

# Executive summary

## Chapter 1: Ten years of transition

The fall of the Berlin Wall in November 1989 was an occasion for hope. It also inspired a sense of euphoria and triumphalism, and – for some – a belief that the transition to a market economy and democratic society would be simple and short. But ten years of experience has demonstrated that the transition is complex and long and that the upheavals and stresses can be harsh. The transition is not a steady march forward; there have been and will be setbacks and crises along the way. But the disappointed hopes of some should not be allowed to overshadow the remarkable achievements over the past ten years. Most output in the region is now exchanged in a market system and produced by the private sector. Free and fair elections in most countries have led to democratic changes of government.

Taking stock of developments over the first decade of reform, Chapter 1 emphasises the need to complement liberalisation and privatisation with the development of institutions and behaviour that support the functioning of markets and private enterprise. This requires a strategy to strengthen simultaneously the capacity and the accountability of the state by empowering domestic constituencies with a stake in the process of reform. Liberalisation and privatisation are not enough to promote these constituencies. Political and economic competition are essential. The hope and challenge for the second decade lie with the democratic process, the entry and expansion of new private firms and continuing international integration.

### Part I: Transition and economic performance

## Chapter 2: Progress and patterns in transition

Over the past decade, two broad patterns in transition have emerged. In the more advanced countries, rapid liberalisation and sustained macroeconomic stabilisation have laid the basis for gradual institutional change. These changes have been driven by the demand from enterprises and voters and have been shaped by the process of European integration. In the less advanced countries, progress in liberalisation and privatisation has been slow and uneven and stabilisation has been jeopardised by the persistence of soft budget constraints. The business environment for new enterprises also remains deeply flawed.

Two issues dominate the second decade of transition. First, the less advanced countries in south-eastern Europe and the CIS need to redouble their efforts to complete liberalisation and lay the basis for macroeconomic stability. In this task, they face serious challenges, confronted with unfavourable legacies from the previous regime's central planning and the need for significant structural change to introduce free markets. To help ease this constraint, governments should reduce obstacles to the growth of new private enterprises, which can provide new employment opportunities and reduce the costs of adjustment. Second, the

process of institutional change in response to demands from the private sector cannot be taken for granted. The state must play a strong and leading role in developing market institutions. Transforming the state remains a pressing challenge for all the transition economies.

## Chapter 3: Macroeconomic performance and prospects

The variation in reforms across countries is mirrored in their macroeconomic performance over the first decade of transition. The severity of initial structural and macroeconomic imbalances has not only influenced the depth of the initial recession in the transition process but also affected the political feasibility of rapid reforms. Even among countries with unfavourable starting points, however, there is clear evidence that rapid liberalisation and stabilisation, as well as progress in small-scale privatisation, have yielded significant benefits in terms of stronger growth in output.

For liberalisation and stabilisation to be sustained, they must be complemented with institutional changes that support markets and private enterprise. The chapter reviews recent cases of reform reversals caused by the lack of underlying structural change in the enterprise and financial sectors. These flaws have also impeded reform of public finances and undermined fiscal stability. Over the medium term, the transition economies are, in principle, well-placed for rapid growth because of their high level of skills and their potential for rapid improvements in productivity following the introduction of new technologies. This potential has begun to be realised in part of the region, primarily in central and eastern Europe. The main challenge for the south and east of the region is to break out of the vicious cycle of policy instability and poor governance.

## Chapter 4: Structural change in transition

A crucial link between progress in transition and growth in output is structural change. Economic reforms were widely expected to lead to substantial reallocation of resources, rectifying the distortions inherited from central planning. While causing temporary economic and social upheaval, this reallocation would underpin the subsequent recovery. A structure of economic activity comparable to market economies has been achieved more rapidly in countries that have quickly liberalised markets and trade than in those with gradual and uneven levels of reform.

The pace of structural change has differed widely in various areas in the economy. Although the adjustment in employment across sectors has been uniform and swift, regardless of the pace and durability of reforms, other areas have been much more sensitive to the extent of progress in reform. These include the reorientation of trade towards the international economy, the development of the private sector and the expansion of key infrastructure services, which are all fundamental to high growth. If structural change is to

give rise to growth, reforms aimed at strengthening these sectors should be a priority. The chapter also shows that the financial sector – which is necessary for growth and stability over the long term – has so far shown little development in response to financial reforms. Regulatory practice will have to be strengthened and competition in finance needs to be promoted if this sector is to support the transition in the next decade.

## Part II: The state and economic reform

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### Chapter 5: The politics of economic reform

Within the constraints provided by differing initial conditions, the political environment has been the major factor influencing policy choices during the first decade of transition. It is commonly believed that successful reform requires a stable, strong government of technocrats committed to reform, but the experience of the last ten years of transition has contradicted this view. A high degree of political competition, rather than a government insulated from electoral pressures, has promoted reform in many countries. This has partly been achieved by weakening the power of vested interests to gain influence over government and to distort reforms.

Four key political factors influencing successful and consistent reforms are identified. First, deposing the old elite at the initial stages of transition has been instrumental in promoting economic reforms, which have not only fostered markets and private enterprise but also weakened the strongly vested interests from the previous regime. Second, the degree of social cohesion around the goals of transition at an early stage is critical for sustaining the reform process through the inevitable pains of adjustment and the change of governments. Third, to maintain the momentum for reforms, it is essential to constrain the power of vested interests to block reforms that threaten to undermine their gains from only partial reforms and distorted markets. Finally, the incentives associated with external alliances can encourage governments to take difficult policy choices and to undertake institutional reforms. The chapter provides a cross-country comparison of the relationship between the structure of the political system and economic reforms, and analyses in detail the politics of privatisation in several less advanced countries.

### Chapter 6: Governance in transition

One of the main goals of transition has been to transform the role of the state in the economy – to persuade it to adopt a form of governance based on support for markets and private enterprise rather than plans and commands. Yet despite the considerable achievements in liberalisation and privatisation in the first decade of transition, the quality of economic governance varies widely across the region, as revealed by the survey of over 3,000 enterprises in 20 countries – the Business Environment and Enterprise Performance Survey – which was undertaken for this Report.

Surprisingly, this variation is not a direct result of the extent of economic reforms that have been adopted. In fact, enterprises in both the most advanced and least advanced countries tend to have relatively favourable assessments of the quality of their governance, while those in countries with partial reforms report a higher level of governance problems. A key to explaining different assessments of governance across the region lies in the extent to which the state is subject to “capture” – or undue influence – by vested interests. The survey provides a unique opportunity to measure and compare the extent of state capture across the region and to investigate its effects on the overall quality of governance.

The survey also shows that the initial hope that privatisation would create the foundation for improved governance and transform the ties between the state and firms has not been fully realised. The impact of privatisation on the quality of governance depends strongly on the extent of state capture. Firms in transition economies continue to interact with the state in a complex web of costs and benefits that differs across countries and types of firms. Enterprises spend considerable resources in lobbying state officials, paying bribes and adjusting to state interference. In return, they receive benefits in the form of subsidies, soft finance, tax advantages and the tolerance of arrears. A key challenge remains the effective “depoliticisation” of firms through further market reforms and measures to constrain state capture by private interests.

## Part III: Enterprise response to reforms

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### Chapter 7: Competition, enterprise performance and the investment climate

A successful transition must unlock and encourage deep restructuring, innovation and growth by enterprises, but in many countries economic reforms have yet to yield strong responses. This chapter examines how reforms influence the performance of firms, using data from the enterprise survey. Importantly, the analysis considers differences in reforms both at the country level, in terms of the pervasiveness of soft budget constraints and assessments of the investment climate, and at the level of enterprises themselves, in particular the degree of competition faced by firms and their origin and ownership.

The analysis reveals the strong influence of competition and hard budget constraints on deep restructuring and product innovation and concludes that these initiatives contribute significantly to the growth of firms. Growth tends to be recorded much more rapidly in new private firms than in other types of firms, even after allowing for their relatively small size. However, firms that operate in countries with unfavourable investment climates tend to grow more slowly. The analysis underscores therefore that competition, hard budget constraints and a favourable investment climate are vital for the restructuring and growth of enterprises.

### **Chapter 8: Market selection and the role of SMEs**

New private firms tend to grow more rapidly than other types of firms. The emergence and growth of these firms occurs most strongly if the market “playing field” is level. One indicator of the strength of the process of market selection in the enterprise sector is the extent to which firms with increasing productivity grow and those with falling productivity decline. An analysis of this process reveals sharp differences among transition economies.

The survey reveals that the main obstacles to the growth of SMEs are anti-competitive practices and corruption, followed by taxes and business regulations. A priority for the next decade of transition is to embrace competition policy that focuses on reducing barriers to business start-ups, introducing measures to combat corruption and crime and hardening the budget constraints on declining industrial enterprises.

### **Chapter 9: Restructuring large industrial enterprises**

The restructuring of existing enterprises remains one of the greatest challenges of the transition. Progress in liberalisation and privatisation has been extensive in the past ten years, but enterprise restructuring – particularly in the industrial sector – has not. The mix of reforms adopted by many transition economies has led to rapid industrial downsizing in terms of employment and capacity, but it has not led to quality investment and the development of new products and production methods. A combination of political, fiscal and social constraints has made the task much more difficult than anticipated and the reforms adopted in many countries have been ineffective.

The way forward remains challenging. Changes in ownership and management will be crucial to break up the vested insider interests and to initiate deep restructuring. The chapter reviews various options that could be used to attract strategic outside investors, including debt forgiveness, creditor-led restructuring, “ring-fencing” in joint ventures, and the hiring of external management expertise.