Between 1917 and 1950 countries containing one-third of the world’s population seceded from the market economy and launched an experiment in constructing an alternative economic system. First in the former Russian Empire and Mongolia, then, after World War II, in Central and Eastern Europe and the Baltic states, and subsequently in China, northern Korea, and Vietnam (with offshoots and imitators elsewhere), a massive effort was made to centralize control of production and allocate all resources through state planning. This vast experiment transformed the political and the economic map of the world and set the course of much of the twentieth century. Now its failure has set in motion just as radical a transformation, as these same countries change course, seeking to rebuild markets and reintegrate themselves into the world economy.

The Communist Manifesto’s portrayal of the turbulent arrival of capitalism in the nineteenth century seems a curiously apt depiction of today’s transition landscape:

Constant revolutionizing of production, uninterupted disturbance of all social conditions, everlasting uncertainty and agitation... All fixed, fast-frozen relations, with their train of ancient and venerable prejudices, and opinions, are swept away, all new-formed ones become antiquated before they can ossify. All that is solid melts into air....

The legacy of planning
Karl Marx had reasoned that socialism would replace capitalism first in the most industrialized capitalist countries. Indeed, the first part of the twentieth century was a period of considerable social ferment, notably in Europe. But revolutionary socialism took hold in more agrarian states, where economic development and the advancement of industry were concerns as important as equitable distribution. The achievements of the planned system were considerable. They included increased output, industrialization, the provision of basic education, health care, housing, and jobs to entire populations, and a seeming imperviousness to the Great Depression of the 1930s. Incomes were relatively equally distributed, and an extensive, if inefficient, welfare state ensured everyone access to basic goods and services (Table 1). But the system was far less stable than it seemed, for the intrinsic inefficiency of planning was overwhelming. Planners could not get enough information to substitute for that supplied by prices in a market economy. Planning became largely a personalized bargaining process, with connections (blat or guanxi) an important element. This proved bad for industry, worse for agriculture. Also, the suppression of...
individual incentives required in their place an intrusive set of controls. At the outset these may have been based on ideological commitment and a dedicated vanguard party, but they frequently degenerated into cults of personality and abuses of position by nomenklatura elites.

The deep inefficiencies of planning became increasingly evident with time. Heavy industries such as machine building and metallurgy were emphasized, while development of consumer goods lagged. After posting high annual growth rates in the 1950s (averaging 10 percent according to official estimates), the Soviet economy decelerated: growth averaged 7 percent per year in the 1960s, 5 percent in the 1970s, and barely 2 percent in the 1980s, and in 1990 it contracted. This trend occurred despite high investment rates—returns to capital formation began a steady and rapid descent in the mid-1950s (Figure 1). A similar stagnation infected Eastern Europe. As a major oil exporter, the Soviet Union benefited from the price increases of 1973 and 1979, but severe shortages and the deteriorating quality of its manufactured goods relative to those of market economies were clear signs of stagnation (Box 1).

Social indicators began to worsen as well, confirming the troubled state of the system. After World War II health indicators in Russia improved rapidly and began to approach levels in the industrial market economies. In the mid-1960s, however, they began to stagnate, and later

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**Table 1** The starting numbers (percent except where stated otherwise)

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Transition economies</th>
<th>Comparators</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Population and income</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Population, 1989 (millions)</td>
<td>122</td>
<td>149</td>
</tr>
<tr>
<td>GNP per capita, 1990 (1990 dollars)</td>
<td>2,268</td>
<td>4,110</td>
</tr>
<tr>
<td>From World Bank Atlas</td>
<td>4,647</td>
<td>6,440</td>
</tr>
<tr>
<td>Growth rate before transition</td>
<td>1.5</td>
<td>1.9</td>
</tr>
<tr>
<td><strong>Economic structure</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Urban population as share of total population, 1991</td>
<td>61</td>
<td>74</td>
</tr>
<tr>
<td>Investment share of GDP, 1989</td>
<td>34</td>
<td>34</td>
</tr>
<tr>
<td>Industry share of GDP, 1989</td>
<td>51</td>
<td>50</td>
</tr>
<tr>
<td>Energy use (kilograms of oil equivalent per dollar of GDP)</td>
<td>0.81</td>
<td>0.91</td>
</tr>
<tr>
<td><strong>Human resources</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gini coefficient, 1989</td>
<td>26</td>
<td>24</td>
</tr>
<tr>
<td>Life expectancy at birth, 1989 (years)</td>
<td>71</td>
<td>69</td>
</tr>
<tr>
<td>Illiteracy rate, 1991</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td><strong>Monetary and exchange rate indicators</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>M2 as percentage of GDP</td>
<td>53</td>
<td>100</td>
</tr>
<tr>
<td>Black market exchange rate premium, 1989</td>
<td>331</td>
<td>1,828</td>
</tr>
</tbody>
</table>

.. Not available.

Note: All measures for country groups are averages, weighted by population.

a. All data for China are for 1978, and those for Vietnam for 1986, except where specifically noted otherwise (i.e., for GDP growth, energy use, Gini coefficients, and life expectancy).
b. Excluding China and India.
c. Data are for 1991 for NIS and Mongolia.
d. Average annual real GDP growth rate at market prices; data are for 1980–89 for CEE and comparators, 1980–90 for NIS and Mongolia, 1966–78 for China.
e. Gross domestic investment.
f. At PPP using 1992 dollars; data are for 1990 for CEE; 1992 for NIS, Mongolia, and comparators; 1980 for China (staff estimate).

Source: IMF and World Bank data; International Currency Analysis, Inc., data.
By the 1970s, Soviet investment was yielding little or no return.

Figure 1 Investment and rates of return in Soviet industry

![Graph showing investment share of GDP and return on investment over time.](graph.png)

Source: Easterly and Fischer 1995b.

Even to reverse: life expectancy fell by two years between 1966 and 1980. This was in marked contrast to the trend in other industrial countries, which experienced increases of some three to four years over a similar period.

Nor were living standards in China's less thoroughly planned economy immune from stagnation. Overall (total factor) productivity declined from 1955 to 1978 despite, or perhaps because of, very high investment in heavy industry. The famines of the Great Leap Forward (1958–60) and the ten disastrous years of Cultural Revolution left Chinese society exhausted by politics and the Communist Party ready for change. Many regions had already begun to experiment with local reforms. Peasants in particular felt that collectivist agricultural policies were harming productivity and living standards. Their views carried weight because the Party had a strong rural base, so that economic improvement became a more urgent goal. The impetus to reform was different again in Vietnam, struggling to recover from forty years of war, and in Mongolia. Unlike China, both had deep links with the Soviet Union and depended on Soviet subsidies. Both needed to break out of isolation.

In response, most of these economies have rejected all or much of central planning and have embarked on a passage—a transition—toward decentralized market mechanisms underpinned by widespread private ownership. Not all follow the same path. Despite common features, the mass of centrally planned economies was far from monolithic. It was composed of countries with different histories, cultures, and resource endowments. And whereas political change toward multiparty democracy was a prime objective in the post-1989 reforms in Central and Eastern Europe (CEE) and the newly independent states (NIS) of the former Soviet Union, neither China, which initiated economic reforms in 1978, nor Vietnam has experienced a political transition away from governments dominated by the Communist Party. There is thus tremendous variety in the departure points, strategies, and outcomes of transition across countries.

Most of the world's economies, at one time or another, have lifted price controls, opened trade, or privatized state enterprises—with varying degrees of success. But as noted above, transition is different. It is not simply the adoption or modification of a few policies or programs but a passage from one mode of economic organization to a thoroughly different one. The underlying habits and rules of an economic system are often so pervasive and ingrained that they are taken for granted; indeed, the better established they are, the less they are consciously reflected upon. Such institutions as the education system, youth and labor organizations, the organization and supervision of work in firms and on farms, and the availability of information to the public were carefully cultivated to serve the process of bureaucratic allocation and the broader objectives of central planning. Paternalistic and restrictive, these institutions delivered goods and services to meet basic needs while setting severe limits on individ-

Box 1 Falling further behind in world markets

Beginning in the mid-1960s there were unmistakable signs that CEE and the Soviet Union were falling behind the newly industrializing economies in product quality. By 1985 CEE's engineering exports earned less than 30 percent of the average unit value received by all exporters of similar products, and these exports were often twenty years behind in their technology. The quality gap was widest for consumer goods, including electronics, reflecting the scant influence that domestic buyers had on product quality. One study found that by 1990 Soviet cars commanded a mere third of the price of similar Western cars in the Finnish market. As with high energy intensity (Table 1), declining quality reflected the incentives created by the system and its isolation from world markets and foreign direct investment. Even large imports of Western capital goods proved unable to make a major improvement.
ual choice and indoctrinating citizens with antimarket propaganda. Thus, for transition to succeed it must transcend economic engineering, restructure the institutional basis of the social system, and develop civil society—an enormous agenda that will take many years to complete.

The economic challenge of transition is daunting in itself. Planned economies were autarkic: some were bound to each other through the trade links of the Council for Mutual Economic Assistance (CMEA), but none traded extensively with the world at large. Decades of bureaucratic allocation created serious distortions, with some sectors (particularly heavy industry) massively overbuilt and others (light industry and services) severely repressed; perhaps as much as a quarter of the Soviet economy served the military alone. Relative prices diverged greatly from market patterns, and this meant massive explicit or implicit subsidies among sectors. Energy, housing, public transport, and staple foods were extraordinarily cheap, whereas consumer manufactures, if available at all, were often shoddy. Pervasive shortages allowed firms to operate in sellers’ markets and reduced incentives to improve quality. With near-complete state ownership, enterprises lacked the defined property rights that spur work effort and profitmaking in market economies. Firms had little reason to use inputs efficiently and strong incentives to hoard both labor and raw materials. Many firms added negative value; at world prices the costs of their inputs would have exceeded the value of their output. The combination of dominant heavy industry, low energy prices, and wasteful use of inputs caused energy intensity to rise to several times its level in market economies (Table 1) and had harsh environmental impacts (Box 2).

Transition must therefore unleash a complex process of creation, adaptation, and destruction. Queuing gives way to markets. The shortage economy gives way to an economy of vast choice, with repressed sectors and activities growing rapidly and overbuilt sectors contracting or adjusting. Property rights are formally established and distributed, and large amounts of wealth cease to be state owned and controlled. Old institutions and organizations evolve, or are replaced, requiring new skills and attitudes. And the relationship between citizens and the state changes fundamentally, with greater freedom of choice but also much greater economic risk. True, changes of a similar nature may be needed in many economies around the world. But in the transition economies the magnitudes are exponentially greater. For example, transition economies have privatized more than 30,000 large and medium-size enterprises in five years. In the eleven years between 1980 and 1991 the rest of the world privatized fewer than 7,000. Countries will have completed their transition only when their problems and further reforms

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**Box 2 The environmental legacy of planning**

For thirty years or more the planned economies focused on raising output through quantitative production targets, with little regard for costs and with severely underpriced natural resources and capital. Expansion of traditional heavy industries, often using coal as the main source of energy, was a high priority. Industrial development on such a scale has been disastrous for the environment wherever it has occurred. But in the planned economies the pollution effects were intensified by the underpricing, and therefore overuse, of energy and raw material inputs. The system promoted a mindset that saw new investment as the solution to all industrial problems. The philosophy of implementing many small improvements to increase efficiency and product quality—the heart of good industrial management—was almost unknown. Visitors to industrial plants in transition economies invariably see scope for good housekeeping measures to reduce spills, leaks, and waste—good industrial and environmental performance go hand in hand. Even where plants had pollution controls similar to those in established market economies, poor maintenance and operating practices meant that they rarely operated at more than a fraction of their design efficiency. Environmental improvement is likely to be a long process involving changes in managerial culture and enforcement of regulations.

The environmental liabilities created by haphazard disposal of wastes are mostly unknown but could be large. Some environmental damage may be irreversible: the destruction of the Aral Sea is an ecological disaster that stemmed from the same desire to raise physical output, in this case of cotton. Pollution of the Black Sea is another serious problem. An issue of particular concern in the NIS is contamination from nuclear waste. Unsafe nuclear reactors and the remnants of the destroyed Chernobyl reactor are additional concerns. Discussion of these issues has stalled because of differences over the severity of the risks and the costs of alternative measures. Limited steps have been implemented to improve controls and safety equipment, operating procedures, and maintenance—but nothing more.
come to resemble those of long-established market economies at similar levels of income.

**Taking stock**

This *World Development Report* tries to distill the lessons of transition by analyzing two sets of overarching questions in detail. The first set, the subject of Part One, relates to the initial challenges of transition and how these have been tackled by different countries and might be tackled by others.

- Do differences in transition policies and outcomes reflect different reform strategies, or do they reflect primarily country-specific factors such as history, the level of development, or, just as important, the impact of political changes taking place at the same time?

This question deals with the broadest theme of transition. Given the wide range of reform strategies and outcomes across transition countries, it is natural—and important—to ask what accounts for this divergence. The Report’s core message is that firm and persistent application of good policy yields large benefits. But the Report shows as well that history and geography matter: that what leaders can accomplish, or even try to accomplish, is strongly shaped by the inherited structure of the economy, by administrative or institutional capacity, and by the ways in which the political system mobilizes and channels public opinion. This interplay between choice and circumstance affects not merely the outcomes of the early stages of transition, described in Chapter 1, but also approaches to other dilemmas that have dogged reformers.

- Are strong liberalization and stabilization policies needed up front, or can other reforms progress equally well without them?

Chapter 2 surveys the range of macroeconomic reforms in transition—liberalized prices and trade regimes, hard budgets, and freedom of entry for new businesses—and discusses the interplay of liberalization, stabilization, and growth. The chapter concludes that both extensive liberalization and determined stabilization are needed for improved productivity and growth and that sustaining these policies requires rapid structural change as well as institutional reform.

- Must a market economy instantly be a private one? Or can privatization take a back seat in the early years of reform?

Chapter 3 reviews the process of creating an economy dominated by the private sector. It discusses the role of entry by new private business and, in particular, the privatization of state-owned firms, farms, housing, and commercial real estate. It analyzes why quite different approaches to ownership change and divestiture can be associated with positive economic results, and it draws out the policy fundamentals that should prevail. The lessons of transition to date are that new entry is vital, that privatization is important, and that the way it is done matters. But different countries will launch privatization at different moments. Moreover, once adopted, privatization should be seen as the beginning, not the end, of a process of reorganizing the ownership and incentive structure of firms.

- Must there be a gulf between winners and losers from transition? How can social policies ease the pain of transformation while propelling the process forward?

Transition produces winners—the young, the dynamic, the mobile, the connected—but it also imposes costs on visible and vulnerable groups, and in many countries it has been accompanied by a surge in measured poverty. Chapter 4 considers social policy reforms and, in particular, the direct measures to alleviate poverty that need to accompany the shift to market-determined wages, increased labor mobility, and the delinking of social services from enterprises.

The second set of questions considered in the Report looks beyond these early reforms to analyze the longer-term agenda of their consolidation: developing the institutions and policies that will help the new system develop and prosper over time. Each transition country is at a different stage in the reform process, but nearly all have made a decisive break with central planning. They have an even greater challenge ahead, that of consolidating the basis for a thriving market economy. There is no unique blueprint for them to follow; indeed, one of the strengths of the market economy is its variety and adaptability across cultures. Yet essential institutions—legal systems, financial systems, and governments—must be adapted or created. Also, the human capital base that is so essential for long-run growth needs to be strengthened, and countries must carve out for themselves a fully integrated position in the global economy. These issues are taken up in Part Two of the Report.

- How should countries in transition develop and strengthen the rule of law?

Chapter 5 examines why governments need to be strong enough to take the lead in defining the new rules of the game and creating the tools for their enforcement.
But the rule of law cannot be created top-down, by decree. It also requires demand from below, stimulated by the growth of market activities. Building trust in a new system also means demonstrating that politicians and officials will themselves abide by its rules and constraints.

- How can countries develop effective financial systems?

Countries started their transition with weak, passive banking systems endowed with little capacity to assess credit risk, and with nonexistent capital markets. As Chapter 6 explains, financial sector reform cannot be pursued independently of other reforms, such as macroeconomic stabilization and enterprise reform. However, handling the problems early and decisively can reduce their impact and plant the seeds of a more effective system.

- How must government restructure itself to meet the needs of a market system?

Chapter 7 considers the problem of achieving fundamental changes in government, both in terms of how it manages spending and revenue collection, and in terms of how it apportions responsibilities among central and local authorities. Both the range and the nature of government’s activities must change, with the state more often seeking to facilitate private sector activity than to supplant it.

- How can countries preserve and adapt their human capital base?

Countries embark on transition with relatively strong endowments of human capital. Yet as discussed in Chapter 8, the inherited health and education systems need extensive reform to increase their effectiveness and flexibility.

- Why is international integration so vital for transition, and what are the implications for trading partners and capital flows? How can external assistance best support countries in transition?

These topics are considered in Chapter 9. Integration into world markets benefits both the rest of the world and the transition countries themselves, in part by locking in their other reforms. The timing and composition of foreign assistance to transition ought to reflect differences between countries: some face more pressing long-term development needs than others. The challenge for donors is to provide assistance that encourages and facilitates the move to the market rather than substitutes for it.

Chapter 10 distills the key messages of the Report.

The Report’s focus is on countries in CEE, the NIS, Mongolia, China, and Vietnam. These countries are now dispersed across a wide reform spectrum, but only one or two of the most advanced reformers are approaching the point at which transition issues are fading into the normal problems of established market economies. The countries examined are far from being the only ones that have had extensively nonmarket economies. A comprehensive list would include Algeria, Cambodia, Cuba, the Lao People’s Democratic Republic, Nicaragua, the People’s Democratic Republic of Korea, and Tanzania, among others. Many other countries have market or mixed economies resting on weak foundations and have at one time or another adopted parts of the planning model. The process of transition is therefore of interest to a wide-ranging set of countries and peoples.