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FROM PLAN TO MARKET

EXECUTIVE SUMMARY

World Development Report 1996

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THE WORLD BANK

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Executive Summary

Constant revolutionizing of production, uninterrupted disturbance of all social conditions, everlasting uncertainty and agitation. . . . All fixed, fast-frozen relations, with their train of ancient and venerable prejudices and opinions, are swept away, all new-formed ones become antiquated before they can ossify. All that is solid melts into air. . . .

—Karl Marx and Friedrich Engels, *The Communist Manifesto*

Between 1917 and 1950, countries containing one-third of the world's population seceded from the market economy and launched a vast experiment in constructing alternative systems of centrally planned economies that transformed the economic and political map of the world. *World Development Report 1996: From Plan to Market* is devoted to the transition of these countries back to a market orientation—a process aptly, if ironically, described by *The Communist Manifesto*'s portrayal of the turbulent spread of capitalism in the nineteenth century.

The Report steps back from recent events and policy changes in twenty-eight countries—ten in Central and Eastern Europe (CEE), the fifteen newly independent states of the former Soviet Union (NIS), and China, Mongolia, and Vietnam—to ask what has been learned about the ingredients of a successful transition from plan to market and how these should be pursued. Transition goes beyond typical reforms because change is deep and systemic, requiring the building of key market institutions (Box 1), even though the essential components of the process are common to many other countries as well.

But at the same time, the economic challenge is daunting. Decades of bureaucratic allocation created serious distortions in planned economies, with some sectors, particularly heavy industry, greatly overbuilt, and others, notably services, severely repressed. Perhaps a quarter of the Soviet economy served the military. Relative prices diverged widely from market patterns, and pervasive shortages reduced incentives to improve quality. Energy intensity was several times that in market economies. Many firms added negative value—that is, at world prices the cost of their inputs would have exceeded the value of their outputs. Transition countries therefore face a massive restructuring task.

As stressed throughout the Report, this is a transition still very much in progress, and some important questions do not yet have definitive answers. The fact that so much remains to be done, however, makes it all the more important to deduce the key lessons of transition to date. The Report analyzes two sets of overarching questions. The first set, addressed in Part One, focus on the initial challenges of transition and how different countries have responded:

- Do differences in transition policies and outcomes reflect different reform strategies, or do they reflect primarily country-specific factors such as economic structure, the level of development, or the impact of simultaneous political changes?
- Are strong liberalization and stabilization policies needed up front, or can other reforms progress equally well without them?
- Must a market economy immediately become a private one, or can privatization wait in the early years of reform? Is privatization indeed necessary at all?
- Must there be a gulf between winners and losers from transition? How can social policies ease the pain of transformation while spurring on the process?

Part Two looks beyond these challenges to the longer-term agenda of consolidating the reforms by developing the institutions and policies that will help the new market system to flourish:

- How should countries in transition develop and strengthen the rule of law and control corruption and organized crime?

Box 1 What is transition?

The ultimate goal of transition in countries shedding central planning is to build a thriving market economy capable of delivering long-term growth in living standards. What distinguishes transition from economic reforms in other countries is the systemic change involved: reforms must penetrate to the fundamental rules of the game, to the institutions that shape behavior and guide organizations. For transition to succeed, it must restructure the institutional basis of the social system—an enormous and enormously time-consuming agenda.

The nuts and bolts of transition encompass three sets of reforms:

- Freeing prices, trade, and entry to markets from state controls while stabilizing the economy. Liberalization is the first step that makes all the other benefits of market reforms possible—decentralizing production decisions to enterprises and households and providing agents with the incentives and information to trade freely and respond to the forces of demand and supply. But markets cannot do their work in an environment of high inflation and macroeconomic uncertainty. Stabilization—reining in excessive budget deficits and keeping inflation at moderate levels—is thus an essential complement to liberalization.
- Clarifying property rights and privatizing them where necessary. People and businesses need clear ownership rights if they are to respond efficiently to market forces. At the same time, countries must re-create—or, in many cases, create from scratch—the many institutions that support market exchange and shape ownership in advanced market economies, especially the rule of law.
- Reshaping social services and the social safety net to ease the pain of transition while propelling the process forward. Addressing extreme poverty, promoting health and education, and helping workers adapt to the needs of a market system support economic growth *and* social justice. This is especially true in transition countries, where policymakers may not be able to implement vital, growth-enhancing reforms if much of the population feels that transition has left them behind. And labor productivity—which depends on workers' knowledge, skills, motivation, and health—is central to economic growth.

- How can countries build effective financial systems?
- How should governments restructure themselves to meet the needs of a market system?
- How can countries preserve and adapt their human skills base?
- Why is international integration so vital for transition, and what are the implications for trading partners and capital flows?
- How can external assistance best support countries in transition?

The final chapter distills the key messages of the Report.

Reforms pay off

Consistent, sustained policies can pave the way for successful economic adjustment and rapid growth—even in countries lacking clear property rights and strong market institutions. In CEE, the NIS, China, Mongolia, and Vietnam, the most effective policies to date have been those that liberalize markets and trade, open the economy to new businesses, and help stabilize prices.

Liberalization

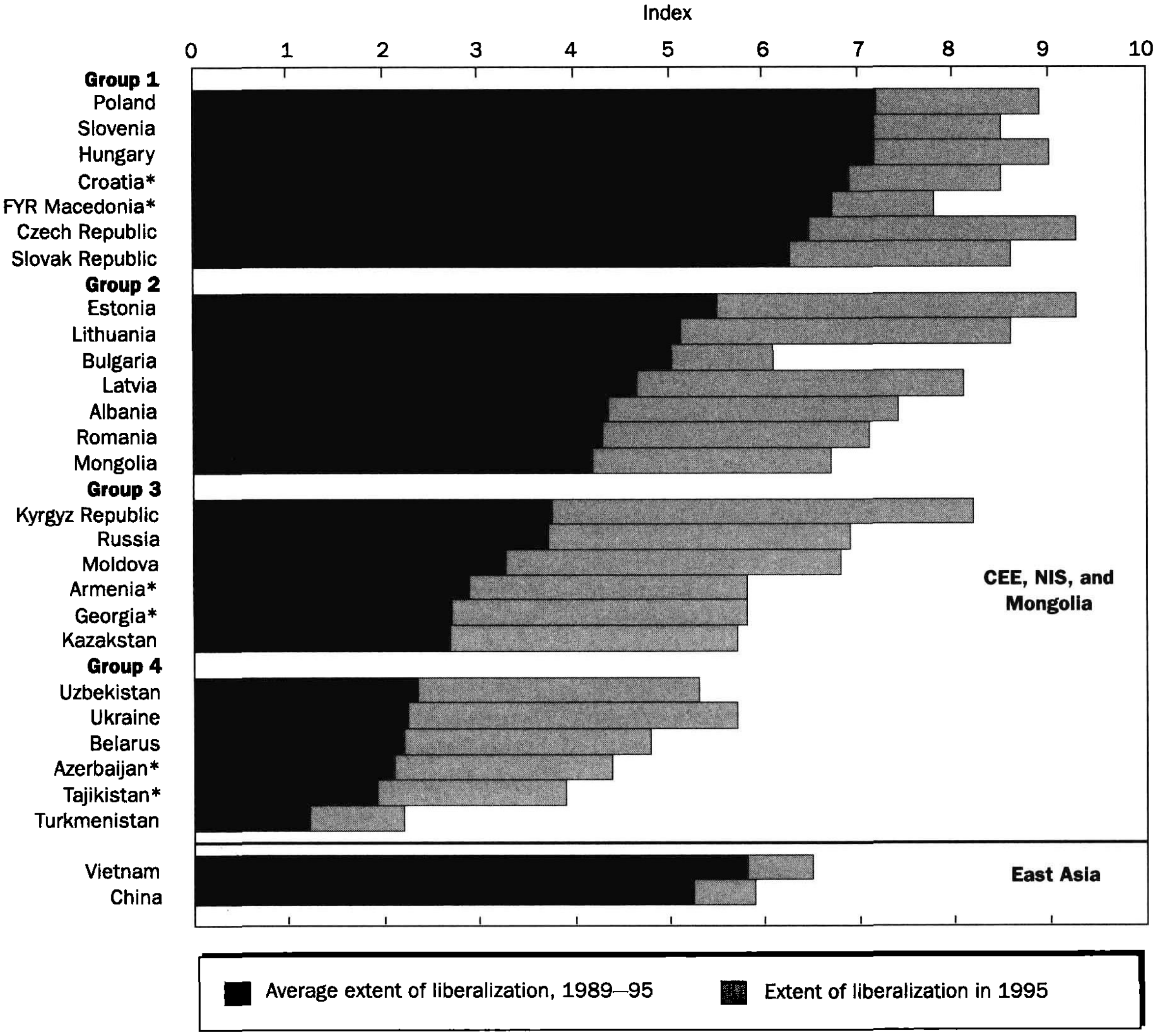
The starting point, speed, and scope of liberalization have varied greatly among transition economies. Figure 1 shows estimates of the degree to which transition economies were market economies in 1995 and the average level of liberalization in the period 1989–95. The CEE countries, the NIS, and Mongolia are categorized into four groups by the latter measure, which reflects both the extent of liberalization and its duration.

China and Vietnam have both liberalized substantially, though in China especially this has been achieved over a longer period than in Europe. Their reforms have resulted in rapid growth in output (Table 1), increases in labor productivity and exports, and marked improvements in living standards. The initial stages of reform in CEE and the NIS, by contrast, were associated with sharp declines in output. Official estimates severely overstate these declines because of statistical weaknesses, including the exclusion of a large and growing unofficial economy. Furthermore, many of the goods lost were of no value in the market system, and the overall quality and variety of goods have risen appreciably. But even after taking these facts into account and adjusting for statistical biases, the output drop was still considerable. Many people have gained from reforms, yet living standards fell for many others—significantly in some cases.

Why did output initially slump in CEE and the NIS? Particularly in the NIS, reforms began in the midst of

Countries have liberalized at different speeds and at different times, but the late starters are catching up.

Figure 1 Economic liberalization by country



Note: Bars indicate the extent to which policies supporting liberalized markets and entry of new firms prevailed in 1995 and on average over 1989–95. Asterisks indicate economies severely affected by regional tensions between 1989 and 1995. The index is a weighted average of estimates of liberalization of domestic transactions (price liberalization and abolition of state trading monopolies), external transactions (elimination of export controls and taxes, substitution of low to moderate import duties for import quotas and high tariffs, current account convertibility), and entry of new firms (privatization and private sector, or nonstate, development). The weights on these components are 0.3, 0.3, and 0.4, respectively. Initial estimates for the three components were based on comparative information in World Bank and other reports. These were revised following consultation with country specialists as well as experts with a comparative perspective across a number of countries. For the twenty-five countries in CEE and the NIS the transition indicators and accompanying text in EBRD 1994 and 1995 provided a further basis for calibration. Nevertheless, any such index is judgmental and necessarily approximate. See also the De Melo, Denizer, and Gelb background paper.

collapsing, disintegrating economies and high inflationary pressures, themselves partly a consequence of decades of falling productivity. Early studies, focusing mainly on CEE, blamed overzealous stabilization for the early economic decline. But the Report concludes that it was mostly driven by three factors: necessary shifts in demand due to market liberalization; the collapse of the Soviet trade bloc (the Council for Mutual Economic Assistance, or CMEA) and the Soviet Union itself; and the weakness of new market institutions.

Nevertheless, across the CEE countries and the NIS, economic recovery has been strongly linked to consistent reform, including liberalization and stabilization programs. Growth has typically resumed about three years after the

Table 1 GDP growth, inflation, and social indicators during transition

Country or group	Average GDP growth (percent per year) 1989–95	1994–95	Average inflation (percent per year) 1989–95	1994–95	Change in social indicators, 1989–94[a] (percent) Life expectancy	Infant mortality
CEE, NIS, and Mongolia						
Group 1	–1.6	4.3	106.0	18.7	0.7	–1.8
Group 2	–4.2	4.0	149.2	59.0	–0.2	–1.8
Group 3	–9.6	–12.5	466.4	406.8	–4.4	0.9
Group 4	–6.7	–11.4	809.6	1,176.5	–1.6	–1.9
Countries severely affected by regional tensions[b]	–11.7	–7.5	929.7	1,328	0.5	–2.7
Other transition economies						
China	9.4[c]	11.0	8.4[c]	20.6	2.1[c]	–11.1[c]
Vietnam	7.1[d]	7.9	114.8[d]	13.2	1.7[d]	–5.4[d]

Note: All data for recent years are subject to revision. See Figure 1 for the countries in each group.
a. Data do not take into account a possible rise in measured infant mortality rates due to the shift to international methodology in the NIS around 1993. Social indicators are population-weighted.
b. The countries asterisked in Figure 1 are taken out of Groups 1–4 and consolidated.
c. Data are for 1978–95.
d. Data are for 1986–95.
Source: IMF and World Bank data.

determined implementation of such measures. Later or less committed reformers have recovered more slowly—indeed, some have yet to bounce back. These countries have not yet sustained decisive reforms long enough to consolidate macroeconomic stability and resume growth.

Consistent liberalization policies have spurred recovery by encouraging the growth of private businesses and previously repressed sectors such as services, and by facilitating the penetration of new export markets. Among the most advanced reformers, the share of services in gross domestic product (GDP) rose an average of 16 percentage points during 1989–94; in these economies the initial "service gap" relative to comparable market economies has now been closed. Spirited entrepreneurs have responded to improved incentives with gusto, sometimes in spite of interference by government and organized crime.

Many transition economies have been strikingly successful in opening their economies and reorienting their exports to world markets. Exporters have penetrated Western markets previously considered beyond them. Some scholars have argued that transition countries in CEE and the NIS should liberalize foreign trade markets more slowly than internal ones. The Report, however, concludes that the benefits of opening up external markets early and extensively—in parallel with domestic liberalization efforts—far outweigh the costs. For example, after the disintegration of the CMEA and the Soviet Union, countries with more open trade practices generally saw exports decline less, recover faster, and contribute more to overall growth than did countries that maintained signficant import and export controls and state trading monopolies.

Even state enterprises have responded to reform. Market competition, coupled with tight budget constraints, spurs deep cost cutting and restructuring within firms, provoking some to break up and others to introduce new products and acquire new capabilities, such as better marketing and financial management. Among advanced reformers, many state enterprises have shrunk dramatically and others have closed altogether. In Poland and Hungary, overall industrial labor productivity in 1995 was already one-third higher than in prereform days.

A striking lesson of transition in all countries is the importance of the new businesses that emerge in response to the lifting of restrictions. To be widespread and effective, entry must be cheap and administratively easy. And to operate efficiently, new firms must have broad access to markets for their products and inputs. In China the majority of new entrants were at first community-owned township and village enterprises (TVEs); more recently, new private firms and joint ventures have constituted the most dynamic sources of growth, employment, and exports. In Vietnam the protected state sector continues to generate growth, but it is the private sector that is producing new jobs. In CEE and the NIS, new private firms, often using old assets carved out from the state sector (a process greatly encouraged by harder budgets), have been the catalysts for recovery. Poland's 7 percent growth rate in 1995 was led by 15 percent growth in private sector output; the state sector declined by 3 percent.

Stabilization

Limiting inflation has also been vital for growth. Evidence from market economies suggests that they perform poorly when the annual rate of inflation is more than about 40 percent. The same seems to hold for the transition economies. Freeing prices after years of comprehensive controls invariably causes an initial, painful burst of inflation. But liberalization has also enabled transition countries to sever the link between governments and enterprises and reduce subsidies to enterprises, thereby laying the groundwork for economic stabilization. Inflation has been more persistent in the less decisive reformers in CEE and the NIS, and household savings in these countries have been severely decapitalized. Stabilization experience in transition countries has thus brought home the lesson that reforms must be sustained—and seen as credible—to be effective.

The relation between reforms and inflation in China has been very different. Reforms have ushered in periodic booms with rapid credit expansion and an accompanying rise in inflation. But inflation has remained at moderate levels for two reasons. First, macroeconomic controls have been applied as needed to contain demand. Second, large growth gains from partial liberalization translated into high savings and a rapid buildup of financial assets by households. This store of savings has also helped support a state sector that remains a drag on the economy, even though its efficiency may be improving and its relative size is shrinking. In the next stage of reforms, China will need to expose state firms to greater competition and progressively redirect savings elsewhere.

Rapid or gradual reform?

Which works best—enacting reforms as quickly as possible or phasing them in more slowly? This question, the most often asked in the study of transition, has no single or simple answer. Many countries were not in a position to choose between the two. In CEE and the NIS, economic reforms paralleled the dismantling of a repressive, and in some cases externally supported, political system. These countries had to overcome huge trade declines as well as severe macroeconomic imbalances and structural distortions created by central planning. They have not been able to generate the savings necessary to sustain their greatly overbuilt state sectors. They therefore face an extremely difficult choice: rapid systemic reforms entailing deep and often painful structural adjustment, or incremental efforts to introduce change while trying to protect the status quo. The latter path may appear less painful at the outset, but it usually leads to spiraling inflation and economic disarray.

The differences between leading and lagging reformers have largely reflected how they have approached this choice. Of course, other factors also influence the course of reform. Dedicated and audacious leaders matter a great deal, and individual country characteristics—their unique advantages and disadvantages—affect what policies leaders can choose and how much they can accomplish. Important advantages include sufficient administrative capacity within the government, proximity to market economies, societal memory of market processes, and a strong desire among the populace to integrate into Western Europe. All of these have helped sustain the pace and scope of reforms in the more advanced countries.

Economic reform in the region has also been deeply affected by differences in the sharpness and timing of political change in individual countries. Rapid reform has proved easier when political change has been rapid and fundamental, as in much of CEE and the Baltic states of Estonia, Latvia, and Lithuania. Citizens who supported the new political system also supported market-oriented policies. A window of opportunity—a period of "extraordinary politics"—emerged in which far-reaching reforms could be initiated with little opposition. Not all countries had such a strong political breakthrough—and some new states saw other priorities. Ukraine's first independent government, for example, was preoccupied with asserting a national identity, and reform accelerated only after a severe and extended economic decline.

Apart from small, diamond-rich Botswana, China has been the fastest growing economy in the world since market reforms began in 1978. Why has China been able to reform in a partial, phased manner and grow rapidly, whereas even vigorous reformers in CEE and the NIS suffered large declines in output (but still generally outperformed the slower reformers)? China's favorable initial conditions are the first piece of the puzzle. Chinese policymakers did not have to confront some serious obstacles that proved very difficult in CEE and the NIS. This is not to imply that China's task was easy. It had to devise and implement a set of market-oriented reforms that gave growth-promoting incentives to farmers and workers while maintaining macroeconomic control and redirecting the interests of the bureaucracy toward supporting reform. These were, and remain, major achievements. But the transition challenge in China—and policymakers' tools for meeting it—were vastly different from those elsewhere.

First, unlike Russia—or indeed most non-Asian reformers—China embarked on its transition with a very large, repressed rural economy and a relatively small state sector (Table 2). The effects of initial, rural reform were overwhelmingly positive. Partial liberalization and the development of a nonstate sector, which created almost 100 million new jobs between 1978 and 1994, sparked rapid productivity gains without imposing sharp adjustments on state industries. As a result, rising incomes from the first wave of reforms were able to build momentum

Table 2 Russia and China: Two very different countries

	Russia		China	
Indicator	**1990**	**1994**	**1978**	**1994**
Sectoral structure of employment (percent of total)				
Industry	42	38	15	18
Agriculture	13	15	71	58
Services	45	47	14	25
Total	100	100	100	100
Employment in the state sector	90	44	19	18
Money and output				
M2 as a percentage of GDP[a]	100	16	25	89
GDP per capita (dollars)				
From *World Bank Atlas*	4,110	2,650	404[b]	530
At PPP	6,440	4,610	1,000[b,c]	2,510

a. Data are averages of quarterly ratios.
b. In 1990 dollars.
c. World Bank staff estimate.
Source: IMF, various years (b); World Bank data and staff estimates.

for further, more difficult changes in a self-reinforcing process. Adjustment in Russia, in contrast, has involved painful downsizing of an overbuilt state sector that was previously sustained by large cross-subsidies, especially from the energy sector.

A second reason for China's strong performance is that growth and effective macroeconomic management encouraged a high rate of saving, from initially low levels of monetization. In contrast, the Russian economy was already highly monetized in 1990, with a large "money overhang" representing resources that had already been supplied to the planned economy. This overhang caused high inflation when prices were freed, eroding confidence in financial savings.

No transition country can escape its starting conditions. But reformers can and do make choices that critically affect the early success and longer-term stability of market reforms. For most transition economies, the answer to the key question about the pace of change is now clear: faster and more consistent reform is better.

Getting property rights right

At the heart of transition lies a change in incentives, none more important than those for managers of enterprises. Managers in centrally planned economies face distorted incentives that sooner or later lead to poor enterprise performance. The first step is to move from the centrally planned regime of transfers and subsidies to one that allows for risk, imposes financial discipline, and creates profit-oriented incentives. This means opening markets to competition and sharply cutting direct government subsidies. Governments must also remove two other cushions: soft bank credits and arrears on payments due to government for taxes and social security. Interenterprise arrears are another form of soft finance. Some governments have implemented complex programs for netting and clearing these arrears, but the best advice, drawn from experience in several countries, is to strengthen market forces to work out the problem.

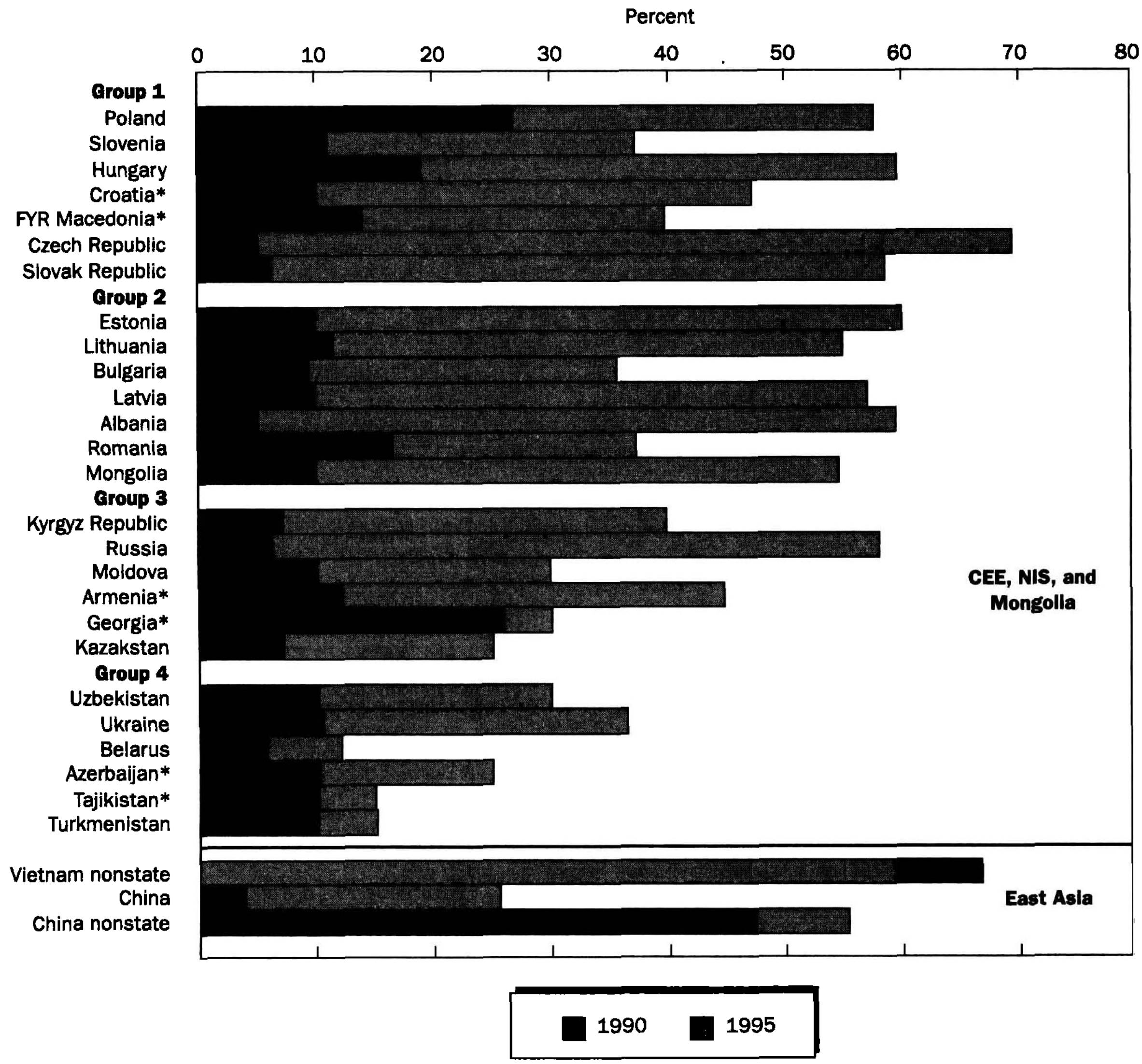
One of the strongest messages to emerge from transition to date is that governments that enforce financial discipline and foster competition will stimulate restructuring in enterprises regardless of who owns them. But ownership change—preferably to private ownership—in a large share of the economy is also important. Why? Because once markets have been liberalized, government cannot indefinitely control large parts of a dynamic, changing economy, and decentralizing ownership will be the best way to increase competition and improve performance.

There are two ways to move to an economy dominated by the private sector: through the entry of new private businesses and through privatization. Both are important, and the share of the private sector has indeed risen rapidly in transition countries (Figure 2). New private firms, spurred by liberalization, can give quick returns and do much to boost growth, but the mass of both large and small state assets in transition economies makes some degree of privatization necessary.

Nevertheless, the need to privatize is not equally urgent in all settings. Slower privatization is viable (although not necessarily optimal) if the government or the workers themselves are strong enough to keep control over enterprises and prevent managers from diverting assets, and if savings and growth in the nonstate sector are high, as in China. But where governments are weak and enterprise managers have few checks on their power, or where restructuring needs dwarf available public funds, as in most of CEE and the NIS, privatization is urgent. The experience of some CEE countries and NIS suggests that the alternative to formal privatization is often not status quo state ownership, but rather an ownership vacuum with fuzzy property rights that lets those in control (usually managers) appropriate assets or the income streams they generate. China and Vietnam have so far prevented egregious asset stripping, but some diversion of assets does seem to be taking place. Informal privatization often precedes the legitimization of a private economy, but it accelerates after such an economy is permitted. An ownership vacuum can delay the restructuring of drifting firms, for which nobody is fully responsible. It can create or prolong macroeconomic problems, because it gives enterprise managers strong incentives to show poor financial perfor-

The private sector has grown rapidly.

Figure 2 Private sector output as a share of GDP



Note: Firms are considered private if they are less than 50 percent state owned. For Vietnam, the nonstate sector excludes public-private joint ventures. For China, the nonstate sector includes collectives and township and village enterprises as well as private firms; agriculture is considered private in 1995, although land is held through long-term leases. Asterisks indicate economies severely affected by regional tensions between 1989 and 1995. Source: EBRD, IMF, and World Bank data; official data.

mance (allowing them to snap up the firm or additional shares at bargain prices). It tends to be highly inequitable and to induce corruption, which can undermine the government's authority.

The political and economic factors that influence the method of privatization differ across countries and among major assets (industrial firms, farms, real estate) in the same country. Experience reveals a tension between promoting efficiency and rewarding existing stakeholders—managers and workers—with a share in ownership. All countries face risks if privatization is mishandled. Smaller assets are the easiest to privatize, and the outcomes are usually good. But larger assets are more problematic, and the tradeoffs among the different ends and means of privatizating them are intricate and intensely political. None of the methods used to divest large firms—sales (as in

Estonia and Hungary), management-employee buyouts (as in Russia), or equal-access mass privatization (as in the Czech Republic and Kazakstan)—is without drawbacks in a transition setting, whether the issue is speed, fiscal impact, access to investment capital, fairness, or the effectiveness of the resulting corporate governance (Table 3).

Nevertheless, the initial assignment of property rights is only a first step toward effective privatization. The broader goal is to develop an efficient secondary trading process, enabling ownership claims to be reorganized smoothly in response to the needs of a market economy. Such a process is particularly needed in all transition economies because many of the governance structures emerging during transition are themselves likely to be transitional. For example, in Russia many firms need to shift from insider to outsider control if they are to attract investors and the skills necessary to survive in a market economy. Farm reorganization will require moving from corporate to individual property rights to create new, viable farms from very large rural enterprises formerly controlled by the state. And further clarification of property rights in China's communally owned TVEs will be needed for their continued development, which will rest in part on the ability to raise finance from outside the community. Countries need to beware of dead ends in the evolution of ownership: management-employee buyouts of large firms may entrench managers or employees and block restructuring and further evolution of ownership. Sales to outside investors are more advantageous, as is the Czech approach, which creates strong external shareholders and stimulates trading among institutional investment funds and investors.

Mobility, poverty, and pensions: Revamping social policy

Transition sets in motion vast social change. Much of this change is positive: individuals have greater choice, including the opportunity to buy high-quality consumer goods, and broader access to information. But transition also generates greater economic uncertainty and sometimes a dramatic growth in crime.

Transition countries start out with labor markets inherited from central planning, which in effect sacrificed mobility of labor for individual security. At first many doubted the ability of labor markets in the CEE countries and the NIS to adjust to the enormous structural and macroeconomic changes taking place. But labor has adjusted: wage levels and employment patterns have shifted, and in many countries pay differentials have begun creating incentives for workers to acquire new skills. The pattern of adjustment has differed markedly in the NIS from that in CEE. In the NIS the primary response to declining output has been lower wages and a surge in informal employment. In most CEE countries, the outcome has been higher open unemployment but also higher wages for those still formally employed.

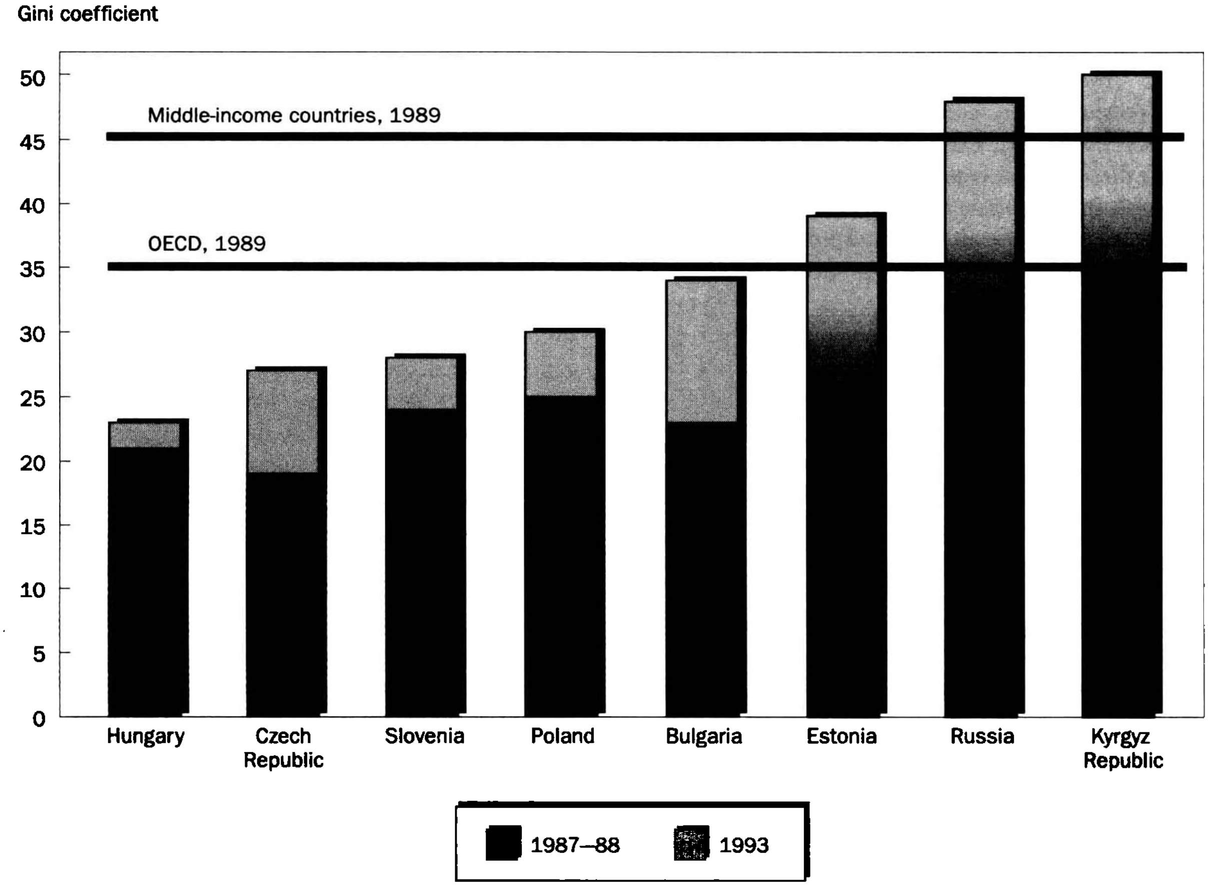
Some increase in the disparity of wages, income, and wealth is a necessary part of transition, because allowing the market to determine these things creates incentives for

Table 3 Tradeoffs among privatization routes for large firms

Method	Objective: Better corporate governance	Speed and feasibility	Better access to capital and skills	More government revenue	Greater fairness
Sale to outside owners	+	–	+	+	–
Management-employee buyout	–	+	–	–	–
Equal-access voucher privatization	?	+	?	–	+
Spontaneous privatization	?	?	–	–	–

Inequality in transition economies is rising toward market economy levels.

Figure 3 Gini coefficients in eight transition economies



Note: For the NIS no reliable data exist for 1987–88 that would allow consistent comparison of income distributions over transition. Levels for middle-income and OECD countries are simple averages. Source: Milanovic, forthcoming.

efficiency that are essential for successful reform. Poverty can rise in the short run since some people and—especially in large countries like China and Russia—some regions invariably benefit more than others. But the "losers" will not necessarily be forced into poverty; it all depends on whether governments restructure social safety nets to meet the demands of a market system and, even more important, pursue market-oriented policies that foster economic growth.

Where transition has accompanied rapid and broadly based growth, as in China and Vietnam, poverty has fallen even though income disparities may have increased. In the CEE countries and the NIS, declining output and rising inequality during the early transition years caused poverty to rise. But, as Figure 3 shows, inequality is no higher now than in other countries at comparable levels of income, so policymakers cannot rely on closing the income gap to cut poverty. What is essential is growth. And since many people are just below the poverty line in these countries, even modest growth can lift significant numbers above that threshold. Early evidence from Poland and Estonia suggests that poverty stabilized after growth resumed, although it is still too soon to assess how rapidly it will fall.

Responding to the social consequences of transition calls for a major reorientation in the social safety net. Before transition, security for working people generally meant a guaranteed job or, in rural China, guaranteed land, rather than the national social safety net more common in market economies. New forms of income support must now be created to take enterprises out of the business of delivering extensive social services, especially in urban China and much of the NIS. Otherwise, immobility will raise the costs of transition by creating pockets of poverty in declining regions and by putting pressure on enterprises and governments to defer necessary restructuring. China faces an especially urgent need to extend the formal social safety net beyond the state sector to include the rural labor force and migrant workers. More than 100 million people now working in rural industry still have only patchy access to health care and no pension rights unless they buy them privately. The growing "floating population" of migrant workers remains largely without insurance coverage. Most migrants are well paid, but some are not, and they may represent the first of an emerging group of new poor.

Not only must the state take over from enterprises, but the approach must also shift away from poorly targeted benefit systems involving extensive cross-subsidies and toward the core aim of stemming poverty. How to target benefits to the poor—whether through income-tested assistance, locally organized relief, targeting by poverty indicators such as age (as in the case of child allowances), or self-targeting (as in public works employment)—depends on the information base and the administrative capacity of government agencies. In many transition countries with large informal sectors and limited administrative capacity, targeting by poverty indicators is the most realistic option. The vast rural population in China has traditionally relied on the extended family for pension support and poverty relief, but with smaller families and rising labor mobility, these ties are weakening. Many of the 30 to 40 million rural poor on the margin of subsistence would face starvation were it not for the state's grain relief system. It is essential that this stay in place.

However, the largest social problem in many transition countries, both for politicians and for public finances, is the funding of state pensions. Generous access to pensions is one way of cushioning the impact of transition on a generation that was prevented from accumulating wealth and has no opportunity to save in the new market system. But it is important to distinguish such transition issues from more fundamental problems with state pensions and to craft appropriate long-term policies. Retirement ages, for example, need to be raised and equalized for men and women. Private pensions are desirable for a variety of reasons, but they are no substitute for directly addressing excessive spending in the state sector.

Creating institutions that support markets

If transition economies are to join the ranks of the established market economies, they will need not just good economic policies but strong, transparent, and accountable institutions to support and implement them. Institutional reform is particularly pressing because the previous structures were adapted to the needs of a very different economic system. Inadequate institutions impose high economic costs, and institutional development—of legal and financial systems and of government itself—takes many years if not decades. Institutional and social policy reforms tend to follow macroeconomic reforms and formal ownership changes and are now high on the reform agenda in all transition economies (Figure 4).

Developing the rule of law

In countries where the rule of law is well established, people rarely stop to wonder where it comes from. But transition economies need to start over, finding ways to replace rule by powerful individuals or arbitrary agencies with a rule of law that inspires the public trust and respect that will enable it to endure.

To be effective, legislation must be well designed. Laws that are passed with poor designs, major inconsistencies, ambiguities, or clear avenues of abuse will slow economic reform and deepen public cynicism and distrust. Many transition economies are well along in the process of drafting and enacting legislation in the fundamental areas of property, contracts, companies, bankruptcy, and competition, although there are still weaknesses in many of these transitional legal frameworks.

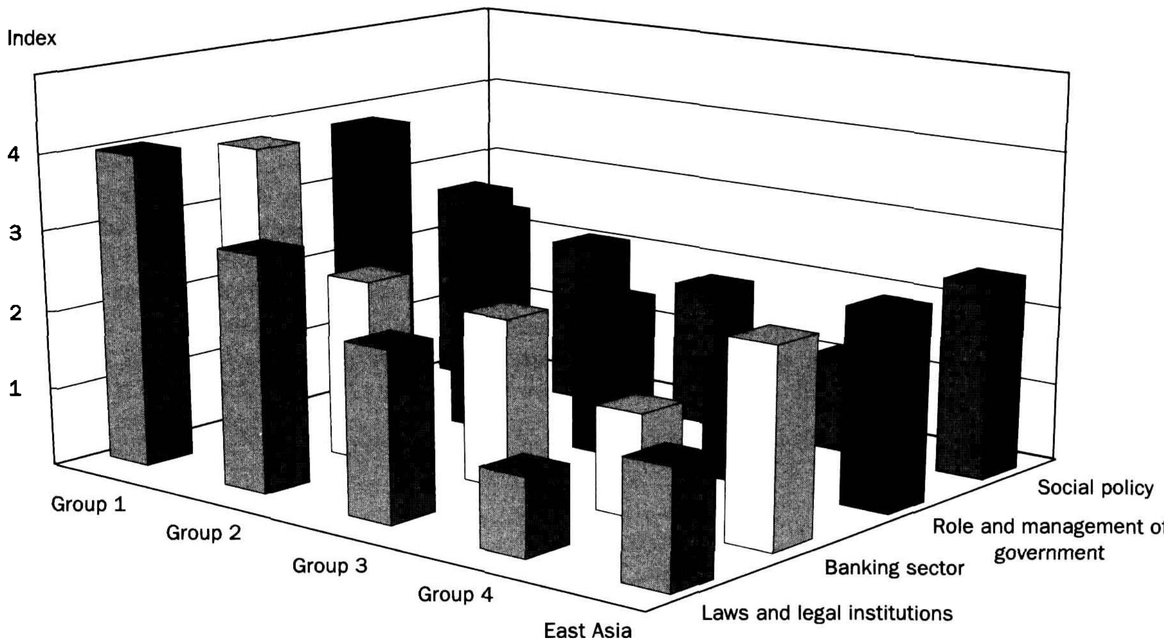
Designing good laws, however, is only the first step. The trick is making sure they are effectively implemented and enforced. Many transition economies have adopted new bankruptcy laws, for example, which could play an important role in supporting restructuring, but few countries have effectively enforced them. And while property rights are recognized on paper and to a growing extent in practice, they are often subject to arbitrary and undue interference by the state.

To ensure effective enforcement, transition economies need to empower judges, prosecutors, and private lawyers, create other "watchdog" institutions such as accountants and securities regulators, and develop such elements of civil society as a free press. Most transition economies have begun such efforts, but it will take time to overcome the legacies of the past and gain the confidence of the public. And of course none of these reforms will work well unless people know what the law is. Laws, decrees, and important court decisions need to be quickly published in an official and widely circulated text. Further, as discussed below, law, like other institutions, requires demand as well as supply to be effective.

In addition, the state must itself be ruled by law and perceived as credible by the private sector. Part of establishing the rule of law is limiting corruption. Yet transition governments are susceptible to graft, bribery, and other offenses during the phase when the state retains both vast assets and extensive powers to intervene in a growing private economy. Corruption can be costly: officials may block further reforms in order to entrench their power and maintain illicit income, and public resources may be diverted away from vital areas such as education,

Markets fuel demand for new institutions.

Figure 4 Institutional and social policy reform by reform type and country group



Note: Data are for 1995 and are simple averages for the countries in each group (see Figure 1). The *laws and legal institutions index* measures the scope and quality of new legislation and development of judicial institutions: 1, little progress on either; 2, some progress on laws, little on institutions; 3, some progress on both; 4, extensive progress on both. The *banking sector index* measures the independence, skills, and credit allocation practices of the better segment of banks, as well as the functioning of supervision and payments systems: 1, little change; 2, some initial progress; 3, system functioning fairly well but with limitations; 4, system functioning fairly well and with a larger segment of better banks. The *role and management of government index* measures the market orientation of government and the effectiveness of public sector management: 1, little change; 2, significant reform; 3, substantial reform; 4, advanced reform. The *social policy index* measures progress in pension reform, reduction of subsidies, streamlining and targeting of income transfers, and divestiture of social assets: 1, no reform; 2, limited reform; 3, modest reform; 4, substantial reform. Source: EBRD 1994, 1995; World Bank staff estimates.

where there are fewer opportunities for bribes. Equally serious, corruption weakens public confidence in government and can help extremist politicians who promise order. Governments must combat corruption, but having made the move to the market, they cannot turn back the clock and resurrect the old constraints. Instead they must reduce the opportunities for abuse of power and simultaneously raise the risks. Liberalization, demonopolization, and—if transparent—privatization are key steps to reducing the scope for corruption and changing people's incentives. So are better pay structures in the public sector, a proper career ladder in government, and serious efforts to publicize and punish high-level corruption.

Private organized crime, while existing before reforms, has grown dramatically in recent years in some countries, where it ranks as a serious concern in surveys of both households and businesses. Like corruption, organized crime thrives when property rights are unclear, legal procedures ineffective, and risks low. It involves high social and economic costs, and like corruption, it is a long-term problem without easy solution. Strong, internationally coordinated law enforcement efforts are called for, and these in turn require a law-abiding security force and dispute-resolution mechanisms that ensure due process. Governments at the national and local levels cannot hope to make inroads against mafia groups without also tackling the corruption within.

Building a strong financial sector

A good financial system plays an integral role in a market economy, channeling savings to their most efficient uses. Worldwide experience shows that countries with well-developed financial systems grow faster and more consistently than those with weaker systems and that they are better able to adjust to economic shocks. Effective finance would be particularly helpful for transition countries, allowing them to achieve the vast reallocations of resources and ownership involved in moving from plan to market. Yet the financial systems these countries start with are in no fit state to help, with monolithic, state-owned banks that are often severely distressed and an absence of financial skills and regulation, key supporting institutions, and capital markets.

Financial sector reforms cannot proceed independently of macroeconomic stabilization, enterprise reform, and the development of supporting legal institutions. Partly as a result, they have generally lagged behind. The challenge for reformers is to find ways to help the financial system overcome the legacy of central planning, while at the same time sow the seeds of a new system in which banks and other financial institutions will be forced to stand on their own feet.

The choice of possible approaches to banking reform brings this problem into stark relief. Should governments seek to rehabilitate heavily overindebted state banks, possibly leading them to expect repeated bailouts? Or should reformers start afresh, promoting rapid entry of new banks and perhaps the liquidation of old ones? Transition countries, responding in large part to the state of their inherited banking systems, have taken a variety of approaches. Their experiences to date suggest that encouraging new entry can be a fast way to build capacity. The best approach to banking reform for some countries, particularly those with weak state banks with eroded portfolios, might be to restrict the activities of state banks while a new or parallel private banking system develops.

Yet in transition settings both the entry of new institutions and the rehabilitation of old ones pose risks, requiring strong complementary reforms. These include improved prudential regulation and monitoring by an independent, market-oriented supervisory agency. Every transition economy now has a supervisory structure in place and has passed laws and regulations aimed at improving the quality of the financial system. Much less progress, however, has been made in translating these reforms into actual regulation and supervision. Because it will take time to train examiners and give them adequate experience, supervision of financial intermediaries is likely to remain weak in many transition countries. Supervisors will not be able to prevent every banking failure. They should therefore focus their limited resources on addressing the most problematic banks, screening new entrants, and improving incentives to encourage prudent practices.

Transition governments should try to minimize their direct role in the allocation of resources. Premature bailouts and repeated recapitalizations, in particular, tend to undermine the credibility of reforms. Self-help for banks should be encouraged—for example, through rules supporting loan-loss provisions that will help banks build capital—and the framework for debt collection should be strengthened. China, for its part, will need to reduce planned allocations of credit and rationalize interest rates. Over time, greater autonomy in setting rates, allocating loans, and initiating workouts with problem debtors, coupled with greater financial sector competition, could transform its specialized state banks into commercial banks. But this will also require administrative changes, such as clarifying and separating policy lending from commercial lending and curtailing new lending to unprofitable enterprises.

Accelerating the development of nonbank financial institutions—an integral part of any financial system—is important in all transition economies because such institutions often finance the small, dynamic new firms that are proving central to economic growth. Portfolio and venture capital funds and simple leasing arrangements are particularly well suited to the transition environment, and their growth should be encouraged.

Capital markets, the third pillar of an effective financial system, are essential in established market economies for raising financing and improving the governance of firms. As with so many institutional reforms, setting up formal securities markets is the easy part: the challenge is to bring them to life by raising both the supply of securities and the demand for them. This will require a wide range of supporting reforms to better protect creditors and investors and tighten up disclosure requirements, in addition to stable macroeconomic policies to raise savings and help develop the institutional investors needed for good corporate governance.

Reinventing government

Transition means less government involvement in the economy. But where the government remains involved—in ensuring the supply of public goods, setting the rules of the game, helping institutions develop, and providing social protection—it needs to become more effective. Governments everywhere have found it extremely difficult to reorient and reduce their role in the economy.

Contrary to general belief, governments as a whole are not vastly overstaffed or underpaid in most transition countries. The problem lies rather in the distribution of labor and in poor incentives. Civil servants tend to be concentrated in the wrong parts of government to meet its rapidly changing functions, they frequently have the wrong skills for their jobs, and they face insufficient rewards for good performance. Public administrations in many transition economies have been plagued by poor morale, absenteeism, and loss of good staff to the private sector.

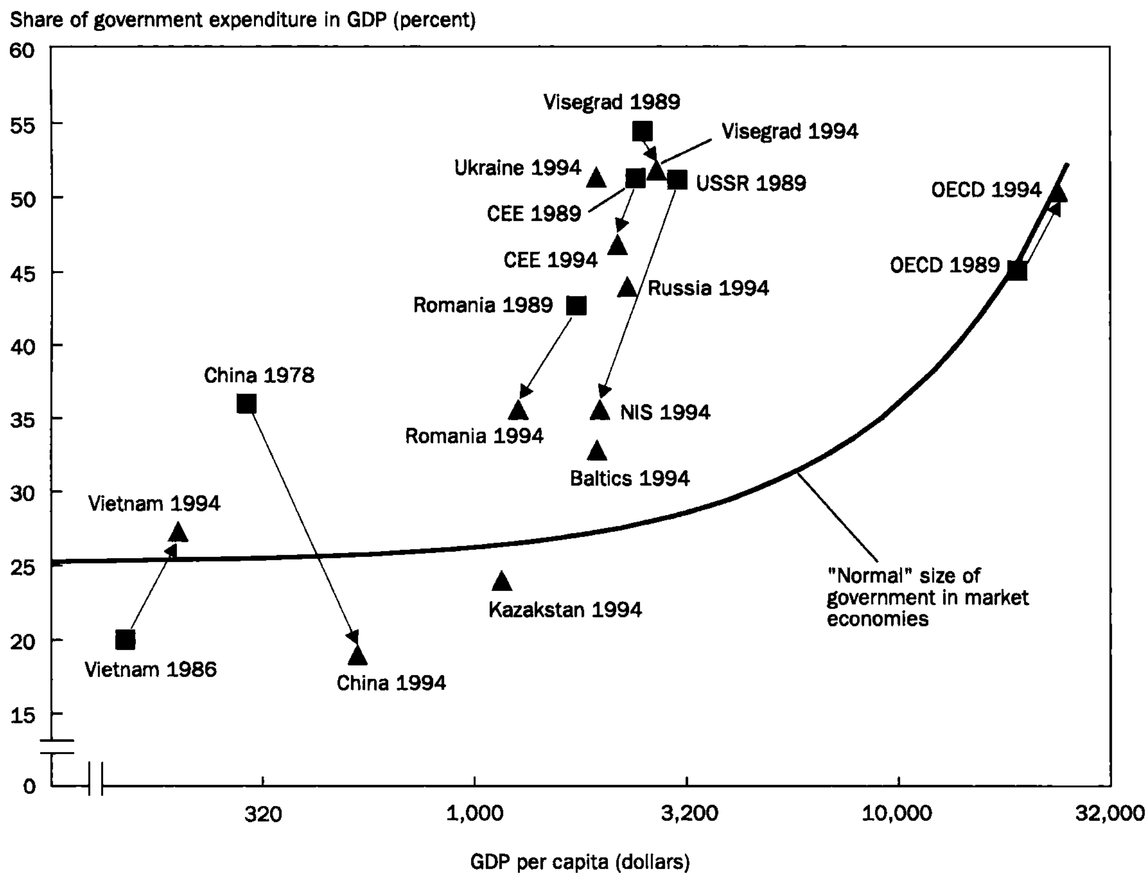
There is no quick fix to these problems, but the direction of needed reforms is clear. Recruitment, pay, promotions, and layoffs need to become more flexible and based on merit. Salary differentials need to widen substantially. And, of special importance in transition economies, governments need to professionalize the civil service, introduce systematic career development and link it to training in market economy skills, and integrate civil service staffing with wage bill and budget planning.

Relative to GDP, government budgets in transition countries vary greatly. Most have shrunk during transition, by necessity or design, but many remain larger than those in market economies at similar levels of income (Figure 5). Only a few countries, such as the Czech Republic, Hungary, Poland, and the Slovak Republic (the Visegrad countries in Figure 5), have been able to finance high spending with taxes. Even there, tax systems remain relatively inefficient and the steep tax rates impose a heavy economic burden, especially on the emerging private sector, thus contributing to expansion of the informal economy. In the long run, tax revenues of nearly half of GDP in these countries may well be unsustainable, and together with large transfer programs, they depress the rate of national saving.

Around the world, high budget deficits often lead to high inflation and slow growth. This is an even greater danger in many transition economies, where progress with fiscal stabilization is mixed, the scope for domestic and external borrowing is limited, and large deficits can be financed only by printing money. So continuing to finance

Governments in most transition economies are shrinking, but many in Europe are still too big.

Figure 5 GDP per capita and ratios of government expenditure to GDP in selected transition economies



Note: GDP per capita is at market exchange rates and plotted on a logarithmic scale. Government expenditure is all expenditure for central and local government plus extrabudgetary operations (quasi-fiscal and state enterprise operations are excluded). The regression line is based on a separate sample of forty-seven developing and industrial market economies. Data for country groups are simple averages. Source: IMF, various years (c); official data; IMF and World Bank staff calculations and estimates.