THE STATE, INSTITUTIONS AND THE MARKET ECONOMY: INSTITUTIONS FOR THE PRIVATE SECTOR IN TRANSITION ECONOMIES

Guy Pfeffermann

The institutional underpinning of successful market economies is a topic that is receiving increasing attention in the economics profession. When asked why living standards improve in some countries and not in others, until about ten years ago most economists would, I think, have focused mainly on the availability of educated people, the state of health, economic diversification and, of course, "getting prices right" and the quality of macroeconomic policy. However, attention to institutional factors was never absent from development discussions. Indeed, the "Washington Consensus," a list of policies which would stimulate healthy economic development, which is much maligned today and unfairly so, quite explicitly encompasses institutional factors. It recommends the abolition of regulations that impede the entry of new firms or restrict competition, as well as a legal system that provides secure property rights and makes them available to the informal sector.[1] To me, the only unfortunate thing about the Washington Consensus is its name.

What I find astonishing is how little attention the economics profession has paid to the role which private enterprises play in fomenting development. Most of the economics literature takes it for granted that firms will respond automatically to macroeconomic and price incentives. Yet private firms play the major role in producing goods and services, including many of the basic goods that we need to survive, as well as to thrive; in creating jobs and incomes; in capturing, applying and transmitting useful knowledge; in generating consumer surplus, and so forth. The International Finance Corporation published a booklet entitled *Paths Out of Poverty*, that articulates the role of private enterprise in developing countries,[2] and a forthcoming book sponsored by IFC and the World Bank will focus on the role private firms play in fostering economic mobility in developing countries.[3]

But times are changing, and Nicholas Stern, the World Bank's Chief Economist, made the quality of the investment climate one of the main pillars of economic growth and poverty reduction, the other being empowerment policies such as making clean water, health and education services available to poor people.[4] One of the reasons Stern focuses on the invest-

---

1. *The Political Economy of Policy Reform.* John Williamson, Editor, Institute for International Economics, Washington DC, 1994 (pp. 26-28).

2. *Paths Out of Poverty—The Role of Private Enterprise in Developing Countries.* IFC, Washington DC, 2000.

3. *Pathways Out of Poverty—Private Firms and Economic Mobility in Developing Countries*. Guy Pfeffermann and Gary S. Fields, Eds., 2002.

4. "A Strategy for Development." Nicholas Stern, World Bank, May 2001.

ment climate is his own experience of dealing with former communist countries when he was Chief Economist of the European Bank for Reconstruction and Development. In these countries, perhaps more visibly than in others, there can be no sustained economic development without a growing and dynamic private sector. All this may seem obvious to you, but it isn't to all economists. Indeed, what Joseph Stiglitz has been writing conveys deep reservations about the role of private firms in development.[5] None of this is to minimize the role of the state. Indeed, it is hard to conceive of a good investment climate without strong and effective public management.

In the next few minutes I will present to you some new empirical evidence about the institutional dimensions of private sector development. I will then zero in on some of the lessons that have been learned in the process of transition from centrally planned to market economies. Any similarity between the countries I mention and an unnamed country that might possibly be on your mind is coincidental. Needless to say, I am speaking in my personal capacity.

My first point is that doing business in developing and transition countries can be exceedingly frustrating.

The World Bank conducted a worldwide survey of businesses, focusing mainly on their interface with public officials.[6] Executives of about ten thousand firms, mostly small and medium-sized enterprises, were interviewed in 80 countries and West Bank & Gaza. This included local firms as well as firms with foreign ownership. The survey asked how problematic were a set of constraints for the growth and operation of their firm. The leading constraints vary by region. In Latin America, for example, the four top perceived obstacles to doing business were (1) taxes and tax regulations; (2) policy instability; (3) street crime; and (4) lack of financing. In European transition countries, taxes and tax regulations came first also, followed by lack of financing; inflation; and policy instability. Responses were similar in the former Soviet Union, except that policy instability was considered more problematic than inflation.

About two-thirds of firms in Central Europe, Latin America and the former Soviet Union report that the government is inefficient in delivering services. Worldwide, the majority of firms express negative opinions for public health, parliament, and public works/roads, while over 40 percent negatively evaluate the courts, police, education services, and central government leadership. The most positive ratings go to the postal, telephone and electric power services. Executives spend an inordinate amount of their valuable time, dealing with public officials. This is obviously related to corruption, which about half the executives interviewed in the former Soviet Union and in Central Europe regard as a serious impediment to doing business. A good number of former communist countries have dysfunctional taxation systems (something that Russia has been taking steps to ameliorate). Not uncommonly, there are so many different taxes on the books that honest firms would end up paying in taxes more than their total earnings. Unsurprisingly, firms are driven into illegality, and hence are particularly vulnerable to demands by corrupt officials.

Perhaps most important, econometric analyses of the survey results demonstrate that these institutional obstacles reduce sales growth as well as investment significantly. In other words, improving the interface between government and business enhances the abilities of firms to produce what people need.

So far, we have looked at perceptions by existing businesses. These are the businesses that "made it" to begin with. Many entrepreneurs were not so lucky and never even made it to the starting post. Regimes that discourage the launching of new enterprises are particularly harmful to economic and social develop-

5. See notably *Globalization and Its Discontents*. Joseph Stiglitz, W.W. Norton & Company, 2002.

6. "Voices of the Firms." Andrew Stone, Daniel Kaufmann and Geeta Batra. Forthcoming, World Bank. The survey data can be found at: http://www.worldbank.org/privatesector/ic/icresources.htm and users can apply an interactive web tool to explore the data at http://info.worldbank.org/governance/wbes/.

ment. New enterprises are more productive than old ones.[7] They outperform old enterprises in sales, exports, investment, and employment. In the Czech Republic, Hungary, Lithuania, and Poland, new enterprises grew very rapidly, and now account for half or more of employment (equal to the average in the European Union) and between 55 and 65 percent of value added. Conversely, in Kazakhstan, Russia and Ukraine, which have seen modest or no growth in new enterprises, the share of employment has stayed at or below 20 percent and the share of value added between 20 and 30 percent. The latter countries favor old established firms, which are draining resources, such as credit, away from potential new and far more productive firms.[8]

Foreign investors too face very different establishment costs in different countries. According to recent World Bank research,[9] foreign firms wishing to operate in the 32 countries surveyed had to face up to 29 administrative procedures in order to enter the market, up to 125 to secure a land site, and up to 26 in order to commence operations. The time required in order to secure all these permits was between 200 and 1,300 business days. Looking at the transition countries surveyed, it took 702 business days in Bulgaria to get permission to enter and secure land, and 634 in Romania. In contrast, this took 75 days in Slovenia, one of the more successful transition economies.

More often than not, governments which make life difficult for new enterprises are acting on behalf of powerful established firms, public or private, which have "captured" policy-makers. The Worldwide Business Environment Survey suggests that in half of the countries in transition, the policies, laws, and regulations are reported by firm executives to have been shaped to a large extent by firms that have made corrupt payments. The impact of such state capture on the business and investment climate is very large. Firms in countries that avoided state capture grew much faster and invested significantly more than firms in countries subject to state capture. Equally important, firms that are "captors" benefited dramatically from their insider status, although not by virtue of their competitiveness.[10]

The most exhaustive study so far of privatization and enterprise restructuring in transition countries offers conclusions that may be very useful to future transition countries.[11] Privatization to outsiders, for example strategic investors (as opposed to incumbent state enterprise managers and workers), has a large positive impact on enterprise restructuring. Privatization to workers did not enhance restructuring in Eastern Europe and had negative effects in the former Soviet Union. Hardened budgets—i.e., reduction or elimination of government subsidies to state enterprises—are also significant in explaining the extent of restructuring. Another lesson (not from this study, but from experience) is that small firms, such as restaurants, dry cleaning establishments, etc., should be privatized very rapidly.

A lesson emerges very clearly from all these transition experiences. Just as nature abhors a vacuum, so it goes for institutions. Once a centrally-planned regime comes to an end, unless new rules of the game are introduced *and enforced* very swiftly, an institutional vacuum will develop which is most likely to be filled by a combination of rent-seeking oligarchs tied to the new government and mafia enforcers. It is then most difficult and in some cases until now impossible to get rid of these parasitic surrogates for market institutions. In other words, both economic reforms and institutional reforms should be carried quickly after transition. This is what was achieved in

7. See *Transition—The First Ten Years*. World Bank, 2002.

8. From *Transition—The First Ten Years.* op.cit.

9. "Administrative Barriers to Foreign Investment in Developing Countries." World Bank Policy Research Working Paper Number 2848, by Jacques Morisset and Olivier Lumenga Neso, May 2002.

10. See *Pathways Out of Poverty,* chapter by Geeta Batra, Daniel Kaufmann and Andrew H.W. Stone.

11. "Enterprise Restructuring in Transition: A Quantitative Survey." Simeon Djankov and Peter Murrell, *Journal of Economic Literature,* forthcoming.

Poland, one of the most successful transition countries. Specifically:

- Prices should be freed as quickly as possible, as was done for example in Poland and Vietnam; maintenance of unrealistic raw materials and energy prices not only drained tens of billions of dollars out of Russia, but discouraged enterprise creation big time;
- Land and real estate ownership should be established as rapidly as possible; restitution claims are best dealt with in cash compensation (or treasury bills), and not in the actual physical assets (land, housing, plant) reclaimed by former owners; unless this is done, the ownership of assets may remain in doubt for years, blocking most new investment, and possibly causing years of lost production, capital flight, high unemployment and social turmoil. Hungary provides a good model of how cash compensation can be achieved quickly; and
- Elementary political good sense suggests that opposition to the market economy should be minimized. There are many ways of doing so, for example: giving employees of privatized or reprivatized firms minority shareholdings at concessional prices; gearing social policies toward preserving advantages that a mixed economy may not provide—so, for example, the women of East Germany lost free child care and therefore find it harder to continue working, not to mention lost reproductive rights ; the same goes for the access of poor persons to basic services such as clean water provision, health and education. A well-educated and healthy work force is an invaluable asset to private enterprise in our globalized economy, as well as to society at large.

Before concluding I would like to touch on what I consider a very important facet of transition, and one which is not often being considered by economists. I am speaking of psychological transition. As the Germans found out after the Wall came down in 1989, the psychological make-up of East Germans who grew up under communism is very different (and in some respects remains so to this day) from that of West Germans. Possibly, some of these differences existed before the communist occupation of East Germany and East Berlin, but mostly, the differences arose as a result of forty years of communist rule. Two signals characteristics of communist socialization are relevant to the transition to market institutions, and they are two sides of the same coin: risk aversion, and the expectation of maximum security, however dismal the standard of living. Risk aversion translates into a bureaucratic mind-set. Employees tended to wait until they were told what to do. Party cadres tried to maintain a monopoly of initiative and organizational skills. At the same time, the regime provided job security, child care, as noted earlier, and other basic benefits, albeit often at minimal levels. Twelve years after reunification, these attitudes still linger with older people in the Eastern states of Germany, many of whom are now saying: "it wasn't so bad back then after all."

In the words of a former East German spy, a member of the party elite, "We always ask whether someone is from east or west. Then all is revealed. The typical West German is to us arrogant. The typical East German is to them lazy. It has not changed. The psychological divide remains deep… But we are not lazy. Germans in the east are still waiting for orders. They have to be told what to do. One bad thing we did was to take initiative away from people."[12]

Such psychological differences are of course hard to manage. A number of foreign businesses in Eastern European transition countries and in Russia only hired very young staff who had never worked under communism. Demography solves the problem eventually, as young people who did not grow up under communism grow in numbers and eventually replace their older compatriots. Until that demographic transition takes hold, the task of government is to avoid a sense of marginalization on the part of the

12. "Life after the Stasi." Jim Hoagland, *Washington Post,* July 18, 2002. The cited East German is Edgar Uher, now a successful entrepreneur.

current majority who never experienced anything except the old regime.

In conclusion, rapid growth and poverty-reduction are possible only when private enterprise operates in a good investment climate. Besides good macroeconomic policies, this requires a firm institutional roadbed, which, in turn, supposes the existence of an administratively competent and relatively un-corrupt government. Some good things most communist systems produced were excellent education (by international standards) and, in many countries, good basic health services for the vast majority of the population. Good health and education (essential elements of "empowerment") are invaluable assets on which post-communist governments can build. Yet the development experiences of transition countries were quite varied: some, like Estonia, have managed very well and are on the point of joining the European Union. Others have failed to bank on their human capital, partly because they did not reform their private sector institutions in depth. Perhaps most important, a transition government must try to avoid institutional vacuum which invites state capture by parasitic elements of society. Whatever the pace of transition, the process is painful and can take a lot of time, but the alternative is worse.