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# Reforms in the Post-Communist World: Rolling-back and rolling-in the State.

Vladimír Zlacký

Abstract

The economists' view of the appropriate role of the State in the economy has seen large swings during the last century. By the end of the 90's a consensus seems to have emerged: one needs to get both prices and institutions right for markets to deliver social optimum. Leaders of the countries of the former communist block differed in their views of the role of the State; thus the policies adopted to facilitate the transition from the command system to a free society also differed. Invariably, countries already reaping the benefits of the transition are those that liberalized, stabilized, and privatized rapidly, and focused on institutions-building once basic reforms were carried out. On the other hand, transition losers are those countries whose adverse initial conditions were combined with the reluctance of their leaders to reform radically. Countries that successfully carried out basic reforms but did not strengthen the State to lead institutions-building in later stages could not sustain their early recoveries. Rolling back the State in the early stages of the reform and "rolling the State in" in later stages seems to have been the winning strategy.

## I. The role of the State and Markets

Debates about the appropriate role of the State in the economy, and in society more broadly, have played a prominent role in the academic, public policy, and popular discourse for a long time. It seems fair to say that since Adam Smith till the interwar period in the 20th century, most economists believed that markets generate socially most efficient outcomes and that the government should play only a minor role in regulating the economy. However, the severity of the Great Depression made academic economists and policymakers reconsider their long-held views about the respective roles of the markets and the State. The advent of Keynesian economics, the recovery of the U.S. from the depression under Roosevelt's New Deal, many Western countries' successful experience with the government's control over the economy during WW II, as well as the rapid, if little brutal, Soviet industrialization gave support to the emerging view that excesses of markets should be kept in check by the strong State.

As a result, many Western countries nationalized significant parts of their economies in the postwar period. The state-led development has become an almost universal doctrine of the underdeveloped countries striving to catch up with the industrialized world. This turnaround on the policy-making level was matched, and supported by, a similar change in the prevailing view of economic academia on the desirable role of the State in the economy. Even many prominent economists who would later become Nobel Prize laureates were vocal in advocating the State's control over economic activity (Shleifer,1998). Only a few economists of that time – such as F.A. Hayek (1944) or M. Friedman (1962) - criticized these unfolding fundamental changes in economic and social structures.[1] The former predicted that, if

[1] On broader aspects of this transformation see Polanyi (1944).

continuing unabated, this process would lead to a complete dominance of the State in the society and ultimately to the dictatorship.

As it happens, predictions of neither "socialists" nor laissez-faire advocates proved very clairvoyant. The socialization and state-led development did not deliver on their promises as they led to excessive bureaucratization that impeded development, and to the adoption of policies that were not conducive to creating incentives necessary for productive forces of the economy to be unleashed. The failure of the doctrine based on governmental interventions at its heart was particularly pronounced in developing countries (Krueger 1990). The governments assumed a central role in activities in which they had no particular comparative advantage, such as controlling production activities, but they failed to provide public goods – such as the rule of law, education, health care, and transport facilities - for which they are better suited than the private sector.

But neither libertarians got it right - the socialization of the economies did not result in serfdom, as Hayek dismally predicted, but rather triggered the neo-liberal economic revolution of the 80s. Originating in the Anglo-Saxon world and catalyzed by the economic misery of the 70s, the economic revolution of the 80s prescribed de-etatization, privatization, and deregulation of most economic sectors. A renewed emphasis was put on market forces to organize economic activity. While the developed countries, U.S. and U.K. in particular, were pioneers, the new policy paradigm was quickly transmitted to the developing world as well, in part through donor-sponsored adjustment programs. Similarly as in the after-war period, also in this case the change in the worldview towards the state and markets was matched, or perhaps even precipitated, by the change in economic academic thinking. New classical economists of the Chicago school style gained prominence and with them also "anti-state" economic models, which ignored market failures and in which there was no place for institutions. Technocratic policy prescriptions were thus put forth with insufficient thought

being given to whether strong assumptions of the ideal frictionless economic model were realistic in practice. As a result, the policies worked better in the developed world, where most necessary institutions underpinning the market economy were in place for years than in developing countries.

Both misconceptions about the appropriate role of the State in the economy, those underlying post-war socialization and the neo-liberal revolution of the 80s, resulted from the economists' overly narrow focus on relative prices and their failure to question the validity of assumptions underpinning the neoclassical model. In his lucid analysis of the merits of private vs. government ownership, Shleifer (1998) states that in the aftermath of the Great Depression, even laissez-faire economists paid attention only to relative prices even at the cost of being benign toward government ownership. Only the development of theories of contracting, which made a clear distinction between control and ownership rights, and of public choice, which turned on the head the assumption that politicians acted to maximize social goals, and empirical evidence documenting the failure of government ownership, led to reconsidering the issue of the role of State in the economy in the '70s and '80s. On the other hand, adopting neo-classical economics, with its narrow focus on price reform, as a sole platform on which development policies for developing countries in the 80s were built, exposed the conspicuous absence of institutions necessary to support markets in these countries. A lack of clearly defined property rights, regulatory and contract enforcement mechanisms, institutions for mitigating risks and managing social conflicts, the rule of law, and clean government meant that economic policies that have private incentives at their heart did not work well in many cases (Rodrik, 2000).

This paper aims to review the experience of countries of the former communist block with their transition to the market-based societies and to relate it to the kind of policies they

were pursuing. Implicit in the chosen policies and in the speed of their adoption were the attitudes of respective countries' leaders toward the role of the State in the economy.

The paper is organized as follows. The next section reviews the initial conditions of the former socialist countries at the beginning of the transition and outlines the suggested reforms agenda inspired by the Washington consensus. Section III turns to a critical review of cross-country empirical evidence to evaluate how the countries fared in the past decade. It also includes two comparative studies to bear on two issues often debated by analysts: whether Russia's difficulties are due to the fact that it reformed too radically, and why the Czech Republic's reputation in the West turned from one of the West's darling to that of underdog. Section IV summarizes and draws lessons.

## II. Reforms in post-communist countries

Emerging from the communist regime in the late 80's and the early 90's, the former Soviet block countries faced significant challenges. Not only did they have to completely revamp their economic systems, but they were also confronted with the formidable task of building a functioning institutional framework for the democratic society and market economy. Only a few former socialist countries in Central Europe had some experience with the capitalist system and democracy from before WW II to draw upon; most had to create market and social institutions without the luxury of re-adopting the historical ones.

*Crises of the socialist economic systems and initial conditions for the reforms*[2]

Most socialist countries were facing the crisis of the socialist system in the late 80's. Although they were able to accomplish a respectable level of industrialization within a decade or two following the communist parties' usurpation of political power, this was possible only at the cost of high enforced savings and, in many cases, physical terror inflicted upon those who resisted the economic policies of the State. Despite sharp economic growth achieved in many countries, the living standards of the population were increasing only very slowly as much of the created product was used for investment, especially in defense and heavy industries. Since this rapid growth was more due to factor mobilization than to innovations and productivity enhancement, it soon started to face bottlenecks.

At the heart of the economic difficulties of the socialist economic systems was the fact that the ruling communist parties replaced the market co-ordination of economic activity with a complete bureaucratic co-ordination. Essentially all of the production was state-owned. Economic resources were not allocated based on price signals but rather bargaining between various levels of bureaucracy and of enterprise sector determined where the resources went. A highly hierarchical system of society's organization meant that loyalty to superiors was appreciated, while invention and innovations were not. Company managers were thus not interested in satisfying customers or creating shareholder value, but their sole objective was to appease their bureaucratic superiors. The system of bargaining over resource allocation built perverse incentives into the economic system – company managers were requesting as high quotas of investment resources and labor, and as low production targets as possible. This led to permanent labor shortages and to excessive demand for investment resources. The latter was magnified by the incentives facing company managers – they gained from having control

[2] This section draws many insights from Kornai (1992)

over larger enterprises but were not penalized if investments failed. Given significant labor shortages and very little interest in profitability, company bosses were prone to pay wages in excess of the real value created by the workers.

All socialist countries had a highly distorted price system. The prices were set centrally; goods and services that were deemed as necessities were subsidized, while luxury goods were overpriced. Since the socialist planners identified the phenomenon of inflation with failures of the capitalist system, all effort was made to repress any inflationary pressures.

In the environment of repressed inflation and the insufficient supply of domestically produced quality goods, wages rising in excess of productivity gains, and over-investment in the enterprise sector led to permanent shortages in most markets. The excess demand in the consumption goods market manifested itself in long queues in front of retail stores, while at the enterprise level, it led to the creation of informal supply networks and to the adoption of autarkic production strategies[3]. Black markets with much higher unofficial prices of goods, services, and foreign exchange developed. The socialist economic system thus suffered from high transaction costs and a lack of specialization.

While the basic features of the socialist economic system were common to all countries, there were also differences. Czechoslovakia, Hungary, and East Germany ran relatively prudent macroeconomic and structural policies and thus excess demand was not so severe there. Bulgaria, Poland, and Romania are example where the goods shortages were very high. Also, the extent to which the private sector was allowed to develop varied; partial reforms in Hungary and Poland allowed the creation of small businesses, and in Poland, farming has never been fully collectivized. On the other hand, the private sector in Bulgaria, Czechoslovakia, and Romania was highly restricted, and thus almost nonexistent.

[3] Informal supply network refers to the phenomenon when coping with the inadequate and unreliable supply of inputs, managers spend considerable time and energy negotiating, networking with, and paying bribes to their counterparts to ensure input shipments. Autarkic production strategy refers to the situation when the enterprises

However, probably the most severe differences among the former socialist block countries lay in their institutional legacy. For the market to work, there need to be commercial codes, bankruptcy laws, accounting standards, contract enforcement, and informal norms to temper the inherent aggressiveness of those who participate in a competitive market economy. While many of these institutions were missing at the inception of the reforms in Central Europe or the Baltics, there was an institutional memory from the pre-WW II period to turn to. Although 45 years of communist rule were a long time, in the early 90's there were still many who remembered how the old system worked. Similarly, some Central European countries (such as Poland and Hungary, although not Czechoslovakia) undertook some partial reforms before the fall of communism and allowed, although in a highly restricted form, the existence of private enterprise.

Countries of the former Soviet Union except the Baltics were much less fortunate. More than seventy years of communism destroyed all institutional memory and thus made the creation of the market infrastructure much more difficult. Even if remnants of institutions remained, their usefulness would have been much limited as, unlike Central Europe, Russia and other Slavic and Caucasian countries of the FSU had not any prior experience with capitalism.

Lastly, the countries of Central Europe, unlike those of FSU, are fortunate to have been endowed with their proximity to the West. Although foreign travel was limited under communism, there was still some cultural and business exchange with the West. Citizens of the communist regimes thus could have observed Western culture and nuances of the market. Once the pro-market reforms were adopted, Western investments, so important not only for capital formation but also for diffusion of knowledge, business practices, and norms, were anticipated to flow more readily to the neighboring countries, rather than to more distant

strive to produce most of their inputs in-house in order to minimize the risks of production disruptions due to missing input supplies (Kornai, 1992).

countries of the former communist block. Moreover, when the capitalist ideal is geographically closer, it is easier to emulate its working and to sustain popular support for reforms necessary to achieve it. As it turns out, the geographical location and differing institutional legacy were to play a significant role in the relative success of reforms adopted by governments following the demise of the communist regimes.

*Reform agenda*

The design of reforms measures to be adopted by transition countries emerged from, the now famously known, Washington Consensus inspired in part by Poland's approach to reforms (Lipton and Sachs, 1990). The recommended reform strategy included price and trade liberalizations, tight monetary and fiscal policies to contain an expected rise in the price level, and hardening budget constraints for economic agents (Fisher and Gelb, 1991). Deregulation and demonopolization of the goods, services, and labor markets, privatization of the enterprise sectors, restructuring, and later liberalization of the financial sector were also deemed essential. The list also included reforms that are now thought to have been overlooked– legal and institutional reforms (Fisher and Sahay,2000) – but they were less strongly emphasized than liberalization and privatization

Some of the post-socialist countries adopted reforms along the suggested lines very early on, some tried to delay their reforms. [4] No doubt, willingness to adopt radical reforms was likely a function of various factors. However, it seems fair to generalize that the nature of the ruling political elite was among the crucial ones. The governments believing in free markets and in the limited role of the State pushed for radical reforms, while those with more socialist beliefs, or those facing powerful opposition of former communists delayed reforms

[4] Countries not belonging to former Soviet Union adopted the core of their reforms in 1990-91. Ukraine and Turkmenistan were the most conspicuous latecomers.

or undertook them only partially. However, by 1994 all of the former socialist countries initiated at least some economic reforms.[5]

## III. Evaluation of the reforms

The decade of transition delivered mixed results. Some countries have been able to accomplish significant achievements, in terms of both rapid economic recovery and building market-supporting institutions. Others are still coping with basic issues such as market liberalization, full macroeconomic stabilization, and the installation of rudimentary market-friendly institutions. In a few exceptional cases, reforms have been reversed and democratic freedoms repressed.

Success stories invariably encompass countries in either Central Europe or Baltic region. The Czech Republic, Hungary, Poland, and Slovakia have been granted admission to the OECD. The first three of them became members of NATO. Bar internal problems of the EU, these countries, together with Slovenia and Baltic countries, have a good chance of becoming full members of the Union in the first half of this decade. Some of the countries in this group have already achieved income levels in excess of their initial starting levels in 1990 (Poland, Slovakia, Slovenia) and inflation levels were essentially brought down to single-digit territory in all of these countries. While institutional development was far from uniform among these front-runners, as some countries such as Czech and Slovak Republics fell behind the frontrunners (Hungary, Poland), all of these countries have established the rudimentary institutional frameworks on which they can build. However, despite the fact that they advanced in building institutions more than their transition counterparts in other regions, for all of them careful institution-building remains the main challenge in years ahead.

[5] See Table 1 in Appendix for growth statistics and for the year of the most intense reform.

In the second group are the countries of Southern-eastern Europe and most countries of the former Soviet Union (FSU). These countries faced adverse initial economic and institutional conditions (most FSU and Balkans), delayed their reforms (e.g. most countries of FSU), suffered temporary political setbacks, which derailed them from their reform paths (Bulgaria, Romania), or experienced a combination of the three phenomena. Their income levels are in the range of 30-70% of their initial levels (with the exception of Albania which reached 86% in 1998) and inflation is yet to be tamed[6]. More worryingly, the countries in this category made relatively modest progress in building market-friendly institutions. Why this is so is open to debate, but institutional heritage and wrong policy choices are among the primary suspects.[7]

Lastly, Belarus and Uzbekistan have reversed reforms and undone modest reform achievements from the early 90's. Their macroeconomic performance has been relatively strong; this is however due to a lack of real reform and means that costs of economic restructuring will have to be borne yet.

While the first half of the past decade was marked by rapid reform achievements, the pace of reform has slowed down during the last three years, as indicated by Figure 1 in Appendix which shows the average transition score compiled by EBRD[8]. This is in part due to the fact that the "low-hanging fruit" of the reforms has been picked up at the beginning of the transition, and now the countries have to follow the thorny path of institutional building which takes more time and effort. Secondly, the slowly growing aggregate index also reflects reform reversal in several FSU countries following the Russian financial meltdown in 1998 (and in Belarus and Uzbekistan due to their idiosyncratic reasons).

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[6] Exceptions to the rule are countries of Caucasus where inflation is invariably single-digit range.
[7] It must be noted though, that countries of Southern-eastern Europe are significantly ahead of FSU countries in the institution building. On the role of social capita, trust, and related issues in transition see Raiser (1999).
[8] EBRD (1999)

Several empirical studies were performed to systematically evaluate the transition experience purporting to identify the main driving forces behind economic recoveries as well as factors impeding transition. The literature on the subject is vast and hence only the most influential papers will be reviewed here.

Aslund, Boone, and Johnson (1996) evaluated the impact of macroeconomic stabilization on overall economic performance. Using data on 23 transition economies spanning 1990-5, they found evidence that immediate radical reforms tend to lead to earlier, but not larger, output decline compared to the case when reforms are delayed. Rapid reforms are also found to lead to faster and stronger development of the private sector. Although most theoretical models of transition tended to suggest that more radical reforms would cause a higher initial unemployment, the empirical evidence in this paper shows that there is no systematic variation of unemployment with the pattern of reforms. Using EBRD's measures of development of laws and legal practices, and of banking and financial institutions, as well as IMF's ranking of institutional change, the authors conclude that, if anything, the empirical evidence suggests that early and radical reforms stimulated institutional development. Having established that radical reforms lead to better performance, the authors ask why any government would delay reforms, or undertake them gradually if that leads to more output losses. Aslund et al. (1996) conjecture that many governments delayed stabilization policies in order to allow the elite of corrupt officials, enterprise managers, and financiers to benefit from rents associated with cheap credit[9]. They conclude that the higher inflation in FSU than that in Central Europe was due to greater rent-seeking in the former reflecting the strength of the elite of former managers. Importantly, they also point out that greater rent-seeking in FSU might be a reflection of the extent to which the rule of law and social norms exist in society.

[9] In a high inflation environment, the value of credit-bearing low fixed interest rates is inflated away over time.

Johnson, Kaufmann and Shleifer (1997) stress the importance of depoliticization as a necessary condition for the development of market economies. Political control, which can be described as exercise of control rights of politicians over firms, can take various forms: direct control over state-owned enterprises, extensive regulations of private firms, restriction of entry into markets, the right to issue trade licenses, control over foreign exchange transaction etc. Since most politicians use their powers to enrich themselves or to promote their cronies rather than to pursue societal goals, the political control over economy deters growth by making true entrepreneurship less profitable (Shleifer and Vishny, 1998).

In order to analyze this phenomenon, Johnson et al. (1997) construct a simple model in which a firm decides whether to work in the official sector or to hide underground. Being in the official sector allows the firm to access public goods provided by the government, such as law and contract enforcement, but the firm has to bear the costs of complying with excessive regulations and taxation imposed by bureaucrats. Alternatively, the firm may decide to go underground thus avoiding taxation, but then needs to hire private security protection (mafia). If politicization is high and the government's provision of public goods is insufficient, firms may find it more profitable to work unofficially. This has, however, negative effects on tax revenues and thus further reduces the ability of the government to provide public goods making it even less profitable for firms to stay in the official sector.

Hence there are two equilibria in this model. In the "good" equilibrium the tax and regulatory distortion are low, the firms stay in the official sector and high tax revenues enable the government to provide public goods sufficiently. Alternatively, if distortions are high, firms decide to go underground, public finances suffer and this leads to deteriorating provision of public goods – much of the economic activity becomes unofficial. If the economy arrives in either equilibrium, absent external shocks or deliberate policies, it remains to be locked in it. Hence if the initial conditions put the economy onto the path towards the

bad equilibrium, the economy might get trapped in a situation where the economic activity is concentrated in the less productive unofficial sector and the mafia becomes more powerful than the State. Importantly, the model makes an important implicit assumption that firms make their decisions about which sector to enter only on the basis of economic costs and benefits, i.e. social norms do not place any restrictions on firms. It is exactly this assumption that makes the model relevant for transition economies – in the developed world social norms and good business practices would enter the firms' calculation and make the bad equilibrium highly unlikely.

Using electricity consumption to proxy for total economic activity, Johnson et al. (1997) construct a measure of the share of the unofficial economy and test their theory drawing on data spanning 1990-95. They find that post-socialist countries can be classified into three categories. First, there are few politically repressed countries, where the share of unofficial economic activity is small despite predatory state behavior and low public goods provision (Belarus, Uzbekistan). Second, there are countries with relatively fair taxes and low levels of distortions, high tax revenues, and good provision of public goods, and thus economic activity concentrated mostly in the official sector (most of Central and Eastern Europe). Finally, there are countries with unfair taxes, extensive regulations, low tax revenues, inadequate provision of public goods, and thus a large unofficial production sector (FSU except for Baltics). By 1995 the countries in the second group grew considerably faster than the countries in the third group.

The findings of the paper provide powerful insight into the differences in the institutional environment in the countries of the former communist block. They show that, while most Central European countries are on their way to the "good" equilibrium, most FSU countries seem to be heading to, or are trapped in, the "bad" equilibrium. It is very likely that the combination of both adverse initial conditions, such as "wrong" institutional legacy and

initial economic structures, and delays in adopting stabilization and liberalization measures pushed former FSU countries towards the bad equilibrium. Although Johnson et.al.(1997) do not explicitly mention it, their model illustrates a fallacy of the simplistic argument that the small government is good and efficient, while the large one is bad and harmful for, in this model, good equilibria are associated with larger governments.

Berg, Borensztein, Sahay and Zettelmeyer (1999) used sophisticated econometric techniques to evaluate the relative role of initial conditions, stabilization, and structural policies on the output performance in transition economies. They conclude that the main force behind the initial declines in output are adverse initial conditions, in particular high share of trade to GDP and high industrialization. They also find evidence that the more radical reformers were in adopting structural policies, the stronger was the ensuing economic recovery. Importantly, their estimated model implies that, in the absence of structural reforms, the output would have continued to decline i.e. there is no automatic economic recovery. Finally, they find that initial conditions do not explain much of the cross-country variation in growth thus suggesting that variation in output performance between Central European and FSU countries is mostly explained by structural reforms, rather than initial conditions. In a nutshell, Berg et al. (1999) interpret the results of their study as evidence that the radical approach to reforms accomplishes much better results in terms of output performance.

However, we should not read the results of their study as the refusal of the hypothesis that initial conditions are important in explaining cross-country differences in the relative success of transition for at least three reasons. First, the regression model includes only the official output variable on the left-hand side and this is too narrow a proxy for the success of the transformation. Few would disagree that Hungary's transformation has been much more successful than that of Slovakia. The former has restructured financial sector, reformed social security, and is much further in integrating into the Western world. Yet Slovakia beats

Hungary on the growth record. The two data points probably do not matter too much in the regression, but they illustrate well the limitations of using official output growth as a proxy for such a complex phenomenon as post-communist transformation. Second, Berg et al. (1999) use several variables to capture the effect of initial conditions on the output evolution. However, all of them strictly relate to economic conditions omitting any variables to capture the effect of institutional legacy[10]. But it is exactly institutional legacy that can help us explain differences in the relative success of post-communist transformation to date. Third, they do not investigate what seems to be an important issue - the potential impact of initial conditions on policy choices.

In a recent paper, Havrylyshyn and van Rooden (2000) analyze the importance of institutional development for restoring economic growth. They use various indices (from Heritage Foundation, Freedom House, EBRD, World Bank, and Euromoney) to measure the additional power that market-enhancing institutions have in explaining cross-section variation in income growth. Their findings show that while institutional variables are significant, in the presence of variables capturing stabilization and structural policies and initial conditions, they directly explain only about 10% of the variation in growth. Authors conclude that institutions are important for growth but one still needs to get prices right and stable.

Finally, in an extremely influential paper, Hellman (1998) investigates the relationship between the pace of reform and its short-term costs and long-term benefits and derives implications for the political economy of reforms. He reviews the mounting empirical evidence that countries that undertook partial reforms incurred higher short-term costs, less economic recovery, and higher redistribution of income than countries that pursued radical

[10] They use dummy variable for BRO (Baltics, Russia and other FSU countries) in their regression to capture effect specific to the countries of FSU. However, this cannot capture differences between Baltics and other FSU, nor can it help discriminate between initial conditions of Romania and Hungary. They also do not use

reforms. He asks why so many governments in transition economies have chosen to reform slowly if this leads to higher short-term costs and lower longer-term benefits. Hellman explains this puzzle by arguing that countries that undertook partial reforms created conditions that allowed their economic and political elites to benefit from rent-seeking opportunities on partially liberalized, and thus highly distorted, markets. Partial reforms produced winners, who, rather than supporting the continuation of reforms as the traditional theory of reforms would suggest, attempted to block them to preserve their rents.

Hence Hellman's paper has important implications for the political economy of reforms. First, radical liberalization and stabilization lead to the early dissipation of rent-seeking opportunities and thus prevent the creation of powerful vested interests that would benefit from distortions, while gradual reforms have the opposite effect. Second, his theory implies that policymakers should concentrate on insulating the State from the early winners of reforms (new owners of enterprises, bankers, bureaucrats), rather than from the early losers (workers, pensioners etc.) that the traditional theory of reforms suggests. The paper thus makes the case for increased political participation, rather than insulations of wide strata of the society.[11] It gives a theoretical explanation of the existing strong relationship between democracy and economic reform in the post-communist world.

Although cross-country regressions are certainly useful for enhancing our understanding of the basic pattern of economic performance in transition countries, given the limited number of observations and not always consistent data, they cannot capture all aspects of complexities of the post-communist transformation. We use two comparative studies to complement the statistical evidence; we study Russia versus Ukraine and the Czech Republic versus Poland. These concise studies are illustrative of two important lessons to be

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a geographical dummy to control for the physical distance of transition countries from the West, which could have picked some cultural effects.

[11] This contrasts with Przeworski and Limongi's (1993) skepticism towards democracy's role in supporting growth.

drawn from the decade of transition: radical reforms are better than partial, and economic recovery cannot be sustained without institutional reforms.

*Comparative Study I: Russia vs. Ukraine*

Strong criticism of the reforms undertaken in transition economies, especially of those implemented in Russia, is voiced by Stiglitz (1999). While he does not disagree with the notion that a "shock therapy" was appropriate for macroeconomic stabilization, he argues that the gradualist, rather than radical, approach toward structural and institutional reforms would have saved many transition countries from creating "grab-all-you-can" capitalism.

Stiglitz takes a particularly strong stab at radical privatization carried out in many countries, pointing at the experience of Russian in particular. He argues that a lack of managerial talent, corporate governance mechanism and bankruptcy framework meant that enterprises did not restructure after privatization. Rather, most of them fell into hands of a few oligarchs, who cared more for asset stripping than for restructuring. He suggests, instead, that the State should have created incentives facing managers in state-owned enterprises to motivate them into restructuring and postpone privatization until adequate institutions are in place. Thus in contrast to Johnson et al. (1997), his arguments seem to imply that if privatization and other structural reforms were delayed until appropriate institutions are built, the former FSU countries would have been pushed towards the "good" equilibrium.

In order to evaluate merits of Stiglitz's arguments and of fast versus gradual reforms in general, it is instructive to compare transition experience of the two most populous countries of the former Soviet Union, Russia and Ukraine. The two countries had been entering transition with similar initial conditions; in 1990 difference of GDP per capita between Russia and Ukraine was only 25%, their economic structures, and cultural and

institutional legacies were similar. The only significant handicap that Ukraine had, relative to Russia, at the beginning of the transition was the necessity to undertake independent state building along with transition.

The pace of the reforms that both governments adopted differed. While Gaidar's economic team in Russia introduced relatively radical liberalization measures and kick-started privatization early in 1992, it was not until 1994 that Ukraine adopted similar measures ( Aslund, Boone, Johnson 1996). In both countries the governments were not persistent in stabilization effort and this had led to outburst of high inflations. In Russia the inflation peaked at over 2,500% in 1992 and was gradually brought down to 22% in 1996. Ukraine did not manage to avoid hyperinflation – in 1993 the inflation exceeded 10,000% and was reduced to tolerable 40% in 1996. Hence by the mid 90's both countries stabilized but the deepness of adopted reforms differed.

In 1994 the EBRD's average transition score of Russia was 2.7, while that of Ukraine was only 1.3. The gap was substantially reduced in 1995 following Ukraine's increased reform efforts (2.6 vs. 2.3). During 1996-97 Russia further advanced while Ukraine showed only slow progress. By 1999 the gap was again eliminated after Russia temporarily introduced market regulations following its financial crises[12]. Importantly, Russia advanced much further in privatization; in 1999 private sector accounted for over 70% of economic activity in Russia, while only for 50% in Ukraine. EBRD's score for small-scale privatization in Russia is 4.0, while it is only 2.0 for Ukraine, and that for large-scale privatization is 3.3 for Russia, and only 2.3 in the Ukrainian case. [13] It is fair to conclude that Russia's reforms were more radical than Ukraine's.

[12] For graphical display of Russia's and Ukraine's transition ratings refer to Figure 2. in Appendix.
[13] EBRD (1999). In EBRD's parlance the score of 4.0 means that "more than 50% of state-owned enterprises and farm assets in private ownership and significant progress on corporate governance of these enterprises." The Score of 2.0 denotes " comprehensive scheme almost ready for implementation; some sales completed". A relatively high share of GDP generated by the private sector is substantially due to start-ups.

Although Russia opted for a more radical approach to liberalization and privatization than Ukraine did, this does not seem to have slowed the creation of its market-supporting institutions relative to Ukraine's, but rather the opposite. Russia gets a higher score from EBRD on fronts of competition policy and overall legal extensiveness and effectiveness[14]. In fact, Ukraine is the second to last in institutional building in the whole EBRD's transition universe. During 1991-5 Ukraine's share of unofficial economic activity on total output increased by 36.2 percentage points while that of Russia increased by 29.6 percentage points (Aslund, Boone, Johnson, 1996). Russia also ranks ahead of Ukraine across all dimensions of 1998 Heritage Foundation's Index of Economic Freedom (Aslund, Boone, Johnson, 2000). If anything, this evidence seems to suggest that more radical liberalization and privatization in Russia have led to no slower creation of market-supporting institutions than in Ukraine, where more gradual reforms were adopted[15].

Moreover, Aslund et al. (2000) argue that, of the two countries, Russia is more likely to break out of the under-reform trap described by Johnson et. al (1997) or Hellman (1998). The reason is that Russia's swift privatization created a strong private sector elite, which is intertwined with the government, but also resists its policies if they do not have economic rationale, competes among itself for not only rents but increasingly also for reputation. On the other hand, Ukraine maintains state hegemony where politicians are entrepreneurs at the same time; there is no real division between business and politics, while this clearly exists in Russia. Mafia is no doubt very influential in Russia, but in Ukraine, the state police itself took over illegal private security enforcement. It can be reasonably argued that the rapid privatization in Russia vs slow one in Ukraine has made a difference. It is very likely that Russia would have been more like Ukraine would it had followed more gradual reforms.

[14] Russia lower 1999 scores on enterprise reform and corporate governance and banking sector reforms than those of Ukraine are due to reform reversal in 1999 following the financial meltdown.
[15] Relatively speaking, the overall economic performance was also better in Russia – in 1998 the gap in income per capita between the two countries reached 55%.

The above comparative study sheds some light on prof. Stiglitz's arguments. Although they are theoretically appealing, they seem not to be nested in the realities of the post-communist world. Arguably Russian privatization should have been done differently, but policies prescribed by Stiglitz would have likely led to continuing political control over the economy with all negative consequences (as described above) and probably even worse ultimate outcome as the rent-seeking opportunities in the state enterprise sector would have been even higher than those in the private sector. Moreover, in an environment where the State's legislative and administrative capacity is severely limited and the country faces innumerable economic problems, it is difficult to imagine that an appropriate legal and regulatory framework would be created in absence of the private sector's demand for it. This is not to say that the private sector's demand is sufficient for the development of institutions, rather the State needs to play a leading role in spearheading the institutions building effort. However, given the capacity constraints, it is unlikely that the State would mobilize resources to do so in the absence of the urgent private sector demand.

On a more normative note, Stiglitz criticizes that radical reformers attempted to abruptly install new institutions and thus destroyed existing social and organizational capital. Instead, he suggests, that they should have induced incremental institutional transformation. However, when thought through to its logical implications, this view is not very appealing (and overly materialistic) since it implies that citizens of post-communist countries, eager to enjoy freedom after years of communist repression, should have lived yet little longer in the state-controlled world just to avoid the necessary economic downturn emanating from the disruption of existing, and often perverse, institutions.

Neither Russia nor Ukraine can be called a transition success story. Both seem to have fallen into the under-reform trap, where the State is weak and the mafia or corrupted police has taken over. It is very likely that adverse initial conditions, in terms of poor institutional

legacy and unfavorable economic structures, played a role. However, of the two countries, one that has pursued more radical reforms now has better-developed institutions and seems more likely to break out of the under-reform trap. Although we miss the counterfactual, if anything, it appears that if Russia reformed more slowly, it would likely have been in even worse shape than it is now[16].

*Comparative Study II: Czech Republic vs. Poland*[17]

Debates on the role of the State in the economy are often clouded with ideological biases, rather than motivated by search for a pragmatic solution. The transition experience of the two early reformers, Czech Republic and Poland, teaches an important lesson on how damaging a blind faith in ideology can be to the nation's economy.

The Czech Republic and Poland have started transition with similar heritage. Both countries have had experience with the capitalist economy from before WW II ,and both became a part of the Soviet block shortly after the War. While the Czech Republic was richer in1990 than Poland [18], industrial structures of the two countries were similar. Both countries shared borders with the West and, after collapse of communism, were eager to join the Western world. Early reformers in both countries were proponents of the radical shock therapy – in fact, the names of Václav Klaus, the Federal Finance Minister of Czechoslovakia

[16] It is often argued that if Russia followed China's partial reform strategy it could have emulated her results. However, central to our argument that partial reforms are harmful is the fact that partial reforms generate distortions on which the elite can prey. It is likely easier to repress rent-seeking activities in communist China than to keep them in check in post-communist Russia. The fact that, of the FSU countries, only Belarus and Uzbekistan, which have totalitarian regimes, were able to repress the unofficial economy further indicates that a totalitarian regime seems to be the necessary condition for repression of the unofficial economy in the transition environment and thus for success of partial reforms. One is led to conclude that only if Russia was totalitarian, the more gradual reforms would have been successful. Thus comparing China and Russia does not seem to be very fruitful for gaining insights into the issue of optimal reform strategy.

[17] Inspiration and basic framework for this study draw from Glaeser, Johnson, Shleifer (2000)

[18] GDP per capita was about $5,800 in the Czech Republic and about $3000 in Poland (measured in 1995 USD)

and later the Czech Prime Minister, and Leszek Balczerovicz, the Poland's Finance Minister, have become known as synonyms of big bang reforms in the post-communist world.

Governments in both countries adopted rapid liberalization and stabilization measures, most of them in 1990-91. Small-scale privatizations were completed in the early 90's in both countries. In Poland, the large-scale privatization spread over the whole decade. The Czech Republic privatized manufacturing sectors via voucher privatization by the mid-90s and delayed privatization of the banking and utility sectors till the end of the decade. In 1997 the level of GDP in Poland was 110% of the 1989 level, while the Czech Republic's GDP stood at the level of 90%. During 1992-97 the average inflation in Poland was 26.5% and 13.9% in the Czech Republic. Overall, EBRD ranked in 1999 both countries' progress in transition on par; the overall transition score was 3.42 in Poland and 3.46 in the Czech Republic. While both countries were highly regarded by foreign investors in the mid-90s, the Czech Republic was arguably the darling of the West at that time.

Although the two countries took similar approaches toward the basic reforms, the attitude of their leaders toward the role of the State in the institution-building differed. Not only did Václav Klaus declare in 1995 that the transition was over, but, in 1997, he was very explicit about his views on reforms: " We knew that we had to liberalize, deregulate, privatize at a very early stage of the transformation process, even if we might be confronted with rather weak and, therefore, not fully efficient markets…Conceptually it was - at least for me - rather simple: all you had to do was to apply the economic philosophy of the University of Chicago"[19]. Leszek Balzerovicz was more careful: "The capacity of the State to deal with various problems varies, mainly because of varying informational requirements. On this basis, one can distinguish on the one hand, the sphere of the State's natural competence (legislating and enforcing the law, dealing with other states, for example) and on the other hand, its sphere

[19] Klaus (1997). I borrowed both, this and following Balczerowicz's, quotes from Glaeser, Johnson and Shleifer (2000).

of natural incompetence (a massive and detailed industrial policy, for example)"[20]. Klaus' laissez-faire and Balczerovicz's more pragmatic approach toward the role of the State are, in broad terms, representative of the respective governments' policies towards institution building at that time.

Nowhere can be the starkly different outcomes of the policies induced by these differing attitudes better demonstrated than in the field of financial markets. A simple model of Glaeser, Johnson, and Shleifer (2000) shows that, in the case of an underdeveloped, unmotivated, and underfinanced judiciary, it might be better to delegate legal rules enforcement to a regulator rather than to a judiciary. If we associate the strong regulator with the strong State and reliance on the decentralized judicial process of law enforcement with the less important role being assigned to the State, the model implies that the strong State should be preferred when the judiciary is underdeveloped and its incentives weak. Glaeser et al. (2000) review the experience of the two countries and conclude that the Czech hands-off policy toward regulating financial markets has been associated with dysfunctional financial markets, while strict enforcement of legal rules by financial regulators in Poland has been associated with booming capital markets. It was not until the crash of the Czech currency in May 1997, in part due to investors' loss of faith in corrupted Czech financial markets, that the authorities in the Czech Republic decided to strengthen regulations. We do not have to stretch our interpretation of the political events following the currency crises too far to argue that the crash has led to a change in the perceived role of the State by the Czech political elite.

Poland and the Czech Republic reversed their roles from the first half of the 90s. The former has now become the window-case of the transition success story, while the latter is considered probably the biggest Central European disappointment. More generally, this case is illustrative of the general lesson that seems to be emerging from the decade of the

[20] Balczerowicz (1995, p.176).

transition. The rolling back of the State implicit in fast liberalization, stabilization, and privatization was imperative in the early stages of the reforms. However, once completed, the early reforms must be followed by careful institution-building in which the State should play a leading role. The Czech Republic paid dearly for its unwillingness to follow this strategy.

## IV. Conclusions

The failure to understand the complexity of economic relationships led to the excessive role of the State in many economies in the aftermath of WW II, and to the overselling of free-market doctrine following the neo-liberal revolution in the 80's. Now the economists seem to be coming to the consensus that prescriptions formulated on the basis of models lacking explicit account for informational asymmetries, coordination and control problems, existence of transaction costs, and definition and enforcement of property rights and contracts lead to extreme views about the role of the State in the economy and thus to wrong policy choices. In this regard, the past decade of transition from the command to market economy of countries of the former communist block offers important lessons.

Empirical and anecdotal evidence suggests that initial conditions – initial economic structure and the extent of inherited distortions, but even more importantly, geographical location, and institutional and cultural heritage – played an immense role in determining the economic situation in which countries found themselves after the decade of transition. Those countries which were fortunate to have favorable initial conditions and which embarked upon radical reforms along the lines of the Washington Consensus are already enjoying the benefits of the free market economy. On the other hand, countries that delayed necessary reforms, or undertook them gradually, allowed the creation of powerful business groups who benefited

from distorted markets. These groups now control politics and block further reforms to preserve their rents. Some of the countries have fallen into the under-reform trap and will need radical changes in their political power structures to break out of it. Put simply, countries with favorable initial conditions, which rolled back the State in the early reform phases succeeded. Those that did not are now facing significant challenges of overcoming powerful vested interests in order to continue reforming their economies.

However, the transition experience also suggests that, once the basic reforms are adopted, the countries need to focus on building market-enhancing institutions. Here the existence of the strong private sector seems to be necessary, but by no means sufficient. Rather, the State needs to assume a leading role in the institution building for this is exactly the area where it has a distinct comparative advantage. The Czech Republic ignored this for ideological reasons and paid a high price by suffering a protracted recession and damaging its reputation with the West. Thus the main message of the last decade seems to be that "rolling the State in" at a certain point is as important for the success of transition as initial rolling back its powers.

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**Appendix:**

Table 1. Growth rates of GDP (%)and the year of most intense reform

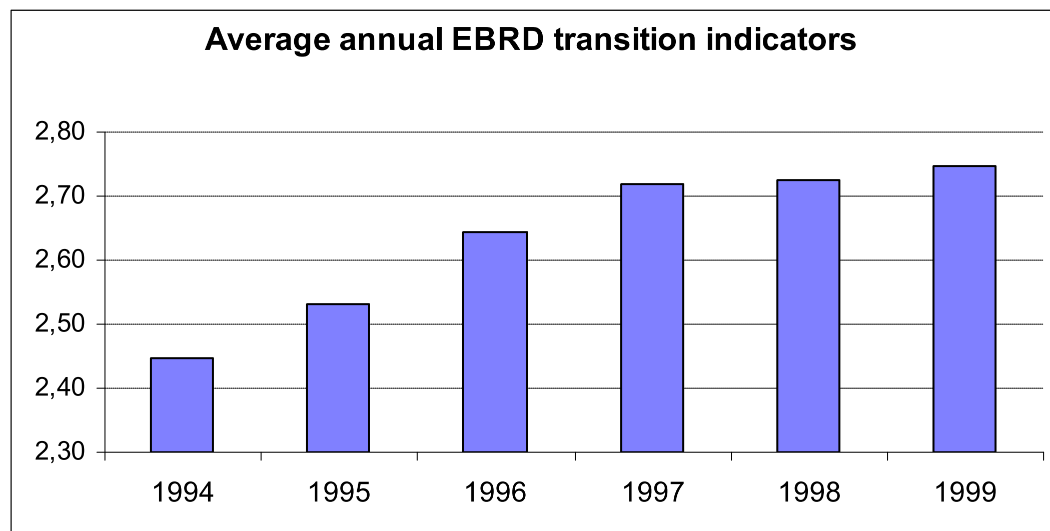
| | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | (1989 = 100) | Year of Reform |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Albania | 9,8 | -10,0 | -27,7 | -7,2 | 9,6 | 9,4 | 8,9 | 9,1 | 7,0 | 8,0 | 86,0 | 1992 |
| Bulgaria | 0,5 | -9,1 | -11,7 | -7,3 | -1,5 | 1,8 | 2,1 | -10,1 | -7,0 | 3,5 | 66,0 | 1991 |
| Croatia | -1,6 | -7,1 | -21,1 | -11,7 | -8,0 | 5,9 | 6,8 | 6,0 | 6,5 | 2,3 | 78,0 | 1990 |
| Czech Republic | 1,4 | -1,2 | -11,5 | -3,3 | 0,6 | 3,2 | 6,4 | 3,8 | 0,3 | -2,3 | 95,0 | 1991 |
| Estonia | -1,1 | -8,1 | -13,6 | -14,2 | -9,0 | -2,0 | 4,3 | 3,9 | 10,6 | 4,0 | 76,0 | 1992 |
| FYR Macedonia | 0,9 | -9,9 | -7,0 | -8,0 | -9,1 | -1,8 | -1,2 | 0,8 | 1,5 | 2,9 | 72,0 | 1990 |
| Hungary | 0,7 | -3,5 | -11,9 | -3,1 | -0,6 | 2,9 | 1,5 | 1,3 | 4,6 | 5,1 | 95,0 | 1990 |
| Latvia | 6,8 | 2,9 | -10,4 | -34,9 | -14,9 | 0,6 | -0,8 | 3,3 | 8,6 | 3,6 | 59,0 | 1992 |
| Lithuania | 1,5 | -5,0 | -6,2 | -21,3 | -16,0 | -9,5 | 3,5 | 4,9 | 7,4 | 5,2 | 65,0 | 1991 |
| Poland | 0,2 | -11,6 | -7,0 | 2,6 | 3,8 | 5,2 | 7,0 | 6,1 | 6,9 | 4,8 | 117,0 | 1990 |
| Romania | -5,8 | -5,6 | -12,9 | -8,8 | 1,5 | 3,9 | 7,1 | 4,1 | -6,9 | -7,3 | 76,0 | 1990 |
| Slovak Republic | 1,4 | -2,5 | -14,6 | -6,5 | -3,7 | 4,9 | 6,9 | 6,6 | 6,5 | 4,4 | 100,0 | 1991 |
| Slovenia | -1,8 | -4,7 | -8,9 | -5,5 | 2,8 | 5,3 | 4,1 | 3,5 | 4,6 | 3,9 | 104,0 | 1990 |
| **Average** | **1,0** | **-5,8** | **-12,7** | **-9,9** | **-3,4** | **2,3** | **4,4** | **3,3** | **3,9** | **2,9** | **95,0** | |
| Armenia | 14,2 | -7,4 | -17,1 | -52,6 | -14,8 | 5,4 | 6,9 | 5,8 | 3,1 | 7,2 | 41,0 | 1992 |
| Azarbaijan | -4,4 | -11,7 | -0,7 | -22,6 | -23,1 | -19,7 | -11,8 | 1,3 | 5,8 | 10,1 | 44,0 | 1992 |
| Belarus | 8,0 | -3,0 | -1,2 | -9,6 | -7,6 | -12,6 | -10,4 | 2,8 | 10,4 | 8,3 | 78,0 | 1993 |
| Georgia | -4,8 | -12,4 | -20,6 | -44,8 | -25,4 | -11,4 | 2,4 | 10,5 | 11,0 | 2,9 | 33,0 | 1992 |
| Kazakhstan | -0,4 | -0,4 | -13,0 | -2,9 | -9,2 | -12,6 | -8,2 | 0,5 | 2,0 | -2,5 | 61,0 | 1992 |
| Kyrgyzstan | 4,0 | 3,0 | -5,0 | -19,0 | -16,0 | -20,0 | -5,4 | 7,1 | 9,9 | 1,8 | 60,0 | 1992 |
| Moldova | 8,5 | -2,4 | -17,5 | -29,1 | -1,2 | -31,2 | -3,0 | -8,0 | 1,3 | -8,6 | 32,0 | 1992 |

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Russia | na | -4,0 | -5,0 | -14,5 | -8,7 | -12,7 | -4,1 | -3,5 | 0,8 | -4,6 | 55,0 | 1992 |
| Tajikistan | -2,9 | -1,6 | -7,1 | -29,0 | -11,0 | -18,9 | -12,5 | -4,4 | 1,7 | 5,3 | 42,0 | 1992 |
| Turkmenistan | -6,9 | 2,0 | -4,7 | -5,3 | -10,0 | -18,8 | -8,2 | -8,0 | -26,1 | 4,2 | 44,0 | 1994 |
| Ukraine | 4,0 | -3,4 | -11,6 | -13,7 | -14,2 | -23,0 | -12,2 | -10,0 | -3,2 | -1,7 | 37,0 | 1994 |
| Uzbekistan | 3,7 | 1,6 | -0,5 | -11,1 | -2,3 | -4,2 | -0,9 | 1,6 | 2,4 | 3,3 | 90,0 | 1992 |
| **Average** | **0,6** | **-3,7** | **-6** | **-14,2** | **-9,3** | **-13,8** | **-5,2** | **-3,5** | **0,9** | **-3,5** | **53** | |
| **Total Average** | **0,3** | **-5** | **-8,1** | **-9,5** | **-5** | **-6** | **-0,5** | **-0,2** | **2** | **-1,2** | **65** | |

Source: a) growth data EBRD (1999)

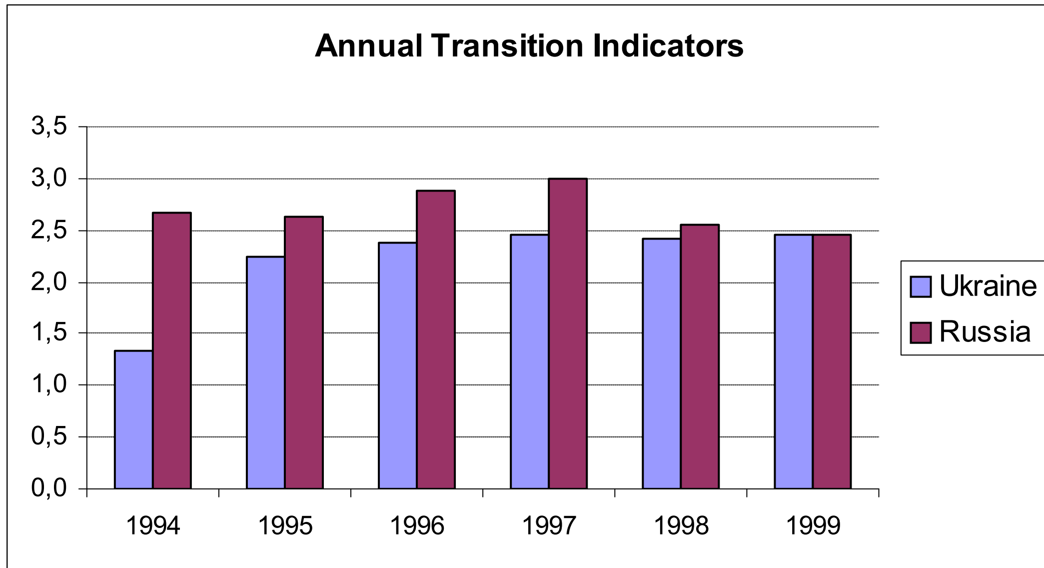
b) year of reform Aslund, Boone, and Johnson (1996)

Fig. 1




Source: EBRD (1999)

Fig. 2




Source: EBRD (1999)