Framework Paper on the Political Economics of Growth in Transition Countries[1]

Micael Castanheira (ECARES (ULB) and CEPR)[2]
Vladimir Popov (Carleton University and Academy of National Economy)[3]

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[2]ECARES - ULB CP 114, 50 Av. Roosevelt, 1050 Brussels, Belgium. e-mail: mcasta@ulb.ac.be.

[3]Institute of European and Russian Studies (EURUS), Carleton University, 1125 Colonel By Drive, Ottawa, Ontario KlS 5B6 CANADA. E-mail: vpopov@ccs.carleton.ca; or Graduate School of International Business, Academy of National Economy, 82 Prospect Vernadskogo, Moscow, 117571, RUSSIA. E-mail: fond372@glasnet.ru

1 Introduction

Unlike developing economies, democracy in transition economies tended to strengthen the reform process thanks to the massive support for democratization and the changing perceptions of the electorate (in favor of economic change). The explanation lies most probably in the different nature of the reform process itself: in transition economies reform meant more than in developing countries, in particular it also meant marketization (i.e. elimination of the centrally planned economy, production quotas, rationed supply of resources and regulation of prices), and mass privatization. These latter components of the reform process gained public support as reforms unfolded despite the economic hardship, and hence major opposition forces never suggested to reverse marketization and privatization.

But focusing on liberalization and privatization exclusively is probably a mistake. Transition in these countries is rather to be seen as a "Process of Large-Scale Institutional Change" (Dewatripont and Roland, 1997), which also involves the creation of new institutions, (property) rights, governments, administrations,... Be this transmutation successful, and rapid growth can be expected. Be it a failure, and the country faces the risk of remaining at a "developing" stage. If the choice were so clear, one could –and should– expect a massive popular (and hence democratic) support for a rapid transition. But the reality is more intricate, as it involves much different rewards for different individuals. In addition, this transmutation runs a (huge) short-run cost. Who is paying it?

These distributive concerns imply that it is crucial to analyze the political economics of transition to understand the phenomena we observed in post-communist countries, together with their effect on (potential) economic growth.

Where do we start from? To understand how political resistance to change can emerge, it is then necessary to look at the initial situation in communist countries. Until 1989, the "communist bloc" was organizing trade flows mainly according to the state plan, rather than the law of the market, with all the known resulting problems.[1]

[1]Note that some intermediary market institutions could exist prior to the dismantlement of the communist bloc. Together with having exchanges controlled by the planner, several countries enacted "market socialism", in which firms are still owned by the state or cooperatives but have the control of

The initial conditions were therefore the following:

- *Non-existence of a market price system.* Central planning was used as a substitute for a flexible price system. At the dawn of transition, governments had thus to liberalize the price mechanism. Together with the reallocation of resources, a side-effect of price liberalization was to reveal the sharp inefficiency of inherited firms and trade flows. This led to a tremendous wage compression, a complete re-shuffling of economic activity, and rapidly to a dramatic fall in production (see Roland 2000, chp. 7 for a review of the literature). Price liberalization, therefore, also had strong redistributive effects, which had to be taken into account by the government. This effect has been witnessed by the rise in income inequality, the soaring poverty rates and the increase in unemployment in all CEECs.[2] Conversely, the dual-track approach undertaken in China has the potential to offer a "reform without losers", as argue Lau *et al.* (1997, 2000), whereas the faster reforms undertaken in Central and East European Countries (CEECs) have not

- *No private property.* The second step to implement a market economy was to allocate the existing wealth of these countries (formerly owned by the state) across the population. In contrast to African or Latin American countries, governments could thus directly control wealth distribution by the means of the privatization method.

- *Strongly distorted allocation of resources.* Transforming the economy requires a tremendous reallocation of resources from the existing enterprises (mainly in the secondary sector) to inexistent firms (to be created mainly in the tertiary sector).

their operations (hiring and selling policy).

[2]Broadly speaking (there are noticeable exceptions, as the Czech Republic), two types of evolution can be identified: a first group of countries experienced a dramatic increase in unemployment rates, but maintained almost stable income inequalities (as measured by Gini coefficients). In the other group, registered unemployment remained low, but at the expense of an increase in income inequalities. For instance, in 1996, unemployment rates had risen to 10.5% in Hungary (up from 0.8% in 1990); 13.6% in Poland (6.1% in 1990), and 12.6% in the Slovak Republic (0.6% in 1990). For these countries, the highest Gini coefficient is 28 (for Poland, in 1993-1997, up from 22 in 1987-1989). As an example of the second group, Russian unemployment remains low (3.4% in 1996), but at the expense of a poor safety net, yielding an increase in the Gini coefficient from 22 in 87-89 to 52 in 93-97. As a result, life expectancy in 1997 was higher in the first three countries (compared to 1989) and fell in Russia, all FSU Republics, and some other countries (Data from the GDN (World Bank), and Roland 2000).

Actually, and this contrasts again with developing countries, transition economies suffer from over-industrialization (see also Ofer 1999 for a more detailed analysis). As a consequence, opposition to change is likely to emerge as most firms have to shed labor and grim alternatives are offered in replacement, and the choice of a transition strategy will determine how much political opposition to change there will be. .

- *Inexistence of democratic and market institutions and administration.* The state used to be authoritarian. When transition started, all state institutions were made obsolete. They needed to be either transformed or created from scratch (not only governing institutions, but also market-oriented administrations). Giving authority and freedom of movement to some politicians allows to speed up transformation, stabilization and the adaptation into a market economy (see also Dethier *et al.* 1999). However, as these transformations also have strong effects on vested interests, resistances could appear also within these institutions. As Ofer (1999) highlights, the required transformation is more profound in transition economies than in developing countries, as the latter generally already benefit from market institutions.

The process of change This makes clear that, with the start of transition, post-communist countries suddenly had the "choice of a system", but at the expense of major costs. They could democratically decide how to shape institutions, wealth distribution, social protection,... but a series of very tight constraints were in the way: the inefficiency of the existing industrial structure was potentially inflicting huge losses for many people; the former ruling class still had a strong grip on power and had to give up a large part of it; finally, the relative valuation of different outputs (the price system) had to be changed fast (Murphy, Shleifer and Vishny 1992), much faster than people needed time to relocate their activity (Aghion and Blanchard 1994; Castanheira and Roland 2000). In addition, governments were constrained by the political acceptability of their reforms, which is not the constraint easiest to satisfy (Dewatripont and Roland 1992, 1995, Roland 2000).

To analyze these problems in more detail, the remainder of the paper is organized in three parts. In section 2 we broadly summarize the initial conditions these countries were facing and some of the changes already observed. In section 3, we analyze the general problem of passing reforms democratically. First, we cover theoretical debates on the speed of transition. Second, in section 3.2, we survey some empirical work that has been done to understand how political support for reforms is shaped and identify potential holes in the theory (section 3.3). Section 4 analyzes separately particular aspects of the political economy of transition, alternating theoretical and empirical arguments. Not only, this latter section analyzes the economic aspects of transition, such as price liberalization (section 4.1) and privatization (section 4.2), but also focuses on institutional capacity building to account for the "Large-Scale Institutional Change" we mentioned (section 4.3). Finally, section 5 concludes.

2 History of transformation

The fall of the Berlin Wall in 1989, in a domino effect, unleashed an anti-communist revolution in all Central and Eastern European Countries, followed by the disintegration of the Soviet Union in 1991. Transition initiated under much different auspices for different countries, both in terms of the violence of the revolution in 1989, and in terms of the reforms already accomplished before (Hungary and Poland, for instance, had initiated reforms much before 1989). All these countries were eager to move away from communism, and towards the new role model of capitalist democracies in Western Europe and North America. The road ahead, however, was long.

2.1 Initial conditions and changes in transition

The existing **industrial structure** was noticeably different from that of a typical developed country (and this is equally true when compared to a developing country). In the former Comecon, central planning was allocating production to large state firms and assigning a production bundle to each country. As a result, countries needed not exploit their comparative advantages, and firm size was chosen to exploit scale economies –even when those were actually absent. As a result, state-owned firms often were much too large, whereas small and medium firms were almost absent. Distortions appeared both across sectors and within sector. The secondary sector was oversized, at the expense of the primary and tertiary sector. Within industry, there was an oversupply of advanced manufactured goods (mainly iron and weaponry). In the tertiary

Table 1: **Sectoral Allocation of Labor in OECD and CPE Countries**

	Agriculture	Industry	Services
OECD (1991)			
8 Richest Countries	5.5%	29.8%	64.7%
8 Middle Countries	5.8%	30.4%	63.9%
8 Poorest Countries	17.9%	29.5%	52.6%
CPEs and GDR (1989)			
GDR	10.0%	44.1%	45.9%
Czechoslovakia	11.6%	46.8%	41.6%
Hungary	17.5%	36.1%	46.4%
Poland	27.2%	36.3%	36.4%
CPEs (1994)			
Czech Republic	...	$\simeq$ 41%	...
Hungary	8.9%	33.4%	57.7%
Poland	...	$\simeq$ 32%	...
Regional Averages (1996)			
Central Europe	14.2%	39.6%	46.0%
Russian Federation	13.6%	41.6%	44.8%
Sources: Roland (2000), OECD (1999), Ofer (1999), EBRD (1999)			

sector, public services and transportation were taking the lion's share. Banking and credit were basically inexistent.

These distortions not only affect physical capital and machinery, but also human capital. As is well known, CEECs benefit from an abundant supply of human capital. But this supply is extremely specific to the former needs of central planning and ill-adapted to serve market-based institutions. The following tables illustrate this in more detail (see Ofer 1999 for data on population structure and education):

<< Insert Table 1 >>

<< Insert Table 2 >>

These tables describe the production structure of the countries in 1989, as well as the evolution accomplished over 5 years. As one sees, the economic structure inherited from Communism was not simply different, but also deeply inefficient. If the latter were not true, changes would have been much more limited over such a small number of years. Such changes, still, implied massive shedding of labor from existing firms.

A mirror problem to the distorted allocation of the means of production is the **distorted price mechanism**. In order to subsidize consumers, food and energy products were strongly underpriced, as well as house rents and public services. This was inducing excess demand in those products, energy-greedy heating systems and inefficient production methods.

Governments were then caught between the devil and the deep blue sea when considering the liberalization of these prices. In order to restore correct incentives for the allocation of the means of production, and to restore equilibrium between demand and supply, it was necessary to let prices adjust rapidly (Lipton and Sachs 1990; Murphy, Shleifer and Vishny 1992; Boycko 1992; Roland 2000). But this also meant an increased cost of food, heating, and housing, while many large firms were facing an increased risk of bankruptcy. These problems were therefore bound to meet strong political resistances.

The initial **macroeconomic conditions** were also strongly different across these countries, and this resulted into very different patterns of economic growth and inflation

Table 2: **Percentage of employment in SMEs**

	1989 (<100)	1994 (<200[1])
FRG	14.1%	64%
France	22.5%	69%
Italy	32.3%	80%
USA	N/A	53%
GDR	1.0%	N/A
Czechoslovakia	0.1%	37%
Hungary	4.5%	24%
Poland	1.4%	23%

Source: Roland (2000), EBRD (1995)

[1] $<n$ indicates that the statistics refer to firms smaller than n employees.

in the last ten years (Fischer and Sahay 2000). Differences appear with respect to all macroeconomic indicators: monetary overhang, (repressed) inflation, indebtedness, and income per capita. With transition, the adjustment of the aggregate price level generated sharp inflation in some countries (Russia and the former Soviet Republics being the most striking example), and this phenomenon was yet reinforced by the lack of a tax base and an appropriate tax system. As governments were not equipped to cope with these macroeconomic disbalances, they only could use seigniorage to finance their deficits. By 1995, all CEECs (Turkmenistan excepted) had implemented a stabilization program which allowed them to initiate disinflation. With the exception of Bulgaria which suffered from a financial crisis in 1997, inflation steadily decreased, to fall below 10% per annum in 1998 in most transition economies.

<< Insert table 3 >>

Countries were also facing unequal foreign debts positions at the start of transition. Under Ceaucescu, Romania had basically cleared its foreign debt. By contrast, Hungary's external debt service in 1989 was representing 49% of current account revenues, with an external debt equivalent to 66% of GNP[3]. As the literature on the political economics of inflation already highlighted, the temptation to use inflation is even stronger with a larger public debt (see Persson and Tabellini, 2000, chp13 for a survey).

The initial levels of income, as well as its evolution these last ten years displayed a variety of patterns. Some countries (e.g. Slovenia, the Czech and Slovak republics, Hungary or Poland) benefit from relatively high income per capita. Others (like Albania and most former Soviet republics) have income levels that are closer to India's. After transition started, all countries experienced some output fall. The presence of an output fall was expected, but it materialized in a size and length that were largely beyond expectations. For instance, Russia still does not experience a recovery (See table 4, Roland 2000, EBRD 1999).

[3] Data from EBRD (1995) and authors' calculations. Other countries with a large foreign debt in 1989 were Bulgaria (51% of GDP), Croatia (75%), and Poland (63%) (Fischer and Sahay 2000).

Table 3: **Inflation rates and M2 growth**				
Inflation rates (consumer prices)				
COUNTRY	**Highest**	(Year)	**Lowest**	(Year)
Hungary[2]	**32%**	1991	**10%**	1998
Czech Republic[1,4]	**57%**	1991	**6.8%**	1998
Slovak Republic[2]	**58%**	1991	**5.4%**	1996
Poland[4]	**640%**	1989	**8.5%**	1998
Bulgaria[1]	**1,082%**	1997	**22%**	1998
Russia[2]	**2,506%**	1992	**11%**	1997
Broad Money (M2) Growth				
Hungary[2]	**36%**	1991	**13%**	1994
Czech Republic[3]	**23%**	1993	**5%**	1998
Slovak Republic[3]	**20%**	1994	**3%**	1998
Poland[2]	**42%**	1998	**32%**	1991
Bulgaria[2]	**360%**	1997	**10%**	1998
Russia[2]	**68%**	1991	**13%**	1996

[1] Data from GDN (World bank) available from 1990 to 1998

[2] Data from EBRD available from 1991 to 1998* (*estimate)

[3] Data from EBRD. In 1991 (not reported here), money base was set at the Czecoslovak level.

[4] Data from Fischer and Sahay (2000)

Table 4: **Initial income and the output fall***				
COUNTRY	Initial Income per capita (PPP adjusted)	Lowest[1]	(Year)	1998 GDP/(T-1) [2]
Hungary	**6081**	18.1%	**1993**	95%
Czech Republic	**8207**	15.4%	**1992**	97%
Slovak Republic	**6969**	24.7%	**1993**	100%
Poland	**5687**	13.6%	**1991**	123%
Bulgaria	**5740**	36.8%	**1997**	72%
Russia	**5627**	45.1%	**1998**[3]	61%

*Data from Fischer and Sahay (2000)

1 Largest observed percentage fall in GDP with respect to 1989 GDP

2 1998-GDP as a fraction of GDP in the year before transition started

3 No data available after 1998

<< Insert table 4 >>

These differences partly reflect the countries' history prior to transition, which determine initial conditions in 1989. Some countries initiated reforms much before that time (mainly Poland and Hungary). These pre-transition reforms determined existing **institutions** at the start of transition. Since 1968, Hungary undertook serious gradual reforms, which delivered market-friendly institutions in 1989. In a similar fashion, during the eighties, Poland had already initiated deep-reaching reforms under the pressure of the Solidarity Union. At the other extreme, the GDR, Albania or Russia maintained a very rigid planning, a closed economy, and limited space for private initiative. These decisions revealed themselves to be huge hurdles for the post-1989 transition. Moreover, the geographic location of the countries strongly influence the prospects of the **accession to the European Union**. This element should be considered as an external "institutional factor" that influences FDI, growth, etc... (see also Roland 2000, and Fidrmuc 1999).

Summing up, "transition countries", despite longing for the same goal, were starting the transition race with very different backgrounds, skills, and chances. Such differences would have probably called for a different transition policy in each country, a policy that would have taken account of countries' specificities. In spite of this, the theoretical debates over transition were perhaps more dogmatic. Some were arguing that because a "big bang" strategy had worked in some country (i.e. Poland), it had to be applied in all other countries. Others argued that, because gradualism works in China, the same strategy should be used in Central and Eastern Europe. The debate between good and bad policies was therefore strongly distorted towards finding a general model of transition, and away from accommodating each country's peculiarities.

3 The debates over the political economy of reforms

3.1 Theoretical Debates...

Gérard Roland (1994 and 1999, chapters 2 and 3) surveys the different theories of the political process at work when reforms are passed. As he makes clear, passing a reform is always submitted to two constraints. Be the reform “Big bang” or “Gradual”, it must be both **ex-ante** and **ex-post acceptable**. The first constraint says that a reform will build itself popular support only if the expected net pay-off of the reform is positive. But there is also the *ex post* constraint that a majority of the population will vote for the *reversal* of the reform if a majority of the population loses in the process. To clarify these matters, let us assume a reform that leaves a proportion p of the population with a positive gain, G. The remainder of the population, a fraction $(1-p)$ experiences a loss, $L<0$. Ex ante acceptability requires

$$p \cdot G + (1-p) \cdot L > 0$$

but ex post sustainability of the reform also requires

$$p > 0.5.$$

Therefore, the multiplication of constraints generates a *status quo bias.* If a political group proposes a big bang reform that satisfies the ex-ante constraint (large expected benefits), but not the ex-post constraint (a majority loses in the process), it makes no sense to pass the reform: it will be reversed afterwards.

Sometimes, gradualist reforms allow to alleviate these constraints. Let us consider the following scenario to illustrate this. A reform $\mathcal{R}$ should be passed. It is composed of two sub-elements, R_1 and R_2. By assumption, each sub-element can be voted upon separately. There are two ways to present the reform $\mathcal{R}$ to democratic approval. The first way is to propose the global reform at once: vote for or against $\mathcal{R}$. As we just showed, such a “big bang” reform will pass the vote if it satisfies both the ex-ante and the ex-post constraints. To make matters interesting, let us see what happens if $\mathcal{R}$ satisfies the ex-ante constraint alone: it is a profitable reform, but it would be reverted if passed at once: $p<0.5$. It does not satisfy the ex-post constraint. Hence, the big bang reform would be blocked.

However, if each of the sub-elements $i=1,2$ satisfy both the ex-ante and the ex-post constraint, it becomes feasible to pass $\mathcal{R}$ gradually, proposing R_1 and R_2 separately. Let us use the following notation: sub-reform i provides gains G_i to a fraction p_i and losses L_i to a fraction $(1-p_i)$. By assumption, $p_i > .5$, and $p_i G_i + (1-p_i) L_i > 0$, $i=1,2$; that is, each sub-reform satisfies both constraints. The following table displays the distribution of gains in the general case and for a particular example.

Fraction in the population	**Gains**	**Sign**	*Example*	*%*	*Gain*
$p_1 \cdot p_2$	$G_1 + G_2$	> 0	*i=1,2*	*36%*	*+2*
$p_1 \cdot (1 - p_2)$	$G_1 + L_2$	$\gtrless 0$	p_i*=.6*	*24%*	*-0.1*
$(1 - p_1) \cdot p_2$	$L_1 + G_2$	$\gtrless 0$	G_i*=1*	*24%*	*-0.1*
$(1 - p_1) \cdot (1 - p_2)$	$L_1 + L_2$	< 0	L_i*=-1.1*	*16%*	*-2.2*

It is important to note that we are assuming that the distribution of gains is independently distributed in the population: gaining from reform R_1 does not increase or decrease the probability to gain from reform R_2. This implies that we are considering a worst case scenario for the reform-minded person: passing R_1 does not increase the popularity of R_2.

Still, the gradualist reform strategy, which consists of presenting the two sub-reforms separately to democratic approval will enact the reform, whereas the big bang strategy would have failed. The rationale behind this result is the following: in the example we use (but the result also applies to more general cases), 60% of the voters gain in each sub-reform and the expected pay-off is positive ex ante for each voter. Therefore, separating the reforms allows to keep this largely majoritarian support alive: there is never any majority to revert one of the two sub-elements of $\mathcal{R}$. This is a "divide and rule" tactic, that replaces the pre-reform status quo bias by a post-reform status quo bias[4].

There is however a cost to such a strategy: it takes times, delays the realization of the main benefits and, in the interim period, forces the coexistence of the pre-reform system with the post-reform system, which can come at an extra cost. This has been a major problem e.g. for the liberalization of the price system.

This simple formalization presents the comparative advantages of a big bang or a gradualist reform in a world without aggregate uncertainty. In reality, the aggregate outcome of transition bears strong uncertainty: what can be the size of the output fall? How long will it last? This aggregate uncertainty adds to the constraints we mentioned before: if transition goes too fast and one realizes that the chosen way is not efficient,

[4]Note that this model is sensibly different from Dewatripont and Roland (1992), where the gainers and the losers are also identified ex-ante. Moreover, our setup crucially depends on the fact that voters cannot reverse the two reforms together, but also have to vote separately on the reversal of each of the two sub-reforms.

the country needs to revert some of the reforms. And the more reforms have been passed, the higher the cost of reverting them. In this case, a big bang strategy may be a way to impose a policy of *fait accompli*: reverting more extensive reforms being more costly, one ensures fewer reversals than with a gradualist reform. But this comes at a cost: inefficient reforms should not have been passed, and the country remains trapped in the bad equilibrium. Gradualism, on the other hand, cannot prevent reversals as efficiently, but allows a trial an error policy that unlocks some political constraints. If voters know that they can easily revert a reform that fails, the cost of trying the reform is lower. Therefore, more reforms can be passed, because the downside risk is also lower. Again, Roland (2000) surveys these effects in more detail.

To summarize, big bang strategies should be favored for packages of reforms that are highly complementary (when the benefits arise thanks to the various elements making the reform, not separately from each of them); when the reform is warranted to satisfy both the ex-ante and the ex-post constraints; or when the costs of making mistakes is low (either reversals are easy or potential losses are limited). By opposition, gradualism should be favored when the joint satisfaction of the ex-post and ex-ante constraints is unclear; when the cost of making mistakes is large (large reversal costs) or benefits are uncertain; or when sub-reforms allow the government to better learn about the global reform.

Noticeably, everyone would agree that some gradualism is needed. It is impossible to wipe out 40 to 70 years of communism overnight. The main difference between the proponents and opponents to big bang is "where to stop gradualism". The meaning of gradualism could be understood as "changing the economic system in parallel with institutional reforms" (which take more time). The meaning of a big bang policy can be summarized with the following quote: "[...] *extensive liberalization and determined stabilization* [are] *both vital for improving economic performance.* [...] *The two are intricately linked and can and should be initiated early. In the longer term, institutional reforms —establishing clear property rights, sound legal and financial structure, and effective government— will be needed to make markets work efficiently and support growth. But liberalization and stabilization are essential first steps* [...]" (World Development Report (1996), p22).

One of the conclusions in this paper, which we shall stress throughout, is that reforming markets without providing appropriate institutions at the same time may prevent the materialization of the benefits to transition, both in economic and political terms. Nevertheless, we shall not try to judge with hindsight whether past economic reforms were "too fast" or "too gradual". Instead, we would like to reflect the idea that, under the differing initial conditions we highlighted, different paces were probably required. As we stressed here, seeking democratic support may bias decisions towards the status quo. But efficient political competition should reflect the different needs of the population with different political platforms. In section 3.2, we analyze the empirical evidence of political support in different transition countries to try and see how political competition worked. In section 3.3 we try instead to identify in which directions the existing theory may still benefit from some extensions to better explain the problems of political transition.

Guide to the literature As a main reference, we used Roland (1999, chapters 2 and 3). Fernandez and Rodrik (1991) introduced the idea of ex ante and ex post constraints. Murphy, Shleifer and Vishny (1992) provide a clear case for big bang policies in the process of price liberalization. EBRD's transition report (1999) covers the history of reforms with great minutia. Reforms complementarities are stressed in Boycko (1992), Van Wijnbergen (1992) or the World Development Report "From Plan to Market" (1996). Roland and Verdier (1994) show that, in order to prevent partial renationalization, privatizations need to be massive enough (this is a critical mass effect: political support for reversal is reduced only if enough firms have been privatized). Rodrik (1995) presents a continuous-time model of the political support for privatization with late reversal. Fidrmuc (1999, chp. 2) generalizes this model by allowing for long-term unemployment. De Melo *et al.* (1996, 1997) and Dethier *et al.* (1999) make undertake an empirical analysis of the effects of democratization on the speed of transition.

3.2 ...and Political Support

In the first years after the fall of the Berlin wall, there was huge enthusiasm in favor of a dramatic cut with the past. To create a clear cut with the past, the pressure to move fast was strong, both from inside and from outside the country. Western Economists attracting much attention, such as Jeffrey Sachs, Andrei Shleifer or Anders

Äslund, were the proponents of a hard-liner policy of liberalism. From inside, even those governments which were actually moving gradually still had to use “Big Bang” arguments to motivate their actions.

In spite of this massive support for quick change, the actual evolution of political support for different parties tends to confirm the effects of the “ex-post constraint”. Actually, when one compares the support for reformist parties across transition countries, one sees that it does not display a stable pattern across time and space. Tables 5 and 6 display the elections' results between 1992 and 1998 in four transition countries: the Czech Republic, Hungary, Poland and Slovakia. Fidrmuc (1999, chp. 4) classifies political parties in groups. We retain the shares of Pro-reforms and “left-wing” parties, whose aggregate shares are displayed in table 5. Left-wing parties (who typically take a position against reforms) obtained quite different level of support. In Slovakia and in Poland, the vote share of left-wing political parties decreased or remained low.[5] By contrast, anti-reform parties in the Czech Republic (LB, CSSD and LSU) increased their overall vote shares, whereas in Hungary the vote shares of left-wing political parties (i.e. MP and MSzP) remained globally unchanged. Conversely, pro-reform parties increased their support level in Slovakia and in Poland[6]. This erratic pattern seems to reject an economic explanation that could motivate these evolutions. Is there any economic sense behind them?

<< Insert tables 5 and 6 >>

There are three possible lines of arguments. The first one is that one cannot compare different countries, as mentalities are different. To address this point the analysis can be led at the regional level, within each country. The second possible argument is that platforms are endogenous. We look at the effect of the legislators' behavior to analyze this effect and to give a second look at vote shares. The third possible argument is that democracy is much too imperfect in these countries for vote shares to have any meaning. This argument often comes back when one tries to define what is a “democracy”. To our knowledge, however, there is no theoretical work that

[5]These are SDL and SDSS in Slovakia; and SLD, PSL and UP in Poland. See table 6 for the vote share of each of these parties.

[6]These are the ODU, KDH and DS parties in Slovakia and BBWR and UD in Poland.

Table 5: Vote results in some Central European Countries

Czech Republic 1992		**Czech Republic 1996**	
(Communists) Left Block (LB)	14.05	Communists Party (KSCM)	10.33
Social Democrats (CSSD)	6.53	Social Democrats (CSSD)	26.44
Liberal Social Union (LSU)	6.52	Free Democrats (SD-LSNS)	2.05
Civic Movement (OH)[I]	4.59	Democratic Union (DEU)	2.8
Christian Democrats (KDU-CSL)[I,w]	6.28	Christian Democrats (KDU-CSL)[I,w]	8.08
Civic Democratic Party (ODS-KDS)[I,w]	29.73	Civic Democratic Party (ODS-KDS)[I,w]	29.62
Civic Aliance (ODA)[I,w]	5.93	Civic Aliance (ODA)[I,w]	6.36
Republicans (SPR-RSC)	5.98	Republicans (SPR-RSC)	8.01
Moravian Movement (HSD-SMS)	5.87	Moravian Movement (HSD-SMS)	0.42
Others	14.52	Others	5.89
Hungary 1994		**Hungary 1998**	
Communist Party (MP)	3.45	Communist Party (MP)	4.15
Socialist party (MSzP)[w]	32.99	Socialist party (MSzP)[I]	32.1
Free Democrats (SzDSz)[w]	19.74	Free Democrats (SzDSz)[I]	8.11
Democratic Forum (MDF)[I]	11.74	Democratic Forum (MDF)	3.13
Young Democrats (Fidesz)[I]	7.02	Young Democrats (Fidesz)[w]	28.37
Smallholders (FKgP)	8.82	Smallholders (FKgP)[w]	13.41
Christian Democrats (KDNP)	7.03	Christian Democrats (KDNP)	5.64
Others	9.21	Others	5.09
Poland 1993		**Poland 1997**	
Post-Communists (SLD)[w]	20.4	Post-Communists (SLD)[I]	27.13
Peasant party (PSL)[w]	15.4	Peasant party (PSL)[I]	7.31
Labor Union (UP¨)[I]	10.6	Labor Union (UP¨)	4.74
Walesa's Non-Party Block (BBWR)	5.4	Solidarity Electoral Action (AWS)[w]	33.83
Democratic Union (UD)[I]	10.6	Freedom Union (UW)[w]	13.37
Independent Poland (KPN)	5.8	Polish Reconstruction (ROP)	5.56
Others	31.8	Others	8.06
Slovakia 1992		**Slovakia 1994**	
Democratic Left (SDL)	14.7	Communist Party (KSS)	2.72
Social Democrats (SDSS)	4	Workers (ZRS)	7.34
Civic Democratic Union (ODU)[I]	4.04	Democratic Left+Soc. Democrats (SV)	10.41
Christian Democrats (KDH)[I]	8.89	Democratic Union (ODU)	8.57
Democratic Party (DS)[I]	3.31	Christian Democrats (KDH)	10.08
Movement for Dem. Slovakia (HZDS)[w]	37.26	Democratic Party (DS)	3.42
Slovak National Party (SNS)	7.93	Movement for Dem. Slovakia (HZDS)	34.96
Hungarian Civic party (MOS)	2.29	Slovak National Party (SNS)	5.4
Hungarian Coalition	7.42	Hungarian Coalition	10.18
Others	10.16	Others	6.92

Parties are ordered according to their political orientation as left wing, right wing, and nationalist/extremist. *I* indicates member of government prior to the election (Incumbent); *w* indicates a member of government after the election (Winner).

Table 6: Vote shares aggregated by "ideological" group

Czech Republic	**1992**	**Czech Republic**	**1996**
Anti-Reform parties	27.1	Anti-Reform parties	38.82
Pro-Reform parties	46.53	Pro-Reform parties	46.86
Hungary	**1994**	**Hungary**	**1998**
Anti-Reform parties	36.44	Anti-Reform parties	36.25
Pro-Reform parties	38.5	Pro-Reform parties	39.61
Poland	**1993**	**Poland**	**1997**
Anti-Reform parties	46.4	Anti-Reform parties	39.18
Pro-Reform parties	16	Pro-Reform parties	47.2
Slovakia	**1992**	**Slovakia**	**1994**
Anti-Reform parties	18.7	Anti-Reform parties	10.06
Pro-Reform parties	16.24	Pro-Reform parties	29.06

Notes: Party vote shares are aggregated based on parties Left-Right orientation and their explicit attitudes toward reform. Left wing parties are considered as anti-reformists. Nationalist parties are not taken into account in the aggregations. In Slovakia 1994 the largest party, HZDS with 35 % of votes, is considered as nationalist. One may, however, classify this center-left wing political party as anti-reform.

Czech Republic 1992: *Anti-Reform parties* : LB, CSSD, SPR-RSC *Pro-Reform parties*: OH, ODS-KDS, ODA, and KDU
Czech Republic 1996: *Anti-Reform parties*: KSCM, CSSD, SPR-RSC, *Pro-Reform parties:* ODS, ODA, KDU-CSL, SD-LSNS and DEU.
Hungary 1994: *Anti-Reform parties*: MSzP, MP, FKgP, MIEP and KDNP. *Pro-Reform parties*: MDF, Fidesz and SzDSz.
Hungary 1998: *Anti-Reform parties*: MSzP, MP, FKgP, KDNP and MIEP. *Pro-Reform parties*: MDF, Fidesz and SzDSz.
Poland 1993: Anti-Reform parties: SLD, PSL and UP. Pro-Reform parties: UD and BBWR.
Poland 1997: *Anti-Reform parties*: SLD, PSL and UP. *Pro-Reform parties*: UW and AWS.
Slovakia 1992: Anti-Reform parties: SLD and SDSS. Pro-Reform parties: ODU, DS and KDH.
Slovakia 1994: *Anti-Reform parties*: SV and KSS. *Pro-Reform parties:* DU, DS and KDH.

has addressed how and when political competition becomes effective. We take up this point in section 3.3 to suggest possible ways of expanding research in political economics in that direction.

The ex post constraint: looking inside the country If different countries have different political support for pro-reform and anti-reform parties, it may just reflect different preferences. However, by comparing vote shares for a same party in different regions of the same country, one can (at least partially) eliminate these country "fixed effects". This is the purpose of the analysis led by J. Fidrmuc (1999, chp. 3). Fidrmuc makes a detailed analysis of political support across regions in the four countries we mentioned. He shows that a powerful explanatory variable for the support of anti-reform parties is the unemployment rate. Unemployed people lose from the transition process, and therefore vote against transition. This "ex-post constraint" phenomenon is very stable across time and countries. Looking at the other side of the coin, the typical gainer in transition is the entrepreneur. Entrepreneurs develop their own business, and thus gain from market-oriented reforms. Fidrmuc shows that these people also typically support reforms, but the time pattern is more delicate than for unemployment. For instance, Hungarian entrepreneurs tended to support left-wing or nationalist parties in 1994, while the opposite was true in 1998. Also, Polish entrepreneurs tended to support anti-reform parties in 1997. However, during their first mandate (1993-1997), such parties actually revealed themselves to be much more "market-friendly" than expected, leading even to the fastest recovery of central and eastern European countries.

This last observation calls for another way of analyzing the political economics of transition. Until now, we have only talked about the behavior of the voters, when they have to cast a ballot for one or another party. We did not even question the idea that a left-wing party would oppose reforms and a "right-wing" party would favor them. In reality, there can be a significant distance between the ideology carried by the "logo", or the name, of the party and the actual behavior of the representatives (legislators, senators, etc...). Moreover, platform positions can change with time, whereas party names tend to remain for a longer period. We then look at the legislators' behavior to see how the actual party position influences voters.

Measuring political position by the legislators' deeds The datasets on legislators' vote behavior are extremely detailed and easily available. In most central and eastern European parliaments, all the legislator's actions in a given vote are registered (i.e. not present, yes, no or abstention). Legislators' registered votes –by opposition to secret votes– are termed roll call votes. Roll call votes can then tell us, for each particular bill, how a given Member of the parliament voted. Since legislators in transition countries voted on many different issues, the number of available votes is extremely large. Typically, for a given term, there are more than 3000 votes for each legislator. It is therefore a unique and extremely precise source of information for researchers interested in the political economics of transition.

The use of roll call data by economists goes back as far as the early 1970s. Roll call votes were used to test hypotheses developed in some theories of legislative voting in the context of the regulation of large private corporations (see for example Stigler, 1971). Afterwards, a large number of empirical studies analyzed legislators' voting behavior on various issues (e.g. Minimum Wage legislation). Examples of empirical papers devoted to legislative decision-making are Kau and Rubin (1979), Kalt and Zupan (1984), or Peltzman (1984). Almost all these papers conclude that legislators vote according to their own ideology and to a lesser extent in accordance with the needs and demands of their constituencies. The econometric tools usually used by these authors are logit and probit regressions. More elaborate econometric tools were developed by Poole and Rosenthal (1985) on the one hand, and by Heckman and Snyder (1997) on the other hand. These two models are quite close to standard factor models. But they have a foundation in a popular political economic model of legislative decision-making: the spatial model of policy positioning developed by Downs (1956).

While the number of empirical studies concerning the American Congress is large, few studies exist for other legislative assemblies. Interestingly, the democratization of decision-making and technological innovations (namely electronic voting systems) now give researchers new opportunities to analyze a large and rich set of data concerning decision-making process in transition countries' legislatures.

Krejci and Soukenik (1998) investigate the interrelation between Czech voters' supports and the actual ideological positions of political parties. Voter supports are measured by opinion polls recorded by different agencies. Ideological positions of political parties are computed with the spatial model of roll call voting developed by Heckman and Snyder (1997). More precisely, they looked at the short run variation in support level for political parties together with the variation in the ideological positions of the latter. Krejci and Soukenik (1998) failed to find any close link between the actual ideological positions of the parties (the one as computed with parliamentary sessions behavior) and voter supports. However, as noted by the authors, one can find several explanations for this failure. Namely, the actual behavior of legislators is not very visible to the man of the street, and –more technically– the unidimensionality of the space used in the analysis. Although this type of studies is far from being conclusive, they are quite promising as a first step attempt to assess empirically the making of economic policy.

Milecova and Noury (1998) and Dobrowolski et al. (1999) have focused on the voting behavior in the Czech and the Polish parliaments. These papers exploit roll call votes with the methodology of Poole and Rosenthal (1997), to analyze the voting behavior of legislators. They show that the transition is not only from the socialist system to a market economy but also to democracy. For instance, the coalition in these parliaments used to be quite unstable at the early stages of transition. Over time, however, coalitions reshuffled to become more stable. Moreover, these coalitions have now a tendency to be formed on an ideological basis. That is, members of a left-wing party are in coalition with other members of similar ideology and they vote together against the members of right-wing political parties. In these parliaments, the coalition / opposition dimension together with the traditional left / right dimension explain most of legislators' votes. Thus, despite the large number of political parties, and the variety of issues to manage during transition, the voting pattern in those parliaments has a very simple structure. In technical terms, the voting space is quite low dimensional. For instance, in case of the Czech parliament, two dimensions are enough to explain almost all of legislators' voting pattern. The first dimension is the government coalition vs. opposition dimension and the second dimension is the left vs. right dimension.

One shortcoming of these papers is that they treat all votes equally, regardless the topic of the vote. They cannot distinguish the behavior of legislators when they decide about crucial issues (privatizations, institution building, etc...) or the issues that are more "business-as-usual". An interesting, yet unexplored, research agenda would be to distinguish legislators' behavior on votes with specific characteristics.

For example, it would be interesting to analyze how legislators take into account the economic cost and benefit of important reforms, in order to examine how legislators change their voting behavior when there is more at stake. Whatever the results, they would improve our understanding of the success or failure of reforms in these countries. Since the ongoing debate on the type of reforms to undertake (e.g. gradualist vs. big-bang) is highly controversial and no one can be convinced by the adverse party, empirical investigations are needed more than ever to find the right solutions. Thus, the importance of institutions can be correctly evaluated.

The evolution of vote shares and the median voter What did we already learn? We started this section by observing how the evolution of vote shares differed across countries, leaving the door open to an interpretation of this fact. Looking within the country, we find some evidence of an ex-post constraint, but also some instability in the entrepreneurs' behavior. We then tried to understand how legislators behave to observe that they are more respondent to their own beliefs than to the voters' needs, but also that coalitions changed substantially in a matter of 5-7 years of transition.

It is safe to say that understanding these facts and the political economy of party formation calls for a much longer analysis than ours. We can nevertheless point at one possible interpretation. First, remember that the status quo bias always refers to the present day's situation. When a comprehensive set of reforms has been undertaken, one cannot expect even anti-reform parties to undo them all. Interpreting a resurgence of left-wing parties as an anti-reform message overlooks this change in status quo. Second, the evolution in vote shares, rather than reflecting non-comparable political situations, may be demonstrating that democracy actually works in the four transition countries we took in example. Indeed, one of the phenomena we witness here is that political groups tend to gather vote shares that are more equal than earlier in transition, in a fashion similar to Germany or the United States. What do we mean with this?

In the US, two parties gather most of the votes. When a party wins, it has a lead which is generally between 2 and 10 points over its adversary. If we were able to consider the groups of parties considered as "anti-reforms" and "pro-reform" as homogenous parties, we could interpret the evolution between 1992 and 1998 as a narrower leadership, mixed with some alternation in power. To compare CEECs with another proportional system, we can use the case of Germany: in 1994, Christian

Democrats received 34% of the votes, Socialists: 36% and the Greens, 7.3%. In 1998 these vote shares evolved to 28.5%, 41%, and 6.7% respectively. These vote shares are quite similar to what we observe, for instance, in Poland.

It therefore seems that successful CEECs are countries which not only managed their economic transition, but also a political one, where electoral forces work. Parties tend to follow the electorate (by reshuffling their representatives, changing coalitions, etc...) and will probably concentrate even more in the future into "big and stable" versus "small and transient" parties.

What does it mean in terms of growth and reforms? Basically, divergence between platforms and the influence of small parties should remain strong as long as the electorate remains dispersed and changing (Castanheira 2000). As time goes by and political needs become more stable, we might observe an evolution that is closer and closer to Germany's or France's. In terms of reforms, Dethier *et al.* (1999) find that democracy helps. More precisely, they regress different measures of liberalization on economic and political variables, and show that both democratization and **elected** pro-reform governments undertake quicker and more comprehensive reforms.

A striking counter-example is of course Russia, where not only economic reforms have been less successful, but also political transition seems more arduous. Why? Are the two linked together? The existing theory in political economics provides no answer to these questions. We conjecture that answering them may represent a real leap in our understanding of the political economics of growth. When is democracy more efficient for growth? What makes a democracy work? Why do some countries create some political barons, instead of competitive political parties?

3.3 Loopholes

The typical way to describe the political game is to use the following sequence of events. During the electoral campaign, each political party (it) announces a *platform*. Then, each citizen (he) *votes*, given his preferences and the announced platforms. Finally, the elected party (or parties) implement(s) its (their) policy. This *policy implementation* affects (possibly stochastically) the *performance* of the government and the welfare of individuals (see Figure 1). Scholars in Political Economics have extensively analyzed this setting using standard game theory tools. Despite its oversimplification, interesting insights can be gained from this exercise by analyzing each step of the game described in Figure 1.

First, let us look at the selection of platforms by parties. As winning the election is a necessary condition to implement any policy, all the parties should offer the policy preferred by the electorate to maximize their probability of winning the election. This result is know as the median voter theorem, that is, all parties propose the same platform, the one preferred by the median voter. In practice, we do not observe this platform convergence. As Calvert (1985) and Wittman (1983) pointed out, if parties have their own political preferences, the platform they propose will be a combination of their own preferred policy and that of the median voter. Another reason for divergence is offered by Castanheira (1999). He shows that, when there are more than two parties in the race, citizens may (rationally) vote for extremist parties to communicate their policy preferences. As a response, and to restrain extremist voting, parties have to diverge to some extent. Other works argue that divergence is a self-handicapping strategy that can be either a credible way to communicate high political ability (Rogoff, 1990) or a commitment to exert extra effort to find the most valuable policy (Carrillo and Castanheira, 1999).

Voting behavior is determined at the second stage of the game. It is important to realize that this behavior crucially depends on the electoral system. For example, under the simple majority rule, if a party is perceived as a loser, no citizen will waste his vote in supporting it, even if its platform is the most attractive one. Therefore, only two parties should receive the support of the electorate in equilibrium. This result is known as Duverger's Law (Duverger 1954 and Cox 1994). Naturally, the working of Duverger's Law does not have the same implications under proportional representation or runoff elections (Cox 1997).

Third, at the implementation stage, one may wonder whether parties, once in power, have an incentive to implement the policy announced during the electoral campaign. After all, the only disciplining device of the electorate is the ballot. If parties have long term concerns, then using a standard reputation argument it is possible to show that the probability of being reelected acts as an incentive to keep (at least to a certain point) the promises on policies. Naturally, as the new election approaches, the willingness of the party in power to please the electorate increases. This leads to the famous *political business cycle* (See Persson and Tabellini 2000 for a review of the literature). Last, suppose that, once in power, the government can exert effort to improve the quality of the policy announced during the campaign (for instance, given the temporal gap between the date in which the policy was proposed and the date in which it has to be implemented some adjustments might be necessary). If the performance is an accurate indicator of the quality of the policy selected, parties have strong incentives to offer sensible platforms and to invest in improving their value. On the contrary, if the random component in the performance of the government is very important, then citizens will not be able to use the political achievements to judge accurately the ability of the incumbent. This in turn weakens the ex-ante incentives of parties to please the electorate. This effect may be at work in some transition countries but it did not receive much attention until now.

One of the most natural ways to make this political game more realistic is to capture the dynamic nature of elections and the evolution of individuals' preferences. Surprisingly, scholars have not paid much attention to this possibility. One exception is Rodrik (1995). In his model, the government always implements the policy preferred by the median voter (he thus overlooks the problems of platform positioning and implementation). He raises the point that labor reallocation between the old (state) and the new (private) sector affects the median voter's preferences. Taking these dynamics into account, he can motivate policy reversals across transition with the evolution of the preferences in the electorate. A worker in the state sector may prefer fast transition (low taxes and subsidies) if he thinks he has high chances of moving to the new sector. As transition unfolds, however, his probability of moving decreases, which motivates a policy reversal (higher taxes, slower transition, and more subsidies to the state sector).

Much work remains to be done in this area: from a static viewpoint, the identity of the median voter is sufficient to know which policy would receive the strongest support from the electorate. However, in a dynamic setting, the evolution of the whole distribution of preferences (and not only of those of the former median voter) will determine the choice and evolution of policies.[7] This has not been captured by Rodrik (1995) or, to the best of our knowledge, by any other work in the discipline.

[7] In others words, the skewness of the distribution (i.e. the proportion of individuals with extremist relative to moderate preferences) should have a significant impact on the policies selected in equilibrium, as they influence the status quo bias and platform selection.

The *efficiency* of the political game is very much related to the ability of the political system to translate the desires of the citizens into policies. The democratic institutions are key to determine how the preferences of the electorate are represented are the legislative and executive level. Several recent studies have analyzed the suitability of some of the existing institutions, as well as the effects of the shape of these institutions on the equilibrium policy. For instance, Persson, Roland and Tabellini (1997, 1998, PRT henceforth) argue that separations of powers (executive and legislative) provides a system of checks and balances which limit inefficiencies in policy choices. Diermeier and Feddersen (1998) analyze how party cohesion can emerge, depending on these institutions.

Last, as emphasized by Carrillo and Mariotti (1999) and Caillaud and Tirole (1999), the very existence of parties and the discipline within them are other institutional devices that affect the translation of voters' preferences into policy outcomes. As we saw that party composition changed dramatically in the first years of transition, one can expect that voters preferences are (and will be) increasingly represented in policy choices, provided that the democratic transition is successful.

However, a common feature to all these studies is that institutions are taken as given. The first key novelty of the Eastern European countries was the absence of a democratic constitution at the initial stage of transition, and therefore their need to design, to build these institutions in a first place. These countries had therefore an incredibly powerful tool to influence the translation of voters' choices into implemented policies. An important area of research would be to investigate in detail how the constitutional choices made by the different countries influenced these outcomes. Did proportional representation affect the speed of transition, as compared to a more majoritarian system? How does the constitution influence the evolution of party formation? A proper analysis of these effects could help academics to recommend appropriate changes in the design of these institutions when needed. Policymakers could then incorporate this possibility when designing their political agenda.

Another tempting approach would be to measure the efficiency of a political system by analyzing the link between policy choices and observed outcomes. One could argue that the results are nothing but the direct consequence of the political decisions made by the government. Should this be true, it would be possible to perfectly measure the ability of the leaders given the observation of their performance. This approach, however, is excessively naive, mainly for two reasons.

First, economic outcomes have always an important stochastic component: in periods of (unanticipated) recession, even the most adequate policy will not yield brilliant results, while during an expansion even a bad decision will not be excessively damaging.[8] But second, and more importantly, governments may not be *able* to enforce their selected policy because of some kinds of friction in the economy. As we show in section 4.3, poor institutions can be a great obstacle to development and growth in transition economies. It would therefore be absurd to measure the achievements of these economies (and in particular the ability of their leaders) without taking this constraint into account. It would be of special interest to analyze the correlation and causality of the rule of law of the different Eastern European countries with both their observed economic performance and the success of their democratic transition. What do we mean with this?

We have seen that institutions in transition countries may not perform efficiently for two main reasons. First, because the desires of the citizens may not be sufficiently taken into account by the government: if the constitution is not well enough established or if there are other inefficient institutions, the concerns of the electorate will not always be reflected in the policy choices. Second, it may be easier to capture (corrupt) public institutions (e.g. administrations) in an economy that incurs a deeper transformation.

This brings us to suspect that the literature overlooked an important aspect of the institutional reform. When the political game is repeated, these frictions will weaken the possibility that elections penalize bad incumbents. In turn, this lack of an efficient system of democratic rewards and punishments will affect the platforms proposed in the electoral campaign. How could this work? In the simple game described in figure 1, parties announce a platform, which is then implemented. Voters observe the effect of this platform on their welfare, which allows them to judge whether it is in their interest to reelect the incumbent. This is the mechanism that allows PRT to compare the outcomes that result from different political systems.

However, if the democratic mechanism of checks and balances is unclear to the voters, it is already hard for them to judge who is to blame for badly chosen policies.

[8]We are coming back to this in section 4, where we show that often policies have had less impact than usual thought on the countries' economic evolution.

Moreover, if the institutions that translate policy choices into policy actions are captured by external agents (mafias, army, or others), then it is even impossible to judge the quality of policy choices themselves. Figure 2 describes such an extended game.

Knowing these problems, what is the optimal behavior for the parties at the campaigning stage? How does this affect the possibility of entry for new parties? Given the absence of existing models, it is hard to give a definite answer to these questions, but we can conjecture that it may lead to exaggerated (more radical) platforms. These radicalization in turn weakens the efficiency of checks and balances, as a policy of systematic opposition to the other party may become a dominant signalling strategy. We think there is much to be learnt in that direction, for instance to understand the events that happened in Russia or Bulgaria.

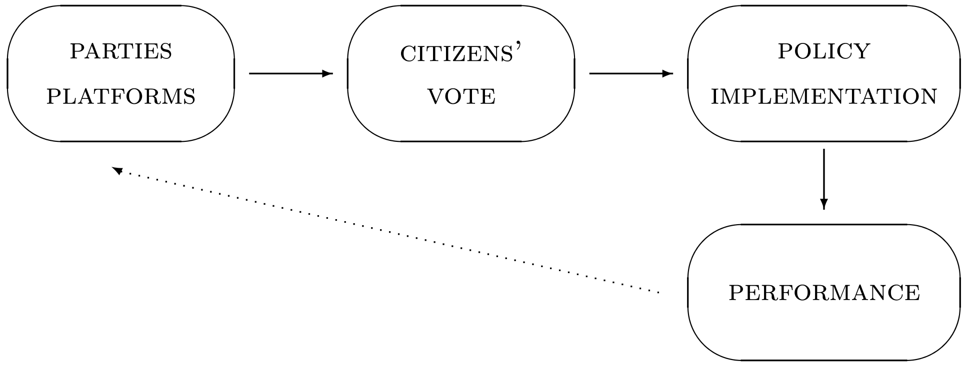


Figure 1.

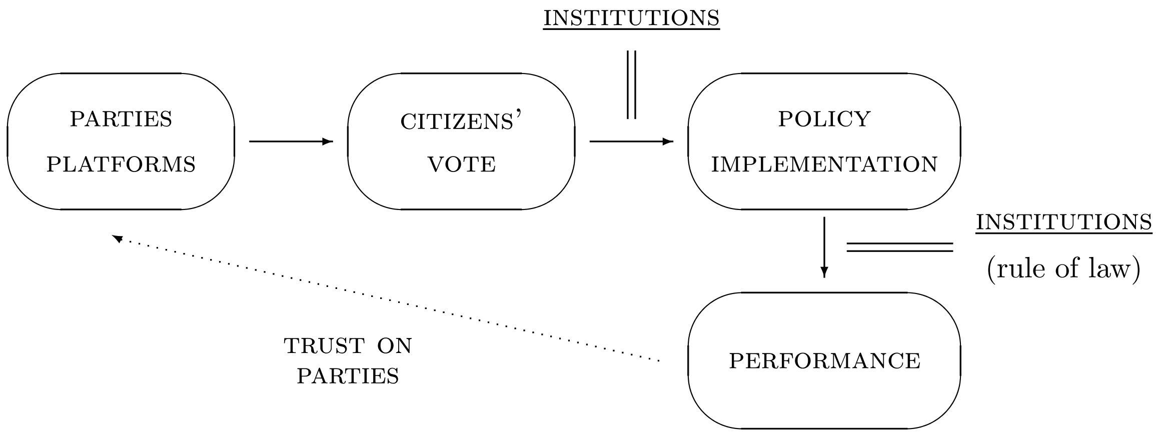


Figure 2.

4 Political Economics Applied to Specific Issues

4.1 Liberalization and reforms

4.1.1 Theoretical predictions

As we already mentioned, 10 years ago, on the eve of transition, economic discussion in the profession was dominated by the debate between shock therapists, who advocated radical reforms and rapid transformation, and gradualists, justifying a more cautious and piecemeal approach to reforms. Shock therapists pointed out to the example of East European countries and Baltic states – fast liberalizers and successful stabilizers, that experienced a recovery after 2 to 3 years fall in output, while their CIS counterparts were doing much worse. Gradualists cited the example of China, arguing that the lack of recession and high growth rates is the direct result of the step by step approach to economic transformation. Shock therapists were arguing that "one cannot cross the abyss in two jumps", that rapid liberalization allows to avoid painful and costly period, when the old centrally planned economy (CPE) is not working already, while the new market one is not working yet. Murphy, Shleifer and Vishny (1992) claimed that, if the weakening state is not able to enforce production quotas under the system of dual pricing, transfer of resources to the private sector with market prices creates bottlenecks and shortages in the state sector, resulting in the fall of total output.

Gradualists, in response, objected to the elimination of old regulations and institutions before the new ones are created, warning that the institutional vacuum may have a devastating impact on output. In particular, they believed that the Chinese strategy of "growing out of socialism" (relying on the rapid growth of newly created private businesses) is superior to the large scale privatization, since property rights in this case can be better preserved and enforced. There were developed a number of models showing that under particular assumptions slow liberalization may be preferable to the "big bang" approach. For instance, Friedman and Johnson (1995) argued that in the presence of complementarities between government policies and enterprise attributes and convex adjustment costs for enterprises (i.e. costs increasing with the speed of reforms) radical "big bang" reforms might not necessarily be optimal.[9] It was also ar-

[9] They concluded that gradual reforms may be the best choice under some initial conditions (China - stable pre-reform economy, the absence of market institutions, strong government), whereas radical

gued (Li, 1996) that in the absence of competitive product markets (monopolization) on the outset of the reforms shock therapy can only lead to the reduction of output, while incremental reforms, such as Chinese type dual track pricing system forcing enterprises to meet production quotas, but allowing them to sell above-the-plan output at market prices, may contribute to the expansion of output. It was also argued that if state firms are allowed to choose between market and centrally planned prices (for both - inputs and outputs), then not only the Pareto optimality is guaranteed at the end of the process, but also – with the appropriate state allocation of cheap resources and production quotas - it could be ensured that at every stage of the transition process no one is going to be worse off and at least someone is constantly made better off (Lau, Qian, and Roland, 1997). Roland and Verdier (1999) showed that investment and output may fall as a result of immediate price deregulation due to the need to find new partners and that under gradual dual track price liberalization it is possible avoid this effect.

At first glance there is some empirical evidence to support this kind of argument. China, pursuing incremental reforms managed to avoid the recession, and so did Hungary in the 1980s following a step by step strategy in deregulating prices and the exchange rate. Also, Uzbekistan pursuing rather gradual reforms under authoritarian regime showed the best economic performance among former Soviet Union (FSU) states in the 1990s.

However, the strong argument against this kind of explanation is the comparison of Vietnam and China - two countries that shared a lot of similarities in initial conditions and achieved basically the same results (immediate growth of output without transformational recession) despite different reform strategies. While Chinese reforms are normally treated as a classical example of gradualism, Vietnamese reformers introduced Polish style shock therapy treatment (instant deregulation of most prices and introduction of convertibility of dong) in 1989 and still managed to avoid the reduction of output.

reforms - under other initial conditions (Poland - poor pre-reform economic situation, weaker potential for creating new firms, and low credibility of reformers). Other authors have also pointed out that Chinese initial conditions were fundamentally different from those in the USSR, that China was still reformable, but the USSR had long since passed that point (Åslund, 1995), and that what is good for Poland should not necessarily be good for China (Sachs and Woo, 1994).

4.1.2 Empirical results

As time passed, there appeared statistics that allowed to test the predictions of the theories. Quite a number of studies were undertaken with the intention to prove that fast liberalization and macro-stabilization pays off and finally leads to better performance (Sachs, 1996; De Melo, Denizer, and Gelb, 1996; Fisher, Sahay, Vegh, 1996; Åslund, Boone, Johnson, 1996; Breton, Gros, and Vandille, 1997). To prove the point, the authors tried to regress output changes during transition on liberalization indices developed by De Melo et al. (1996) and by EBRD (published in its Transition Reports), inflation and different measures of initial conditions.

The conventional wisdom was probably summarized in the 1996 World Development Report "*From Plan to Market*", which basically stated that differences in economic performance were associated mostly with "good and bad" policies, in particular with the progress in liberalization and macroeconomic stabilization: countries that are more successful than others in introducing market reforms and bringing down inflation were believed to have better chances to limit the reduction of output and to quickly recover from the transformational recession. "Consistent policies, combining liberalization of markets, trade, and new business entry with reasonable price stability, can achieve a great deal even in countries lacking clear property rights and strong market institutions" – was one of the major conclusions of the WDR 1996 (p. 142). The conclusion did not withstand the test of time, since by now most economists would probably agree that the major reason for the extraordinary output collapse in CIS states was liberalization carried out without strong market institutions.[10]

At first glance, there seems to be a positive relationship between liberalization and performance (figures 3 and 4). However, a more careful consideration reveals that

[10]The conventional wisdom was labeled " Washington consensus" . The term emerged in the 1980s and was used to describe similar policies (liberalization, privatization, macro stabilization, openness) that were previously recommended to and carried out by developing countries. The reconsideration of both sets of policies is now under way (post-Washington consensus) since they did not produce expected results neither in developing countries, nor in transition economies. Was it the case that good policies were in fact not that good or that that did not translate into better performance? Easterly (1999) asks exactly that question about the slow down of growth in developing countries in the 1980s and 1990s: if policies, in particular liberalization and macro stabilization were good, better than in the previous two decades (1960-79), why the growth rates declined? He finds, however, good policies did pay off, whereas stagnation was associated with the external shock – the slowdown in the industrial world.

Fig. 3. Liberalization and output change in 1989-98

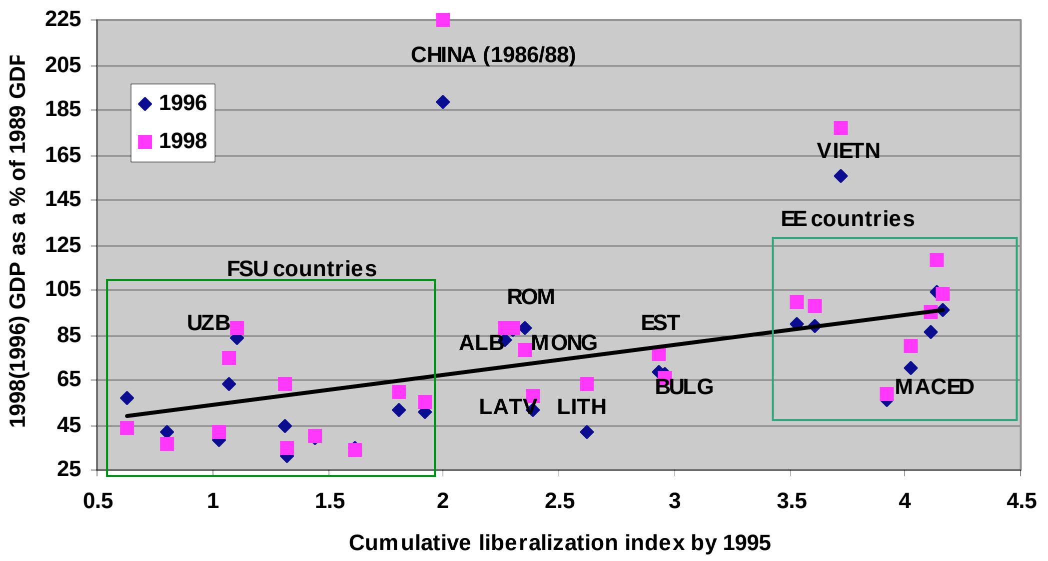
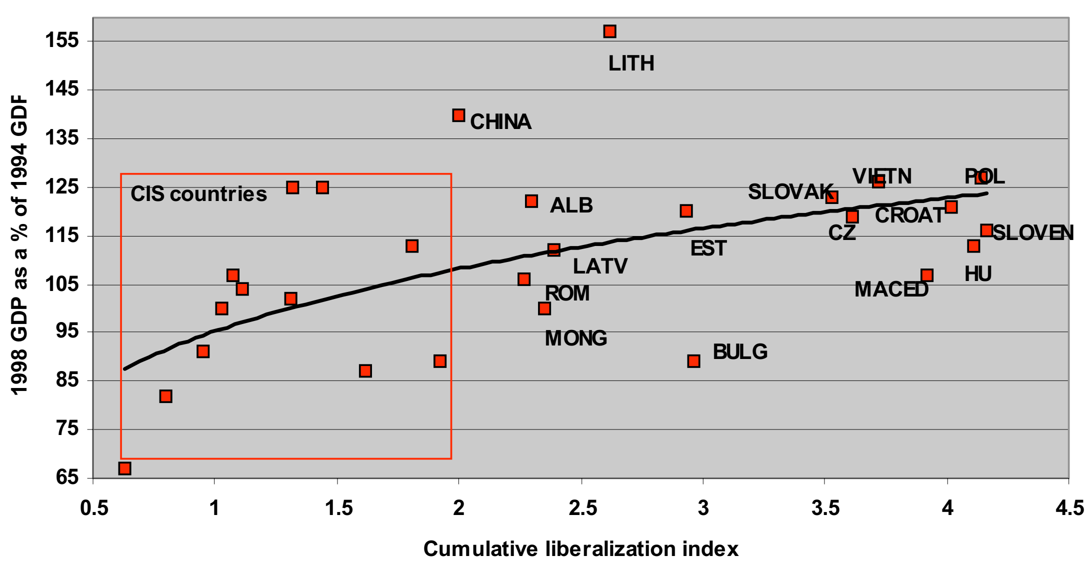


Fig. 4. Liberalization index by 1995 and performance in 1994-98



the link is just the result of sharp difference in the magnitude of the recession in EE countries, as a group, and FSU states, also as a group (figure 3). Within these groups the correlation –if any– is much weaker, not to speak about China and Vietnam, which are outliers.

<< Insert figures 3 and 4 about here >>

Overall, attempts to link differences in output changes during transition to the cumulative liberalization index and to macro stabilization (rates of inflation) have not yielded any impressive result: it turns out that dummies, such as membership in the ruble zone (i.e. FSU) and war destruction, are much more important explanatory variables than either the liberalization index or inflation (Åslund, Boone, Johnson, 1996). Other studies that tried to take into account a number of initial conditions (repressed inflation – monetary overhang before deregulation of prices, trade dependence, black market exchange rate premium, number of years under central planning, urbanization, overindustrialization, and per capita income) found that in some cases liberalization becomes insignificant as well (De Melo, Denizer, Gelb and Tenev, 1997, p25).

Moreover, it was shown that over 60% of the differences in the economic performance can in fact be explained by uneven initial conditions, such as the level of development and pre-transition disproportions in industrial structure and trade patterns (see also section 2.1). After controlling for these non-policy factors, the impact of liberalization becomes insignificant. Once variations in inflation rates and institutional capacities of the state (as measured by the change in the share of government revenues in GDP) are added to the list of explanatory variables, together with non-policy factors, they explain 85% of differences in GDP change in 28 transition economies (Popov, 2000). Similarly, Campos (1999a) found evidence that government expenditures are positively, and not negatively, associated with economic growth in transition economies.

Two basic explanations were suggested to account for the puzzling absence of a link between liberalization and growth. First, the non-linear character of the relationship, implying there is a certain threshold level of liberalization, which needs to be achieved to reap the benefits of the market reforms, and the lagged effects of liberalization (Hernandez-Cata, 1997). It was suggested by Selowsky and Martin (1997) that performance depends positively on the accumulated stock of reform, but negatively on the contemporaneous liberalization. De Melo, Denizer, Gelb and Tenev (1997) obtained the statistical evidence for this kind of relationship, finding that “a liberalization step that more than doubles the previous period’s level of liberalization is required for overall effect on growth to be negative” (p.27). However, even accounting for these factors, it is difficult to demonstrate a strong and clear-cut relationship between the variables in question. The example of Chinese reforms that were transformed into higher growth rates of output right away casts doubt on the “ lag theory” , while the correlation between the degree of liberalization by the end of 1994 and the performance in 1994-98 (figure 4) is actually weaker than the correlation without the lags, for 1989-96/98 period (see figures 1 and 2, and tables 4 and 6 in Popov, 2000).

Second, it was suggested that the speed and extent of liberalization, which is included as an explanatory variable on the right-hand side, may itself be endogenous, i.e. liberalization policy may depend on the initial conditions and the magnitude of the decline in output as a result of liberalization (Ickes, 1996; De Melo, Denizer, Gelb and Tenev, 1997; Kruger and Ciolko, 1998; Heybey and Murrell, 1999). It was shown that liberalization itself depends on the initial conditions and on political change (as measured by the Freedom House political freedom index - De Melo, Denizer, Gelb and Tenev, 1997). Krueger and Ciolko (1998) demonstrated through constructing the instrumental variable (by linking liberalization to initial conditions specified only as the pre-transition share of exports in GDP) that the hypothesis of the endogeneity of the liberalization variable cannot be rejected. The worse the initial conditions for transformation, the greater the probability of the deep transformational recession, and hence the more likely delays in liberalization. This second argument is precisely a political economics argument: what reforms legislators should put in place depends on the political acceptability of those. When initial conditions are favorable, rapid liberalization is feasible and preferable. When they are not favorable, the best liberalization strategy is to sweeten reforms. Milder reforms are the only way to speed up the process and enhance political acceptability, as we highlighted in section 3.

The correlation between liberalization and distortions[11] is obvious (figure 5), but

[11]Figure 3 uses the cumulative measure of distortions as a % of GDP equal to the sum of defense expenditure (minus 3% regarded as the “normal“ level), deviations in industrial structure and trade openness from the “normal“ level, heavily distorted trade (among the FSU republics) and lightly

it is less clear whether there is a causation relationship between these variables[12]. Empirically, the speed of liberalization may be equally successfully explained by other factors. It is known that economic liberalization and democratization go hand in hand, supporting one another (figure 6). Hernandez-Cata (1999) shows that 85% of variations in liberalization indices may be explained by geographical proximity to market economies, index of political reform, size of the shadow economy and different regional dummies. Fidrmuc (1999, chp. 1) shows that the relationship between political reforms and growth performance is actually non-linear, with increasing returns to political reforms beyond a certain threshold only. Also, he shows that the political performance of the incumbent crucially depends on past performance (as measured by realized unemployment and growth rates)[13].

<< Insert figures 5 and 6 about here >>

4.1.3 Political Economy of Liberalization and Reforms

The literature provides a number of arguments on why decision-making process in a perfectly democratic environment may lead to sub-optimal economic policy choices. If reforms lead to gains for the majority of the population in the long-run, but only at the cost of short-term losses for some groups, they can be blocked by the electorate and will never be carried out. Income inequalities give rise to the option of redistribution, which may be more attractive to the majority of the electorate than the option of promoting economic growth. Redistribution is harmful for growth but, for the poorer majority, losses resulting from the slowdown of economic growth may be counterweighted by gains from redistribution (Alesina and Rodrik, 1994; Persson and Tabellini, 1994).

distorted trade (with socialist countries) taken with a 33% weight. See (Popov, 2000) for details.

[12]Our data suggest that 84% of the variations in the liberalization can be explained by distortions in the industrial structure and trade patterns, decline in government revenues and rule of law and democracy indices (all coefficients significant at 5% level). The GDP change variable, if added to the above mentioned, is insignificant.

[13]Fidrmuc (1999, chp 1, pp11-12) distinguishes the effects of these variables on the support for different types of parties. Pro-reform parties tend to lose voters if unemployment increases and growth slows down. The support for former Communist parties and nationalist parties reacts exactly in the opposite way. Note still that most of the left-wing parties, once elected, pursued reforms at least as heavily as pro-reform parties before them.

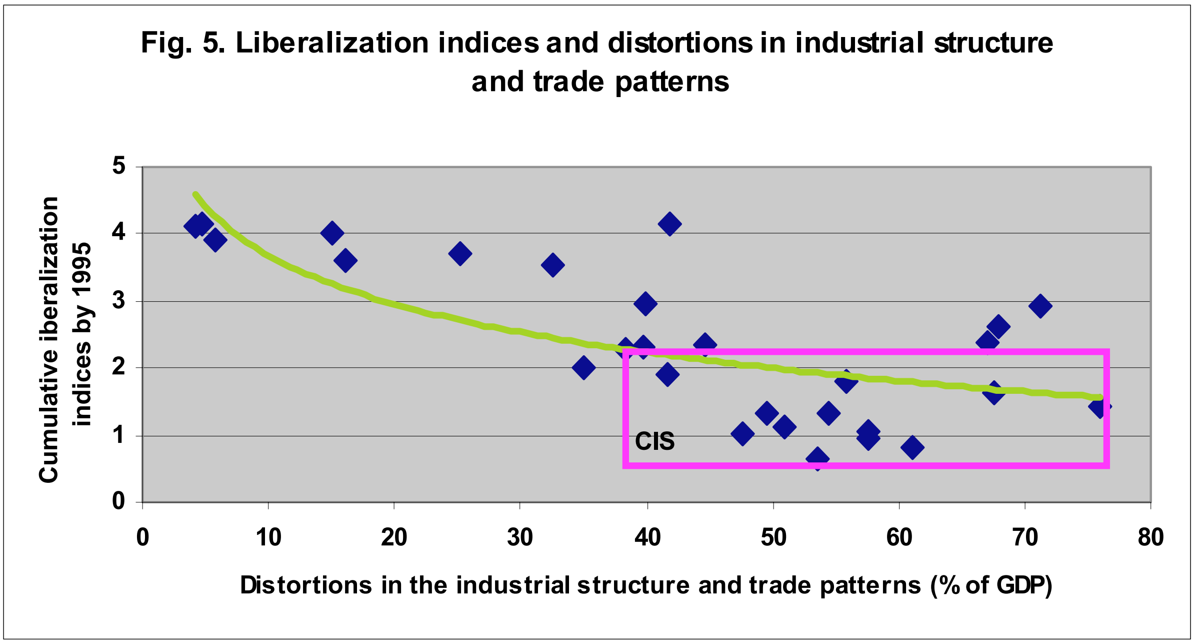


Fig. 5. Liberalization indices and distortions in industrial structure and trade patterns
Cumulative iberalization indices by 1995
Distortions in the industrial structure and trade patterns (% of GDP)
CIS
0
1
2
3
4
5
0
10
20
30
40
50
60
70
80

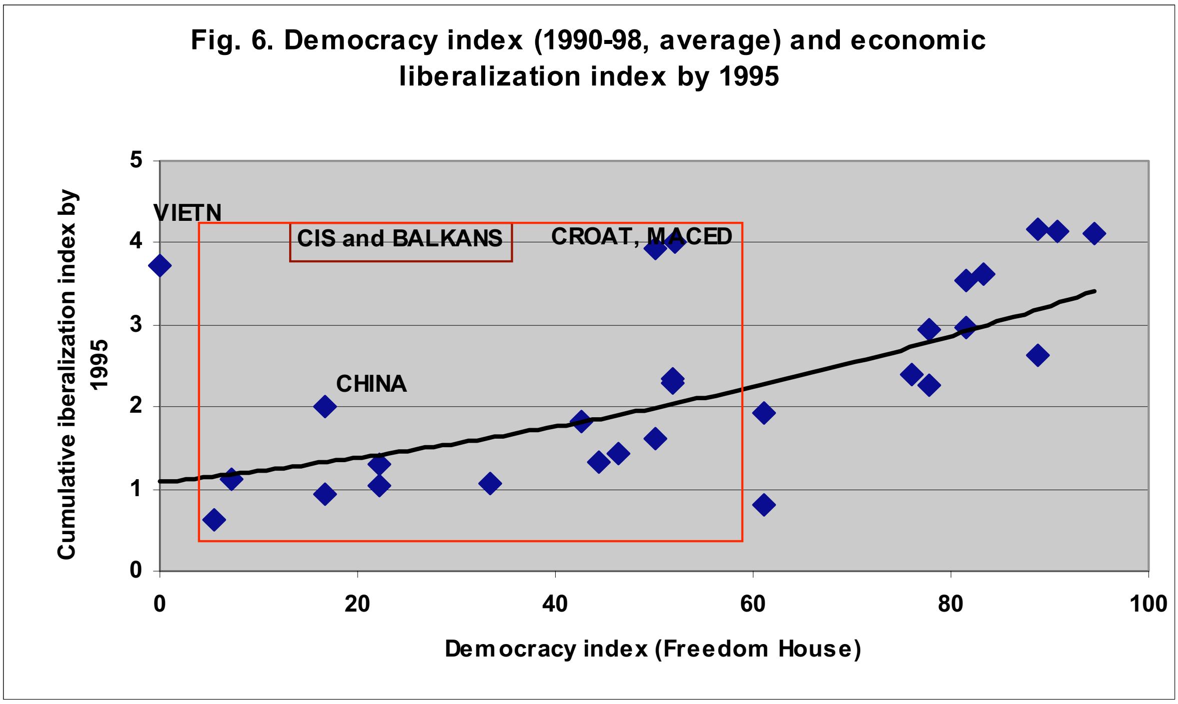


Fig. 6. Democracy index (1990-98, average) and economic liberalization index by 1995
Cumulative iberalization index by 1995
Democracy index (Freedom House)
VIETN
CIS and BALKANS
CROAT, MACED
CHINA
0
1
2
3
4
5
0
20
40
60
80
100

Even when it is known that losses from economic reforms will only affect the minority, the uncertainty about the possible outcomes may lead a rational individual to vote against the reforms (Fernandez and Rodrik, 1991).

The uneven distribution of gains and losses, and the uncertainty about the possible gains and losses appear to be, not the only one, but the most powerful theoretical justification for the "autonomous", if not authoritarian, leadership insulated from particularistic pressures (Rodrik, 1996).

The conventional wisdom before transition tended to identify reform with liberalization and to suggest that democracy may threaten the reform process. The implicit assumption was that deregulation and greater marketization (liberalization and reform) should inevitably lead to greater efficiency in the allocation of resources, and hence will necessarily increase the total welfare in the long-run. In the short-term, however, it was understood that reforms may cause considerable losses for certain groups of the population and thus provoke resistance to reform. It was therefore suggested that reforms should be implemented quickly (shock therapy), before the pain of reforms generates opposition that makes further reforms politically impossible. In fact, one of the major justifications of shock therapy was the belief that reformers have a narrow window of opportunity –if they were not be able to capitalize on the reform momentum, the democratic process would finally allow the losers to gain strength and stall the reforms. "*The concentration of political power, limited political competition and rapid implementation enhance the prospects of the adoption of economic reforms*", –this is how the conventional wisdom was summarized in the recent EBRD Transition report (EBRD, 1999, p.102). This conventional wisdom emerged mostly from the analysis of the reform experience in developing countries.

Nothing of this sort seemed to have happened in transition economies. First, as was argued earlier, the pace of reforms did not have a significant impact on performance, which was determined mostly by initial conditions, by the institutional capacity of the state, and by how prudent macroeconomic policy was. Countries lagging behind the front-runners (in terms of liberalization) in many cases did better than most advanced reformers. Land has never been in privatized –nor traded– in China during the reform period, but agricultural output grew faster than in any other transition countries.

Secondly, and surprisingly, the pace of reform/liberalization turns out to be higher in countries with stronger democratic institutions, less stable governments, frequent elections and changes of governments. While reforms in East European countries were initially carried out by non-communist parties, later, when opposition communist-successor parties came to power, they did not reverse the reforms and sometimes even did not slow down the pace of liberalization. The Transition Report (EBRD, 1999, chapter 5) provides evidence that there is a positive correlation between the reform index on the one hand and the dissolution of political power. Countries with limited executive power (limited authority of the president and/or the prime-minister), with governments based on coalitions rather than on a firm parliamentary majority, with the frequent changes of governments (short average tenure of governments), and with higher level of democracy in general were also ahead of others in terms of the speed of economic reforms. Hellman (1998) examines the cases in which reforms got stuck and concludes that the frequency of elections actually helps to push reforms forward. The more elections the country had, the better were the chances to re-ignite the reforms. Dethier, Ghanem and Zoli (1999), using panel data from 25 post-communist countries, argue that democracy facilitates economic liberalization. While the way the causation runs is still disputable in all studies, there is little doubt that economic liberalization and democratization in post communist countries were going hand in hand.

4.1.4 Democracy, elections and liberalization

The political science tradition is to try and explain cross-country differences in reform efforts by political-social-cultural factors, such as educational levels, the degree of democratization (political freedom), the outcome of the first elections, the dominant religion, the ethnic composition of the population, the type of government (presidential versus parliamentary democracy). So far, available evidence suggests that the key variable that overshadows all the other social-political factors is the outcome of the first post-communist elections: if reform parties do well at these elections, the future steep trajectory of economic liberalization is pre-determined (Fish, 1998a). Furthermore, the outcome of these first elections appears to be a good predictor of future political liberalization with the result that both the path of economic reforms (economic liberalization) and the path of democratization are shaped by and large by this single crucial event on the eve of transition (Fish, 1998b).

The question then, of course, is what explains the behavior of voters at the polls, why they vote in or out more or less reformist governments. To begin with, authoritarian regimes, like in China, Vietnam, Soviet Union before the collapse, Uzbekistan and Turkmenistan seem to have the option to choose whether to proceed with gradual or radical economic reforms. China opted for dual track price liberalization, while Vietnam, after brief experiments with the Gorbachev-type step-by-step reforms in 1986-89, introduced Polish style shock therapy (instant deregulation of most prices and introduction of convertibility of dong).[14] More or less democratic regimes, on the contrary, seem to try and carry out economic reform programs at once. In fact, is quite meaningful, that "classical" gradualists in economic liberalization (with dual track pricing) are found only among communist authoritarian countries (China, Hungary in the 1980s, USSR and Poland in late 1980s, Vietnam in 1986-89, Yugoslavia in 1972- 1990), whereas in countries with the minimal amount of democracy, prices are deregulated right away, overnight. Later, the reforms in these democratic countries may slow down, but in this case they are usually called procrastinators (not "gradualists"), proceeding with economic reforms slowly and inconsistently. This is probably another instance of the ex-post constraint explained in section 3.1.

Whether economic liberalization slows down or not because voters facing large reduction of output change their attitudes to reforms, remains an open issue, even though anecdotal evidence seems to be pretty strong: in many East European countries and FSU states, radical reform parties that introduced shock therapy packages were voted out of power. This was once the major concerns of the "big bang" theorists, so they were putting a heavy emphasis on working out the blueprint for reforms in secrecy and introducing the whole reform package at once, so that the status quo bias is moved and it becomes too costly to revert reforms.

In the first half of the 1990s, when radical (reform minded) parties in power contested elections, they won in 3 out of 5 cases, whereas slow-reform parties lost in 4 out of 4 cases, and ex-communist parties lost in 2 out of 4 cases (Åslund, Boone and Johnson, 1996). Also, in Russia there appears to be some correlation between the

[14]Immediate deregulation of prices in Uzbekistan and Turkmenistan and other former Soviet republics in 1992 was dictated by the deregulation of prices in Russia and the inability to maintain control over domestic prices given the absence of custom borders. Later, however, reform paths of these Central Asian states diverged from that of Russia.

preferences of the electorate (as measured by the results of the mid 1990s regional and federal elections – both legislative and gubernatorial and presidential elections) and reform-oriented economic policies of the regional administrations (measured as the average of the indicators of price controls, small privatization, and the share of subsidies in the regional budgets and in agricultural output)[15] - figure 7. Moreover, the electoral preferences themselves appear to be quite stable: pro-reform regions in 1993-96 (that voted for reform leaders and parties in this period) generally supported reformers again at March 2000 presidential elections (Yavlinsky versus Zuganov).[16] Another study of the Russian regional voting patterns found that reform policies of the regional governments are not rejected, but supported by the voters at the polls, even when such " objective" factors as urbanization, education levels, preceding reduction of income during reforms, wage arrears and alcohol consumption are controlled for and instrumental variable for reform efforts is used (Warner, 1997).

<< Insert Figures 7 and 7a about here >>

This way or the other, even if we accept the reasoning that high costs of reforms (output fall leading to real income reduction and unemployment) forces the public to reconsider previous reformist perceptions and to vote out too radical governments, this reasoning would not carry us too far. First, even assuming the pace of reforms slows down, this should not be the issue of major concern, since there is way too much evidence today that the speed of liberalization does not influence performance or influences it insubstantiality as compared to other factors (institutional collapse). Second, in retrospect, the perceptions of the public and policymakers on the eve of transition were so different from today's knowledge based on the decade-long transition experience, that it is difficult to see how rational choices could have been made at that time. If one recalls the debates that took place in communist countries during the initial stages of reforms and compare them to today's knowledge and level of discussion, it is apparent that the public opinion itself changed dramatically during transition.

[15] See (Popov, 1999c) for details.

[16] The pro-reform vote is measured by the ratio of Yavlinsky (pro-reform) to Zuganov (against reform) votes since other major presidential candidates did not have a clear cut political orientation.

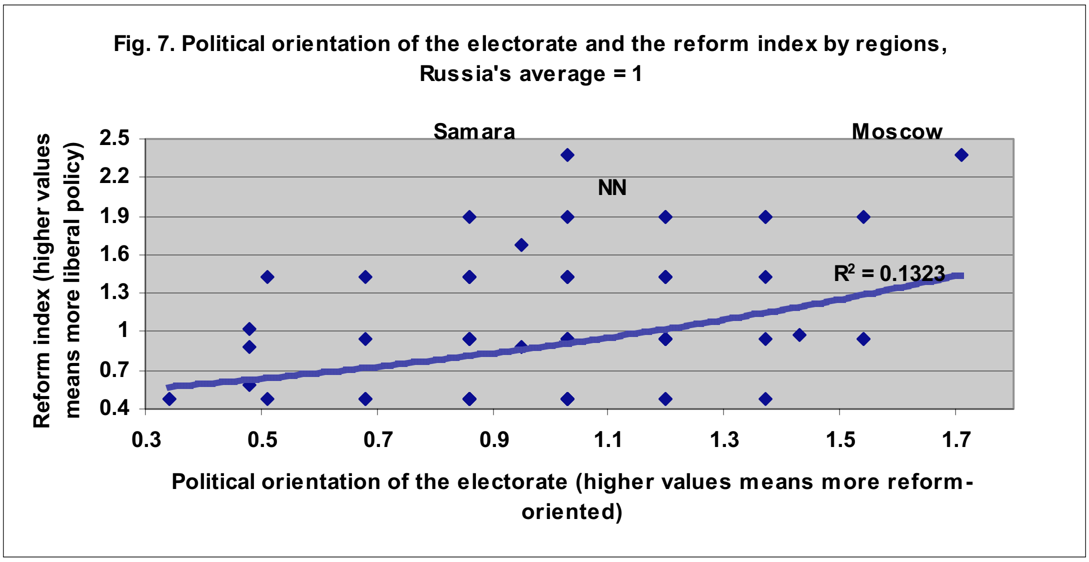


Fig. 7. Political orientation of the electorate and the reform index by regions, Russia's average = 1
Samara
Moscow
NN
$R^2 = 0.1323$
2.5
2.2
1.9
1.6
1.3
1
0.7
0.4
0.3
0.5
0.7
0.9
1.1
1.3
1.5
1.7
Reform index (higher values means more liberal policy)
Political orientation of the electorate (higher values means more reform-oriented)

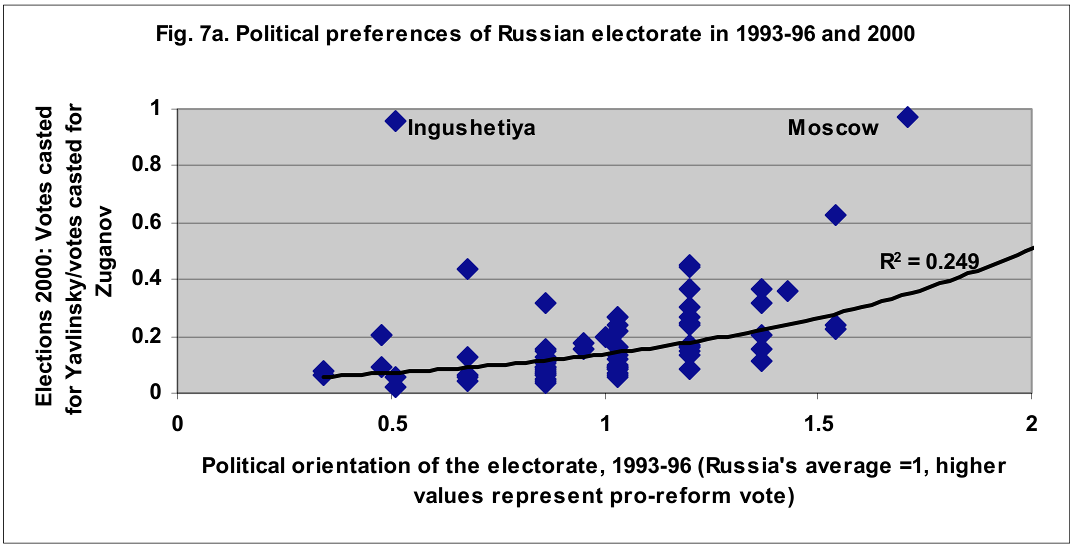


Fig. 7a. Political preferences of Russian electorate in 1993-96 and 2000
Ingushetiya
Moscow
$R^2 = 0.249$
1
0.8
0.6
0.4
0.2
0
0
0.5
1
1.5
2
Elections 2000: Votes casted for Yavlinsky/votes casted for Zuganov
Political orientation of the electorate, 1993-96 (Russia's average =1, higher values represent pro-reform vote)

One example would be the opinion polls carried out in 1989-90 in the former Soviet Union about the attitude to different reform proposals: most respondents were against cooperatives, which at that time were selling their output at market prices; 47% of respondents supported the idea of private enterprises, but over 50% simultaneously believed that they should remain family businesses and should not be allowed to hire employees; 2/3 felt that state enterprises should dominate in the future Russian economy (Ekonomika i Zhiz'n, Nov. 2, 1990; Izvestiya, February 26, 1990; Argumenty i Facty, No. 21, 1990).

To cite another example, the government program of the gradual transition to the market in the USSR, which failed to get the support of the Soviet Supreme Soviet in May 1990, was based on the forecasts that now could be described at best as naive: 50% increase in GDP from 1990 to 1995 in case of shock therapy and 30% increase in case of gradual transition (table 7).[17]

<< Insert Table 7 about here >>

It is thus clear that the perceptions about the need for reforms and the cost of reforms were not stable, and instead changed dramatically over time. The median voter that voted for Yeltsin in 1991 was against deregulation of prices, whereas the median voter that supported Yeltsin in 1996 does not question the need for market prices, despite the reduction in real incomes in 1990-96. The traditional approach can help explain opposition to reforms that emerged during the hardship, but it does not explain why this opposition did not translate into the reversal of reforms. More importantly, it says nothing about the change in the preferences of the electorate itself.

[17] In the late 1980s the pervasive expectation was that market reforms should lead to the immediate increase in output. In 1989 one of the authors of this paper tried to publish the article entitled " Tighten Your Belts, Hard Times Ahead" (arguing that there is going to be 25 to 30% reduction of output in 3 to 5 years to come) in Soviet press, but several newspapers refused on the ground that it over-dramatizes the situation (in English it appeared in Geonomics Newsletter, May-June 1991). Even in 1990, when the reduction of output has already started, the predictions of the first radical program of the transition to the market in the USSR (" 500 days") were: a temporary (unspecified in quantitative terms) reduction of output during first 400 days and increase in unemployment from 6 million in 1990 to 12 million by the end of 1991 (i.e. a rise in the unemployment rate from 4 to 8%), and " stabilization" of living standards during the transition period (Shatalin et al., 1990).

Table 7. The Two Restructuring Scenarios Presented by the Government to the Supreme Soviet, May 1990

Year	Indicator	Percentage change from 1990: Shock therapy	Gradual change
1991	GNP	-10 to -15	-5 to -9
	Employment	-5 to -7	-3 to -5
	Investment	-47 to -52	-14 to -19
	Real incomes	-4 to -7	-1 to -3
1995	GNP	+44 to +50	+25 to +35
	Employment	0 to +2	0 to +1
	Investment	+47 to +57	+5 to +10
	Real incomes	+25 to +30	+5 to +10

Source: *Ekonomika i Zhiz'n*, 1990, No28.

What needs to be explained is the change in the perceptions of the majority of the voters in the pro-reform direction despite economic hardship caused by reforms.

Voting patterns in post-communist countries seem to be very different from those in mature democracies in that they are not sensitive to the deterioration of economic situation. Whereas the conventional wisdom states that, in liberal democracies, incumbents benefit from the expanding economy, whereas and opposition thrives on misery, the study of the voting behavior in three Central European countries (Fidrmuc, 1999) revealed a different pattern. Retirees and unemployed tended to vote for leftist (successor-communist) parties not only when these parties were in the opposition, but also when they took power. To put it differently, they were prepared to accept economic hardship from social-democrats, but not from rightist parties. Even the losers (unemployed and pensioners) supported the key elements of the reform program (marketization and privatization), if not in the beginning of reforms, then later, after these reforms were carried out, and were prepared to pay a price for these reforms in the form of the reduction of living standards. In Poland and Hungary comprehensive privatization programs and harsh austerity measures, including pension reform, were carries out by leftist post-communist parties.

To summarize, there is still no theoretical evidence that a "big bang" approach is associated with less costs than the gradual one. And there is still no persuasive empirical evidence that fast liberalizers performed better than slow liberalizers. When policy-makers and the public were making choices in the first democratic elections, they usually opted for fast track reforms on the assumption that this would minimize pain. Several years later, the opposite assumptions (that slow reforms would be less painful) were used to justify the idea of "less shock and more therapy". Some reform parties and leaders were voted out of power, but it did not lead to the reversal of reforms, since the perception of the electorate, despite reform-generated economic hardship, changed in favor of pro-market system.

Today's growing body of evidence seems to suggest that in both cases the assumptions were wrong, since there are more powerful factors determining the performance during transition and diminishing the impact of the speed of liberalization to a point of secondary, if not tertiary importance.

Nevertheless, even though the speed of liberalization in transition economies does not matter that much, it is interesting to observe the link between democratization and reforms. Unlike in developing economies, where democratic decision making often resulted in the populist policies and setbacks in the reform process, in transition economies democratization tended to strengthen the reform process due to the changing perceptions of the electorate (in favor of marketization). The explanation lies most probably in the different nature of the reform process itself: in transition economies reform meant more than in developing countries, in particular it meant marketization (elimination of production quotas, rationed supply of resources and deregulation of prices), i.e. elimination of the centrally planned economy, and mass privatization. These latter components of the reform process gained public support as reforms unfolded despite the economic hardship, and hence even major opposition forces never suggested to reverse marketization and privatization. On the contrary, with respect to conventional reform agenda (industrial policy, subsidies and industrial restructuring, macroeconomic stabilization) political economy of reform in post-communists states seems to follow the patterns revealed for developing countries. These conventional reform areas are discussed in the subsequent sections (4.4 and 4.5).

4.2 Privatization

Even if, at the start of transition, price liberalization was the most urgent problem, the one requiring most effort and investment was certainly restructuring the production structure. The first step in that direction was to hand the existing production structure to the private sector. For the governments, this privatization process was a real challenge. **Selling** the assets is a way to loosen the governments' budget constraints. But selling takes time and requires huge funds on the buyers' side. And governments wanted to go fast, while available resources were dim. Moreover, the privatization process was also a way to distribute wealth across citizens, which made equity concerns enter into the play. For equity reasons, *selling* was a problem (by opposition to give-aways). Extracting rents from (rich) foreigners is a good thing. Extracting money from (poor) nationals goes against moral –and hence political– principles. Last but not least, democratic pressure was important in such fresh democracies, and citizens need not want the same as academics.

The first purpose of this section will be to briefly remind the reader of the possible privatization methods and compare their expected efficiency. As we shall see, the number of *efficient* methods is quite limited. But all countries did not use one of these methods. The second purpose of the section will then be to try and rationalize the choice of inefficient methods. We are also proposing some new alleys of research to rationalize citizens' behavior in that process.

As main references, we are using Roland (2000, chps. 10 and 4); Boycko, Shleifer and Vishny (1993); and Schmidt and Schnitzer (1997).

4.2.1 A few privatization methods

Very early, privatization proved to be one of the crucial aspects of transition. The economy could grow only if investment was channelled to the right enterprises. To attract investment, enterprises must yield benefits to the investors. To this end, they had to be efficiently managed, and hence property transferred to the right entrepreneurs. An efficient privatization method must therefore achieve both an efficient *ranking* of potential buyers and provide the right *incentives* to them after privatization. Therefore, the method must first reveal information about the valuations and the abilities of the different buyers. More efficient managers should be able to generate more value added and therefore should be willing to bid higher prices for the firm.[18] Auctions are an efficient way to achieve such a screening. Privatization could then be made by auctioning the firms, either for money or for vouchers. But if one wants to sell all the country's firms within a couple of years, liquidity constraints will limit feasible bids. Therefore, auctioning firms for money was bound to deeply undervalue these firms, a widespread problem in the early phase of transition. A way to circumvent this is to auction firms for *non-cash bids*, which untie intrinsic valuation from liquidity constraints: the buyer must offer a future flow of payments in exchange for the firm, instead of cashing money up-front[19].

[18] Valuing these firms is also a difficult task, as they were never operated according to market rules and at market prices before. This valuation is also bound to take time. Nevertheless, auctions is also an efficient way to aggregate available information, as bids reflect available information. See Schmidt and Schnitzer (1997) for a discussion of the revenue raised by different types of auctions.

[19] Roland (1999, chp 10) also clarifies the distinction between top-down (the government decides when to sell which firm) and bottom-up (buyers announce which firm they are interested in) privatization methods. In addition, the problem of ex-post incentives depends on the ownership structure. We are coming back to this below. About non cash bids, refer to Roland (2000), section 10.2.1.

The main concern with auctioning the firms was the time, the resources and the information needed to achieve an efficient auction. In fact, even countries like Germany, which managed to start privatization very fast in the first years had a problem later to maintain momentum, in spite of a 3000-employee strong Treuhandanstalt.

Another possibility is to give firms away, to citizens or workers. These can then decide whether to keep their shares or resell them (in the Czech republic reselling was forbidden for a year). This method is rapid and fair: even the poorest citizen can become a shareholder. But it needs not be efficient. For the privatization method to be efficient, it needs to give the right incentives to the managers. To this end, a good solution is to have a core shareholder with a good project for the firm. Former managers generally do not have the appropriate ability. Their skills were appropriate to serve the plan, not necessarily the market. Workers, in the same way, were facing new challenges, which they might not be able to overcome. For that reason, privatization to insiders poses ex-post problems: the firm faces an increased risk of being unable to restructure. For instance, if workers become the owners of the firm, the latter becomes a cooperative, and cooperatives are known to generate inefficient labor hoarding. Giveaways to insiders then poses a double-edge problem: first, it does not improve the matching between the management and the firm, and second, it gives the worst ex-post incentives to restructure. Still, it may be favored by insiders who mainly fear the new, market-oriented, institutions.

4.2.2 Presumed efficiency of the different methods

The main trade-offs were thus the following ones:

1. *Selling or giving-away?* Selling provides resources to the government. Giving away builds more support for privatization. For that reason, selling should be more efficient (it lowers future taxes), but may be blocked.

2. *To insiders or to outsiders?* Outsiders improve the expected efficiency of the firm in the future, but requires more effort and generates more risk for the insiders, who may be made redundant in the process. Insiders know how to serve themselves better, but should not be expected to restructure the firm very deeply[20].

[20]Ex-post measurement of firms' performance tends however to show that actual differences were

3. *Top-Down or Bottom-Up?* Bottom-up privatization has the advantage of revealing the demand-side, but faces a selection bias problem. Indeed, two types of demands will mainly emerge. On the one hand, the insiders who try to buy a firm may be those who know they have most to fear from outsiders. On the other hand, outsiders –mainly foreigners– will mainly buy the "jewels" of the country. This is not the best way to improve the efficiency of the average firm, and it may displease nationals. Top-down privatization removes this selection bias, but faces the speed vs. efficiency trade-off: *all* the firms of the country had to be privatized. Which solution is most efficient depends on available resources, average initial productivity, initial efficiency, etc...

Germany chose a top-down with sell-away method. Poland never managed to pass through such a reform, as insiders were blocking the process. Russia, in the first (and main) round of privatization, gave firms away to insiders, preventing bottom-up privatization besides voluntary reselling by the new owners. Given the trade-offs we presented, this seems to be the worst possible choice. The rationale behind such a choice is the political pressure, as we discuss below.

Note that we did not mention the option of "growing out of socialism". Following this road, no firm is privatized, but new private firms are allowed to be create on the side of existing state firms. This road is followed in China, but did not even seem to be an option in CEECs.

4.2.3 The political economics of privatization

To our knowledge, there is little empirical work on the political economics of the choice of a privatization method. As we mentioned in section 3.2, the availability of data on roll call votes should enable extremely interesting research on this topic, to identify the political movements behind these choices. This would enable researchers to identify the main forces shaping these decisions. Was it a left-right ideological debate? Rent-seeking? Insiders' pressure? At this time, we can mainly "build a story" based on available evidence, common wisdom, and newspapers' reports.

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not that strong between insider and outsider privatized firms. Only firms with a large share of foreign shareholders perform significantly better. But this may reflect a selection bias problem, showing that foreigners purchase only the very best assets.

The most interesting case to analyze in the framework of a political economy paper is that of Russia. A detailed analysis of the Russian privatization program can be found in Boycko, Shleifer and Vishny (1993).

All main theories about the method of privatization focus on the best way to maximize the value, the productivity or the efficiency of the firm. As we just explained, some methods are clearly "efficient", while some others are clearly "inefficient". Still, the "inefficient" methods were used intensively, mainly in Russia, where the main privatization method was give-aways to workers. This method transforms state-owned enterprises into some kind of cooperatives, a type of organizational form which is known to be inefficient.

The important thing to note, however, is that "inefficient choices" were generally made under popular pressure. Several types of explanations can be put forward to explain why the people, the "working class", was so fond of these inefficient methods. The first one –the easy way–, is some kind of irrationality or at least deep misunderstanding of the implications of the privatization method. Following this kind of explanations, bad choices are made because people wanted to make these choices, a purely tautological explanation, and actually the best to argue why democratic choices are inefficient. Still, deep misunderstanding or irrationality does not seem so convincing in front of the data. For instance, Shiller, Boycko and Korobov (1991) polled Russians (Moscovites) and Americans (New Yorkers) and asked them how they would behave if confronted to some economic problem. Their result is that, in most dimensions, the attitude towards the market was not statistically different between the two sets of people, even a few months after the beginning of transition. Therefore, nor their rationality, nor their understanding of markets, is an issue. Different choices seem to be mainly motivated by different incentives, not by a deep misperception of the effects of the privatization method.

Roland (1999, chp. 4) summarizes the main theories developed around the political economy of privatization. The main type of argument is the risk of policy reversal, in the same line as we saw in section 3.1 with the problem of ex post constraints. A privatization method that creates huge efficiency benefits but pays only to a small minority faces the risk of strong pressure for renationalization. Roland and Verdier (1994) show that this risk can be fully eliminated only if a certain critical mass is reached, ensuring that enough voters favor further privatizations. In their framework, the pressure for reversal comes from the desire to maintain labor hoarding, and therefore reduce transitional unemployment. To counterbalance this increased risk of unemployment, giveaways distribute parts of the benefits of the restructuring to more people/voters. Giveaways aim then at building support for privatization. But giveaways to insiders do not pool risk and therefore enforce fewer irreversibility than giveaways at large (Schmidt 2000). This argument is the same as an optimal portfolio one: a rational investor diversifies risk.

But then why choose the worst type of choice in Russia? We would propose the following explanation, which certainly requires better analytical and empirical work. Existing theories were looking for increased *efficiency* in the privatization method and confronted efficiency gains to the political risk of *reversals*.

Our argument would be that voters were rather maximizing their *individual income*, that is the sum of salary, on-the-job perks, their valuation of controlling the speed of internal restructuring, and the usual efficiency gains. All the "classical" elements of the other theories are the same as here, excepted that one should also consider that workers may like to control *when* to restructure. If one supposes that policy reversals are impossible, the only risk for insiders is not to find another employment. For them it is then crucial to have some control on the timing of restructuring. Restructuring requires lay-offs. For the workers, it is best to face the risk of lay offs when the ratio of vacancy to unemployment is high. Therefore, when unemployment is (expected to be) high workers have high incentives to delay restructuring and maintain a low wage rather than no wage. And the weaker the industrial structure, the stronger is the incentive to resist immediate restructuring. Another mechanism which reinforces this phenomenon is the absence of a good social safety net. Unemployment benefits act as an insurance, reducing risk aversion against unemployment.

Russia is the typical example where, first, the industrial structure was extremely inefficient, second distances are huge –and therefore job switching most costly–, and last, on top of this, the social safety net is almost absent. The absence of the latter has been proved to be a strong hurdle to labor mobility (see Boeri 2000, and Friebel and Guriev 2000).

Just to make the comparison starker, let us pursue our argument with two examples. Consider first a country were the production system is rather efficient on average.

Inefficiencies are concentrated in some particular firms and budget constraints are hardened already. The typical firm is then likely to be efficient, requiring few lay-offs. In this case, selling the firm to the best manager is the best choice: the probability to lose one's job is limited and it should be easy to find another employment. In this case, individual income is mainly linked to the efficiency of one's firm and workers/voters reason in the same way as economists. But now consider another example, a country where the industrial structure is known to be inefficient and labor hoarding is common place, as in Russia. In this case, the efficiency of the firm is of secondary importance. The shares a typical citizen can buy would represent a couple of percents of her income. What has value in a share is not dividends. It is voting rights, which can ensure the control of the timing of restructuring. With a different type of argument, Boycko, Shleifer and Vishny (1993) argue that "*privatization is always and everywhere a political phenomenon. [...] By creating a class of supporters of reform and reducing the power of its opponents, privatization can change the political balance in the country*" (p.147). In their view too, the Russian privatization program was built only to meet political constraints –the tighter in all transition countries according to them–. They detail extremely well the fact that each political actor received a share of the pie that was proportional to their bargaining power. But they do not seem to give a detailed argument for insider rather than outsider privatization.

The Czech republic, with the benefit of some luck, achieved an efficient privatization. The Czech privatization plan was to sell firms for vouchers well below their actual value. This would have generated excessive dispersion of ownership and therefore inefficient ex post incentives for the management. But luckily trust funds were created, where stockholders were offered extremely high returns for delegating voting rights. Through this process, a large fraction of the population participated privatization but control rights remained concentrated.

4.3 Institutional Capacity Building[21]

4.3.1 Government Spending, Institutions, and Performance

The decline of the institutional capabilities contributed a great deal to poor economic performance, especially in CIS countries. If regression equations that account for initial

[21] This section is partly based on Popov (2000).

conditions only are used to predict economic performance (GDP change), it turns out that China and Vietnam did much better than expected, EE and Baltic states on average did not so good –but still a bit better than expected–, whereas most CIS states did much worse than expected (Popov, 2000). Exceptions within CIS prove the rule: Uzbekistan and Belarus, i.e. exactly those countries that are not only known for proceeding with slow reforms, but are also believed to have the strongest state institutions among all CIS states.[22] The Ukrainian example, on the other hand, proves that it is not the speed of reforms *per se* that really matters: being a procrastinator, it did nevertheless worse than expected due arguably to the poor institutional capabilities (trust in political institutions in Ukraine is markedly lower than in Belarus).

The efficiency of state and non-state institutions is not easily measurable. In most FSU and Balkan countries the collapse of the institutions is observable in the dramatic increase of the share of the shadow economy; in the decline of government revenues as a proportion of GDP; in the inability of the state to deliver basic public goods and appropriate regulatory framework; in the accumulation of tax, trade, wage and bank arrears; in the demonetization, "dollarization" and "barterization" of the economy, as measured by high and growing money velocity, and in the decline of bank financing as a proportion of GDP; in poor enforcement of property rights, bankruptcies, contracts and law and order in general; in increased crime rates; etc. Most of the mentioned phenomena may be defined quantitatively with a remarkable result that China and Vietnam are closer in this respect to EE countries than to CIS. However, the construction of the aggregate index of the efficiency of institutions is problematic because the rationale for choosing weights is not clear.

One possible general measure is the trust of businesses and individuals in various institutions - here FSU states rank much lower than East European countries in all available surveys. In the global survey of firms in 69 countries on the credibility of the state institutions, CIS had the lowest credibility, below that of Sub-Saharan Africa (World Bank, 1997, pp. 5, 35). Especially striking was the gap between EE and CIS countries: differences in credibility index between South and Southeast Asia and EE were less pronounced than differences between Sub-Sahara Africa and CIS.

Another good proxy for measuring institutional capacity of the state is the financial

[22]The decline in government revenues as a % of GDP in these countries was less pronounced than elsewhere in CIS (fig. 9).

strength of the government - the share of state revenues in GDP. Though much have been said about "big government" and too high taxes in former socialist countries, by now it is rather obvious that the downsizing of the government that occurred in most CIS states during transition went too far. This argument has nothing to do with the long-term considerations of the optimal size of the government in transition economies – it is true that in most of them government revenues and expenditure as a share of GDP are still higher than in countries with comparable GDP per capita. But whatever the long term optimal level of government spending should be, the drastic reduction of such spending (by 50% and more in real terms) cannot lead to anything else but institutional collapse.

Before transition in former socialist states not only government regulations were pervasive, but also the financial power of the state was roughly the same as in European countries (government revenues and expenditure amounted to about 50% of GDP). This allowed the state to provide the bulk of public goods and extensive social transfers. During transition tax revenues as a proportion of GDP decreased markedly in most countries. However, Central European countries and Estonia managed to arrest the decline, while Russia (together with Lithuania, Latvia, and several Southeast Europe and Central Asian states) experienced the greatest reduction. In Vietnam the share of government revenues in GDP grew by 1.5 times in 1989-93. Chinese government revenues as a percentage of GDP fell by over 2 times since the late 1970s, but it looks more like a conscious policy choice rather than a spontaneous process (authoritarian regimes have always better powers to collect tax revenues, if they choose to do so, as did all governments in the CPE's before the transition).

In most CIS states the reduction of the government expenditure occurred in the worst possible way - it proceeded without any coherent plan and did not involve the reassessment of government commitments. Instead of shutting down completely some government programs and concentrating limited resources on the other with an aim to raise their efficiency, the government kept all programs half-alive, half-financed, and barely working.

This led to the slow decay of public education, health care, infrastructure, law and order institutions, fundamental R&D, etc. Virtually all services provided by the government - from collecting custom duties to regulating street traffic - are currently the symbol of notorious economic inefficiency. There were numerous cases of government failure which further undermined the credibility of the state since many government activities in providing public goods were slowly dyeing and were only partly replaced by private and semi-private businesses.

Three major patterns of change in the share of government expenditure in GDP[23], which generally coincide with the three major archetypes of institutional developments, and even broader - with three most typical distinct "models" of transition, are shown in figure 8. Under **strong authoritarian regimes** (China), cuts in government expenditure occurred at the expense of defense, subsidies and budgetary financed investment, while expenditure for "ordinary government" as a percentage of GDP remained largely unchanged (Naughton, 1997); under **strong democratic regimes** (Poland), budgetary expenditure, including those for "ordinary government", declined only in the pre-transition period, but increased during transition itself; finally, **under weak democratic regimes** (Russia), the reduction of the general level of government expenditure led not only to a decline in the financing of defense, investment and subsidies, but to the downsizing of "ordinary government", which undermined and in many instances even led to the collapse of the institutional capacities of the state.

While in China total budgetary expenditure and that for "ordinary government" are much lower than in Russia and Poland, they were sufficient to preserve the functioning institutions since the financing of social security from the government budget was traditionally low. In Russia, however, though expenditure for ordinary government seem to be not that much lower than in Poland, the pace of their reduction during transition exceeded that of GDP: to put it differently, given the various patterns of GDP dynamics, while in Poland "ordinary government" financing grew by about one third in real terms in 1989-95/6 (and while in China it nearly doubled), in Russia it fell by about 3 times! The Russian pattern of institutional decay proved to be extremely detrimental for investment, and for general economic performance.

Normally in market economies there is a positive correlation between the level

[23]Data for China (World Bank, 1996b), Russia (Goskomstat) and Poland (Rocznik Statystyczny 1990, Warszawa; and data from Institut Finansow provided by G. Kolodko) do not include off-budget funds, which are very substantial in all three countries and are used mostly for social security purposes. Defense expenditure are from official statistics, i.e. lower than Western estimates, which is likely to lead to overstatement of spending for investment and subsidies at the expense of defense outlays. For USSR/Russia investment and subsidies are shown together.

of taxation, the share of government revenues in GDP and the size of the shadow economy: if taxes are excessive, economic agents tend to avoid taxation through underground activity, including non-reported barter operations (Gardner, 1988, p.24). In transition economies, the opposite is true: the lower are state revenues the larger is the shadow economy (figure 9)[24]. In fact, there was a nearly one-to-one crowding out effect: for every percentage point of reduction in the share of state revenues in GDP, the share of the shadow economy increased by 1 percentage point. To put it differently, the dynamics of the share of government revenues in GDP in transition economies is a rather accurate measure of the ability of the state to enforce rules and regulations. The decline in government revenues is obviously correlated with performance (figure 10), but it is not correlated with other explanatory variables, allowing to avoid multicollinearity.

<< Insert figures 8, 9 and 10 about here >>

After adding the decline in government revenues variable to the ones that characterize initial conditions (level of development and distortions) and external environment (war dummy variable), the explanatory power of the regression increases to 75% with the excellent *t*-statistics (28 observations). And it is quite remarkable that the inclusion of liberalization variables at this point does not improve regression statistics. Factoring in inflation allows to improve the explanatory power to 85%. The correlation coefficient rises further up to 92%, if other indicators of the institutional capacities, such as the share of shadow economy, are added, though the number of observations in this case is only 17 because of the lack of data (see Popov 2000, for details).

Running regressions with the data for 1998 GDP (as a % of 1989) produces similar, though a bit weaker results. Again, liberalization coefficient, after factoring in

[24]To put it differently, Laffer curve apparently is not applicable for macroeconomic comparison of Western countries, since higher tax rates result in higher tax revenues despite the increase in shadow economy (tax avoidance). In transition economies, at least in those where institutions are weak, shadow economy growth (whether caused by higher tax rates or not) is so substantial that it more than counterweighs possible increases in revenue collection. Similar results were reported by Friedman, Johnson, Kaufmann, Zoido-Lobaton (1999) for a larger group of 69 countries - higher tax rates were associated with less unofficial activity.

Fig. 8. Government expenditure, % of GDP

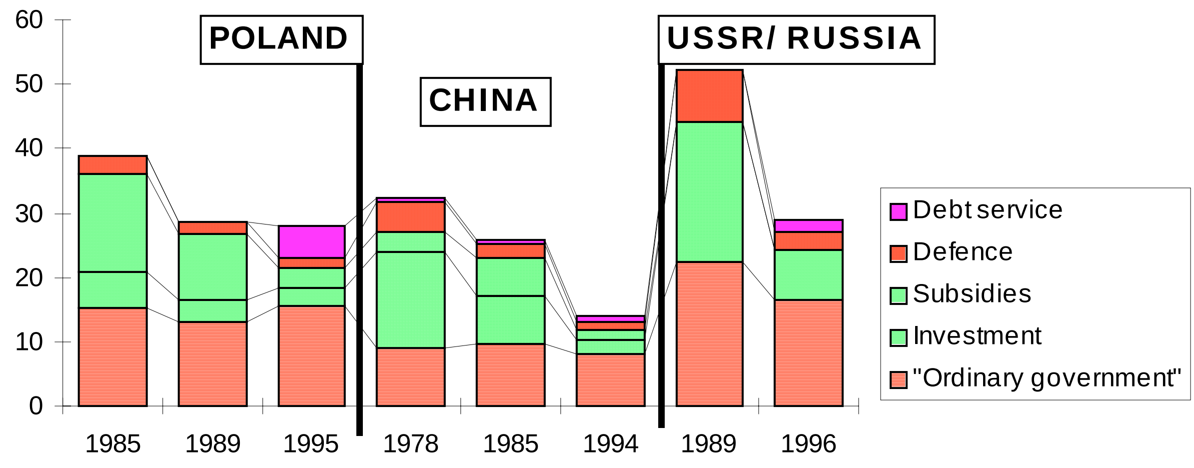


Fig. 9. Government revenues and shadow economy, % of GDP, 1989-96

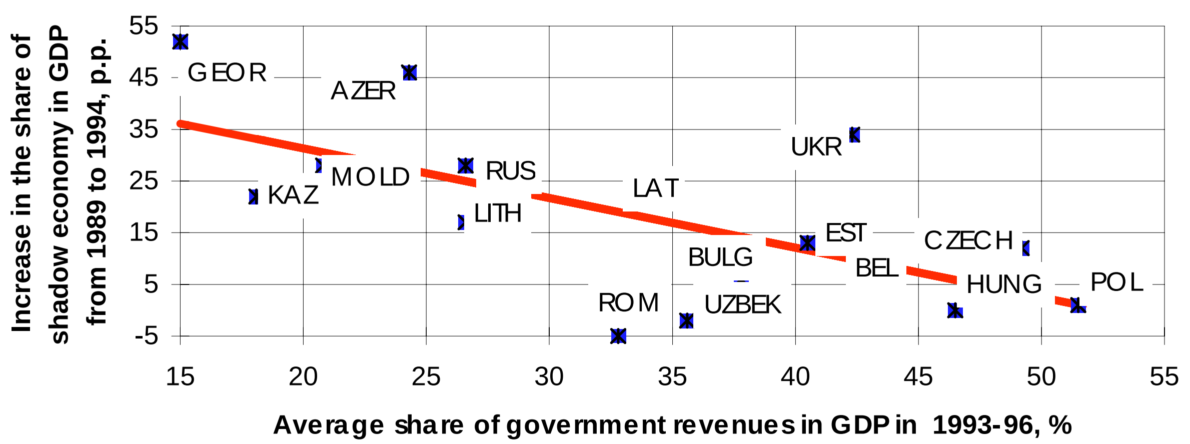
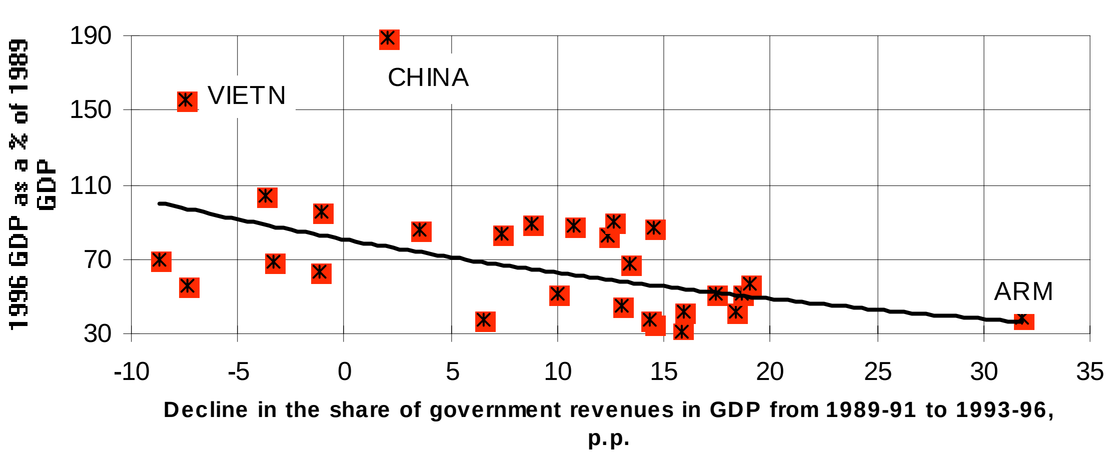


Fig. 10. Change in GDP and in the share of government revenues in GDP



distortions and the decline in government revenues, becomes insignificant, although the explanatory power of the equation does not rise higher than 80%. Thus, the arguments about the "threshold" levels of liberalization (it starts to affect performance only, when it reaches a certain threshold) or about the lagged impact of the liberalization do not seem to be supported by the evidence.

The importance of institutional factors was pointed out more than once for various countries and regions, including transitional economies (Polterovich, 1998). Rodrik (1996) found that nearly all variations in the rates of growth in labor productivity in Southeast Asian countries in 1960-94 can be explained by per capita income in 1960, average length of education and the index of the quality of institutions derived from surveys conducted in the 1980s. Similarly, it was found that 70% of the variations in investment in 69 countries can be explained by only two factors – GDP per capita and institutional capacity index (World Bank, 1997). Stiglitz (1998, 1999) talks about emerging post-Washington consensus with the greater emphasis on the role of institutions, whereas Holmes (1997) believes that the major lesson to be learned by Western democracies from recent Russian developments is exactly the one about the crucial importance of the state institutions: whereas the Soviet Union proved that the non-market economic system with the strongest state cannot be efficient, Russia today is proving that the market without strong state degrades to the "exchange of unaccountable power for the untaxable wealth" leading to economic decline. Similarly, Campos (1999a) found evidence that government expenditures are positively, not negatively, associated with economic growth in transition economies.

There was only one group of transition economies, where the share of state revenues in GDP remained relatively stable during transition – Central European countries (figure 11). Outside Central Europe there were only 4 countries where the share of government revenues in GDP did not fall markedly – Belarus, Estonia, Uzbekistan, Vietnam. The first 3 are also the top 3 performers in the FSU region, whereas Vietnam's performance is second to only that of China. It is noteworthy that Belarus and Uzbekistan, commonly perceived as procrastinators, nevertheless show better results than most more advanced reformers. On the other hand, this is the alternative explanation of the Estonian success in economic transformation as compared to most CIS states and even to neighboring Baltic states: the usual interpretation focusing on the progress in liberalization may overlook the impact of strong institutions.

According to EBRD (1999), the quality of governance in the transition economies, as it is evaluated by the companies themselves, is negatively correlated with the state capture index (percentage of firms reporting significant impact from sales to private interests of parliamentary votes and presidential decrees). The relationship seems to be natural - the less corrupt is the government, the better the quality of governance. What is more interesting, both, the quality of governance (positively) and the state capture index (negatively) are correlated with the change in share of state expenditure in GDP, so that countries like Belarus and Uzbekistan fall into the same group with Central European countries and Estonia (small reduction of state expenditure as a % of GDP during transition, good quality of governance, low state capture index).

It is precisely this strong institutional framework that should be held responsible for both - for the success of gradual reforms in China and shock therapy in Vietnam, where strong authoritarian regimes were preserved and CPE institutions were not dismantled before new market institutions were created; and for the relative success of radical reforms in East European, especially in Central European countries, where strong democratic regimes and new market institutions emerged quickly. And it is precisely the collapse of strong state and institutions that started in the USSR in the late 1980s and continued in the successor states in the 1990s that explains the extreme length, if not the extreme depth of the FSU transformational recession.

To put it differently, Gorbachev reforms of 1985-91 failed not because they were gradual, but due to the weakening of the state institutional capacity leading to the inability of the government to control the flow of events. Similarly, Yeltsin reforms in Russia, as well as economic reforms in most other FSU states, were so costly not because of the shock therapy, but due to the collapse of the institutions needed to enforce law and order and carry out manageable transition.

To sum up, there is enough evidence that differing performance during transition, after factoring in initial conditions and external environment, depends mostly on the strength of institutions and not so much on the progress in liberalization *per se*.

The fact that results for 1989-98 are weaker than for 1989-96 is consistent with other studies (Havrylyshyn and Wolf, 1999) and also seem to fit logically into the suggested explanation. By the end of the 1990s, many countries were already recovering from the transformational recession, so the model of the supply side recession (the greater the distortions in the industrial structure and trade patterns, the larger the reduction of output) is no longer applicable. Regressing output change in 1994-98 on the same variables that proved to be important for explaining the magnitude of the recession produces some strong, though negative, results. In short, the same regression equation that worked for the periods of 1989-96 and 1989-98 does not work at all for the period of 1994-98 (Popov 2000). The distortions coefficient has the "wrong" sign, t-statistics deteriorates sharply, and about 2/3 of the variations in growth rates remain unexplained anyway.

In a sense, this is exactly the kind of the negative result that supports the conclusions drawn for the 1989-96 period. By mid 1990 supply side recession was over or coming to an end in most countries and the theory that could explain reasonably well the performance during the collapse of output is no longer relevant. The process of economic growth that has already started in most transition economies has nothing to do with the adverse supply shocks resulting from price, exchange rate and trade liberalization. Accumulated distortions in industrial structure and in trade patterns – the remnants of the planning past that were so important for explaining performance during the transition period – are no longer relevant, since almost by definition they can affect only the process of the reduction of output, not the process of economic growth. In fact, although data for 4 years are obviously not enough to draw conclusions, poor regression results for 1994-98 period (R^2 is no higher than 33%) may mean exactly that (Popov 2000). Like standard growth accounting exercise yields strange results, if carried out for transition economies in the first half of the 1990s (Campos, 1999a), the transformational recession model fails to explain data pertaining to post decline period.

To explain the relationship between the liberalization and performance, the analysis of the transformational recession should be separated from the analysis of process of economic growth (recovery), since the nature of these two phenomena is different. The former (the collapse of output during transition) can be best explained mostly by distortions in industrial structure and trade patterns accumulated during the period of central planning, and by inflation and the strength of the state institutions during transition period, while the speed of liberalization does not seem to play a major role. The latter process (recovery) should be treated as a normal growth process: it could be modeled by using conventional production functions and in the long run may demonstrate the ability to capitalize on liberalization by increasing factor efficiency. The new economic dynamics of the transition economies – the growth process unfolding in most of them in the second half of the 1990s - could probably be best described in the framework of the conventional growth theory (production functions), where both – institutional capacities and the level of liberalization - will play a non-negligible role.

There are signs that economic liberalization starts to pay off in some countries, such as China and Vietnam and Central European states. Losses in allocative efficiency in the CPE, as compared to market economies, existed mostly in the form of low capital productivity: in particular, higher capital accumulation ratios in these countries were needed to achieve growth rates similar to that of market economies (Shmelev and Popov, 1989). Things, however, are starting to change and recently observed improvements in capital efficiency in some post-communist countries should be attributed to the impact of marketization (Popov, 1998a, 1999b). China and Vietnam managed to accelerate substantially the rates of growth during reform period with relatively small increases in investment/GDP ratios, whereas Poland maintains reasonable growth rates with the lower share of investment in GDP than before transition - thus reaping "marketization dividend" in the form of higher capital productivity. These countries, however, are exactly the ones that managed to preserve strong institutions during transition. The previous conclusion, thus, is only reinforced: benefits of liberalization can be noticeable only in economies with strong institutional capacities.

4.3.2 Patterns of institutional decay: the rule of law and democracy

There is an extensive literature on the interrelationship between economic growth and democracy (see Przeworski and Limongi 1993, and Afontsev 1999, for a survey). Democracy is said to undermine investment (because of populist pressure for increased consumption) and to block "good" economic policies and reform because the governments in democratic societies are exposed to pressures from particular interests. Autocratic regimes are believed to be better suited than democratic to oppose pressures for the redistribution of income and resources coming from the poor majority of the population (Alesina, Rodrik, 1994). Taiwan, South Korea, Chile, and China are usually cited as examples of autocracies that were successful in implementing liberalization and reform. It has been noted that cases of successful simultaneous economic and political reforms are relatively rare (Intriligator, 1998) and that introducing voting in post-communist countries may be detrimental economically (Cheung, 1998).

On the other hand, Olson (1991) argued that autocracies can be predatory, since there is no one to control the autocrat. He also believes that the populist problem of democracies can be dealt with by introducing constitutions that require supermajorities for certain government actions (2000). Sen (1999) argues that comparative studies that are now available suggest that there is no relation between economic growth and democracy in either direction and that all major famines occurred under democratic, not under authoritarian regimes.[25]

A survey of 18 studies (Przeworski and Limongi, 1993) produced mixed results – the only pattern that one can discover in these findings is that most studies published after 1987 find a positive link between democracy and growth, whereas earlier studies, although not different in samples or periods, generally found that authoritarian regimes grew faster.

Here we are suggesting one more link between democracy and growth that seemed to be extremely important in post-communist countries: democratization under the poor tradition of the rule of law leads to the institutional collapse, which undermines economic growth. In the absence of rule of law tradition, it is easier to guarantee property and contract rights, to enforce state regulations and to maintain order in general with the authoritarian rather than with the democratic regime. The immediate results of democratization in the absence of the rule of law tradition are greater corruption, poorer enforcement of regulation, higher crime rates.[26]

Using the terminology of political science, it is appropriate to distinguish between strong authoritarian regimes (China, Vietnam, Uzbekistan), strong democratic regimes (Central European countries) and weak democratic regimes (most FSU and Balkan states – figure 8). The former two are politically liberal or liberalizing, i.e. protect individual rights, including those of property and contracts, and create a framework of law and administration, while the latter regimes, though democratic, are politically

[25] Ellman (2000) challenges this point referring to the lack of famines in the authoritarian USSR after 1947 and to Sudan famine that occurred under the democratic regime in 1985-89.

[26] Triesman (1999) argues that the current degree of democracy, despite theoretical arguments, has no significant impact on the level of corruption; it is only the long exposure to democracy that limits corruption.

not so liberal since they lack strong institutions and the ability to enforce law and order (Zakaria, 1997). This gives rise to the phenomenon of "illiberal democracies" – countries where competitive elections are introduced before the rule of law is established. While European countries in the XIXth century and East Asian countries recently moved from first establishing the rule of law to gradually introducing democratic elections (Hong Kong is the most obvious example of the rule of law without democracy), in Latin America, Africa, and now in CIS countries democratic political systems were introduced in societies without the firm rule of law.

Authoritarian regimes (including communist), while gradually building property rights and institutions, were filling the vacuum in the rule of law via authoritarian means. After democratization occurred and illiberal democracies emerged, they found themselves deprived of old authoritarian instruments to ensure law and order, but without the newly developed democratic mechanisms needed to guarantee property rights, contracts and law and order in general (upper left quadrant in figure 12). No surprise, this had a devastating impact on investment climate and output.

As figure 13 suggests, there is a clear relationship between the ratio of rule of law index on the eve of transition to democratization index, on the one hand, and economic performance during transition, on the other, although the positive correlation for authoritarian countries is apparently different from that for democracies. To put it differently, democratization without strong rule of law, whether one likes it or not, usually leads to the collapse of output. There is a price to pay for early democratization, i.e. introduction of competitive elections of government under the conditions when the major liberal rights (personal freedom and safety, property, contracts, fair trial in court, etc.) are not well established.

If the rule of law and democracy indices are included into the basic regression equation, they have predicted signs (positive impact of the rule of law and negative impact of democracy) and statistically significant (Popov, 2000), which is consistent with the results obtained for larger sample of countries (see survey in Przevorski and Limongi, 1993). However, the experience of transition economies seems to indicate that democratization has a marked negative impact on economic performance especially in the absence of the rule of law. These conditions are captured by the ratio of the rule of law index to democracy index: the lower is the rule of law and the higher is democratization, the lower is this ratio.

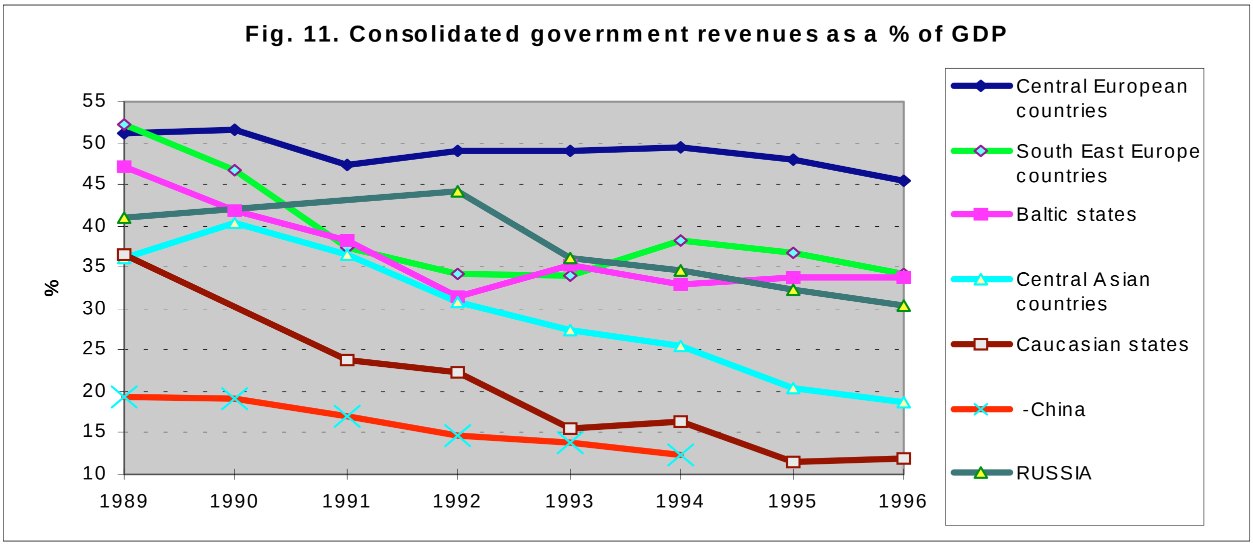


Fig. 11. Consolidated government revenues as a % of GDP
%
55
50
45
40
35
30
25
20
15
10
1989
1990
1991
1992
1993
1994
1995
1996
Central European countries
South East Europe countries
Baltic states
Central Asian countries
Caucasian states
-China
RUSSIA

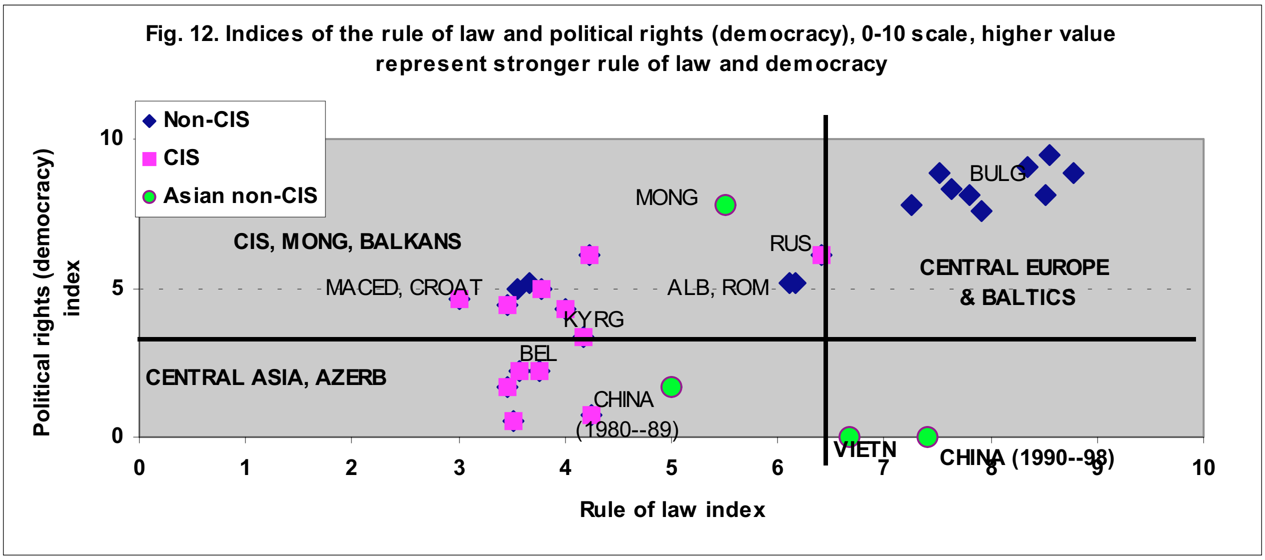


Fig. 12. Indices of the rule of law and political rights (democracy), 0-10 scale, higher value represent stronger rule of law and democracy
Non-CIS
CIS
Asian non-CIS
Political rights (democracy) index
Rule of law index
CIS, MONG, BALKANS
MONG
RUS
BULG
MACED, CROAT
ALB, ROM
KYRG
CENTRAL EUROPE & BALTICS
BEL
CENTRAL ASIA, AZERB
CHINA (1980--89)
VIETN
CHINA (1990--98)

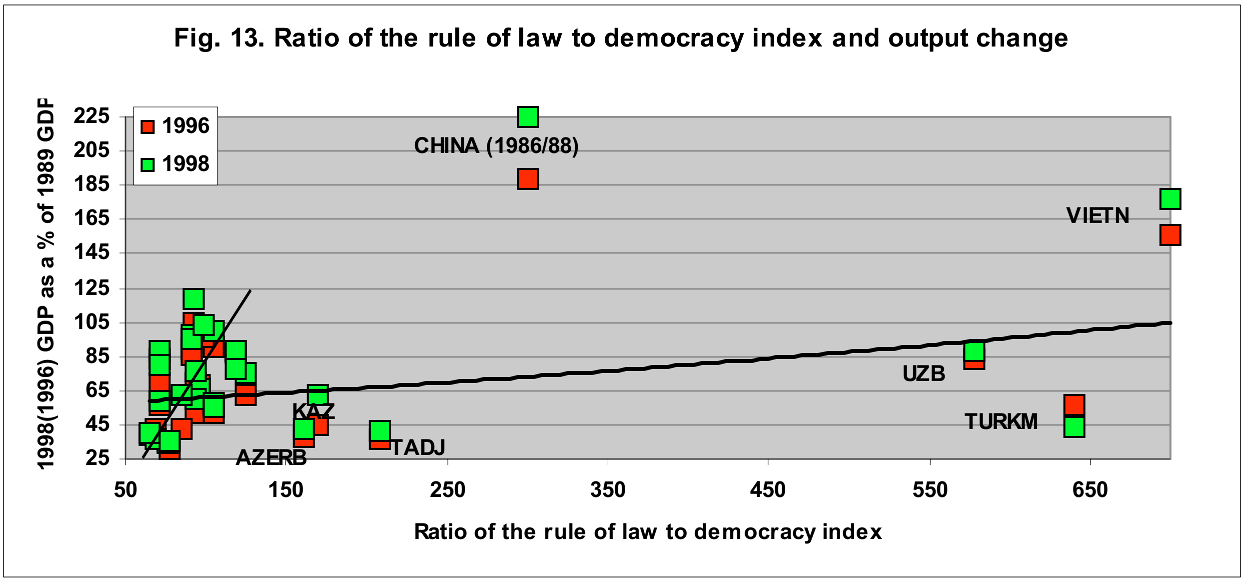


Fig. 13. Ratio of the rule of law to democracy index and output change
1996
1998
1998(1996) GDP as a % of 1989 GDP
Ratio of the rule of law to democracy index
CHINA (1986/88)
VIETN
UZB
TURKM
KAZ
TADJ
AZERB

<< Insert figures 10-13 about here >>

Including this ratio into the regression for output change yields impressive results: nearly 80% of all variations in output can be explained by only three factors – pre-transition distortions, inflation, and rule-of-law-to-democracy index. If liberalization variable is added, it turns out to be not statistically significant and does not improves the goodness of fit. At the same time, the ratio of the rule of law to democracy index and the decline in government revenues are not substitutes, but rather complement each other in characterizing the process of the institutional decay. These two variables are not correlated and improve the goodness of fit, when included together in the same regression, to 88% – better result than in regressions with either one of these variables. The liberalization index, when added to the same equation, only deteriorates the goodness of fit, is not statistically significant, and has the "wrong" sign (Popov 2000)

In a sense, the overwhelming importance of preserving strong institutional capacity of the state (as opposed to liberalization) for ensuring good performance may be considered as the main finding of this paper with strong policy implication. After allowing for differing initial conditions, it turns out that the fall in output in transition economies was associated mostly with poor business environment, resulting from institutional collapse. Liberalization alone, when it is not complemented with strong institutions, can not ensure good performance. The best performance during transition was exhibited by countries with low distortions and strong institutions (China, Vietnam), the worse performance – by countries with high distortions and weak institutions (CIS) – table 8. Moreover, the process of the collapse of output in transition economies is best described by the supply side recession model, where the key determinants are initial conditions and the strength of institutions, while the impact of liberalization is hardly noticeable. It follows that the debate about the speed of the liberalization (shock therapy versus gradualism) was to a large extent misfocused, whereas the crucial importance of strong institutions for good performance was overlooked.

Table 8. Main factors affecting performance

Institutions / Distortions	Weak	Strong
High	CIS	Central Europe
Low	Albania, Mongolia	China, Vietnam

Institutional capacities in turn depend to a large extent on the combination of the rule of law and democracy: the data seem to suggest that both - authoritarian and democratic regimes with the strong rule of law can deliver efficient institutions, whereas under the weak rule of law authoritarian regimes do a better job in maintaining efficient institutions than democracies. To put it in a shorter form, the record of illiberal democracies in ensuring institutional capacities is the worst, which predictably has a devastating impact on output. The most efficient institutions are in countries with the strong rule of law maintained either by democratic (Central Europe, Baltics) or authoritarian regimes (China, Vietnam). The least efficient institutions are in illiberal democracies combining poor rule of law with democracy (CIS, Balkans, Mongolia). Less democratic regimes with weak rule of law (Central Asia, Azerbaijan, Belarus) appear to do better than illiberal democracies in maintaining institutional capacity (figure 11, table 9).

Table 9. Main factors determining the institutional capacity

Rule of law/ Democracy	Weak	Strong
More democratic	CIS, Mongolia, Balkans	Central Europe, Baltics
Less democratic	Central Asia, Azerbaijan, Belarus	China, Vietnam

4.4 Industrial policy and macroeconomic stabilization

The impact of subsidies on growth may be different. On the one hand, there is an example of East Asian countries which were subsidizing strong and competitive export-oriented sectors and were relying on export as a locomotive of economic growth: in China, for instance, the share of export in GDP increased from 5% in 1978 to 23% in 1994, while the GDP itself was growing at an average rate of about 10%. On the other hand, there are much less appealing examples of import-substitution industrialization (ISI) – subsidization of weak, non-competitive industries. Soviet industrialization of the 1930s and beyond became a major isolationist import substitution experiment: from that time on the share of export in Soviet GDP did not increase until large scale fuel sales abroad started in the 1970s. The huge perverted industrial structure created without any regard to costs and prices of the world market proved to be stillborn and nonviable in 1992, when it finally faced foreign competition after half a century of artificial isolation. One can also cite the examples of “the champion of isolationism“ - North Korea - and other socialist countries, of many developing countries of socialist orientation, which were creating their own heavy industries following advises and using assistance of the Soviet Union, of India (where the share of export in GDP remained frozen at a level of 6% from the 1950s to the 1980s) and many Latin American countries.

Extensive explicit and implicit subsidies were in place in all centrally planned economies. In most EE and FSU countries on the eve of transition, in 1989-92 only direct subsidies from the government budget amounted to 10-15% of GDP (World Bank, 1996, p. 116; EBRD, 1997, p. 83). Direct subsidies went mostly to cover the cost of housing, public utilities and food. Besides, there were hidden subsidies, for instance, low prices for fuel, energy and raw materials, not associated with any transfers to/from government budget, but efficiently redistributing rent from resource industries to secondary manufacturing and to all energy consumers.

By mid 1990s direct subsidies in most of these countries declined to about several percent of GDP (0-4%)[27] and relative prices largely approached world market ratios. With democratization small and well organized interest groups (resource companies, for example) that had a lot to win from straightening prices, found themselves in a position to exercise greater lobbying power than numerous, dispersed and unorganized consumers (Olson, 198). Despite these radical changes, however, in most transitions economies subsidies continue to be much more important than in other countries and prices distortions (as compared to Western countries) are still very pronounced. In 1997, for example, effective electricity tariffs in most EE and FSU countries were 1-4 US cents per kWh (only in Poland, Latvia, Hungary and Slovenia it was 6 cents and higher) as compared to 8 cents in the US and 14 cents in 15 European Union countries on average (EBRD, 1998, p. 43).

If subsidization is carried out through price controls, it is even worse, since price distortions worsen the allocation of resources. In all countries, where energy is cheap, the energy intensity of GDP is high: in FSU states electricity consumption per $1

[27]These numbers do not include subsidies from the regional budgets in some countries.

PPP GDP is nearly 2 times higher than in EE countries, whereas in EE countries it is 2 times higher than in Western Europe (EBRD, 1998, p. 47). Moreover, energy intensity of GDP was relatively stable in Central European countries during transition, but increased by about 40% in 1989-95 in the Balkan and CIS states (EBRD, 1999, p. 95). Only in 1996-98, when domestic energy prices in these countries started to approach world level, energy intensity showed some signs of decline, but not for long. New drop in relative domestic energy prices after 1998-99 devaluations in the CIS states staged conditions for another round of increase in energy intensity. Consumer subsidies have similar effect – they favor consumption over savings and lead to inefficient use of subsidized goods (housing, energy, etc.). In addition, consumer subsidies are generally socially unfair, since more subsidies go to households that consume more (which are usually the richest).

If non-export subsidies are so bad, the appropriate political-economic question to ask then is why they persist in transition economies?[28] Why practically all transition economies (including China and Vietnam with heavily subsidized housing) continue to subsidize households? Why Russia and other resource abundant CIS states are still choosing to keep fuel, energy, and resource prices low and thus are relying once again on import substitution, which seem to have lost in recent decades all the supporters among economists and policy makers?

A decade ago the research on the macroeconomics of populism in Latin America raised a similar question and suggested two answers: (1) sharp asset and income inequalities (as compared to Asian countries) and (2) sharp division between primary products export sector controlled by the traditional oligarchy and employers and workers in industry and services (Kaufman and Stallings, 1991). It was argued that upper income groups are generally in a good position to resist taxation and this placed a limit on the capacity of Latin American governments to deal with distributive pressures within the context of the growth-oriented export models. In small open European economies the expansion of the welfare state allowing to adjust painlessly to costs of internationalization, was an important political concomitant of liberal trade policies.

[28] With the exception of China and Vietnam, there is no large-scale subsidization of export in transition economies. Subsidies are given mostly either to households (consumers) – this is the case in most post-communist countries, or to non-competitive industries (resource rich CIS countries) with the goal of import substitution.

In East Asian countries political weight of urban popular groups (pressing for redistribution of export revenues in their favor) was counterbalanced by the presence of the large class of independent farmers or small export-oriented manufacturing firms. In contrast, in Latin America the state had a much more limited capacity to tax income and assets directly, and the export-oriented oligarchy was not willing to share its revenues, but at the same time not able to resist the pressure for redistribution because of political isolation.

The heritage of the CPE put the transition economies into a situation, somewhat similar to Latin American countries. Whatever were the reasons for the wide scale redistribution income in former socialist countries, in the very beginning of transition, after the deregulation of prices, they experienced a dramatic and quick increase in personal income inequalities and sectoral inequalities in the profitability of enterprises. Previously, under authoritarian regimes, the government was strong enough to impose substantial burden of transfers on the producers (the government revenues in most former socialist countries were way above 50% of GDP). Democratic governments, however, faced in addition with falling budget revenues, were not in a position to maintain large scale open subsidization and had to choose between gradually eliminating the bulk of all subsidies and finding alternative ways of financing these subsidies (inflationary financing, building up domestic and foreign debt, maintaining the overvalued exchange rate, driving foreign borrowing up and/or foreign exchange reserves down).

The inability to cut subsidies inherited from the era of central planning, observed mostly in the CIS region, was the major reason for the macroeconomic instability experienced by these countries – budget deficits, inflation, increased domestic and foreign indebtedness, overvalued exchange rates leading to currency crises. Inflation remained rather high in the CIS and some Balkan states for a number of years (since late 1980s in Yugoslavia and in 1992-94/5 in Bulgaria, Romania, and CIS) and re-materialized a couple of years later, after the currency crises (Bulgaria and Romania – in 1996-97; Belarus – in 1997-98; Russia - in 1998). It has already been largely documented that high inflation tends to reduce growth performance, and as inflation was and still is important in quite a number of countries, it deserves a detailed analysis as a phenomenon of persistent clear-cut sub-optimal policy. In this respect, however, transition economies are quite similar to developing countries, where the political economy of subsidies and macro instability were thoroughly analyzed.

In the first approximation, it seems like inflation results from the weakness of the governments in the region (CIS and the South East Europe) caused by the lack of consensus on the issue of financing the costs of economic reforms. The Chinese government was able to impose such a consensus “from above“ using authoritarian methods, and in East European countries this consensus was built “from below“ leading to the emergence of relatively strong democratic governments.

In contrast, the CIS and South East Europe societies seem to have been more divided than in Central European countries and Baltic states, where a greater consensus on how to proceed with economic reforms existed.

In Russia, for instance, not only communists (which are different from social democrats in Eastern Europe) and nationalists were stronger, but also there were clear and deep contradictions between major industrial groups (namely, agriculture, defense and machine building, and fuel and resource sector) on the issue of financing economic reforms. In Russia weak democratic government was not able to withstand the pressure of these interest groups (“complexes“, as they are called in Russia - fuel and energy complex, military industrial complex, and agro-industrial complex), of regions, and of political parties; and, as a result, it did not have the power to bring its expenditure in line with the revenues. The lack of political consensus at three levels - between the central government and the regions, between the parliament and the government, and within the government itself -may have been the main reason for the failure of shock therapy attempts to fight inflation in 1992-93 (Desai, 1994).

Inflationary financing under these circumstances was a sort of a safety valve - a device allowing to finance the reforms (with the inflation tax) without forcing the conflicting parties to come to the explicit agreement. The alternative would have been the open conflict between the confronting sides, which could have been associated even with greater costs than highly inflationary environment.

Simplifying things, there was always a feeling that if the Central Bank will peg the exchange rate, depriving the government of credits to finance its deficit, the day after either the government or the exchange rate will have to fall. In this sense, the rate of inflation may be a pretty accurate measure of the degree of social consensus on financing the burden of reforms.

The other macroeconomic reason – linked to the first one in a sense that it was also routed in the weaknesses of newly emerged democratic governments - was the unique magnitude of the second (shadow) economy and the resulting inability of the government to raise tax revenues. Usually economists believe that there is a choice between high inflation and high taxes (with higher taxes it is possible to reduce the deficit and the financial requirements of the government). In Russia it may not be the case. While Russian tax rates are high as compared to other countries, its tax revenues are pretty low (figure 11- section on institutions) because the shadow economy expanded dramatically in recent years[29]. Estimates based on the share of cash in total operations of Russian businesses put the size of the shadow economy as high as 1/3 of total GDP (whereas in the late 1980s only 2% of total cash was held by enterprises, in 1994 it was about 40%, and cash operations are mostly not reported for tax purposes). Estimates based on electricity consumption suggest that in Eastern European countries the share of shadow economy in 1989-94 increased on average from 18 to 22%, whereas in the former Soviet republics it increased from 12 to 37%.[30]

Overall, inflation turns out to be a symptom of the tensions and contradictions between the interest groups and perhaps even plays the role of the "safety valve" that allows the government to function under the conditions of disagreement between major parties. As Russians put it, " inflation is the substitute for civil war" and " nobody yet died from inflation" .

The problem, of course, is to measure the degree of consensus between " the major interested parties" , or the polarization of the society in terms of opinions and perceptions that distinguishes " truly weak" governments from " seemingly weak" , that is do say governments that would inevitably fall, once they stop or substantially decrease redistribution of incomes, from governments that can do it, but prefer to rely on populism to boost their ratings at the polls. Once there is a need, whether

[29]In Russia government revenues plummeted after the CPE was dismantled, falling below 30% of GDP (including off-budget funds) in 1997. This is still more than in East Asian countries and other economies with similar GDP per capita on average (Illarionov, 1998; Mau, 1998), but much less than in Central European countries and much less than needed to finance government commitments - still very large agricultural and housing subsidies, mostly free education and health care, and universal pay-as-you-go system of social insurance.

[30](World Bank, 1996, p.27). Goskomstat disagrees with this estimate, putting the size of the shadow economy at 20-25% of GDP.

mythical or real, to redistribute income in favor of poorest social groups and weakest enterprises, coupled with the inability of the governments to raise enough taxes for this redistribution activity, the story unfolds pretty much in line with Latin American type macroeconomic populism (Dornbusch and Edwards, 1989; Sachs, 1989) and leaves a strong sense of *déjà vu*. Constraint by inability to raise tax receipts and by the simultaneous need to maintain redistribution in favor of particular social groups, the governments are left basically with only three or four options for indirect financing of subsidies.

The **first** one is to maintain control over particular prices. Controls over prices of non-resource goods do not solve the problem completely, since they require explicit subsidies from the budget to cover the losses of companies producing those goods. In contrast, price control for fuel, energy and other resource commodities effectively takes away rent of resource sector and redistributes it to consumers. Redistribution of rent in this case does not require counter subsidization of resource sector, especially if it is more efficient than the rest of the economy. This option is available to resource rich countries, which may give additional explanation, why the resource endowment is found to have a positive effect on shadow economy and corruption and negative effect on growth (Gylfason, 1999; Sachs and Warner, 1996).

The **second** alternative way to maintain subsidies under budget constraints is to resort to trivial inflationary financing of the government budget. The government in this case compensates for the shortfall of tax revenues by imposing the ruinous for growth inflation tax on everyone.

The **third** way is certainly debt financing – either domestic or external borrowing. Debt financing makes sense, when it buys some time for maintaining subsidies while conflicting parties are negotiating the way to get rid of them. If it continues for too long, however, it only makes things worse, since debt service payments impose an additional burden on the government budget.

Finally, the **fourth** way to continue redistribution with no funds in the budget is to maintain the overvalued exchange rate that favors consumers over producers, exporters over importers and leads to increase in consumption at the expense of savings. Consumption increases in this case due to increase in imports financed through external borrowing or foreign exchange reserves, and obviously provides only a temporary solution, leading to the balance of payments crisis in the longer term. It was shown for developing countries that overvaluation of the exchange rate is detrimental for economic growth (Dollar, 1992; Easterly, 1999).

Overvaluation of the exchange rate is usually supported by the governments (that collect their taxes in domestic currency, but service the international debt in foreign currency) and, of course, by the importers, whose political influence may exceed that of exporters (Bates and Devarajan, 1999). Transition economies that maintained the overvalued exchange rates (and that later, in 1998-99, experienced the currency crises) and in particular Russia, pose a number of questions in this respect. Although Russian exports is highly concentrated (several resource commodities and only a couple of dozen of companies), major exporters before 1998 crisis were not pushing for a lower rate[31].

This is another reason why exchange rate based stabilization and currency board arrangements are quite risky for transition economies (Montes and Popov, 1999). Opening the possibility for the appreciation of real exchange rate (and ensuring equilibrium only through balance of payments crisis) these arrangements allow also for the continuation of populist policies – redistribution of income from producers to consumers. At the end of the day inflation has to be dealt with at its source, i.e. high budget deficits, unregulated banking systems, fragile revenue collections, so exchange rate management as a weapon to fight inflation can play only a limited role (Desai, 1998).

Different countries in different periods resorted to one or more of the described above mechanisms of implicit redistribution. In Russia, for instance, the government was initially (1992-94) relying on controlling resource prices and inflationary financing. Since 1995, when exchange rate based stabilization was carried out and the ruble reached 70% of its purchasing power parity value (i.e. Russian prices, including resource prices approached 70% of the US prices, which was the apparent overvaluation of the ruble), the government relied mostly on debt (domestic and foreign) financing and redistribution via overvalued exchange rate. Since 1998 financial crisis, however, leading to the collapse of the overvalued rate and to the cessation of international and domestic debt financing, the government has to rely largely on price control (via export

[31] Of all Russian " oligarchs" and main exporters only one (Boris Berezovsky) spoke out openly in favor of devaluation before the August 1998 crisis, whereas the others (Vladimir Potanin, for instance) publicly opposed devaluation until the very last moment.

taxes and export restrictions) on major tradable goods (oil, gas metals)[32].

There seems to be two logical ways to deal with the populist redistribution and to ensure stable macroeconomic environment. First, to eliminate the need for redistribution, i.e. to alleviate social and sectoral income inequalities, which is of course the task for the long run. Second, to strengthen the government, so that it can redistribute income explicitly (direct subsidies) rather than indirectly, or cut the magnitude of redistribution altogether. The research on Latin American and other countries has proven that the " transitional democracies" are less efficient than either authoritarian regimes or well established democratic regimes in resisting macroeconomic populism. It was also shown that countries where one or two multiclass parties have provided the government elites with stable electoral majorities are less prone to demands of populist coalitions (Kaufman and Stallings, 1991).

There is also evidence that institutional arrangements, such as a more independent central bank, and clear separation of powers between the executive branch and the legislature and between the central government and the regions, help protect macroeconomic policy from populist demands. When a government controls monetary policy, it will tend to finance government spending by taxes or seignorage, relying more on the second tool when it is more difficult to pass a good tax reform (see e.g. Cuckierman, Edwards and Tabellini, AER 1992).

5 Conclusions

This paper covered various aspects of the political economy of growth in former communist countries. By looking at initial conditions, we identified some potential political resistances to the processes of political and economic change in the region. We showed that theory highlights quite clearly the problem of the status quo bias in transition countries, and could find some empirical confirmation that this mechanism is at work. Nevertheless, we also stressed that, when the democratic transition is successful, parties react very fast to the new needs of the population, by reshuffling themselves and

[32]Whereas export tariffs for oil and metals were eliminated in 1996, they were reintroduced again shortly after the August 1998 currency crisis. As oil prices increased in 1999, so did export tariffs. Since June 2000 crude oil export tariffs are set at EUR 2-7 per metric ton for every $2.5 increment in a world price of oil per barrel exceeding $12.5 per barrel.

adapting their platforms. Interestingly, in equilibrium such a success in the political adaptation to the democratic process spurs, rather than hinders, transition and growth.

Conversely, economic transition can pose a series of problems to the success of democratization, and when institutions collapse because of transition, the opposite effect materializes: the democratic process is adversely hit by weak institutions and this generates harmful policies. To the best of our knowledge, this link between institutions and political competition has never been analyzed in the literature. A thorougher analysis of this link may help understand what makes democracy work and help us to understand when institutional collapses can occur.

After this general analysis of the political economic problems of growth, we analyzed particular issues in the transition process: liberalization, privatization, institutional capacity building, and industrial policy and macroeconomic stabilization. Strangely enough, we can conclude that economic performance (growth or decline) is basically unaffected by the speed of liberalization at the initial stage of transition. Instead, the weakening of the institutional capacity reveals itself to be a much stronger determinant of this performance. This tends to confirm our theoretical *a priori* that theory overlooked the crucial importance of institutions in the determination of economic growth.

In turn, what makes institutions work? Basically, the past tradition of the rule of law and command of democracy seem to be important factors. In a sense, democratization is not enough to achieve a successful democracy. The latter requires the support of the rule of law, the existence of real property rights, the enforcement of contracts, etc... Conversely, fast democratization and reforms under a poor rule of law generate an institutional collapse, which reinforces the output fall and prevents recovery.

Probably for this reason, the conventional wisdom, which says that reforms tend to be stalled more easily under a democratic regime, does not apply to most of the post-communist countries. When the democratic transition is successful, the strong popular support for change is translated into efficient policies. As a result, even when former communist parties come back to power, the pace of reforms is not slowed down. Empirically, it has been shown that more democracy (party alternation in power, number of elections, etc...) is correlated with faster reforms and recovery. The puzzle of transformation in post-communist countries, in contrast to developing countries, is that the support for reform was so strong and sometimes even growing despite the unprecedented economic hardship generated by the reform. The explanation for this puzzle lies in the different nature of the reform process in transition and development countries. Unlike in developing countries, reforms in transition economies implied elimination of production quotas and pervasive deregulation of prices (marketization), as well as **mass** privatization. Whereas the way to proceed with these two major reforms were widely debated, the idea of marketization and privatization itself was never put into question. In fact, this idea gained support as democratization unfolded, and this is why even economic hardship did not produce wide spread anti-reform sentiments. Fears that pressure from the losers will build up and stall the reform proved to be groundless. The logic of carrying out reform as fast as possible before the painful results will lead to wide spread opposition in retrospect looks unjustified.

The only aspect for which transition countries do not seem to differ from developing countries is the one of macroeconomic stabilization. The Russian experience of high inflation, followed by an overvaluation of the exchange rate, and eventually its default on foreign debt, shows that traditional theories also apply here.

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