Material balances are like balance sheets with two columns where all planned demands for a given good are listed in one column and all planned supplies for that good are listed in the other column. Planners would readjust planned supplies and demands for a given good until total demand and supply would be equalized. The problem is that material balances were not mutually consistent. For example, the planned supplies of a steel factory could be adjusted upward to equalize the material balances of, say, a given type of machine, but this adjustment would not lead to an increase in the input requirements for that factory on other material balances where its inputs figured on the demand side. The real puzzle of socialist economies was thus how, in the absence of markets and consistent plans, total chaos did not result! In reality, the problem was less dramatic than it appears. First of all, Montias (1962), Manove (1971), and others showed that the system of material balances could lead to some convergence, despite the absence of the input-output methodology, at the disaggregated level. Also, planning was not only an iterative process but also a cumulative one. The point of departure for the plan in period  $t + 1$  would be the achieved level of production in period  $t$ . Planning should thus be seen as an incremental process, known as “planning from the achieved level” (in Russian *planirovanie ot dostignutogo urovniia*, Birman, 1978). The required consistency to achieve a general equilibrium in the economy was thus limited to output *increments*, since existing output *levels* were equilibria—though not necessarily desirable equilibria. Note that with the increasing complexification of the economy, it became increasingly difficult to plan important deviations from previous production paths. Indeed, it is easier to plan a 2 percent increase in all goods than to expand some sectors by, say, 20 percent, while shrinking others by comparable amounts. This fact led to an important bias toward the status quo. This bias is ironical because one of the claimed strengths of central planning over the market was its capacity to organize large deviations from existing production patterns, especially in the presence of nonconvexities.

These incremental adjustments were done at the level of economic ministries, which were thus the spinal cord of the economy and played a key role in coordinating production and adjusting to unexpected disequilibria. In most socialist economies, with the exception of China and Yugoslavia, the planning administration was organized along a functional principle with branch ministries: ministry of steel, ministry of coal, ministry of machine-building industries, and so on.<sup>6</sup> Ministries had aggregate output

<sup>5</sup> Throughout the twentieth century, there was a big debate, starting with Barone (1908), von Mises (1920), and Lange (1938), about the theoretical possibility of central planning that culminated in the two fundamental welfare theorems showing the equivalence of central planning and competitive market equilibrium. Hayek, however, emphasized that, even if central planning was theoretically conceivable, in practice it could not be operational because of the complexity involved in gathering all the relevant information to compute consistent and efficient plans.



plan fulfillment objectives and relied on the enterprises under their jurisdiction to achieve these goals. Ministries not only played a crucial role in planning the yearly outputs and inputs of their enterprises, but also intervened constantly in enterprise activities. In general, these interventions were responses to perceived shortages by enterprises. Ministries would often use their influence with central planning authorities to try to reroute specific deliveries in response to such shortages.<sup>7</sup> They would also readjust enterprise plans in response to shortages. Enterprises unable to meet their plan often had their plan lowered, while enterprises with more slack or more productive capacity had their plan increased.<sup>8</sup> Overall, interventions of ministries could be seen as various forms of input and output substitutions in response to shortages, leading to improvement of the aggregate output target of the ministry (Powell, 1977; Roland, 1990). Such mechanisms played a key role in preventing general output collapses in the absence of markets.

The general situation was one of perceived shortages. For enterprises, overproduction or excess supply was never seen as a problem, whereas shortage or excess demand was. Indeed, because of incentives for plan overfulfillment and soft budget constraints, any above-plan production was always easily sold. However, any shortage was likely to lead to plan underfulfillment and was perceived as a serious threat. Perceptions of shortage led to all sorts of behavior like hoarding (Weitzman, 1991), including hoarding of labor, or “forced substitution,” substituting an available input or material for an unavailable one, leading to possible quality deteriorations or further distortions of output mix (see Kornai, 1980, for a comprehensive treatment of economic behavior under shortage).

Shortages in markets for consumer goods meant that producers did not have to worry about quality or lack of consumer demand. Shortages were a nightmare for consumers who lost hundreds of hours each year in queues and were forced to buy lower quality goods and make forced substitution. However, the sellers’ market created by shortages gave workers important bargaining power toward management of enterprises. The threat of unemployment was therefore virtually nil, and labor discipline was extremely poor (see, e.g., Moskoff, 1984; Roland, 1988). Authoritarian and repressive campaigns to impose labor discipline under Stalin or under Andropov always failed after a temporary surprise effect. Voluntary mobility was also high as dissatisfied workers could easily find work elsewhere. Managers could only use positive incentives (rewards) to motivate and attract workers. Given the soft budget constraints, they were tempted to increase wages for that purpose. Central authorities resisted this kind of move under central planning by centralizing wage funds and denying firms any autonomy in wage setting. Managers had to use indirect tricks to motivate workers such as declaring secretaries to be managers and unskilled personnel to be skilled. One particularly popular way of attracting workers was to have in-house shops where workers could buy food and basic goods. It is also for this reason that social services, such as day-care centers, were frequently developed inside enterprises. Enterprises could thus use their clout in the central planning system to short-circuit the retail system and assure that “their” workers would not face shortage and would have decent enough conditions of living so as not to quit. In periods of more acute shortage, goods would disappear from shop shelves, but

<sup>6</sup> China and Yugoslavia were organized along regional lines with planning done at the level of regions or provinces. Khrushchev attempted to introduce a regional organization of planning in the early 1960s (the so-called *sovnarkhoz* experience), but these attempts were undone when Khrushchev was overthrown.

<sup>7</sup> Ministries also lobbied hard to have their own delivery administration that they could manage directly in order to reroute supplies between enterprises of their jurisdiction. For example, the steel ministry would be able to use its own delivery network to reroute coal from steel factory A to steel factory B.

<sup>8</sup> In the former case, plan adjustments were needed for incentive reasons. Enterprise managers lost all their bonuses if they did not fulfill the plan. Once the plan target was out of reach, it was not worthwhile putting up effort to increase output, since managers were indifferent between, say, 5 percent and 10 percent underfulfillment. Ministries were not indifferent because enterprise output contributed to their own plan target and therefore reduced plan targets in response to shortages in order to elicit effort. The corresponding plan increase in enterprises with more slack had an obvious adverse incentive effect, leading to attempts to hide slack as much as possible.

the refrigerators of workers' households were never empty. Because the labor market was a sellers' market and because social services were so concentrated inside enterprises, it is no wonder that enterprise restructuring under transition would be perceived as the most threatening reform to workers. Worker resistance and political constraints to restructuring could thus easily be predicted before the beginning of transition, especially in countries like Poland where they had had the opportunity to organize themselves.

The economic literature on socialist economies also discovered the existence of investment cycles under central planning. This was an interesting paradox, since one of the proclaimed goals of central planning was to eliminate the business cycle. Theories of the investment cycle (Bauer, 1978; Kornai, 1980; Simonovits, 1991) were based on central planners' macroeconomic adjustments to shortages. In a situation with less than normal shortages, planners would approve a larger number of investment projects than usual. Enterprises had all sorts of tricks to get their investment project approved: underestimation of costs, low first-year budget, and so on. After a while, the number of unfinished construction projects would accumulate, as well as the information on increased shortages. Given soft budget constraints, unfinished projects would never be abandoned and would ultimately be completed.<sup>9</sup> As a result, planners would halt the approval of new projects and inject funds as a priority to finish existing projects until perceptions of shortage would decrease, leading to a new investment boom, and so on. Econometric evidence tended to confirm the existence of such cycles and adjustment mechanisms (Grosfeld, 1987; Roland, 1987; Ickes, 1990; see, however, the book by Mihalyi, 1992, containing a comprehensive review of the literature while advocating a less deterministic approach to investment cycles).

Despite a general perception of shortages at the microeconomic level, it was not clear that the "classical" centrally planned economy was in a state of excess demand at the aggregate level. At the macroeconomic level, planners had various instruments to balance aggregate supply and demand, like central control over wages. A whole literature developed to test disequilibrium models of the macroeconomy on socialist economies (Portes and Winter, 1980; Portes et al., 1987) suggesting that there was little evidence of systematic states of macroeconomic excess demand, except for Poland, which was no longer a "classical" centrally planned economy but a reformed socialist economy.<sup>10</sup>

Certain socialist economies indeed had a history of market-oriented reforms before the fall of communism. Hungary abolished mandatory planning in 1968, and Yugoslavia introduced self-management in 1965. Poland underwent similar reforms in the early 1980s, followed by the USSR under Gorbachev. The typical reform in a socialist economy consisted in measures increasing enterprise autonomy substantially. One of the inefficiencies of planning is that enterprises tried to bargain for plans that were as low as possible and attempted to hide as much slack as possible in order to achieve that goal. Communist leaders thought that if enterprise managers had more autonomy in determining their output mix and prices, they would show more profit awareness and increase enterprise performance and that the result would be increased flexibility. However, the most immediate consequence of such reforms was wage drift. Enterprises started distributing most of the value added in the form of wages. Because soft budget constraints

<sup>9</sup> As we will see in Chapter 9, such behavior is not necessarily specific to the socialist economy. At the heart of the soft-budget-constraint syndrome is the sequential rationality of bailing out existing projects and incurring sometimes substantial cost overruns in order to finish given investment projects.

<sup>10</sup> Empirical work by Chawluk and Cross (1997) suggested a substantial monetary overhang in the case of Poland.

prevailed, enterprises under reform socialism or under Yugoslav self-management indeed started bargaining for more resources for wages and investment. These increased pressures from below led to a further weakening of the planning system and to a weakening of the central authorities, who yielded to enterprise demands. These increases in enterprise demands started leading to serious macroeconomic imbalances that the “classical” socialist planning system had been able to prevent. The consequence was increased foreign borrowing or increased shortages and forced savings. Countries with a history of reform prior to transition, like Hungary, Poland, Yugoslavia, and the USSR, tended to start transition with serious macroimbalances, requiring a stabilization package, whereas countries that had no prior history of reform, like the GDR, Czechoslovakia, and Romania, did not have such a stabilization problem at the beginning of transition.

## 1.4 OBJECTIVES AND CONSTRAINTS OF TRANSITION

Given the initial conditions of the socialist economy (with or without a history of reforms), what are the tasks involved in transforming the economy toward a well-functioning market economy? In this section, we provide a brief description of the main objectives of transition and of the constraints in achieving those objectives. There has not always been a consensus among economists on these objectives and constraints. We indicate the issues that are more controversial.

In terms of objectives, the following are broadly agreed upon:

1. Improving allocative efficiency by correcting the distortions of socialism through the introduction of flexible relative prices and the creation of a competitive market environment open to the world economy.
2. Stabilizing the macroeconomy, which is necessary for a correct functioning of the price system.
3. Providing better incentives and corporate governance arrangements to make firms respond to market signals. Privatization at a large scale is a key component of such changes, but so is encouragement of entry of new private firms and the creation of an entrepreneurial class.
4. Creating government institutions “adequate” for a market economy. Economists have different views of what the “adequate” government institutions are, but there is a relative consensus on (a) the need for political and institutional stability and (b) the need to protect private property rights from encroachment (by government but also by the Mafia) and to protect taxpayers from rent-seeking behavior of pressure groups toward government.

While economists tend to agree on the preceding objectives, it is also crucial to stress the constraints facing the transition process:

1. Uncertainty of outcomes, at both the aggregate and the individual levels, is a key feature of transition. Economists sometimes diverge in their appreciation of the importance of uncertainty. Implicit in many policy analyses on transition is the idea of a clearly defined goal, usually the analyst's pet blueprint for an ideal economic system. To be honest, however, one must acknowledge that the model of capitalism toward which transition economies should converge is not necessarily clear. Existing controversies among economists on the role of government in a market economy transpose quite naturally to debates on transition. More importantly, even if there is a clear goal of transition, there is no accepted theory of how to get there. Can our economic theories tell us whether the outcome of the transition in Central and East European economies will be closer to the West German miracle or the Weimar Republic, not to speak of former Yugoslavia? Thus there is huge aggregate uncertainty about outcomes, and the experience so far in these countries has not reduced the perception of uncertainty. Indeed, as stated earlier, the important output fall early in transition was not expected. Since then, some countries, like Poland, have been recovering very well while others, like Russia, have not and seem to be sinking further. It is quite possible that, as a consequence of transition, Russia will suffer a permanent shock to its income level and remain economically fragile for a very long time. Worse scenarios can also be imagined. In 1999, at the moment of writing, the uncertainty concerning Russia's future has not yet been resolved. Aggregate uncertainty is thus very important. One must also add that economic agents and policymakers act and make decisions taking as given this aggregate uncertainty. Because the transition process is the result of decisions made by individuals and policymakers facing important uncertainty of outcomes, a theory of transition must integrate this relative ignorance in modeling the process of transition. A theory of transition must also integrate the experimentation and learning process that must take place during transition.
2. Another important constraint is related to the complementarities and interactions between reforms. One obtains a wrong picture of transition by focusing on individual reforms. There are, for example, evident complementarities between privatization and price liberalization. Profit incentives in distorted markets lead to resource misallocation, and free prices alone do not deliver optimal allocative outcomes if firms do not face incentives for value maximization. Macroeconomic stabilization programs also require different instruments if prices are liberalized than if they are not. Economists all tend to agree on these complementarities but not necessarily always on their implications. Some think that complementarities are a sufficient argument to justify a big bang approach to reform, while others do not. We will see in the next chapter that the latter view is correct and that complementarities may even be a necessary condition for the optimality of gradualist strategies.

3. Finally, political constraints are of crucial importance, because transition is an economy-wide process involving winners and losers, even if aggregate welfare is enhanced. These political constraints are particularly relevant in the countries of Eastern Europe where political reform—the move to democracy—has preceded economic reform—the move to the market. Political constraints matter *ex ante*, to convince voters to start a (possibly uncertain) reform process and *ex post*, to avoid reversal of this process (Roland, 1994). It is important to emphasize the central role of political constraints in large-scale economic reforms such as transition and the importance of not separating the economics and politics of reform. In the past, economists have too often blamed (ugly) politics for messing up (elegant) economics. This tendency goes back to the Pigovian tradition and to welfare economics whereby economics is endogenous and the object of analysis whereas politics is exogenous and the object of policy recommendations by economists. As noted by Weingast (1997) in referring to that tradition, “an ironic aspect of the economists’ position is that they want individuals to pursue their self-interest in markets but not in politics.” Indeed, what economists had too long ignored until relatively recently is the economics underlying the politics. Politicians and interest groups are rationally worried about their potential losses from economic reforms. There is no reason for economists to ignore the implied political constraints, just as they cannot ignore budget constraints or incentive constraints.

Even though agreement on the ultimate goal of reform exists, important policy disagreements have surfaced concerning the speed and sequencing of reforms. It is important to trace down the sources of these disagreements, in terms of the constraints that are stressed and also in terms of the internal logic of the arguments.

It is a challenging and complex task to try to integrate aggregate uncertainty, complementarities, and political constraints simultaneously in a single theoretical model. Such complexities may partly explain why relatively little theoretical work has been produced on transition. Indeed, any theory of transition will run the risk of being irrelevant if transition is not seen as a process of institutional change at a large scale, including the components that we have listed, and there are many other unsolved problems in economic theory to work on that can be more focused and still relevant. As an area of economic research, transition faces the well-known problem of the drunken man who had lost his key in front of the doorstep but was searching under the streetlight because it was the only place where there was light. Theorists know that the goal of theory is to select key features from this complex reality and to analyze their interaction in a tractable framework. Tractability can be a very important constraint. We can only deal with this problem by making compromises. We start Part I of the book, in Chapter 2, with a model incorporating complementarities, aggregate uncertainty, and political constraints. This has the advantage of comprehensiveness and yields results that we think are crucial to understanding transition strategies and transition processes. The drawback is that for the sake of tractability, these features must be modeled in a relatively abstract way, with little institutional and economic flesh. But we think it is better, when dealing

with transition, to see the forest before seeing the tree. In later chapters, the analysis is more detailed and specific, focusing on particular aspects of transition, while abstracting from others.

## 1.5 STYLIZED FACTS ABOUT TRANSITION

We already mentioned some of the main unexpected aspects of transition. We now turn to a brief description of the stylized facts about transition that economic theory should try to explain.

### 1.5.1 DIFFERENCES IN REFORM PATHS AND STRATEGIES

Using the word “strategy” when talking about transition can in some sense be misleading. It may give the impression that conscious plans were elaborated at the beginning of transition and that those have been followed like a road map. First of all, because of aggregate uncertainty, there is nothing like a road map in transition. Therefore, actual paths of reform can also turn out to be very different from the initial strategies. Transition paths can be as much improvised responses to unexpected events and pressures as conscious forward-looking choices under uncertainty. We nevertheless think it is useful to talk about strategy when discussing the initial choices of reform paths. Even though such rationalization may tend to overestimate the degree of foresight and strategic thinking of reformers, it is nevertheless useful in understanding the logic behind the dynamics of reform in various countries. Talking about strategies does not mean that the choice set was the same in all countries nor that policies were simply a matter of choice. Differences in initial conditions and in political constraints in the various countries played an important role. Therefore, one should be cautious especially when making comparisons across countries. We should not conclude, however, that there was no choice at all between various strategies in each individual country nor that the strategies chosen were necessarily optimal. Even though the choices made can be rationalized in the specific contexts in which they were made, there is no reason to exclude errors of judgment and wrong representations of reality, not to speak of capture by specific interest groups.

Table 1.3 gives a rough overview of the speed and sequencing of reforms in selected transition economies. We chose the timing of the start of given reforms and indicated whether given reforms like liberalization, privatization, and restructuring were introduced gradually or by a big bang. In some cases, even though laws were enacted, little enforcement followed. In all cases, we tried to give the year where a given reform started to be really implemented.

Table 1.3 shows differences as well as similarities in the transition strategies in various countries. First of all, there are countries that have mainly followed a gradualist strategy: China, Hungary, and Slovenia. An interesting observation is that those countries tended to start reforms earlier than the other countries: China in 1978, Hungary in 1968, and Slovenia in 1965 inside the former Yugoslavia. Moreover, the sequencing of

**TABLE 1.3 THE SPEED AND SEQUENCING OF REFORMS**

	Political Reform	Liberalization	Stabilization	Tax Reform	Entry	Privatization	Enterprise Restructuring	Bankruptcy Reform	Banking Reform
China	1978	1984 (dual)	1994	1980	1978	1995 (gradual)	1995 (gradual)	—	—
Hungary	1989	1968 (gradual)	1995	1988	1982	1990 (gradual)	1992 (gradual)	1992	1991
Vietnam	—	1989 (big bang)	1989	1990	1979	1989 (gradual)	1989	1993	1991
Poland	1989	1990 (big bang)	1990	1992	1990	1990 (gradual)	1993 (gradual)	1992	1993
Czech Republic	1989	1991 (big bang)	Not relevant	1993	1991	1992 (mass)	1993 (gradual)	1993	1991
Slovakia	1989	1991 (big bang)	Not relevant	1993	1991	1992 (gradual)	1993 (gradual)	1993	1991
Slovenia	1989	1965 (gradual)	1990	1990	1965	1993 (gradual)	1989 (gradual)	1989	1993
Russia	1991	1992 (big bang)	1995	1995	1992	1993 (mass)	1992 (gradual)	1993	1992
Ukraine	1991	1994 (big bang)	1995	1992	1992	1994 (gradual)	1995 (gradual)	—	1995
Romania	1989	1990 (big bang)	1994	1993	1991	1991 (gradual)	1993 (gradual)	1995	—
Bulgaria	1989	1991 (big bang)	1991	1994	1993	1994 (gradual)	1991	1994	1997

Source: European Bank for Reconstruction and Development, author's evaluations.

reforms follows definite patterns. Policies to encourage entry of the small private sector tend to start early on, and privatization and restructuring occur later in the transition process. In those countries, liberalization and privatization also tend to be gradual.<sup>11</sup> Stabilization, when it occurs, usually takes place in the middle of the transition process, not in the beginning. Even though Vietnam introduced liberalization and stabilization in a big bang way in 1989, it had encouraged entry and market activities since 1979. The “contract system” in agriculture was close to the Chinese responsibility system, and dual pricing was strongly present before 1989. By 1989 when radical reforms were introduced, the private sector in agriculture and manufacturing occupied 60 percent of GDP and 85 percent of the labor force. Privatization is, if anything, gradual, in Vietnam. The sequencing of reforms in Vietnam is thus quite close to the one observed in China, even though there are important differences in timing.

The other countries can be considered roughly to have followed big bang strategies, a statement which we must qualify. The best example is Poland, where most policies started in 1990. Nevertheless, in Poland, privatization proceeded *de facto* in a gradual way after mass privatization (fast privatization via giveaway of assets through a voucher scheme) was blocked politically between 1991 and 1995 and had lost momentum by then. The Czech Republic is the next-best example of a big bang policy with liberalization, stabilization, and privatization all occurring between 1991 and 1992. It is also the first example of privatization achieved through a voucher scheme, started in 1992. Nevertheless, a certain sequencing of reforms can be observed in the Czech Republic with restructuring being delayed until the end of the privatization program. Restructuring was more gradual than in Poland and Hungary with in particular a very soft bankruptcy law and an accumulation of bad loans in the banking sector after privatization (Anderson and Kegels, 1997). Slovakia follows closely the pattern of reforms in the Czech Republic except for the fact that privatization policies switched to a gradual one after the split of the country. Russia can also be considered to have followed, partly at least, a big bang strategy. Liberalization, stabilization, and privatization were all launched in 1992. Stabilization policies failed to gain political support, and it was only in 1995 that some significant progress could be made on stabilization. Mass privatization was achieved quickly, as in the case of the Czech Republic.

The Russian experience illustrates a case that is to a certain degree equally or even more valid in other countries like Romania, Bulgaria, and certainly the Ukraine and other countries from the former Soviet Union: countries starting the transition process later are less successful in implementing them. Attempts to pass radical reforms do not pass through the political process and are blocked. Ukraine could only seriously start its transition in 1994 and 1995 despite false starts since its independence in 1991. Since then, the reform process has seriously stalled. Policy reversals are also more frequent in countries that started later. Bulgaria has experienced reversals of price liberalization, starting in 1992, and has experienced enormous resistance to privatization. Price liberalization has been undone in Russian “red belt” regions. Romania has also experienced setbacks with its privatization program and could never give momentum to plans for

<sup>11</sup> *Liberalization in Hungary accelerated substantially from 1989 onward.*



mass privatization. Countries starting later have in general also been less successful with stabilization.

Liberalization happens mostly in a big bang way, with the exceptions of gradualist countries. In China, dual pricing was introduced comprehensively in 1984. Prices were liberalized in all sectors at the margin, maintaining planned prices for planned output.

In all countries, enterprise restructuring tends to happen at later stages of transition, never in the beginning, and is always gradual: money-losing enterprises are never closed in one stroke; the process of redundancies is spread out across time. Interestingly, plans for mass privatization faced strong political resistance in Poland and Romania, with only the Czech Republic and Russia able to achieve swift implementation of mass privatization.

Traditional economic thinking would take these policies and strategies as given and simply evaluate their economic effects, a task that is clearly important to undertake. It would, however, not ask how these differences and similarities between strategies come about. For example, the less obvious success (and often outright failure) of countries liberalizing later (and in a more piecemeal way) has been interpreted by the World Bank and other economists as suggesting that faster liberalization yields better stabilization results and faster growth (World Bank, 1996; Åslund, Boone and Johnson, 1996; and others). This interpretation views policy decisions as exogenous and does not take political constraints into account. An alternative explanation is that countries starting transition later were facing stronger resistance to reforms and thus faced stronger political constraints in implementing reform policies. This view is consistent with the observation of stalled reforms and partial policy reversals in those countries. In that case, being told that faster liberalization will yield better economic results is not very helpful, from the policy point of view, when delay and incompleteness in reforms result from political constraints.

### 1.5.2 DIFFERENCES IN MACROECONOMIC PERFORMANCE AFTER LIBERALIZATION

After having reviewed the differences in transition paths and strategies across countries, it is useful to look at the difference in terms of macroeconomic performance. Figures 1.1 through 1.5 show the evolution of real GDP in selected transition economies in the years following liberalization.

We clearly see different and diverging time patterns of output performance after liberalization. Figure 1.1 highlights five patterns for output response to liberalization. China shows a continuous, smooth, and strong growth after liberalization.<sup>12</sup> All other countries have experienced an initial output decline. Some have started recovering after a few years of output fall. Poland is the best example of such a pattern. Similar countries are grouped in Figure 1.2 (Poland, Hungary, Slovenia, Czech Republic, Slovakia, Croatia, and Estonia). Another group of countries has experienced an uncertain recovery with further output fall after an initial recovery. Bulgaria and Romania belong to that group, illustrated in Figure 1.3. Other countries still have experienced a very severe output

<sup>12</sup> We took 1984 as the year of liberalization because this is the year dual-price liberalization was introduced widely in industries. If we had taken 1978, the year of decollectivization and liberalization in agriculture, the growth trend would have been even stronger.

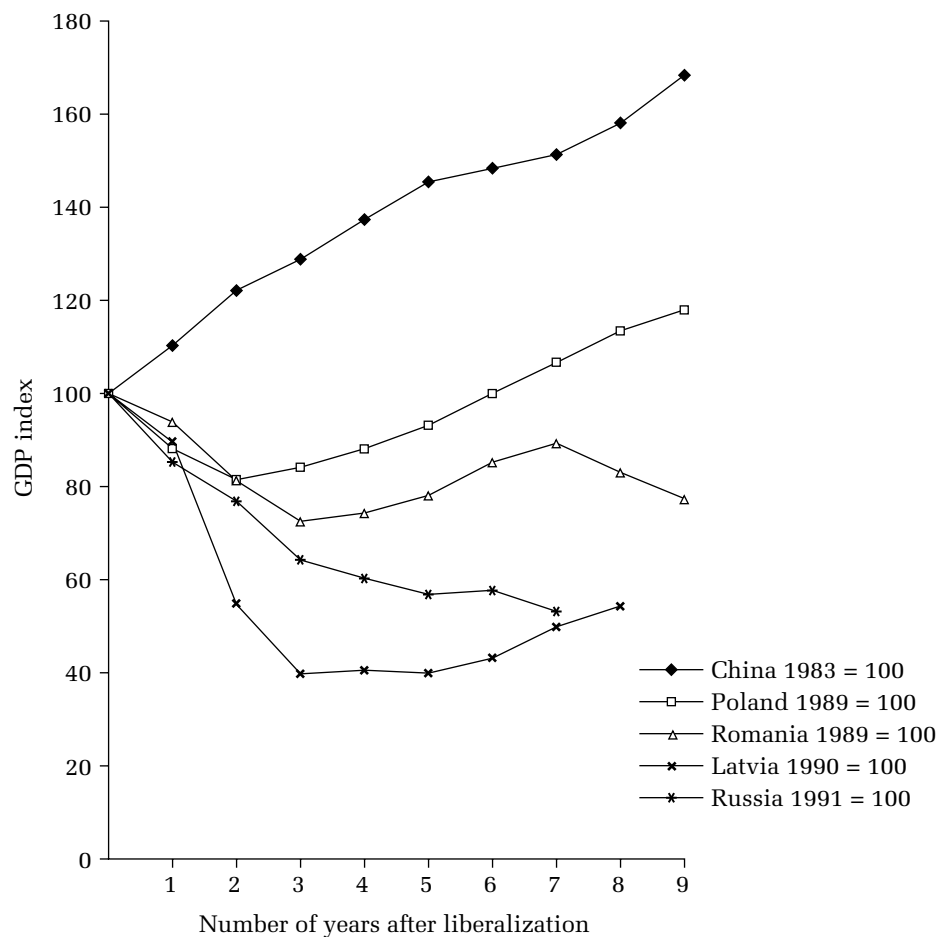


FIGURE 1.1 REAL GDP TRENDS IN TRANSITION ECONOMIES AFTER LIBERALIZATION

fall and are far from having reached a full recovery of the initial output fall (Latvia and Lithuania, Figure 1.4), while a last group of countries (Russia, Ukraine, and Belarus) have experienced a continuous output fall since liberalization with few signs of recovery (Figure 1.5). The apparently permanent, huge negative output shock in this last group of countries constitutes not only one of the most bitter surprises of transition, but also a terrible economic drama that is likely to have important yet unmeasured consequences far into the twenty-first century. The registered output fall of roughly 50 percent in many former Soviet republics must however be corrected by estimates of the hidden economy. Using data on electricity consumption, Johnson, Kaufmann, and Shleifer (1998) estimate the share of the unofficial economy in Russia and Ukraine, respectively, to be 27 and 26.4 percent in 1990–93 and 41.6 and 46.9 percent in 1995, indicating both a high share and a sharp increase. Countries in the former USSR that have experienced the strongest

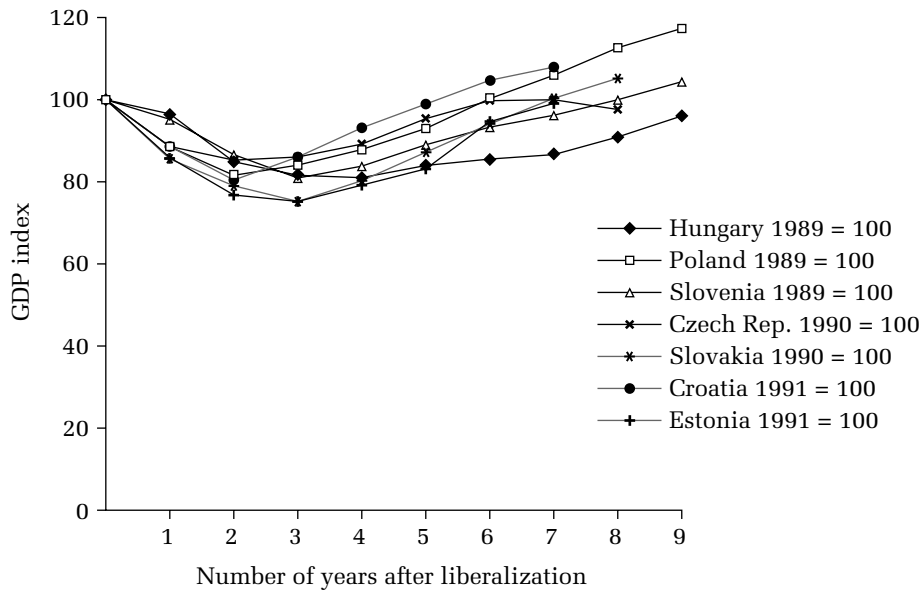


FIGURE 1.2 COUNTRIES RECOVERING AFTER AN INITIAL OUTPUT FALL

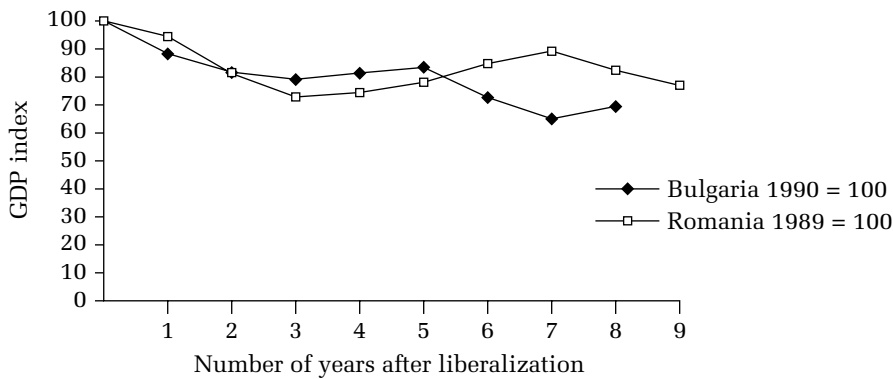


FIGURE 1.3 COUNTRIES EXPERIENCING AN INITIAL OUTPUT FALL AND UNCERTAIN RECOVERY

output fall have also seen the most dramatic increase in the share of the unofficial economy. Given the important inefficiencies associated with operating in the hidden economy with no rule of law and security of property rights, the increase in the share of the latter does not compensate for the big output loss but makes it appear less apocalyptic. Understanding why the economy goes underground in some transition countries is an important question to raise.

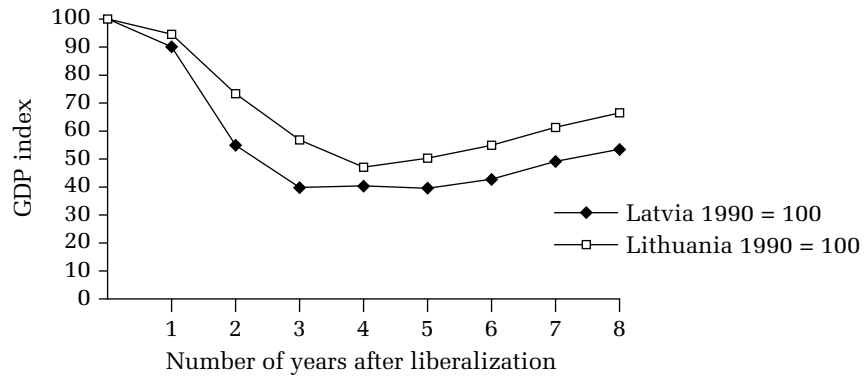


FIGURE 1.4 COUNTRIES EXPERIENCING A VERY STRONG OUTPUT FALL AND A SLOW RECOVERY

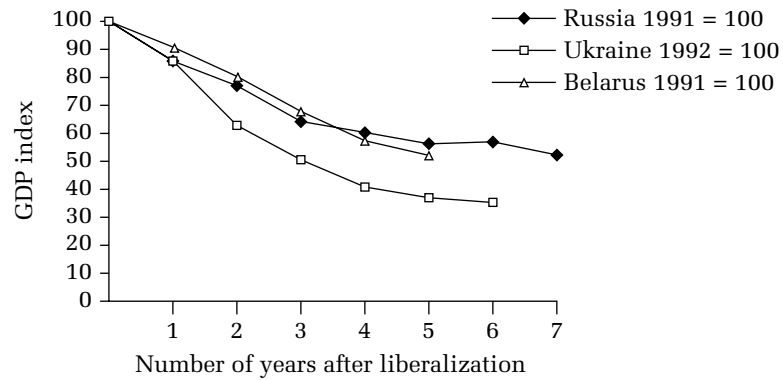


FIGURE 1.5 COUNTRIES EXPERIENCING A CONTINUOUS OUTPUT FALL

In a way, Figure 1.1 is an illustration of the aggregate uncertainty we were referring to earlier in this chapter. Few observers (if any) would have expected either that we would observe output falls of such significant magnitudes or such a divergence in output patterns across transition economies. It is therefore important to have theories able to explain both the sharp output fall in some countries and the differences between, say, China, Poland, and Russia.

Other key indicators of transition are summarized in Table 1.4. One phenomenon observed in transition countries is a decrease in life expectancy. This is clearly the case in Russia and Ukraine, slightly less the case in Romania and Bulgaria. Inequality has increased in all transition economies, but the increase has been much stronger in Russia and Ukraine. This increase has been relatively mild in Central European countries, where the Gini coefficient generally remains below 30. Figures for GDP per capita in 1989 should

TABLE 1.4 SUMMARY INDICATORS FOR SELECTED TRANSITION ECONOMIES

	Life Expectancy at Birth		Inequality (Gini Index)		GDP per Capita (constant 1995 \$)	
	1989	1997	1987–89	1993–97	1989	1997
Russia	69.2	66.9	21.9	51.8	3,900	2,240
Ukraine	70.5	67.4	23	47.3	3,500	1,490
Poland	71	72.7	26	28	3,050	3,650
Hungary	69.5	70.6	20.7	22.9	4,820	4,540
Czech Republic	71.7	73.9	19	27	5,730	5,110
Slovenia	72.7	74.7	22.9	22.3	8,270 <sup>a</sup>	10,160
Romania	69.5	69	23	29	1,680	1,400
Bulgaria	71.8	70.7	23	34	1,730	1,270
China	70	70	36	41.5	340	670
Vietnam	66	68	n.a.	35.7	202	314

Source: *World Bank, Milanovic (1998, 1999)*.

<sup>a</sup>1992.

be taken with extreme caution for Central and Eastern European countries. The figures for 1998 show an important difference in income across transition economies with Vietnam at \$314 on one hand and Slovenia with \$10,160 on the other hand.

### 1.5.3 DIFFERENCES IN ENTERPRISE PERFORMANCE IN RESPONSE TO CHANGES IN OWNERSHIP AND CORPORATE GOVERNANCE

A number of different ownership and corporate governance structures have emerged in transition economies. The obvious distinction is between state-owned and private enterprises, but reality has shown that within these categories there has been substantial variation of performance. As stated previously, the big surprise in Chinese reforms has been the growth of the township and village enterprises (TVEs), which have been the main source of growth of the Chinese economy in transition (see, e.g., Byrd and Qinsong, 1990). TVEs are not pseudo-private enterprises but enterprises owned and controlled by community governments in rural China (Che and Qian, 1998a). How can we explain the superior performance of TVEs compared to SOEs? Another major surprise, as stated earlier, has been the observation of SOEs restructuring before privatization. Similarly, among privatized enterprises, whether they were privatized through mass privatization

or by sales, whether privatized to insiders or to outsiders, the nature of the outsiders (dispersed shareholders, investment funds, or foreign multinationals) does seem to make a difference in terms of performance.

There is an important empirical literature emerging, based on firm-level data, trying to identify the effects of ownership and corporate governance on enterprise performance. Such an exercise is not an easy one because of endogeneity and selection effects. Regressing measures of enterprise performance on ownership form may be misleading because performance and internal characteristics of the firm may have an effect on the form of privatization itself. Results so far from that literature, which we will review in Chapter 10, suggest that insider privatization, privatization to dispersed owners, or privatization via voucher only or to voucher investment funds only, yields inferior performance compared to outsider privatization.

The growing empirical evidence calls for theories allowing a comparison of various ownership and governance structures and a finer understanding of the various links between restructuring and privatization. It is important to understand the specific channels through which state ownership and various forms of private ownership affect managerial incentives in firms.

#### **1.5.4 SUMMARY**

We have come up with three important sets of questions raised by the transition experience: (1) How do we understand differences in transition strategies, given the initial conditions faced in each country? (2) How do we understand differences in macroeconomic performance after liberalization? (3) How do we understand differences in enterprise performance depending on the changes in ownership and corporate governance? Each of the three parts of the book will address each set of questions in turn.