How to Catch Up with the Industrial World—Achieving Rapid Growth in Europe's Transition Economies

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The preeminent economic challenge for the Central European Economies in transition (CEEs) is to grow rapidly over a sustained period in order to narrow the economic gap with Western Europe. If the CEEs grow only slightly faster than the EU, convergence will take several decades (see Transition, vol.7, no.1, January-February 1996, p. 6). Poland's income level today is 36 percent of average income in the EU. Assuming that per capita income grows an average of 1 percent a year in the EU and 3 percent a year in Poland, it would take forty-six years for Poland to reach 90 percent of the average per capita income of the EU. But if Poland manages to boost growth to 5 percent per capita a year, the time it takes Poland to reach 90 percent of EU per capita income would be cut in half, to twenty-three years. The key issue for Poland and the other CEEs, therefore, is how to achieve high rates of economic growth in the next decades.

To do this, the CEEs will have to do better in the coming years than the recent performance of the less advanced EU economies—Greece, Ireland, Portugal, and Spain. Although Ireland, Portugal, and Spain each grew rapidly in the last five years of the 1980s, that proved to be a short phase—only Ireland has achieved rapid growth in the 1990s. Greece has never achieved sustained rapid growth in the past fifteen years, and Spain and Portugal grew very slowly in the early 1980s and the early 1990s. For the fifteen-years during 1980-95, all four countries fell short of 5 percent per capita growth. Therefore, instead of being satisfied with these growth rates, the CEEs should instead try to match the performance of the countries that have a proven record of sustained rapid growth.

Our list of very fast growing economies (VFGEs) includes Chile, Hong Kong, Republic of Korea, Malaysia, Mauritius, Singapore, Taiwan (China), and Thailand. All are middle-income developing countries with populations (in 1989) of more than 1 million. They achieved a per capita annual growth rate of at least 4 percent during 1985-94.

These countries all share important characteristics of economic strategy. Their outstanding success is based on four clusters of factors:

1. Allocative efficiency (the efficiency with which resources are allocated among the various sectors of the economy at a point in time) is especially high. They rely mainly on market forces in the allocation of resources and have kept government intervention to relatively low levels. These countries are further characterized by a high degree of market competition, open trade, flexible labor markets, and low taxes, especially on labor income.

2. Savings and investment rates are high, as a result of high government saving and investment, high private saving, and high foreign direct investment. The VFGEs invest considerably in infrastructure (energy, communications, and transport), often in support of international trade activities. In turn, high private saving seems to be related mainly to a combination of demographic characteristics, overall fiscal and regulatory policies, and national pension (retirement) policy, based on individual saving accounts run by private pension funds.

3. The VFGEs have quickly absorbed new technologies from abroad (acquired through promoting foreign direct investments and licensing) and have adapted them in domestic production (technological upgrading). None of the VFGEs is a major innovator in technology, but all have been effective in using world-class technologies to upgrade domestic production and infrastructure. The VFGEs have established special economic zones to encourage new export-oriented industries and science parks for high-tech industries. These economic zones are often

supported by tax holidays and government provision of infrastructure (such as land, energy, communications, warehousing, expedited customs processing, and improved transport links to nearby airports and seaports). The government's education policy also helped to achieve high growth rates.

4. The VFGEs also have some natural advantages that have enabled them to pursue rapid export-led growth. They are all coastal economies with natural seaports that could be equipped with modern container port facilities. On the whole, these are abundant labor economies and relatively scarce in natural resources (Chile and Malaysia are the two exceptions in this regard).

The abundance of labor meant low initial wages and the ability to compete internationally on the basis of labor-intensive manufactures (footwear, apparel, textiles, and electronics assembly operations). These manufactures provided the starting point for export-led industrialization in these economies, except for Chile, where the recent export-led growth has come mainly in agriculture and resource-based industries. A scarcity of natural resources has been an advantage to economies seeking to establish export-led growth in manufactures—in the past twenty-five years such economies have tended to grow more rapidly than resource-rich economies.

If the CEEs adopt the policies of the VFGEs, the time needed to reach 90 percent of EU per capita income can be cut from 120 to 23 years for Hungary, and from 141 to 31 years for Poland. Similarly, the time needed to reach 70 percent of the EU average can be cut from 36 to 10 years for the Czech Republic, from 45 to 13 years for Hungary, and from 65 to 21 years for Poland. Harmonization with the standards of the VFGEs will lead to large increases in expected growth rates: the Czech Republic can grow at 6.58 percent, Hungary at 4.61 percent, and Poland at 6.10 percent.

The less-advanced EU economies failed to emulate the VFGEs in fiscal policy: Greece, Portugal, and Spain (but not Ireland) saw steep increases in public spending and taxation as a percentage of GDP during the 1980s and first half of the 1990s, associated with a rising tax wedge (the difference between the cost of labor and the net wage), a high and rising unemployment rate, and a falling national saving rate. (Ireland bucked the trend after 1986, reducing total government spending from 53 percent of GDP in that year to about 43 percent of GDP in 1994.)

For several reasons the CEEs are subject to the same fiscal pressures as the less- advanced economies of the EU: a common ideological commitment to a universal social welfare state; an effort to harmonize social, fiscal, and tax policies as well as other areas of economic management, including a large government role in the economy; and the political and economic ratchet effects of entitlement spending (when generous social insurance systems are in place, they are extremely difficult to unwind). This outcome is not inevitable, however. The EU is going through deep soul-searching over the role of the state, as country after country reaches a point of fiscal stress. Perhaps the CEEs will be able to take a larger step toward a smaller and growth-promoting state.

There is no doubt that the CEEs have achieved a stupendous breakthrough in allocative efficiency since the start of market reforms. They became full-fledged market economies underpinned by administrative, political, and legal changes, in a relatively short period of time—about half a decade. Within another few years the CEEs should rival the Western European economies in other areas of legal and administrative reform, such as banking reform, securities market development, and competition policy.

But the size of the government spending and taxation as a proportion of GDP has not declined since the onset of reforms in 1989; total public spending remains about 50 percent of GDP, among the highest in the world, and certainly the highest for market economies at comparable levels of income. (A sharp cut in budget subsidies to enterprises and households has been offset

by an equally steep increase in social spending as a share of GDP. The bulk of the increased spending went to retirement pensions.) The overall high levels of tax collection are also reflected in high marginal tax rates and a tax wedge on labor income that is vastly higher than that in the VFGEs, and even that in the less-advanced European economies.

While overall government spending is very high, budgetary investment spending is low by comparison with that of the VFGEs. CEEs have squeezed infrastructure spending excessively to make room for large current expenditures, particularly transfer payments. Extremely high public expenditure and taxation in the CEEs is likely to lend to substantial disincentives to labor supply, rising long-term unemployment rate, encouragement of black-market activities, lower foreign direct investment, large public deficits, and a reduction in national saving rates. Many of these effects are already at play: public sector saving is lower, deficits are higher, and overall national saving and investment rates are far lower in the CEEs than in the VFGEs.

Rates of Growth, Savings, and Investment *(percent)*

Type of Economy	*Growth of real GDP per person 1985-94*	*Growth of real GDP per economically active pop. 1985-92*	*Savings as a share of GDP 1995*	*Investment as a share of GDP 1995*	*Real GDP per person (PPP adjusted 1994 dollars) 1994*
Very fast growing economies					
Chile	5.1	4.8	25.9	24.9	3,467
Hong Kong	6.4	6.4	n.a.	28.8	10,599
South Korea	9.2	8.3	35.8	33.5	4,217
Malaysia	5.1	4.8	33.7	27.9	4,146
Mauritius	5.7	5.5	24.8	27.8	4,226
Singapore	5.7	5.7	42.3	33.1	8,616
Taiwan (China)	7.7	7.3	32.1	22.6	5,449
Thailand	7.4	5.9	28.8	33.8	2,463
Slow growing economies					
Argentina	2.1	2.3	19.1	16.6	5,324
Brazil	-0.5	-1.1	24.0	21.0	4,017
Mexico	1.6	0.3	19.7	21.1	5,621
Turkey	3.1	2.4	21.5	23.2	3,077
Poor European Union economies					
Greece	1.4	1.0	15.2	19.2	6,224
Ireland	4.1	4.1	20.7	17.6	7,275
Portugal	8.1	8.6	20.4	28.5	5,070
Spain	3.8	3.3	21.0	23.3	7,526
Central European economies					
Czech Republic (1994)	2.4	n.a.	21.1	20.0	5,880
Poland (1995)	5.0	5.0	18.0	19.0	3,826
Hungary (1994)	2.5	2.1	11.6	21.0	4,645

n.a. Not applicable.
Source: Authors.
Notes: See p. 15-16 of original manuscript.

The CEEs have several important growth-promoting tasks in addition to the completion of market reforms (especially privatization and financial market deepening) and fiscal reform (especially pension reform) to lower tax distortions and raise national saving rates:

1. A clear target date for membership in the EU is important in order to lock in the economic reforms and boost investor confidence. Most of the difficulties of accession can be overcome if a few basic principles are recognized:

• The CEEs need market access, not financial aid from the EU. (In return for rapid accession, the CEEs should unilaterally renounce their desire for a significant share of EU structural funds.)

• The CEEs should join the EU with a long transition period, presumably a decade from the time of membership, in which to harmonize agricultural policy and achieve free labor mobility.

• The CEEs should opt out of the Social Charter (in return for agreeing to a postponement of free mobility of labor), because these economies should not be further burdened with high social costs.

2. A coherent medium-term strategy is required for expanded infrastructure investment spending (transport, communications, and education) linked to economic integration with Western Europe. Science and technology policies should spur productivity growth.

3. A clear medium-term strategy should provide for the completion of privatization and deepening of the rule of law, broad fiscal reform to reduce the share of government spending and taxation in GDP, and setting appropriate (and ambitious) growth targets for the next ten years, with the aim of emulating the growth performance of the VFGEs.

Years Required to Close the Gap with the European Union

Country	*1993 GDP as percentage of the EU Average*	*Policy action*	*Years to raise GDP to 70 percent of the EU average*	*Years to raise GDP to 90 percent of the EU average*
Czech Republic	53	Keep current policies	23	56
		Harmonize with EU	36	111
		Harmonize with VFGEs	10	20
Hungary	48	Keep current policies	n.o.	n.o.
		Harmonize with EU	45	120
		Harmonize with VFGEs	13	23
Poland		Keep current policies	194	n.o.
		Harmonize with EU	65	141
		Harmonize with VFGEs	21	31

n.o. Not obtainable with current policies.
Notes: see pp. 29-30, original manuscript.
Source: Authors.

This article is based on the authors' paper "Achieving Rapid Growth in the Transition Economies of Central Europe," Discussion Paper 544, July 1996, Harvard Institute for International Development, One Eliot Street, Cambridge, MA 02138. To order, fax: (617) 495-0527. Jeffrey D. Sachs is Professor of International Trade at Harvard University and advises governments in several transition economies. Andrew M. Warner is Research Associate at the Harvard Institute for International Development.