Country Note E

Eastern Europe's Transition: Building Institutions

The economic and political consequences of the end of Communism in Eastern and Central Europe and the collapse of the Soviet Union have changed the lives of 400 million people in 27 countries. The transition was without precedent, and vividly illustrates how complex is the transformation and establishment of institutions, even in societies that are well endowed with human capital and rich cultural traditions.[1]

Legacy

Fifty years of communism left a relatively large stock of physical capital—in the form of infrastructure, manufacturing industries, and housing (much of it technically obsolete)—and of human capital. Literacy and health indicators were comparable with those of industrialized countries, and the scientific and intellectual cadres were among the world's best. But resources had been inefficiently used because prices were administratively set and the state owned everything. Centrally made decisions on production and pricing disregarded preferences and scarcity. For example, Uzbekistan grew cotton extensively, drying up the rivers that fed the rapidly diminishing (inland) Aral Sea. Energy was as wastefully consumed in industry as water and fertilizer were in agriculture.[2] Many industries subtracted rather than added value: at world prices, their inputs were worth more than their outputs. Despite Soviet scientific achievements, machinery often embodied obsolete technologies because prices did not signal value and influence resource allocation.

All East European countries faced the same transition issues: to reorganize production and reallocate resources better. The expectation was that market allocation provided better incentives, leading to less waste, and economic prosperity would follow, especially with the end of the costly arms race following the demise of communism,.

Transformation was a daunting task, and some economic turmoil was anticipated, but the countries' prospects were not bleak. Most advisers—including international financial institutions, think tanks, and academics—advocated rapid reform, meaning open trade with low tariffs, rapid removals of controls over the economy in general, and quick privatization. As reformers have highlighted (notably the Russian Federation's former Minister of Finance Gaidar, in World Bank 2005b), speed was essential. The political and administrative collapse that accompanied the transition virtually everywhere meant that gradual trade liberalization, or carefully planned and sequenced privatization, was simply not possible.

Outcomes

Output in all countries declined much more sharply than expected. The 12 Central and Southeastern European countries and the 3 Baltic countries (CSB) fared better than the 12 countries of the Commonwealth of Independent States (CIS).[3] Over four years, CSB had a cumulative average output decline of 22 percent, or 12 percent when weighted by population. By contrast, CIS output fell 50 percent over 6.5 years, or by 45 percent when weighted by population.

Recovery diverged more sharply. Output in CSB now exceeds its pretransition levels, but that in the CIS is still one-third lower, or one-fifth lower when weighted by population at the end of 2003. Within the CIS, there are differences as well (figure E.1). For example, Georgia's output declined by roughly 75 percent between 1990 and 1994, and at the end of 2003 it was no more than 40 percent of its pretransition level, partly because of civil war. Incomes are more unequal now within countries (the Gini coefficient almost doubled in Bulgaria, Armenia, and several other countries). More worryingly, absolute poverty has risen.

Private enterprise overtook the state sector in most countries; but its share of output varies from more than 80 percent in Hungary to a mere 20 percent in Belarus. Newly established private firms account for much of the growth, although many are spinoffs from older firms. International trade expanded, especially with countries outside the former Soviet bloc. Exports from the CSB have outpaced those from the CIS (8.8 percent annual growth versus 3.2 percent during 1993–98). This was partly because these countries had ports or had good roads to connect them but also because foreign firms invested there, since the countries were expected to join the European Union. Whether it is a cause or consequence, CSB governments have introduced policies that provide a better investment climate that fostered domestic firms and attracted inflows of direct foreign investment: Hungary has attracted foreign investments of more than 5 percent of its gross domestic product (GDP) since 1995, among the highest rates of foreign direct investment (FDI) in the world. Russia, Poland, and the Czech Republic have also attracted substantial FDI, although the amounts were smaller fractions of their GDP.

The transition buffeted government finances. Revenues fell. Collecting taxes requires a different administration than does commanding resource transfers, and developing new tax administrations was difficult and slow. Meanwhile fiscal deficits ballooned. Concomitantly, government spending rose, because unemployment called for additional outlays and because firms requested funds (subsidies, guarantees, or loans) to restructure their operations. Cutting government spending was risky: police officers easily organize protection rackets, and members of the military at the borders with weapons and transport are tempted to smuggle contraband.[4] Domestic borrowing was difficult because savings fell, and foreign lenders were not always forthcoming. Printing money created inflation that hurt the poor, who (unlike in Africa or Asia) had no extended families to fall back on.

Reorganizing the real sector involved more than freeing prices. Every firm had to decide how and what to produce and how much to charge, which workers to retain, and so forth, but neither governments as owners nor state-owned banks as creditors could oversee the firms' managers. Mechanisms such as hard budget constraints were needed for this purpose and to discipline firms. Some firms were slow to restructure and continued operating as before, building up inventories and interenterprise arrears. Some governments (for example Romania, twice) sought to break the logjam, thereby loosening the hard budget constraint.[5] Utilities posed special problems: their finances were often sapped by the unpaid bills of energy-intensive industries, but shutting them down could be a death sentence for consumers in cold climates, because workers lived in company housing. Many governments made mistakes when tackling issues such as this, but some recognized and corrected the mistakes more quickly than others.

Problems were similar in agriculture: although farmers could switch crops and use inputs more efficiently in theory, those growing cash crops (for example Uzbek cotton growers) faced problems similar to those in industry when they could not easily adapt irrigation and the marketing infrastructure. De-collectivizing agriculture was not easy: even when restitution claims were sorted out and land was redistributed, farmers sometimes had to continue operating collectively because they lacked their own equipment and access to credit.

Financial intermediaries did not develop quickly. Countries licensed many new banks, often creating so-called commercial banks with the stroke of a pen, but developing a credit culture takes time, and in any event banks had little to lend. As incomes fell, so did savings rates, and few savers entrusted their savings to banks, especially since they lost much of their deposits to high inflation during the early years of the transition. Banking deposits now range from 3 percent of GDP (Georgia) to 60 percent (Czech Republic); those in most transition countries are in the 10–20 percent range. Some countries (Albania, Romania, and Russia) suffered from destructive pyramid schemes that added to depositors' distrust and to the liabilities of governments that intervened. The inexperienced central banks found it difficult to oversee financial systems or to resist government demands that led to inflation.

Privatization was only one of the many real-sector issues that governments tackled. Allowing new firms to emerge required changes at many levels in the bureaucracy, including company registration and tax collection. As noted above, in countries with no tradition of voluntary tax compliance, developing tax administration proved difficult. Governments traditionally collected payroll taxes, but relying heavily on this method implied high tax rates that deterred new business formation or forced activities into the untaxed informal sector.

Thus, although social concerns were important, funds for schools, health care, and pensions had to be cut. Spending on education declined to 2–8 percent of GDP and on health care to1–6 percent of GDP. Many social services that were formerly provided by enterprises (such as housing and childcare) had to be transferred to local governments, but their costs far outstripped the governments' ability to raise revenues. When spending on such services declined, it was difficult to protect vulnerable groups, especially when there were large regional disparities and no transfer mechanisms in place. Some of the spending cuts were accomplished by eliminating overly generous provisions: Poland, for example, had been spending twice as much on disability pensions as the Organisation for Economic Co-operation and Development (OECD) average.

Pensions and unemployment insurance were provided centrally, and these amounted to a high 10–13 percent of GDP—double their pretransition proportion, and unsustainable. Because tax rates on wages were already high, encouraging evasion, most countries made it harder to qualify for pensions, unemployment insurance, and other benefits by raising the retirement age and other eligibility requirements. Improving the efficient delivery of social services will take time.

Many people were adversely affected by the changes taking place, and their perceptions now mattered because most countries were becoming democracies. (The few that remained authoritarian were not among the economic reformers.) It did not help when newly prosperous citizens flaunted their wealth, especially when this wealth had been "legally stolen" through noncompetitive privatization. The hardships caused many citizens to resent the harshness of markets, but no country has reverted to communism, and more impressively, there has been no significant policy reversal.[6] But democracy's roots have yet to spread, especially in the CIS; media criticism is new; and politicians are unseasoned. Georgians, and more recently Ukrainians, took to the streets to oust an unpopular president after a rigged election, but their new heroes face familiar constraints and cannot work miracles.

Despite the difficulties, the achievements are impressive and the outlook is bright: by the end of 2003, real GDP in the CIS (weighted by population) was 50 percent higher than in 1998, and citizens of the Balkans enjoy peace after years of war and civil conflict. Eight transition countries have joined the European Union, and this has spurred their own efforts and those of other prospective members to improve their societies in all their dimensions.

Lessons

Though endowments matter, so do policies. The countries that prospered most were not those that many observers had predicted. For example, the former East Germany's endowments did not lead to prosperity, and the Czech Republic's progress belied expectations stemming from its "reforms" (soft budget constraints and the resulting lack of industrial restructuring precipitated the Czech crisis during 1996–98).

East Germany's experience, in particular, shows the importance of sound policies. The East was fortunate to be well located, sharing West Germany's language, culture, and history (except during the communist years). East Germany could quickly and smoothly adopt laws and organizations from the West, and it obtained considerable financial assistance: 40–60 percent of its GDP from the West as cumulative transfers during 1991–97 and only slightly less thereafter. Nevertheless, East Germany's output fell substantially, and remains more depressed than that of many transition countries whose disadvantages are greater. Unifying the German currency at an overvalued level, and adopting West Germany's rigid labor laws and generous welfare benefits, resulted in too much of East Germany's capital being scrapped and too few investments being made, leading to high unemployment. Foreign direct investors leapt over East Germany into countries such as Poland that had better economic policies.

The transition countries show no consistent statistical association between particular types of reform policies and growth.[7] This should not be surprising: even if the policy reform index chosen identifies and measures the right policies, the response of the economy to reform also depends on many other factors including government credibility, institutions, and social cohesiveness, which differ greatly across countries (and perhaps also over time in each of them).

Even so, some observations are notable.

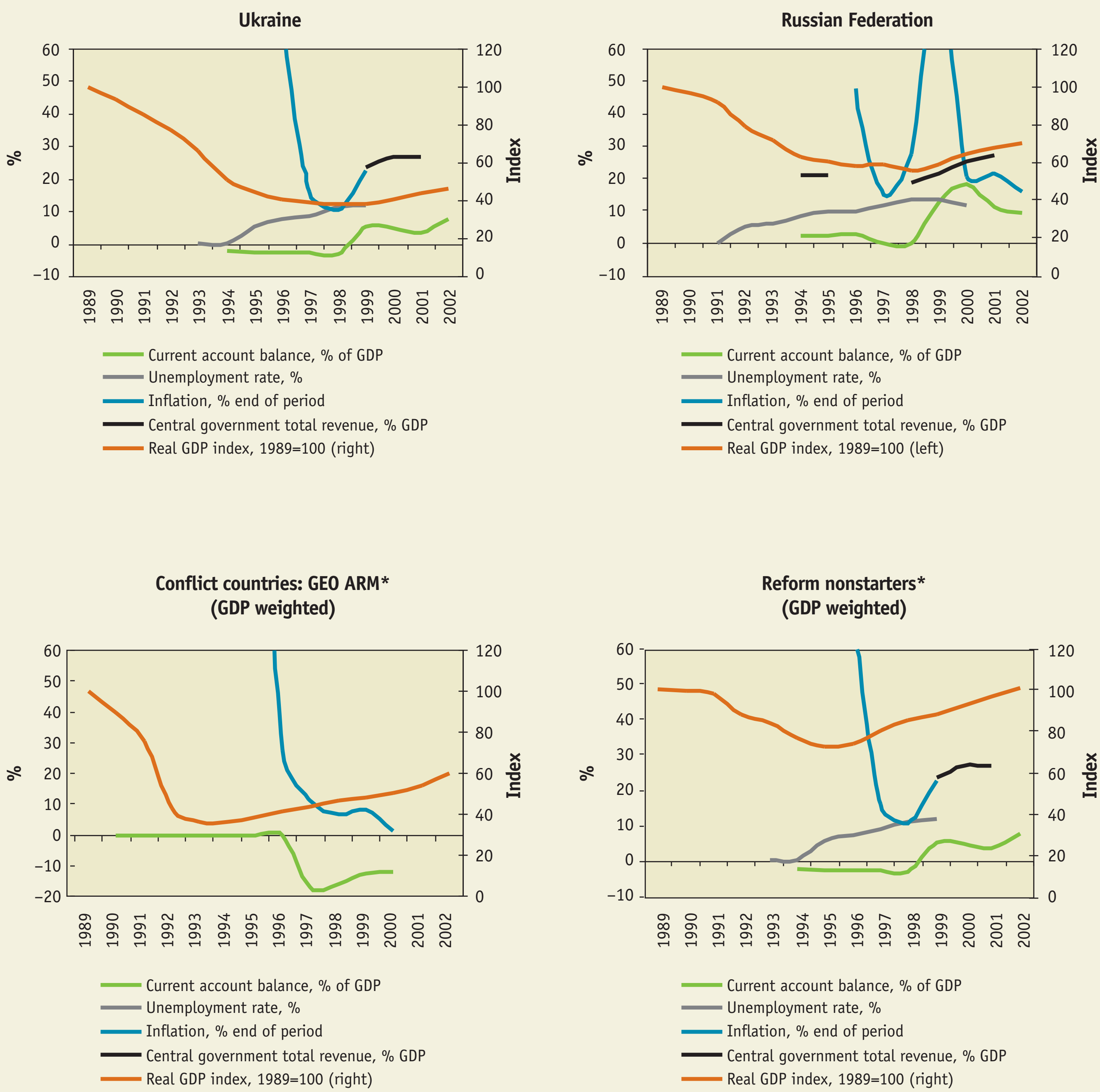
First, as discussed further in chapter 6, some slow privatizers have fared better than fast ones, yet the issue is not speed per se, but a rapid move to a market economy. Although studies have found that growth has come disproportionately from newly created firms, privatizing existing firms ensures that these new firms have assets with which to work (McMillan and Woodruff 2002).

Second, building a consensus is important and takes time. As noted above, many reforms perforce had to be done quickly. Prices had to be freed, and firms had to be sold rapidly, especially if the state had lost control and firms operated in limbo. But other changes, such as improving accounting or a court system, take time to accomplish. Accelerating such reforms precludes the discussions needed for compromises and consensus building. Even if such reforms are not reversed, they may not bear fruit if complementary measures are not taken. As Larry Summers put it, "Well executed policies that are 30 degrees off are much more effective than poorly executed policies that are spot on.... the ability to do things we take for granted in modern market economies is actually a crucial part of success [in the transition economies]" (World Bank 2005b). Some political systems seem to enable consensus building better than others (World Bank 2002a, 2002c). And competitive democracies (such as the Czech Republic, Hungary, Poland, Slovenia) have sustained reforms better than noncompetitive political regimes (such as Belarus, Uzbekistan, Turkmenistan), though here it is hard to distinguish the effect of new leaders from the effect of new political regimes.

Third, policies and endowments, including institutions, are not entirely independent of each other. Societies take many years to change, and in retrospect it was unrealistic to have expected market-supporting institutions to emerge rapidly in response to demand. If policies are effective only when there is a broad consensus about them—rather than any particular reform measure per se, or the zeal and speed with which it is implemented—this also depends on endowments and institutions. Assured of broad support for the reform course, governments can change the implementation of policies to respond to opportunities and shocks (for example by speeding up or slowing privatization, or adjusting budget deficits), with good results, as in Poland and Hungary.

FIGURE E.1

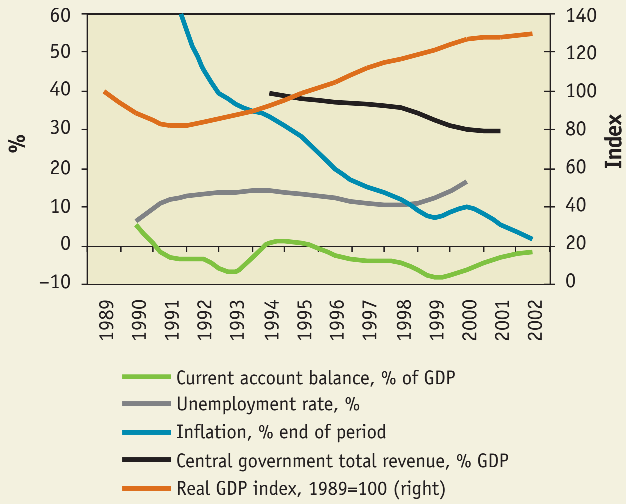
Key Indicators for Transition Countries



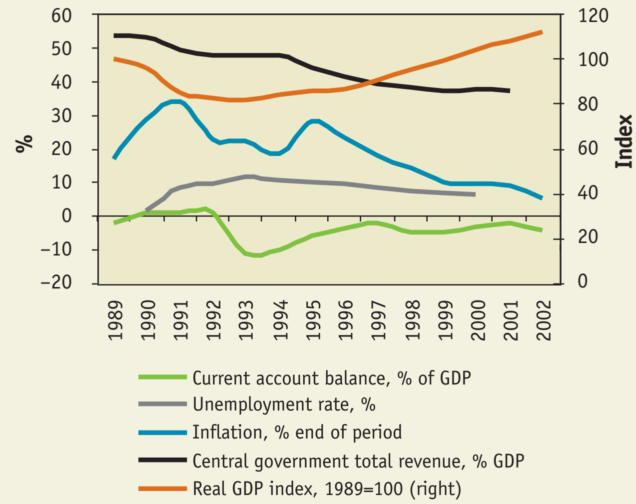
Source: World Bank, *WDI*; European Bank for Reconstruction and Development 2003.

[AU: Can't find a 2003 reference for EBRD; do you simply mean that the data are from 2003?]

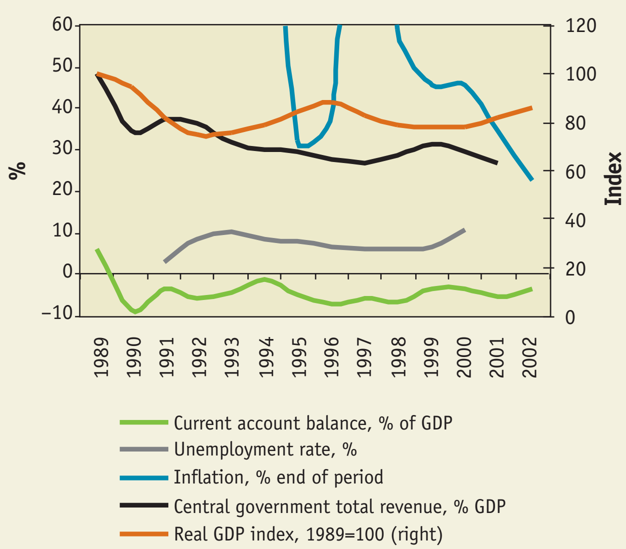
Poland



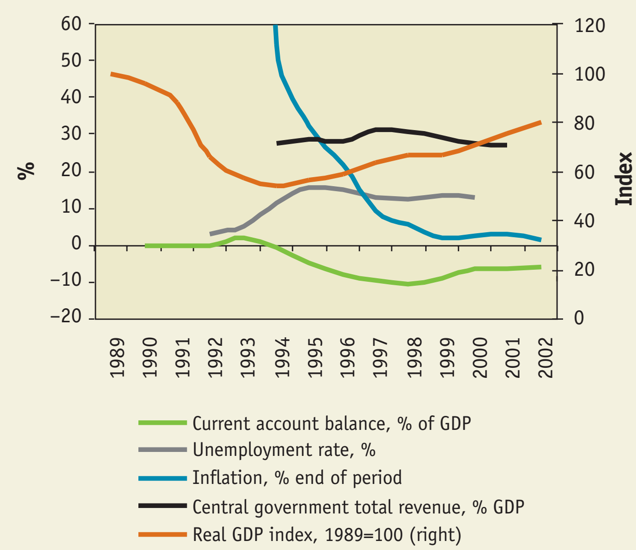
Hungary



Romania



Baltic states (GDP weighted)



Notes

1. The large literature on the transition includes the World Bank's *World Development Report 1996* and a report examining the first 10 years of transition (World Bank 2002c). Looking at the ingredients for successful transition, the World Bank's 2002 report emphasized the role of policies facilitating the entry of new firms and limiting the flow of resources to old industries; and the role of market institutions that, among other things, enforced property rights and ensured good governance. It also indicated that competitive democracies (that is, those that established and protected civil liberties and political rights permitting multiparty democratic elections) recovered sooner and grew faster than others. While recognizing the importance of initial conditions, the report concluded that after the first few years, policy and institutional reforms had been more important than those conditions in explaining performance.
2. For example, in 1985 the Soviet Union used 0.95 tons of oil equivalent per $1,000 of GDP, nearly double the 0.5 tons used by OECD countries (IMF, World Bank, OECD, and EBRD 1991).
3. The 12 CSB countries are Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, the Former Yugoslav Republic of Macedonia, Poland, Romania, the Slovak Republic and Slovenia. The CIS comprises Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, the Russian Federation, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.
4. In several countries, high excise taxes on tobacco and cigarettes attracted well-organized smuggling operations that also moved drugs, weapons, and people (illegal immigrants and victims of bondage).
5. Condon and Ramachandran (1993) show that this buildup would plateau and that the situation would correct itself.
6. As measured by the European Bank for Reconstruction and Development's transition indicator.
7. Selowsky and Martin (1998) use panel data to measure the effect of reforms (using a liberalization index) on growth after controlling for initial conditions and other factors (such as dummies for war). The coefficient on the liberalization index is statistically significant. However, Heybey and Murell (1999) find that correcting for its possible endogeneity (using initial level, share of industry, and the like as instruments) the liberalization index does not explain growth during the first four years of the transition. Brown and Earle (2004) find that interfirm reallocation of output, labor, and capital are not related to productivity, although privatization improves such reallocation.