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Would a Second Transition Stage Prolong the Initial Period of Post-socialist Economic Transformation into Market Capitalism ?

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Abstract

The article attempts to define the relevant yardsticks that can be used to delineate the end of the transition process or, alternatively, a second stage in the post-socialist economic transformation into market capitalism. A first benchmark is EU accession, but it does not apply to non accession transitional economies. Moreover, a delay is going to appear between accession and the full benefit of common policies – a second transition period will open in May 2004. Convergence criteria are likely to postpone the end of transition for decades, if not for ever. Institution building varies significantly among transition countries, but the non accession countries are trapped for a long time in a no man's land between the former system and a market economy with its necessary institutions. Our privileged analysis is that transition ends when the economic phenomena that are specific to transition will vanish (and the associated concepts will disappear). These are assumed to be transformational recession, transitional unemployment, barterisation, the typical informal sector and managerial entrenchment. They are not going to fade away without a second stage of transition.

JEL : F15, F43, O11, P27, P33

Key words: transition economies, EU enlargement, economic convergence, institution building, transitional specificities

1. Introduction

The process of transition started in the front running reforming economies of Central and Eastern Europe in 1989, and was followed in the CIS and Balkan countries since late 1991. Through this process, the so-called post-socialist economies in transition (PETs) were supposed to transform themselves into fully-fledged market economies and institutionally-built capitalisms. Fourteen years later, is the transition over? This question has been raised since the late 1990s in the comparative economics literature. Moreover, with EU accession of eight Central Eastern European countries (the CEEC8 in the following) in May 2004, and the expected admission of Bulgaria and Romania (the CEEC2) in 2007, the question is reactivated. Have these countries not been admitted earlier into the EU even though their economic convergence is real and their institutional harmonisation to the *acquis communautaire* is nearly complete? Has the most developed CEEC (Slovenia) not yet overtaken the level of economic development of the least developed incumbent EU member (Greece)?[2] However, the debate is open, since what pertains to Slovenia applies neither to other acceding CEECs nor to non-accession countries in the Balkans and CIS (CIS12), on the one hand and, on the other hand, EU accession may not be a comprehensive criterion for assessing whether the transition process has reached its full stop or not.

[1]Honorary director of ROSES (CNRS), former EACES president (1997-98), incumbent president of the International Association of Sport Economists (2002-05).

[2] While Slovenia's GDP per capita has not yet overtaken Greece's in current dollars, when measured in PPP, the former ($18,233) exceeded the latter ($17,482) by 2001..

The debate about when transition will be over is a bit puzzling because extremely different yardsticks have been used to fix the end of the transition process. Some criteria are rather subjective such as 'when I walk today in the street in Prague, I (as a westerner) do not feel in a different system' or 'when I am stuck in a traffic jam on my way to the Sheremetevo (Moscow) airport, I cannot imagine that I am not in a market economy'. Murrell (1996) has put it saying that transition will be over when developments in these countries erase the economic connotations of the adjective *western* European. Some others have referred to more institutional criteria, as Marie Lavigne (1999, p. 276) did: "as the European Union requires that its members be 'functioning market economies', all the countries admitted into the EU would have by definition completed their transition". Joining the EU would mean that economic and institutional transformation had been completed. But what about this criterion if, once admitted into the EU, the CEECs would not be treated – and would not benefit to the same extent from the same policy measures as – exactly as the incumbent members? This is the sort of perspective which raises some doubt against the comprehensive compliance of acceding CEECs to the requirements of a 'well-functioning' (not to speak of a fully-fledged) market economy. Since the benefit of some EU policies will be delayed for acceding CEECs, the issue is not an empty one and will be discussed first (section 1), arguing that a second transition period will start for the CEEC8 in May 2004. Moreover, it may well be that, even after harmonising the whole *acquis communautaire*, some CEECs would remain, for years, rather remote from the average level of economic development within the EU. In other words, real convergence would not have progressed far enough to bring with it a genuine catching-up. It is then legitimate to conclude that "the problems and policy issues confronted by today's transition economies resemble those faced by other countries at similar levels of development" (Gelb, 1999, p. 36). In some sense, the study of PETs would increasingly leave the area of comparative economics for development economics but, by the same token, it would mean that a second stage of economic development is required for PETs (including CEECs) to catch up (section 2). The World Bank (2002) considers that transition is not over as long as there is still a wide dispersion in the productivity of labour and capital across types of enterprises due to a mix of new enterprises and old restructured (or even not yet restructured) firms. Thus, the phasing out of enterprise restructuring is to be added to the level of economic development in the catching up of PETs.

Another subtle approach (Brada & Kutan, 2000, p. 113) suggests that "rapid system change will cease, and economic institutions will stabilise" so that "even if legacies from the communist era persist, the policy concerns in both successful and unsuccessful transition economies will lose their uniqueness". However, in unsuccessful PETs, a new economic system will combine 'etatism', paternalism, cronyism, kleptocratic and rent-seeking behaviour with weak market institutions. It is obvious here that the transition process can not be regarded as being over, unless one agrees that, from the very beginning, the objective of a new 'crony rent-seeking state' capitalist system is as acceptable as a well-functioning market economy. A second transition is then urgently needed, based on those measures likely to reduce 'etatism', cronyism, and rent-seeking and to strengthen market institutions, *i.e.* a second stage focused on institution building (section **3**). Those PETs which cause most concern (primarily the CIS12) are at a crossroads. Should they improve little by little the existing formal and informal institutions – and phase out the dysfunctional ones – that result today from the

initial stage of the transition process? Or should they erase all at once the inefficient institutions and rebuild the entire institutional setting from scratch?

For instance, in the face of the dubious outcome of privatisation in Russia and the CIS (Nellis, 2002; Andreff 2003a), an improvement could consist in upgrading as far as possible the existing corporate governance structure of privatised firms, in giving up the wrong privatisation schemes – such as mass privatisation – for privatisation through asset sales, and in promoting the entry of new start-ups instead of striving to privatise unmarketable state assets. Such is the new World Bank's train of thought (World Bank, 2002) which expresses, in addition, the need for PETs to consolidate the gains of the first decade of transition and address 'second generation' reform issues (p. 6), *i.e.* the need for a second stage of the transition process, going beyond the former Washington consensus (stabilisation-liberalisation-privatisation). A more radical option, as regards to the privatisation outcome, is to recommend that assets of privatised firms that do not pay taxes within a sixty-day deadline should be seized (Stiglitz, 2002). Stiglitz considers re-nationalisation as a solution to tax arrears and as a path towards a new re-privatisation which would be more legitimate than, for instance the 'loans for shares' scheme promoted under Yeltsin. Even Jeffrey Sachs – formerly an advocate of mass and rapid privatisation – is known to have stated that the Russian government should re-nationalise the valuable firms wrongly privatised through the loans for shares, with a view to re-privatising them fairly (Nellis, 2002). We would not elaborate here on the reasons why this radical solution would probably destabilise again the relevant PETs, leading to a second (re-nationalisation) and third (re-privatisation) wave of asset stripping, capital flight, embezzlements, bribery, corruption, money laundering, and violent appropriation of assets and so on and so forth [3]. Thus, it is clear that Stiglitz, Sachs and others are clearly wondering about another different stage in the transition process.

The only problem with the aforementioned approaches is that, after looking at the results of the initial stage, the second stage of transition is clearly required empirically in view of scheduling new economic policy measures, but its theoretical background is missing. An attempt at a theoretical sequencing of two different stages in the ongoing transition process (Andreff, 2003b) dwells upon the fact that a number of transition 'surprises' have of course not been expected (or not to the extent observed in the statistics) by mainstream economic analysis of transition, and the analysis of such surprises in the early years of transition has been neglected. Surprises such as transformational recession, transitional unemployment, barterisation, a flourishing informal economy, and managerial entrenchment encompass economic facts specific to the transition process from the former planned economy to a market economy. The associated concepts have not yet received a definitely accepted and uncontroversial economic analysis (Andreff, 2001a). We contend that transition will be over when all these specific surprises disappear, and the associated concepts lose their relevance (section 4).

[3] This is extensively argued in Andreff (2004).

2. A second stage towards the full benefit of EU membership: the CEEC case

As a symbol, EU enlargement is very significant for both incumbent and acceding EU members. In this respect, it is not surprising at all that EU membership is associated with the end of a process – i.e., the end of accession negotiations. If the accession countries were only less developed, poorer and more agricultural (like Greece, Portugal and Spain in the 1980s) than incumbent members, they should benefit, without any specific advantage and without any specific restriction, from all common EU policies, immediately after accession. This would mean that by the date of accession they will have fulfilled the Copenhagen criteria (1993), that is:

1. stability of institutions guaranteeing democracy, the rule of law and human rights;
2. the existence of a functioning economy capable to cope with pressures and market forces within the UE;
3. the ability to take on obligations of membership, including adherence to the aims of political, economic and monetary union, and harmonisation of the entire *acquis communautaire*.

But this cannot be said about the CEEC10. Changeovers of political power between different parties have taken place during the last fourteen years in nearly all them, so that the first Copenhagen criterion must be regarded as being nearly fulfilled. On the other hand, negotiations between some accession countries and the European Commission until end of December 2002, regarding hot issues such as EU budget, the common agricultural policy (CAP) and structural funds, have been extremely harsh. This shows that CEECs have not yet comprehensively filled criteria 2 and 3 above. The EU position eventually softened towards Poland and Latvia, which were further than the other CEEC8 from closing all 31 chapters of the accession negotiation by the December 2002 deadline. In fact, the European council in Copenhagen (2002) admitted different speeds of economic and institutional convergence of accession countries. On these grounds, the accession of Bulgaria and Romania has been postponed up to 2007 while the Baltic states and Slovenia have been assessed as "being able to take over the *acquis communautaire* in the medium term only if they achieve significant efforts". Only Hungary, the Czech Republic, Slovakia and (not without some political pressures) Poland were judged capable of taking over most of the *acquis* in the medium term, if they progress in some specific sectors (namely CAP, the land market, workers' migration, regional development or environmental externalities, depending on the country). When deciding that all the CEEC8 are ready to sign the accession treaty, the Copenhagen council has somehow adopted a big bang policy of enlargement. As a consequence, in all CEEC8, the European Commission considers that a lot remains to be done until May 2004, not only in harmonising the *acquis* but even more so in enforcing it. No one bet that by May 2004 its comprehensive enforcement will have fully materialised in all the CEEC8.

What can we learn from the previous evidence? The fifth EU enlargement is politically too important, and historically too symbolic, to be submitted to a strict economic and institutional conditionality. But economic analysis cannot be satisfied with a sequencing of the end of transition, relying on a mere political will and on historical symbols. However, some other signals have recently emerged that seem to profess, for instance, that Russia has reached the stage of a fully-fledged market

economy: the U.S. government, and later on the European Commission, have officially recognized Russia[4] as a genuinely functioning market economy; the FATF[5] has withdrawn Russia from its black list of financially rogue states even though a whole UNODCCP (2001) report has exhibited Russia as one of the major home countries for international money laundering. On top of these politically-determined decisions, there is obviously a transition fatigue of western governments when facing a long-lasting process which has not simply ended up with the phasing out of the economic policy backed by the Washington consensus.

One of the strongest arguments in favour of the claim that, after EU accession, the CEEC economic transition will go on, simply consists in witnessing the planned delay between the date of their accession and the date when they are to obtain the full benefit of all policies and advantages which apply to incumbent members. This delay is the clearest proof of a second transition period after accession. The structural aids to accession countries which are budgeted by the EU for 2004-2006 represent a transitory measure. The real benefit in terms of structural funds and cohesion funds that will accrue to acceding CEECs will be determined only with the adoption of the forthcoming EU budget for 2007-2013. The negotiations about this budget promise to be extremely harsh – probably even harsher than the accession negotiations themselves. They will have to reconcile the extension of the regional development policy (structural and cohesion funds) to the new CEECs members with the determination of the incumbent members, announced in the Berlin European council (1999), to stabilise the EU budget, and with the reluctance of regions (countries) that currently benefit from structural and cohesion funds to give them up in favour of less developed regions in the CEECs. With the fifth enlargement, 67 regions, all the regions of the CEECs except Bratislava, Ljubljana and Prague, will be entitled to structural funds, while at least 15 regions (23 after Bulgaria's and Romania's accession) in Greece, Italy, Spain, France and East Germany will lose the benefit of these funds. The idea of re-nationalising regional development policies is thus pushed forward by the experts of the main net contributors to the EU budget – Germany, the Netherlands and the U.K.

When it comes to CAP, the Berlin council did not envisage the full extension of direct financial aid to the accession countries' agriculture. It was admitted however, in 2002, that accession countries could not be excluded indefinitely from the agricultural *acquis* and should benefit from it some time in the future (Duboz, 2002). Otherwise, the single European market would be meaningless in the agricultural sector. Finally, the European Commission made the decision that CEEC peasants will not receive 100% of the financial subsidies they are entitled to from 2004, the excuse being that these subsidies would slowdown and freeze the modernisation and restructuring of existing farms in CEECs. A ten year transition period was introduced before the full benefit of CAP by CEEC agriculture: CEEC peasants will get only 25% of the entitled payments in 2004, 30% in 2005, 35% in 2006, and eventually 100% in 2013. Thus, a second transition stage is already planned in agriculture.

In some other common policy areas, the CEECs will also be affected by a second transition period. Negotiations about the free movement of labour resulted in a

[4] It was of course before Mikhaïl Khodorkovski's imprisonment.

[5] Financial Action Task Force on Money Laundering – a group for financial action against money laundering under the aegis of the OECD.

seven year transitory period, divided into three stages. During the first two years after accession incumbent members are allowed to maintain all existing restrictions against inward worker migration from CEECs. The EU15 will keep the option of prolonging national controls over labour migration for another three years. But even after five years it would still be possible to restrict labour inflows from the CEECs if they are seriously destabilising the EU labour market for two more years. Thus Germany and Austria, where the prospect is an inflow of CEEC manpower in the range of 2.5 million and 470,000 migrant workers respectively—only 100,000 in France—it is expected that the transition period for labour migration will last up to 2011. On the other hand, the CEECs will be entitled to limited transitory periods for adjusting to European norms and establishing an efficient regulation of their banking sector. Some CEECs, namely Poland, have negotiated a seven year transition period before EU investors (from foreign countries) will be allowed to buy agricultural land. All in all, the CEEC8 will enter in May 2004 a second transition period which is likely to last until 2011-2013 (even later in the case of Bulgaria and Romania) depending on the EU policy concerned.

This additional transition period notwithstanding, the stress is now on creating a big common market, first of 25 countries (including Cyprus and Malta) and then of 27 countries (with Bulgaria and Romania). The fifth enlargement should provide this market with a strong growth potential due to the 19% increase in its geographical size and the 15% increase in its population. The emergence of a stronger European economic might based on a 375 (by then over 400) million consumers is a real fact as well as a mighty symbol. The EU-CEEC international trade has already materialised in very substantial gains before the fifth enlargement as a result of the association agreements (Andreff, 2001b). For the CEECs, the share of the EU in their overall foreign trade has grown from roughly 40% in 1990 to 70% now, and simulations with gravity models have shown that it may rise to up to 80%. Nevertheless, transition is not over – and will not be over by 2004 – as regards the CEEC trade reorientation towards EU countries. Even if slower, the commercial integration of CEECs within EU will be a continuing process in the coming years.

The Stability Pact launched in 1999 with the five Balkan countries is to be followed by the negotiation of stabilisation and association agreements (already signed with Croatia and Macedonia) which promise a free trade area with the EU within six years and refer to the potential candidacy for EU membership. The application of Croatia, and its hope to join Bulgaria and Romania in the 2007 wave, should not obscure the fact that for most Balkan countries EU membership is a long term prospect that will not materialise before the second decade of the 21rst century, since the real starting point of transition has been delayed after 1991 due to the Balkan wars. The transition process will still last some time in this area. The partnership agreements signed with the EU by the CIS12, except Tajikistan, do not even refer to potential candidacy so that, if EU membership is taken as the benchmark for the end of transition, CIS countries are stuck in transition for ever, or at least beyond any foreseeable future. This demonstrates the fallacy of the discussed criterion. Joining EU only proves that the CEECs have progressed on their transition path and have come closer politically and economically to incumbent members than any other PET, but it does not say whether a second stage of transition will be needed – and for how long it may last.

3. Real and nominal economic convergence: a second stage of catching up

When it comes to economic convergence between the CEECs and EU incumbent members, the criterion for assessing the end of transition switches to macroeconomic variables and eventually the level of economic development in PETs comes to the fore. We return to the above-mentioned Copenhagen criteria and to the convergence of real macroeconomic variables, and to the Maastricht criteria – now the stability pact[6] criteria – of nominal convergence (Andreff, 1999a). Even though the latter are not EU accession criteria, but only preconditions for joining the euro, they have constantly been referred to during the accession negotiations. Moreover, once they are EU members the CEECs have to apply those macroeconomic policy measures that enable them to stick to the EMS II, and the result will be some sort of nominal convergence. All the more so if a country intends, after two years in the EMS II, to join the euro.

Table 1: Nominal convergence between accession countries and the European Union

Country	Inflation rate			Long term interest rate			Fiscal deficit/GDP			Public debt/GDP		
	1993	2000	2001	1993	2000	2001	1993	2000	2001	1993	2000	2001
Bulgaria	56.0	10.3	7.4	63.0	11.5	11.1	15.7	1.1	1.5	111.0	94.1	n.a.
Czech Rep.	20.8	3.9	4.7	16.5	7.2	7.1	(-1.4)b	3.0	1.9	29.0	15.1	16.9
Estonia	89.8	4.0	5.7	17.2	7.4	7.8	1.1	(-0.2)b	(-2.6) b	n.a.	3.1	2.7
Hungary	22.5	9.8	9.2	28.5	12.6	12.1	6.3	3.5	3.0	65.0	55.0	57.6
Latvia	109.0	2.7	2.5	27.0	11.9	11.2	(-0.6) b	2.7	1.4	n.a.	13.2	15.0
Lithuania	411.0	1.0	1.2	108.0	12.1	9.6	4.9	1.3	0.4	n.a.	23.3	23.0
Poland	35.3	10.1	5.5	48.5	20.0	18.4	4.0	(-0.3) b	4.4	54.0	39.6	40.4
Romania	256.0	45.7	34.5	70.0	47.3	36.1	0.1	4.0	3.1	16.0	34.7	31.6
Slovakia	23.2	12.0	7.3	16.5	14.9	11.2	7.1	3.0	3.2	29.0	30.3	42.2
Slovenia	32.3	10.9	9.4	49.6	15.8	15.1	0.3	1.3	1.1	n.a.	25.7	27.4
Mean	105.6	11.0	8.7	44.5	16.1	14.0	3.8	2.0	1.8	50.7	33.4	28.5
Standard dev.	122.4	12.8	9.4	28.2	11.6	8.5	4.9	1.4	1.8	31.6	25.9	16.6
Maastrichta	3.2	3.1	3.4	9.1	9.4	8.8	3.0	3.0	3.0	60.0	60.0	60.0

a Value of the Maastricht criterion b Minus means here a fiscal surplus

Sources: EBRD and World Bank.

Comparing the fulfilment of nominal convergence criteria by the CEECs in 2000-2001 to1993 (Table 1), it is crystal clear that they have moved forward toward the inflation rates prevailing in the EU. In 1993, no CEEC was close to the Maastricht target (3.2%); in 2000-2001, both Latvia and Lithuania have satisfied the stability pact inflation criterion and the Czech Republic and Estonia were not far from fulfilling it.

[6] Although the stability pact seems to be jeopardized by a fiscal deficit over 3% of GDP in 2003, and probably in 2004, in France and Germany, both countries have accepted to come back in the tracks in 2005 after budget stabilisation measures. For example, in France, all the civil servants wages are frozen in 2003, and a wage cap (a 0.5% limited increase) is planned in the public and governmental sector for 2004.

The same conclusion applies for long term interest rates, the Czech Republic and Estonia being below the target while Latvia, Lithuania and Hungary were not very far. In 2000, only Romania had too high a fiscal deficit and in 2001 – only Poland. Except for Bulgaria, all the accession countries comply with the public debt criterion. Half the CEEC10 currencies are stabilised within fluctuation bands that are narrower than or equal to those defining the EMS II (Table 2). In several CEECs, the exchange rate regime has evolved toward more flexibility in recent years, even though in countries with a floating exchange rate central bank interventions are aimed at stabilising the domestic currency against a targeted hard currency.

Thus, the CEECs have markedly converged in nominal terms towards EU countries and the Maastricht criteria. Does it mean that most of them will be ready to join the EMS II soon after the fifth EU enlargement? Does it mean that transition is over? For sure, one aspect of it, the stabilisation of nominal variables has nearly been achieved. However, on average, CEEC inflation rates and long term interest rates still remain too high. Moreover, it is not obvious that it would be worth the CEECs to hurry up to join the EMS II and then the euro. In those CEECs with a free or managed floating exchange rate, sticking to a fluctuation band or to the euro may be destabilising while in CEECs with a fixed exchange rate the strict fulfilment of nominal convergence criteria implies a lasting austerity policy before entering the euro, which may be followed by a devastating relaxation of this policy once inside the euro (Aglietta *et al.*, 2003). Joining the euro too swiftly is likely to deepen the CEECs trade deficit (Doisy & Hervé, 2003) which, beyond some threshold, will jeopardize the requirements of sticking to exchange rate stability. Thus, if belonging to the euro is the deadline for the end of transition, it will require a number of years for CEECs to reach it (not to speak of the current EU members that are opting out: are they not fully-fledged market economies?). It seems sensible to give up nominal convergence as a yardstick by which to measure how close the CEECs are to the end of transition.

Table 2: Table 2 – The exchange rate regimes in Central and Eastern Europe

Currency	Since	Exchange rate regime	Target currencies	Fluctuation band
Bulgarian lev	01.01.1999	Currency board	Euro	0%
Czech crown	27.05.1997	Managed floating rate	Euro	
Estonian crown	01.01.1999	Currency board	Euro	3%
Hungarian forint	01.10.2001	Crawling band	Euro	15%
Latvian lats	02. 1994	Fixed anchor	SDR	1%
Lithuanian litas	01.02.2002	Currency board	Euro	0%
Polish zloty	01.04.2000	Managed floating rate	Euro	
Romanian leu	08.1992	Managed floating rate		
Slovak crown	02.10.1998	Floating rate	Euro	
Slovene tolar	01.1992	Managed floating rate	Euro	

Source: EBRD

If we accept nevertheless that the CEEC10's nominal convergence would soon be completed, then we are left with the problem of Balkan and CIS countries. In 2001, for instance, their average inflation rate was in the range of 16-17%, a level reached by the CEEC8 as early as 1995. Again, we have to conclude that a second transition stage would be necessary now in two-thirds of the PETs, to reduce inflation to the EU rates.

Besides, nominal convergence is not enough if it is not complemented by real convergence.

Converging nominal variables are not independent of the real macroeconomic variables. Nominal convergence pertains to prices, including interest rates and the rate of exchange, but the latter variables do depend to some extent on the momentum of real variables – and *vice versa*. For example, the CEECs lasting trade deficit, regardless of the exchange rate regime, reflects a structural weakness of domestic savings as compared to the level of investment required by the real convergence (the gap has been filled by foreign direct investment so far). The relative weakness of CEECs currencies also results from a missing real convergence, similar to the one that was observed in the southern EU countries several years ago.

Table 3: Real convergence between the CEECs and EU countries: growth and unemployment

	1992	1994	1996	1998	2000
CEEC10 GDP rate of growth					
mean	(-11.5)	2.7	2.6	2.7	4.2
standard deviation	12.2	2.2	4.7	3.4	1.6
EU15 GDP rate of growth					
mean	1.1	3.0	2.6	3.7	4.3
standard deviation	1.9	1.5	1.6	1.6	2.0
CEEC10 unemployment rate					
mean	8.1	9.9	9.2	10.1	11.9
standard deviation	5.4	4.5	3.7	3.1	3.8
EU15 unemployment rate					
mean	8.5	10.4	9.9	8.5	6.9
standard deviation	4.3	5.1	4.5	4.0	3.4

Calculated in Andreff (2003b)

Table 3 shows that, after the 1993 growth recovery in the CEECs, their average growth rate has converged towards the EU average, except during the 1998 Russian financial crisis. The convergence of unemployment until 1997 is even more striking; afterwards, unemployment in the CEECs starts to diverge upwards from the EU unemployment path. The standard deviation gives an idea of the σ-convergence. In the growth recovery period, the dispersion between the CEECs growth rates has decreased and, compared to the mean value, the dispersion of unemployment rates is very narrow. Therefore, effective signs of σ-convergence within the CEEC10 and between them and EU average are noticeable (it is even confirmed with a larger number of real variables in Andreff, 1999 & 2003b). Is it good news as regards to the end of transition? Not really. Let us put it this way: if the growth rate is nearly the same, with a narrow dispersion around averages, in a sample of developed countries (EU) and a sample of less developed countries (CEECs), this means that there is no significant catching up of the former by the latter. Then, if the end of post-socialist transition is gauged by the gap in the level of economic development, this end is not to be expected before several decades.

A sound evaluation of real convergence also requires a test of β-convergence. In a previous work (Andreff, 2003b), the calculation of β-convergence within the CEEC10 sample has exhibited a swifter speed of real convergence (nearly 3%) than in EU

countries (2%). A recent more sophisticated econometric analysis (Tykhonenko, 2003) invalidates the above-mentioned implicit assumption of an absolute β-convergence between CEECs and EU countries and verifies a conditional convergence in which the variables determining the trend of convergence are domestic credit to the private sector, the ratio of foreign trade to GDP, the ratio of export to GDP, civil rights and political liberty, and the absence of war. Moreover, the same work identifies convergence clubs with an extremely interesting outcome: the CEEC8 are in the same club with Greece, Portugal, Spain, Belarus, Croatia and Russia, while another convergence club gathers the twelve remaining (more developed) EU countries, and a third club encompasses the fourteen remaining Balkan and CIS countries (including Bulgaria and Romania). The problem is that the growth paths are diverging from one convergence club to the other, basically due to initial conditions at the beginning of transition. Thus, it seems that the length of the transition period heavily depends on where a PET comes from, and its end cannot be expected within a decade for most Balkan and CIS countries.

Table 4: The development gap between the CEECs and EU countries: GDP per capita, $PPP

Country	1990	1992	1995	1997	1999	2001	Country[b]	2000
Greece	11,967	12,368	13,415	14,382	15,427	17,482	Armenia	614
Portugal	11,176	12420	13,812	15,103	16,341	17,571	Azerbaijan	653
Spain	12,848	14,047	15,463	16,623	18340	20,374	Belarus	1,274
Bulgaria	5,207	4,703	5,822	4,862	5,196	6,179	Croatia	4,206
Czech Rep.	12,357	10,801	12530	13,266	13,258	14,884	Georgia	562
Estonia	7,934	6,321	6,541	8,087	8,631	10380	Kazakhstan	1,231
Hungary	9,517	8,578	9,638	10,221	11,394	12,941	Kyrgyz Rep.	289
Latvia	7,794	6,575	5,047	5,793	6,417	7,759	Macedonia	1,792
Lithuania	9,059	6,575	5620	6,571	6,849	7,764	Moldova	398
Poland	5,675	5,508	6,824	7,701	8,514	9,326	Russia	1,784
Romania	6,219	5,395	6,569	6,512	6,298	7,036	Serbia-Mont.	942
Slovakia	9,029	7,644	8,703	9,902	10,732	11,739	Tajikistan	160
Slovenia	11,345	11,145	13,254	14,586	16,216	18,233	Turkmenistan	473
							Ukraine	634
							Uzbekistan	264

a in 1991, b current dollars

Source: EBRD

Even the most developed CEECs have to go through a second stage of real convergence if the target is to reach 90% of the EU average GDP per capita, the threshold beyond which a member country is no longer considered a poor country and is no longer entitled to social cohesion funds. Except Slovenia, no CEEC seems likely to be able to attain this threshold within a decade, and it might be no sooner than 2040 in the case of Bulgaria and Romania. Thus in terms of catching-up, the end of transition is even further than when other yardsticks are used. Regarding some CIS countries, catching up would probably need a century or so. Not surprisingly, it takes decades for developing countries to close the gap with developed countries, as the experience of emerging Asian and Latin American countries exemplifies it. But it may be that a criterion deeply rooted in development economics is not the most suitable gauge for fixing the end of a systemic transition. There were more and less developed economies within the former socialist bloc until 1989, and there are still developed, underdeveloped and impoverished countries in the capitalist system.

Eventually the convergence of CEECs unemployment rates towards the EU average gives some ground to the assumption according to which converging from a centrally planned to a market system does not only trigger favourable or desirable economic trends; some of which can be assumed into a negative convergence or congruence hypothesis (Andreff, 1992). The CEECs, having established a more liberal labour market than in the EU countries, and facing the heavy task of restructuring the whole economy, their unemployment rate has skyrocketed above the EU average in recent years. It is over 7% in all the CEEC10 and below 10% only in Hungary and the Baltic states. As a consequence, with the fifth enlargement the EU25 will gain overnight more than 5 million additional unemployed. It is a major cause of the very cautious migration policy of the incumbent members and of their imposition of a seven year transition period. In addition, roughly another 5 million unemployed are likely to move through the new EU borders from Balkan and CIS countries. New visa regimes aim at closing the door to migrant workers from the South and the East of the enlarged Europe and, by the same token, postpone the end of transition as far as employment is concerned (a new 'wall' separating the EU labour market from its southern and eastern neighbouring markets).

4. A second stage of institution building: the case of the CIS and the Balkans

The main benefit for accession countries is qualitative, in that EU accession is transferring to them a new set of institutions. The great bulk of it is contained in the *acquis communautaire* which must not only be legally implemented but also enforced in the CEEC8 and then the CEEC2. Once the *acquis* is comprehensively enacted and enforced in an accession country, the latter will have more than 75% of enterprise assets in private ownership, no state ownership of small enterprises and a free land market. Furthermore, effective corporate control exercised through domestic financial institutions and markets, comprehensive price liberalisation and efficiency-enhancing regulation of utility pricing, effective enforcement of competition policy securing unrestricted entry into most markets. In international relations, the removal of most tariff barriers and WTO membership, and in the financial market, a full convergence of banking laws and regulations with BIS standards and the provision of a full set of competitive banking services, a full convergence of securities laws and regulations with IOSCO standards and a fully developed non-bank intermediation. In terms of the EBRD transition indicators, the mark of "4+" for all indicators is required – no CEEC has so far more than two 4+ marks. Thus, if we refer to the yardstick of institution building, transition is clearly not complete today and will not be completed by May 2004 in the CEECs. Again, a second stage of transition is required.

In concluding the 31 chapters of accession negotiations, the European Commission has simply notified the incumbent EU members that their citizens and enterprises will meet in the CEECs an institutional environment of a market economy which is going to become increasingly comparable to the one they are accustomed to meet in their home countries. Human rights, civil rights, free mobility, free circulation of information and public security are legally more or less guaranteed today in the CEECs, in addition to the *acquis communautaire*. The devil is in the details of effective enforcement which can and must improve after accession. Bankruptcy laws must be more systematically enforced, the enforcement of corporate laws has to be improved. The

protection of minority shareholders is still quite far from effective, and corporate governance is still weak in a number of privatised enterprises (see below: managerial entrenchment).

The issues of the enforcement of competition policy and state financial subsidies have spoiled the accession negotiations with most CEECs, e.g., in the steel industry with Poland, the car industry with Hungary and the Czech Republic, and in various industries with Slovakia. Whatever the CEECs' efforts until May 2004 may be, the enforcement of competition policy will remain weak as long as widespread state subsidies are prevalent and collusion still exists between the state and firms, even privatised ones, and while some privatisation outcomes have not yet been finalised. The European Commission routinely points at corruption, economic crime, courts that lack independence and the required means to settle commercial cases and protect property rights (even though the situation is considerably better in this respect in the CEECs compared with Balkan and CIS countries). The fight against corruption, money laundering and economic crime in accession countries will be on the agenda for years after May 2004.[7] Perhaps it will be kept on the agenda even beyond the end of transition, however the latter is defined. A second stage of transition in CEECs thus will be one of enforcing more systematically the whole institutional setup after having first legally implemented the *acquis communautaire*.

In other PETs, in particular in the CIS12, the systemic reforms have been flawed by an insufficient and ineffective institutional change. In Belarus, Kyrgyzstan and Moldova the pace of reforms has slowed down after the mid-1990s. Belarus has preserved most features of a centrally planned economy while progress on the transition path has been very slow in Uzbekistan and quite negligible in Turkmenistan. Tajikistan has started reforming in earnest only in 1997. In such countries, it is not the question of a second stage in the transformation process which is open; the real concern is still the first stage of transition. Privatisation programmes, even in Russia, have primarily proceeded with mass privatisation and management-employee buy-outs (MEBOs) which have often transferred assets to incumbent managers (Andreff, 2004). Enterprises in the CIS are now mostly owned by a combination of dominant management insiders and dispersed employee-owners and outsiders. In many CIS countries, residual state property is significant (Andreff, 2000). This corporate governance structure, resulting from mass privatisation and MEBOs did not by itself bring about firm restructuring (Andreff, 2003a). One decade after launching the privatisation drive, CIS countries realise that supporting institutional reforms are necessary in order to yield positive effects from privatisation. Ownership matters, but even more so do institutions.

After one decade of transition, most CIS countries are still without genuinely comprehensive price and trade liberalisation. Among the CIS12, only Armenia, Georgia, Kyrgyzstan and Moldova have so far joined the WTO. In spite of the new fiscal codes introduced in most CIS countries, the efficiency of tax collection remains rather low by international standards. As a result, governments are unable to collect enough taxes to finance a market-supporting legal system or to guarantee effective judicial enforcement of legal rules. Thus, there are a greater number of obstacles to the institution of the rule of law in the CIS12 than in the CEEC10. The winners in the early phases of transition

[7] Jean-Claude Trichet (2002) was recently calling the acceding governments to seriously fight against money laundering using money transfers abroad, and against intertwined economic crime and terrorism (Mr. Trichet has since been appointed to head of the European Central Bank).

successfully attempt to block further institutional reforms that could threaten their newly acquired vested interests. Commercial law is not sufficiently enforced due to a lack of adequate administrative and judicial support when it is not due to outright corruption. Competition policy is not yet able to guard against the abuse and misuse of market power. Enforcement of bankruptcy laws remains problematic and does not lead to firm exit, while barriers to entry still consist of bureaucratic hurdles, unpredictable regulations, incumbent managerial positions and political connections. These provide strong incentives for small and medium enterprises to operate in the informal economy.

Many CIS countries are trapped in situations of partial reform, whose progress is blocked by the winners of the initial stages. Therefore a second stage of institutional transition is badly needed in CIS countries, and to a lesser extent in the Balkans.

5. A theoretically delineated second stage of the transition process: the disappearance of transition surprises

The perspective of EU accession since 1993 has exacerbated a deep divergence between the CEEC8 on the one hand, the CIS12 on the other hand with the Balkan countries in between. Given their different initial conditions, the unexpected and undesirable developments – the so-called transition surprises – have been much fewer and less extreme in the CEECs than in CIS countries. These differences have served to support the argument that transition will end up with the fifth EU enlargement, but of course only in the CEECs. However, EU accession by itself does not guarantee that transition surprises will disappear overnight. Moreover, in Balkan and CIS countries transition surprises, which are caused by the specific processes of the systemic transformation, are likely to last longer. Now, I would support the view that the end of the transition process must be associated with the comprehensive disappearance of transition surprises in post-communist economic transformation (Andreff, 2001a & 2003b). Let me put it this way: transformation will reach its end when the economic processes that are specific to post-communist transition have entirely disappeared.

The question now is: what are these specific economic processes? The answer, in a nutshell, consists in looking for economic facts and analyses that cannot be resorted to when observing developed and developing market economies in which no communist regime and no command (and centrally planned) economy have ever prevailed before. Such a statement is of course open to a wide debate. However, the emergence of an economic process which is not expected by the current mainstream economic analysis of transition to a market economy has a very high probability to be specific. It is a 'surprise' after the collapse of the communist regime and the command economy, and after the break-up of CMEA and the USSR (Ellman 1997; Ledeneva & Seabright 2000). A less demanding version of the criterion is that an economic consequence of the transition policy is not expected to reach the wide scope and significance actually observed in the statistics. For instance, recession and unemployment were not entirely unexpected, but output collapse and mass unemployment were not forecasted to be as pronounced. If accepted as relevant, the suggested analysis will fix the end of transition at the moment when transformational recession, transitional unemployment, barterisation, a flourishing informal economy and managerial entrenchment have ended. No one of the PETs is on the brink of simultaneously getting rid of all these five transitional economic phenomena.

The five stylised economic phenomena specific to the transition period, and their associated concepts, have not yet been offered a definitely accepted and uncontroversial economic analysis. In fact, various economic explanations of transformational recession compete, depending on the economic paradigm (mainstream, post-Keynesian, evolutionist, etc.) one has in mind. The same applies to transitional unemployment, barterisation, the informal economy and managerial entrenchment. Economists still proceed by trial and error, and econometricians do test alternative hypotheses without being able to determine the most sensible and relevant independent variables explaining the five phenomena observed in all PETs. Some room is left for intuitive economic analysis of the five above-listed processes, and it is exactly why transition economics remains interesting fourteen years after the start of transformation.

The concept of *transformational recession* has been coined by Kornai (1994). The corresponding stylised fact has been referred to as an output fall or production collapse. After four years of transition, average CEEC GDP declined to 79% of its 1989 level. Output fall has been even more marked in the Baltic states and lasted five years, and in CIS countries nine years. Output fall has caught mainstream economic analysis of transition on the wrong foot. As stated by Blanchard (1997), the former economic system was characterised by a myriad of imbalances so that one should have to expect that phasing them out would increase, not decrease, production. In other words, output should have skyrocketed instead of collapsing (Stiglitz, 1999). Today, in all PETs, transformational recession is over even though we do not have a single unified analysis of it at hands.

The first assumption blames the output fall to the collapse of *aggregated demand* (Laski & Badhuri, 1997). Shock therapy is assessed as 'guilty'. In such a post-Keynesian analysis, a policy that reduces money supply will not only lower the newly-liberalised prices, but will also affect quantities downwards. The second hypothesis puts the cause of output fall on the *supply side*. Facing a dramatic shift in the structure of aggregated demand, the market has not met its match due to supply side rigidities, resource immobility and the like (Gomulka, 2000), inherited from the past. Moreover, the restrictive monetary policy embedded in shock therapy has also affected the supply side: the credit crunch has dried up financial resources that enterprises need for input purchases and, thus, has hindered production. Interest rates have skyrocketed preventing enterprises from borrowing – and state banks from lending – in order to finance input purchases (Calvo & Coricelli, 1993).

A third approach analyses transformational recession as a trend inherent in the *systemic change* underway in PETs and as its unavoidable consequence during the transition period. Initial conditions, *i.e.* the economic crisis in the last years of the command economy and all the legacies of inefficient and distorted economic structures, are often put forward as major causes of recession, once the economy has been opened to the wind of market competition (Balcerowicz, 1995). The very fact that transformational recession has spread over all PETs backs the argument of a structural or 'systemic' recession. Thus, output fall can be explained as a rational process and can be seen as desirable and useful insofar as it is supposed to facilitate an efficiency-improving close-down of enterprises and industries producing a negative value added (Hughes & Hare, 1991), which improves economic efficiency. Kornai (1994) contends that a hardening budget constraint has compelled the enterprises to adjust their production downwards. He further argues that initial reforms of the transition period have destroyed former institutions and planned coordination mechanisms without

setting up new institutions that fit the market; a sort of vacuum in economic coordination results in a recession. Blanchard (1997) explains that disorganisation of backward and forward linkages along the chain of planned input supplies has not paved the way for new market relationships. In the command economy each enterprise had only a few suppliers and customers. A hold-up problem arises from such a situation (Blanchard and Kremer 1997) that generates an overall lack of confidence in an uncertain or 'no future' economic environment in which no one (after state desertion) and nothing can impede the development of opportunistic behaviour. For fear of being held up by the downstream customer, each producer of intermediary products will stop its production and, by the same token, will break-up the chain of inter-industry relationships. Production must fall due to input shortages.

Using a computable general equilibrium model Roberts (1997) concludes: there is no consensus as to a definite theoretical explanation of output fall, and empirical evidence does not help to discriminate decisively among available explanations. This is exactly the state of art that overwhelms what we define as a concept specific to the transition period. The only cautious and sensible conclusion to date is that many factors have combined their economic effects to determine a transformational recession. However, in 2001, transformational recession has reached its end in all PETs, the last recession year being 1999 in Croatia, Estonia, Lithuania, Moldova, Romania, Serbia-Montenegro and the Ukraine. In this respect, the typical recession triggered by transition is over now.

A strong decrease in employment has accompanied the early years of transition with a time lag compared to the sequence of output fall. The rise of unemployment was less than proportional to the latter, meaning a decline in labour productivity. The stylised fact to be explained is a sort of inertial behaviour of unemployment rate with respect to output fall, laying some grounds for the assumption of a structural or transitional component of unemployment, not linked to the output level (Burda, 1994). However, a high unemployment rate still prevailed after economic recovery, and large differences showed up in unemployment rates among the PETs, both pointing at a second stylised fact: unemployment generated by enterprise restructuring has not yet been 'mopped up' by new economic activities, namely in the newly developing private sector. This empirical phenomenon has been called *transitional unemployment* by Boeri (1994).

The first analysis basically considers unemployment as a transition between a former job (in the state sector) and a new job (in the private sector). In the Aghion-Blanchard (1994) model, the growth of private employment is an increasing function of the unemployment rate. Therefore, the expansion of the private sector 'mops up' job losses due to state enterprises restructuring. Aghion and Blanchard demonstrate the existence of an optimal unemployment rate (and an optimal speed of transition) that is reached when the number of job losses due to restructuring is equal to the number of workers hired in the new private sector. However, Blanchard (1997) believes that negative initial shocks have led to excessive unemployment rates that slow down restructuring and the pace of transition.

The empirical evidence of an extremely low outflow from unemployment, as well as the very long average duration of unemployment in PETs have reduced the attractiveness of this model of optimal labour reallocation. This is the starting point of an alternative analysis by Boeri (1994), in which transitional unemployment is characterised as a 'stagnant pool': once in the pool, the unemployed have a low

probability of leaving it. The labour market adjustment is not providing a transition from a (former) job to unemployment and then back from unemployment to a new job. On the other hand, the unemployment inflow is rather slow reflecting a slower pace of restructuring than the one desired by reformers, but unemployment outflow is even slower. Such a low turnover in the unemployment stagnant pool is at odds with Aghion-Blanchard assumptions. Available data shows that employment growth in the private sector does not basically rely on hiring unemployed workers on the market. It consists instead in direct job transfers from the state sector to the private sector and in hiring new entrants in the labour force. The unemployed, being less skilled on average, are not (or rarely) re-employed. Boeri (2000) divides workers who have left state enterprises into those who have voluntarily left and those who have been fired: the former are more numerous than the latter in CEECs. This is another fact that does not agree with the assumptions of the Aghion-Blanchard model that ascribes job losses primarily to restructuring. So far no PET has been able to get rid of transitional unemployment. In the CEECs, the unemployment rate has climbed above the EU average in recent years and may increase again as a result of EU accession that threatens the less competitive CEEC firms. In Balkan countries, the unemployment rate is still skyrocketing over 20% while in the CIS12, in spite of delayed restructuring, it has already reached three-quarters of the EU level on average. The end of transitional unemployment cannot be expected in the foreseeable future.

Barterisation is the most paradoxical phenomenon in the process of transformation of a command economy into a fully-fledged market economy. A variety of non monetary means of settlement have developed in Russia and the CIS: inter-enterprise credits, payment arrears to suppliers, workers and fiscal authorities (or to banks in charge of collecting taxes), and then payment in goods or services (barter *stricto sensu*), debt settlement with money surrogates such as *prostoi veksels* (promissory notes) and *peredvodnoi veksels* (bills of exchange) issued by enterprises, debt offsets in goods, and wage, pension and tax payments in goods. All of them are used in an *ad hoc*, often illegal, sometimes criminal, bilateral trade. Following the current literature, we call 'barter' (*lato sensu*) the whole variety of these non monetary payments which have expanded up to 70% of GDP in Russia and 80% in Ukraine in 1998. Such a phenomenon is quite specific to post-communist transition in the CIS and, to a lesser extent, in CEECs.

Explanations of barterisation are many-fold, revealing a still unclear and non-stabilised economic analysis of the phenomenon (Vincentz, 2000). Emerging hypotheses are a myriad, so that we cannot screen all of them in depth. *Hyperinflation* is one of the first factors which have been suggested as a cause of demonetisation in PETs. However, barter had not reached its peak in the CIS in 1992-1993 when inflation rates were over 1,000%. They peaked after 1995, when inflation rates were at a two-digit level and decreasing (Ledeneva & Seabright, 2000). Moreover, in other regions of the world economy, such as Latin America in the seventies, long hyperinflation waves have not triggered barterisation to the same extent as in PETs. A second argument links barterisation to the *credit crunch* generated by a too restrictive monetary policy. In tightly hardening the liquidity constraint of Russian (CIS) enterprises, credit crunch compelled them not to pay and then to resort to money surrogates, and finally to payments in goods (Woodruff, 1999). A third approach of barterisation states that it is transition-specific in countries where *enterprise budget constraints* have not been hardened enough, or not at all (Rostowski 1993). Non payment and barter are the tools through which enterprise managers use to carry on with the soft budget constraint that has prevailed in

the command economy and delay restructuring (Commander 2000). This argument traces back to the hypothesis of managerial entrenchment (below). Survival strategies of enterprises and managers (Andreff 1996) are facilitated by maintaining the same supply network within which it is easy to substitute barter to monetary transactions. Thus, the very existence of non restructured and non profitable firms is, *per se*, a source of barterisation (Poser 1998). The failure of most privatisation programmes to provide efficient corporate governance structures helps to maintain quantitative objectives instead of promoting profit maximizing within privatised firms.

The fourth well-known analysis of barterisation may be titled the hypothesis of a *virtual economy* in PETs, in particular in Russia and the CIS. Here barter is a way of hiding the 'true' (and very low) market value of the output produced in Russia – because a part of the economy is simply virtual, and of distorting the real value of profits in order to avoid taxation (Gaddy & Ickes, 1998). The virtual economy is based on illusion, and the result is that the Russian economy claims to be bigger than it actually is, and it spends much more than it can really afford. The very large industrial sector seems to produce some value whereas, in fact, it is value-destroying. But this reality is concealed by an arbitrary price system, namely barter pricing. The output of the virtual economy is measured with overvalued prices; thus, the Russian GDP is artificially inflated and its annual growth is statistically exaggerated. Since the price depends on the means of payment, enterprises attempt to pay in goods as much as they can, and keep cash for transactions that can only be settled in cash. Barter is more significant in enterprises whose managers resist restructuring. Those enterprises which shed labour and increase labour productivity have a smaller share of barter in their overall sales than those which keep over-manning even when output falls (Berglöf & Vaitilingam, 1999). A fifth hypothesis has its roots in *institutional failures*, primarily linked to nascent banking and tax systems, as the determinants of barterisation. Barter results from non implementation of new accounting rules, and non enforcement of laws regulating debt settlements and bankruptcies; it is also due to absent sanctions for non payment. Indebted firms can openly reveal a profit without paying any tax or debt. In addition, the Russian (CIS) banking system is markedly inefficient, thus costly for clients, and cash payment is forbidden for large transactions in order to prevent capital flight (Poser, 1998). Hence, barter is safer and cheaper. The weaker the state and institutions, the more widespread is barter. Ickes (2000) concludes that non monetary transactions are a sort of institutional trap of transition.

Market imperfection and multiple equilibria are backing a sixth train of thought as regards barterisation. In most PETs monopolistic competition prevails, a legacy of the command economy. A statistically significant relationship between the degree of market power and the share of barter has been found on a wide sample of enterprises in various PETs (Carlin *et al.* 2000). Barter increases enterprise differentiation, thus diminishing competition among enterprises. It creates distinct 'islands' of local monopoly power (Ledeneva & Seabright, 2000). *Inertia in inter-industry and inter-firm relationships* is the cornerstone of a seventh analysis of barterisation. Barter expands through supplier-customer relationships and creates a chain of debts (Marin & Schnitzer, 1999). The purchaser's lack of liquidity gives him/her an opportunity of hold up if he/she threatens not to pay the input supplier, and he/she uses such a threat as a lever to lower prices, thus equilibrating the bargaining power between contracting parties. Equilibrium is reached when the input supplier accepts a lower price, given that his/her only alternatives consist in either insisting to maintain the initial price or involving the violent

entrepreneurship (see below) or mafia into the transaction's problem solving. In fact, barter introduces a second profitable transaction in the form of a payment in goods, the client (purchaser) committing him/herself not to exploit his/her bargaining power and accepting to share the profit with the input supplier. Through barter, the two enterprises lock each other in the transaction but eventually avoid the hold up problem.

A last interpretation of barterisation is to view it as the result of a *predatory co-operation* (Poser, 2000) which can be put in a nutshell as follows. Whilst economic interdependencies force economic agents to cooperate, non monetary transactions are the vehicle for collusion and rent extraction detrimental to third parties. Upstream and downstream firms collude for credit from held up banks. Enterprises and banks collude to show they are safe and viable in order to extract credit from the central bank. Insiders (workers and managers) collude to force the state to bail-out their enterprise. Enterprises collude in overvaluing their output in order to extract a tax credit (and thus they create a virtual economy). Enterprises, central and local governments mimic the behaviour in tune with the IMF conditionality, reduce subsidies and balance their budgets in order to extract credit from international organisations.

Barterisation is probably the best example of a concept (and a reality) specific to the transition period. Some sort of barter is durable and widespread, though unevenly, in all PETs. Barterisation is one of the most striking surprises or unexpected events in the transformation process. We have just seen how numerous are the publications on this topic, and our non exhaustive survey has pointed to no less than seven analytical explanations of barter in PETs. Barter has not disappeared in any of them, although it has significantly declined in CEECs and it has also been on the decline in the CIS12 since the Russian financial crash in 1998. However, a period of time is still needed for barterisation to fade away and for transition to end up after a second stage of 'de-barterisation'.

Another transitional surprise is the growth of the *informal economy*, previously named the underground or shadow economy in the former centrally planned system. The content of this sector's activity has changed with transition, but its size has increased whereas mainstream economics was assuming that legalised market mechanisms would shrink it or even phase it out. Deregulation, the withering away of the State, and the dismantling of the State sector through privatisation were assumed to eliminate the informal economy and to help transform it into a private market economy, once the latter is no longer forbidden. The opposite has happened: the early years of transition exhibit an increasing share of the unofficial economy in GDP (Table 5), alongside progress in privatisation. Only Estonia, Poland, Slovakia and Uzbekistan had a smaller informal economy in 1995 than in 1990. What went wrong is basically due to missing or unenforced institutions.

A full theory of the new informal economy in PETs has not yet been formulated. We can only focus on some specifics of the transition period that relate to the weakness of the institutional framework. In most PETs, laws are so lax that management is readily susceptible to negligence or to conducting corporate affairs for personal profit. There are very few barriers to self-dealing behaviour of managers and sanctions against it are limited to lawsuits by shareholders. However, the latter cannot sue if they lack complete information (which is the usual case with managerial entrenchment, see below) about the financial affairs of the corporation, and even if they can sue, their suit is hindered by the weakness of the judicial system. A clear definition of theft has practically disappeared in PETs while theft is usually the fastest way of

transferring property rights (Mlcoch, 1998). How can one sue thieves in a court under such circumstances?

Table 5: Share of the unofficial economy in transition countries (% of GDP)

Country	1990	1992	1995
Azerbaijan	21.9	39.2	60.6
Belarus	15.4	13.2	19.3
Bulgaria	25.1	25.0	36.2
Czech Republic	6.7	16.9	11.3
Estonia	19.9	25.4	11.8
Georgia	24.9	52.3	62.6
Hungary	28.0	30.6	29.0
Kazakhstan	17.0	24.9	34.3
Latvia	12.8	34.3	35.3
Lithuania	11.3	39.2	21.6
Moldova	18.1	37.3	35.7
Poland	19.6	19.7	15.2
Romania	13.7	18.0	19.1
Russia	14.7	32.8	41.6
Slovakia	7.7	17.6	5.8
Ukraine	16.3	33.6	48.9
Uzbekistan	11.4	11.7	6.5
Mean	16.7	27.7	29.0

Source : EBRD (1997).

As communism was collapsing, existing criminal organisations, dishonest bureaucrats and managers had incentives to pursue profitable schemes, legal, illegal or borderline. For instance, managerial wealth is all too often built up not by efficient company performance or restructuring, but by deliberate and semi-legal capital extraction. Looting privatised enterprises has become one of the preferred managerial exercises, e.g., by asset stripping or tunnelling. Common ways of unofficial asset transfers have been: favourable conditions of sale (lower price, longer payment deadlines) offered to politically suitable buyers for buying-out state-owned enterprises' assets; loans allocated to managers by state-owned banks without any mortgage or guarantees; repayment of shares or loans from the assets of the privatised company; fictitious recapitalisation; concealed appropriation of the company's profit by majority shareholders and/or managers; criminal acts such as deliberate and fraudulent bankruptcy prior to privatisation, embezzlements, bribery, fraud, corruption; and finally operating on informal stock markets. The above list is by no way exhaustive.

Once the institutions of the former regime have been weeded out and the state apparatus has been disorganised, first the government consists of a large number of substantially independent bureaucrats pursuing their own agenda, including bribe taking; second, the government is ineffective in providing basic services (including protection, security, police), courts are ineffective in resolving disputes (transaction costs skyrocket) and agreements are enforced privately (Frye & Shleifer, 1997). Shop-owners and property owners often pay private security agencies to protect them from crime and help them resolve contractual disputes. This informal institution is known as a 'roof' (*krycha*) in Russia, and an 'umbrella' in Poland. Private enforcement of law and order

plays a greater role in Russia than in Poland, since economic crime is more widespread in the former.

Table 6: Average bribery payments as share of gross firm revenues

Country	% of revenues	Country	% of revenues
Albania	4.0	Kyrgyzstan	5.3
Armenia	4.6	Latvia	1.4
Azerbaijan	5.7	Lithuania	2.8
Belarus	1.3	Moldova	4.0
Bulgaria	2.1	Poland	1.6
Croatia	1.1	Romania	3.2
Czech Republic	2.5	Russia	2.8
Estonia	1.6	Slovakia	2.5
Georgia	4.3	Slovenia	1.4
Hungary	1.7	Ukraine	4.4
Kazakhstan	3.1	Uzbekistan	4.4

Source: Hellman *et al.* (2000).

A specific industry or business – known as 'violent entrepreneurship' (Volkov, 1999) according to a classical analysis – has developed to cope with extremely high transaction costs. It is an informal 'transaction costs saving industry' since it takes over the task of private enforcement of contractual rights. This business is partly criminal, partly legal. Its main function is an 'enforcement partnership' (*silovoe partnerstvo*), meaning that an organised group or enterprise, deriving from the skilful use of actual or potential force on a commercial basis, is employed to maintain certain (informal) institutional conditions of business activity, such as security, contract enforcement, dispute settlement and transaction insurance (in the absence of the enforcement of formal market institutions by state authorities). This business grew out of the regularised protection racket (*krycha*) of the late 1980s and early 1990s and enrolled, in CIS countries, former sportsmen, Afghanistan warriors, etc. In the face of frequent non repayment of debts, failure to observe contracts, the spread of swindling and theft, on the one hand, and the shortage of legal protection and justice, on the other hand, businessmen and firms were compelled to pay such mediators 'for solving questions' (*reshat' voprosy*). The questions to be solved were: physical protection, debt recovery, dispute settlement, mediation between private business and state bureaucracy, obtaining permissions and licences, registration, tax exemptions, the use of state organs – fire inspection, sanitary control services, etc. – also to impose damage on competing companies. Afterwards, these groups of violent entrepreneurs have invested their money in firms whose problems they have solved, and sometimes even introduced their representative to the board of directors. For sure, they are outsiders in the ownership structure, probably the least desirable ones. Obviously, the price paid for 'question solving' (about 20-30% of the profit of the client enterprise) reflects high transaction costs in an institutionally unstable economic environment. In addition, all PETs have been affected, by having to bribe government officials (Table 6).

A more critical analysis of the extralegal and criminal economy (Oleinik, 2001) starts from the hypothesis of the predominant importance of rent and profit seeking in the behaviour of those involved in criminal markets, in a context where weak or absent

institutions relax all the ethical bounds to economic activity. The ensuing break up of norms and values, freeing human behaviour from any moral attitude, is a basic incentive to outlaw rent and profit seeking without any restraint. Such a situation favours the unilateral self-enforcement of explicit or implicit contracts by resorting to violent entrepreneurship. This is facilitated by the economic environment of network capitalism that promotes a contracting process outside the emerging legal framework. In PETs, the high rate of criminality spreads from absent alternatives to such a behaviour which eventually casts doubts on the validity of both old vanishing norms and values and newly emerging ones. Since we do not believe that crony network capitalism is the final aim of transition, the latter will not be over as long as PETs remain plagued by a sprawling informal sector with a hyper-active criminal sub-sector. A possibly long and painful second stage of transition has to call a halt to this most hideous face of the transition process.

Among the concepts emerging from the analysis of transition, *managerial entrenchment* is the one which has been less focused on in the literature. Managerial entrenchment is a consequence of non standard methods of privatisation (Bornstein, 1997) and of the weak corporate governance structures they have generated. The focus has been put on the link between privatisation, corporate governance and enterprise restructuring (Andreff, 1999b). What does managerial entrenchment exactly consist of? It refers to the empirical evidence of incumbent managers who continue to manage privatised (and of course public) corporations. We can find such a situation in Western capitalist joint stock companies. What is new with PETs is not only the magnitude of the phenomenon, but the means utilised by incumbent managers to keep their power over corporate and privatised former state-owned enterprises. First, mass privatisation and MEBOs have eventually transferred controlling blocks of shares to incumbent managers. In the whole sample of PETs, two-thirds of all the privatised firms have had their shares transferred to private owners through mass privatisation or MEBOs (Andreff, 1999b). Managers are even more strongly entrenched in still state-owned enterprises and in privatised enterprises with a share of residual state property.

In privatised enterprises in PETs, incumbent managers also unscrupulously utilised all legal and illegal means for guaranteeing the firm's survival and their own entrenchment in management positions (Labaronne, 1998). Managers have retained or hidden relevant information, or introduced bias into it, in order to increase the opportunity cost of monitoring by shareholders. They have not been disciplined by the threat of bankruptcy insofar as bankruptcy laws are scarcely enforced in PETs. They have not been disciplined either by the threat of takeover, merger or acquisition since stock exchanges in PETs are tiny, non transparent and inefficient, reflecting an extremely imperfect competition on capital markets. Moreover, incumbent managers are involved in networks linking managers, bureaucrats, politicians, former *nomenklatura* and former *komsomol* members that make their governance position impregnable. Last but not least, incumbent managers have circumvented the law: one can list more than twenty sorts of violations of the corporate law in Russian privatised enterprises, extending from not convening the shareholder assembly to votes by a show of hands. Managerial entrenchment strategies have been successful: managers remain in power at the head of numerous firms in the CIS, even though the same evidence is less common in CEECs. The swifter the privatisation drive, the more unchanged is managerial governance that accompanied the change of property rights (Brada, 1996). Even if the specificity of managerial entrenchment in privatised enterprises in PETs has been

correctly grasped in the most recent literature, a deeper economic analysis of this concept remains to be elaborated. Managerial entrenchment might well be the most long-lasting specific feature delaying the end of the transition period.

6. Conclusion

Our conclusion is that EU enlargement is not a sufficient yardstick by which the end of transition can be fixed, not even in the CEECs. Convergence criteria are of interest. However, filling the average GDP per capita gap between PETs and the EU will take from fifteen years to at least one century depending on the PET one is looking at. Institution building varies significantly among the PETS in favour of CEECs, but the non accession countries are trapped for a long time in a no man's land between the former system and a market economy with its necessary institutions. With our privileged analysis, transition ends when transformational recession, transitional unemployment, barterisation, the typical informal sector and managerial entrenchment will all have vanished. Transformational recession may be over, but the four other characteristics of transition are not going to fade away without a second stage of transition.

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