

# Transformation after Socialism in a Comparative perspective

September 2010

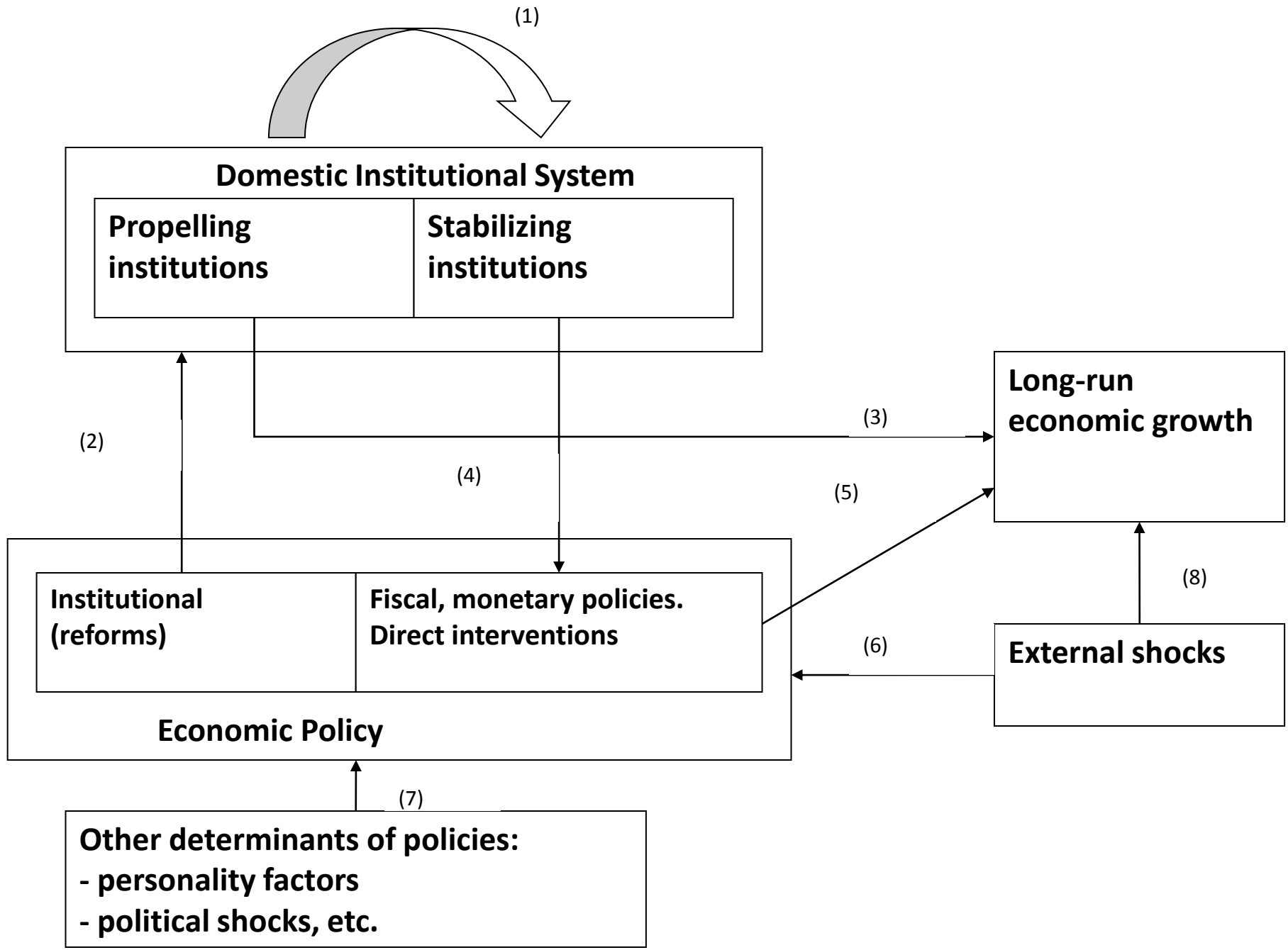
Leszek Balcerowicz

# Agenda

- 1. Institutional Systems and Policies**
- 2. Socialist Institutional System**
- 3. Cost of Socialism**
- 4. Institutional Trajectories after Socialism**
- 5. Economic and Non-Economic Outcomes**
- 6. The Global Financial Crisis and the CEE**

*I am grateful to Aleksander Laszek for his assistance in preparing this presentation.*

# 1. Institutional Systems and Policies



## 2. Socialist Institutional System

---

### **A. The control exerted by the socialist state was exceptionally extensive:**

- private entrepreneurship was banned, which, together with the initial nationalisations, resulted in a monopoly of the state sector;
- state-owned enterprises were subject to central planning, which included output commands, rationing of input and foreign exchange, price controls, and directed foreign trade;
- the range of financial assets available to enterprises and individuals was extremely limited, as a market-type financial system could not have co-existed with central planning;
- the establishment and functioning of non-economic organisations were also heavily controlled, that is, civil society was suppressed and political opposition was banned;
- foreign travel was restricted;
- the media were subjected to formal censorship, direct party control and personnel policy – the mass media were largely an instrument of communist state propaganda.

**B. These extensive restrictions co-existed with an overgrown socialist welfare state, which included:**

- relatively large transfers in kind (education, health);
- social protection delivered via state-owned enterprises (SOEs);
- artificially low prices for foodstuffs, energy, and housing;
- a social safety net, typical of some market economies, did not exist as the need for it was sharply limited through the curtailment of individuals' opportunities and risks.

**C. The socialist state was peculiar with respect to the provision of public goods.**

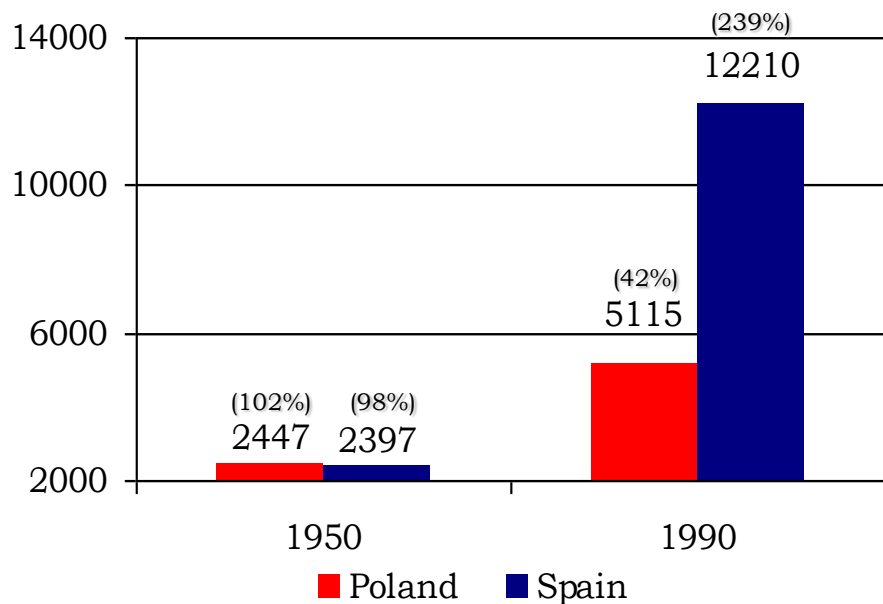
- Defence spending was excessive and was shaped by the imperial aspirations of the ruling elites.
- Law and order was kept at a reasonable level, but at the cost of practices typical of a police state.
- The legal framework and the justice system criminalized private economic activity and independent political activity, and were ill suited to the market economy, the rule of law and a free society.

### 3. Cost of Socialism

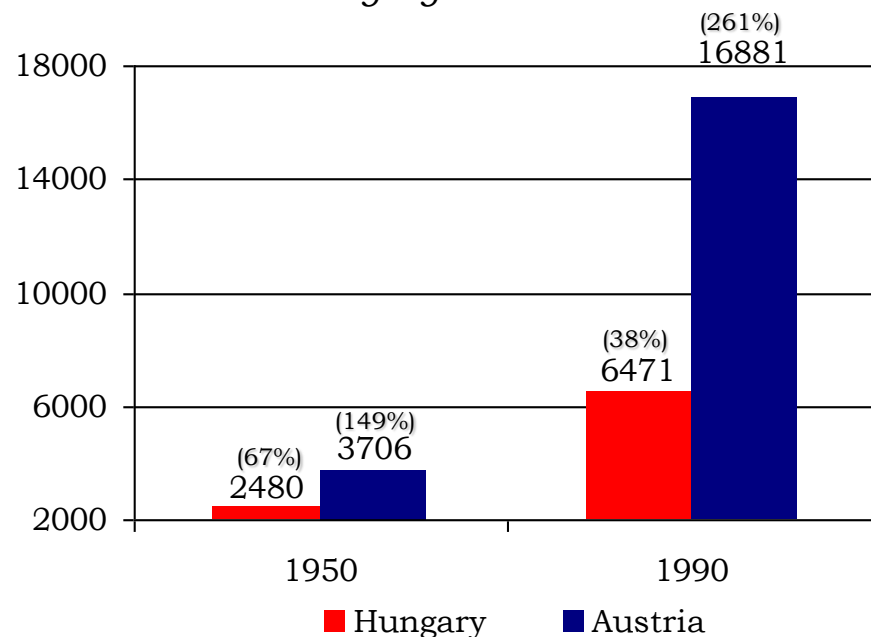
- **Countries under communism lost a lot of distance to Western European economies.**

*Per-capita GDP (in 1990 international dollars) in 1950 and 1990:*

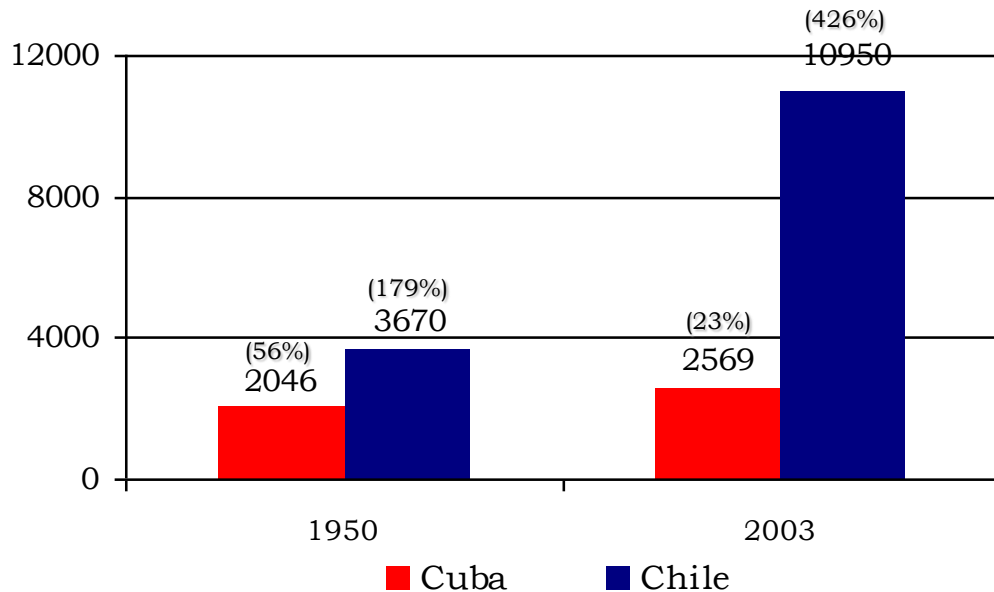
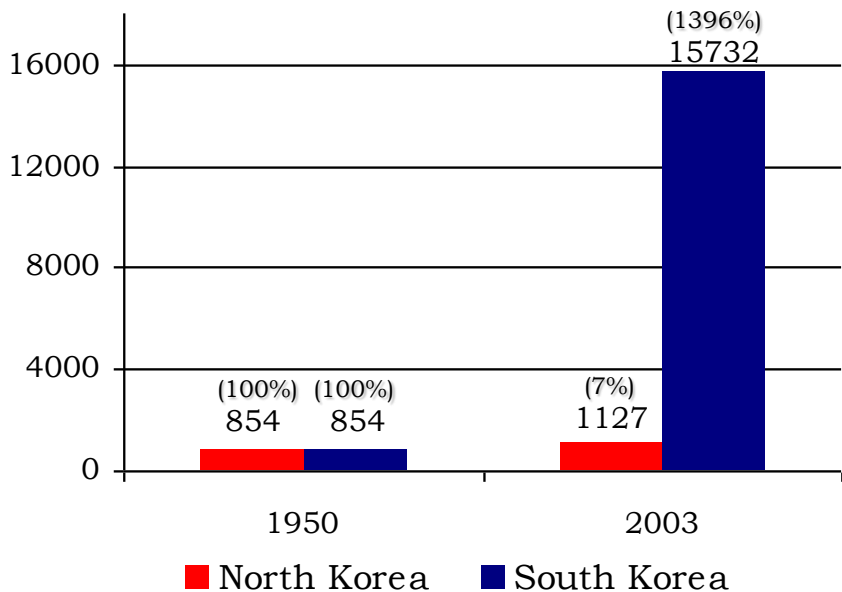
*Poland vs. Spain*



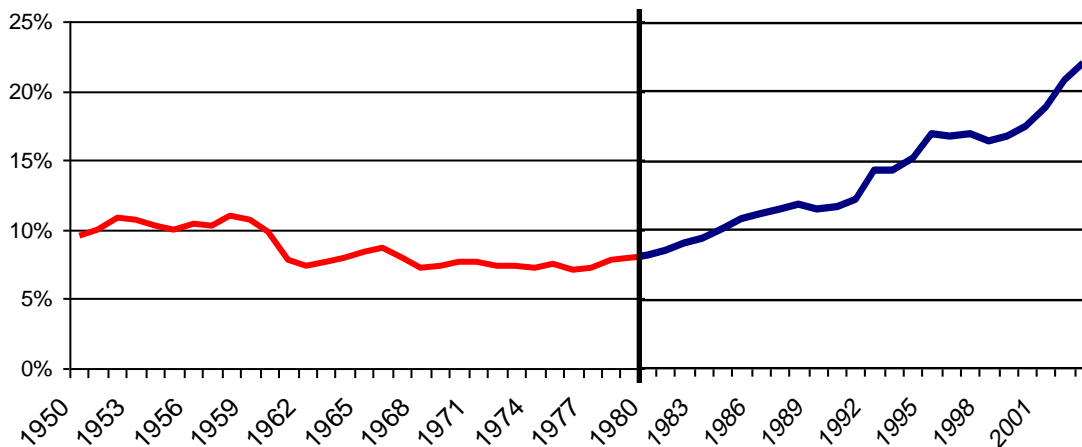
*Hungary vs. Austria.*

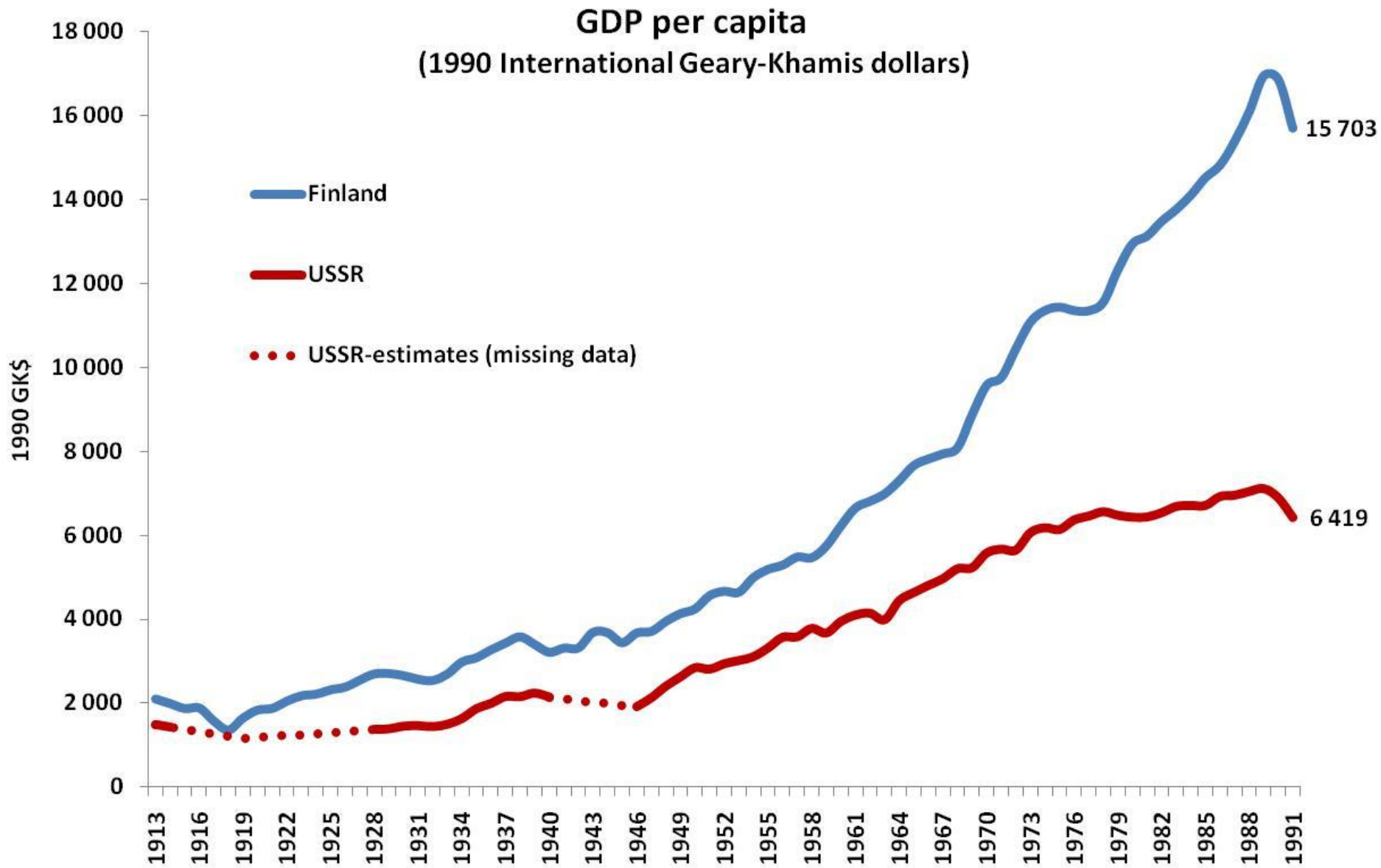


*Per-capita GDP (in 1990 international dollars) in 1950 and 2003:  
North Korea vs. South Korea* *Cuba vs. Chile*



*Per-capita GDP (in 1990 international dollars) in China (Western Europe=100).*



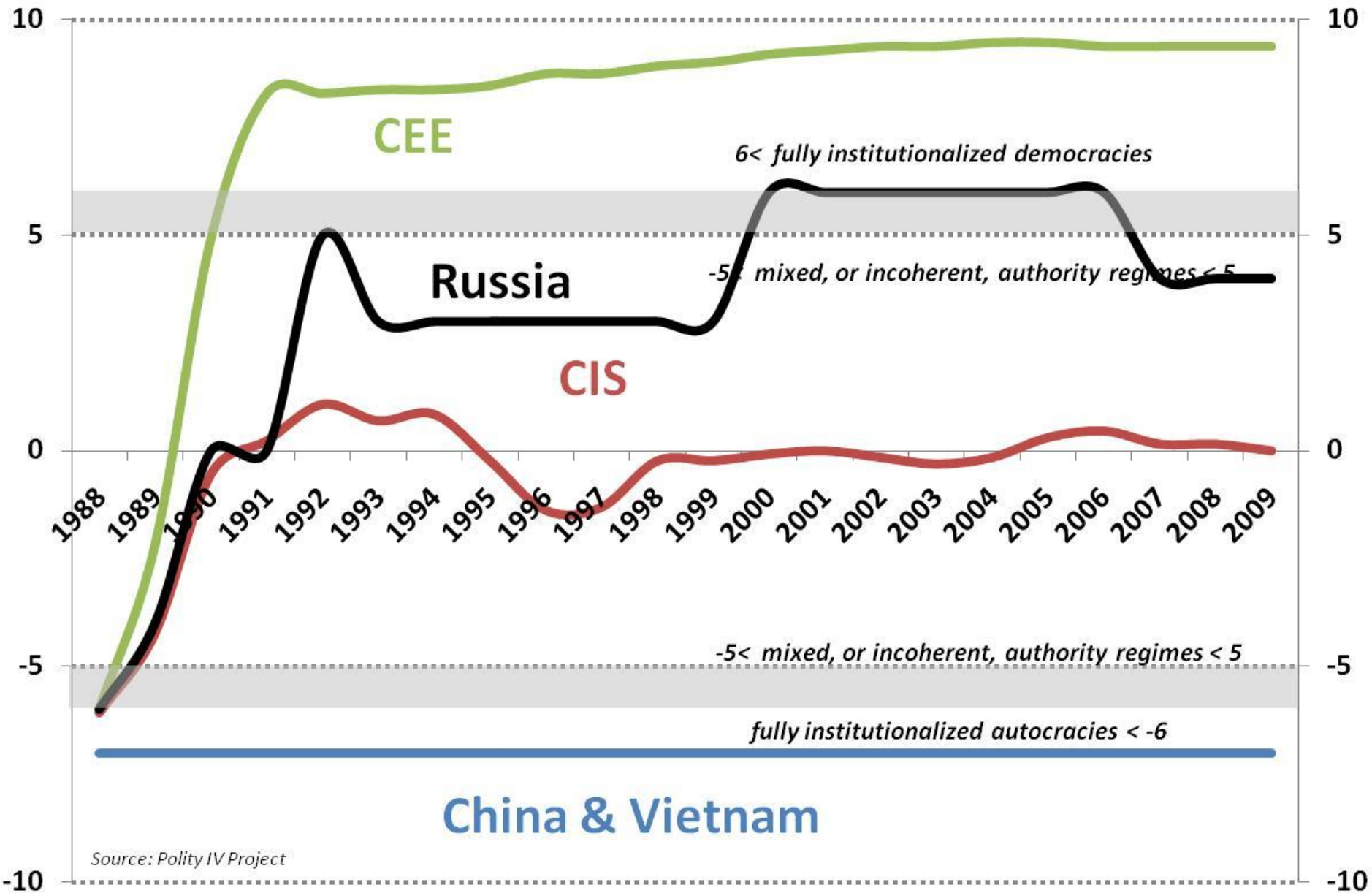


**In 1913 Finland was part of Russian Empire with above average GDP per capita (140% of future USSR countries). After nearly 80 years of capitalism in Finland and socialism in USSR in 1991 Finnish GDP per capita was equal to 245% of USSR average.**



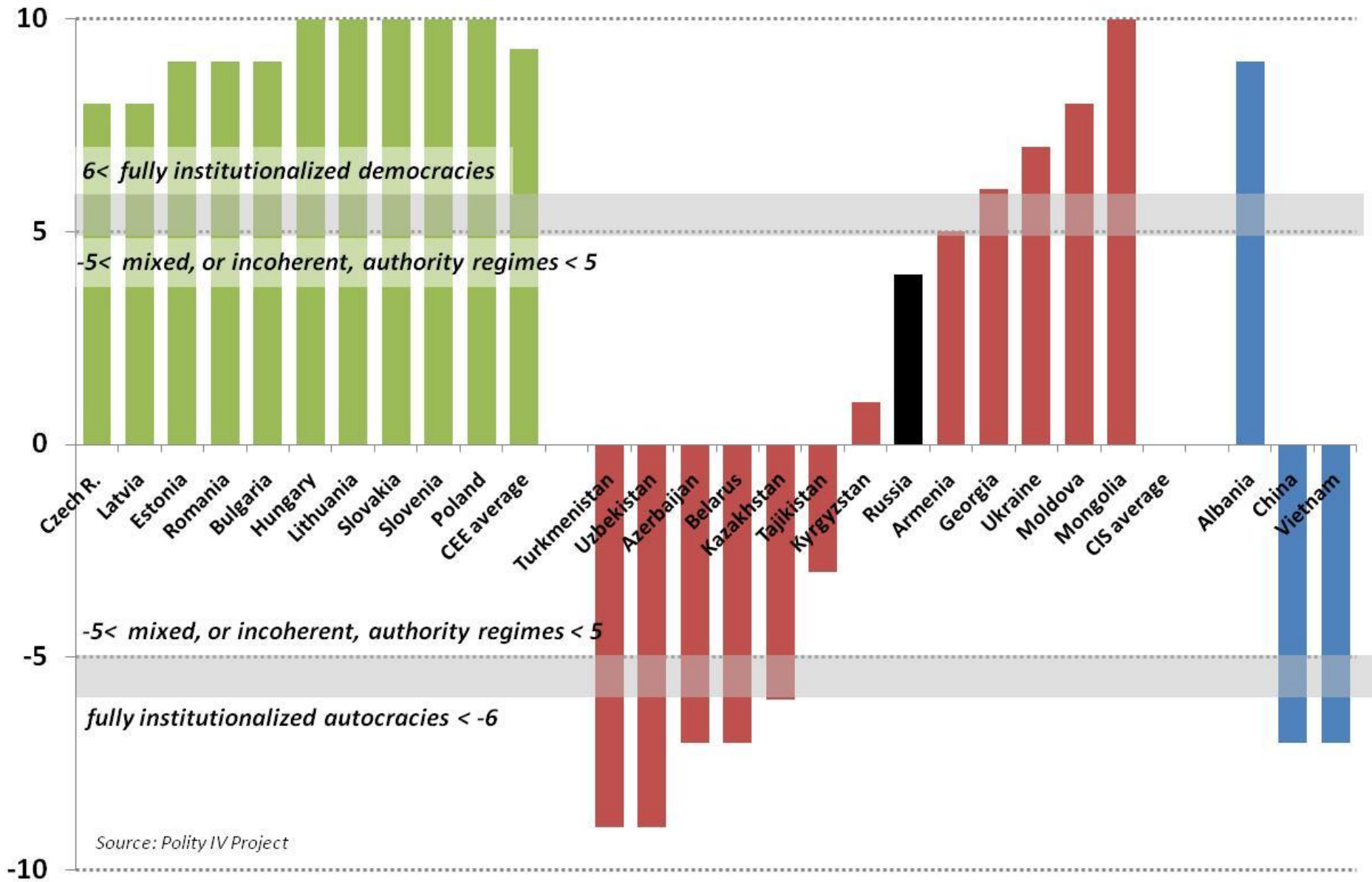
## **4. Institutional trajectories after socialism**

# Political freedom (Polity IV)



Source: Polity IV Project

# Political freedom 2009 (Polity IV)



Source: Polity IV Project

## The Socialist System

## Institutional System in 2009

## Institutional Change

### I. The Legal Framework

#### 1. *Classical (negative) rights*

Fully and extensively suppressed.  
Attempts to exercise these rights legally recognized as crimes

Full catalogue, as in Western democracies

Liberalizing legislation

#### 2. *Welfare (positive) rights*

Extensive catalogue

In most countries: extensive catalogue, similar to that in some West European democracies

Post-socialist legislation, including constitutions, entrenched welfare rights in most countries

#### 3. *Economic laws*

- Secured the monopoly of “social” (i.e state) ownership and the operation of central planning  
- Little legal basis for the market transactions

- Full catalogue of laws supporting market transactions

- Eliminating the “command” regulations  
- Massive legislation in support of the expanding markets.

#### 4. *Civil laws*

Prohibitively strong restrictions on setting up independent foundations and associations.

Regulations which ensure the freedom of association, i.e. the basis for the development of civil society

Substantial legislative effort in support of civil society

#### 5. *Laws regulating political process*

Electoral laws which ensured the monopoly of the socialist party and made elections and parliaments into facades

Electoral laws which enable political pluralism

Substantial legislative effort to support democracy

## The Socialist System

## Institutional System in 2009

## Institutional Change

A monoparty holding power in an oppressive (antiliberal) state

A multi-party system

The transformation of the inherited parties and the development of new ones, based on liberalizing legislation and electoral laws

Rubber stamp institution

*6. The Party System*  
*7. The Parliament*  
The Parliament reflects the political pluralism. Varying regulations and practices governing the legislative process i.e. the quantity, quality and (in)stability of legislation

From rubber stamp to democratic Parliament. Different changes in regulations and practices governing the legislative process

Controlled by the party apparatus and grouped into many ministries to suit the needs of a command economy

*8. Public administration*  
Basically apolitical and grouped into for fewer ministries. Specialized regulators e.g. in telecommunication, energy, media

Elimination of party control, reorganizations of the public administration. Creation of new regulatory bodies, modeled on the West

Centralized state – no room for local autonomy

*9. Local government*  
Autonomous local government

Dividing the state power along the central – local dimension

Very extensive and dominating over the police in order to block attempts to use classical rights

*10. The Security Apparatus*  
Radically changed in line with liberalizing legislation and in order to deal with new threats (e.g. terrorism)

Dismantling the old apparatus, building the new one

Controlled by the Party and occasionally used as a ultimate tool to maintain its overall control

*11. The Army*  
De-linked from the party system, subject to a different form of civil control.

Different extent of restructuring and re(training)

Varying efficiency in preventing and dealing with ordinary crime. Weak constraints of the due process. Controlled by the party and easily used against the opponents of the regime

*12. The Police*  
Different efficiency.  
Stronger constraints of due process.  
De-linked from the Party system.

Different extent of restructuring and (re)training.

Controlled by the Party and thus easily used for prosecuting “socialist” crimes.  
Dominating over the judiciary

*13. The Procuracy (Prosecutors)*  
- Largely de-linked from the party system.  
- Focused on prosecuting ordinary crimes  
- Most of the legal dominance removed. Judges have legal controls over the key prosecutors’ decisions, e.g. on temporary arrests  
- Different efficiency

Different extent of restructuring and retraining

## The Socialist System

Subject to ultimate Party control and thus potential tools of political prosecution.

- Penitentiaries weakly constrained by human rights.
- Few, if any, specialists enforcing the courts' decisions, say, in insolvency issues (bailiffs)

Politically controlled by formal and informal censorship

Suppressed by the legal framework, the security apparatus and the Party control.  
Official "social" organizations e.g. trade unions, youth organizations, subject to Party control

- In the financial sector the main organization was the mono-bank
- Non financial organizations: overwhelming dominance of the state firms compulsorily grouped in the monopolistic, branch-based associations

## Institutional System in 2009

### *14. The Courts*

Legally independent.  
Varying efficiency

### *15. Organizations to enforce the courts rulings*

- Stronger constraints in relation to human rights, but situation differs across countries.
- Expanded number of bailiffs etc., but situation differs across countries.

### *16. The Media*

Free from political control, possibly except for the public media

### *17. Civil Society*

No legal restrictions. Different extent of development.  
Restructured and reduced in size

### *18. Organizations of the Economy (narrowly defined)*

- Independent central bank.
- Competing commercial banks
- Many competing, mostly private firms

## Institutional Change

Legal independence granted during the breakthrough period  
Different extent of reforms dealing with accountability and efficiency

- Different extent of restructuring.
- Development of new professions and organizations.

Dismantling of political controls.  
Spontaneous growth of private media thanks to revenues from advertising resulting from the growth of a market economy

Spontaneous growth of foundations and associations related to the growth of market economy  
Restructuring

Separating the central bank from the mono-bank and granting it independence  
Privatization of the inherited state banks, entry of new ones.  
Creating the institutions of the capital market  
Dismantling of compulsory associations.  
Privatization of the inherited SOE's; entry of new private firms.

## The Socialist System

State monopoly of the supply and finance. Party – control over sensitive subjects (social sciences)

Monopoly of the public sector  
Education and research in the social sciences subject to ideological interventions and constraints, and largely isolated from the West.  
Research and development in technical sciences subjected to anti-innovative constraints and influences of the command economy.

- Extensive pay-as-you go pension system. No private pension schemes.
- Extensive catalogue of other transfers in cash, but no unemployment benefits as open unemployment did not exist under socialism
- Dominance of the state on the supply and the financing side of the health sector.

## Institutional System in 2009

### *19. Elementary and Secondary Education*

Limited share of the non-public schools, privately financed.  
On the whole, little socialist ideology in the education programme

### *20. Higher education and Research*

Substantial share of the private sector in higher education.  
Education and research in social sciences largely free of ideological influence and constraints and open to contacts with the West.  
Different extent of the remnants of the R+D organizations inherited from socialism.  
New R+D organizations in the private sector, linked to technology transfer.

### *21. The Welfare State*

Basically preserved but in some countries increasingly supplemented by a funded system.  
- Basically preserved. Unemployment benefits available.  
- Financing largely private, more private provision

## Institutional Change

Limited entry of the private sector  
Different extent of changes in the teaching programmes.

Substantial entry of the private sector. Some restructuring of the public universities.  
Liberalizing the education and research in social sciences  
Different extent of restructuring of the inherited R+D organizations.  
Gradual development of the new R+D organizations in the private sector

Different extent of reforms  
- Relatively little reform of the inherited transfers  
- Introduction of unemployment benefits and of the related labour offices.  
- Some reforms which enlarged the role of the private provision and changed the organizational form of the public payer.

**III. Mechanisms of mass and regular interactions**

22. Central planning

Markets

Dismantling of command mechanism, and largely spontaneous development of markets.

23. Collective bargaining as an autonomous mechanism non-existent as both employers' and employees' organizations were controlled by the party

Increased role of collective bargaining due to emergence of autonomous trade unions and employers' organizations

Dismantling of command mechanism, and largely spontaneous development of markets.

Different extent of change.



# Economic and Political Rights, 1996-2005

Country	Economic Rights <sup>(1)</sup>	Political Rights <sup>(2)</sup>
	<b>The Leaders</b>	
Denmark		
Finland		
New Zealand	90-95	1
Switzerland		
	<b>The Transition Countries</b>	
Bulgaria	50 → 30	2 → 1
Czech Republic	70	1
Estonia	70 → 90	1
Hungary	70	1
Latvia	50	1 → 2
Lithuania	50	2 → 1
Poland	70 → 50	1
Romania	30	2
Slovakia	50	2 → 1
Slovenia	50 → 60	1
Belarus	50 → 20	6 → 7
Russia	50 → 25	4 → 6
Ukraine	30	4 → 3
China	30 → 20	7
	<b>Other OECD Comparators</b>	
Greece	70 → 50	1
Italy	70 → 50	1
Portugal	70	1
Spain	70	1

<sup>(1)</sup> Heritage Foundation, "Index of Economic Freedom", 2009

<sup>(2)</sup> Freedom House, "Freedom in the World", 2009

# The Court's Independence, Impartiality and Efficiency

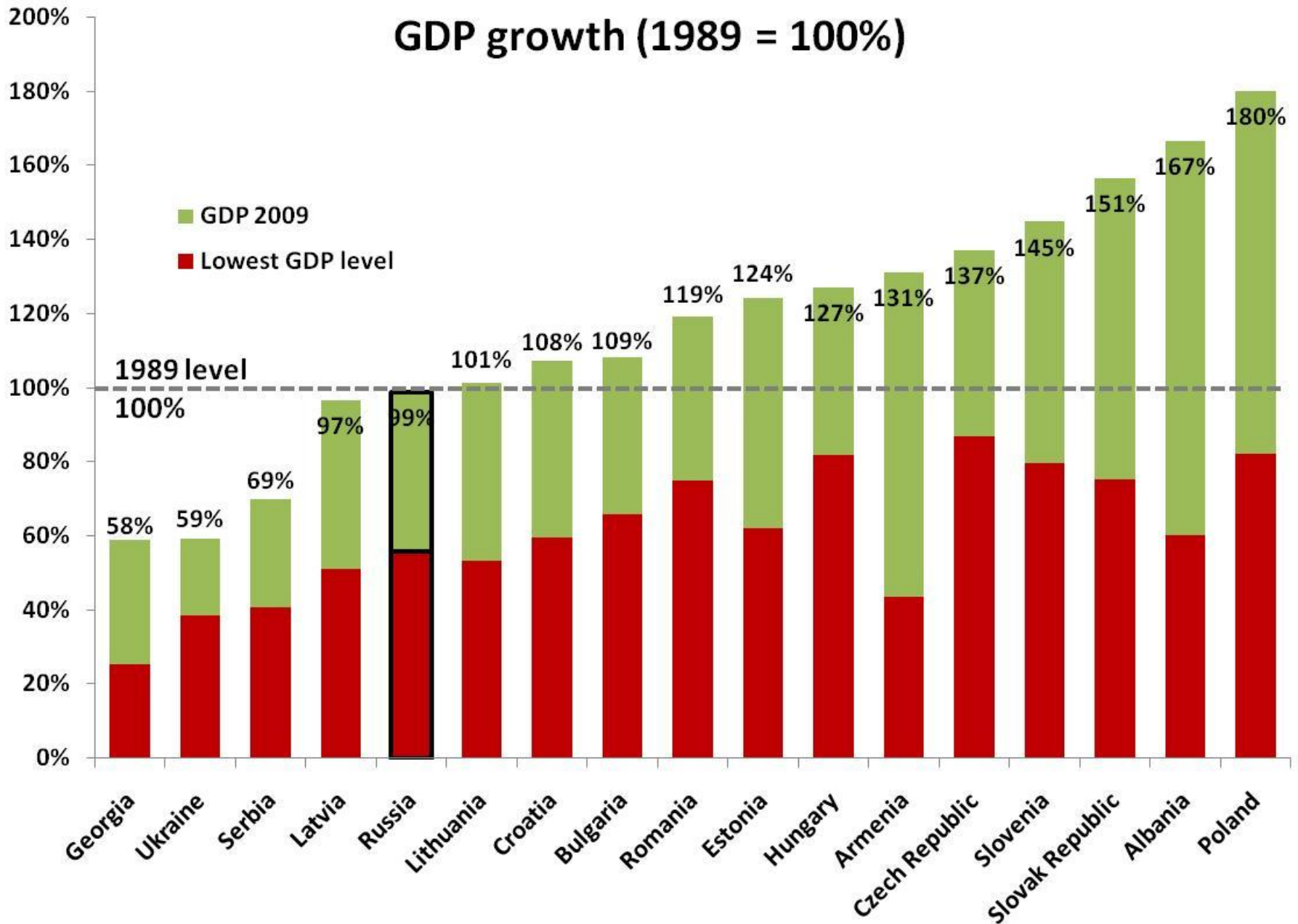
Country	Judicial <sup>(1)</sup>	Judicial Impartiality <sup>(2)</sup>	Contract Enforcement – days <sup>(3)</sup>	Contract Enforcement – cost (% of debt) <sup>(4)</sup>
<b>Leaders in Political and Economic Rights</b>				
Denmark	9	9	380	23→24
Finland	9	8,5	235	10→11
New Zealand	9	8,5→9	216	22
Switzerland	8,5	8,5	417	21→23
<b>Transition Countries</b>				
Bulgaria	3	3	564	24
Czech Republic	5	4	820	33
Estonia	7	6,5	425	19
Hungary	5,5→6	5	335	13
Latvia	4,5	4,5	279	16
Lithuania	4	4	210	24
Poland	4,5	4	980→830	12
Romania	3	3	537→512	20
Slovakia	4→4,5	4	565	26
Slovenia	5→6	5→6	-	19
Belarus	-	-	250	23
Russia	2,5	2,5→3	281	13
Ukraine	2,5	3	354	41,5
China	4	4,5	406	11
<b>OECD Comparatives</b>				
Greece	5,5→6	5,5→6	819	14
Italy	4,5→5	3,5→4,5	1390→1210	30
Portugal	7,5→8	5→5,5	577	14
Spain	4,5→5	5→5,5	515	17

<sup>(1)</sup> and <sup>(2)</sup> Fraser Institute, "Economic Freedom of the World: 2008 Annual Report"

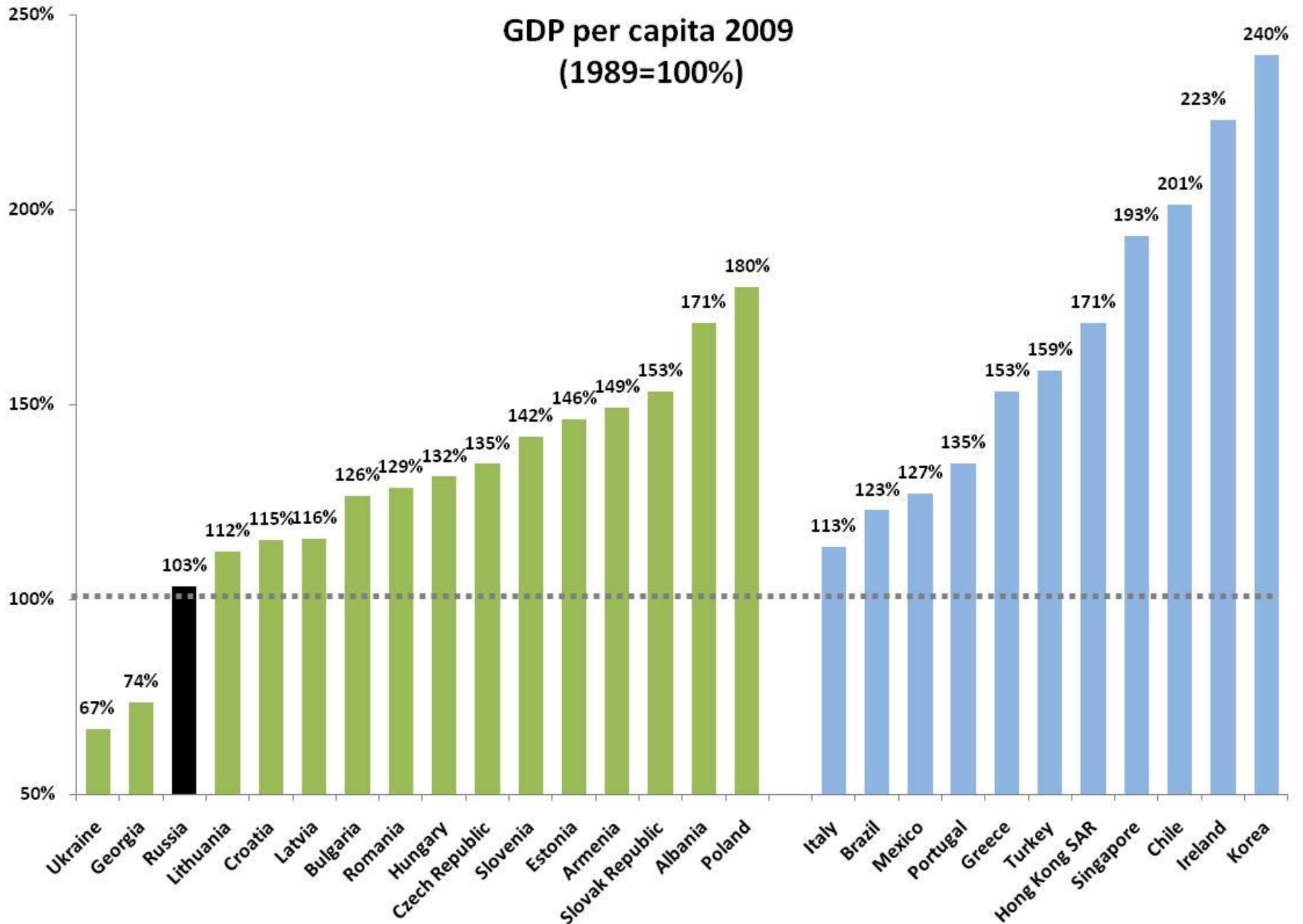
<sup>(3)</sup> and <sup>(4)</sup> World Bank

## **5. Economic and Non-Economic Outcomes**

# GDP growth (1989 = 100%)

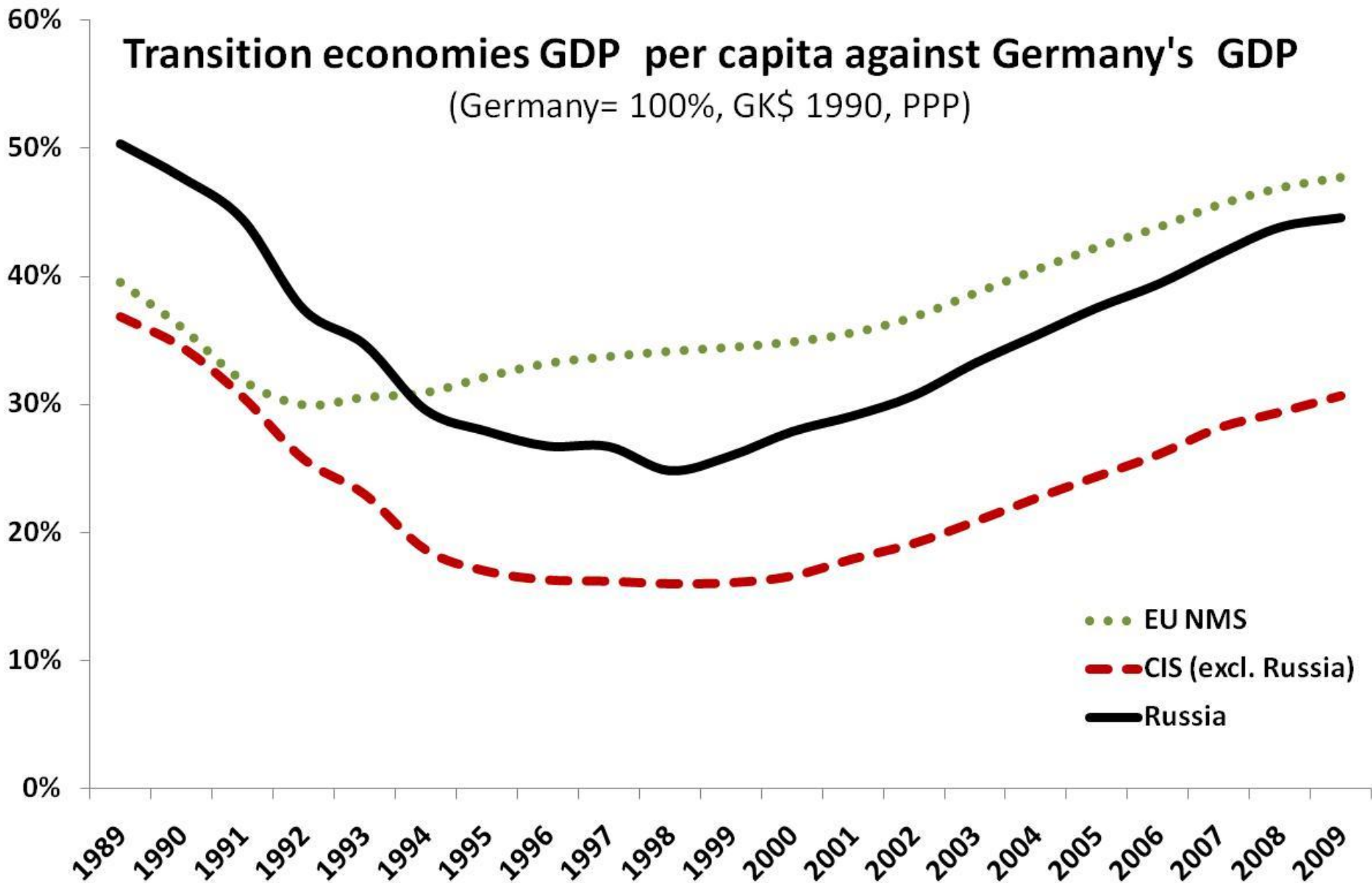


# GDP per capita 2009 (1989=100%)



# Transition economies GDP per capita against Germany's GDP

(Germany= 100%, GK\$ 1990, PPP)



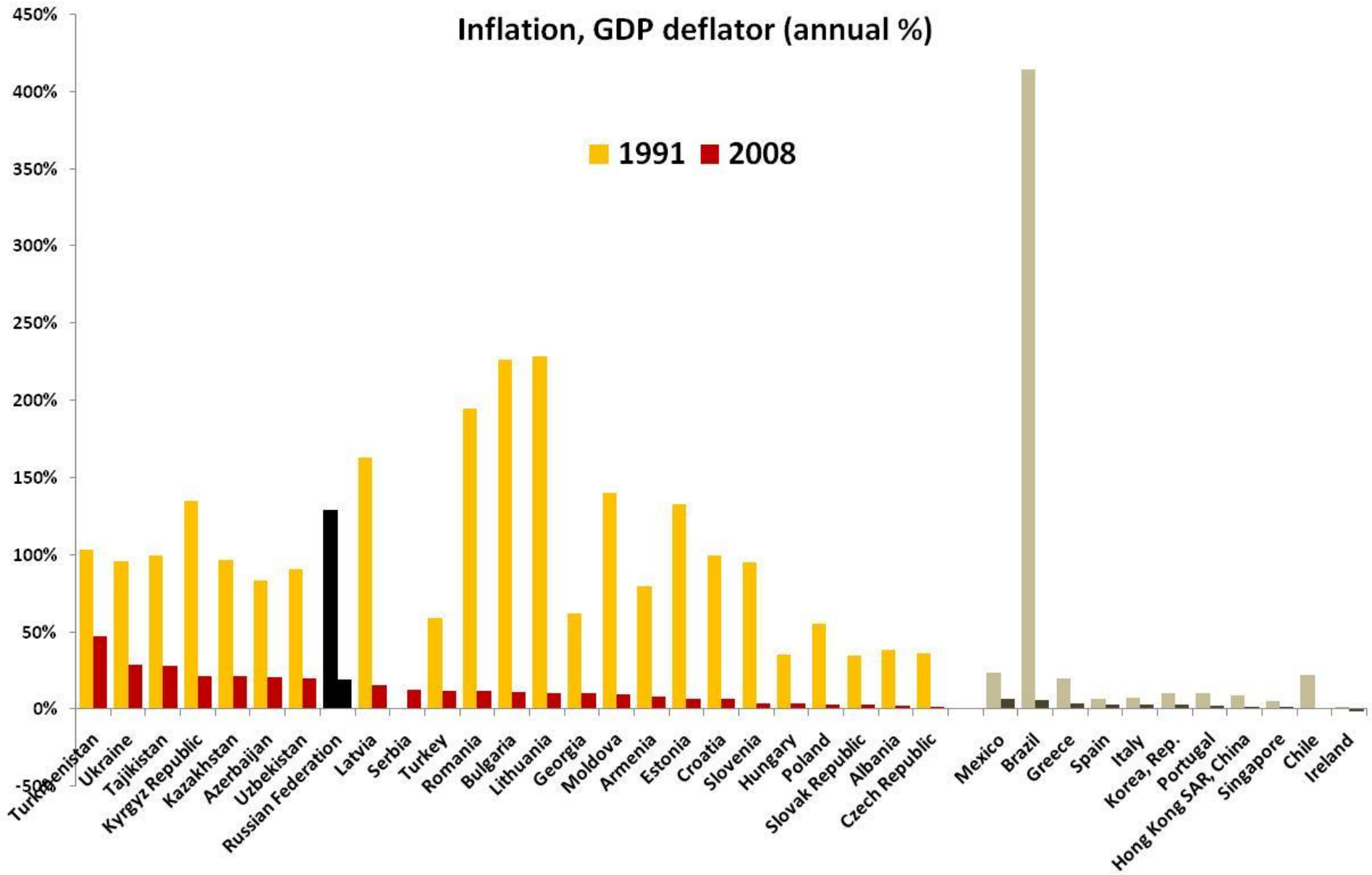
NMS=Bulgaria, Czech R., Estonia, Hungary, Latvia, Lithuania, Slovak R., Slovenia, Romania, Poland

CIS=Armenia, Azerbaijan, Armenia, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Turkmenistan, Tajikistan, Uzbekistan, Ukraine

Source: The Conference Board and Groningen Growth and Development Centre, Total Economy Database, January 2009

# Inflation, GDP deflator (annual %)

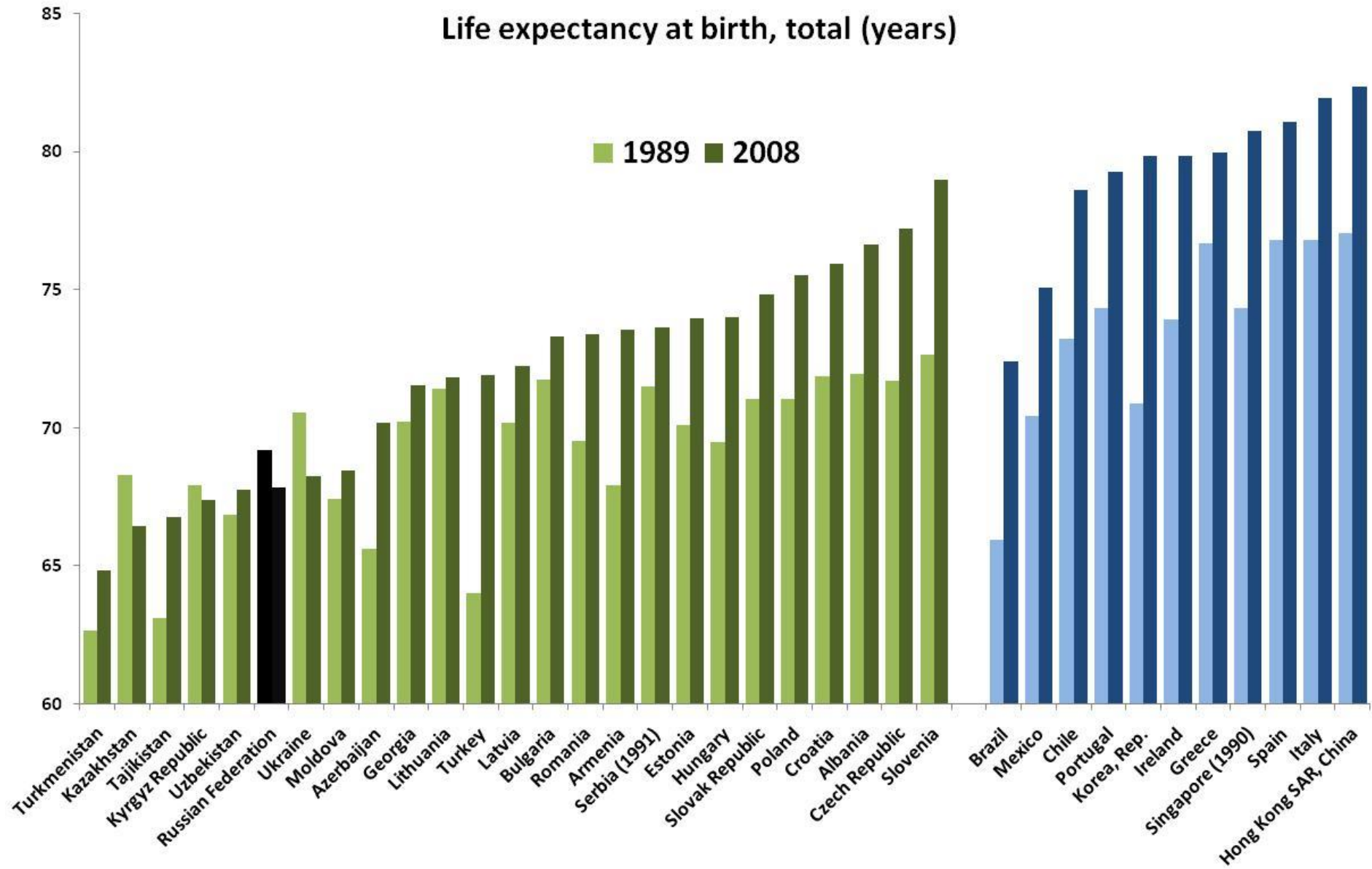
1991 2008



Source: World Bank World Development Indicators online 14 IX 2010

# Life expectancy at birth, total (years)

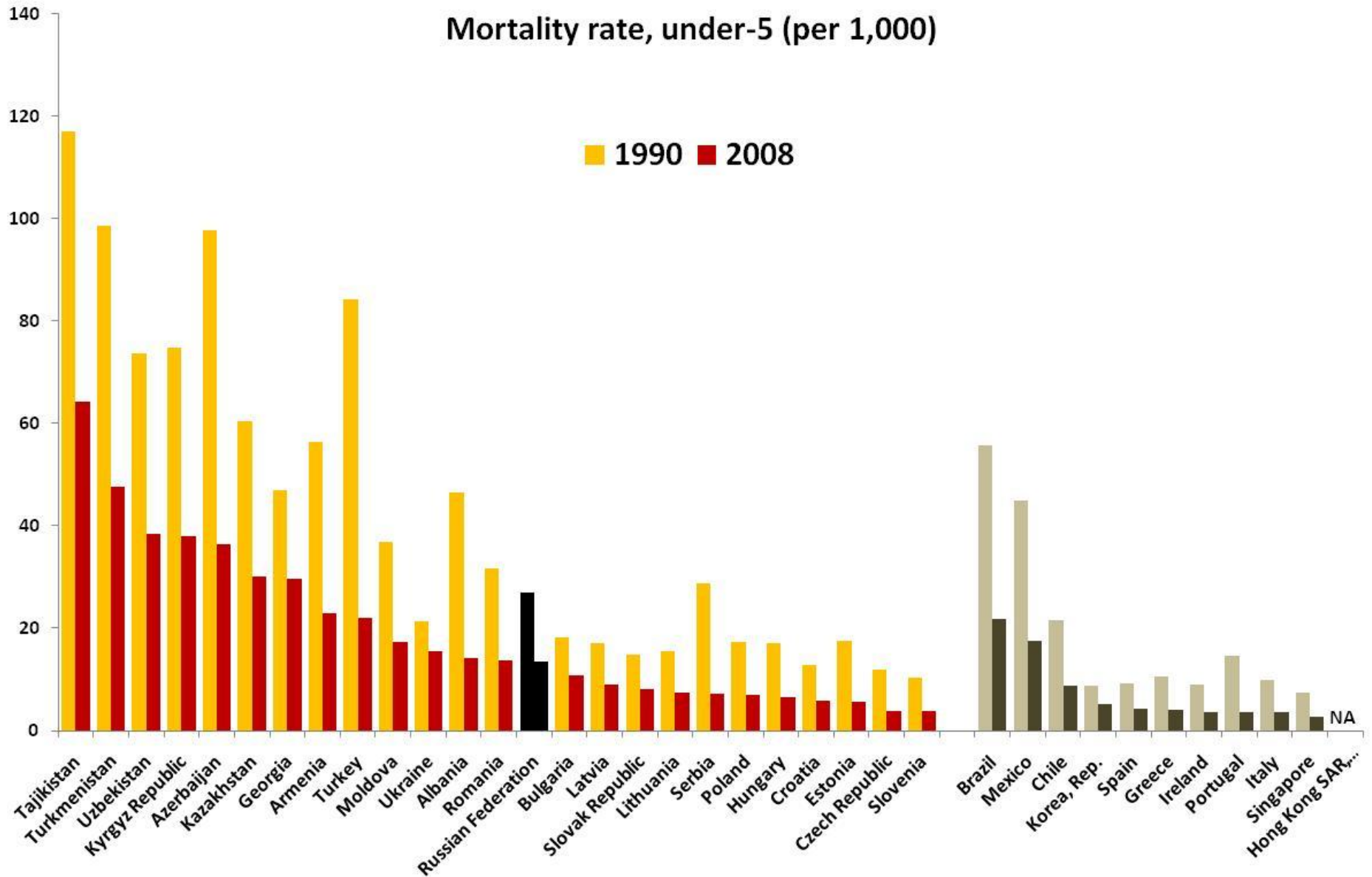
1989 2008



Source: World Bank World Development Indicators online 14 IX 2010

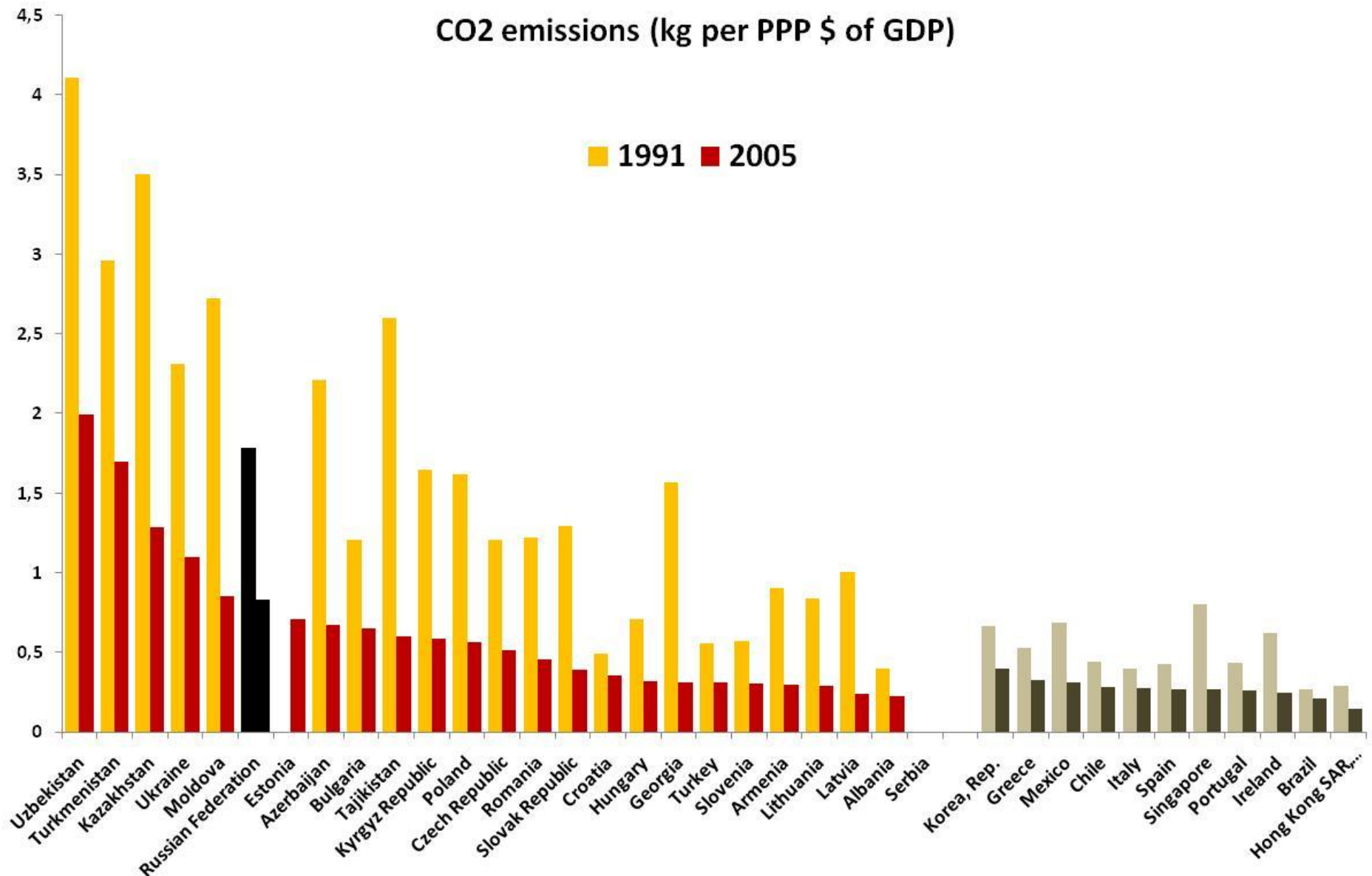


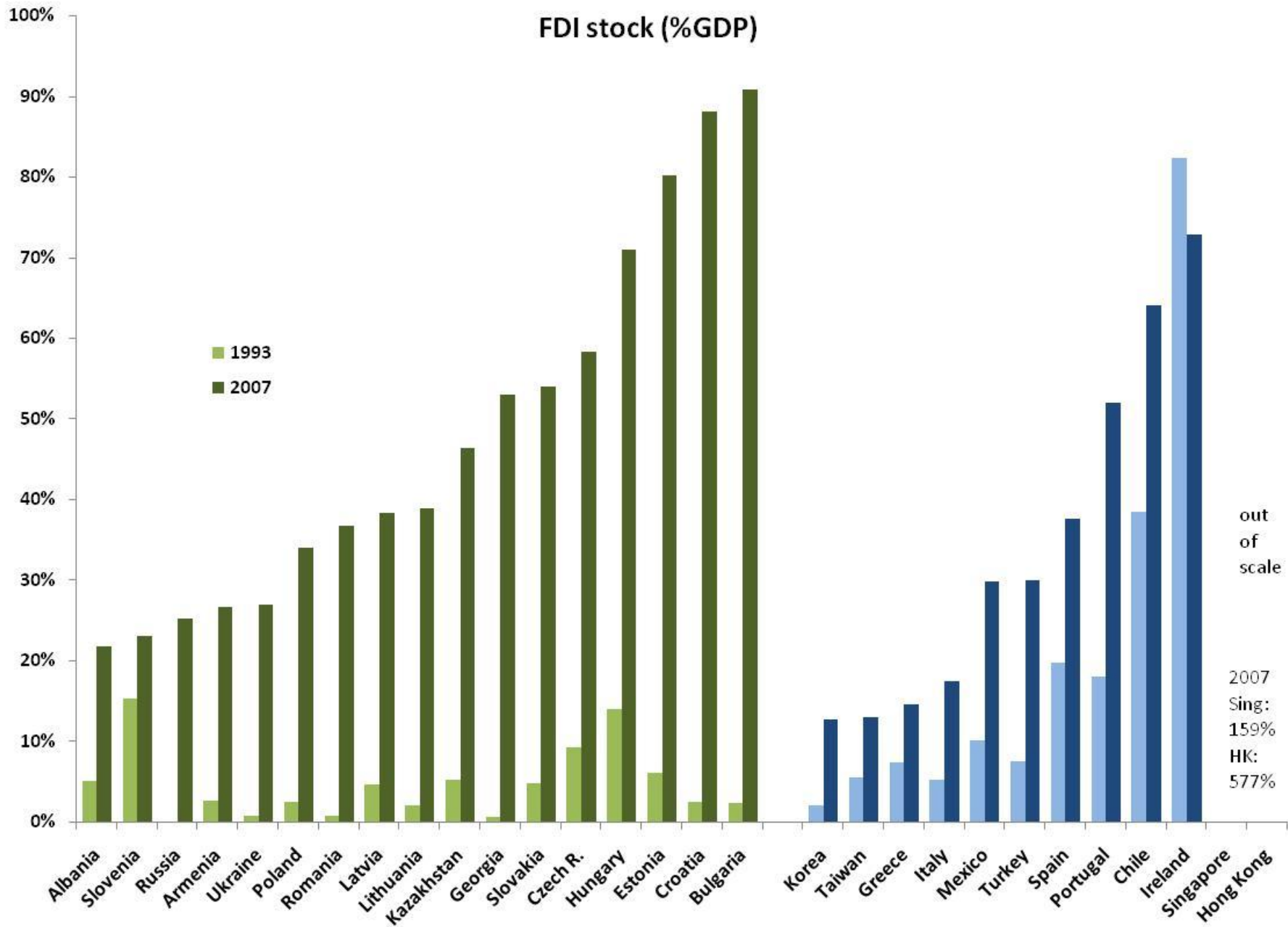
# Mortality rate, under-5 (per 1,000)



Source: World Bank World Development Indicators online 14 IX 2010

## CO2 emissions (kg per PPP \$ of GDP)





Source: UNCTAD, FDI Online 2008

# Explaining the differences in economic outcomes

---

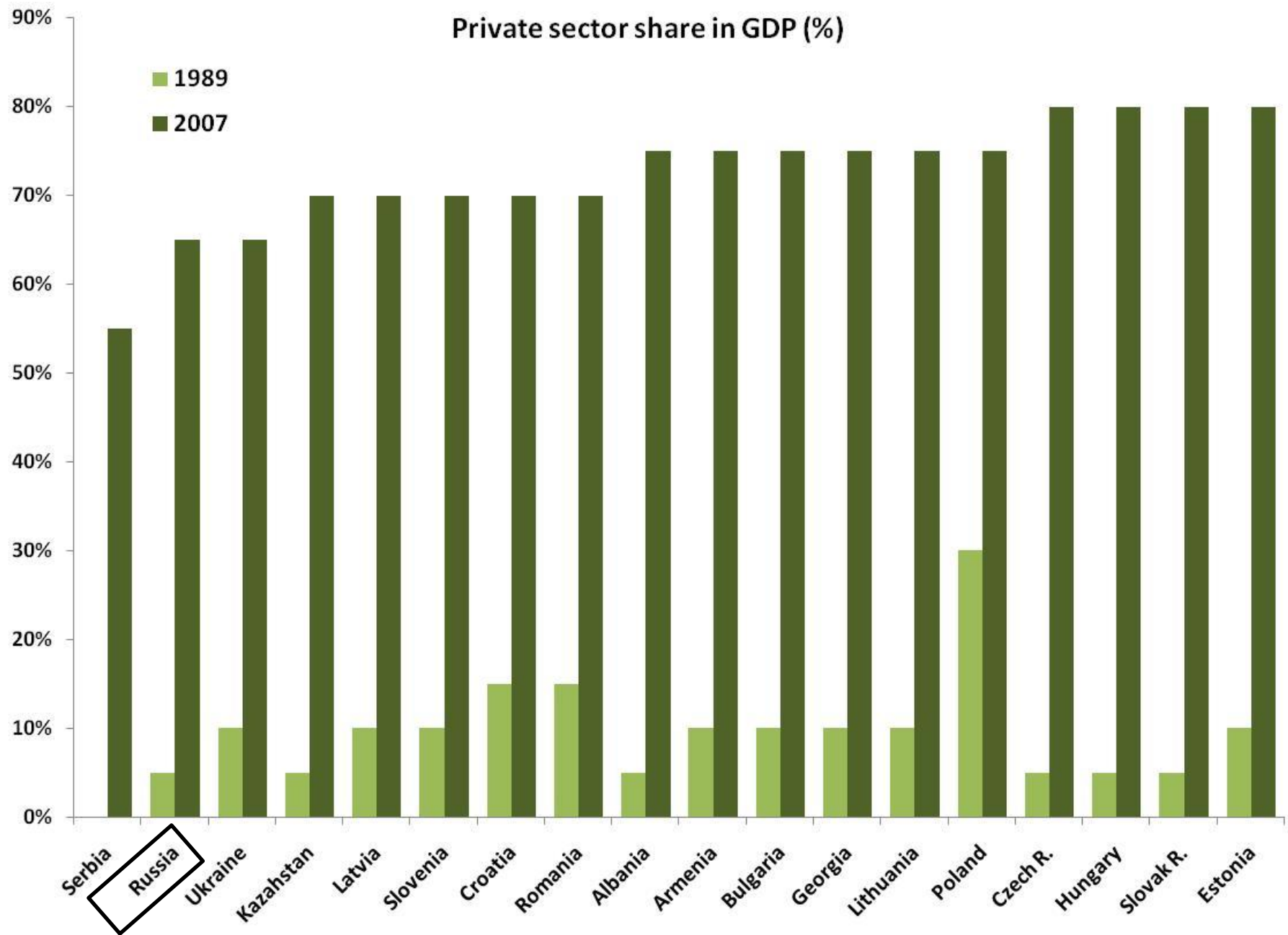
**The principal factors explaining differences in growth rates are:**

- **initial conditions,**
- **external developments (e.g. the Russian crisis) including:**
  - **access to markets,**
- **location,**
- **extent of market reforms and the nature of macroeconomic policies:  
most important in the long run**

• **These findings are strongly supported by substantial empirical literature reviewing the experience of countries in transition.**

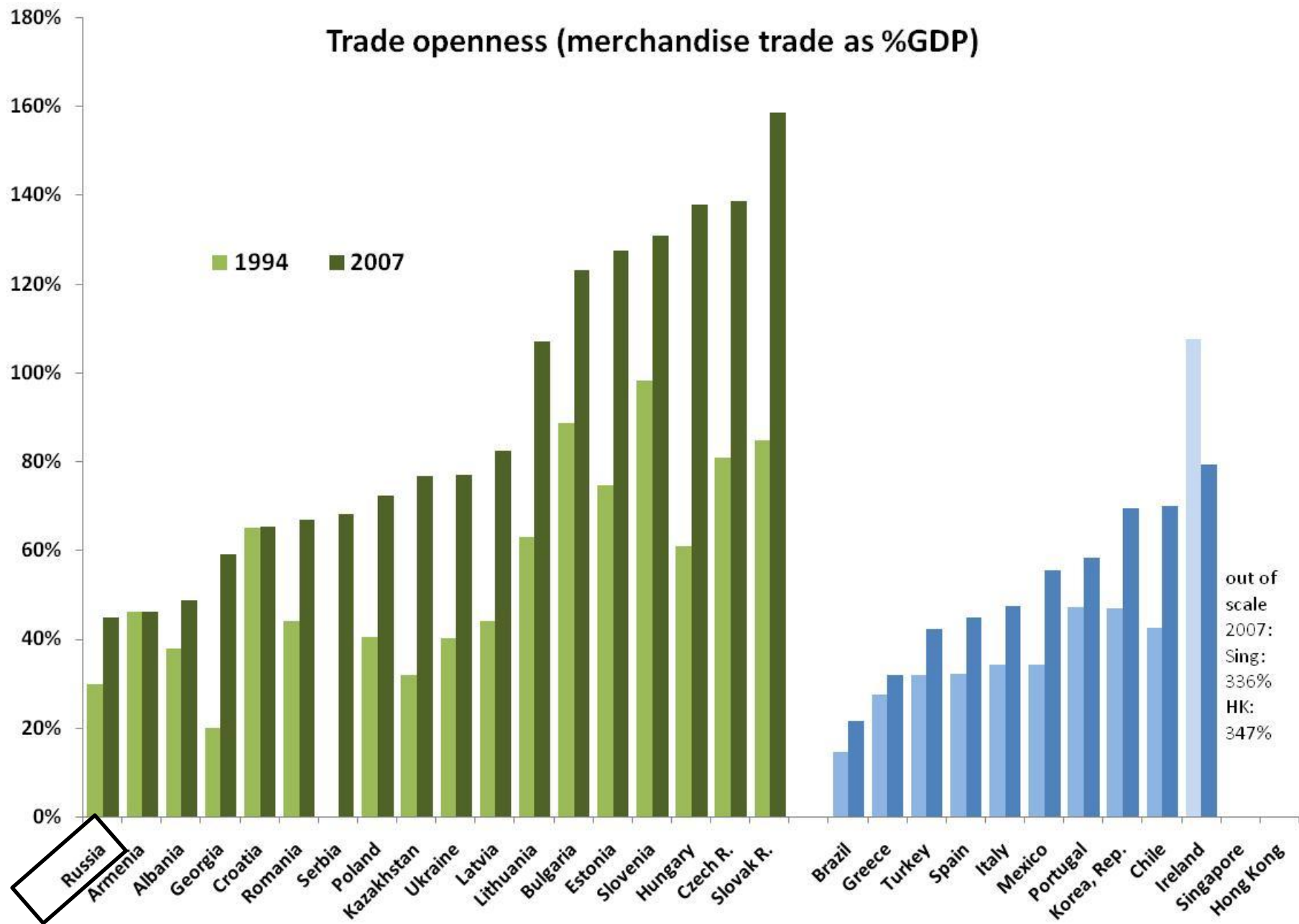
<p>Polanec, Sašo (2004)</p>	<p><i>"(...) we find that in later stages of transition, measures of economic reforms matter for productivity growth, although with a lag, which is in our exercise equal to four years. This result confirms importance of reform efforts in enhancing the potential for growth."</i></p>
<p>Krueger, Anne O. (2004)</p>	<p><i>"(...) it is worth noting that those transition countries that experienced the most rapid structural reforms have, by and large, experienced more rapid growth. This is true, for example, of the Baltic States. In recent years, Russia has also seen higher rates of growth – a result, in large measure, of reforms that were implemented in the 1990s."</i></p>
<p>Fischer, Stanley; Sahay, Ratna (2004)</p>	<p><i>"The general conclusion was that the effect of initial conditions, while strong at the start of transition, wears off over time (...). Moreover, the importance of the fiscal policy variable (the budget balance) increases with the longer period data set. The coefficients on the reform indices (...) are significant throughout the period, irrespective of the time period considered."</i></p>
<p>Falcetti, Elisabetta; Lysenko, Tatiana; Sanfey, Peter (2006)</p>	<p><i>"During transition, a positive correlation between progress in market-oriented reforms and cumulative growth is observed for most countries. This is reassuring to those who have promoted the virtues of reforms; is also serves as a warning of the dangers that arise when 'reform fatigue' set in, as it appears to have done in parts of some region (...) We find that the importance of initial conditions as a determinant of growth has declined over time, but that fiscal surpluses remain positively associated with higher growth."</i></p>

# Private sector share in GDP (%)



Source: EBRD Transition Report 2008

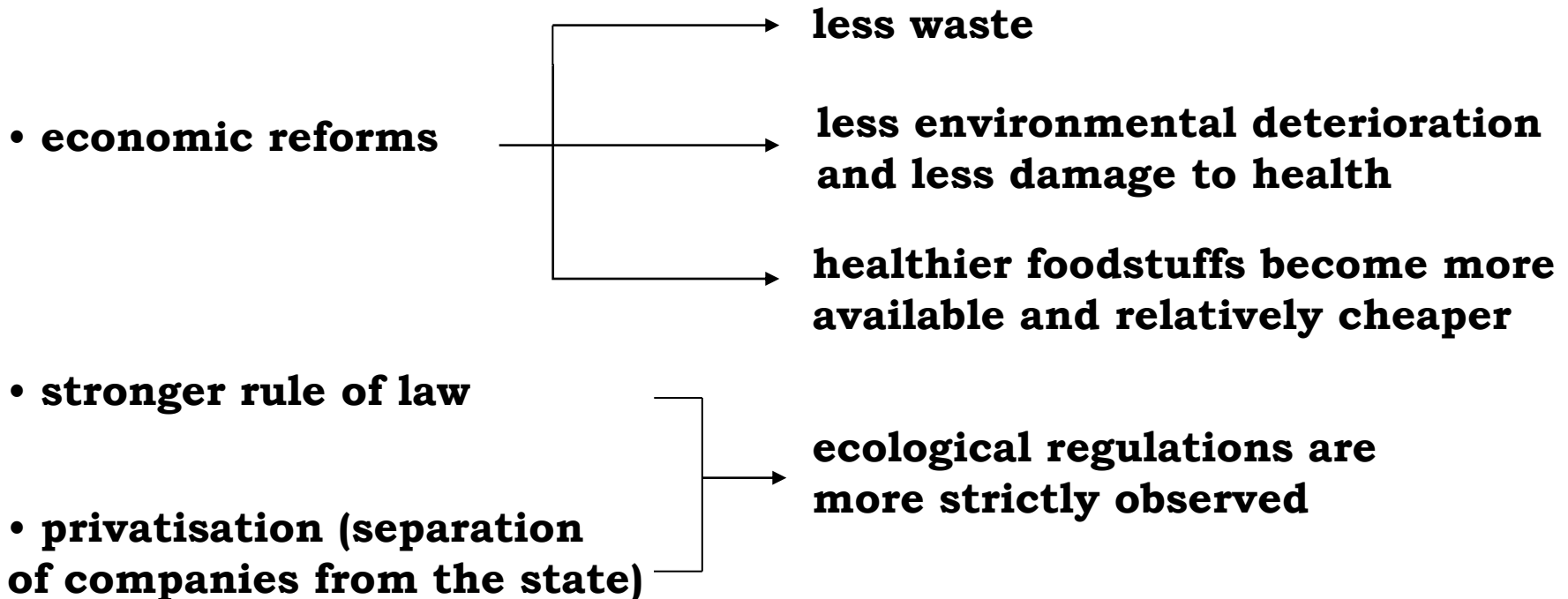
## Trade openness (merchandise trade as %GDP)



## Why better economic results go hand in hand with better non-economic indicators (health, environment, etc.)?

---

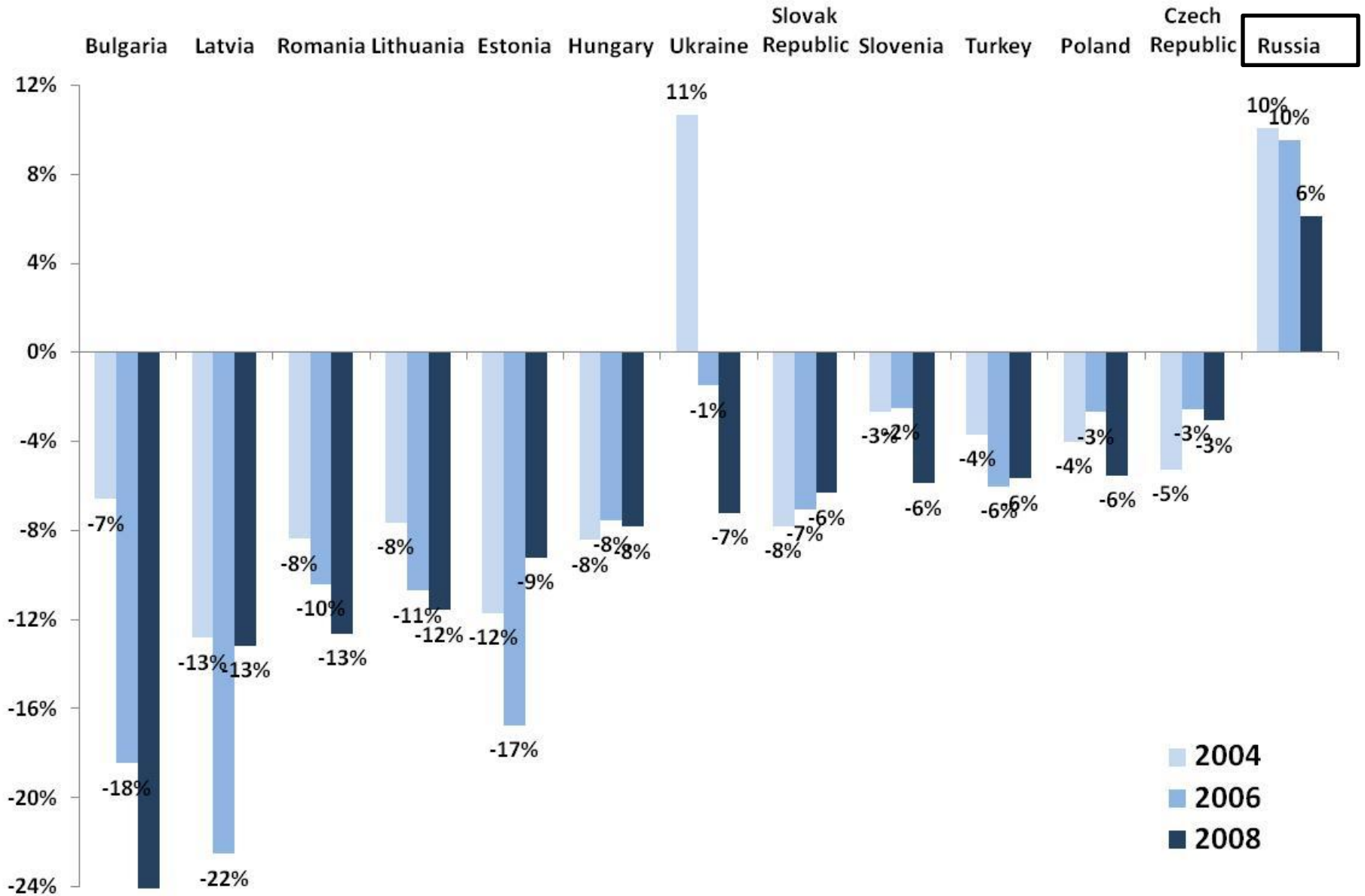
Some crucial factors conducive to long-term economic growth are also conducive to environmental improvement and to favourable health-related developments, e.g.





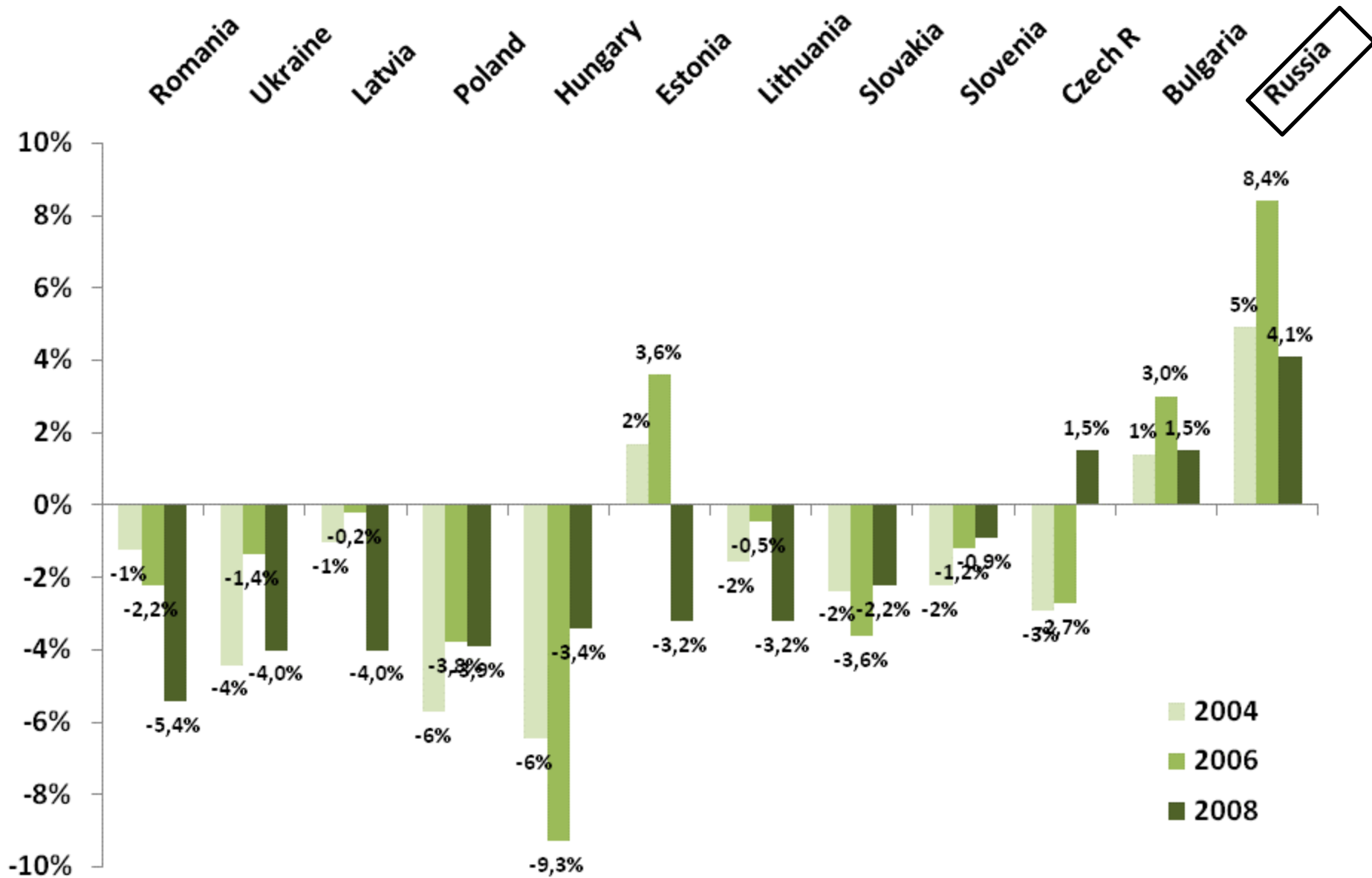
## **6. The Global Financial Crisis and the CEE**

# Current account (%GDP)



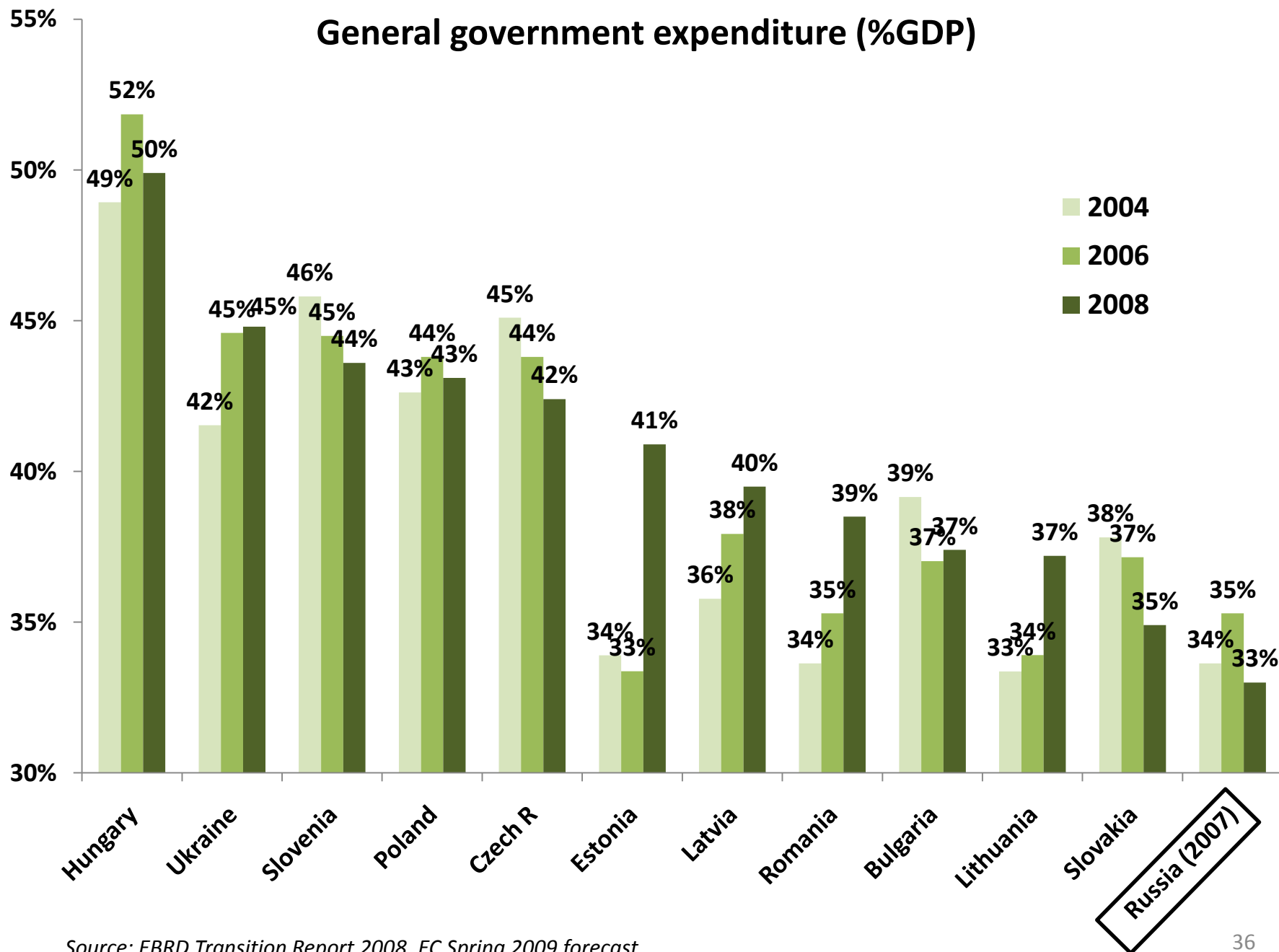
Source: IMF, World Economic Outlook IV 2009

# General government balance (%GDP)



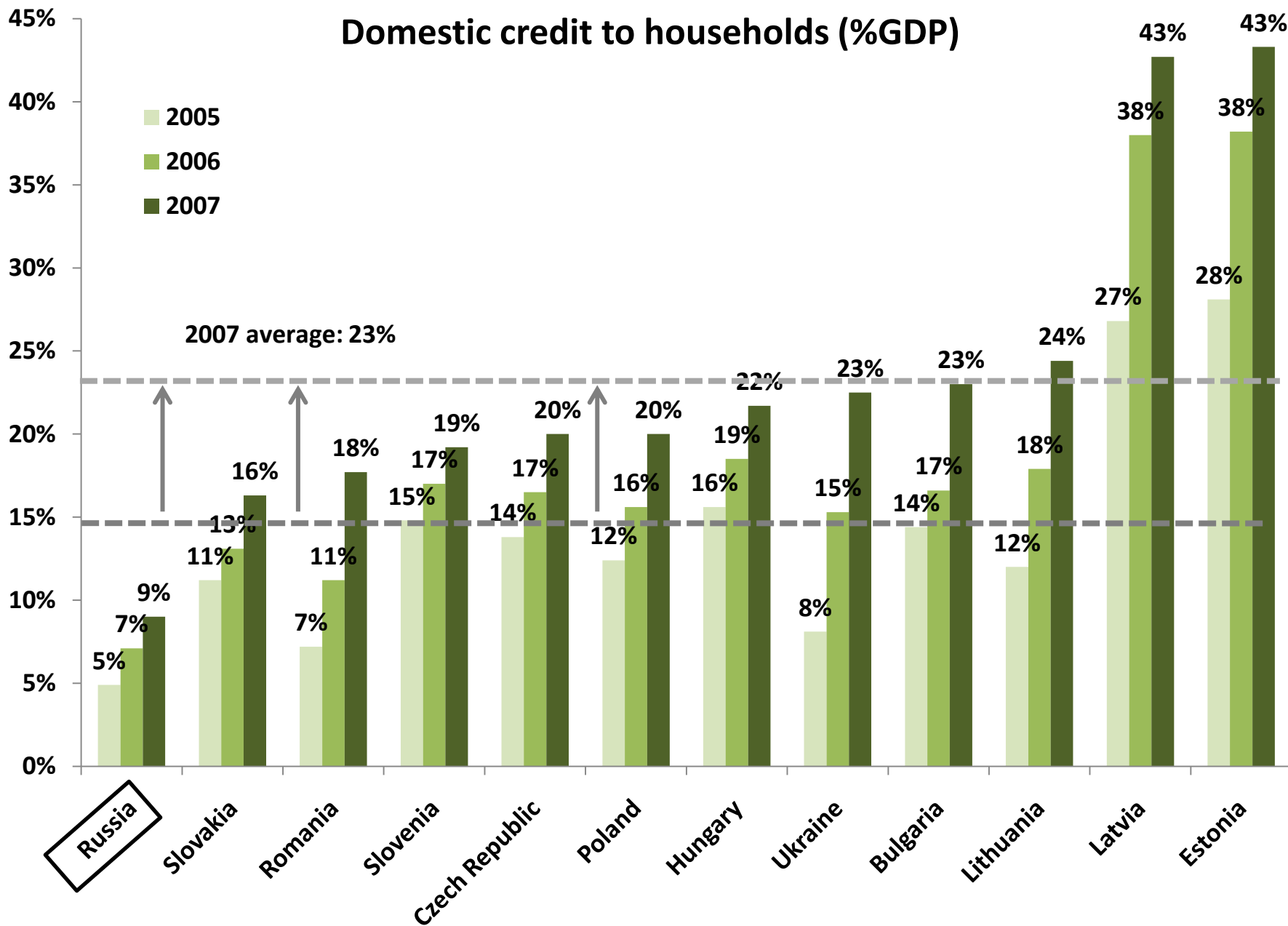
Source: EBRD Transition Report 2008, EC Spring 2009 forecast

## General government expenditure (%GDP)



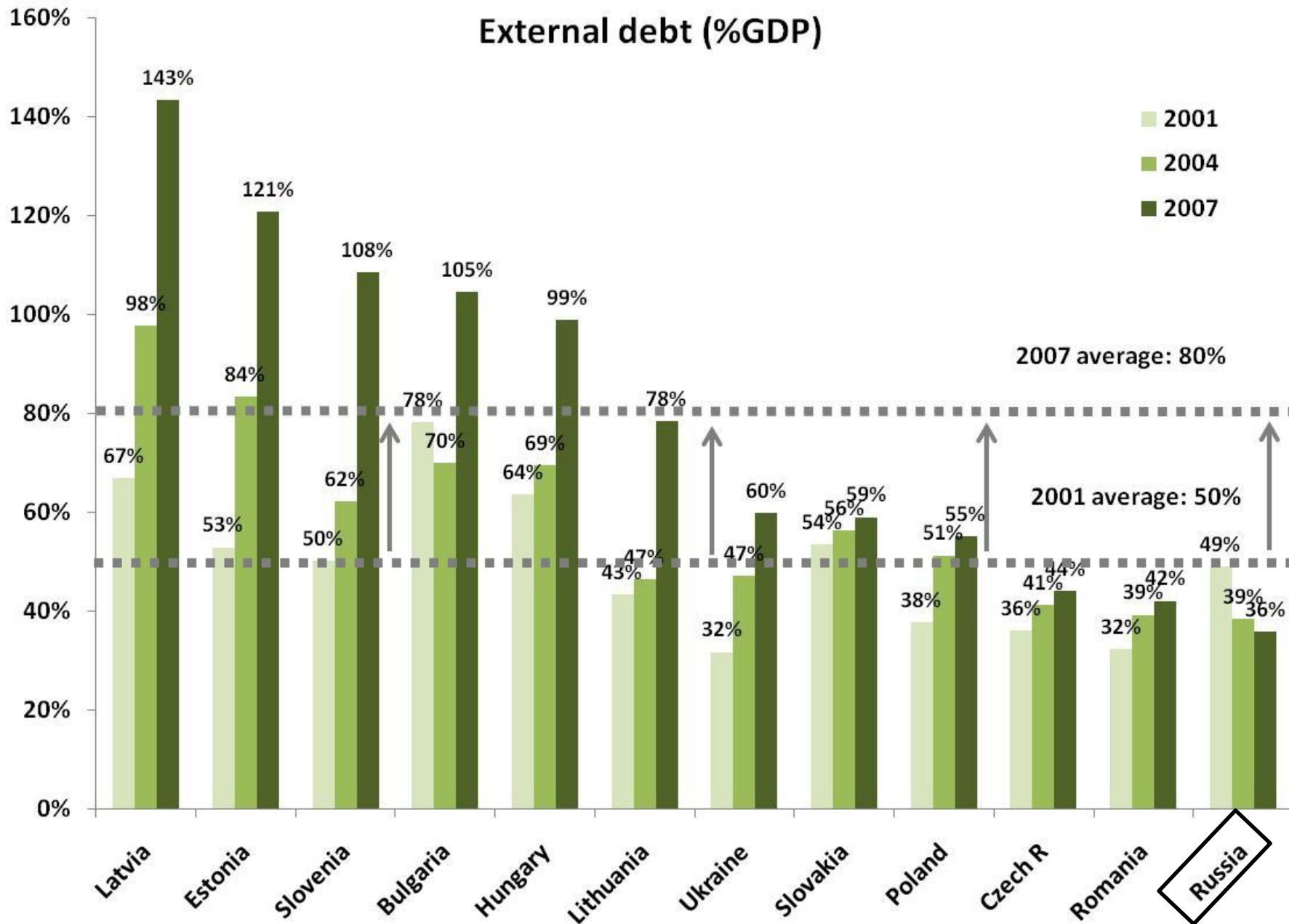
Source: EBRD Transition Report 2008, EC Spring 2009 forecast

# Domestic credit to households (%GDP)



Source: EBRD Transition Report 2008,

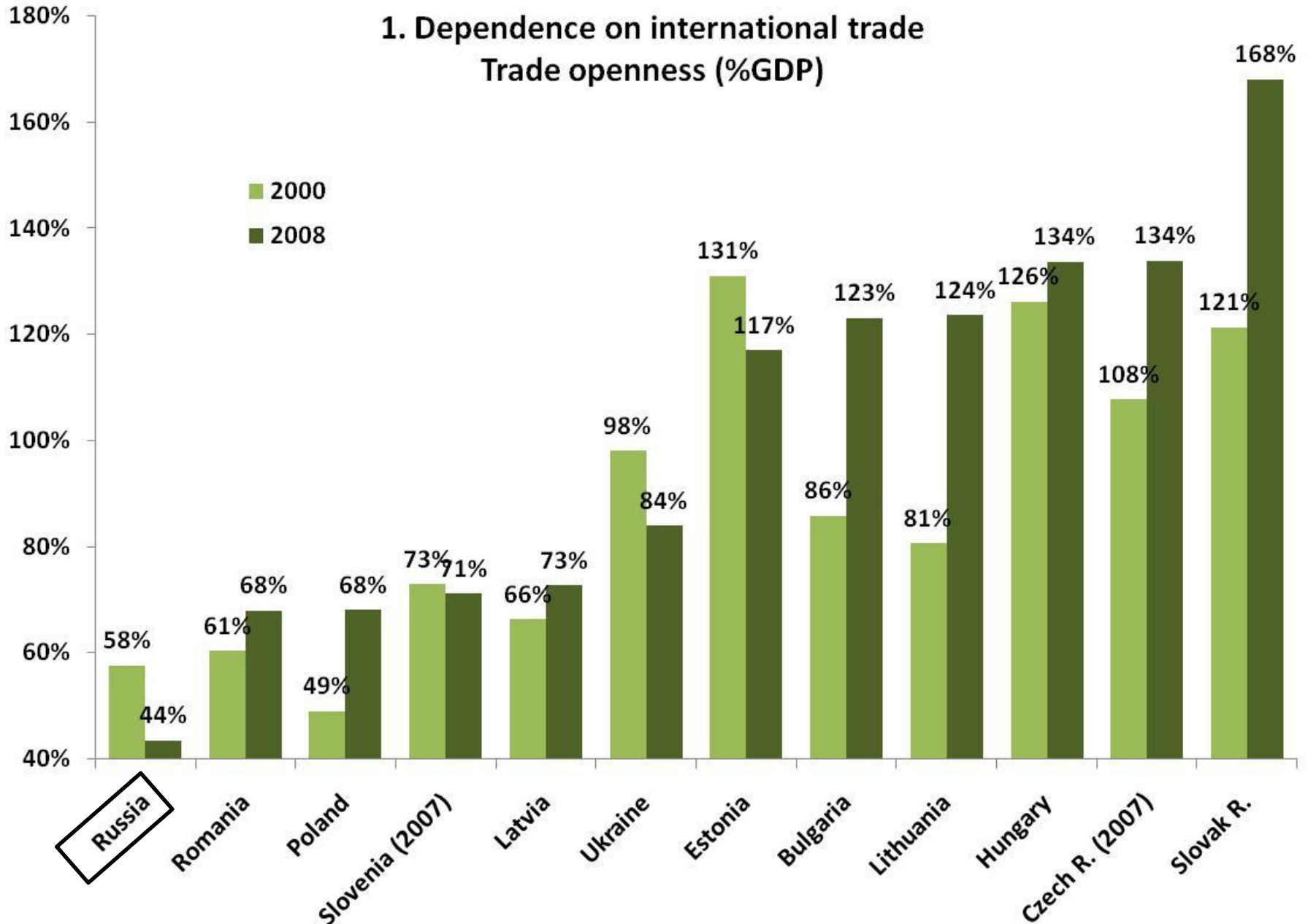
# External debt (%GDP)



Source: EBRD Transition Report 2008

# Determinants of the CEE countries vulnerability

## 1. Dependence on international trade Trade openness (%GDP)



# Determinants of the CEE countries vulnerability:

## 2. Dependence on commodities export

### Ukraine

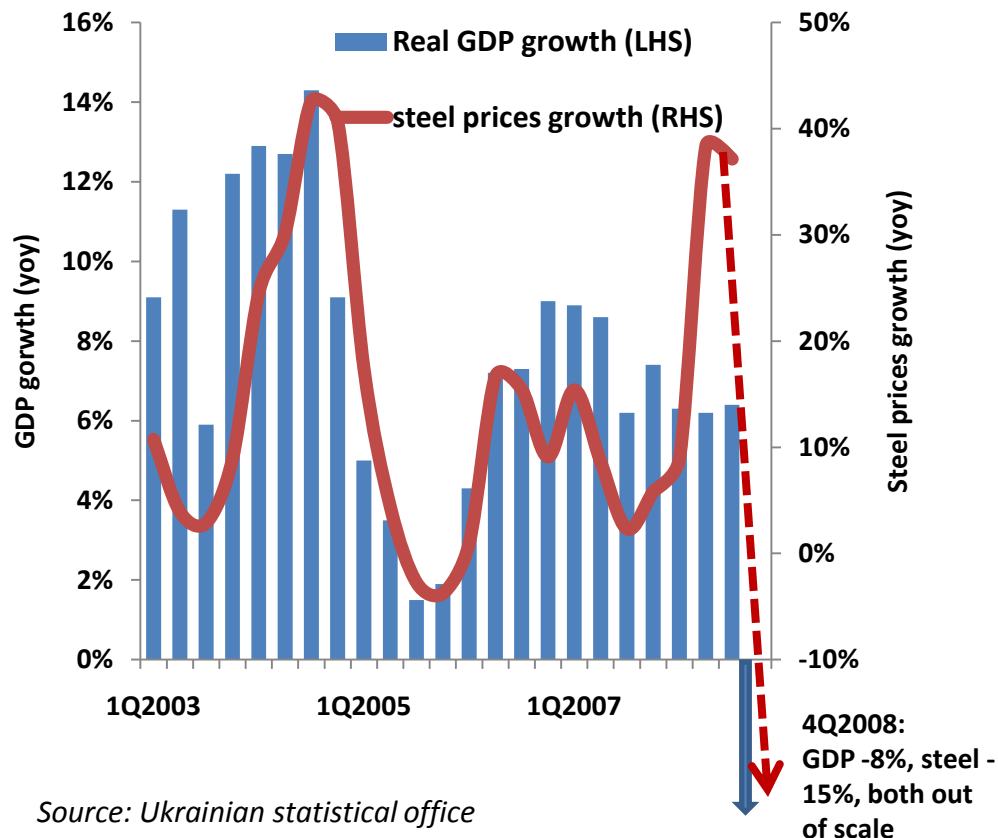
In 2008 steel export (with world prices well above long term average) represented 15% GDP (40% of overall export).

### Russia

In 2007 minerals (including gas and oil) together with metals represented 80% of Russian export and quarter of GDP. Machinery represented only 6% of export, but over 50% of import.

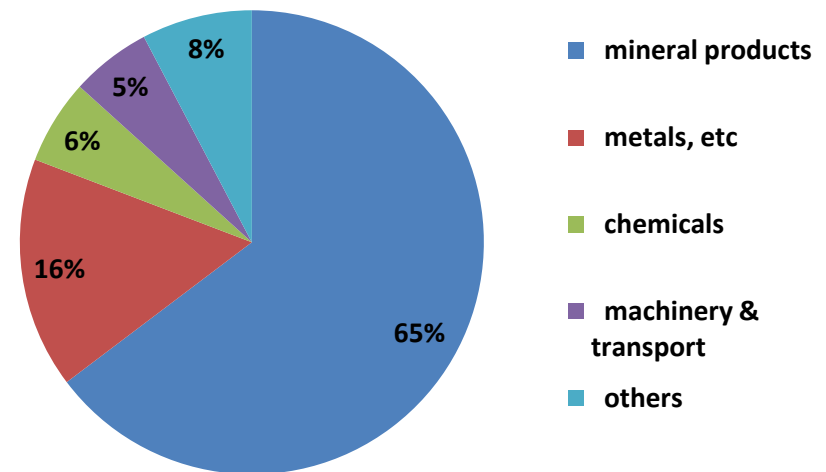
### Ukraine:

#### GDP growth vs. steel prices



Source: Ukrainian statistical office

#### Russian export structure

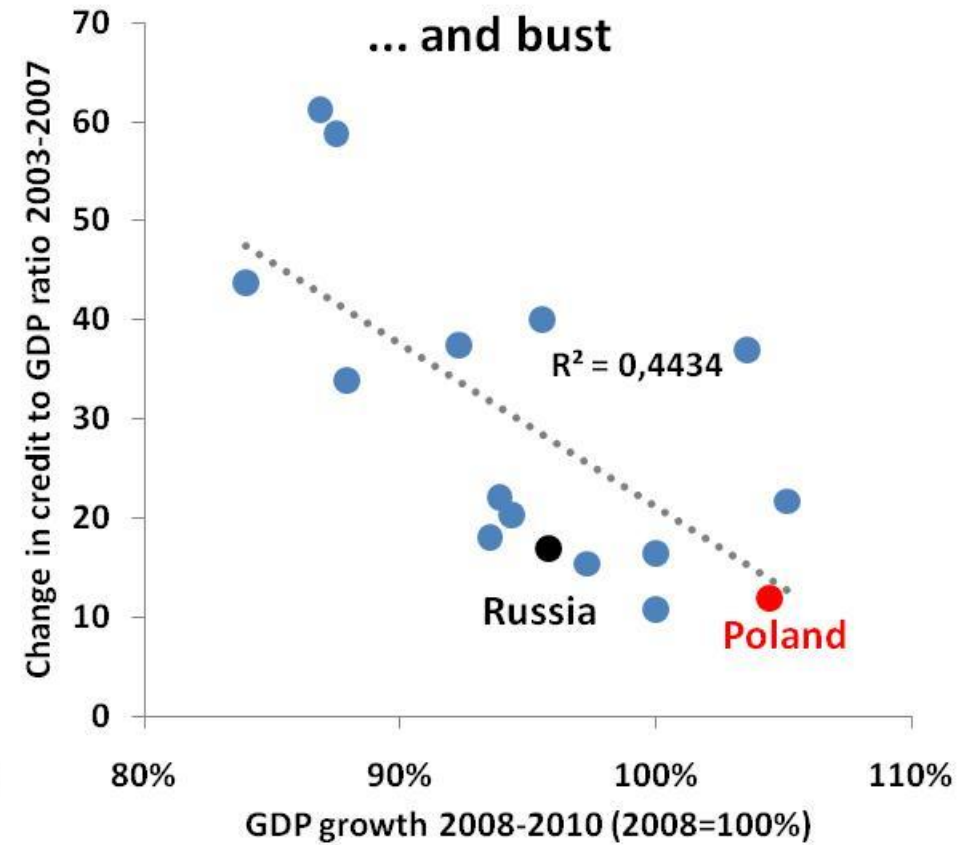
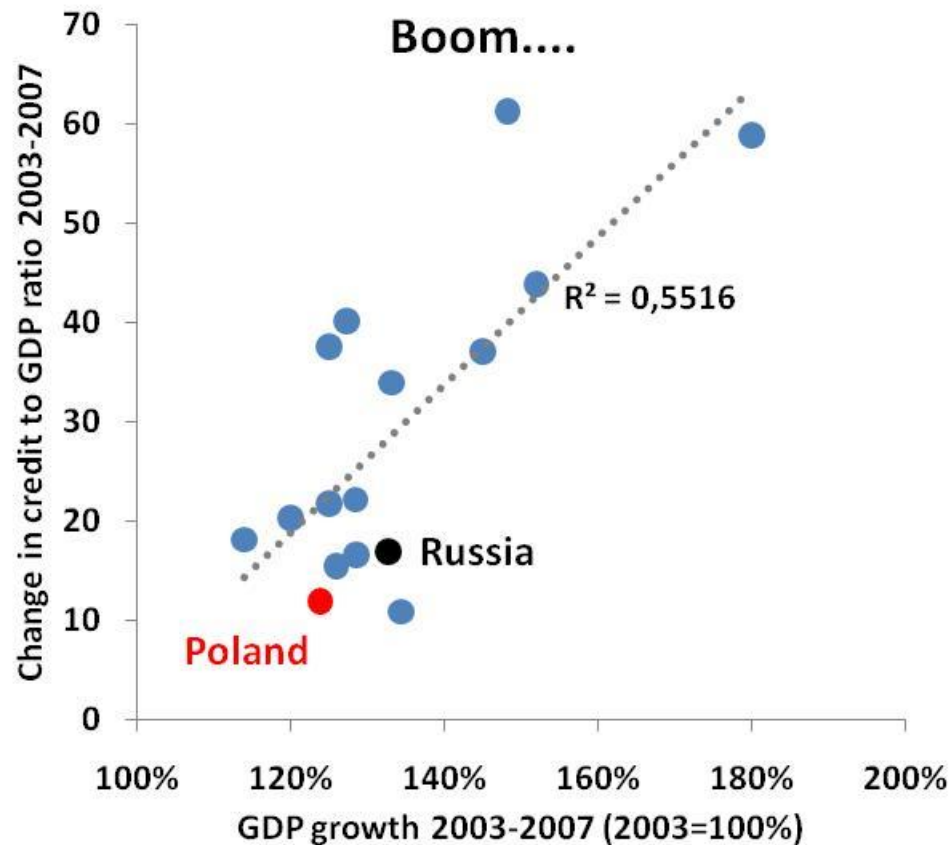


Source: Federal state statistics service



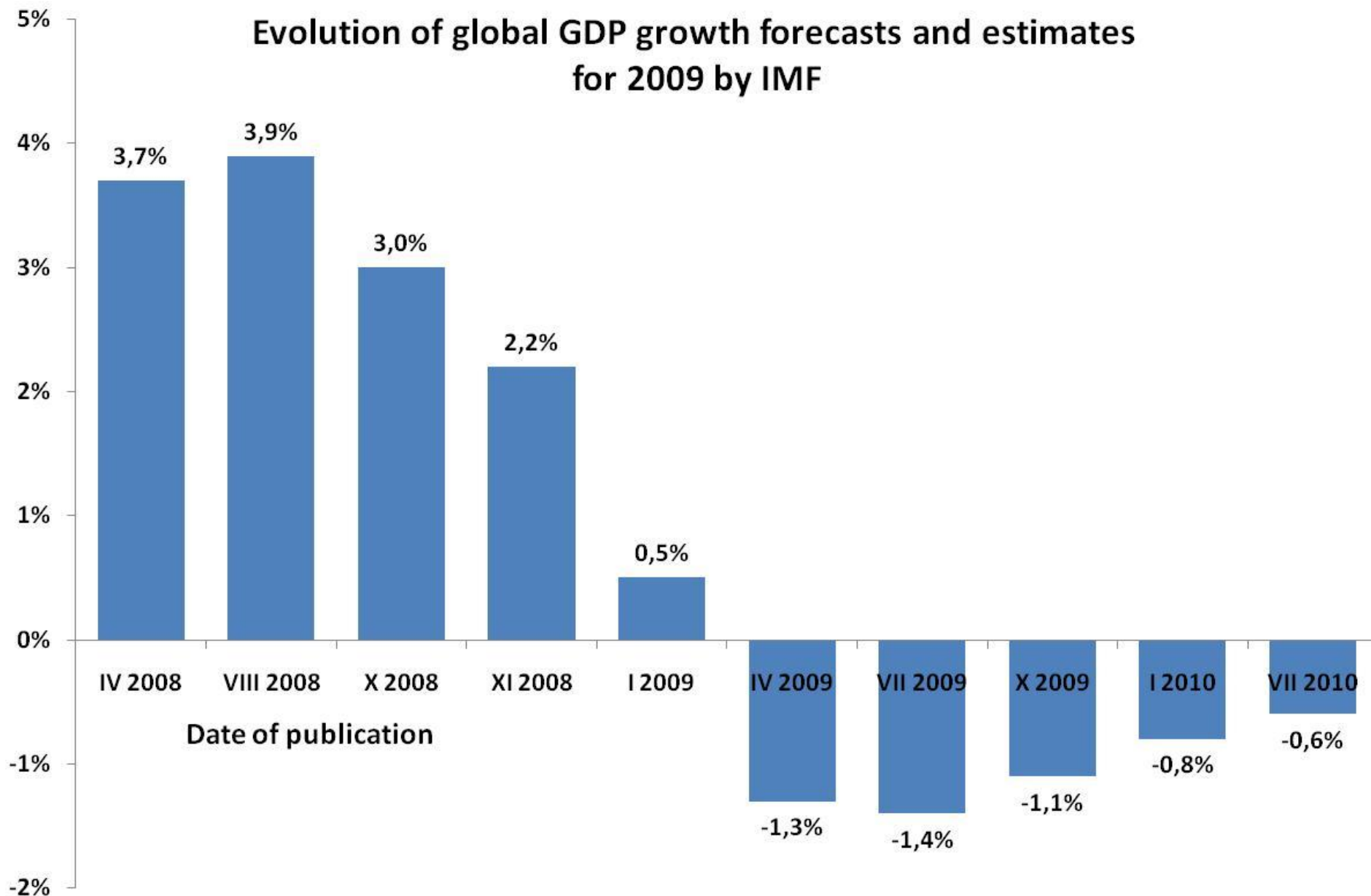
# Determinants of the CEE countries vulnerability:

## 3. Dependence on credit



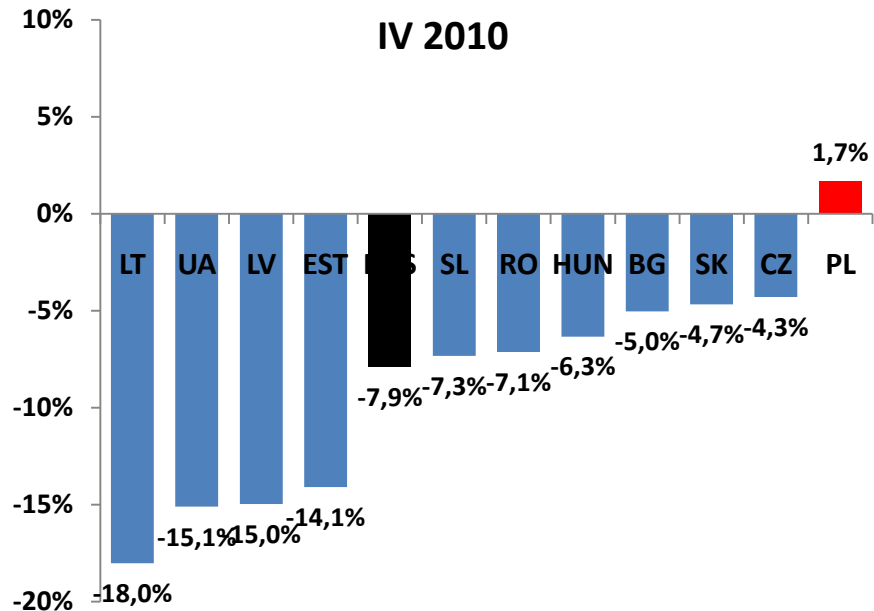
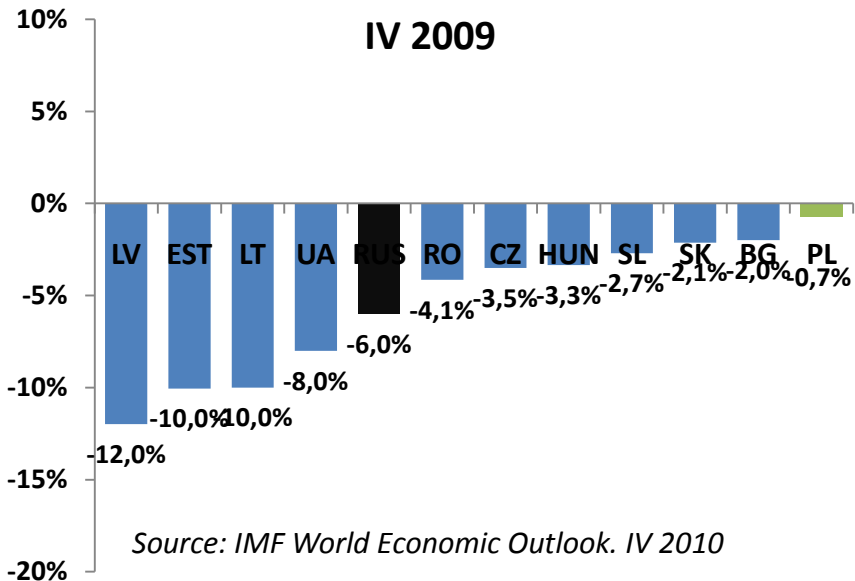
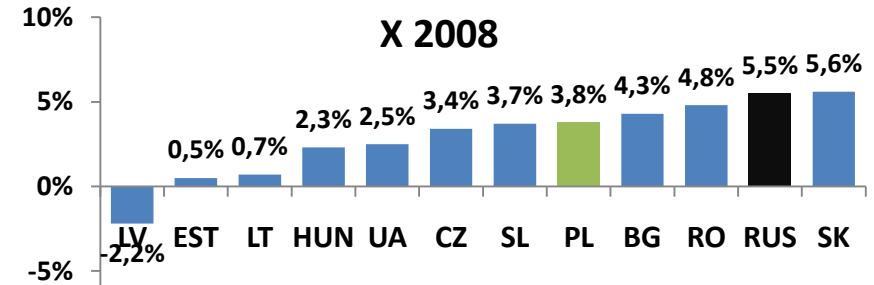
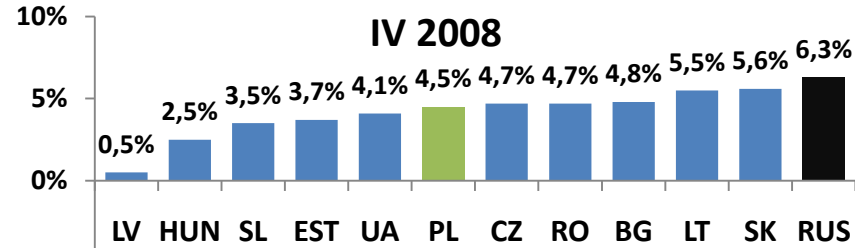
*Growth in domestic credit to private sector (in per cent of GDP) and GDP growth in EU New Member States (Bulgaria, Czech R., Estonia, Hungary, Latvia, Lithuania, Slovakia, Slovenia, Romania, Poland) and Albania, Croatia, Kazakhstan, Moldova, Russia, Ukraine. Data for Baltic states, where boom started earlier are for years 2002-2007.*

## Evolution of global GDP growth forecasts and estimates for 2009 by IMF



Source: IMF World Economic Outlook. IV 2010

# Changing forecasts and estimates of GDP growth in 2009 (IMF)



Source: IMF World Economic Outlook. IV 2010

## Projected GDP change 2008-2011 (2008=100%) Based on IMF WEO forecast

