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How Far Has the Transition Progressed?

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In the few years since the fall of communism, more than 400 million people in the 29 reforming countries of eastern Europe and the former Soviet Union have witnessed a century's worth of changes. Consider the circumstances just five years before the writing of this paper, in early 1991. Then, Mikhail Gorbachev was surrounding himself with hard-liners, boding the end of *perestroika* and *glasnost* in the USSR. Soviet troops clashed violently with demonstrators in the rebellious Baltic republics. Impasse on economic reform was personified in a new prime minister, the singularly hapless Valentin Pavlov, who in January 1991 presided over perhaps the most maladroit monetary reform in world history, betraying a level of incompetence fully evident seven months later in his participation in the shambolic coup that spelled the end of the Soviet Union.

In early 1991, eastern Europe was in the first stages of its move from communism, with dark clouds hanging over that process. The uncertainty in the USSR brought foreboding to former satellites. The repercussions of a breakup of Yugoslavia were becoming clearer. With postcommunist economic reforms still in their infancy, the depth of recessions and the intransigence of inflation bred alarm. In Poland, the leader in economic reform, "the sudden switch to a market economy . . . aroused profound anxieties, as most households . . . wondered whether they would be able to stay afloat—much less prosper—in the new system" (Sachs, 1990).

Five years later, the 15 states emerging from the USSR now implement monetary policies that reflect the tutelage of the International Monetary Fund rather than the whims of Mr. Pavlov. The independent Baltic nations lead in economic and political reforms. The economic clouds over eastern Europe are lifting: growth

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is occurring across the region, creating the assurance that the huge recessions are truly transitional phenomena. Eastern European inflation, which reached peak levels averaging 610 percent (excluding Serbia's hyperinflation), averaged 18 percent in the latter half of 1995. Slovenia, arising from the tatters of the old Yugoslavia, is at the forefront of economic recovery. Given the importance of example in an era of open communications (itself a momentous consequence of the fall of communism), eastern European economic progress acts as a beacon to those ex-republics of the USSR that are still mired in deep transitional recessions.

Of the 29 countries now undergoing the transition consequent on the fall of communism in eastern Europe and the former Soviet Union, five are newly emergent from Yugoslavia;[1] two sprang from Czechoslovakia's velvet divorce; 15 are former republics of the USSR; Mongolia was nominally independent of the Soviet Union but considered the de facto sixteenth republic; East Germany is now reunited with the West; and the other five are nations of eastern Europe that have not gone through a shift in national boundaries. These countries are listed in Table 1, together with background data on size, location in terms of the distance from the center of Europe, level of development, political status at the start of transition and whether reforms have been affected by war.[2]

This symposium analyzes the economic transformation of these countries. The papers describe economic reforms, their consequences and the lessons that economists and policymakers might derive from the reform process. The present paper offers a broad overview and sets the context for the three other contributions, which focus in more detail on three crucial areas of reform. The paper examines the pathways of transition, briefly describing areas of reform not covered in the other contributions and cataloging outcomes, both of policies and of results. The final section considers future possibilities in the light of the events of the last few years. In the symposium's other contributions, Stanley Fischer, Ratna Sahay and Carlos Végh focus on stabilization policy, Josef Brada examines privatization, and Andrzej Rapaczynski reflects on the role of the law in economic reforms.

Politics

Since politics and economics are inevitably intertwined, I begin with a brief summary of political developments. Columns 1 and 2 of Table 2 summarize

[1] Confusingly, the two rump republics of Yugoslavia, Serbia and Montenegro, retain the name of Yugoslavia. I will follow popular usage in referring to this entity as Serbia.

[2] There are several reforming countries whose reform processes are so distinctive that they cannot be considered within the present framework. East Germany's reforms are so dependent on the power and largesse of West Germany that they are mentioned only briefly here. Bosnia is omitted from Table 1 and all further discussion because it provides few economic lessons. Reforms are proceeding at great pace in China and Vietnam, but the processes are very different from those of the countries included in the present symposium. For the important lessons from China, see the symposium in the Spring 1994 issue of the *Journal of Economic Perspectives*.

Table 1
Background Information on Countries in Transition

	1 Population in Millions 1993	*2 Distance of Capital City from Vienna, in Miles*	*3 GNP Per Capita, in PPPs, % of U.S., 1994*	*4 Geo-Political Status in 1989*	*5 Economy Seriously Affected by War or its Accompanying Dislocations*
Albania	3.39	503	4.6	As in 1996	
Armenia	3.73	1489	7.9	USSR	YES
Azerbaijan	7.38	1727	6.6	USSR	YES
Belarus	10.19	624	19.2	USSR	
Bulgaria	8.87	508	16.4	As in 1996	
Croatia	4.51	166	15.0	Yugoslavia	YES
Czech Republic	10.30	156	30.4	Czechoslovakia	
East Germany	16.10	325	27.8	Independent	
Estonia	1.55	845	21.0	USSR	
Georgia	5.45	1450	6.2	USSR	YES
Hungary	10.21	135	24.4	As in 1996	
Kazakhstan	16.95	2868	10.9	USSR	
Kyrgyzstan	4.59	2775	8.1	USSR	
Latvia	2.61	684	20.4	USSR	
Lithuania	3.71	590	12.4	USSR	
Macedonia	2.08	495	8.7	Yugoslavia	YES
Moldova	4.41	587	8.4	USSR	YES
Mongolia	2.32	3920	8.0	de facto USSR	
Poland	38.30	347	20.5	As in 1996	
Romania	22.76	532	11.3	As in 1996	
Russia	148.67	1037	16.8	USSR	
Serbia & Montenegro	10.57	304	8.8	Yugoslavia	YES
Slovakia	5.31	34	25.8	Czechoslovakia	
Slovenia	1.94	177	35.0	Yugoslavia	
Tajikistan	5.77	2662	3.9	USSR	YES
Turkmenistan	3.92	2205	10.6	USSR	
Ukraine	51.55	655	13.4	USSR	
Uzbekistan	21.86	2588	9.4	USSR	
Mean	15.32	1085	14.7		
Population-Weighted Mean		990	15.8		

Sources: Column 1, World Bank (1995a); column 2, Fitzpatrick and Modlin (1986), supplemented by author's calculations; column 3, World Bank (1994, p. 220), updated by author using national statistics.

the data for 1989 and 1994 from one widely cited survey of political conditions (Freedom House, 1989; Karatnycky, 1995). This survey evaluates countries on two dimensions: a measure of political rights captures the ability of people to participate freely in the political process, while the score on civil liberties summarizes the freedoms that individuals have to develop views and institutions separate from

Table 2
Political and Economic Liberalization, 1989–1994

	1 *Democratic Rights Index 1989*	*2* *Democratic Rights Index 1994*	*3* *Government Revenues % of GDP 1989*	*4* *Government Revenues % of GDP 1994*	*5* *Degree of Economic Freedom 1989*	*6* *Degree of Economic Freedom 1994*
Albania	0	58	48	28	0	73
Armenia	25	58	52	28	3	43
Azerbaijan	25	17	26	35	3	37
Belarus	25	50	38	35	3	37
Bulgaria	0	83	60	38	13	73
Croatia	42	50	15	27	43	87
Czech Republic	17	92	62	51	0	90
East Germany	17	92			0	100
Estonia	25	75	43	35	7	90
Georgia	25	33	32	8	3	37
Hungary	58	92	59	52	37	87
Kazakhstan	25	25	41	17	3	40
Kyrgyzstan	25	58	39	24	3	77
Latvia	25	75	52	36	3	80
Lithuania	25	83	50	25	3	83
Macedonia	42	58	36	47	43	80
Moldova	25	50	35	17	3	57
Mongolia	0	75	49	28	0	67
Poland	58	83	41	46	23	87
Romania	0	58	51	33	0	73
Russia	25	58	41	28	3	67
Serbia & Montenegro	42	17	34	30		
Slovakia	17	75	62	50	0	87
Slovenia	42	92	42	47	43	83
Tajikistan	25	0	40	27	3	30
Turkmenistan	25	0	32	6	3	23
Ukraine	25	58	26	42	3	27
Uzbekistan	25	0	35	33	3	43
Mean	25	56	42	32	10	65
Population-Weighted Mean	27	57	40	33	7	63

Sources: Column 1, an aggregation of the information in Freedom House (1989); column 2, an aggregation of the information in Karatnysky (1995); column 3, World Bank (1995a); column 4, multiple World Bank and IMF sources; columns 5 and 6, De Melo, Denizer and Gelb (1995), supplemented by author's calculations.

those of the state. The indexes in Table 2 aggregate the two scores to form a scale in which 100 is the maximum achieved anywhere in the world, and the minimum is zero.

The most dramatic feature of the data needs no emphasis—how far the countries have traveled from 1989 to 1994, especially in view of the fact that many of the 1989 scores already embody significant gains from Gorbachev's *glasnost.* Several countries in eastern Europe move from the lowest levels to scores comparable to those of their western European neighbors. The rudiments of democracy, if not the refinements, have been established with remarkable speed in the majority of ex-socialist countries. These changes are a landmark in the history of the spread of democracy.

Lesser levels of political change are related to the presence of war and to geography. Outliers from this relationship are Kyrgyzstan and Mongolia, in Central Asia, and the Baltic republics, all with stronger moves to democracy than might be predicted from developments in neighboring countries. Croatia and Serbia are notable underperformers.

Of course, day-to-day realities frequently reveal the many challenges that still lie ahead. For example, constitutional guarantees of a free press offer little comfort when the new private sector has few resources and when competition is strong from newspapers still owned by the government. Even in the most advanced reforming countries, ephemeral political squabbles threaten important democratic gains. In Hungary, the independence of television and radio was under attack during one such episode. The most respected reformer in Central Asia, President Askar Akaev of Kyrgyzstan, has toyed with the idea of postponing elections and has used threats and laws to rein in a press that was regarded as too critical of his reforms.

There is no better example of the difficulties of political reform and of country differences than the issue of political decentralization, on which communist countries were at the far end of the spectrum from developed capitalist democracies. In the more advanced reformers, such as Poland, the Czech Republic and Hungary, local democracy is well established. In many other countries, decentralization occurs more by default than by decision, with the weakening power of the center. Local democracy is slow to be instituted for a variety of reasons—in Russia, the center resists; in Kyrgyzstan, local clan politics supersedes national politics; in Mongolia, few appear interested; and in countries such as Uzbekistan and Kazakhstan, autocratic politics prevents movement.

The struggles in Russia portray the ambiguities of postcommunist decentralization. With the disarray on the fall of the USSR, several regions of Russia declared autonomy or even independence, threatening the viability of the Russian state. Resource-rich, industrialized ethnic states, such as Tatarstan, appeared in the Russian heartland, with a wholly ambiguous relationship to Moscow. The continuing tragedy of Chechnya exhibited this state fissure at its worst.

Simultaneously, the Russian center resisted conventional, reform-oriented decentralization in the ethnically homogeneous regions that did not threaten secession. Local elections scheduled for 1992 were postponed by Yeltsin, who favored presidential appointment of heads of local administrations, to maintain central control. Elections to local legislatures, rescheduled for 1994, have proceeded in fits and starts with irregularities and postponements often tied to central intervention (Wishnevsky, 1994). Even Moscow lacks an elected mayor.

The chaotic decentralization is a symptom of a portentous development, a rapid collapse of governmental authority in a majority of the reforming countries.

This collapse springs from a variety of factors—the previous reliance on communist party control mechanisms, state fissure, reformers' policies of demolishing the bureaucracy to promote change, and the poor fit of old institutions with the new world of democracy and capitalism. One statistic that conveys the declining power of government is the share of revenues in GDP, presented for 1989 and 1994 in columns 3 and 4 of Table 2. Tax collections have declined by more than 13 percent of GDP in 14 countries. The countries in which the ability to tax has been maintained are those on the western periphery, where continuity in governmental administration has been higher, or those where reform is still in its infancy, such as Ukraine and Belarus.

In many countries, the fall in tax collections goes way beyond the reformers' goals of slimming the economic role of government; it is a process more akin to starvation than to dieting. There is a widespread decline in the capacity of central governments to undertake systematic and concerted actions in pursuit of goals that would be regarded as legitimate in any functioning democracy. This breakdown coexists with much unsystematic, counterproductive government activity, conducted by local governments in defiance of the center and by central government bureaucrats acting independently of their leaders.

In sum, many of the reforming countries have established the central processes of democracy, and they have done so more smoothly than generally predicted before the fall of communism. However, uncertainty about the sustainability of present arrangements remains in a significant number of countries, especially in the former Soviet Union. The democratic processes are commonly not grounded in firm institutional underpinnings. The decline in governmental capacity places a question mark over the future, as do reactions to the vast economic and social changes that are in progress. According to an old dictum, democracy is firmly in place when two governments have quietly left office on losing elections. For many countries, not enough time has elapsed to administer this test. In Russia, no leader has ever left office voluntarily. With two successive parliamentary elections now realized, Russia's mid-1996 presidential election presents a critical test of democracy.

Economic Liberalization

In the planned economies, central directives provided most economic decisions. Local initiative was further muted by the omnipresence of second-guessing, criticism and sanctions for earlier decisions later deemed inappropriate. Freeing agents from central intervention was an immediate task of reform. This process of liberalization has proceeded apace everywhere, via many routes.

In Poland, the communists introduced significant, partial reforms. Then, in the last days of communism, firms and individuals ignored a failing regime; finally, the dramatic moves of the first postcommunist government completed the task. Czechoslovakia, relying on its traditional well-functioning bureaucracy, employed the effective but paradoxical approach of liberalization by design, with one year for preparation and then a coordinated economy-wide move. Further east, the process has been less smooth. In Russia, and several other countries, dramatic announcements from leading politicians were tempered by the leaders' inconsistencies in following through and their inability to control both localities and their own ministries. A final pathway of liberalization has been through breakdown and disorder unalloyed by any central vision, as in Belarus and in war-torn countries such as Tajikistan.

De Melo, Denizer and Gelb (1995) have developed three separate measures of economic freedoms for the transition countries, charting the liberalization of internal markets, foreign trade and private sector entry. These three measures are highly correlated across countries. Columns 5 and 6 of Table 2 present the mean of all three for each country in 1989 and in 1994, scaled so that a score of zero corresponds to a classic centrally planned economy, and a score of 100 would likely be typical of an OECD member.[3]

The median score on economic freedom has advanced from 3 to 70, meaning that the median country has traveled nearly two-thirds of the distance from central planning to OECD levels within a few years. Taken as a whole, this is the most dramatic episode of economic liberalization in economic history. Of the three dimensions of liberalization, the freeing of internal markets has proceeded farthest, largely reflecting the ending of centralized planning, centralized distribution and price controls over state enterprises. Freedom of private sector entry has advanced the least, this being the aspect of reform where laggard reformers seem particularly slothful. The opening of foreign trade has been very fast compared to historical experience, as documented in Papageorgiou, Michaely and Choksi (1989). Within just a few years, three-quarters of the countries abandoned centrally managed trade, removed most quantitative restrictions, reduced tariffs to fairly low levels and adopted essentially full convertibility on current account (EBRD, 1994).

Of course, there is much variation between countries. The ex-Yugoslav republics had less far to go from the beginning; the Baltics and the Czech and Slovak Republics have traveled farthest. As in the case of politics, the degree of change appears to be related to initial conditions, geography and the presence of war. Indeed, both the amount of liberalization from 1989 to 1994 and the level of economic freedom in 1994 are strongly correlated with the political variable in column 2 of Table 2, with correlation coefficients of 0.69 and 0.73. The outliers in politics are usually the outliers in economics. This extensive multicollinearity between many of the variables measuring the extent of reforms probably vitiates any attempt to draw strong causal conclusions concerning the specific sources of economic progress.

Indexes such as those in columns 5 and 6 of Table 2, which are largely based

[3] The comparison with the OECD countries is this author's interpretation rather than that of De Melo, Denizer and Gelb (1995).

on observations at the apex of government, inevitably miss important aspects of the policy environment. Policy mutates as it descends from aggressive reformer at the top to staid bureaucrat on the front lines. There is a much different atmosphere of interaction between government and individual economic agents in ex-socialist countries than in countries with a long tradition of free markets. Thus, even in the much vaunted Czech reforms, the initial price liberalization measures contained many ambiguities allowing for central intervention. The Czech Finance Ministry threatened a renewal of price regulation if "monopolists" misused their position.[4] In several countries, including Russia, the old price bureaucracy provided the staff for the new antimonopoly agencies, using price controls as sanctions in combination with rather inclusive interpretations of what constitutes a monopoly.

As one moves away from the advanced reforming countries, from prominent policy measures, and from the capital cities to the regions, strong liberalization measures are muted by bureaucratic inertia, the culture of policymaking bestowed by central planning and local political resistance.[5] Resultant policy is a mélange of the old and the new, a pattern typical of times of great institutional change, when revolutions in formal rules move far ahead of modifications in informal arrangements and behavior (North, 1990).

In interpreting the liberalization data, one must also remember that a large number of interventions might be welfare-enhancing in ex-socialist countries, given the very underdeveloped capital markets and few market-compatible, social-protection institutions. Hence, once a country has undertaken extensive reforms, the qualitative character, rather than simply the amount, of any further liberalization will be the major determinant of social welfare. The reported data certainly do not reflect the character of the liberalization process, given the dependence of that process on such factors as the effectiveness of bureaucracy and the capacities of inherited institutions.

Institutional Reconstruction

Summarizing institutional transformation is difficult. Massive changes are taking place everywhere as government and society are buffeted by the economic forces unleashed by liberalization and privatization. But with institutional development frequently arising from mutations of existing structures and often contingent on the efforts of particular individuals, the profile of institutional reform varies greatly across countries.[6] In addition, so much of institutional advance is informal: when

[4] See Decree 01/91 of Federal Ministry of Finance of Czechoslovakia and a report in the Foreign Broadcast Information Service, volume EEU–91–214, p. 13.
[5] For a picture of the myriad ways in which dramatic liberalization measures are muted and an argument that the culture of policymaking is central, see Murrell, Dunn and Korsun (1996).
[6] Stark (1992) goes as far as to argue that it is inappropriate to speak of one transition process, rather than many distinctive transformations.

politicians can effectively employ the quantity theory of money as political rhetoric when resisting further government spending, stabilization might be more secure than under all the constitutional guarantees of central bank independence. For these reasons, the pertinent evidence on the institutional bases of economic improvements will surely only arise slowly and, if history is any judge, be clouded with controversy, as in the case of the east Asian economies.

Institutional change is a vast topic, and the ensuing paragraphs can touch on only a few issues. The paper by Rapaczynski in this symposium analyzes in detail one particular set of institutions central to capitalism, those pertinent to property rights, contract enforcement, corporate governance and creditors' rights.

In the immediate postcommunist years, perhaps the most important institutional problem was to settle the relationships among elected leaders, the legislature and the bureaucracy. Two central tasks were the subordination of the bureaucracy to democratic leaders and the division of responsibilities between presidents and parliaments. In eastern Europe, popularly elected leaders are now primary, and laws and budgets constrain the bureaucracy, with politicians simply facing the immense principal-agent problems that exist everywhere. Struggles over turf between elected leaders, symbolized most notably by the disagreements between Lech Walesa and Poland's parliament, have continued but with decreasing intensity over time, indicating that precedent and custom are beginning to fill the gaps in written laws and constitutions.

In many of the successor states of the USSR, basic agreements on divisions of powers are still lacking, resulting in contradictory rules and legislation.[7] Russia has only half-succeeded in following Napoleon's dictum that the best constitutions are short and confused. A large and growing presidential administration duplicates and vies for power with the older administrative apparatus under the prime minister. Even by 1995, the official budget still served as only a rough guide for governmental expenditures, rather than the legal determinant. With these ambiguities, coherent political control of the bureaucracy is still an agenda for the future, as is a settled delineation of the powers of the president, relative to those of Parliament, the courts and the prime minister. Russia is not atypical. It is clear that arrival at an acceptable and relatively undisputed division of power and authority will require many more years of precedent creation and perhaps constitution revising in the ex-Soviet republics.

All countries have emphasized the creation of a set of laws attuned to capitalism: constitutional protections for private property, antitrust statutes, commercial codes, bankruptcy laws, foreign investment guarantees, and so on. Some successes have occurred. For example, Poland's new antimonopoly office has been a catalyst for procompetitive policies; privatization agencies have accomplished much; regulatory agencies are beginning to function in the more advanced reforming

[7] These comments are restricted to democratic countries, authoritarian ones not having solved a more basic problem.

countries. But in general, the quality of laws is quite low, in many cases lacking internal consistency and completeness. Moreover, these laws are often a facade without a foundation. Missing are the appropriately structured agencies, effective courts, the customary practice of enforcing private rights, the professionals, the scholarly and judicial opinion, and the web of ancillary institutions that give substance to written law. In the large majority of countries, especially in the former republics of the USSR, it will take a generation, or more, for the legal system to buttress capitalism in the manner imagined by the drafters of the many new laws. Although these laws are beginning to affect behavior, they are presently of no more than marginal significance.

Restructuring the government bureaucracy has generally not been a prime focus of reformers. Changes are occurring largely as a byproduct of other goals: for example, economic administrative tasks were removed as a result of liberalization and privatization. Some of the most advanced reforming countries are now wrestling directly with the problems of revising methods of governmental administration, but progress is slow.[8] For example, Bird and Wallich (1994, pp. 97–101) characterize the vital task of fiscal decentralization as still in its infancy, a rudderless process, uncoordinated with other crucial reforms such as privatization, and with many local actors unaware of powers and responsibilities.

The need for restructuring government is dire. Old departments are overstaffed, sometimes having no function in the new system. Meanwhile, important new functions go unassigned and new agencies lack resources. However, even when large changes occur, there is the question of whether the moves really constitute desirable reform. For example, Yeltsin's large and growing presidential administration is reminiscent of the apparatus of the Soviet Communist Party Central Committee.[9]

Some high-priority areas have seen substantial changes. With guidance, support, and sometimes pressure from the IMF, the formal status and operating modes of central banks have been revamped across all countries. Similarly, in pursuit of stabilization, budgetary subsidies have declined dramatically in a short time period: in the Ukraine, from 13 percent of GDP to 3 percent in three years; in Russia, from 15 percent to 7 percent in two years (Cheasty and Recanatini, 1996). It seems clear that a vital reform—the hardening of budget constraints—has advanced almost everywhere, but there is little firm evidence on the ultimate causes of this hardening or on its magnitude. As Rapaczynski suggests in this symposium, it is possible that progress on the hardening of budget constraints could counterbalance much of the inaction in other areas of institutional reform.

Financial sector reform was postponed at the beginning of reforms and progress is still largely concentrated in the countries bordering western Europe. In the typical ex-socialist country, private banks still do not have a significant presence,

[8] For an early overview of the status and slow progress of administrative reform, see Hesse (1993).

[9] *Moskovsky Komsomolets*, May 19, 1995.

while the implementation of prudential supervision and regulation is in its infancy (EBRD, 1994). In some countries, notably Russia, an underdeveloped sense of fiduciary responsibility and the slow implementation of prudential regulation are combined with a free-for-all in financial markets, auguring considerable future instability. Private financial intermediaries are beginning to spring up, but financial markets are very thin. Most enterprise investment is financed by retained earnings. The market for takeovers is virtually absent, despite the large number of privatized firms ripe for restructuring.

Systems for Social Protection

The old system of social protection relied on an over-full-employment labor market combined with distribution of benefits by enterprises (Milanovic, 1995). The system was inefficient, using little targeting and few incentives to keep down costs, but it worked better than many other aspects of the centrally planned economies. Because of this and because reformers saw higher priorities elsewhere, redesign of the system of social protection received little attention. This relative neglect, combined with the spillover effects of privatization, liberalization and recession, spells deep crisis in the forthcoming years.

With unemployment rising and liberalized enterprises increasingly unwilling to play the role of social benefactor, the old arrangements are no longer viable, and a huge burden now falls on the state apparatus. In several countries, the consequence has been a rise in government spending on social welfare measures. But in most countries an increase was not feasible, because of a decline in revenue-generating capacity. Social welfare expenditures fell in relation to the target population, with large-scale cuts in benefits, especially for those poor below the retirement age.

Faced with this situation, most reforms have been reactive, rather than systematic. The biggest changes have undoubtedly arisen from the erosion of entitlements by inflation. There have been some modifications in the parameters of pension systems, which have often been favorable to pensioners, but basic structures have largely remained intact. In other areas, such as benefits for children and assistance for the working poor, governments have eliminated or reduced benefits in reaction to budgetary pressures. The most significant active measure has been in increasing the importance of unemployment programs, which were virtually unneeded before reforms. Private sector provision of education increases largely through growth of a nascent private sector, not through privatization. Health care is increasingly quasi-private, usually through the rise of corruption rather than as a result of privatization.

The highest priority of reform of social protection is to divorce its provision from the enterprise sector, so that the threat of dire social consequences does not hamper the reallocation of resources (Fischer and Gelb, 1991, pp. 100–101). Although this step is largely accomplished in eastern Europe, even an advanced reformer such as the Czech Republic continues to delay broader economic restructuring as a means of social protection (Brom and Orenstein, 1994). In less-reformed countries, subsidies from the financial system to enterprises, restriction of raw material exports, and beneficial access to imports are being used to bolster the incomes of those who would otherwise be reliant on inadequate or nonexistent social protection programs.

The Russian coal industry provides an outstanding example of the enormity of the task that lies ahead. Formerly, the miners were the kings of labor, even adding the word "Stakhanovite" to the English language, an allusion to the legendary performance of a miner in the 1930s. Now, current forecasts suggest a halving of the labor force of 800,000 miners, many of whom are trapped by poverty, outdated skills and poorly functioning housing markets in isolated, coal-based communities. With the introduction of free markets, the temporary solution has been massive subsidies, at times equal to 2 percent of GDP, but now declining.[10] For administrative ease, these subsidies flow through a monopoly coal company, effectively a renamed department of an old Soviet ministry. The subsidies, after much inefficiency and corruption, pay for housing, health care, child care, meal allowances, educational facilities and in-kind benefits. At some time, these burdens must pass to the localities, but at the moment the local authorities seem administratively, financially and cognitively unable to face what lies ahead.

Early Results

It is early days for the economic transition of the formerly socialist economies: the present reforms are as much a long-term investment as focused on immediate results. Hence, any examination of results is necessarily provisional, able only to impart a rough sense of comparative developments over the last few years. Economic miracles will not be evident, but there is already enough differentiation among countries to draw some broad conclusions.

Turning first to inflation stabilization, the immensity of the task can be understood simply by noting that in the median country, the inflation rate peaked at a level of 1290 percent per year, the peak usually occurring immediately after comprehensive liberalization but before stabilization programs began to bite. The median inflation rate during 1995 was below 40 percent a year. This is vast progress, the magnitude of the effort behind which is conveyed by the budgetary adjustments necessary for these gains. During the years 1989 to 1994, budget deficits peaked at an average value of 14.4 percent of GDP. In 1994, deficits averaged 6.3 percent of GDP, which is close to a level allowing for noninflationary finance for the smaller, poorer countries, where foreign aid can reach this level. For the half of the countries experiencing the worst budgetary problems, the mean highest deficit was over

[10] The miners were early prominent supporters of Yeltsin, who has repaid his debt to them many times over.

23 percent of GDP, while 1994 deficits averaged 10.7 percent. These adjustments usually occurred in less than two years, in most cases with the added complication of a simultaneous, rapid decline in revenue-generating capacity.

Coincident with progress on stabilization and liberalization, output has declined by historically unprecedented amounts. The causal mechanism underlying this decline is the subject of much debate. Calvo and Coricelli (1993), for example, focus on a credit crunch affecting aggregate supply; Berg and Blanchard (1994) lay blame primarily on the fall in aggregate demand; while Murrell (1992) emphasizes the destruction of the old institutional, social and organizational capital before analogous market structures have time to develop. Whatever the cause, the decline is dramatic: measuring the recession by the fall in output from pretransition peak GDP to the lowest level between 1989 and 1994, declines average 41 percent. But regional variations are very important. In eastern Europe, this 41 percent mean is exceeded only in ex-Yugoslav republics affected by civil war. Most countries emerging from the Soviet Union fare worse than non-Yugoslav eastern Europe. Only Uzbekistan, with fortuitous conditions and gradual reforms, escapes this pattern.

By the end of 1994, GDP per capita was increasing in more than half of the countries. Poland has now finished its fourth year of growth, with the other eastern European countries and the Baltics having joined the recovery in the intervening time. Despite the large declines of previous years, the majority of the ex-Soviet republics still experienced declining GDP in 1995, but at much lesser rates than before. By the end of 1995, it appeared that the recession had reached its trough in the former Soviet Union. However, even if strong growth were to follow immediately, the effects of the previous output declines would be with these countries for many years. Even with an unlikely 7 percent growth rate maintained from 1996 on, GDP in the former Soviet Union would still be below 1990 levels in the year 2005. More detailed quantitative information on the cross-country patterns of growth and inflation is presented by Fischer, Sahay and Végh in their paper in this symposium.

The data on unemployment present a paradoxical picture, even accounting for measurement problems, as shown in column 1 of Table 3, a table which contains data on some of the results of transition that are not reported elsewhere in this symposium. The typical pattern in eastern Europe is that the percentage unemployment rate rises rapidly to the mid-teens and then stabilizes. In a few countries, unemployment has begun to edge down, but there are no expectations of a rapid fall. In the former Soviet Union, unemployment rates have remained much lower. This difference between regions reflects at least two phenomena. First, restructuring within enterprises has proceeded less rapidly in the former Soviet Union. Secondly, the shift from enterprise-based social protection is slower in the ex-Soviet republics. Employees retain official employment, without work or pay, to qualify for benefits, and they have little incentive to become registered as unemployed.

Turning to the establishment of a private sector, there are two major questions: how large that sector is and whether the move from state to private has had discernible effects. The evidence on each question is less than transparent. In this

Table 3
Miscellaneous Early Results of Transition

	1 Unemployment Rate 1994	2 Male Life Expectancy 1989	3 Male Life Expectancy 1990s	4 Foreign Direct Investment % of PPP GDP 1994	5 Lowest Level of Economic Risk Index 1989–1994	6 Level of Economic Risk Index 1995
Albania	19.5	69.1	69.3	1.91	17	25
Armenia	5.6	64.6	68.7	0.00	14	28
Azerbaijan	0.9	66.4	66.3	0.00	12	12
Belarus	2.1	67.1	63.8	0.03	19	29
Bulgaria	12.8	68.6	67.8	0.28	23	41
Croatia	12.8		67.2	0.26	18	31
Czech Republic	3.2	68.1	68.5	1.50	53	74
East Germany	16.5	70.1	69.8		67	98
Estonia	8.1	66.2	64.1	0.73	23	49
Georgia	2.0	68.0	68.7	0.00	16	19
Hungary	10.9	65.4	65.0	4.50	52	60
Kazakhstan	1.0	63.9	63.8	0.39	19	30
Kyrgyzstan	0.7	64.2	64.2	0.00	18	18
Latvia	6.4	65.8	61.6	0.20	22	36
Lithuania	3.8	67.1	64.9	0.14	21	35
Macedonia	31.8		68.9		18	26
Moldova	1.2	65.5	63.9	0.25	14	22
Mongolia	10.1	60	62.7	0.21	18	27
Poland	16.0	66.8	66.8	0.70	36	48
Romania	10.7	66.6	66.6	0.52	31	49
Russia	2.2	64.4	57.3	0.16	18	28
Serbia & Montenegro	23.8	68.7	69.6	0.00	18	
Slovakia	14.8	66.4	66.4	0.23	44	58
Slovenia	14.5	67.4	67.8	0.42	18	61
Tajikistan	1.7	66.2	65.4	0.00	14	14
Turkmenistan	0.0	61.8	62.3	0.00	15	26
Ukraine	0.3	66.4	64.0	0.14	19	26
Uzbekistan	0.3	65.8	66.1	0.09	16	21
Mean	8.3	66.2	65.8	0.49	24	37
Population-Weighted Mean	5.7	65.8	63.0	0.39	24	36

Note: For tables reporting results on inflation, growth and the development of the private sector, see the papers by Brada and Fischer, Sahay and Végh in this symposium.
Sources: Column 1, miscellaneous National Statistical and World Bank Publications; columns 2 and 3, Heleniak (1995) and World Bank (1995b); column 4, International Monetary Fund (1995), supplemented by author's calculations; columns 5 and 6, *Euromoney.*

symposium, Brada details the problems in the data on size of the private sector and presents estimates. Typical estimates of the private sector share of GDP for these countries were in the range of single digits or barely above in 1989, with the exception of Poland at about 28 percent. By 1994, the estimates ran from

15–75 percent with an average of 40 percent, the Czech Republic having the largest private sector.

The private sector has increased dramatically everywhere. But how much is this change purely formal? To answer this question, one must distinguish between two distinct phenomena, the growth of new private firms and the conversion of the large state enterprises to private ownership. There is universal agreement that new private firms have been of great significance. For example, while the state sector in Poland has been viewed as performing creditably, the economy's strong recovery derives largely from private firms not originating in the state sector (Gomulka, 1994, p. 8). The most usual result emerging from systematic empirical studies portrays significant differences in performance between new private firms and all others, but few differences between state and privatized firms (Brada and Singh, 1994; Belka, Schaffer, Estrin and Singh, 1994; Ickes and Ryterman, 1995a). The only new owners of former state enterprises having a consistently large effect are foreigners (Carlin, van Reenen and Wolfe, 1994).

The picture does change somewhat when examining the internal decision-making structure of firms, rather than current behavior (Belka, Schaffer, Estrin and Singh, 1994, p. 19; Estrin, Gelb and Singh, 1994). For example, Korsun and Murrell (1995) find that while historical relationships predominate in explaining the patterns of influence over decision making in privatized enterprises, ownership does have an effect immediately after privatization, an effect that grows with time. Thus, the changes wrought by ownership are likely to arise gradually, suggesting that judgments on the power of policy to eradicate inherited patterns of behavior are key in understanding enterprise behavior in times of large policy change (Murrell, 1992).

As a consequence of the steep recessions, the decline of the old system of social protection, and shrinking state resources, poverty has dramatically increased. For a set of reforming countries with a combined population of 320 million, Milanovic (1995, p. 13) finds that 100 million people are now in poverty, in contrast to 15 million people so classified before the fall of communism.[11] He attributes the increase in equal proportions to the general decline in living standards and to increasing income inequality. Levels of inequality have risen sharply in most but not all countries. Russia, Estonia and Lithuania already have Gini coefficients comparable to those of the most inegalitarian OECD countries, while inequality in Belarus and Slovakia has remained at the low levels of the communist era.

One entirely unexpected development is a complex set of changes in demography and health. In Russia from 1991 to 1993, for example, the birth rate dropped by 12 percent, the death rate increased by 26 percent, the marriage rate declined by 20 percent, the infant mortality rate increased by 4 percent, and the mortality rate of middle-aged adults rose by 13 percent (UNICEF, 1993). The changes have been most dramatic for males, especially those in middle age. Coronary disease, cancer and social ills such as suicide, alcoholism and murder are the prime culprits.

[11] He excludes war-torn and central Asian countries, where the data are less reliable.

In Russia from 1989 to 1994, male life expectancy dropped from 64.4 to 57.3 years (Heleniak, 1995), a statistic as foreboding as it is unprecedented. In fact, as the data in columns 2 and 3 of Table 3 show, male life expectancy has fallen in half the transition countries in the postcommunist era.

Consistent with many patterns identified above, these demographic changes are more pronounced the further one moves from central Europe, although few countries have escaped entirely. The one exception to this general characterization is East Germany, where demographic changes are immense, even though the generosity of the German social welfare system has negated the effect of the recession on living standards. This, together with the fact that middle-aged males living in countries with the largest recessions seem most affected, resonates with an earlier literature relating macroeconomic changes to general increases in social ills (for example, Stern, 1983).

With a majority of countries still less than five years from the fall of communism, it is instructive to examine forward-looking data. One way of gauging the economic future is to consider the extent to which foreign investors are betting on the future health of the transition countries. A straightforward measure here is foreign direct investment measured in relation to purchasing power parity GDP, reported for 1994 in column 4 of Table 3. Three countries—Albania, the Czech Republic and Hungary—have investment flows exceeding 1 percent of GDP, levels comparable to that of Greece and Portugal. For these countries, and probably Poland and Estonia, foreign direct investment will make a significant contribution to economic progress; but it is only in Hungary, where flows now reach 4 percent, that foreign investment is likely to become a primary growth force. In most of the remaining countries, foreign investment is still trivial. In Russia, for example, total inward investment flows from 1989 to 1995 amounted to only one-third of Russian capital flight during reforms (*PlanEcon Report,* 1995).

Euromoney publishes a widely used measure of future economic risk, a broad indicator of an economy's potential, currently ranking 187 countries worldwide. This index reflects market-based measures, such as ease of rescheduling debts, debt repayment records, access to bond markets and availability of short-term finance, as well as opinion, the assessments of bankers and insurance brokers on likely future economic developments and political risk. The index ranges from 0 to 100, higher scores indicating better prospects. Column 5 of Table 3 lists the lowest value of each country's score on the index over the last five years, while column 6 presents values for 1995.

The ex-socialist countries fare poorly in these rankings, but significant gains appear. The average lowest score of the transition countries equals that of the 157th of 187 countries ranked by *Euromoney.* The mean 1995 level is equal to that of the 110th country, a very significant change over a short time period for such a large group of countries. The gains are spread very broadly; almost every country not affected by war improved significantly on the index. But there is far to go. Even advanced reformers with relatively easy access to western European markets, the Czech Republic, Hungary and Poland, rank on average below 50 other nations, including countries such as China and South Africa, which are undergoing their own rather different transitions.

Reflections on the Patterns of Transition

Economic, political and social changes have proceeded at an astounding pace in virtually every country abandoning communism in the years from 1989 to 1991. Achievements are transparent: the reductions in unsustainable budget deficits, the improvements in political systems, and the return to growth in eastern Europe. Problems are also evident: the depth of recessions, the stubbornness of inflationary processes, and the dramatic increase in poverty. Moreover, as economic aggregates swing violently, via wrenching recessions and state dissipation, behavior at the level of the individual producer and the lesser public official shows greater persistence than might be expected given the changed macroeconomic environment and the new legal and property regimes. Thus, while much has been accomplished in a few short years, many changes lie in the future. If one asks how close the structure and behavior of the reforming economies are to their putative target, then the answer must be that there is a long way to go.

One can view the transition through a different lens, however, focusing on the institution of process, rather than the attainment of outcomes. In this view, the essence of reform lies in the establishment of core processes that foster a productive evolution of socioeconomic structures. Those processes are political and economic competition, resting upon democratic and economic freedoms and solid institutional foundations.

From this process perspective, the transition is more or less complete in countries such as the Czech Republic, Hungary, Poland and Slovenia. In 10 to 20 years—a short time, historically speaking—developments in these countries will erase the economic connotations of the adjective *western* European. Of course, path dependence will play its role, leaving a bloated state sector here, creating an expensive welfare state there. Some countries will progress strongly, as Spain, others with the fits and starts of a Greece. Nevertheless, the events of the last few years in the western rim of transition countries point strongly in one direction, when viewed in broad historical perspective.

In extrapolating from the experience of these early reformers, however, one must make difficult judgments on whether, and to what degree, the effectiveness of the newly instituted political and economic competition depends on factors beyond the control of reformers during the early stages of transition. Certainly, early reforms can be complemented by inheritances: a capitalist past surviving in memory and in statute, an effective bureaucratic culture, a predisposition toward the rule of law in reaction to the previous era, communist era economic reforms, and even usable features of the old system. Some countries also benefit from the widespread sentiment that there is no choice but to proceed away from the old system. Outside factors also provide complements—the discipline imposed by the promise of entry into the European Union or the opportunities afforded by easily accessible developed country markets.

The real question then is how far east one might take the confident prediction emanating from central Europe. Certainly in central Asia and the Caucasus, the processes of transition are still in their infancy, or stillborn, as for democracy in Azerbaijan or Uzbekistan or for most everything in Turkmenistan. Between the western rim and Central Asia, there is a penumbra, with Russia both enigma and pivot, as always. Having failed in 1992 with a precipitate stabilization and liberalization, Russian reformers embraced the view that reform is essentially the institution of a few core processes. They gambled that privatization is the sufficient condition for all other reforms, even where history and geography have not been as kind as in central Europe, even where institutionalized political competition is still weak and where the chaos of the half-destroyed past arises constantly. The experiment is certainly interesting, but economic knowledge and historical experience provide little help in forecasting where it will end.

Implicit in the above discussion is the observation that there are pronounced differences between countries. In fact, there is strong evidence of increasing differentiation in the measures of economic performance examined above on inflation rates, levels of per capita income, scores on the political index, the *Euromoney* indexes of economic risk and mortality rates, for example. Only on indexes of liberalization and of deficit reduction is there increasing homogenization. Policy might have become more homogeneous over time, but outcomes have become more varied, suggesting that initial conditions greatly determine the effectiveness of policies (Ickes and Ryterman, 1995b).

The increasing differentiation can be viewed either optimistically or pessimistically. The optimistic view begins with the assumption that country differences are more quantitative than qualitative. As one moves west to east, the deeper recessions, the greater stubbornness of inflation and the delayed recovery are simply the result of less reform before the fall of communism, the later advent of postcommunism, greater repercussions from state fissure and greater distances from dynamic markets. Under this view, the former Soviet Union is simply following eastern Europe, with larger adjustment costs and somewhat slower progress on reforms.

A more pessimistic scenario might take seriously the assumption that there is a minimal endowment—institutional, economic, cultural, social and political—necessary to ensure that the standard menu of reform policies leads directly to a benign evolutionary process. Without these endowments, the dramatic changes in policy and the destruction of the old system will not be so effective in spurring the movement toward developed democratic capitalism. The result will be slow improvement, with GDP remaining below 1989 levels for the first two decades of the postcommunist era. Possibly, social and political chaos will result if the huge recessions of the last few years do not quickly give way to the hope of economic recovery. The observation of whether the optimistic or the pessimistic scenario comes to pass will provide one of the more interesting data points directly encountered by the present generation of economists.

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