**Paper presented at the Conference "Czech Society in the EU",
Faculty of Social Sciences, Charles University, Prague, 21-23 October, 2004,
and at CRCE Symposium in Bled, Slovinia, 25th – 28th September 2004**

1989-2004: 15 YEARS OF TRANSITION – THE END OF THE NEVER-ENDING STORY?

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ABSTRACT

The paper aims at general statements concerning all 25 transition countries of post-communist Europe and Central Asia, even though it concentrates more on the transition in new EU-8 members and Russia. It discusses first the causes of transition and argues that internal forces pressing for more substantial reforms than *perestroika* were present in all these countries, even though not always in an active quest for a market solution of such changes. The initial period of macroeconomic stabilisation was followed by a much longer period of privatisation, followed by its extensive spin-offs. Contrary to expectations, there were widely spread negative externalities coming from the insufficient enforcement of property rights. The paper then discusses the outcomes on various segments of the economic system: growth, exports, FDI, labour, private enterprise sector and public sector. It is discussed widely why the growth in transition can be underestimated due to objective and subjective reasons. The paper concludes that, notwithstanding enormous transaction costs, clashes of the market sector with the hierarchical governance systems and the protracted delays in concomitant reforms, the market economy has shown its enormous viability during transition and, in the long run, is leading gradually the way to the improving prosperity in transition countries.

The abandonment of markets and their replacement by centrally planned systems for the allocation of economic resources was a giant social experiment of the 20th century that miserably failed. The subsequent transition of socialism to capitalism was initially seen – presumably after some two to five years of muddling-through – as a grand victorious comeback. Five more years elapsed and the comeback turned into another trauma – that of disillusion.

According to Mundell, 1997, the performance of transition economies was a fall "never before experienced in the history of capitalist economies (at least in peacetime)". Was it such an unexpected flop? We argue in this paper that there were clear reasons for a delay in development longer than required by macroeconomic stabilisation or the loss of markets. They were associated with shortsighted strategies in privatisation, institutional failures and disorganisation in the relational (social) capital that led to disruptions in economic co-ordination in production. However, after allowing for them and their gradual phasing out, the levels of performance have not been so negative and the future of for transition economies is brighter then ever before.

A/ CAUSES & TOILS OF TRANSITION

The velvet collapse of the social experiment with central planning of the economies in the Soviet empire was a historically unprecedented relinquishment of a political puissance that directly held sway over 400 million people and, indirectly, the future of a third of mankind. The event was augured neither by the social scientists, nor betokened by omens of widespread political breakdown or the deepening of economic impotence. The preceding unrest in Poland, Hungary or East Germany could have been contained by force that was not challenged by a world-wide military coalition. The evident communist losses in the arms race or in the economic contest were not a clear argument for a bloodless dismantling of the seemingly monolithic hierarchy of command and power built by generations.

The communist extra-market system was an outcome of three catastrophic failures of the capitalist democracies: World War I, the Great Depression of 1928-33 and World War II. Although in all three cases the free market system received a severe blow, it recovered and evolved into a more complex mechanism, until entering the stage of a world-wide globalisation in 1970s. The communist imperium seemed to be the last impediment on its victorious way and the battle finally concentrated on the status of human rights and individual choice.

Moving beyond the explanations of the historical collapse in 1989-1990 exclusively at the level of macro-political confrontations, we should turn to more closely examine socio-political cohesion. The atoms of any social structure are formed by the actions of individuals. Instead of dealing exclusively with the top echelons of hierarchies, we may turn to examine micro-battles at the grassroots – at the "markets" for human interests, opportunity costs of supporting the "Big Brother" hierarchies, and values of free choice in consumption, speech and entrepreneurship. Billions of such micro-battles ended in a Pareto-inefficient conclusion: a change of the system would make me (and definitely my children) better off or the same. The craving for having a choice, the fascination of private ownership and the feel of adventure from opening-up to the world were potential improvements that counterpoised all risks. As also the generation of apparatchiks born after World War II (in Russia called "Andropov's children") found the potential change Pareto-improving, there was hardly any demand for opening a new wave of "Cultural Revolution".

The collapse of communism was a definite demonstration of the powers of the market system, conceived in the Smith-Mises-Hayek sense as an invisible hand: a universal,

spontaneous, autonomous and completely decentralised universal auction for the allocation of resources, human time and decision-making power. We should be aware that elements of markets are impurgeable - the markets were present spontaneously also in the system of central command, even though its transaction costs were high, information channels weak and the excludability was often explicitly enforced. It was the omnipresent inefficiencies of planning that called for the existence of an elementary implicit market mechanism that helped unofficially (or even illegally) with the final allocation of resources. It helped reduce the huge dead-weight losses and brought surpluses to individuals. Mechanisms of such rudimentary markets, which were both complements and rivals to central planning, were described by Brixiova and Bulir, 2001 and 2003, Kornai, 1980, Hlavacek, 1990, or Mlcoch, 1990.

The jump-start dismantling of communism declared its victors immediately: the public choices by means of political democracy, the markets for economic decision-making and the property rights for private ownership. Given that, one could easily find the presumed losers by using the logic of negation: political autocrats, hierarchical institutions of economic command and public ownership. Economists on both sides (West and East) easily persuaded the public that the post-communist era would be the time for a full-fledged reliance on markets. Allied with a fundamental de-etatisation, the changes were presumed to return the transition societies to the traditional values of liberal capitalism: meritocracy, entrepreneurship, strengthening of communities and families, and individual responsibilities that in the affluent West were obliterated by the idea of the welfare state.

The various programmes for transition were forged at the national level as early as 1990, often independent of each other. Nonetheless, they included a group of four universal policies: macroeconomic stabilisation, trade and price liberalisation and privatisation – forming what was later called the "Washington consensus". The only remaining issue seemed to be how quickly the reforms should be introduced and what kind of rule, order and discipline could be enforced. Since it was presumed that the transition was inherently an evolutionary change issuing from the long-suppressed human nature that was avowed by a landslide majority, it was also assumed that transition itself would be a self-sustaining order, where each problem would find soon its market solution.

However, already at that time there were omens portending that the passage to new capitalism need not be easy. Just at the time of big bang of transition, Baumol published his seminal paper about entrepreneurship (Baumol, 1990). In line with Schumpeterian notions of an authentic and a degenerated entrepreneurship, he defined it not only as a productive activity, but distinguished also its redistributive and destructive mutations (Schumpeter, 1934 and 1942). The difference rested in incentives – in the institutions defining the rules of the game. Similarly Olson, 1982,[1] discriminated between markets rife with predatory ownership, where markets were subjected to hierarchical subordinations, and markets where all economic agents recognised the need of protecting the property rights and underpinning the incentives to produce, invest, specialise and trade. However, the sweeping transition paid little attention to the rules or incentives and brought these soon out of touch with reality. The clash culminated in the issue of **organisational costs of creative destruction, relational capital, contracts, privatisation and property rights**. The evolution of markets clashed with their most substantial impediment – the transaction costs. Let us first explain the problem by discussing privatisation.

Economic transition is, by its nature, a period when property rights are in a process of re-definition and, due to the needs of a speedy mass privatisation, their protection is demanded to be eased or even relinquished. Thus the build-up of new private sector in

[1] Olson elaborated his previous ideas even further in a way more appropriate to the infant diseases of transition in 1990s (see Olson, 2000).

practically all post-communist countries[2] included a spectrum of activities such as property transfers based on auctions, mutual agreements with compensations at various degrees, unrequited transfers by decree, foundations from own or borrowed endowments or predation (theft). In transition, when the emerging democratic governments lost the authoritarian character, these complicated property transfers were subject to yield and price uncertainties, asymmetric information, adverse selection and predation, what made them intransparent and insecure. These, as explained by Olson, 2000, were a highly defective way for building the foundations of social prosperity. In addition, privatisation did not concern the ownership of physical assets and their yields only but also a *carte blanche* to loans, control over minority shareholders and opportunities of agents to dominate vaguely defined principals. The price of such deals therefore easily exceeded the discounted flows of profits (often negative ones). The incentives for a moral hazard were widely opened.

The establishment of private property as an institution is of crucial importance in transition because, simply, the market economy would have hardly any contents without it. In traditional capitalist societies it is built by gradually by generations. In transition this task must be speeded up substantially and the solution is seen in privatisation. With this, the entrepreneurial motive for redistribution gets a special incentive for enhancing its importance and for putting economic policies into service. Putting aside alternative options, society is suddenly challenged by an ideology for elevating privatisation to the level of obsession (Sato, 1995 and 2000), endowing it with the following features:

a/ the physical capital accumulated under central planning (and allocated without proper market signals) is declared the most important national asset to be saved;
b/ even wasteful assets are presumed to be turned easily into profitable assets once the markets commence to function and the private owners take over the management;
c/ the potential for reallocation of such assets to alternative uses is high as the owners are helped by evolving capital markets (disregarding somehow the fact that the market value of sunk cost non-profitable capital is negative);
d/ State owned enterprises should be saved, even by means of various implicit subsidies;
e/ it is alleged that the immobility of their employees is the main social burden;
f/ as an implicit subsidy, real (unit) labour costs can be decreased by inflation, thus offering larger margin to profits (neglecting the macroeconomic argument about its impact on sinking aggregate demand);
g/ the edge of international competition can be subdued by a massive real devaluation that again offers higher leeway to capital returns (disregarding the impact of terms of trade losses on the national welfare);
h/ it is alleged that there are not enough private funds for a direct privatisation, therefore the privatisation must be based on running debts. (Here the asset pricing is often simplified by confusing its market value with illusory accounting price); and
i/ it is alleged that foreign investors may be hostile to the national economy and the priority should be assigned to supporting the indigenous owners.

By yielding to the demands for opening widely the redistributional window of opportunities, the policies of transition became in many countries a hostage of the privatisation process.

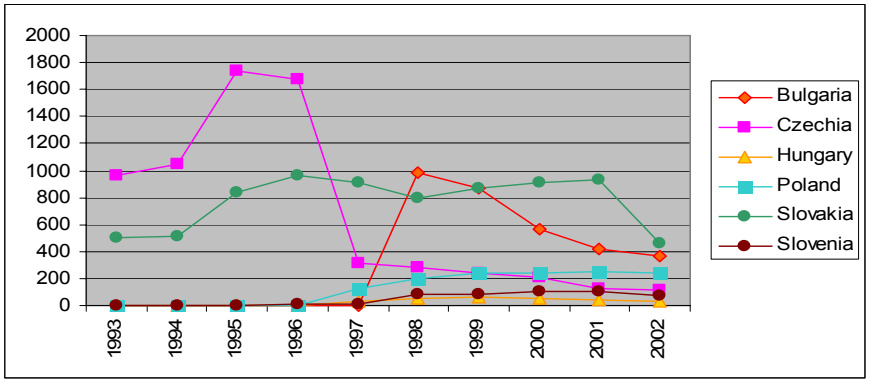
[2] The only exception was Slovenia, where privatisation was very slow. Eastern Germany was an exceptional case where the enforcement of property rights was nearly perfect on one hand, but on the other hand the privatisation takeovers were often hostile and the incentives to entrepreneurship were negative due to extremely highly regulated labour costs.

Our implications are of crucial importance for economic policy-making. We affirm that **the development of societies in transition may depend very heavily on how the privatisation was conceived and later conducted.** Mass privatisation schemes in an economy, in which the State was an exclusive owner of nearly all productive assets, may unleash in people such motives and expectations that could divert the behaviour of the whole society to aberrant (redistributive or destructive) patterns. A precipitated strategic decision about privatisation based on debt and lacking clear rules about property rights induced spin-offs of unfavourable externalities afflicting the growth and restructuring of the whole economy for many years. Many economies got locked in a series of incomplete contracts, defaults and induced maladjustments. In countries like Czechia, Bulgaria, Russia or Ukraine their influence was felt for nearly a decade.

Although the society may later find the situation untenable, the enduring hysteresis effect will make the needed re-adjustments difficult. The powerful winners from initial rounds of such mass privatisation acquisitions had strong motives for stabilising their ownership by distorting the institutions of competition and hard budget constraint. Economic institutions, instead of acting as an exogenous parameter, become endogenised by the players. An attempt at eliminating the created loopholes is then opposed by powerful lobbies. Privatisation of national monopolies protected by undervalued exchange rate can even endogenise the markets.

Surprisingly, the capital and financial markets have proven to be the most vulnerable. For example, as the Czech commercial banks became the main intermediaries in the privatisation schemes their portfolio of loans was composed by 34% of classified credits in 1998 (21% of GDP)[3]. In some other countries the peak came in 1999 when the share of bad loans per total loans was 40% in Slovakia and 37% in Romania, while it was only 3% in Hungary and Estonia and 15% in Poland (World Bank, 2000). We could observe that nearly the equivalent of the **full value of assets privatised under the non-traditional schemes** (such as the voucher scheme) was counter-balanced by debts pending partially even today to be bailed out by the state budget.

Building of the capital market (stock exchange) was another spin-off associated with privatisation that generally failed. While stock exchanges in Britain or US provide market capitalisation over 100% of GDP, the five most important stock exchanges (Warsaw, Prague, Budapest, Ljubljana and Bratislava) provide much less then 25%, even though some of them were established as all-embracing hubs. The attempts of creating capital markets by mandatory listing of companies after voucher privatisation failed, as is shown in Figure 1.



[3] In Czechia the proportion of accumulated bad loans per total loans in 1999 was 31.4%. It was comparable only with Slovakia (40%) and Romania (36.6%), while it was 3% in Hungary and Estonia and 15% in Poland (see IMF, 2000, World Bank, 2000 and EBRD, 2000). Various subsidies and bailouts paid by the government or by other State institutions (like the Fund of National Property, Czech National Bank, etc.) are excluded from these estimations of "implicit subsidies".

Figure 1: Number of companies listed on stock markets
Source: Homepages of national stock exchanges, 2003

Another reason why the merits of mass privatisation schemes fell short behind the expectations of liberal institutional economics is based on the role of transaction costs, insiders in privatisation and their advantages in network capital. For example, Alexeev, 1999, treats even the managerial buy-outs as a rent-seeking contest where the incumbents (e.g. the managers and their associates) became the highly problematic winners. The superiority of chances for the dominance of former "nomenklatura" in mass privatisation schemes was given by their access to informal property rights over assets prior to the reform, information asymmetry and the network capital invested in the hierarchies of insiders. The higher was the deviation from the competitive standard of privatisation (what Alexeev called "a genuine reform") the more likely it was that privatisation would downgrade into a rent-seeking event pervaded by moral hazard. The legacy of privatisation dominated by rent-seeking is generally counter-productive even in the long run due to its negative externalities into political lobbying, corrupt ethics, institutional distortions, income inequality, redistributive taxation and a lack of motives for restructuring.

Bezemer, Dulleck and Frijters, 2003, go even further and use the concept of relational capital by following the school of "new" institutional economics (Williamson and Masten, 1999) and the "disorganisation" hypothesis of co-ordination failure (Blanchard, Kremer, 1997, or Roland, Verdier, 1999). According to them, the low growth in transition economies can be explained by the depth of necessary creative destruction required for setting up new enterprises, effectively privatising old ones, finding new contacts for selling outputs, purchasing inputs, finding managers and know-how and the relations required for innovation and marketing. Authors argued that such creative destruction incurred exceptionally negative externalities on the relational capital of other firms, resulting in high transaction costs in conducting business in transition countries.

We can add that, as the successful firms were in distress, opportunistic redistributional and destructive motivation of the parties grew on intensity and crowded-out the co-operative requirements. Even though the markets in transition economies kept opening up at a high speed from the beginning of transition, so did the transaction costs due to the shortage and actual destruction of relational capital, insufficient trust among partners, lack of ethical behaviour, retention or revival of hierarchies acting as competitors of the markets and the rise of bureaucracy.

Now we can connect this part back with the problems of privatisation. Benacek, 2001, and Winiecki, 2004, posit that the transition to capitalism did not pay sufficient attention to the development of **new private firms**, which became a weak link in the systemic changes. Their establishment and expansion, their share in the aggregate output and employment, along with the enabling conditions required for their success, are shown to be of crucial importance for the growth. Taken from this view, the authentic *de novo* firms became the politically less supported complements of the old (privatised) firms, which turned into being rivals competing not only for the access to limited resources (e.g. finance or factors) but also to institutions supporting the productive objectives of entrepreneurship and growth.

The ownership transformation, labelled as privatisation "from above" (Winiecki, 2004), gained the deserved status of a crucial policy for the outset of transformation. But its specificity was that it required much more state activism than the establishment and the expansion of new private firms. Thus at the moment when the status of privatisation should have been downgraded (e.g. after 3-5 years of transition) and superseded by policies commensurate to the development of new firms, the evolved vested interests between large

private enterprises, state bureaucrats and political parties got to a lock-in and resulted in building barriers to growth and to natural expansion of the market economy.

The main weakness of the privatisation "from above" does not rest in potential frauds, insider trading and appropriation but in the inefficient usage of the property so acquired. Not only that owners skilled in winning bureaucratically contrived privatisation deals are seldom as efficient in restructuring its productive assets, but the whole institutional environment, designed for helping such deals, hampers the process of finding the final owners motivated by productive aims and skilled in restructuring.

Let us pose another question: would it be advisable, having learned that "the king of mass privatisation is naked", to introduce a hard budget constraint for all firms? That would imply that both the government and the banks would have to persist on an absolute financial discipline and punish the trespassers by bankruptcy procedures. This problem is widely discussed by Frydman et al., 2000, and Maskin, Xu, 2001. We can agree that this would be an optimal policy for those enterprises whose objective function is restructuring and efficient governance. However, if the domestic economy has been split into three sectors guided by different real conditions (i.e. foreign green-field enterprises, small indigenous firms under authentic private ownership and the sector of [mass-]privatised or state-owned corporations), this universal strategy introduced ex-post would be sub-optimal. It would only speed-up the process of non-creative destruction that commenced by formal privatisation, postponed restructuring and flaws in corporate governance in the third sector.

The objective of transformation rests in the opposite: in rescuing of the property subject to sunk cost and its gradual transformation into a more productive use by means of recoupment into a cash-flow for further reinvestment. Once the mistake of launching a mass privatisation scheme was made, a part of its "natural" institutional complements should not be suddenly repealed. There should continue clear general rules of market-consistent industrial policies, such as taxation and depreciation incentives, state credit guarantees and interest subsidies, which would prevent the sudden demise of frail privatised enterprises that are capable of at least partial recoupment through medium-term bankruptcy procedures and ownership changes. Privatisation of banks and restructured legislation and judiciary able to enforce property rights are necessary conditions for such remedial actions.

Economic transition itself can be defined as a period when the property rights are in a process of re-definition and their protection is uncertain. Thus the development of new private sector includes such spectrum of activities as property transfers based on mutual agreements and compensations, unrequited transfers by decree, foundations from own or borrowed endowments or predation (theft). In transition, when the emerging democratic governments are not fully in control, these complicated property transfers become highly intransparent and insecure, what makes them biased to adverse selection and predation. But predation, as explained by Olson, 2000, is a highly defective way for building the foundations of a social prosperity.

Asset stripping is a sort of an accelerated recoupment strategy used in cases where the discounted private yields from long-term recoupment are low, subject to a high opportunity cost [4]. A part of the capital is thus immediately recyclable, for example by selling it to another enterprise (e.g. to a SME) or to final consumers. Unfortunately, it allows only a small part of

[4] The paradox rests in the word "private". In the transition's ownership tangle there may be too many private claimants, be it past owners, new owners, their agents, collateral banks, bureaucrats or simply thieves. The period of their "ownership entitlement" can be also limited. The result is then an asset "yield" optimal only from a view of a short time period and subject to constrained ownership power. Also, if the opportunity cost of a narrow set of privatisation insiders is very high, they cannot accept assets with low yields spread over a long period of recoupment. Therefore privatisation should be based on wide competitive markets, too.

a plant stricken by sunk costs to be transferred into alternative uses. The risk of social loss rises if there is an institutional bias for asset stripping strategies. Under weak protection of property rights the liquid assets in firms with high sunk costs can be embezzled by a myriad of agents around principals. This will happen notwithstanding the fact that the remaining viable property could lose all its productive functions.

It is a sub-optimal short-run outcome typical for situations ruled by prisoner's dilemma, even if there are more productive alternatives subject to long-run co-operation, such as the recoupment of sunk cost assets through depreciation. If the property rights enforcement plunges into anarchy (e.g. the ownership is indeterminate and/or the property rights are not sanctioned) kleptocracy becomes a standard. A natural outcome of the mechanisms of adverse selection. As was pointed out by Olson, 1982 and 2000, the rent-seeking behaviour can have various degrees of intensity. The most detrimental of them is set when the property rights can be claimed by anyone, what Olson described as the case of "roving bandits". Then there is no encompassing interest in the property performance from any of its competing claimants – be it principals, their agents, governments or thieves.

This crawling approach must be distinguished from the "shock restructuring therapy", as it was practised, for example, in Eastern Germany. It was subject to an abundance of financial capital for new investments or large unused capacities in viable enterprises elsewhere. Unfortunately, even the transfers of 700 billion euros used in that case were not enough for transforming Eastern Germany into a prosperous economy (Sinn, Westerman, 2001). An alternative gradual approach to transformation was successfully practised in Vietnam (Van Tho, 2000) and partially also in China (Wu, 2000) where the availability of capital was much smaller. According to Murrell, 1991, p. 43, the state sector in the poor post-communist economies should be reduced only slowly, at a pace consistent with an "optimal capital replacement policy".

B/ OUTCOMES OF TRANSITION, 15 YEARS AFTER

Notwithstanding the academic feuds among gradualists and shock therapists, now we can judge the outcomes of transition from a distance of 15 years' experience. If we would like to pick transition heroes among the 25 transition countries, heirs of the post-Soviet/European camp, there are many and none. For example, all among the eight-plus-two EU accession members had a period of high tides followed by deep ebbs. There were heroic economic achievements at macro or micro levels closely followed by headaches of frustration from wrong choices practically everywhere. The battlefields of transition were so extensive that we cannot find a set of outcomes for any single country whose vector of "scores" would be better from the others in all elements. The multicriterial ranking of countries at such a scale is hardly credible. Even an attempt to form groups has problems because of their disjunctivity. There were no such winners like Germany of 1950s, Austria of 1960s or Ireland of 1990s.

It is easier to follow the outcomes of policies, provided we are able to distinguish the consistency of their implementation. Hardly anyone would dispute the usefulness of monetary or fiscal stabilisation, price and trade liberalisation or the development of private businesses. Less bureaucracy is preferred to more bureaucracy. However, there are no real acts isolated from time and space, and many policies went on in parallel, what makes the assessment of their amalgamated outcomes ambiguous.

GROWTH IN TRANSITION COUNTRIES

At the time when the communist economic foundations were floundering, it was presumed that the move to free markets would soon initiate a quick catching up, once the plethora of artificial impediments to sound decision-making and private initiative would be cast away. The Shatalin plan for Soviet Union of 1990 spoke about 500 days, the Czech transition leader spoke about the overtaking of Finland in 16 years and West Germans even conferred East Germans the same wage standards from the very start.

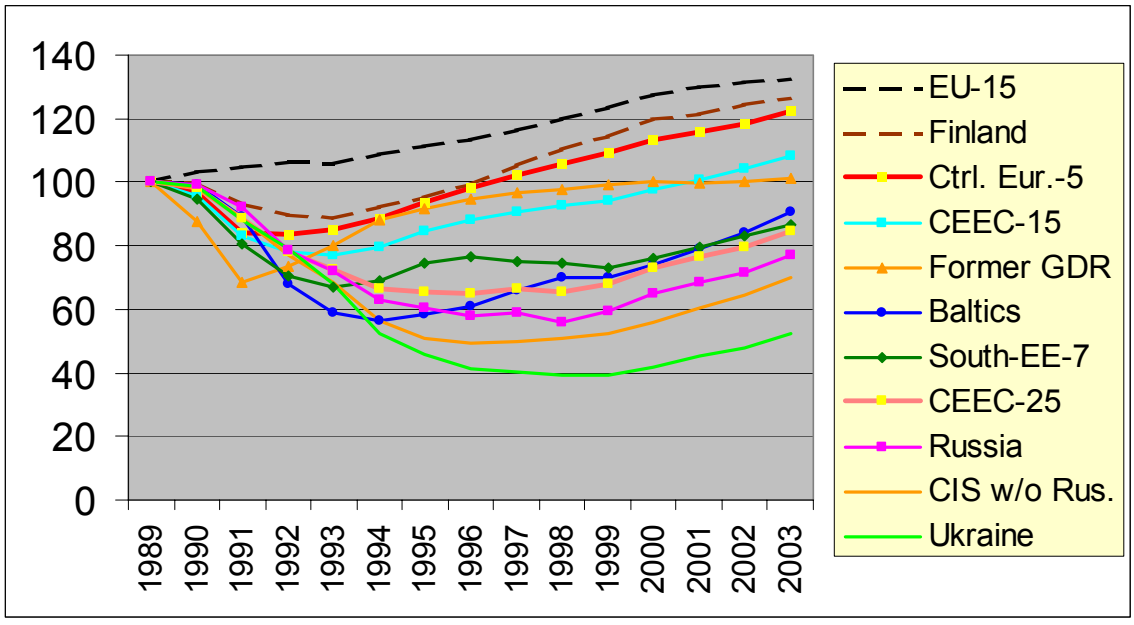


Figure 2: Official growth of European transition countries after 1989
Source: The Economic Survey of Europe. ECE, United Nations, Europe, no. 2, 2004

As the Figure 2 depicts, the official time series about growth seem to suggest that such optimism was hardly justified. Could it be said that it was the markets that failed the expectations? It may be the case for those who believed that markets act immediately like *deus ex machina*. There are two clear cases of failures: those of East Germany and Ukraine.[5] From the remaining countries, the Central European five (PL, CZ, SK, H, SLO) were clearly the leaders, but none was able to retain an unimpeachable record for the whole period and overcome the performance of Finland.

Nevertheless, there are several provisos that would suggest that these official growth figures have stricken an unacceptable bias to the explanation what went on in reality. The first one is the initial sharp decline of output.

As is explained by Winiecki, 2004, or by Campos and Coricelli, 2002, the primary source of the output decline was an outcome of the freedom to choose. In the environment free of the planning command there was no demand for a large part of production. The problems with external demand had a clear indicator in the real exchange rate, which depreciated in all countries. In some of them even over-reacted to unparalleled depths. Thus the capital had to shrink, trade to reorient and labour to move. Their future was in different products, markets and enterprises. For long, the bottleneck of growth rested in the rise of new authentic private firms and new productive incentives and institutions. The path dependency on institutions of government paternalism was the most resilient to change. Therefore the progressive reformers of institutions and entrepreneurship had the lower rates of decline.

Next come the problems of statistics. The economic value of a product with no utility is zero, whatsoever have been its costs. The communist calculation of GDP and growth was based on costs and not on utilities, as is the case of government expenditures on non-traded goods in general everywhere. Therefore the GDP for 1989 should be re-estimated, at least by using constant prices of 1992, if not by re-considering the usefulness of volumes, too. Then the decline in output after 1989 would be much lower, even though the growth rates in domestic currency would still remain modest. A much better indicator of economic progress is in estimating the GDP per capita at current exchange rate.

Here again the deep gap between growth rates in domestic and foreign currencies leads to a revision of statistical methodology of GDP at constant prices. Economists and statisticians assign it a rather different meaning, which is subdued in stabilised gradually evolving economies but brought to absurdity in economies evolving from an extreme to another by jumpstarts. The problem is explained in Figure 2 that is based on recent research by Kohli, 2004 and Hosek, 2004.

[5] In the Eastern German case, unfortunately even the average net transfers of astronomical 65 billion euros per year (of which a third was used for investments) and additional transfers of institutions and public services were not enough for transforming Eastern Germany into a prosperous economy (Sinn, Westerman, 2001). This was not a market solution and the incentives were not driving the agents to entrepreneurship. In addition, Gundlach, 2001, estimated that the supply of Easterm human capital fell short of requirements for such a task.

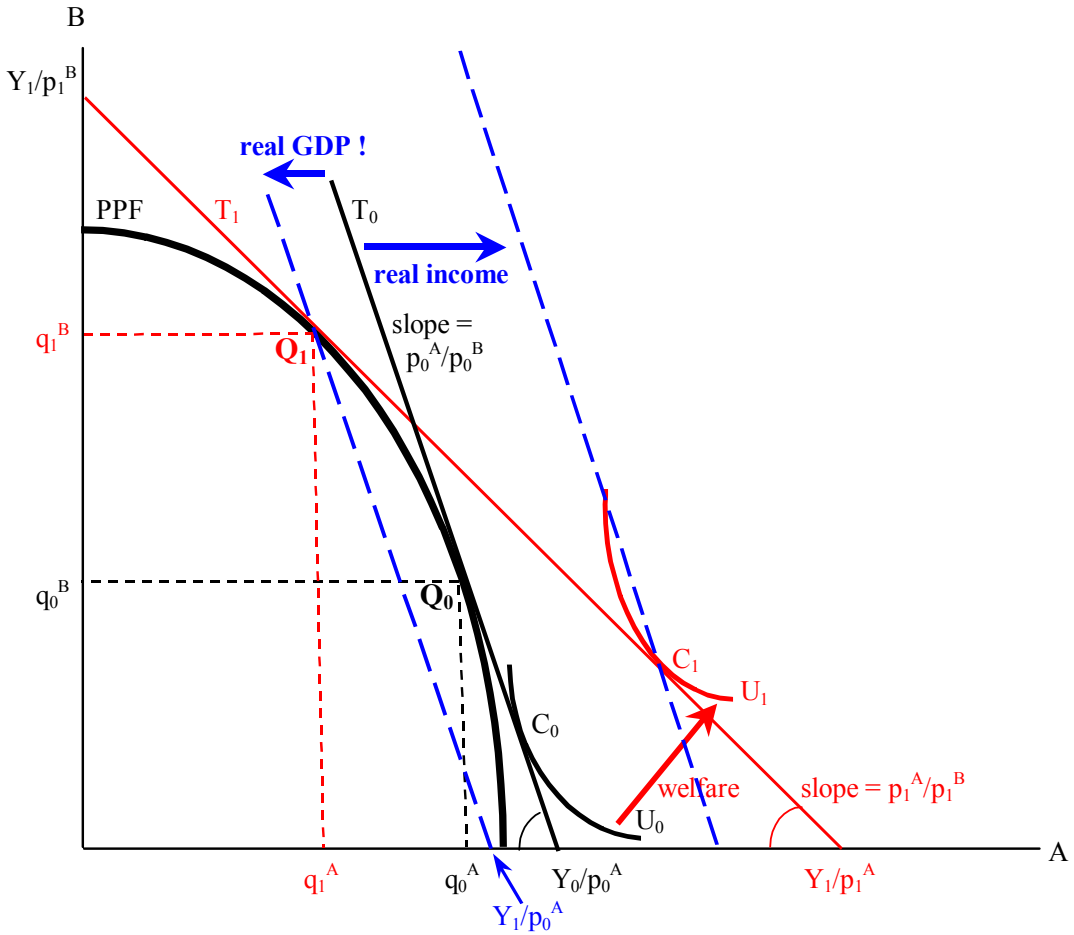


Figure 3: Reallocation of production after trade liberalisation

Figure 3 depicts the production possibility frontier (PPF) for traded commodities A and B before and after the opening-up, subject to time 0 and 1. The reallocation of production according to comparative advantages from Q_0 to Q_1 results in:

a/ Terms of trade improvement because the price of imported good drops ($p_1^A < p_0^A$) and the price of exported good rises ($p_1^B > p_0^B$). Thus also the tangent barter trade lines change their slopes.

b/ Nominal GDP rises due to more production of B (more expensive good) is not fully offset by the fall in the value of production A (now cheaper).

c/ Welfare of consumers increases as the consumption relocates from C_0 to C_1 enjoying higher utility of U_1.

d/ Real GDP falls if the value is estimated in the constant prices of the initial period (t_0).

e/ The real GDP contraction is a statistical illusion because of the estimation of positive deflators (Paasche index) that simulates the existence of an "inflation", which only reflects the impacts of comparative advantages and the terms of trade improvements. In the theory a real GDP contraction is a sign of a loss in the utility to consumers, which in this case is not true.

f/ The welfare is associated with the real income gains because exporters get higher proceeds from sales and consumers gain by purchasing cheaper imports.

The above problem is typical for transition economies where the trade opening-up results in intensive price adjustments associated with terms of trade improvements. Higher efficiency and the gains in social income and welfare are actually assessed as a GDP contraction ! The methodological bias thus leads to a false impression about the slow progress of transition, notwithstanding that these two are inversely related.

Kohli, 2004, and Hosek, 2004, therefore recommend to use different measures for the estimation of growth in transition economies. First of them is the command GDP [6] and the other may be the GDP adjusted for the trade balance financing [7]. As is shown in Table 1 both of the alternative techniques reveal more favourable growth rates for the majority of transition countries, meanwhile the EU old members gain very little or lose, as can be seen from the last two columns.

Table 1: The official average annual growth of GDP and its alternatives for measurement

		Annual growth rates			Differences	
Country	Period	Real GDP	Command GDP	Adjusted GDP	Command minus real	Adjusted minus real
Lithunia	96 - 03	7,2	10,5	11,3	3,3	4,0
Czechia	96 - 03	1,9	3,6	3,9	1,6	2,0
Poland	96 - 01	5,8	7,3	7,4	1,6	1,6
Estonia	96 - 03	8,2	9,3	9,7	1,1	1,4
Latvia	96 - 03	9,2	10,2	10,7	1,0	1,5
Bulgaria	96 - 03	0,4	1,1	2,0	0,7	1,6
Denmark	96 - 03	2,6	3,3	3,2	0,7	0,5
United Kingdom	96 - 03	3,3	3,9	4,1	0,5	0,7
Spain	96 - 03	4,1	4,4	4,5	0,3	0,4
France	96 - 03	2,9	3,2	3,1	0,2	0,2
Greece	96 - 03	4,3	4,5	4,7	0,2	0,4
EU-15	96 - 02	3,0	3,1	3,0	0,1	0,1
Italy	96 - 03	1,8	1,9	1,9	0,0	0,0
Germany	96 - 03	1,4	1,4	1,3	0,0	0,0
Austria	96 - 03	2,4	2,4	2,4	0,0	0,0
Netherlands	96 - 03	3,0	3,0	2,9	0,0	-0,1
Hungary	96 - 03	5,6	5,5	5,9	-0,1	0,3
Switzerland	96 - 02	1,9	1,6	1,7	-0,2	-0,2
Japan	96 - 03	1,3	1,1	1,1	-0,3	-0,3
Ireland	96 - 03	7,8	7,4	6,6	-0,3	-1,1
Belgium	96 - 03	2,6	2,3	2,3	-0,4	-0,4
Slovakia	96 - 03	4,9	4,1	4,2	-0,9	-0,8
Sweden	96 - 03	3,3	2,3	2,2	-0,9	-1,1
Finland	96 - 03	4,8	3,8	3,3	-1,0	-1,6

Source: Hosek, 2004

In addition to the previous, there is a second methodological bias present in assessing the macroeconomic growth of a transition economy, which is caused by the repercussions of the Balassa-Samuelson effect dealing with different perception of productivity between traded (T) and non-traded (NT) commodities, as it is explained in Figure 4.

[6] The Command GDP (or „Ability to Earn“, as is used by the Eurostat) is the GDP where exports are not deflated by export price changes but by import prices. I.e. exports are valued by what the national citizens can buy with the money exports bring. It includes the purchasing power of exports, rather than the volume produced and deflated by gains in higher export prices (e.g. due to quality improvements).

[7] The GDP adjusted by the impact of trade balance is based on the calculation where the trade balance is deflated by the index for prices of domestic consumption. Its impact in positive (raising the growth) when the prices of tradables (relative to non-tradables) decline and the trade balance is in deficit. The real income gain is due to easier financing of the trade deficit.

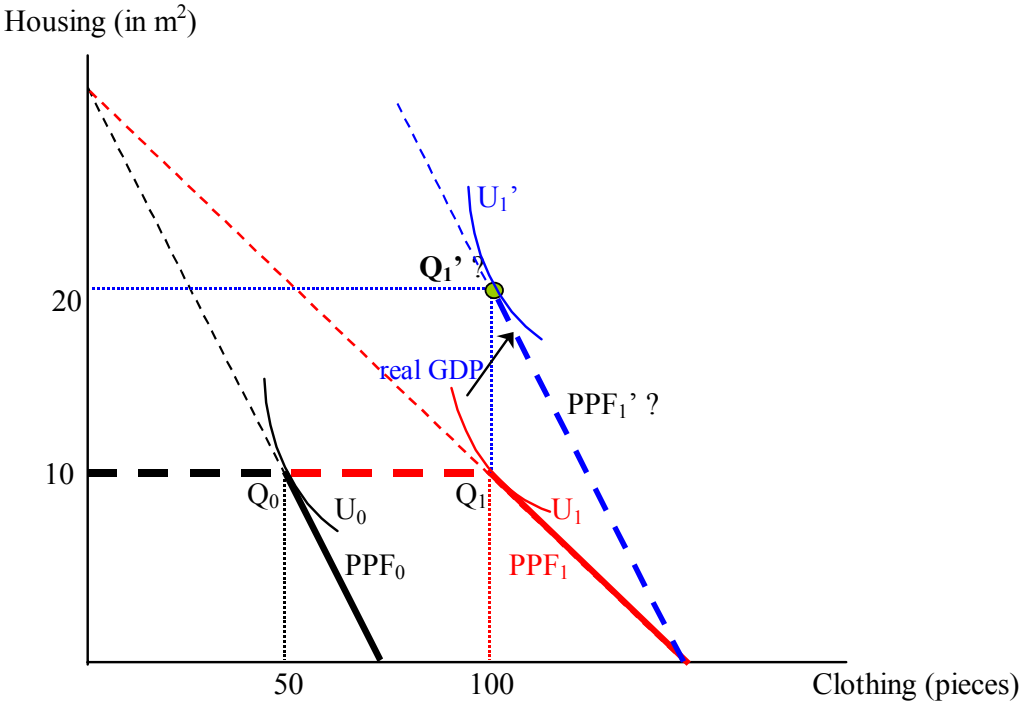


Figure 4: The expansion of GDP in the traded sector and the re-assessment of a "stagnating" non-traded sector

Let us assume that the traded sector is able to double its labour productivity from time 0 to time 1, meanwhile the non-traded sector produces the same commodity without any obvious change in the productivity (measured in m^2 per worker). As the wages rise in the traded sector, so do those in the non-traded sector and, proportionally, the prices of housing double. The latter contribution to the nominal GDP is completely expurgated from the real GDP on grounds of inflation. But what if the quantity of housing is assessed by using a different characteristics? E.g. the quality of design, heating, windows, infrastructure, safety, etc.? With a more taste for new housing, we could end up even in point $\mathbf{Q_1'}$ offered by a differently shaped PPF_1. In this particular case the statisticians should rather introduce a new more complex housing product where one m^2 would be "traded" for two m^2 in the old housing. The real GDP would be higher and the deflator lower. The decision depends on the real position of the consumers' utility (i.e. in U_1' or in U_1, or in somewhere between) how the GDP estimation should be made. Transition countries are more liable to underestimation of such rapidly proceeding qualitative and pricing changes than the developed countries.

The third possibility for a biased estimation of the real GDP rests in an extenuation of the above problem of quality perception also to the traded sector. Not all price increases are just caused by a monetary or cost inflation. There are also numerous aspects in the changes of quality concerning durability, reliability, servicing and packaging. One should also consider a gain in goodwill, image, status, delivery in time, greater choice, consumer credit, advertisement, etc. – which are the paramount characteristics of modern marketing and consumer society. Here again the changes are most intensive in the transition countries because modern marketing had hardly any tradition there 15 years ago and the productivity convergence filled most intensively this gap.

There are further reasons for undershooting the GDP growth, which were estimated by Filer and Hanousek, 2000, for the Czech economy:

a/ Consumer substitution – due to differences in price changes consumers are more flexible than is estimated by the sampled statistical price surveys in purchasing lower-priced goods. Their weight in statistics is thus underestimated.
b/ Outlet substitution – where statistical officers visit with their surveys long-established shops and discriminate visiting new outlets (such as hypermarkets) that offer large initial price discounts.
c/ New goods bias – due to a delay when new price competitive goods enter a market and when they are included in the surveys. E.g. using the system of baskets with constant prices for more than 5 years virtually eliminates such adjustments.

According to this and later estimates of the authors (Hanousek, Filer, 2004), **the true growth rate in many transition countries could have been higher by 2 up to even 5 per cent a year**. Otherwise it is very difficult to explain why their real exchange rates appreciated steadily without much explanation provided by Balassa-Samuelson effects (Egert et al., 2003) and without striking disequilibria in their external balance. Also it would help in understanding why there was such a wide disparity between real growths measured in commercial euros and in domestic currencies.

The recent new wave of interest in measuring the role of quality in statistics is a result in the deepening of competition on oligopolistic markets with differentiated products, brand recognition, networks and intra-industry trade (Bils and Klenow, 2001; Lebow and Rudd, 2003). Many authors confirmed that although transition countries commenced at very low levels of quality, their progress in quality upgrading was striking (Aiginger, 1997; Landesmann and Stehrer, 2002). For example, the advances in the later period of transition, as analysed by Dulleck et al., 2003, have been significant for all five central European accession countries in using all three channels for avoiding the low quality trap in the division of labour:

- shifting the volumes of exports from low to high tech industries;
- shifting the composition of production inside of industries to high quality segments;
- upgrading the quality of products.

The three Baltic countries performed slightly worse than the CE-5. Their quality shift was present, however, they were not followed by more intensive volumes from such groups. However, the group that included Bulgaria and Romania revealed some lock-in effects in low quality exports. Some other studies point to a dramatic increase in the horizontal intra-industry trade specialisation and the production of sophisticated components in CEECs (Navaretti et. al, 2002, or Kaminski and Ng, 2002).

The capitalist development in post-communist Europe improved the welfare of consumers not so much as by giving them more quantities but by offering them new choices in quality. If the methodology and the staff in statistical offices remains captured in the legacy of quantities pursued under central planning instead of concentrating on the features of modern market growth, the measurements of advances in transition countries will remain underreported.

There are still further statistical specificities that may underestimate both the absolute level and the growth of GDP in transition countries. They are mainly associated with the estimation of the nominal GDP:

- underestimation of the grey economy because of higher motivation to tax evasion (illicit employment, underinvoicing of sales or simply illegal enterprising);
- omission of some services because the methodology used is not fully compatible with that of Eurostat;
- leakages of value added in multinational corporations that use transfer pricing for an invisible transfer of profits to tax paradises or to non-profitable mother companies abroad. The FDI penetration into transition economies was relatively high and its returns were also

significant, reflecting the disparity between the presumed high initial risk premia and the lower real risks.

Conclusions about the growth:

There are strong reasons to believe that alleged poor growth performance of transition countries has been statistically biased in two ways: over-reported prior to the changeover and later under-reported because of the unprecedented extremal downturns and upturns in production. The U-shaped growth path could be in reality flatter in the first 5 years, with a higher catching-up drive following the next 10 years, as the markets and institutions stabilised. The GDPs were expanding more in the parameters of quality than in better visible quantity measures.

EXPORTS AND FDI

The growth in exports in CEECs during 1992-2003 was an exceptional achievement, notwithstanding the large trade diversion that hit mainly Russia and the countries of former Yugoslavia (see Table 2). In estimating the determining factors of the trade creation we should consider such impacts as the liberalisation of tariffs and quotas with the EU, creation of free trade areas in Central Europe and among Baltics, FDI inflows, upgrades in the quality of products, gains in total factor productivity and low relative labour unit costs (Benacek, Podpiera, 2004). In the Czech case their influence was so strong that the adverse influences of the real exchange rate appreciation and low aggregate demand in the EU countries were more than countervailed.

Table 2: Visible exports of central/eastern Europe, Russia and Ukraine, 1993-2002
(in billion dollars)

Country	1993	1998	2003	Annual growth 2002/1993
Albania	0,1	0,2	0,5	15,0%
Bulgaria	3,8	4,2	7,4	6,7%
Croatia	3,7	4,5	6,2	5,2%
Czechia	14,5	26,4	48,7	12,1%
Estonia	0,8	3,2	4,5	17,3%
Hungary	8,9	23,0	42,5	15,6%
Latvia	1,4	1,8	2,9	7,3%
Lithuania	2,0	3,7	7,2	12,8%
Macedonia	1,1	1,3	2,3	7,4%
Poland	14,2	28,2	53,6	13,3%
Romania	4,9	8,3	17,6	12,8%
Serbia&Mt.N.	2,5	2,9	2,5	0,0%
Slovakia	5,5	10,8	22,0	13,9%
Slovenia	6,1	9,1	12,7	7,3%
All above, exports	69,5	127,9	230,7	12,0%
All above, imports	*80,4*	*173,3*	*288,7*	*12,8%*
Russia	67,3	74,4	134,8	6,9%
Ukraine	7,8	12,6	23,1	10,9%

Source: UN-ECE and WTO, World Trade Statistics, 2003

International trade is practically in all transition countries, including Russia, the vehicle for integration and convergence. A failure in this sector would isolate the country

from modern tendencies in economies, businesses and technologies. The balance of trade deficit is a positive factor because it extends the intake of new technologies and high-quality material inputs that are crucial for the domestic development and exports. Russia is the only country that systematically waives this opportunity. The analysis of trade flows reveals (e.g. in Benacek and Podpiera, 2004, for Czechia) that imports in the majority of fast reformer countries are a pre-requisite for a fast growth in exports. The intra-industry patterns of trade are now approaching the levels of advanced EU-15 and the contents of high-technology exports in some countries (Hungary being the leader) are already over the level of the EU-15 average.

FDI inflows is another factor of crucial importance that acts as a driver of modernisation and restructuring. The intensity of annual inflows to the new EU-8 in the last 12 years were some of the highest in the world (relative to GDP). The wave of drastic FDI cuts that hit the world in 2002 avoided the transition countries completely, but it was felt in the accession countries in 2003. Countries of the south-east Europe kept on advancing.

Table 3: Stocks of FDI in central and eastern Europe, 2003
(In millions of dollars and percent)

	Cummulative net inflows (stocks)		
Countries, regions	**USD mil.** 2003	**% of GDP *b*** 2003	$ per capita ***b*** 2003
Albania	1064	23,1	**308**
Bosnia and Herzegovina	1082	20,5	**252**
Bulgaria	6256	42,2	**805**
Croatia	9155	41,8	**2060**
Czechia	44019	68,9	**4315**
Estonia	4028	61,9	**2965**
Hungary ***c***	24611	41,3	**2423**
Latvia	3363	45,3	**1438**
Lithuania	3785	29,0	**1091**
Macedonia	974	28,5	**476**
Poland	42788	28,1	**1119**
Romania	10321	26,1	**461**
Serbia and Montenegro	2829	17,5	**340**
Slovakia	10774	45,2	**2003**
Slovenia	3670	18,1	**1839**
*** All above	168719	37,3	**1340**
Russia	31030	9,7	**215**
Ukraine	6500	17,7	**136**

Source: National balance of payments; IMF*Statistics*; UN-ECE estimates of 2/2004

b National forecasts of the GDP for 2003 and the population for 2003 are used in the denominator.

c Excludes reinvested profits.

The data for 2002-2003 also reveal that countries with a high degree of FDI stocks might potentially become important FDI exporters, what is a qualitatively new but natural trend in their development. From now on we can expect that the amalgamated accounts of FDI and capital incomes will converge to balance. The present accumulation of FDI stocks in countries outside of CIS is now by 40% higher than the level of world's average stock per GDP, but due to only 12 years of intensive FDI inflows it is still significantly below the values of FDI per capita, customary in the less developed countries of the EU-15 (for

example, $4360 for Portugal or $5290 for Spain in 2002, relative to $2309 per capita for the whole non-CIS eastern Europe).

Until recently there were not many studies that would come with a conclusion that FDI in eastern Europe and CIS led to a significant degree of productivity spillovers into the existing domestic sector by technological transfers. Görg and Greenaway, 2002, quote that none out of five studies on the topic brought a conclusive evidence about positive spillovers and actually four of them discovered the existence of negative spillovers at the enterprise level. Mencinger, 2003, is even more negative and suggests that the optimism about FDI externalities is a fiction because the negative trade-offs prevail. So far, only the study by Campos and Kinoshita, 2002, seems to be the only one discovering a positive robust link between FDI and growth in eastern Europe. Notwithstanding the little evidence about spillovers (both positive and negative), there are prevailing beliefs in the studies of FDI in CEECs about the advances inside of the firms with foreign investment and spillovers they have on further FDI proliferation and general improvements of the local institutional environment.

DEVELOPMENT OF THE PRIVATE SECTOR

The share of private sector on GDP in 1989 was very small in many countries – practically negligible in the Soviet Union and 1,5% in Czechoslovakia. But also 8.5% in Eastern Germany, 14% in Hungary and 26% in Poland (Janacek, 2000). The last two mentioned had also an advantage in larger openness to the West in the last 20 years before 1989, both cultural and economic. As was explained by Winiecki, 2004, the path dependence was important but not in the firms that were already private in the communism but in tracing back the countries' past legacy of capitalism.

Table 4: Shares of the private sector on GDP
according to alternative sources of data for 2002

Country	2002	2002	2002
Albania			75
Bosna & Herz.			45
Bulgaria	50	71	70
Croatia		68	60
Czechia	80		
Hungary	85		
Macedonia			60
Moldova			50
Poland	72		
Romania			65
Serbia & Mont.		65	40
Slovakia	82		
Slovenia	55	67	
Poland	65		

Sources:
column B: http://www.centreurope.org/panoramagb/private_public_sector_cee_countries.htm
column C: http://www.bih.prsp.info/knjiga/ZA-WEB/english/pdf/III.2%20Privatization.pdf
column D: http://www.weforum.org/pdf/SEEurope/EBRD_paper.pdf

The statistics of how the private sector expanded point to a large progress in the majority of countries, even though the statistics look inconsistent and unable to depict the qualitative substance of privatisation. Privatisation can have various forms and contents: formal de-etatisation, joint-stock company with or without a dominant owner, property ownership transfer, cooperative, foreign acquisition, merger, NGO or a green-field *de novo* firm. It depends on the quality of ownership how the enterprise behaves and what kind of incentives and objectives it follows. Transition experience has demonstrated that diluted ownership, created e.g. by the voucher privatisation, had different performance and growth than the authentic private sector, especially the *de novo* firms.

Commercial banks had a privileged situation in transition because they served as intermediators of the scarcest factor in the early stages of transformation: the financial capital. An intensive mass privatisation on debt combined with the existence of semi-state banking sector serving as a substitute for expansionary fiscal and monetary policy could not succeed in building an authentic private sector. Their role was often limited to distributing credits as subsidies. Later the majority of banks in Central Europe were sold (or even swapped for debt) to foreign owners. As the next figure shows, in some countries nearly all banks are foreign. That is very different from other OECD countries where foreign ownership of banks is often less then 10%. Unsurprisingly, the banking sector after such privatisation performs often better than in their mother countries. The equity prices of some smaller new owners thereafter received an unexpected strong spur and their commercial power shifted suddenly to the "East".

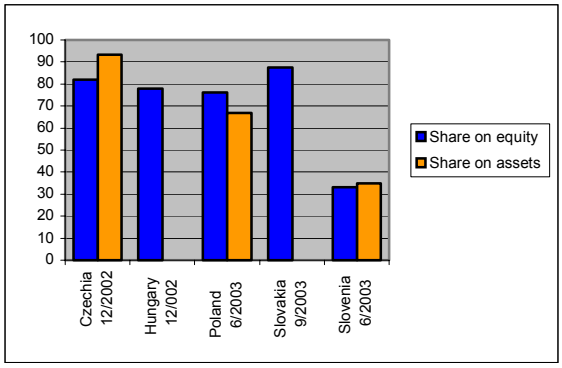


Figure 5: Foreign ownership of the banking sector in central Europe, 2002-2003
Proportion of foreign banks' equity capital and assets on national total (%)

EMPLOYMENT AND WAGES

The total employment rates were falling in all transition countries because of the forced full employment policy. The restructuring resulted in raising the unemployment to levels previously not heard about and shooting above what was estimated the normal rate. Even though the figures are not much different from the rates in the EU-15, the higher long-term unemployment is a liability more difficult to overcome.

Table 5: Rates of total unemployment and long-term unemployment

	Rate of total unemployment (%)		Rate of long-term unemployment (%)		Index long-term / total
Country	**1998**	**2003**	**1998**	**2003**	**2003**
Slovakia	15,1	17,1	7,3	11,1	0,649
Poland	10,2	19,2	4,8	10,7	0,557
Czechia	6,4	7,8	1,9	3,8	0,487
Hungary	8,4	5,8	4,2	2,4	0,414
EU-15	9,4	8,0	4,4	3,3	0,413
Ireland	7,5	4,6	3,9	1,5	0,326
Finland	11,4	9,0	4,1	2,3	0,256
Britain	6,2	5,0	1,9	1,1	0,220

Source: Eurostat, Structural indicators, 2003

Table 6: Coefficient of the income distribution per person (in %):

Country	Year	Gini coef.	Year	Gini coef.
Bulgaria	1989	21,7	2000	37,1
Czechia	1988	20,0	2002	27,3
Hungary	**1987**	**24,4**	**2001**	**28,0**
Poland	1987	25,0	2002	35,0
Romania	1989	23,3	2002	32,0
Russia	1991	26,0	2001	**51,8**
Slovakia	1987	19,5	2000	27,8
Slovenia	1987	19,8	2001	28,0
EU-15	-	-	1996	32,0

Source: The World Bank, Social Statistics, 2004

The unequal distribution of income was rising sharply, even though in some countries it remained lower than in the EU, reflecting the local cultural legacy of having the society more homogenous.

If converted to euros at commercial exchange rate the wages in transition countries are still very low, compared to incomes in Portugal or Greece. There is a visible “discount” on hourly wages that makes then even the relatively lower than the ratios of GDP relative to EU countries. For example, while the Czech GDP per capita was 59% of EU average at PPP and 27% at commercial exchange rate, the wages were only 16%. The workers in transition countries compensate it by working longer (the difference is up to 20%).

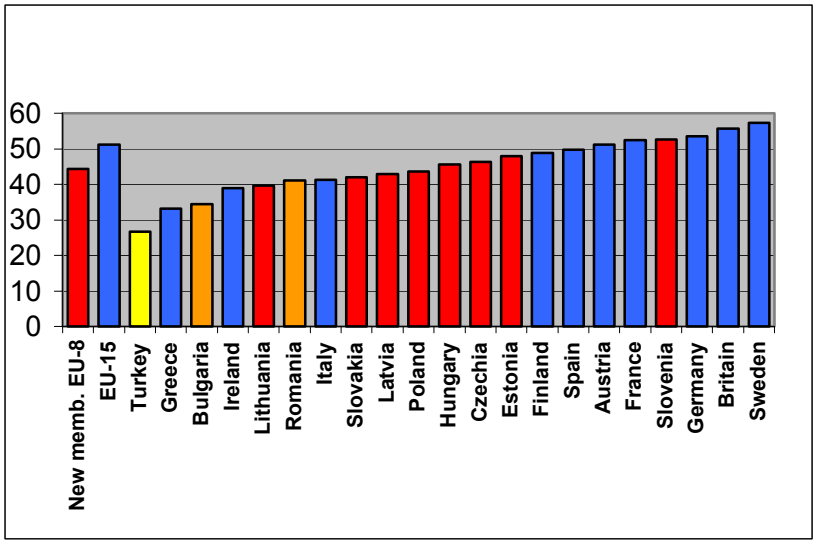


Figure 6: Share of the total compensation of employees in GDP (% of GDP in 2002) Source: Eurostat, New Cronos, 2/2004

However, what matters for the wage competitiveness are the full relative unit labour cost. As the above figure testifies, the competitiveness in wages has been retained until now but its margin is approaching gradually to the levels where wage rises could not be greater than the growth in productivity.

A presumably high mobility of labour in CEECs, that would shift in huge quantities to the West because of the wage differential, is a myth that has been nurtured by the EU populist politicians from the very start of transition and resulted in the derogations of free labour movement from the new EU-8 up to seven years. This was evidently a move that hurt the competitiveness of labour in the EU-25 and curtailed a part of benefits it could bring. However, such benefits would not be very large because of the very low mobility of labour in the EU-8, as was predicted by Boeri and Brücker, 2001.

GOVERNMENT SECTOR AND TAXATION

One of the greatest challenges for policies in transition is the government/public sector. As was found years ago by Coricelli et al., 1997, high tax wedge was a burden in all transition countries where the government was bound to be an active player in the economy [8]. Although the original share of the state budget revenues in GDP decreased in Central European countries from such heights like 60-70% in 1989 to 35-44% in 2000 (measured by the full tax quota method), reaching the average EU level, it was still far above the "natural" level pertaining to its economic development, which should be below 35%. In addition, in some countries there are still in existence extra-budgetary institutions and the state taxes should be consolidated with the hidden debts that may raise the present burden of the state over 45% of GDP.

[8] The exceptions were countries where the alternative hierarchical structures (i.e. "oligarchs") took over the role of the State, as it happened practically in all CIS countries. Privatization was thus extended to such fields like the "privatization of privatization" or to the "privatization of the State".

Table 7: Total tax revenue as percentage of GDP (OECD Countries)

	1995	2001
Ireland	32,7	29,2
United Stated *	27,6	29,6
Slovakia	37,0	33,1
Poland *	39,6	34,1
Switzerland	33,1	34,5
Spain	32,8	35,2
Germany	38,2	36,4
United Kingdom	34,8	37,4
Hungary	42,4	38,6
Czechia	40,1	39,0
Netherlands	41,9	39,9
Greece	31,7	40,8
Italy	41,2	41,8
Belgium	44,6	45,3
France	44,0	45,4
Austria	41,6	45,7
Finland	45,0	46,3
Denmark	49,4	49,0
Sweden	47,6	53,2

Source: OECD, 2003
* Data for 2000 instead for 2001

Nevertheless, in the last three years we can observe a tendency for decreasing the corporate/income tax significantly below the levels of the EU core (Germany, France or Italy). The leaders are Estonia and Slovakia. It is not only in some less radical transition countries but also in Germany and France where there are fears that they would have to follow suit. The competition in the income tax relief brought to the EU-25 is one of the most progressive fruits the transition brought to Europe. Policies for finding an alternative to the welfare state are now debated throughout Europe and transition countries may become its leaders that should be followed by all. The outcome will depend crucially on the "cultural appeal" of the new trends to the EU incumbents and on how politically sustainable they may be in the transition countries in the long run. At the end, the bottleneck of development does not rest in economics. The final say is in hands of the political responses and responsibilities to changes. Europe needs new models for development, as the Irish and the Scandinavian models keep losing on attraction. Unfortunately, politics seems to be the weakest chain among the forces behind the build-up of prosperity in this part of Europe.

CONCLUSIONS

Taken from the outlook of its 15 years, the majority of the transition countries have made a **substantial progress** in transforming their socio-economic set-up into an arrangement where private economic agents could become the drivers of economic development. The road to such arrangement, that was perceived irreversible only at the end of the millennium, was however full of blind alleys and pitfalls.

Practically all the transition countries got entrapped in a **non-productive motivation** that was driven by the wide redistributional opportunities, once the new concept of property rights differed substantially from the old one. Although privatisation is an absolutely unavoidable part of transition, the opportunistic spin-offs of the privatisation conflicts of interest raised new social costs that were often diverting economic agents from higher growth in the short-run.

It took approximately 10 years to complete the reallocation of inefficient resources according to market criteria of the new economic geography and many such assets were either liquidated, lost (if the institutional arrangements were not fine-tuned to such a conversion) or remained, as sunk costs, an impediment to growth for too long. A large obstacle to overcome was an obsession with the **fetish of large formerly state-owned enterprises**, whose transformation was later revealed to be more a liability than an asset to economic growth. It seems now apparent that the development of the small and medium-sized enterprises, or more precisely the development of *de novo* enterprises, was a policy alternative that would yield higher economic returns. However, due to its lower political returns, it remained and still remains the weak link in the transition policy-making.

The **negligence of the institutional framework** for securing the enforcement of productive incentives, property rights, low transaction costs of contracts and decentralised decision-making, which are actually the *spiritus agens* of all market-based economies, was another trap that slowed down the growth in all transition economies. Once the mentioned pitfalls of transition depleted its potential for gains to powerful lobbies of vested interests and their existence turned into a political "disgrace", the growth of transition economies accelerated quite sharply.

What concerns the risks for the future, the present weakest link in the development of transition economies rests in the non-transformed public sector, especially the strengthening "public-private partnership" that colludes local large enterprises (often national monopolies) with state bureaucracy and political parties. This is most visible in Russia and other CIS countries. Public sector or the public "domain" in the majority of transition countries remains still too large and the political rents from keeping the taxation and the public debt above economic rationale are too tempting to resist. The growth of bureaucracy, as a new force independent from political parties (but still complementary to their power), is another factor that slows down the development in transition countries.

Notwithstanding all these impediments, the transition economies have shown that they are ready for becoming the most dynamic part of the European economy. They also confirm an intuitive economic insight that it is the markets and the private initiatives that decide about the development. Some alleged failures in growth and welfare can be just a statistical illusion. As some new insights into the Czech "most disappointing economic performance" reveal, the low growth can be explained by a fossilised legacy in the methodology of national accounts.

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