Building Capitalism

The Transformation of the Former Soviet Bloc

This book offers the most comprehensive empirical analysis of the economic transformation of the countries comprising the former Soviet bloc during the first decade after communism. It debunks many myths, seeing transition as a struggle between radical reformers and those thriving on rent seeking. Populations have gained from fast and comprehensive reforms. Economic decline and social hazards have been greatly exaggerated, since people have forgotten how awful communism was. Swift liberalization of prices and foreign trade, as well as rapid and profound fiscal adjustment, have been vital for growth, institutional reforms, legality, and greater equity. Privatization has undoubtedly been beneficial, and its positive effects will grow over time. The main problem has been the continuation of large, unregulated, and ubiquitous state apparatuses living on corruption. Where malpractices of the elite can be checked, market reforms and democracy have proceeded together.

Anders Åslund is a senior associate at the Carnegie Endowment for International Peace in Washington, D.C., since 1994. From 1989 until 1994, Dr. Åslund was Professor and Director of the Stockholm Institute of East European Economics at the Stockholm School of Economics. He served as an economic advisor to the Russian government from 1991 until 1994 and to the Ukrainian government from 1994 until 1997. Since 1998, he has advised President Askar Akaev of Kyrgyzstan. *Gorbachev's Struggle for Economic Reform* (1989); *Post-Communist Economic Revolutions: How Big a Bang?* (1992); and *How Russia Became a Market Economy* (1995). He is co-author of *Getting It Wrong: Regional Cooperation and the Commonwealth of Independent States* (1999). Dr. Åslund has also published as a commentator in *Foreign Affairs*, the *New York Times*, the *Washington Post*, and the *Financial Times.*

Advance Praise for *Building Capitalism*

"This is an original, wide-ranging, and intensively-researched book. Aslund analyzes key economic, political, and social aspects of the transition in the last decade in Eastern Europe and the former Soviet Union. He challenges misconceptions about the reform process, and trenchantly criticizes the views of many prominent Eastern and Western economists. The volume is a significant contribution to the literature."

– Morris Bornstein, *University of Michigan*

Building Capitalism

The Transformation of the Former Soviet Bloc

ANDERS ÅSLUND
Carnegie Endowment for International Peace

CAMBRIDGE
UNIVERSITY PRESS

For Anna, Carl, and Marianna

CAMBRIDGE UNIVERSITY PRESS
Cambridge, New York, Melbourne, Madrid, Cape Town, Singapore, São Paulo

Cambridge University Press
40 West 20th Street, New York, NY 10011-4211, USA

www.cambridge.org
Information on this title: www.cambridge.org/9780521801393

First published 2002
Reprinted with corrections 2003

A catalogue record for this publication is available from the British Library

Library of Congress Cataloguing in Publication data

Åslund, Anders, 1952–
Building capitalism: the transformation of the former Soviet bloc / Anders Åslund.
p. cm.
Includes bibliographical references and index.
ISBN 0-521-80139-7 (hard)– ISBN 0-521-80525-2 (pbk.)
1. Europe, Eastern – Economic policy – 1989– 2. Europe, Eastern – Economic conditions – 1989– 3. Postcommunism – Europe, Eastern. 4. Privatization – Europe, Eastern. 5. Russia (Federation) – Economic policy – 1991– 6. Russia (Federation) – Economic conditions – 1991– 7. Soviet Union – Economic conditions – 1985–1991. 8. Privatization – Russia (Federation) 9. Privatization – Former Soviet republics. I. Title.
HC244. A813 2001
338.947 – dc21 00-065989

ISBN-13 978-0-521-80139-3 hardback
ISBN-10 0-521-80139-7 hardback

ISBN-13 978-0-521-80525-4 paperback
ISBN-10 0-521-80525-2 paperback

Transferred to digital printing 2007

Contents

List of Tables and Charts

TABLES

CHARTS

Acknowledgments

This is a book I have wanted to write for a long time, but to avoid incongruities I have written the whole book anew in 1999 and 2000, though drawing on my previous work. Growing up in Sweden, I was acutely aware of the suffering of the small neighboring but captive Baltic nations, seemingly condemned to extinction. Even so, I developed a love for Russian classical literature, most of all Fyodor Dostoyevsky, and Russian culture. In Sweden everything seemed gray, while Russia displayed the full spectrum from black to white. A Prince Myshkin (*The Idiot*) or Aliosha Karamazov (*The Brothers Karamazov*) was not possible in Sweden. At university, I studied Russian on the side. From that time, my best friend Mats Staffansson and I have repeatedly roamed the region.

My next favorite country was Poland, where I was happily surprised to find great intellectual pluralism and openness. Yet, as a trainee at the coal exporting company Węglokoks in Upper Silesia in the summer of 1974, I also encountered partymindedness and communist bureaucracy. From that time, together with my anticommunist Polish friends I waited for a serious crisis of communism in Poland.

After one Swedish university degree in economics and another in Russian, Polish, history, and politics, I went to Oxford to study comparative economic systems, attaining a D.Phil. in Modern Economic History. I wanted to compare two communist countries empirically to examine the limitations of communism. In those days, empirical work in the Soviet Union was all but impossible, while Poland was an open book. Strangely, private enterprise was extensive but not controversial in the German Democratic Republic (GDR), so I wrote a dissertation on private enterprise in Poland and the German Democratic Republic (Åslund 1985). While at Oxford, I supported myself by working as temporary Scandinavian consul in the rough Polish port city of Szczecin during my holidays. I acted as a social worker, bailing out drunken Swedes and Norwegians from jails and retrieving them from morgues, which removed any doubt about crime and social policy under communism.

Before and after Oxford, I worked as a Swedish diplomat in rather irrelevant places, but in 1984 the Swedish ambassador to Moscow, Torsten Örn, called me to do economic reporting there. I went to Moscow in late 1984 with great expectations, and since then I have been following Russian affairs on a daily basis. The stagnation of the Konstantin Chernenko administration was so complete that something had to happen. Not very surprisingly, Mikhail Gorbachev surged to power in March 1985. I stayed in Moscow for three years, traveling extensively around the country in spite of difficulties. More often than not, the KGB called one day before our planned departure and briefly announced without apology: "Your journey will not take place." This meant that we had been refused visas to travel outside of Moscow. Even so, the Soviet Union was opening up and, thanks to my combined status of scholar and diplomat, I managed to meet several leading Soviet economists as well as a couple of young reformers, namely Boris Fedorov and Aleksandr Shokhin.

After my sojourn in Moscow, I happily spent one year at the Kennan Institute for Advanced Russian Studies in Washington and wrote the book *Gorbachev's Struggle for Economic Reform*, concluding that a major convulsion in the Soviet Union was likely. The last sentence in the second edition read: "Whatever turn Soviet events will take in the next few years, they are likely to belong to the most important developments of this century" (Åslund 1991, p. 234). This book landed me a professorship in Soviet and East European economics at the Stockholm School of Economics, where I set up the Stockholm Institute for Soviet and East European Economics. From that position, I closely followed the collapse of communism from 1989 until I moved to Washington in 1994. I made frequent trips in the region and enjoyed seeing old friends, such as Leszek Balcerowicz, assume positions of power. In Stockholm, I particularly benefited from my collaboration with Michael Sohlman, Ardo Hansson, Sten Luthman, Michael Wyzan, and Örjan Sjöberg.

Unlike many specialists in Soviet and East European economics, I have never been attracted to anything socialist. Having spent three years in the Soviet Union and one year in Poland, I knew communist reality pretty well and found it absolutely awful. Poland had a wonderful civil society, but it had arisen in opposition to communism. In my view, communism was a politically and economically inferior system. As it was reasonably consistent in itself, most reforms had proven reversible. Therefore communism could not be reformed but had to be destroyed (Balcerowicz 1995). However, the successful imposition of martial law in

Poland in 1981 had shown that the resilience of a communist regime must not be underestimated. The communist regimes needed to be uprooted and replaced by democracy.

Since I was preoccupied with the Soviet Union, I missed out on Poland at its critical reform juncture, but I was greatly impressed with Jeffrey Sachs and David Lipton. Despite limited prior knowledge of the region, they understood what communism was about. I liked the idea of a radical market reform and a big Western aid package. For the Soviet Union, I saw three necessary preconditions. First, the Communist Party must lose power and be succeeded by democracy before any real transformation. Second, Soviet President Mikhail Gorbachev had neither the credibility nor the intellectual abilities to promote a sufficient reform. Third, the Soviet Union had effectively ended in 1990, and any reform had to be based on an independent Russia and other new independent states (Åslund 1991).

This became evident with the abortive hardline communist coup in Moscow in August 1991. Jeffrey Sachs and I went there two weeks later to figure out who the Russian reform leaders would be, and soon afterward I repeated the trip with David Lipton. We found five different groups assembling alternative government teams and elaborating on economic reform programs. We knew people in three groups and found agreement with the Gaidar–Shokhin–Chubais team. By early November, President Yeltsin had wisely selected this lineup, and he invited us to advise his newly formed government at a meeting in Moscow on December 11, 1991. With financial support from the Swedish government and the Ford Foundation, we worked at the Council of Ministers for Yegor Gaidar, who rose to Acting Prime Minister in June 1992. After he was ousted in December 1992, we continued working with the Russian government, primarily for Minister of Finance and Deputy Prime Minister Boris Fedorov.

While many complain about "shock therapy" in Russia, the sad truth is that too little shock was delivered to achieve any therapy, and the actual reforms were far less radical than those in Central Europe (Dąbrowski 1993a,b). Admittedly, Boris Fedorov achieved a great deal in 1993 (Fedorov 1994, 1995). When both the reappointed Gaidar and Fedorov resigned from the government in January 1994, Jeffrey Sachs and I, together with our Macroeconomic Finance Unit at the Ministry of Finance, resigned from our advisory work for the Russian government. A government of industrial lobbies had taken over, even though Anatoly Chubais singlehandedly continued the reformist struggle at the highest level and achieved more privatization than anybody had anticipated. I summed up what I had learned in my book *How Russia Became a Market Economy* (the Brookings Institution, 1995).

I have learned a great deal from friends and collaborators in Russia for this book. Apart from my former superiors Yegor Gaidar, Boris Fedorov, and Anatoly Chubais, I would like to thank (in alphabetic order) Sergei Aleksashenko, Petr Aven, Maxim Boycko, Mikhail Dmitriev, Aleksandr Dynkin, Yevgeny Gavrilenkov, Andrei Illarionov, Vladimir Kosmarsky, Alexei Kudrin, Andrei Lushin, Tatyana Maleva, Vladimir Mau, Alexei Mozhin, Nina Oding, Yevgeny Saburov, Lilya Shevtsova, Nikolai Shmelev, Pavel Teplyukhin, Alexei Ulyukaev, Dmitri Vasiliev, Sergei Vasiliev, Valentina Vedeneeva, Inna Voennaya, Arkady Volsky, Yevgeny Yasin, Ruben Yevstigneev, and Gennady Zoteev. Among our Western collaborators in Moscow, I want to express my gratitude to John Anderson, Andrew Berg, Lars Bergström, Peter Boone, Betsy Brainerd, Jacques Delpla, Brigitte Granville, Torun Hedbäck, Georg Kjällgren, Richard Layard, Andrea Richter, Judith Schapiro, Andrew Warner, and Charles Wyplosz.

Ukraine started off with very gradual economic reform policies, putting itself in a quandary. I visited the country repeatedly, looking for a reformist opening. With my experience from the complicated Russian transition, I was not interested in easy cases. On the contrary, I thought I could make most of a contribution in complex post-Soviet dilemmas because of my knowledge of Soviet precedents, eyeing Ukraine and Belarus. In July 1994, Ukraine elected a new president, Leonid Kuchma, who seemed to move the country in the right direction. I contacted George Soros, who had a strong foundation in Ukraine, and he graciously invited me to accompany him to Kiev in August 1994. We met with President Kuchma, and Soros suggested that I could organize an economic advisory team for him at Soros's expense, and President Kuchma accepted his offer. During the ensuing intense months, our team assisted the Ukrainian government in a substantial liberalization and a significant improvement of the public finances. Alas, by June 1995 the reform endeavors fizzled out. Again, the problem was not too radical, but too timid, reforms, since more profound reforms would have harmed the vested interests of the economic elite.

We enjoyed excellent cooperation with many senior Ukrainians, notably Viktor Yushchenko, Viktor Pynzenyk, Roman Shpek, Ihor Mitiukov, Yuri Yekhanurov, Serhyi Tyhypko, Serhyi Teryokhin, Ihor Shumilo, Tamara Solyanik, Viktor Lysytsky, Valery Lytvytsky, Vasyl Rohovyi, Andrei Honcharuk, Yuri Yakusha, Serhyi Kulyk, Oleh Rybachuk, and Irina Titova. Our group included Marek Dąbrowski, Georges de Ménil, Peter Boone, Simon Johnson, Michael Zienchuk, Michael Blackman, Eva Sundquist, Elisabeth Hopkins, Agha Ghazanfar, Joel Turkewitz, Marcin Luczynski, and numerous talented young Ukrainians. Outside our group, I particularly benefited from the insights

of John Fox, William Green Miller, Daniel Kaufmann, and Martin Hallquist.

In 1998, President Askar Akaev kindly asked me to undertake a review of the economic policies of Kyrgyzstan. I enjoyed full access to the whole government, and I have remained engaged, happily finding that Kyrgyzstan now has a functioning market economy, although many typical post-Soviet problems persist. Apart from President Akaev, I have benefited from exchanges with Roza Akhnazarova, Nelli Beishenalieva, Sadriddin Djinbekov, Naken Kasiev, Rafkat Khasanov, Valery Khon, Amangeldy Muraliev, Esengul Omuraliev, Ulan Sarbanov, Boris Silaev and Murat Sultanov, Ron Hackett, and Fred Huston, as well as Anna Stjärnerklint and Nazgul Jenish at the UNDP.

I have been involved in a multitude of other activities in various post-communist countries that have offered me insights into their transition. In 1992, I was a member of the International Baltic Economic Commission. The World Economic Forum has included me in many conferences in the region and Davos. I have been a member of the Center for Strategic and International Studies Commissions for St. Petersburg, Poland, and Romania. For the Soros Foundation and the World Bank, I have worked for the promotion of higher economics education in the whole region. My engagements have given me the privilege of meeting people from all countries in the region rather often. Apart from those already mentioned, I would like to thank the following politicians, officials, academics, and businessmen from the region for the insights they have shared with me (in geographic order): Mart Laar, Toomas Hendrik Ilves, Jüri Luik, Arvo Kudde, Einars Repše, Inna Šteinbuka, Ojars Kehris, Algirdas Saudargas, Andrius Kubilius, Leszek and Ewa Balcerowicz, Jerzy Osiatynski, Barbara Błaszczyk, Grzegorz Kołodko, Andrzej Olechowski, Wojciech Kostrzewa, Alexander Smolar, Irena Grosfeld, Václav Klaus, Vladimir Dlouhý, Josef Tošovsky, Brigita Schmögnerova, György Suranyi, László Bokros, Iván Major, Kálmán Mizsei, László Urban, Victor Ciorbea, Daniel Daianu, Valentin Lazea, Christian Popa, Alexander Boshkov, Ognian Pishev, Ion Hutu, Stanislav Bogdankevich, David Onoprishvili, Vladimer Papava, Levon Barkhoudarian, Armen Darbinian, Nursultan Nazarbaiev, Grigory Marchenko, Erzhan Utembayev, and Nadia Badykova.

Among academics, I remain most indebted to Jeffrey Sachs, the leading light of the early transition. In the United States, I have benefited greatly from conversations with (in alphabetic order): Leon Aron, Rudiger Dornbusch, Stanley Fischer, Roman Frydman, Sherman Garnett, Ardo Hansson, John Hardt, Simon Johnson, Daniel Kaufmann, János Kornai, Cliff Kupchan, David Lipton, Michael McFaul, Mark Medish, Martha Brill Olcott, Irina Paliashvili, Carlos Pascual, Boris

Pleskovic, Andrzej Rapaczynski, Ben Slay, John Odling-Smee, Marcelo Selowsky, Stephen Sestanovich, Andrei Shleifer, George Soros, and Lawrence Summers.

For many years, I have traveled extensively in the region, talking to innumerable people. During several transition years, I spent more than half the year in the region, mostly in Russia and Ukraine, but I have visited eighteen of twenty-one countries in the region in the last fifteen years. The exceptions are Moldova, Tajikistan, and Turkmenistan.[1] I have participated in numerous conferences and meetings with ministers, other officials, economists, and businessmen from all countries of the region, which has given me opportunities to check the situation in their countries.

I am especially grateful to Simon Johnson, Michael McFaul, Andrei Shleifer, Andrew Warner, John Hardt, Cliff Kupchan, Georges de Ménil, Glifford Gaddy, Carlos Pascual, Ben Sloy, Victoria Levin, Scott Parris of Cambridge University Press, an anonymous reviewer, and my wife Anna, who have helped me greatly by reading and commenting on my manuscript.

I have had the privilege of writing this book as part of my work at the Carnegie Endowment for International Peace in Washington, D.C., and partly at the Carnegie Moscow Center. My greatest gratitude goes to President Jessica Mathews and Vice Presidents Paul Balaran and Thomas Carothers, for generously and liberally supporting my work. Jordan Gans-Morse provided me with wonderful research assistance and composed most of the tables and charts, while Marc Fellman did the early work and Victoria Levin completed it. In addition, Vira Yakusha and Natalia Udalova have assisted me in Washington, Oksana Sinyavskaya and Natalia Firsova in Moscow, and Svitlana Bocharova in Kiev. The wonderful librarians at Carnegie – Jennifer Little, Kathleen Daly, and Christopher Henley – have offered me their impeccable services.

Anders Åslund
May 2001
Washington, D.C.

[1] In the course of the transition, I have also visited East Germany, Slovenia, Croatia, Yugoslavia, and Albania.

List of Abbreviations

ADB	Asian Development Bank
CIS	Commonwealth of Independent States
CMEA	Council of Mutual Economic Assistance
CPSU	Communist Party of the Soviet Union
EBRD	European Bank for Reconstruction and Development
ECE	Economic Commission for Europe (UN)
EU	European Union
FIG	Financial-industrial group
FSR	Former Soviet Republic
FSU	Former Soviet Union
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GDR	German Democratic Republic
GNP	Gross national product
IBRD	International Bank for Reconstruction and Development (World Bank)
IFIs	International financial institutions
ILO	International Labor Organization
IMF	International Monetary Fund
IPO	Initial public offering
NATO	North Atlantic Treaty Organization
OECD	Organization of Economic Cooperation and Development
PHARE	EU technical assistance program for EU accession countries
TACIS	Technical Assistance for the CIS (EU program)
UNDP	United Nations Development Program
USAID	United States Agency for International Development
VAT	Value-added tax
VPK	Military-industrial complex
WIIW	Vienna Institute for Comparative Economic Studies
WTO	World Trade Organization


SWEDEN
GERMANY
ARCTIC OCEAN
Baltic Sea
FINLAND
Bering Sea
CZECH REP.
POLAND
RUSSIA
LITHUANIA
Barents Sea
East Siberian Sea
ESTONIA
SLOV.
Minsk
LATVIA
Kara Sea
Laptev Sea
HUNG.
BELARUS
Moscow
ROM.
Kiev
MOLDOVA
UKRAINE
Chisinau
Black Sea
RUSSIA
Sea of Okhotsk
GEORGIA
Tbilisi
Yerevan
ARMENIA
Astana
Baku
Aral Sea
KAZAKHSTAN
AZERBAIJAN
Caspian Sea
IRAQ
TURKMENISTAN
UZBEKISTAN
KYRGYZSTAN
N
Ashgabat
Tashkent
Bishkek
MONGOLIA
0
500 mi
0
500 km
IRAN
Dushanbe
Sea of Japan
JAPAN
TAJIKISTAN
AFGHANISTAN
N. KOREA
CHINA
PAKISTAN

Gulf of Finland
Tallinn
ESTONIA
SWEDEN
Gulf of Riga
Riga
LATVIA
Baltic Sea
LITHUANIA
Vilnius
RUSSIA
RUSSIA
Warsaw
GERMANY
POLAND
Prague
CZECH REPUBLIC
UKRAINE
SLOVAKIA
Bratislava
Budapest
AUSTRIA
MOLDOVA
HUNGARY
SLOVENIA
ROMANIA
CROATIA
BOSNIA AND HERZEGOVINA
Bucharest
YUGOSLAVIA
Black Sea
Adriatic Sea
BULGARIA
Sofia
ITALY
MACEDONIA
TURKEY
N
ALBANIA
TURKEY
0
200 mi
0
200 km
GREECE
Aegean Sea

Introduction

Sunday June 4, 1990 was a sunny day in Moscow. My host woke me up to tell me that Ayatollah Khomeini had died, but that was only the third news item on the BBC World Service. On the same day, the Chinese communist dictators massacred democratic protesters on Tiananmen Square, while Poland held partially democratic parliamentary elections. For me, communism ended on that day. Soon, one communist domino after another was to fall.

This was an extraordinary event. A complete ideological, political, economic, and social system just passed away, and a large part of the world with some 400 million inhabitants was to choose new shape in every regard, including what countries they should divide themselves into. This was one of the greatest revolutions the world has seen, and it was a liberal revolution in the classical European sense.

The time had come for an unequivocal rejection of the socialist system. Overtly, a broad consensus aspired to democracy, a normal market economy based on private ownership and rule of law, but the actual opposition to these goals was expressed in disagreement on how to accomplish these purportedly common aims, and soon the opposition came into the open.

This attempt at building capitalism and the resistance it faced are the themes of this book. Over a decade has passed since the demise of communism in what used to be called Eastern Europe and the Soviet Union, and it is time to take stock. The aim of this book is to tell a comprehensive story of postcommunist economic transition. Since this drama has been both complex and profoundly ideological, involving more than a score countries, prejudices abound, and our ambition is to clarify the key facts about the transition because so much confusion clouds the picture. The situation under communism is rapidly falling into oblivion. The intentions of central actors have often been misunderstood; the many constraints on decision making are poorly perceived, and wishful thinking recommends options that never were available. Not even the main forces in the battle over transition are clearly perceived. To help sort out the prevailing confusion, this book is intended to present a clear interpretation of this important period in history.

To neutralize a variety of biases I adopt a comparative approach, particularly well suited to this drama. Seldom have so many countries, with so many preconditions in common, attempted a fundamental change of their economic and political systems simultaneously. Therefore, comparisons among postcommunist countries offer a telling picture of what has worked. The counterfactual question is more difficult: What could have been done differently? Politics and economics are rife with constraints, but these are rarely obvious until you try to undertake a reform. Yet we can check what cures were tried and how they have worked.

THE OPTIONS OF POSTCOMMUNIST TRANSFORMATION

The initiative was seized by liberal revolutionaries, who hoped for a "normal society" and a "return to Europe." These radical reformers demanded the opposite of the petrified, state-dominated system. Communist dictatorships had to give way to democracy, pluralism, and individual freedom, replacing vertical state commands with horizontal market signals, and public ownership with private property. Communism had rejected the very idea of a rule of law, which now had to be established. Nobody thought the transformation would be easy, and it was not, because the communists had planted plenty of poison pills to make sure that their destruction of capitalism was irreversible. The comprehensive nationalization of property, the annihilation of civil society, the elimination of market economics, as well as the suppression of law can all be seen as effective poison pills.

The opposition against liberal revolution overtly accepted its goals but focused on purported tactical flaws, arguing that numerous tasks could not be accomplished quickly. These arguments were as many as varied. The open debate took place between radical reformers and protagonists of more gradual reform, but no country pursued gradual reform to attain social benefits. After a decade of transformation, two alternative courses to radical reform are evident. One is the reestablishment of state despotism, most clearly represented by Belarus and Turkmenistan, which adopted minimal economic and political reforms and gradually reversed them. Their economies remain state-controlled, with predominant state ownership, multiple exchange rates, regulated prices and strictly regulated foreign trade. Politically, Belarus has returned to dictatorship, while Turkmenistan's communist ruler has remained in power. These authoritarian regimes persisted as one-man dictatorships serving their despots, just abandoning any pretense of socialism. Uzbekistan, Tajikistan, and Azerbaijan come close to this model.

The second alternative to capitalism was a rent-seeking state. By rents, we mean "profits in excess of the competitive level" (Brealey and Myers 2000). This model is confusing because it is neither a competitive market economy nor a state-controlled economy. Political power is diffused in the elite, obscuring the power struggle and the true villains. Often, honorable reformers subsist in key positions in government, and only in hindsight does their failure in decisive battles become evident. The dominant interest in a rent-seeking state is not economic welfare of the whole nation, but the state redistributes available resources through its budget and regulations to enrich a few privileged. The opposite of rent seeking is profit seeking on a competitive market (Krueger 1974; Buchanan 1980). Consequently, as output is not a chief concern of the rulers of a rent-seeking state, stagnant or declining production is its hallmark. Rent seeking has been prominent in the whole region, but Ukraine, Russia, Moldova, Romania, and Bulgaria have been outstanding examples.

Where liberal revolutionaries failed to gain political power, it was usually seized by state enterprise managers, state officials, and new entrepreneurs, who made money on the very transition from a regulated economy to the market (Åslund 1996). Rather than minimizing market distortions for the common good, they wanted to maximize and perpetuate rents for their personal benefit. Aspiring to their own economic freedom, they promoted severe regulations for others. Wisely, they avoided pronouncing their strategy openly but justified their endeavors with social concerns.

The rent seekers' strategy involved a confusing mixture of extreme freedom and severe regulation. Several avenues of early enrichment were prominent throughout the region. The first large rents arose from arbitrage between free market prices and state-controlled prices, and their discrepancy was aggravated further by multiple exchange rates. As inflation mounted, arbitrage opportunities amassed, and huge interest subsidies became available, since state interest rates remained low. Large state enterprise subsidies persisted and state enterprise managers and officials swiftly privatized them through transfer pricing. Privatization is widely seen as the main vehicle of rent seeking, but that is hardly true, because most rents arose in the public sector. Some rents faded away over time, notably those generated by inflation, but successful rent seekers bought so much politics that they could impose new rents. The problem of postcommunist transition was the self-reinforcement of rent seeking (Hellman 1998).

The purest example of such a rent-seeking state was Ukraine in the mid-1990s. It had stopped halfway in most reforms. After a slow financial stabilization, Ukraine remained half privatized, half liberalized and half free. Moldova remains similar, and so were Bulgaria and Romania until their financial crises of 1996. These states have been popularly described as oligarchic regimes. Russia undertook more early reform, especially privatization, but soon it got stalled to be dominated by rent-seeking. That is also true of Kazakhstan.

Yet, the transitional rent-seeking state appears a positive development in comparison with state despotism. Most rent-seeking states are semidemocratic and might develop true democracy, while little but a revolution can change the state-dominated dictatorships. Although distorted, the rent-seeking states are still market economies. Rents are endangered by the development of a competitive market economy and intense feuding among "oligarchic" groups. Their drawbacks were initially expanding corruption, rising income differentials, and an aggravation in the functioning of the state.

Thus, during the transition, we have witnessed the materialization of three alternative visions of the state. Real reformers dreamed of a democratic state working for the society. Despots thought of little but their personal power, while rent seekers wanted to appropriate the state for their own interests. Each of these three state models corresponds to one economic system: a normal market economy, a restored command economy, and a rent-seeking transition economy. Economic performance has varied accordingly. While supportive of rent-seeking, communism and socialism have not appeared as independent alternatives in the debate.

The argument is often made that all the transition countries have pursued the same policies, but that they have had different outcomes because of different preconditions (Lavigne 2000). But that is not true. Postcommunist governments have intentionally chosen very different economic policies, leading to different outcomes. Bad policies are promoted by narrow interests. The questions are how so many governments could get away with such an antisocial choice, and why other governments cared about social goals. Hence, the credo of the radical reformers appears empirically robust: "The countries that have done the best are those who have pursued their reform agendas most consistently; they are also those who seemed from the start most committed to reform" (Fischer and Sahay 2000, p. 3).

These simple observations lead to several important conclusions. The goals were not given and there were real alternatives to a market economy and democracy. The central drama of postcommunist economic transformation has been an intense struggle between liberal reformers, who wanted to build a normal democracy and market economy, and rent-seeking businessmen and officials, who desired to make money at the expense of the state and society in transition.

At the outset of transition, a wide range of choices was open, but the range soon narrowed. Therefore, it was critical for the fate of a transition country which side prevailed at the start. To alter the strategic choices made then is difficult and costly. A market economy generated its own paradigm and new entrepreneurs, who wanted its perpetuation, while a rent-seeking economy bred rents that enriched the rent seekers, who invested their returns in politics to perpetuate their rents. As a consequence, great path dependence has prevailed. A clear initial conceptualization and a speedy launch of the reforms helped greatly, but also the building of democratic institutions, which could resist the rent-seeking elite, contributed to cementing a market economy. The crucial question was whether a policy promoted rent seeking or not. Only after that litmus test, should other plausible social effects of the policy be considered.

Many critics of radical reform allege that reformers "forgot" about law, institutions, or social policy (e.g., Bogomolov 1996; Goldman 1996). This is not true, as is evident from the sources (see Fischer and Gelb 1991). The real problem, however, was that reformers were few and weak, so they were often defeated by rent seekers. The same critics are at a loss, when trying to explain why similar radical reformers were successful in other countries. National myths offer little enlightenment while the political leverage of reformers is vital.

MAJOR IDEAS OF THIS BOOK

This book challenges much of the conventional wisdom of postcommunist transformation and attempts to debunk many factual misconceptions. To give the reader a taste of what is to come, I shall summarize twelve major conclusions.

- The main drama of postcommunist transformation was the struggle between radical market reformers and rent seekers, rendering the containment of rent seeking the main task of transition.
- Preconditions differed greatly with country, and the development of democracy and civil society in the last couple of years before the end of communism is of great importance for the economic outcome. The former Soviet Union and Poland experienced profound economic crises at the time of the demise of communism, demanding instant and radical action.
- The universal collapse of output is a statistical aberration. In fact, some countries experienced early growth, but others substantial

slumps. The main statistical biases are due to the rise in the unmeasured real economy after communism and the inclusion of communist value detraction in prior output measures.

- To an extraordinary extent, real growth is correlated to the degree of systemic reform. Liberalization, especially of prices and foreign trade, was key, and a certain degree of price stabilization was a precondition for growth. The idea that radical reform would cause a precipitous fall in output is not substantiated.
- The stark dividing line between East-Central Europe and the Commonwealth of Independent States (CIS) can, to a great extent, be explained by the lingering of the ruble zone and state trading system in the CIS.
- The growth task has involved the liberalization of supply and not the stimulation of demand. Growth has invariably been export-led.
- The key assignment in fiscal policy has been a sufficient fiscal adjustment through a cut in public expenditures. Public revenues and taxes have been far too high and largely remain so.
- In the short term, privatization might not be of vital economic importance for enterprise performance, but it certainly is in the long term. Its most important effects might be in stimulating markets and supporting democracy. The quality of privatization does not improve over time unless a critical mass of private enterprises, around two-thirds of gross domestic product, has been reached.
- The overall social situation has improved greatly after a temporary setback in the early transition. The main concern has been a great increase in inequality in intermediary reformers, and consequently an increase in poverty in poor countries.
- Democracy and political competition benefit reforms and growth, while instability is a surprisingly minor worry.
- Western aid to transition has been limited. The United States has benefited from a peace dividend immensely greater than the aid it has given to postcommunist transition. In total, the transition countries have paid Western governments and international financial organizations more in servicing old communist loans than they have received in grants and official loans. Yet, Western technical assistance has contributed to a complete change in economic thinking, and financing by the International Monetary Fund has assisted in financial stabilization.
- The success of transition was never a given. Three starkly different paths are apparent. Radical reformers have built democratic and dynamic market economies, while gradual reformers have achieved only semidemocratic, semiprivatized rent-seeking societies with limited growth. Nonreformers, however, have maintained firm

dictatorships with state-controlled economies and dominant public ownership. The latter two groups got stuck in underreform traps of varying stability.

THE STRUCTURE OF THIS BOOK

The former Soviet bloc has undergone an extraordinary conversion. Today, it is widely accepted that democracy is better than dictatorship; that private enterprise is superior to public enterprise; that a market economy is preferable to a state-controlled economy; and that the rule of law is better than decisions by fiat. Only a decade ago, however, many adhered to the opposite principles and hundreds of millions of people lived under communist regimes.

The purpose of this book is to provide general academic readers with a broad empirical and analytical overview of what postcommunist economic transformation really amounted to in the whole former Soviet bloc in Europe and the former Soviet Union. My ambition is to debunk many myths that have accumulated without empirical foundation. I also hope to offer an empirical base for future theoretical work. The book is designed to be comprehensive so that it can be used as a university textbook, while its breadth in terms of themes and countries limits its depth. Still, I endeavor to cover the major arguments and the best of a large literature in many languages. While passing judgments, I also try to provide full data and arguments to give readers a fair opportunity to disagree.[1]

This is essentially an economic history of the first decade of postcommunist transformation. My ambition is to show major economic developments – marketization, macroeconomics, privatization, international finance, and social policy. Since this is also a very political topic, I shall discuss the role of the state and politics in the economic transformation at length.

An important question is why certain countries have performed better than others. Covariance between various policies and preconditions is great, as similar countries usually pursue similar policies and achieve similar results, but many interesting exceptions enlighten us. Major causes of failures and successes pertain to initial conditions, policies pursued, politics, external influences, and their interaction.

Purists argue that the term "postcommunist economic transformation" is more appropriate than the commonly used word "transition," as the latter suggests that the goal was evident, which was never true. Yet,

[1] I have previously written a prescriptive book on what the postcommunist economic transformation ought to be (Åslund 1992).

we use the words "transition" and "transformation" interchangeably as it has become customary.

The structure of this book is driven by the main questions about postcommunist economic transformation. Still, two brief background chapters seem necessary. The first chapter outlines the prime features of the socialist system. The whole environment had been permeated with communist ideology. Many remnants of vulgar Marxism persist as prejudices among nonsocialists. Ideas are important, and the intellectual poison pills left behind by communism are both more numerous and better concealed than is often understood. Notably, the illicit practices of the communist states rendered them outright kleptocracies. Readers familiar with the old system might skip this brief chapter.

The second chapter discusses how the socialist system collapsed showing palpable differences between various countries. Crucial economic and political specifics constrained later choices. Of vital importance was the development of markets and civil society prior to the collapse of communism. This helps to explain why the Baltics have done so much better than South-East Europe. The economic collapse was horrendous in the former Soviet Union, while Hungary and Czechoslovakia barely experienced a crisis.

From 1989 to 1991, the world's leading public debate concerned the move from communism to capitalism. Chapter 3 presents the main arguments. The critical choice was between radical and gradual reform. The radical reform program was reasonably clear-cut, while gradualist ideas varied greatly.

One of the greatest myths of postcommunist transformation, scrutinized in Chapter 4, is that it has caused an unprecedented collapse in output. But the registered decline in output can be explained largely by an increase in unmeasured output and a reduction of value detraction, or the production of unsalable goods, involving no loss of real output. Yet, even after statistical revision, the difference between success and failure remains great. Successful output development is strongly correlated with radical reform policies. Especially Poland shows a strong and early supply effect. An intermediary reformer, such as Russia, hardly saw any decline in output, less reformist Ukraine a moderate slump, while nonreforming Belarus did very badly, although it appears a star performer in flawed official statistics. The main social concern is that some countries have taken so long to return to economic growth. Chapter 4 examines the correlation between major preconditions and policies, on the one hand, and output or growth, on the other, drawing on a substantial literature of regression analyses. Economic growth is positively related to all reforms: liberalization, macroeconomic stabilization, and privatization. The earlier and the more comprehensive reforms have been, the more dynamic an economy has become. An interesting discrepancy is that some countries in the Commonwealth of Independent States have reaped much less economic return from their reforms than others. I explain this phenomenon with the excessive and harmful public expenditures in the laggards, reflecting more rent seeking.

Chapter 5 deals with the creation of markets or liberalization. A comprehensive deregulation, especially price liberalization and foreign trade liberalization, seems the most important reform. To a surprising extent, in liberalization a country reaches as far as it first jumped, and then it barely advances. I identify two dangerous reform traps. One is little or no liberalization, which leads to the preservation of a state-controlled economy. The other reform trap is partial liberalization, which breeds such corruption and rent seeking that a strong interest group emerges and impedes further liberalization. In hindsight, the case for radical and comprehensive liberalization is overwhelming, but the window of opportunity has closed.

Macroeconomic stabilization has also been vital for economic growth, as discussed in Chapter 6. In contrast to liberalization, every country has stabilized sooner or later, since the rents arising from high inflation have dissipated over time, while monopoly rents persist. Yet, most countries have taken a long time to get inflation under control. Meanwhile, rent seekers amassed fortunes, with which they bought political influence and created new rents. Therefore, a forceful and early macroeconomic stabilization has been so beneficial. No single country has overreacted. The main fiscal problem has been large budget deficits.

Chapter 7 probes privatization, which has been the most controversial part of the transition. The methods and extent of privatization have varied with preconditions and policy. Most postcommunist countries have become predominantly privatized, but as with liberalization, a major push was necessary to achieve substantial privatization. A few countries that had privatized little have stopped doing so altogether and reversed to all-dominant state ownership. Those states that privatized only slightly more have found it hard to regain momentum. These are strong arguments for an early and vigorous privatization. While the choice of method is broad, it is severely constrained by national economic, political, and legal conditions.

A view has proliferated that postcommunist transformation has been a social disaster, which we scrutinize in Chapter 8. While no good data exist for the development of output, data on the actual standard of living are even worse, and we are unlikely to gain much deeper insights in the future. The comparative standard of living under communism is indeterminate because of measurement problems. Yet, an indisputable concern is a sharp rise in income inequality in some former Soviet republics (FSRs), which appears an effect of rent seeking. The most disturbing social development has been a substantial decline in male life expectancy in most FSRs, but it has been contained and reversed. Infant mortality, on the contrary, has fallen significantly in almost the whole region. The much talked about collapse of the health care and education systems has not taken place, though these public social service systems suffered from severe disorganization in the early transition, and they have become more geared toward the interests of the middle class.

The politics of postcommunist economic transformation is the theme of Chapter 9. A major idea in this book is that a small powerful elite has designed policies to its own benefit to maximize rent seeking. This has been possible because the state has been weak as a representation of the public interest, and civil society has been fragile. Democracy is vital for postcommunist economic transformation, because it builds up the strength of the state and endows it with a public interest. By contrast, any dictator is likely to be co-opted by the small elite surrounding him and become a vehicle for their corruption, as the communist states were kleptocracies. Nor is it advantageous to make any deal with the old establishment or a new corrupt elite if such compromises can be avoided. All empirical observations suggest that a maximum of political competition is preferable, even when it leads to considerable political instability. Elections and frequent changes of government promote reform, and coalition governments perform better than one-party governments. A parliamentary system is more effective than presidential rule, because parliaments can scrutinize governments closely, while the president and his administration are usually beyond real accountability. Contention keeps a corrupt establishment at bay, while unity promotes its sense of security. A dangerous trap of underreform arises, when a government has pursued little reform, because then the Communist Party remains so strong and unreformed that it can successfully block reform for years to the disadvantage of public welfare.

Chapter 10 examines the role of the outside world. In sharp contrast to all talk about Western aid to postcommunist states, the region saw a significant outflow of government and intergovernmental funds during the first years of transformation, as Western governments extracted more in debt service on old communist-era debts than they provided support. Instead, considerable inflows have come from the private sector, but not early on. The actual Western policy has been characterized by more talk than resources, though the West did help Poland and the Baltics, which might have been critical for their success. The great Western shortfall was not to provide financial support for the radical reform attempt in Russia in early 1992. Through this sin of omission, the West ended all hope for the rest of the CIS region for a few years, because Russia's economic success was vital for their fortunes.

Finally, I conclude what has worked and not worked in postcommunist economic transformation, trying to discern path dependence and traps of the transformation, and how obstacles can be overcome.

REGION AND PERIOD OF STUDY

There are at least twenty-eight former communist countries. I have selected twenty-one of them – what used to be called the Soviet bloc in Europe, including Poland, the Czech Republic, Slovakia, Hungary, Romania, Bulgaria, and all the fifteen former Soviet Republics, while excluding all the former Yugoslav republics, Albania, China, and Mongolia.

The two considerations behind this choice are initial conditions and statistics. All the countries of the Soviet bloc had much in common: the same hierarchical and bureaucratic communist dictatorship; originally the same economic system; closely connected foreign trade systems. Although reforms in Hungary and Poland had altered their systems, their origins and pillars remained. The economic and political systems of Yugoslavia and China were not of a Soviet hue but profoundly different. Albania is very peculiar. It had preserved the purest Stalinist model, but it was extremely poor in comparison with its neighbors, and it has received far more international assistance than any other country. Mongolia had a pure Soviet system, but my usual sources of statistics do not include Mongolia, complicating comparisons.[2] Some aspects of East Germany, such as privatization and labor market policy, will be discussed, while its unification with West Germany makes its macroeconomic situation unique.

During the period of this study, the names of the region and its subregions have been in flux. My ambition is to simplify and adopt one reasonable terminology. Under communism, "Eastern Europe" used to signify the German Democratic Republic, Poland, Czechoslovakia, Hungary, Romania, and Bulgaria. Today, Poland, the Czech Republic, Slovakia, and Hungary are usually called "Central Europe," which is my terminology.[3] I shall call Bulgaria and Romania "South-East Europe." A

[2] The European Bank for Reconstruction and Development (EBRD), the Europe and Central Asia (ECA) region of the World Bank, and the United Nations Economic Commission for Europe (ECE).

[3] Slovenia is usually included in Central Europe, which is sometimes extended further.

third subgroup is the Baltic states – Estonia, Latvia, and Lithuania. I call the combination of these three subregions "East-Central Europe." The remaining twelve countries are all associated with the Commonwealth of Independent States (CIS), which is the other main region.[4] Sometimes, I distinguish between the Caucasus (Georgia, Armenia, and Azerbaijan); Central Asia (Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan); and the Western CIS (Moldova, Ukraine, and Belarus). There is usually a rather clear dividing line. Mostly, it runs between Central Europe and the Baltics, on the one hand, and South-East Europe and the CIS, on the other. Often, East-Central Europe differs from the CIS, but sometimes the former Soviet Union (FSU),[5] which consists of the Baltics and the CIS, contrasts to Central Europe and South-East Europe.

The period of this study is straightforward. It is 1990–2000 for Central Europe and South-East Europe and 1992–2000 for the FSU, that is, the time of real postcommunist transformation.

METHODOLOGICAL TRAPS

The literature on postcommunist economic transformation is huge, comprising thousands of academic articles and books. Most studies focus on one or a few countries – usually Poland, Hungary, and Russia. While these countries have hosted the main debates on transition, their experiences are not altogether representative. The possibly greatest success story, Estonia, has been comparatively poorly studied, and the worst failures have received minimal attention. This skewed perspective has made Russia look extreme, which is rarely correct.

As time passes, it is all too often forgotten that communism was a world of lies, but its cultural repercussions are alive. A successful Soviet career required a willingness to lie, and old habits die hard. Thus, a standard speech by Russian communist leader Gennady Zyuganov alleges that gross domestic product (GDP) has fallen "several times," which is obviously untrue, but that does not stop him from repeating it. While such inaccuracies are evident, this legacy breeds confusing misperceptions. An old belief is that whatever the authorities say, the real situation must be worse, but weak postcommunist statistical agencies regularly

[4] Several countries have ambiguous relations with the CIS. Georgia did not join at all initially, but has done so later on; Moldova, Turkmenistan, and Ukraine never ratified the CIS Charter and insist on not being members, but they mostly participate in its meetings, and the CIS remains the common organization (Olcott, Åslund, and Garnett 1999).

[5] The Balts officially refute the concept of "the former Soviet Union."

understate national achievements. Conspiracy theories enjoy extraordinary popularity. A popular idea is that nobody tells the truth. Then, only crooks who boast about their crimes are deemed truthful. Many members of the Soviet elite even considered it unsophisticated to tell the truth. While pure Marxism has been abandoned, vulgar Marxism has flourished as a substitute for social theory, in particular, in the Russian debate. "World experience" is often used as a misnomer for vulgar Marxist perceptions to prove any statement. Now, lies have become commercialized. Anything can be published, and somebody always believes in the printed word.

Any scholar of the region must be aware of these biases and check facts accordingly. Fortunately, many scholars in the region are well trained in such critical scrutiny. Thanks to the great freedom of the media and the liberty of travel and association in most postcommunist countries, most caveats can be sorted out, but only through intensive contact within the region. Some frequent errors require special mention.

A standard mistake is to adopt judgments from the popular debate, which are not based on facts. A good example is the common idea that Russia suffered from "shock therapy," meaning very radical structural reforms, but the Russian reforms were not very radical in comparison with Central Europe or the Baltics (Aven 1999; Fedorov 1999; see Table 5.1). To escape this trap, I quantify whenever convenient.

Another typical error is to select a single policy, for instance, privatization, as the explanation of every conceivable variance between two countries, regardless of other differences. Often the performance of Poland and Russia, respectively, is explained by their privatization policies, but preconditions and other policies must also be considered. Therefore, I try both to make comparisons among many countries and to contemplate alternative causes, drawing extensively on multicausal, multicountry regressions.

A frequent illusion is that policymakers possess full freedom of choice and that every country can do everything at any time, but actual choices are limited by political or economic constraints, which may not be obvious. Often, real power relations become evident only after a reform attempt has failed. For instance, state enterprise managers have been strong in all countries, but in some countries they have effectively controlled the state, while reforms have defeated them in other countries, which could hardly have been known in advance.

A problem of theoretical social scientists is their habit of assuming preconditions and developments regardless of the absence of precedence or likelihood in that context. Much of the theorizing about postcommunist societies by economists and political scientists has been based on unrealistic assumptions, often drawing on the Western domiciles of these scholars. The most conspicuous assumption is that radical reform leads to a greater decline in output and welfare, which has not been substantiated. Yet, few of those making such assumptions have felt any need to check actual developments, even when unambiguous empirical data are available. As Ronald Coase (1988, p. 29) so pointedly wrote about economist James Meade in another context: "Meade furnishes another instance of the practice of economists of giving illustrations of their theoretical findings without feeling the need to investigate whether what they say corresponds to what is found in the real world."

Time perspectives also cause confusion. Often, the success of a country is measured in the last year's growth rate, causing vacillating judgments. Hungary, the Czech Republic, and Poland offer telling illustrations. At the outset of the transformation, Hungary looked like the obvious winner, since it had achieved the most reform, while Poland endured hyperinflation, and many reckoned it had overreacted with its "shock therapy." Numerous observers condemned the Polish reform strategy (Kołodko 1992; Bożyk 1992). Soon, however, Poland seemed superior to Hungary because of its earlier return to growth as well as continuously higher growth. When the Czech Republic launched its reforms in 1991, it appeared to carry out key reforms even more thoroughly (Klaus 1992, 1994), but by 1997 this reform star had faded because of low growth, and Hungary overtook it. Perceptions have changed more than reality, which calls for certain humility.

Broad historical truths are often overgeneralized and much less obvious than thought. At the time of this writing, Russia is widely perceived as one of the most corrupt countries in the world and an utter disaster. This perception is often corroborated with Richard Pipes's (1974) outstanding history *Russia under the Old Regime*. However, if Russia all of a sudden attained several years of significant growth, we would soon learn that this was self-evident for such an old cultural nation, which has been part of the Western world for most of the last few hundred years (Malia 1999). Both these historical perspectives have impeccable pedigrees. When I worked as a tourist guide in Leningrad in the 1970s, each Intourist guide who showed the beautiful palace of count Stroganoff emphasized what a decadent aristocrat he had been. Soon after the city had become St. Petersburg again, I passed the palace in a private cab. My driver commented approvingly that Stroganoff, a man of simple origins, had been the greatest self-made capitalist of his time. Peter the Great even made him a count. History is a rich source of alternative myths.

Many misperceptions are natural because postcommunist transformation is intrinsically ideological, and ideology thrives on myth. Facts that challenge a person's political views are not easily accepted. This book is an attempt to sort out the reality in the feeble hope that future ideological battles will contain slightly more empirical evidence than in the recent past.

TREACHEROUS STATISTICS

An abundance of statistics has become available since the end of communism, but so many new statistics cannot all be of good quality. The more you learn about these statistics, the more skeptical you become. Each country had its own biases under communism, and many of them have persisted. Richard Ericson (1994, p. 195) has perceptively characterized the prior state of affairs: "Thus the whole economic system was based on economic illusion – the pursuit of goals unrelated to economic value creation in the absence of real economic information."

The fundamental problems of communist statistics are illustrated with the vital measurement of output. In his novel *1984*, George Orwell (1949) described the unscrupulous official embellishment that prevailed under communism. Everything good, such as output and standard of living, was exaggerated, while flaws, such as falling life expectancy and rising infant mortality, were understated or left out altogether (Davis and Feshbach 1980).

With such an official policy, the solution of technical statistical problems was not desirable. The statistical system under communism was based on the assumption that all economic activities take place in large or medium-sized state or cooperative enterprises, while no data were collected about small or private enterprises. Naturally, old heavy state industry was better registered than new services and trade carried out in small private enterprises. Usually, public statistics were based on aggregate data, and little or no sampling was used, persistently underestimating all new economic activities. The faster a country restructured its economy, the more its GDP was understated.

With transition, both prices and industrial structures have changed profoundly. Now, it matters greatly what weights are used in time series, and the differences between alternative indices have become extraordinary. Yet, these index number problems are rarely brought into the open and they are seldom compensated for, although they can lead to sizable gaps in output series.

As nearly all biases have been downward, the first public numbers on plummeting output were highly exaggerated. Gradually, one country after another has undertaken major statistical revisions, but at different times, complicating comparisons with both old data and other countries. Most statistics have been revised repeatedly, and the changes have been staggering. In the former Soviet republics (FSRs), the cumulative upward revisions of GDP usually exceed 10 percent of GDP, and even so the decline in GDP probably remains overstated.[6] Even in the best of cases, statistics become a bit arbitrary. For instance, in Russia registered official trade accounts for only 30 percent of total retail trade, while the statistical authorities try to estimate the total.

The more conservative national statistical authorities were, the more they understated GDP and other aggregates, such as consumption and living standards. As the Ukrainian Ministry of Statistics was much more rigid than the Russian State Committee on Statistics, Ukrainian output is probably more understated than Russian production. In general, the more reformist countries have been better at adjusting their statistics, and with faster restructuring official statistics have increasingly noticed unregistered activities. Today, Polish statistics might be the best. At the other end of the spectrum, Belarus and Uzbekistan have not abandoned the socialist economic system. Therefore, their numbers still reflect all the shortcomings and, presumably, overreporting of the old system. The countries with intermediary reforms are likely to have the largest underground economies and the greatest understatements of their output (Johnson, Kaufmann, and Shleifer 1997a).

The statistics of the five war-torn states (Armenia, Azerbaijan, Georgia, Moldova, and Tajikistan) are especially poor, as their statistical systems simply collapsed, and with them registered output, though not necessarily actual output. That is particularly true of Georgia and Tajikistan. Much of the strong recovery in Georgia since 1996 appears to be rooted in the registration of previously unrecorded economic activity, but nobody knows to what an extent.

Turkmenistan is in a category of its own with extremely unreliable statistics. Turkmenistan's statistics are just arbitrary. For long, the Turkmen authorities implausibly claimed that their GDP had *increased* by 36 percent in 1992 (United Nations Economic Commission for Europe [henceforth ECE] 1998, p. 199). Eventually, this was revised to a *decline*

[6] The first official report for 1991 stated that Bulgaria's GDP had fallen by 26 percent and for 1992 by 22 percent (ECE 1993, p. 73). Both numbers were later revised – to half (12 percent) for 1991 and one-third (7 percent) for 1992 (see Table 4.1). In 1999, Lithuania revised its national accounts radically, so that the total decline from 1989 to 1993 was no longer 62.8 percent (ECE 1998, p. 199), but "only" 39.8 percent (ECE 1999c, p. 128), eliminating a purported drop of 23 percentage units! The Lithuanian output decline in 1992 was no longer 34 percent but 22 percent.

of 15 percent (ECE 2000a, p. 225), that is, a shift of 51 percent for one single year! While Turkmenistan is included in many tables, we shall largely disregard its statistics as completely unreliable.

The old statistical standards were flawed, and they cannot be fully corrected, leaving us with indeterminate numbers. The question is whether it makes sense to try to compare the level of output before and after transition. We shall discuss this further in Chapter 4, but we shall never learn the truth about the decline in output. New growth, however, is likely to be better recorded.

Monetary and financial statistics are generally the most reliable. They are collected by central banks and ministries of finance, which control these variables through government monopoly on taxation and the issue of money. Even so, there are problems. Certain government bodies, such as extrabudgetary funds, are beyond the control of the Ministry of Finance and they tend to collect taxes and expend public monies independently and covertly. We do not know how much of their revenues tax and customs authorities pass on to the state. Hence, budget statistics are repeatedly revised, usually expanding budget deficits, revenues, and expenditures.

Wage and income statistics are particularly understated, since wages are subject to high taxes, encouraging tax avoidance and evasion. Incomes based on household budget surveys are not much better. Moreover, the composition of incomes has changed considerably as the share of wages has fallen sharply. Opponents of reform have lamented sharp official falls in "real wages" with the introduction of a market economy. Jan Adam (1993) complained of a 32 percent decline in real wages in Poland in 1990 (the first transition year), but, using consumer expenditure data, Andrew Berg and Jeffrey Sachs (1992) showed that the weighted volume of consumption in Poland fell by around 4 percent from 1989 to 1990, not even taking into account the rise in product variety, product quality, and the end of queuing. If these factors were included, the standard of living clearly rose. This comparison was made between a saturated market and a prior market of massive shortages. Thus, it is virtually impossible to make sense of any income or wage statistics around the time of transition. And Poland has probably the best statistics.

Foreign trade has been notoriously understated due to the avoidance of foreign trade taxes and capital flight. Thanks to payment statistics, it is possible to undertake substantial improvements, which notably Russia has done. Yet, customs statistics tend to be close to useless. For long, the borders within the CIS were not controlled, and customs officers have a reputation for being the most pervasively corrupt of all post-Soviet officials, quite an achievement. Even World Trade Organization (WTO) and

World Bank statistics on foreign trade in the region are completely disparate.

Savings and investment tend to be calculated as residues of national accounts, easily leading to overstatement. Unemployment is reasonably measured in East-Central Europe, but only in a few FSRs, because unemployment benefits have been so tiny that few have registered. Yet, Russia has established a decent regular labor force survey.

Only a few countries have meaningful statistics on the private sector contribution to GDP. Privatization has been vaguely estimated by the European Bank for Reconstruction and Development (EBRD). The degree of reform has been assessed by competing outside agencies, which challenge one another. Yet, both measurement and weighting of the factors cause disputes. By comparison, good opinion polls provide data of comparatively high quality, and enterprise surveys have become important. Possibly the best statistics in many countries are election results, which are both precise and widely available.

This is no pretty picture. Without dwelling on these complications, it is necessary to keep them in mind and do what is possible to mitigate them. First, I rely largely on statistics produced by respectable international organizations, such as the International Monetary Fund (IMF), the World Bank, the EBRD and the UN ECE, for reasons of access, broad coverage, and standardization of statistics.[7] Second, I use the latest tables available, since most numbers are being revised repeatedly. Third, I strive to minimize the number of sources for each table, as they tend to be incongruent, although this means that some tables are not complete or fully updated. Fourth, when odd numbers are obviously absurd, I have preferred to leave the space empty. Fifth, most social scientists discuss the problems with statistics and then ignore them, but I am intent on drawing the consequences of what I know, even when I cannot provide an alternative estimate of reasonable precision. Fortunately, often the contrasts are so great that even major statistical flaws cannot conceal reality. The countries most frequently discussed tend to have the best statistics, as well as the best alternative estimates, thus giving some sense of the validity of statistics.

In the text, I use many averages among countries. These averages that I have calculated are unweighted; that is, they do not compensate for population or size of GDP, because our interest is to see how various countries have performed in relation to one another, while the com-

[7] Language has not been a major barrier, as so much of the important materials have been translated. Besides, I do read Russian, Polish, Ukrainian, German, French, and Scandinavian languages. I have continuously followed and participated in the debate in Russia, Poland, and Ukraine.

posite performance of the region is usually less relevant. Any average weighted by GDP just records Russia's dominance.

Thus, we are ready to enter our story about valiant liberal reformers, fighting against self-dealing rent seekers profiting from inconsistencies of the transition economy. In the background, we hear extraordinary noise of relevant as well as irrelevant arguments. All preconditions and policies served as arms in this frightful battle.

1

What Communism Actually Was

A decade after the end of communism, it is difficult to imagine that once upon a time many intelligent people believed that socialism was superior to capitalism and democracy. They thought that a benign almighty state would have higher aims than a messy democracy and would be better at executing its altruistic ideals as well. Numerous ideas we take for granted were alien to communists.

Socialist paraphernalia have faded in the postcommunist countries, but multifarious remnants persist. Marxist–Leninist ideas, the actual socialist system, its crises and collapse conditioned the transition. We need to recall the communists' major ideas. I shall also outline what the Soviet-type system actually amounted to.

In many ways, the essence of communism was to free the Communist Party and the state from all possible constraints. Checks and balances were intentionally eliminated. The communists' aim was to render the transition to socialism irreversible. The purpose of this chapter is to show what they accomplished.

THE IDEAS OF COMMUNISM

Because our concern is the former Soviet bloc, I ignore the broader socialist debate and focus on Soviet-type communism. Soviet communists made a sharp distinction between socialism (the existing system) and communism (a future utopia). However, because the rulers called themselves communists, the international practice has been to label their system "communist," and I use "socialist" and "communist" as synonyms for Soviet-type communism. Communism/socialism was quite different from West European social democracy.

Most fundamental socialist ideas were formulated by Karl Marx and his contemporaries. In a Hegelian spirit, Marx thought of history in stages of development. He did not focus on individuals but classes, and he aspired to the social emancipation of the modern, but exploited, working class, greatly concerned with the alienation of modern workers in grim factories. Marx was inclined toward the modern and favored certain progressive economic trends (Kołakowski 1981a). He developed a peculiar set of strongly held ideas.[1]

The most fundamental Marxist principle is the *dictatorship of the proletariat*. One of the first lines of *The Communist Manifesto*, written by Karl Marx and Friedrich Engels in 1848 (1967, p. 79), reads: "The history of all hitherto existing society is the history of class struggles." The working class was supposed to take over from the bourgeoisie. Since this was a struggle between classes, democracy in its usual liberal meaning was irrelevant, because "Political power . . . is merely the organized power of one class for oppressing another" (p. 105). Marx and Engels concluded that the bourgeoisie would not give up power voluntarily. Therefore, bourgeois democracy was no real democracy, and a proletarian revolution should terminate it. The authors drew the paradoxical conclusion that a dictatorship would be more democratic, because then "the free development of each is the condition for the free development of all" (p. 105). In reality, the dictatorship of the proletariat was to mean the dictatorship by a Communist Party, but the bourgeoisie had no rights.

Another fundamental communist principle was the *nationalization of the means of production*. To alleviate the alienation of modern factory workers from the means of production, socialism aimed to eliminate the exploitation of man by man. Marx and Engels's key demand was that private ownership of land and the means of production be abolished and replaced by state or collective ownership. Because capitalists had accumulated their ownership through the exploitation of others' labor, their property should be confiscated without compensation. Mass nationalization of everything but personal property was a requirement.

Socialists were profoundly concerned about social justice, sharply reacting against excessive differences in income and wealth, while focusing on how income was earned. Marx ([1867] 1981) devoted the first chapter in *Das Kapital* to the *labor theory of value*, arguing that the market value of a good did not represent its real value. Instead, the real value was the work or value-added put into the good. Marx distinguished between productive and nonproductive activities, implying that only material production was productive, while so-called nonmaterial services, ranging from health care and education to banking, were nonproductive. The socialist concept of national income excluded nonproductive services. The natural consequence was that anything but

[1] This section draws on Brus and Laski (1990).

material production was to be neglected by communists. In line with Marx's labor theory of value, communists thought that the market formation of prices was unjust. They wanted prices to be regulated by the state at a level lower than the exploitive prices set by the capitalists, which led to the pervasive regulation of prices below market equilibrium. Yet, Marxist price theory was never clear or unequivocal. A strong market socialist tendency was initiated by Oskar Lange in the interwar period. Therefore, the regulation of prices was not as holy a principle as the nationalization of the means of production, and market socialism was revived again in the Soviet bloc soon after Stalin's death.

Central state planning was also an important communist economic principle. Capitalist production was perceived as not only exploitive but wasteful, irrational, and speculative. In the nineteenth century, the market economy was highly volatile, as speculative bubbles interrupted economic life. Large investments were undertaken but not used, while the savings rate and ensuing investments were low, limiting growth. Consequently, wages were low, while unemployment was high. Communists desired more order, better organization of economic life, and faster growth of workers' welfare. They insisted that a socialist state could compel society to save more and channel the savings into productive investment. Higher investment would create more jobs and a higher growth rate. The state would be able to undertake a more effective and rational centralized economic policy, so their natural choice was central state planning. Focusing on socially useful production, socialists preferred central planning in physical quantities rather than in illusory monetary terms. The idea of central planning was already discernible in *The Communist Manifesto*. It grew much stronger under Lenin, and Stalin clarified the communist understanding of central planning with the first five-year plan (1929–33). The legacy was extreme centralization, vertical state command, excessive investment, and inefficiency.

Communists believed in certain modern economic trends, such as the division of labor and economies of scale, which they wanted to develop maximally. Since they denied the benefits of competition in the market, the logical conclusion was large centralized state monopolies. Communists believed in technical progress, and a socialist state would spend much more than capitalists on development and research. Moreover, capitalism shrouded technological progress in the secrecy of patents, whereas socialism would make innovations freely available to all.

Socialists disliked money, seeing it as a screen hiding real economic processes as well as a means of undesirable speculation. Marx and Engels (1967, p. 104) had demanded: "Centralization of credit in the hands of the State, by means of a national bank with State capital and an exclusive monopoly." Under War Communism during the Russian revolution, attempts were made to abolish money, with effects so disastrous that they were abandoned forever. Communists settled for a limited, passive role of money as a unit of account and store of value.

Marx, Engels, and the early Russian communists awaited a world revolution. Therefore, they had little reason to think about foreign trade, which became a residue of national economic policy, which it was not supposed to hinder. Yet, the state should have a centralized monopoly on foreign trade. Since domestic prices were regulated nationally, they had to be delinked from world market prices. Because communists disliked money, a unified exchange rate made no sense. In effect, each good had its own exchange rate to the extent that one could talk about any exchange rate at all. Foreign trade became subject to arbitrary decisions by communist rulers.

Although socialism embraced social pathos, Marx originally distinguished between socialism as a system characterized by the *socialist principle* "to each according to his work" and communism characterized by the communist principle "to each according to his needs" (Marx [1878] 1951). Because all communist states stopped at the socialist stage, no general social welfare policy developed but on the contrary a strictly remunerative policy. *The Communist Manifesto* (1967, p. 105) prescribed "Free education for all children in public schools." However, in early Stalinism, children of "class enemies" were barred from education and discrimination by social origin was approved.

REAL SOCIALISM

Marx, Engels, Lenin, and other communist theoreticians left behind many ideas and principles on how to develop a socialist state, but numerous choices had to be made. Josef Stalin did so when he formed the classical communist economic system with the first five-year plan of 1929–33 (Nove 1969). This system remained intact until his death in March 1953, and it was imposed on all countries in the Soviet bloc. Although many attempts at reform were undertaken, the changes were remarkably small within the Soviet bloc, while going much further in Yugoslavia and China. This system is the least common denominator of all the countries discussed in this book.

To understand the ensuing events, we need to have some comprehension of the main elements of "really existing socialism" as the communists called their system in the 1970s and 1980s.[2] Our interest is limited to idiosyncrasies of the communist system faced by reformers.

[2] The ensuing account draws on a broad range of literature, but the primary source is Kornai (1992a), which is arguably the best account of the communist economic system. I also draw on Hewett (1988) and Nove (1969, 1977).

The obvious point is that the institutional barriers to reform were formidable and that reformers needed great strength to break these barriers down.

Communist Party and Nomenklatura Dictatorship but No Civil Society

The communist system was the most thoroughly politicized system the world has seen. Therefore, as János Kornai (1992a, p. 360) teaches us: "The key to explaining the classical socialist system is . . . the political structure. The starting point is the undivided political power of the ruling party, the interpenetration of the party and the state, and the suppression of all forces that depart from or oppose the party's policy." For communists everything was politics and had to be imbued with Marxism–Leninism, their official ideology. The essence of communism became the dictatorship by a hierarchical Communist Party.

The communist parties were highly elitist. Early on, a special Nomenklatura system was developed. It was reminiscent of the hierarchical tsarist civil service. In each communist country, Party and state officials formed one national hierarchy and the Party strictly controlled their careers. An intricate system of privileges developed to motivate the officials. With each advancement in rank, an official was entitled to access to better shops, clinics, holiday resorts, and so on (Voslenskii 1984). The first requirement of advancing communists was to obey the Party and its ideology. They had to alter their views whenever the communist leader did. Work performance was subordinate to obedience, as politicization ruled, and a cult of flattery toward superiors evolved. Personal patron–client networks became a hallmark of the communist system.

The Communist Party claimed to represent the people universally and to control everything. Organizations were either brought under Communist Party control or liquidated. Thus, trade unions, professional associations, sports clubs, and the scout movement were taken over by the Communist Party, while opposing parties and sundry popular organizations were prohibited. The church was a rare exception as it was too strong to be quashed and too alien to be incorporated, so the communist state had to find some compromise with it, but churches suffered from repression and infiltration by the secret police.

The communist states tried to manipulate the thinking of their citizens. Until the end, they pursued massive propaganda campaigns through all media and public outlets. A communist city was extraordinarily gray and drab, as little advertising was allowed, but absurd communist slogans lit up the cities, though locals developed a talent for not seeing them. Many worried about brainwashing and thought control, as famously put by George Orwell (1949) in *1984* and Czeslaw Miłosz [1953] in *The Captive Mind*, but all this propaganda produced mainly alienation and boredom. The distance between state and society seemed only to have grown, and people talked about the government as "them" and society as "us."

Thorough Nationalization of the Means of Production

Nationalization of the means of production was carried out zealously in most communist countries, with enterprises becoming either state or quasistate property. Industry, trade, transportation, infrastructure, and banks were usually nationalized. Agriculture, handicrafts, and some services were initially collectivized and gradually nationalized. The collectivization of small farmers was the most brutal struggle in every country. Hardly any legal entrepreneurs persisted.

The main exception was the German Democratic Republic (GDR), where Stalin apparently did not decide to Sovietize the economy until the summer of 1952, so nationalization had not proceeded far before Stalin's death in March 1953. A labor uprising in June 1953 prompted the East German leadership to mitigate its nationalization efforts. As late as 1972, one-third of the urban labor force in the GDR was employed in the private sector (Åslund 1985). The other significant exception was Polish agriculture, 70 percent of which remained private until the end of communism. In June 1956, a strong popular protest persuaded the Soviet leadership to accept a slightly more moderate form of socialism in Poland. In both Poland and Hungary, the urban private sector had been devastated under Stalinism, but it started reviving in 1956, though it remained marginal. Curiously, housing stayed private to a surprising extent in some countries, notably in the GDR and rural housing in the Soviet Union. In both cases, this was not a privilege for property owners but a way for the government to escape the costs of housing.

The nearly complete nationalization of the means of production was supposed to cement the communist domination of society forever and to make it impossible to restore capitalism again. It may be seen as a poison pill left behind by the communists, forming a major barrier to a transition to any other economic system.

Centralized Allocation

Market allocation was abandoned for centralized allocation with a vengeance, but its essence has been disputed. The communist state focused on determining physical production targets for all major goods and enterprises through thousands of "material balances" compiled by the Central Planning Committee (Gosplan) and its suborgans. These balances were composed of production targets on one side and allocation of the products on the other. The Soviet five-year plan of 1929–33 was the initial model. Yet, the plans were in fact central commands that were constantly altered in response to production results, reassessments of needs, personal relations, and lobbying. Therefore, the system has often been called "command economy." However, as principals central state officials could not fully control their agents, enterprise managers, who possessed all local information. Hence, negotiations or bargaining developed about the "commands" between plan officials and enterprise managers, causing some to call it a "bargaining economy" instead. The actual distribution of power between central officials and enterprise managers was unclear.

As communists abhorred profits as a narrow capitalist aim of production, they promoted multiple plan indicators, of which quantitative physical production targets were the most important. Manifold objectives facilitated their manipulation by managers. The targets had originally been designed to maximize production efforts, but as one goal was added to another the eventual outcome was a bureaucratic maze petrifying enterprises rather than inspiring them to any serious efforts.

The investment ratio rose extraordinarily as desired, as did public consumption, and Stalin boosted military expenditures to a degree never seen in peacetime. As a consequence, wages and private consumption were held back and the standard of living stagnated. A saying developed: "They pretend to pay us, and we pretend to work." Shoddy work, poor quality, low efficiency, and demoralization became hallmarks of the command economies.

The communist economy was good at one thing: the swift mobilization of free resources. Therefore, it was suitable as a war economy, which was presumably Stalin's prime objective. For a few simple products, such as steel, it functioned, and steelworks became the symbol of communist economies. Even in the 1980s, a steelworks was shown every evening in the prime-time Soviet TV news program. With the growing complexity of a modern economy and its millions of products and services, the system became increasingly dysfunctional.

The centralized allocation system never worked well, making patent shortages a trademark of communism. Soviet people who had never traveled abroad considered stories of capitalist shops without shortages ludicrous, rendering any trip to the West a devastating disillusion with the communist system. Multiple experiments were undertaken with decentralization and even limited marketization in Hungary and Poland, but physical planning was retained everywhere.

Hierarchical Organization of the Economy

The economic policymaking bodies of a Soviet-type economy differed from those of a market economy. At the top was the Politburo of the Communist Party. It was served by the Central Committee of the Party, which had an omnipotent economics department. The government or Council of Ministers was subordinate to the Party and not very important for policymaking. Most government economic power was delegated to the State Planning Committee (Gosplan), which issued production targets to a multitude of industrial branch ministries, which formulated plan targets for individual enterprises. A Central Bank and a Ministry of Finance existed, but they were subordinate to the State Planning Committee and functioned more as bookkeeping control organs than as economic policy organs. In parallel, Party control organs and the KGB tried to instill discipline in the poor citizens. Under Stalin, that meant mass arrests, executions, and deportations of tens of millions of people. Even toward the end of the Soviet era, major economic crimes could warrant capital punishment and many managers were sentenced to prison.

Operative state control over enterprises was delegated to scores of branch ministries. To simplify their administration, they gradually limited the number of enterprises by merging them, though the ministries also desired to compare and control enterprises, which made them oppose full monopolies. Hence, the Soviet-bloc countries did not have very large companies but had extremely few enterprises due to the dearth of small firms.

Within each enterprise, the manager and a couple of deputy managers decided everything. The manager was almost always an engineer; his first deputy was the chief engineer rather than the chief accountant, and there was no financial director. The manager took pride in knowing all the details of output and technology, but he could not care less about profit. All workers were obligated to be members of official trade unions, and the chairman of the union at an enterprise was a member of the management. Yet, trade unions were essentially social welfare administrations.

As markets functioned poorly, enterprises had very few subcontractors, trying to incorporate as many subcontractors as possible into their own company. This limited the desired specialization and thus efficiency (Berliner 1957).

This system left severe legacies. A profound problem was the system of extralegal superior bodies, notably the Party and the KGB, which were beyond accountability and financial controls yet commanded state organs. Another legacy was the weakness of the Central Bank and the Ministry of Finance. Not only Gosplan but also the many branch ministries were alien bodies to a market economy. Enterprise management was excessively centralized, and the size structure of enterprises was unrelated to market economic considerations.

Regulated Prices and Passive Money

Since physical output was the central objective, prices were subordinate. Prices of major products, such as raw materials and staple foods, were fixed, while most prices were set as cost plus a regulated markup, and higher prices were allowed for new products. As a result, the prices of raw materials were largely constant, while more complex products were subject to hidden inflation. This pricing system encouraged an intentional lowering of quality and fake innovations. Prices became increasingly distorted, since they were not checked by market forces, real costs, or foreign influences.

While money was passive, the national currency became in effect several separate currencies, as different people and enterprises had access to separate markets with varying prices and supplies. The big divide was between enterprise money or bank transfers and cash that was reserved for transactions with ordinary citizens – wages and retail purchases. A bank ruble and a cash ruble had different values, and they were arbitraged in black markets. Most communist countries experienced one or more confiscatory currency reforms, which undermined the confidence in the domestic currency, which was not even perceived as a sound store of value. Goods and hard currency were frequent objects of savings.

Banks and credits had no real economic role except bookkeeping. Intermittently, government bonds were issued, but they were often a form of forced savings, and no other securities existed. There was no capital market whatsoever.

The government budget was substantial – about half of GDP, that is, as high as in high-tax West European countries (Pryor 1968). However, given that much redistribution took place through regulations and price distortions, the meaning of the size of the government budget is ambiguous. State revenues derived mainly from three taxes: profit taxes, payroll taxes, and trade taxes, all of which were paid by enterprises. Enterprises had no real interest in making any profit, because all retained profits were collected by the state at the end of the year, when debts of loss makers were pardoned. Naturally, this system encouraged waste. Trade taxes were calculated as the difference between wholesale prices and retail prices, set independently of one another. Only the payroll tax was a proportional tax on the wage fund.

Consequently, the longer communism lasted, the more distorted the prices became and with them the structure of the economy. The absence of any capital market rendered the allocation of investments ever more economically arbitrary. The government finance system favored excessive investment and punished efficiency.

Protectionism and Autarky

Each communist country had a national economic system aiming at autarky. Foreign trade was accepted, but it was perceived as a residue in the state allocation system that should be neutralized so as not to influence the domestic economy. Therefore, the government maintained state monopoly over foreign trade to prevent opportunities for arbitrage.

In the classical socialist system, no exchange rate existed. The Ministry for Foreign Trade purchased abroad according to instructions from the State Planning Committee and sold as much as was necessary to pay for imports. Foreign trade prices were detached from domestic prices. This isolation from the world market was hailed as advantageous socialist stability, because international price fluctuations had no impact on domestic prices. Foreign trade taxes were substantial, but they were simply the difference between domestic prices and world market prices. This was a system of extreme protectionism and autarky.[3]

Producing enterprises were not allowed to have any contacts with foreign companies, limiting foreign suppliers' knowledge of the demands of their eventual customers. The Soviet Union was littered with expensive uninstalled imported equipment, because the customers did not know how to install it, and they were prohibited from contacting the supplier for advice. This palpable waste was recorded as investment in national accounts.

After World War II, the Soviet Union tried to develop a socialist foreign trade system for its new satellites. In response to the Marshall Plan, the Council of Mutual Economic Assistance (CMEA) was set up in 1949 as a Soviet bloc trade organization for eventually ten member states. It became very bureaucratic even by Soviet standards, but considerable specialization was agreed on, though actual trade was undertaken on the basis of five-year bilateral state agreements. Arguably, both trade and prices were even more distorted in CMEA trade than domestically because of the political detachment from economics. As within each communist state, the prices of manufactured goods rose unduly in relation to raw materials in CMEA trade, boosting implicit Soviet subsidies to the Central European members of the CMEA. Curiously, the Soviet Union had established a system that made it subsidize all the other members, but nobody was grateful for these subsidies, which they

[3] The classic book on the communist foreign trade system is Pryor (1963), which cost its author half a year in East German prison for purported espionage.

disputed, because the CMEA imposed an irrational division of labor often unrelated to economics (Hewett 1974; Sobell 1984).

The longer the communist system lasted and the greater share of its GDP a country traded with the CMEA, the greater were the distortions of its economy. The extraordinary distortion of foreign trade was one of the greatest poison pills communism was to leave behind. The tragedy was that much of the CMEA trade was totally worthless, which the exporters were not prone to recognize, unlike the importers.

Economic Policy Aiming at Maximum Growth

Communists were preoccupied with high growth rates, which the capitalist world seemed unable to achieve in the interwar period. The socialist state claimed to be concerned about long-term economic development not short-term welfare.

The main strategy was the mobilization of all resources. First, the socialist state organized jobs for the unemployed and women. Unemployment was labeled parasitism. Second, socialism enhanced public savings in the economy by limiting private consumption. The accumulated resources were poured into investment. Third, through gigantic construction projects Stalin wanted to prove that the socialist state could mobilize much larger resources than any capitalist state and that it displayed a longer time perspective. Finally, free access to all technology, unimpeded by patents or other intellectual property rights, as well as massive state imports of foreign technology were supposed to stimulate growth. Hence, Stalinism paid tribute to technological development.

Stalinism also embraced the idea of unbalanced growth, allocating disproportionate resources to strategic industries to speed up economic development. Heavy industry, particularly steel and heavy machinery, was regarded as the most strategic. Agriculture, on the contrary, was perceived as backward and reactionary. Regulated prices were manipulated to boost industrial prices in relation to agricultural prices, forcing agriculture to finance investment in industry, while the "nonmaterial" sector, especially human services, was disregarded. Stalin minimized investment in transportation and housing, as well. The communist idea of efficiency in transportation was full utilization of all capacity, while the timeliness of transports was neglected and shortages were patent. Because transportation was not perceived as a production cost, Soviet calculations ignored such costs, which caused a very inefficient allocation of factories with wasteful haulages. By forcing strangers to share housing, Stalin minimized privacy and maximized people's reporting on one another to the secret police.

The essence of Stalin's economic policy was to build up a strong military industry so that the Soviet Union could defend itself against the capitalist encirclement. His policy did not aim at economic welfare but at military strength. The strongest argument for Stalinism was the Soviet victory over Nazi Germany during World War II.

The most positive aspect of socialism was its belief in investment in human capital. Communism provided good education, assuring general literacy, and much mathematics and engineering was taught. However, three academic disciplines in particular were intentionally neglected. The first was economics in the Western sense of the word, as market economics was considered ideologically wrong. Another was law. Because few lawyers were needed, few were trained. Finally, foreign languages were poorly taught, since citizens of socialist countries were discouraged from going abroad, having contacts with foreigners, or even reading foreign literature.

The result of these structural policies was further aggravation of the distortions of the economy in comparison with a market economy. The far-reaching militarization was obviously baneful, and the shortcomings of essential skills were also worrisome.

Terror and Kleptocracy

Terror was an intrinsic component of the Stalinist system. Soviet power was born out of revolution and a terrifying civil war, establishing the standard of violent rule. Tens of millions of people were deported, put into camps, or executed. Few countries can compete with the Soviet Union in terms of state repression.[4]

The terror performed several vital functions in the Stalinist system. First, it secured a ruthless dictatorship. The extraordinary terror kept people under control and isolated them from the outside world. Some "saboteur" or other was blamed for every misdeed. Second, repeated executions of the elite enticed others to make fast careers by climbing over corpses. Third, terror was used for selective repression of various nationalities. About one-quarter of the Ukrainians and as many of the Kazakhs were liquidated during the collectivization of agriculture in these two republics. During World War II, more than ten nations were deported to the East in their entirety. Fourth, the communist economy was a campaign economy, and seemingly arbitrary executions were used to motivate people to work harder. Fifth, terror facilitated swift redistribution from consumption to investment, as wage and consumption demands were suppressed. Sixth, slave labor

[4] The classic work on the Stalin Terror is Conquest (1968).

became a central element of the Stalinist system. Many construction projects and industries in the far north were based entirely on slave labor.

Law played an insignificant role in this system. Marxism–Leninism saw the rule of law as a harmful bourgeois concept, since it limited the power of the omnipotent Communist Party. Nobody could sue the Communist Party or the KGB. Communism preferred decrees over laws, and the Soviet Union promulgated only a few laws a year. In Central Europe, most precommunist laws stayed on the books, but modern commercial legislation was not adopted, while the Soviet Union had a minimum of commercial legislation. Still, a judicial system persisted, even if the prosecutor was superior to the judges, whose court decisions could be influenced politically, and defense councils were often absent.

With only a rudimentary legal system and patent shortages, little rule of law could develop. The communist state had reserved for itself the right to violate any rule, but its example encouraged others to do the same. Since orders were inconsistent, uncoordinated, and often secret, it was impossible to adhere to the law. Although enterprises rarely received the necessary supplies, they had to fulfill Gosplan's production targets. The only way to do so was to acquire illicit supplies. A large corps of *tolkachi* (literally: pushers), in fact, operators or traders, helped enterprises to obtain supplies beyond the boundaries of the law. If you had to become a criminal to fulfill the plan, why not gain some extra benefits at the same time? A late Soviet joke ran:

"Why is the Soviet Union the richest country in the world?"

"Because everybody has stolen as much as they can since 1917, and there is still plenty to steal."

The Soviet Union evolved into a kleptocracy, where theft became an intrinsic part of the system because state property was not respected. The dominance and unaccountability of the Communist Party and the KGB rendered organized crime an integral part of these official structures (Zemtsov 1976; Simis 1982; Vaksberg 1991).

While communism was a system that cherished lawlessness and arbitrary decision making by dictators, it had many control organs, which were to falter with its demise. Therefore, this kleptocracy was bound to explode in crime. It had to get worse before it could get better. This was another poison pill of communism.

Persistence of Marginal Markets

The economic system could not manage entirely without active money and markets. As wages were paid in money and people were usually free to choose their place of work, a labor market existed, even if it was severely regulated. A state wage tariff system regulated wages, but enterprises that attained their plan targets added substantial bonuses. Since physical output was the main objective and costs were of little concern, more money was issued than the consumer market could bear with its fixed prices. People used their money for purchases, and although trade was largely state owned, the state could not decide what people wanted to buy.

Much has been written about the thriving underground economy under communism. Household plots were often critical in salvaging poor Soviet citizens from starvation. Yet, if the underground economy had been that large, shortages would have been less severe. An excellent interview survey with Soviet émigrés to Israel from 1972 to 1974 suggested that private activity in the urban consumer sector would add only a paltry 3–4 percent to Soviet GNP, which is far less than in Western economies (Ofer and Vinokur 1992, p. 100).

Soft Budget Constraints

Today it is quite difficult to perceive what socialism was, but it was equally difficult for people in the socialist countries to understand what capitalism was like. In so many ways, these societies were opposites.

Possibly the most characteristic feature of the communist economic system was patent shortages of goods and services, which had developed from the outset. At the macro level, the volume of money exceeded the volume of goods at given prices, and at the micro level people demanded other goods than those supplied. János Kornai (1980) has labeled this "economics of shortage."

To enterprises, money was not scarce, so they suffered from "soft budget constraints," in János Kornai's expression. This means that the state subsidy available to a state enterprise was not fixed but subject to bargaining (Kornai 1992a, p. 140). Negotiations concerned not only subsidies, but also taxation, bank credits, which were akin to subsidies, and administrative pricing. A state enterprise could hardly go bankrupt, and whatever the management did, the state would eventually bail it out. Naturally, personal and political relations with superiors were more important than economic performance in such an environment.

This stood in sharp contrast to the hard budget constraint of most private enterprises in market economies, where subsidies were minor and set in advance, tax rates equal for all, credits issued on the basis of creditworthiness, and prices set by enterprises with regard to the market situation and costs. When facing a hard budget constraint, an enterprise had to work for profit.

Any enterprise manager's whole behavior was dependent on his budget constraint. If the budget constraint was soft, the manager had better concentrate on lobbying among government and party officials, ignoring efficiency of production. To justify subsidies, he needed large capital costs and a substantial work force. If he faced a hard budget constraint, on the contrary, he had to restructure, cut costs, reduce employment, promote sales, abandon unprofitable investment projects, improve output, and stimulate innovation. Since a shift from soft to hard budget constraints altered the entire management strategy, a manager had to be convinced of the permanence of such a change. Therefore, credibility was crucial to enterprise restructuring.

HIGH GROWTH RATES BUT LITTLE WELFARE

The great pride of the communists was double-digit growth rates. In the first half of the 1950s, the new communist economies boasted growth rates of about 10 percent a year (see Table 1.1). This purported high growth was accomplished thanks to a mobilization of all available resources: high savings, directed to investments in machinery and new factories, high employment, and comprehensive public education.

For decades, the outside world was impressed by the apparent fast economic development in the Soviet bloc, and many Western intellectuals paid tribute to great socialist achievements. These alleged accomplishments were all the more striking since the Western world was suffering from the Great Depression in the early 1930s. During World War II, the effectiveness of the Soviet war economy was also impressive. After the war, the West was stunned by the detonation of the first Soviet atomic bomb in 1949 and the launching of the first sputnik in 1957.

Eventually, Soviet growth rates turned out to have been greatly exaggerated, and the real rates are still open to dispute.[5] This falsification was so extraordinary that even the late Soviet authorities did not want to publish any exact growth rates for the period prior to 1960. While the Soviet era saw substantial economic growth, the growth rates were not very high by international comparison. The iconoclastic Russian economists Vasili Selyunin and Grigori Khanin (1987) argued that the real Soviet growth rate was an average of 3.2–3.5 percent a year from 1928 to 1985, which seems plausible.

The relative level of production has been as disputed as the growth rates. Many attempts have been made to assess the standing of the communist countries in relation to Western countries, but none is satisfactory, and the truth cannot be determined, as so many statistical issues are open to justified dispute. Two dominant schools developed. The CIA, the

[5] The main downward revision was Bergson (1961). In the late Soviet period, Russians went much further in degrading historical Soviet growth rates (Selyunin and Khanin 1987).

Table 1.1. Net Material Product (National Income), 1951–1989 (Annual change in percent)

Year	1951–5	1956–60	1961–5	1966–70	1971–5	1976–80	1981–5	1986–9	1989
Bulgaria	12.2	9.7	6.7	8.8	7.8	6.1	3.7	3.1	–0.4
Czechoslovakia	8.2	7.0	1.9	7.0	5.5	3.7	1.8	2.1	1.0
GDR	13.1	7.1	3.5	5.2	5.4	4.1	4.5	3.1	2.1
Hungary	5.7	5.9	4.1	6.8	6.3	2.8	1.3	0.8	–1.1
Poland	8.6	6.6	6.2	6.0	9.8	1.2	–0.8	2.9	–0.2
Romania	14.1	6.6	9.1	7.7	11.4	7.0	3.0	–1.7	–7.9
Soviet Union	..	..	6.5	7.8	5.7	4.3	3.2	1.3[a]	–6.1[b]

.. Not available.
[a] 1986–90.
[b] 1991.
Sources: SEV (1988, pp. 26, 27, 29, 32–5); ECE (1990, p. 87; 1991, p. 41; 2000a, p. 225).

Table 1.2. Per Capita GNP as Share of U.S. GNP, 1970, 1980, and 1989 (Share of U.S. GNP, percent)

	1970 (World Bank)	1980 (Marer)	1989 (World Bank)
GDR	52	52	..
Czechoslovakia	47	42	..
Soviet Union	38	37	..
Hungary	34	39	39
Poland	29	33	23
Romania	20	24	29
Bulgaria	16	31	25

Sources: World Bank (1975, 2000a); Marer (1985, p. 7).

UN Economic Commission for Europe, the Vienna Institute for International Economic Comparisons, and the German Institute for Economics put the Soviet GNP per capita in the 1980s at 50–60 percent of the U.S. level (Lancieri 1993). These high figures resulted from the usage of physical input data, implicitly assuming the same efficiency of production as that in the West, although it was known that one unit of output in the Soviet system required at least two to three times more input. The World Bank, which drew on a broad empirical knowledge, produced the lowest and thus most plausible estimates, assessing the Soviet GNP per capita in 1980 at 37 percent of the U.S. level. Even the lower numbers did not consider the doctoring of statistics, the lower quality of socialist products and shortages. All these numbers have appeared pretty irrelevant after the end of communism, as it became obvious that these countries were much less economically developed than generally believed (Lancieri 1993; Åslund 1990). Table 1.2 presents three attempts by the World Bank to assess the East European countries' GNP per capita in purchasing power parities in relation to the U.S. GNP in 1970, 1980, and 1990. Considering the patent conservatism of statisticians, even these numbers probably exaggerate the economic level of the Soviet bloc. At best, the region might have reached one-third of the U.S. GNP per capita.[6] We shall never know the exact numbers, and the plausible range is wide.

[6] The statistical biases boosting the communist output were many: First, enterprises exaggerated their output to reach output targets. Second, the central statistical authorities did so too and tended to utilize index numbers. Third, quality was steadily falling under communism, while the opposite was largely true under capitalism. Similarly, technological development was less under communism. Fourth, shortages were notorious under communism, and far fewer goods and services were produced. Fifth, unreported economic activities were at least as common under capitalism as under communism.

Table 1.3. Structure of Production, 1989–1991 (Share of GDP, percent)

	Agriculture	Industry	Services, etc.
Central Europe			
Poland, 1989	13	44	42
Czech Republic, 1989	10	43	47
Slovakia, 1989	6	53	42
Hungary, 1989	14	31	42
South-East Europe			
Romania, 1989	14	53	33
Bulgaria, 1989	11	52	37
Baltics			
Estonia,1991	22	35	43
Latvia, 1991	23	38	39
Lithuania, 1991	20	45	35
CIS			
Russia, 1991	14	39	47
Belarus, 1991	21	41	38
Ukraine, 1991	22	42	36
Moldova, 1991	34	25	40
Armenia, 1991	25	38	38
Azerbaijan, 1991	32	25	43
Georgia, 1991	29	29	42
Kazakhstan, 1991	29	28	43
Kyrgyzstan, 1991	37	29	34
Tajikistan, 1991	26	35	39
Uzbekistan, 1991	37	27	36
Reference countries			
United States, 1989	2	29	69
Germany, 1989	2	37	62
France, 1989	3	29	67
United Kingdom, 1989	2	37	62
Portugal, 1989	9	37	54
Greece, 1989	16	29	55
Mexico, 1989	13	32	56
Brazil, 1989	9	43	48
South Africa, 1989	6	44	48
Thailand, 1989	15	38	47

Sources: ECE (1996, p. 89); World Bank (1991, p. 209).

The communists succeeded in their ambition to build a different society. The systemic peculiarities left lasting imprints on the very structure of the socialist economies, and the longer communism lasted, the greater became these distortions from a market economy. Communism distorted the structure of production as shown in Table 1.3.

On the whole, the Soviet bloc was probably at the level of economic development of Greece, Mexico, or Brazil, though South Africa or Thailand are also a possibility, while the Caucasus and Central Asia were more backward. The socialist countries were overindustrialized, with industry accounting for more than 50 percent of GDP in the most extreme cases of Slovakia, Romania, and Bulgaria, which appears about 20 percent of GDP too much. Correspondingly, the service sector was 10–20 percent of GDP too small. Curiously, the communist hostility to agriculture resulted in a large but inefficient agricultural sector. Within industry, the great waste led to a predominance of raw materials and intermediary goods production, while manufacturing was underdeveloped.

The communist economy was foremost a war economy, and the Soviet economy was extremely militarized. As much as one-quarter of GDP might have gone to defense in the late 1980s (Åslund 1990). The very logic of a military economy with all its peculiarities permeated the Soviet economy and made it difficult to turn it to something useful. One example of this was small isolated company towns (Gaddy 1996).

Thus, the distortions were manifold. Planners preferred large, but not too large, enterprises and abhorred small firms. Autarkic tendencies in the economy worked against specialization and promoted industrial conglomerates. Disregard for transportation costs and the political nature of major investments led to highly inefficient location of enterprises, with long and unnecessary hauls. Socialist economies had no exit mechanism, so factories remained where they had once been built and were hardly ever closed down. No price of land was considered. Consequently, a big old power station faces even the Kremlin. As economic conditions changed, the petrified industrial structure became ever more irrational. These structural distortions amounted to another poison pill left by communism.

The Soviet system provided its citizens with certain social benefits, but they were always exaggerated by the propaganda. Under Stalin's long tenure, little housing was built and overcrowding became awful. Yet, education and health care were free, and real unemployment was minimal, though real wages and the standard of living were miserable (Matthews 1986). Contrary to popular myth, real socialism was no social welfare state.[7]

[7] For a devastating and illustrative account of the social affairs at the end of the Soviet Union, see Aron (2000).

2

The Decline and Fall of Socialism

The rise and fall of socialism was one of the great developments of the twentieth century. The decline of communism was as protracted as its eventual collapse was sudden. Many dates can be inferred as the beginning of the end, and each date suggests one particular cause of the demise. From the outset, Ludwig von Mises [1920] declared that the economic principles of socialism could never work. Real Stalinism and its terror ended with the death of Josef Stalin in March 1953. In June 1953, a first major workers' protest against dictators ruling in their name occurred in Berlin. The Hungarian revolt of October 1956 was the first open challenge to both communism and the Soviet empire. The Warsaw Pact invasion of Czechoslovakia in August 1968 suppressed thoughts that Soviet-type socialism could be reformed to attain a "human face." Repeated Polish worker uprisings in 1956, 1970, 1976, and 1980 forewarned of socialism's collapse. The sixteen months in 1980–1 when the Solidarity trade union existed legally made evident that it was only a matter of time before communism would collapse and that this might first occur in Poland.

These many beginnings illustrate the inevitability, complexity, and tardiness of the collapse of the communist political and economic system. The economic and political problems were multiple, but the tenacity of communism was impressive. On the one hand, the strong centralized control kept communism alive longer than many had anticipated. On the other hand, the very petrification of communism made its collapse inevitable and ascertained that the collapse would be all the more profound (Bunce 1999b).

The point is often made that the preconditions of postcommunist countries varied, but more often than not one peculiarity is brought out by comparing Poland and Russia, although the differences between these two countries are numerous. Preconditions are rarely systematically studied for many countries, but this chapter tries to do that. To begin with, we focus on the main problems that augured the collapse of communism. They were out of control in some countries but minor in others. The exit from communism and the entry into a postcommunist era are both vital preconditions for postcommunist transition. To understand the whole region, we ponder the main features of the end of communism in each country in the region. Some countries share commonalities, but their last period of communist rule and political exit from communism varied greatly. These major differences in preconditions had profound impact on the fates of these countries in their ensuing attempts at building capitalism.

THE DECLINE OF SOCIALISM

The argument is frequently made, with reference to some indicator in one or several socialist countries, that the demise of communism was not inevitable. However, its collapse appears to have been overdetermined and long overdue, although the final crises of the communist countries were multifaceted and varied. As Lev Tolstoi began his novel *Anna Karenina*: "All happy families are similar, but every unhappy family is unhappy in its own way."

No single factor explains the collapse of communism or its timing, since many causes contributed. Still, the fundamental problem that doomed communism was its institutions (cf. Bunce 1999b). Some economic causes were of a long-term nature. One example is steadily aggravated distortions. Another was the inability to handle new challenges, such as information technology. The Soviet Union could not keep up the arms race with the United States. Economic reforms were attempted, but they did not deliver the expected growth. Instead, they delegitimized the economic rationale of the socialist system. In parallel, the system lost its political legitimacy, however limited it had been, and national grievances contributing greatly. In the end, most countries were hit by fiscal emergencies, such as severe shortages, excessive fiscal deficits, and excessive external debt service, and these crises were accompanied by external shocks. Our interest is not weighing the importance of all these factors but rather illuminating the palpable differences between various countries at the time of communism's demise.[1]

Falling Growth Rates

In the early 1960s, growth rates started declining sharply. The most developed countries – Czechoslovakia, the GDR, and Hungary – recorded the

[1] My preferred source on the demise of communism and the Soviet Union is Dobbs (1997); see also Dunlop (1993) for an early and detailed account of the Soviet collapse.

lowest growth rates (see Table 1.1). In 1963, Czechoslovakia was the first communist country to register an official decrease in national income in peacetime, a shattering event. By the early 1980s, general stagnation had taken hold, even if it was masked by doctored official statistics. Soon, the long reign of Secretary General Leonid Brezhnev from 1964 to 1982 became known as the period of stagnation in the Soviet Union.

In comparison with highly developed industrialized countries, the region's official increase in national income from 1980 to 1985 may not appear bad (see Table 1.1), but the socialist countries were not very developed, and their official growth rates were exaggerated by 1–3 percentage points, implying near stagnation. During the Solidarity crisis in 1980–1, Poland suffered from a drastic fall in output. From 1985 to 1989, growth rates fell in most of the region, and Romania saw a significant decline. In the revolutionary year of 1989, only the GDR and Czechoslovakia enjoyed economic growth. Romania and the Soviet Union were in dire straits. In Romania, output fell by almost 8 percent in 1989 because of Nicolae Ceauşescu's draconian endeavors to pay back the entire national debt. The Soviet Union suffered a near breakdown in 1991 because of massive fiscal and monetary imbalances. A similar acute shortage crisis hit Albania with even greater severity that year. Its GDP fell by no less than 28 percent (Åslund and Sjöberg 1992; EBRD 1998, p. 206).

The stagnation was caused by underlying systemic shortcomings, leading to ever greater obsolescence and economic distortions, which prompted declining efficiency and quality. The surprise was that the system could keep going for so long. Part of the explanation lies in the large Soviet natural resources, notably oil and natural gas, which financed imports of high-quality goods. In Soviet parlance, socialism had succeeded in "extensive" growth, but socialist economic system was unable to proceed to desired "intensive" growth through higher efficiency.

The Arms Race and Challenges from Information Technology

Today, it seems incredible that the decrepit Soviet Union could harbor illusions of keeping up with the United States in a modern arms race in the late 1980s. Until 1988, the Soviet Union increased its defense expenditures every year, and they reached about one-quarter of GDP, while the United States spent only 6 percent of its GDP on defense (Åslund 1990). By challenging the Soviet Union with its high-tech "Star Wars" initiative, U.S. President Ronald Reagan exposed the Soviet technological and systemic weaknesses. Mikhail Gorbachev singled out the arms race as his rationale for economic reforms just before he was elected secretary general of the CPSU in December 1984:

Only an intensive, highly developed economy can safeguard a reinforcement of [our] country's position on the international stage and allow it to enter the next millennium with dignity as a great and flourishing power. (Gorbachev 1987, p. 86)

The rigid communist system appeared helpless when facing new challenges from the rise of information technology, because its incentive structure resisted technological change and innovations. Its hierarchical command structure could not handle small enterprises or entrepreneurship, which new technology required. The communist police mentality opposed the free transmission of information, facilitated by personal computers and modern telecommunications, and even the use of photocopiers was restricted until the downfall of the Soviet Union. The old isolation from the outside world could no longer be maintained, but enough damage had been done to the economy. The Soviet system could hardly have survived the Internet, but it collapsed before the information revolution.

Delegitimization of Socialism by Economic Reforms

Declining growth rates inspired economic reforms in most communist countries.[2] Initially, attempts were limited to the streamlining of the classical communist system, including organizational changes and improvement of incentives, but systemic shortfalls persisted. In the mid-1950s, Poland pioneered market socialist reforms, and Czechoslovakia and Hungary followed in 1968, but only the Hungarian reforms survived. Poland again tried market economic reforms in 1982, and this time they lingered. In the Soviet Union, Mikhail Gorbachev tried significant but less ambitious reforms than those in Hungary and Poland in the late 1980s. Still, the old system continued in East Germany, Czechoslovakia, Bulgaria, and Romania.

The most serious reforms, aiming at market socialism, were limited to Hungary, Poland, and partially the late Soviet Union. Since decision making was perceived to be too centralized, the number of plan indicators was reduced, and power was delegated from branch ministries to enterprise managers. Economic incentives were promoted, and pricing was made more flexible and market oriented, but distortions remained substantial. Foreign trade was partially liberalized, with numerous firms being granted foreign trade rights, but this privilege was reserved for the well connected. Exchange rates were introduced, but they varied with commodity and type of transaction. Hence, extraordinary privileges were

[2] They have been studied in an immense literature, which today looks rather dated. My main source here is Kornai (1992a). I am also drawing on my own study of the late Soviet reforms (Åslund 1991).

created for a limited number of well-connected state enterprise managers, who could buy goods at low, state-controlled, domestic prices and sell them abroad at high world market prices. They could extend their profits by arbitraging among multiple exchange rates. In the 1980s, Poland, Hungary, and the Soviet Union eased up on small private enterprises, of which many became clearinghouses for arbitrage by state enterprise managers between low state prices and high market prices. These partial market reforms empowered enterprise managers and vested them with a strong interest in a regulated and distorted market, laying the foundation for the exorbitant rent seeking in the postcommunist transformation.

Another aspect of the socialist market reforms was the development of a social democratic welfare society. A social democratic tax system was introduced, with tax rates for enterprise profits and import tariffs. The already high payroll taxes were raised even further, notably in Hungary. High progressive income taxes of up to 60 percent in Hungary replaced the previous minimal income tax. While taxes became less arbitrary, they rose. The increased state revenues were devoted to social benefits. As unemployment had been legalized, Poland, Hungary, and the Soviet Union introduced unemployment benefits. Pensions for all citizens over retirement age were introduced in the Soviet Union in 1985. Yet, the communist tradition of low, subsidized food prices persisted everywhere apart from Hungary.

While increasingly ambitious, these partial market economic reforms did not deliver the anticipated economic growth or welfare, though they broke down many ideological barriers. Importantly, the reforms annihilated socialism's claim of social superiority over capitalism, and they legitimized not only the market economy but also democracy and international contacts.

Deconcentration of Power

Strangely, one of the most misunderstood issues has been the nature of Soviet political power. Under Stalin, Soviet power was truly totalitarian; as the secretary general of the Communist Party, Stalin did whatever he cared to do with a minimum of political constraints.

However, with the end of terror, the communist elite or Nomenklatura, which included less than 1 percent of the population (Voslenskii 1984), arose as the collective dictator through a gradual deconcentration of power (Murrell and Olson 1991). Arguably, the Politburo was the ruling body under Nikita Khrushchev, and it ousted him, when he appeared too willful, without deploying terror. Leonid Brezhnev's long tenure from 1964 to 1982 was rendered possible by his sensitivity to the collective will of the Nomenklatura. He did not really rule but concurred with the desires of the Party and state bureaucracy. Under Brezhnev, the Soviet Union became a dictatorship of industrial ministers and regional first Party secretaries.

This structure of power became evident with the appointment of the headstrong and ambitious Mikhail Gorbachev as secretary general of the CPSU. Since Gorbachev aspired to reform the system, the constraints on his power became apparent. While many blamed him for not being sufficiently reformist, he had little choice in his early years because of political resistance posed by the communist elite. After he had failed to get anything accomplished in his early attempts at economic reform, Gorbachev opted for partial democratization in January 1987 in an effort to check the power of the conservative Party establishment. Clearly, Gorbachev saw the senior officials as his main opponents, and his actual resolution was to delegate power further. Economic power was largely vested in state enterprise managers, but they were not accountable to anybody (Åslund 1991, Brown 1996).

Gorbachev's fundamental problem was that too little power remained at the top to make possible any top-down reform against the interest of the bureaucracy. Even if he had possessed more power, Gorbachev as well as all his advisors had no clue what political and economic reforms he should undertake, since the Nomenklatura system prevented the development of such ideas. Hardly anybody had studied abroad, and no free thinking was allowed. The power structure was totally petrified because of the continuous devolution of power to lower bureaucrats. This decentralization did not imply democratization but a collectivization of the dictatorship by a small communist elite, and nobody thought about the common good, as they were not even informed about it. The Soviet polity was like a supertanker that could no longer turn. It was only a matter of time before such a ship would sink.

Similar developments were replicated in other Soviet bloc countries, though Poland and Hungary were much more liberal and open. For the future, the tremendous power of the state enterprise managers was one of the most important, and least noticed, predicaments.

Aggravated Political Illegitimacy

No country had chosen communism voluntarily or democratically. After Nikita Khrushchev put an end to the Stalinist terror with his secret speech to the Twentieth Congress of the CPSU in 1956, a society deeply frozen in fear started slowly reviving. Rather than being grateful for the end of terror, people began perceiving communist dictatorship as illegitimate. In foreign policy, the credibility of an outside threat withered in spite of government propaganda about capitalist encroachment.

The political emancipation of Soviet bloc peoples occurred in fits and starts through reform movements and popular uprisings, usually following the ascent of a new Party leader in Moscow. Any new Soviet leader brought turmoil to the whole bloc, as power relations were so personalized. In June 1956, Polish workers in Poznań staged an uprising. Moscow responded with compromise, accepting a more nationally oriented communist leader and private agriculture. In October–November 1956, a full-fledged Hungarian attempt at national and anticommunist liberation provoked the Soviet Union to use massive force, killing and executing tens of thousands. Eventually, though, Hungary was allowed to introduce greater personal freedom and market socialist reforms in 1968.

The Prague Spring in 1968 was heralded by the new Communist Party leader of Czechoslovakia, Alexander Dubček. With his slogan "socialism with a human face," he aspired to socialist renewal and market socialism. For the last time, socialism was genuinely popular and engaged people's creative imagination, but a military invasion by the Warsaw Pact crushed these hopes and hundreds of thousands of people were purged from the Party and their jobs.[3]

In both December 1970 and August 1980, Polish shipyard workers in Gdańsk and Szczecin on the Baltic coast rose for economic dissatisfaction. In 1970, they contented themselves with promises of a better standard of living and low meat prices, but in 1980 they questioned the communist system. The regime quashed this latter attempt at real democratization with a military clampdown in December 1981.[4] Even so, Poland had dealt a death blow to communism. It was only a matter of time before Soviet communism would falter. "Goulash communism," as Hungarian market socialism was called, had disappointed both economically and politically. Thanks to greater international openness, millions of Poles and Hungarians could travel abroad and see for themselves what the West was like, and they rejected communism.

In 1969, Soviet dissident Andrei Amalrik (1980) foresaw the end of the Soviet Union in 1984. The ground for his prophecy was the increasingly negative selection of cadres in the Soviet system. As performance and merits were subordinated to obedience in the Soviet promotion system, officials were prone to promote those less competent than themselves. In the end, the Party elite would be too weak to rule.

[3] Zdeněk Mlynář (1980) has provided us with the deepest insights, and his book bears the subtitle: "The End of Humane Socialism."

[4] The story is eminently told in Ash (1983).

National Illegitimacy

More than the Hapsburg Empire, the Soviet bloc deserved the nickname "the prison of peoples." The Soviet Union had occupied Central Europe at the end of World War II and imposed communist dictatorships, deplored by most nations, particularly the Poles, Hungarians, and Romanians, while German communists settled in the East. Originally, Czechs, Slovaks, and Bulgarians had a relatively positive view of the Soviet Union, but decades of Soviet dominance soured popular attitudes. In Romania, communist leader Nicolae Ceauşescu tried to legitimize his ferocious dictatorship through nationalism.

In the Soviet Union itself, Russians comprised only a slight majority. The country was formally a union of fifteen national republics, and in each republic the titular nationality had reinforced its position. The Baltic states, West Ukraine, and Bessarabia (the bulk of Moldova) were incorporated by force during World War II, and the native populations remained deeply resentful of Soviet rule. Ukraine and the three Caucasian states, which had been independent in the years 1918–20, kept their legacy of independence alive. The Central Asian states had been conquered by the Russian Empire rather late, from 1847 to 1873, but they had little appetite for independence, and the Belarusians were possibly least interested in independence. Thus, about half of the Soviet republics (the Baltics, the Caucasus, Ukraine, and Moldova) aspired to national independence, and the Balts would accept nothing less (Dunlop 1993).

Shortages, Incomes, Inflation, and Fiscal Balance

Toward the end of communism, most countries were hit by severe economic crises with devastating shortages of consumer goods. Unfortunately, shortages were not measured, but involuntary savings, nominal incomes in comparison with inflation, real incomes, and the fiscal deficit may serve as proxies.

The development of the population's savings tells us something about their involuntary savings. Poland and Hungary had liberalized most prices, allowing the price level to rise with aggregate demand. As a result, their population's savings dwindled to about 20 and 30 percent, respectively, of annual retail sales in 1989. Other communist countries displayed large forced savings. In Bulgaria, the population's savings exceeded the annual retail sales from 1985 to 1990, while this ratio rose slowly from 75 to 80 percent in Czechoslovakia. The sharpest rise occurred in the Soviet Union – from 69 percent in 1985 to 90 percent in 1990. Romania also saw a substantial increase – from 55 percent to 70 percent (ECE 1991, p. 55).

Table 2.1 Nominal Money Incomes and Real Incomes of the Population and Inflation, 1985 and 1989–1991 (Annual change in percent)

	Nominal Income		Real Income		CPI	
	1985	**1989**	**1985**	**1989**	**1985**	**1989**
Bulgaria	..	..	2.9	−2.4	1.7	6.2
Czechoslovakia	3.2	3.3	2.3	−2.4	1.3	1.5
GDR	4.0	3.0	..	..	0	2.3
Hungary	9.2	20.4	1.9	2.4	7.0	18.8
Poland	23.3	280.4	6.0	6.2	14.4	259.5
Romania	4.0	..	2.0	2.3	0.4	0.9
Soviet Union	3.7	70[a]	2.4	−3[a]	0.8	144[a]

[a] 1991.
Sources: ECE (1991, pp. 224–6; 1992, pp. 105, 106).

Another measure of the imbalance on the consumer market is the relationships between nominal money incomes, real incomes, and open inflation. Nominal incomes grew moderately in 1985 in all countries apart from Poland and Hungary (see Table 2.1). By 1989, Poland had lost control over nominal wage increases, as the Soviet Union did in 1991, while Hungary experienced substantial wage inflation. The others proved the strength of their dictatorships, controlling nominal incomes to the bitter end.

Real incomes rose sharply only in Poland (see Table 2.1), because the Polish government could neither hold back wage increases nor raise prices sufficiently. In 1988, Polish "real" incomes rose by a hefty 13.2 percent (ECE 1991, p. 225), which was untenable and resulted in pervasive shortages. Although Hungarian nominal incomes rose significantly, prices surged correspondingly, keeping shortages at bay. Bulgaria, Czechoslovakia, and the Soviet Union suffered from the opposite problem of significant decreases in real incomes during their last year of communism, which provoked popular discontent.

Before the collapse of communism, open inflation was problematic only in Poland and the Soviet Union, which both had inflation exceeding 100 percent a year (see Table 2.1). Incredibly, Czechoslovakia, the GDR, and Romania reported inflation below 3 percent a year even in the revolutionary year of 1989, while Bulgaria had a moderate inflation of 6 percent that year. Their price controls remained firm until the end.

Fiscally, the communist ideal was a balanced budget, which was attained to a surprising extent, even if there was some tinkering with the accounts (Birman 1981). Officially, only the Soviet Union had a

Table 2.2. Fiscal Deficit, 1985 and 1989 (Consolidated state budget balance as percentage of GDP)

	1985	1989
Bulgaria	..	..
Czechoslovakia	..	–0.9
GDR	0.4	..
Hungary	–1.5	–3.2
Poland	–0.3	–3.0
Romania	2.2	7.5
Soviet Union	–1.8	–8.6

Source: ECE (1991, p. 58).

significant budget deficit, exceeding 6 percent of GDP from 1986 (Åslund 1991, p. 192). Poland and Hungary had small deficits of 3 percent of GDP in 1989, while Bulgaria, Czechoslovakia, and the GDR had no official fiscal deficits (see Table 2.2). Absurdly, Romania had a budget surplus of an incredible 7.5 percent of GDP in 1989, because of Ceauşescu's strenuous efforts to repay Romania's foreign debt. Little wonder that he was toppled and executed.

Although budget deficits were small, they could cause great harm, because these countries had hardly any financial instruments. Apart from foreign loans, the only available financing of a budget deficit was monetary emission, which led to either shortages, inflation, or both. Poland experienced a minor hyperinflation in the fall of 1989, although its budget deficit was officially only 3.0 percent of GDP, but real budget deficits were probably larger.

Thus, the financial situations varied greatly. The Soviet state finances were out of control since 1986, with the country heading toward hyperinflation. Poland's fiscal situation was untenable. Hungary managed its finances reasonably in a market-oriented fashion, while Bulgaria, Czechoslovakia, and the GDR kept their old systems intact. In Romania, Ceauşescu pursued a brutal policy of fiscal restraint for his caprices.

Excessive External Debt Service and External Shocks

One means of alleviating the fiscal crunch was foreign borrowing. Nationalizations had initially made the communist countries pariahs on the international credit market, but their stigma faded with time.

In the early 1970s, Poland started borrowing heavily from abroad to increase both investment and consumption for growth and social peace. This strategy ended with the fall of communist leader Edward Gierek in

Table 2.3. Gross Foreign Debt, 1985 and 1989 (U.S.$ billions)

	1985	1989
Bulgaria	4.1	10.7
Czechoslovakia	4.6	7.9
GDR	13.6	33.0
Hungary	14.0	20.6
Poland	29.3	40.8
Romania	6.6	0.7
Soviet Union	31.4	58.5

Source: ECE (1991, p. 250).

1980 and Poland's subsequent external default. It remained a basket case throughout the 1980s with a foreign debt of $41 billion in 1989 (see Table 2.3). Hungary drew foreign credits more cautiously than Poland, but its foreign debt approached $21 billion in 1989, almost twice the Polish per capita debt. A third indebted country was the GDR, which was bankrolled by West Germany. Less conspicuously, poor Bulgaria had accumulated debts of nearly $11 billion by 1989, excessive for this small country. The Soviet Union had a limited foreign debt, but its domestic financial crisis prompted an external default in December 1991, as its international reserves were depleted. Thus, five countries suffered from serious foreign debt problems, of which only Hungary's seemed manageable.

Yet, two hardline communist countries had a comfortable foreign debt situation, namely Czechoslovakia and Romania. Czechoslovakia's terrible international reputation after the communist clampdown of 1968 scared off potential foreign lenders. Romania had no foreign debt at the end of 1989, because Ceauşescu had decided so.

Foreign financial balances were greatly influenced by the foreign debt service. Table 2.4 shows that only Bulgaria and the Soviet Union had problems with their trade balances toward the end of the 1980s, while Czechoslovakia and Romania had a positive current account balance. For Bulgaria, Hungary, Poland, and the Soviet Union, the current account deficit was too large in 1989, and for the Soviet Union it grew much worse in the following two years.

As these crises gained momentum, they were amplified by related external shocks. With excessive debt service, international finance dried up. Because of extensive unofficial arbitrage, governments were forced to accept some market adjustments and freed exchange rates, which plunged. Plummeting exchange rates and the absence of

Table 2.4. Balance of Trade and Payments, 1985 and 1989 (U.S.$ billions)

	Trade Balance		Current Account	
	1985	1989	1985	1989
Bulgaria	–0.4	–1.2	–0.1	–1.3
Czechoslovakia	0.7	0.4	0.7	0.3
Hungary	0.1	0.5	–0.8	–1.4
Poland	1.2	0.1	–0.5	–1.9
Romania	1.4	2.6	0.9	2.9
Soviet Union	0.7	–2.3	0.1	–4.0

Source: ECE (1991, p. 92).

Table 2.5. Crises at the End of Communism

	Falling Output	Rising Shortages	Wage Inflation	High Inflation	Large Fiscal Deficit	Excessive Foreign Debt
Bulgaria	×					×
Czechoslovakia						
GDR						×
Hungary	×					
Poland	×	×	×	×		×
Romania	×	×				
Soviet Union	×	×	×	×	×	×

Sources: Tables 1.1 and 2.1–2.3.

international credit caused severe external shocks to all countries save Hungary.

A Great Variety of Crises

While all of these multiple crises had systemic roots, they varied considerably. Table 2.5 summarizes the situation with six macroeconomic variables. The Soviet Union was in a profound macroeconomic crisis, having lost control over the budget in 1986, and the budget deficit was largely monetized. Tremendous shortages caused a drastic fall in output, and hyperinflation appeared a near certainty. The Polish crisis was similar but not as deep, and substantial structural changes had been undertaken.

The other countries faced less severe financial concerns. Bulgaria had lost control over its foreign account, while its domestic financial situation was prosaic. Romania suffered from a strange austerity crisis, prompting a drastic decline in output and an even sharper fall in the standard of living. The GDR had no serious financial concerns, but it lacked national legitimacy. Only Hungary had succeeded in reforming itself to a socialist market economy, managing its macroeconomic strains. Czechoslovakia, finally, maintained a truly Brezhnevian economy with little dynamism but surprising balance.

THE DEMISE OF COMMUNISM IN CENTRAL EUROPE

Each country experienced its own unique demise of communism. We have discussed the underlying economic, political, and national causes, but foreign policy unleashed the collapse of communism in Central Europe. The Cold War ended in December 1988, when Soviet President Mikhail Gorbachev allowed Central European countries to go their own ways, and they did so in the fall of 1989.

In the leading reform countries, Poland and Hungary, communism ended through a negotiated process. In the other countries, the transfer of power occurred through coups or revolutions. The specific features of the end of communism in each country were to assume great importance for their future reform strategies. Therefore, we need to understand the essence of what happened in each country.

The pace of change accelerated. As Timothy Garton Ash (1990, p. 78) quipped: "In Poland it took ten years, in Hungary ten months, in East Germany ten weeks: Perhaps in Czechoslovakia it will take ten days!" (It actually took 24 days.) The configuration of parties and winning coalitions varied greatly. The differences in outcome reflected the power relations in the old system, the strength of civil society or social capital, and public understanding.[5]

End of the Brezhnev Doctrine

Those countries over which the Soviet Union had seized military control were not allowed to abandon the Soviet camp or fundamental Soviet policies. The boundaries were clarified by trial and error in actual Soviet policy, including invasions. After the Warsaw Pact invasion of Czechoslovakia, the Soviet Union officially declared that together with other Warsaw Pact countries it had the right and duty to intervene to "defend socialism" in any part of the socialist commonwealth where the system was threatened. This became known as the "Brezhnev doctrine" (Brown 1996, p. 240).

[5] The outstanding account of these epic events is Ash (1990).

Hence, the Soviet Union invaded Afghanistan in December 1979, but it got bogged down in a bloody guerrilla war in inhospitable mountains. To the Soviet Union, the war in Afghanistan became what the Vietnam war had been for the United States. It was costly, bloody, and unpopular; it damaged Soviet international relations; it could not be won, and it was inordinately meaningless. For Soviet reformers, notably President Gorbachev and Minister for Foreign Affairs Eduard Shevardnadze, the conclusion of the war in Afghanistan became a key foreign policy objective, and the only solution was the withdrawal of the Soviet troops, which was completed by February 15, 1989 (Brown 1996, p. 233–5). The Brezhnev doctrine had been jeopardized.

In parallel, President Gorbachev altered the Soviet attitude toward its client states. In a major speech to the United Nations in December 1988, Gorbachev declared explicitly that all countries had freedom of choice, effectively abolishing the Brezhnev doctrine:

> For us the necessity of the principle of freedom of choice is clear. Denying that right of peoples, no matter what the pretext for doing so, no matter what words are used to conceal it, means infringing even that unstable balance that it has been possible to achieve. Freedom of choice is a universal principle and there should be no exceptions. (Brown 1996, p. 225)

Socialist rule in Central Europe had been established and maintained by Soviet troops, and Soviet-type socialism had failed both economically and politically. Therefore, it seemed only a question of when and how the suppressed people would rise and overthrow Soviet tutelage.

Soon, the Soviet-supported regimes started falling like tenpins. As the Soviet Union had withdrawn voluntarily, the liberation from Moscow was already secured. Instead, the primary political focus in these countries became freedom from domestic dictators and democratic elections. Everywhere, people yearned for a "normal" economy, implying an ordinary Western market economy.

Poland: The Pioneer

For all their prior democratic and market economic developments, Poland and Hungary were the obvious candidates for early democratization, but Poland took the lead. Because of staunch opposition from the Solidarity trade union movement and the strong Catholic Church, the communist government could barely rule. It was relatively liberal due to weakness rather than inclination. In early 1989, the communist government and Solidarity gathered at a roundtable and agreed to hold partially democratic parliamentary elections on June 4.

The result was a stunning landslide victory for Solidarity, which was eventually allowed to form a coalition government in September 1989, led by Prime Minister Tadeusz Mazowiecki from Solidarity, with the liberal economics Professor Leszek Balcerowicz as Minister of Finance. However, communist Wojciech Jaruzelski stayed as president, and communists retained control over the ministries of interior and defense. As this was a peaceful and negotiated transfer of power, democrats were induced to compromise, which caused cracks within their own ranks. Nor did the democrats have a majority in the Parliament, but they had committed themselves not to call early parliamentary or presidential elections.

Hungary: Transition Led by Communist Party

The Hungarian democratization competed with the Polish lead. The Hungarian Socialist Workers' Party was the most liberal ruling communist party, and Hungary had undertaken more reforms than any other socialist country. The communist government negotiated with the opposition at a roundtable from June to September 1989. The parties agreed on a set of documents depicting a path to full democratization, with free parliamentary elections to be held on March 25, 1990.

Unlike their Polish counterparts, the Hungarian opposition was deeply divided. The Hungarian Democratic Forum won the elections in March 1990 and formed a government. It was a conservative, Christian Democratic party with rural roots. While it was committed to a market economy, it was more interested in national themes than economics. The Free Democrats, who were the runners up, drew on the liberal, intellectual dissident movement. The Young Democrats gathered young liberals, who fared poorly at the polls. The Hungarian Socialist Party did its utmost to transform itself into a social democratic party. Ironically, good economists belonged to the three latter parties and not to the governing Hungarian Democratic Forum.

The Hungarian transfer of power was probably the smoothest and led to full democracy. However, divisions among the noncommunist parties were severe from the beginning, as the communist dictatorship had become so mild that the opposition had little need for unity. Economic policy was left without firm leadership (Stark and Bruszt 1998).

GDR: Popular Revolt through Escape

The German Democratic Republic remained a repressive dictatorship until 1989, expelling any dissident to West Germany. The leadership of the Socialist Unity Party was gerontocratic, and communist dictator Erich Honecker had ruled for almost two decades.

Reforms in the Soviet Union, Poland, and Hungary caused internal pressures in the GDR, which became apparent in 1989. Rather than trying to reform their country, East Germans exploited the freedom of travel to Poland and Hungary to flee to the West. The catalyst of change was that the Hungarian government opened its border to Austria on September 10, 1989. Thousands of young East Germans crossed that border to escape to West Germany, where they automatically obtained citizenship. The mass escape aroused large demonstrations in the GDR, primarily in Leipzig under the slogan: "We are the people!" Finally, unrest spread to Berlin, and when on November 9 the communist leadership agreed to open the wall to West Berlin, the illegitimate regime crumbled in no time. As East German civil society had been drained through the steady emigration of free thinkers, the drowsy opposition that emerged was rather socialist and naïve, making East Germans put their trust in West German parties and organizations instead.

In parliamentary elections on March 18, 1990, the Christian Democratic Union (CDU) won and formed a government in East Germany. West German Federal Chancellor Helmut Kohl won these elections with the slogan "Nobody will be worse off and many will be better off." Many new East German politicians were revealed as informers for the secret police and discredited. On July 1, 1990, East Germany adopted the West German deutsche mark on favorable conditions. By October 1990, it acceded democratically to the Federal Republic after having adopted its legislation in bulk. The reformed communist party, renamed the Party of Democratic Socialism (PDS), gained some popular support, because it was the only truly East German party. In effect, West Germany took over in East Germany with democratic consent.

Bulgaria: A Communist Coup

Bulgaria had undertaken little reform, and only in response to pressure from Moscow. On November 10, 1989, the day after the fall of the Berlin wall, Todor Zhivkov, Bulgaria's communist dictator since 1954, was ousted in an internal communist coup. This putsch started the country's democratization, carried out under reform communist tutelage. A roundtable negotiation from January to March 1990 led to democratic elections to a Grand National Assembly on June 10, 1990.

Politically, Bulgarians were almost equally divided between socialists and democrats, with a small Turkish minority party straddling the middle. The first democratic elections led to a narrow communist victory, now renamed socialists (Bell 1997). Bulgarian transition to democracy left a legacy of peacefulness, but the political parties and democratic institutions had been formed in haste. The country was characterized by a deep polarization between a still strong socialist party and a motley of democrats. Since the democrats had not had time to sort out their differences before the elections, they did so afterward, which greatly weakened them.

Czechoslovakia: The Velvet Revolution

Remarkably, Czechoslovakia, the country with the proudest democratic traditions from the interwar period, was only the fifth country in Central Europe to attempt a democratic transition. This reflected Czechoslovakia's profound petrification after the Warsaw Pact invasion of 1968 under the dictatorship of President Gustáv Husák, who was considered a national traitor. In 1977, Charter 77, an important dissident movement, had been formed. Although it was suppressed, it remained active as a democratic light.

Eventually, something happened even in Czechoslovakia. On November 17, 1989, students staged a minor demonstration for freedom, and the police lashed out at them with truncheons, igniting the spark that set Czechoslovakia alight and caused its "Velvet Revolution." Large mass demonstrations erupted, and opposition groups united in the Civic Forum, a broad popular front led by Václav Havel. In Slovakia, its sister organization, Public against Violence, was formed under Catholic dissident Jan Čarnogursky who was released from prison. The Civic Forum demanded the ouster of leading communists, freedom, and democracy. The stale regime gave in swiftly but not fast enough to save itself. Roundtable talks lasted only two days.

By December 10, President Husák resigned. A government was formed with a majority of Civic Forum members but a communist prime minister. The leading Czech economic reformers entered the government – Václav Klaus as Minister of Finance and Vladimir Dlouhy as Minister of Planning. On December 29, Václav Havel was elected president by Parliament (Ash 1990).

Parliamentary elections were held in June 1990, and parties arising out of the Civic Forum were victorious. The "Velvet Revolution" had the air of a fairy-tale. The old evil surrendered without bloodshed. After years of suffering, well-educated and sensible dissidents came to power to serve their country, and the show was eminently directed by the country's greatest playwright. In this euphoria, few noticed that the very pace allowed for little development of a civil society.

Romania: Communist Exploitation of a Popular Revolt

Then only Romania was left of the Soviet bloc in Europe. It had pointedly been characterized as "socialism in one family." Unlike the countries discussed above, it was relatively independent from the Soviet Union. Communist leader Nicolae Ceauşescu had long pursued a ruthless and uninterrupted dictatorship, with the secret police intruding deeply into private life, stifling civil society. Yet, after the other diehard communist dictators – Honecker, Zhivkov, and Husak – had fallen, Ceauşescu looked very isolated.

Unrest in Romania started with a demonstration on December 16, 1989, against police attempting to evict a Hungarian protestant pastor from his house, and the police caused a carnage. The most evocative television image of the revolutions of 1989 was Ceauşescu speaking in front of tens of thousands in the Palace Square on a cold winter day of December 21. Suddenly, the crowd started booing, forcing the dictator to flee by helicopter. Rebellious masses stormed the Central Committee building, and wild shooting erupted, though it was unclear who was shooting whom. Miraculously, the Romanian Communist Party, with 3.8 million members, just disappeared. A few days later, the fleeing Ceauşescu was caught and summarily executed.

A power vacuum arose, but it was swiftly filled by disgruntled representatives of the Communist Party, the army, and the public, while the harsh repression had not permitted the formation of any organized opposition. Members of the communist establishment formed the National Salvation Front, led by an old communist functionary, Ion Iliescu, but the Front was widely appreciated for having ousted the tyrant. It won 66 percent of the votes in democratic parliamentary elections in May 1990, and Iliescu was elected president. Two old nonsocialist parties were recreated, but they suffered from having leaders who had spent many years abroad (Tismaneanu 1997). Hence, the communist establishment managed to legitimize its leadership by executing Ceauşescu, and events unraveled so fast that few understood what was going on and civil society had no time to develop.

Very Different Political Situations

The essence of this exposé is to show how different political preconditions were. The first big dividing line is whether communist parties stayed in power, as in Bulgaria and Romania, or whether they were ousted, as in Poland, Hungary, East Germany, and Czechoslovakia.

Another important distinction is the strength of civil society. Poland had the strongest civil society, closely followed by Hungary. Czechoslovakia had the proud tradition of Charter 77, but its civil society was pretty weak. Civil society in East Germany was feeble by default, while it was possibly even weaker in Bulgaria, and Romania had the least because of severe repression until the end.

A curious aspect was the development of the communist parties and their interaction with democrats. The Polish and Hungarian communist parties were already becoming social democratic, enticing democrats to make compromises with them that would be held against these democrats. In Czechoslovakia, where the communists had no time to transform, the new regime was the least bound by compromises, making a clean slate appear possible. In Bulgaria and Romania, the communist parties were not much reformed, but they stayed in power.

Among noncommunists, the choice of economic strategy appeared rather accidental, determined by who happened to become minister of finance. In Poland and Czechoslovakia, Leszek Balcerowicz and Vaclav Klaus insisted on radical economic reforms, while no strong economic policymaker emerged in Hungary.

THE COLLAPSE OF THE SOVIET UNION

Although the Soviet Union had been one country, the fifteen countries arising out of its ruins harbored even greater differences than Central and South-East Europe in culture, history, politics, and economic development. Six countries drew on Muslim patrimony and nine on predominantly Christian heritage of different denominations. Communism's duration was much shorter in the Baltics, Moldova, and Western Ukraine, which had been incorporated during World War II. The Baltics, Georgia, and Armenia could claim to be old nation-states, while others had less sense of national identity, and all states but Armenia were multinational. All these factors gained importance in the Soviet twilight.

National causes became increasingly divisive in the Soviet Union. The Balts and West Ukrainians had never been reconciled with their incorporation into the Soviet Union, just longing for its demise. Any liberalization meant that they could raise their national cause, as they did in the late 1980s.

The contradiction between each republic and Russia was gradually aggravated. From the mid-1960s, the titular nationality of each of the fifteen union republics had grown stronger politically because of preferential treatment in Party and state appointments. Yet, in parallel, attempts at Soviet standardization and Russification continued, as Russian was the language of the elite, magnifying national conflicts.

Unwittingly, Mikhail Gorbachev contributed to the destruction of the union, apparently believing that the Soviet Union had solved all national questions (Gorbachev 1986). He allowed previously forbidden questions about national repression to be raised, but he had no good answers.[6] Why, for instance, had one-quarter of the Ukrainians been

[6] In his book *Perestroika*, Gorbachev (1986, p. 118) states: "If the nationality question had not been solved in principle, the Soviet Union would never have had the social, cultural, economic and defense potential it has now. Our state would not have survived if the republics had not formed a community based on brotherhood and cooperation, respect and mutual assistance." As the secretary general of the CPSU was so detached from reality, the collapse of the Soviet Union appeared a near certainty.

killed by an artificial famine in the 1930s? The old conflict between the Armenians and Azerbaijanis erupted again with greater freedom in 1988. Curiously, Russian nationalists belonged to those dissatisfied with being discriminated against in what they saw as the Russian Empire (Dunlop 1993).

Juan Linz and Alfred Stepan (1992) have argued plausibly that the sequence of democratization sealed the fate of the Soviet Union. The democratization proceeded faster at the republican level in Russia and in the most developed republics than at the all-union level. Thus, the republican parliaments elected in semidemocratic elections in early 1990 had more legitimacy than the all-union parliament elected in March 1989 in a less democratic vote. Conversely, Soviet President Gorbachev never contested a democratic vote or committed to real democratization, depriving both himself and Soviet institutions of authority, while Boris Yeltsin was democratically elected Russian president on June 12, 1991, endowing the Russian presidency with full democratic legitimacy. This made the end of the Soviet Union inevitable. In addition, the Soviet leadership was incapable of handling the rampant economic crisis.

The death knell of the Soviet Union was delivered by a failed coup by hardliners from the Communist Party, the government, the KGB, and the military on August 18–21, 1991. The aftermath of this farcical putsch set the future national and political dividing lines. First, the new Russian administration under President Yeltsin emerged as the legitimate power in Moscow, swiftly abolishing most Soviet institutions. Second, democracy broke through in Russia, because Yeltsin had already been democratically elected but hitherto had no real executive power. Third, President Gorbachev discredited himself for good, by returning to Moscow citing Lenin and claiming: "I am convinced that socialism is correct" (Dunlop 1993, p. 259). Fourth, the putsch ridiculed the hardliners, prompting the prohibition of the Communist Party of the Soviet Union. Fifth, the other union republics had little choice but independence. The Baltics hastened to make themselves fully independent, while the others waited until December 1991. Finally, the abruptness of the collapse gave those ready to act a great advantage, and those who happened to be in power in each republic were given the political initiative.

In their formation, the Soviet republic varied in their attitude to nation building, each other, democracy, and market economy.

Russia: Opting for Democracy and Market Economy

As Russia was the pinnacle of the Soviet Union, it played a crucial role in many regards. All the other Soviet republics, with the exception of the Baltics, looked to Russia. Most of all, they wanted to know what would happen to Soviet power, and only Russia could break it. Moscow was also the dominant intellectual center, to which others looked for ideas. Foreign policy was alien to most but Moscow top officials.

With its democratically elected president, Russia laid the foundation of a democracy after the abortive August 1991 coup. Unfortunately, few felt any urgency to adopt a democratic constitution and to dissolve the quasidemocratic parliament, which had been elected without political parties in March 1990. Its deputies were accidental, disorganized, unaccountable, and predominantly communist.

Unlike the other Soviet republics, which were preoccupied with nation building, Russia focused on market economic reforms in the fall of 1991. The economic and institutional chaos was horrendous, and a vicious opposition raised its head in Parliament and the old Soviet institutions before the end of 1991.

The Russians avoided the sensitive question of transforming Russia from an empire to a nation. The Commonwealth of the Independent States (CIS), created in December 1991 as a substitute for the Soviet Union for all but the Baltics, functioned as a fig leaf for the Russian elite, and they hid their unresolved national question behind it (Åslund 1995).

The Baltics: Impatiently Longing for Independence

The three Baltic states (Estonia, Latvia, and Lithuania) had been independent in the interwar period. In July 1940 they were occupied by the Red Army and forcefully annexed to the Soviet Union.[7] A large share of the population was deported to camps in Siberia, while others fled to the West. Estonia and Latvia were historically and geographically related to the Scandinavian countries, and the Balts could find no mitigating factor in their occupation by the Soviets.

Their national independence movements began blossoming as soon as Soviet repression started to ease. The first popular concerns were environmental, because they were most acceptable to the Soviet power structures. Soon, however, national attention turned to the condemnation of the Molotov–Ribbentrop Non-Aggression Pact concluded by the Soviet Union and Nazi Germany on August 23, 1939, which had awarded the three Baltic states to the Soviet Union.[8] Developments in these three

[7] This section draws primarily on Lieven (1993).

[8] So named for the German Foreign Minister Joachim von Ribbentrop and his Soviet counterpart Vyacheslav Molotov. Through this pact, Nazi Germany and the Soviet Union agreed to divide much of East-Central Europe between them, allowing Germany to invade Poland one week later, while the Soviet Union took Poland's Ukrainian and Belarusian parts and later the three Baltic states and Bessarabia, which was then part of Romania.

countries were largely parallel. Estonia and Lithuania competed in the lead, while Latvia followed suit.

In all three countries, broad anticommunist popular fronts were established in 1988. Their main aim, stated openly in 1989, was to restore their countries' independence. The Lithuanian Communist Party tried to keep up with the nationalists and departed from the CPSU in December 1989. The Estonian Communist Party followed in March 1990, while the Latvian Communist Party split in the middle, with half of the party staying hardline. In elections in February–March 1990, the popular fronts won more than two-thirds majorities in all three parliaments, and they assumed executive power in the spring of 1990. Then they declared independence from the Soviet Union, which refused to accept that, retaliating with an oil embargo on Lithuania. However, after Soviet troops killed several people in Lithuania and Latvia in January 1991, the Soviet Union refrained from open aggression.

After the August 1991 coup in Moscow, the Soviet Union recognized the independence of the Baltic states. Thus, these nations and their civil societies had matured in a lengthy process of democratization. They were ripe for full democracy with multiparty elections. Their popular fronts soon split into ordinary political parties. A moot point was that, according to the census of 1989, only 52 percent of the population in Latvia was ethnic Latvians, 62 percent of the population in Estonia was ethnic Estonians, while 80 percent of the people in Lithuania was ethnic Lithuanians.

Only Poland and Hungary were better prepared than the Baltic states for democracy. Their national objectives were firmly set: to turn their backs on Russia, to integrate with the West, and to establish ordinary Western systems.

The Caucasus: Nationalism Leading to Armed Conflicts

The Caucasus was incorporated into the Russian Empire in the early nineteenth century. Georgia and Armenia were ancient, combative nations, but the region is also characterized by ancient minorities, national disputes, and political violence. The three Caucasian countries were ready to leave the Soviet Union early, but all were drawn into armed conflicts before its demise. The great threat of warfare permitted little thought or energy to economics. An old economic peculiarity of the region is an extraordinary large underground economy (Grossman 1987). The Caucasus also had powerful organized criminal groups, which were entrenched in the Party and state apparatus.

In Georgia, a hardline communist leadership allowed for little liberalization. Even so, opposition politics exploded in 1989, after the Soviet military opened fire on a peaceful demonstration, killing twenty people on April 9, 1989. The Georgian communist leaders were ousted, but the new leaders gained no authority, leaving the field open for nationalist and anticommunist opposition. The dominant national leader was Zviad Gamsakhurdia, a prominent dissident of long standing. His party won a comfortable majority in the first democratic parliamentary elections in October 1990 and formed a new government, while the Communist Party dwindled away. In May 1991, Gamsakhurdia won an overwhelming victory in democratic presidential elections. Yet, Georgian politics remained conspiratorial and uncompromising. No broad popular front was formed, while national problems evolved. Two autonomous regions, South Ossetia and Abkhazia, tried to break away by force, moving beyond Georgian political control. Gamsakhurdia was virulently anti-Soviet, and he aroused armed resistance, leading to his overthrow in a brief but bloody civil war in December 1991 to January 1992. Three years of chaos followed, prompting severe economic collapse. Anarchic Georgia seemed barely governable. The government did not control the whole territory and was unable to pursue any economic policy. Former First Party Secretary of Georgia and Minister for Foreign Affairs of the Soviet Union Eduard Shevardnadze returned to Georgia in March 1992, effectively assuming the office of president, though his democratic election occurred only in 1995 (Slider 1997).

Political developments in Armenia and Azerbaijan were closely interlinked by their mutual strife. Armenia, the oldest Christian nation, remained preoccupied with the Turkish slaughter of over one million Armenians in 1915 and the potential threat from neighboring Turkic peoples, notably the Azerbaijanis. Armenia requested support from the Soviet Union, and later Russia, for its national security. Russification was not an issue in Armenia, as 93 percent of the population was Armenian in 1989. Therefore, Armenia had been less repressive than most Soviet republics, but some Armenian nationalists were always demanding independence. Armenian nationalism was aroused by the issue of Nagorny Karabakh, a small mountainous ethnically Armenian autonomous region in neighboring Azerbaijan. In February 1988, the regional authorities in Nagorny Karabakh demanded its transfer from Azerbaijan to Armenia, and they were supported by large demonstrations in Yerevan. In response, Azerbaijanis in the industrial city of Sumgait started a spontaneous riot, killing at least thirty-two people, primarily local Armenians (Brown 1996, pp. 262–4). The Armenian–Azerbaijani conflict over Nagorny Karabakh escalated into a full-scale war in February 1992, and this conflict has defined the politics of both countries.

Armenians were upset by the Soviet leaders' refusal to accommodate their demands on Nagorny Karabakh. Nationalist dissident Levon Ter-Petrossian was elected to Parliament as early as 1989, and the

Communist Party was discredited for its inability to defend Armenian interests against Azerbaijan. A motley of noncommunist Armenian parties won the parliamentary elections in 1990, and in the summer of 1990 Ter-Petrossian was elected chairman of Parliament and later president. The Armenian government presented a market economic program and launched the first land reform in the Soviet Union in 1991, but the conflict with Azerbaijan and an Azerbaijani blockade put both reform and the economy in jeopardy in this small, landlocked country. The war with Azerbaijan became the overwhelming issue (Dudwick 1997).

Although the conflict over Nagorny Karabakh did not stir up any national consciousness of the Azeri elite, it served as a catalyst for Azerbaijani political developments. The Communist Party of Azerbaijan maintained a harsh dictatorship, and opposition was weak. Yet, in July 1989, an Azerbaijani Popular Front was formed under nationalist Abulfaz Ali Elchibey, and it adopted a liberal program of full democratization. However, in January 1990, a mysterious pogrom of Armenians occurred in Baku. The communist authorities blamed the Popular Front, and Soviet troops moved in. Hundreds were killed in this carnage. This ruthless Soviet action, which provoked no international protests, quashed the anticommunist resistance in Azerbaijan.

A rigged parliamentary election in the fall of 1990 resulted in a communist-controlled government with no prospects for democratization. Even so, the communist regime fell because of its poor performance in the war over Nagorny Karabakh, and the Popular Front assumed power in May 1992. Elchibey was elected president democratically in June 1992 with about 60 percent of the vote, but he was to remain in power for only a year, after which the old communist establishment took over under old Soviet leader Heidar Aliyev (Altstadt 1997). Neither democracy nor market economic reform were on Azerbaijan's agenda when the Soviet Union collapsed, while a history of political violence and instability had evolved.

Ukraine and Moldova: Communists as Nationalists

Ukraine has an old national legacy and was intermittently independent during the civil war from 1918 to 1920. Nationalism was strongest in Western Ukraine, which had never belonged to the Russian Empire. This region was occupied by the Soviet Union in September 1939 as part of the Molotov–Ribbentrop Pact on the partition of Poland. Always wary of Ukrainian nationalism, Soviet leaders made sure that public debate and social sciences were well repressed in Ukraine. As oppression eased under Gorbachev, a strong national movement called *Rukh* was built primarily among West Ukrainians. However, *Rukh* advocated linguistic nationalism, while most of the population in Ukraine spoke Russian, and the West Ukrainians comprised only 9 million of the 52 million people in Ukraine.

Although the Communist Party of Ukraine remained hardline, it won no less than 83 percent of the seats in the first quasidemocratic elections for its republican Parliament on March 4, 1990, reflecting how limited the democratization was. However, the Ukrainian communist establishment soon realized that the communists might lose power in Moscow, and much of the Ukrainian Nomenklatura embraced independence to stay in power. In the summer of 1990, state enterprise managers started lobbying Ukrainian parliamentarians to Ukrainize Soviet enterprises in Ukraine. Many nationalists forgave their elite past misdeeds for their conversion to Ukrainian nationalism.

Hence, the Ukrainian Parliament declared Ukraine independent on August 24, 1990, but Leonid Kravchuk, Second Secretary of the Communist Party of Ukraine responsible for ideology, became the new national leader. On December 1, 1991, 90 percent of the Ukrainian voters cast their vote for independence, while Kravchuk was democratically elected the first president of Ukraine with 62 percent of the votes. As Ilya Prizel (1997, p. 344) has put it: "Ukraine lacked both an elite committed to democratic reforms and liberal economics and a fully developed, capable democratic alternative." National independence and unity were the prime considerations. Russia posed an external threat, but the internal cleavage between the nationalist west and the Russified east was no less important. Economic reform barely entered the political agenda.[9]

The situation in Moldova was more complicated. In June 1940, Romanian Bessarabia was also occupied by Soviet troops, in accordance with the Molotov–Ribbentrop Pact. On August 2, 1940, the Soviet Socialist Republic of Moldavia was formed by the Soviets out of Bessarabia and a slice of Ukraine on the other side of the river Dniestr. Bessarabia, whose population was predominantly Romanian, was agricultural and poorly developed. The customary Stalinist repression and mass deportations ensued, and deported Moldovans were replaced by Ukrainians and Russians, reducing the Moldovan share of the population to 64 percent by 1989. Gorbachev's reforms excited Moldovan nationalism and reformism, and the Popular Front of Moldova was formed in 1989. Its focus was national and cultural – to strengthen the role of the Moldovan language, which was essentially Romanian. Some nationalists were

[9] I spent the week before the August 1991 coup in Kiev talking to economic policymakers. I was shocked by the predominance of hardline communists in economic policymaking, while the rising nationalists had little clue about economic affairs.

pan-Romanian, while others preferred a Moldovan state. In the fall of 1989, Petru Lucinschi, a reform communist and moderate Moldovan nationalist, became First Secretary of the Communist Party of Moldova.

The republican parliamentary elections in February 1990 signaled a breakthrough for the Moldovan Popular Front, which won one-third of the seats. Together with sympathizers, it commanded a parliamentary majority. With its support, a reform communist, Mircea Snegur, was elected chairman of Parliament, and later president. Moldova declared itself independent on August 27, 1991, after the abortive August coup.

Yet, in the summer of 1990, Russian separatists had declared Transdniestria an independent Soviet Socialist Republic, and open battles between Moldova and the separatists broke out in 1992, though they were soon contained (Crowther 1997). Thus, Moldova had to balance pro-Romanian and pro-Russian sentiments, rendering Moldovan independence the natural compromise. The preoccupation with security and nation building left little time for economics, which benefited reform communists as in Ukraine.

Belarus: Persistence of Communist Rule

Belarus can be described as the Prussia of the Soviet Union, being the most militarized, Sovietized, Russified, and disciplined Soviet Republic. Dissent was weak, while repression was awesome, and the Communist Party solidly hardline. Nowhere in the Soviet Union did the command economy work as well as in Belarus, and people even refused to accept tips only because it was forbidden. Nonetheless, the Soviet liberalization also reached Belarus. The wake-up call was the Chernobyl nuclear catastrophe of April 26, 1986, which harmed Belarus the most. Revelations of Stalinist mass executions, as well as national grievances, caused concern too. In October 1988, the Belarusian Popular Front for *perestroika* was established, inspired by Lithuania. Surprisingly, the Popular Front became as radical as those in the Baltic States, but it went too far for Belarusian popular sentiment.

The first multicandidate elections to the Belarusian Parliament were imposed by Moscow in March 1990, but they were not very democratic. The Popular Front won only 7.5 percent of the seats while the Communist Party got 86 percent. Notwithstanding that the Belarusian communist leaders supported the August 1991 hardline coup, they stayed in power until the elections in 1994 (Mihalisko 1997). Belarus had developed no preconditions for reform, and its independence in December 1991 appeared an accident. Ironically, the Belovezhsky agreement on the dissolution of the Soviet Union was signed by Stanislav Shushkevich, the centrist speaker of the Belarusian parliament, one of the few noncommunist senior officials in Belarus. The communists' stagnant rule prompted the victory of the populist Aleksandr Lukashenko in the presidential elections in July 1994, and he finished off Belarusian democracy, while civil society remained very weak. Economic reform was hardly an issue.

Central Asia: Predominance of Old Rule

Apart from Belarus, Central Asia saw the least political change. No early grassroots democratization occurred in these five countries, but they were influenced by the democratization coming from Moscow, notably the Soviet and republican parliamentary elections in 1989 and 1990, respectively. Central Asia neighbored on Afghanistan, and all these countries had substantial national minorities. Therefore, they were preoccupied with security, and none was pushing for early independence.

In three countries, Kazakhstan, Turkmenistan, and Uzbekistan, no real democratization took place, and their last communist leaders stayed in power. They abandoned the communist parties, but they ruled through old Nomenklatura networks. Turkmenistan's First Party Secretary and later President Saparmurat Niyazov was appointed in 1985 to impose central Soviet control. Kazakhstan's President Nursultan Nazarbayev and Uzbekistan's President Islam Karimov, on the contrary, were appointed Party leaders in June 1989 to conciliate their republics' interests. Neither country was exposed to any overburdening exigency, and the leaders reacted astutely to the demands of the time. In Kazakhstan, the authoritarian rule softened somewhat, while Turkmenistan and Uzbekistan maintained severe dictatorships. Niyazov has even introduced his own cult of personality. As Kazakhs made up only about 40 percent of the population in Kazakhstan, President Nazarbayev supported the Soviet Union until the end. As an old and large nation, the Uzbeks were more anxious to become independent, as was Turkmenistan because of its geographical location (Olcott 1996).

Kyrgyzstan is a small, poor, and mountainous country, with large Russian and Uzbek minorities. Its communist elite was jolted by an outbreak of bloody ethnic riots between Uzbeks and Kyrgyz in the south of the republic in the summer of 1990. As the Communist Party was blamed for the hundreds of deaths, its leader was ousted in October 1990. In opposition to the Communist Party, Parliament elected Askar Akaev, a prominent liberal physicist who had lived for years in Russia, as its Chairman. In October 1991, Akaev was democratically elected President and became a strong charismatic leader. Surprisingly, Kyrgyzstan democratized and developed quite a strong civil society with an independent press. The country was politically ripe for a market economic transformation, although the available economic knowledge was limited (Olcott 1996).

Tajikistan was the poorest of the Soviet republics, and it has become even more troubled than Georgia. As a small mountainous republic bordering on Afghanistan, with the same ethnic cleavages, Tajikistan has got trapped in political instability. In September 1991, the communist president was ousted by an unholy alliance of communists, Islamic activists, and democrats, headed by the pre-Gorbachev communist leader. As could be expected, this coalition fell apart, and in May 1992 a full-fledged civil war broke out after Islamic activists and democrats had ceded power. A Russia-led force intervened and brought a communist, Emomali Rahmonov, to power. With the support of Russian troops and much bloodshed, Rahmonov has managed to stay in power, but political stability remains evasive, and Rahmonov is a weak leader (Olcott 1996). Tajikistan is the closest candidate to a failed state in the former Soviet bloc.

WHAT THE COLLAPSE WAS ABOUT

The collapse of communism, termination of the Soviet bloc, and dissolution of the Soviet Union were all sudden disruptions, involving multiple economic and political crises. To conclude this chapter, we shall focus on two salient features of the breakdown. First, these countries faced very different political preconditions for economic transition. Second, their collapses proceeded in sharply contrasting ways. Change was facilitated by extraordinary opportunities for the old Nomenklatura to enrich themselves, but their enrichment complicated the ensuing transition to a real market economy.

Very Different Political Preconditions for Economic Transition

Reviewing all the countries in the former Soviet bloc, the disparities in their preconditions are striking. A first group of countries, consisting of Central Europe, the Baltics, Russia, and Kyrgyzstan, was reasonably democratic, with liberal regimes and strong civil societies. Their governments wanted a transition to a market economy. In all these countries, democratization had brewed for a couple of years before the democratic breakthrough, which generated comparatively strong civil societies. Armenia and Georgia do not quite make it but are closest to this group. Armenia's war with Azerbaijan jeopardized its early reforms and weakened its democracy. Georgia's initial attempt at democracy ended in civil war.

A second group consisted of Bulgaria, Romania, Moldova, and Ukraine, reasonably democratic countries where the old communist elites successfully stayed in power. Also geographically, these countries formed a second echelon just south of Central Europe.

Farther from Europe, a third group encompassed Belarus, Azerbaijan, Kazakhstan, Uzbekistan, Turkmenistan, and Tajikistan, which were never democratized, and where the old communist elite just continued to rule.

However, five countries were caught up in war or civil war, which left them with time for little but national survival during their initial years of independence. They were Georgia, Armenia, Azerbaijan, Tajikistan, and, to a lesser extent, Moldova.

Considering how different were the regimes, problems, and objectives of these countries, diverse economic policies and outcomes were to be expected. The first group is dominated by successful radical reformers. The second group contains unsuccessful partial reformers, and the third group consists largely of nonreformers. The exceptions are minor. This political perspective explains why Kyrgyzstan was more successful in its economic reforms than Bulgaria and Romania.

Thus, several political factors appear important for the success of economic reforms: democracy, the disruption of communist rule, the strength of civil society, national identity, and peace. We shall investigate these relations further in the chapter on politics. Distant history seems less salient than the development of democracy, civil society, and thinking in the two years before the collapse of communism.

The Dynamics of the Collapse

In the end, the collapse had its own dynamism. A vicious cycle of increasing inevitability was particularly marked in Poland and the Soviet Union. Output did not only stagnate but started declining. Governments were concerned about popular dissatisfaction, which they tried to mitigate by importing consumer goods and raising wages and social benefits, while controlling prices. As a result, foreign debt grew excessive and shortages increased, as did inflation. Extraordinary shortages rendered work both impossible and meaningless, aggravating the fall in output. Obvious mismanagement and a falling standard of living delegitimized the communist regime. The government tried to legitimize itself through democratization, but it was too little too late. Democratic forces gained strength, but barred from government responsibility, they applied populist pressure, demanding the issue of more money, while resisting price increases. Politically, this formula kept a broad democratic front united, but economic crisis spiraled out of control. The economic and political system had entered a tailspin that could only end in a total crash (Åslund 1991).

Meanwhile, the old communist elite reacted in a way that aggravated the crisis. As always, crisis not only implied suffering for most but great opportunities for some. "The greater the economic chaos and confusion, the greater the opportunities for personal enrichment" (Dobbs 1997, p. 368). The late market socialist reforms had allowed some members of the elite to set up their own trading companies, establish their own banks, and pursue private foreign trade. With excessive monetary emission, black or gray market exchange rates plunged. Privileged members of the elite were permitted to buy hard currency at a low official exchange rate and sell it at a free exchange rates, several times higher. As the prices of commodities, notably oil, natural gas, and metals remained fixed in greatly devalued domestic currencies, they became incredibly cheap. The domestic Soviet wholesale price of crude oil fell to less than half a percent of the world market price in 1991, calculated at the free exchange rate. Interest rates stayed low at several percent a year in the Soviet Union, while inflation soared to hundreds of percent a year. Hence, credits from the Central Banks at an interest of several percent a year were not really credits but rather gifts. Primarily young members of the Nomenklatura took advantage of these splendid opportunities to make substantial fortunes in no time (Åslund 1995, 1996).

The political effect of this enrichment was that the communist elite split, as numerous state enterprise managers, party, state, and KGB officials exploited these opportunities. As Michael Dobbs (1997, p. 373) has put it: "There was a *fin de régime* atmosphere in Moscow in the spring of 1991, and bureaucrats were lining up to jump ship before it was too late . . . many members of the elite were now discovering that they could maintain their privileged positions in society even without the ideology." They faced the question: "Why drive a Volga when you could be driving a Mercedes?" The resulting division of the elite probably helps to explain the pathetic nature of the abortive August 1991 coup. Smart Nomenklatura operators already preferred capitalism, and they contributed to the peaceful termination of communism, while the putschists were losers.

Michael Dobbs (1997, p. 440) concurs: "The durability of communism and the speed with which it collapsed were two sides of the same coin. There came a point at which the strengths of the system – massive repression, rigid centralization, an all-embracing ideology, the obsession with military power – turned into fatal weaknesses." Soviet communism proved so petrified that it could not be reformed.

Unfortunately, the coup made rent seekers appear politically progressive in the public mind. The extraordinary economic distortions had bred strong vested interests. State enterprise managers favored a market economy of sorts, but they wanted to reserve this privilege for themselves, favoring regulation for others. This was probably the most important precondition of the transition, but few understood it at the time, and all underestimated the might and tenacity of these vested interests. The winners became so rich that they could buy politics lock, stock, and barrel (Hellman 1998).

A difficult dilemma had arisen. On the one hand, the economic crisis necessitated radical reform. On the other hand, the elite enrichment from the Soviet collapse made it extremely difficult to impose a radical market reform against the wishes of this elite. Moreover, the extraordinary economic distortions made their elimination painfully unpredictable.

That is why prior democratization and the strength of civil society were so important. If by happenstance democratic reformers assumed power early on, they needed to act fast and hard, while their popular mandate was fresh and strong, so they could undertake reforms before the old establishment recovered and undermined their democratic power.

Given these conditions, we would expect the most successful reforms to occur in countries with the strongest democracy and civil society and rather severe but not extraordinary economic crises. Arguably, Poland and Estonia best fit that description. We would generally expect positive results in strong democracies, meaning Central Europe and the Baltics. The worst results, on the contrary, would be expected in countries with a combination of economic stagnation and no democratization.

3

Strategic Policy Choices

The end of communism in Europe was the event of a lifetime. Suddenly some 400 million people in twenty-eight countries had to choose their political and economic systems anew. Where should they begin? What was most important? What was possible? Which discipline was most relevant? What theory should be applied? A frequent point was that no book prescribed how to transit from socialism to capitalism, while hundreds elaborated on the opposite, no longer desired, direction. A popular joke compared the transition from communism to capitalism to making an aquarium out of fish soup.

The discussion became heated because so much was at stake. The fate of a large part of the world was up in the air. Could and should the former Soviet bloc be embraced by the Western world or shunned? What armed conflicts were plausible and could they be avoided? How much more economic and social hardship would people in these countries have to suffer? What ideology would win? All conceivable intellectual issues were at play.

Intellectuals of all disciplines and convictions, governments, and international organizations geared up to answer the many questions. While no clear goal was defined, a strong sense of direction prevailed. The popular battle cry was: "We want a 'normal society'!" By "normal" people in the Soviet bloc meant an ordinary Western society – a democracy with a market economy, predominant private property, and the rule of law. Because all these countries had far to go, the final goal did not appear very relevant at the outset of the march, and any specification of the goal could be politically divisive. Some social support system was considered necessary, but all Western societies have that. In the havoc of a collapsing socialist system, East and Central Europeans cared little whether their final society would be a West European social welfare state or a freer American market economy, both being evidently superior to their socialist ruins. These distinctions were left for later.

For Central Europe, South-East Europe, and the Baltics, the urge for a normal society was complemented by another battlecry, for a "return to Europe," meaning their integration in West European economic and political organizations, notably membership in the European Union, but also in the Council of Europe, North Atlantic Treaty Organization (NATO), and the Organization for Economic Cooperation and Development (OECD).

Many socialist ideas had just died. "Market socialism," workers' self-management or a "third way" between capitalism and Soviet-style socialism were no longer discussed. The central issue was instead the strategy of transition to a market economy. How fast and in what order? The dominant intellectual debate over postcommunist transition was a strife between radical and gradual reformers, while the outright enemies of market reform kept quiet.

Some have subsequently denied this divide. Marie Lavigne (1999, p. 118) argues that it was soon "recognized that stabilization should be conducted swiftly, and that structural reform can only be implemented over years." But this is an after-construction, usually by prior opponents of radical reforms. There was no consensus on anything anywhere. In 1992, a leading Polish communist economist, Pawel Bożyk (1992), published a vitriolic attack on Poland's transition to a market economy and Minister of Finance Leszek Balcerowicz under the expressive title "Who Is Guilty?"[1] The leading Russian reform communists stood by their old beliefs as late as 1996 (Bogomolov 1996). Others obfuscate with technicalities: "the dichotomy between big bang and gradualism is artificial and misleading. In reality, we are dealing with a four-by-four matrix . . ." (Islam 1993, p. 188). Some tasks could not be done very fast, such as privatization and institution building, but the issue was whether the possible reforms should be undertaken as fast as was possible or not. "*Different processes of economic reform have different maximum possible speeds*" (Balcerowicz 1994, p. 82, emphasis in original). Most radical reformers wanted to undertake all important reforms at a maximum pace, while their opponents preferred intentional delays. This was the issue of the debate over radical or gradual reforms.

The purported objective of all reformers was the same, namely to establish a market economy, leading to higher economic efficiency, economic growth, and improving the average standard of living, but other agendas were concealed. The future economic system was one issue, and

[1] Bożyk (1992), who had been the chief economic advisor of the communist leader Edward Gierek, accused Balcerowicz of seven mortal sins, including having pursued fast and radical reforms, being antidemocratic, and having disregarded the high costs of transition. (Gierek's economic mismanagement had prompted the birth of Solidarity.)

it had repercussions for domestic politics in the West. Another was concrete economic interests of various groups in the East. Some people stayed out of the public debate, focusing on making money on the transition, but they turned out to be the main opponents of the radical reformers.

HISTORICAL LEGACIES AND INTELLECTUAL REFERENCES

It was not quite true that no relevant precedents or theories for transition existed. Many historical examples were pertinent and had an impact on the thinking about transition.

For American macroeconomists, the IMF, and the World Bank, the recent Latin American experience of macroeconomic stabilization was of fundamental importance. The lesson was that a radical and comprehensive reform program was the best cure (Bruno et al. 1988). Standard measures were the minimization of the budget deficit, a broadening of the tax base and cutting of top tax rates, a reorientation of public expenditures, a strict monetary policy, the liberalization of prices and foreign trade, deregulation, demonopolization, financial liberalization, the liberalization of foreign direct investment, unification of the exchange rate, the privatization of state enterprises, and the reinforcement of property rights. Democracy had proven beneficial to such reforms, and a social safety net for the poor was desirable. This program had been named the "Washington Consensus" by John Williamson (1990, 1993). Latin America also showed the danger of economic populism (Dornbusch and Edwards 1991).

A pertinent historical precedent had occurred after World War I, when most of Central Europe went through hyperinflation after the dismembering of the Hapsburg Empire. Only Czechoslovakia escaped the havoc, because it swiftly established its own currency and central bank. The others kept the old Hapsburg currency, although no single currency authority prevailed, and plunged into hyperinflation. Eventually, they achieved financial stability by launching their own currencies and independent central banks, with international financial assistance through the League of Nations. One lesson was that a swift breaking up of a common currency zone and strict macroeconomic policy are the best economic cure to the demise of a monetary union. Another was that international financial support is vital at the creation of new currencies, and a third that independent central banks help provide stable currencies. This case also drew attention to the threat of dictatorship after hyperinflation. Only Czechoslovakia remained democratic throughout the interwar period (Sargent 1986; Dornbusch 1992).

Europeans drew on experiences after World War II, when Europe had moved gradually from a highly regulated war economy to a social market economy. In particular, the transformation of the Nazi German command economy seemed relevant. Prominent conclusions were that reforms should be slow and that the state should play a major role in the economy. The confiscatory German currency reform of 1948 was suggested as a model for the former Soviet Union. The European Payment Union, which had successfully existed in Europe from 1950 to 1958, implied that early full convertibility was not needed (ECE 1990; van Brabant 1991; Eichengreen 1993). However, these events were not necessarily well interpreted. In the early 1950s, public finances were very limited in Western Europe. West German Minister of Economics Ludwig Erhard (1957) was no gradualist, but he undertook a drastic price liberalization, which he concealed under the slogan of a "social market economy." There was no consensus in postwar Germany. The Social Democrats advocated a planned economy until 1959, bitterly opposing Erhard's liberal market economy, which they almost defeated in early elections (Hansson 1990). The Marshall Plan was much talked about and many proposed a repetition for the post-Soviet world, but the parallels were not very poignant. The Marshall Plan had cost the United States 2 percent of its GDP a year, which would have corresponded to $125 billion in 1992. Nobody was prepared to put up that kind of money. The Plan had been highly interventionist and drew on strong West European institutions (see e.g., Eichengreen and Uzan 1992; Kostrzewa, Nunnenkamp, and Schmieding 1989).

The Great Depression is generally perceived as the worst crisis of capitalism, rendering it an odd reference at the collapse of communism. Yet, many drew parallels to the collapse in output and the rise in unemployment from 1929 to 1933 and the ensuing rise of fascism in several European countries. This parallel was particularly popular among political scientists (Przeworski 1991), as well as among left-wing economists. The upshot was that large fiscal deficits and monetary expansion were needed to stop sharp falls in output and large rises in unemployment.

When communism collapsed, East Asia stood out as a shining economic success. The East Asian model was primarily invoked by Western leftists, Russian red directors, and the Central Asian Nomenklatura (Parkhomenko 1992; Amsden, Kochanowicz, and Taylor 1994; Nolan 1995). They suggested that the state should pursue an activist industrial policy, that reforms should be gradual, and that an enlightened dictatorship was better than democracy. More liberal conclusions from China were that it was better to start with agricultural reforms and the development of small enterprises than focus on the privatization of large industrial enterprises (Goldman 1996). The idea that East Asia had benefited from free trade and very small public sectors was also put forward, but it failed to catch on (Sachs and Woo 1994).

Russian economists tended to focus on their own history because of prior restrictions on their learning of economics or of other countries. Many invoked Lenin's New Economic Policy (NEP) in the 1920s. A common idea was that high inflation was best handled by repeating the Soviet currency reform of the early 1920s and introducing a second, parallel currency, leaving aside the need to cut the budget deficit and public expenditures (Kazmin and Tsimailo 1991). Another idea was that privatization of large industrial enterprises was not necessary. A third was that gradual and partial reforms are desirable (Bogomolov 1993).

An obvious analogy was Europe in the 1840s, but that was largely left for historians, as few social scientists involved knew much about it. Ralf Dahrendorf (1990) and Timothy Garton Ash (1990) reckoned that the Central European revolutions of 1989 most resembled the European revolutions of 1848. In many ways, the late Communist society was reminiscent of feudal society, with its hierarchic rule and delegation of partial property rights to vassals, with detailed regulation but no rule of law. The natural response in both cases was a demand for as far-reaching liberalization as occurred in the 1840s (Åslund 1992). However, this argument did not catch on, as few decision makers had insight into that historical situation.

In the early 1990s, any comparison with Africa would have been perceived as a deadly insult. Later on, however, as disillusion spread about the predicament of the postcommunist states, parallels were drawn with bureaucratic state socialism in postcolonial Africa, as the pervasive and dysfunctional corruption of post-Soviet states appeared akin to that of African nations (Shleifer and Vishny 1993). The problems of rent seeking by a small, unconstrained, and ruthless elite were similar too (Collier and Gunning 1999). Toward the end of the 1990s, some talked of African failed states as a potential pitfall for some post-Soviet states, notably Tajikistan.

Privatization of public enterprises was a novelty that had been introduced by British Prime Minister Margaret Thatcher after her election in 1979. Her case-by-case privatization through public offerings had set the standard for the privatization of large enterprises. UK-based investment bankers, auditors, and consultants had learned it, and they preached it to the rest of the world, with little regard to differences between postcommunist countries and the United Kingdom.

Perspectives and preconditions varied. Foreign scholars often knew little of the local situation, but many had a grasp of relevant social sciences and international analogies. Local analysts tended to have a better understanding of relevant forces and interests, but most disregarded or misunderstood social theory and international parallels. Curiously, the universality of economic laws was more easily comprehended than the general applicability of political theories.

Whenever countries and cultures are involved, a variety of theories inspired by the prewar German historical school or national mysticism enter the stage. We are told that certain nations are just like that and can never change, and this idea is particularly popular about Russia.[2] Fortunately, these factors can be studied with modern regression analysis. While culture, history, and religion may have some impact, multicountry growth regressions make evident that their contributions are minor in comparison with economic policy, technology, investment, and geography (Sala-i-Martin 1997). Since virtually all reasonably developed nations already have changed fundamentally and repeatedly, any idea that such a nation cannot change may be rejected as national mysticism. More often than not, culture, history, and religion are brought up as substitutes for solid analysis (cf. Mau 1999).

On the whole, radical reformers focused on recent macroeconomic stabilization and structural reforms in Latin America, but also eyed Central Europe in the interwar period. Their conclusion was that as many reforms as possible should be undertaken when just possible, and liberalization and stabilization had to lead. Gradualists emphasized the Chinese reforms, the lessons of the Great Depression, and the postwar experiences of Western Europe. They favored slow liberalization, gradual macroeconomic stabilization, limited privatization, and a large role for the state, including industrial policy. Strangely, the Central European revolution of 1989 forged a brief, broad consensus in the West that a swift and comprehensive transition to full democracy and market economy was the best approach, but this view was soon attacked from different angles, and it was never widely accepted for Russia.

The worse the economic situation, the harder the resistance of vested interests, benefiting from rents caused by economic distortions, and the public understanding of economics tended to be worse. Yet, the deeper the systemic crisis, the more radical the influential economic thinkers.

[2] For an extreme case of historical determinism applied to Russia, see Gerner et al. (1995, pp. 137): "That Russia stood outside renaissance, reformation, and enlightenment is manifested clearly in its linguistic development: the Russian language never faced the task of developing words and concepts to describe the functions of democracy and market economy. . . . To borrow the *words* from the English market economic vocabulary as is now the case does not help much in this regard. How could Japan ever make it? The same authors conclude: "The absence of purgatory in the orthodox tradition means that it has no room for compromises" (Gerner et al. 1995, p. 111).

Thus, the least radical thinking evolved in Hungary, as little crisis was in evidence. In Poland and the Czech Republic, the leading economic reformers Leszek Balcerowicz and Václav Klaus considered themselves Hayekians, but their actual policy choices barely went beyond the social democratic domain.[3] In Estonia and Latvia, economic crisis was rampant, and the leading economic thinkers were radical free marketeers in both ideas and practice.

By this logic, the most radical liberal thinking evolved in Moscow and particularly in St. Petersburg. Arguably the most radical liberal to be taken seriously in Europe was the Moscow economist Vitaly Naishul (1994), who argued for the limitation of the state to the protection of private property rights and contract rights, while practically all public goods, including education, medical services, and even the monetary system, could be privatized. Naishul wanted to minimize public expenditures to 2 percent of GDP.[4] In practice, the most radical solutions were sought in Estonia and in Georgia, after it had been devastated by civil war (Wellisz 1996). In the same way as the classical liberals in the nineteenth century reacted against the corrupt dysfunctional feudal state by demanding laissez-faire, these avantgardist post-Soviet economic thinkers wanted to minimize the state so that it could at least carry out its key functions, law and order.

THE RADICAL REFORM PROGRAM

The radical reform program was proposed by three powerful groups. One group consisted of leading mainstream Western, primarily American, economists, such as Jeffrey Sachs, Stanley Fischer, Lawrence Summers, Michael Bruno, Andrei Shleifer, and David Lipton. Harvard University, MIT, and the London School of Economics were focal points of radical reform thinking. Another important group was the best economists in the East, notably János Kornai in Hungary, Leszek Balcerowicz in Poland, Václav Klaus in Czechoslovakia, and Yegor Gaidar in Russia. They were few but bright, and they knew what they wanted. They were later joined by politicians with economic insights, such as Mart Laar in Estonia and Einars Repše in Latvia. The third group supporting radical reform was the international financial institutions, primarily the IMF and the World Bank, and the major Western governments, primarily their Ministries of Finance and Central Banks.

[3] For instance, Balcerowicz accepted huge increases in social expenditures, notably pensions, in 1990, and Klaus long resisted both effective bankruptcy and unemployment.

[4] Other very liberal Russian economists of great influence were Sergei Vasiliev (1999) and Andrei Illarionov, both from St. Petersburg, and a host of economists around Yegor Gaidar and Anatoly Chubais.

The Essence of the Radical Program

The most explicit early propagators of radical, comprehensive reform were Leszek Balcerowicz, Jeffrey Sachs, and David Lipton.[5] They focused on Poland, but their prescriptions applied for other countries in similar predicaments (Sachs and Lipton 1990):

- The immediate concern was to halt hyperinflation, which required elimination of a large budget deficit. Therefore, fiscal policy had to be centralized and brought under control by a reinforced Ministry of Finance.
- For the same reason, monetary policies must be tightened, and positive real interest rates were necessary. The Central Bank had to become independent and focus on low inflation.
- Prices had to be deregulated and price subsidies eliminated to let demand and supply determine prices.
- Domestic trade should be liberalized and monopolies broken up to avoid monopolistic pricing.
- The exchange rate had to be unified and the currency needed to be convertible on current account to be freely available for foreign trade.
- A regime of free foreign trade should be established, eliminating rents in both exports and imports. A realistic price structure would be imported. Free trade would alleviate the rampant shortages, facilitate production, and boost living standards.
- Restrictions on the private sector should be abolished, and new private entrepreneurs should be offered a maximum of freedom.
- Small-scale privatization should be initiated early on.
- The privatization of large and medium-sized enterprises should be started as soon as possible, but it would take time.
- The ardors of restructuring required the introduction of a social safety net targeted to new groups in need, especially the unemployed, and a reinforcement of pensions.

Western key government functions, notably centralized fiscal and monetary control, did not exist. Therefore, radical reformers wanted to minimize the role of the old state apparatus, eliminating its harmful parts, while building a new democratic government. Any social engineering was out of the question. Jeffrey Sachs (1994, p. 510) summarized the radicals' view of the state in transition:

[5] See Balcerowicz (1992, 1994, and 1995), Lipton and Sachs (1990a), Sachs and Lipton (1990) and Sachs (1990, 1991, and 1993a).

A government facing political and economic collapse (the case at hand) must give up responsibility for market prices in order to focus on the core functions of government that are not being met: law and order, public security, a stable monetary system, and basic social welfare. Governments that have reached hyperinflation cannot, *self-evidently*, be expected to develop complex industrial policies or structural policies. After all, they aren't even carrying out their most fundamental tasks.

Virtually everybody acknowledged that the state would have an important role to play, but it would be very different. Many state functions had to be strengthened, notably the rule of law, the registration and defense of private property rights, the fiscal system, central banking, banking and financial markets regulation, and targeted social support. Radical reformers supported unemployment insurance, as they aspired to stimulate and facilitate structural change (Fischer and Gelb 1991). The later so frequent accusations that radical reformers had "forgotten" about institutions and social policy have no base in reality. Indeed, the successful radical reformers have undertaken the greatest institutional reforms and spent greatly on social assistance.

On all these measures, the radical reformers agreed, while their views varied on some other measures:

- Poland, Czechoslovakia, and Estonia pegged exchange rates early on as nominal anchors for their financial stabilization, while others opted for floating exchange rates.
- Poland and Czechoslovakia introduced strict wage controls as an important part of their initial stabilization policy, while others had little wage control.
- The role and size of international financial assistance and debt relief varied, with Jeffrey Sachs taking an international lead as a proponent of aid, while others opposed nearly all financial support.
- There were as many views on privatization as there were economists, though the radical reformers considered speedy privatization important.

Still, most of these differences seemed to be more of a technical than ideological nature. The proponents of radical reform broadly agreed on the essence of reforms.

The Need for Speed and Comprehensiveness

The radical reformers were anxious that all these major reforms be undertaken comprehensively and swiftly for many reasons (Åslund 1992, pp. 29–34). Liberal economists in the Soviet bloc had bitter experiences of failed and reversed reforms (Kornai 1990; Winiecki 1991a). They concluded "that the economic reforms failed because they were not radical enough, that is, they did not reach a certain threshold of necessary changes rapidly" or a "critical mass" of market reforms (Balcerowicz 1995, pp. 341–2).

The system must achieve a certain degree of cohesion and consistency. Otherwise, it could theoretically be even more inefficient than the old command economy. By necessity, a new market would be imperfect, but the communist state was even more imperfect, so it could not be entrusted with much intervention. The reforms had to be radical, comprehensive, and fast to break the hold of the old system and introduce a viable new market economy. The very importance of the shock was emphasized from the outset (Gomułka 1989).

People's expectations had to be changed to render the systemic changes credible and irreversible. Balcerowicz (1995, p. 342) derived from Leon Festinger's theory of cognitive dissonance in social psychology "that people are more likely to change their attitudes and their behaviour if they are faced with radical changes in their environment, which they consider irreversible, than if those changes are only gradual." Otherwise, people would suspect a rollback toward communism, refusing to adjust their behavior, which meant abandoning a certain organizational capital and investing in new organizational capital.

This was a time of epochal change with a general sense of deep crisis breeding idealism. The public was prepared to make short-term sacrifices for long-term benefits of society. Radical economic reforms were popular in several countries. Balcerowicz (1994) emphasized the importance of utilizing this period of "extraordinary politics" to get a full package of reform laws adopted by Parliament. If the government failed to deliver sufficient change fast, people would be disappointed. It was preferable to hold new parliamentary elections early after full democratization, so Parliament would reflect the views of democratic society and not those of the prior communist dictatorship.

A quick systemic change also transforms the intellectual paradigm. In countries with a strong tradition of intellectual dissent, such as Poland, Hungary, and Russia, reform communists and professors of the political economy of socialism represented a serious impediment to a real market economy. These socialist holdovers were largely ignorant of market economics, but they enjoyed some public authority and wanted to stay prominent. Poland and Hungary overcame this hurdle through comprehensive reforms and an intense public discussion that changed the intellectual paradigm. In Russia, however, much slower reforms kept bizarre economic ideas alive.

Macroeconomic stabilization was least controversial among leading macroeconomists, broadly favoring a comprehensive package of swift and radical measures that would generate credibility and break inflationary expectations. To minimize the budget deficit, it was necessary to cut a few major budget expenditures drastically. The obvious choices were price and enterprise subsidies, which required price liberalization.

Liberalization of prices and trade had to go far enough. Since the old prices were hopelessly distorted, any gradual adjustment would make prices send inaccurate signals about costs, demand, and supply. The profitability of an enterprise would be determined by price regulations, which would make bankruptcies socially unacceptable and maintain inflationary expectations. Then, entrepreneurs would be unwilling to invest. As the domestic market was monopolistic, competition from abroad was vital to activate the market. Shortages had to be ended, and the best means available was free imports, which would both provide for consumer satisfaction and do away with production bottlenecks. Only imports could set decent quality standards instantly. Because of a new cost structure, exports had to be restructured, and only enterprise managers with the right incentives and prices as well as freedom could figure out what to export (Sachs and Lipton 1990).

The hardest task was to correct the incentives of enterprise managers. To become capitalist enterprises, firms had to face hard budget constraints or a "demand barrier," and the managers had to be convinced of their tenacity. Otherwise they would not adjust (Sachs and Lipton 1990). This was difficult. Enterprises used their newly won freedom to raise prices more than costs with little concern for unsold surplus stocks. When they ran out of money, they just did not pay state banks, taxes, other enterprises, and their employees, since the threat of bankruptcy appeared unlikely, especially as state enterprise directors agitated against radical reform and reform governments.

An important reason for radical reform was that corruption, misappropriation of public funds, and rent seeking were ballooning amid the breakdown of communism, and only a swift and comprehensive reform could mitigate this parasitism. Partial liberalization, on the contrary, facilitated arbitrage by the privileged between regulated prices and free prices. With the demise of the secret police and the control organs of the Communist Party, nobody checked the patent bribery of state officials. Even regulations that are standard in many Western countries were exploited for rent seeking.[6]

[6] In Ukraine in 1996, I learned that the environmental inspectorate was considered one of the most lucrative generators of bribes because of severe environmental standards that could not possibly be imposed. Therefore, there was severe competition for its top positions.

Extremely little accurate information was available during the early transition, as everything was changing fast and radically. The first new statistics were often completely wrong. If little could be measured and few relevant facts could be established, it would have been pretentious to attempt anything but a rather basic policy (Balcerowicz 1995).

Finally, the state bureaucracy had all reasons to oppose a radical reform program. It would lose its prior power, and most of its human capital would become obsolete, as the old methods of a socialist command economy with uneconomic micromanagement of enterprises would become superfluous. Bureaucrats easily colluded with abundant secret service and military officers as well as state enterprise managers and Communist Party officials. "Populist politicians will try to hook up with coalitions of workers, managers and bureaucrats in hard-hit sectors to slow or reverse the adjustment . . ." (Sachs 1990). The danger of a bureaucratic counterrevolution was apparent, if bureaucrats were not disarmed through radical reform, vital also for the sustenance of democracy. For all these reasons, radical reformers were convinced that a radical and comprehensive reform would cause the least social costs while the economic upswing would be earlier and sharper.

Many economists simultaneously presented similar ideas about the need for radical economic reform.[7] The intellectual development in the East was very sudden. Even the most radical reformers in the Soviet bloc did not think of a full-fledged market economic transformation as a real possibility until the late 1980s. The breakthrough occurred in Moscow in early 1987, as the literary journal *Novy mir* published a couple of articles with devastating criticism of the Soviet economic system (Selyunin and Khanin 1987; Shmelev 1987). The first truly market economic program even proposing large-scale privatization was presented in Poland in 1988 (Dąbrowski et al. 1989). In the West, similar ideas were predominant, and they coincided with the "Washington Consensus."

The protagonists of a radical reform had a clear understanding that many measures could not be undertaken instantly and that transition would take at least a decade (notably Fischer and Gelb 1991). Everybody realized that privatization of large enterprises and land reform would take years. The same was true of any complex reform ranging from tax reform, social reforms, civil service reform, and legal reforms to the development of a financial sector.

[7] Notably Blanchard et al. (1991); Boycko (1991); Brada (1993); Fischer and Gelb (1991); Kornai (1990); and World Bank (1996a). My own contribution to this discussion is Åslund (1992).

The Case for Large-Scale International Assistance

Many proposed foreign assistance, but the proposal of early large-scale international assistance was primarily connected with the radical reform program, with Jeffrey Sachs as the leading advocate (Lipton and Sachs 1990a; Sachs 1993a, 1994).

Sachs emphasized that foreign assistance could be useful only if a country made serious attempts at economic reform: "Of course, foreign aid is not the main factor in economic success. The reforms themselves are the key. My argument is that foreign aid is critical to helping the reforms themselves take hold" (Sachs 1994, p. 504). Most of these countries started from a position of depleted international reserves, excessive debt service, and, in the case of Poland and Bulgaria, excessive foreign debt. To give financial stabilization a chance, a country needed replenishment of its reserves and possibly some international assistance with its foreign debt service. Sachs (1994, p. 504) argued: "The market cannot do it all by itself; international help is critical."

Sachs's advocacy (1994, p. 504) was not only economic but also political: "Aid is crucial because reforms are inherently very fragile at the outset. There is typically little consensus on what should be done, pessimism is rife, and the reformers' hold on power and on policy is tenuous." He refuted the idea that reformers succeed by constructing a "social consensus" and he underlined the degree of confusion, anxiety, and conflicting opinions at the time of any major reform. In Poland in 1989, as in Germany in 1948, there was no consensus, and consensus was no precondition of successful reform. On the contrary, it arose out of successful reforms. Similarly, Andrei Shleifer and Robert Vishny (1998, p. 13) argued: "Foreign aid, if used politically, can come to the aid of these reformers, and offer them resources that help them to stay in power and pursue their goals."

These ideas never became a Western consensus but remained controversial. Some free marketeers opposed government assistance in principle, while others, including the IMF and the leading Western governments, insisted that a country had to prove itself first.

GRADUAL REFORM PROGRAMS

While we can single out one school of radical reform, there was no dominant school of gradual reform. Nor did a full conceptualization of a gradual reform exist. Instead, proponents of gradual reform tended to oppose radical reformers on one or several points, but rarely on all, and many would object to be labeled "gradual reformers." In 1990, the discussion was dominated by contrasts between the just-launched reforms in Poland and Hungary. Gradualists defended the Hungarian methods against the Polish shock therapy, but they did so for the whole region with little regard for diverse preconditions.

The fundamental difference between gradualists and radical reformers was their view of market failure and state failure. First, gradualists thought the old communist economy and state more viable than radical reformers did. Second, they downplayed the economic crisis after communism, looking at Hungary rather than the Soviet Union. Third, gradualists could not believe that the communist state was highly corrupt or even kleptocratic. They were more concerned about failures of the new market economy, such as possible monopoly effects, wanting the state to do more and retaining a strong belief in social engineering. Fourth, while radical reformers considered the transition a risky task that could fail, gradualists tended to take for granted the success of the market economy, daring to suggest a detailed optimal sequencing of reform measures. As a consequence, gradualists wanted to impede the stampeding transition process, while radical reformers feared it would be stalled and wanted to speed it up. Fifth, the radical reformers saw a systemic lack of supply as the prime problem, while gradualists focused on demand management. The overt disputes were limited to the speed and order of reforms, while hardly anybody defended a larger public sector than in Western Europe in the early transition debate, not even Amsden et al. (1994). In reality, however, many gradualists retained more socialist views than they wanted to concede at the moment of liberal triumph.

It is difficult to classify the gradualists. The following discussion is structured by the main ideas of each group, attempting to show how varied the gradualists actually were. The gradualist groups are most easily categorized on a scale from the left to more technocratic arguments. We shall discuss the gradualists in four broad categories.

The first group opposed a normal market economy but did not want the old system. The most ardent critics of radical reform were the reformist part of the old Soviet establishment, especially the old reform communist economists. Behind them lingered the politically most influential group, which consisted of rent-seeking state enterprise managers and Soviet officials, who benefited from the inconsistencies of the transitional system and wanted to perpetuate them. Strangely, late naïve Soviet reformers ended up with similar positions as a legacy of confused thinking from the Soviet pretransition reform debate.

A second group consisted of leftwing economists, who accepted a market economy but tried to develop a full-fledged alternative program of gradual economic reforms. They were generally skeptical of a free market economy and wanted as much socialism as possible, while accepting democracy and a market economy. Their alternative tended to become less socialist over time. These ideas were broadly representative of the opposition to radical reform in Central Europe, which was much more economically enlightened than the opposition in the FSU. A broad group of gradualists saw the successful Chinese reforms as an alternative for the former Soviet bloc. Social democratic political scientists opposed radical reforms, arguing that such reforms would jeopardize democracy.

A third group encompassed economists who were more theoretical than political. A big theoretical literature of political economy was based on assumptions that radical reform was more socially costly than gradual reforms. Therefore, reform had to be mitigated to become politically possible, and tradeoffs between reform and social costs were inevitable. Some mainstream economists were afraid of excessive shocks from macroeconomic stabilization, liberalization, or privatization. Others labeled themselves institutional economists and opposed the introduction of market economy until most institutional reforms had been undertaken. Later on, the strongest argument for a gradual approach became that the immediate aftermath of transition was characterized by "disorganization."

Late in the day, Joseph Stiglitz presented a revisionism that was clearly leftwing, drawing on all kinds of gradualist arguments.

The Opposition of the Reformist Soviet Establishment

The starkest antireform opposition came from the old Soviet establishment in Russia, but it resonated throughout the FSU. In Central Europe, this criticism found little fertile ground because economics was too well known.

As soon as President Boris Yeltsin and his Deputy Prime Minister Yegor Gaidar presented their idea of radical economic reform in late 1991, reform communists started attacking it viciously with a mixture of vulgar Marxism, populism, and vested interests. Their purported preference was a more socialist market economy. The Department of Economics of the Russian Academy of Sciences, the most prominent Soviet economists, led the offensive, but behind them stood state enterprise managers and bankers, well organized in the Russian Union of Industrialists and Entrepreneurs and the Russian Association of Banks.

The old reform communists regarded production and investment as important, unlike finance, money, and inflation. They saw money as a free utility and ignored the budget balance, while they considered the sharp fall in output the cause of inflation. Therefore, they wanted to issue more money to support production. According to the antireformist chairman of the Central Bank of Russia, Viktor Gerashchenko (1992), the money supply should rise with the price level: "Could the economy manage with the former money supply when the prices were rising. . . . were the previous monetary resources really sufficient to exist at the present price level, when the wholesale prices have risen 16–18 times? According to my view, they were inadequate. That is the cause of the insolvency crisis."

Several prominent Soviet economists insisted: "Financial stabilization cannot precede the stabilization of production. . . . As long as the fall of production does not turn into sustained growth, it is necessary to abandon any attempt at forming a state budget without deficit. When the volume of production in a country is falling, a budget without a deficit can only be accomplished at the price of hyperinflation . . . there are no state budgets without deficits even in well-to-do countries with market economies" (Fedorenko et al. 1992). It was both wrong and impossible to eliminate the budget deficit: "the budget deficit cannot be diminished by tax increases. Their rise will lead to price hikes and the reduction of production and tax evasion . . ." (Abalkin 1992).

An additional argument was that inflation was structural and not monetary: "Liberalization of prices on energy will indisputably lead the economy to open hyperinflation." The government faced the choice "either to abandon strict monetary policy and satisfy the demand for money to preserve production or to allow mass bankruptcy of commercial banks and completely disorganize monetary circulation" (Yaremenko et al. 1992). At that time, commercial banks were making more money than ever before or after, while high inflation was disorganizing the payment system (Johnson 2000).

These Soviet market socialists considered the deregulation of prices and trade simplistic and unprofessional. Although they acknowledged the need for a market, the state had to build it, and it would be wrong to assume that the market would develop spontaneously. They did not think of legislation and institutions but something they called "market infrastructure," by which they meant trading enterprises and their technology. "Only under the conditions of sufficiently strong state regulation can the transition to the market take place; the most important part of this transition must be a state program for the establishment of a market infrastructure" (Petrakov et al. 1992). Russian Vice President Aleksandr Rutskoi (1992) could not imagine the absence of price controls: "The liberalization of prices without the existence of a civilized market requires strict price control. . . . In all civilized countries such strict controls exist." With their limited belief in the market, these critics did not think liberalization would abolish shortages. "I suppose that we should not place great hope in the abolition of the multiple shortages and the appearance in the shops of an abundance of goods" (Bogomolov 1992). The state, on the contrary, was considered omnipotent in spite of its rampant crisis, and the issue was only political will. "Is the state really not able to establish control over the prices of monopolized production? Of course it can, if it wants to" (Rutskoi 1992). While the reformers aspired to restructuring of Soviet-era production, their opponents saw this as a tragedy, desiring the full utilization of the old production capacity.

Sequencing was a major concern. While the Soviet establishment opposed the privatization of large and medium-sized enterprises until 1991, they all of the sudden joïned extreme liberals, arguing that privatization should have been done first. As one old Soviet academician put it: "And why was it not possible to start with a fast privatization and the breaking up of monopolies already [in October 1991]" (Arbatov 1992). An opposition consensus developed that privatization had to be undertaken before price liberalization. Soon, however, after the Russian government had undertaken a stunningly fast privatization, the same people complained that privatization had been too fast (Russian Academy of Sciences 1994).

These Soviet economists disregarded ordinary economic theory, of which they were largely ignorant. Instead, they referred to Franklin Roosevelt's New Deal and China's economic reforms to defend their international credentials. Their ultimate feat was when five American Nobel Prize laureates in economics joined the whole Soviet economic establishment in what was effectively a campaign effort for the communist presidential candidate Gennady Zyuganov in 1996.[8] Commonly agreed demands were a higher progressive income tax (then 35%, which could not be collected), selective wage and price controls, a development bank offering long-term credits for priority production, higher protective customs tariffs and industrial policy, including government subsidies and credits. Their key request was "the necessity to reinforce the role of the government in the process of transformation," while the malfunctioning of the state was ignored. Instead, corruption was presented as a consequence of privatization: "To a considerable extent, privatization, which goes together with the spreading corruption, lowers the existing level of welfare and leads to the impoverishment of most of the population." (Bogomolov 1996, pp. 17–21). One of the leading communist economists, academician Dmitri S. Lvov (1996, p. 181–2), insisted that inflation stimulated production:

[8] The five Nobel Prize winners were: Kenneth Arrow, Lawrence Klein, Vassily Leontieff, Douglass North, and James Tobin. They were joined by John Kenneth Galbraith and Marshall Goldman (Bogomolov 1996, pp. 21–3). Their joint declaration in apparent support of Zyuganov was published in *Nezavisimaya gazeta*, July 1, 1996, just before the presidential elections (Mau 1999).

Macroeconomic calculations show that a reduction of inflation by one percent results in a fall of output of three–five percent. . . . to "cut" inflation from 10 percent a month to zero, it is necessary to reduce production almost to zero. But if we agree to increase inflation to, for instance, 15 percent a month, it is possible, as these calculations evidence, to reach a production level 70 percent of the level of 1991.

Academician Leonid Abalkin (1996, p. 139), the highly respected director of the Institute of Economics of the Russian Academy of Sciences, lamented that the government had cut the budget "artificially," by systematically not paying for primarily military procurement and agricultural subsidies. What cuts could be more socially justified? The communists' young whiz kid, Sergei Glaziev (1996, pp. 245, 251), focused on foreign trade, regretting that its gradual liberalization had not been even slower and arguing that domestic prices were approaching world prices too fast. He also advocated higher export tariffs, state subsidies to the export industry, and more protectionism. These were major causes of corruption in Russia, but Glaziev avoided that theme.

The reform communists' fundamental point was that Russia was unique. "Our situation is special. It cannot be described by general rules" (Petrakov et al. 1992). "The economic reforms must not be based on abstract and extremely simplified models, but on decisions derived from real life, on considerations of the real situation in the economy, the population of the country, and the experiences of the whole political and socioeconomic history of Russia" (Khasbulatov 1992). The idea of the need for a unique national model was even stronger in Ukraine.

Many Western critics of Russian reformers have complained about their unwillingness to listen to the old wise academicians, but those critics cannot have spent much time reading these academicians. Although Soviet economists and populist politicians took the public lead in the Russian debate, the ultimate beneficiaries of their arguments were the state enterprise managers. They abstained from acrimonious criticism, while cautioning that government policy should be "pragmatic." They called for "common sense," "consensus," and "moderation," which all meant minimal and slow reforms, while they did not desire to return to the Soviet system (Parkhomenko 1992).

Many more sophisticated arguments were made against radical reform, but this was the gist of the public debate in the CIS countries in 1992 and 1993.

Grigori Yavlinsky and the Soviet 500-Day Program

In February 1990, three young Russian economists, Grigori Yavlinsky, Mikhail Zadornov, and Aleksei Mikhailov, composed the so-called 400-day program, calling for a transition to a market economy within 400 days. Its salient features were rapid mass privatization through sales, fiscal stabilization through higher state revenues, and a swift yet gradual price liberalization. The authors acknowledged that they were inspired by the radical reforms in Poland: "The time for gradual transformations has been missed, and the ineffectiveness of partial reforms has been proven by the experiences of Hungary, Yugoslavia, Poland, and China" (*Delovoi mir*, July 31, 1990).

This program was transformed into a "500-day program" in the summer of 1990, when it became the center of the Soviet economic debate. A broad group of leading young and old Soviet economists were given a mandate by Soviet President Mikhail Gorbachev and Russian President Boris Yeltsin to elaborate upon it in August 1990. The group produced a substantial book within a month (*Perekhod* 1990). Politically, this program was a breakthrough, and the word "socialism" was amazingly not even mentioned. The 500-day program was too radical for President Gorbachev, and in October he buried it forever.

Economically, the program broke new ground, but it was written in haste in the early transition and it left three cumbersome legacies. First, it insisted that privatization should be undertaken fast but before price liberalization, which has not been done anywhere. Yet, the informed Soviet public concluded that it was unprofessional to liberalize prices before privatization. Second, it advocated sales over giveaway schemes. Third, although advocating fast price liberalization, the 500-day program wanted it to be gradual, as all preceding Soviet reform programs. These three legacies influenced the ensuing Russian debate and ironically rendered the once radical 500-day program a bulwark against radical reform.

One consequence was that the partially liberal Yabloko party, headed by Grigory Yavlinsky, became gradualist. Yavlinsky's personal stands in the early 1990s varied greatly, reflecting the confusion in the twilight of the Soviet Union. After the 500-day program, in 1991 he was the Russian leader of the Grand Bargain proposal, which advocated a truly big bang with a far-reaching price and trade liberalization as well as a swift macroeconomic stabilization (Allison and Yavlinsky 1991). Alas, in late 1991 Yavlinsky worked with Soviet President Gorbachev, attempting to salvage the Soviet Union through the Economic Union Treaty, and Russian President Yeltsin chose Yavlinsky's rival Yegor Gaidar as his chief economist. Then Yavlinsky's position appears to have been defined by his personal opposition to Gaidar for years, turning him into a vitriolic government critic, combining liberal and antiliberal arguments in a not very comprehensible fashion. More often than not, his position coincided with the Soviet academicians cited above.

His article with Serguey Braguinsky (1994) written in fall 1993 reflects his possibly most leftwing position. Yavlinsky accused the Russian reform government of having pursued "shock therapy" and laissez-faire, but his arguments contradicted his thesis: "The failure of shock therapy is most striking in its total inability to attain the goals of curing and cutting the budget deficit . . ." (p. 90). If the budget deficit had not even been cut, no shock therapy had occurred. Similarly, he makes clear that too little deregulation occurred: "Those regulations are entrenched in economic practice precisely because the government tries to disengage itself from economic regulation . . ." (p. 90).

The lesson to Yavlinsky, however, was "that it is *impossible to attain macroeconomic stabilization prior to institutional, structural, and other real adjustment*" (emphasis in original, p. 98). He presented the Russian government as a hostage to economic pressures, having "to compensate the suppliers of final demand items and military factories for their losses" (p. 91), while ignoring that the reformers faced virulent opposition from the majority of the semidemocratic parliament as well as Yavlinsky. Rather than starting with liberalization and macroeconomic stabilization, Yavlinsky agreed with the communists: "Economic growth must be ensured in order to stabilize the financial system of the country and its currency. . . . The effort to control inflation by controlling the budget deficit and money supply should be exactly reversed. . . . Economic growth . . . should be attained, which alone can help the economy grow out of various hysterisis effects and root out the basic causes of inflation" (p. 109).

His solution was selective government and international financing of prospective enterprises through a "network of government and private long-term financial institutions, acting with government support . . ." (p. 110). The model was Japan's MITI. Conversely, for foreign trade Yavlinsky advocated "a strategy of strengthening the competitiveness of national industry, including export and import subsidies where necessary" (pp. 112–13). With regard to other CIS countries, Yavlinsky reckoned: "The introduction of soft passive local currencies is self-defeating" (p. 113), although all CIS countries had already introduced their own currencies at this stage.

Yavlinsky's belief in the strength and honesty of the post-Soviet state is amazing. As it was impossible to reduce inflation in Russia by ordinary macroeconomic stabilization before technical demonopolization, he insisted that inflation had to stay first 10 percent a month and, later, 100 percent a year. In substance, Yavlinsky's policy prescriptions in 1993 almost coincided with those of the reform communists and the red directors, and he reflected a broad nonsocialist opinion, which was still captured in vulgar Marxism. Similar thinking also prevailed in the other

FSRs. That even "liberal" economists embraced such views showed the paucity of public economic thinking in the CIS countries just after communism.

Leftwing Opposition to Standard Macroeconomic Stabilization

The debate in Central Europe was much more connected with the Western debate. One of the few Western institutions that attempted an all-out attack on radical reform and tried to formulate a program of gradual reform was the Vienna Institute for Comparative Economic Studies (WIIW 1993), which was dominated by Central European émigrés of reform communist orientation. Its tone was quite positive on the socialist economies, but, like other opponents, it softened its resistance to radical reform in the early 1990s.

The WIIW focused on opposition to standard IMF stabilization programs, drawing on Lance Taylor's ideas of structural, rather than monetary, causes of inflation. Taylor argued that the monopoly power of state enterprises had boosted prices more than anticipated, and the devaluations had encouraged all sellers to raise their own prices in line with an exchange rate hike (Taylor 1994; Amsden et al. 1994, p. 35). The WIIW added Keynesian ideas that restrictive fiscal and monetary policies prompted excessive declines in output and employment, arguing that the combination of administrative prices of basic services, energy and transport, higher import prices, and declining labor productivity had caused a strong cost-push inflation. Consequently, the WIIW (1993, p. 57) advocated "expansionary fiscal and monetary policies, especially government budget deficits, greater availability of credits, and lower nominal interest rates. . . ." Łaski and Bhaduri (1997, p. 115) wrote: "A restrictive financial policy . . . is not the proper method to combat a cost-push inflation and can even become counterproductive." Apart from stimulating demand, they proposed an incomes policy to boost capacity utilization, which would reduce both unemployment and inflation.

These gradualists opposed early currency convertibility, because "the essential elements of a market economy must be already actually functioning, before the attainment of even a restricted form of convertibility can be meaningful" (Levcik 1991, p. 31). They reckoned that "the freeing of domestic prices must precede the freeing of imports" (p. 39) and that East Germany had shown instant price liberalization a disaster. The WIIW (1993, p. 54) argued that a too radical reform program could be self-defeating as "sweeping trade liberalization or privatization may fail to be sustainable." Still, these gradualists did keep up with mainstream economics and they were not caught outside of ordinary market economic thinking, reflecting the swift adjustment of economic thinking in Central Europe.

Many other economists focusing on Central Europe started out in sharp opposition to the radical reforms in Poland, but over time their differences of substance dwindled to matters of nuance rather than principle. Characteristic examples are Grzegorz Kołodko, Mario Nuti, and Richard Portes.[9] They preferred a more gradual approach, complaining about "overshooting" of reform efforts, but they tended to accept the achievements of radical reform after some time.

Their fundamental criticism was that the initial macroeconomic stabilization, especially monetary policy, had been too strict, and that macroeconomic stabilization had been overemphasized at the expense of microeconomic policies. These critics wanted a slightly larger budget deficit, much lower interest rates, and generally looser credit policies, because they thought inflation easy to control, while they feared tight monetary policies would cause a greater than necessary fall in output. Portes (1993, p. 40) stated:

> The results of economic transformation so far have been remarkably similar. The stabilizations have been relatively successful. The initial jump in the price level is always greater than expected, sometimes so much that significant inflation persists; but the rate does come down rather than taking off into hyperinflation.

This was published when ten former Soviet countries experienced hyperinflation, that is, more than 50 percent of inflation in the course of one month.

Similarly, these gradualists reckoned that too fast liberalization in foreign trade could cause dangerous "overshooting." Swift convertibility would bring about too low an exchange rate, which would boost inflation through import prices unnecessarily, while they were pessimistic about the supply effects that open markets could bring about. While some gradualists feared too rapid restructuring because of early convertibility, Mario Nuti (1991, p. 53) worried that it would boost substandard industry:

> The faster the rush to convertibility, the higher the cost. A relatively rapid move to convertibility increases the share of low-positive-value-added activities that have to be run down, and increases the impact on the terms of trade, price elasticities being lower in the short than in the longer term. Hence, the faster the move to convertibility, the greater the domestic-currency undervaluation necessary to ensure its credibility.

In particular, Nuti thought that the Polish złoty had been devalued too much because it had been made convertible early on, which had led

[9] Relevant examples of their very many publications are: Kołodko (1991, 1992, and 2000); Kołodko, Gotz-Kozierkiewicz, and Skrzeszewska-Paczek (1992); Kołodko and Nuti (1997); Nuti (1991); Nuti and Portes (1993); Portes (1993, 1994).

to both higher inflation and greater output decline than necessary. Similarly, Portes (1994) criticized the early dissolution of the CMEA, which had been accompanied by a dramatic fall in interregional trade.

Privatization was a third field of severe opposition. These critics of radical reform opposed fast privatization.

> Meanwhile, the authorities should immediately take steps to reverse the "state desertion" that has left state-owned enterprises floundering: commercialize them, pay attention to their management and the environment in which it operates, redirect managerial incentives, improve corporate governance in so far as is possible without privatization, and rehabilitate industrial policy.... The market cannot and will not restructure the large state-owned enterprises.... (Nuti and Portes 1993, p. 15)

Nuti and Portes (1993) thought the state had greater control over formally state-owned enterprises than radical reformers did, and they endowed the state with greater political power over the state enterprise managers, while they were skeptical of the strength of market forces. Since the state was strong and good, no shock was needed to overcome the resistance of the state enterprise managers or induce credibility of the reform program. Nor was it desirable to draw a sharp line between government and enterprise. While the reformers wanted to get the state out of enterprises, Nuti and Portes complained about "state desertion," assuming that the state was manageable, accountable, and good. Therefore, they saw any shock as an undesired disruption and desired greater precision. These thinkers revealed a great belief in social engineering, the capacity of government, and the precision of statistics.

Still, they were part of mainstream macroeconomics, and Nuti and Portes (1993, p. 14) reckoned that for "other East European countries [than Hungary] and those of the former Soviet Union, there may be a necessary 'minimum bang'." Similarly, Nuti and Portes (1993, p. 14) revised their resistance to early convertibility: "In external policy, the move to currency convertibility should come as soon as it is at all feasible. In addition to reinforcing the move to openness and the credibility of policy, convertibility helps to import competition and a new equilibrium price structure." As Polish minister of finance from 1994 to 1997, Kołodko excelled by pursuing the Balcerowicz reforms further (though he would never accept that description). In his grand overview of transition, Kołodko (2000) came close to the substantive positions of Balcerowicz, although he still accused Balcerowicz of overshooting that had prompted economic recession. While their initial polemic sounded like an all-out attack on radical market reform, these gradualists' final stand only implied a greater belief in the capacity of the state and less in the ability of the market. The swift adjustment of these economists reflects how the differences between gradualists and radical reformers were quickly disappearing in Central Europe.

The Chinese Model

The Chinese model stood out as a successful model of postcommunist economic transition, and a large literature advocated it for the former Soviet bloc, notably for Russia (e.g., Amsden et al. 1994; Nolan 1995; Goldman 1996; Chen, Jefferson, and Singh 1992, Stiglitz 1999a). The arguments vary from fundamental political-economic issues to technicalities, but most disregarded the differences in preconditions.

A standard argument was that Mikhail Gorbachev was mistaken to start with democratization in January 1997 and that he should have begun with economic reforms instead. This point was made strongly by members of the Russian Nomenklatura, but many Westerners concurred (Nolan 1995, pp. 64–74; Goldman 1996). However, the implication is that Russia had the wrong preconditions. In Russia, the Communist Party of the Soviet Union had opposed any market economic reform when Mikhail Gorbachev became its secretary general in March 1985 (Åslund 1991). He attempted economic reforms for two years, but the omnipotent party bureaucracy blocked everything, so Gorbachev launched partial democratization to undermine it. Marshall Goldman (1996, p. 194) remarks: "Sometimes some patience is needed." But Soviet society was utterly petrified and increasingly dysfunctional, while the reforms in China started after the devastating Cultural Revolution, with economic decline and terror against the Party apparatus. To argue that democratization should have followed market economic reform is to oppose change in the Soviet Union.[10] Vladimir Mau (1999) has observed that "the Chinese way entailed nothing less than leaving power in the hands of the old Nomenklatura to preserve the one-party system and the ideological purity of the regime." The Nomenklatura was almighty, while the common public good had no voice. The Chinese state was stronger in relation to the Party apparatus and thus reformable (Amalrik 1980; Voslenskii 1984; Åslund 1989). One reflection of the differing strength

[10] Marshall Goldman (1991, p. 224) presented a much more plausible view of the Gorbachev reforms in 1991: "even if Gorbachev had adopted a more rational and coherent policy, it is unlikely that he would have succeeded. The Soviet population . . . was too resistant to evolutionary change. For that reason, the odds are that no one else would have done much better." The problem, though, was the Nomenklatura rather than the population.

of the states was that the Soviet Union collapsed in hyperinflation, while the Chinese leaders never lost control over macroeconomic stability. Therefore, Russia and China required different macroeconomic policies.

Another frequent argument was that China was right in carrying out a far-reaching decentralization, while the Soviet Union failed to do so. However, Peter Murrell and Mancur Olson (1991) argued convincingly that the decline of the centrally planned economies could be explained by the devolution of power within the party and state hierarchy and the collusion of bureaucrats at lower levels undoing the dictatorship of the secretary general. "The last stage of communism is not the stateless and classless society that Marx forecast, but rule by a rather large aristocracy of upper level bureaucrats" (p. 260). This was largely true of the Soviet bloc countries. Wide powers were devolved, both within the party bureaucracy and to state enterprise managers, but accountability and responsibility did not follow. The Chinese Communist Party maintained control over its own bureaucrats, while the Soviet Union even fell apart, which is of course the ultimate devolution. For instance, the Ukrainian independence movement was captured by the Nomenklatura. The Soviet bureaucrats were relatively more numerous than Chinese bureaucrats, but more importantly the incentives of Soviet officials seem to have been more flawed, rendering them more harmful. China and Russia are today deemed almost equally corrupt, but Russian corruption is perceived as socially more costly (Transparency International 1999; Shleifer and Treisman 2000). Again, preconditions differed.

A third argument was that experimentation was better than full-scale reforms (e.g., Murrell 1992b; Stiglitz 1999a), but that is an absurd statement, because no communist country experimented as much as the Soviet Union. It carried out reforms and experiments in the 1920s, 1950s, 1960s, and 1980s (Nove 1977; Åslund 1991), but they were all reversed. The same was largely true of Central Europe (Balcerowicz 1995). Only in Hungary did significant systemic changes persist, but they did not lead to significant growth, and a broad Hungarian consensus advocated more radical reforms (Kornai 1986, 1990). The question is rather why experimentation succeeded in China and failed in the Soviet bloc.

All the champions of Chinese reforms agreed that it was right to start the reform with agriculture and small enterprises and leave the large industrial enterprises in state hands, creating a dual economy with a market economy for the small enterprises and the old state governance for the large state enterprises. The new private or quasiprivate sector could generate growth and develop without antagonizing the old state sector (Chen et al. 1992; Amsden et al. 1994; Goldman 1996; Nolan 1995). Murrell just assumed that reform was not in danger but would inevitably proceed, as if the dominant state sector in the Soviet bloc did not represent any interest and would not crowd out the private sector. "Even a slow reform will eventually destroy many of the existing economic ties" (Murrell 1992b, p. 91).

Jeffrey Sachs and Wing Thye Woo (1994) object that agriculture in China was dominant, while it was a small part of the economy in Central Europe and the Soviet Union, which were heavily overindustrialized. Therefore, state industry could not be left aside, and Soviet agriculture was industrialized and large scale, too. To break up big state and collective farms was technically difficult, even if the huge communist agrarian bureaucracy had not blocked any progressive economic development for their selfish reasons. Gorbachev tried agricultural reforms in the Soviet Union in the spring of 1985, but he got nowhere. He grandly legalized cooperatives, which could be any kind of private enterprises in May 1988, but they became vehicles of management theft rather than a large movement of small enterprises (Åslund 1989, 1991).

Most proponents of the Chinese model of market economy reform favor gradual price liberalization and a gradual opening of the economy to the outside world (Chen et al. 1992; Amsden et al. 1994; Goldman 1996; Nolan 1995). Well, the Soviet Union did so, and the result was massive rent seeking by prominent members of the Nomenklatura, which is also going on in China (Dąbrowski, Gomulka, and Rostowski 2000). Thus, some countries tried the Chinese approach, and their results were truly disastrous.

In the end, surprisingly little can be compared. Although both China and the Soviet Union were communist dictatorships and had socialized economies, most preconditions differed when they launched market economic reforms in 1978 and 1985, respectively. First, the Soviet state and Party were so petrified that they could no longer reform but only collapse, while the Chinese state and its Communist Party were still reformable (Åslund 1989). Second, China was dominated by agriculture, but the Soviet Union by large-scale industry (Sachs and Woo 1994). With different preconditions, we would expect different outcomes.

Social Democratic Political Economy

A large group of leading international scholars of comparative politics presented a rather homogenous view. Adam Przeworski (1991) wrote a highly acclaimed book on democracy and the market in Eastern Europe. His first postulate was: "To evoke compliance and participation, democracy must generate substantive outcomes: It must offer all the relevant political forces real opportunities to improve their material welfare"

(p. 32). In postcommunist transition, Przeworski noted problems of high inflation, rising unemployment, slumping output, and increasing income differentials, leading him to the question: "Can structural economic transformation be sustained under democratic conditions, or must either reforms or democracy be sacrificed?" (p. 138) His underlying thought was: "Even if the post-reform system would be more efficient ... a transient deterioration of material conditions may be sufficient to undermine either democracy or the reform process" (p. 137). Hence, Przeworski assumed that people opted for democracy for the sake of economic welfare, not for political or other benefits from democracy itself.

Przeworski (1991, p. 163) made an explicit assumption that "the social cost is higher under the radical strategy, where social cost is defined as the cumulative decline in consumption during the period of transition" (p. 163). He accepted that radical reforms were often popular initially and might be irreversible. Therefore, he argued (p. 174): "Radical programs are more likely to advance reforms farther under democratic conditions even if voters would have preferred to start with a more gradual strategy." Thus, he just assumed that voters would prefer a gradual strategy, contrary to the evidence available. Then, he assumed that the economic results would turn sour: "Inflation is likely to flare up again and again under inertial pressures. Unemployment, even if temporary, is difficult to tolerate. Increasing inequality stokes conflicts ..." (p. 189). Finally, he assumed that "the continuing material deprivation, the technocratic style of policy making, and the ineffectiveness of the representative institutions undermine popular support for democracy" (pp. 189–90). Hence, gradual market-oriented reforms were to be preferred because Przeworski had assumed that they provided for a better economic outcome. None of these many assumptions had any sound empirical basis.

In his 1995 book, Przeworski (1995, p. 85) came back with a harsher judgment: "we have been critical of the standard neoliberal recipes since we believe that they are faulty in three fundamental ways: They induce economic stagnation, they incur unnecessarily large social costs, and they weaken the nascent democratic institutions." However, he found no reason to test his beliefs, which had been disproved. Next, he assumed the existence of a better gradual reform path without evidence. Then, he saw the viability of democracy as dependent on the depth of economic hardship, ignoring expectations or prospects. Larry Diamond (1999), on the contrary, has shown that people see democracy as a value in itself and do not judge it only by economic results. Finally, Przeworski presumed that the threat to democracy comes from a dissatisfied population, but the elite has proven to be the real danger. Similar unfounded assumptions have been shared by a large number of political scientists of more or less social democratic convictions.[11]

Przeworski also criticizes radical market reformers for preferring a top-down approach and for their purported tendency to bypass representative political institutions:

> The autocratic policy style characteristic of Washington-style reforms tends to undermine representative institutions, to personalize politics, and to generate a climate in which politics becomes reduced to fixes, to a search for redemption. Even if neo-liberal reform packages make good economics they are likely to generate voodoo politics. (Bresser Pereira et al. 1993, pp. 9–10)

However, radical reformers have usually had a substantial popular vote behind them in parliamentary or presidential elections, which Przeworski and his coauthors disregarded, and, as we shall see in Chapter 10, all radical reform countries remain democratic. They even ignored that many political institutions had not undergone democratization. Therefore, this criticism does not apply to its target, the Balcerowicz reform in Poland. It is another matter that policy has to slow down in the longer term and should be subject to democratic and institutional checks and balances (Rodrik 1996).

Political Economy Arguments for Gradualism

A small group of Western economists, primarily Gérard Roland, Mathias Dewatripont, Phillipe Aghion, and Olivier Blanchard, have developed an extensive theoretical literature on the political economy of transition. With a cursory look at economic developments in a few transition countries, they have made rather heroic assumptions, which fortunately tend to be very explicit.

The gist of this literature is the assumption that radical reform leads to a sharper decline in output and greater social costs than gradual reform: "Assume that big bang . . . has a negative expected outcome" (Roland 1993, pp. 534–5). As a consequence, these authors suggest slow liberalization and privatization as a trade-off to make reforms politically possible.

Another explicit assumption is that the key political actor is the majority of the population (Dewatripont and Roland 1992b), implying that the nascent democratic institutions are highly effective and representative. Then, "gradualism may allow for 'divide and rule' tactics when compensation for the losers from reform is costly, provided the

[11] A large literature has concurred with and elaborated upon approximately the same views as those expressed in Przeworski (1991), e.g., Elster (1990), Offe (1997); Andreas Pickel, in Pickel and Wiesenthal (1997); Stark and Bruszt (1998).

government has enough agenda-setting power" (Roland 1994, p. 1162). In reality, however, the losers were not very important in the political process, as the elite dominated politics (Hellman 1998).

A third assumption is that the government is strong and effective, representing the common good. In particular, Dewatripont and Roland (1992b) assume nearly perfect social engineering, but if that were the case liberalization would not appear necessary. Even so, they assume a total information failure, resulting in the government giving all unemployment benefits, whether they need them or not, which seems at variance with this perfect state.

A fourth assumption is that people act on the current state of affairs and that they do not tolerate a certain decline in output or a certain degree of unemployment. Aghion and Blanchard (1994, p. 292) state as a fact for Poland: "High unemployment largely explains the results of the 1993 elections. . . ." But the former Communist Party received only 20.4 percent of the votes cast, and the Polish right lost power because of its extraordinary party fragmentation that left 34.5 percent of the votes cast unrepresented in Parliament. An electoral analysis makes evident a far greater support for radical than gradual reform (Åslund et al. 1996).

A fifth assumption is that the cost of transition is being covered by the state through unemployment benefits or subsidies. In that case, social suffering and rising income differentials would not have caused such concern.

A sixth assumption is that the public costs of the social transition are passed on to the private sector through taxes. A more radical reform would lead to higher taxes and therefore a slower growth of the private sector: "The higher is unemployment, the higher are taxes, the lower is private job creation. . . . Private job creation declines, leading to a faster increase in unemployment. Eventually . . . the fiscal burden becomes so large that both the new and the privatized sectors become unprofitable and close down" (Aghion and Blanchard 1994, pp. 298–9; cf. Dewatripont and Roland 1992a). Roland (1994, p. 1163) goes even further: "in the presence of political constraints, a policy of very fast and nondifferentiated approach to privatisation carries with it the danger of partial renationalisations and general delay in restructuring" (cf. Roland and Verdier 1994). In reality, however, higher open unemployment has been positively related to private job creation, notably in Poland and Hungary, while countries with very gradual reform, such as Belarus and Ukraine have had the highest tax rates, little privatization, and minimal restructuring. It would be remarkable if a minority of unorganized unemployed had possessed such political power in any society.

As a consequence of their assumptions, these economists have advocated slow restructuring and privatization to make sure that it actually takes place under the motto "political feasibility is a condition for credibility" (Roland 1993, p. 536). If the plausibility of the assumptions had been checked, their modeling could have been useful. As the following chapters show, however, all six assumptions singled out here run counter to the empirical evidence. In particular, radical reforms have been less socially costly than gradual reforms. These unrealistic assumptions severely limit the usefulness of this extensive theoretical work.

Limit the Shocks from Liberalization and Stabilization

Economists differed in their views of how the newly created markets would react. Some radical reformers expected an early supply effect, if the shock was big enough. Others anticipated a tardy supply effect, but wanted a shock to shake out moribund structures. Most gradualists, however, reckoned that the shock would be harmful and preferred a more gradual adjustment. Theoretical models with nominal rigidities predicted lower output losses for a less radical reform. The two major themes were the liberalization of foreign trade, which has usually been gradual in other parts of the world, and the severity of macroeconomic stabilization.

Ronald McKinnon (1991a,b) focused on the Soviet economy. He noticed that the exchange controls, the state trading apparatus, disguised taxes, and subsidies taxed raw material exporters while offering nearly absolute protection from foreign manufacturers. Therefore, distortions in both prices and industrial structure were extraordinary. He presumed that "industries producing finished goods might well exhibit negative value added at world market prices" at the beginning of the transition (McKinnon 1991b, p. 165). Then, "a precipitate move to free trade could provoke the collapse of most domestic manufacturing industries no matter at what level the exchange rate is set, and no matter that some of this industry might eventually be viable at world market prices" (McKinnon 1991a, p. 114). Therefore, he proposed to make implicit tariffs explicit through a cascading import tariff, with the highest tariffs on finished goods to be scaled down within five to ten years. Still, McKinnon advocated convertibility and the immediate elimination of export taxes.

McKinnon understood the paucity of Soviet manufacturing, which he labeled value detraction, but why continue such production? Why destroy fine raw materials and other inputs through the production of unsalable goods? It would be better to sell the raw materials and reallocate other assets when they were still valuable.

The rigor of the stabilization policy was obviously a matter of degree, as well as the relative role of fiscal policy, monetary policy, incomes policy, and exchange rate anchors. Many argued that the Polish stabilization had been stricter than necessary, but as the Polish budget deficit soon widened, the advocacy of softer fiscal policy faded, while criticism focused on monetary policy. The main stricture was that "the contraction of bank credit to enterprises after December 1989 had a direct depressive effect on production" (Calvo and Coricelli 1992, p. 205). Guillermo Calvo and Fabrizio Coricelli (1992, 1993) reckoned that interest rates had been set too high and credit ceilings been too tight at the beginning of the Polish stabilization program, which led to a greater decline in output than necessary (that is, than in Hungary).

However, after two years both countries had seen similar output falls, and then Poland grew while Hungary stagnated. Then, Calvo and Coricelli (1995, p. 3) instead objected that "stabilization programs may also fail if the associated monetary contraction turns out to be 'excessive,'" suggesting that the explosion of interenterprise arrears in Romania was a result of too tight credit. Radical reformers opined that Romania's problem was its lack of credibility because of too gradual reforms (Rostowski 1998).

Few serious macroeconomists opposed a relatively radical stabilization policy in Poland and the FSU, given the initial degree of macroeconomic instability. Output had started collapsing when budget deficits had been wide and credit ample, and it was obviously in need of restructuring. Therefore, most suggested a demand barrier rather than demand management. The issue was only how strict the stabilization should be.

Institutions First

One of the most popular complaints about radical reformers was that they had "forgotten" institutions. The outstanding institutional economist and Nobel laureate Douglass C. North led this charge. North (1994, p. 359) saw radical reform ideas as dominated by neoclassical theory and argued that neoclassical "theory is simply an inappropriate tool to analyze and prescribe policies that will induce development. It is concerned with the operation of markets, not with how markets develop." He reasoned: "While the rules may be changed overnight, the informal norms usually change only gradually. . . . The implication is that transferring the formal political and economic rules of successful Western market economies to third-world and Eastern European economies is not a sufficient condition for good economic performance. Privatization is not a panacea for solving poor economic performance."

North stayed at a very general level, but neither he nor anybody else seem to have presented any evidence for this alleged forgetfulness of institutions, because virtually all radical reformers were deeply committed to changing the old communist institutions. In fact, Friedrich Hayek [1944] (1960), the leading liberal institutionalist, was the main source of inspiration of the postcommunist reformers rather than neoclassical economists (Balcerowicz 1992; Klaus 1992; Akaev 2000; Mau 1999).

A host of gradualists insisted that market institutions should be put in place before the economy was liberalized. Otherwise market failures, such as monopolization, would be excessive. The UN Economic Commission for Europe (1990, p. 23) pleaded: "legal and financial infrastructures of the market economy must be put in place before markets can perform. . . ." Similarly, Friedrich Levcik (1991, p. 42) stated: "First a legal base has to be established; then institutions must be set up to implement and execute the new laws, which also have to be tested in practice." Only after that, could liberalization, stabilization, and privatization occur.

This approach was technocratic. A large number of laws had to be adopted, and large-scale training in market skills was required. Then, foreign trade and prices would be liberalized gradually as in postwar Western Europe. Since postcommunist transition was a much more complicated process, the ECE argued that it had to be even slower, although the monopoly effects would be worse in the interim. The ECE noticed the importance of credibility but suggested that it could be created through the presentation of a coherent reform program with a credible sequence of reform. This view took for granted a strong government with the political will to undertake a market reform and ability to govern the reform process in detail, while the market was perceived as weak.

The counterargument is that institutions and legislation develop only with demand. What interests would push for the sensible regulation of private enterprise if there were no private enterprises? At least a couple of hundred laws were needed, requiring a few years of legislative activity. It was neither politically nor economically feasible for all market economic reform efforts to halt for a few years while a comprehensive legislative framework was completed. Only East Germany quickly adopted another commercial legislation (the West German) lock, stock, and barrel.

Peter Murrell (1992a–c) tried to develop an evolutionary theory for postcommunist economic transition (drawing on Nelson and Winter 1982). His starting point was that the radical reform model faced large implementation problems in Central Europe, because the "organizations that were expected to change their behavior in response to the new conditions have failed to do so," particularly the dominant large state enterprises (Murrell 1992b, p. 81). He shared the radical reformers' conviction of the need for a coherent economic environment, but he concluded that "little in the economic record of the past two years suggests that the radical program of reform can be successful. The old cannot be simply destroyed and therefore the radical reform plans have serious problems of coherence" (ibid., p. 82). Murrell (1992c, p. 50) drew on Joseph Stiglitz's information theory, concluding: "The information and skills of existing personnel are attuned to the existing set of institutions and lose much of their value when those institutions are destroyed." His idea was that sector-specific capital could not be turned into alternative uses. A number of models were made that predicted lower output losses with more gradual reforms, because the old sector would suffer less, while the new private market sector would develop better (Atkeson and Kehoe 1993; Murrell and Wang 1993).

Murrell was curiously torn between a desire for systemic consistency and a wish for continuity. He advocated a dual economy reminiscent of China, leaving state enterprises under central planning to be gradually phased out, while a nascent private sector would grow in a full-fledged market. He emphasized that "change must be slow enough to avoid the collapse of productive organizations" and that the "basic variable that will most determine the speed of change is the extent to which resources are freed for the new private sector" (Murrell 1992b, pp. 92–3). However, a dual economy with one highly regulated sector and a free-market sector maximizes corruption.

Murrell assumed that more continuity would boost the economic outcome, but one of his examples was the purported harm caused by the sudden collapse of the CMEA trading system, which seems a great success in comparison with the prolonged decline of the CIS state trade system (Olcott et al. 1999). Murrell also thought that gradual reforms would mitigate resistance against reforms, but the very gradual reforms in Russia and Ukraine aroused great public adversity as their gradualism deprived these reforms of credibility. If it is plausible that change can be blocked, the incentive to resistance is of course greater.

Was Disorganization an Argument for Gradualism?

Olivier Blanchard and Michael Kremer (1997) have developed an alternative model to explain the decline in output with disorganization. Their starting point was that each industry had typically fewer firms than in the West. For many inputs, firms knew of only one supplier and for many outputs only one buyer. With transition, old trade links were disrupted or became uneconomical. However, with asymmetric information or incomplete contracts, the initial results of bargaining might have been inefficient, implying that market imperfections caused output to fall with the transition. Blanchard and Kremer drew on Murphy, Shleifer, and Vishny (1992), demonstrating the potentially perverse effects of partial price liberalization, and they noticed that shortages persisted, as adjustments took time. Looking upon Central Europe, the Baltic countries, and Russia, they found empirical evidence for the decline in output having been more pronounced for goods with more complex production processes. They inquired "whether the need to preserve existing production networks provides a justification for gradualism" and whether "a commitment by the government to subsidize state firms for some time may avoid their immediate collapse" (Blanchard and Kremer 1997, p. 1123). However, the authors cautioned that this was only a limited, theoretical case for gradualism, and they acknowledged that it was valid only in the short term, since enterprises could be presumed to solve their contract and bargaining problems relatively soon.

This idea of disorganization as a cause of output decline has had considerable intellectual impact. Blanchard (1997) and Roland and Verdier (1999) have pursued similar arguments. Konings and Walsh (1999) empirically tested the effects of disorganization on a sample of 300 firms in Ukraine, and Marin and Schnitzer (1999) have studied 165 barter deals in Ukraine, seeing interfirm arrears and barters as a mechanism for smoothing the transition from the old to the new regime.

Intuitively, it seems plausible to interpret the inefficiencies of the Ukrainian economy as caused by disorganization, but Ukraine was the epitome of gradual reform, leading to rampant rent seeking. Then, the "disorganization" in the Ukrainian economy is not a result of asymmetrical information and imperfect contracts caused by too radical reform. On the contrary, gradual reform resulted in intentional "disorganization," which was a means of making information asymmetrical to promote rent seeking (Åslund and de Ménil 2000).

The disorganization thesis, as advanced by Blanchard and Kremer (1997) raises serious questions. As the authors stated, disorganization could influence output in a brief period. However, the longer the decline has lasted, the greater the total contraction has become. Therefore, the output slump is greatest where reform has been slow, Ukraine being the case in point. Any effect of disorganization is clearly less important than the effect of slow structural reform, as extensive regressions by Berg et al. (1999) show.

Blanchard and Kremer's empirical proof was a regression, showing that more advanced industries had declined more, but those were the greatest value detractors. As their produce was substandard and often unsalable, it was desirable that their output plummeted. Any possible effect of disorganization must have been minor and it cannot be distinguished as a separate effect.

Finally, Blanchard and Kremer fail to differentiate the interests of managers from those of firms. While post-Soviet enterprises certainly suffered, their managers have often been doing reasonably well because of extensive management theft, and subsidies tended to be particularly easy to steal. That must be considered when a recommendation of further subsidization is being made. Hence, the costs of disorganization seem to have been far less than the costs of rent seeking, which have been boosted by gradual reform.

Yet, clearly the disruption of systemic change brought about major problems of information and the conclusion of novel contracts without adequate institutions at hand. Every enterprise had to review all its contracts, when it undertook desired restructuring. This review period would naturally lead to an economic slowdown because of disorganization. But that was one of the original arguments for radical reform, which was designed to minimize the period of disorganization (Boycko 1991; Murphy, Shleifer, and Vishny 1992). Bringing rent seeking into the discussion, we find it an additional argument for fast reform, as rent seekers could prolong the period of poor information and contracts to extract rents from a poorly functioning market. One of the best examples of a disorganized industry is probably the healthcare sector, a state-owned industry very slow to restructure (see Chapter 8).

Stiglitz's Revisionism

After the Russian financial crash in August 1998, transition in the former Soviet Union appeared endangered, which encouraged a revival of socialistic ideas. In 1999, prominent economist Joseph Stiglitz, then chief economist of the World Bank, started advocating full-fledged gradualism (Stiglitz 1999a,b, 2000).[12]

Stiglitz's most original contribution was his ignoring of the profound crisis at the end of communism. The economic collapse of the Soviet Union had been so devastating that nobody defended the policies leading to the crash, but Stiglitz lauded them: "The Gorbachev-era *perestroika* reforms furnish a good example of incremental institutional reforms" (Stiglitz 1999a, p. 24). He did not even mention the macroeconomic problems that contributed to break the Soviet Union apart and asunder. Instead, he attacked radical reformers for their urgency. Nor was he concerned about the extraordinary price distortions. Stiglitz criticized the deregulation of banking ("Whoever got the banking license got a license to print money, and the license to print money is a license to acquire government enterprises," p. 5), apparently unaware of the proliferation of unregulated private banks that was part of the pre-Yeltsin reforms (Johnson 2000). He defended the dysfunctional postcommunist

[12] His writing has enraged liberal economists throughout the post-communist world. Excellent critiques are Mau (1999) and Dąbrowski, Gomułka, and Rostowski (2000); see also Yevstigneev and Yevstigneeva (1999).

state: "The state is seen as the primary source of the problems: interfering in state firms and preying on private firms. The emphasis is on government failure, not on market failure" (p. 20), while he abused radical reformers as "market Bolsheviks" (p. 22).

Picking up the institutional arguments of Peter Murrell, Stiglitz (1999a, 2000) accused the reformers of having ignored the importance of the institutional infrastructure of a market economy and dissipated the communist organizational capital, as if that was something valuable. To him, corruption did not arise out of the lawless communist state but out of reforms and privatization. He criticized radical reformers for blaming "the failure of the shock therapy on corruption and rent seeking at every turn . . . without recognizing any role of the institutional blitzkrieg in destroying but not replacing the old social norms – and thus in removing the last restraints against society-threatening levels of corruption. . . . Once dissipated, organizational capital is hard to reassemble. . . ." (Stiglitz 1999a, p. 9). Yet, that organizational capital consisted of the Communist Party, the secret police, and the Red Army, which are rarely praised in democratic societies. While democrats aspired to disrupt the dictatorship, Stiglitz hoped for its continuity. In line with his apparent disregard for democracy, Stiglitz (1999b, p. 4) logically praised Uzbekistan.

One of Stiglitz's greatest concerns was Russian privatization. In a book from 1994, Stiglitz played down the differences between public and private production, even if he saw significant advantages of private enterprise with regard to commitments and incentives (Stiglitz 1994, p. 194). He concluded: "While government ownership is clearly no panacea, there remains scope for further experimentation" (p. 277). In 1999, he saw the Russian loans-for-shares scheme as the main source of corruption, preferring the insider privatization to stakeholders, dominated by managers: "Perhaps trying to discipline spontaneous privatization might have offered the greatest hope" (Stiglitz 1999a, p. 6). That implied giving state enterprises away to the old elite, whose privileges would be perpetuated, which runs counter to any social concern. He proposed as a cure "a strategy of privatization of stakeholders" (p. 13), apparently unaware of that having been the policy that the chief advisors on privatization to the Russian government had recommended (Boycko, Shleifer, and Vishny 1995), and the dominant outcome (Blasi et al. 1997).

Apart from some technicalities on privatization and corporate governance, Stiglitz's position is reminiscent of Soviet reform communists. The public attention he attracted reflected the importance of his office, his standing as an economist, and the general malaise in the aftermath of the Russian financial crash. Although he was the chief economist of the World Bank, Stiglitz (2000) had nothing to say about the role of outside financial assistance, while he opposed the fast reforms and privatization that the World Bank had embraced.

MAJOR ISSUES OF DISPUTE

The public debate differed starkly from the real policy strife. The overt discussion occurred between reformers in government and opposing academics. The real dispute, however, stood between the reformers in government and strong interest groups. The latter wanted to make money on the transition but had no interest in revealing their strength through public statements.

Outstanding radical reformers in government were Leszek Balcerowicz in Poland, Vaclav Klaus and Vladimir Dlouhy in the Czech Republic, Lajos Bokros in Hungary, Yegor Gaidar and Anatoly Chubais in Russia, Mart Laar and Siim Kallas in Estonia, and Einarš Repše in Latvia. Their main opponents were state enterprise managers. A few industrial lobbies posed the toughest resistance, namely commodity production and trade, agriculture, and banking, especially in Russia. The biggest state enterprises posed the greatest challenge to reform, notably the large natural monopolies in energy and transportation. Strangely, importing and exporting energy lobbies appeared equally strong. The Ukrainian gas importers appeared as influential as Gazprom, the giant Russian gas monopoly. Many potential threats surprised by their timidity. Social and labor unrest was minimal. The dreaded military-industrial complex appeared a paper tiger after communism. Real communist ideology and nationalism were no effective forces. As expected, new small entrepreneurs were few and poorly organized, and they had a minimal impact as a group.

After having dwelled upon the public debate, we shall sum up the real disputes, identifying the main camps and summarizing their primary bones of contention. Yet, many points were almost beyond dispute.

The Main Controversies

The real controversies are easy to understand, if one accepts that ideology or social welfare were only tactical devices of the resistance, while the enrichment of a small elite was their real aim. Then, our analysis focuses on the transitional distortions that generated the largest rents. Reform governments tried to do away with such systemic inconsistencies for the public good, while rent-seeking enterprise lobbies attempted to aggravate them for private gain.[13] Another important dis-

[13] All too often, representatives of reform governments fell for the temptation of bribes from rent seekers, but that only changes the personal position of those people, not the principles of the drama.

tinction for our understanding is that managers of state enterprises did not necessarily think of the benefits of their enterprises but of their personal gains.

The liberalization of prices was one of the most controversial decisions. The deregulation of consumer prices was accomplished with surprising ease, while the freeing of commodity prices, especially energy and metals, was enormously contentious because of persistent transit pricing. Often price differentiation had been facilitated through multiple exchange rates, so the unification of the exchange rate was also opposed by rent seekers. Curiously, the managers of energy enterprises fought for *low* energy prices contrary to what one would expect from ordinary price theory, because their interest was a maximum price difference between state-regulated prices and market prices, as they were buying these commodities on their private account at low state prices and selling them abroad. Enterprise profits were none of their concern.

Another seemingly paradoxical controversy involved the liberalization of exports of commodities. Again, it was opposed by commodity exporters, whose enterprise profits would have been boosted by free exports, but managers of these state enterprises thought merely of their own gains. They defended their privileged access to export quotas and licenses.

A third major battle raged over direct budget subsidies to big industrial enterprises, the energy sector and agriculture. Therefore, industrialists and agrarians advocated larger budget deficits, and their calls for industrial policy were covert demands for subsidies.

Fourth, both the government and the Central Bank were subject to extreme pressure from industrial and agrarian lobbies for cheap credits. Arguably, this battle was key to whether an early stabilization attempt succeeded, which almost equaled fortuitous transformation.

Privatization, finally, qualifies as a fifth contentious issue. This strife was much more complex than the four depicted above. Speed or methods of privatization were not central but who benefited was, as everybody wanted to get a share. The exception was agriculture, where the state and collective farm managers opposed privatization. For the rest, no principal cleavage prevailed between reformers and their foes over privatization, as most were prepared to compromise to make a deal.

Thus, the truly controversial questions in the transition were whether the powerful and well-connected would get great privileges or not, and how the public property should be divided. In perspective, the number of principal conflicts was surprisingly small, but that might have contributed to the ferocity of the battle between two clear-cut camps. While the public discussion varied greatly between Central Europe and the CIS countries, the bones of contention were the same everywhere. However, less public understanding of market economics and greater economic distortions greatly benefited rent seekers.

Issues of Little Controversy

Although great public disagreement over the fundamentals of economic policy prevailed for the first few years of the transition, surprisingly many issues aroused little controversy. Some disputes had not risen on the agenda yet, but sometimes a broad consensus existed.

Although the unification of the exchange rate was a contentious issue, convertibility seemed a natural consequence of unification. Ideas of payments union had no significant support in Central Europe, and in the CIS official support seemed more virtual than real.

The liberalization of food prices and other consumer prices was far easier than anticipated. While Polish and Soviet workers had risen against meat price increases under communism, broader price liberalization – as distinct from price rises – agitated little negative sentiment.

The deregulation of imports caused minimal opposition, unlike the liberalization of exports. Several countries, such as Poland, Russia, and Estonia, went straight from a highly regulated import system to free imports without quotas, licenses or even tariffs. Deregulated imports were seen as a cure to rampant shortages of consumer goods in the decaying Soviet Union. Because of extremely low exchange rates, producers were not concerned about price competition.

The regulation of natural monopolies was initially avoided by the reformers as too complex. Their restraint, however, allowed monopolies to reinforce their already great power.

Taxation was originally a side issue, because few people paid personal income taxes, and the state enterprises were used to confiscatory taxation. Technically complicated tax reforms were left for later. The early replacement of old discretionary sales taxes with a rather high value-added tax was accepted with surprising ease.

Reformers were later accused of having ignored social policy. In reality, everybody talked about the need for reinforcing social expenditures and the social safety net in the initial transition. Social expenditures, especially pensions, rose as a share of GDP in virtually all transition countries, and unemployment benefits were introduced (Milanovic 1998), while more complex social reforms were perceived as too complicated for the early stage of reforms.

Another accusation against reformers has been that they forgot about the rule of law, but all spoke about the importance of building market economic institutions and the rule of law. An extraordinary volume of legislation was adopted and various legal reforms were initiated. Since most reformers were economists, they talked less about the details of legal reform, while lawyers were comparatively conservative, but law as such was not a bone of contention.

Much of the early political discussion was focused on the distribution of power between parliament and executive (government/president), while the distribution of power between the central government and the regional governments attracted little attention. Governance reform seemed both too daunting and less urgent. Bureaucratic intervention in enterprises, that was to rise as a serious problem later, was not significant just after communism, when democratic revolution deterred bureaucrats from abuses. Therefore, the potential of this problem was ignored.

A Gradual Strategy of Rent Seeking

On the basis of these disputes, we would expect that some countries would adopt reasonably consistent radical reform programs, and several did. Poland, Czechoslovakia, and Estonia, swiftly did so. While their details differed, they all undertook early financial stabilizations, balancing their budgets, imposing strict monetary policies and pegging their exchange rates, with the support of ample international funding. They rapidly liberalized prices, foreign and domestic trade, as well as entrepreneurship, while their privatization policies varied considerably. All these countries became real democracies, and liberal governments gained power through parliamentary majorities.

The gradual alternative is not equally apparent. At the time, Hungary was perceived as the gradualist model, as it did not tighten its fiscal policies until 1995, but Hungary faced no fiscal crisis unlike almost all the other postcommunist countries. Its liberalization was reminiscent of Czechoslovakia and Poland, and its privatization was faster than Poland's. In hindsight, the distinction between Hungary and Poland seems far less significant than it did at the time.

Instead, several post-Soviet countries, especially Ukraine, appear characteristic gradual reformers. Most post-Soviet countries were run by their old communist leaders, who wanted a minimum of political and economic change, though they were forced to adjust to financial collapse and reform in Russia. They listened to Soviet reform economists and abstained from fiscal stabilization. As a result, all the eleven countries that remained in the ruble zone in June 1993, except Russia, experienced hyperinflation that year. They liberalized prices only partially, forced to do so by the Russian price liberalization, and kept foreign trade regulated. Huge price differentials persisted between regulated and free prices. Though central planning fell apart, state orders persisted for much production, and the input market was not deregulated. Privatization was slow, and insider privatization by state managers dominated. As most power stayed with the state, democracy remained weak. Some of these countries are becoming market economies, while a few have reverted to socialist economies without ideology and central planning, but all are profoundly corrupt.

Nobody seems to have put the full strategy of gradual reform on paper, but it was the dominant choice and today its essence is obvious. This economic model was spearheaded by state enterprise managers, state officials and new entrepreneurs, who wanted to make money on the very transition to a market economy through privileged arbitrage (Åslund 1996). They sought rents, that is, "profits in excess of the competitive level" (Brealey and Myers 2000), by maximizing economic distortions. They aspired to economic freedom for themselves but advocated severe regulations for others. Hence, they wisely avoided pronouncing their strategy openly and usually motivated their endeavors with purported social concerns. Their strategy involved a confusing mixture of extreme freedom and severe regulation. Its essence was to make money on state subsidies and state regulation, in practice, through cheap state credits, export regulation, import regulation, enterprise subsidies, tax privileges, and nonpayments.

A first characteristic seemed libertarian, namely the deregulation of commercial banking in the Soviet Union. Its origin was the Soviet Law on Cooperatives of May 1988, which had become the inadvertent base for the establishment of 1,360 commercial banks in Russia alone before the collapse of the Soviet Union. It was speeded up through a rivalry between the Soviet State Bank (Gosbank) and the new republican central banks, which competed in providing the best conditions for banks to obtain their registration, offering low reserve ratios and minimal interest rates to the benefit of the borrowing commercial banks. The new commercial bankers demanded unlimited access to free money (Johnson 2000). Their overt defense was that monetary expansion stimulated production. In May 1990, I chaired a seminar in Stockholm with the Moscow Professor of Economics Ruslan Khasbulatov, who later became chairman of the Russian parliament. Responding to a question about the monetary overhang in the Soviet Union, Khasbulatov exclaimed: "What is the problem? If there is more money, there will be more production!" True to this policy, as chairman of the Russian Supreme Soviet, he commanded the issue of massive cheap credit (Matyukhin 1993).

A second characteristic of the gradualist program was strict export regulation in combination with low regulated prices of commodities, especially oil, natural gas, metals, chemicals, and timber. Rent seekers claimed that industrial production would collapse if faced with world market prices, and a broad post-Soviet public concurred out of ignorance. In reality, rent seekers bought large volumes of these commodities privately and sold them abroad at world market prices. Their profitable arbitrage was made possible by price controls, their exclusive access to these commodities, and their export privileges. Therefore, they favored export quotas and licenses, while they did not object to export tariffs, which they could evade. In the Soviet Union, such a system was in place from 1988 (Aven 1994). Similarly, rent seekers advocated low procurement prices of grain and a procurement monopoly, allegedly so that consumers would benefit from lower prices, but they were absorbed by middlemen.

A third feature of gradual deregulation was the old Soviet import regulation with multiple exchange rates. The rent seekers argued so forcefully that starvation would result if food import subsidies were eliminated that subsidized exchange rates were left in place for food imports in most of the FSU in 1992. In Russia, this exchange rate was as low as 1 percent of the market rate in 1992. To finance these import subsidies, grain traders demanded foreign commodity credits to salvage their country from starvation. Domestically, however, they saw little need for low prices, so they seized the subsidy themselves (Åslund 1995). Conversely, energy importers in the CIS insisted on subsidized exchange rates for imports of oil and natural gas from Russia. In Ukraine, such a rate was maintained until the end of 1994, rendering semiprivate gas importers the richest people of the land (Timoshenko 1998).

A fourth source of rents was direct enterprise subsidies. Enterprise managers argued plausibly that workers were not yet prepared to face unemployment. However, the same enterprise managers persistently opposed unemployment benefits, which would have gone directly to the poor and cost the government budget less than enterprise subsidies (Layard and Richter 1995). These managers were not concerned about social costs but about making money for themselves at the expense of the state through nontransparent subsidies. Such direct subsidies have proven particularly long-lived in coal industry and very large industrial enterprises.

Fifth, especially in Russia and Ukraine, barter, nonpayments, and offsets were widely used as means of distorting prices to extract implicit subsidies from the government (Pinto et al. 1999). The tricks were many. When an enterprise did not pay its taxes, the local government asked it to deliver in kind, for instance, construction services, effectively offering a noncompetitive public contract. Naturally, the construction company would hike up its prices and diminish the service provided to a sheer minimum, while minimizing the quality, extracting palpable implicit subsidies (Gaddy and Ickes 1998).

There were many other less important forms of rent seeking. Privatization was the most visible and transparent form, which limited its rents. Financial flows were more discreet, larger, and more concentrated. Tax exemptions and the forgiveness of tax arrears were easy options. The state could issue state guarantees for loans, effectively taking on responsibility for the payment. Private bankers could be allowed to handle state funds, not paying much for holding those funds. State officials could do so many things to generate monopoly rents, harass businessmen, and extort bribes. Licenses and inspections involving fees and penalties proliferated. Often, foreign businessmen could not understand why officials did not try to maximize their own long-term bribes, but they might have been working for a rent-seeking businessman who did not want competition.

The number of rent seekers was limited, and they made extraordinary gains during the transition (Hellman 1998). Yet, many of these techniques were temporary. Inevitably, huge price differentials were reduced by arbitrage. In the long run, large subsidized credits that had caused hyperinflation could not be tolerated. Barter was expensive with transaction costs of 20–30 percent on the gross price (Broadman 1999). Rent seekers rarely possessed full monopoly power, and they were enticed to overexploit their opportunities. This led to competition over rents, driving them down toward zero in the same way as mercantilism and feudalism had degenerated into a competitive market economy (Ekelund and Tollison 1981; Shleifer and Vishny 1998). Alternatively, a few major rent seekers could distribute real monopolies among themselves, but then they would have to assume full control over the state through dictatorship.

This was the main struggle of the transition.[14] In a few radical reform countries, the proponents of the common good won over the rent seekers early on, but in most countries a protracted and uncertain struggle between reformers and rent seekers ensued. In the worst cases, rent seekers won and reestablished quasistate monopolies and dictatorship.

[14] I first developed this theme in Åslund (1996) and elaborated on it in Åslund (1999).

4

Changes in Output and Their Causes

One of the most important but least understood issues of postcommunist economic transformation is what has actually happened to output. There is no agreement on the fundamental facts, and the statistical uncertainties are so numerous that no consensus is likely to emerge any time soon. The transition started with huge recorded falls in output throughout the region, arousing great controversy. Some argued that a unique devastation was taking place, while others saw a combination of measurement problems and a necessary "creative destruction" in Joseph Schumpeter's sense.

We begin with the official data on what happened to output, for how long its decline lasted, to what extent countries have returned to growth, and how strong and stable growth has become, taking note of the new patterns of growth and lasting stagnation have emerged.

Next, we analyze the huge but varied initial declines in recorded output. Were these declines real? First, we focus on the truly postcommunist decline, deducting the slump in the two last years of Soviet power. Second, we add the increase in the unofficial economy, which is real but unmeasured and which rose sharply especially in intermediary reformers. Third, we deduce worthless production or value detraction from the last communist GDP, as revealed by plummeting manufacturing. Besides, implicit trade subsidies were huge. While these involved real resources, they ceased as a consequence of independence, not transition. My startling conclusion is that radical and some moderate reform countries experienced no contraction of output in their first years after communism, while war-torn and nonreforming countries suffered. The great postcommunist output collapse is a myth.

A second stage of transition ensues with further structural adjustment. As transition is concerned with the effective deployment of underutilized resources, it presumably differs from ordinary growth theory, which focuses on both the accumulation of factors of production and the efficiency of their utilization. Our query is how the new economic growth can be explained. We scrutinize the impact of various aspects of economic reforms and policy on output, drawing on an extensive literature of cross-country regressions involving the whole region.

In the longer term, the distinctive features of the postcommunist transition will fade and we shall look at these economies like any other economy, and ordinary growth theory should apply. However, depending on the nature of their transition, these countries will end up with certain preconditions for the next stage of development.

In most countries, market-oriented reforms were introduced at a distinct point of time, usually the beginning of a year. Poland and Hungary were the pioneers, launching their transition on January 1, 1990. Czechoslovakia and Bulgaria followed suit in early 1991. The Russian attempt at a radical reform in January 1992 forced all former Soviet republics to undertake some reform, at least deregulating many prices. Only in Romania was the start of the transition diffuse, though it may be said to have started in 1991. The transition in the region thus started in three different instances.

SHARP DECLINE IN RECORDED OUTPUT

When the transition to a market economy began, recorded output plummeted in all countries, though the Soviet economy was already in a free fall, which is often forgotten, and the statistical systems were also in a state of collapse. Huge structural changes were taking place and the fundamental problem of interpretation is how to assess these structural changes. This section establishes what the official statistics say happened to output.

Dramatic Initial Decline Everywhere

In 1990, only Poland and Hungary launched their transitions. The sudden declines in their recorded output caused a shock, and their relative economic performance set the stage of the early debate. Poland's GDP plummeted by 11.6 percent, while Hungary's dropped marginally by 3.5 percent (see Table 4.1). Poland's initial drop frightened people and put radical reform in disrepute. In 1991, however, Poland's GDP shrank by 7.0 percent, but Hungary saw a decline of 11.9 percent. All of a sudden the two competitors had come even.

When other countries in Central and South-East Europe entered the transition in 1991, their registered output plummeted by 12–15 percent, so Poland no longer looked bad. In 1992, the former Soviet republics entered their transition, with monumental recorded output falls. The war-

Table 4.1. GDP at Constant Prices, 1990–2000 (Annual percentage change)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000 (prel.)
Central Europe											
Poland	–11.6	–7.0	2.6	3.8	5.2	7.0	6.1	6.9	4.8	4.1	4.1
Czech Republic	–1.2	–11.6	–0.5	0.1	2.2	5.9	4.8	–1.0	–2.2	–0.2	3.1
Slovakia	–2.5	–14.6	–6.5	–3.7	4.9	6.7	6.2	6.2	4.1	1.9	2.2
Hungary	–3.5	–11.9	–3.1	–0.6	2.9	1.5	1.3	4.6	4.9	4.5	5.2
South-East Europe											
Romania	–5.6	–12.9	–8.8	1.5	3.9	7.1	3.9	–6.1	–5.4	–3.2	1.6
Bulgaria	–9.1	–11.7	–7.3	–1.5	1.8	2.1	–10.9	–6.9	3.5	2.4	5.0
Baltics											
Estonia	–6.5	–13.6	–14.2	–9.0	–2.0	4.3	3.9	10.6	4.7	–1.1	6.4
Latvia	2.9	–10.4	–34.9	–14.9	0.6	–0.8	3.3	8.6	3.9	0.1	6.6
Lithuania	–5.0	–5.7	–21.3	–16.2	–9.8	3.3	4.7	7.3	5.1	–4.2	2.9
CIS											
Russia	–4.0	–5.0	–14.5	–8.7	–12.7	–4.1	–3.5	0.8	–4.6	3.2	7.7
Belarus	–3.0	–1.2	–9.6	–7.6	–12.6	–10.4	2.8	11.4	8.3	3.4	5.8
Ukraine	–3.4	–11.6	–13.7	–14.2	–23.0	–12.2	–10.0	–3.0	–1.9	–0.4	6.0
Moldova	–2.4	–17.5	–29.1	–1.2	–31.2	–1.4	–7.8	1.3	–8.6	–4.4	0.0
Armenia	–7.4	–11.7	–41.8	–8.8	5.4	6.9	5.9	3.3	7.2	3.3	6.0
Azerbaijan	–11.7	–0.7	–22.6	–23.1	–19.7	–11.8	1.3	5.8	10.0	7.4	10.5
Georgia	–12.4	–20.6	–44.8	–25.4	–11.4	2.4	10.5	10.8	2.9	3.0	2.0
Kazakhstan	–0.4	–13.0	–2.9	–9.2	–12.6	–8.2	0.5	1.7	–1.9	1.7	9.6
Kyrgyzstan	3.0	–5.0	–19.0	–16.0	–20.1	–5.4	7.1	9.9	2.1	3.6	5.1
Tajikistan	–1.6	–7.1	–29.0	–11.0	–18.9	–12.5	–4.4	1.7	5.3	3.7	8.3
Turkmenistan	2.0	–4.7	–5.3	–10.0	–17.3	–7.2	–6.7	–11.3	5.0	16.0	17.6
Uzbekistan	1.6	–0.5	–11.1	–2.3	–4.2	–0.9	1.6	2.5	4.4	4.1	1.5

Source: EBRD (2000a, p. 65); EBRD Press Release, April 22, 2001.

ridden countries suffered the worst: Armenia (–53%), Georgia (–45%), Tajikistan (–29%), Moldova (–29%), and Azerbaijan (–22%). Small countries with great trade dependence were also badly hit: Lithuania (–38%), Latvia (–35%), and Kyrgyzstan (–19%). Yet, two groups of countries got away relatively easily, namely the oil and gas producers Kazakhstan and Turkmenistan, and conservative countries with little systemic change: Belarus, Uzbekistan, and Ukraine. Still, two vigorous reformers, Estonia and Russia, did comparatively well with a decline of just over 14 percent.

Shockingly, however dramatic these initial falls were, they were surpassed by later slumps in several former Soviet countries. Belarus, Ukraine, Moldova, and Kazakhstan saw their biggest contraction in 1994, and Turkmenistan in 1997. The former Soviet countries, including the Baltics, recorded much greater declines in output than the Central Europeans.

Greatly Varied Duration of the Slumps

As substantial declines continued year after year, attention turned to their duration. Poland took an early lead by returning to growth in 1992. The Czech Republic and Romania followed in 1993, but the Czech growth rate stayed low, and Romania had a false start.

By 1994, the whole of Central Europe and South-East Europe registered growth, and three of the most vigorous reformers in the FSU had also arrived – Armenia, Lithuania, and Latvia. In 1995, they were followed by other reformers, namely Estonia, Georgia, and Kyrgyzstan. Five countries (Poland, the Czech Republic, Slovakia, Romania, and Armenia) had reached growth rates of 6–7 percent that year. By 1997, Georgia, Estonia, and Kyrgyzstan even surpassed 10 percent of growth. Central Europe, the Baltics, the Caucasus, and Kyrgyzstan appeared to have attained sustainable economic growth. The unreformed countries Belarus and Uzbekistan had also achieved growth, but through recentralization of state control.

However, several FSRs experienced prolonged decline followed by stagnation, in particular, Russia, Ukraine, Moldova, and Kazakhstan. The market economic reforms they had undertaken did not suffice for growth. Turkmenistan was a problem of its own, heavily dependent on unreliable access to Russian pipelines to export natural gas and even more unreliable payments from other FSRs, and it pursued a haphazard economic policy. Tajikistan was intermittently stuck in, or on the verge of, civil war. Bulgaria and Romania had registered growth, but with limited structural reforms they relapsed into macroeconomic crisis and economic decline by 1996 and 1997, respectively, at great social cost.

In 1998, the international financial crisis hit the whole region, particularly Russia. Its financial crash in August 1998 reduced growth rates throughout the region, because the other countries saw both their export markets and borrowing options drying up. After the crisis, however, all FSRs but Ukraine and Moldova reached significant growth in 1999. In 2000, most CIS economies took off, with Russia's GDP rising by 8.3 percent; even Ukraine achieved a growth of 6 percent. Turkmenistan and Kazakhstan led the growth league thanks to high world market prices of energy, but Ukraine's growth suggested that structural reforms had started to bite.

Total Decline Substantial but Diverse

Total recorded fall in output has been staggering. According to official statistics, the aggregate decline in GDP was 19 percent in Central Europe and 29 percent in South-East Europe (see Table 4.2).[1] In the former Soviet Union, the collapse was truly stunning, with 44 percent in the Baltics and 53 percent in the CIS. The total registered declines in GDP range from 13 percent from 1989 to 1992 in the Czech Republic to 77 percent from 1989 to 1994 in Georgia.

Within the former Soviet Union, four of the five war-torn countries – Georgia, Azerbaijan, Tajikistan, and Moldova – suffered the worst official slumps, ranging from 70 to 77 percent, while Armenia experienced a fall of 56 percent. The two least reformed countries, Uzbekistan and Belarus, saw the smallest drop of barely 20 percent and 37 percent, respectively. The economy of the most radical reformer, Estonia, shrank by "only" 36 percent, but other reformers, such as Lithuania, Latvia, and Kyrgyzstan, went through bigger contractions. Terms of trade changes were obviously of great importance, as the three big energy importers – Kazakhstan, Turkmenistan, and Russia – faced comparatively small declines of 39–44 percent. Apparently, it was costly to get rid of socialism, but the cost varied greatly, and it was much greater in the former Soviet Union than in Central Europe.

An alternative but related picture is provided by GDP per capita in purchasing power parities, which the World Bank heroically calculates. Recent data have been subject to substantial upward revision, while the communist numbers remain unchanged and are presumably far too high. Of our twenty-one countries, only three Central European countries are judged to have had a higher GDP per capita in PPP in 1998 than in 1989 (see Table 4.3). Poland is a outstanding success with a

[1] All averages are unweighted; that is, each country has equal weight. The reason for this choice is that I am equally interested in the development of each country, as my focus in qualitative.

Table 4.2. Total Fall of GDP and Year of Nadir

	Year of Nadir	Total Fall in GDP from 1989	Total Fall in GDP from 1989
Central Europe	*1992*	*17*	*17*
Poland	1991	17.8	17.8
Czech Republic	1992	13.1	13.1
Slovakia	1993	24.9	24.9
Hungary	1993	19.1	19.1
South-East Europe	*na*		
Romania	1992	25.0	25.0
Bulgaria	1997	33.4	33.4
			Total Fall in GDP from 1991
Baltics	*1994*	*44.8*	*38.6*
Estonia	1994	33.6	23.0
Latvia	1995	49.0	44.7
Lithuania	1994	43.9	40.5
CIS	*1998*	*46.1*	*40.7*
Russia	1998	39.8	34.7
Belarus	1995	36.6	34.6
Ukraine	1999	54.0	47.8
Moldova	1999	61.7	52.4
Armenia	1993	50.1	40.2
Azerbaijan	1995	63.0	57.8
Georgia	1994	76.0	64.2
Kazakhstan	1995	39.2	31.0
Kyrgyzstan	1995	46.9	45.0
Tajikistan	1996	64.2	61.0
Turkmenistan	1997	35.8	33.8
Uzbekistan	1995	19.5	18.4

Source: ECE (2000a, p. 225).

growth of 41 percent, while Georgia recorded the greatest decline, at 66 percent.

Patterns of Decline or Growth

The picture of contraction is pretty clear. All countries suffered large initial drops in output, but they have varied considerably in both size and duration, especially between Central Europe and the former Soviet Union. We shall distinguish countries by subregion and degree of structural reform, putting the countries into three categories – radical reformers, intermediary reformers and nonreformers. This grouping is illus-

Table 4.3. GDP per Capita in Purchasing Power Parities, 1989 and 1998 (Current international $)

	1989	1998
Central Europe		
Poland	5,411	7,619
Czech Republic	12,373	12,362
Slovakia	8,734	9,699
Hungary	9,194	10,232
South-East Europe		
Romania	6,398	5,648
Bulgaria	5,706	4,809
Baltics		
Estonia	8,230	7,682
Latvia	8,090	5,728
Lithuania	7,556	6,436
CIS		
Russia	10,090	6,460
Belarus	6,803	6,319
Ukraine	6,631	3,194
Moldova	3,205[a]	1,947
Armenia	1,705[a]	2,072
Azerbaijan	5,418	2,175
Georgia	9,650	3,353
Kazakhstan	6,544	4,378
Kyrgyzstan	3,340	2,317
Tajikistan	2,587	1,041
Turkmenistan	5,881	2,550[b]
Uzbekistan	2,215[a]	2,053

[a] 1992 data.
[b] 1997 data.
Source: World Bank (2000a).

trative in the following analysis and a series of tables adapted from Havrylyshyn and Wolf (1999).

The growth rate after recovery is most important for the future, and it is quite differentiated. Central Europe, the Baltics, Armenia, Georgia, and Kyrgyzstan have entered a steady growth path of on average 4–6 percent a year. Romania, Bulgaria, and Russia, on the contrary, suffered serious macroeconomic crises in the years 1996–98, which caused their output to plummet anew. Ukraine, Moldova, and Kazakhstan have been stuck in persistent decline and stagnation. Until the Russian financial crash, a new pattern had been established: significant growth or no growth. This is a major query to be investigated further.

The division between the FSRs and Central Europe together with South-East Europe no longer hold. The countries in our region can roughly be divided into three categories on the basis of what happened before 1998, although the FSU had experienced a shorter period of transition.[2] A first group of reformist countries can be described by a U-curve, with an initial decline followed by a steady recovery. They include Central Europe (Poland, the Czech Republic, Slovakia, and Hungary); the Baltics (Estonia, Latvia, and Lithuania); the Caucasus (Armenia and Georgia); and Kyrgyzstan. Azerbaijan is no reformer, and its growth can be explained entirely by a massive inflow of foreign direct investment because of its oil assets. Belarus and Uzbekistan have achieved growth by reinvigorating state control over the economy (see Chart 4.1).

Six countries in a second group are marked by an L-curve of a sharp decline followed by stagnation. They comprise three big CIS economies:

Chart 4.1 Patterns of GDP Growth, 1995–1997 (Average GDP change in percent per year).

	Central Europe	*Baltics*	*South-East Europe*	*CIS*
Consistent Growth, U-curve	Poland Czech Republic Slovakia Hungary 4.8	Estonia Latvia Lithuania 5.1		Armenia Georgia Kyrgyzstan 5.7 Belarus Azerbaijan Uzbekistan 0.1
Growth Reversals, W-curve			Bulgaria Romania -1.8	
Little Growth, L-curve				Russia Ukraine Moldova Kazakhstan -4.0 Tajikistan Turkmenistan -9.6

Source: Calculated from EBRD (1999).

[2] It might appear unfair to compare countries after different periods of transition, but the Russian financial crash of 1998 had international repercussions that are difficult to categorize, so I want to avoid them. What is important here is which countries got out of the transition crisis fast.

Russia, Ukraine, and Kazakhstan, as well as Moldova, all intermediate reformers. The fate of nonreforming Tajikistan and Turkmenistan has been similar, though their statistics are incredibly poor. Tajikistan has been devastated by civil war, while Turkmenistan is totally dependent on when and how it can export its natural gas.

A third group of two countries have ended up with a W-curve, a double-dip with a first decline followed by some recovery and a new decline. Until 1998, Bulgaria and Romania had gone through such a development (as had Albania). Russia could be transferred to this group at a later date, though its recovery in 1997 was barely significant. All these countries are intermediary reformers.

THE MYTH OF OUTPUT COLLAPSE

Much of the literature about the slump in output discusses it as a sheer tragedy, and many draw parallels with the Great Depression of 1929–33. However, the words "depression" and "recession" evoke the images of a business cycle gone awry, whereas this was a profound systemic change. The structural changes that followed represented a desired return to a normal economic structure. The real costs had already been imposed on society by communism.

Unfortunately, both communist and postcommunist statistics are deeply flawed, but in different ways. While everybody recognizes these statistical problems and some authors detail them, all proceed to work with official statistics, as no full alternative set exists. For many purposes, this approach is reasonable, but the fundamental question about the fate of real output is left unanswered. The purpose of this section is to figure out what really happened to real output during the initial transition in the period 1989–95 for East-Central Europe and 1991–5 for the FSU.

My conclusions contrast sharply with the conventional view. First, everywhere the decline in output has been much smaller than perceived, and a few countries experienced instant growth rather than contraction. Second, the Soviet economy was in far worse shape than generally understood. Third, even after revision, the differences between failures and successes remain vast. Fourth, the correlation between economic performance and structural reform remains strong after statistical revision. Fifth, flawed statistics have disinformed policymakers in postcommunist transformation, inciting them to adopt inefficient gradual reforms, which reinforced rent seeking and prolonged stagnation. Economic welfare has diminished far less than output. Yet, no precise knowledge of the actual development of output in transition is possible because of paramount methodological problems.

Focus: Postcommunist Fall in Output

The first statistical problem is the starting point. Economic chaos prevailed at the end of communism, and Romania and the Soviet Union registered sharp falls of output in the last year of communism. While East-Central European transition is measured against the last communist year, the standard for the former Soviet republics (FSRs) is 1989, although it should be 1991 if we discuss postcommunism. That correction eliminates an average of 11 percent of 1989 GDP of the decline for the FSRs (see Table 4.1).

Then, the registered contraction was 17 percent of GDP in Central Europe from 1989 to 1992, some 30 percent in Bulgaria and Romania from 1989 to 1997, and in the FSU an average of 40 percent, ranging from 18 percent in Uzbekistan to 65 percent in Georgia (see Table 4.2). Five countries (Armenia, Azerbaijan, Georgia, Tajikistan, and, to a minor extent, Moldova) were hurt by military conflicts, but for most other countries these recorded drops were unparalleled in peacetime.

Sharp Increase in Unregistered Output

Central planning was a system of cheating. Everybody had an interest in overreporting production, as bonuses of ministers, managers, and workers depended on their gross production. This led to persistent overreporting, probably amounting to some 5 percent of GDP (Åslund 1990). The interest in such doctoring of numbers disappeared immediately with transition.

Under capitalism, on the contrary, people and enterprises are anxious to avoid taxes, implying a downward bias. Furthermore, statistical agencies failed to keep up with myriad new enterprises. Even in Hungary, enterprises with fewer than 50 employees were not included in aggregate statistics for years. A large unofficial economy emerged, which was not necessarily illegal, but just not reported to the state statistical office (Johnson, Kaufmann, and Shleifer 1997a, p. 173).

Admittedly, an underground economy existed also in the Soviet Union as well, but it was tiny because of severe repression, as evident from the pernicious shortages. On the basis of interviews with Soviet émigrés in the early 1970s, Gur Ofer and Aaron Vinokur (1992, p. 100) concluded that private activity in the urban consumer sector would add just 3–4 percent to the Soviet GNP.

The only comparable GDP numbers available for many transition countries are based on electricity consumption, assumed to develop broadly in line with GDP (Johnson et al. 1997a). Table 4.4 shows the most elaborate and comprehensive estimates of the unofficial economy ranging from 27 percent of GDP in Hungary to 6 percent in

Table 4.4. Underground Economy, 1989–1995

	Unofficial GDP as a Percentage of Total GDP							1995 GDP Index (1989 = 100)	
	1989	1990	1991	1992	1993	1994	1995	Official	Total
Central Europe									
Poland	15.7	19.6	23.5	19.7	18.5	15.2	12.6	98.3	94.9
Czech Republic	6.0	6.7	12.9	16.9	16.9	17.6	11.3	84.3	89.3
Slovakia	6.0	7.7	15.1	17.6	16.2	14.6	5.8	83.1	82.9
Hungary	27.0	28.0	32.9	30.6	28.5	27.7	29.0	84.7	87.1
South-East Europe									
Romania	22.3	13.7	15.7	18.0	16.4	17.4	19.1	77.7	74.7
Bulgaria	22.8	25.1	23.9	25.0	29.9	29.1	36.2	73.7	89.2
Baltics									
Estonia	12.0	19.9	26.2	25.4	24.1	25.1	11.8	69.1	68.9
Latvia	12.0	12.8	19.0	34.3	31.0	34.2	35.3	47.3	62.3
Lithuania	12.0	11.3	21.8	39.2	31.7	28.7	21.6	45.1	50.6
CIS									
Russia	12.0	14.7	23.5	32.8	36.7	40.3	41.6	49.1	74.0
Belarus	12.0	15.4	16.6	13.2	11.0	18.9	19.3	56.1	61.2
Ukraine	12.0	16.3	25.6	33.6	38.0	45.7	48.9	39.0	67.0
Moldova	12.0	18.1	27.1	37.3	34.0	39.7	35.7	43.0	58.8
Armenia	..	..	..	..	..	..	..	..	..
Azerbaijan	12.0	21.9	22.7	39.2	51.2	58.0	60.6	31.4	70.1
Georgia	12.0	24.9	36.0	52.3	61.0	63.5	62.6	16.0	37.6
Kazakhstan	12.0	17.0	19.7	24.9	27.2	34.1	34.3	46.5	62.3
Kyrgyzstan	..	..	..	..	..	..	..	..	..
Tajikistan	..	..	..	..	..	..	..	..	..
Turkmenistan	..	..	..	..	..	..	..	..	..
Uzbekistan	12.0	11.4	7.8	11.7	10.1	9.5	6.5	84.0	79.0

Source: Johnson et al. (1997a, p. 183).

Czechoslovakia and 12 percent in the Soviet Union in 1989 (Kaufmann and Kaliberda 1996).[3] This method only approximates the development of the unofficial economy, and it cannot be applied to four countries in the region, and the series ends in 1995.[4]

[3] The numbers have been contested (especially by Lackó 2000), but alternative estimates present a similar picture.

[4] Armenia suffered severe power cuts; in Kyrgyzstan, local electricity was substituted for imported energy; Tajikistan and Turkmenistan had no power consumption statistics avail-

With the start of transition, the underground economy expanded everywhere. Soon, however, it shrank both in successful reform coun-tries and the most repressive state-controlled economies, while con-tinuing to grow in partially reformed economies. Hence, the unofficial economy peaked in 1991 in the most successful transition economies (Poland, Hungary, and Estonia), while in less reformist countries (Russia, Ukraine, and Azerbaijan) it was still rising in 1995. Mostly, the unregistered economy peaked when the official GDP hit its nadir.

On the whole, the unofficial economy expanded tremendously. The average unregistered share of real GDP in former Soviet countries rose from 12 percent in 1989 to 36 percent in 1994. In the extreme cases of Azerbaijan and Georgia, it exceeded 60 percent of total GDP, and presumably also in war-torn Armenia. In East-Central Europe, by contrast, the unofficial share rose from 17 percent in 1989 to 21 percent in 1992 but then dwindled to 19 percent in 1995.

Taking the unofficial economy into account, the economic development of the region looks very different (see the last two columns in Table 4.4). First, on average the contraction from 1989 to 1995 was 32 percent rather than 40 percent for the whole region, and 36 percent instead of 54 percent in eight CIS countries. Second, the differences between the most successful reformers and the laggards are reduced substantially, as the unofficial economy grew most in intermediate reformers, such as Russia and Ukraine. This adjustment eliminates 18 percent of 1989 GDP of the purported decline in output in the CIS, and it is huge for some countries: for Azerbaijan 39 percent of 1989 GDP, for Ukraine 28 percent, and for Russia 25 percent. Third, the underground economies shrank in the most repressive economies (Belarus and Uzbekistan). With this single adjustment, the intermediate reformers Russia and Ukraine both overtake nonreforming Belarus, and Russia almost catches up with Uzbekistan, which seems eminently plausible.

Revisions of official GDP are undertaken all the time, considering not only output but also the end-use side of GDP (consumption, investment, and net exports; Koen 1995). Gradually, they include ever more of the hitherto unregistered economy, and almost all revisions boost output numbers, but revisions remain timid.

able. The initial unofficial economy in the Caucasus is definitely understated. Family budget interviews with émigrés in the 1970s indicated that the underground economy was most developed in the Caucasus, large in Ukraine and Moldova, but small in Russia, Belarus, and the Baltics (Grossman 1987).

End of Shortages and Value Detraction

The fundamental problem with socialist economies was qualitative. Enterprises had little or no interest in producing what customers wanted because of prevailing shortages of goods and services as well as soft budget constraints on enterprises. The persistent shortages implied extreme monopoly, reinforced by severe protectionism. Enterprises aimed at attaining their physical production targets, happily ignoring quality and choice of products, which steadily grew worse. Almost anything was difficult to buy in the Soviet Union, and a typical Soviet grocery store was empty when communism collapsed. Partial market economic reforms had improved the situation significantly in Central Europe, notably in Poland and Hungary, but it remained bad.

Much of Soviet manufacturing was sheer value detraction, as Ronald McKinnon (1991a) put it. For instance, Soviet fishermen caught excellent fresh fish. Rather than selling it on the market, they processed it into often inedible fish conserves, reducing the fish's value to almost zero. Incorrectly, this value detraction was recorded as value added in national accounts and thus included in the GDP. Value detraction increased down the processing chain. Soviet raw materials were excellent, Soviet intermediary goods (such as metals and chemicals) were shoddy, while consumer goods and processed foods were substandard. Value detraction also involved excessive costs because of obsolete equipment still in use and uneconomical location, with heavy industry located far from both inputs and markets, producing what nobody wanted to buy in any case (McKinsey Global Institute 1999). Many unsalable goods disappeared in storage or were quietly scrapped without any statistical recording.

Proper national accounts should exclude most of the "production" of consumer goods and processed foods, and any elimination of such value destruction is positive. The decline in manufacturing was staggering everywhere, for instance, in Russia from 1991 to 1996, 84 percent in light industry, 44 percent in food processing, and 57 percent in civilian machine building (Goskomstat 1997, p. 336). Because it was difficult to find any manufacture goods worthwhile buying even at extremely low prices, this decline in manufacturing output seems to reflect some reduction of value destruction. Yet, it was recorded as a decrease of GDP, and most observers misconceived it as a major tragedy. This positive effect can be noticed in expanded exports of raw materials and intermediary goods, which have typically led economic recovery in transition countries. This is probably the greatest statistical confusion in postcommunist transition.

Value detraction can be assessed in various ways. Unfortunately, we cannot calculate the eliminated value detraction directly because manufacturing's share of GDP is not available. Another measure is trade with nonmarket economies as a share of GDP, but all socialist trade was not useless, and it cannot be easily related to GDP because of sharp swings in real exchange rates and thus GDP in dollar terms. The same is true of increased exports of raw materials and intermediary goods. One single measure is preferable to avoid double counting; it should be related to GDP in domestic currency; and it must be widely available. Rather than total value detraction, we are interested in eliminated value detraction, as much has been maintained for years through subsidies.

The most relevant overall measurement of reduced value detraction available appears to be reduced overindustrialization, measured as the decline in the industrial sector's share of GDP (see Table 4.5). It is reasonably neutral to GDP level and exchange rates, while reflecting a major structural improvement. Yet, this is a partial measurement. Although most value detraction pertained to manufacturing, it existed throughout the economy. Value detraction persists in nonreforming countries, while new production has arisen in parallel, but we need a long period of measurement to capture the whole adjustment.

For most countries, this decline in industrial share – or reduced value detraction in industry – is in the range 9–20 percent of GDP till 1995.[5] This decline largely corresponds to the intensity of structural reforms. As hard budget constraints started to bite later in most FSRs, the contraction of their industrial sectors continued after 1995, while nonreforming Belarus pumped up its old industrial sector after 1995, undoing its initial reduction of value detraction. It appears plausible that the share of unsalable goods, or value detraction, amounted to around 20 percent of GDP in the last year of communism in most countries.

Foreign Trade Shocks or Reduction of Implicit Trade Subsidies

The economic distortions of communism were especially severe in trade among socialist states, as both commodity structure and prices was largely politically determined. Socialist states mostly exchanged goods nobody wanted, forcing substandard and overpriced merchandise upon one another. The wrong things were traded for the wrong reasons between the wrong people in the wrong places at the wrong prices.

[5] Because of early market reforms, Hungary had the least distorted industrial structure at the outset of its transition. Moldova and Tajikistan had not adjusted much to the market by 1995, but nor did they suffer much from overindustrialization to begin with. Turkmenistan is an exception with its rising energy industry.

Table 4.5. The Declining Share of Industry in GDP, 1989/1991–1995 (Share of GDP in percent)

	Industry		Difference
	1989/1991	1995	
Central Europe	*1989*		
Poland	52	34	–18
Czech Republic	58	39	–19
Slovakia	58	37	–21
Hungary	44	32	–12
South-East Europe	*1989*		
Romania	56	43	–13
Bulgaria	59	31	–28
Baltics	*1991*		
Estonia	40	30	–10
Latvia	44	33	–11
Lithuania	51	34	–17
CIS	*1991*		
Russia	48	39	–9
Belarus	46	37	–9
Ukraine	50	42	–8
Moldova	33	32	–1
Armenia	49	32	–17
Azerbaijan	..	31	..
Georgia	37	19	–18
Kazakhstan	45[a]	32	–13
Kyrgyzstan	35	20	–15
Tajikistan	35	35	0
Turkmenistan	31	59	28
Uzbekistan	37	28	–9

Note: Industry includes construction. The statistics around 1990 vary greatly for no good reason, leaving great uncertainty. The strange Turkmen numbers depend on its expansive and dominant fuel industry.

[a] 1992.

Source: World Bank (2000a).

The share of unsalable goods in mutual trade was probably even greater than in the domestic economies. For instance, Hungarian losses of exports to formerly socialist countries consisted predominantly of machinery and buses, which Hungary hardly exported to the West (Gács 1995, pp. 165–6). Much of the intraregional trade consisted of exports of manufactured goods from the more developed countries to the energy exporters, which paid implicit subsidies to the exporters of manufactures.

Raw materials, on the contrary, were fine, but their low prices involved huge implicit export subsidies from the energy exporters, essentially Russia, Turkmenistan, Kazakhstan, and Azerbaijan. A lot of these raw materials were wasted and would not be in demand at market prices in a market economy. Moreover, much could not be profitably transported to regions of actual demand. The early decline of intraregional trade amounted to an elimination of implicit trade sub-sidies rather than a costly deterioration of terms of trade, as the early literature on the collapse of the socialist trading system argued.

Berg et al. (1999) note that high trade dependence had the greatest adverse aggregate effect on the initial output decline. EBRD (1999) and Popov (2000) rightly specify the problem as trade with other communist countries, which was even more distorted than domestic trade. The decline in mutual trade between the postcommunist countries was largely a beneficial shake-out of unsalable goods or unaffordable waste of raw materials, although a certain disruption of viable trade occurred. Trade restructuring comprised a desirable systemic change and the elimination of implicit trade subsidies. While the losses of implicit subsidies were real, they were inevitable costs of national independence.

In 1991, the clean dissolution of the Council of Mutual Economic Assistance (CMEA) eliminated both unsalable goods and energy subsidies. Economists calculated the "costs" or changes in terms of trade for South-East and Central Europe, which pursued about half of their foreign trade with CMEA countries (Rodrik 1992; Rosati 1995; Gács 1995). Their assessments of the impact of the Soviet trade shock ranged from a high of 7.8 percent of GDP for Hungary (Rodrik 1992) to 1.5 percent for Czechoslovakia and negligent for Romania in 1991 (Rosati 1995, p. 152; see Table 4.6). These totals are likely to be understated, since their trade with market economies was enormously dynamic, providing a strong positive effect.[6] The trade effect was greater on countries that traded more with the Soviet Union and the CMEA (notably Bulgaria), countries that were more open (most of all Hungary), and countries that imported a lot of energy (Bulgaria and Hungary). Thanks to far-reaching early liberalization of foreign trade, the East and

[6] For Central Europe, new beneficial trade started instantly. Hungarian exports to former CMEA countries dropped by 60% from 1988 to 1992, but its exports to the West surged by 60%, providing Hungary with a positive net effect from trade restructuring (Gács 1995, p. 179). Similarly, in 1990, Polish exports outside of the CMEA increased by no less than 51%, while its exports to the still existing CMEA dropped by 13%. As a result, foreign trade made a *positive* contribution to Poland's GDP of 5.5% of GDP in its first year of transition (Berg 1994, p. 7).

Table 4.6. Estimated Initial Impact on GDP of Changes in Trade with the CMEA (Percentage of GDP)

	Rodrik: Terms of trade	Rosati: Exports only	Gács: Exports only
Poland	−3.5	−2.2	..
Czechoslovakia	..	−1.5	..
Hungary	−7.8	−2.6	−4.1
Romania	..	0.4	..
Bulgaria	..	−5.4	..

Sources: Rodrik (1992); Rosati (1995); Gács (1995).

Central European countries, including Estonia and Latvia, achieved shares of exports to the EU predicted by the gravity model as early as 1994 (EBRD 1999, p. 91).

Foreign trade distortions were far greater in the Soviet Union than in Central Europe. Extreme protectionism forced most Soviet republics to pursue 90 percent of their trade with one another. Further aggravating the situation, the CIS countries undertook slow trade and payments reforms, maintaining much of their mutual trade in unsalable goods till 1994. The share of mutual trade among the CIS countries dwindled gradually, from 57 percent of their total trade in 1992 to 33 percent in 1997 (Michalopoulos and Tarr 1997), more than the gravity model would have predicted (EBRD 1999, p. 91).

Lucjan Orlowski (1993) and David Tarr (1994) have calculated implicit trade subsidies for the FSRs, comparing the prior prices with prevailing world market prices. Orlowski dealt only with interrepublican subsidies, while Tarr also included subsidies in trade with other former socialist countries. Both focused on 1990, and their numbers are surprisingly similar (see Table 4.7). For seven FSRs the total effect was less than 5 percent of their GDP. Three countries exporting oil and natural gas provided substantial subsidies as a share of their GDP, namely Russia (17.7% of GDP), Turkmenistan (19.5%) and Kazakhstan (7.4%). These three countries benefited greatly from the abolition of implicit trade subsidies. Five states enjoyed substantial trade subsidies, namely Moldova (16.1% of GDP), Estonia (12.7%), Latvia (11.3%), Lithuania (9.7%), and Armenia (7.6%). Not surprisingly, these countries, with the exception of Estonia, have suffered comparatively large falls in recorded output, although most have undertaken substantial reforms.

Subsidization dwindled only gradually after the break-up of the Soviet Union at great Russian expense, as the Russian government

Table 4.7. Implicit Transfers as Share of GDP, 1990 (Percentage of GDP)

	Tarr Outside of USSR	Tarr Interrepublican	Orlowski Interrepublican	Tarr Total
Estonia	0.7	–13.5	–12.1	–12.7
Latvia	0.2	–11.6	–10.4	–11.3
Lithuania	5.9	–15.6	–17.1	–9.7
Russia	13.2	4.5	3.7	17.7
Belarus	7.2	–11.4	–8.9	–4.2
Ukraine	3.8	–6.9	–3.6	–2.6
Moldova	2.7	–18.8	–24.1	–16.1
Armenia	3.5	–11.1	–9.2	–7.6
Azerbaijan	10.5	–6.7	–10.1	3.7
Georgia	12.1	–12.1	–16.0	0.0
Kazakhstan	4.0	3.4	–0.5	7.4
Kyrgyzstan	2.6	–1.3	–2.7	1.4
Tajikistan	8.6	–6.9	–6.1	1.7
Turkmenistan	3.6	15.9	10.8	19.5
Uzbekistan	3.1	–1.9	–1.3	1.1

Source: Tarr (1994, pp. 18–19); Orlowski (1993, p. 1006).

reduced both its financing and implicit trade subsidies by raising commodity prices, but by 1995 these subsidies were small.

In Soviet times, direct budget transfers between states were of limited significance, but they were substantial for Soviet Central Asia, whose five states benefited from large direct budget transfers from the central Soviet government. Lucjan Orlowski (1995, p. 66) has dug out these numbers for 1989, when Kyrgyzstan received 7.8 percent of its GDP in union budget transfers, Tajikistan 8.2 percent, Turkmenistan 9.0 percent, Kazakhstan 9.3 percent, and Uzbekistan 11.3 percent of its GDP. From 1994, however, these subsidies were gone. These were inevitable losses for the Central Asian republics, connected with their independence rather than any change of economic system. "The elimination of these subsidies hurt economic welfare in Central Asia, especially the provision of public services, whereas the previous donors, primarily Russia, benefited when these transfers ceased.

Thus, the foreign trade "shocks" reflected a combination of unsalable goods, previously disregarded transportation costs, and the elimination of implicit trade subsidies – essentially from Russia, Turkmenistan, and Kazakhstan – to other countries. Their eradication was a result of political independence rather than any cost of transition. Because of the very gradual transition in the CIS, implicit transfers were huge in 1992–4, complicating any comparisons among these countries in those years (Olcott et al. 1999). Their elimination hurt economic welfare in Central Asia, especially the provision of public services. The previous donors, primarily Russia, benefited when these transfers ceased.

Collapse of Defense Production and Consumption

Soviet defense expenditure was a persistent dispute in the Western Sovietological community. Gradually, the CIA raised its assessment of Soviet defense spending to 15–17 percent of GDP in 1986 (Berkowitz et al. 1993), but that was based on the CIA's clearly exaggerated estimate of Soviet GDP. As late as 1990, the CIA considered Soviet GDP per capita no less than 43 percent of the U.S. level in purchasing power parities (PPP). The European Comparison Program (ECP), which cooperated with Soviet statistical authorities, undertook a careful empirical analysis, setting Soviet GDP per capita at 32 percent of that of the United States in 1990 (and Soviet household consumption per capita at only 24 percent of the U.S. level; Bergson 1997).[7] If we use the CIA assessment of Soviet defense expenditures and the ECP assessment of Soviet GDP, the defense burden would amount to 22 percent of GDP.

Yet, even these GDP numbers are too high, as the poor quality of goods and services cannot be fully considered, while shortages and forced substitution are disregarded. Thus, the Soviet Union probably spent about one-quarter of its GDP on military purposes in the late 1980s (Åslund 1990), going to both military production and military consumption, but representing a sheer waste of public resources.

The Russian reform government swiftly reduced military spending to an internationally normal level of about 3 percent of GDP, while most other postcommunist countries reduced such expenses to 1–2 percent of GDP. Such a reduction of defense expenditures would result in a nominal decline in the 1989 GDP of about 22 percent in the whole FSU. Yet, this might be an exaggeration. Much of barter, arrears, and enterprise subsidies pertains to the military-industrial sector. Western intelligence argues that a couple of percent of GDP should be added, because the military does not pay for all the cost it actually causes society, such as electricity and land usage. A counterargument is that the military may use more resources for black market activities than for defense.

Unfortunately, we do not possess sufficient information to distribute the military costs among the FSRs. For Russia, Belarus, and Ukraine, this

[7] This tallies well with a World Bank study led by Paul Marer (1985) setting the Soviet GNP per capita at 37% of the U.S. level for 1980. The ECP numbers offer an alternative for making the exaggerated communist GDP numbers more realistic, but the series is far from complete as yet.

nominal decline must have been disproportionately large, because they had hosted most of the military-industrial complex. In East-Central Europe, military expenditures were not much higher than in the West, but even there the trimming of the military sector probably accounted for a couple percent of the fall in recorded GDP. Yet, we abstain from making any correction here to avoid the accusation of double counting, as part of the declining defense costs are reflected in the contraction of industry. Moreover, some would argue that even the excessive soviet defense expenditures represented value added rather than waste.

Wasteful Investment

Socialism was a system of waste. Soviet production usually needed three times more inputs than a Western factory, since costs were irrelevant to managers. Some of these losses represented inefficiency, others theft. With the introduction of harder budget constraints, enterprises started bothering about costs, sharply reducing domestic demand for inputs, such as steel, metals, and chemicals. Initially, however, budget constraints were soft or lacked credibility, prompting energy intensity to rise everywhere.

The same was true of investment. Communist regimes prided themselves on huge investment ratios, but the socialist landscape was scarred by unfinished construction projects (Winiecki 1988, 1991b). One reason was the accepted practice of theft by state employees from construction projects to build their own houses or repair their apartments. Enterprises also used unfinished construction projects to pressure the government to provide additional state funds, as the state usually financed investment. Therefore, the persistently high investment ratios in fixed investment were indications of theft and waste rather than substantial real investment. As ample capital goods were underutilized or unusable, a contraction of investment for a few years was desirable to stop the notorious theft by employees, to halt the hoarding of investment goods, and to allow for a reallocation of unused capital goods.

Socialist countries piled up large inventories predominantly of inputs, such as raw materials, which were labeled investment in national accounts. As these inventories continuously accumulated without any cyclical tendency, this was obvious waste. Poland had the best statistics, showing that "investment" in inventories amounted to 7 percent of GDP or one-quarter of total investment in the mid-1980s (World Bank 2000a).

Already in the early transition, reformers managed to introduce a demand barrier in a few countries, notably Poland, Czechoslovakia, Estonia, and Latvia. The national demand curve shifted permanently, initially reducing recorded output. Substantial dishoarding of inputs and capital goods started, as desired, while stocks of finished goods rose to a lesser extent, reflecting the problems to sell leading to the characteristic overproduction of capitalism. The dishoarding of inputs led to a stark decline in demand for enterprises producing inputs. Andrew Berg (1994) has calculated that the total reduction in inventory accounted for two-thirds of the total decline in Poland's GDP in 1990. Yet, although Polish enterprises faced a real demand barrier in 1990, heavy manufacturing and mining contracted the least, suggesting that the budget constraints of large Polish producers remained pretty soft. Apparently, even Poland needed a more severe monetary crunch.

The investment that was sheer waste should preferably be deducted from GDP. A comparison with East Germany is apt. The German Institute of Economic Research (e.g., DIW 1977) in West Berlin assessed that East German GDP per capita was stably about 60 percent of the West German level, and the GDR had a higher investment ratio than West Germany. When the Berlin Wall fell, it became obvious that the East German fixed capital per capita was only 30 percent of the West German level (Siebert 1992, p. 39).

Without more detailed knowledge, it would appear reasonable to deduct the difference between the investment ratio under late communism and the investment ratio at the nadir. The result is displayed in Table 4.8. While the average decline in the investment ratio of 11 percent of GDP makes sense, the individual observations clarify that these data contain far too much noise. Any single year of measurement contains special biases, and investment ratios vary greatly from year to year. Some countries had artificially boosted investment ratios in 1989–90 (especially Armenia, Latvia, and Poland). A few countries suffered truly devastating crises, which depressed investment excessively at the nadir (notably Georgia, Armenia, and Bulgaria). Most countries undertook large-scale wasteful public investment long after their nadirs, while new productive investment started early on. Moreover, because some double counting may occur with unsalable goods being included in investment, we abstain from making a justified adjustment.

A Reinterpretation of the Nominal Output Data

This line of analysis gives us a new perspective on output in transition, prompting a revision of both current and old GDP numbers. We shall limit ourselves to the most conservative, indisputable revisions. We need several years to capture the structural change, but the availability of

Table 4.8. Gross Domestic Investment as a Share of GDP (Percentage of GDP)

	Investment Ratio	Investment Ratio at Nadir	Change
Year 1989			
Poland	38	19	–19
Czech Republic	27	26	–1
Slovakia	32	27	–5
Hungary	27	20	–7
Bulgaria	33	11	–22
Romania	27	31	4
Year 1990			
Estonia	30	29	–1
Latvia	40	18	–22
Lithuania	33	18	–15
Russia	30	16	–14
Belarus	27	25	–2
Ukraine	27	21[b]	–6
Moldova	25	26[b]	1
Armenia	47	10	–37
Azerbaijan	..	24	..
Georgia	31	2	–29
Kazakhstan	32[a]	23	–9
Kyrgyzstan	23	18	–5
Tajikistan	23	..	..
Turkmenistan	40	..	..
Uzbekistan	32	27	–5

[a] 1992.
[b] 1998.
Source: World Bank (2000a); own calculations.

assessments of the unofficial economy hinders us from proceeding beyond 1995. Our starting point is the latest official GDP in 1995, as a percentage of the official GDP in 1989 (see Table 4.9, column 1).

1. The unregistered real economy has grown substantially, especially in intermediary reformers (Russia, Ukraine, Azerbaijan, and Georgia). We added it to real GDP in 1995 (see column 2 in Table 4.9).
2. The decline in registered output started during the last years of communism, but our focus is postcommunist transition, so we start with 1991 for the former Soviet republics. That boosts primarily small post-Soviet countries (the Baltics, Moldova, and the Caucasus; see column 3 in Table 4.9).

3. Eliminated value detraction, as revealed by declining industrial share of GDP until 1995, hovers around 20 percent of GDP in some of the most reformist countries (Poland, the Czech Republic, Slovakia, Lithuania, Armenia, Georgia, and Kyrgyzstan). GDP before transition should be reduced with this share of GDP to correct for its overestimation (see column 4 in Table 4.9).[8] However, value detraction was undoubtedly much greater under communism to judge by the East German evidence.

Table 4.9 sums up these corrections, which raise the overall output level in 1995 substantially, but the differences between success and failure remain stark. Central Europe and Estonia saw no contraction of output, and Central Europe even enjoyed significant early growth, with Poland in a class of its own. Within the CIS, the order of performance is reversed, with Russia, Ukraine, and Belarus performing in correspondence to their degree of reform. While statistics are incomplete, the war-torn countries, Georgia, Tajikistan, Azerbaijan, Armenia, and Moldova, probably lost 20–30 percent of their GDP, as did nonreforming Belarus and Turkmenistan, revealing these presumed star performers in official statistics as miserable failures.

These assessments are exceedingly conservative. No adjustment has been made for the reduced defense expenditures, which benefited the whole of the FSU, but most of all Russia, Belarus, and Ukraine. Nor has the abolished waste in the investment sector been considered. If only one-quarter of investment was taken out of the base GDP for increased inventory of unsalable goods, most numbers would rise by about 8 percent. Most import, value subtraction, was clearly larger than our correction, and communist era GDP numbers remain exaggerated.

A Different View of Transition

Does this revision tally with other observations related to output? Obviously, communism caused a serious economic crisis, which contributed to its collapse. Then, it would be strange if the abandonment of communism greatly enhanced social costs, even if the poison pills of communism led to significant transition costs.

Everybody agrees that the underground economy has grown and that it is still not fully included in official statistics. Regression analyses on the effects of initial conditions on output show that overindustrialization and trade with socialist countries are of overwhelming importance, explaining 60–75 percent of the contraction (Berg et al. 1999; Popov 2000;

[8] Neither the Bulgarian prominence here, nor its overall numbers make sense, and it has to be taken out.

Table 4.9. Revision of GDP Development in Transition, 1989/1991–1995

Country	Official GDP in 1995 (% of 1989)	Including Unofficial Economy in 1995 (% of 1989)	Postcommunist Development	Deduction of Value Detraction from Base GDP	Final Revision of GDP at Nadir or 1995
Central Europe			*% of 1989*	*% of 1989*	*% of 1989*
Poland	98.6	94.9	94.9	115.7	116
Czech Republic	94.1	89.3	89.3	108.9	109
Slovakia	84.2	82.9	82.9	104.9	105
Hungary	85.6	87.1	87.1	99.0	99
South-East Europe			*% of 1989*	*% of 1989*	*% of 1989*
Romania	84.8	74.7	74.7	85.9	86
Bulgaria	79.7	89.2	89.3	..	..
Baltics			*% of 1991*	*% of 1991*	*% of 1991*
Estonia	66.4	68.9	85.3	94.8	95
Latvia	51.0	62.3	67.6	76.0	76
Lithuania	56.1	50.6	56.5	68.1	68
CIS			*% of 1991*	*% of 1991*	*% of 1991*
Russia	60.2	74.0	81.1	89.1	89
Belarus	63.4	61.2	63.9	70.2	70
Ukraine	46.0	67.0	78.5	85.3	85
Moldova	38.3	58.8	73.0	73.7	73
Armenia	49.9	..	..	..	..
Azerbaijan	37.0	70.1	79.9	..	80
Georgia	24.0	37.6	54.1	66.0	66
Kazakhstan	60.8	62.3	71.9	82.6	83
Kyrgyzstan	53.1	..	..	..	..
Tajikistan	35.8	..	..	..	..
Turkmenistan	64.2	..	..	..	..
Uzbekistan	80.5	79.0	78.1	85.8	86

Notes: Column 1 is from Table 4.2. For the countries whose nadir occurred after 1995 and the difference is limited, that year is selected for lack of later data for the underground economy. Russia's GDP was 65.3% of its 1991 level, 52.3% for Ukraine, and 47.6% for Moldova. Bulgaria does not make sense here as it had a big decline until 1997, involving great structural changes.
Column 2: last column from Johnson et al. (1997), p. 183.
Column 3: 1990 and 1991 deducted from Table 4.1, which contains the most updated GDP numbers.
Column 4: Deduction of value detraction from base GDP, as revealed in industrial structure in Table 4.5. No correction has been made for Turkmenistan and Azerbaijan, which have expanding fuel industries.
Sources: ECE (2000a), p. 225; Johnson et al. (1997), p. 183; EBRD (2000a), p. 4; World Bank (2000a).

EBRD 1999; De Melo, Denizer, Gelb, and Tenev 1997a). As we have identified these initial conditions as measures of value detraction, these regression analyses fit our results perfectly.

East Germany offers an enlightening comparison. As mentioned above, the German Institute of Economic Research (DIW 1977) in West Berlin assessed East German GDP per capita steadily at about 60 percent of the West German level. When the wall fell, the GDP level, as well as consumption and public investment, were boosted by large West German subsidies, while production slumped because of excessive wage rises imposed by West German trade unions. Therefore, the most relevant indicator of East German production appears productivity, which was barely 30 percent of the West German level (Siebert 1992, p. 39). Thus, the West thought East German production was twice as large as it really was. A similar overestimation for most of the former Soviet bloc appears likely, with the exceptions of semireformed Hungary and Poland.

But why do people in opinion polls indicate that the material situation has deteriorated? The best counterevidence comes from East Germany, where people admit to massive material improvements on all specific questions, while they claim a general deterioration. This issue appears more psychological than material. One reason is that people are unable to handle negative publicity about their own society, which was prohibited under communism. Another explanation is that they have learned how badly off they always in comparison with the Western world, which few knew under communism. A third reason is that people do not think in terms of Pareto optimality, whether total welfare rises or falls. They look upon their relative position, making jealousy part of their evaluation. These were times of momentous changes, and it is particularly pensioners who opposed reforms, while they were the main material beneficiaries of the early reforms (Milanovic 1998). Thus, public sentiment about the general situation should be taken with a great deal of skepticism.

After communism, excess demand and thus value detraction dwindled, as private hoarding ended instantly. In national accounts, the dishoarding after price liberalization looked like sudden destitution verging on starvation (Cornia 1994), as both sales and demand declined, but real welfare might not have been affected. Scrutinizing statistics on consumption, investment, and exports, Sachs and Berg (1992) found that the decline in Polish GDP from 1989 to 1990 was not 12 percent as stated in the production statistics, but 4.9 percent. Unfortunately, we do not possess such statistical series even for Poland, so we have to make do with production statistics and just keep this bias in mind.

Chapter 8 shows that social hardship has been greatly exaggerated, though poverty has increased with growing income inequality, but Soviet statistics on social matters were so poor that we shall never know the real change.

In Chapter 9, the politics of transition will be discussed. Transition has faced surprisingly little popular resistance, and the ex-communist parties have been strongest in relatively slow reform countries. This is much easier to understand, with no major output collapse and little deterioration in the standard of living.

The revised output data correspond better to related observations than the old official statistics. The absurd official statistics herald nonreforming and miserable Belarus as far more successful than, for instance, reforming Latvia and Lithuania, while any Ukrainian can tell you how awfully Belarusians live. This approach should alter the absurd but predominant perception of postcommunist transformation. The implications are profound, although our reassessments are very conservative, requiring further upward revisions.

First of all, the purported tragedy of universal output loss after communism is a myth, though the region suffered from stagnation during the first half of the 1990s. This helps to explain the mysterious absence of social unrest and of electoral backlashes against reformers. Nor is it possible to understand the sharp rise in social expenditures in most postcommunist countries in the first half of the 1990s, if an output collapse had taken place.

Second, the socialist economies were in far worse shape than most Western observers believed at the time of its demise. The evidence is overwhelming for anybody who wants to check. In the late 1980s, Soviet health statistics, industrial structure, and foreign trade structure placed the country close to Mexico and Brazil among what the World Bank calls "upper-middle-income countries" (Åslund 1990). The alleged misery in postcommunist transformation is primarily the delayed revelation of the true costs of communism. In the future, we may realize that the Soviet stagnation did not start around 1980 but perhaps a decade earlier.

Third, even after most effects of adverse "initial conditions" have been deducted, the differences between failures and successes remain almost as large as in the flawed official statistics, ranging from a decline in GDP of perhaps 35 percent in Moldova to a rise of at least 20 percent in Poland. This indicates that economic reform policies have been even more positive for economic performance than previously understood.

In other words, the main problem of transition was that value detraction was not impeded quickly enough. Therefore, underutilized or wasted resources were not reallocated to facilitate new supply. In the radical early reformers, Poland and the Czech Republic, a positive supply effect was in evidence early on.

Fourth, distorted official statistics have been a major cause of bad policies, as they did not reveal the strong, early supply effects shock reforms brought about. Consequently, the successful Polish model was not widely adopted, and many started calling for fiscal and monetary stimulation instead. Even if postcommunist people are healthily skeptical of statistics, they tend to believe in bad news, which has led them astray. The distorted official statistics encouraged a march of folly toward bad policies.

The overall lesson is that radical reforms, involving liberalization and financial stabilization, were both economically effective and socially desirable. The real social concern of postcommunism was not initial decline in output but lasting stagnation in many countries.

CAUSES OF DECLINE AND GROWTH IN TRANSITION

Turning to the ensuing economic growth or decline after the initial transition, we encounter a highly varied picture, with some countries having obtained early substantial growth rates while others have continued to linger (see Chart 4.1). These growth statistics are more plausible, as the worst statistical traps of the transition have been passed. The large number of countries in simultaneous transition from a socialist economy to a market economy has facilitated cross-country regression analyses of various effects from 1995. Most of these studies have been undertaken by people in the World Bank and the IMF because of their empirical interest and greater access to early data,[9] but some outsiders have also contributed.[10]

This literature displays a great deal of agreement, both on methodology and on results. The number of countries analyzed tends to be around twenty-five, also including Slovenia, Croatia, Macedonia, Albania, and sometimes Mongolia, but this makes little difference for the outcome. Various authors have investigated most conceivable causes checking

[9] The main contributions are as follows: De Melo, Denizer, and Gelb (1997a) was the pioneering work that provided most of the fundamental answers, and De Melo, Denizer, Gelb, and Tenev (1997b) studied the role of initial conditions. Fischer, Sahay, and Vegh (1996a,b and 1997), Lougani and Sheets (1997) and Christoffersen and Doyle (2000) focused on the role of macroeconomics. Berg, Borensztein, Sahay, and Zettelmeyer (1999) and Havrylyshyn and Wolf (1999) provide the current view of the state of affairs. Other papers of relevance are: De Melo and Gelb (1996, 1997); Fischer and Sahay (2000); Hernandez Cata (1997); and Selowsky and Martin (1996).

[10] Åslund, Boone, and Johnson (1996); Sachs (1996); Krueger and Ciolko (1998); and Heybey and Murrell (1999).

their impacts. We shall leave technicalities aside and focus on significant outcomes. The output data used are by necessity the official data, which means that later studies are based on better data, and countries with large unofficial economies are underrated.

Controlling Inflation

To begin with, all transition countries but Hungary and then Czechoslovakia were hit by inflation of over 100 percent a year. Financial stabilization became the natural focus of economists' attention, especially as macroeconomists and the IMF came to the fore. Many have criticized this preoccupation with macroeconomic stabilization, but high inflation is detrimental to growth. Virtually all the multicountry regressions have found a strong correlation between high inflation and falling output.

The papers by Fischer et al. (1996a,b and 1997) came to rather strong conclusions about the impact of inflation on growth. Fischer et al. (1996b, p. 89) stated: "The simple – but essential – message that emerges . . . is that real GDP rebounds following inflation stabilization, which in turn appears highly correlated with the improvement in the public finances." The regularity has been striking. The fall in output outlasted high inflation in every single country. No country returned to economic growth until inflation had fallen below 45 percent a year (compare Tables 4.1 and 6.1). The total slump was not mitigated by loose fiscal and monetary policies, but the longer high inflation lasted, the greater the total contraction in output (De Melo et al. 1997a). Christoffersen and Doyle (2000, p. 439) established: "There is no evidence that disinflation necessarily incurs significant output costs, even at moderate inflation rates."

However, in some former Soviet economies (Russia, Ukraine, Moldova, Kazakhstan, and Belarus) growth did not rebound after stabilization, and over time the direct link between macroeconomic performance and output has become more tenuous. These data have prompted a new conclusion. While stabilization appears a necessary condition for achieving growth, it is not a sufficient condition (Havrylyshyn and Wolf 1999).

In 1999, Berg et al., concluded: "The impact of macroeconomic variables, while significant, is much smaller than that of either initial conditions and structural reforms." They found that the fiscal balance was more important for growth than the control of inflation. Several countries brought down inflation primarily through very strict monetary policy, with lasting real interest rates of 50–100 percent a year, because their budget deficits remained too large.

A multitude of multicountry regressions with output and inflation have created a broad consensus that inflation must be under a certain threshold. Otherwise, it will seriously hamper growth. Fischer (1993) had established through cross-country regressions that growth is negatively associated with inflation, large budget deficits, and distorted foreign exchange markets. Bruno and Easterly (1998) suggested that this hurdle would be an inflation of 40 percent a year. Christoffersen and Doyle (2000) have assessed this threshold for transition economies at 13 percent a year.

This was a serious empirical rebuke to the Russian economists, who had argued that it was structurally impossible to lower inflation to less than 100 percent a year without hampering growth because of the preponderance of monopolies and state ownership in the Russian economy (Yavlinsky and Braguinsky 1994; Lvov 1996).

The evidence also ran against advocacies of a more moderate macroeconomic stabilization, such as Guillermo Calvo and Fabrizio Coricelli (1992, 1993, who had argued that Polish output had suffered from an excessive credit crunch. Andrew Berg (1994, p. 21) noted that enterprise managers complained in a survey of a lack of demand for their output, not inability to purchase inputs. He concluded that "there is no evidence that tight credit caused a supply constrained output decline." Moreover, Poland did maintain significant inflation throughout the 1990s, suggesting that budget constraints remained too soft.

The broader meaning was that the postcommunist economies were in bad need of harder budget constraints, which were very difficult to impose. Hence, demand was not a problem, while supply was (Fischer and Sahay 2000). Given the very high import prices of all imports at the initially extremely low exchange rates, all domestic goods that were at all salable could be sold, but many were of extremely low quality.

Liberalization the Most Important Factor

The first cross-country regressions on transition economies established that "economic growth is positively correlated with reform progress" (Sachs 1996, p. 128), and this evidence has grown ever stronger.

Liberalization is usually divided into internal and external liberalization. Internal liberalization comprises the freeing of domestic prices and the abolition of state trading monopolies. External liberalization refers to the unification of the exchange rate and currency convertibility, the elimination of export controls and export taxes, and the substitution of moderate import tariffs for import quotas and high import duties (De Melo et al. 1997a, p. 24). Beginning with De Melo et al. (1997a) and the EBRD *Transition Reports*, a number of liberalization indexes have been

Chart 4.2 Degree of Structural Reform, 1997 (Average value of Structural Reform Index, 0–1).

	Central Europe	*Baltics*	*South-East Europe*	*CIS*
Consistent Growth, U-curve	Poland Czech Republic Slovakia Hungary 0.82	Estonia Latvia Lithuania 0.77		Armenia Georgia Kyrgyzstan 0.66 Belarus Azerbaijan Uzbekistan 0.47
Growth Reversals, W-curve			Bulgaria Romania 0.67	
Little Growth, L-curve				Russia Ukraine Moldova Kazakhstan 0.65 Tajikistan Turkmenistan 0.38

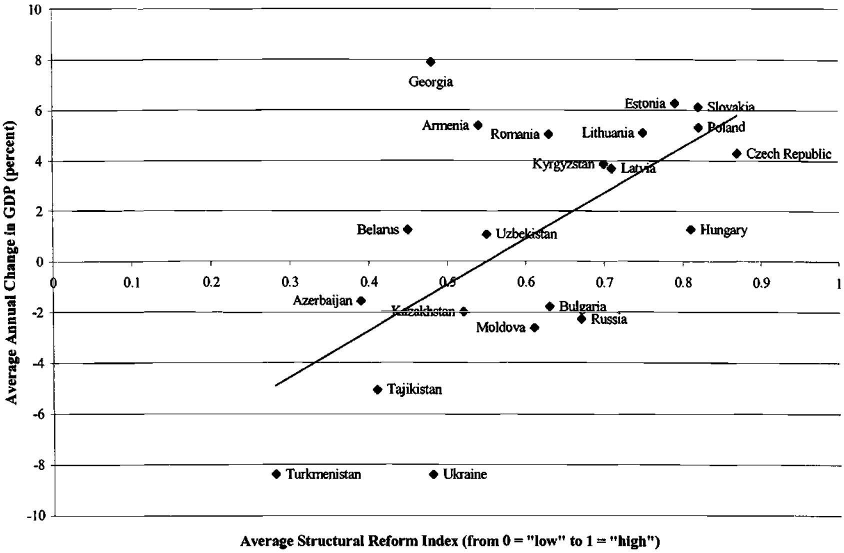
Sources: EBRD (1998); Table 5.1.

made. They combine a number of different measures of liberalization with the same weight, although some factors are undoubtedly more important than others.

Chart 4.2 shows the average of the structural reform index for the various groups of countries in 1997. The closer to 1, the more liberal an economy is. Central Europe and the Baltics have high values, as we would have anticipated. Bulgaria and Romania are doing only a little better than most countries in the CIS. Curiously, the CIS reformers with consistent growth differ little from the CIS reformers stuck in stagnation. In particular, Russia has advanced almost as far in structural reforms as Latvia and Lithuania, but it has been blessed with less growth (see Table 5.1 for details).

Chart 4.3 offers a different presentation of the same data series, with averages of three years for each country. We have taken mean economic growth of years 4–6 after the start of transition, and the average structural reform index for years 3–5 to get one year's lag. The picture is about the same. The positive outliers are Armenia and Georgia, whose

Chart 4.3 GDP Growth and Structural Reform.



Sources: Tables 4.10 and 5.1. *Note*: Average economic growth years 4–6 after the start of transition (Poland and Hungary, 1993–5; the Czech Republic, Slovakia, Bulgaria, and Romania, 1994–6; the FSRs 1995–7). Average structural reform index for three years, one year earlier.

growth rates were presumably boosted by the return of informal activities to the registered economy as well as easy recovery after martial chaos. Negative outliers are Ukraine, Russia, Moldova, Hungary, and Bulgaria, of which all but Hungary saw a rise in its unregistered economy at this time. Besides, their underperformance probably reflects that these countries had less liberal economies than the structural reform index captured.

Initially, liberalization was often seen as a subfactor of financial stabilization, and perceived to bring about initial costs (Selowsky and Martin 1996; Hernandez-Cata 1997). Over time, however, liberalization has emerged as the most important growth-stimulating factor in the transition countries. Berg et al. (1999) found that liberalization helps all countries in the later transition and most of them even in the early transition. From the fourth year after the transition, mainly structural reforms, also including privatization, determined growth, and they are the driving force behind economic recovery. External liberalization has had a particularly great positive effect on output. Havrylyshyn and Wolf (1999) reckoned that most measures of structural reform were closely correlated with reform in general. The only measure they could single out as uniquely effective on its own was price liberalization.

It is easy to understand why liberalization has had such a great positive impact on output. The slump was largely attributable to substantial shifts in relative price and demand, which rendered much of the previous production unsalable. This necessitated a change in the composition of output, which was facilitated by real competition and enterprise change. The recovery in real output is driven by dramatic changes in the sectoral composition of GDP (De Melo et al. 1997a). Differently put, for "over-industrialized, distorted, and inefficient economies, recovery only comes after some elimination of the wasteful old production" (Havrylyshyn and Wolf 1999, p. 31; Hernandez-Cata 1997). Jeffrey Sachs (1996, p. 129) summed up the evidence: "Experience suggests that a quick move on liberalization following the fall of communism was important in achieving comprehensive liberalization, since delays in liberalization gave time for vested interests to form around remaining barriers to trade." The implication is that the postcommunist economy was primarily supply constrained and not demand constrained.

Privatization Helps

Privatization has been heralded both as the key solution (Yavlinsky and Braguinsky 1994) and as of little consequence (Stiglitz 1999a), and it has undoubtedly been the most controversial part of the transition. Many studies do not single out privatization but treat it as an element of structural reforms, together with liberalization.

Among studies with regressions of the impact of privatization on economic growth, the judgment appears unanimous. There is a strong positive correlation between the share of GDP arising from the private sector and output (Åslund et al. 1996; Havrylyshyn and Wolf 1999; see Chart 4.4). Berg et al. (1999) found that privatization and private sector conditions had significant effects on growth in the ensuing period, because it takes some time for privatized enterprises to become effective.

There is a strong perception that privatization has been less effective in the FSU than in Central Europe. A number of studies have argued that privatization to insiders has little or no beneficial effect, while privatization to outsiders tends to have a pronounced positive effect (Frydman et al. 1998b). Another empirically confirmed observation is that newly started enterprises are doing much better than former state enterprises that have been privatized (Johnson and Loveman 1995). Many enterprise surveys in the FSU show little difference between large and medium-sized enterprises that are still state-owned or have been privatized. EBRD (1999) even argued that privatization might be counterproductive if it allows vested interests to reinforce their hold on the state

Chart 4.4 Private Share in GDP, 1997 (Percent).

	Central Europe	*Baltics*	*South-East Europe*	*CIS*
Consistent Growth, U-curve	Poland Czech Republic Slovakia Hungary 73	Estonia Latvia Lithuania 67		Armenia Georgia Kyrgyzstan 57 Belarus Azerbaijan Uzbekistan 35
Growth Reversals, W-curve			Bulgaria Romania 60	
Little Growth, L-curve				Russia Ukraine Moldova Kazakhstan 56 Tajikistan Turkmenistan 23

Source: EBRD (2000a).

and public finance. Yet, the statistical evidence suggests that privatization is at worst neutral (see Chapter 7).

Renewed Growth Export-Led

Foreign trade has played a great and dynamic role in the transition. In spite of exceedingly poor statistics, the pattern during the recovery has been clear and striking. Exports have started increasing before output in almost all countries, and their increase has been considerable, swiftly expanding as a share of GDP, and growth has clearly been export-led (World Bank 1999). Christoffersen and Doyle (2000) found that export market growth is strongly associated with output growth. A considerable restructuring of foreign trade has occurred. All the former communist countries reoriented their trade from one another to the West, and growth in postcommunist countries has depended on access to Western markets. The most reformist countries have seen an impressive and steady increase of their exports (Havrylyshyn and Wolf 1999).

As exports grew, the successfully exporting countries received more money for imports, and imports have largely followed exports. To begin with, most countries went from a current account crisis to a trade surplus. As they obtained access to foreign finance, they could let imports grow more than exports, and in most cases they have developed significant current account deficits. Like exports, imports have been reoriented toward the West, as the gravity model predicted.

Exports have been the dominant engine of early economic growth, and the restructuring of foreign trade has been truly amazing in both speed and quality, especially in the most fortuitous reform countries. For most CIS countries, Russia remains the main export market, and it should remain so according to the gravity model, which means that Russia's economic recovery was and remains vital to growth in many transition economies (Christoffersen and Doyle 2000).

Growth Not Investment-Led

A major macroeconomic distortion under socialism was that consumption was too small and investment too large as shares of GDP. It was anticipated that consumption would increase as a share of GDP, and investment decline, as superfluous material inputs and underutilized real assets would be sold off. Yet, Poland and Hungary had already run down their investment to a low level because of popular pressure to boost consumption at the expense of investment in the 1980s.

Table 4.10 shows the portion of GDP devoted to consumption and fixed investment, respectively, before and after the change in system. Most countries show a substantial increase in the share of GDP going to consumption from an average of 73 percent before the transition to 84 percent around 1997. The consumption ratios are lowest in the Czech Republic, Slovakia, Hungary, Russia, and Belarus – that is, relatively rich countries – while the poorest countries have the highest consumption ratios.[11]

The numbers for investment are more interesting. The overall investment ratio has fallen significantly from an average of 28 percent of GDP in 1989 to 21 percent of GDP in 1997, which is quite respectable, but differentiation has increased. A caveat is that investment numbers are usually exaggerated, as they are calculated as a residue, and they might include capital flight. Yet, two groups of countries were actually spending a larger share of their GDP on investment in 1997 than before the transition, namely the most advanced reformers in Central Europe, and the conservative states Azerbaijan, Belarus, and Uzbekistan, which continue Soviet practices of wasteful public investments (further fueled by

[11] In some cases, the numbers are boosted by inflows of foreign capital, so consumption and investment do not add up to 100.

Table 4.10. Consumption and Gross Fixed Investment as Share of GDP, 1989 and 1997 (Percentage of GDP)

Total Consumption as Percentage of GDP			Gross Domestic Investment as Percentage of GDP		
	1989	1997		1989	1997
Central Europe			*Central Europe*		
Poland	57.3	81.9	Poland	16.4	20.8
Czech Republic	69.4	71.6	Czech Republic	26.0	30.7
Slovak Republic	71.5	71.6	Slovak Republic	27.5	38.6
Hungary	70.1	73.1	Hungary	21.6	22.1
South-East Europe			*South-East Europe*		
Romania	70.5	85.5	Romania	29.9	19.2
Bulgaria	68.6	82.6	Bulgaria	26.1	11.3
Baltics			*Baltics*		
Estonia	74.1	81.6	Estonia	28.9	26.5
Latvia	62.0	90.4	Latvia	32.0	19.3
Lithuania	74.2	84.0	Lithuania	31.7	24.4
CIS			*CIS*		
Russian Federation	65.3	75.3	Russian Federation	31.8	19.4
Belarus	..	78.4	Belarus	..	24.7
Ukraine	71.2	83.7	Ukraine	25.4	18.3
Moldova	..	99.7	Moldova	..	19.6
Armenia	..	128.8	Armenia	..	9.4
Azerbaijan	..	90.5	Azerbaijan	..	27.1
Georgia	74.7	103.7	Georgia	..	7.2
Kazakhstan	..	86.5	Kazakhstan	..	16.3
Kyrgyz Republic	86.8	86.2	Kyrgyz Republic	31.6	12.6
Turkmenistan	73.9	..	Turkmenistan	..	..
Uzbekistan	81.8	81.4	Uzbekistan	31.3	34.6
Tajikistan	87.5	..	Tajikistan	..	..

Source: World Bank (1999).

extensive foreign direct investment into oil exploitation in Azerbaijan). While the Baltics have recorded a decline in investment, their investment levels remain high. Most countries, however, have seen sharp declines in their investment shares, which seems a combined result of poverty and a poor investment climate. Investment has virtually ceased in the war victims Georgia and Armenia. Several other countries, especially Bulgaria and Kyrgyzstan, have far too little investment.

A common view is that economic growth has to be investment-led, but this appears a confusion between postcommunist transition and general growth theory. As these countries suffered from overindustrialization and overinvestment, they needed to rationalize and reallocate their capital goods rather than expand an already excessive stock. Furthermore, total investment includes inventory, which should shrink with the transition to a market economy, so investment in fixed assets is the relevant measure.

Two observations can be made. The first one is that investment has not preceded the return to growth. It has risen after a return to growth rather than being the engine of growth (see Table 4.11; De Melo et al. 1997a; Havrylyshyn and Wolf, 1999). Thus, renewed economic growth has not been investment-led. Second, the decline in investment has generally been far greater than the decline in output, while the later investment expansion has been all the greater in the successful reformers. We may conclude that investment is important for the consecutive, but not the initial, output expansion.

Speed of Reform: Vicious vs. Virtuous Circle

Regardless of our measure of reform, true reform countries do the most reforms, while others do little. Although there is considerable variation among countries, we can talk about a dichotomy. A country has entered either a vicious circle or a virtuous circle (De Melo and Gelb 1997).

A path dependence is apparent. A slow start of a reform leads to little reform also in the future, while a radical start of a reform usually leads to deeper and more comprehensive reforms and better economic results. Initial conditions matter for policies as well. Countries with adverse initial conditions are likely to pursue worse economic policies than those with advantageous initial conditions. Yet, there are exceptions in both groups. A number of countries in the region have defied difficult initial conditions and achieved real success (Armenia, Georgia, and Kyrgyzstan). The three Baltics states, Kyrgyzstan, and Poland have done much better than could have been expected from their preconditions, while Bulgaria, Romania, and Ukraine have done worse (EBRD 1999, p. 30). The conclusion is that policies matter, and they are not entirely predetermined by initial conditions (De Melo et al. 1997b).

The choice of path seems highly dependent on how a country starts its transition. Either it enters a reform track or a reform trap. In the early transition, economic policy has an extraordinary effect on the distribution of wealth. If multiple and highly distorted prices and exchange rates persist for some time, and if state property and finance are left unguarded, people with privileges will make huge amounts of money on rent seeking, arbitraging between regulated and unregulated markets, and extracting money from the state. As a result, passive policies have concentrated economic wealth and power in the hands of privileged

Table 4.11. Gross Fixed Investment, 1990–1999 (Annual percentage growth)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999[a]
Central Europe										
Poland	–6.7	–2.6	3.6	4.3	8.3	16.5	19.7	21.7	14.5	6.9
Czech Republic	260.3	–27.3	16.5	0.2	9.1	19.8	8.2	–4.3	–3.8	–5.5
Slovakia	11.6	–25.2	–3.3	–5.4	–4.6	5.3	39.8	14.5	11.0	–18.2
Hungary	–7.1	–10.4	–2.6	2.0	12.5	–4.3	6.7	8.8	11.4	5.8
South-East Europe										
Romania	–35.6	–31.6	11.0	8.3	20.7	6.9	3.9	–15.9	–19.2	–10.8
Bulgaria	–33.6	–19.9	–7.3	–17.5	1.1	16.1	–21.2	–23.9	16.3	28.8
Baltics										
Estonia	–12.0	–24.0	–43.7	6.3	8.5	0.3	11.4	17.5	8.1	–14.1
Latvia	..	–63.9	–28.7	–15.8	..	..	22.3	20.7	11.1	–9.1
Lithuania	..	..	..	..	–14.4	7.1	–2.4	4.8	11.2	..
CIS										
Russia	..	–15.5	27.2	–25.8	–26.0	–7.5	–16.0	–5.0	–3.2	–1.7
Belarus	..	4.5	–18.6	–7.5	–13.7	–29.5	–3.3	23.6	11.8	..
Ukraine	..	–20.8	–15.0	–30.5	–41.0	–30.8	–22.7	2.1	–4.3	..
Moldova	..	..	–32.4	–5.4	–12.9	–18.5	12.4	3.7	0.7	–19.5
Armenia	..	–33.0	–87.2	–7.8	–23.9	–17.3	10.3	2.1	11.9	..
Azerbaijan	..	..	..	..	..	–34.5	102.4	50.3	16.8	..
Georgia	..	..	..	..	..	618.6	57.7	41.4	10.3	..
Kazakhstan	..	..	..	–10.2	–13.0	–36.6	–24.7	3.6	1.7	..
Kyrgyzstan	..	..	..	..	–66.4	248.7	17.3	–38.7	–0.8	–11.9
Tajikistan	..	..	..	..	..	..	..	..	..	..
Turkmenistan	..	..	..	..	..	..	..	..	..	..
Uzbekistan	..	..	..	..	..	..	..	..	..	..

[a] January–September for Bulgaria, Hungary, Estonia, and Latvia.
Sources: 1990–8 data, World Bank (2000a); 1999 data, ECE (2000a).

groups, notably parts of the old Nomenklatura. Later, the ability of these vested interests to influence the state and its policy to their advantage has been a primary threat to economic reform (EBRD 1999, p. 102).

Therefore, radical reform policies are positively correlated with one another, while gradual policies are also positively correlated, reflecting dominance what the state interests dominate. The radical reform policies represent a broader public interest, while slow and partial reform policies are supported by rent-seekers. We can identify the two different paths. The virtuous path of reinforcing market economic reforms leads to substantial economic growth. Alternatively, "[t]he vested interests often began by accumulating wealth through rent-seeking profits from large price distortions in energy and raw materials, and by borrowing from central bank credits during inflationary years. . . . A potential virtuous circle of reforms and growth is replaced by a vicious circle of suspended reforms and stagnation" (Havrylyshyn and Wolf 1999). Then, it is logical that growth does not result, because the revenues of a privileged few may be totally unrelated to the development of the national economy. Some countries have caught up in reforms, for instance, Bulgaria and Georgia, but these latecomers have suffered big social costs, and they have usually gone through a profound crisis altering the government.

Speed of reform is, thus, of crucial importance, which is emphasized by almost all the regression analyses cited here. It reflects the dominant interests of society. The emergence of an opportunity for substantial reform is usually a matter of chance, but if it is missed, the cost to society will be high and lasting.[12] The extensive literature on the benefits of gradualism appears disproved. The major remaining query is the design of privatization under various conditions, as privatization might serve to reinforce the power of the vested interests under unfortunate circumstances.

The main drama of transition from communism is what kind of interests will dominate society. One alternative is a small group of vested interests, to whom rent seeking is key, while overall economic growth is not essential. The other alternative is a group that is sufficiently broad to represent a real public interest more concerned about overall economic growth than about its distribution.

[12] One paper (Heybey and Murrell 1999) argues the opposite, that the effect on growth of faster reforms has been negative since the beginning of transition, on the basis of methodological problems in all the other studies cited here. Instead, they argue that speed of reform has insignificant effects, presuming that the costs of dislocation in the existing state sector balances the substantial gains from liberalization and entry of new firms. However, Berg et al. (1999) have recounted the Heybey–Murrell model and arrive at the conclusion that properly applied it shows that speed matters and has a positive effect.

Why Are Some Partial Reformers in the CIS Successful and Some Unsuccessful?

Most major differences between transition countries may now have been illuminated, but we are left with one curious discrepancy. Within the CIS, three partially reformed countries – Armenia, Georgia, and Kyrgyzstan – achieved an impressive average growth rate of almost 6 percent a year for the three years 1995–7. At the same time, four other partial reformers – Russia, Ukraine, Kazakhstan, and Moldova – had an average decline of 4 percent a year (see Chart 4.1). However poor the statistics, this is a significant discrepancy.

In line with our analysis, we would have expected structural reform to explain this difference, but the slow-growing countries, especially Russia, had actually undertaken slightly more structural reform than the fast-growth countries (see Chart 4.3), and both groups had undertaken about as much privatization (see Chart 4.4), so this cannot be the explanation.

The popular view is that Russia and Ukraine are terribly corrupt countries and that it is impossible to do business there because of bureaucratic interference. However, the credible EBRD survey of how much enterprises pay in bribes as a share of their sales shows that corruption is actually considerably less in the slow-growing countries than in the fast-growing (see Chart 4.5). This corresponds to traditional perceptions of the Caucasus as the most corrupt part of the Soviet Union and Russia as comparatively honest, and corruption is highly dependent on historical legacy (Treisman 2000). Corruption on its own is not the explanation.

Reviewing all kinds of alternative variables, the best explanation I have found is public expenditures as a share of GDP (Chart 4.6). While Ukraine, Moldova, and Russia had public expenditures of 38 percent of GDP, Armenia, Georgia, and Kyrgyzstan had public expenditures of only 25 percent of GDP in 1997. The reader may immediately object that the successful Central Europeans, not to mention the West Europeans, have larger public expenditure ratios but those governments are not as corrupt. If an administration is pretty corrupt, it will do less damage if it has smaller resources for extortionary inspections and subsidies.

If this conclusion were correct, we would expect the less successful CIS countries to suffer from significantly more state intervention, as verified in Chart 4.7.

My explanation for the relative failure of at least Ukraine, Moldova, and Russia is that they were quite corrupt, but the effects of corruption were aggravated by a large and intrusive state apparatus

Chart 4.5 Frequency and Extent of the Bribe Tax, 1999 (Average bribe tax as a percentage of annual firm revenues).

	Central Europe	*Baltics*	*South-East Europe*	*CIS*
Consistent Growth, U-curve	Poland Czech Republic Slovakia Hungary 3.6	Estonia Latvia Lithuania 3.5[a]		Armenia Georgia Kyrgyzstan 6.8 Belarus Azerbaijan Uzbekistan 5.1
Growth Reversals, W-curve			Bulgaria Romania 3.8	
Little Growth, L-curve				Russia Ukraine Moldova Kazakhstan 5.4 Tajikistan Turkmenistan na

[a] This average does not include Latvia, as statistics for Latvia are unavailable.

Source: EBRD (1999).

with more resources than it could handle. Bulgaria and Romania fit this picture.

LONG-TERM GROWTH PROSPECTS

In the longer term, there is no apparent reason to expect any fundamental difference from other regions of the world. Yet, some problems of postcommunist countries will persist.

Standard neoclassical growth theory suggests that growth is largely determined by the initial level of income, the investment rate, investment in human capital, and the rate of population growth (Levine and Renelt 1992). A large number of possible factors have been considered in multicountry regression analyses. Xavier Sala-i-Martin (1997) has gone through all conceivable variables, checking any statistically significant effect.

Among economic policy variables, Sala-i-Martin found that market distortions were important, measured as real exchange rate distortions or black market premia. Another important economic policy indicator is the openness of an economy. Jeffrey Sachs and Andrew Warner (1995)

Chart 4.6 Public Expenditures as Share of GDP, 1997 (Share of GDP in percent).

	Central Europe	*Baltics*	*South East Europe*	*CIS*
Consistent Growth, U-curve	Poland Czech Republic Slovakia Hungary 47	Estonia Latvia Lithuania 29		Armenia Georgia Kyrgyzstan 25 Belarus Azerbaijan Uzbekistan 40
Growth Reversals, W-curve			Bulgaria Romania 34	
Little Growth, L-curve				Russia Ukraine Moldova Kazakhstan 38 Tajikistan Turkmenistan 20

Source: Table 6.5.

have shown that countries that have been reasonably open to foreign trade for a number of years do achieve economic growth. The degree of capitalism in the economic organization has has proven of significance (Hall and Jones 1996).

Ceteris paribus, laggards tend to catch up with more advanced countries, but so far they have done comparatively worse. The explanation is evidently that they have mostly pursued worse economic policies. Yet, the growth rates in a few states – Estonia, Armenia, Georgia, and Kyrgyzstan – suggest that they may advance faster, after they have put their economic policies in order. Clearly, the postcommunist countries suffer from political blockages, as rent-seeking interests dominate the politics of many states. In the world in general, a number of political variables have turned out to be significant, notably the rule of law, political rights, and civil liberties, which are all good for growth, while war is bad. We would expect these factors to be all the more important in the weak but intrusive postcommunist states.

Nobody denies the long-term importance of investment, and investment has recovered in successful reform countries. The standard

Chart 4.7 State Intervention in Enterprise Decisions, 1999 (Percentage of firms reporting state intervention).

	Central Europe	*Baltics*	*South-East Europe*	*CIS*
Consistent Growth, U-curve	Poland Czech Republic Slovakia Hungary 30.1	Estonia Latvia Lithuania 16.8[a]		Armenia Georgia Kyrgyzstan 15.7 Belarus Azerbaijan Uzbekistan 29.9
Growth Reversals, W-curve			Bulgaria Romania 19.7	
Little Growth, L-curve				Russia Ukraine Moldova Kazakhstan 24.1 Tajikistan Turkmenistan na

[a] This average does not include Latvia, as statistics for Latvia are unavailable.

Source: EBRD (1999).

measurement of human capital is secondary school enrollment, and another measurement is the teaching of mathematics. By both measures, our region benefits from a great endowment, which should provide an eminent potential in the future. The rate of population growth, however, is low or even negative because of low nativity and emigration.

Two other factors are also likely to play a role in the region in the long run. One is the importance of primary sector production. Sachs and Warner (1996a) have shown that the larger the share of a country's exports that consists of raw materials, the slower it will grow, as the presence of raw materials tends to generate rents and poor economic policies. The other factor is geography, which the EBRD (1999) formulates as distance from the European Union, involving market access and transportation costs.

Sachs and Warner (1996b; Sachs 1995b) have argued that not even the Central European countries may catch up with the European Union, if they do not adopt more aggressive growth policies than those prevalent in the EU. Sachs and Warner reckon that the transition countries need lower rates of marginal taxation, lower levels of current government expenditures as a share of GDP, relatively high levels of government investment expenditures, and pension policies based on individual savings accounts rather than public pay-as-you-go transfers. The requirements for short-term growth do not contradict the needs for long-term growth. The main distinction is that in the short term the region has benefited from abundant physical and human capital. McKinsey Global Institute (1999) has investigated Russia concluding that with the right policies Russia could reach an economic growth rate of 8 percent a year without any significant increase in investment, as the real capital is in better shape than widely believed. The key problem for this region is economic policies, not resources.

RADICAL COMPREHENSIVE REFORM BEST BUT OFTEN NOT TRIED

The transition from socialism to capitalism has not come without costs. However, most of the big recorded decline is not real but can be explained with an expansion of the unregistered economy and the elimination of value detraction. In addition, many countries lost substantial implicit trade subsidies.

The alleged universal output collapse after communism is a myth, while the overall problem was rather stagnation. Yet, the differences between successes and failures remain almost as substantial after statistical revision, though their order changes. A strong early supply effect was apparent in the most radical reform countries, especially Poland. Output development is closely correlated with radical reform policies, and the revised statistics single out the nonreformers as failures.

The long delay in economic recovery in many countries has involved greater social cost, as the duration of the decline has varied greatly. Poland returned to growth in its third year of transition, while Ukraine achieved some recovery in its ninth year of transition. Many years of lost growth is the concern rather than the initial slump.

To return to economic growth has been far more difficult in some laggard states than was universally anticipated. Recovery has by no means been automatic or cyclical, underlining that the initial slump was no cyclical recession. Before any recovery could start, inflation had to be brought under control, but this was only a necessary condition for growth. Monetary and fiscal stimulation have been extensively tested, but they have been not only ineffective but counterproductive.

The driving force behind economic recovery has overwhelmingly been structural reforms, primarily liberalization but also privatization. Since countries that reform tend to undertake most positive measures, while reluctant reformers do little, great covariation makes it difficult to establish which reforms are key. Still, external liberalization and price liberalization appear crucial. While privatization on the whole has had a positive impact, it remains controversial what kind of privatization helps.

Foreign trade has played a great and dynamic role in the transition, and the renewed growth has invariably been export-led. Initially, investment fell sharply everywhere, but it has recovered in the most successful reform countries, though investment has followed rather than preceded economic recovery.

By and large, the region has been divided into three groups, successful reformers in a virtuous cycle, unsuccessful partial reformers in a vicious cycle, and nonreformers. The first group of countries include Central Europe, the Baltics, Georgia, Armenia, and Kyrgyzstan, which largely enjoy high and seemingly sustainable growth. Most of these countries have undertaken substantial reforms of all kinds. Another group of partial reformers have experienced growth setbacks and stagnation, notably Bulgaria, Romania, Russia, Ukraine, and Moldova. A last group, Belarus, Turkmenistan, and Uzbekistan, have not really undertaken market economic reform.

The best explanation why Russia, Ukraine, and Moldova have done so much worse than the Georgia, Armenia, and Kyrgyzstan is that the former group has far higher and more distortional public expenditures, as well as taxes, than the latter group. While all these countries are rather corrupt, the more successful ones are actually assessed as more corrupt, but their corrupt administrations are not allowed to do as much harm to the economy, since they control less administrative and financial resources.

The region has ample underutilized real capital and human capital, which can play a great, positive role, if these countries succeed in adopting better economic policies. However, the quality of the state itself is likely to be decisive for the adoption of economic policies that can lead to a high, sustained economic growth.

The evidence is overwhelming that early, radical and comprehensive reforms constituted the best option for the whole region. Almost all the arguments for gradual reforms reported in the preceding chapter have been empirically disproved. Fast and comprehensive stabilization and liberalization have proven better than slower or partial reforms. More privatization is better than less, though qualitative aspects and policy choices remain in dispute. Radical reform has led to less overall decline in output, and seemingly to greater economic welfare of the population than partial reform. The countries that have undertaken the most radical and comprehensive structural reforms have also implemented the most far-reaching institutional reforms.

5

Liberalization

Freedom of trade, prices, and enterprise is the essence of a market economy, while stable prices prevailed also in centrally planned economies. Private enterprise had dominated in the planned Nazi economy, and in the orthodox communist German Democratic Republic the private sector comprised over one-third of the urban economy until 1972 (Åslund 1985). In contrast, any partially deregulated socialist market economy has been unstable and functioned poorly.

The quintessence of liberalization was to move from a shortage of goods and services to a scarcity of money, which is the predicament of capitalism. It involved a switch from a sellers' market to a buyers' market, and a transfer of economic power from producers to consumers. We have already seen that the liberalization of prices and foreign trade are the most forceful structural reforms. Because economic freedom is the foundation of a market economy, we shall discuss liberalization before macroeconomic stabilization and privatization.

Although deregulation appears the most important group of systemic reforms, it has received little scholarly attention. One reason is the paucity of relevant economic indicators, such as the degree of shortage, regional price dispersion, relative prices, product quality, and market structure. Economists had to create their own data sets, rendering empirical work arduous, but that was also true of privatization, which aroused innumerable enterprise surveys.

Another reason was that market-oriented economists tended to look upon liberalization as something simple, done quickly and requiring little afterthought. Initially, liberal politicians and economists harbored an excessive belief in the spontaneous formation of markets, reckoning that it was enough to eliminate central planning, to destroy the administrative command system, and to introduce private property (Akaev 2000, p. 39). Regulatory reform was barely an issue. Economists preferred sophisticated issues, such as financial markets and corporate governance, rather than bureaucratic impediments.

A third reason was that the old administration was in such disarray for a couple of years after the collapse of communism that it did not appear a plausible threat. Moreover, the problem was not classical monopolies, which are easily handled by normal price theory, but high transaction costs, which are more difficult to analyze (Coase 1988, pp. 9–10). The empirical analysis is thin and limited to Russia until the end of the 1990s, when the EBRD and the World Bank realized the complexity of deregulation.

Transition countries have adopted different strategies of deregulation; two alternative approaches are outlined in the first section. Next we probe deeper into the domestic liberalization of prices, trade, and enterprise. We proceed to external liberalization, which involves the unification of exchange rates, currency convertibility, and the liberalization of foreign trade. Two specific problems call for separate discussion, namely energy companies, natural monopolies, and agriculture.

STRATEGY OF DEREGULATION

The essence of a market economy is economic freedom. At the outset of transition, all countries in the former Soviet bloc undertook significant deregulation, but two very different approaches were evident, as the purpose differed. One model involved a radical and comprehensive deregulation to a real market economy to the benefit of the population at large. The alternative model comprised gradual and partial liberalization, breeding rents. The many theoretical ideas of gradual liberalization to the benefit of the population were not attempted anywhere.

Measuring Marketization

A number of indexes of structural reform or economic freedom have been elaborated. The three main indexes including our region have been composed by the World Bank and the EBRD, by the Heritage Foundation and the Wall Street Journal, and by the Fraser Institute (Gwartney and Lawson 2000). The first is called a structural reform index, while the second two are called indexes of economic freedom. On the whole, they offer very similar results. We shall use the World Bank/EBRD index here (see Table 5.1), since it is the most complete, covering all the countries from 1990 to 2000. The Heritage Foundation index is annual, but it started only in 1995, and it has gradually expanded from eleven to twenty-one of our countries (see Table 5.2). The Fraser Institute index covers only 1990, 1995, and 1997, and just eleven of our countries (East-Central Europe, Russia, and Ukraine). The World Bank and the EBRD

Table 5.1. World Bank/EBRD Structural Reform Index, 1990–2000

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Central Europe											
Poland	0.68	0.72	0.82	0.82	0.83	0.79	0.79	0.81	0.86	0.86	0.86
Czech Republic	0.16	0.79	0.86	0.90	0.88	0.82	0.82	0.82	0.90	0.90	0.93
Slovakia	0.16	0.79	0.86	0.83	0.83	0.79	0.79	0.77	0.90	0.90	0.89
Hungary	0.57	0.74	0.78	0.82	0.83	0.82	0.82	0.87	0.93	0.93	0.93
South-East Europe											
Romania	0.22	0.36	0.45	0.58	0.67	0.65	0.64	0.66	0.76	0.82	0.82
Bulgaria	0.19	0.62	0.86	0.66	0.63	0.61	0.57	0.67	0.79	0.79	0.85
Baltics											
Estonia	0.20	0.32	0.64	0.81	0.83	0.77	0.78	0.82	0.90	0.93	0.93
Latvia	0.13	0.29	0.51	0.67	0.71	0.67	0.74	0.74	0.86	0.86	0.82
Lithuania	0.13	0.33	0.55	0.78	0.79	0.71	0.74	0.74	0.82	0.82	0.86
CIS											
Russia	0.04	0.10	0.49	0.59	0.67	0.64	0.71	0.72	0.64	0.64	0.64
Belarus	0.04	0.10	0.20	0.33	0.42	0.50	0.44	0.37	0.37	0.37	0.43
Ukraine	0.04	0.10	0.23	0.13	0.33	0.54	0.57	0.59	0.65	0.65	0.68
Moldova	0.04	0.10	0.38	0.51	0.54	0.64	0.64	0.64	0.76	0.76	0.75
Armenia	0.04	0.13	0.39	0.42	0.46	0.54	0.61	0.61	0.76	0.76	0.72
Azerbaijan	0.04	0.04	0.25	0.31	0.33	0.40	0.44	0.51	0.61	0.61	0.65
Georgia	0.04	0.22	0.32	0.35	0.33	0.50	0.61	0.66	0.79	0.79	0.79
Kazakhstan	0.04	0.14	0.35	0.35	0.42	0.50	0.64	0.66	0.79	0.72	0.71
Kyrgyzstan	0.04	0.04	0.33	0.60	0.71	0.71	0.67	0.70	0.82	0.79	0.79
Tajikistan	0.04	0.11	0.20	0.26	0.42	0.40	0.40	0.39	0.55	0.58	0.61
Turkmenistan	0.04	0.04	0.13	0.16	0.29	0.27	0.27	0.36	0.36	0.36	0.35
Uzbekistan	0.04	0.04	0.26	0.30	0.50	0.57	0.57	0.54	0.57	0.50	0.49

Note: This index was originally set up by Martha de Melo, Cevdet Denizer, and Alan Gelb (1997a), with World Bank assessments for 1990–4. They also indicated how their assessments were related to EBRD indexes. Havrylyshyn and Wolf (1999) updated their series for 1995–7, while we have updated correspondingly for 1998–2000. The formula is rather simple. The first element is 0.3 times EBRD's index for price liberalization and competition policy. The second element is 0.3 times EBRD's index for trade and foreign exchange liberalization. The third element is 0.4 times EBRD's index for large-scale privatization, small-scale privatization, and banking reform. Each index is normalized to reach a maximum of 1. Thus, this index represents liberalization to 73%, while the rest is privatization. The weights have been arbitrarily selected, but actually it does not matter much what weights are chosen for the countries' relative standing to one another, as the covariance is great.
Sources: De Melo et al. (1997a); Havrylyshyn and Wolf (1999, p. 34); own calculations from EBRD (1998, p. 26; 1999, p. 24; 2000a, p. 14).

Table 5.2. Index of Economic Freedom, 1995–2001 (Heritage Foundation) (Score from 1 = free to 5 = unfree)

	1995		1996		1997		1998		1999		2000		2001	
	Rank (of 101)	*Score*	*Rank* (of 142)	*Score*	*Rank* (of 150)	*Score*	*Rank* (of 156)	*Score*	*Rank* (of 161)	*Score*	*Rank* (of 161)	*Score*	*Rank* (of 161)	*Score*
Central Europe														
Poland	62	3.25	71	3.05	85	3.15	69	2.95	65	2.95	53	2.80	54	2.75
Czech Republic	12	2.10	12	2.00	11	2.05	20	2.20	12	2.05	22	2.20	27	2.20
Slovakia	29	2.75	62	2.95	75	3.05	77	3.05	75	3.05	74	3.00	59	2.85
Hungary	31	2.80	57	2.90	64	2.90	66	2.90	62	2.90	41	2.55	42	2.55
South-East Europe														
Romania	82	3.55	112	3.70	98	3.40	94	3.30	95	3.30	94	3.30	124	3.65
Bulgaria	74	3.50	100	3.50	108	3.60	114	3.65	106	3.45	100	3.40	95	3.30
Baltics														
Estonia	17	2.25	26	2.35	25	2.35	17	2.15	18	2.15	22	2.20	14	2.05
Latvia	..	..	71	3.05	67	2.95	62	2.85	61	2.85	44	2.65	46	2.65
Lithuania	..	..	100	3.50	78	3.10	74	3.00	72	3.00	61	2.90	42	2.55
CIS														
Russia	73	3.50	100	3.50	115	3.65	104	3.45	106	3.45	122	3.70	127	3.70
Belarus	83	3.65	106	3.55	129	3.85	135	4.05	140	4.15	145	4.10	146	4.25
Ukraine	92	3.90	126	4.00	123	3.75	125	3.80	124	3.80	116	3.60	133	3.85
Moldova	94	4.10	94	3.45	94	3.35	96	3.35	97	3.35	90	3.20	120	3.60
Armenia	..	..	117	3.75	100	3.45	104	3.45	106	3.45	84	3.10	68	2.95
Azerbaijan	..	..	134	4.70	142	4.60	143	4.40	143	4.30	147	4.20	139	3.95
Georgia	..	..	124	3.85	129	3.85	114	3.65	116	3.65	120	3.65	114	3.55
Kazakhstan	..	..	..	..	..	..	136	4.10	137	4.05	122	3.70	130	3.75
Kyrgyzstan	..	..	..	..	..	..	132	4.00	135	4.00	116	3.60	124	3.65
Tajikistan	..	..	..	..	..	..	143	4.40	147	4.40	139	4.00	139	3.95
Turkmenistan	..	..	..	..	..	..	145	4.50	149	4.45	148	4.30	148	4.40
Uzbekistan	..	..	..	..	..	..	146	4.55	147	4.40	151	4.40	149	4.45

Sources: Johnson and Sheehy (1995, 1996); Johnson, Holmes, and Kirkpatrick (1997, 1998, 1999); O'Driscoll, Holmes, and Kirkpatrick (2000, 2001).

also appear more empirical in their assessments than the Heritage Foundation and the Fraser Institute, which are inclined to look at law rather than practice.

The World Bank/EBRD index is a synthetic indicator based on six weighted EBRD indexes, of which 30 percent is price liberalization and competition, 30 percent external liberalization, 13 percent banking reform, and 27 percent privatization (De Melo et al. 1997a). Thus, it represents liberalization to 73 percent and privatization to 27 percent. While the weights have been chosen arbitrarily, they matter little because of great covariance. Either a country undertakes multiple reforms or few reforms. The other two indexes are broader, involving taxation and property rights, and so on.

There is a great positive correlation among all the structural reform indexes. All three indexes put Central Europe and the Baltics first, followed by South-East Europe, the most reformist CIS countries, and then the rest of the CIS. In comparison with the World Bank and the EBRD, the Heritage Foundation appears to overrate the Czech Republic and Moldova, but underrate Kyrgyzstan and Kazakhstan. The Fraser Institute seems to understate Poland's achievements.

The World Bank/EBRD structural reform index offers two important distinctions. First, it measures how far countries have advanced toward a market economy. By empirical judgment, countries below 0.50 are nonmarket economies, while countries over 0.70 are clearly market economies, leaving those in the interval of 0.50–0.70 as intermediary market economies. Yet, these measures are too subjective to be considered exact. The true dividing line between nonmarket economies and partial market economies seems to be whether a country has a unified exchange rate or not, because many regulations follow from such a policy. Our second distinction is whether a country undertook a radical change or not. Empirically, the relevant threshold appears to be a change in the structural reform index of 0.45 units in the course of two years.

Radical Marketizers

Initially, all the countries in Central Europe and the Baltics except Latvia undertook swift and comprehensive deregulation. The two reform leaders Poland and Hungary set the example, reflected in big jumps in the World Bank/EBRD structural reform index (see Table 5.1). Poland concentrated its liberalization to one big bang in January 1990, while Hungary spread it out over slightly more than a year, reflecting different political tactics, but the essence of both deregulations was the same. There was nothing gradual about Hungary's liberalization. Greater political controversy in Poland forced the government to combine all major measures in one package to get them through the restive parliament.

In January 1991, Czechoslovakia launched an even more radical and comprehensive deregulation, overtaking the two pioneers. Estonia followed in 1992–3, and Lithuania almost caught up with Estonia in 1993 (while Latvia was lagging slightly behind). All these countries pursued similar strategies for deregulation. They aspired to create real market economies with a level playing field swiftly. By 1992, Central Europe had already accomplished very far-reaching liberalization. The Baltics have gradually caught up, and they made a big effort in reaction to the Russian financial crisis in 1998, taking them as far as Central Europe. Deregulation in all these six radical liberalizers has proven irreversible, and they have become full-fledged market economies.

Three other countries undertook radical deregulation by our standard, too, namely Bulgaria, Kyrgyzstan, and Russia. Bulgaria is the most disappointing case. It launched a radical deregulation in 1991–2, but much of it was undone in 1993, after the communists had returned to power. It represents the only case of a radical deregulation that was considerably reversed. Yet, that abrogation led to the horrendous financial crash of 1996, which swiftly brought Bulgaria to a real market economy. Kyrgyzstan is the most curious and fortuitous example. Far out in Central Asia, President Askar Akaev launched a truly radical marketization in 1993, and Kyrgyzstan has not seen any reversal but has benefited from substantial economic growth, unlike its more well-endowed post-Soviet neighbors. Kyrgyzstan debunked the cultural myth. It proved that a country could break with its peers and its history, opting for radical reform, and that it could benefit from quickly becoming a full-fledged market economy. Russia is the most spurious case. It did undertake a reasonably radical reform in 1992, but it did not reach very far, only in 1996 attaining the level of a full-fledged market economy, from which the EBRD degraded it in 1998.[1]

Gradual and Partial Liberalizers

All the other twelve countries in the region, Romania, Latvia, and ten CIS countries, started with partial and slow liberalization, but their gradual strategies stood in marked contrast to those suggested by Western economists, aspiring to mitigate social suffering. Most of these countries undertook significant marketization (0.22–0.41 structural index

[1] The EBRD's downgrading of Russia in 1998 appears an overreaction to the Russian financial crash.

units), though less than Central Europe had achieved by 1991. The spread among them has been great, complicating generalizations. We shall focus on where these countries have arrived at the end of the decade.

Half of these countries (Latvia, Romania, Moldova, Armenia, Georgia, and Kazakhstan) have become real market economies, but most of them received this distinction after several years of unsuccessful intermediary reforms. For most, the decisive push was delivered by the devastating financial crisis of 1998. While their liberalization has been precarious, it has not been revoked.

Three CIS countries have clearly gotten stuck in a nonmarket economy, namely Belarus, Turkmenistan, and Uzbekistan. Interestingly, Belarus and Uzbekistan undertook significant liberalization and then regressed to nonmarket economies, suggesting that in each case the liberalization was not sufficient to be irreversible. Nor were they supported by substantial privatization or democratization.

Three CIS countries remain in an intermediary stage but seem set on moving towards real market economies. After a late but substantial reform in 1994–5, Ukraine has advanced slowly, overtaking regressing Russia. Azerbaijan and Tajikistan could be deemed nonmarket economies until 1997, though they may now appear partial market economies.

This is not a very impressive record. Out of twelve gradual reformers, only six have become full-fledged market economies to date, unlike virtually all nine radical reformers, while three have become nonmarket economies, and three remain in a dysfunctional intermediary stage. Moreover, two countries have undergone a serious and seemingly terminal regression, while only one of the radical reformers underwent a temporary, though socially costly, setback.

DOMESTIC LIBERALIZATION

Deregulation of the domestic economy was usually discussed as price liberalization, surmising the equally important deregulation of domestic trade. With few exceptions, the vital freedom of enterprise was not even on the agenda.

Two views stood against each other. Radical reformers presented in theoretical analyses the pitfalls of partial price liberalization, which could aggravate price distortions and consequently slumps in output (Boycko 1991; Murphy et al. 1992). Their opponents, particularly audible in Russia, argued that price liberalization was harmful and could not lead to the creation of a market economy, because Russia lacked the prerequisite of a "market infrastructure." They insisted that the far-reaching monopolization of the Soviet economy impeded market competition, so price liberalization would only lead to monopoly rents and inflation (Yavlinsky and Braguinsky 1994).

Liberalization was both more important and more difficult in the FSU than in Central Europe. The relative prices in the FSU were far more distorted, so any delay in price liberalization would involve enormous social costs, but free prices would deal a great shock to society. Huge shortages and a massive monetary overhang further aggravated the shock. Moreover, the state trading system was much stronger in the FSU. Independent entrepreneurship was still formally prohibited as "speculation," and it remained alien to many Soviet citizens.

Price Liberalization

Price liberalization must be discussed in different price categories. The communist state had never been able to control most prices. Decentralized cost-plus pricing had been used, although producers were not allowed to raise prices to a market clearing level. The liberalization of such prices was not very controversial.

The most contentious prices in the public debate were those of heavily subsidized essential foods, notably meat and bread. Attempts at hiking these prices under communism had repeatedly led to popular disturbances in Poland and the Soviet Union. Now the issue was no longer price rises but a comprehensive liberalization of wholesale and retail prices. Only Hungary had undertaken a broad price liberalization before 1990, and among the other countries Czechoslovakia alone did not suffer severe shortages. Poland took the lead in January 1990. Its prices surged instantly by 78 percent in January, but goods returned swiftly to the market, and relative prices soon adjusted to market equilibria (Lipton and Sachs 1990a). The same happened in Czechoslovakia and Bulgaria a year later.

The Russian price liberalization in January 1992 was more complicated, and most CIS countries followed Russia. Price liberalization in Russia involved nearly as many goods as in Poland or Czechoslovakia, freeing 80 percent of wholesale prices and 90 percent of retail prices in value terms, but prices remained indirectly controlled, as state trade was subject to a ceiling on its markup, severely hampering the adjustment of prices, and trade remained more regulated (Koen and Phillips 1993). As a consequence, Russian shortages disappeared only gradually despite an initial consumer price hike of 350 percent. Moreover, considerable price differences evolved between state and private trade, between official and informal trade and between regions. Only by 1995 did food prices in state shops converge with private retail prices (Berkowitz et al. 1998). As could be expected, prices of nontradeables, such as services, adjusted more slowly than goods' prices. Regional price differentials remained large for years, and they were aggravated by local controls on prices and trade. Russia illustrated the danger of a less than full price liberalization. While Central Europeans had enjoyed the immediate abolition of shortages thanks to radical price liberalization, people in CIS countries saw a slow entry of goods in their markets and far greater price hikes.

Prices of a few important categories remained controlled in most postcommunist countries. One was energy and major export commodities. Another category was rents, utilities, and public transport. A third was agricultural procurement prices. All these prices were kept far below the cost recovery level. Only the second category reflected the interests of the population, while the first and third groups involved rent seeking.

One early unexpected effect of price liberalization was that producer prices rose far more than consumer prices everywhere, but in hindsight this appears natural. Producer prices were far more artificial and generally further from world prices than consumer prices. While consumers faced hard budget constraints all along, state enterprises did not. The discrepancy was greatest in those countries that saw large interenterprise arrears accumulate (Koen and Phillips 1993; Koen and De Masi 1995).

Curiously, the formal degree of price liberalization was about the same in most postcommunist countries, as assessed by the EBRD, and it has changed little. In 1994, the EBRD (1994, p. 10) reckoned that price controls remained for several important product groups only in Belarus, Georgia, Kazakhstan, Turkmenistan, and Ukraine, while no country had utility prices that reflected economic costs. By 1999, just Belarus and Turkmenistan remained that regulated, while Uzbekistan had returned to price regulation. Still, no single transition country has full-cost prices for utilities (EBRD 1999, p. 24).

Although the Central European and post-Soviet countries pursued rather similar price liberalization, the effects were far worse in the FSU because of more distorted initial prices and a much less liberalized trade system. A first lesson is that a country does not get much more price liberalization than in its initial deregulation, as any additional freeing of prices arouses unending debates, impeding any advance. Therefore, it was vital that the initial price liberalization was as comprehensive as possible. Even Poland and Estonia were too cautious and have yet to reach the Western level of price liberalization. Second, the more distorted the initial prices, the greater the need for a comprehensive price deregulation, but the more politically difficult this becomes, as people balk at massive changes of relative prices. Third, the population does accept a price liberalization that implies a change of paradigm. In no single country did price deregulation arouse popular unrest.

Trade Liberalization and the Freedom of Enterprise

One of the most confusing themes in the transition has been monopolies. As Vladimir Capelik (1994), the leading Russian specialist on antimonopoly policy, writes: "Authors frequently see monopolistic behaviour where it does not exist."

The prevalent conviction among Soviet economists and Sovietologists alike was that the Soviet economy was characterized by production monopolies, and that numerous products were produced by a single enterprise (Hewett 1988; Yavlinsky and Braguinsky 1994; Goldman 1996), but this was a misperception. Often a single enterprise delivered a highly specified product to the State Committee for Material and Technical Supplies (Gossnab), but there were many other producers. Annette Brown, Barry Ickes, and Randi Ryterman (1994) have shown that the monopolistic industrial structure was a myth. The largest enterprises in Soviet Russia were actually comparatively small. The total number of employees in the twenty biggest Russian enterprises in 1989 was less than in the twenty largest companies in the United States, Japan, Germany, the United Kingdom, and France, even in absolute numbers. The one hundred largest Russian enterprises accounted for as little as 14.3 percent of total employment. Only 43 of over 20,000 civilian manufacturing enterprises constituted national monopolies. In virtually every industry, Russia had too many large companies in urgent need for consolidation. The problem with the Russian enterprise structure was too few enterprises and the absence of small enterprises. Russia's monopolies were not production but trade monopolies, maintained by state orders and monopolistic wholesale organizations, and foreign trade competition was limited.

These opposing perspectives on the nature of existing monopolies inspired two contrary approaches to the liberalization of domestic trade. Leszek Balcerowicz stood for the radical initial liberalization consisting of four vital measures in January 1990. The first was a far-reaching price liberalization; the second, a truly radical external liberalization; the third, the breaking up of state concerns and associations into single state enterprises before privatization. The fourth measure was possibly the most important, namely an early legal act allowing anybody to sell anything any time in any place at any price to anybody. As a result, central squares in big cities were flooded with people who just started trading and soon made a living, absorbing substantial employment. Within two years, the most successful street traders had established themselves as real merchants and shopkeepers (Balcerowicz 1992; Lipton and Sachs 1990a). When traveling in Poland in 1993, I saw to my surprise private wholesale traders in every village. To any visitor, it was soon evident that competition between Polish shops was far greater than in Hungary or the Czech Republic, because Poland had liberalized domestic trade far more, which became Poland's hallmark. As domestic product markets became competitive, Polish producing enterprises could assess demand more accurately than elsewhere and thus adjust their production earlier.

In Russia, Deputy Prime Minister Yegor Gaidar attempted a similar liberalization in January 1992. The popular response was the same as in Poland, but the official response differed. After three months of busy street trading, the mayors of big cities started prohibiting street trade, although it had been permitted by a superior presidential decree. While the police ignored skyrocketing crime, they imposed this prohibition rigorously. Official shops and racketeers had suffered from competition with the cheap street trade, which they forcefully terminated (Åslund 1995). The Russian reformers divided the state associations into single enterprises, but competition remained feeble due to limited liberalization of both domestic and foreign trade.

The alternative approach focused not on liberalization of trade but on regulatory antimonopoly policy, which became dominant in the CIS. The Russian Federation had established a State Committee for Antimonopoly Policy and the Promotion of New Economic Structures in the fall of 1990, and already in March 1991 Russia adopted an antimonopoly law. The Russian Antimonopoly Committee started registering "monopolists," defined as supplying at least 35 percent of the market for a particular good in any region. Over 5,000 "monopolists" had been registered by 1993. Rather than liberalizing trade and prices, the Antimonopoly Committee imposed price controls and other administrative regulations on often rather small firms. Some local antimonopoly committees went astray altogether, demanding that an enterprise should sell a certain quota locally. However, they did not break up enterprises (Capelik 1992, 1994; Slay and Capelik 1997). The Antimonopoly Committee did not promote competition but stifled the market, often with the conscious intent to promote real monopolists. The same was true of most of the CIS. No country succeeded in breaking up enterprises through an antitrust policy.

In the first transition countries, hundreds of thousands of new small enterprises emerged in every country (Johnson 1994). Initially, this was also true of Russia, but soon the number of small enterprises started stagnating (Åslund 1997b). In the rest of the CIS, their number remained very limited, because enterprise entry was not facilitated, and it became ever more restricted through the extortion of bribes by government officials, often requiring multiple licenses (Hellman et al. 2000a). The opportunity to liberalize entry had been missed, and it did not come back. An ubiquitous bureaucracy had made extortion its bailiwick.

In parallel with a corrupt bureaucracy, the partial liberalization of trade gave rise to extensive organized crime wherever regulation and state monopoly prevailed. This was true of the exports of price-regulated commodities and domestic wholesale trade, while the two most liberalized economies, Estonia and Poland, benefited from the least corruption (EBRD 1999, p. 125).

The domestic liberalization of prices, trade, and the entry of enterprise stands out as the prime example of the necessity of as big a bang as possible. Each country tended to reach as far as it jumped at the beginning of its big deregulation. The liberalization had to be both simple and comprehensive, while any complication generated rents.

EXTERNAL LIBERALIZATION

As we saw in Chapter 4, external liberalization also had a great impact. The first step was the unification of all exchange rates and the introduction of currency convertibility. The liberalization of imports was relatively easy, as people regretted the shortage of goods, while the liberalization of exports was controversial and more complicated.

Foreign trade liberalization differed greatly between East-Central Europe and the CIS. In the East, state trade persisted for a long time, rendering the external liberalization slow and incomplete. East-Central Europe, on the contrary, aspired to return to Europe, wanting to join the EU as soon as they were allowed. One part of this policy was swift trade liberalization and reorientation to the West. As a result, a chasm has opened up between the EU accession countries and the CIS, and it will not be easily overcome.

Early Convertibility and Unification of Exchange Rates

The old Soviet system had no real exchange rate, as no decentralized foreign trade was allowed. With pretransition reforms, multiple exchange rates for different goods had been introduced, functioning as differentiated foreign trade taxes. With the transition to a market economy, a unification of the exchange rate was undertaken, but it was usually gradual. The number of exchange rates varied greatly from country to country. Until the end of communism, even the most reformist countries, Hungary and Poland, had several exchange rates – a black market exchange rate, a commercial rate, and an official rate. Radical reformers typically combined the unification of exchange rates with the liberalization of prices and foreign trade, merging a very low black market rate with a pretty high official exchange rate (Williamson 1991).

A spectacular achievement of most postcommunist countries was the instant adoption of convertibility on current account. It applied to foreign trade and tourist traffic, while capital account convertibility was adopted progressively from 1994, with the Baltic states taking the lead (Nuti 1996; EBRD 1997, p. 88). In most CIS countries, however, convertibility was initially limited by government requirements that exporters surrender part of their hard currency revenues at different exchange rates to the central bank, to commercial banks, or on the domestic currency market. This system contributed to capital flight through the underinvoicing of exports, while the tax effect was easy to escape (Aven 1994). The requirement of the repatriation of a certain share of export revenues has persisted in many countries.

In both Central Europe and the CIS, instead of full convertibility plenty of people suggested some regional payments union, in line with the European Payments Union that had existed from 1950 to 1958 in Western Europe (e.g., Van Brabant 1991). In Central Europe, this idea was swiftly dismissed, as none of the governments embraced it. In the CIS, though, a payments union was formally adopted and mulled over for a few years after the breakup of the ruble zone in 1993. It did not lead to any concrete results, but it slowed down the establishment of an ordinary payments system until 1995, when major commercial banks in Russia, Belarus, Ukraine, Kazakhstan, and Azerbaijan established an interbank clearing union (Olcott et al. 1999).

Imports Widely Liberalized and Tariffs Leveled

With the unification of exchange rates, foreign trade tariffs assumed a real role. The most reformist socialist countries – Hungary and Poland – had experimented with import tariffs, but foreign trade regulation and taxation remained highly discretionary until the demise of communism.

Shortages prevailed in all socialist economies. Many products were not available at all, while others, notably cars and consumer electronics, were exorbitantly expensive. Therefore, the liberalization of imports enjoyed strong popular support. Furthermore, initially extremely low real exchange rates in the transition countries made all imports so expensive that price competition was out of question. In all reformist countries, the liberalization of imports was fast. Import quotas and licenses became exceptions, and rather low import tariffs were introduced in their place. A common early tariff was only 10 percent. Russia had no import tariffs for the first half of 1992, and Estonia abolished them altogether.

However, three international organizations encouraged countries to raise import tariffs to 10–15 percent. The International Monetary Fund (IMF) advocated low and uniform import tariffs as a good means of collecting state revenues. The European Union pressed the countries aspiring to accede to the Union to have at least as high tariffs as the EU, with Estonia being the main victim. For entry negotiations with the World Trade Organization (WTO), it was widely regarded as necessary to have some import tariffs to be able to negotiate their reduction. Thus, the early pressure for higher import tariffs came ironically from international organizations. Only later did domestic protectionist pressures mount.

After a few years, however, real exchange rates had appreciated with financial stabilization, and domestic producers faced foreign price competition. Then they demanded higher import tariffs as well as quotas. Yet, in truly liberalized countries, resistance against protectionism was strong. Average import tariffs have stayed in the range of 5–15 percent. This might appear surprising in view of much public talk about the need for protection, but the new urban middle class and entrepreneurs dependent on imports have formed a bulwark against protectionism.

Exports Remained More Regulated

It was far more arduous to deregulate exports than imports, because powerful exporters advocated their regulation in the transition countries. The domestic prices of major export commodities – energy, metals, agricultural produce, chemicals, and lumber – stayed low because of state regulation. In December 1991, the price of one ton of crude oil in the Soviet Union was 50 cents, while the world market price was about $100. The producers had the privilege to export these commodities. Enterprise managers, commodity traders, bankers, and officials joined hands in a highly lucrative export of commodities, buying commodities on their personal account at low domestic state-controlled prices and selling them abroad at world prices, which could be 10 to 100 times higher from 1991 to 1993 in the FSU. These rents motivated their strong opposition to the deregulation of exports.

At the popular level, fear reigned that any liberalization of exports would deplete the domestic market. After many years of shortages, people could not imagine that the simultaneous liberalization of prices and foreign trade would balance the domestic market. Considering the domestic currency worthless, they thought all attractive goods would be exported. Similarly, both common people and state enterprise managers thought most enterprises would go bankrupt if energy prices rose to world levels. They could not conceive that other prices would soar as a partial compensation.

A common idea among Western economists and the international financial institutions (IFIs) was that the price discrepancy for commodities was so large that this price adjustment had to be gradual. As a means, they advocated export tariffs and the auctioning of export quotas. Politically, this turned out to be virtually impossible. Little of the export tariffs was collected and repeated attempts at the auctioning of export quotas failed in various countries, because the main exporters were too powerful for the weak state. They got exempted from export tariffs and acquired export quotas without payment. It was cheaper to pay corrupt government officials.

Many countries and regions have toyed with "free economic zones." Initially, they were promoted by very reformist regions, such as Leningrad. Later on, local interests lobbied for tax exemptions or their right to collect central taxes. The IFIs tried to contain free economic zones, which they saw as tax loopholes. That perception was largely correct, and the advocates of free economic zones tended to be interventionist, wanting to plan their enterprises in detail. Even so, free economic zones were legislated in many countries. Prominent examples were the Kaliningrad exclave in Russia and the Crimea in Ukraine. They often obtained substantial tax exemptions, but they rarely thrived. Tax privileges tended to attract organized crime, and there was no obvious reason to liberalize one region more than another. Attempts at free economic zones in backward regions usually failed. The only flourishing free economic zone I have seen in the CIS was the Bishkek Free Economic Zone in Kyrgyzstan. It freed enterprises from many taxes as well as undue government interference, though it also thrived on tax evasion.

The EU Accession Countries Turned to Europe

All countries in East-Central Europe undertook early and radical liberalization of their foreign trade regimes (EBRD 1994, p. 10). The liberalization of their exports was complete, nearly all quantitative barriers to trade were abolished, and import tariffs were reduced dramatically, for instance, to an average of 5.5 percent in Poland (EBRD 1994, p. 115). With rising protectionism, import tariffs rose somewhat, but they stayed moderate. The CMEA state trading system was eliminated on January 1, 1991. Thereafter a liberal foreign trade system was firmly established, orienting protectionist tendencies primarily toward the raising of import tariffs.

Trade liberalization was confirmed by multiple international agreements. The East-Central European countries were determined to

Table 5.3. EU Agreement Policy

	EU Association Agreement	EU Partnership and Coop. Agreements
Central Europe		
Poland	March 1992	..
Czech Republic	March 1992	..
Slovakia	March 1992	..
Hungary	March 1992	..
South-East Europe		
Romania	March 1993	..
Bulgaria	January 1994	..
Baltics		
Estonia	June 1995	..
Latvia	June 1995	..
Lithuania	June 1995	..
CIS		
Russia	..	June 1994
Belarus	..	March 1995
Ukraine	..	June 1995
Moldova	..	November 1994
Armenia	..	April 1996
Azerbaijan	..	April 1996
Georgia	..	April 1996
Kazakhstan	..	January 1995
Kyrgyzstan	..	February 1995
Tajikistan	..	..
Turkmenistan	..	November 1997
Uzbekistan	..	June 1996

Source: EBRD (1997, p. 88).

"return to Europe," and from 1992 to 1993 the EU concluded so-called Europe Agreements with the Central and South-East European countries (see Table 5.3). They aimed at a broad integration of these countries into the EU, not only lowering barriers to trade, but also establishing a framework for political dialogue and the harmonization of legislation. The Europe Agreements provided for free trade in industrial goods within ten years, with the EU reducing protectionist measures faster than the East-Central European countries. The EU concluded free trade agreements with the Baltic states in 1994 and Europe Agreements in 1995, but it did not offer such beneficial agreements to any CIS state. Instead, the EU proposed to them partnership and cooperation agreements of much less substance (EBRD 1994, p. 112).

All the East-Central European countries applied for membership of the EU early on, and in July 1997 Poland, the Czech Republic, Hungary, and Estonia were invited to negotiate terms for membership. In 1999, this offer was extended to all the other applicant countries in this region; that is, Latvia, Lithuania, Slovakia, Romania, and Bulgaria. All these countries know that they would eventually be allowed to join the EU, which has come to dominate their whole outlook. Their radical trade liberalization helped the East-Central European countries to reorient their trade at an extraordinary speed to the European Union, which soon accounted for two-thirds of their trade, embedding these countries in the Western trading system. Ukraine, on the contrary, has been making public statements about its intent to apply for membership of the EU from 1996, but it has been cold-shouldered by the EU.

The Central European countries and Romania were already members of the General Agreement on Tariffs and Trade (GATT), which became the World Trade Organization. Therefore, they were part and parcel of the international legal norms for trade, and they could turn to the WTO for protection in international trade disputes, while Bulgaria joined the WTO in 1996. Even so, by 1993, 17–36 percent of the exports from Central and South-East Europe were subject to nontariff barriers from the EU, though much less from the United States (EBRD 1994, p. 117). The three Baltic countries applied swiftly, but they were admitted to the WTO only in 1998–2000. An additional international organization guaranteeing their free trade system was the Central European Free Trade Area (CEFTA), which was established on the model of the European Free Trade Area (EFTA), harboring West European countries outside of the EU.[2]

State Trade Long Persisted in CIS

Trade developed very differently in the CIS. In early 1992, all CIS countries were in a state of shock because of financial collapse and the acute shortages of most goods. Producers' desire to secure supplies dominated foreign trade policy. The exporters, on the contrary, exported whatever they could, because of low domestic commodity prices throughout the CIS. Governments were preoccupied with state building and short-term crisis management, having little time for long-term strategy.

In this vacuum of policymaking, bureaucrats of the old state planning system took control over intra-CIS trade, turning it into a Soviet theme

[2] CEFTA eventually included seven members: Poland, the Czech Republic, Slovakia, Hungary, Slovenia, Romania, and Bulgaria.

park. Although free trade was evolving domestically, state trade prevailed in intra-CIS trade. The first CIS trade agreements were reminiscent of old Soviet trade agreements within the CMEA, with compulsory deliveries and fixed prices for major products. The old state supply organizations were transformed into monopolies for CIS trade. In effect, old state enterprises continued to produce unsalable goods for delivery to other CIS countries in exchange for Russian state credit. Commodities sold to CIS countries at low regulated prices were often reexported illicitly (IMF 1994b; Olcott et al. 1999; Michalopoulos and Tarr 1994; Michalopoulos and Drebentsov 1997).

The cost of this trade to the Russian state was enormous, as it ran a huge trade surplus with most CIS countries (see Chapter 6). In spite of strong resistance from Russian exporters and other CIS countries, the Russian government gradually reduced both its financing and implicit trade subsidies by raising commodity prices. As a consequence, intra-CIS trade dwindled fast by some 70 percent from 1991 to 1994 (Michalopoulos and Tarr 1997), but due to the rigidity of this trading system, little new trade evolved.

The main trade barrier was the discretionary regulation of exports. CIS exporters had to sell their commodities through a state trading organization, as in the Soviet Union, at a price far below the world price (though usually higher than the domestic price). Commodity exports required export licenses and quotas, issued by the national Ministry of External Economic Relations, which naturally became a pinnacle of corruption. Any export liberalization would have led to a reorientation of commodity exports to wealthier customers, primarily to the industrialized West (Michalopoulos and Tarr 1996). The exporting enterprises would have benefited greatly from higher prices, but their managers thrived personally on arbitrage.

Notwithstanding all these vested interests, the CIS state trading system gradually fell apart, as Russia no longer was prepared to pay. The introduction of a new market-oriented trading system required the introduction of national currencies, which occurred in the second half of 1993 (see Chapter 6). Payment primarily in national currencies was another precondition, which was fulfilled by 1995. Only then had most CIS countries (apart from Belarus, Uzbekistan, and Turkmenistan) liberalized most exports, and intra-CIS trade was reasonably free. Trade liberalization together with macroeconomic stabilization boosted exports of the CIS countries both to the outside world and other CIS countries in 1995 and 1996 (Olcott et al. 1999; Michalopoulos and Tarr 1997).[3] Soon,

[3] Intra-CIS trade statistics are particularly poor, but the contrasts are stark. These figures are derived from Planecon and the World Bank.

however, protectionism gained momentum. The liberalization had come too late to the CIS countries to hold for new protectionist pressures, unlike in East-Central Europe. While formal tariffs remained low, non-tariff barriers, such as the certification of produce and quotas, proliferated. Incredibly, in the fall of 1997 the Ukrainian parliament promulgated a Law on the State Regulation of Import of Agricultural Products, which required mandatory certification, radiological control, and sanitary epidemiological control of all imported foods, but no agency was authorized to certify these products, rendering bribes to customs officials the only solution which was possibly the intention of this law.[4] Increasingly, CIS countries undertook unilateral sanctions against one another. For instance, Russia introduced strict quotas on imports of vodka and sugar from Ukraine in 1996, and Kazakhstan levied 200 percent import tariffs on some imports from Kyrgyzstan and Uzbekistan in 1999 (Olcott et al. 1999). The usual cause was a successful expansion of exports, often unleashed by abrupt changes in real exchange rates. Even so, average tariffs remained low by historical and international standards, in the range 10–20 percent to the outside world, with free trade within the CIS. The two big exceptions were imports of agricultural goods and energy (Leidy and Ibrahim 1996).

The new protectionist tendencies prompted mutual trade in the CIS to fall from 1996 to 1999. Protectionism was aggravated by the Russian financial crash in August 1998, as demand contracted and exchange rates realigned. All countries were forced to turn to outside markets, as CIS markets shrunk, though mutual trade among CIS countries was still one-third of their total trade in 1997. Uzbekistan and Russia pursued only one-fifth of their trade with CIS countries, but such trade accounted for 50–70 percent of the total trade of Belarus, Kazakhstan, Moldova, Kyrgyzstan, Ukraine, Turkmenistan, and Tajikistan. Some countries were so deeply embedded in the CIS that geography offered them little choice, while other countries, notably Moldova, suffered from the severe protectionism of the West against agricultural produce, which was its dominant export (Michalopoulos and Tarr 1997).

Nor had the CIS countries locked in foreign trade liberalization through any international agreements. Only in October 1998 did Kyrgyzstan become the first CIS country to join the World Trade Organization; it was followed by Georgia in 2000. Armenia and Moldova are now qualified for WTO membership, but no other CIS country is likely to join the WTO for years. While the CIS countries have concluded individual trade agreements with the EU, these grant them only limited trade access. Two-thirds of the exports of Ukraine, consisting of metals,

[4] Personal information from the Ukrainian government at the time.

agricultural produce, chemicals, and textiles, is deemed "sensitive" by the EU. Moldova is even worse off with its predominant agricultural exports. The absence of any legal multilateral framework has made the CIS countries suffer both from each other's unilateral sanctions and from the absence of legal defense against antidumping actions in the rest of the world.

Gulf between EU Accession Countries and CIS

The liberalization of foreign trade has been considerable everywhere, but from the very beginning a great divide erupted between East-Central Europe, including the Baltics, and the CIS countries. In its first *Transition Report* in 1994, EBRD (1994, p. 10) assessed that foreign trade was fully liberalized in the whole of East-Central Europe but in none of the CIS countries. Most CIS countries have followed, but Belarus, Turkmenistan, and Uzbekistan still maintain state trading and multiple exchange rates (EBRD 1999, p. 24).

Foreign trade in the early transition was characterized by dramatic changes. Exports led the transformation, because trade balances were so strained that imports had to adjust to exports. Apart from liberalization, inflation and exchange rates also mattered. As long as high inflation prevailed, enterprises had little incentive to export because of the ease of selling at home. Foreign trade statistics are extraordinarily poor for the early transition, but the exports of the Soviet Union fell by no less than 56 percent in 1991, its last year of existence (UNCTAD 1999, p. 20).

By contrast, Poland and Hungary excelled, with great export expansion in 1990 due to their early export liberalization and low real exchange rates (see Table 5.4). Typically, liberalizing countries experienced a concentrated export boost. In 1993, Estonia and Lithuania approximately doubled their exports. In 1994 and 1995, most countries had liberalized and started stabilizing, while their real exchange rates stayed low, boosting exports from the region by about 30 percent a year. The export potential proved far greater than many had expected.

In geographical restructuring, however, a stark contrast arose between the East-Central European countries and the CIS countries. East-Central Europe benefited from a clear break with the old socialist trading system, while the CIS countries tried to mitigate the disruption with the Soviet-like CIS trading system. In addition, the CIS countries' access to EU markets remained more restricted.

The gravity model predicts the volumes of trade a country will have with other countries depending on their GDP and distance from one

Table 5.4. Exports of Goods and Services, 1991–1999 (Annual percentage change)

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Central Europe									
Poland	9.4	−10.6	6.1	20.5	34.3	6.7	5.4	2.6	−3.1
Czech Republic[a]	−7.6	3.4	..	7.9	51.9	18.9	2.7	15.7	1.9
Slovakia	..	..	..	20.8	30.3	2.8	0.2	11.8	−4.9
Hungary	7.1	4.4	−16.5	20.4	16.8	1.2	21.6	20.4	8.7
South-East Europe									
Romania	−26.1	2.3	12.1	25.7	28.6	2.2	4.3	−1.5	2.4
Bulgaria	−71.3	12.0	−16.6	16.1	29.0	−10.2	1.0	−15.1	−5.6
Baltics									
Estonia	..	..	80.9	62.0	40.7	11.3	41.1	10.3	−9.2
Latvia	..	..	7.5	−0.1	33.4	11.0	15.9	8.3	−4.9
Lithuania	..	..	137.7	0.2	33.3	24.0	15.1	−3.9	−19.3
CIS									
Russia	..	..	5.4	52.7	20.0	9.3	−0.3	−16.3	0.5
Belarus	..	..	−44.6	27.4	87.5	20.1	29.2	−3.2	−16.2
Ukraine	..	..	−2.8	31.8	29.2	8.4	−1.2	−11.2	−8.4
Moldova	..	..	2.8	28.2	19.4	8.9	10.1	−27.8	−26.9
Armenia	..	..	88.0	38.5	25.5	7.0	−19.9	−5.2	5.4
Azerbaijan	..	..	−36.8	−35.8	−14.7	15.8	23.8	−22.4	53.3
Georgia	..	..	1.5	126.1	−1.3	29.2	20.5	−19.7	23.7
Kazakhstan	..	..	134.4	−1.4	56.7	23.0	9.9	−16.3	2.9
Kyrgyzstan	..	..	7.9	0.0	20.3	23.7	19.6	−15.0	−11.6
Tajikistan	..	..	215.3	40.6	52.2	2.7	−3.1	−20.0	15.4
Turkmenistan	..	..	15.5	104.5	−12.3	−10.0	−55.3	−20.9	99.9
Uzbekistan	..	..	−17.0	253.5	10.7	49.3	−4.4	−20.1	−9.0

[a] 1990–3 data for Czechoslovakia.
Sources: 1990–6 data, UNCTAD (1999, pp. 18–20); 1997 data, ECE (2000a, p. 44); 1998–9 data, ECE (2000b, p. 16).

another. A number of such assessments were made early in the transition (Collins and Rodrik 1991; Hamilton and Winters 1992). They predicted a drastic reorientation of the postcommunist countries' trade to the West, primarily to the EU. Oleh Havrylyshyn and Hassan Al-Atrash (1998) found that East-Central Europe had undertaken such a reorientation of its commerce as early as 1992 (see Table 5.5).

The CIS countries, however, continued to trade primarily with one another. Undoubtedly, the persistence of the CIS state trading system and the ruble zone dealt two major blows to recovery in that region. Yet,

Table 5.5. Share of Exports to Former Soviet Republics, 1990, 1992, and 1994 (Percentage of total exports of each country)

	1990	1992	1994
Central Europe			
Poland	15.3	9.2	9.3
Czech Republic	25.9	10.6	5.7
Slovakia	25.9	10.6	7.0
Hungary	20.2	13.1	10.2
South-East Europe			
Romania	25.2	13.9	6.6
Bulgaria	47.1	23.2	11.8
Baltics			
Estonia	94.3	..	44.0
Latvia	95.5	48.8	50.8
Lithuania	91.4	..	57.7
CIS			
Russia	64.4	..	24.3
Belarus	88.9	69.4	62.8
Ukraine	81.8	53.1	38.4
Moldova	92.5	66.6	73.1
Armenia	97.0	..	..
Azerbaijan	91.9	50.7	44.3
Georgia	90.9	..	62.8
Kazakhstan	88.7	..	72.2
Kyrgyzstan	97.3	74.9	59.1
Tajikistan	81.9	..	22.4
Turkmenistan	95.9	..	50.8
Uzbekistan	89.1	..	46.6

Source: Havrylyshyn and Al-Atrash (1998, p. 14).

by the end of the decade, only Belarus, Tajikistan, and Moldova pursued most of their trade with transition countries, reflecting a tremendous structural change (see Table 5.6).

One reason that external liberalization had such a great impact on the transition economies was that they were very open. Table 5.7 shows the ratio of exports plus imports to gross domestic product in a number of countries. The transition economies are among the most open in the world, especially the Baltics and Central Europe. These high ratios were boosted by the low exchange rate, which depressed their GDP in current dollars. Yet, these ratios rose significantly for all transition countries, although they went through major real appreciations, and it even doubled for Slovakia.

Table 5.6. Share of Total Trade with Nontransition Countries, 1991–1999 (Percentage of total trade)

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Central Europe									
Poland	83.2	84.4	87.7	86.3	82.3	79.3	75.5	77.4	79.3
Czech Republic	..	..	..	68.6	68.1	71.3	72.1	74.3	73.9
Slovakia	..	..	39.5	44.9	45.6	49.4	54.2	62.0	62.0
Hungary	82.3	80.6	78.2	79.1	77.7	77.0	81.2	84.3	87.9
South-East Europe									
Romania	65.8	74.8	84.4	86.2	88.8	88.9	86.5	88.0	89.5
Bulgaria	80.0	85.1	84.2	76.1	65.4	66.2	72.0	76.9	80.4
Baltics									
Estonia	..	..	54.8	54.5	61.6	59.5	73.1	64.3	76.3
Latvia	..	46.8	43.6	46.4	49.5	50.0	56.7	66.4	..
Lithuania	..	..	75.0	35.0	43.0	38.8	54.6	46.6	50.9
CIS									
Russia	..	..	..	66.6	68.2	67.0	65.4	66.9	70.5
Belarus	..	..	..	28.5	20.5	19.0	19.3	17.3	22.6
Ukraine	..	..	..	38.7	40.3	45.5	57.1	53.6	57.4
Moldova	..	..	..	8.9	16.5	15.4	19.4	29.2	40.3
Armenia	..	..	..	34.3	52.4	55.5	55.4	60.0	62.0
Azerbaijan	..	..	..	58.4	58.3	53.1	43.8	43.7	..
Georgia	..	..	..	33.3	33.1	27.6	35.7	58.7	70.0
Kazakhstan	..	..	..	33.2	39.9	41.7	52.4	47.3	58.7
Kyrgyzstan	..	..	..	40.2	17.6	19.4	33.5	57.7	55.7
Tajikistan	..	..	..	75.6	58.9	52.7	28.2	27.6	23.6
Turkmenistan	..	..	..	23.3	31.8	32.4	38.8	72.6	61.0
Uzbekistan	..	..	..	45.6	34.9	47.3	38.2	47.4	53.5

Source: EBRD (2000a).

The alternative foreign trade reforms endowed different groups of businessmen with political power. In Central Europe and Estonia, internationally competitive exporters insisted on liberal foreign trade, while in the CIS, Latvia, and South-East Europe, businessmen pursuing discretionary commodity trade were most influential, and they thrived on a restrictive foreign trade regime. Their overdependence on CIS markets had multiple negative effects. These economies were all fragile, and in 1998 CIS exports fell on average by 13 percent because of the Russian financial crisis. They also undertook vicious trade sanctions against one another.

The EU became a savior for East-Central Europe, effectively locking the accession countries into a standard Western trading system, as well as a West European social and economic system. The CIS countries, on

Table 5.7. Openness of the Economy, 1990 and 1997 (Exports plus imports as a percentage of GDP in current dollars)

	1990	1997
Central Europe		
Poland	50.1	55.5
Czech Republic	108.4[a]	120.6
Slovakia	62.1	120.0
Hungary	59.7	85.8
South-East Europe		
Romania	42.9	66.0
Bulgaria	69.8	117.0
Baltics		
Estonia	114.6[b]	166.0
Latvia	96.7	111.0
Lithuania	117.2	120.0
CIS		
Russia	36.1	43.0
Ukraine	56.3	85.0
Reference Countries		
United States	21.2	25.3
Japan	20.6	21.0
Germany	51.0[a]	52.1
France	45.1	49.3
Netherlands	103.7	104.9
Sweden	59.5	80.6
Mexico	38.3	60.6
Turkey	30.8	55.0
Korea	60.1	76.9

[a] 1991 data.
[b] 1992 data.
Source: OECD (2000b, p. 17).

the contrary, had nowhere to turn but to one another, and weak states make weak partners.

PROBLEMS OF ENERGY AND NATURAL MONOPOLIES

In each postcommunist country, a limited number of big, old state enterprises resisted market adjustment at great cost to society. Their produce was homogenous, typically energy or transportation, and its great social importance was used as an argument against full marketization. These companies were usually monopolists. Three outstanding examples in each country were a natural gas monopoly company, a public utility, and public railroads.

These companies suffered from the standard shortcomings of monopolies, such as inefficiency, having too many workers with too high wages. Conversely, the public monopolies invested too much, continuing building Soviet-type white elephants in Siberia, while their interest in servicing their customers was minimal (Slay and Capelik 1997, pp. 410, 416).

In the 1990s, standard principles were developed for how natural monopolies should be handled, and the World Bank (1994b) preached them in the region and tried to assist in their implementation. To begin with, an independent regulatory authority should be established, preferably one for each industry because of branch intricacies. Prices should be raised to cover costs and allow for a moderate profit. If potential for competition existed, privatization was desirable. Some so-called natural monopolies were broken by new technologies, facilitating competition, most evidently telecommunications. If a monopoly was truly natural, production, transportation, and trade should be separated, and production and trade could usually be subdivided into several companies. The key was to develop wholesale trade, and a favorite idea was wholesale auctions. Then the ensuing privatization of production companies was considered reasonably simple.

These principles were accepted to different degrees in various countries and industries. Some ideas worked surprisingly well, while others turned out to be all but impossible.

Natural Gas and Electricity

The most complex and thus powerful monopolies were those of natural gas and electricity. The very symbol of a post-Soviet monopoly was Gazprom, the Russian natural gas monopoly company, which was the only Soviet industrial ministry to be corporatized lock, stock, and barrel. With over 300,000 employees, it contained all the assets of the old ministry: all gas production, gas pipelines, plenty of related and unrelated enterprises, such as 200 large state farms, and even all regulatory bodies. While other enterprises were selling off social assets and other extraneous assets, Gazprom bought whatever it could in the old Soviet mold of hoarding.

The last Soviet minister of gas industry and Gazprom's founder, Viktor Chernomyrdin, became Russian deputy prime minister for energy in May 1992, auguring the end of the attempt at radical reform. In December 1992, he advanced to prime minister with broad parliamentary support, reflecting Gazprom's political strength. As prime minister, Chernomyrdin reinforced the company's monopoly power and undertook an insider privatization to the benefit of its managers and employees. The CEO of Gazprom was allowed to vote for the remaining state share. Gazprom was simply too big and powerful to be controlled by the weak Russian state. Instead, it captured the state, becoming a state within the state (Slay and Capelik 1997, pp. 410–12).

The financial dealings between Gazprom and the state were excruciatingly complicated, which was also true of the national public utility, Unified Energy System (UES). Their prices and payments were distorted. Gazprom regulated everything itself for a long time, while electricity prices in Russia were regulated at a regional level, where governors insisted on low tariffs. The regulated prices were supposed to be based on costs, not demand or world prices, which left producers with no incentives to save energy. Prices remained uniform for each class of users, regardless of transportation costs. As a result, domestic prices were generally far below world market prices, though gas prices exceeded costs, and the monopolists did not press for high prices (Gray 1998). In addition, industry subsidized households, which could be charged as little as one-sixth of the industrial price. Providers of natural gas and electricity were often prohibited from cutting off deliveries to nonpaying users, while many government bodies were not given state funds to pay for necessary gas, heat, and electricity.

The Russian natural monopolies responded to this distorted incentive structure by opting for barter and arrears. In 1996–7, only 7 percent of retail gas and electricity purchases were paid in cash, and arrears abounded (Slay and Capelik 1997, pp. 400–1). One reason for the surge in barter was that it allowed natural monopolies to differentiate their prices, as barter prices tended to be 40–50 percent higher than ordinary prices (OECD 2000a, pp. 98–100). The natural monopolies also accumulated arrears to extract substantial discounts in their taxes through offsets against their unpaid taxes. Thus, they kept lossmakers going by extracting implicit subsidies from the government for themselves (Commander and Mumssen 1998; Gaddy and Ickes 1998).

The government could do little against these big companies that often collaborated against it with the support of many top officials. Incredibly, until 1997 Gazprom was not even registered as a monopoly by the Russian Antimonopoly Committee. In the spring of 1997, Russian First Deputy Prime Minister Boris Nemtsov declared a *kamikaze* attack on the natural monopolies, which was an apt description. Within half a year, the natural monopolies had won at the expense of Nemtsov's political career (Slay and Capelik 1997).

Counterintuitively, the substantial exports and profits of Gazprom and the minimal exports and profitability of UES made little difference. Their functioning was determined by monopoly, while the interests of the monopolists were helped by nontransparency. Observers of Gazprom argue that its Western exports are the most transparent and thus the most legal part of its business, while its nontransparent exports to other CIS countries and domestic sales are notoriously criminal.

Russian gas exports to Ukraine are illustrative. Here Gazprom charged high prices, and gas imports were heavily subsidized by the Ukrainian state through a special exchange rate until 1995. The Ukrainian gas purchasers were state-owned or a few private wholesale traders with regional monopolies. They rarely paid for the deliveries from Russia, because the Ukrainian state had originally guaranteed these payments, and Gazprom insisted on its responsibility, leaving private traders with little incentive to pay. Gazprom also accused Ukrainians of stealing gas from the pipeline. However, Russia could not cut off deliveries to Ukraine, because all its gas exports to the West went through Ukrainian pipelines. The usual result of negotiations on how much Ukraine owed Russia for gas imports was that some amount was added to Ukraine's state debt to Russia. The same problems of domestic nonpayments that existed in Russia persisted in Ukraine (Lovei 1998b; Mercedes Balmeceda 1998; Timoshenko 1998).

Curiously, the gas barons were more powerful in Ukraine than in Russia, showing that the economic leverage arose from nontransparency, monopoly, and access to state funds rather than exports. The common ill-gotten gains were shared among exporters, importers, and transit traders. Even the division into several regional monopoly wholesalers did not help, as they did not compete against each other on the market, but only through intrigues in the corridors of power. The gas importers became the dominant economic and political forces in Ukraine. Ownership hardly mattered, as the business was so state-regulated and nontransparent, minimizing the difference between private and state-owned enterprises. Gazprom did not change its mode of operation when it was half privatized in 1994. One of the leading Ukrainian gas barons gave up his private gas trading company for a state company in 1998 to make more money on the state as an insider. Fortunes were made on monopoly rents that were somehow transferred to a private bank account abroad.

Another feature of these monopolies was their treatment of third parties. The Russian pipeline systems discriminated systematically against alternative producers of natural gas in both Russia and Turkmenistan and of oil in Kazakhstan. Russian oil companies that produced natural gas were forced to burn it, because Gazprom refused to carry the products of competitors through its pipelines. Turkmenistan suffered a slump in GDP of 26 percent in 1997, when its exports plummeted by more than half, because Gazprom did not allow it to export its natural gas through Russian pipelines.

In electricity, Ukraine has astounded by undertaking an early and radical reform, instigated by the World Bank. In 1994, Ukraine decided to unbundle the power sector and develop a competitive national wholesale market for electricity according to the UK model. The power plants were divided between a handful of producing companies, while the regional grids were corporatized individually. Several private wholesalers started operating, and Ukraine had a market. Although electricity tariffs remained politicized, market forces had started operating, facilitating privatization toward the end of the 1990s (Lovei 1998a). This is one of the few examples of a latecomer benefiting by being able to undertake a more radical reform because of vested interests not having grown strong as yet.

Inefficient and Overpriced Railway Transportation

The post-Soviet railroads posed more ordinary market economic problems of monopolies. Unlike energy companies, the railroads overcharged, employed far too many people, and overinvested in prestigious projects. Incredibly, in 1996 the Russian railroads employed no fewer than two million people. While the volume of freight on the Russian railroads fell by 52 percent from 1991 to 1995 and the passenger traffic decreased by 25 percent, employment increased. In the midst of the Russian economic crisis, the construction of a high-speed railway was started, leading to little result at great cost.

Also here, two post-Soviet peculiarities were apparent. One was that the Russian railroad management had set up a large number of offshore companies that sold railroad services. Due to their low purchasing prices, they were effectively management theft companies. The other peculiarity was that the railroads were deeply involved in barter transactions, which apparently served to facilitate management theft (Slay and Capelik 1997, pp. 414–19).

Easy Adjustment for Oil Industry

Oil and coal did not suffer from the problems of natural gas and electricity. Oil prices rose comparatively quickly toward the world level (when transportation costs are taken into account). The oil industry was highly profitable and export-oriented, and alternative means of transportation existed, all of which facilitated its market adjustment. The dominant Russian oil industry was broken up into several independent production companies, whose mutual independence was reinforced by privatization, mainly in 1995. A highly competitive oil industry had developed by 2000.

The oil pipeline system, however, remained a problematic state monopoly (Transneft), and it limited Russian oil producers' access to export markets on a discretionary basis, keeping the domestic Russian oil price somewhat below the world level for years. Transneft's obvious purpose was to enrich oil managers through arbitrage between a low domestic oil price and a high world market price. Still, alternative supply routes, such as railroads, limited price differentials. The long-term solution appears to be the construction of pipelines independent of Transneft, which is being done both inside and outside of Russia. Although oil involved the greatest export revenues, the market distortions were the least for this kind of energy.

A Hopelessly Inefficient Coal Industry

Coal industry existed primarily in Poland, Romania, Ukraine, Russia, and Kazakhstan, and it was terribly inefficient and loss-making everywhere. Coal prices were typically regulated far below both costs and world prices, aggravating losses. Especially in Ukraine and Russia, the coal industry became infamous for three features: huge state subsidies, persistent wage arrears, and many strikes. The managers of the coal companies, however, were thriving on state subsidies. Their ruthless search for subsidies led to a far-reaching criminalization of coal industry in Russia and Ukraine. Its problem was neither monopoly, foreign trade, state ownership, nor transportation, but excessive political leverage to extract unwarranted subsidies, amounting to 1–2 percent of GDP, which were largely absorbed through management theft.

In Russia, a practice developed that coal mines sold their produce for two-thirds of the price the utilities bought it for, with the difference going to middlemen, including mine managers. Because of the low prices paid to the mines, the managers claimed that they could not pay wages to their workers, whom they urged to strike to extract more subsidies from the government.

The Ukrainian coal managers became a major political force. All over the world, coal miners are easily organized, as they work in large units, and they seem militant in their helmets. The Ukrainian coal miners' strikes, however, were usually organized by the Minister of Coal Industry, and a most disreputable Ukrainian coal manager, Yukhum Zviahilsky, was so successful in organizing strikes that he was named acting prime minister in 1993 to stop him from doing so.[5] The Ukrainian Ministry of Coal Industry was notorious for purported "reform" proposals about recentralizing all coal sales under the Ministry and transferring coal mines to holding companies, mimicking the old Soviet enterprise associations, while arranging complicated barter deals and lobbying for

[5] He later escaped to Israel after being officially accused of having stolen $25 million from the state. He had allegedly asked purchasers of exported state petrol to pay into his personal bank accounts abroad.

more subsidies in Parliament. The only sensible approach to this Ministry was to abolish it, which eventually was done. The Ukrainian coal industry was disciplined through the liberalization of coal imports and prices, dispelling the myth of the coal industry being essential to national security. Politically, it was easier to close obviously uneconomical mines than to try to restructure potentially viable mines (Lovei 1998c).

The Romanian coal miners functioned as the storm troopers of the Communist Party and assisted in the ousting of a somewhat reformist government in a violent onslaught on reform adherents in Bucharest in June 1990 (Tismaneanu 1997). Thus, some coal-miners' unions became instruments of rent seeking of the old elite.

Airlines and Telecommunications Adjusted

Most countries had one dominant national airline and capital airport. The airlines caused most countries great harm by insisting on bilateral agreements with international airlines on unfavorable conditions. Therefore, few international airlines developed traffic to most countries in the region. Here, Russia was the positive exception, because it subdivided Aeroflot into a couple of hundred small regional airlines, which gradually consolidated. Hence, air traffic recovered on a market basis in Russia, while it stumbled, for instance, in the Czech Republic, Romania, and Bulgaria. Similarly, the Central Asian countries insisted on substandard monopoly airlines.

Telecommunications are often viewed as a natural monopoly, and initially they suffered from some of those drawbacks. However, because of new technology, a few independent mobile phone companies and internet service providers appeared in several countries. Since they catered to a wealthy elite, high tariffs were socially acceptable, attracting competition. The presence of independent competitors made it easier for the big national carriers to raise their tariffs for international calls, rendering them profitable. Phone services were not regarded as a social necessity, so phone companies successfully insisted on cash payments and cut off nonpayers without hesitation.

Therefore, telecommunications could be privatized on commercial terms, and tariffs were checked by the market rather than price regulators, with Hungary as the pioneer. As early as 1994, it issued a tender for local telephone services, and the national telephone company was limited to two-thirds of the districts. It had already been partly privatized and privatization has proceeded, while competition has developed in other areas of telecommunications. Telephone penetration has quadrupled since the demise of communism, and tariffs have dropped sharply because of competition (Bruce et al. 1999). A reason for the early and radical liberalization of telecommunications in Hungary was that the country was suffering from an extremely sparse telephone network, indicating a miserable state failure. The early cure was the competitive development of private mobile telecommunication companies. In Russia, telephone companies were broken up regionally and privatized in the early voucher privatization, which helped to create a competitive market. International and mobile telecommunications have been subject to competition between private and public enterprises for long, rendering telecommunications one of the most legal industries in Russia.

Curiously, three of the otherwise most advanced reformers, Poland, the Czech Republic, and Estonia, have been lagging in their telecommunication reforms, presumably because their old telecommunication companies were not as hopeless. Unlike Hungary and Russia, they failed to market, adjust, or liberalize phone tariffs, and their old monopolies persisted, stifling both local and international phone services, while private operators thrived in mobile services, which benefited from the tardiness of other phone services. A large share of the Czech monopoly was sold to state-owned European telecommunication companies, which resisted reform as they did at home (Bruce et al. 1999). These countries are committed not to liberalize until 2001, and their phone systems are suffering. For years, Moscow has had much better telephone connections than Warsaw.

Problems of Big Socialist Enterprises

This survey shows how many problems rent seekers in a few large Soviet-type enterprises could concoct at great social cost. They detracted from national economic welfare while extracting large government subsidies. They used up excessive resources for themselves and promoted waste in the rest of economy through distorted prices. Hence, the already extraordinary energy intensity of production actually rose for a couple of years after the collapse of communism in the whole region, and railways priced many exports out of the market because of excessive tariffs. If these companies exported, they indulged in extensive capital flight. Besides, large nontransparent state companies have been involved in major fraud and financial scandals in virtually every country. Being the hearths of management theft, they were the cancer of the postcommunist state, contributing to the corruption of society.

These large companies are often summed up as natural monopolies but sometimes as energy and transportation companies. Their great size made them powerful, and the more monopolistic they were, the worse for society. Although it is hard to combat these giants, much has been accomplished, suggesting that they are not invincible.

The key to a successful defense of monopoly was to escape marketization by controlling three elements – prices, transport, and trade. The best for the monopolists was to control pricing themselves, as Gazprom has done. The second best was to have regional price regulation that could be negotiated with weak regional authorities, as for Russian electricity, while central state regulation might actually have had more integrity or been exposed to more contradictory interests. Yet, innumerable modes of price regulation have been tried, but nothing seems to work, as powerful monopolies can always influence regulators. These states appear too weak to manage any socially oriented price regulation. The only solution seems to be competitive pricing on a real market.

Curiously, the monopolists' pricing policy has varied greatly from the railways' overpricing to the underpricing of gas and electricity, as the insiders have lived on arbitrage between fixed prices and free prices. Foreign trade has facilitated transfer pricing, creating price discrepancies regardless of whether a good has been exported or imported. Homogenous commodities have facilitated collusion among producers for price fixing and transfer pricing. If a commodity is of social importance, such as natural gas and electricity, it has ironically been easier to organize antisocial collusion, as price distortions are more easily justified.

For monopolists, it is vital to avoid any real market. The less open the domestic market, the greater the power of the monopolists. Some enterprises have been broken up, notably the Russian oil companies and many telecommunication companies, swiftly generating markets, while the incorrigible gas companies and railroads have stayed monopolistic. Telecommunications show that demonopolization works, and oil prices have been much more influenced by the market than the gas and electricity tariffs. However, the development of markets around dominant powerful companies has largely failed. No matter how attractive wholesale auctions of gas or electricity might appear, they have inevitably miscarried, if the market consists of small private operators, challenging one forceful company.

Transportation appears the critical pillar of monopoly power. The standard international advice has been to divide or separate transportation from production, but the experiences of the Russian oil pipelines and the Ukrainian gas pipelines suggest this is not enough. Monopolistic transportation companies are such bullies that competing transportation systems appear necessary to check them, which is about to happen with the construction of competing pipelines. The oil industry has developed some market features because of alternative means of transportation, such as railways and shipping. Railways face competition both from pipelines and roads, which might keep them in check.

Quite a lot of privatization has occurred, notably of telecommunications, oil companies, airlines, and coal mines. When not monopolies, privatized telecommunications and airlines have swiftly established market competition, which is especially true of privatized Russian oil companies. The privatization of Russian coal mines, however, was initially ineffective, as the coal mines continued to live on state subsidies rather than profits, but privatization was a first step toward cutting subsidies. Similarly, the implicit state guarantees for private gas importers in Ukraine have made them preoccupied with state subsidies, and although Gazprom is half privatized, it behaves like a Soviet ministry. Still, because they have been privatized, these companies have come under severe public attack, as public opinion is more easily aroused against subsidies to private companies than to public enterprises, facilitating a better regulatory regime. Similarly, it is difficult to defend the monopoly of a private telecommunication company, so privatization might facilitate the emergence of private competitors.

Thus, the most intractable problems of natural monopolies appear to arise out of monopolistic gas pipelines and electricity grids, while the other concerns seem manageable over time. Price regulation does not seem to work in weak states. Therefore, all possible market solutions seem desirable, while the state should be reinforced by other means.

TROUBLESOME AGRICULTURE

Agriculture is usually discussed separately, as its problems are special. Its development has varied greatly. Its share of GDP has declined in most countries, especially in the most successful reform countries, but its share has risen significantly in some intermediary reformers – Romania, Bulgaria, Armenia, Georgia, Kyrgyzstan, and Moldova. To some extent, this development reflects a drop in overall output and a return to subsistence agriculture, but these countries excelled with early agricultural reforms, although they are no leading reformers.

The apparent explanation is that agricultural reform occurs first in countries, where this sector is important. In Romania, little reform occurred outside agriculture, while private farmers took over 80 percent of the land in a spontaneous privatization in 1990. Evidently, agriculture flourishes in countries with comparative advantages for it, characteristic of countries with a relatively low level of economic development but good agricultural conditions.

Another explanation is market access and demand. Over all, postcommunist countries have developed through exports to the wealthy EU market. The closer a country is to the EU, the better it has fared, but the

EU has been extremely protectionist on agriculture, so this has not been true for agricultural producers. Meanwhile, the EU has dumped its subsidized agricultural produce on Eastern markets, arousing protectionist resentment. Once I asked an Estonian minister whether he regretted any of their many radical reforms.[6] He responded that, when abolishing their import tariffs, they should have maintained the option of a compensatory tariff against EU dumping, as the EU sold pork to Estonia at a price below the local production cost. For agricultural producers, such as Moldova and Kyrgyzstan, the largest and most open agricultural market was actually Russia.

Agricultural marketization has been arduous in most countries, because a large, closely knit, agricultural establishment resisted. It consisted of a huge Ministry of Agriculture, a procurement agency that was even a ministry in the Soviet Union, foreign trade organizations, an agricultural bank, the managers of collective and state farms and an array of regional officials. The agrarian establishment was originally highly communist, but with democratization the agrarians set up their own parties and agrarian unions, acting as lobbyists and gradually distancing themselves from the Communist Party, which no longer corresponded to their interests. These organizations represent the interests of the agrarian elite rather than the predominantly old and subdued peasants.

The agrarian establishment aspired to live on arbitrage through price subsidies, subsidized credits, enterprise subsidies, and direct public investments. The key was a differential between consumer and wholesale prices, which could be achieved through state procurement. It did not matter which of these two prices was higher or lower. In 1992, the Russian agrarians fought for artificially high procurement prices (Åslund 1995), while in 1996 the Ukrainian agrarians imposed a procurement price for grain in Ukraine that was half the world market price (Åslund and De Ménil 2000).

Agrarians had a standard scheme, with the monopoly procurement agency as their command center. They tried to maximize the volume of state procurement, scaring people with the specter of starvation or at least food shortages. To make their procurement monopoly effective, they insisted on administrative control over foreign trade. Exports were typically prohibited, as food, needed to avoid starvation, would otherwise leave the country, while in reality the export prohibition facilitated export monopoly. Imports were also controlled – either through distortional "food aid," distributed by the procurement agency, or later on through high import tariffs. In the former case, import prices were nil, which benefited the people controlling the procurement agency, while

[6] Minister for Foreign Affairs Toomas Hendrik Ilves in 2000.

they could be very high in the latter case, which deterred competitors. In 1996, Romania had an average agricultural import tariff of 75 percent and a pork tariff of 236 percent, although only 26,000 people worked on the big pig farms, and pork is a staple in Romania.[7] Controlling procurement and foreign trade, the agrarians could allow themselves to pretend to be liberal by accepting domestic food prices set by the domestic market, which also saved them from the embarrassment of food shortages. Since the procurement agency had no capital, it demanded subsidized credits that covered all of its purchases, and sometimes more (Åslund 1995).

When fear of starvation no longer could be invoked, the agrarians turned bureaucratic or into sheer gangsters. The most telling example was Prime Minister Pavlo Lazarenko in Ukraine. He regretted that grain procurement had been liberalized at the end of 1994. After seizing power in 1996, he wrote on an ordinary sheet of paper that a regional governor who feared shortage of grain in his region could prohibit exports of grain from his region. This was not an official document, and such a prohibition contradicted the law of the land, but the governors got the hint and proscribed grain exports. Just in case, Lazarenko also asked the minister of railways to issue a minor statute prohibiting the export of grain from Ukraine and the port authorities to proscribe grain exports from their ports. Thus, without any cabinet decision or legal act, grain exports had been blocked for all but Lazarenko and his accomplices, who controlled state power for their own benefit.[8]

Thus, the key to agricultural marketization is the abolition of state procurement of food, which has no role to play in a market economy. That requires the liberalization of foreign trade, which is controversial due to the extensive EU dumping of food. Moreover, with the EU market closed, it is difficult to find substantial export markets, which are a vital incentive for liberalization. While land reform was important, marketization was key. Without the liberalization of agricultural trade, many private farmers had to close down in Russia, and Romanian private farmers remained at a subsistence level because of extensive regulation, compelling the country to import food. Yet, Armenia and Kyrgyzstan have proved how forceful the combination of marketization and land reform can be.

[7] Information from consultation with the Romanian government, January 27–8, 1997. An official from the Ministry for Foreign Trade informed me that the Ministry had calculated that this was the optimal tariff. The calculations were based on data from 1987. When I queried whether the change of economic system and all prices had not changed that rate of optimality, this official told me that it remained exactly the same, because these calculations were highly scientific.

[8] Personal information from a Ukrainian minister in late 1996.

BIG BANG IS VITAL IN DEREGULATION

This chapter provides us with rather strong conclusions. More than other policies, deregulation has been characterized by three important dichotomies.

The first dichotomy concerns the choice of liberalization strategy. Central Europe, Estonia, and Lithuania opted for radical and comprehensive deregulation, aiming at a real market economy from the outset. Romania, Latvia, and all the CIS countries pursued a gradual and partial deregulation policy, seeking the maximization of rents for a small entrenched elite. In most of these countries, this hybrid system degenerated into a more ordinary market economy, but at least three countries – Belarus, Turkmenistan, and Uzbekistan – have chosen nonmarket economies with very limited liberalization. Unfortunately, it is not true that "in most of the [postcommunist] states, liberalization was quickly achieved . . ." (Lavigne 2000, p. 18).

The socially oriented gradual strategy that so many Western economists and social scientists had theorized about was nowhere to be seen, as gradual liberalization and a socially oriented economic policy appeared mutually exclusive. Even well-meaning economists who had advocated a gradual strategy tended to become pretty radical when they joined government.[9] The only exception to this dichotomy was Bulgaria, which launched a very radical deregulation in 1991–2, but it was reversed to a significant extent in 1993, as the Communist Party came back to power. These observations show how important it was to undertake a truly radical deregulation from the beginning. If a country failed to do so, rents grew so large that the rent seekers bought political power, impeding marketization to maximize their personal rents.

A second dichotomy involves domestic liberalization of prices, trade, and enterprise. The general conclusion is that you hardly reach further than you did in your first jump. In no other case does the initial choice appear as important. The reformers had a brief window of opportunity of extraordinary politics, as Balcerowicz (1994) has emphasized. If they did not take that chance, the rent-seeking establishment soon blocked liberalization, even if it were formally legislated.

A third dichotomy concerns foreign trade. Here the division is strictly regional. East-Central Europe opted for a "return to Europe" with far-reaching early liberalization of foreign trade and a reorientation of their trade toward the European Union. The CIS countries, on the contrary, tried to minimize the disruption in trade. For years, they maintained a

[9] The outstanding example is Grzegorz Kołodko, Polish Minister of Finance and Deputy Prime Minister, 1994–7.

mutual state trading system with distorted prices and muddled payments. As a result, their trade was restructured slowly while it contracted sharply.

Two groups of enterprises offered the fiercest resistance against marketization. One group was large energy companies and natural monopolies, too large and powerful to be controlled by weak states. The more monopolistic they were, the more harm they caused. Contrary to common belief, it mattered little whether they were exporters or importers. They thrived on disproportionate political and market power as well as nontransparency. Since they used many different levers of power, they were difficult to defeat.

Almost everywhere agriculture was another troublesome industry. The key hurdles to the marketization of agriculture have been the liberalization of both domestic and foreign trade in agricultural goods. Agricultural reform has advanced relatively far in a half dozen countries that were otherwise intermediary reformers, namely Romania, Bulgaria, Moldova, Armenia, Georgia, and Kyrgyzstan. The explanation appears to be that agriculture is most easily reformed where it is important and lucrative because of comparative advantages.

Our overall conclusion from the three dichotomies is abundantly clear. Early radical deregulation is of fundamental importance for successful economic development. Any inconsistency causes problematic rents, and they tend to be aggravated rather than resolved in the medium term. If rent seeking surges above a certain level, the rent seekers are likely to assume political power and impede further liberalization. Even if rent seeking remains moderate, the rent seekers may block important liberalization, notably in the regulation of major commodity producers and natural monopolies. Several countries seem to have been trapped at suboptimal equilibria with high levels of rent seeking and low output. This appears the main problem of transition.

As Murphy, Shleifer, and Vishny (1993) point out, such suboptimal equilibria are a natural effect of increasing returns of rent seeking. After a certain set of economic rules has been established and a group of well-entrenched beneficiaries of these rules has arisen, it is difficult to break up this system. The winners have taken all, both the economic system and political power (Hellman 1998). These equilibria may not be eternal, but they can last for a long time, as we have seen in Ukraine, Moldova, Russia, and Kazakhstan. Africa offers even uglier examples (Collier and Gunning 1999).

One hope is that rent seekers fall out with one another and that their competition drives down the rents. Such a hopeful acrimony prevails among the Russian tycoons. Another possibility is that external competition will limit rents. Therefore, both domestic and external liberalization are vital for economic performance, however difficult it is to impose them after the early transition. Other possibilities involve financial and political crises.

A sharp dividing line has arisen between successful and unsuccessful transition countries, mainly depending on their degree of initial liberalization. If the first jump was too cautious, it is very difficult to cross the chasm to a normal market economy. As the economic development of many African countries in the last three decades has shown, there is no necessary limit for how deep a mismanaged rent-seeking dictatorship can fall.

6

Financial Stabilization

A well-functioning market economy requires reasonable price stability, but almost all transition countries started off with skyrocketing prices, unleashed by price liberalization in the presence of huge excess demand. Monetary expansion had been out of control for some time, and the very institutions of macroeconomic policy were feeble or missing.

The old socialist system had aspired to financial balance, but this was no priority, and inflation was primarily checked through price controls. Capitalism required a different institutional setup, transferring economic policymaking from the Central Committee of the Communist Party, the State Planning Committee, and industrial ministries to the Ministry of Finance and the Central Bank.

The key macroeconomic task was fiscal adjustment. Huge public expenditures and budget deficits had to be reduced. Large public outlays went to rents, and they rendered rent seekers richer and more powerful. An exaggerated fear of collapsing state revenues prevailed while the main problem was that both state receipts and tax rates were too high. Ironically, countries that maintained high tax rates and undertook little early fiscal adjustment saw their public incomes fall the most.

Initially, monetary policy was little understood and therefore loose, allowing rent seekers to thrive on cheap state credits. After a few years, people had learned about the harmful effects of a loose monetary policy, and independent central banks had been formed while the rents from high inflation had been dissipated. Therefore, monetary policy became firm in almost all transition countries, though a poor bank system caused troubles.

A couple of issues were given great attention at the outset of the transition but later faded in significance. To begin with, currency areas had to be determined once and for all. Exchange rate policy attracted great attention and aroused passion, but it does not appear as important in hindsight. Incomes policy was perceived as essential at the time, but that was hardly the case. Instead, arrears and barter emerged as great and partly unprecedented problems.

A MULTITUDE OF MACROECONOMIC PROBLEMS

The formerly socialist countries entered their transition with severe financial crises, as discussed in Chapter 2. Poland and the former Soviet Republics (FSRs) were approaching hyperinflation, and only Czechoslovakia was in relative balance. With the transition, high and lasting inflation erupted in most countries.

Many New Causes of High Inflation

With the start of transition, several new macroeconomic pressures were added. The liberalization of domestic prices in the presence of shortages and monetary overhang inevitably boosted most prices. The unification and market adjustment of the exchange rate involved substantial devaluations, inflating domestic prices, and dramatic shifts in foreign trade prices.

A licentious financial environment arose out of bad habits of the socialist economy, such as insufficient fiscal and monetary controls and the loosening of old administrative controls. The situation was aggravated further by numerous quasifiscal expenditures, as extrabudgetary funds were set up by multiple state agencies beyond the purview of the weak Ministry of Finance. The crisis was used as an argument for the issue of huge subsidized state credits to industries suffering from an absence of demand, although few expected them to pay back. Although central banks issued large credits at subsidized interest rates, that was not considered a budget cost. State credits were ultimately subsidies, because bad debts of state enterprises were regularly forgiven. Similarly, government expenditures financed with foreign loans tended to be omitted from government expenditures and were often beyond the control of the Ministry of Finance.

The ouster of the communist regimes was accompanied by two expressions of populism. First, governments had allowed – or been forced to accept – public wages spiraling out of control. Second, already high social expenditures had been raised, especially in the FSU in 1991. Strangely, revenue collection remained pretty high, because nearly all taxes were collected from socialist enterprises through the state bank system, and state enterprises had soft budget constraints, caring little about the money lost. Tax systems were discretionary, based on the socialist idea that a good socialist engineer could establish the correct tax for each enterprise.

The situation was further complicated by the limited understanding of macroeconomics, among both the public and policy makers. Old-style Marxist professors of political economy dominated, especially in the CIS countries, and they thought macroeconomics was wrong. Even more sensible local economists harbored an instinctive preference for slow, gradual financial stabilization. Nor could these countries turn to international markets to solve their financing needs, with the exception of Hungary and Czechoslovakia, which were creditworthy. Inflation was bound to soar with the transition, and the questions were rather how high inflation would spiral and for how long it would last. This was a macroeconomic nightmare.

Radical Stabilization

The attitude to macroeconomic stabilization came to characterize a country's whole approach to postcommunist economic transformation. There were two major alternatives. One was a radical early stabilization, aiming at financial stability regardless of initial costs. The alternative policy was more gradual, purportedly concerned with social costs.

Poland pioneered radical financial stabilization or "shock therapy" as it became known, particularly among its opponents. Its main architects were Minister of Finance Leszek Balcerowicz (1992) and his advisors Jeffrey Sachs and David Lipton (Sachs 1990; Lipton and Sachs 1990a; Sachs 1993a; Sachs and Lipton 1990). They wanted to get the fundamentals right from the outset and thought it better to play it safe than to risk failure.

This stabilization program was part of a comprehensive radical market reform. The budget was supposed to be balanced from the beginning. To make that possible, prices were liberalized, which eliminated price subsidies, and enterprise subsidies were reduced. A strict monetary policy, with positive real interest rates and restrictive credit issue, was pursued. Wages were checked through a rigorous incomes policy. To render the program politically palatable, pensions were raised substantially, and generous unemployment benefits were introduced. The exchange rate was pegged for the time being to the dollar, and it was supported by a stabilization fund guaranteed by Western countries. This stabilization policy was formalized as an IMF standby program. Yet, Poland's budget deficit grew sizably in 1991 and 1992, breaking the IMF program, and Poland was forced to devalue in the spring of 1991, but the idea of Polish shock therapy stood firm.

In 1991, Czechoslovakia launched an even more radical program of liberalization and stabilization. Estonia escalated further, committing itself by law to a fixed exchange rate to the German mark. Latvia followed suit, with a somewhat looser program, without a currency peg, and Lithuania adopted a much less comprehensive, though similar, program (Banarjee et al. 1995; Lainela and Sutela 1994). Only these six countries actually undertook radical stabilization programs.

A More Gradual Approach

The evident alternative was the Hungarian model of financial stabilization, which was perceived as gradualist. In effect, Hungary did as little as it could get away with. It tightened its budget deficit in 1990 but then let it lapse, instead borrowing as much money abroad as it could possibly service. Rather than pegging its exchange rate, Hungary maintained a dirty float with no official target rate. The monetary policy was reasonably strict and responsible, but no big fuss was made about it (Székely and Newberry 1993; Banarjee et al. 1995).

The decisive difference between Hungary and Poland was the initial conditions, as Poland faced hyperinflation, while Hungary only suffered from somewhat high inflation and a large foreign debt service. These two situations inspired different attitudes and thus policies, but they became two opposing models in the debate. In structural reforms, Hungary excelled.

The real alternative, however, was little or no stabilization, which was the actual choice of most transition countries. It amounted to a very gradual policy, but without Hungary's justifications. Throughout the CIS, enormous budget deficits persisted for no good economic reason. They were financed with the hyperinflationary issue of money, as monetary policy remained very lax. Under such conditions, no stabilization of exchange rates was possible, and nor was it attempted. Eventually, financial stabilization was undertaken, but only after serious financial crisis, which showed the need for a radical policy.

High and Persistent Inflation

Inflation has been high and persistent. In most countries, it skyrocketed at the outset of the transition, and extraordinary efforts were required to vanquish it. Even after serious stabilization efforts, inflation has stayed in the double digits in most countries for years (see Table 6.1).

We can distinguish between four inflationary patterns. Hungary stands out as an exception, being a truly gradual stabilizer, but a successful one. Unlike all the other countries, it never had high inflation, peaking at only 33 percent, and it had a remarkably stable inflation, lingering from 18 to 33 percent a year from 1989 to 1997.

Poland, Czechoslovakia, and the three Baltic countries form a second group of successful radical stabilizers. Poland and the Baltic states started

Table 6.1. Inflation, 1989–2000 (Change in year-end retail/consumer price level, %)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000 (prel.)
Central Europe												
Poland	639.5	249.0	60.4	44.3	37.6	29.5	21.6	18.5	13.2	8.6	9.8	8.5
Czech Republic	1.5	9.6	56.6	12.7	18.2	9.7	7.9	8.6	10.0	6.8	2.5	4.0
Slovakia	1.5	18.4	58.3	9.1	25.1	11.7	7.2	5.4	6.4	5.6	14.0	8.4
Hungary	18.1	33.4	32.2	21.6	21.1	21.2	28.3	19.8	18.4	10.3	11.2	10.1
South-East Europe												
Romania	0.6	37.7	222.8	199.2	295.5	61.7	27.8	56.9	151.4	40.6	54.8	40.7
Bulgaria	10.0	72.5	338.9	79.2	63.9	121.9	32.9	310.8	578.6	1.0	6.2	11.4
Baltics												
Estonia	..	..	303.8	953.5	35.6	41.7	28.9	14.8	12.5	4.4	3.9	5.0
Latvia	..	..	262.4	958.6	34.9	26.3	23.1	13.1	7.0	2.8	3.2	2.6
Lithuania	..	..	345.0	1,161.0	188.8	45.0	35.7	13.1	8.4	2.4	0.3	1.4
CIS												
Russia	..	..	161	2,506	840	204.4	128.6	21.8	10.9	84.5	36.8	20.2
Belarus	..	..	93	1,559	1,996	1,960	244	39.3	63.4	181.7	251.3	..
Ukraine	..	..	161	2,730	10,155	401	181.7	39.7	10.1	20.0	19.2	25.8
Moldova	..	..	151	2,198	837	116.1	23.8	15.1	11.1	18.2	43.8	..
Armenia	..	..	25	1,341	10,896	1,885	31.9	5.8	21.8	–1.3	2.0	..
Azerbaijan	..	..	126	1,395	1,294	1,788	84.5	6.5	0.4	–7.6	–0.5	..
Georgia	..	..	131	1,177	7,488	6,474	57.4	13.7	7.3	7.2	10.9	..
Kazakhstan	..	..	136.8	2,984	2,169	1,158	60.4	28.6	11.3	1.9	18.1	9.8
Kyrgyzstan	..	..	170	1,259	1,363	95.7	32.3	34.9	14.7	18.4	39.9	..
Tajikistan	..	..	204	1,364	7,344	1.1	2,133	40.5	163.6	2.7	31.3	..
Turkmenistan	..	..	155	644	9,750	1,328	1,262	445.8	21.5	19.8	21.2	..
Uzbekistan	..	..	169	910	885	1,281	116.9	64.3	27.6	26.1	25.2	..

Sources: EBRD (1999, p. 76; 2000b, p. 9); for 2000, compiled official announcements.

off with high inflation of hundreds of percent, while Czechoslovakia had minimal inflation initially, but they all undertook early, radical, and successful stabilizations. Even so, Poland and the Baltics had high inflation for years. The Czech Republic and Slovakia were the most successful inflation fighters, being the first to reduce inflation to single digits in 1994 and 1992, respectively. Czech Prime Minister Vaclav Klaus proudly showed that the inflation curve in his country was exactly as had been anticipated after a radical and consistent stabilization.

The third group encompasses most CIS countries. They experienced hyperinflation or more than 50 percent inflation for at least one month in 1993. Late in the day, they launched serious stabilization efforts from 1994 to 1996 and got inflation under control.

The fourth group is the most curious one. It consists of five countries that succeeded in getting inflation below 40 percent a year at one stage, but later faced new high inflation. By 2000, those examples of renewed high inflation were Bulgaria in 1996–7, Romania in 1997, Russia in 1998, Belarus in 1997–9 and Tajikistan in both 1995 and 1997. Bulgaria, Romania, and Russia set a pattern. They had suffered from late and slow stabilization, with insufficient fiscal adjustment, leaving them with large budget deficits. The renewed inflation crises erupted, when they no longer could raise credits to finance their excessive budget deficits, which unleashed debt crises, bank crashes, and large devaluations. Belarus had never undertaken a real transition to a market economy, and it remains unstable and unreformed. Tajikistan had wiped out its money through a confiscatory currency reform in 1994 without a full-fledged stabilization, and the country remained on the verge of civil war.

The high inflation had many harmful consequences. Bank savings of the population were inflated away, which hit the well-to-do and elderly, who often maintained large bank holdings in domestic currency in the absence of other investment options. Curiously, their considerable anger was directed against the reformers, who liberalized prices, rather than the communists, who had issued too much money. High inflation undermined all confidence in local currencies, prompting a mass flight from them, and the volume of money as a ratio of GDP fell sharply, as the velocity of money rose, since few wanted to hold local money. Instead, dollarization proliferated, with cash dollars becoming a second currency in most countries in the region. The volume of money to GDP plummeted. Those with large holdings of money transferred it abroad, when capital flight caught on even before the end of communism, although it took years before capital transfers were officially condoned. Another effect was sharply vacillating relative prices. Thus, inflation brought about a huge destruction and transfer of wealth, while rendering the economic environment unstable and unpredictable.

Hyperinflation is a modern phenomenon. It could not exist without fiat and bank money, and it first emerged after World War I. Until the end of the 1980s, the world had recorded only 16 cases of hyperinflation, that is, inflation of at least 50 percent a month. A more telling anecdotal distinction between high inflation and hyperinflation is that under high inflation, a thief steals the money and leaves the bag, but under hyperinflation he takes the bag and leaves the money, because hyperinflation makes money lose not only its role as a store of value but even its functions as a unit of account and transaction. If we disregard the initial price hikes after price liberalizations, this region saw no less than eleven hyperinflations during the transition: Poland in 1989 and ten FSRs in 1993. In addition, Yugoslavia had two bouts of hyperinflation. Thus, the broader region experienced thirteen hyperinflations, almost as many as the whole world had suffered before the demise of communism.

These initial observations and Chapter 4 suggest several general conclusions. First, macroeconomic stabilization was a very difficult undertaking that required all attention and political will. Second, the most fortunate stabilizers were bound to be the most fortunate early growth countries. Third, high inflation precluded economic growth, and the return to high inflation coincided with growth reversals. Fourth, later stabilizations tended to be not only more socially costly but also more fragile. Fifth, a large fiscal deficit was a time bomb that had to be disarmed. Otherwise, it would explode and devastate the economy. Any significant financing of a large budget deficit could only be a temporary convenience.

THE DISASTROUS RUBLE ZONE

In macroeconomic terms, a chasm divided Central Europe and South-East Europe from the FSU, including the Baltics, from the outset. The former countries had admittedly high inflation, but the latter experienced extreme inflation ranging from 950 percent a year to 11,000 percent a year. The initial macroeconomic crises and distortions were far worse in the Soviet Union than in Central Europe, but the duration of high inflation and the attainment of hyperinflation depended on the time a country stayed in the ruble zone. The fundamental monetary question was the currency area or what geographical territories would have their own currencies, which was an open issue in the collapsing Soviet Union.

Mixed Objectives

When the Soviet Union fell apart in December 1991, the break was not clean. The Commonwealth of Independent States (CIS) was established as a substitute for the Soviet Union, but its economic and political functions were hazy. The main bone of contention was the common currency, the ruble, which was the last Soviet institution.

By 1991, a competitive issue of ruble credits had started between the old Soviet State Bank and fifteen new republican central banks. The more ruble credits one republic issued, the larger share of the common GDP it extracted, but the worse its hyperinflation became.

Ruble currency was only printed in Russia, however, which rationed its deliveries to the other republics. In early 1992, many CIS policymakers did not understand that credits equaled money. Some endeavored to limit the emission of currency, while they happily issued huge credits. The natural consequence was a great deficit of cash, which led to the emission of surrogate money, usually provisional coupons, in most CIS countries. This problem peaked in the summer of 1992 (Hardy and Lahiri 1994).

Views on the ruble zone differed. The Baltic nationalists were determined to leave the ruble zone as soon as possible and establish their own national currencies, as the best border against Russia. The Balts disregarded transition costs, because they saw a West-oriented, stable market economy as the best long-term option (Hansson 1993).

Nationalists in other FSRs favored independent national currencies in principle, but they felt poorly prepared and wanted to extract maximum benefits from cheap Russian credits and raw materials. They feared their predominant trade with Russia would be disrupted if they abandoned the ruble zone, and they had no clue how to establish their own currency or pursue monetary policy. Much of the monetary discussion was devoted to aesthetic issues, such as the name of the national currency, its design, and where to print it. Yet, all nationalists regarded a national currency as a necessary prerequisite of an independent state, and their question was only when and how to introduce it.

Some countries stayed pragmatically close to Russia out of necessity or convenience. Neighboring Belarus and Kazakhstan were close to, and dependent on, Russia, while Armenia and Tajikistan, on the contrary, were far from Russia, but small and weak. Therefore, they saw no threat from Russia, while they desired Russian financial, political, and military support against hostile neighbors.

Russia was the obvious key. The Russian economic reformers, notably Yegor Gaidar (1993), advocated the early "nationalization of the ruble" as the term ran. They realized the enormous cost of the ruble zone to Russia, but they thought the breakup could not be undertaken until the middle of 1992 because of technical problems, such as the printing of a new currency. Their Western economic advisors were unanimously for the instant introduction of an independent ruble (Sachs and Lipton 1993), but the reformers were in no position to decide. The old Soviet establishment, including the Central Bank of Russia, the old Soviet ministries, and state industry, resisted the departure of the Soviet Union, and Gosplan staff had taken charge of CIS trade. State enterprise managers wanted to continue delivering their substandard produce to other FSRs in return for Russian state credits. The sales of Russian oil and gas at very low prices to other CIS countries facilitated lucrative arbitrage for state enterprise managers, commodity traders, and bankers throughout the CIS. Thus, a rent-seeking elite benefited from the persistence of the ruble zone, as did Soviet deadbeats, while the broader public did not understand the issue, instinctively preferring minimal change (Åslund 1995).

The IMF was the main international agency involved. It considered the ruble zone such a politically infected issue that it preferred to be neutral. It assisted the Baltic states after they had decided to launch their own currencies in mid-1992, but only in May 1993 did the IMF actively encourage a country (Kyrgyzstan) to depart from the ruble zone. The IMF (1992b) reckoned that the CIS countries needed to agree on a controlled system of emission, but this was never feasible, as each central bank could issue ruble credits. Since the EU was about to establish its single currency, EU spokesmen defended the ruble zone (Emerson 1992).

The only reasonable policy, however, was to divide the ruble zone swiftly and clearly, as Czechoslovakia had done after the dissolution of the Hapsburg Empire, thereby avoiding the high inflation that had devastated all the other successor states of the Hapsburg Empire (Pasvolsky 1928), and these lessons were alive and understood in the international economic debate (Sargent 1986; Dornbusch 1992).

A Protracted and Destructive Separation

After the initial price hike in early 1992, inflation decreased in most CIS countries until the summer due to halfhearted stabilization attempts, but in the late summer monetary emission and ensuing inflation gained momentum throughout the region. The competition over monetary emission had caught on. The Russian government tried to limit credit to the other FSRs from July 1992, but with little success, as strong forces spearheaded by the Central Bank of Russia insisted on such credits.

As a result, ten of the twelve members of the ruble zone experienced hyperinflation in 1993. The only exceptions were Kyrgyzstan, which left

Table 6.2. Russian Financing of Other FSRs, 1992 (Percentage of national GDP financed by CBR)

Russia	–11.7
Tajikistan	90.7
Uzbekistan	69.9
Turkmenistan	53.3
Georgia	51.5
Armenia	49.0
Azerbaijan	25.8
Kazakhstan	25.5
Kyrgyzstan	22.9
Ukraine	21.7
Moldova	11.3
Belarus	10.7
Estonia	4.0
Lithuania	3.2
Latvia	1.0

Source: IMF (1994a).

the ruble zone in May 1993, and Russia, which possibly pursued the strictest monetary policy in a poor race, while Ukraine and Armenia experienced inflation of over 10,000 percent. Hyperinflation caused economic chaos.

In 1992 the cost of the maintained ruble zone to Russia amounted to 9.3 percent of its GDP in subsidized credits and 13.2 percent of GDP in implicit trade subsidy, that is, a total of 22.5 percent of GDP (IMF 1994a, p. 25). Formally, the gains of other CIS states were enormous, ranging from 11 percent of GDP in Belarus and Moldova in 1992 to 91 percent of GDP in Tajikistan (see Table 6.2). In reality, however, no country is likely to have benefited from this flow of money, only a variety of rent seekers.

In 1993, Russia's reformist minister of finance, Boris Fedorov (1994), did his utmost to break up the ruble zone, trying to cut credits to other CIS countries and supporting Kyrgyzstan's departure. Strangely, his nemesis Viktor Gerashchenko, the old-style chairman of the Central Bank of Russia (CBR) and the main advocate of the ruble zone, suddenly terminated the ruble zone by declaring old Soviet banknotes null and void at the end of July 1993. Gerashchenko's intention was possibly to threaten other countries to accept the rule of CBR, but his action caused panic and compelled all remaining members of the ruble zone to establish their national currencies within the next few months (Granville 1995a).

Although the dysfunctional ruble zone had lingered for so long, few CIS countries had prepared themselves for monetary independence. They fell into complete disarray and inflation actually surged in several CIS countries in late 1993. However, with the exception of Azerbaijan, they all had less inflation in 1994 than in 1993. The end of the ruble zone made monetary stabilization possible.

Czechoslovakia Did It Right

The split of Czechoslovakia into two countries was peacefully agreed upon in 1992 to occur on January 1, 1993. In sharp contrast with the CIS, the Czech Republic and Slovakia repeated their success after World War I. The original intention was to divide the currency on June 1, 1993. However, an immediate run on the currency led to a separation of the Czech and Slovak korunas in mid-February, and the Slovak koruna was devalued in relation to the Czech koruna. Thanks to this early division of the currencies, monetary stability could be maintained in both countries, although inflation rose a bit and some trade disruption occurred (Nuti 1996).

EXCHANGE RATE POLICY

At the outset of the transition, exchange rate policy was a major theme. Most radical reformers advocated an exchange-rate-based stabilization, with a fixed exchange rate as nominal anchor, but others preferred the money supply as nominal anchor in a money-based stabilization.

As long as multiple exchange rates prevailed, the black market exchange rate was widely considered the "real" exchange rate, as it was set by a market. However, it was depressed by the diversion of government funds at an unrealistic official rate, a domestic monetary overhang, pent-up domestic demand for imported goods, high inflationary expectations, flight from the currency in crisis because of minimal confidence and prevalent uncertainty. When the exchange rate was unified and liberalized, the initial result was huge devaluations of market exchange rates (Halpern and Wyplosz 1996). In Russia, the average wage was merely six U.S. dollars a month by the free exchange rate in December 1991, and the level was similar in other FSRs. The higher the initial inflation and the greater the shortages were, the greater the real devaluation. Many economists regarded these exchange rates as undervalued, complicating price stabilization (Nuti 1996).

A wide debate raged about whether exchange rates should float or be pegged, and which exchange rate to pick. The key countries in this discussion were Poland, the Czech Republic, Hungary, Estonia, and Russia. The pegging of the exchange rate was initially seen as crucial to the success of some early financial stabilizations, but a few countries stabilized without fixing their exchange rates, leading to a questioning of the need for a peg.

Initially, the problem was undervaluation of the domestic currency, but later on real appreciation led to current account deficits and threatened international competitiveness, raising the question, How can a country maintain a competitive exchange rate?

Poland and Czechoslovakia Pegged

In 1989, when the Polish exchange rate fluctuated wildly at the onset of hyperinflation in October, there was no consensus about a reasonable exchange rate (Granville 1990). Because of this vacillation and the perceived need for a nominal anchor for macroeconomic stabilization, the pegging of the Polish złoty to the U.S. dollar became a major policy objective, combined with immediate convertibility and a stabilization fund (Sachs 1990, 1992). Poland successfully raised credits of $1 billion, financed by 13 industrialized countries to guarantee its exchange rate from January 1990 (IMF 1994c). This policy became standard for countries that opted for a big bang, because a peg reinforced external liberalization and compelled a country to maintain monetary discipline (Wyplosz 1999).

Poland presented its peg as a temporary measure, and in May 1991, it was compelled to devalue without much drama. Soon, the country adopted a "crawling peg," committing itself to staying within a band of moderate devaluation, which was modified from time to time. This policy of a temporary fixing of the exchange rate and an ensuing gradual devaluation was widely acclaimed. The fixity helped financial stabilization, while the crawling peg provided predictability and made Poland avoid an overvalued exchange rate (Rosati 1996; Nuti 1996). Poland is considered one of the few successful exits from a peg (Fischer and Sahay 2000).

Another big-bang country, Czechoslovakia, followed suit and pegged its exchange rate to the U.S. dollar with the support of a stabilization fund, provided by Western bilateral financing from January 1991. Because of little prior inflation, it was much easier to pick a plausible exchange rate for the Czechoslovak koruna. The peg served its purpose well as a nominal anchor, and inflation that rose with price liberalization was swiftly brought down also by strict fiscal, monetary, and wage policies. However, inflation in Czechoslovakia remained much higher than in the United States or Western Europe, leading to a continuous real appreciation, which hampered exports. The Czech current account turned negative in 1994 and became worrisome in 1996. The deteriorating foreign account deflated economic growth, and in May 1997, the Czech Republic was forced to abandon its peg (Begg 1998). Slovakia pursued a similar policy, though it devalued in early 1993 after its separation from the common koruna with the Czech Republic. Yet, Slovakia maintained the peg until October 1998, when it also opted for a managed float after having had a large current account deficit of about 10 percent of GDP from 1996 to 1998 and high real interest rates.

Like Poland, the Czech Republic and Slovakia had started with just a temporary peg, but their stable exchange rates became matters of national pride. Afterward, many blamed the overvalued exchange rate for the Czech recession. The Czech example became an argument against pegs, because it illustrated how easily a peg could lead to an overvalued exchange rate. Several Latin America countries undertook successful exchange rate-based stabilizations but fell into balance-of-payments crises (Calvo and Végh 1999). Such a stabilization provided governments with little incentive to undertake fiscal reform, since the low inflation was associated with the stable exchange rate rather than with a limited budget deficit (Tornel and Velasco 1995). Slovakia especially conforms with this picture.

As Russia was approaching its big bang of early 1992, Jeffrey Sachs (1995a) campaigned for a $6 billion stabilization fund for the pegging of the ruble. However, international support was not forthcoming, and the issue fell off the table. No further stabilization funds were established.

Quite a few not very reformist countries, such as Romania, Ukraine, Belarus, and Uzbekistan tried to fix their official exchange rates intermittently. Yet, several exchange rates developed, one official, one privileged rate for certain imports, and a black market exchange rate, because inflation was high, rendering the official exchange rate increasingly overvalued. From time to time, the official rate was devalued in an attempt to unify the exchange rate and render the official exchange rate more realistic (Daianu 1996). These practices gave pegs a bad name and many people in the region viewed any peg as a remnant of the socialist economy.

Currency Boards Starting in Estonia

As so often, Estonia took the lead in the Baltics and went for an even more radical reform than Poland. In April 1992, Estonia made a number of stark macroeconomic choices, focusing on its currency and exchange rate policy.[1]

[1] The Baltic section is largely based on Ardo Hansson (1997). An American of Estonian extraction with a Ph.D. in economics from Harvard University and an associate of Jeffrey

For Estonia, the main goal was to attain full independence from the Soviet Union and to become an integral part of the West. As other FSRs, Estonia faced near hyperinflation in early 1992, but it wanted to minimize inflation regardless of costs. Therefore, the Estonian government of bright young academics made radical decisions. Estonia was the first country to break out of the ruble zone in June 1992 and to establish its independent currency, the kroon, in order to distance the country from the Soviet Union and to facilitate financial stabilization. Estonia was also the first postcommunist country to opt for full convertibility in 1994.

The idea of a currency board arose in several quarters (Hansson and Sachs 1992; Hanke, Jonung, and Schuler 1992). The exchange rate of the kroon was permanently fixed to the German mark to facilitate macroeconomic stabilization. The Estonians willingly committed themselves to balance the state budget, disavowing both monetary policy and public borrowing. This full-fledged currency board was a robust arrangement, creating credibility both at home and abroad, and inflation would be determined by the balance of payments.

The currency board was possible because unlike other postcommunist countries Estonia started with large reserves, covering the whole domestic supply of currency. Before World War II, the Estonian government had deposited its gold reserves in Sweden, the United Kingdom, and Switzerland. Now it demanded and obtained them back. While the IMF did not initiate the currency board, it accepted the idea.

The currency board and stabilization policy were introduced in a true big bang in June 1992, combined with an IMF standby program and substantial Western financial support. Since a low exchange rate was chosen, it was easily defended, but the drawback was sizable real appreciation, which kept inflation rather high. The currency board, together with completely free trade, minimized government interference in foreign trade, rendering Estonia the freest trader and the least corrupt postcommunist country (EBRD 1999). Estonia also benefited from a large early inflow of foreign direct investment, and its interest rates fell faster than elsewhere.

Lithuania carried out a currency reform, inspired by Estonia, in October 1992 and eventually opted for a currency board in April 1994, pegging its exchange rate to the U.S. dollar. However, Lithuania maintained a significant budget deficit, contrary to the standards of a currency board, and inflation stayed in the double digits until 1997 (Hansson 1997;

Sachs, Ardo Hansson was for years the leading economic advisor to the Estonian government and the Bank of Estonia.

Berengaut et al. 1998). Its current account deficit hovered around 10 percent of GDP from 1995 to 1999. Although Lithuania escaped any serious financial crisis forcing it to devalue, it was more lucky than virtuous, with little exposure to short-term foreign debt.

The lesson from Estonia was that currency boards are good for small, open economies with a great need for credibility, but a stable misaligned exchange rate could lead to protracted inflation as in the Baltics, or squeeze exports as in the Czech Republic. Few perceived currency boards as suitable for large economies, such as Russia and Ukraine, although such proposals were made in the West (Hanke, Jonung, and Schuler 1993). For large countries, it seemed inappropriate that the balance of payments would determine the money supply, especially in the face of external shocks. Besides, it was difficult to mobilize reserves covering the whole money supply, to abstain from central bank policy, and to commit credibly to a balanced budget. The absence of a lender of last resort was also a concern (Williamson 1995; Berengaut et al. 1998).

In 1996, Bulgaria entered a severe macroeconomic crisis, with a collapse of its banks, excessive debt service, a large budget deficit, a plummeting exchange rate, and soaring inflation. Then, a currency board was widely perceived as the best means of restoring credibility. It was introduced in July 1997, fixing the leva to the German mark. Bulgaria was another small, open economy that desperately needed credibility, and the international community was prepared to finance a currency board, as the amount required was limited. Similarly, a currency board was conceived by the international community for Bosnia in 1998 (Minassian 1998). Currency boards had become reserved for small, open economies suffering from extreme financial instability.

More Flexible Exchange Rates

As so often, Hungary made a different, but fully sensible, choice than Poland and Czechoslovakia. Since it had attained near convertibility by 1989, it had little need to rush to full convertibility. With a market-adjusted exchange rate and near constant inflation, Hungary had no reason to devalue greatly or to use the exchange rate as a nominal anchor, since its strict and sophisticated monetary policy already served as a nominal anchor. Its natural choice was frequent but small devaluations to limit real appreciation, to contain its current account deficit, and to stay competitive on international markets. In 1995, after two years of excessive current account deficits, Hungary adopted a policy of preannounced crawling pegs to limit the uncertainty and irregularity of devaluations (Halpern 1996). This policy was as pragmatic as successful.

Through slightly different paths, Hungary and Poland had arrived at the same policy of crawling pegs, attaining both a predictable degree of devaluation and a reasonably valued currency. The complaint was that this system made inflation permanent.

To the international community, the Hungarian example suggested that a fixed exchange rate was not necessary as a nominal anchor. It was cheaper as no stabilization fund with international funding was required. Latvia was a more explicit example. Although it largely followed Estonia, its economic thinking was less developed, and Latvia did not have such large international reserves. Its predominant reformer was the chairman of the Bank of Latvia, Einarš Repše, who reckoned that the exchange rate should appreciate in real terms to keep inflation down, leading Latvia to opt for a stricter monetary policy than Estonia as well as a balanced budget. Repše led Latvian macroeconomic policy by focusing on monetary targets and incessantly quoting Baroness Thatcher. When Latvia launched its currency in July 1992, it officially pursued a managed float, but it was really an informal peg, and from February 1994 it pegged to special drawing rights.

Most CIS countries started with floating exchange rates by default, as they had small international reserves, little credibility, and even less policy. In May 1993, the IMF program for Kyrgyzstan broke this trend by opting for a floating rate professed by the IMF, as later occurred in several similar cases, such as Georgia, Armenia, and Moldova. In these countries, a floating rate appeared a market economic choice, because the alternative was a fixed artificial official rate and a much lower black market rate.

Currency Bands

After Russia had failed to mobilize international financing for a stabilization fund in early 1992, it allowed its currency to float. Although the nominal exchange rate plummeted irregularly, the ruble underwent a substantial real appreciation. As stabilization seemed to be approaching in early summer 1995, even the nominal exchange rate of the ruble started rising, arousing worries about a destabilizing exchange rate vacillation. The Russian authorities responded by introducing a fairly broad currency band in July 1995. This band was initially flat, but soon it started sloping downward, and it was adjusted about twice a year. The currency band contributed to the stabilization of both prices and the exchange rate. Ukraine adopted a similar policy.

The problem with the Russian and Ukrainian currency bands was, ironically, that they were too successful in attracting foreign portfolio investment. The combination of very high domestic interest rates and a seemingly predictable exchange rate enticed a massive inflow of portfolio investment of $46 billion, or 10 percent of GDP, into Russia in 1997 (RECEP 1999). This capital inflow went primarily into short-term domestic treasury bills, causing a false sense of financial security, which led to too little devaluation and too soft a fiscal policy, prompting the Russian financial crash of August 1998. The result was a devaluation from 6 to 24 rubles per dollar and an inflation of 85 percent that year (Illarionov 1998ab), although Russia maintained a current account surplus. Ukraine suffered less, because it had attracted less foreign capital.

Like the Czech currency crisis of May 1997 gave pegs a bad name, the Russian financial crash brought disrepute to currency bands, while a managed float became the favored exchange rate policy after initial price stabilization (Wyplosz 1999).

The Euro?

In 2001, the EU accession countries in the region can be divided into two groups with regard to exchange rate policy. Central Europe and Romania have managed float or crawling pegs, while the Baltics and Bulgaria have fixed exchange rates. For the latter group, a peg to the euro is a natural development, as Estonia and Bulgaria have in effect done.

The Central European economies are well managed and inflation is under control. Yet, inflation remains higher than in Western Europe and slow devaluation continues. A rising demand is the pegging of these currencies to the euro, as continuous devaluation is seen as the cause of excessive inflation. A more radical proposal is to adopt the euro unilaterally. That would provide the accession countries with even more credibility and avoid the danger of excessive appreciation because of high interest rates (Rostowski 1999). Yet, the early German currency union shows the danger of an overvalued currency.

The CIS countries appear stuck with national currencies that incite little confidence and thus remain fragile. Real interest rates stay high and exchange rates precarious. Does it make sense to have such weak independent currencies? If East-Central Europe would adopt the euro, some CIS countries might adopt the euro as well. It would bring them monetary stability, with lower interest rates, greater financial depth, better banking systems, and larger foreign direct investment, but they would run the danger of an overvalued currency.

A Peg Is a Good Start but a Bad End

The discussion over exchange rates is untypical of the debate on transition, as same people have changed their views repeatedly.

After the successful Polish stabilization, a peg based on a stabilization fund was the preferred option. Estonia's fixed exchange rate, safeguarded by a currency board, was seen as a special case, while Hungary, Latvia, and Slovenia showed that monetary policy could do the trick without a peg.

After Russia failed to attract funding for a stabilization fund, the whole concept of a peg or currency board seemed unrealistic for CIS countries. The Czech forced devaluation of May 1997 taught that a peg is good for initial stabilization, but it is politically difficult to abolish, and it breeds excessive current account deficits and inflates cost of production. The Russian financial crash of August 1998 showed that even a broader currency band could instill a harmful illusion of security.

In the end, a near consensus has developed about three alternative approaches for different groups of countries. Successful transition countries close to entering the EU might adopt a currency board tied to the euro. Countries that are stable but not quite safe may pursue a crawling peg with gradual but predictable devaluation. Those further away from Europe are advised to let their exchange rates float. Yet, future financial crises might shake this new received wisdom.

RADICAL FISCAL ADJUSTMENT WAS KEY

To begin with, fiscal policy and economic policymaking had to be centralized to the Ministry of Finance. Most postcommunist countries started with huge budget deficits, which remained remarkably large until the late 1990s. As stabilization started to bite, tax revenues started contracting. The key to successful financial stabilization was to cut budget expenditures sharply, which has proven as necessary as politically difficult.

Particularization and Centralization of Fiscal Policy

Under socialism, fiscal policy was subordinate to material flows, and fiscal institutions and instruments were merely supposed to control the fulfillment of production and allocation plans. Organizationally, the State Planning Committee and a row of industrial lobbies were senior to the Central Bank and the Ministry of Finance.

Initially, the Ministry of Finance had little control over state expenditures and revenues. Price and foreign trade subsidies were automatic and not subject to fiscal decisions. The presidential administration took what it wanted. Extrabudgetary funds with independent revenues and expenditures proliferated and assumed a nontransparent, quasiprivate character. The Central Bank issued subsidized credits without asking the Ministry of Finance. Authorized banks handled government money in Russia without paying significant interest. One of the most treacherous and lasting forms of concealed government spending was state guarantees, legally committing the state to cover the bill, while giving the beneficiary little reason to pay. State or semistate commercial banks, especially agricultural banks, saw as their duty to issue credits to state enterprises, which had no intention of paying back.

Under capitalism, on the contrary, fiscal policy is key. In the West, the minister of finance controls fiscal policy and the government's purse strings. In rank, he or she is usually next to the prime minister. In transition, finance suddenly became important, and a major systemic battle ensued between reformers who aspired to centralize fiscal control, developing new financial institutions, and rent seekers who wanted to seize public revenues and assets for their private interests.

All governments tried to impose a variety of central controls over both revenues and expenditures. The successful early reformers (Central Europe and the Baltics) managed to centralize fiscal control to the Ministry of Finance reasonably well, and the minister of finance became deputy prime minister in several countries (for instance, Poland, the Czech Republic, and Slovakia). In the CIS countries, Romania and Bulgaria, on the contrary, this struggle has lasted. The degree of central fiscal controls reflects a stark dichotomy between success and failure in transition.

The old establishment responded to reformist pressures with quasi-privatization of fiscal institutions. Both ministries and regional governments set up a plethora of extrabudgetary funds for "their own" public revenues, while most countries controlled the cash flow from major taxes. State agencies developed additional revenues, called "special means" or "paid services," which rose to several percent of GDP in most CIS states. Usually, these additional revenues were unaccounted for and beyond central state control. Because major taxes had to be paid to the central treasury, state agencies invented multiple licenses, fees, and penalties to enlarge their revenues. Along the roads, the police edged out racketeers and extorted bribes to let people through. For instance, a Mercedes driver told me that he was stopped by the police 120 times on the road from Germany to Kyrgyzstan. The ministries for foreign affairs charged exorbitant visa fees as their "paid services." Many institutions had minimal budget revenues, but they held real estate, which they illicitly let out to commercial organizations.

At the top, the presidential administration seized the property of the Communist Party to maintain Nomenklatura benefits. Especially in Russia, an absurd system of remuneration developed. A deputy minister could earn about $200 a month, while he or she could obtain an apartment from the Kremlin property management worth up to $1 million, while many deputy ministers received nothing. About 2,000 such apartments were being distributed on personal fiat each year. Similarly, the Ministry of Defense and the Ministry of Security were beyond treasury control in CIS countries.

When involved in business, government officials also benefited personally. Revenue agencies became formally self-financing, seeing little reason to pass on their revenues. I once asked the Moscow police chief in the early 1990s how large a share of policemen's personal income consisted of salary. His guess was one-fifth. The rest was not only straightforward bribes but also revenues from independent enterprises run by the police.

These "special means" had all possible drawbacks. They were effectively taxes but highly inefficient. Unpredictable and arbitrary, they aggravated government controls and the enterprise environment. The distinction between the state and illegal private enterprises was diffuse, as a taxpayer never knew what share of his payment went to the state or to extorting officials. For the state administration, these revenues were very labor intensive, bloating state bureaucracy. Since they were not subject to any accountability, the nontransparency of these state revenues was nearly complete. As a result, total state revenues were much larger than officially stated. While justified state supervision was undermined by corruption, enterprises suffered from persistent unjustified inspections. Thus, "special means" worsened the evils of transition: corruption, bureaucracy, the weakness of the state, bad enterprise environment, and unequal treatment.

Why didn't governments prohibit "special means"? The fundamental problem was the pernicious Soviet budgeting practices. Governments budgeted in an old fashion for each kind of expenditure, habitually ignoring most of them. In Soviet times, the government corrected for these budget shortcomings after the fact, by forgiving debts at the end of each year. With transition, however, budgets assumed real meaning, while budget organizations were asked to do far more than they would get resources for. Typically, a state agency in a CIS country received budget money for only half of its actual expenditures, usually salaries, while the agency was asked to find money itself for rent, communal services, office costs, transportation, phone calls, and so forth.

In most post-Soviet countries, weak ministries of finance did not dare to refuse requests for expenditures, ending up with larger "planned" expenditures than they could possibly finance, enticing the invention of fictive revenues. Ukraine was the most extreme case. The Ukrainian government raised its revenue projections every year by leaps and bounds to 86 percent of GDP in 1994, although its revenues stayed nearly constant at 42 percent of GDP (Dąbrowski, Luczyński, and Markiewicz 2000). This overbudgeting was also a means of manipulating the budget to the benefit of vested interests at the expense of the population. The costs of the administration and subsidies of major interest groups were covered, while science and culture had to accept the largest cuts, followed by social expenditures. Little wonder it was so difficult to impose budget discipline in CIS countries.

In the end, governments cut their expenditures through discretionary sequestration, resulting in government arrears. The shortfall also prompted special deals or offsets, notably with the energy sector, but even so budget organizations fell in financial disarray, unable to finance the tasks allotted to them. The line between government and enterprise was hopelessly blurred. These malpractices have outlasted the 1990s in most post-Soviet countries.

The Development of a New Tax Service

Under socialism, taxes had been paid by a limited number of state enterprises, and tax collection had been automatic through the state bank system. Now each country needed a large new tax collection agency, and a broad Western opinion worried about its absence. From the left to the IMF, fear prevailed that tax collection would collapse, requesting high tax rates and draconian tax collection.

However, the fearful were happily surprised by the resurgence of the communist bureaucracy. The post-Soviet countries organized huge tax inspections with comparatively qualified staff in no time, because the old communist system mastered inspection and punishment, and the tax police were highly motivated, since they worked on commission.

Many other new state organs were also considered necessary, such as ecological inspectorates and antimonopoly committees. Russia and Ukraine, which took the lead in innovating inspections, had soon established over sixty state agencies for inspecting enterprises and certifying products. These energetic inspectors operated in accordance with the old Stalinist principle of the superiority of state officials over people. Multiple surveys have revealed the great frequency of inspections and the sizable bribes extorted (Kaufmann and Kaliberda 1996; EBRD 1999).

These well-intended efforts to build new government agencies resulted in the rise of a Soviet-like bureaucratic Leviathan in countries that needed to be liberalized from the state. The legal protection of businessmen was ignored. They faced up to the challenge, as EBRD (1999, p. 120) puts it:

Although the formal system of central planning has been abandoned, the bargaining between the state and firms has not ceased but rather changed form . . . state and enterprises engage in a web of interactions beyond the standard provision of public goods in exchange for taxes. The state gives a wide range of benefits to firms, in the form of state financing, explicit subsidies and implicit subsidies, including tax-related benefits (for example, offsets) and tolerance of arrears. Firms provide state officials with political and private benefits in the form of control rights over company decisions and bribes.

The tax service was supposed to be subordinated to the Ministry of Finance, but as it collected revenue, it gained importance and independence. Beside the tax service, the CIS countries set up tax police with full-fledged policemen. They did not obey the tax service, and the tax service and the tax police collected the same taxes from the same taxpayers. The Customs Service had traditionally been subordinate to the Ministry of External Economic Relations, collecting foreign trade taxes but also value-added tax (VAT), without coordination with the tax services. Payroll taxes designed for social purposes were collected by a number of ineffective extrabudgetary funds. These different revenue services collected similar taxes from the same taxpayers in competition with one another, which naturally led to overgrazing of the tax base (Shleifer and Treisman 2000). The government monopoly of taxation had broken down. If you paid taxes to one service, you were more likely to be charged by another one, as the tax system was too arbitrary to offer any legal protection to honest taxpayers.

While East-Central Europe has been reasonably successful in establishing a strong revenue service, virtually all CIS countries suffer from overgrazing by competing revenues services. Until the state monopoly of taxation is restored, little order can be established.

Fiscal Relations between the Center and Regions

The problems of competition in taxation also involved relations between the center and the regions. The early reformers and the small countries – Central Europe and the Baltics – had highly centralized fiscal systems that worked. Especially for the large CIS countries, Russia and Ukraine, fiscal relations between the central government and the regions became a major problem (Shleifer and Treisman 2000; Kravchuk 1999).

Regional and local taxes started proliferating. Although a handful of taxes reaped more than three-quarters of state revenues, Russia had a total of 200 taxes in the late 1990s, as each region invented taxes to cover its own needs. Usually, these taxes were licensing fees or penalties, often designed for individual, profitable enterprises (McKinsey 1999). The number of tax bases proliferated, too. Road Funds and Emergency Funds levied fees on enterprise turnover. Profit-making enterprises without political protection were overgrazed, often fatally.

Once in Ukraine, I met a devastated director of a brewery who told me that her city district had introduced a hefty licensing tax on mineral water. Naturally, this brewery was the only producer of mineral water in that district. Repeated attempts to eliminate seemingly superfluous taxes were foiled, as a vested interest stood behind each tax.

The problem here was not only the corruption of tax officials, but also the incentives the central government offered the regions. While the tax service was formally a centralized state agency, Russian tax inspectors received their variable income from their regional government. Naturally, they gave the regions priority, which explains why the regions obtained a larger share of total revenue than planned until 1999. The regions had no incentive to deliver additional funds to the center or collect more revenue. Kravchuk (1999) found that the marginal tax effect on a Ukrainian regional government was over 100 percent. Thus, if it collected more revenue, it would lose part of what it had already collected for itself.

In both Ukraine and Russia, the regions and the center have been supposed to share up to a score of different taxes. These ratios have varied for each tax and between regions. Although meant to be constant, they have changed every year, or even more often, in negotiations reminiscent of the old Soviet system. In Russia, the original reform government had intended to reserve certain taxes for the center and others for the regions, but some taxes brought increasing revenue, notably the VAT, while others, such as the profit tax, reaped declining revenues, and regions insisted on their share of rising taxes.

Until the financial crash in 1998, the Russian federal government persistently received less than its planned share of collected state revenues, because regions hid revenue. One trick was offsets, which the central government could not share. Another means was additional local taxes, which explains the proliferation of new taxes. A third alternative was semifiscal revenue, such as fees and penalties. Thus, regional governments had a totally flawed incentive structure, with no rewards if they collected more official revenues, as these could reduce their own incomes, while devastating extortionary raids that disrupted the work of enterprises were most lucrative. Moreover, the less tax revenues that were collected in monetary form, the larger the regional share.

Strangely, the World Bank initially favored revenue sharing in Russia, because regional income inequality was so great that the federal government needed to serve as an equalizing force (Wallich 1994). This argument sounds laudable, but it presupposes an orderly government. It might have worked in Central Europe, but in Russia it was harmful.

In the end, this system appears too dysfunctional to last. Shleifer and Treisman (2000) have drawn logical conclusions, arguing that tax bases, taxes, and tax services should be divided between the center, the regions, and the municipalities. Each level of government should be fully in charge of certain taxes with separate tax bases. Similarly, the responsibilities for various kinds of expenditures should be clearly divided between different levels of government.

Large Budget Deficits

Although most of the region has suffered from large budget deficits for a protracted period, fiscal policies have differed greatly.[2] For the early transition, three different approaches were apparent. A first group of virtuous reformers (the Czech Republic, Slovakia, Estonia, and Latvia; see Table 6.3) started their transition with more or less balanced budgets, which they maintained, suggesting that the easiest way of balancing a budget is to do so from the beginning.

A second group (Poland, Hungary, and Lithuania) failed to minimize their budget deficits, compelling them to substantial readjustments, Poland in 1992, Hungary in 1995, and Lithuania in 1997. Even so, they have not been as successful in their budgetary restraints as the first group, regardless of strong economic performance.

The third group, encompassing all the CIS countries, Bulgaria, and Romania, have had lasting, large budget deficits.[3] They all started off with huge fiscal imbalances which they have found it remarkably difficult to reduce. Only the absence of financing has compelled them to cut their deficits, which were small in most countries by the end of the transition decade.

[2] Budget statistics are amazingly poor, and numbers vary greatly with source – by over 40 percent of GDP for a single year! There are several major sources of divergence. The IMF tends to count government commitments, but a post-Soviet government commitment was not a real promise, so actual cash payments appear more relevant. Foreign credits, especially among the CIS countries, were huge in 1992 and 1993, and they were often ignored in fiscal statistics, although they were actual government expenditures. Subsidized credits issued by the central bank are often omitted, but they are also government expenditures. The operations of public extrabudgetary funds are usually revealed long afterward, if at all. Assessments of GDP in local currency are often revised substantially. All these problems were far worse in the CIS than in Central Europe, though Romania and Bulgaria were notorious for not including all quasifiscal expenditures in their budgets, such as forgiven bad state credits and exchange rate subsidies. Often, budget deficits are revised upward, as real expenditures are detected after some time.

[3] Notably Romania, Belarus, and Turkmenistan.

Table 6.3. General Government Balances, 1989–1999 (Percentage of GDP)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Central Europe											
Poland	−7.4	3.1	−2.1	−4.9	−2.4	−2.2	−3.1	−3.3	−3.1	−3.2	−3.3
Czech Republic[a]	−2.8	−0.2	−1.9	−3.1	0.5	−1.1	−1.4	−0.9	−1.7	−2.0	−3.3
Slovakia	..	..	..	−11.9	−6.0	−1.5	0.4	−1.3	−5.2	−5.0	−3.6
Hungary	−1.4	0.0	−3.0	−7.2	−6.6	−8.4	−6.7	−5.0	−6.6	−5.6	−5.6
South-East Europe											
Romania	8.4	1.0	3.3	−4.6	−0.4	−2.2	−2.5	−3.9	−4.6	−5.0	−3.5
Bulgaria	−1.0	−8.1	−4.5	−2.9	−8.7	−3.9	−6.3	−12.7	−2.5	1.5	−1.0
Baltics											
Estonia	..	..	..	−0.3	−0.7	1.3	−1.3	−1.9	2.2	−0.3	−4.6
Latvia	..	..	..	−0.8	0.6	−4.4	−3.9	−1.8	0.3	−0.8	−4.2
Lithuania	..	..	..	0.5	−5.3	−4.8	−4.5	−4.5	−1.8	−5.8	−8.6
CIS											
Russia	..	..	..	−18.9	−7.3	−10.4	−6.0	−8.9	−7.6	−8.0	−1.0
Belarus	..	..	..	−3.3	−5.2	−1.3	−6.9	−1.9	−1.2	−0.6	−5.6
Ukraine	..	..	..	−25.4	−16.2	−7.7	−6.1	−6.1	−5.0	−3.0	−2.5
Moldova	..	..	..	−26.6	−7.5	−5.9	−5.8	−9.7	−7.5	−3.3	−3.2
Armenia	..	..	..	−13.9	−54.7	−16.5	−9.0	−8.6	−5.8	−3.7	−5.9
Azerbaijan	..	..	..	2.7	−15.3	−12.1	−4.9	−2.8	−1.6	−4.2	−5.4
Georgia	..	..	..	−25.4	−26.2	−7.4	−5.3	−4.9	−7.0	−6.5	−6.7
Kazakhstan	..	..	..	−7.9	−4.1	−7.7	−3.4	−5.3	−7.0	−7.7	−5.3
Kyrgyzstan	..	..	..	−17.4	−14.4	−5.7	−8.4	−8.8	−8.8	−11.2	−12.8
Tajikistan	..	..	..	−30.5	−20.9	−5.2	−5.3	−5.8	−3.3	−3.8	−3.1
Turkmenistan	..	..	..	−9.4	−4.1	−2.3	−2.6	0.3	0.0	−2.7	0.9
Uzbekistan	..	..	..	−18.3	−10.4	−6.1	−4.1	−7.3	−2.4	−3.0	−1.8

[a] Figures for 1989–91 given for Czechoslovakia.

Sources: EBRD (1999, p. 77; 2000a, p. 68).

The lesson is evident. If a country could, it was best off balancing its budget from the outset. Either it succeeded in doing so continuously, or the initial attempt facilitated a later balancing. Those countries that maintained large budget deficits saw no recovery of their economies, but only inflation and economic decline, finally convincing them to reduce their deficits. The extensive advocacy of economic stimulation through fiscal deficit appears baseless, and expenditures have not been very socially beneficial, as they have been oriented toward rent seeking.

Contracting State Revenues

Socialist governments redistributed a great deal. On average, about 50 percent of GDP was collected by the central government. Czechoslovakia took the lead with no less than 61 percent of GDP in 1989 – that is, the highest level of taxation in the world together with Sweden, but for countries at that level of economic development, public revenues of 15–25 percent of GDP is normal (Tanzi and Tsibouris 2000).

If the purpose had been to promote economic growth, tax revenues should have been driven down to such a level, especially considering the nature of the taxes and their collection, but an unholy alliance supported high public revenues and expenditures. Strangely, many West Europeans saw the communist level as the standard. Even many East European reformers accepted Western Europe with its high public revenues and expenditures as their model, and their fear of collapsing public revenues prompted reform governments to raise taxes. Numerous economists argued that the state would require more resources to take on the social tasks of state enterprises and to establish a social safety net. Predictably, the old elite wanted to maintain the public resources they so enjoyed. The IMF insisted on a small budget deficit, but it was neutral to the level of public involvement. Just about everybody did their utmost to maintain high state revenues.

The surprise was how well they succeeded. In Central Europe, total state revenues were still 42 percent of GDP in 1999 (see Table 6.4).[4] The Baltic republics, Bulgaria, and Romania had an average of 36 percent of GDP.

The CIS, however, falls into two contrasting categories. The three Caucasian countries, Kazakhstan, Kyrgyzstan, Tajikistan, and Turkmenistan, had 16–21 percent of GDP in total state revenues in 1999. This group

[4] These numbers understate revenues in CIS countries, as not all extrabudgetary funds and other decentralized state revenues are included. However, the denominator, GDP, is generally understated, as the unofficial economy is not included. Hence, Table 6.4 reflects the official tax burden on the official economy.

Table 6.4. General Government Revenue and Grants, 1989–1999 (Percentage of GDP)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Central Europe											
Poland	41.4	45.3	42.0	43.8	47.6	46.8	45.7	45.0	44.4	42.9	42.7
Czech Republic	62.4	58.9	59.1	45.0	45.9	44.7	43.5	42.5	41.3	40.3	40.3
Slovakia	48.3	46.7	50.7	46.1	44.3	46.4	48.7	47.7	44.9	42.8	39.7
Hungary	..	47.1	48.5	46.2	45.7	43.5	42.5	44.4	43.7	42.1	42.7
South-East Europe											
Romania	50.9	39.8	41.9	37.4	33.9	32.1	32.7	30.1	30.7	30.1	32.1
Bulgaria	57.4	52.8	40.4	38.4	37.2	39.9	36.1	32.6	31.6	34.8	39.8
Baltics											
Estonia	..	..	..	33.3	38.6	41.1	39.9	39.0	39.3	39.5	35.7
Latvia	..	..	..	28.1	36.4	36.5	37.6	38.3	40.6	43.9	40.8
Lithuania	..	..	..	32.0	30.2	31.7	32.3	29.6	32.6	33.8	31.9
CIS											
Russia	..	..	..	39.5	36.2	34.6	33.5	33.0	36.4	31.5	34.1
Belarus	..	..	..	46.0	54.3	47.5	42.7	40.9	31.4	39.0	41.4
Ukraine	..	..	..	34.2	42.7	41.9	37.8	36.7	38.0	34.0	34.7
Moldova	..	..	..	30.3	22.8	31.3	33.9	32.1	36.3	34.6	24.0
Armenia	..	..	..	26.7	28.9	27.7	19.9	17.6	19.7	20.6	17.5
Azerbaijan	..	..	..	51.0	40.5	33.8	17.6	17.6	19.7	17.1	19.6
Georgia	..	..	..	10.2	9.7	7.7	10.7	14.2	17.8	16.4	15.8
Kazakhstan	..	..	..	24.5	21.1	18.5	16.9	13.2	13.6	18.2	19.0
Kyrgyzstan	..	..	..	16.7	25.1	20.8	16.7	16.6	16.2	18.1	17.5
Tajikistan	..	..	..	35.2	37.3	56.0	10.8	12.1	12.2	12.0	15.9
Turkmenistan	..	..	..	42.2	12.8	8.1	10.7	16.6	25.4	23.1	20.5
Uzbekistan	..	..	..	31.5	35.3	32.3	34.6	34.2	30.1	31.1	32.1

Sources: 1989–98 data, Tanzi and Tsibouris (2000, p. 19); 1999 data, ECE (2000a, p. 67), EBRD (2000a, p. 69).

combines three successful reformers and the war-ravaged countries, with Kazakhstan and Turkmenistan as odd men out. If 15 percent of GDP in state revenues is the minimum requirement for countries at this level of economic development, no country falls below this threshold. The other five CIS countries still had rather stable average state revenues around 35 percent of GDP, which is far too much for countries at their level of development, hampering their economic progress. One group consists of Russia, Ukraine, and Moldova, which clearly suffer from too high taxes and distortional public expenditures, though Moldova has moved to the low-revenue countries. The other two countries are Belarus and Uzbekistan, which have undertaken little reform.

As long as inflation stayed high, state revenues did not fall much. This runs counter to the standard Olivera–Tanzi effect, implying that enterprises delay their tax payments at times of high inflation and thus reduce their real taxes, but postcommunist enterprises did not behave like that for four reasons. First, they faced no hard budget constraints yet, so they did not mind paying taxes. Second, public enterprises had no effective owners, and their managers cared little about enterprise profits. Third, the state confiscated taxes directly through the state bank system regardless of what enterprise managers desired. Fourth, much of the taxes were actually paid in advance on the basis of preliminary assessment.

Instead, state revenues started falling, when stabilization began to bite. Then, money was getting scarce; banks no longer confiscated money to the benefit of the state; and many enterprises had got real owners. However, state revenues fell much more in those states that had experienced a longer period of inflation and had insisted on larger public expenditures than they could finance. While the causality is not evident, the correlation is. Those countries with lasting inflation were the most corrupt, and fiscal developments appear reflections of changing forms of rent seeking. To begin with, high inflation was a splendid source of rents, making a small elite wealthy. Next, these very rich bought themselves tax exemptions, which caused tax revenues to plummet. In the meantime, taxpayers in the official economy became subject to an ever greater tax pressure, as they were so few, prompting many to withdraw from business or to opt for the underground economy. Thus, both the high inflation and the later low state revenues were reflections of rent seeking.

Thus, almost all CIS countries have failed to liberate their economies from excessive taxation. Yet, regardless of other reforms, where state revenues have dwindled, economic growth has recurred, the exception being Kazakhstan until 2000. If tax rates are excessive, it appears better for economic growth if they are not paid.

Insufficient Cuts of Public Expenditures

As a consequence of both excessive budget deficits and public revenues, public expenditures have been far too large (see Table 6.5). Everywhere apart from the Caucasus and Central Asia, the level of public expenditures is West European, although these countries have far lower GDP per capita.

Public expenditures have been reduced substantially, but except for Central Europe and the Baltics, cuts were insufficient for fiscal balance until the end of the 1990s. Public expenditures have usually been curtailed because of serious crises or radical reform.[5] Yet, some countries still have too high expenditures, notably Central Europe, Belarus, Ukraine, Russia, and Moldova.

A big early budget adjustment was the elimination of consumer price subsidies, notably for milk and meat, which passed without protest in all stabilizing countries. Military expenditures were also reduced, especially in the FSU. Russia's Deputy Prime Minister Yegor Gaidar initially cut arms procurement by 85 percent in 1992, which eventually became 70 percent. While the military-industrial complex had been perceived as invincible, this strike was highly successful (Åslund 1995). However, most reformers failed in cutting enterprise subsidies which frequently exceeded one-tenth of GDP.[6] During the so-called shock therapy in Poland in 1990, over 7 percent of GDP was spent on enterprise subsidies, making evident how soft the Polish stabilization actually was (EBRD 1997, p. 83). Subsidies were concentrated to a few not very profitable industries, namely agriculture, the coal industry, and very large enterprises, which were very successful lobbyists. Only the three Baltic states managed to cut these harmful public expenditures sharply from the outset.

Social expenditures were a stumbling block, especially in Central Europe, but also in Ukraine, where they had risen steeply at the end of communism and in the early transition. This rise was difficult to undo immediately afterwards.

Decisive, however, was whether reform or rent seeking prevailed. Rent seeking greatly influenced both state budgets and their execution. The most problematic countries were Russia, Ukraine, and Moldova, which had inordinately high public expenditures for their level of economic development.

[5] In the Czech Republic in 1991, in Hungary in 1995, in Bulgaria in 1991–2, in Russia in 1995 and 1998, etc.

[6] Most of these subsidies are heavily understated, as most parties involved had an interest in hiding actual subsidies and it was rather easy to do so. Less reformist countries tend to hide their subsidies more carefully, complicating comparisons.

Table 6.5. General Government Expenditures and Net Lending, 1989–1999 (Percentage of GDP)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Central Europe											
Poland	..	42.1	49.1	49.5	50.5	49.2	48.0	47.5	47.5	45.7	44.7
Czech Republic	61.1	61.1	54.2	47.1	45.4	45.8	45.3	43.6	43.4	39.4	44.4
Slovakia	60.3	61.7	59.3	58.0	51.3	47.8	48.3	49.0	50.1	48.2	43.3
Hungary	..	46.0	52.1	53.7	54.6	52.1	48.7	47.5	48.5	46.4	48.3
South-East Europe											
Romania	42.8	38.7	38.7	42.0	34.2	33.9	34.7	34.1	34.3	33.7	36.8
Bulgaria	58.8	65.6	55.0	43.6	48.1	45.7	42.4	45.2	34.1	33.3	40.7
Baltics											
Estonia	..	..	..	33.6	39.2	39.8	41.1	40.6	45.0	44.6	41.0
Latvia	..	..	..	28.9	35.8	40.5	41.1	39.7	39.2	43.9	44.6
Lithuania	..	..	..	31.5	35.4	36.5	36.8	34.1	34.4	39.6	40.6
CIS											
Russia	..	..	..	57.9	43.6	45.0	39.6	41.7	44.3	39.5	36.0
Belarus	..	..	..	46.0	56.1	50.0	44.6	42.6	32.1	41.7	43.0
Ukraine	..	..	..	57.4	54.5	50.6	42.7	39.9	43.6	36.7	37.1
Moldova	..	..	..	56.0	30.4	40.8	39.7	38.7	43.1	37.6	28.1
Armenia	..	..	..	64.3	68.6	37.8	31.0	26.9	25.5	24.8	21.6
Azerbaijan	..	..	..	80.0	55.8	45.9	22.4	20.4	22.5	18.8	24.1
Georgia	..	..	..	55.7	50.0	33.2	17.6	20.9	23.4	21.5	22.0
Kazakhstan	..	..	..	31.9	25.2	26.2	20.1	18.5	20.7	25.8	24.7
Kyrgyzstan	..	..	..	31.4	39.8	32.4	34.0	26.5	25.1	28.1	20.0
Tajikistan	..	..	..	65.7	60.7	61.0	18.7	17.9	15.3	15.8	18.9
Turkmenistan	..	..	..	28.9	13.1	9.2	12.1	16.9	25.4	25.8	19.6
Uzbekistan	..	..	..	42.8	54.9	36.4	38.1	39.8	32.5	34.5	34.0

Sources: 1989–98 data, Tanzi and Tsibouris (2000, p. 22); 1999 data, ECE (2000a, p. 68), EBRD (2000a, p. 70).

First, rent seekers distorted the budget process. As Vito Tanzi and Hamid Davoodi (1997) have shown in general, corruption and large public investment go together, as rent seekers can extract rents more easily from overpriced public investment projects than from public services, such as education or health care. Ukraine continued large public investments at a time of purported austerity, while the public inadvertently complained about decapitalization.

Second, with large arrears and little budget discipline, rent seekers could allocate funds to their favored purposes, even after the state budget had been promulgated by Parliament. In Ukraine, three budget posts tended to be subject to overexpenditures, namely unplanned enterprise subsidies, government administration, and unplanned public investment projects. On the whole, Ukrainian budget targets were never reached but at the expense of science, all social expenditures, and defense. In short, the less socially beneficial public expenditures were, the less they were cut, and vice versa. The picture for Russia was similar, though less extreme.

Third, offsets and other nonmonetary payments of taxes further distorted the budget execution. An offset usually implied that a government agency accepted payment in kind rather than in money. Typical examples were supplies of construction services for unplanned construction projects. Hence, enterprises extracted public contracts at favorable prices by not paying taxes. As a result, as much as 16 percent of Russia's GDP was wasted in public enterprise subsidies in 1998 (Pinto et al. 1999).

Part of the problem was that these rent-seeking countries resisted cuts of full programs. Keeping a large number of underfinanced programs contributed to nontransparency and enhanced the options of the rent seekers. Therefore, they were overtly anxious to avoid the elimination of any social programs, while they could not care less about their execution. Real reformers, on the contrary, eliminated unjustified public expenditure programs (Rose-Ackerman 1999, pp. 39–42).

Ironically, as Yegor Gaidar (1998) has shown, those countries that insisted on larger public expenditures than they could afford condemned themselves to high and lasting inflation, which prompted their state revenues to fall even further, eventually compelling these countries to make do with even less. A similar effect was that "the stabilization process was not sustained in countries that had persistent fiscal deficits and slow structural reforms" (Fischer and Satay 2000, p. 9).

A NEW TAX SYSTEM

Everybody agreed that substantial changes in taxation were needed. The old socialist economy had no real tax system, as it was based on the confiscation of all remaining profits of state enterprises at the end of each year. Turnover and foreign trade taxes were simply the balance between arbitrarily set prices. This system of arbitrary discretion could not continue.[7]

Social Democratic or Liberal Tax Reform

A few principles were widely embraced. First, a broad consensus desired the abandonment of individually set taxes and the introduction of universal tax rates. Yet, many policymakers maintained ideas of social engineering and insisted on differentiated tax rates. Second, the worry about the collapse of tax collection made governments opt for high tax rates. Third, a simple and transparent system was desirable. Fourth, taxes should no longer be concentrated to enterprises, but the tax base should be broadened to people. Fifth, a desire prevailed to move taxes from production to consumption. Finally, a consensus perceived tax reform as so complicated that it had to be legislated and implemented over many years. All countries had developed some elements of an ordinary tax system under socialism, and these prior reforms greatly influenced the new tax system.

Hungary reformed its tax system the most before the end of socialism. In 1988, it had broadly adopted the Swedish tax system, with high VAT, a progressive income tax reaching 60 percent, a payroll tax of almost 60 percent, but comparatively low profit taxes and import tariffs. This social democratic model became one extreme standard for tax reforms in the region. Central Europe followed the Hungarian example rather closely, as neither Poland nor the Czech Republic displayed any liberalism in taxation. The least reformist FSRs – Ukraine, Belarus, and Uzbekistan – also followed this road, though their tax systems remained more discretionary.

Estonia pioneered an alternative liberal and simple tax system with few taxes and minimal loopholes. Its main innovation was a flat income tax of 26 percent for all. Estonia abstained from all foreign trade taxes. A VAT of 18 percent was its main tax. Apart from a comparatively low payroll tax (33 percent), profit tax, and land tax, Estonia hardly had any other taxes. Even so, it collected nearly 40 percent of GDP in state revenues thanks to a highly legitimate tax system and eminent collection. Because of its high tax revenues, it was able to abolish the profit tax in 2000. As usual, Latvia and Lithuania closely followed Estonia's example (OECD 2000c).

[7] This section draws heavily on IMF materials, notably Tanzi (1992) and Ebrill and Havrylyshyn (1999), as well as Dąbrowski (1996), Dmitriev and Kartsev (1996), and Dmitriev (1997).

After its state revenues had collapsed altogether, Georgia introduced an even simpler tax system than Estonia, with a VAT, profit tax, and flat personal income tax of basically 20 percent, while the payroll tax remained rather high at 35 percent and a flat import tariff of 12 percent for non-CIS imports (Wellisz 1996). Kyrgyzstan and Kazakhstan adopted similar liberal tax codes. However, in these three countries vested interests have successfully lobbied for tax exemptions, and tax collection has remained low. In response, ad hoc taxes have been added to boost budget revenue, which has compromised the liberal principles. Other countries have chosen tax systems between these two contrary models.

IMF advice has greatly influenced the tax systems in post-Soviet countries, but it has been contradictory. Strategically, the IMF has advocated a simple and liberal tax system, but, when facing a concrete annual budget, the IMF has usually chosen quick fixes with a few hefty additional taxes on few taxpayers, regardless of distortions. Such taxes, typically on energy and alcohol, have often turned out to be hard to collect, as the presumed taxpayers have been leading rent seekers, and with their great political powers they have refused to be taxed. This is particularly true of export tariffs, which have generated extraordinary arbitrage opportunities. Big businessmen of the region have not resisted high taxes but on the contrary favored them, since they are only for their competitors. Yet, a number of clear-cut choices have been made on major taxes, such as VAT, profit taxes, income taxes, and payroll taxes.

Turnover Taxes Replaced by VAT

The discretionary socialist turnover taxes/subsidies had to be replaced. One alternative would have been a sales tax, but VAT was preferred, as a modern and nondistortional tax that could collect more revenue. VAT has the advantage of being a tax on dishonesty, because a businessman wants to show receipts including the VAT he has paid for inputs.

Relatively high VAT rates of around 20 percent have become standard throughout the region. In terms of collection, VAT has been a success despite many exemptions. It has become the dominant source of state revenues, contributing about one-tenth of GDP in most countries, ranging from 3 percent of GDP in Georgia to 14 percent of GDP in Poland, Slovakia, Belarus, Estonia, Moldova, and Uzbekistan (Ebrill et al. 1999; Dąbrowski 1996).[8] Curiously, it works both in reformist and unreformed countries.

Even so, the VAT has been an administrative nightmare in the CIS. As all countries introduced a VAT system tried by the Soviet Union in

[8] Including minor excise taxes.

1991, they faced the same problems. Originally, many imports and organizations were excluded from VAT, which meant unfair competition. All along, exporters have complained that they cannot get VAT refunds, because one authority collected VAT from their imports, while another was supposed to pay them refunds. The obvious solution has been to adopt new better VAT laws, and slowly the FSRs have done so.

Excise taxes were introduced all over on the advice of the IMF. They were concentrated to petrol, alcohol, and tobacco as in the West. While they were supposed to bring in about 1–2 percent of GDP, they have been extremely difficult to collect in weak states, because trade in these goods was often criminalized, and criminals pay little taxes.

The IMF has advocated low and uniform import tariffs as a good means of collecting state revenues, and import tariffs of 10–15 percent have become standard for trade outside of the CIS (with free trade in the CIS). However, foreign trade tariffs have provided as little as 1 percent of GDP in state revenues (Ebrill et al. 1999). Massive smuggling has persisted through porous borders, and the customs are considered the most corrupt government service in virtually every country, including Central Europe and the Baltics. As with excise taxes, the tax base is too narrow and consists of too powerful people, who see little reason to pay taxes.

The Estonian policy of forgoing all foreign trade taxes for the sake of a maximum of market development has clearly proved justified, as reflected by its growth of output and economic welfare as well as fiscal revenue.

Profit Taxes Reduced and Equalized

Discretionary profit taxes were the main source of state revenue under communism, together with turnover taxes and payroll taxes. Reform communists had introduced profit taxes, which were originally very high, around 60 percent, and differentiated by industry. With transition, most countries chose flat profit taxes of 30–35 percent for production, and often more for the financial sector, trade, and gambling. Central Europe has maintained higher profit taxes than the FSU. Less reformist countries, notably Ukraine, experimented with an income tax for enterprises, which ended when serious reforms were attempted. The IMF cleaned out these miscomprehensions, which disregarded costs of production.

While nominal rates appeared reasonable, real profit tax rates were almost confiscatory, because plenty of business costs could not be deducted, and no adjustment was made for skyrocketing inflation, as nominal historical costs were used. The EBRD (1995, pp. 88–9) assessed the average effective profit tax rates in 1994 from a low of 43 percent in Hungary to 83 percent in Bulgaria and 86 percent in Ukraine.

Toward the end of the 1990s, most FSRs improved their profit tax laws, and this tax burden eased as well as its arbitrariness. In parallel, nominal profits had been depressed by disinflation, the hardening of budget constraints, and increasing competition. Hence, state revenues from profit tax plummeted from nearly 10 percent of GDP to 2–3 percent of GDP, which is standard in the West, though in the unreformed countries, Turkmenistan and Uzbekistan, profit taxes still contribute 6–7 percent of GDP (Ebrill et al. 1999; Dąbrowski 1996).

Most countries have attempted lump-sum taxes for individual entrepreneurs, which lay the foundation of the large private sector in Poland before the end of communism (Åslund 1985). When lump-sum taxes have guaranteed low, stable, and predictable taxation, as well as the liberation from government inspectors, they have been highly successful, for instance, in Kyrgyzstan and Ukraine, where they have legalized and stimulated small entrepreneurs. The big tycoons have not opposed such liberalization, as small businessmen have not posed much of a threat to them, while low-level officials have been upset about their loss of control. Repeatedly, they have insisted on more inspections and more flexible taxation, as small entrepreneurs represent an important source of their personal incomes.

Thus, in reformist countries the overtaxation of enterprise profit has ended, which is a major structural accomplishment, but it has proceeded slowly in the FSU. Still, why does the profit tax persist, when it is so cumbersome and reaps so little revenue? Like no other tax, it is a tax on honesty, entrepreneurship, and initiative. Only Estonia has faced this question squarely, abolishing its profit tax in 2000.

Income Taxes Boosted

Personal income taxes were insignificant under communism. The GDR levied no income tax on public employees, while the Soviet Union extracted a flat income tax of 12 percent. As the transition started, virtually everybody wanted to raise income taxes for a mixture of social democratic ambitions, populism, and aspirations to tax people more and enterprises less. Income tax rates have frequently been changed in most countries, but we may distinguish among three alternative models.

Hungary represented one extreme with its social democratic model and a progressive income tax rising to 60 percent, but Ukraine actually exceeded that record, raising its maximum personal income tax to 90 percent in 1994. As hyperinflation had boosted nominal incomes, this marginal tax rate applied to people who earned as little as $100 a month (Dąbrowski, Luczynski, and Markiewicz 2000). Needless to say, no Ukrainian paid that tax, and even in Hungary tax evasion became pervasive.

The standard model was a progressive income tax, starting with 12 percent for ordinary people and rising to a maximum of 30–40 percent, but in the FSU few were prepared to pay an income tax of more than the old rate of 12 percent.

Finally, there was the flat income tax of Estonia, Latvia, and Georgia with tax rates of 26, 25, and 20 percent, respectively. If tax revenue is the goal, the Baltic model has proven the only success. While most CIS countries collected 1–2 percent of GDP from high progressive personal income taxes, Estonia obtained 8 percent of GDP from its flat tax. However, not even a relatively low flat income tax worked in Georgia (Ebrill et al. 1999). In 2001, Russia introduced a flat income tax of 13 percent.

Excessive Rise in Payroll Taxes

The Soviet Union had a high payroll tax of 38 percent. Formally, it was considered a social insurance fee, distributed to a few extrabudgetary social insurance funds, primarily the pension fund. In the late 1980s, reform communists raised payroll taxes in an endeavor to improve social security and finance unemployment benefits. Hungary topped the region in payroll taxes with a peak of 62 percent. The other ambitious tax raiser, Ukraine, introduced a special Chernobyl Fund financed with a payroll tax of 12 percent, pushing its total over 50 percent.

Payroll taxes were primarily paid by state enterprises, whose managers were disinterested in profits, while private enterprises easily evaded them. Extrabudgetary funds were supposed to collect these taxes independently, but they were ineffective. Therefore, payroll taxes faced little political resistance, although they were formally cumbersome.

Only in the late 1990s did postcommunist countries start trimming their payroll taxes. These cuts were complicated by the simultaneous need to undertake complex social reforms to finance the cuts. Collection from the payroll taxes is highest in the most and least reformist countries. Hungary leads, collecting 18 percent of GDP in 1993, and the rest of Central Europe follows suit. The Baltic states, Belarus, and Ukraine collect about 12 percent of GDP (Ebrill et al. 1999; EBRD 1994, p. 86).

Too High and Too Many Taxes but Little Compliance

Postcommunist tax reforms offer no pretty story, apart from the Baltics, Georgia, Kazakhstan, and Kyrgyzstan. The most accurate description appears to be West European social democracy running wild, reinforced by populism and communist bureaucracy. Misdirected attention has been devoted to an unsubstantiated need to boost state revenues, downplaying the need to eliminate harmful public expenditures.

Even reformers accepted tax hikes, contrary to their long-term vision of low taxes, and it became part of their political legacy. Yegor Gaidar and I once shared a cab in Warsaw. I asked the driver what he thought of Leszek Balcerowicz, then out of power. The taxi driver gave us a harangue about how Balcerowicz had raised taxes. Gaidar and I had a good laugh. That is not how a reformer wants to be remembered. Back in government, Balcerowicz advocated a flat income tax of 21 percent, but he failed to get it accepted.

The IMF has played a harmful role when preaching that taxes must not be cut until tax administration has been improved, while high tax rates have bred corruption and tax exemptions, harming tax administration. No postcommunist country has been cured in this way, and raising tax revenues through arbitrary repression is no good. "Kleptocratic states . . . should not be helped to become more efficient at controlling and exploiting their own population" (Rose-Ackerman 1999, p. 179). The Baltic countries have improved their tax administration thanks to early radical tax reforms. The IMF advocacy of high tax rates has contributed to the excessive tax burden and distortional public expenditures, as rent-seeking states collect taxes from the official economy to redistribute them to rent seekers. Both lower tax rates and less tax collection would have reduced rent seeking, probably explaining why Georgia, Armenia, and Kyrgyzstan have achieved significant growth.

Three subregions have ended up with different problems. Central Europe's dilemma was that it collected taxes too well, causing a high effective tax burden. These countries became, in Janos Kornai's (1992b) words, "premature social welfare states." Their high taxes and social transfers blunted incentives of work and entrepreneurship and created a strong antireform constituency. Russia, Ukraine, and Moldova were also overtaxed and collected too large revenues, but their distortional and discretionary tax systems condemned them to economic stagnation until they launched serious tax reforms. The Caucasus, Kyrgyzstan, Kazakhstan, and Tajikistan faced real revenue collapse. Their troubles persuaded them to undertake radical, liberal tax reforms. While their designs are promising, these new tax systems unfortunately work badly as yet, because of poor implementation, as both additional taxes and tax exemptions have proliferated. Most successful were the Baltic countries, led by Estonia. They introduced simple tax systems with low tax rates, achieving high collection rates. In Estonia, this simple, liberal, and well-functioning tax system has contributed to the least corruption in any transition country.

Despite limited success to date, the main lessons have been widely learned. This region can no longer live with West European tax rates. The post-Soviet mess of competing revenue service, focusing on inefficient taxes, cannot be allowed to continue for long. The number of taxes, the structure of the tax system, and the tax rates must be reduced, and virtually the whole region is undertaking incremental tax reforms in that direction.[9]

MONETARY POLICY: FROM LOOSE TO STRICT

With transition, money became active, and central banks were gradually strengthened and eventually started pursuing market-oriented monetary policy. Initially, monetary policy was very loose, but at some stage it turned quite strict. Old socialist banks should not be perceived as banks, and many new banks were no real banks either. A sober look is needed on banking after communism.

The Reinforcement of Central Banks

The problems of central banks were similar to those of ministries of finance. The Central Bank should be in charge of monetary policy, while fiscal policy and monetary policy should be separated. In the old socialist system, this distinction was fudged, as the Central Bank issued subsidized credits without discussing their financing with the Ministry of Finance. Nor was central banking distinct from commercial banking, as the Central Bank issued credits directly to enterprises.

Reformers wanted the Central Bank to be given a status semiautonomous from government and Parliament, both of which tended to order the issue of money. Although the chief reformer was mostly minister of finance, central banks usually developed faster than ministries of finance. One reason was its relative independence from the state administration, which gave its chairman as well as staff a relatively safe tenure. Central banks tended to have higher salaries than ministries of finance and could therefore attract more qualified staff, who easily developed an elitist *corps d'esprit*. Finally, they formed a corps of their own, providing one another with effective technical assistance and training. Therefore, central banks were usually better organizations than the ministries of

[9] A forceful advocacy for lower taxes and transfers is Sachs and Warner (1996b).

finance after a few years of transition. Many chairmen of central banks had long tenures and became the heroes of stabilization in their countries (for instance, in the Czech Republic, Hungary, Romania, Latvia, Ukraine, and Kyrgyzstan).

However, a curious problem arose when bad central banks got independence but no accountability. The outstanding example is the Central Bank of Russia under its longtime chairman, Viktor Gerashchenko, who held that post thrice, although he issued more money than anybody else, causing both high inflation and currency collapse, while doing a minimum to develop the Central Bank technically (Johnson 2000). His malpractices helped many privileged to enrich themselves, and the relative independence of the Central Bank of Russia shielded Gerashchenko from accountability. The lesson is not that central banks should not be independent, because it worked well in so many other countries, but that the chairman of a central bank had to be accountable and have a clearly set goal of monetary stability.

Monetary Policy: From Loose to Overly Strict

Monetary policy has undergone a swift and complete transformation. When radical economic reforms were initially discussed, they were often called monetarists, although few reformers used that notion. The essence of the accusation was that a person favored the existence of monetary policy, which the late socialists opposed in principle, since they considered money a free utility (RAN 1994).

Reformers identified two broad tasks. Their first assignment was to restrict the issue of money, which was out of control in the late Soviet Union. Their second task was to move from direct, or administrative, measures to indirect, market-oriented instruments. These tasks were closely interconnected. Direct credits by the Central Bank to enterprises had to be stopped, but state enterprise managers fought hard for such credits. In 1990, only Hungary and Poland did away with direct enterprise credits, which remained substantial in most CIS countries until 1995. Reformers also wished to raise interest rates to a positive real level. In the CIS, all countries started with very low old Soviet interest rates of just a few percent, and as interest had possessed no economic function in the Soviet system, few understood its significance. Reformers wanted commercial bank interest rates to be set by the market, while the Central Bank would interact only with the commercial banks through a refinancing and open market operations. To introduce high reserve ratios, however, was surprisingly easy (de Melo and Denizer 1999).

Everywhere, the initial price liberalization led to a greater price hike than anticipated. In Poland, prices instantly jumped by 70 percent in

January 1990, while the authorities had expected 35 percent. For Russia, the IMF had forecast a price rise of 50 percent in January 1992, but prices skyrocketed by 350 percent (Boone and Hørder 1998, p. 47). In Czechoslovakia, Minister of Finance Vaclav Klaus (1992) rightly prided himself on having understood that this initial price surge could not be predicted, only its shape. The large price increases had two immediate effects. One was that the volume of money to GDP fell sharply, and the other was a strong demand for compensatory monetary expansion.

In 1989, the volume of money (M2) to GDP was 55 percent in Central Europe and the Soviet Union compared with 75–80 percent in the West, because the population held large savings in currency and bank deposits. To many observers, the East European ratios made sense, being slightly lower than in the West. In the West, the ratio of M2 to GDP is considered an indicator of financial depth, which plenty of research has shown is good for economic development. Under socialism, however, people often held money involuntarily, because they could find nothing to buy as a result of shortages of goods. What looked like financial depth was actually forced savings. Forecasters could not possibly estimate how much money people would like to hold after a transition to capitalism, and the forced savings turned out to be huge. The price rises also undermined the confidence in money as a store of value and reduced the demand for money (De Melo and Denizer 1999; Boone and Hørder 1998).

After the first price hike, high inflation persisted, while interest rates remained low, so it was better to hold savings in hard currency or commodities. Only gradually did enterprise managers start economizing, as their budget constraints grew harder. The combined effect was a steady decline in the demand for domestic money, though the flight from money varied greatly. After three to four years of high inflation, the ratio of M2 to GDP had fallen to 8–20 percent in most CIS countries, while the Czech Republic and Slovakia escaped serious demonetization, maintaining M2 at a Western level of around 70 percent of GDP (see Table 6.6). Even after successful stabilizations, remonetization was slow, indicating the faint credibility of domestic currencies.

The demonetization, together with the fall in output, aroused a virulent political reaction. The old establishment advocated the emission of money, not recognizing that it would only increase the supply of money and not demand. One idea was that the government must index the working capital of enterprises, which several CIS countries actually did in 1992. Reformers, on the contrary, saw an excessive supply of money, which depressed the real demand for money. Money supply expanded at an extraordinary rate in the early transition, and apart from Slovakia, it is difficult to talk about any monetary restraint whatsoever (see Table 6.7).

Table 6.6. Broad Money as a Share of GDP, 1990–1999 (Percentage of GDP)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999 (est.)
Central Europe										
Poland	32.2	31.6	35.8	35.9	36.7	36.1	37.2	39.6	40.2	43.1
Czech Republic	..	..	69.8	70.6	73.6	75.3	71.3	73.0	71.2	75.4
Slovakia	68.0	73.0	64.3	64.8	64.4	65.4	68.8	66.2	62.1	64.6
Hungary[a]	..	54.8	59.2	56.8	52.2	48.7	48.6	46.9	45.8	46.2
South-East Europe										
Romania[a]	59.6	46.9	30.8	22.3	21.4	25.3	27.9	24.8	25.1	25.7
Bulgaria[a]	..	76.0	79.0	78.3	79.5	66.3	74.9	35.3	30.6	32.3
Baltics										
Estonia[b]	..	..	28.3	33.1	33.8	33.1	34.8	40.4	35.5	42.7
Latvia[b]	..	..	..	31.5	33.4	22.3	22.2	26.6	25.7	27.2
Lithuania[b]	..	..	0.5	23.1	25.8	23.3	17.2	19.0	19.4	21.1
CIS										
Russia[b]	70.1	68.4	37.4	19.0	16.0	13.9	13.4	14.4	16.7	14.4
Belarus[a]	..	..	0.4	34.6	38.1	15.0	14.8	16.2	32.8	17.5
Ukraine[a]	..	..	33.7	33.6	26.5	12.7	11.5	13.4	14.9	17.0
Moldova[a]	..	69.5	44.4	19.2	15.9	19.2	18.3	21.6	19.3	20.6
Armenia[a]	..	..	0.4	68.2	13.0	7.9	8.3	8.8	10.2	11.3
Azerbaijan[a]	..	..	39.0	54.9	55.9	12.2	11.3	13.1	10.6	12.7
Georgia[a]	..	..	44.6	20.1	5.6	4.9	4.5	8.3	7.7	7.7
Kazakhstan[a]	..	..	42.9	27.9	13.1	11.4	9.5	10.3	8.6	14.4
Kyrgyzstan[b]	..	..	..	13.2	12.7	17.1	14.3	13.6	14.4	13.6
Tajikistan[a]	..	..	..	..	..	19.1	8.3	8.6	6.9	7.2
Turkmenistan[a]	..	..	..	22.2	25.6	18.8	8.1	10.2	15.7	14.9
Uzbekistan[a]	..	..	68.9	53.5	34.7	18.2	21.0	17.5	16.1	15.5

[a] M3.
[b] M2.
Sources: EBRD (1997, 1999, 2000a).

Although real intellectual confusion prevailed, the vehement demands for monetary emission were orchestrated by those in the establishment who benefited from large credits issued at very low real interest rates. In 1992, most Russian credits were issued by the Central Bank at an interest rate of 10 or 25 percent a year, while Russia's inflation amounted to 2,500 percent that year, and the situation was similar in other CIS countries. State credits were actually gifts to the rich and powerful. With no real corporate governance, state enterprise managers swiftly transferred these benefits to themselves through transit pricing (Åslund 1995, 1999). The power of the beneficiaries made it difficult to stop their pilfering of public assets.

Table 6.7. Average Annual Growth Rate of Money, 1990–1994 (Central and South-East Europe), 1992–1994 (FSU) (Percentage, average of December–December growth rates)

	Base Money	Broad Money
Central Europe		
Poland	51	66
Czech Republic	29	18
Slovakia	24	13
Hungary	28	23
South-East Europe		
Romania	78	98
Bulgaria	31	60
Baltics		
Estonia	91	52
Latvia	64	95
Lithuania	127	175
CIS		
Russia	650	437
Belarus	993	1,115
Ukraine	2,009	1,070
Moldova	352	265
Armenia	1,711	970
Azerbaijan	652	733
Georgia	1,978	2,447
Kazakhstan	843	600
Kyrgyzstan	284	242
Tajikistan	1,113	722
Turkmenistan	742	875
Uzbekistan	552	644

Source: De Melo and Denizer (1999, p. 46).

Central banks in East-Central Europe were also subject to considerable pressures at the outset, but they soon gained strength as institutions, holding firm even in Romania. In the CIS, however, the initial monetary expansion was extreme (see Table 6.7), but it subsided by 1994. All of a sudden, one country after another went from a very soft to strict monetary policy, when high real interest rates became politically possible, causing stabilization. Many countries opted temporarily for extremely high real interest rates of 150 percent a year in Russia and even 200 percent a year in Ukraine in the spring of 1996. They stayed high for long in many CIS countries because of sizable fiscal deficits, and the need for state financing crowded out private investment.

The explanation of this sharp turnaround was probably that the benefits of cheap credits had dwindled. As demonetization proceeded, the seignorage or inflation tax declined, since people and enterprises were no longer willing to hold much money. The same was true of subsidized credits. Therefore, the beneficiaries were no longer so strident (Åslund et al. 1996). Another reason was that people had learned that a loose monetary policy was very socially costly while statistics made plain that massive cheap credits had no positive effect on production. On the contrary, as long as large credit emission continued in a country, output plummeted.

Development of a Problematic Bank System

The socialist economies had institutions that were called banks, but that was a compliment, because everything was wrong with them from a market economic perspective (Begg 1996). Under socialism, money had been a passive unit of account that was distributed on command from the planning authorities by one or several state monopoly banks, which gave credits to large, loss-making, state enterprises. Therefore, credits were allocated through negative selection, and bad debts piled up. Eventually, the state wrote them off, so state credits were appropriately perceived by all as subsidies. Many saw international credits in the same light, breeding moral hazard.

The old state banks outlived socialism, but they had few of the required talents. They had no staff able to make a credit assessment. Nor did they possess any information system, as the old socialist concept of profit was only a bookkeeping definition. Macroeconomic conditions were pretty unpredictable. Major economic trends were enigmatic, making it unclear what industries were to rise or decline, and what enterprises were to flourish or perish. In this absence of both skills and information, banks fell back on their old personal relations with managers of large state enterprises, which were least likely to do well. Hence, the old state bank system pursued negative selection in its credit allocation. Adding corruption to this cocktail of misallocation, the bank system was bound to be dysfunctional.

As cogs in the state machinery, state banks had no reason to secure their loans with collateral. The Central European countries still had some old commercial laws on their books, and a tiny private sector had enjoyed some legal regulation, but most countries had little commercial legislation on elementary credit rules, including on collateral and pledge, not to mention private ownership of land, with the exception of Poland. Even when a law on collateral came into existence, there was little collateral to pledge.

If laws were rudimentary, their execution was worse. A legal system with prosecutors and judges had existed under socialism, though defense councils played only a minor role. Soviet judges were not particularly corrupt, but they were used to obeying political orders and were subordinate to the prosecutors, and they were few and poorly trained for commercial disputes. The socialist state had collected debts by confiscation through the state bank system, so ordinary debt collection services barely existed. Over time, the court system gained commercial importance, but that promoted corruption, as judges could earn much more illicitly. Curiously, the court system is extensively and ever more used by businessmen in conflicts with other enterprises and the state (Hendley et al. 1997).

Thus, everything was wrong with this inherited illusory bank system. With the transition, banks developed very differently in Central Europe and South-East Europe, on the one hand, and in the FSU, on the other. In Central Europe, the old state banks survived, remaining dominant. Small private banks, usually specialized, business-oriented banks, emerged, but they stayed tiny.

In the FSU, including the Baltics, developments were more exciting because state banks were so bad that they soon dwindled or perished. Instead, hundreds of new commercial banks mushroomed in the last years of the Soviet Union. In January 1992, Russia alone had 1,360 banks registered, and their number peaked at over 2,500 in 1994 (Johnson 2000, pp. 7, 27). But these banks were of a dubious nature. They had been set up under the Soviet Law on Cooperatives of May 1988, and they were totally unregulated because of the competition between the Soviet State Bank and the Central Bank of Russia. They offered a good example of how regulation can be undone if mutually independent state agencies compete in issuing licenses.

The new bank capital originated largely from management theft, and in the early post-Soviet years banks thrived on cheap state credits and financed arbitrage in commodity exports. Household deposits and enterprise lending, on the contrary, were minimal. As Grigori Yavlinsky once put it: "Usually banks attract deposits from the population and give credits to enterprises, but our banks take money from the state and put it into bank accounts in Switzerland."[10] These banks were born as rent-seeking vehicles. Many were "pocket banks" of enterprises, rich

[10] Statement at the World Economic Forum in Davos in 1997.

individuals, or old ministries (Johnson et al. 1993; Dmitriev et al. 1996; Johnson 2000).

Not surprisingly, almost all countries in the region have gone through bank crises. While bankers made fortunes on high inflation in the early transition, they suffered from stabilization, dissipating their rents. Early bank crashes in Hungary led to excessive recapitalization by the state, soon becoming repetitive at great cost to the state (Bonin and Schaffer 1995). When Hungary wanted to put its finances into order in 1995, the government sold all the remaining state banks to foreign investors. That helped. Hungarian banks became transparent, competitive, service-oriented, and cautious, probably the best banks in the region. The large-scale permission of international bank competition appears the only long-term solution to the bank morass. Hungary pioneered, by having the most open attitude to foreign investors.

Soon after its vigorous stabilization attempt, Estonia faced a major banking crisis in late 1992. As usual, Estonia went for a radical solution. Revealing extensive fraud, the Bank of Estonia closed and bankrupted the three biggest commercial banks in the country. The shareholders lost everything, and the depositors received only partial compensation, since they had taken obvious risks, betting on high interest rates, while facing a wide choice of interest rates differentiated by risk. Banks were forced to accept truly hard budget constraints. Latvia treated its bank crisis even more harshly, purging half of its banks in 1995 (Hansson and Tombak 1999).

Surprisingly, most post-Soviet countries followed the Balts in the severe treatment of failing banks. Even Ukraine closed scores of banks with little compassion for the bankers. Although many post-Soviet banks were kept alive with state subsidies because of their political influence, it was more remarkable how many large banks were closed down. Politically, this was possible because the banking system was not very important to the economy and the bankers were not all too powerful. With so little monetization and a credit volume limited to several percent of GDP, even weak governments dared to bankrupt banks, and the independence and relative decency of central banks facilitated this task.

The combination of little economic damage and limited state largess to banks rendered bank crises in the region much less costly than in other parts of the world (Hausmann and Rojas-Suarez 1996), costing at most a couple of percent of GDP. Unfortunately, bank systems did not necessarily improve after one cleansing. If one bank went bankrupt, the powerful owner just opened another pocket bank. Kyrgyzstan went through an awesome banking crisis in late 1993, closing all the culprits down (Kloc 1994), but in 1999 the country faced another major bank crisis.

Each country inherited an agricultural monopoly bank, distributing subsidies to socialist agriculture. Not surprisingly, it tended to be particularly corrupt and prone to bankrupcy. Many countries, such as Estonia, Kyrgyzstan, Russia, and Romania, bankrupted their agricultural banks, but usually quite late in the transition.

Bank lending and deposit rates were usually liberalized early on, but for years the gap between lending and borrowing rates amounted to 20 percent a year in Central Europe (Rostowski 1995), and it was far greater in the CIS, with interest gaps around 30 percent in 1999 (RECEP 2000). Obviously, the banking system was able neither to direct credits rationally nor to issue large volumes of credit. Because of the high cost of credits, creditors tended to be desperate companies, which reduced the probability of them paying back (Dmitriev et al. 1996).

International organizations, such as the World Bank and the EBRD, supported an early development of the commercial bank system (Lamdany 1993; Johnson 2000, p. 100). They thought enterprises suffered from a dearth of financing, but the primary problem was that they did not restructure because of soft budget constraints. Another idea was that early financial depth was vital, but a change in enterprise behavior had to come first. Only later would it be realistic to enhance the financial depth. Still, as a result of the wildcat bank expansion, ATM machines spread like wildfire through Russia, and credit cards became widely acceptable, developing the technical sophistication in payments.

In the Russian bank crash of 1998, the most prominent victims were the very banks the World Bank and the EBRD had certified as of high quality (Johnson 2000, p. 211), and the same has been true of other bank crashes. Serious bank crises have been a standard feature of the developed West in the last two decades, and it would be strange if not every postcommunist country were to suffer from such a crisis. For social welfare, it matters how large a share of GDP is lost in each crash, and limited financial depth has been the saving grace of the post-Soviet bank crises. It has also facilitated the bankrupting of bad banks and thus the raising of banking standards and the hardening of budget constraints. The cart had been put before the horse. Financial depth should develop as a result of the maturing of a well-functioning financial system and not as a result of premature state-sponsored financing, enticing banks to take excessive risks.

The bank-led financial-industrial groups (FIGs) were perceived to dominate the Russian economy, seemingly running counter to this perception of extremely weak banks, but let us scrutinize this phenomenon. Russian FIGs flourished for a brief time from 1996 to 1998. Russian banks showed minimal interest in the voucher privatization in 1992–4, as they were making much more money on cheap state credits. Next, they benefited from exclusive access to high-yielding treasury bills. Then, they thrived on the management of state funds as so-called authorized banks (Johnson 2000).

Only in 1995, as stabilization started to bite, did banks begin buying equities and enterprises on a significant scale, and they turned to the government for sweetheart deals in 1995. They rose as conduits for financing for Yeltsin's presidential campaign in 1996, while extracting funding and enterprises from the state in return. The secret of their rise was government favors given because of close personal connections of the main owner with the top of the Russian administration. Banks were convenient vehicles for dubious transactions, connected with the presidential campaign, while the bankers did not make their money on banking after the initial high inflation. Revealingly, most top "bankers" soon became heads of their industrial holding companies instead, while most of these banks effectively went bankrupt in August 1998 (Johnson 2000). Similarly, the state banks in the Czech Republic became depositories of major voucher funds and assumed control over large enterprise empires, but that was not directly connected with their status as banks.

Capital Flight

Capital flight has become a big theme primarily in the discussion of Russia's transition, and it is closely connected with Russia's large commodity exports. Yet, Ukraine and Kazakhstan appear to have quite large capital flight in relation to the size of their economies. For other countries, capital flight has probably been more limited and much of it connected with the reexport of raw materials from Russia.

Common estimates of the capital flight from Russia put it at about $20 billion a year, starting in 1991, that is, the last year of the Soviet Union. The origin of the capital flight was underinvoiced commodity exports, mainly oil and metals. The exporters were both stealing from state enterprises and evading export tariffs, holding their revenues at offshore banks. In addition, the instability of the Soviet ruble compelled all to escape from it. Individuals bought U.S. dollars or goods, while enterprises bought commodities or transferred their money to hard currency accounts abroad.

In 1994–5, the capital flight from Russia abated with the reduced gains on commodity arbitrage and the onset of stabilization, but, contrary to expectations, it gained momentum again from 1996. Now, the main purpose appears to have been tax evasion through false import invoices. Meanwhile transfer pricing for commodities continued, partly because new managing owners wanted to defraud other owners. Lacking confidence in local currencies remained a major cause.

An additional reason for capital flight was the poor quality of Russian banks. After the bank crash of August 1998, nobody in his right mind kept more money than necessary for transactions in Russian banks, which are better understood as a payments system than banks. The so-called Bank of New York scandal that absorbed U.S. media in the fall of 1999 was essentially a reflection of all sensible Russians transferring their money holdings abroad.

Capital flight has often been blamed on these countries' early introduction of convertibility (Stiglitz 1999a), but capital flight ballooned in Soviet times in 1991, while Russia introduced convertibility on capital account in June 1996, and Ukraine in May 1997 (EBRD 1997, p. 88). Convertibility neither caused nor impeded the capital flight, which had many other causes, including shaky national currencies, tax policy, poor domestic banks, and lack of investment opportunities.

BARTER AND ARREARS

One of the most perplexing macroeconomic anomalies of postcommunist transformation has been the proliferation of arrears, barter, and other forms of nonmonetary payments. These phenomena were not anticipated by reformers, and their critics invoked the rise of arrears and barter as evidence of the futility of market reform, as ordinary market economic laws did not apply to postcommunist reality. Explanations vary, but two rather different phenomena seem to have been dominant, deserving separate discussions. The first was the universal early rise of arrears, while the later growth of nonpayments and barter, which occurred primarily in Russia, Ukraine, and Moldova, was quite another matter.

The Early Arrears Crisis

Any attempt at macroeconomic stabilization rendered money scarce. Enterprises found themselves unable to pay everybody, and they started piling up unpaid debts to banks, other enterprises, tax debts to the state, or wage arrears to their workers in all transition countries (Rostowski 1993, 1994). Many critics, though, claimed that monetary constraints did not work, because people simply did not pay.

In fact, the very inclination not to pay showed that the economic system had changed. The old socialist system had not tolerated arrears, and state banks had regularly netted them out, issuing credit to eliminate outstanding balances, so no arrears signified the absence of a market economy. The seriousness of the interenterprise arrears crisis was highly exaggerated, because people did not know that unpaid bills and their collection are persistent headaches of capitalism. Nor did they realize that trade credits of a few months' duration are standard under capitalism. Thus, much of these interenterprise arrears should be dismissed as standard trade credits (Schaffer 1998).

Another part of arrears was caused by governments, which did not include all necessary public expenditures in their budgets. Moreover, because of unrealistic budgets, governments did not pay what they had promised, while rent seeking induced them to divert funds to other purposes, as has been discussed above.

Yet, there were other concerns. Initially, creditors had ineffective tools to extract their claims. The first strong sanction against nonpayment was the draconian Hungarian bankruptcy law of 1992. Even so, enterprises that really wanted to collect outstanding payments proved that they could do so, and Poland resolved its interenterprise arrears swiftly with limited use of bankruptcy, because delinquent payers found it difficult to attract deliveries (Begg 1996).

The fundamental problem, however, was the credibility of stabilization programs. If enterprise managers assumed that a stabilization would not take hold, they would be fools to pay, as the Olivera–Tanzi effect would inflate away their debts. Accordingly, enterprise managers demanded that the old system of netting out mutual debts should continue, as happened in Romania, Azerbaijan, Belarus, Kazakhstan, Russia, Turkmenistan, Ukraine, and Uzbekistan. The eventual debtors benefited from new cheap state credits, and each netting out operation bred demands for, and expectations of, new bailouts (Citrin and Lahiri 1995). A serious moral hazard had arisen.

An additional problem was the payments system. In most countries, manual payments system, working through ordinary mail, did not have capacity for the rising number of enterprises. Neither the commercial banks nor the centralized clearing system of the Central Bank could keep up. In Poland, this problem was resolved easily, by allowing everybody to pay in cash. In the FSU, however, bank transfers remained compulsory, because they were perceived as essential to avoid tax evasion. As a consequence, inept and power-hungry central banks clogged the payments system for years in some countries, notably Russia. Delays were aggravated as commercial bankers lay on credits, making money on them, while credibly blaming the payments system.

A simple mechanism in the Soviet payments system facilitated collective action among enterprise managers: All bills were paid in chronological order of filing by the banks. If more credit was issued, everybody would be paid, and nobody could jump the queue through individual action to extract a payment before the others. Therefore, the whole enterprise world pressured government and central banks to issue more credit. Hungary and Poland had liberalized their payment systems under socialism, but this was a difficult political process in the CIS (Sachs and Lipton 1993). Russia did so in 1992, while Ukraine maintained this filing system till the late 1990s.

Statistics on interenterprise arrears are patchy, but their share of GDP subsided where stabilization took hold early on, that is, in Central Europe, the Baltics, but also in Kyrgyzstan and Kazakhstan, which had professional and reformist Central Bank leaderships. Thus, the amassing of arrears was not a necessary feature of the post-Soviet system, but it continued for years in Belarus, Ukraine, and other late reformers (Begg 1996).

Barter and Nonpayments in Russia, Ukraine, and Moldova

By 1996, Russia, Ukraine and Moldova had finally attained financial stabilization with inflation below 40 percent a year. Even so, arrears remained a serious problem, and barter was a rising concern. These problems were limited in the neighboring countries, Slovakia, Kazakhstan, and Kyrgyzstan, where they were perceived as related to trade with large enterprises in Russia and Ukraine. In Central Europe and the Baltics, barter was not a problem (Hellman et al. 2000a).

Thanks to the regular monthly inquiry into the behavior of Russian industrial enterprises, *The Russian Economic Barometer* (2000), we have monthly series of the share of barter in transactions in Russian industry since 1992. The nadir occurred in May 1992, when barter accounted for only 4 percent of industrial sales. This share increased steadily to peak at 54 percent in August 1998, after which it declined steeply to 21 percent in August 2000. Yet, barter persisted only in industry and construction, which accounted for barely 40 percent of GDP in Russia in 1995 (World Bank 2000a). Little barter was used in the consumer or service sectors.

To the disappointment of Russian reformers, barter did not abate with inflation, but it continued to grow at a steady pace. Clearly, stabilization was not a cure, but the abundant emission of money had not been helpful either, so unlike the initial arrears crises, monetary policy was not the issue.

Another idea was that barter had been inherited from the old system, but the command economy implied a vertical command, while barter occurred on a horizontal market. Moreover, it had risen in the course of the transition. Yet, it could be seen as a transitional phenomenon in the sense that the playing field was not level. The masters of barter trade were big companies, selling natural gas, electricity, metals, and construction materials, which could all be sold on the market, and 40 percent of barter was involuntary (Aukutsionek 1998).

Obviously, enterprises that failed to sell their produce for real money wanted to resort to barter, but why did enterprises with salable goods comply? The most plausible explanation was that these companies could extract benefits from the state through barter, such as subsidies and offsets of taxes at lower real cost. Prices were inflated by 40–50 percent in barter, allowing all kinds of manipulations. A variety of absurd legal rules, such as the restrictions on sales below prime cost, could be avoided. In offsets, governments at different levels offered substantial tax discounts, often by half, making offsets a means for enterprises to extract public contracts on favorable terms. Sometimes, arrears were simply forgiven as bad debts. Both loss-making companies and the profitable energy companies colluded through barter and other nonmonetary transactions against the state to extract additional subsidies at the expense of the rest of society (Commander and Mumssen 1998; Gaddy and Ickes 1998; OECD 2000a).

The implicit subsidization of the participants in barter and nonpayments was great, justifying a transaction cost of 20–30 percent of the gross price (Broadman 1999). A study by Brian Pinto et al. (1999) estimated the implicit Russian budget subsidies through barter and nonpayments at 7.6 percent of GDP in 1996, rising to 10.4 percent of GDP in 1998. Thus, total subsidies to the Russian enterprise sector amounted to no less than 16.3 percent of GDP in 1998, suggesting that the rise of barter did not have monetary but fiscal causes, with barter and offsets being the latest fashion in rent seeking.[11]

A related explanation for the prevalence of barter is persistent management theft in the CIS. The standard method of management fraud was transfer pricing, which barter greatly facilitated with its distorted prices.

Barter seems to have developed in a similar manner in Ukraine, though less data are available. The only country that used barter extensively in foreign trade was Belarus, and its purpose was to extract large benefits from Russia (ECE 1998, p. 102).

After the financial crash of August 1998, barter declined sharply in both Russia and Ukraine. A first reason was that the governments cleaned up their finances in both countries, reducing subsidies as well as government arrears. Second, enterprises saw their budget constraints

[11] Barter has been subject to a great deal of myth making. One of the most remarkable examples is a whole book on barter by David Woodruff (1999), in which he fails to notice that the essence is rent seeking. Instead, he argues for the necessity of a slow transition, which was the very cause of this rent seeking.

hardened from all sides, as subsidies declined, while bankruptcies soared. Third, the crash brought credibility to the hard budget constraints that reformers had failed to deliver because of lacking political strength. Paradoxically, the crash convinced entrepreneurs that the market economy had come for good. Fourth, cash became king in the aftermath of the crisis, and enterprises feared indulging in barter even if they could make money on it. The crash brought about a flight to quality payments, that is, money. A change of payments meant also a switch from the rent-seeking transitional economy to a more normal market economy, which involved substantial investments (Braguinsky and Yavlinsky 2000). Finally, enterprises adjust their payments to their partners, so if some enterprises change others follow.

On the basis of their understanding of the system of barter and offsets, Clifford Gaddy and Barry Ickes (1998) have developed a concept of a virtual economy, which they see as the dominant new economic system in Russia. The phenomena they observe are evident, and it is true that Russia has developed a dual economy. However, Gaddy and Ickes see a permanence in this virtual economy that does not appear warranted, considering the rapid decline in barter after Russia's financial crash. This system of barter and arrears arguably caused the financial crash, and it is not likely to survive due to its excessive social costs. Therefore, neither government nor society are likely to accept this wasteful system after its functioning and consequences have been revealed. Gaddy and Ickes disregard that their virtual economy is limited to industry and construction, exaggerating its importance to the economy as a whole. As most final produce is actually paid for in cash, the virtual economy hardly influences the assessment of GDP. Offsets would reduce the real size of especially regional budget revenues, but those numbers are hardly reported fully in public statistics. Enterprises operate primarily either in the monetary or the nonmonetary economy, and this transition is the essence of enterprise restructuring.

STABILIZATION AFTER ALL

A decade after the collapse of communism, inflation is under control everywhere (apart from Belarus). However, many countries suffered from extreme inflation for years, and average inflation remains high, suggesting substantial inflationary inertia. The durability of inflation is a good indicator of the degree of rent seeking and corruption or, differently put, the weakness of the state.

A myth persists: "All the postcommunist countries pursued similar policies aimed at curbing inflation, balancing the budget, and stabilizing the exchange rate" (Lavigne 2000, p. 18). However, as we have shown, the differences in policy have been considerable, and the contrasting outcomes are hardly enigmatic but natural consequences of the policies pursued. Large budget deficits do nurture high inflation, which benefited rent seekers with access to subsidized credits.

Great Dramas of Stabilization

The pattern of financial stabilization has varied considerably, and a few countries stand out for positive or negative developments. Most notable are Poland in 1990, Russia in 1992, Estonia in 1992, Kyrgyzstan in 1993, Romania and Bulgaria in 1996, and Russia in 1998, which have taught clear lessons.

Poland was the pioneer of transition, doing everything to control inflation. Its high inflation prompted a radical reform program of both liberalization and stabilization. Poland overbalanced its budget in 1990; it pegged its exchange rate to the U.S. dollar with the support of a stabilization fund, an IMF program, and substantial international funding; it pursued a tax-based incomes policy and a relatively firm monetary policy. Yet, because of political furor, the strict fiscal and monetary policies could not be maintained for long. Monetary policy loosened up in the summer of 1990, and the budget deficit ballooned to 7 percent of GDP in both 1991 and 1992. As a result, inflation stayed as high as 44 percent in 1992, when Poland returned to growth. What was widely perceived as an excessively tough stabilization policy at the outset appears in hindsight a wise precaution.

The greatest drama was the abortive Russian stabilization in 1992. Its main achievement was the balancing of the budget in the first quarter, thanks to far-reaching price liberalization and cuts in military expenditures, but the reformers failed to win political control over monetary policy, and the persistence of the ruble zone warranted the competitive emission of money. With no international financing but with domestic acrimony, the Russian reformers lacked the political muscle to undertake a few key reforms. They lost their struggle to liberalize prices and exports of commodities. While the outside world provided no financial support for reforms, it financed huge import subsidies, benefiting rent seekers hostile to reform. A positive surprise was that minimal unemployment arose. Nor did any wage pressure emerge, but workers were used as pawns by enterprise managers to extract enterprise subsidies. The result was near hyperinflation of 2,500 percent in 1992. Stabilization and market reform had suffered a devastating blow, with repercussions for the whole of the CIS.

In June 1992, Estonia lit a light in the otherwise darkening post-Soviet world. In the face of total macroeconomic destabilization, Estonia followed the radical reformer Poland, but it went even further. With the introduction of a currency board, it fixed its exchange rate to the German mark. It committed itself to a balanced budget and tied its monetary policy. Estonia also undertook the most far-reaching liberalization of foreign trade, an early liberal tax reform, and a profound government reform. Large prewar reserves, substantial international financing, and an IMF program reinforced this reform effort. Its inflation plummeted from 954 percent in 1992, to 36 percent in 1993. Latvia undertook an equally impressive stabilization, with an IMF program and large international financial support, but the heart of its stabilization was a very strict monetary policy spearheaded by the stubborn chairman of the Bank of Latvia. The free-market radicalism of Estonia and Latvia was inspired by their determination to succeed as independent states regardless of cost.

Curiously, the first CIS country to opt out of the ruble zone and undertake a serious financial stabilization was faraway Kyrgyzstan. It did so with a full-fledged IMF program and substantial international financing in May 1993. In spite of considerable expenditure cuts, it maintained a large deficit, which was mostly financed with international loans. As a compensation for soft fiscal policy, it pursued a very strict monetary policy with high positive real interest rates. Its exchange rate was left floating, because reserves were scarce and no strong currency dominated in its foreign trade. Kyrgyzstan managed to cut its inflation from 1,363 percent in 1993 to 96 percent in 1994 and to 32 percent in 1995. Moldova undertook a similar stabilization later in 1993. Armenia, Georgia, Azerbaijan, Kazakhstan, and Uzbekistan followed in 1994, Russia in 1995, and Ukraine in 1996. However, the budget deficits of most CIS countries remained substantial. They tried to compensate for their fiscal laxity with very strict monetary policies, but their lack of fiscal adjustment was to come back to haunt them.

Bulgaria's ex-communist government had undertaken a halfhearted stabilization, but in 1996 it bumbled into a serious fiscal crisis. The budget deficit exceeded 10 percent of GDP, and the external debt service became untenable. The many state banks had been doling out subsidies to cronies of the government, while being replenished by the state budget. Eventually, the state could no longer afford this roundabout subsidization, and plenty of banks went bankrupt. As a consequence, the exchange rate went into tailspin, driving inflation to hyperinflation in February 1997. GDP collapsed by 10 percent in 1996, and the Bulgarians took to the streets and democratically ousted the ex-communist government through the ballot boxes for its display of total irresponsibility. Late in the day, in 1997 Bulgaria adopted a currency board and economic polices similar to those Estonia had embraced five years earlier. Much of the time of its transition appeared wasted. Also ruled by an ex-communist government, Romania went into a similar destabilization in 1996. Yet, it was less devastating, as Romania had little foreign debt. Like Bulgaria, Romania saw a democratic change of government, but as its crisis was much milder, the Romanians could afford to remain less responsible and continued to pursue too lax a fiscal policy. Both countries treated the IMF as an organization to be cheated and tapped on money until they had little choice but to take it seriously.

In August 1998, Russia faced a financial crash reminiscent of the Bulgarian crisis. Rather than continuing to reduce its large budget deficit after the initial stabilization of 1995, the Russian government had irresponsibly allowed it to rise to some 8 percent of GDP in 1996 and 1997. This deficit was financed with international credits and short-term domestic bonds, much of which was bought by private Western portfolio investors. The capital inflow boosted the exchange rate, which was stabilized by a currency corridor. Many have blamed the exchange rate corridor for the financial crash, but the fundamental problem was the persistent budget deficit, though the corridor admittedly facilitated its financing. To an extraordinary extent, the large public expenditures went to rent seekers, who successfully resisted any fiscal adjustment against their interests, but it was the inflow of private portfolio investment that made such a large budget deficit possible. Until August 1998, the exchange rate had been defended with declining international reserves and IMF and World Bank financing, and inflation had been kept low, while output had started plummeting. On August 17, 1998, the Russian government let the exchange rate float downwards defaulting on its domestic bonds, and declaring a moratorium on foreign debt payments for 90 days. The reformist, but powerless, government of Sergei Kirienko fell within a week.

At the time, Russia seemed set to follow Bulgaria toward hyperinflation, but events took a different turn. In the absence of financing, the government was forced to minimize its budget deficit and put its public finances into order, sharply reducing expenditures as well as arrears. The profligate regional governments suddenly faced a hard budget constraint, forcing them to cut enterprise subsidies. The default on the domestic debt reduced total public debt substantially, and the devaluation led to a competitive undervaluation of the ruble. Since the government had chosen to devalue when international reserves remained substantial, no large foreign loans were needed to replenish reserves. Half of the banks effectively closed down, but this meant that the worst banks revealed themselves and the payment system actually improved. At long last, the Russian economy faced the shock therapy that its reformers had failed to deliver because of insufficient political credibility. Russia took a big step from rent seeking toward a profit-seeking market economy. While Russia's early opening to short-term international financial flows exposed the country to the vagaries of world financial markets, it also forced it to face the consequences. With its very open economy, Russia has little choice but to adjust to world market standards.

Major Lessons from Postcommunist Stabilization

The macroeconomic policies pursued have been remarkably different, and the outcomes of the opposing policies are approximately as we would have expected. In Chapter 4, we noticed that getting inflation under control is vital for the success of transition, but we can draw other major conclusions about postcommunist macroeconomic stabilization.

A radical, early, and comprehensive stabilization is the best cure for the economic system as a whole, because it minimizes the rent seeking arising out of high inflation. Contrary to all gradualist arguments, the period of high inflation has involved far greater costs than the process of stabilization, whose costs remain in doubt (Christoffersen and Doyle 2000). The alleged collapse in demand was a myth. The problem was on the supply side, as open markets rendered many substandard products unsalable, showing the need for vigorous structural reforms.

No risk of overshooting is in evidence, because no country has overdone stabilization and proceeded to early low inflation.[12] Even in relentlessly radical Estonia, inflation was as high as 29 percent in 1995, three years after its stabilization was launched. However, examples of unbalanced and insufficient stabilization policies abound. Too small fiscal adjustments were undertaken, eventually prompting compensatory measures, such as exceedingly strict monetary policy or excessive foreign borrowing. The political resistance to stabilization has been extraordinary everywhere, because a small elite made fortunes on inflation, and state enterprise managers have comprised the kernel of resistance.

The early stabilizers have also excelled in the most profound institutional reforms, showing that these reforms are complementary. All the strictures of excessive focus on financial stabilization and "monetarism" appear little but demagogy. The real issue was whether the rent seekers could be brought under political control or not, and an early stabilization deprived them of substantial revenues, for which they could have bought politics to ascertain future privileges.

[12] Azerbaijan and Armenia recorded deflation in 1998, but that was long after their stabilization.

Fiscal policy has been key for successful financial stabilization. An early shift to a strict budgetary policy has proven vital. An excessive fiscal deficit often leads to a financial crisis, which prompts a more severe adjustment at a higher social cost much later. Fiscal adjustment requires primarily expenditure cuts. To decrease consumer price subsidies has been surprisingly easy, while two critical stumbling blocks have been the reduction of enterprise subsidies and the liberalization of commodity prices. Curiously, enterprise subsidies are most easily cut after open unemployment has emerged, which is a strong argument for decent unemployment benefits. For long, state revenues remained too high in most transition countries, and the prevalent fear of their collapse has been exaggerated.

A necessary precondition for any stabilization in the FSU was the breakup of the ruble zone, which had bred monetary irresponsibility through the competitive emission of money. The cost of the persistence of the ruble zone was so great that it appears one of the main dividing factors between successful and unsuccessful transition countries.

Conditional international financing has been part of each success born out of severe hardship. Yet, it is no guarantee, and large budget financing appears harmful, as it easily induces complacency with large budget deficits, while public debt accumulates. Early unconditional international financing has been a recipe for disaster, regardless of source. It relaxes the pressure on governments to undertake necessary fiscal adjustment and structural reforms, while boosting the real exchange rate.

Financial crises involve large social costs, but they are highly pedagogic both to the elite and the population. They lead to the political activation of people as we saw in Poland in 1989, and in Bulgaria and Romania in 1996. They render hard budget constraints credible for governments and enterprises. Hence, crises force governments to make healthy fiscal adjustments and render necessary expenditure cuts politically possible. Enterprises get convinced to switch from rent seeking to profit seeking. Financial crises also force debt holders to reconsider whether they are not demanding more than is realistic, and whether they would benefit from offering debt relief.

Monetary policy should also be brought under control, but it must not become a substitute for fiscal policy. High real interest rates keep inflation down and exchange rates up, but they also drive down investment and economic activity, and they cannot cure patent budget deficits.

As for exchange rate policy, an early peg has proved helpful in cases of high inflation, but a peg easily becomes a matter of political prestige after it has served its purpose. After stabilization, some kind of dirty float appears more propitious, since a peg easily breeds the overvaluation of a currency. For the future, it is not obvious that all these countries would benefit from maintaining their national currencies.

Incomes policy appears to have been irrelevant, as wage pressure has been no serious threat to price stability. Real wages have proven shockingly downward flexible, and we shall discuss labor and wage arrears as social issues rather than a concern pertaining to stabilization. Cost-push inflation, which was a major worry of many gradualists (notably, WIIW 1993), was not in evidence.

The overall lesson is that more vigor and rigor were needed for stabilization in postcommunist countries than elsewhere, because of weak fiscal control, plenty of quasifiscal deficits, and considerable inflationary inertia. The original tendency to look to Latin American stabilizations for instruction has been helpful. The postcommunist peculiarities appear more limited in hindsight than most thought at the time. The most prominent peculiarity might be the search for subsidies in the form of large-scale barter in some FSRs.

7

Privatization

Nothing has aroused more passions than privatization.[1] It involves politics, law, justice, morals, and economics, being the fundamental dividing line between a socialist and capitalist society. No obvious precedent existed. Augusto Pinochet in Chile and Margaret Thatcher in the United Kingdom had rendered privatization a serious topic in the 1980s. The need for novel approaches contradicted the liberal reformers' battle cries, "return to a normal society" and "no more experiments." Privatization was partly very simple, partly highly complex, and as nobody was an expert, everybody felt competent.

Privatization was so concrete, and all people wanted their own piece of property for living or work. This concreteness led to misperceptions of the value of enterprises. As state factories were badly managed, run down, obsolete, and heavily overstaffed, many were worthless smokestacks, but few understood that. Conversely, few realized the value of large financial flows, discreetly moving between bank accounts, because Marxism left an inheritance of property fetishism and a lingering contempt for finance.

Similarly, many exaggerated the importance of privatization at the expense of marketization, not realizing the limitations of formal ownership, but if the market is not liberalized, private property rights are highly limited, as was the case with the large but stifled private sector in the German Democratic Republic (Åslund 1985). While liberalization was a precondition for real property rights, many perceived privatization as primary.

Large-scale privatization was not seriously discussed in the communist world until 1988–9,[2] but a swiftly formed consensus held it was

[1] General sources for this chapter are Havrylyshyn and McGettigan (1999) and EBRD (1999).

[2] Astoundingly, the first substantial discussion of privatization even in Poland was Dąbrowski et al. (1989).

necessary, since "public enterprises are inefficient because they address the objectives of politicians rather than maximize efficiency" (Boycko et al. 1995, p. 109). As public enterprises functioned worse in the socialist countries than in the West, popular disillusion with them was greater in the East. In current Russian, "kolkhoz" (collective farm) is a synonym of chaos. The question was not whether to privatize but how.

Privatization was discussed in categories of property. Small enterprises were most easily privatized. The privatization of large and medium-sized enterprises was the most complex assignment, attracting the greatest controversy. Land reform and the privatization of real estate implied the largest transfer of wealth, but they aroused less national interest, often being handled as local issues and constrained by traditional claims. Over time, the importance of new enterprises has become evident, but that was not a big theme early on.

"Private" might appear an obvious concept, but it is not. A natural definition would be "more than 50 percent of shares and votes belonging to private individuals and companies," but most postcommunist countries require 70 percent private ownership to classify an enterprise as private, since the state possesses additional powers as owner. In numerous companies, the state has retained a "golden" share, meaning a government veto, undermining the property rights of other owners. Privatization has often been encumbered with restrictions. A new proprietor might not be allowed to change the profile of a shop, lay off workers, choose suppliers, change its interior design, and so on, underscoring that the dividing line between deregulation and privatization is often blurred.

ALTERNATIVE VIEWS OF PRIVATIZATION

To understand privatization, we first look at the initial conditions that constrained privatization and the different goals various people saw in privatization. It was an act of fundamental aims of ethics and justice, but it was also supposed to achieve many economic goals, which had to be balanced with political goals and constraints. On the basis of all these considerations, privatization strategies were formed.

The Setting

These countries were in a multifaceted mess of great variation when they chose their privatization strategies. The control over enterprises varied by country. In the Soviet Union, incumbent state enterprise managers had become quasiowners, since the Law on State Enterprises of 1987 had made them independent of the industrial ministries, which no longer could sack enterprise managers (Åslund 1991). In Poland, workers' councils had assumed power, arousing a fear of the development of Yugoslav workers' self-management, with its boosting of workers' wages and state investment per worker, high inflation, and high unemployment (Lipton and Sachs 1990b). In Hungary, workers' councils of uncertain strength existed, but the state and the industrial ministries remained real owners of state enterprises in Czechoslovakia, Romania, and Bulgaria. The politics of privatization differed accordingly, but the relative strength of political groups was poorly understood in advance. Typically, the power of workers, trade unions, and industrial ministries was exaggerated, while the power of state enterprise managers was underestimated.

A large-scale spontaneous privatization was already under way in Poland, Hungary, and the Soviet Union. Public ownership was widely undermined, since managers had "leased" enterprises, controlling the cash flow of the company. State managers deprived "their" firms of money, usually through transfer pricing. A manager could sell the output of "his" state enterprise, or even a part of it, to his private firm at a low price, reselling the product at a much higher price, seizing the whole profit from the state. Even in the Czech Republic, where the government possessed the greatest power over state enterprises, Minister of Privatization Tomáš Ježek (1997, p. 480) observed: "Managers of state-owned enterprises typically established private companies under their ownership and siphoned state-owned assets into these companies through various dubious techniques." Often, leasing gave the manager, or nominally the work force, the right of a gradual management–employee buyout at a very low price (Grosfeld and Hare 1991; Johnson and Kroll 1991).

A major aim of formal privatization was to stop spontaneous privatization, which was inequitable, slow, and inefficient. Reformers feared it would arouse a popular political backlash against privatization and reform, as indeed happened all over (Kaufmann and Siegelbaum 1996). Especially in the FSU, the saying "what is not privatized will be stolen" suggested the urge for great speed.

Ownership rights to an asset comprise control rights and cash flow rights. Control rights encompass the rights to decide on the usage of an asset, including sale or lease, while cash flow rights are the rights to the yields. Cash flow rights had been separated from control rights and were held by different state officials, but these rights had to be united to allow for efficient enterprise management. Otherwise, the managers' incentives were to divert the cash flow to themselves with little consideration of the cost to the enterprise, which is tantamount to corruption (Boycko et al. 1995; Kaufmann and Siegelbaum 1996).

None of the socialist countries had permitted any capital market apart from marginal markets for summer houses and small machinery.[3] With

[3] Hungary had a bogus stock market, at which predominantly state banks traded a small volume of marginal stocks in state banks.

no markets, no market prices of assets could exist. In their absence, many people perceived existing book prices or historical costs as the real price, although they had been detached from both costs and market prices. Neither rules nor institutions for the selling of property or enterprises were in place. When property markets started emerging, they were illiquid and thus haphazard. A general conclusion was that historical evaluations must be ignored and early market prices would be low and arbitrary for complicated enterprises (Frydman and Rapaczynski 1994). Commercial law was rudimentary, but it was more developed in Poland and Hungary because of their substantial legal private sectors. Therefore, those two countries could opt for more complex schemes of privatization than the others, which needed to keep courts out of their schemes.

Naturally, no state administration for privatization existed, and it was widely agreed that the old industrial ministries could not possibly manage privatization, as they either opposed it or wanted to privatize to their own benefit. Therefore, each country built up a large privatization administration, mostly relatively decentralized, leaving most property to be privatized by regional and local government administrations. The new privatization authorities fought against the remnants of old industrial ministries to acquire state control over state enterprises.

None of the relevant legal, commercial, or administrative expertise for privatization was at hand in the postcommunist world. Nor did Western consultants and investment bankers have the right know-how. An American investment banker once told me that his firm was only interested in advising on the privatization of enterprises worth $100 million or more given the fee level, and only a score of enterprises in the region were of such value.

The Soviet Union was in a rampant economic crisis, and output seemed to be in free fall. With the absence of any apparent responsibility for anything, a common conclusion was: "The only way of remedying the crippling inefficiency of post-socialist state enterprises is to move as fast as possible toward a genuine property regime" (Frydman and Rapaczynski 1994, p. 13). Thus, the urgency of privatization varied considerably with country.

A Matter of Justice

Privatization was a matter of morals and justice, but there were more moral principles than unity around them. To some, the fundamental principle of justice was restitution, returning everything to the original owner or legal inheritors. This principle was strongly embraced in the Baltic republics for national reasons and in East Germany due to

German legal principles. In East Germany, some two million claims were presented, clogging the courts for years and stopping thousands of construction projects and enterprises because of uncertain legal claims. Some restitution occurred in most Central European countries, particularly of farmland and real estate, while the restitution of medium-size and large enterprises was avoided. In the CIS, restitution was hardly an issue, since communism had lasted for over seventy years (World Bank 1996a).

Serious objections were raised against restitution by liberal economists. Many had suffered from communism. How could it be moral to compensate only the loss of property? The technical difficulties were illustrated by East Germany, which was the only postcommunist land that had swiftly adopted a Western legal system with great court capacity. The communists, World War II, or accidents had sometimes destroyed documented titles of land (Frydman and Rapaczynski 1994; Klaus 1994).

A related idea of justice was that the suffering under communism could not be assessed. The moral solution was to distribute all property evenly to the whole population, which could be done by giving all citizens vouchers with claims to state property. Then, the state could auction property for vouchers. Milton Friedman is credited as the originator of voucher privatization, while in Russia the acclaimed originator was the neoliberal Moscow economist Vitaly Naishul, who wrote a book about voucher privatization in 1987 (Chubais 1999). Václav Klaus became its main protagonist in the postcommunist world. Opponents argued that this radical solution was communism in reverse and accused the adherents of "market bolshevism" (Glinski and Reddaway 1999).

A more socialist idea of free distribution was that enterprises should only be given to their workers. This view was much stronger in the Soviet Union than in East-Central Europe. It was most popular at small enterprises, which had often been cooperatives under communism.

A contrary, right-wing stand was that no property should be given away, because what was given for free would not be respected. This view was widely held in Hungary, as well as in Poland, where a domestic bourgeoisie had developed before the end of communism, and the state still functioned.

Yet, moral objections were raised against those who might be able to buy an enterprise, as only four controversial groups possessed money in the early transition: communist officials, organized criminals, dubious new businessmen and foreigners. With a large supply of property but little money for demand, property would inevitably be sold cheaply, benefiting those luckily endowed with cash.

In the West as well, large state-owned enterprises tend to be the breeding ground of corruption, as illustrated by corruption scandals in Italy, France, Austria, and Greece. Therefore, fast privatization appeared a means of ending the pervasive socialist corruption (Kaufmann and Siegelbaum 1996).

Some Western economists, notably David Lipton and Jeffrey Sachs (1990b), raised the idea of the transfer of large minority shareholdings to pension funds, but it took years before this idea caught on, presumably because it was perceived as technically too complex and the beneficiaries were too abstract to form a lobby.

In the FSU, bank savings were inflated away by massive monetary emissions and ensuing price liberalization. Those hurt demanded compensation, possibly through privatization. This option was investigated in Russia, but the Savings Bank could not open privatization accounts for lost savings faster than after three years, which dissuaded the reformers. In Ukraine, the liberal Deputy Prime Minister Viktor Pynzenyk revisited this idea after stabilization in 1996 and issued "compensation certificates" for lost savings to be used as privatization vouchers. Technically, this scheme worked, but it did not arouse any popular appreciation.

Economic Goals

Privatization was considered a means to attain numerous economic goals. They have been categorized as the improvement of allocative efficiency – the reallocation of resources from old to new activities – and X-efficiency – restructuring within surviving firms (Blanchard 1997). However, a third, broader category was the functioning of the very market economy, including the development of newly created private enterprises.

Ludwig von Mises's [1920] fundamental truth came home to roost: "Socialism is the abolition of rational economy. . . . Exchange relations between production goods can only be established on the basis of private ownership of the means of production." No clear line delimits a socialist economy from a capitalist economy, but no Western economy has a public sector that produces more than one-third of GDP. Increasing empirical evidence was showing that private and privatized enterprises outperformed public enterprises all over the world (Vining and Boardman 1992; Megginson et al. 1994).

However, the goal was not only to improve the operation of individual enterprises but to establish a well-functioning market economy. As the Czech Minister of Privatization, Tomáš Ježek (1997, p. 480), has succinctly put it: "the primary purpose of privatization in Czechoslovakia was not to increase the efficiency of particular companies, but to create market structures to encourage private businesses. Fundamentally, this meant that privatization sought to bring about an essential transformation of the role of the government in the economy."

A leading theme in the socialist reform debate was that socialist enterprises had too few powers to be real enterprises, and they had no real owner, as the state was so effusive. Therefore, the slogan under Gorbachev was that enterprises must be given real "masters" (*khozyayeva*). The eventual postcommunist conclusion was that privatization is necessary to establish real owners.

Similarly, socialist enterprises were linked not only to the state but also to one another through multiple networks. Privatization was needed to break enterprises free from all these noneconomic considerations and make them truly independent of one another, which was a precondition for real competition. As Kyrgyzstan's President Askar Akaev (2000, p. 47) stated: "Efficiency is mainly determined by the market structure and the development of competition. The main goals of privatization are, therefore, to change property relations, to form the market structure and to reinforce competition." Foes of privatization have tried to argue that competition and demonopolization are more important than privatization (Bogomolov 1996), but no such contradiction existed. No competition agency succeeded in breaking up state enterprises, which occurred on a mass scale in the privatization process (Slay 1996).

Privatization was also a means of imposing harder budget constraints on enterprises. While governments may give subsidies also to private firms, state enterprises are likely to receive more subsidies, and politically it is much easier to defend subsidies to public corporations.

The key concern among analysts of privatization has been enterprise restructuring, driven by more appropriate incentives for managers and better supervision over them, that is, corporate governance. Only strong owners could resolve the great principal–agent problem to control and motivate managers. Because managers were so unwieldy, many wanted to minimize the number of owners, often seeing one single powerful owner as ideal or at least a strong core owner. Analysts saw a danger in highly dispersed ownership to the public, although initially the dominant view was that outsider owners were economically preferable. Another worry was the predominance of insider ownership. Employees with many disparate interests were not likely to focus on economic efficiency. Alternatively, their property rights could become diffuse and be usurped by the incumbent manager. While one strong owner was appreciated, the old manager might not have the necessary skills for the new market economy, and he would be impossible to oust. Among outsiders, foreigners with capital and know-how were seen as qualitatively superior (Havrylyshyn and McGettigan 1999).

Large-scale privatization was a precondition for the creation of a real capital market and a more rational allocation of capital. Until the end of the 1990s, many post-Soviet governments continued investing public funds in enterprises without economic criteria. Still, under most privatization schemes, the initial structure of ownership was not likely to be all too efficient. Therefore, the early development of trade in shares was considered important to facilitate the accumulation of shares by new strong owners. This propelled an anxiety to develop stock markets early on as well as transparent and effective corporate governance. External control could only be exercised if the managers were forced to be accountable (Frydman and Rapaczynski 1994). Clearly, such hopes were unrealistic, but stock markets were the fad of newly made capitalists, and few harbored illusions about an early effective ownership structure. This was an attempt to choose the least evil.

A much broader economic goal than enterprise restructuring was to facilitate the exit of obsolete enterprises and the entry of new firms, what Joseph Schumpeter [1943] called creative destruction. The destruction could take many forms, but it would not happen until a hard budget constraint made itself felt, and bankruptcy was the ultimate verdict. Few companies went bankrupt, but many were compelled to sell unutilized assets, creating an asset market and becoming the foundation of new enterprises. Therefore, the exit of companies was often a precondition for the entry of firms.

Investment, especially foreign investment, was widely considered a major objective of the privatization process, but confusion reigned. Many argued for sales of enterprises rather than free distribution, because they wanted more investment, seemingly not realizing that payments for enterprises were state revenues and no real investment. Reformers opposed such diversion of private savings to the state treasury (Ježek 1997). The hopes for foreign investment were universally exaggerated, through a surviving communist idea that international capital was restless to enter the former communist countries and that such investment was the main aim of Western policy. This misunderstanding contributed to a late start for foreign direct investment in all countries but Hungary and the Czech Republic.

In the West, state revenues are usually a major reason for privatization, but this was a subordinate issue in most transition countries, where systemic change and justice were emphasized. As public corporations were usually extremely badly managed, their value was not all too large. The exception was Hungary, whose enterprises were more valuable because of advanced reforms, while its treasury suffered from a persistent fiscal squeeze.

Political Goals and Constraints

In the end, political goals and constraints were decisive, as "privatization is a political process, reflecting the art of the possible" (Kaufmann and Siegelbaum 1996, p. 439). The foremost political aim of the reformers was to break up the hegemonic state power and make private ownership a foundation of freedom of democracy, inspired by Friedrich Hayek's [1944, p. 78], "the system of private property is the most important guarantee of freedom, not only for those who own property, but scarcely less for those who do not."

Maxim Boycko, Andrei Shleifer, and Robert Vishny (1995), who were the main thinkers behind the Russian privatization, considered "depoliticization" the prime goal. Under communism, managers had been selected and promoted on political criteria. Politicians had to be separated from property, which was far more important than effective corporate governance. "In our view, controlling managers is not nearly as important as controlling politicians, since managers' interests are generally much closer to economic efficiency than those of politicians" (p. 65).

The division of the state from enterprises was not done once and for all, as the state Leviathan easily reemerged in other shapes. Reformers saw the first threat in industrial ministries, which were defeated in early reforms in Hungary, Poland, and the FSU, since reformers and state enterprise managers stood united against the ministries, but the natural monopoly ministries tended to be corporatized. Numerous proposals for new bodies reminiscent of ministries, such as holding companies, recurred for years, often proposed by businessmen.

Another important liberal political objective was to build a new middle class of educated and property-owning people. Two major proponents of this view were Václav Klaus (1994) and Yegor Gaidar (2000). Consequently, they favored voucher privatization and the development of new start-ups.

Politically, it was impossible to ram through one scheme of privatization. In fact, little legal privatization occurred until a broad coalition had been formed, and this coalition had to be actively involved in both legislation and implementation, since the government did not own anything outright because of strong claims of many stakeholders, including the managers, employees, ministerial officials, and local officials. The question was how an effective consent could be formed among these interests to facilitate successful reforms (Boycko et al. 1995). The strength of the claims varied with country, because of prior legislation and distribution of power, and privatization schemes had to vary accordingly. Stakeholder privatization ran against the aspirations of effective corporate governance, as the leading stakeholders were incumbent managers and employees, who were widely considered the least suitable owners of large companies. This complicated postcommunist privatization, but without such a compromise, little privatization occurred in CIS countries.

Intended Scope of Privatization

The scope of privatization was no big deal, as nobody had any interest in discussing its eventual extent. Since the most aggressive in the old elite rushed for their share, outright opposition to privatization was insignificant. Reformers pragmatically went for the least resistance, as there was an abundance of property to privatize. Yet, a broad understanding ruled that privatization should proceed so far that these countries would not have a larger public sector than Western Europe.

Some industries caused special problems. In the Czech Republic, an early debate raged over the "family silver," enterprises of emotional national value, which were not to be privatized. In Russia, the kernel of the defense industry was excluded from privatization. In Ukraine, the communists specified thousands of enterprises to be excepted. Natural resources and monopolies were controversial everywhere, as people feared they would be sold off too cheaply. Similarly, domestic ownership of agriculture was treasured by the agrarian lobby, and there were also justified fears of speculative purchases of cheap land by absentee landlords. Yet, few opposed the privatization of multiple small and medium-size enterprises and most big manufacturing enterprises. A standard compromise was to establish a list of industries or enterprises that would not be privatized for the time being. Reformers tried to limit these lists and emphasize their temporary nature.

How to Privatize

This discussion left the privatizers with a wide range of options and constraints. On some broad principles a fair degree of consensus prevailed.

- Privatization had to lead to real, clearly defined, private property rights.
- The new owners must be endowed with effective control over management.
- Privatization had to be socially acceptable.
- It should facilitate the enhancement of economic efficiency both within the privatized enterprises and in the economy as a whole.

On other points there was a choice between contradictory positions:

- Some emphasized the importance of speed, while others focused on the quality of privatization.
- Conversely, some favored insiders, while others preferred sales to outside investors.
- Principles of justice and political convenience stood against principles of economic efficiency.

The choice of actual method of privatization varied with the nature of the property, political situation, bureaucratic capacity and prior claims. The main alternatives were:

- Open sales
- Management or employee buyout
- Mass privatization
- Restitution
- Liquidation.

The dominant conflict concerned the privatization of large enterprises. One camp demanded only sales for money regardless of speed for the sake of quality of privatization, while the opposing camp saw speed as more important than quality and accepted giveaways both to insiders and to the general populace. In contrast to the strife over liberalization and macroeconomic stabilization, this was not a struggle between reformers and rent seekers. Both camps were championed by reformers, while rent seekers tried to pitch in and benefit however they could. This has rendered privatization much more difficult to understand from a moral or political perspective, while it became feasible.

Speed, Corruption, and Equity

In the choice of privatization strategy, three major concerns were corruption, speed, and equity. Privatization is vilified as a cause of corruption in postcommunism, for which reformers are often blamed (Stiglitz 1999a; Goldman 1996). However, corruption can be defined as the abuse of official power for private gain. Privatization means the end to these transactions, while any lease or licensing implies their continuation (Kaufmann and Siegelbaum 1996). While theoretically possible, it is implausible that an official would be able to discount the present value of all bribes he could extract. Moreover, a purchaser would demand a substantial discount for his considerable risk premium because of the uncertainty of the early transition. A review of actual rents suggests that privatization was not a major source of income (Åslund 1999).

"While it is undeniable that, in the transition economies, an increase in corruption coincided with the process of privatization, it does not necessarily follow that this increase was actually caused by the privatization process" (Kaufmann and Siegelbaum 1996, p. 428). Corruption is likely to have paralleled the rise in crime, which peaked just after the collapse of communism and then abated. Both were reflections of the weakening of the state (Åslund 1997a). Regular privatization started one or two years after the demise of communism. By elementary logic, a cause cannot follow its effect and privatization appears more likely to have contributed to the abatement of corruption, as it meant officials had less to sell.[4] Like many other transitional events, corruption and privatization occurred roughly in parallel, and involved wealth transfer, but that is true of many other phenomena, and simultaneity must not be confused with causality.

Yet, corruption was a major consideration for the speed and strategy of privatization. Hungarians argued in a normal Western fashion that privatization had to be proper, creating strong owners with full corporate governance, and that the state should receive due revenues: "State property must not be squandered by distributing it to one and all merely out of kindness.... The point now is not to hand out the property, but rather to place it into the hands of a really better owner" (Kornai 1990, pp. 81–2). The precondition for such a view, however, was that the state was in such good shape that it could manage and maintain public enterprises. Only Hungarians, Poles, and soon Estonians could concur with Kornai (1990, p. 82): "But the state is alive and well. Its apparatus is obliged to handle the wealth it was entrusted with carefully until a new owner appears who can guarantee a safer and more efficient guardianship." Then, speed was of little significance. For the maximization of state revenues, the best business strategy was a steady flow of privatization.

In the post-Soviet chaos, however, state enterprises were subject to extraordinary theft, partly through the ongoing spontaneous privatization by incumbent managers. Time offered an opportunity to introduce a more legal form of privatization, because the transaction cost of illicit deals is high and they take time to negotiate. This was a strong argument for mass privatization which would enhance the equity and popularity of privatization. Since public administration was a bottleneck, high speed could not be achieved without reducing the administrative discretion, also diminishing corruption. A high pace also required the involvement

[4] Unfortunately, statistics are still too poor to allow us to compare the development of privatization and corruption.

of many people, which would render an equitable privatization more likely, and a fast privatization could engage and mobilize people. Privatizers also hoped to thrive on chaos and get privatization going before the old establishment recovered and reinforced their claims to public property. For a few years after the end of communism, large assets had no clear market values or very depressed values. This uncertainty of values facilitated a simplified privatization scheme. The aim was to create a critical mass of private enterprise so that the survival of a market economy could be secured. Besides, power always corrupts, and sufficient property had to be transferred out of the government's hand while idealism prevailed, as the large unregulated public property would inevitably corrupt many top officials. Hence, privatizers saw mass privatization as a way to regularize and speed up privatization, and all postcommunist countries but Hungary, East Germany, and Azerbaijan opted for some scheme of mass privatization (Kaufmann and Siegelbaum 1996; Boycko et al. 1995; Chubais 1999; Åslund 1992).

SMALL-SCALE PRIVATIZATION: IF STARTED, SWIFTLY DONE

The easiest privatization in every country involved small shops and kiosks.[5] It was vital that it got done, but it was not very important how. The most reformist countries had pioneered limited small-scale privatization of retail shops before the end of communism.

However easy small-scale privatization was, it was not automatic. Even reformist Kyrgyzstan did its small-scale privatization as late as 1994 to 1996, and Ukraine pursued it in 1995 and 1996. A number of preconditions had to be in place. First of all, the government had to give local authorities the right to privatize small public enterprises. Second, local government had to establish a privatization administration, because old trade departments would oppose losing their assets in the same way as industrial ministries did. Third, local governments had to decide to sell, often prompted by a financial squeeze. Otherwise, local authorities preferred leases, maximizing their power over shopkeepers. While these decisions were easy, little happened until they were made. Usually, small-scale privatization was delayed, but once the process started it was completed within two years, as everybody realized this was the only time they could get a piece of property cheaply.

Before small-scale privatization occurred, a heated discussion raged about whether shops should be sold at auctions or cheaply to the

[5] Earle et al. (1994) offer an exhaustive account of this process in the Czech Republic, Hungary, and Poland, while the World Bank (1996a) accounts for the whole region.

employees. Liberal economists usually preferred auctions, while shop employees wanted to take them over for free. Some auctions took place in many countries, but only the Czech Republic claims to have auctioned all (Ježek 1997, p. 482). The bulk of small enterprises was sold cheaply to insiders even in Poland. Auctions led to faster structural changes, not least because their property rights were clearer, and they were less bound by residual regulations imposed by local trade authorities.

Since privatization, problems have been caused by local regulations, such as short leases on premises, licenses that must be renewed each year, limited rights to change the profile of a shop, restrictions on the laying off of workers, and dependence on state wholesale trade. These problems concern a lack of freedom of trade, but such regulations have often been reinforced by conditional privatization. It took years before anybody but a detective could notice any difference between a state shop and a privatized shop in Moscow, while new private shops looked completely different. Frequently, the staff did not know whether their shop had been privatized or not, suggesting little transparency. Yet, if only small-scale privatization occurred, market forces ruled within a few years. Today, few discuss small-scale privatization, underscoring its success. In the whole region, hundreds of thousands of small enterprises have been privatized.

LARGE-SCALE PRIVATIZATION: THE BIGGEST HEADACHE

The privatization of large and medium-size enterprises has been the big drama of privatization, where all the political, economic, and technical problems of privatization coalesced. The debate has been lengthy and acrimonious, resulting in extensive and complex legislation.[6]

The questions were daunting. The government had to determine who should privatize what. A vast volume of legal acts had to be drafted and needed through parliamentary debates. Enterprises passed to be corporatized and possibly broken up first. The authorities had to define the property of each enterprise. Little restructuring of enterprises prior to sales was feasible. A huge wealth transfer was anticipated, but nobody could evaluate the property. Sales had to be organized, often through special privatization committees. Usually, privatization vouchers or coupons were distributed or sold, which was a burning political issue.

[6] The literature on large-scale privatization is enormous. The privatization programs and principles of most countries have been publicized in several anthologies. When not marked otherwise, I have drawn the facts on the various national privatization programs primarily from Earle et al. (1993), Frydman et al. (1993a,b), Lieberman et al. (1997), and Borish and Noël (1996).

Demand and supply had to be matched, which was technically difficult. Frequently, the legal and technical problems became so cumbersome that mass privatization came to a halt in countries as different as Poland and Ukraine.

Large-scale privatization varied significantly between countries that otherwise pursued similar reforms, as national preconditions and politics greatly influenced the design of privatization policies. Typically, one country opted for one primary method out of a half dozen major forms of large-scale privatization but also pursued other options in parallel. Often the initial choice was altered because of abortive implementation. In hindsight, this pluralism appears fortunate, while it was accidental. The most striking example is Poland, where the polity chose mass privatization, but the rulers failed to agree on its details, delaying it for years. Meanwhile, liquidation became a major form of privatization by chance.

Because of poor statistics, the choice of major forms of large-scale privatization cannot be quantified. Still, in Table 7.1, the EBRD gives us an approximate picture. Sales to outsider owners could be initial public offerings, direct sales, or investment tenders. Voucher privatization and management and employee buyouts were the standard forms of mass privatization. In several countries, no large-scale privatization was undertaken, which was also a political choice. Unexpectedly, bankruptcy and liquidation turned out to be important forms of privatization. After initial privatization, ownership could be restructured through trade in stocks, but the question is to what extent.

Initial Public Offerings

In the West, initial public offerings (IPOs) on the stock exchange have been the standard form of privatization of large companies. In the 1980s, this practice was finessed in the United Kingdom, and its practitioners looked for new markets. Immediately after Poland had announced that it would privatize, a half dozen London-based investment banks sent their missionaries to Warsaw to preach the virtues of IPOs, largely at the expense of the UK Know-How Fund.

Many sound arguments favored IPOs, being the most public and transparent form of privatization, as extensive information about the enterprise would be disclosed. The privatization would be open both to the public and foreign investors. Outside investors would come in with all incentives and rights to restructure the company. The pricing would be done by the market, and the government would receive the maximum revenue. Corporate governance would be ideal, and IPOs would form the basis for a sound stock exchange.

Table 7.1. Methods of Privatization of Medium-Sized and Large Enterprises

	Sale to Outside Owners	Voucher Privatization (Equal Access)	Voucher Privatization (Significant Concessions to Insiders)	Management-Employee Buyouts	Other[a]
Central Europe					
Poland	Tertiary	Secondary	..	Primary	..
Czech Republic	Secondary	Primary	..	..	..
Slovakia	..	Secondary	..	Primary	..
Hungary	Primary	..	..	..	Secondary
South-East Europe					
Romania	Secondary	..	..	Primary	..
Bulgaria	Primary	Secondary	..	..	..
Baltics					
Estonia	Primary	..	..	Secondary	..
Latvia	Secondary	Primary	..	..	..
Lithuania	..	Primary	..	Secondary	..
CIS					
Russia	Secondary	..	Primary	Tertiary	..
Belarus	..	..	..	..	..
Ukraine	..	Secondary	..	Primary	..
Moldova	Secondary	..	Primary	Tertiary	..
Armenia	..	Primary	Secondary	..	..
Azerbaijan	..	..	..	..	..
Georgia	..	..	Primary	Secondary	..
Kazakhstan	Secondary	Primary	..	..	..
Kyrgyzstan	..	Primary	..	..	..
Tajikistan	..	..	..	Primary	..
Turkmenistan	..	..	..	..	..
Uzbekistan	..	..	..	Primary	Secondary

[a] Includes asset sales through insolvency proceedings and a mass privatization program based on preferential credits.
Source: EBRD (1997, p. 90).

Yet, there were serious objections. The required information would not be available for years, postponing privatization. The cost of an IPO was so large that few enterprises could come into question. IPOs could alienate the population, as foreign investors were likely to dominate, and they would acquire their stocks cheaply because of the dearth of domestic capital. In the West, much effort has been put into restructuring public enterprises before privatization, but only a few leading transition countries could possibly do that. The others lacked both management capacity and state control over managers. Nor did existing stakeholders have any incentive to accept IPOs. Hence, IPOs could not be a major avenue of privatization (Lewandowski and Szomburg 1989; Lipton and Sachs 1990b).

Poland and Estonia have undertaken a score of IPOs each, and Hungary has done several, while other countries have barely started. IPOs did provide the base for the Warsaw stock market, which has been saved from scandals, but they became insignificant for privatization during the first decade of transition. The critics proved right: IPOs were never a feasible option for substantial privatization.

Direct Sales or Investment Tenders

Another way of selling large state enterprises to outsiders was through direct sales or investment tenders. Their advantage was that one or a few outsider owners would acquire substantial ownership and be motivated to pursue progressive enterprise restructuring, and they could be designed to attract foreign investors. Through investment tenders, the state could demand substantial investment, and state revenues could be considerable. For certain big enterprises in need of a specialized Western owner, this was the only plausible option for survival.

However, the disadvantages were serious. Direct sales or investment tenders were not transparent, and the many conditions that were negotiated with government officials bred maximum administrative discretion and corruption. They were the least equitable privatizations, and their absence of incentives for stakeholders aroused resistance and complicated privatization. In theory, this was the worst form of formal privatization.

Virtually all countries have undertaken some direct sales and investment tenders, but they became the primary form of privatization only in East Germany, Hungary, Estonia, and Bulgaria, and they were perceived as successful merely in Hungary, Estonia, and the Czech Republic, the countries with the best public administration. Only in these countries did privatization become a substantial source of state revenues, and such sales were publicly accepted. These countries became the major recipients of FDI per capita (see Table 10.11).

The German government sold 13,000 state-owned enterprises in East Germany from 1990 to 1994 surprisingly fast but at an extraordinary cost. While the *Treuhand* privatization agency collected \$50 billion in privatization revenues, it spent no less than \$243 billion on this privatization (Brada 1996, p. 71). The sales were heavily concentrated to West German companies, signifying a very closed shop. One exception, the purchase by the French company Elf Aquitaine of the refinery Leuna Werke, has become the potentially greatest corruption story in France and Germany ever. Arguably, *Treuhand* was the world's most generous corporate welfare agent, which was apparent to outside observers early on (Akerlof et al. 1991; Kaser 1996). Among other postcommunist countries, only Estonia followed the East German example, and the unpopular privatization strategy is considered to have contributed to the loss of the Estonian reform government in the 1995 elections (Åslund et al. 1996).

Looking East and South, the results of direct sales and investment tenders have been nothing but disastrous. The revenues have been insignificant, because these "sales" were like to giveaways to the rich and powerful. The more direct sales and investment tenders that took place, the more corrupt the privatization process was. In Bulgaria, direct sales to the elite lay the ground for business empires, such as Multigroup, which actively contributed to the financial collapse of 1996–7. When Pavlo Lazarenko was prime minister of Ukraine in 1996–7, he considered the privatization of large enterprises so sensitive that he took them over himself, and privatized about every second enterprise to his own enterprises.[7] In Kazakhstan, major metallurgical assets were sold off to outright crooks in discrete deals. In Russia, the infamous "loans-for-shares" sales of stocks in a dozen major companies took place in late 1995 after voucher privatization had ended and all other forms of privatization had been blocked.

These direct sales to the privileged and criminals did little for the objectives of privatization. In particular in Russia, Ukraine, and Kazakhstan, they coincided with the evolution of large "financial-industrial groups." These groups did not promote the depoliticization of enterprise, demonopolization, or enterprise restructuring, because their main asset was political influence, and they were so powerful that they tended to capture the state (EBRD 1999). These postcommunist states and societies were too weak and the elites too strong. The many liberal economists who had resisted discretionary direct sales and investment tenders were proven right. Still, if the only alternative is to leave dominant property with the state, direct sales might be better than none.

Voucher Privatization

Voucher privatization was a pet idea of liberal economists and possibly the only real invention of postcommunism. It became the dominant form of privatization in the Czech Republic, Lithuania, Latvia, Armenia, Kazakhstan, Kyrgyzstan, and initially in Slovakia, while almost all countries issued some vouchers, notably Poland, Bulgaria, Russia, Georgia, Moldova, and Ukraine.

[7] Information from the State Property Fund of Ukraine and the Ukrainian Cabinet of Ministers at the time.

Mass privatization through vouchers, distributed to virtually the whole population, was theoretically attractive. It was fast, and it would create a market and an equitable wealth distribution. The distribution of vouchers alleviated the shortage of domestic demand for property purchases. As the whole population would benefit, it had great popular potential. Its administration was much less costly and complex than IPOs, since voucher auctions simplified evaluation problems. However, voucher privatizations were riddled with practical, administrative, and political problems. The main economic disadvantage was very dispersed ownership and ineffective corporate governance.[8]

The key issue was what enterprises, and how much of each enterprise, should be privatized through voucher auctions, which tested the political strength of the state in relation to state enterprise managers. Managers of valuable enterprises wanted to privatize to their own benefit, while bad enterprises were more easily thrown into voucher auctions. Arguably, this power balance is the distinction between the eight countries where voucher privatization was the primary form of privatization and the six where it was secondary.

In Russia, Minister of Privatization Anatoly Chubais was firmly committed to a maximum of voucher privatization, but only 20 percent of the stocks in the 16,462 enterprises that went through voucher auctions until June 1994 were sold for vouchers, while 51 percent of the shares were usually given cheaply to managers and workers (Blasi et al. 1997, p. 192), showing that the managers prevailed over the state. Moreover, the most attractive enterprises were usually withheld from voucher auctions (Marcinèin and van Wijnbergen 1997). As a result, people were disappointed, obtaining less than their anticipated share of national property, especially as their expectations had been exaggerated by the reformers' propaganda about the potential benefits of privatization. In Poland so many enterprises were withheld from the mass privatization that it is was delayed for years and became a minor part of overall privatization.

Auctions and financial intermediaries involved many important technicalities. Initially, the suddenly emerging voucher funds in the Czech Republic appeared genial, facilitating investment for ordinary people,

[8] In the Czech Republic and most CIS countries, every citizen got the same number of vouchers, while Latvians and Lithuanians obtained vouchers based on the number of years they had lived in the country, and various compensation vouchers were issued, for instance, in the Baltics and Ukraine. A minor issue that aroused an amazing acrimony was whether the vouchers should be distributed to or collected by the citizens, and whether and how much people should pay for them.

but popular enthusiasm evaporated when the head of the biggest voucher fund eloped to the Bahamas with a great fortune that was his and not the investors'. The investment funds were a late improvisation in the Czech voucher privatization and time did not suffice for their regulation, but after they had emerged as major owners, they resisted being regulated (Ježek 1997). The Czech voucher funds became closely linked to the still state-owned banks, seemingly nullifying much of the privatization. In Russia and Ukraine, voucher funds just faded away, offering no benefit to their many tiny investors (Pistor and Spicer 1996). As no country managed to solve the problem of corporate governance of investment funds, it seems insolvable at this stage of institutional development.

Regardless of its many technical problems, voucher privatization made a huge contribution to privatization. It provided a much more even wealth distribution than direct sales. Initially, the Czech Republic excelled with eminent enterprise restructuring thanks to dominant outsider ownership (Frydman et al. 1997). In Lithuania and Latvia as well, voucher-privatized enterprises appear to have done well. In the longer run, however, the murky nature of the voucher funds in the Czech Republic seems to have hampered Czech economic development. In the CIS, voucher privatization had limited impact, as insider ownership became dominant and marketization was a critical hurdle. In Kyrgyzstan, President Akaev (2000, p. 48) noticed with satisfaction: "The fast mass privatization allowed us to sharply restrict the informal privatization, which had been named 'Nomenklatura *prikhvatizatsiya* (grabbing)'." Today, voucher privatization suffers from exaggerated popular expectations, but those expectations facilitated privatization. Furthermore, it has become commonplace to blame voucher privatization for any unrelated problem, including insider privatization and management theft (see Stiglitz 1999a).

Manager or Employee Privatization

In many countries, managers and employees had such strong claims to state enterprises that anything but an insider privatization was unrealistic.[9] The real choice was between giving away substantial ownership to insiders and leaving enterprises in a void of unclear collective ownership. This was true of Poland, Russia, Ukraine, and most other CIS countries, and management or employee privatization became the dominant form of large-scale privatization in Poland, Romania, Slovakia, Russia, Ukraine, Moldova, Georgia, Tajikistan, and Uzbekistan. The standard

[9] A general source on employee ownership is Uvalic and Vaughan-Whitehead (1997).

term is "buyout," but it is a misnomer, as insider privatization usually reaped a tiny fraction of the market price.

A great advantage of insider privatization was that it could be undertaken fast. Many liberal economists recognized the quasiproperty rights of managers and employees, arguing that they should be given substantial ownership in the form of individual stocks, rendering the widespread ownership legitimate as well. Administratively, this was the easiest form of privatization. Otherwise, insiders would block privatization whenever they could (Lipton and Sachs 1990a; Boycko et al. 1995). Some argued that management/employee buyouts could enhance efficiency, as the incentives for managers and employees would improve (Earle and Estrin 1996; Shleifer and Vasiliev 1996).

Polish privatization was geared toward employees, while insider privatizations in Russia, Ukraine, Moldova, Georgia, Kazakhstan, and Kyrgyzstan led to management control, with Russian managers typically owning about 20 percent of the stocks and employees about 40 percent (Blasi et al. 1997). In Ukraine, managers owned more, and Georgian managers were usually majority owners (Djankov 1999b, p. 138).

Some of the strongest companies in the region underwent insider privatization benefiting their managers. Outstanding examples are Gazprom and the two respected Russian oil companies, Lukoil and Surgut. These managers were allowed to get away with their booty, because they were not only strong but also considered competent, and they wisely accepted privatization. Mismanaged oil companies, whose managers pursued outrageous embezzlement or resisted privatization, were targeted by the state for outside privatization. I was told by a representative of the new owners of the Russian oil company Sidanco that the previous management had stolen $350 million a year from the company through transfer pricing.[10] Yet, embezzlement hardly diminished after their privatization, as the new majority owners defrauded minority shareholders through transfer pricing.

Bankruptcy and Liquidation

Together with price liberalization and external liberalization, bankruptcy is probably the most effective means of transition, but it is one of the least studied and understood subjects, as its total effects are impossible to measure. Bankruptcy and liquidation have been possibly the best forms of privatization.

[10] Oil and oil products from Sidanco were sold below the market price to offshore trading companies owned by the old management, who collected the difference from the world market price.

A bankruptcy can do many good things. First of all, the very threat of bankruptcy imposes a hard budget constraint on all enterprises and boosts payment morale. It leads to the ouster of incumbent managers, and this specter disciplines most managers. Bankruptcy eliminates old owners who have failed. It is also the most efficient and comprehensive means of restructuring of enterprise assets. Executors take an unprejudiced look at the enterprise and they may split up a misconceived company and sell off assets piecemeal. It guarantees the new owners a legally clean slate without hidden debts. A bankrupt enterprise is sold through executive auction, the preferred method of privatization. Old debts and claims encumbering many old firms are settled, also cleaning up the finances of creditors. Bankruptcy improves the competitive environment and levels the playing field, as government subsidies to loss-making enterprises are terminated. It opens markets captured by subsidized producers, and it frees up underutilized productive resources, such as premises and machines, that could be sold off to aspiring new entrepreneurs on newly generated asset markets. Finally, bankruptcy is a complete sale, leaving no residual state equity (Mizsei 1993; Balcerowicz et al. 1997; Gray and Holle 1997; Kaufmann and Siegelbaum 1996). No other form of privatization had so many positive effects.

The naïve observer would presume that such a beneficial method would catch on, but the EBRD *Transition Report 1997* (p. 85) observed: "Only a handful of countries at more advanced stages of transition . . . have bankruptcy procedures operating even at a minimal level." In Poland, liquidation became a major strategy of privatization of medium-size companies by accident, when other forms of privatization were stalled. Just Estonia embraced liquidation intentionally as a privatization strategy, and the results have been excellent (Kaufmann and Siegelbaum 1996, pp. 428, 435).

As most reforms, bankruptcies gained early significance in Central Europe and the Baltics. Poland was the pioneer, since it had a vibrant private sector under communism. Its number of bankruptcies rose from 151 in 1990 to 4,349 in 1992, and liquidation with ensuing sales of the enterprise without bankruptcy became a major means of privatization of medium-size firms. Atypically, Hungary introduced a draconian bankruptcy law with an automatic trigger in 1992, and no less than 14,060 bankruptcies were filed that year. The Czech Republic followed more timidly, with its filings rising from 350 in 1992 to 2,990 in 1994 (Balcerowicz et al. 1997). Estonia also had an early functioning bankruptcy process (Nellis 1994).

Many other countries introduced bankruptcy laws, but they had little effect. In Russia, President Yeltsin passed a decree on bankruptcy in June 1992, and Parliament promulgated a Bankruptcy Law in November 1992, but bankruptcy became significant only with a new Bankruptcy Law in March 1998. In 1999, about 10,000 bankruptcies were filed in Russia, almost twice as many as the previous year, and of those the state had only initiated 16 percent (Åslund 1995; Novoprudsky 2000). Not surprisingly, barter fell in parallel from 54 percent of industrial interenterprise transactions in August 1998 to 21 percent in August 2000 (*Russian Economic Barometer* 2000).

The most obvious impediment was that bankruptcy required several related laws, usually a commercial code, a civil code, and some laws regulating debts. Bankruptcy proceedings were personnel intensive for understaffed courts, delaying the effectiveness of bankruptcy. Hence, few had any incentive to initiate a bankruptcy. Creditors doubted legal recourse would give them any money, while the launching of a bankruptcy would damage their relations. Banks were generally ineffective. The state had multiple interests and was reluctant to challenge powerful enterprise managers or provoke unemployment, while tax revenues were no top priority.

Part of the problem is that bankruptcy fell between the stools of economists and lawyers. To most economists, hard budget constraints, creative destruction, and the reallocation of scarce assets are laudable, but bankruptcy was largely left for lawyers. In the CIS, American lawyers provided most legal advice, and they saw bankruptcy primarily as the rehabilitation of enterprises in line with Chapter 11 in the U.S. bankruptcy law. The vested interests of lame-duck enterprises concurred with American law, whereas the deplorable financial discipline and weak legal systems called for draconian bankruptcy procedures.

Yet, the main explanation of the slow introduction of bankruptcy was that it would deal a devastating blow to the old system. In a populist vein, the opponents of bankruptcy frightened people that if it were introduced, all companies would go bankrupt, leading to mass unemployment and depression. This fear of mass bankruptcies effectively blocked any bankruptcy in most countries. International assistance agencies, notably the World Bank, recognized the significance of effective bankruptcy procedures, but change took time.

Even when bankruptcies started, few realized their importance. Complaints abounded about incompetent or partial executioners and courts, solvent enterprises being bankrupted rather than unprofitable ones, unfair and poorly advertised auctions with low prices, tardy restructuring of the bankrupt companies, unjust redistribution of property with frequent accusations of corruption. But these complaints are beside the point, as they do not touch upon the many benefits of bankruptcy. Bankruptcy should establish a credible threat of exit for those who do not pay, and it did.

Bankruptcy was one of the greatest sins of omission in the postcommunist transformation, and it is significant that the most successful reformers – Poland, Hungary, and Estonia – were the pioneers in large-scale bankruptcy.

Fast Privatization or Little Privatization

A standard assumption is that privatization could be undertaken either now or later, but this is a dubious premise. Privatization has not been a continuous process. In most countries with substantial privatization, one or two breakthrough years have represented a major boost in the private share, caused by a concentrated privatization of large and medium-size enterprises, after which privatization has slowed down.

Either a concerted effort at large-scale privatization is undertaken, or state enterprises remain dominant. In countries with little privatization, notably Belarus and Turkmenistan, no such jump is apparent, as privatization was more gradual. Then privatization stopped altogether, as a dictatorial state recovered its economic and political control (see Table 7.2). EBRD statistics do not reveal any reversal in the private share, but substantial resocialization has occurred in Belarus, as private owners have been squeezed out by impossible business regulations.

Another group of countries, especially Ukraine and Moldova, launched their privatization late, and they have moved ahead only after Herculean efforts. Nor did the quality of their privatization rise. On the contrary, these later privatizations were qualitatively worse than in Russia, as more stocks went to insiders, corporate governance and minority shareholders' rights were more limited, stock markets faltered, fewer market reforms occurred, especially in Ukraine (Yekhanurov 2000; Djankov 1999b). A slow start of privatization led to the entrenchment of an establishment that thrived on state ownership in corrupt ways, exactly as Kaufmann and Siegelbaum (1996) had predicted. Even in reformist Latvia, an observer reported in 1996:

> Many members of Latvia's new political elite serve on the boards of directors of large state enterprises, where their salaries in most cases are several times higher than those for governmental or parliamentary posts. Officials in such positions have diverted funds through state enterprises by having the enterprises guarantee loans to private firms in which the officials themselves had interests. Those loans were seldom repaid. . . . (Paeglis 1996, p. 37)

Thus, we have discerned another case of dangerous path dependence leading to suboptimal equilibria. Both with minimal or limited initial privatization, the danger is great that strong vested interests will thrive on state ownership and impede further privatization to the detriment of the building of a full-fledged market economy.

Table 7.2. Private Sector as Share of GDP, 1991–2000 (EBRD estimates, midyear, percentage of GDP)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000 (prel.)
Central Europe										
Poland	40	45	50	55	60	60	65	65	65	70
Czech Republic	15	30	45	65	70	75	75	75	80	80
Slovakia	15	30	45	55	60	70	75	75	75	75
Hungary	30	40	50	55	60	70	75	85	80	80
South-East Europe										
Romania	25	25	35	40	45	55	60	60	60	60
Bulgaria	20	25	35	40	50	55	60	65	70	70
Baltics										
Estonia	10	25	40	55	65	70	70	70	75	75
Latvia	10	25	30	40	55	60	60	65	65	65
Lithuania	10	20	35	60	65	70	70	70	70	70
CIS										
Russia	5	25	40	50	55	60	70	70	70	70
Belarus	5	10	10	15	15	15	20	20	20	20
Ukraine	10	10	15	40	45	50	55	55	55	60
Moldova	10	10	15	20	30	40	45	50	45	50
Armenia	30	35	40	40	45	50	55	60	60	60
Azerbaijan	10	10	10	20	25	25	40	45	45	45
Georgia	15	15	20	20	30	50	55	60	60	60
Kazakhstan	5	10	10	20	25	40	55	55	60	60
Kyrgyzstan	15	20	25	30	40	50	60	60	60	60
Tajikistan	10	10	10	15	15	20	20	30	30	40
Turkmenistan	10	10	10	15	15	20	25	25	25	25
Uzbekistan	10	10	15	20	30	40	45	45	45	45

Source: EBRD (2000a).

The choice of privatization strategy typically went through two stages. Initially, privatization was an intellectual and idealistic exercise, which bred the many voucher schemes, for instance. Next, privatization became the art of the possible, as powerful political forces were less interested in the effects on society than in their own fortunes. As a consequence, the strategies involving little corruption were downgraded to the benefit of strategies that offered privileges. Out of five major privatization strategies for large and medium-size enterprises, voucher privatization and international public offerings (IPOs) are, in principle, transparent and involve little administrative discretion, and they should thus generate less corruption. Reformers fought primarily over these two options, but neither has become very significant. Instead, the dominant privatization strategies have been management and employee privatization, spontaneous privatization, and direct sales, which offer no transparency but allow for great administrative discretion. The cleanest form of privatization, liquidation, has played only a minor role, because even few reformers understood its charm (cf. Kaufmann and Siegelbaum 1996). Nor has equity determined the choice, although it has played a role, as voucher privatization and employee privatization have been the most equitable forms of privatization. In successful reform countries, a regularization of later privatizations has occurred, giving IPOs and more transparent tenders a greater role.

Hence, the problem was not that privatization by itself caused corruption but that only reasonably corrupt forms of privatization were politically acceptable, often offering the choice between not very clean privatization and no privatization. Thus, the problem was not privatization but a weak state and rudimentary democratic institutions. Still, the emergence of millions of private owners in the region has created a base for building a stronger state and democratic institutions.

The Role of Stock Markets

The importance of the initial distribution of stocks depends on the ease with which they can be redistributed. The Coase theorem states that under perfect competition, private and social costs will be equal (Coase 1988, p. 14). To Coase, this was only a theoretical construct, as he argued that transaction costs determined the design of economic institutions. The privatizers hardly harbored this illusion, but the idea that the original distribution of titles was of no importance enjoyed great currency. However, the redistribution of property depended on the efficiency of secondary markets (Sutela 1998), which was bound to be inadequate for years.

Both Western and local stock markets specialists tended to focus on superficial technical features, such as electronic trading systems. Early on, Kiev received as technical assistance a modern stock exchange equipped as in Lyons, but for years only three or four stocks were traded. Key problems were instead the registration of titles, custody, externally audited accounts, corporate governance, and the supervision of stock exchanges.

Stock markets took off in four countries, Hungary, Poland, Estonia, and Russia. The first three went through a similar evolution. Hungary pioneered a stock exchange before the end of communism, but Hungarian state banks only traded marginal shares in other state banks, though all procedures were in place. When real stocks entered the market, trade developed without complications. Poland let its few IPOs comprise a stock exchange that was an impeccable symbol of capitalism from the outset, replete with stockbrokers' red suspenders. Yet, the market capitalization in Poland stayed low, since energy and telecommunications were not privatized. Slovakia, Latvia, and Lithuania did something similar, but their markets were both smaller and less reputable, impeding their bloom.

The Russian development was a world apart, being big, wild, and spontaneous. A couple of hundred exchanges had arisen before the end of communism as wildcat entrepreneurship, and from 1993 the country was awash in stocks. If an enterprise was of value, a market for its stocks developed easily, and ownership was consolidated, attracting core owners. Local stockbrokers visited such enterprises and bought up stocks from the workers. They delivered large packages of stocks to the Moscow market. However, most enterprises were of little value, leaving their shares too dispersed to surmount transaction costs. Hence, their shares were barely traded, and ownership was not consolidated. The more valuable companies, notably telecommunications, utilities, and oil, rose on the stock market in 1994. After this first boom, a minor bust followed. In 1996 and 1997, the Russian stock market quadrupled, becoming the best performing market in the world in both years. Its market capitalization peaked at $100 billion, one-fifth of GDP or ten times more than the Polish market capitalization, as the most valuable Russian companies were on the stock exchange. However, market capitalization plummeted by 84 percent between October 1997 and August 1998.

Apart from the Russian financial collapse, pervasive dilution of minority shareholders deterred foreign equity investors. Although Russia had good legal standards on its books, the Federal Security Commission had scant legal powers and failed to implement most rules. The Russian stock market has revived, but it has remained volatile and speculative, with low valuations, rendering equity an expensive method of raising capital. Future developments of the Russian stock market are likely to pass the judgment on Russian capitalism, which is reassuring for a believer in markets. Its historical record may seem awful, but so was the record of the now highly regarded Hong Kong stock exchange.

In spite of its voucher privatization, the Czech stock market never became reminiscent of Russia. It never thrived, lagging behind its neighbors Poland and Hungary. Unlike Russia, ownership did not coalesce so easily. The Prague stock exchange was flooded with a couple of thousands of listed stocks, most of which were not actively traded. The market was avoided by foreign investors as too nontransparent. Strangely, Prime

Minister Vaclav Klaus opposed the setting up of a Security Exchange Commission, which was established only in 1998 after his departure. The ensuing delisting of most stocks has led to a revival of the market. This appears another possible consequence of voucher privatization, but the problems were conserved by the longevity of the government. The idea that the stock market could work to the benefit of small enterprises was odd and not validated.

A beneficial effect of a functioning stock market has been international financial integration. In all the countries with real stock markets, brokerages and investment banks swiftly developed. Many are international, and their domestic counterparts tend to adopt international standards with surprising ease. Since no relevant skills had existed in the region, protectionism was feeble. This instant global integration opened the access to international capital markets and related services. All these spin-offs of the early development of stock markets are likely to play a greater role in the future.

PRIVATIZATION OF LAND, REAL ESTATE, AND HOUSING

The ownership of land, real estate, and housing differed greatly in various countries for arcane historical reasons. The German Democratic Republic had the most private real estate, possibly followed by the Russian countryside, while Czech and Slovak houses were thoroughly socialized (Åslund 1985). Nor was their privatization much related to other reform policies. Since these privatizations were so peculiar, we shall discuss them just briefly.

Real estate falls into three major categories: agricultural land, commercial real estate, and housing. The efficacy of their privatization depended on the existence of a legitimate form of privatization, and only two forms of privatization were widely perceived as legitimate. The first one was restitution, which was exercised widely in the whole of East-Central Europe, especially for collective farmland, accounting for about three quarters of all farmland in East Germany, Czechoslovakia, Hungary, Bulgaria, Romania, and the Baltics (Swinnen 1999). Usually, old land titles remained on the books and could be fully restored. A great deal of land and housing soon found legitimate owners, which improved the reputation of restitution among economists. In Czechoslovakia, agricultural land was never formally socialized, when it was taken over by collective farms, and it could be returned with relative ease. In 1990, Romania undertook a swift spontaneous land reform, allowing peasants to take their old land. Bulgaria went through an agricultural decollectivization aiming at the restitution to prewar owners, but it got stuck halfway in a change of government (Wyzan 1993).

The other form of legitimate privatization was the transfer of ownership to occupants, whether of agricultural land or housing. The bravest example was Albania, which undertook a precipitous, spontaneous land reform in a couple of months in 1991, permitting peasants to take a certain area of land for themselves (Åslund and Sjöberg 1992). First, the peasants just sat on the land, indulging in subsistence agriculture, but after a few months Albania's agriculture started growing fast and the growth has kept up. In the CIS, residents possessed such strong quasi-property rights to their apartments that they claimed them for free, which was widely accepted and the transfer of titles went well. Enterprises were usually privatized without land, but many were allowed to buy the land under the enterprises cheaply throughout the region. For the rest, it was extremely difficult to privatize land, real estate, and housing. Even the auctioning of unused land tended to be so controversial that it failed, as many claimed some rights to the land.

The most difficult of all privatizations was probably that of commercial real estate. Since communism had not recognized property, it had neither been properly delineated nor registered. The property rights of real estate were often divided among several state organizations in an unwieldy fashion. One enterprise might formally own a property, while another used it and saw itself as the real owner. The municipality might be entitled to rent, while another local body was entitled to receipts of a sale, and several others had to approve of a decision to change the status of the property, demanding compensation for their agreement. The legal status of various financial claims was unclear, as the socialist states had often written off claims and debts. Responsibility for environmental damage had not even been an issue. The fragmentation of property rights meant that a simple lease of a commercial unit could require permission by as many as seven agencies. Before anything could be privatized, reasonably full property rights had to be established (World Bank 1996a; Harding 1995).

NEW ENTERPRISE DEVELOPMENT

Marxism-Leninism had cherished the idea of the whole country as one big company, and gigantomania had been a hallmark of communism, especially in the Soviet Union and Romania. This idea was popularly embraced. Many Soviet citizens could not imagine that small enterprises could grow big or that small enterprises could be relevant for economic growth. Therefore, few saw any point in facilitating entry for new enterprises even after the end of communism.

However, a few countries differed. The main exception was Poland, whose agriculture had largely remained private. Poland and Hungary had accepted a revival of small, urban enterprises of many kinds from 1956. By the early 1980s, these two countries already had a prominent class of wealthy private businessmen, who had started as individual entrepreneurs. As a consequence, Poles and Hungarians realized the economic significance of small entrepreneurs, and the importance of providing them with a reasonable enterprise environment (Åslund 1985).

To the Balts, small entrepreneurs represented the normality of the interwar period, when they had enjoyed independence. They cherished a petty bourgeois ideal of peasants, craftsmen, and shopkeepers. These countries lived for E. F. Schumacher's slogan "Small is beautiful." After independence, they did whatever they could to revive their old beautiful world of smallness.

As communism ended, two very different perspectives on small entrepreneurship took hold. While both were overtly positive on small enterprises, one emphasized economic freedom, but the other underscored the need for financial support from the state. The main herald of economic freedom was Leszek Balcerowicz, who granted small entrepreneurs the freedom to do virtually anything without government permission.

The other view, which dominated in the CIS countries, was permeated with paternalist thinking of the command economy, arguing that small enterprises could not manage without support of the state though subsidies, subsidized credits, and tax exemptions. Everything was wrong with this approach. The fundamental problem was that state officials argued that small entrepreneurs could not do anything without "help" from bureaucrats, who would request personal "commissions." State committees and funds for the support of small business were set up in several countries, but they tended to allocate the small financial resources the state gave them to people close to themselves and not necessarily to small enterprises. These institutions were breeding grounds for corruption. The same was true of discretionary tax exemptions, which were paid for. Rather than stimulating private enterprise with economic freedom and a level playing field, these governments suffocated them with regulation and extortion under the pretext that they needed financial support. Even so, during the first two years of chaotic transition, the number of legally registered private enterprises mushroomed in Russia, but then the bureaucrats came back with a vengeance, and they had never retreated much in the CIS countries (Åslund 1997b).

In early inquiries, entrepreneurs assured that most important for their development was a decent tax system, freedom from bureaucratic interference, free foreign and domestic trade, and access to a market for premises (Johnson 1994). Initially, small entrepreneurs did not receive much bank or state financing in any country, having to make do with private savings and retained earnings. For a couple of years after the collapse of communism, bureaucrats were too frightened to interfere or even tax, allowing hundreds of thousands of new enterprises to shoot up in the first transition countries. In the most liberal countries, however, the norms of economic freedom had taken hold and keep the bureaucrats to some standards.

One of the most comprehensive surveys of new firms was undertaken by Simon Johnson, John McMillan, and Christopher Woodruff (2000) in Poland, Slovakia, Romania, Russia, and Ukraine in 1997. They found Poland and Romania far advanced, with Slovakia slightly behind, while Russia and Ukraine were backward. The profits of an entrepreneur depended primarily on the efficiency of the resolution of commercial disputes and secondly on the unofficial and official taxes actually paid. Contrary to the perception of lawlessness, courts were widely used by businessmen in all these countries, and they worked, but much less efficiently in Russia and Ukraine. Total official taxes paid were substantial, varying as a share of sales from 16 percent to 17 percent in Central Europe to 24 percent in Russia and Ukraine. In addition, in the latter countries entrepreneurs paid 6–7 percent of their sales in unofficial payments to government officials, to compare with 4 percent in Poland and Slovakia. Thus, the higher the taxes were, the higher the bribes extorted. A lack of formal bank finance was no binding constraint on private sector growth. In accordance with pronounced policy, bank loans and finance from state enterprises were more important sources of initial capital for new firms in Ukraine and Russia, while new firms grew faster in Romania and Poland. Firms were more stimulated by a developed wholesale trade. As all relevant conditions remained worse in Russia and Ukraine, there was no sign of them catching up with Central Europe.

When communism ended, people throughout the region suddenly realized that it was possible to build up good and mighty companies from nothing in a very short time. By 1995, Simon Johnson, Daniel Kaufmann, and Andrei Shleifer (1997b) estimated that 33 percent of GDP in the region arose in start-ups. This share ranged from half of GDP in Poland, Estonia, and Latvia to 10 percent of GDP in Belarus (see Table 7.3). The average varied from 41 percent of GDP in East-Central Europe to 23 percent in the CIS countries. Naturally, the size of the legal private sector as well as the small enterprise sector was inversely related to the underground economy, which was caused by excessive regulation and taxation (Johnson et al. 1997b; Lackó 2000).

Virtually every enterprise survey anywhere verified that start-ups were most efficient in every regard. The best early explanation was provided by Simon Johnson and Gary Loveman (1995). Since everything socialist enterprises had done was wrong from a market economic

Table 7.3. De Novo Share of GDP, 1995

	De Novo Share (Percentage of GDP)
Central Europe	*38*
Poland	50
Czech Republic	30
Slovakia	25
Hungary	45
South-East Europe	*38*
Romania	35
Bulgaria	40
Baltics	*47*
Estonia	50
Latvia	50
Lithuania	40
CIS	*23*
Russia	20
Belarus	10
Ukraine	30
Moldova	20
Armenia	35
Azerbaijan	25
Georgia	25
Kazakhstan	20
Kyrgyzstan	35
Tajikistan	15
Turkmenistan	15
Uzbekistan	30

Source: Havrylyshyn and McGettigan (1999, p. 9).

standpoint, as discussed in Chapter 1, it was so difficult to transform them that it was better to start anew. Firms needed to produce better products; develop marketing that had been rudimentary and reach out to new markets; establish proper accounting, with cost controls and adjustment to a different cost structure; dishoard excessive supplies of inputs and labor; change suppliers of inputs and often equipment. At the same time, they needed to stop the piecemeal theft that was institutionalized at state enterprises and introduce a mentality of honesty and service-mindedness.

In short, most organizations needed total change, but, then, new organizations were likely to do a better job, which explains the success of the start-ups. As much of the socialist production value detracting, much of the socialist organizational capital was negative (Dąbrowski, Gomułka, and Rostowski 2000).

ENTERPRISE PERFORMANCE

Apart from exchange rate policy, few aspects of transition have undergone so many reevaluations as the performance of various kinds of enterprises. Enterprise restructuring has often been seen as directly dependent on ownership, but most empirical studies now suggest that a competitive environment and the hardness of the budget constraints are more important. Demand at home or abroad is a precondition of recovery and development, but many industries have enjoyed ample demand for years without responding with any supply. The significance of these factors varies over time, as enterprise restructuring evolves, spurring these contrasting evaluations.

At a first stage of enterprise restructuring, managers can be replaced. A second stage involves defensive restructuring, essentially cost cutting. A third stage comprises offensive restructuring, with the expansion of sales, profits, exports, and employment as well as the introduction of new products and new investments. A fourth stage might arise when substantial equity capital is raised through the stock market. At each stage, various factors influence performance of enterprises, and ownership is only one of these factors.

Change of Managers Enabled by Privatization

From 1988, it was all but impossible to oust a Soviet enterprise manager. Managers dug in their heels during the demise of communism in Central and South-East Europe, too, though Polish workers' councils often dismissed managers. Therefore, the first goal of privatization was to facilitate managerial turnover.

The problem was that managers had never had it so good, enjoying more freedom, power, and money than ever before or later. Under the old regime, industrial ministries and the Communist Party had monitored them closely, sometimes sending managers to prison. In the capitalist future, shareholders would demand both information and yields from them. In the early transition, however, managers enjoyed quasiproperty rights over "their" enterprises without accountability. They could take what they wanted from state enterprises, without paying taxes.

Even if a manager seized full ownership of the enterprise, he would suffer a fall in income. His large transition rents would disappear, and both he and his enterprise would have to pay taxes. Therefore, managers could not be tempted into capitalism. Instead, they had to be convinced that their transitional paradise would come to an end very soon, rendering liberalization and stabilization shocks vital for enterprise restructuring. Similarly, managers had to be convinced that privatization was inevitable. If given the choice, as in Ukraine, managers remained passive, but when convinced that privatization was unavoidable, managers' incentives changed. They no longer resisted privatization but figured how they could get the most ownership. If they opted for ownership control, they had an interest in the amelioration of the enterprise, and if they wanted to hold on to their jobs, they had an interest in proving themselves through early restructuring. Yet, if they were convinced that they would lose out, they could as well steal as much as they could.

Privatization proved a potent threat to managers. Wherever privatization took place, a rather normal turnover of managers started, even when insider privatization dominated. Joseph Blasi et al. (1997, p. 203) recorded that the manager changed in 33 percent of the privatized Russian enterprises they surveyed from 1992 to 1996. The threat of hostile takeovers had appeared, and in Russia they became common.

By 1999, managerial turnover had caught up and reached about 10 percent a year in both state-owned and privatized enterprises in the whole region, but with low turnover in state-owned firms in Belarus and Ukraine, where privatization had been limited. Privatization restored some order in property management, and the state imitated private owners, recovering its proprietary power to dismiss managers soon after privatization, and managerial changes were actually greater in state enterprises than in privatized enterprises in East-Central Europe in 1999 (EBRD 1999, p. 139; Mau 1999).

Defensive Restructuring Thanks to Hard Budget Constraints

The second task of enterprises in transition was defensive restructuring aimed at enhancing efficiency by cutting the large unjustified costs of labor, inputs, investment, and unrelated activities. Liberalization gave managers a freedom of choice, and their incentives changed when money became scarce. The hardness of budget constraints is difficult to measure as it depended on many factors – the volume of subsidies, state bank loans, tax exemptions, tax arrears, other nonpayments, and barter, as well as government discretion.[11]

[11] One minor element, such as tax arrears, is not an overall indicator of the hardness of budget constraints, as the EBRD (1999, p. 138) has presumed. Typically, one factor after another is tightened, and not all equally.

Yet, whenever a hard budget constraint was imposed, it was apparent. The initial observation of defensive restructuring was made in Poland, and surprisingly all kinds of enterprises, including state enterprises, undertook substantial restructuring (Pinto et al. 1993). Grosfeld and Roland (1995) found that 600 large state enterprises in Poland, the Czech Republic, and Hungary shed some 30 percent of their work force in the first two years of transition. To dismiss workers and reduce stocks of inputs were the easiest forms of cost cutting. In Central Europe, this restructuring paralleled macroeconomic stabilization.

Managers were more reluctant to part with physical capital, and only a serious threat of bankruptcy persuaded them to do so. Thus, this occurred in Poland, Hungary, and Estonia, where the assets released on the market contributed to the generation of the many new start-ups in these countries. However, this process was much slower in the Czech Republic and Slovakia, and in most countries in the CIS the famed asset stripping did not take place. As Marek Dąbrowski, Stanisław Gomułka, and Jacek Rostowski (2000) notice: "It was the Russian treasury which was directly asset stripped, not the manufacturing firms. . . ." Ownership was not very important for defensive restructuring (EBRD 1999, p. 134), though one study of Russian enterprise restructuring concluded that breakups and mergers were more common among privatized than state-owned firms (Earle and Estrin 1997).

Before stabilization, little happened, as money remained abundant during hyperinflation, and many enterprises in the CIS continued to hoard workers and inputs in the hyperinflationary years 1992 and 1993. With stabilization, cost cutting started, but it was less impressive than in the early reform countries. One impediment was that liberalization was more limited in these latecomers to reform. Moreover, macroeconomic stabilization did not suffice to impose hard budget constraints in the CIS, as many sources of soft budget constraints persisted, such as large state subsidies, indirect subsidies through barter and nonpayments, and their free negotiation, especially with regional authorities (Commander and Mumssen 1998).

Ownership Mattered for Offensive Restructuring

Offensive restructuring was a much more complex undertaking. It required the development of an expansionary business strategy, with new products, innovations, expanded sales and exports, new investment, and more staff, leading to greater profitability. This was worlds apart from mere cost cutting, and in the West a new manager is usually desired for this stage. Now, greater differences between various kinds of enterprises emerged, and ownership was one critical factor, but there were several others.

One would expect private enterprises to be more innovative than state enterprises, but the differences in the development of new products are limited throughout the region, though the state sector is the worst. Yet, state enterprises in Russia and Ukraine are actually doing as well as privatized enterprises in Central Europe and the Baltics (EBRD 1999, p. 134). Presumably, resource endowment is the explanation. The high-tech military-industrial complex in Russia and Ukraine remained state owned, and what can underemployed researchers do but invent new products? An innovation is not necessarily commercially viable. Start-ups, on the contrary, were initially busy exploiting the most obvious shortfalls in the market, requiring little research and development. Therefore, the development of new products is no strong indicator of commercial adaptation in the early transition.

The expansion of sales seems a more relevant indicator, and in this regard start-ups are doing far better than both state enterprises and privatized firms everywhere apart from in the not very reformist Central Asia and the Caucasus, where state enterprises do equally well. Privatized companies are expanding sales much faster than state firms in Central Europe and the Baltics, though actually slower than state enterprises in the rest of the region. A number of studies suggest the cause is a negative selection of enterprises for privatization. The most profitable corporations, exporting commodities such as oil, gas, metals, and chemicals, tend to be privatized late, while these exports are the first to surge. Undercapitalized light industry and the food-processing industry, on the contrary, are typically privatized early (EBRD, 1999, pp. 133).

A change of channels of supply and sales probably tells us more about entrepreneurial activity and the break-up of old crony networks. New entrants and privatized enterprises change suppliers approximately as often in the whole region, while state enterprises are more conservative (EBRD 1999, p. 134). Earle and Estrin (1997) found a greater tendency for privatized companies in Russia to change sales channels.

The expansion of employment seems one of the best and most easily verifiable indicators. The order is clear and as expected throughout the region. Start-ups are most expansive, followed by privatized firms, while state enterprises come last. The differences are significant (EBRD 1999, p. 134). Frydman et al. (1997) concluded that private companies expanded employment in comparison with state enterprises, because of their superior capability of generating revenues.

The essence of successful performance is higher profitability, but here all problems of statistics, reliability, validity, and comparison concur, and few have dared to investigate profitability. Increased employment could be seen as a proxy but only a very imperfect one. A number of studies, which have controlled for the selection bias of privatized enterprises, come to the overall conclusion that they outperform state-owned enterprises (Claessens and Djankov 1997; Grosfeld and Nivet 1997; Frydman et al. 1998b).

The performance of enterprises by ownership varies considerably with time and country, but there are clear patterns in East-Central Europe. In general, start-ups do better than all other enterprises, and foreign-owned companies have performed well after some initial problems, while privatized enterprises do not always achieve more than state-owned enterprises. One study of Central Europe concludes that "privatization is effective in enhancing revenue and productivity performance of firms that come to be controlled by outsider-owners, but produces no significant effect in firms controlled by insiders" (Frydman et al. 1998b). The authors found that politicization of decision making explained inefficiencies in the cost behavior of state enterprises, but it did not explain their inferior revenue performance, which seemed to depend on differing attitudes to risk and varying degrees of accountability between state and private managers (Frydman et al. 1998a).

The evidence from CIS countries is still scattered, but the advantage of privatization for enterprise performance seems to be limited at best for a long time. Devastatingly, in Ukraine Estrin and Rosevear (1999) could not find any evidence that private ownership or any particular dominant private owner was associated with improved enterprise performance, while insider owners did more restructuring than outsider owners. In other cases, insider ownership resulted in unclear ownership and no responsibility. However, with the start of growth in Ukraine in early 2000, thoroughly privatized industries showed the highest growth. One of the latest and biggest studies of Russian industrial enterprises finds that nonstate firms outperform state enterprises, even after controlling for selection bias in privatization (Brown and Earle 2000). The explanation appears to be that strictly regulated privatized enterprises cannot undertake much positive restructuring, and even if they succeeded in doing so, their profitability might not rise under arbitrary and confiscatory taxation, as has long been the case in Russia and Ukraine. Then, the problem is not privatization, but the dearth of other structural reforms.

Insider-owned enterprises suffer from serious theoretical drawbacks, having natural incentives to boost wages and maintain excessive employment, which should result in as little restructuring as in state enterprises (Aghion et al. 1994). A practical handicap was that individual ownership was not always clarified, since the manager could keep the stocks locked up or refuse to register sales of stocks to outsiders, effectively capturing the firm in many CIS countries. This hampered corporate governance, sales of stocks to outsiders, and naturally takeovers by outsiders. Some managers seized assets to sell them at a profit later, not realizing that they could turn obsolete and lose value, while others just lost their way but refused to leave (EBRD 1997, p. 91).

The surprise is that over time insider-owned enterprises have clearly done better than state-owned enterprises, though worse than those subject to outsider privatization, including mass privatization (EBRD 1999). Frydman et al. (1997) found in Central Europe that manager-owned enterprises earned more revenue than employee-owned enterprises. In the CIS countries, however, insider-privatized enterprises have done better than outsider-owned firms. Earle and Estrin (1997) noticed that Russian enterprises that had been privatized to managers were doing more restructuring than outsider-owned companies. Similarly, a study of Moldova and Georgia noticed that firms privatized to managers and employees were more dynamic than voucher-privatized and state-owned enterprises, which barely differed (Djankov 1999b).

In comparison with theory, this appears amazing, but if we consider who the outsiders were and how they had obtained their assets, the surprise fades. In Russia, many of the best assets had been snapped up by people in power, or close to those in power, in discretionary sales of several thousand companies for cash, proliferating in 1995 and 1996 after the voucher privatization. These sales were neither competitive nor transparent, unlike the voucher privatization, and they reaped little revenue. They raised serious concerns about equity, concentration of market power, and corporate governance (Broadman 1998). Similar direct sales occurred throughout the CIS area. Sometimes these new owners did not know what to do with the assets, seeing their purchase as a temporary speculative act, rendering themselves absentee landlords.

Accordingly, Earle and Estrin (1996) found the ties between outsider-owned enterprises and the state as strong as those of state-owned enterprises. The irony is that the large-scale cash privatization, succeeding voucher and insider privatization throughout most of the CIS countries, was not much noticed because of its lack of transparency, although it was the most unjust and uneconomical privatization. Instead, people tended to blame voucher privatization, since its transparency had made its comparatively minor flaws visible. Unfortunately, this confusion has taken hold in the Western discussion.[12]

[12] Joseph Stiglitz (1999a) takes the prize for ignorance in his criticism of the Russian privatization. He advocates stakeholder privatization, plainly unaware that this was both the official ideology of the Russian privatization and the actual result (Boycko et al.

To date, empirical studies have focused on the importance of ownership, but our general knowledge suggests that the competition enterprises face is decisive for their development (Porter 1990). David Brown and John Earle (2000) have found in Russia that import competition has an immediate impact on enterprise performance, while domestic product market competition shows positive effects with a lag of four years. Also competition on the local labor market makes a difference, while private ownership is another positive factor. In the future, the degree of competition will probably be better measured and show its impact as elsewhere in the world.

However, ownership matters also in this regard, because there is much less competition among state firms. Nearly 30 percent of the state-owned enterprises in the region face no competitor, while that is true of only 5 percent of the new entrants and 9 percent of the privatized enterprises (EBRD 1999, pp. 135–6). The selection of enterprises for privatization is biased, but state-owned monopolies have proven very difficult to break up, while few private monopolies persist. The predominant idea is that monopolies should not be privatized but first broken up by the state (World Bank 1994b). Though large state energy and transportation companies have not been privatized, most post-Soviet states have lacked the political prowess to break them up, which perpetuates their harm to economic welfare (see Chapter 5). A common view is that "a public firm is easier to monitor than a private one" (Rose-Ackerman 1999, p. 43), but that is hardly true of large post-Soviet state companies. Private monopolies are much more vulnerable. For instance, the Latvian telecommunications company was privatized with a certain period of monopoly, which the government is now trying to reduce, showing how political forces have turned against the monopoly after its privatization. Therefore, if it appears impossible to break up state monopolies, it might be better to privatize them however politically possible. Eventually, hard budget constraints and bankruptcy will sort out mismanaged privatized firms, while mismanaged state monopolies might persist forever.

Sources of Enterprise Finance

A prime objective of privatization was to terminate enterprise subsidies. Opponents of fast privatization have argued that "soft budget constraints and rent-seeking are not unique to [state-owned enterprises]. Private firms also lobby to get subsidies and to seek rents" (Roland 2000, p. 7). While this is true, EBRD (1999, p. 137) found that subsidies are highly

1995; Blasi et al. 1997), which has not stopped him from condemning privatization in Russia at length.

concentrated to state-owned enterprises throughout the region. State enterprises received 26 percent of all financing for fixed investment from the state, compared with only 3 percent in privatized enterprises, while start-ups received virtually no subsidies. Even in progressive Central Europe and the Baltics, state enterprises obtained one-fifth of their investment financing from the state, showing that even good structural reforms without privatization were not enough to terminate these subsidies. Hence, privatization has made a major contribution to the hardening of budget constraints.

An extensive literature on banking in transition has favored banks as sources of enterprise finance and as key players in corporate governance, inspired by German and Japanese banks (Aoki and Kim 1995), but the banks were miserable, and the blind are not very suitable to lead the blind. The underlying thinking confused equity with credit. Both Soviet traditionalists and Western experts reckoned investment capital was needed for the restructuring, and they wanted banks to provide that, but such investment would have required risk capital, which should preferably take the form of equity and not be provided by banks, which should act conservatively and all the more so in the unstable postcommunist environment. In reality, bank finance has been insignificant, because the banks were so dysfunctional. The EBRD (1999, p. 137) found that bank loans provided only 8 percent of all financing for fixed investment. Worse, bank lending has been misallocated, concentrated on the state dinosaurs, though recently it has been reoriented to privatized enterprises and even new entrants, which still suffer from discrimination. Nor do banks monitor corporations effectively. Pohl et al. (1997) concluded that policies of increasing bank lending to firms or forgiving debts may do more harm than good.

Amazingly, equity has already become almost as important for the financing of fixed investment as banks in Central Europe and the Baltics, which hardly anybody had expected, and it is expanding faster than bank lending. This would suggest that the postcommunist region is developing toward the Anglo-American model, where equity markets supply most enterprise capital, and not toward the German bank-dominated model, but it is still early to tell.

As one would expect in an economy characterized by market failures, retained earnings are the dominant source of financing for new and growing enterprises because of high risks, poor information systems, moral hazard, and insufficient regulation and supervision, which Ronald McKinnon in particular had foreseen (McKinnon 1991b; Pleskovic 1994). Retained earnings provide half the funding for fixed investment in Central Europe and the Baltics and about two-thirds in the rest of the region (EBRD 1999, p. 137). The best government policy would be to minimize or preferably abolish the profit tax so that the profitable can grow organically.

As a consequence, external finance for enterprises has been much less of a need than commonly perceived. The main initial problem of the enterprise sector was the absence of a hard budget constraint, which was best achieved by a dearth of external financing for a few years. Then, enterprises were forced to undertake defensive restructuring, sell off their excessive stocks of inputs, diminish their overstaffing, sell unused equipment and machinery, lease out superfluous premises, and so on, which they were so reluctant to do. No outsider could impose effective corporate governance early on, and then no outsider should be willing to provide financing either.

Many Surprises

The performance of various types of enterprises has repeatedly upset the conventional wisdom. The first surprise was that small start-ups outperformed all other enterprises.

The second revelation was that even the dinosaurs, the large old state enterprises, could undertake defensive restructuring, as cost cutting depended primarily on hard budget constraints and not on ownership.

Third, voucher privatization to outsiders has disappointed by not leading to very effective ownership so far, as corporate governance has remained weak, and it has taken time for stock markets to evolve.

Fourth, a considerable surprise has been that insider privatization, particularly by managers, has turned out to be more effective than outsider privatization in several CIS countries.

At the end of the decade and the millennium, however, the pattern is approximately as expected. Start-ups and foreign-owned enterprises are the star performers. Most privatized enterprises comprise a second group, while state-owned enterprises and privatized enterprises without effective owners and competitive environment perform the worst.

An important conclusion is that the old organizational capital of state enterprises was largely harmful and was best liquidated. The physical capital, on the contrary, was better than many had thought, and the human capital was excellent but underutilized (Dąbrowski, Gomułka, and Rostowski 2000; McKinsey 1999).

EXTENT AND SUCCESS OF PRIVATIZATION

Privatization was supposed to change not only the economy but the whole society. Therefore, it must not be judged merely by the degree of enterprise restructuring, but it must also be related to democracy, other structural reforms, and market structure.

Rapid Expansion of the Private Sector

Statistics on privatization and private property are notoriously bad. In communist times, only Poland, Hungary, and the German Democratic Republic had statistics showing the private sector as a separate statistical category, and few postcommunist countries have introduced such statistics. Most countries offer only partial statistics on how many enterprises of different categories have been privatized, but the number of enterprises has multiplied through partition. The only available statistics on the relative contribution of private enterprise to GDP for the whole region are loose estimates produced by the EBRD (1994, 1995, 1996, 1997, 1998, 1999, 2000a), which appear plausible.

At the end of communism, private enterprise was marginal. The only important exceptions were Poland, whose predominantly private agriculture and small urban enterprises contributed almost 30 percent of GDP, and Hungary with 18 percent of GDP coming from the legal private sector in 1989. Other countries had marginal legal private activities, such as household plots, handicrafts, and market trading, amounting to about 10 percent of GDP (Havrylyshyn and McGettigan 1999).

The world has never seen such an enormous privatization as in the former communist countries in the 1990s. John Nellis (1998) assessed that about 6,800 medium-size and large enterprises were privatized in nontransition countries from 1980 to 1991, while some 60,000 such companies had been privatized in transition countries from 1990 to 1998, and the process continues. Since hardly anything was privatized anywhere before 1980, the former communist countries have privatized ten times as much in a decade as the rest of the world throughout its history. The contribution of the private sector to GDP of the region has surged from some 10 percent in 1989 to about 60 percent in 2000. As a whole, the region is close to the standards of the most socialized countries in Western Europe. This is an incredible achievement.

As early as 1994, private enterprise accounted for half or more of GDP in seven countries – Central Europe, Estonia, Lithuania, and Russia (see Table 7.2). By 2000, fifteen countries had achieved a private share in GDP of at least 60 percent, adding Romania, Bulgaria, Latvia, Ukraine, Armenia, Georgia, Kazakhstan, and Kyrgyzstan to the seven pioneers. They were exactly the countries we would have expected with regard to other reforms. The only discrepancy is that Russia did better in privatization. The nonreformers Belarus and Turkmenistan, had marginal private sectors of 20–25 percent of GDP, and the rest 40–50 percent of GDP.

Thus, all countries have privatized about as fast and as much as they have liberalized and stabilized, with the single exception of Russia, whose early privatization has become a common explanation of everything that has gone wrong in the Russian economy (Goldman 1996; Stiglitz 1999a), but it appears more problematic that Russia did so few other reforms.

The course of privatization indicates an important path dependence. If a country did not privatize substantially in the early transition period, it was difficult to do so later on, as vested interests mobilized in opposition.

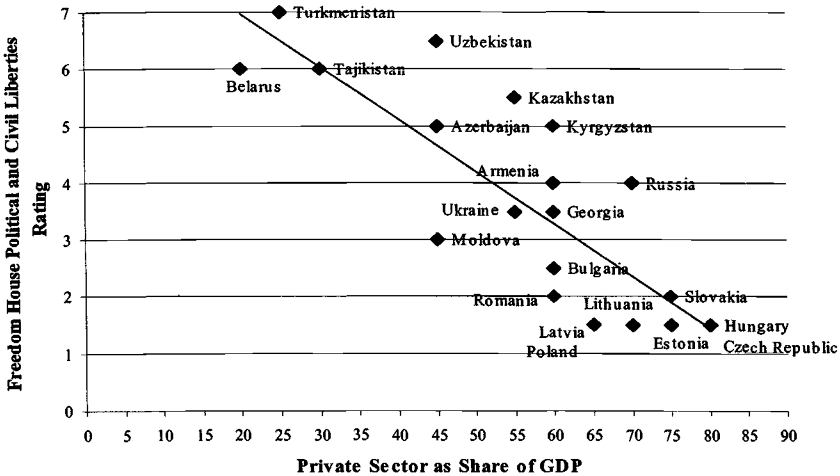
We can distinguish two suboptimal equilibria. One is represented by Belarus and Turkmenistan, which started off with a minimum of privatization and have never managed to do more. The other is best represented by Moldova, which has undertaken more privatization but has found it extremely difficult to proceed. Late privatizations in countries with little prior privatization have also resulted in a poorer quality of privatization. Countries that privatized a lot early on, on the contrary, proceed, albeit more slowly, with rising quality of privatization where other reforms have succeeded in parallel. Renationalization has not proven a serious threat for fast privatizers, while private enterprises are being squeezed out in Belarus and Uzbekistan.

Privatization, Democracy, and Structural Reform

The greatest political aim of privatization was to break up the socialist state hegemony and facilitate democracy, and the correlation between democracy and privatization is strong. Democracy is completely subdued in the countries with the least privatization, while all countries with a private sector of less than 60 percent of GDP in 1999 are considered unfree or partly free by Freedom House (1999). Those in the interval 60–70 percent are either partly free or free, and the four countries with a private sector contributing more than 70 percent of GDP are all free (1-free and 7-unfree; see Chart 7.1).

The logic is evident. A state that is hegemonic through ownership, like Belarus and Turkmenistan, leaves little room for democracy. Belarus's experience is especially illuminating. That country was reasonably democratic from 1992 to 1995, but the power of the democratically elected populist President Alexander Lukashenko was so great, partly because of the paucity of the private sector, that he could easily abolish democracy in 1996. President Lukashenko and President Saparmurat Niyazov in Turkmenistan each clearly realize that privatization would undermine their dictatorial powers so they have stalled it. Semiprivatized countries, such as Moldova, are semidemocratic, while the leaders in privatization, as well as in structural reform, in Central Europe and the Baltics are fully democratic.

Chart 7.1 Democracy and Privatization, 1997.



Sources: EBRD (2000a); Karatnycky et al. (1997).

Is privatization so important that it would be worthwhile at any price, if democracy is in danger? We may look at the most controversial of all postcommunist privatizations from this perspective, the so-called loans-for-shares privatization of fifteen large Russian enterprises at the end of 1995. After the completion of the Russian voucher privatization in 1994, cash privatization had been largely stopped for over a year. First Deputy Prime Minister Anatoly Chubais faced the Scylla of communist state enterprise managers and the Charybdis of new crooked businessmen. Perceiving the communist threat as the greater evil before the presidential elections with a strong communist contender in June 1996, Chubais (1999) opted for selling packages of stocks of fifteen major companies cheaply to major new Russian businessmen in closed auctions, and these businessmen provided most of the financing for President Yeltsin's successful election campaign.

Probably, no privatization has been as criticized as the loans-for-shares privatization (notably Freeland 2000). While it was indeed an unsatisfactory discretionary privatization, the criticism seems heavily overdone. The outcry was caused by the involvement of noble privatizer Chubais, who was seen as committing the original sin, and a contentious presidential election campaign that was under way. Yet, the negative attention was magnified by these deals being so few that people could recount the details and by their transparency making all the details publicly available. Marxist resource fetishism prevailed, envisioning raw materials as the true value. Moreover, the oligarchs who benefited represented a real change of management, and initially they were neither successful nor honest at their new enterprises, indulging in malfeasance in corporate governance, such as transfer pricing.

Yet, these privatizations must be seen in perspective. While a total of fifteen companies were involved, only four were truly valuable and changed control, three oil companies (Yukos, Sibneft, and Sidanko) and one metal producing company (Norilsk Nickel). Each was worth a couple of billion dollars on the vacillating stock market, with a current total value of around $10 billion. While this was substantial, the insider privatizations of Gazprom, Lukoil, and Surgut were much larger dubious deals, and the sum is tiny in comparison with the U.S. stock market. Most new owners paid actual money, which was rarely the case in insider privatizations. These deals gave the buyers real property rights, altering management. Whereas the situation looked bad in 1997 and 1998, at least Yukos and Sibneft had restructured on a competitive market by 2000. They invest massively in production in Russia, and they were highly active in mergers and acquisitions, paying ample dividends with Yukos as the comet on the Russian stock market in 2000. Since they had been singled out for outsider privatization because they were particularly badly managed, this appears a laudable result in merely four years.

The oligarchs were rich and powerful before these privatizations, in which only a few of them were involved. Therefore, it is plainly wrong to argue that loans for shares created the oligarchs. On the contrary, the enhanced property rights of the oligarchs increased their security and thus hardened the competition among them, which quite swiftly led to their weakening.

Politically, the oligarchs engaged actively in the presidential campaign against the communist candidate, because they wanted to safeguard their newly won private property. The political effects on privatization are ambiguous. While the loans-for-shares set a bad example for later privatizations, they aroused a healthy opposition against discretionary deals. Considering that the real political alternative was not privatization at all and that many privatizations occurred that were both dirtier and bigger, the outrage over the loans-for-shares seems overdone.

In Ukraine and Kazakhstan, on the contrary, "oligarchs" relied on state enterprises and fiat to a greater extent and indulged in court intrigues rather than open competition. The medium-term growth underperformance of Bulgaria, Russia, Ukraine, Kazakhstan, and Moldova can be explained by the strong oligarchic structures in these countries, state capture, or excessive rent seeking. My suggestion is that privatization can help break this vicious circle, while state ownership may perpetuate it. Ukraine's return to growth in 2000 was preceded by substantial dirty privatizations of large enterprises to oligarchs, which seemed to enhance competition and openness in Ukraine as well. The alternative argument is that privatization might perpetuate the power of the corrupt, which is partially true. Yet, openly owning big enterprises in Russia and Bulgaria gave the oligarchs a sense of security so that they entered open political competition, not least with one another. Their splits, which were founded in privatization, might have salvaged democracy in these countries. By contrast, democracy is much weaker in Kazakhstan and Ukraine, and even the most powerful businessmen are anxious not to criticize the ruler in public, fearing exile, while democracy is dead in Belarus and Turkmenistan. It is still early to say what the right choice was.

A common underlying assumption is that democracy will survive without privatization, but dictatorship, predominant state ownership, and a state-controlled economy are all closely related. Most major privatizations have been undertaken as big campaigns, because it is important to change the mindset of enterprise managers so that they perceive privatization as an inevitable fate. Otherwise, their opposition against privatization might be overwhelming. Thus, also in privatization there is a case for a radical break from the old system, though this might not have applied to Poland and Hungary, which had already accomplished a radical breakthrough with so many other successful reforms.

Those countries that have privatized most have also undertaken the most other structural reform, and the correlation between liberalization and privatization is extremely close, which is a natural outcome (Åslund et al. 1996). This was an intention of the privatizers: "It is precisely because of privatization, and the creation of groups with a vested interest in protecting their own property, that the Russian government began to take steps to create market-supporting institutions" (Shleifer and Vishny 1998, p. 10). More enterprises breed more competition; the emergence of start-ups is a direct effect of liberalization. We have also found that most monopolies are state-owned, and that private enterprises receive much less subsidies, and thus face harder budget constraints. Moreover, the emergence of a large private sector has made state enterprises manageable, though they are still less accountable than private enterprises.

Peter Murrell (1992b) suggested a direct trade-off between privatization and the development of a new private sector, seeing government capacity as a critical bottleneck that could be used either for privatization or the development of a market environment, facilitating the growth of start-ups. This has proven a false contradiction. On the contrary, there is a strong positive correlation between start-ups and privatization. The critical resource has not been government capacity but political support of the private sector as a whole, and government capacity appears to grow with privatization.

The Real Options and Constraints

A common technocratic view is that each polity has a free choice in its country's privatization, but the options of privatization have been severely constrained by initial claims on property, political power, legal and administrative capacity, prior privatization, and other reform policies. The harsher the prior dictatorship, the more dominant state ownership, and the worse both state and corporate governance have become. What works in one country might be detrimental or impossible in another. Evidently, the efficacy of corporate governance depends on the kind of privatization, but the feasible methods of privatization have been fewer than usually perceived for major enterprises.

Only three countries have successfully undertaken the qualitatively most advanced form of privatization, initial public offerings, on a significant scale, namely Poland, Estonia, and Hungary. Outside these three countries and the Czech Republic, direct sales have been exceedingly corrupt, and they have led to the worst enterprise performance in the CIS, causing the state incredible losses even in East Germany.

The predominant insider privatization in the CIS has actually led to better corporate governance and enterprise results than direct sales. As widely anticipated, voucher privatization has led to poor corporate governance, but more was privatized than otherwise possible in several difficult countries. Ukraine provides an illuminating example. For nationalist reasons, Ukraine did not want to follow the Russian example of voucher and insider privatization, but the prolonged debate over privatization aroused such acrimony that little privatization was executed until Ukraine implemented an essentially Russian scheme in 1996 (Yekhanurov 2000). The real choice CIS countries faced was minimal and very corrupt privatization or combined voucher and insider privatization.

Another popular view has been that the timing and pace of privatization do not matter, while the quality of privatization is important (Murrell and Wang 1993; Roland 1994, 2000). This idea presupposes the absence of positive complementarity between the volume of privatization and other structural reforms, which contradicts the evidence. It also presumes a strong state, which was only true of Hungary, Poland, and Estonia. In the CIS and South-East Europe, the choice has not been between a good late privatization and an early dirty privatization, but between an early privatization and no privatization.

Simplistic comparisons are often made between Poland and Russia, arguing that Poland was better off than Russia, because Poland privatized more slowly, but this argument does not hold. In fact, Poland and Russia privatized at a rather similar speed (see Table 7.2). In any comparison, one must control for preconditions and other relevant factors, and Poland undertook virtually all structural reforms earlier, faster, and more radically than Russia. This appears to be a more plausible reason for Poland's greater early success. Having undertaken so many radical reforms, Poland could afford to pursue large-scale privatization more leisurely, while the opposite was true of Russia. The present predominant private ownership spurs a demand for renewed structural reforms in Russia. The preoccupation with this two-country Polish–Russian monocausal comparison is an intellectual hazard of swaying away from a multicountry comparison and multicausal analysis.

It makes more sense to compare Russia with the two other Slavic former Soviet republics, Belarus and Ukraine, which all had very similar preconditions. Russia, with its mass privatization, has proceeded with structural reforms and remained reasonably democratic, while Belarus with a minimum of privatization has retarded into a dictatorship with a state-regulated economy. Ukraine, which privatized much more slowly than Russia but more than Belarus, falls slightly short of Russia on most accounts, which shows in its worse growth performance. We may go a step further and query whether a communist reversal would have occurred in Russia, if the disreputable loans-for-shares privatizations had not taken place at the end of 1995, which Chubais (1999) claims. Most would object to such a conclusion, but such a reversal was taking place at that time in Russia's western neighbor Belarus.

The Czech Republic may also deserve a different perspective. Today, the Czech voucher privatization is often ridiculed for causing poor corporate governance, while gradual sales to outsiders in Poland and Hungary are praised, but until late 1989 Czechoslovakia was a frightful communist dictatorship, with an unreformed command economy and complete state ownership. A small alternative elite won power through democratic elections and undertook truly radical reforms, but the Czech legal and administrative capacity was so limited that hardly anything but a voucher privatization could have succeeded.[13] The Czech corporate governance problems arising out of dispersed stock ownership and poorly regulated investment funds are evident, but Poland and Hungary's corporate governance was never within reach because of its less sophisticated prior corporate culture (Johnson 1994).

[13] I owe this thought to one of the Prague's most prominent investment bankers and a Czech minister in conversations with them in 1999.

Liberalization, stabilization, and privatization are all positively correlated both logically and empirically. Their relative impact has varied over time. Liberalization was necessary to create any freedom of choice, but enterprise restructuring only started when enterprises faced hard budget constraints, which required that stabilization had taken hold. A competitive environment encourages further restructuring, but private ownership and good corporate governance are required for strategic expansion.

8

Social Developments and Policy

The main aim of economic policy is to enhance economic welfare. Economic growth is vital, but it makes little sense if the fruits of labor are being wasted. Postcommunist economic transformation is often presented as a social catastrophe. However, this is not generally true and the social trauma is greatly exaggerated.[1]

In Chapter 4, we have dismissed as a myth the sharp decline in registered output that was apparent after communism. Although statistical real incomes plummeted even more than recorded output, there are reasons to believe that they diminished less if at all, while it is true that income differentiation and poverty have increased in many countries.

The most disturbing social development under transition is that life expectancy has fallen significantly in some countries, while the differences between countries are palpable. This has led to the belief that the region is experiencing a serious health crisis, but infant mortality has on the contrary fallen, and health budgets have increased, though systemic reform in health care has lagged.

Another common view is that the education system is collapsing, but the opposite is true. The whole region has seen an extraordinary expansion of higher education during transition. However, the growth is concentrated to undergraduate teaching and the education system faces serious structural problems.

One of the greatest surprises of transition has been very limited unemployment. Curiously both registered and real unemployment has increased slowly in countries with the largest decline in output, reflect-

[1] This chapter draws heavily on work carried out by the World Bank, particularly Milanovic (1998), a superb source with which I largely agree. The Carnegie Moscow Center has undertaken a social policy project, largely by my Carnegie colleagues Mikhail Dmitriev and Tatyana Maleva, which is also a major source (Åslund and Dmitriev 1996; Maleva 1998, Åslund 1997c). My preference is World Bank statistics.

ing tardy structural change. The main labor market problem has been too timid labor.

When the transition to capitalism was initiated, social suffering was anticipated. The natural response to such worries was to raise social expenditure. Contrary to popular perception, the share of social expenditures in GDP and total public expenditures has increased in most postcommunist countries. The most developed transition countries are encumbered by untenably large public expenditures, while social expenditures have contracted in those countries that have suffered the worst. However, social transfers have not been very social, as they often are not targeted on those in the greatest need but on privileged groups. A great need for social reforms has accumulated.

As a consequence of their disparate social policy developments, the countries in the region are evolving into two different worlds. The social system of Central Europe is becoming ever more West European. The CIS, on the contrary, has assumed Latin American features in its social indicators, inspiring more radical solutions than Central Europe. South-East Europe and the Baltics occupy intermediary positions.

INCOMES: DIFFERENTIATION AND POVERTY

From the outset, the common assumption was that postcommunist transformation would involve social trauma, as incomes would plunge with output. With transition to a market economy, the economic structure and relative values of professions would change, altering the income structure, and income differentials would probably rise. A contraction of average incomes and a widening of income differentiation would naturally aggravate poverty. While the direction of these changes was anticipated, the rising gap between countries in the region has been a surprise.

Questionable Decline in Incomes and Consumption

Recorded incomes of the population have declined considerably in most postcommunist countries in the course of the transition, but not in all, and not as much as has been widely stated. Even by the standards of postcommunist transition, incomes have been subject to extraordinary statistical confusion. The declines in incomes have been grossly overstated, but we cannot say for certain what has happened in most countries.

The contraction of incomes is exaggerated for the reasons that the fall in GDP has been amplified, as discussed in Chapter 4, but the statistical quandary has been even greater with regard to incomes. All statistics show that "real" incomes fell more than output, which is merely a reflection of the huge monetary overhang that boosted statistical incomes just before price liberalization, as communists in crisis gave people more money instead of goods or services. Much of the new and unofficial economies benefits consumers, unlike the old heavy industry, especially defense. In addition, as investment fell as a share of GDP, more money was left for private consumption. Hence, incomes must have contracted much less than GDP.

Traditionally, wages from their main state employer dominated the incomes of people in socialist countries. With the new market economy, private incomes ballooned and tax avoidance and tax evasion proliferated. Even officially, private incomes other than wages have increased by about one-tenth of GDP. Contrary to public perceptions, the share of social cash transfers has risen everywhere by 1–4 percent of GDP. In addition, the share of health and education to GDP has increased by 2–3 percent of GDP. Therefore, the relative public sector contribution to the standard of living has actually risen in the transition virtually everywhere.[2]

People seem to lie in household surveys to an extraordinary extent. World Bank household surveys in six East European countries showed that reported mean expenditures were 3 percent higher than reported average incomes in six countries in 1993–4, which seems implausibly little, while in five countries in the former Soviet Union in 1993 and 1995, surveys reported mean expenditures 58 percent higher than reported average incomes and 132 percent higher than incomes in Kyrgyzstan. Hence, household surveys hardly tell us much about reality, and they show even larger income declines than macroeconomic data, which is not credible (Milanovic 1998, pp. 33–5). The unfortunate conclusion is that we have little idea of what happened to incomes in the early transition.

This conundrum is further aggravated by the impossibility of comparing consumer standards with the prior communist economy, with its monetary overhang, massive shortages and queuing, forced substitution, poor choice, and poor quality. How much did people's welfare improve because of freedom of choice, better allocation of goods, and the disappearance of unsalable and substandard goods? Statisticians do not seem

[2] In an analysis of the composition of incomes in 14 postcommunist countries from 1987–8 to 1993–4, Branko Milanovic (1998, pp. 36–8) found that the share of labor income to GDP stayed constant in Central Europe, while it declined by 12 percentage points in the three East Slavic states. Instead, nonwage private sector income has risen greatly everywhere – by 9 percent of GDP in Central Europe, and 10 percent of GDP in the East Slavic states. These numbers have since risen, and they tend to be missed in national accounts.

to care much about these complicated issues, but then we cannot say anything about how living standards developed from communism to capitalism.

Consequently, few dare publish statistics on real incomes around the time of transition. A rare exception is Milanovic (1998, p. 34), who found that the initial declines in incomes ranged from 23 percent in Central Europe to 54 percent in the former Soviet Union from 1988 to 1993, judging from the household surveys (see Table 8.1). Clearly, real declines have been far less, and the factors mentioned above could easily compensate for more than the whole recorded decrease. Thus, we do not know whether average incomes actually diminished during transition, and this query appears methodologically indeterminate.

Consumption statistics are also partial and unreliable, bound to be understated, but slightly better than income statistics. Table 8.2 presents

Table 8.1. Change in Real per Capita GDP and Real per Capita Population Income (Percent)

	Real per Capita GDP	Real per Capita Income (Macro Data)	Real per Capita Income (HBS Data)
Central Europe	–18.5	–11.5	–23
Poland (1987–93)	–12	–11	–26
Czech Republic (1988–93)	–18	–7	–12
Slovakia (1988–93)	–29	–29	–29
Hungary (1987–93)	–15	+1	–26
South-East Europe	–26.5	..	–44
Romania (1989–94)	–26	–18	–43
Bulgaria (1989–93)	–27	..	–45
Baltics	–49	..	–41
Estonia (1988–94)	–37	..	–37
Latvia (1988–95)	–43	..	–45
Lithuania (1988–94)	–66	–44	–42
CIS	–37	–43.5	–54
Russia (1988–93)	–27	–33	–42
Belarus (1988–95)	–43	–30	–44
Ukraine (1988–95)	–49	–64	–62
Moldova (1988–93)	–66	–67	–67
Kazakhstan (1988–93)	–26	–57	–61
Kyrgyz Republic (1988–93)	–35	–58	–66
Turkmenistan (1988–93)	–31	–40	–46
Uzbekistan (1988–93)	–20	+1	–43

Source: Milanovic (1998, p. 34).

Table 8.2. Real Total Consumption Expenditure, 1989–1999 (Indices, 1989 = 100 or earliest year available thereafter)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Central Europe											
Poland	100.0	88.3	94.9	98.2	103.0	107.0	110.5	118.4	125.6	130.8	136.4
Czech Republic	100.0	104.9	85.5	88.4	90.2	94.5	97.2	103.0	104.6	102.3	103.2
Slovakia	100.0	103.3	76.9	75.6	74.2	71.5	73.9	82.4	86.5	91.1	89.2
Hungary	100.0	97.3	92.2	92.8	97.9	95.6	89.3	86.6	88.6	91.7	95.6
South-East Europe											
Romania	100.0	108.9	96.0	90.7	91.8	95.3	105.5	112.9	108.1	103.7	99.1
Bulgaria	100.0	100.6	92.3	89.4	86.2	82.3	80.7	75.3	64.0	68.8	72.0
Baltics											
Estonia	..	..	..	..	100.0	101.2	110.4	116.5	124.4	131.3	131.8
Latvia	..	100.0	76.7	49.2	46.5	47.4	47.0	50.8	52.7	56.0	55.5
Lithuania	..	..	..	..	..	..	100.0	108.2	116.4	125.4	120.2
CIS											
Russia	..	100.0	93.9	89.0	88.1	85.8	83.3	80.7	82.7	76.7	72.6
Belarus	..	100.0	93.4	84.0	82.1	72.1	65.3	67.4	73.8	81.2	84.6
Ukraine	..	100.0	94.3	88.6	72.0	65.0	62.6	57.4	56.4	56.3	56.6
Moldova	..	..	..	..	100.0	82.6	90.3	99.7	111.5	109.3	92.9
Armenia	..	100.0	97.4	84.9	66.4	68.9	74.5	76.8	81.7	85.4	85.7
Azerbaijan	..	..	..	..	100.0	80.3	78.0	84.3	93.2	103.8	..
Georgia	..	100.0	79.2	77.1	45.4	42.4	46.1	..	..	..	..
Kazakhstan	..	100.0	96.8	96.1	84.9	67.7	55.0	51.3	51.8	49.0	48.3
Kyrgyzstan	..	..	100.0	87.2	77.1	62.0	52.0	55.3	50.8	58.5	60.9

Source: ECE (2000b, p. 161).

statistics from the UN Economic Commission for Europe, and they seem to make some sense for Central Europe and South-East Europe. Poland stands out as an unchallenged star, with an increase in total consumption of 36 percent from 1989 to 1999. The Czech Republic and Romania have also exceeded their communist level of consumption, while the others have fared worse. Most former Soviet republics for which we have statistics show stunning total declines in real consumption of 30–50 percent after 1990, which can largely be dismissed as statistical errors. The amazing decline in Latvia, far larger than in truly suffering Armenia, appears especially implausible. Considering our revision of output numbers in Chapter 4, these statistics cannot be taken seriously.

The actual standard of living is confused by a radical alteration of relative prices and consumption baskets, also involving access to new goods and quality amelioration. Those who want to show how arduous the transition has been tend to use consumption of meat as a yardstick, showing radical declines, because meat was enormously subsidized under communism. Those who want to play down the costs of transition, on the contrary, emphasize the rapid increase in the number of cars, household appliances, and consumer electronics, whose relative prices have fallen sharply, while people queued for a new car for up to ten years under communism (Berg and Sachs 1992).

Table 8.3 shows the main success indicators of capitalism – the ownership of passenger cars and TV sets – in various transition countries in 1990 and 1997. A totally different picture emerges. Virtually all countries have seen rapid improvements, and car ownership has approximately doubled in Russia and Estonia. If the improvement of quality were taken into account, the picture would be even more impressive, as imported cars replaced awful, obsolete cars. These stunning improvements were accomplished by falling relative prices and access to imports. They are not representative of the average standard of living, but they are part of the picture.

Thus, we cannot establish that average living standards have actually fallen during transition. Undoubtedly, living conditions have deteriorated in some countries, but we dare not elaborate on which ones, since national standards of statistics vary enormously. We know little but that Poland has seen a substantial improvement in average living standards, and that official statistics grossly exaggerate human hardship.

Increasing Income Differentiation

A greater differentiation of incomes was generally expected with the transition to a market economy. In Central Europe especially, income

Table 8.3. Ownership of Passenger Cars and TV Sets, 1990 and 1997 (per 1,000 inhabitants)

	Passenger Cars		TV Sets	
	1990	**1997**	**1990**	**1997**
Central Europe				
Poland	138	221	295	413
Czech Republic	228	344	315[a]	447
Slovakia	180[a]	211	284[a]	401
Hungary	188	226	418	436
South-East Europe				
Romania	62[a]	107	199	226
Bulgaria	151[a]	208	250	366
Baltics				
Estonia	153	293	343	479
Latvia	106	176	367	592
Lithuania	132	238	350	377
CIS				
Russia	57	120	369	390
Ukraine	96	96	328	493
Reference Countries:				
Developed Economies				
United States	574	489	772	847
Japan	283	373	611	708
Germany	460[a]	500	479	570
France	415	442	538	606
Netherlands	347	372	482	541
Sweden	419	418	467	531
Emerging Economies				
Mexico	84	93	152	251
Turkey	29	59	230	286
Korea	48	165	209	341
Spain	309	389	194	466
Greece	171	223	398	506
Portugal	162	288	186	523

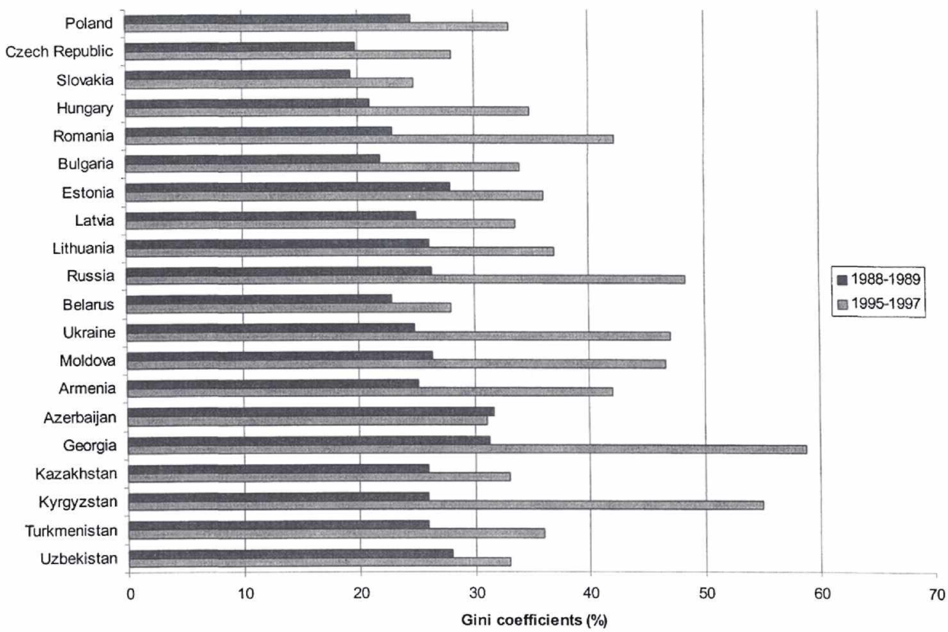
[a] 1991 data.
Source: OECD (2000b, pp. 32–3).

differentials had been the most compressed in the world, and no market economy, not even Scandinavia, could, or would like to, maintain such extreme egalitarianism. Fast structural change would also boost the differentiation of incomes, and the greater income differentiation improved incentives for fast restructuring. Measurements of inequality are always poor, and they are very sensitive to statistical inaccuracies (Keane and Prasad 2000).

On the whole, income differentiation has increased approximately as expected and desired. The average Gini coefficient of disposable income rose from 24 in 1988–9 to 33 in 1995–7, which is a normal West European level (Milanovic 1998, p. 40). The boost in differentiation has been steep, concentrated to the first few years of transition and leveling off around 1995 in the former Soviet Union (see Chart 8.1).

The surprise, however, has been a very uneven development. The region has fallen into three different groups. The first group encompasses Central Europe and the Baltics. These radical reformers have experienced a comparatively moderate increase in income differentiation, reaching a low West European level with Gini coefficients around 30. Curiously, the least reformist CIS countries – Belarus, Azerbaijan, Turkmenistan, and Uzbekistan – have a similarly even income distribution,

Chart 8.1 Gini Coefficients, 1988–1989 and 1995–1997.



Note: The latest available data for Kazakhastan, Kyrgyzstan, Turkmenistan, and Uzbekistan are 1993–4. *Sources*: Milanovic (1998, p. 41); OECD (2000b, p. 41); UNU/WIDER (1999).

to the extent that we dare believe in their very poor statistics. The most striking development, however, is that most of the intermediary reformers have experienced considerable surges in income inequality. No less than seven countries have recorded Gini coefficients rising over 40, which is the level in the United States. They are Georgia, Kyrgyzstan, Russia, Ukraine, Moldova, Armenia, and Romania, with Georgia and Kyrgyzstan reaching Latin American levels of inequality.

A few countries may be substantially mismeasured, and small changes in the method of measurement make a great difference, but these results make sense. A swift liberalization checks the rise in inequality as market competition quickly develops. Conversely, the old state-controlled system could also keep income differentiation at bay. However, a slow and partial reform breeds distorted economies, generating huge rents and thus great inequality (Hellman 1998).

The income differentiation in the intermediary reformers does not appear an unfortunate incidence but a choice, reflecting the prior distribution of power. The Nomenklatura in the Soviet Union was so much more dominant than in Eastern Europe that it collectively imposed a partial reform strategy, allowing it to usurp a share of the wealth that corresponded to its power. In the more unreformed CIS countries, however, the monopoly of corruption has not been broken up as yet. This appears an argument both for a radical comprehensive reform and a democratization prior to a change of economic system. A more prosaic proposition is that worse initial economic distortions cause more rent seeking, thus breeding greater income differentials.

Sources of Increasing Inequality

An ordinary newspaper reader would presume that the increased inequality reflects a few tycoons, but they fall outside any statistics. Instead, the main cause is wages (see Table 8.4; Milanovic 1998, pp. 47–54; Rutkowski 1996). In Russia, wages account for no less than three-quarters of the increased inequality, indicating the emergence of a large new middle class, which flourishes in the new private sector of entrepreneurship and services. Wages also explain most of the gulf between the former Soviet Union and Central Europe. This suggests that liberalization of the labor market is key to greater equality.

Next, our newspaper reader would assume that reduction of social transfers, such as pensions, has aggravated inequality. However, while social transfers have risen as a share of GDP, they have not helped the poor, on the contrary, aggravating inequality (Misikhina 1999). This is particularly true of the former Soviet Union. Most of this inequality is explained by pensions, which are partly related to prior income (with the exception of Latvia, which introduced almost flat pensions in 1992).

Surprisingly, entrepreneurial incomes have hardly contributed to recorded inequality. Part of the explanation is that entrepreneurs comprise not only the richest in society but also many marginal subsistence workers and the unemployed, so entrepreneurs as a group, earn less than the average, if these statistics can be believed.

These changes in income distribution have altered the relative position of various social groups. The greatest surprise is that pensioners as a group were the main winners in the early transition in comparison both with workers and with peasants in all countries for which data are available (Milanovic 1998, p. 58; Van Atta 1998). One factor behind the relative success of the pensioners has been the centralized, independent, and comparatively well-functioning pension systems. Moreover the pensioners were many, mobilized, and well organized, with the communist parties as their effective advocates. In the later stage of the transition, however, pensioners have suffered (Flemming and Micklewright 1999). Ironically, in Russia real pensions could only be cut by the communists in government in 1998–9.

Yet, statistical challenges are daunting. In a fine analysis of Polish statistics, Michael Keane and Eswar Prasad (2000) have shown that inequality in incomes and consumption in Poland was virtually the same in 1997 as in 1989, even falling in the early transition. They debunked the prevailing view that Polish inequality had increased substantially (see Table 8.4). While wage differentials certainly expanded, they were fully compensated for by larger social transfers. We are left wondering how much Poland excels because of better policies and better statistics, respectively.

Table 8.4. Decomposition of the Change in the Gini Coefficient during the Transition

	Wages	Social Transfers	Pensions	Nonwage Private Sector	Overall Gini Change
Poland (1987–95)	+3.4	+3.5	+3.2	+0.8	+7.0
Hungary (1989–93)	+5.9	–0.6	+1.4	–0.6	+2.2
Bulgaria (1989–95)	+7.8	+0.9	+0.4	–0.4	+10.0
Latvia (1989–96)	+15.0	–1.5	–2.0	+1.4	+10.0
Russia (1989–94)	+17.8	+5.1	+3.9	+3.0	+23.6

Source: Milanovic (1998, p. 48).

Importance of Rent Seeking

The underlying cause of the sharp rise in inequality was the massive rent seeking characteristic of intermediary reformers in the transition. The rents are difficult to assess and varied over time, but the initial large rents came from four sources: export arbitrage, import subsidies, subsidized credits, and enterprise subsidies. Later on, these rents have tended to decline, while a variety of minor new rents have surged. Overall calculations are missing and difficult to undertake, but as an illustration we shall analyze Russian rents in the peak year of 1992.[3] We have discussed the techniques above, but here we shall quantify their effects.

In 1992, the state-controlled prices of commodities were at most one-tenth of the world market prices, and more than 70 percent of Russia's exports were commodities subject to export quotas (Aven 1994, p. 84). Total Russian exports outside of the CIS amounted to $42.2 billion. The collected export tariffs amounted to some $2.4 billion, while GDP was only $79 billion in 1992, because of the very low exchange rate (World Bank 1996b). Hence, the total export rents were no less than $24 billion or 30 percent of GDP. These rents dwindled fast, but they have remained significant. Usually, transfer pricing implied that the profit was transferred to private businessmen's offshore accounts. Russia's large exports boosted these rents, but even for Ukraine the dominant export rents for metals amounted to 20 percent of GDP in 1992 (Åslund and de Ménil 2000).

Second, when Russia received commodity credits for essential foods, the importers bought hard currency for only 1 percent of the going exchange rate in 1992. The IMF (1993, p. 133) has calculated total Russian import subsidies at 17.5 percent of GDP in that year. (Alternatively, those subsidies can be calculated as 15 percent of GDP; Halligan et al. 1996). They dwindled to less than one-quarter in 1993 and were eliminated by 1994. Other countries received less commodity credits, and this was just a temporary rent.

A third source of rents was the emission of subsidized credits by the central banks. The Central Bank of Russia issued new credit of 31.6 percent GDP in 1992 (Granville 1995b, p. 67). As these credits were largely given at an interest rate of 10 or 25 percent a year, while inflation that year was 2,500 percent, they were sheer gifts (Åslund 1995). Others prefer to count it as less, however. The IMF (1993, p. 139) focuses on direct credits to enterprises, which were tantamount to subsidies, at 23 percent of GDP.

[3] I have elaborated on rents in Russia in Åslund (1996, 1999).

Table 8.5. Subsidization of the Russian Economy, 1992–1994 (Percentage of GDP)

	1992	1993	1994
Federal level			
CBR directed credit	15.5	5.0	2.5
Import subsidies	15.0	2.8	0.0
Budget subsidies to enterprises	5.4	2.4	1.4
Budget investment grants	2.3	1.2	0.7
Subsidized budget loans for investment	0.7	0.3	0.1
Local level			
Tax exemptions	..	3.5	4.0
Direct transfers	..	4.7	5.1
Budget loans	..	0.6	1.0
Investment grants	..	0.3	0.6
Total	**38.9**	**20.8**	**15.4**

Source: Halligan et al. (1996, pp. 111, 114).

Fourth, the state budget provided direct enterprise subsidies, amounting to 10.4 percent of GDP in Russia in 1992 (EBRD 1997, p. 83). Liam Halligan, Pavel Teplyukhin, and Dirk Willer (1996) have undertaken a brave attempt to estimate all Russian subsidies or rents in the years 1992–4. Their conservative assessments are assembled in Table 8.5, assessing federal subsidies to 39 percent of GDP in 1992, and total subsidies to 15 percent of GDP in 1994. They do not include export rents, as it was no direct subsidy. Adding them and using our number for credit subsidization, we get a total level of gross rent in the Russian economy of no less than 85 percent of GDP, not including local subsidies. The subsidization and rent seeking were extraordinary in other FSRs as well.

Table 8.5 also shows how the nature of subsidies or rents changed. While federal subsidies dwindled, regional subsidies rose. Barter became an important category of implicit subsidies, peaking at 10.4 percent of GDP in 1998, which boosted total budget subsidies to enterprises to 16.3 percent of GDP in that year (Pinto et al. 1999).

As select Russians transferred these rents and subsidies from state enterprises to their private accounts through transfer pricing or outright theft, they became very rich, and the same happened throughout the CIS. The more partial and slow the reforms, the greater the distortions, and the larger the rents. Therefore, these rents were far higher in the CIS than in Central Europe and the Baltics. Contrary to common prejudice, privatization was no major source of rents.

The level of rents in various economies is probably the best indicator of the relative economic success of the countries in this region, making inequality a key indicator of the quality of a new market economy. Unfortunately, we do not possess the numbers for other countries, and full calculations are quite difficult, requiring great local knowledge.

Widespread but Shallow Poverty

If income disparities rise dramatically in relatively poor countries, poverty is bound to rise. Recorded poverty has soared shockingly, though the number of poor varies greatly by measure. The World Bank (2000b, p. 34) has chosen a poverty line of $2.15 per person per day in 1996 purchasing power parity (see Table 8.6). By this standard, poverty is minimal in East-Central Europe. In the CIS big variations appear to reflect the quality of statistics rather than reality, implausibly rating Ukraine and Belarus as far better off than Russia. However, poverty has become a major concern in the CIS, involving 20–50 percent of the population in most countries. No comparison with the Soviet situation is possible, as the Soviet plainly denied the possibility of poverty, but poverty has undoubtedly increased substantially.

The saving grace about poverty in the region is that most of it is relatively shallow, with many people living just below the poverty line. An anomaly in comparison with the rest of the world is that few poor are as literate and well educated as the post-Soviet poor. Under propitious political and economic conditions, this should lead to a fast decline in poverty (Milanovic 1998, pp. 60–79). The poorest are the unemployed and families with children, not the pensioners (Milanovic 1998, p. 117). Poland and the Baltics are swiftly reducing their poverty thanks to fast economic growth, but most of the former Soviet Union has not seen much improvement, so the gulf between Central Europe and the Baltics, on the one hand, and the CIS, on the other, is deepening.

LIFE AND HEALTH

One of the proud claims of communism was well-developed and free public health care. However, the system focused on the consumption of certain inputs, such as hospital beds, not upon final results or the efficient use of resources, and actual health standards were poor. This inconsistency between public claims and reality became obvious toward the end of communism. Yet, transition has been accompanied by such disturbing tendencies as declines in life expectancy, population, and nativity, prompting the question of what has happened to health care.

Table 8.6. Absolute Poverty Rates, Selected Years, 1995–1999

	Survey Year	Poverty headcount (%) $2.15/day
Central Europe		
Poland	1998	1.2
Czech Republic	1996	0.0
Slovakia	1997	2.6
Hungary	1997	1.3
South-East Europe		
Bulgaria	1995	3.1
Romania	1998	6.8
Baltics		
Estonia	1998	2.1
Latvia	1998	6.6
Lithuania	1999	3.1
CIS		
Russia	1998	18.8
Belarus	1999	1.0
Ukraine	1999	3.0
Moldova	1999	55.4
Armenia	1999	43.5
Azerbaijan	1999	23.5
Georgia	1999	18.9
Kazakhstan	1996	5.7
Kyrgyzstan	1998	49.1
Tajikistan	1999	68.3
Turkmenistan	1998	7.0

Source: World Bank (2000b, p. 35).

Falling Life Expectancy and Infant Mortality

Life expectancy has fallen in almost all transition countries, but the average decline is insignificant. In 1989, the average life expectancy at birth for all the transition countries was 70.3 years, and by 1995 it had fallen infinitesimally to 70.0 years (UNDP 1998, p. 213). The group hit is essentially men, while women's life expectancy has increased in most transition countries. Even these statistics are subject to considerable and repeated revisions, substantially changing the picture, usually aggravating it.

The main concern is the FSU, where the average life expectancy for men dropped by three years from 1990 to 1993, primarily in nine countries – the three Baltic states, the whole of Western CIS, Russia, Kazakhstan, and Kyrgyzstan. Russia saw the greatest decline – seven years – from 1989 to 1994, but it recovered by no less than four years by 1998. Meanwhile all countries apart from Belarus and Ukraine experienced rising life expectancy for men. By 1998, Belarus overtook Russia as the worst performer, since its male life expectancy was four years shorter than in 1989, compared with Russia's three years shorter. In Central Europe, male life expectancy barely declined, and it had risen by one to three years by 1998, while it fell by one year in South-East Europe. The Caucasus and the remaining Central Asian states have such bad statistics that they might not tell us the truth, though they suggest a slight improvement (see Table 8.7). The countries concerned do not really form any other clear pattern, which is evident from regression analysis (Brainerd 1998). Strangely, the war-ridden countries in the Caucasus have not suffered, and the decline is not related to recorded decreases in living standard.

The low male life expectancy in Russia has been thoroughly analyzed. Most of the additional deaths are due to cardiovascular diseases and accidents. One obvious explanation is that alcohol sales increased with falling relative price of alcohol following Mikhail Gorbachev's severe anti-alcohol campaign. Russia has very high homicide rates and suicide rates, but all the three Baltic states have higher suicide rates, though only Azerbaijan has a higher murder rate (UNDP 1998, p. 215). A fine regression analysis by Vladimir Shkolnikov et al. (2000) examines all possible health-related causes and socioeconomic factors and finds no explanation among them. The health problems of Russian males seem primarily related to their psychology. Judith Shapiro (1995) suggests that the problem might be men's inability to handle stress caused by uncertainty and transition, and Shkolnikov et al. (2000) concur.[4] Thus, the problem was not starvation or abject poverty.

If the decline in life expectancy had reflected a serious aggravation of health services, other deteriorations would be apparent as well. Infant mortality is a key health indicator. The communist countries always had a much higher infant mortality than the West, but almost all postcommunist countries experienced a radical reduction in infant mortality from 1989 to 1998, and this desline is positively related to radical reform (see Table 8.8). Poland and the Czech Republic have seen their infant mortality decline by half in a decade, and the Czech Republic has one of the

[4] Elizabeth Brainerd (1997) points to the change in relative prices of health inputs as well. Kennedy et al. (1998) argue that social cohesion and social capital are an important determinant of the population's health, but explanations are more esoteric than obvious.

Table 8.7. Male Life Expectancy at Birth, 1989–1998 (Total years)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Central Europe										
Poland	66.8	66.5	66.1	66.7	67.4	67.5	67.6	68.1	68.5	68.9
Czech Republic	68.1	67.5	68.2	68.5	69.3	69.5	70	70.4	70.5	71.1
Slovakia	66.9	66.6	66.8	67.6	68.4	68.3	68.4	68.8	68.9	68.6
Hungary	65.4	65.1	65.0	64.6	64.5	64.8	65.3	66.1	66.4	66.1
South-East Europe										
Romania	66.6	66.6	66.6	66.6	66.1	65.9	65.7	65.3	65.2	65.5
Bulgaria	68.6	68.1	68.0	68.0	67.7	67.2	67.1	67.1	67.2	67.4
Baltics										
Estonia	65.7	64.6	64.4	63.5	62.4	61.1	61.7	64.5	64.5	64.4
Latvia	65.3	64.2	63.8	63.3	61.6	60.7	60.8	63.3	64.2	64.1
Lithuania	66.9	66.6	65.3	64.9	63.3	62.8	63.6	65	65.9	66.5
CIS										
Russia	64.4	63.8	63.5	62.0	58.9	57.3	58.3	59.6	60.9	61.3
Belarus	67.1	66.3	65.5	64.9	63.8	63.5	62.9	63.1	62.9	62.7
Ukraine	66.1	65.6	64.0	64.0	63.0	62.8	61.8	61.9	61.9	61.9
Moldova	65.5	65.0	64.3	63.9	64.0	62.3	61.8	62.9	62.9	62.9
Armenia	69.0	68.4	68.9	67.7	67.9	68.1	68.9	69.3	70.3	70.8
Azerbaijan	66.6	67.0	66.3	65.4	65.2	65.2	65.2	66.3	67.4	67.9
Georgia	68.1	68.7	..	68.5	..	..	..	..	68.5	68.7
Kazakhstan	63.9	63.8	63.3	63.0	61.8	60.6	59.7	58.5	59.0	59.2
Kyrgyzstan	64.2	64.2	64.6	64.2	62.9	61.6	61.4	62.3	62.6	63.1
Tajikistan	66.2	66.8	67.6	65.4	..	63.4	65.5	65.6	65.6	65.7
Turkmenistan	61.8	62.9	62.3	..	..	..	..	..	62.3	62.5
Uzbekistan	66.0	66.1	..	..	..	..	..	..	66.1	66.3

Source: World Bank (2000a).

Table 8.8. Infant Mortality, 1989–1998 (per 1,000 births)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Central Europe										
Poland	19.1	19.3	18.2	17.3	16.1	15.1	13.6	12.2	10.2	9.5
Czech Republic	10.0	10.8	10.4	9.9	8.5	7.9	7.7	6.0	5.9	5.2
Slovakia	13.5	12.0	13.2	12.6	10.6	11.2	11.0	10.2	8.7	8.8
Hungary	15.7	14.8	15.6	14.1	12.5	11.5	10.7	10.9	9.9	9.7
South-East Europe										
Romania	26.9	26.9	22.7	23.3	23.3	23.9	21.2	22.3	22.0	20.5
Bulgaria	14.4	14.8	16.9	15.9	15.5	16.3	14.8	15.6	17.5	14.4
Baltics										
Estonia	14.7	12.4	13.4	15.8	15.8	14.5	14.8	10.4	10.1	9.3
Latvia	11.1	13.7	15.6	17.4	15.9	15.5	..	15.8	15.2	14.9
Lithuania	10.7	10.3	14.3	16.5	15.6	13.9	12.4	10.1	10.3	9.2
CIS										
Russia	17.8	17.4	17.8	18.0	19.9	18.7	18.1	17.4	17.2	16.5
Belarus	11.8	11.9	12.1	12.3	12.5	13.2	13.3	12.5	12.4	11.3
Ukraine	13.0	12.9	13.9	14.0	14.9	14.3	14.4	14.3	14.0	13.9
Moldova	20.4	19.0	19.8	18.4	21.5	22.6	21.2	20.2	19.8	17.5
Armenia	20.4	18.6	17.9	18.5	17.1	15.1	14.2	15.5	15.4	14.7
Azerbaijan	26.2	23.0	25.3	25.5	28.2	25.2	23.3	19.9	19.6	16.6
Georgia	19.6	15.9	13.7	12.4	18.3	18.3	13.1	17.4	17.3	15.2
Kazakhstan	25.6	26.3	27.3	25.9	28.1	27.1	27.0	25.4	24.9	21.6
Kyrgyzstan	32.2	30.0	29.7	31.5	31.9	29.1	28.1	25.9	28.6	26.2
Tajikistan	43.2	40.7	40.6	45.9	47.0	40.6	30.9	31.2	27.9	23.4
Turkmenistan	54.7	45.2	47.0	43.6	45.9	46.4	42.2	..	40.0	33.2
Uzbekistan	37.7	34.6	35.5	37.4	32.0	28.2	26.0	24.2	23.1	22.5

Source: World Bank (2000a).

lowest infant mortalities in the world – reflecting truly remarkable social progress. Clearly, radical reform helps lowering infant mortality.

By 1998, the whole postcommunist region had seen a rapid drop in infant mortality, with the exceptions of Ukraine and Belarus, indicating a major improvement of health care a few years after communism.

No Major Decline in Health Budgets

Contrary to popular perception, health expenditures have not collapsed but have been reasonably stable in real terms. For instance, Russia's real public health spending exceeded the level of 1990 as early as 1994 (Davis

Table 8.9. Total Expenditure on Health, 1990–1991 and 1997 (Percentage of GDP)

	1990–1	1997
Central Europe		
Poland	5.0	6.2
Czech Republic	5.9	7.1
Slovakia	5.4	6.7
Hungary	6.7	6.4
South-East Europe		
Romania	2.9	4.2[a]
Bulgaria	5.1	4.3
Baltics		
Estonia	..	6.4
Latvia	2.5	6.2
Lithuania	3.0	8.3
CIS		
Russia	2.6	5.7[b]
Belarus	3.5	6.3
Ukraine	3.3	5.4
Moldova	4.8	6.7
Armenia	2.7	7.8[b]
Azerbaijan	2.9	7.2
Georgia	3.2	4.7
Kazakhstan	4.4	4.8
Kyrgyzstan	4.4	3.6

[a] 1996 data.
[b] 1995 data.
Sources: UNDP (1998, p. 215); World Bank (2000a).

forthcoming). However, the more relevant measure is the region's total health expenditures' share of GDP, which increased by no less than half from 4.0 percent of GDP in 1990–1 to 6.0 percent of GDP in 1997 (see Table 8.9). Even so, 1990–1 was a time of radical increase in health budgets because of populist pressures throughout the region.

This is almost a West European share of GDP devoted to health care, which is highly respectable for countries at this level of development, suggesting that people care about their health and can direct spending to it. National variations are considerable without any strong pattern. Lithuania and the Czech Republic spend a higher percentage of their GDP on public health care than some of the richest countries. Only Georgia, Azerbaijan, and Tajikistan spend clearly too little (World Bank 2000b, p. 268).

The contrast with public health care in the Soviet Union is stark. A Soviet economist reported in 1988: "The USSR has 4,000 district hospitals, but more than 1,000 of them have no sewage system, 2,500 no hot running water, 600 have neither hot nor cold water" (Bolotin 1988). In 1985, Soviet public health care funding had fallen to a dismal 2.2 percent of GDP, while it rose to 2.9 percent of GDP in 1990 (Goskomstat 1991, pp. 9, 16). Health indicators improved greatly under Gorbachev, but only temporarily because of his brief and unsustainable campaign against alcohol (White 1995). After this last Soviet campaign had faded away, the long-term decline in most health indicators recurred in most former Soviet republics.

Another problem with socialism was the popular attitude to health, especially in the Soviet Union. People behaved as if their health did not belong to them but to the state. Government health information was available, but popular demand was negligible. Public health care was free, and sick allowances equaled wages, meaning that health costs were socialized. The good public health system of socialism is as great a myth as is its collapse under capitalism.

Attempts at Health Care Reform

Arguably, the health care system has suffered most from disorganization. Unlike other parts of the postcommunist economy, it has hardly benefited from any privatization, while a large gray sector has prevailed, as medical staff preferred to use the capital of the public health care system for informal private work rather than to set up expensive private policlinics. While health care had been free in theory, corruption and tips were well developed in most countries under communism. Usually, health care systems remained highly centralized for a long time, stifling local initiatives. Therefore, the performance of the health care system probably deteriorated for a few years despite large budget allocations (Davis forthcoming).

Yet, as economic reforms have proceeded, health care has attracted attention. The first ambition was to raise health care expenditures, while governments have postponed attempts at structural reform of the complicated health sector. One concern has been to promote cost effectiveness. Most countries had too many hospital beds and too many specialists, but not enough general practitioners, nurses, medicines, and modern medical equipment, offering glaring examples of diseconomies. Czechs had developed a habit of going to the doctor 14 times a year on average because of no cost, and Hungarians consumed five times as much drugs as Poles (Nicholls 1999).

In general, health care reforms have tried to separate the funding of care, the purchasing of medical services and medicine, and the provision of care in line with principles common to most OECD countries. The more progressive countries have introduced medical insurance, usually financed with a payroll tax. The Hungarian, Czech, and Polish governments have launched far-reaching medical insurance schemes, but most other insurance schemes have been partial, though in the CIS Kyrgyzstan has a successful medical insurance.

Health care reforms have improved efficiency somewhat, but initial results were humble, although socialist health care was so inefficient. One obvious aim has been to reduce the excessive number of hospital beds. For the nineteen countries about which we have data, sixteen reduced the number of hospital beds from 1989 to 1993–4, and only three countries increased them (UNDP 1998, p. 214). Clearly, the restructuring of health care has accelerated from the mid-1990s in most countries, with the exception of Ukraine and Belarus. Often, reforms have taken on a decentralized life of their own, when hospitals and other local bodies have gained some independence.

One reason for the lateness of medical reforms has been that they have involved large numbers of medical staff, who have often resisted reforms and been prone to strike. Another obstacle is the absence of a credible alternative system. The U.S. insurance system is generally seen as too costly. Therefore, the West European public health care system serves as a natural model, but it is not renowned for high quality or good service. Little competition between service providers has developed, and the corruption of public health care breeds inefficiency and dissatisfaction (Nicholls 1999; Chernichovsky, Barnum, and Potapchik 1996).

One of the greatest improvements lies outside of the public health care system. With the introduction of a market economy, medicines have become widely available, but this did not happen immediately, as trade in pharmaceuticals was regulated by ailing state wholesale trade monopolies in many countries, which prompted a serious criminalization of this trade in Russia.

EDUCATION ADJUSTING TO DEMAND

The situation in education resembles health care, but it is better, because entrepreneurship and private undertakings have taken off on a broad front. Even more than health, comprehensive education was the pride of communism, which could boast of real achievements. The whole region enjoyed 99 percent literacy. Secondary education was standard, and university education was as common as in Western Europe.

Unlike health care, education was a real priority of communism. In 1990–1, the transition countries spent on average 5.9 percent of their

Table 8.10. Public Expenditures on Education, 1989 and 1996 (Percentage of GDP)

	1989	1996
Central Europe		
Poland	4.6[a]	7.5
Czech Republic	..	5.1
Slovakia	4.9	5.0
Hungary	6.0	4.6
South-East Europe		
Romania	2.3[b]	3.6
Bulgaria	5.5	3.2
Baltics		
Estonia	..	7.3
Latvia	3.8	6.3
Lithuania	5.2	5.4
CIS		
Russia	3.4	3.5[c]
Belarus	4.9	5.9
Ukraine	5.1	7.3[c]
Moldova	4.4	10.6
Armenia		2.0
Azerbaijan	6.1	3.3
Georgia	..	5.2[d]
Kazakhstan	3.4	4.7
Kyrgyzstan	8.6	5.3
Tajikistan	9.7	..
Turkmenistan	4.2	..
Uzbekistan	9.0	7.7

[a] 1987 data.
[b] 1988 data.
[c] 1995 data.
[d] 1994 data.
Source: World Bank (2000a).

GDP on education, compared with 5.4 percent of GDP in the OECD countries (UNDP 1998, p. 217). The general perception is that education expenditure has fallen sharply, but this is only true of real public expenditures, while public education expenditures as a share of GDP have increased moderately for the region as a whole (see Table 8.10). By 1998, average public spending on education remained high at 4.4 percent of GDP in the postcommunist countries, compared with 4.9 percent of GDP in the rich OECD countries. Yet, Armenia, Georgia, and Tajikistan had such low public education expenditures that basic education for all was endangered (World Bank 2000b, p. 241). Private expenditures on education have surged, but they are not well surveyed. Real total expenditure on education has most probably risen after communism.

Declining Primary Education but Expanding Universities

The most worrisome tendency is that primary school enrollment is no longer comprehensive in several former Soviet countries. By 1995, Moldova, Latvia, Ukraine, and the whole of the Caucasus and Central Asia showed less than 90 percent enrollment of the relevant age group for basic education, while secondary school enrollment is constant (UNDP 1998, p. 217). Stories abound of teachers suffering long wage arrears and of shortages of textbooks, but schoolteachers belong to the most strike-prone groups, suggesting that they feel they have clout. A poor underclass appears to be dropping out of education, while the sector as a whole is not suffering. During a visit to Oshoblast in southern Kyrgyzstan in September 1998, I learned to my surprise that half of the hundreds of primary and secondary schools in the region had computer labs.

University education offers the real surprise. Definitions vary, but the number of university students has risen greatly, approximately doubling from 1989 to 1999. This surge was particularly marked in Poland, Bulgaria, Hungary, Armenia, and the whole of Central Asia (UNDP 1998, pp. 74, 217). The expansion of university education seems a response to increasing demand, with the strongest development of business administration (Pleskovic et al. 2000).

Tuition Fees and Private Universities Proliferate

At the beginning of the transition, many in the region reckoned that education was no longer of significance, since only the ability to trade counted, but that view was never tenable and lasted only a couple of years. Soon, young people throughout the region realized they needed to learn economics, business administration, law, and languages. These subjects were no specialties of the old universities and institutes, so numerous new institutions developed. During a trip to St. Petersburg in 1992, I learned that the city harbored no fewer than 200 institutions that proudly, though somewhat pretentiously, called themselves business schools. Many barely existed and soon closed down, but the degree of entrepreneurship in higher education, particularly business training, was just extraordinary. The return on human capital has soared with transition, as reflected in the rising income differentials.

In a study of economic education in twenty postcommunist countries, we found a proliferation of new, usually private, universities. Apart from Russia, the Caucasus, Kazakhstan, and Kyrgyzstan seemed to sport the largest number of new universities. Small Georgia took the prize with no fewer than 279 officially registered institutions of higher education, 179 of them located in the capital, Tbilisi. People are evidently drawing the sensible conclusion that the old public universities in the Caucasus and Central Asia are no good, establishing new institutions, but the new pluralistic and competitive climate has reinvigorated the old universities as well. In the Baltics, Central Europe, and South-East Europe, on the contrary, the old universities have survived, though a few new schools, notably business schools, have been added. While education is a politically sensitive topic, most postcommunist countries have evidenced an amazing openness to private initiative and outside funding except the hard dictatorships of Belarus and Uzbekistan (Pleskovic et al. 2000).

Private financing of education is difficult to survey, but the greater the reduction in public financing, the more private funding is provided as tuition fees, with the Caucasus leading. In the poorer countries in the FSU, about half the students pay tuition fees. Fees of up to $5,000 a year are not uncommon for renowned business schools. As bribes for admittance were frequent in Soviet days, formal tuition fees are easily accepted. They tend to replace prior bribes, and corruption in education seems to have dropped with the privatization of higher education.

Postcommunist people are realizing that investment in their human capital is worthwhile. The bottleneck is the training of university teachers and researchers, because they are usually paid a piece rate per lecture by the new private schools, and they have few incentives or opportunities to improve their qualifications. Many universities and business schools have substantial cooperation with foreign institutions, but only a few good graduate programs in economics exist in the whole region, rendering it necessary to educate a new corps of teachers in the West while building new institutions in the region (Pleskovic et al. 2000).

Many Western textbooks have been translated from English into local languages or written anew, primarily through George Soros's generous financing, and the free and small-scale book market has swiftly spread modern textbooks throughout the region, providing a strong base for better education in social sciences distorted by Marxism-Leninism. Similarly, the curricula of good Western university courses have swiftly proliferated, especially at new universities in the region.

Curiously, education has seen far more entrepreneurship and experimentation than the health sector, as postcommunist people seem more prepared to invest in their brains than in their health. Part of the explanation might be that the young want education, while the old and conservative demand health care, and education requires less starting capital. The more uneven income distribution has also led to a new dominance of, and orientation toward, the middle class, which is reflected in the greater emphasis on university training. This tendency is reminiscent of Latin America.

UNEMPLOYMENT AND LABOR MARKET REFORM

The labor market is one of the most paradoxical areas of the transition. Widely held expectations turned out to be completely wrong. First, wages have not been driven up by strong trade unions, but on the contrary they have been depressed by ruthless managers. Second, the anticipated mass unemployment never occurred. Third, workers have not become a major source of unrest. Fourth, great differences between Central Europe and the former Soviet Union have also been a surprise.[5]

Wage Policy

At the beginning of transition, wage inflation was a major macroeconomic concern, because of a recent populist wage policy prompted by workers' protests, while managers were weak having no interest in opposing them, as no real owners existed. Furthermore, cost-push inflation could lead to mass unemployment.

Therefore, the early reformers opted for strict incomes policies. Poland launched a tax-based incomes policy, imposing a heavy penalty tax on any wage increase above a fraction of the inflation rate. The Polish scheme appeared a splendid success, as incomes were firmly checked and few strikes erupted, and most countries followed Poland's lead (Blanchard and Layard 1990).

Gradually, however, it emerged that no country suffered significant wage inflation regardless of policy (Tait and Erbas 1995). The Polish tax-based incomes policy might have been genial, but it was superfluous. As Jacek Rostowski (1998, p. 139) notes: "Indeed, in Poland in 1990 prices soared far ahead of wages during the first quarter of the stabilization programme, so that wage controls are unlikely to have been important in forming inflation expectations."

East Germany was a special case. When Germany was reunified in 1990, the East German mark was set equal to the deutsche mark, and social benefits were equalized with those in West Germany. Wage setting was delegated to employers and trade unions, but since civil society and social organizations were weak in East Germany, West German trade unions and employers' associations took over in the East. Neither

[5] This section draws on Commander and Coricelli (1995), Commander and McHale (1996), Kuddo (1995), Allison and Ringold (1996), Dmitriev and Maleva (1997), and Maleva (1998).

had any interest in competitive wages in the East, but both wanted to minimize competition from the East. Nor was the privatization agency *Treuhandanstalt*, which controlled all state companies, concerned about controlling wages. As a result, the amalgamated West German interests let East Germany price itself out of the market through excessive wage rises, as Helmut Wiesenthal has shown (Picked and Wiesenthal 1997). East Germany lost no less than 40 percent of its jobs, resulting in mass unemployment, as nowhere else in the postcommunist world, of 35 percent of the labor force in 1991 (Siebert 1992, pp. 34–9, 120–3).[6] A veritable social welfare trap had been created at huge costs to West German taxpayers.

Surprisingly Little Unemployment

Although the socialist labor market had been heavily regulated, it was a market. With minor exceptions, workers had the right to choose their jobs. The last true claim of communism was full employment, because socialist enterprises hoarded everything, including labor, causing extreme overstaffing. This excess demand for labor gave workers considerable leverage under socialism, leading to wage inflation.

The end of chronic overstaffing was widely expected with capitalism. Since socialist production was rightly seen as obsolete and in need of substantial restructuring, the general expectation was that transition would be accompanied by a sharp decline in output, causing mass unemployment.

The early reform countries lived up to these expectations. Unemployment increased by an average of half a percent of the labor force a month in Poland and Slovakia in 1991, as well as in Hungary and Bulgaria in 1992. However, unemployment did not continue to rise incessantly, but it leveled off at 10–12 percent of the labor force, which was the West European average, and it arose only in Poland, Slovakia, Hungary, Bulgaria, and Romania during the early years of transition. Initially, Poland and Bulgaria had the highest unemployment rates, peaking at just over 16 percent of the labor force in 1994 and 1993, respectively (see Table 8.11).

In the FSU, everybody expected a much larger fall in output and therefore greater unemployment. Some people predicted an unemployment of half the labor force in Russia, and it was widely expected to become the greatest social problem, providing a forceful argument for slow reforms. The surprise was a minimum of open unemployment in the FSU. Often only registered unemployment is measured, but even in

[6] Including open unemployment, part-time workers, employees in public works, and labor market training.

Table 8.11. Unemployment, 1991–1999 (Percentage of labor force)

	1991	1992	1993	1994	1995	1996	1997	1998	1999 (est.)
Central Europe									
Poland	11.8	14.3	16.4	16.0	14.9	13.2	8.6	10.4	13.0
Czech Republic	4.1	2.6	3.5	3.2	2.9	3.5	5.2	7.5	9.4
Slovakia	..	10.4	14.4	14.6	13.1	12.8	12.5	15.6	19.2
Hungary[a]	7.4	9.3	11.9	10.7	10.2	9.9	8.7	7.8	7.0
South-East Europe									
Romania[a]	3.0	8.2	10.4	10.1	8.2	6.5	7.4	10.4	11.5
Bulgaria	11.1	15.3	16.4	12.8	11.1	12.5	13.7	12.2	16.0
Baltics									
Estonia	..	..	6.6	7.6	9.8	10.0	9.7	9.9	12.3
Latvia	0.6	3.9	8.7	16.7	18.1	19.4	14.8	14.0	14.4
Lithuania	0.3	1.3	4.4	3.8	17.5	16.4	14.1	13.3	14.1
CIS									
Russia	0.0	5.3	6.0	7.8	9.0	9.9	11.2	13.3	11.7
Belarus[a]	0.1	0.5	1.4	2.1	2.7	3.9	2.8	2.3	2.1
Ukraine	0.0	0.2	0.3	0.3	0.5	1.3	2.3	3.7	4.3
Moldova[a]	..	0.7	0.7	1.1	1.4	1.8	1.5	1.9	2.0
Armenia[a]	4.0	3.5	6.3	5.8	8.4	10.1	11.3	8.9	11.6
Azerbaijan	..	15.4	9.6	10.4	11.7	12.1	12.7	12.9	13.9
Georgia[b]	0.2	5.4	9.1	3.6	3.1	2.8	7.5	14.7	14.9
Kazakhstan	0.0	0.4	0.6	7.5	11.0	13.0	13.0	14.0	14.1
Kyrgyzstan[a]	0.0	..	..	3.1	4.4	6.0	4.3	..	..
Tajikistan[a]	..	0.3	0.8	1.2	1.3	1.6	1.8	1.8	1.8
Turkmenistan[c]	2.0	..	..	..	..	..	..	..	..
Uzbekistan[a]	0.0	0.1	0.3	0.4	0.4	0.4	0.4	0.5	0.6

[a] Officially registered unemployment.
[b] Up to 1996, registered unemployment, total unemployment thereafter.
[c] Every Turkmen citizen is guaranteed employment, thus official unemployment does not exist. 1991 and 1995 figures are household survey estimates, but do not take account of substantial public sector overemployment.
Sources: EBRD (1999, 2000a).

proper labor surveys, unemployment was for years in the single digits in nearly all FSRs, including the Baltics. The five CIS countries that have proper measurement of unemployment (Russia, Armenia, Azerbaijan, Georgia, and Kazakhstan) had unemployment of 10–14 percent in the late 1990s, but only in 1997 did unemployment in Russia rise over 10 percent, the West European level.

Two countries in Central Europe were exceptions. Czech unemployment lingered around 3 percent of the labor force, albeit it started rising from 1997. About as many people were laid off in the Czech Republic as in the other countries, but far more of the newly unemployed found new jobs (Ham, Svejnar, and Terrell 1998). The other exception was East Germany with its mass unemployment.

Stark Differences in Labor Productivity

With the fall in output, total employment has contracted throughout the region, with the exceptions of the nonreformist countries, Uzbekistan and Turkmenistan, as well as Azerbaijan and Kyrgyzstan, whose labor force has continued growing fast (see Table 8.12). It has declined less in the FSU than in Central Europe, where it has varied considerably among similar countries. The labor force in Poland and the Czech Republic diminished by only about 10 percent from 1989 to 1998, while it plummeted by some 30 percent in Hungary and Bulgaria. Seemingly small divergences in economic policy made a great difference.

This contraction of the labor force is partly a market adaptation, since communism had forced nearly all to work, and the prior overemployment diminished when involuntary labor quietly withdrew from the labor market, primarily women with small children and old-age pensioners. The employment of women diminished, but as the working frequency of women had been the highest in the world in the socialist countries, this appeared to reflect a choice. The greatly increased wage differentials convinced more spouses to stay at home and take care of small children.

Registered unemployment is positively correlated to growth. Therefore, large increases in employment would hardly help output to recover (De Melo et al. 1997a). As employment has fallen less in the former Soviet Union than in Central Europe, while the opposite is true of output, the development of labor productivity – measured as official GDP in relation to employment – has been extremely divergent. The countries fall into four different groups, seemingly rather idiosyncratic. Hungary, Poland, and Slovakia top the list, by boosting their labor productivity by an average of almost 30 percent from 1989 to 1998 (see Chart 8.2). A second group of the Czech Republic, Romania, Bulgaria, and Estonia had approximately constant labor productivity. Latvia, Lithuania, Kazakhstan, Russia, Armenia, and Kyrgyzstan experienced a fall in official labor productivity of 20–35 percent in this period, while Ukraine, Moldova, Azerbaijan, Georgia, and Tajikistan registered a shocking decline in registered labor productivity of 60 percent.[7] Here, the differences within both Central Europe and the FSU astound,

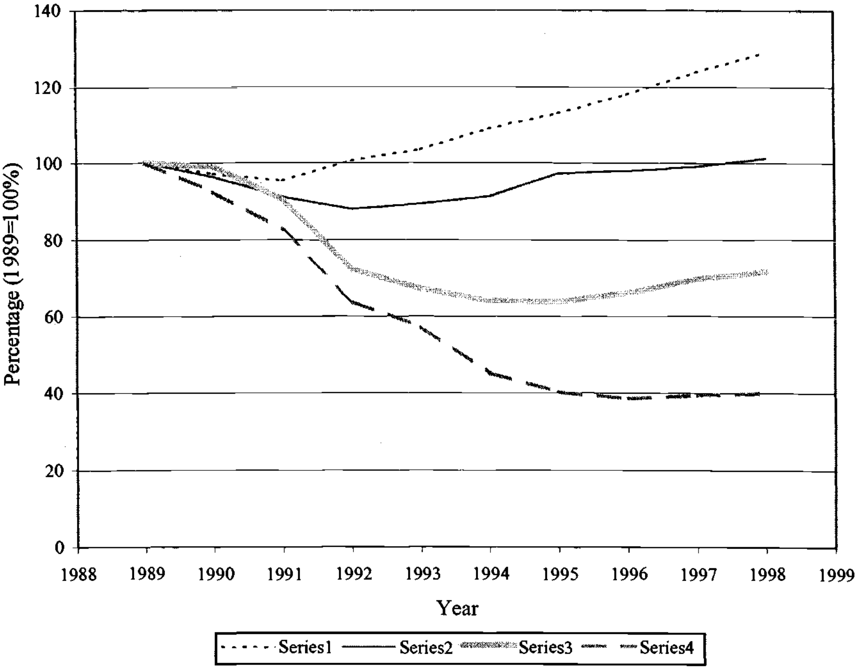
[7] I ignore the unreformed countries Belarus and Uzbekistan, as their output is not very desired, and Turkmenistan is left out because of its arbitrary statistics.

Table 8.12. Total Employment, 1989–1999 (Index, 1989 = 100.0)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Central Europe											
Poland	100.0	95.8	90.1	86.3	84.3	85.1	86.7	88.3	90.8	92.9	92.4
Czech Republic	100.0	99.1	93.6	91.2	89.7	90.4	92.8	93.4	91.6	90.2	86.9
Slovakia[a]	100.0	98.2	85.9	86.8	84.6	83.7	85.7	84.5	82.6	81.8	78.0
Hungary[b]	100.0	96.7	86.7	78.1	73.2	71.8	70.4	69.8	69.8	70.7	72.9
South-East Europe											
Romania[a]	100.0	99.0	98.5	95.5	91.9	91.5	86.7	85.7	82.4	80.5	76.9
Bulgaria	100.0	93.9	81.6	75.0	73.8	74.3	75.2	75.3	72.3	72.2	70.4
Baltics											
Estonia	100.0	98.6	96.4	91.4	84.5	82.7	78.3	77.0	77.4	76.4	73.3
Latvia	100.0	100.1	99.3	92.0	85.6	77.0	74.3	72.3	73.7	74.1	73.8
Lithuania	100.0	97.3	99.7	97.5	93.4	88.0	86.4	87.2	87.7	87.0	86.6
CIS											
Russia	100.0	99.6	97.7	95.3	93.7	90.6	87.9	87.2	85.5	84.2	84.6
Belarus	100.0	99.1	96.6	94.1	92.9	90.4	84.8	84.0	84.1	85.0	85.5
Ukraine	100.0	99.9	98.3	96.3	94.1	90.5	93.3	91.3	88.8	87.9	85.8
Moldova[c]	100.0	99.1	99.0	98.0	80.7	80.4	80.0	79.4	78.7	78.5	71.5
Armenia	100.0	102.4	105.0	99.2	97.0	93.5	92.8	90.2	86.2	84.0	82.9
Azerbaijan	100.0	100.9	101.7	101.4	101.2	98.9	98.4	100.5	100.7	100.9	100.9
Georgia	100.0	102.3	93.3	73.5	66.4	64.8	79.0	79.1	82.7	84.6	..
Kazakhstan	100.0	101.3	100.1	98.3	89.9	85.4	85.0	84.6	84.0	79.5	79.2
Kyrgyzstan	100.0	100.5	99.6	105.6	96.6	94.6	94.4	95.0	97.1	98.0	101.5
Tajikistan	100.0	103.2	104.9	101.6	98.7	98.7	98.6	92.1	95.3	95.6	91.9
Turkmenistan	100.0	103.4	107.0	110.5	114.0	118.5	122.5	124.7	127.2	128.8	129.7
Uzbekistan	100.0	104.2	109.2	108.7	108.5	109.9	110.8	112.3	113.8	115.4	116.5

[a] End of year.
[b] End of year, up to 1992, since 1992, annual average.
[c] Excluding Transdniestria since 1993.
Source: ECE (2000b, p. 163).

Chart 8.2 Labor Productivity.



Series are averages of listed countries.
Series 1: Hungary, Poland, and Slovakia.
Series 2: Czech Republic, Romania, Bulgaria, and Estonia.
Series 3: Latvia, Lithuania, Kazakhstan, Russia, Armenia, and Kyrgyzstan.
Series 4: Ukraine, Moldovia, Azerbaijan, Georgia, and Tajikistan.
Sources: Calculations are based on real GDP and real employment in ECE (1999b, pp. 65 and 68).

reflecting the extent of the underground economy, the degree of reform, and actual output development.

No other indicator shows such great disparity between success and failure. The most radical reformers have not only raised output but also laid off workers, while the laggards have experienced the greatest real fall in output and the largest expansion of their underground economies, but their public enterprises have laid off few workers. However, some reform countries (notably Georgia) have seen a sharp fall in labor productivity, while some not very reformist countries have held up reasonably well (Romania and Bulgaria).

Why So Little Unemployment?

The labor market was an early focus of policymaking. Toward the end of socialism, a real market economy was seen as the only cure to economic stagnation, but capitalism was understood to mean unemployment. Therefore, the limited unemployment came as a surprise, but it was a real phenomenon, which can be explained by weak labor and employers' incentives to keep many cheap workers.

Many analysts had presumed that as communism was after all a form of socialism, workers would emerge as a strong social force when released by democracy. But socialism was not the workers' but the Nomenklatura's state, so the Nomenklatura rose like the Phoenix instead of the workers. Enterprises were controlled by their managers. Even if this was broadly understood, the managers' strength and ruthlessness surprised. Workers' councils had some influence in the privatization process in Poland, while Soviet workers' councils evaporated without a trace.

The immediate cause of the small unemployment was that real wages were extraordinarily flexible downward, lagging behind high inflation, since labor was so weak, particularly in the FSU. No wage indexation developed in the FSU despite persistent high inflation, and wages were raised haphazardly at the behest of the enterprise management (Maleva 1998).

All over the FSU, wage arrears became standard, harming as much as two-thirds of the Russian work force, not necessarily because enterprises could not pay but because they perceived no need to do so. Even worse, workers in Russia and Ukraine were often forced to accept payments in kind in the form of produce of their enterprises. The worst example I saw was in a southern Ukrainian village in August 1996. A block of reinforced concrete stood for sale in front of each house, representing the poor workers' wages in kind, which they tried to hawk to passersby. As it was not necessary to pay wages, employers had no need to lay workers off. By contrast, wage arrears were almost unknown in East-Central Europe.

Although many countries had a formal union membership of over 80 percent, this meant little in the FSU, where these "trade unions" were sheer social security administrations. Their main task was to administer extrabudgetary funds financed out of the payroll tax for various social benefits for workers, such as holiday trips. They were closely allied with the old state enterprise managers, seeing themselves as supportive junior partners. Often, employers paid union fees, unknown to their union "members" (Dmitriev and Maleva 1997, p. 1516). In the FSU, workers had to accept the wage offered, while qualified staff pursued individual wage bargaining (Christensen 1997). In Central Europe, by contrast, real trade unions existed, especially in Poland, where Solidarity challenged the old trade unions to become active. Trade unions also were relatively strong in Hungary, Romania, and Bulgaria, while they were weak in the Czech Republic and Slovakia (Commander and McHale 1996, p. 304).

Labor has been surprisingly silent during the transition. Although strikes have been allowed and tolerated in most countries, few strikes have occurred, and they benefited small groups of relatively privileged workers (Cook 1997). The most serious strikes were concentrated to the coal industry in Poland, Romania, Russia, and Ukraine. In Russia, more than 80 percent of all recorded strikes from 1990 to January 1997 took place in three sectors: coal mining, secondary education, and health care, which were characterized by collective action and negotiable government subsidies. Strikes were rare in manufacturing and almost absent in trade and services. Although workers enjoyed more clout in Central Europe, all strike rates were extremely low compared with Western Europe (Dmitriev and Maleva 1997, pp. 1516–17; McFaul 1999).

This pattern resembles that in liberal states in the West with weak trade unions, reflecting the limited bargaining power of workers. Strikes arise out of a sense of strength, not out of desperation, and many were organized by senior officials. When I visited Volgograd in February 1994, the regional governor revealed in a conversation with me that he and the management of the local Dzerzhinski Tractor Factory had organized a strike to pressure the government for more subsidies. Wage arrears were another reflection of the feeble labor in the FSU. In Central Europe, especially in Poland and Hungary, trade unions were better organized and represented broader social interests, but even so wage-push inflation never became the problem Balcerowicz had feared.

Workers lacked effective representation and they were fearful of unemployment. Many lived by the old socialist saying: "They pretend to pay us, and we pretend to work." Workers preferred to look for a new job while still having one. Even if they were not being paid, they wanted access to an enterprise's social benefits, such as child care. Many workers started working in the informal economy, but their old formal employment helped them escape taxation and undue interest from the authorities. Thus, millions of post-Soviet workers formally retained some public employment while they roamed around as shuttle traders or temporary laborers. In spite of government attempts to persuade enterprises to transfer their social assets to municipalities before privatization, social benefits remained a major component of total compensation in Russia and Ukraine through 1995 (Commander and Schankerman 1997).

A large part of the labor force disappeared into the lawless underground, as the economy was divided into a formally highly regulated labor market with high taxes and an unregulated informal economy with few taxes or social benefits.

For a surprisingly long time, managers refused to believe in systemic change, sticking to the old system and hoarding workers. They perceived the sudden decline in output as temporary, to be followed by increased demand, requiring reserve capacity. In the FSU, state enterprises continued to operate under soft budget constraints. Each worker was an argument in negotiations with the authorities for more subsidies, rendering continued overstaffing beneficial. Meanwhile, labor and tax laws provided strong incentives against outright dismissals. Most postcommunist countries had introduced an excess wage tax to control wage pressure. Since it taxed high average wages, enterprises kept numerous marginal workers on minimum wages to save on tax. Severance payments, however, were high – two months' salary in Central Europe and originally three months' in the FSU. Thus, enterprises preferred to keep workers but not pay them rather than to lay them off. Mass layoffs were rare, and most labor mobility arose out of voluntary resignations, so the labor market remained tight for skilled workers (Commander and McHale 1996; Layard and Richter 1995; Tait and Erbas 1995; Garibaldi and Brixiova 1997).

Yet, good market economic reasons also kept unemployment low. The socialist economies were overindustrialized and overinvested, but underserviced. With the emergence of capitalism, labor transferred from capital-intensive heavy industry to small service enterprises, which created many new jobs with minimal capital expenditures.

All governments were anxious to establish unemployment benefits because of their fear of mass unemployment and social disruption. Hungary, Poland, and the Soviet Union did so before the end of communism. Like West European social democrats, they desired wide coverage and high compensation, which contributed to the early rise in unemployment in Poland, Slovakia, Bulgaria, and Hungary (Ham et al. 1998; Allison and Ringold 1996).

A popular reaction erupted against too many people getting too large benefits, which were cut with surprising ease. Within a year, all countries but Hungary had reduced the share of unemployed receiving benefits, and Hungary followed in 1993 (Allison and Ringold 1996). The Czech Republic adopted a particularly tough line, with maximum unemployment benefits limited to six months, amounting to only 60 percent of the previous net wage, or a maximum of 150 percent of the minimum wage, while other countries initially adopted a replacement level of 70 percent. In East-Central Europe, minimum wages are set at 30–40 percent of the average wage (World Bank 2000b, p. 345). An apparent result was that the unemployed in the Czech Republic swiftly found jobs, unlike their colleagues in other Central European states (Ham et al. 1998). The combination of reduced unemployment benefits and reviving economies made the initial postcommunist unemployment peak around 1993 in Central Europe.

In the Soviet Union, all kinds of populist social benefits had been introduced in 1990 and 1991 just before the country collapsed. Although not taken seriously, they were legislated. Most benefits were defined as a multiple of the minimum wage. Ensuing governments were presented with a stark social bill, and they chose a facile solution. In the midst of high inflation, they let the minimum wage slip well below subsistence levels. In Russia, it dropped from 45 percent of the average wage in 1990 to 10 percent from 1995 to 1997, leaving the minimum wage at only 20 percent of the subsistence minimum (Dmitriev and Maleva 1997; Standing and Vaughan-Whitehead 1995). In that way, most FSRs minimized their unemployment benefits, and most unemployed did not bother to register.

Two different labor market regimes have arisen in the region. Five countries (Poland, Slovakia, Hungary, Romania, and Bulgaria) have established West European social democratic models, with considerable barriers against the dismissal of workers and almost as high unemployment as Western Europe. However, their labor markets have gradually grown more flexible as the fear of mass unemployment has been mitigated and the generous distribution of unemployment benefits has tightened. Further deregulation is being promoted by governments, but the need for change is limited, since unemployment has abated and the financial costs of unemployment support are bearable.

The Czech Republic and the whole of the FSU offer a stark contrast. In these countries, the labor market is far more flexible. Each year, 20–25 percent of the labor force changes jobs (Commander and McHale 1996, pp. 280–6; Layard and Richter 1995). People are more inclined to leave their employment, because it is easy to find new occupations. The Czech Republic and the Baltic states have codified their liberal labor market practices (OECD 2000c).

In the CIS countries, the labor market is flexible in spite of formally rigid labor legislation. Some undesirable rules are respected, notably three months of severance payment, while the fundamental right to be paid wages earned on time is widely disregarded. Several countries have adopted new labor codes, for instance, Kazakhstan and Kyrgyzstan, while Russia and Ukraine have failed to do so. Alas, the Kyrgyz labor code was drafted by German consultants, who wanted to confound all the social achievements of the Soviet Union with those of Germany, drafting an even more restrictive labor code. Little surprise that two-thirds of the actual labor force in Kyrgyzstan has disappeared into the underground economy.

The labor market regulation has contributed to the division of the economy into a highly taxed and heavily regulated official economy and an extensive underground economy beyond law. Resources are irrationally allocated, investment being concentrated to the official economy while the underground economy is labor intensive and starved of investment. Therefore, reformers in CIS countries are increasingly demanding a radical deregulation of the labor market to individual labor contracts in line with the real situation and sharp cuts in payroll taxes (Dmitriev and Maleva 1997, pp. 1525–9).

Theoretical papers have tended to be too distant from postcommunist reality to be relevant for the FSU. Aghion and Blanchard (1994) argued that unemployment had an ambiguous impact on the speed of transition, because higher unemployment would decrease wages in the private sector but increase taxes on private firms. Similarly, Burda (1993) thought that high unemployment benefits would have a negative impact on the growth of the private sector because of taxation. The prime question, however, has been whether the public sector is subject to hard budget constraints or not, and higher open unemployment has been a good indicator of harder budget constraints. In reality, prohibitive taxation has prevailed where the private sector has been small, because it has been crowded out by a public sector with soft budget constraints, while high unemployment has been part of fast restructuring.

Higher Unemployment Benefits but Fewer Severance Payments

Notwithstanding that unemployment has been surprisingly limited, the situation is far from satisfactory, because economic efficiency as well as social rights have been sacrificed. Two major measures are needed. First, severance payments should be reduced to make it easier to lay off workers. Second, unemployment benefits should be raised to render such a change socially acceptable.

The debate over unemployment benefits has been strangely skewed in the FSU. Virtually all outside advisors have advocated higher unemployment benefits contrary to all powerful domestic groups, while the unemployed are silent. The strongest opponents of decent unemployment benefits have been the state enterprise managers. As long as the social safety net is weak, they can credibly argue that it would be socially unacceptable to dismiss workers, reinforcing their demands for enterprise subsidies. Conversely, it was surprisingly easy to reduce unemployment benefits, with notable resistance apparent in Hungary and Poland. But, unemployment benefits effectively harden enterprises' budget constraints, because alternative subsidies cost the state more than targeted unemployment assistance, and they preserve the old socialist economy of negotiations, impeding desired structural change. Tellingly, direct enterprise subsidies have remained substantial in Russia and Ukraine. That the managers' purported social concern is only a trick in their rent-seeking efforts is evident from their huge wage arrears. Hence, high severance payments benefit conservative managers, not workers.

SOCIAL TRANSFERS AND PENSIONS

Social support appears one of the most misperceived elements of the transition.[8] The problem has not been collapsing social support systems, but on the contrary the expansion of social expenditures to an unsustainable level. Another concern is that these substantial resources have not been directed to those in true need but rather to the relatively wealthy. A transition to a more efficient and targeted system has started, but developments are going in rather different directions.

The most important social transfers come from the pension system. All countries in the region have had comprehensive public pensions for a long time, although millions of Soviet citizens were excluded from old-age pensions until 1985. However, the pension system has been marred by serious problems, provoking demands for substantial reforms. As pension systems are big, important, and complicated, their reformation has come late.

Too Large and Inefficient Social Support

The general perception is that social assistance and transfers have declined, but social transfers have actually increased sharply as a share of GDP in Central Europe, the Baltics, and the Slavic states of the FSU (see Table 8.13). Only in the Caucasus and Central Asia have they shrunk, but social supports here exceed East Asia's. The exceptions are Georgia and Tajikistan, where the very states are on the verge of disintegration. In Central Europe and the Baltics, social transfers have risen even in real terms. In addition to social transfers, substantial enterprise, housing, and utility subsidies have been maintained in some countries. Social transfers have not been too small but far too large. Neither are they affordable for middle-income countries, nor have they provided effective social protection.

The old social benefits were not very social, because a relatively limited share went to the poorest. A sharp line falls between Russia and Ukraine, on the one hand, and Central Europe together with the Baltics,

[8] This section draws on UNDP (1998), Kramer (1997), Åslund and Dmitriev (1996), Åslund (1997c), Holzmann (1997a,b), Impavido (1997), Dmitriev (1996), and Goleniowska (1997).

Table 8.13. Regional Trends in Spending on Social Transfers, 1989 and 1994–1995 (Percentage of GDP)

	CEE		Baltic States		Slavic States		Caucasus	
	1989	**1994/5**	**1989**	**1994/5**	**1989**	**1994/5**	**1989**	**1994/5**
Pensions	4.7	9.1	5.6	8.7	5.2	6.5	5.0	3.2
Family & maternity Allowances	2.7	2.0	0.5	1.5	0.2	1.2	1.2	0.8
Social assistance & unemployment compensation	0.3	1.9	0.0	1.1	0.0	0.1	0.7	0.4
Total	**7.7**	**13.0**	**6.1**	**11.3**	**5.4**	**7.8**	**6.9**	**4.4**

Source: UNDP (1998, p. 94).

on the other. In the former, about 10 percent of all social transfers go to the poorest 20 percent (see Table 8.14). A couple of hundred categorical benefits remained on the books in Russia and Ukraine in 1999, and they were targeted on the old Nomenklatura, which had received such benefits instead of higher salaries. Targeted Nomenklatura benefits were usually financed by the state budget, while holiday benefits came from the trade-union-managed Social Insurance Fund. In 1998 the Russian Ministry of Labor and Social Affairs found that 70 percent of all social transfers went to the 30 percent wealthiest households (Misikhina 1999; Dmitriev 1999).

Central Europe and the Baltics, on the contrary, had relatively efficient social assistance, which helps to explain their even income distribution. Thanks to radical social reforms, Estonia and Latvia offered good support to its poor, while Slovakia's old system remained effective (see Table 8.14).

Family and maternal allowances are very small, in the range of 1–2 percent of GDP, although families with children belong to the poorest. Little wonder that these countries suffer from extremely low nativity. To raise the child support should be one of the fiscal priorities for most of the region (with the exception of the Czech Republic and Hungary). However, as elsewhere, young parents with small children do not constitute a pressure group.

Under communism, the government provided large price subsidies, but these can hardly be considered social benefits. After all, all prices were artificial, and the wage share of GDP was far lower in communist countries than in any capitalist country, so the subsidies were really paid by the workers. Still, several subsidies had some social function, such as price subsidies for food. Some countries tried to maintain subsidies for

Table 8.14. Percentage of Social Assistance, Unemployment Benefits, and Nonpension Cash Social Transfers Received by the Bottom Quintile of the Population

	Social Assistance	Unemployment Benefits	All Nonpension Cash Social Transfers
Transition Economies	28	29	22
Poland (1993)	29	26	25
Slovakia (1992)	52	37	31
Hungary (1993)	35	33	29
Romania (1992)	23[a]	25	25
Bulgaria (1995)	36	46	19
Estonia (1995)	36	56	26
Russia (1994)	6	8	12
Ukraine (1995)	6	0	8
Market Economies	42	27	23
Australia (1989)	78	50	30
United States (1991)	70	15	19
United Kingdom (1991)	55	29	33
Chile (1990)	51	57	31
Finland (1991)	43	20	26
West Germany (1984)	40	26	14
Netherlands (1987)	31	11	18
Switzerland (1982)	25	20	16
Sweden (1987)	21	10	9

Source: Milanovic (1998, p. 113).

essential foods, but the result tended to be undesirable shortages. In Kyrgyzstan in 1992, low fixed milk prices led to the mass slaughtering of cows, with long-term consequences for milk and meat production (Chu and Gupta 1993, p. 25).

The politically most difficult subsidies were large housing and utility subsidies, which were defended tooth and nail by the upper middle class in the big cities, because they were regressively concentrated to a narrow stratum. Transportation subsidies were also difficult to abolish because of public transportation monopolies, but they were so small, typically half a percent of GDP, that they were not very significant.

Evolution of New Social Support Systems

The old Soviet-type social support system was corporatist, although pensions comprised a centralized state system. Health care and education were centralized state systems, but ministries and enterprises had their own facilities. As many social benefits were provided by enterprises, no comprehensive social welfare system existed (OECD 1996). The region can schematically be divided into four different models.

Hungary and Poland had opted for West European social democratic welfare systems in the 1980s, which they maintained after communism. The benefit was that the social welfare system became independent of enterprises and thus universal. Yet, the costs of social protection in Hungary and Poland rose to 30–35 percent of GDP, which was not sustainable. János Kornai (1992b) has pointedly dubbed these countries "premature welfare states." Other Central European countries emulated the developments of Hungary and Poland, though they checked the costs. The high expenditures are forcing the Central Europeans to undertake significant social welfare reforms.

The Baltic states were more liberal and radical because they had less money. They chose a mixture of a liberal and a social democratic social welfare model, developing the most modern and efficient social welfare system in the region.

Russia, Ukraine, Belarus, Moldova, and Uzbekistan have had great problems parting with the old Soviet model of social welfare, although they have increased their expenditures on social transfers substantially. They maintain substantial enterprise subsidies – 8–10 percent of GDP in Russia and Ukraine for much of the 1990s – and big housing and utility subsides – steadily around 4 percent of GDP in Russia. Their social support is extremely inefficient. One reason for their misfortune is that these countries have been able to collect too much state revenues. The other cause is that the old elite have maintained such power that they can concentrate social benefits to themselves. The need for social welfare reforms is greatest here, but the antireform constituency remains formidable. Therefore, the Russian reformers are so radical, and social democracy is not a feasible option in these countries.

The Caucasian countries, Kazakhstan, and Kyrgyzstan have all seen their public revenues fall below 20 percent of GDP, forcing them to prioritize among their public expenditures, and the result has been radical social welfare reforms. Kazakhstan and Kyrgyzstan have sought inspiration from East Asia and international liberal ideas, while social democratic thoughts are absent there. Together with the Baltic states, these five states have undertaken the most far-reaching and sensible social welfare reforms.[9]

[9] Turkmenistan has let its social sector decline, as its priority is to build palaces for the omnipotent President Niyazov. Tajikistan could be presented as a reformer, but it is still scarred by civil war.

Curiously, the Baltics, the Caucasus, Kazakhstan, and Kyrgyzstan stand out with the most modern social welfare models. Central Europe labors on with an old-fashioned and expensive model, but the awareness of the need for reform is so great that they are likely to change before the West Europeans. Russia, Ukraine, Belarus, Moldova, and Uzbekistan cause the greatest concern with their old Soviet corporatist systems.

What Social Safety Net Is Possible?

After the first bout of populism at the end of communism and in the early transition, domestic support for social safety nets has been minimal. Part of the problem is that it is difficult to reach the truly poor in the FSU, considering the lack of reliable data on personal incomes and the corrupt state administration. Too much of the purported social benefits go to corrupt middlemen rather than the poor. The locals usually know that, whereas foreign experts rarely understand. The question is what can be done in the CIS.

Branko Milanovic (1998, pp. 115–19) wisely concludes that an OECD-like minimum income guarantee would hardly work in the CIS because of the great income underreporting. Instead, support to specific groups – pensioners, children, and the unemployed – will have to suffice. In the CIS, it would make sense to raise the minimum wage as a social protection for poor workers, considering that they have so little clout. However, since part-time work and multiple places of work are so common, it is difficult to establish a minimum wage (Standing and Vaughan-Whitehead 1995).

A decent unemployment benefit for half a year is one way of reaching a truly poor group. As families with children form an exposed group, family allowances – whether universal or means-tested – can help. Means-tested housing allowances have been tried out in Russia and seem to work (Puzanov 1996). Altogether, this does not amount to much. Means-tested local social welfare is still needed for the truly poor, there being no universal or simple solution with such a poor information basis and such a corrupt delivery system.

A Problematic Pension System

The pension systems that the transition countries inherited from communism suffered from many shortcomings. They were very expensive, because the postcommunist regimes raised pensions substantially. In 1989, the costs of pensions ranged from 4.4 percent of GDP to 9.1 percent in the European part of the Soviet bloc, but by 1994 the costs had surged to 6.5–15.8 percent of GDP. By comparison, the average in the OECD is a public pension expenditure of about 7 percent of GDP, ranging from

2 percent of GDP in Iceland and Australia to 13 percent in Italy in 1995 (Impavido 1997, p. 107).

Poland had taken the lead, doubling the real costs of its pensions to almost 16 percent of GDP, the highest share in the world. The first Polish reform government had decided to index pensions fully, maintaining real pensions even when real incomes fell, to mitigate the resentment of the elderly (Goleniowska 1997). However, the old were angry and voted disproportionately for the communists in any case, while the young had to pay the high pension costs. Yet, it can be argued that the overgenerous social benefits contributed to social calm (Kramer 1997, p. 47).

The large costs were not caused by a high benefit level but by far too many being covered. The retirement age in the Soviet Union was the lowest in the world – 55 for women and 60 for men, while 60 for women and 65 for men were standard in Central Europe. Many vulnerable professional groups, ranging from coal miners and ballerinas to colonels, were entitled to early pensions. In exaggerated fear of mass unemployment, the early Central European reformers had encouraged workers to take early pensions, and fraud was common. Altogether, about one-quarter of the population was entitled to pensions.

Exorbitant payroll taxes financed the pensions. Hungary had the highest total payroll tax, peaking at 62 percent in 1993, while Poland had the highest pension tax of 45 percent in the mid-1990s. The old Soviet payroll tax of 38 percent was actually the lowest, but most FSRs had raised them to 40–50 percent, as compared with 12 percent in the United States (Holzmann 1997a, p. 199; Kramer 1997, pp. 60, 82). These payroll taxes were not tenable and led to a massive tax evasion and flight to the underground economy.

The pension system was unjust as well. Contributions and resulting pensions were barely related. The Nomenklatura had special high state pensions paid directly from the state budget. Working pensioners received full pensions and paid little or no tax, as their pensions were not subject to taxation. Pensions were adjusted in persistent political meddling, rendering them unpredictable and bringing little security in the CIS despite high costs. In the CIS, pension arrears became as notorious as wage arrears, notably in Ukraine, where pensioners could wait for half a year for their pensions in the mid-1990s. As state finances worsened in the CIS countries, the state could no longer afford reasonable pensions, driving average pensions down toward minimum pensions and below subsistence minimum in the poorer countries.

Thus, notwithstanding a very expensive pension system, CIS pensioners could not entrust their survival to ordinary pensions regardless of their contribution. With the financial crash in Russia in 1998, the average Russian pensioner fell below the official poverty line. Still, unlike other social benefits, pensions were actually paid out to everybody who was entitled, even if delays occurred. In Central Europe and the Baltics, the problem was limited to high costs. Yet, everywhere it was obvious that a fundamental pension reform was needed.

Attempts at Pension Reform

The discussion on pension reforms started in the early 1990s, when the excessive costs and the insufficient social protection became evident. The debate has developed in three waves, which have impacted different regions under the influence of international experiences.

Initially, the International Labor Organization (ILO), the OECD, and the EU took the lead. They proposed a West European pension system, maintaining the basic state system, with some adjustments. They suggested a higher retirement age, taxation of working pensioners, closer connection between contributions and pensions, and elimination of various privileges. They wanted to fix the pay-as-you-go system rather than replace it (Holzmann 1997a, pp. 203–4). However, only Estonia succeeded in undertaking such a reform, and a radical increase in the retirement age led to the demise of its very reformist government in the elections in 1995. Politically, this was an arduous road, not really popular with anybody.

A more radical reform appeared necessary. In 1994, the World Bank (1994a) published its report *Averting the Old Age Crisis*, propagating new thinking about pension reform, and the IMF supported these endeavors. It was inspired by the Chilean pension reform and ensuing reforms in Latin America. The World Bank favored the introduction of a three-pillar system. The first pillar would be a minimum pay-as-you-go state pension for all. The second pillar was to be a funded system based on compulsory saving in individual accounts, and the third would be voluntary private pension savings. Apart from securing pensions and lowering the payroll tax, such a reform would stimulate savings, the development of the capital market, and ultimately economic growth. The system has been embraced by most countries in Central Europe and the Baltics. Hungary, Poland, the Czech Republic, Latvia, and Estonia have already launched reforms of this kind, and the other countries in the region are likely to follow (Holzmann 1997b). A more radical reform had several political advantages. The connection between contribution and benefit became credible, transforming pensions from entitlement to savings and insurance, which generated middle class support. Then, retirement age became a matter of personal choice rather than a battle.

In the CIS, the distrust of the state and its ability to handle anything was much greater than in Central Europe and the Baltics, where the old pension system still functioned. Therefore, reformers in Kazakhstan and Russia opted for a pure Chilean pension reform, with private, funded pensions, while minimal state pensions would persist for those in the old system and the poor. By doing so, they joined a liberal international ambition to privatize social security (Feldstein 1998). Kazakhstan adopted such a system in 1998, with a funded private pension scheme with a contribution rate of 10 percent of incomes, while old pensions were not touched (Holzmann 1997a, p. 208). Two major problems have arisen, however. The first is that there are few sensible objects of investment in Kazakhstan, because the stock market has not developed, and the treasury bill market is limited. The other problem is that funding has been taken away from the old pension system, while its expenditures remain the same for the already retired, and its underfunding is an increasing burden upon the budget (Cangiano et al. 1998). In Russia, a similar scheme was politically defeated in early 1998 (Gordon 1998).

For the time being, the World Bank's three-pillar system seems the natural development, with the West European pay-as-you-go model clearly out of fashion. Many countries have discussed the possibility of setting aside some assets for pension funds through privatization to cover part of the implicit public pension debt, but with no result to date.

CONVENTIONAL WISDOM LITTLE BUT PREJUDICE

A closer look at social developments under transition reveals most common perceptions as sheer prejudice. The widely presumed collapse in living standards is not evident, and social expenditures – health care, education, and social transfers – have increased as a share of GDP.

Athough serious problems persist, they have not been caused by a shortfall in social budgets but by systemic problems of the transition. A striking development is that income disparities have increased substantially in intermediary reformers in the CIS and South-East Europe but little in Central Europe, the Baltics, and the unreformed CIS countries. As a consequence, poverty has grown. The explosion of inequality in about seven countries is a reflection of the extraordinary rent seeking of a narrow elite in partially reformed economies.

Another great concern has been a temporary fall in male life expectancy in most FSRs. Thorough analyses have not evidenced any major cause, and the most plausible explanation is that men in Central and Western FSU did not know how to handle the transition psychologically, while the falling relative price of alcohol and a temporary disorganization of the health care system may be partial causes. The much discussed demographic catastrophe is not apparent, though nativity has been low because of uncertainty and poor social conditions for young families.

The labor market has offered a host of surprises. Contrary to expectations, unemployment did not skyrocket, and it stayed low for long in the FSU. The main explanation has been that real wages have been highly flexible downward, as labor has been very weak. Moreover, managers refused to adjust to a market economic regime, hoarding labor and using their surplus work force as pawns to extract subsidies from the government. In the FSU, low unemployment benefits have in effect kept subsidies high and thus impeded desirable restructuring.

The prime problem with the social welfare system is that it mainly benefits the upper middle class in the FSU, as social transfers have remained highly regressive. It has been politically controversial to reduce old Nomenklatura benefits in Russia and Ukraine, while it has been equally difficult to raise unemployment benefits or family allowances. Contrary to public perceptions, pensioners benefited most from transition, at least initially. The poorest groups in the region are not pensioners but the unemployed and working poor with children.

Conversely, little has been done to create an effective social safety net targeted on the truly poor. One explanation is that the young and middle-aged poor have been disorganized, lacking political representation. The communists have shown little interest in this conundrum, while they have fought tooth and nail for Nomenklatura privileges and also defended pensions. Another explanation is that no delivery system could easily reach the poor, while the centralized pension systems were in comparatively good shape. The government has little real knowledge of personal incomes, and its apparatus is partially corrupt. The social administrations, which are large and conservative, have resisted reform. Finally, the socialist principle that "those who do not work should not eat" has been generally accepted in the CIS, breeding nearly universal opposition to any public payment to the poor.

The efficacy of social support systems seems correlated to democracy in the same way as Amartiya Sen established that famines had disappeared with democracy in India (Drèze and Sen 1989). The fully democratic countries in Central Europe and the Baltics have comparatively well-functioning and equitable social support systems. The partially democratic countries that have got stuck in severe rent seeking have large social expenditures, but they are geared toward the wealthy. The same is true of the nondemocratic countries.

Arguably, the large systems supplying social services, notably health care and education, have been among the slowest to reform and restructure, which explains why people complain so much about them, although they have absorbed large resources. They suffered from being nearly fully state-owned and centralized, allowing neither private nor local initiative. Presumably, no industry suffered as badly from disorganization as the public social service providers. It is illuminative that unreformed Belarus has about the worst mortality and vitality indicators, although it officially boasts about little initial decline in output and high economic growth.

While social reforms have arrived late, they have started all over and seem to be gaining momentum in the late 1990s, driven by rising costs or declining public revenues. The first concern was to secure sufficient financing for basic needs, such as health, pensions, and basic education, and that has largely been accomplished. The next concern is to check costs and improve efficiency. Two focal points have been health care, which has been strikingly inefficient, and pensions, which have been expensive yet left everybody dissatisfied.

9

State and Politics in the Transformation

Our discussion has centered on rent seeking, which is an extended concept of corruption, defined as "the misuse of public power for private gain" (Rose-Ackerman 1999, p. 91).[1] Corruption implies dysfunctional public institutions, which are poorly adapted to achieve social development goals, while the state building after communism aimed at the construction of a functional state capable of achieving social goals, such as high economic growth, the delivery of vital public goods, and a reasonable degree of equity. The politics of postcommunist transformation involved rendering such a transformation of the state politically possible.

Today, communism is already such distant history that many have forgotten that it was a system of kleptocracy, meaning that corruption was organized at the top of the government (Rose-Ackerman 1999, p. 114), working for the empowerment and enrichment of the Nomenklatura (Voslenskii 1984). Where the political regime did not change, the Nomenklatura continued its enrichment with fewer constraints than under the old system. Taxes, regulations, subsidies, prices, and privatizations were used by the kleptocrats to enrich themselves, and illegality marred the economy. The more corrupt and larger the state was, the less growth and the lower total investment. Among public expenditures, subsidies, and public investment crowded out investment in human capital through education and health care, as elsewhere in the world (cf. Tanzi and Davoodi 1997; Mauro 1995, 1998; Knack and Keefer 1995). The sizable state revenues have aggravated the harmful effects of a dysfunctional state, misallocating a large share of GDP to rent seeking.

The daunting task of liberal reformers was to transform this kleptocratic monster into a law-abiding state, serving the interests of the

[1] I want to express special thanks to Michael McFaul, who has made many substantial proposals on how to improve this chapter.

people. A characteristic of the old Nomenklatura was: "Loyalty to other members of the organization is as important or more important than good administration" (Rose-Ackerman 1999, p. 107). Often, poorly paid officials saw any act against corruption as a morally objectionable attempt to take the food out of their mouths.[2] Old Nomenklatura networks had to be broken down or taken out of state employment. The negative organizational capital of the communist dictatorship had to be disbanded (Shleifer and Vishny 1998, p. 233). A maximum disruption was desirable, though public order had to be maintained.

The most fundamental issue is for whom the state works – a small privileged elite or the population at large. Conversely, is the state containing or profusing rent seeking? The rulers' interests have been reflected in their reforming or not reforming the state.

On almost every political issue, there are traditionally two positions. One is that strife must be avoided, as it will be divisive and destabilizing to society. The opposing view is that openness and competition or pluralism are beneficial to the development of society, which is my belief.

CORRUPTION AND GOVERNANCE

Corruption means the malfunctioning of the state, with politicians and civil servants selling public goods for private gain, whereas good governance is the opposite, with state servants working for public purposes. While only hardline communists claim that market reform has caused corruption, a common belief is that transition has boosted corruption, widely seen as the greatest problem of the transition.

The debate is complicated by the measurement of corruption and governance, and no time series exists. The broadest survey, which involves eighteen of our states, was undertaken by the EBRD in 1999; we shall draw on it extensively,[3] investigating the relationships between state intervention and corruption, as well as between the size of government

[2] I have had personal experience of this in Ukraine and Kyrgyzstan.

[3] I feel uneasy about the Corruption Perception Index of Transparency International (1999), because the perception of corruption is easily boosted by two irrelevant factors. First, the more public discussion there is about corruption, the more people become aware of corruption, but publicity and public awareness tend to check corruption. Second, the harmfulness and the cost of corruption are different things. Transparency International presumably measures the former rather than the latter. The EBRD (1999) survey measures the latter and it is much easier to interpret. It simply asks: How much do enterprises in your industry pay in bribes as a share of sales? Then, it assesses the money paid for corruption and not its effects. One example of the disparity is that Transparency International (1999) ranks Armenia as less corrupt than Russia, which is totally implausible to anybody who has visited both countries and runs against all prior evidence, while EBRD (1999, p. 125) assesses Armenia's bribe tax as 66 percent higher than in Russia.

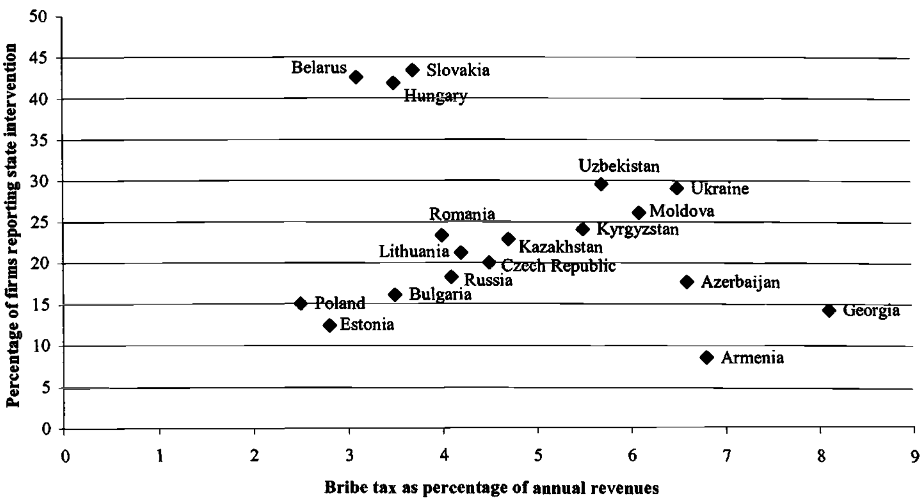
and corruption, the nature of corrupt state-enterprise relations and a plausible strategy to combat corruption.

State Intervention and Corruption

The liberal instinct suggests that state intervention and corruption should be closely correlated, and that hypothesis holds true in general. Chart 9.1 shows the strong positive correlation between the share of firms that report state intervention and the share of annual revenues that enterprises state they pay in bribes (EBRD 1999). However, there are some exceptions. In the three Caucasian countries, corruption is massive, while state intervention is highly limited. These countries were perceived as the most corrupt in Soviet times as well (Simis 1982; Zemtsov 1976), and they had the largest unofficial economy by far (Grossman 1987). A plausible explanation is that it takes a long time to alter corruption (Treisman 2000).

On the other extreme, Belarus was always perceived as honest, and it still is, although it is highly interventionist.[4] Hungary and Slovakia have a lot of state intervention, but little corruption. This might be explained by little prior corruption and a comparatively well-functioning state administration.

Chart 9.1 State Intervention and the Bribe Tax, 1999.



Source: EBRD (1999, pp. 123 and 125).

[4] When I visited Minsk in 1986, I was shocked to find that waiters categorically refused tips only because it was forbidden, something that I never encountered anywhere else in the Soviet Union.

The other twelve countries nicely reflect the close correlation between bribes and state intervention. The most interventionist countries – Ukraine, Moldova, and Uzbekistan – are also the most corrupt. (Presumably, Turkmenistan and Tajikistan would also belong to this group, if data had been available.) At the other end of the spectrum, Poland and Estonia have the least corruption and state intervention (EBRD 1999, pp. 123–6).

Contrary to common perceptions, Russia is not especially corrupt and is less corrupt than the Czech Republic and Lithuania. One reason why we hear so much about corruption in Russia is the country's great openness, with good, mutually independent and competitive media. In addition, many senior officials are honest and boldly fight against corruption. A completely corrupt elite leaves nobody to complain about bribery. Besides, graft in Russia appears particularly ineffective, harming economic development more than elsewhere, as reflected in complaints by people who have paid bribes but not received the services paid for (Shleifer and Vishny 1993).

State intervention and bribery are likely to reinforce one another. In traditionally corrupt states, the old elite reassures itself of great state intervention to maintain their bribes. One of the most remarkable developments is that Poland, which was traditionally perceived as quite corrupt, is now deemed surprisingly honest.

Corruption and Size of Government

Another liberal instinct is that the larger the government, the greater corruption. However, share of GDP being redistributed through taxes and public expenditures is negatively correlated to corruption. Central Europe has the largest public expenditures as a share of GDP, but little graft, while the Caucasus has minimal public expenditures and huge bribery.

But the quality of government is missing in our reasoning. La Porta et al. (1999) have shown with empirical material from 200 countries that bigger government is usually better. Wagner's law has long taught us that public expenditure as a share of GDP rises with GDP per capita, but Vito Tanzi and Ludger Schuknecht (2000) argue that public expenditures have risen as a share of GDP because of political ideas rather than out of necessity. Well-functioning governments have been allowed to grow disproportionately with growing resources, because people thought that the state could pursue more functions successfully. For instance, the Scandinavian governments were among the smallest in the West until the 1930s and functioned well, which was the reason why their size mushroomed later on, while their functioning degenerated more slowly

(Lindbeck 1997). La Porta et al. (1999) argue that the quality of government is mostly a result of political history.

Adding the quality of government, the causality between corruption and public expenditures is rather clear in the postcommunist world, as most of these countries started with public expenditures of around 50 percent of GDP. The countries that undertook early and successful reforms, notably Central Europe, have maintained high state revenues and expenditures of 44–48 percent of GDP in 1999, as they had comparatively well-functioning governments. Conversely, the Baltics follow with 40–45 percent of GDP in public expenditures (see Chart 4.5).

The big fall in state revenues occurred with hyperinflation, which was a misuse of government, as it enriched a small powerful group, and it may be perceived as one form of corruption. On the whole, the worse a government has functioned, the smaller it has become, prompting a sharp reduction in the very corrupt Caucasian governments. However, the Chapter 4 comparison of governments with a similar degree of initial corruption shows public expenditures as a share of GDP and the degree of state intervention were the big differences between the fast-growing and slow-growing partially reformed CIS countries (see Charts 4.6 and 4.7).

Thus, while all the CIS countries are very corrupt, the size of the government seems to be the most plausible explanation for their contrasting economic performance. The conclusion is that "opportunities to engage in corruption need to be scaled down by reducing the government rule in the economy" (Tanzi and Schuknecht 2000, p. 169). To obtain growth with these corrupt governments, the size of that cancer has to be reduced, so that free enterprise can flourish in spite of them. In parallel, bribery can be combatted by other means, and it tends to abate with economic growth.

Who Corrupts Whom?

Two contrasting views persist on demand and supply in corruption. One idea is that corruption is caused by unscrupulous entrepreneurs who exploit the state to their own advantage. The other perception is that poor entrepreneurs are subject to extortion by corrupt politicians and bureaucrats. As corruption describes a relationship between the state and the private sector, either party can dominate (Rose-Ackerman 1999, p. 113).

Joel Hellman, Geraint Jones, and Daniel Kaufmann (2000b) distinguish three kinds of relationships between firms and the postcommunist state, namely state capture, influence, and administrative corruption. State capture, also called political corruption, forms the rules of the game, that is, laws, decrees, and regulations, through illicit private payments to public officials. Influence also alters the rules of the game but without private payments to public officials. Administrative corruption implies private payments to public officials to distort the implementation of official rules, that is, ordinary bribery.

The patterns of bribery, state intervention, and distribution of subsidies reveal evident discrimination between enterprises of different ownership. State-owned enterprises are subject to most state intervention, but they pay moderate bribes while receiving the largest subsidies, maintaining a cozy relationship with the government. The state intervenes almost twice as much in state-owned enterprises as in private firms. Admittedly, privatized enterprises face much less state intervention, pay slightly less bribes, and still manage to extract significant indirect state subsidies. The real victims are new enterprises, which are easy prey for unscrupulous inspectors. The EBRD (1999, p. 127) established that "the more a firm pays in bribes, the less likely it is to receive direct subsidies," and there is no trade-off between time spent with officials and bribes paid. On the contrary, "comparing across enterprises within any given country, bribery, state intervention and time spent with officials tend to go hand-in-hand" (EBRD 1999, p. 125).

Our impression of bureaucrats as predators is being confirmed. State officials are indulging in extortion on a massive scale. The weaker the victim, the worse the persecution. While large firms report paying 2.8 percent of their annual revenues in bribes, small firms are forced to pay almost twice as much – 5.4 percent. Obviously, this lawless repression harms small private enterprises. The situation is far worse in the CIS than in East-Central Europe. The EBRD survey found that enterprises in the CIS countries pay almost twice as much of their revenues in bribes (5.7%) than do enterprises in East-Central Europe (3.3%).

The EBRD survey confirms that privatization is beneficial to the combat of corruption, as Daniel Kaufmann and Paul Siegelbaum (1996) have argued. Privatization has really removed the state from many company decisions. The large bribes paid by small private enterprises do not underscore their corruption but their lack of power before the post-communist bureaucratic Leviathan. This fits the empirical result by La Porta et al. (1999) that wealthy government officials extract more bribes than poor ones. Bureaucrats do not extort bribes because they are poor but because they are powerful.

State Capture

With so much corruption, one would expect some enterprises to exploit the opportunities, buying their piece of state policy. If all public goods are for sale, enterprises can benefit by purchasing parliamentary votes, presidential decrees, central bank funds, and court decisions. In 1999, the EBRD surveyed enterprises in 18 of the 21 countries of interest here, measuring state capture (see Table 9.1; Hellman et al. 2000b).

Table 9.1. State Capture, 1999 (Percentage of firms affected by purchase of . . .[a])

	Parliamentary Legislation	Presidential Decrees	Central Bank	Criminal Courts	Commercial Courts	Party Finance	Capture Economy Index[b]
Central Europe							
Poland	13	10	6	12	18	10	12
Czech Republic	18	11	12	9	9	6	11
Slovakia	20	12	37	29	25	20	24
Hungary	12	7	8	5	5	4	7
South East Europe							
Romania	22	20	26	14	17	27	21
Bulgaria	28	26	28	28	19	42	28
Baltics							
Estonia	14	7	8	8	8	17	10
Latvia	40	49	8	21	26	35	30
Lithuania	15	7	9	11	14	13	11
CIS							
Russia	35	32	47	24	27	24	32
Belarus	9	5	25	0	5	4	8
Ukraine	44	37	37	21	26	29	32
Moldova	43	30	40	33	34	42	37
Armenia	10	7	14	5	6	1	7
Azerbaijan	41	48	39	44	40	35	41
Georgia	29	24	32	18	20	21	24
Kazakhstan	13	10	19	14	14	6	12
Kyrgyzstan	18	16	59	26	30	27	29
Uzbekistan	5	4	8	5	9	4	6

[a] Firms were asked whether corruption in each dimension had no impact; minor impact; significant impact; very significant impact on their business. The table reports the proportion of firms reporting significant or very significant impact of state capture in each dimension.
[b] Calculated as the unweighted average of the six component indices.
Note: The columns reflect share of enterprises reporting that they purchased:
1. Parliamentary votes on laws to private interests;
2. Presidential decrees to private interests;
3. Central Bank funds;
4. Court decisions in criminal cases;
5. Court decisions in commercial cases;
6. Illicit party and campaign contributions.

Source: Hellman et al. (2000b).

Table 9.1 shows an EBRD survey of state capture, displaying astounding differences (Hellman et al. 2000b). The countries with little state capture consist of two groups, the most advanced reformers (Poland, the Czech Republic, Hungary, Estonia, Lithuania, Armenia, and suspiciously Kazakhstan) and the firmest dictatorships (Belarus and Uzbekistan), while the countries with the greatest state capture are largely intermediary reformers (in order of state capture: Azerbaijan, Moldova, Ukraine, Russia, Latvia, Kyrgyzstan, Bulgaria, Georgia, the Slovak Republic, and Romania). Individual countries may be mismeasured, but the overall picture makes sense. In liberal states, private enterprises do not find it worth privatizing state policy, while it is the way to success in very corrupt states.

Naturally, state capture influences the economic success both of nations and of individual enterprises. The average growth of sales was almost twice as high in the countries with little state capture as in countries with high state capture, reflecting the great cost of state capture to society. The sales of captor firms grew nearly four times faster than those of either firms in high-capture environments, but less in countries with little state capture, indicating one vicious and one virtuous circle.

The businessmen who paid politicians, senior officials, and judges were not typically from the old Nomenklatura but new ruthless entrepreneurs, prepared to do what it takes to make a fortune, reflecting the popular image of the oligarchs. Large old state enterprises, though, influenced the same kinds of officials through their close formal and informal ties rather than private payments. However similar their mode of operation, these two groups of enterprises represent different cultures. The evolution of state capture further underscores the dangers of gradual and partial reforms, which thus corrupt new entrepreneurs, or benefit the most unscrupulous new businessmen.

Strategy against Corruption

The fundamental cause of corruption is that "[c]orrupt incentives exist because state officials have the power to allocate scarce benefits and impose onerous costs" (Rose-Ackerman 1999, p. 39). Any strategy to combat corruption must diminish the supply of goods and services that officials can use to extort bribes, while disciplining officials.

Liberalization, stabilization, and privatization all serve to combat corruption (Rose-Ackerman 1999), as shown in Chapters 5 to 7. The foundation, however, must be the construction of a consistent legal system. While communism had denigrated law and favored discretionary decisions by the authorities, a noncommunist state needed to establish a clear hierarchy of legal rules and an effective system of the implementation of law. Institutions that protect property rights are crucial both to economic growth itself and to investment (North 1981), as they diminish transaction costs.

Deregulation would most obviously reduce corruption. It would diminish the power of officials to extract bribes for services or arbitrage opportunities, by legalizing previously prohibited activities, such as private enterprise, by abolishing licenses and permissions, by freeing prices and trade, and by unifying the exchange rate. State monopolies were notorious dens of corruption, as they maintained as many distortional regulations as possible.

Fiscal changes are equally important to reduce the scope of corruption, but they are less understood. Most important, subsidies and exceedingly ambitious public programs that could not be fully financed should be cut. A strange communist feature was that the state invested directly in enterprises, and these practices have continued in many countries, even after enterprises have been privatized. Such public investment must be eliminated. Program budgeting was needed so that the state budget really covered all costs necessary to carry out government programs, and the budget should be implemented without arrears or diversion of resources to favored lobbies.

The government's revenue side has been as involved in corrupt activities. A state monopoly over the state extraction of taxes must be established, but numerous powerful authorities insist on their semiprivate extrabudgetary funds beyond audits and public purvey. Taxation in some countries has degenerated into tax farming, where tax rates are at most nominal, and taxation is a matter of negotiation rather than law. Tax legislation must not exempt the big and powerful, but to make equal taxation politically possible, tax rates must be reasonably low. Taxes must be paid only in real money, as any monetary surrogate involves discounts to the powerful, while tax rules should be standardized and equal for all.

Privatization is more controversial, but it should be obvious both in theory and from the current practice that privatization has reduced corruption. "Privatization can reduce corruption by removing certain assets from state control and converting discretionary official actions into private, market-driven choices." Even if the process of privatization is inevitably fraught with corrupt opportunities, they are not continuous processes (Rose-Ackerman 1999, p. 35; cf. Kaufmann and Siegelbaum 1996). The alternative to full privatization is leasing, which seems highly corrupt all over. Apart from distancing enterprises from corrupt officials, privatization promotes the intensification of competition, as discussed in Chapter 7.

These measures aim at taking resources out of the hand of officials (deregulation, reduced taxation, and privatization), regularizing government procedures and constraining officials (improved fiscal procedures). However, a government needs to provide many collective services, such as law and order and a regulatory framework, that only the state can offer efficiently. Therefore, it is vital to clean up the government, which is a highly political task.

A Rise in Crime during Transition

Crime as a whole is perceived to have risen with transition in the same way as corruption, which appears a natural consequence of the breaking down of any system of order. Crime is many different things, and some, such as "speculation" and illegal entrepreneurships, disappeared by definition with communism. Crime statistics are not standardized, complicating any international comparison, but most transition countries probably saw an approximate doubling of their crime rates. They soared during the last years of communism, and Poland and Hungary saw a surge in their crime by over half in 1990, their first year of reform, but Poland then experienced a stabilization in its crime rate (Åslund 1997a).

In the FSU, the rise in crime seemed related to the degree of reform. The most radical reformers, Russia and Kyrgyzstan, faced the greatest increase in crime from 1988 to 1992, when it more than doubled, while the crime rate grew the least in the most conservative countries, Turkmenistan and Uzbekistan (Mikhailovskaya 1994).

A cursory look at crime statistics from various countries suggests that a more radical reform brought about an earlier peak in crime followed by a stabilization, while the gradual reformers saw a longer but steady increase. Very distorted markets clearly bred crime, and a period of great distortions around the beginning of the transition was unavoidable (Åslund 1997a).

In the early transition, organized crime and racketeering were serious concerns, inspiring associations with the Sicilian Mafia. Many factors were reminiscent of the postfeudal situation in Sicily that produced the Mafia, such as the lack of public law enforcement, private demand for legal services, and the availability of willing private providers of protection services (Gambetta 1993). However, much of the organized crime and racketeering has been socialized over time, as official police have taken over racketeering in the CIS.[5] Thus, what started as private rack-

[5] Personal conversations with people in the CIS over the years.

eteering has partly become extortion by public officials. Presumably, the reason for the differing development from Italy is that the public law enforcement providers are more powerful in the CIS, while their interest in law is limited.

FOR WHOM IS THE STATE WORKING?

The fundamental question is this: For whom is the state working? There are two sharply contrasting views. One sees the state as good and the people unable to understand their real interests, which easily becomes a justification for enlightened despotism. The other camp worries that the state is being exploited by an elite for its own purposes, wanting the elite to be held accountable, for which democracy is the most obvious cure.

Democracy or Dictatorship

Many people, especially West European social democrats, presume that the state is good, working in the best interests of the people. Not long ago, social democrats, such as Nobel Prize laureate Gunnar Myrdal (1968), advocated dictatorship in Third World countries to speed up their economic and social development. His argument ran: "The experience of the countries in central, eastern, and southern Europe after the First World War suggests that when a democratic form of government is imposed on an economically and politically immature nation it rapidly succumbs to authoritarian pressures and does so for internal reasons" (p. 774). As an enlightened social engineer, Myrdal put his ideals of modernization over democracy, with no consideration of participation. "Yet it may be doubted whether this ideal of political democracy – with political power based on free elections and with freedom of assembly, press, and other civil liberties – should be given weight in formulating the modernization ideals" (p. 65). "An authoritarian regime may be better equipped to enforce a social discipline, though its existence is no guarantee of this accomplishment" (p. 67).

The idea that democracy was the preserve of the West and countries of high economic development was deeply embedded in modernization theory, whose leading representative is Samuel Huntington (1991). As late as 1992, he argued that "authoritarian governments are better positioned than democratic governments to promote economic liberalization" (Huntington 1992–3, p. 12). When transition started, many argued that the preconditions for democracy had to be built first. A premature move to democracy could hinder growth by increasing the influence of special interest groups and fostering political instability (Isham et al. 1997).

In a contrary vein, many political scientists have long reckoned that democracy and a market economy naturally belong together, but this positive correlation has been tenuous (Lindblom 1977). As Larry Diamond (1995, p. 108) has put it:

> There are powerful logical, theoretical, historical, and empirical reasons to expect a close association between capitalism and democracy, with a logical relationship flowing almost inescapably from the very definitions of these terms. Capitalism is an economic system based on private ownership of the means of production and the determination of prices and rewards through competition between private producers. . . . Democracy is a political system based on the autonomy and freedom of individual citizens, and the determination of public power and policies through competition between groups of citizens, based in parties and interest groups. Economic freedom and political freedom thus would appear, at a minimum, to be natural companions, even if one does not strictly require the other.

Recently, this idea has been subjected to regression analyses. In one large cross-country regression for the whole world, Robert Barro (1996) established a universal positive correlation between democracy and growth. However, he argues that when the effects of the rule of law, free markets, small government consumption, and high human capital are set aside as well as the initial level of GDP, the overall effect of democracy on growth is weakly negative, but those effects are typical consequences of democracy. No free markets and no rule of law exist in postcommunist dictatorships.

The reputation of democracy was greatly enhanced in the late 1980s after the economic reforms in Latin America, which were usually preceded by democratization. "Only in Asia does authoritarianism appear conducive to economic liberalization" (Geddes 1994a, p. 107). In reality, most dictators reveal limited compassion for their people, while caring more for the fortunes of their families and friends. After all, the many dictatorships in Africa have not been known for socially inclined policies (Collier and Gunning 1999). Barbara Geddes (1994a, p. 113) has summed up the new democratic insights: "In many countries the biggest, and certainly the most articulate and politically influential, losers from the transition to a more market-oriented economy are government officials, ruling-party cadres, cronies of rulers, and the close allies of all three. These are groups whose ability to make effective demands does not decline as regimes become less democratic, which explains why many authoritarian governments have had difficulty liberalizing their economies."

Larry Diamond (1995, p. 131) has pursued this case for postcommunist countries, arguing for the early adoption of a new constitution and the consecutive holding of parliamentary elections: "the state in these last decades of communist rule had ceased to represent *any* common national interest, and its collapse left nothing but powerful congeries of rent seekers, utterly contemptuous of law, with the skills and ruthlessness to accumulate enormous wealth, rapidly and illegitimately. Permitting them to do so risks discrediting the entire new order."

Democracy Beneficial for Transformation

In the former communist countries, this correlation between democracy and successful economic reform is particularly strong. First, the communist state was far more dominant over economy and society than anywhere else in the world. Second, its elite was narrow and tight-knit. Third, the few checks and balances of communism faded with its demise, leaving the powerful without constraints. Fourth, the opportunities for rent seeking were fabulous due to extraordinary economic distortions.

By contrast, none of these conditions were apparent in East Asia, where the public share of GDP is tiny – in the order of 15–25 percent of GDP, compared with 40–50 percent of GDP in the communist countries. Significant economic distortions are absent, and civil institutions are strong and functioning autonomously (Pei 1994).

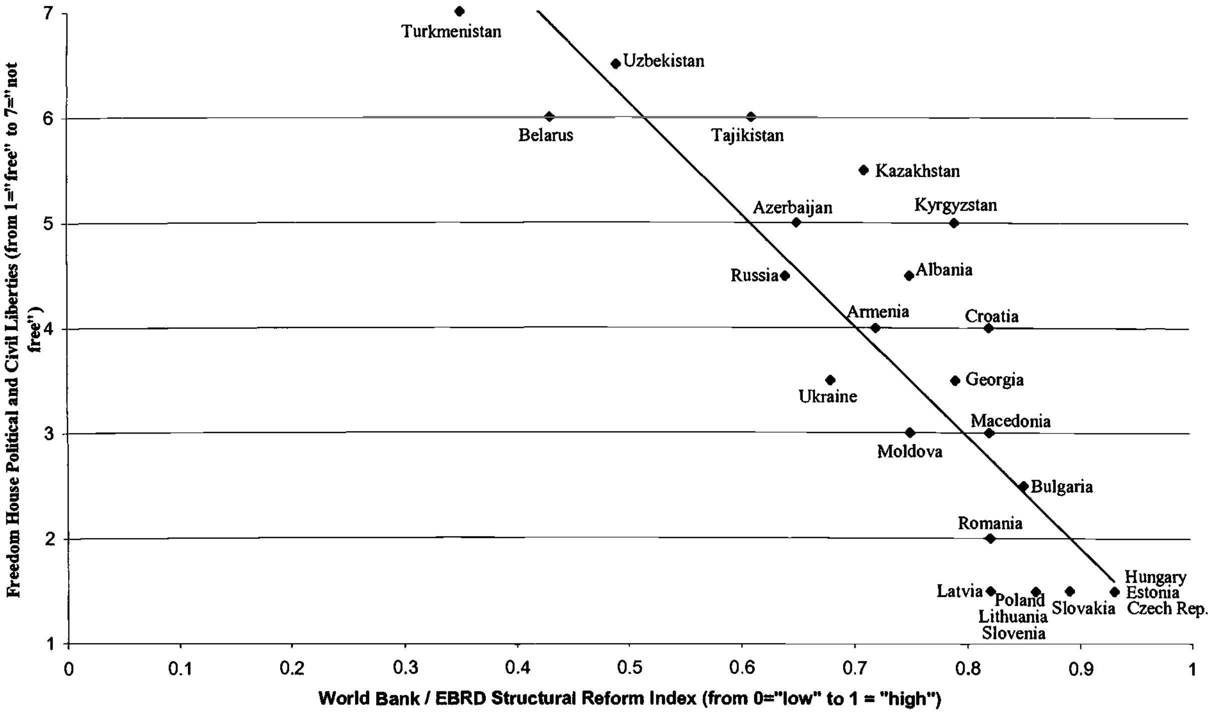
Thus, the central task for the economic success of transition was to control the old elite, for which democracy appears an ideal instrument. De Melo et al. (1997a) found a strong correlation between political freedom and economic liberalization (see Chart 9.2). The democracies in the region have opted for either radical or gradual reform, while the dictatorships have chosen little or no market reform.[6] As it should, the competitive political system has acted as a check on corruption, and the opposite of corruption has been radical reform (cf. Rose-Ackerman 1999, p. 127).

The dividing line between different models of transformation has been the interest dominating policy. One option was a small group of vested interests, to whom rent seeking was key, while growth of the national economy was not essential. An alternative was a group sufficiently broad to represent the public interest concerned about economic growth.

This contrasts starkly with the social democratic school of political economy for the postcommunist countries, spearheaded by Adam Przeworski (1991), discussed in Chapter 3. Like Myrdal and Huntington, Przeworski saw a choice between democracy and radical economic transformation, with radical reform being a threat to democracy, but all these

[6] Valerie Bunce (1999a) has elaborated on the logic of these correlations.

Chart 9.2 Democracy and Market Reform, 2000.



Sources: EBRD (2000a); Freedom House (2000).

arguments have been disproved. First, radical reform has not caused a greater but a smaller fall in output than gradual reform. Second, people have not risen against reform or endangered democracy because of steep falls in recorded output, as long as their governments have appeared serious about reform. Third, the threat to democracy has not come from the people but from the elite. Furthermore, that people would be so preoccupied with short-term economic results that they would jeopardize democracy for any shortfall runs against any consideration of expectations.

Similarly, Jon Elster, Claus Offe, and Ulrich Preuss (1998, p. 272) summarized two kinds of vicious circles they had anticipated. Either "the unrestrained use of democratic freedoms would undermine any national program of economic recovery because the citizens would use their newly acquired voting power to remove out of office every government that dared to impose on them economic and social hardships. . . . " Or "the unrestrained use of state power to impose economic reform of the 'shock therapy' kind on society irrespective of the social costs would necessarily provoke active or passive resistance of society against the reform and at the same time cause a considerable number of people to live in poverty and even misery." But they conclude that "fortunately neither of these hypotheses has come true in their extremely pessimistic versions."

The "Pinochet school" has argued that a temporary dictatorship is needed to introduce a market economy, but that view has been rejected for the same reasons. (cf. Maravall 1994). Not surprisingly, the Pinochet argument has been more popular among old communists (for instance, Silviu Brucan 1992) and Russian industrialists than among actual supporters of a liberal market economy. Yet, some Russian economic liberals do call for a Russian Pinochet (Aven 2000).

Impact of Electoral Rules on Party Formation

The essence of democracy is institutions, effectively representing the public interest, and elections are the main vehicle in their construction. As with the economic transformation, the timely execution of political institution building is vital, and timely usually means early. A few seemingly technical aspects of the first elections have been essential for the political development of each country.

A first issue was to build political parties, which could serve as barriers against corruption. A party is more broad-based than an individual deputy, which makes it inclined to represent a broader public interest. It needs to have some party line, and it cannot change too often and too much to be credible. Moreover, the existence of a party formalizes procedures for contacts with outsiders and decision making, so that individuals do not face large funders alone. As a result, parties make it easier for deputies to resist corrupt proposals. The parties' formation depended greatly on their role in the first founding elections, whether they were permitted, and if the electoral system encouraged them (McFaul 1997).

Central and South-East Europe launched ordinary party elections from the outset, but all the elections in the Soviet Union in 1989 and 1990 precluded any formal role for political parties, which rendered them merely semidemocratic. As a consequence, the electorates and the ensuing parliamentary factions were neither structured nor disciplined, and the deputies were accidental figures accountable to nobody. The only exceptions were the Baltic states, Georgia, and Armenia, where the national popular fronts had grown so strong that they became real political parties despite the electoral system. In Ukraine, parties were proscribed even in the second parliamentary elections in 1994. The result was freewheeling corruption of individual deputies and an unruly parliament. One consequence was that about one-third of the Ukrainian deputies elected in both 1994 and 1998 were active businessmen. Their purpose was not to facilitate deregulation, but on the contrary to extract their share of rents, partly by sponsoring legislation benefiting their enterprises, partly by selling their legislative initiative to other businessmen.[7]

Another important election rule was whether parliaments were based on proportional representation or on majority election in single-mandate constituencies. The East-Central Europeans and Balts chose proportional elections, while the CIS countries have mixed systems. Some had proportional representation (Armenia and Georgia); some single-mandate constituencies (Belarus, previously Ukraine, and Kyrgyzstan); and some have a combination of both (Russia, Ukraine, and Kyrgyzstan). In the countries with proportional representation, a steady party system evolved rather soon, and those are the strongest democracies in the region (Kitschelt et al. 1999). There is an apparent trend to a mixed system as in Russia. As elsewhere in the world, proportional representation facilitated the formation of strong parties and thus reform efforts (Geddes 1994b). Ironically, the challenge from the Communist Party often forced the other political groups to get organized and thus improve the efficacy of their democracy.

A third election rule with great impact was whether any threshold for proportional representation existed, usually 4 or 5 percent of the votes cast. Some countries introduced such a hurdle from the beginning, and

[7] Personal conversations with Ukrainian businessmen-deputies over the years.

they obtained neatly structured parliaments with up to six parties from the outset. This was true of East Germany, Hungary, the Czech Republic, Slovakia, Bulgaria, Romania, Estonia, and Lithuania. The exceptions were Poland and Russia. Poland had no less than 28 parties represented in its first freely elected *Sejm*, and Russia had many independents from the 50 percent of deputies elected in single-mandate constituencies. Initially, a large share of the votes cast resulted in no representation because of the large number of parties. Georgia took the prize in its October 1992 parliamentary elections, as over two-thirds of the votes were cast for small parties that were not being represented. Soon, however, people learned and increasingly selected parties that were actually represented (McFaul 2000).

A fourth factor of great importance for the future party structure was the timing of the first founding parliamentary elections (McFaul 1999). The population was most enthusiastic for economic reforms just after their launch, focusing on vision rather than costs. The later the first postdemocratization elections were held, the worse the result for reformers. Countries that had mobilized to overthrow communist rule tended to unite around one broad popular movement. If elections were held within less than a year, these movements could be transformed into large democratic parties, while any delay caused divisions. Successful early elections took place in East Germany, Hungary, and the Czech Republic. Poland, Russia, and Latvia, on the contrary, held their first parliamentary elections very late, almost two years after they had attempted radical economic reform programs. These elections resulted in a complete fragmentation of the popular movement for democratization and serious backlashes against reform. In Poland, Solidarity was broken up into a score of parties, and in Russia the once impressive popular movement Democratic Russia dwindled into insignificance. Similarly, Latvia held its founding parliamentary elections almost two years after independence and saw its popular front fractured and demolished.

National peculiarities do matter. None of the postcommunist countries has a party structure that resembles that of any other postcommunist country, showing more originality than West Europeans (Kitschelt et al. 1999). Still, the impact of party elections, proportional representation, hurdles for representation, and timing of a founding election have been as effective as any political scientist would have predicted (McFaul 1997).

Campaign Financing

One of the most difficult problems in any democracy is campaign financing, which tends to be one of the last vestiges of corruption throughout the world (Rose-Ackerman 1999, pp. 130–3). In the post-communist world, party financing was initially limited, as campaigns were poorly organized. In the first elections, many big businessmen had been so contemptuous of politics that they boasted of not having time to vote.

Soon, however, businessmen realized the economic utility of politics and after a few years the outright purchasing of political parties became common in Russia and Ukraine. A businessman promised to fund a party, and the party responded by defending the businessman's interests. Especially in Ukraine, big centrist parties were actually formed for business purposes. Politicians tended to look for only one big funder and they accepted being his employee. This was true of both parties and individual parliamentarians. Naturally, this funding was unofficial and completely nontransparent, but the knowledge who paid what for whom was widespread, as virtual price lists developed for different political services. Deputies could be bought in retail or wholesale as parties, for individual votes or as permanent representatives (Fedorov 2000, pp. 227–33).

From the mid-1990s, campaigning has become sophisticated and very expensive by Western standards. The unofficial cost of President Yeltsin's reelection campaign in 1996 was US$600 million.[8] The second most expensive campaign was probably President Leonid Kuchma's reelection in October 1999. These two campaigns involved conspicuous malpractices, as top tycoons got together to finance the presidents' reelection in exchange for cheap government bonds and privileged privatizations of large companies.

Political funding is one of the most intricate problems of corruption. Legislation against these practices exists, but it has proven ineffective. Enterprise accounts are nontransparent, and offshore funds are easily used. The declaration of incomes and property of politicians, as is done in Russia, has become a big joke, but it does expose some politicians.

Part of the solution must be increased transparency of government and its budget to complicate direct sales of government. Another part is economic growth, altering the interests of leading businessmen from rent seeking to profit seeking. In Russia, parties have been forced to broaden their financial base after the financial crash, and the new funders tend to be producers rather than sheer rent seekers. Although the purchase of parties exists, strong parties caring about their reputation are probably the best limitation on the purchasing of politicians. Only truly populist parties can auction their votes to the highest bidder.[9] A clear left–right

[8] Personal information from one of the main fund providers.

[9] Russian populist Vladimir Zhirinovsky is famous for doing so (Fedorov 2000, p. 232).

distinction helps to limit a party's inclination to corruption (Rose-Ackerman 1999, p. 202). Many politicians have become disillusioned with capricious tycoons with no stable political views but only interests, and they attempt to broaden their financial base.

Yet, campaign financing cannot be easily restrained, and it involves the indirect purchase of government. Ultimately, the best cure is a substantial reduction in government redistribution, being one of the strongest reasons why post-Soviet governments must be very small.

REFORM OF THE STATE

The possibly most difficult task of the postcommunist transition has been to reform the state to alleviate the chronic state failure of communism. An important first choice has been the nature of constitution – parliamentary or presidential rule. The next task was to rebuild the state apparatus, which has turned out to be particularly cumbersome. A third task has been civil service reform. Finally, the very mode of operation of the government should preferably change to facilitate a new servicemindedness, but the question is how that can be done. Although much has been tried, this is possibly the sphere of the worst flaws in an average transition country.

Parliamentary System or Presidential Rule

The communist states were not full-fledged states, as the state apparatus was only an appendix to the real state, the Communist Party. The Party stood unregulated above the law, intervening however it found convenient, but never accountable.

The former communist countries were left with a contradictory constitutional inheritance, with written constitutions never meant to be applied. Now these bogus constitutions assumed a life of their own, while most countries also tried to draw on precommunist national history. To a surprising extent, constitutions and politics were seen as national prerogatives, and international experience was widely ignored. Therefore, the impact of Western models was much more limited than in the economic sphere, albeit Western advice played a greater role in the western part of the region.

The main conflict concerned the division of power between the president, the council of ministers, and parliament. While the struggle between the president and parliament has been the most dramatic, the government often played an important role in policymaking. This strife was further aggravated because the principle of the division of power, which had prevailed in the rest of the world since the late 18th century thanks to Montesquieu [1748], had never been accepted by the communists, since it circumscribed the complete power of the Communist Party, and the public understanding of the benefit of such a principle was strangely absent. Nor did any independent judiciary exist. In the old Soviet-type legal system, the prosecutor was superior to the judge, and defense counsels were rarely welcome. These conflicts were the worst in CIS countries with some democracy – Belarus, Ukraine, Moldova, Russia, Kazakhstan, Kyrgyzstan, Georgia, and Armenia, while the EU accession countries tended to adopt European standards gradually.

The communist institutions did not just go away. Under communism, the Politburo and the Central Committee of the Communist Party had been supreme. Their places were taken by the president and his administration, and at the regional level by the governor and his administration. By communist tradition, the presidential and gubernatorial administrations could interfere at will without accountability. The presidential administrations were quite large – at one stage 6,000 people in Russia and 1,000 people in Ukraine.[10] These large central bureaucracies became centers of rampant corruption because of their large assets, great rights of intervention, and absence of accountability.

The Soviet parliament was a rubberstamp institution that convened twice a year and adopted one or two laws each time. Its members were often token members of various social strata, especially milkmaids, rather than powerful individuals. According to the Soviet Constitution of 1977, however, parliament was powerful and sovereign. After communism, parliaments in the western part of the region assumed the roles of their West European counterparts, but farther to the east, ideas of peculiar national models held sway. Post-Soviet parliamentarians demanded substantial executive powers, notably in fiscal and monetary matters as well as privatization. The problems of the post-Soviet parliaments were aggravated by the lack of party structure and the not fully democratic parliamentary elections in early 1990.

Initially, the presidency was relatively strong in most countries to offer firm leadership. Poland was an exception, since the illegitimate Communist President Wojceich Jaruzelski stayed on, as well as Hungary which chose a parliamentary system from the beginning. The Czech Republic, Slovakia, Bulgaria, and the Baltic Republics have had ambiguous constitutions, but their presidents have increasingly developed into elderly statesmen rather than leading executives, inspired by Western Europe. Legislation became the concern of parliament, and the government was responsible to parliament, while the president focused on constitutional and international issues.

[10] Personal information from working with these governments.

In the FSU, presidential powers have persistently been much stronger, but parliaments have challenged them, leading to virulent conflicts. The most dramatic one occurred in Russia in September-October 1993, ending with the president dissolving the predemocratic and unrepresentative parliament, which responded by organizing an armed uprising. The governance problems were even worse in Ukraine, and they have persisted longer. In Ukraine, the government was often a full-fledged party in a tripartite strife with president and parliament. Presidents responded to irresponsible parliaments by demanding greater power, but the parliaments refused, pointing to the corruption of the government. Similar conflicts have occurred in Armenia, Belarus, Moldova, Kazakhstan, and Kyrgyzstan.

Over time, some clarity has been established. In general, the greater the continuity and the less democratic a country has been, the stronger the presidential powers. But a continuous improvement in certain procedures is notable. Previously, ministerial officials wrote decrees on the basis of oral orders passed down from the Party. Now they are adjusting to the idea of a rule of law. Increasingly, they draft laws that are to be discussed, amended, and promulgated by parliament. As the practice of issuing many decrees continued, this change occurred only gradually.

The Russian parliament no longer tries to intervene in executive matters, and since 1996 the president and the government have reduced their number of decrees and instead tried to promote laws adopted by parliament, as presidential decrees have not very effective, credible, or well drafted. They can easily be issued, withdrawn, and contradicted by other decrees or overturned by courts, while the time-consuming adoption of a law requires commitment from a substantial number of people (Remington et al. 1998; Remington 1999). In Kyrgyzstan, the duplication of the presidential administration and the government apparatus persists, diluting decision making and responsibility, although the apparatuses are quite small with only 100 officials each. In Kazakhstan, which is mildly authoritarian, the president has greater power, issuing many principal laws as presidential decrees with the power of law, but these seemingly good laws are surprisingly ineffective. An attempt in early 1999 to shift many of the ordinary duties of government to the presidential administration – even the state budget – ended with the president transferring these tasks, and his most trusted collaborators, to the government.

The broader implication is that a successful reform requires the support of an elected legislature, because a couple of hundreds of laws have to be promulgated, and decent laws can only be adopted by a parliament with a reformist majority.[11] Therefore, the greatest shortcoming

[11] I owe this point to Alexander Boshkov.

of the Russian reform efforts appears to have been that the reformers did not secure a parliamentary majority until December 1999, and their victory in presidential elections in June 1991 and June 1996, as well as in a referendum in April 1993, did not suffice.

A number of key principles need to govern the constitutional distribution of powers. First, there must be a clear division of executive and legislative powers. By and large, the democracies in the region have accomplished this, but at a rather high costs, since they did so through trial and error rather than through principled consideration. Second, there must be some transparency and accountability, which is a strong argument for parliamentarianism, because a parliament can supervise a government relatively closely, while presidents and their administrations are patently nontransparent and unaccountable. A third principle is that law should rule society, which means that parliament must possess substantial legislative powers, while those of the government and the president should be minimized. Considering the moral weakness of government, discretionary decrees are more often than not intent on favoring a specific lobby. Under the existing conditions, parliamentary rule is much preferable to presidential rule in the whole region, and the purported need for a strong president is only a variety of the myth of the need for a dictator. A strong state is an accountable state.

Government Reform

The communist state did too much and the wrong things in the wrong way, while vital state functions were ignored.

The bureaucrats had to get out of enterprises and government be separated from business. In a market economy, the state apparatus implements legal regulation rather than manages enterprises. Therefore, numerous state bodies designed for the management of industries and enterprises had to be abolished, ranging from the State Planning Committee, its subordinate State Material Supply Committee, and the State Price Committee, to scores of industrial branch ministries. Poland and Hungary had completed these changes before the transition, while it was a hard struggle in most post-Soviet countries. Abolished branch ministries tended to reemerge, as their functions had not been eliminated.

Preferably, all state bodies should be prohibited from managing enterprises, but officials benefit from mingling in business. They protest that their duty is to "help" firms, refuting the market economic view of the regulatory state as a defeatist idea. In 1992, I remember hearing the view about Russian Minister of Privatization Anatoly Chubais that he had no political future, because "he did not solve problems," that is, he did not take bribes. Intrusive state intervention persists in enterprise decisions throughout the region (EBRD 1999, p. 123).

In other cases, state power is both too centralized and too diffuse. It is not uncommon that a post-Soviet decision requires twenty to thirty signatures, and then nobody is responsible. Functional ministries should wrangle power from the council of ministers and the presidential administration to become policymaking bodies, but responsibility remains diluted between these bodies, as these habits of collectivism linger.

For communism, secrecy was even more sacrosanct than openness is for democracy. A first step is to publish all legal acts, which Poland and Hungary had done before the end of communism, but many post-Soviet countries are still reluctant to do so. Eventually, the publication of all legal acts on the Internet is likely to solve this problem. Considering the weakness of the legal system and poor compliance with the law, one would assume businessmen to ignore most legislation, but enterprise surveys in Russia have shown that both large and medium-size enterprises pay for legal services and keep themselves well informed about new legislation. Moreover, enterprises are suing both each other and the government more each year (Hendley et al. 1997). The logical conclusion is that new laws eventually will change businessmen's behavior.

Another novelty has been public audits of the government. Under communism, Poland was an exception with its strong Auditing Chamber. Impressively, most countries have tried to establish some kind of auditing agency. Curiously, in Russia and Ukraine, the left-wing opposition has tended to control the auditing chambers, which have become strongholds of uncompromising critics of reform.

Not surprisingly, it has been extremely difficult to reform government. While numerous necessary changes are obvious, many of those working in the government apparatus have little reason to welcome such changes, because of their perverse incentives. Quite a few officials are more interested in enriching themselves through extortion and theft (Hay and Shleifer 1998; Shleifer and Vishny 1998). How to defeat these enemies from within has been one of the most difficult tasks of the transition. Andrei Shleifer and Robert Vishny (1998, p. 12) conclude that "deregulation and liberalization are far more important for fighting corruption than the improvement of incentives and personnel selection inside the bureaucracy."

Civil Service Reform

Under communism, all senior officials were members of the Communist Party, but in reality even ministers were civil servants rather than policymakers, as merely a few top people made policy. With transition, it was desirable to draw a clear line between politicians and civil servants, and the civil service needed to be depoliticized, but only Estonia has done so. The confusion between politicians and civil servants continues almost everywhere.

A substantial renewal of cadres was necessary. The communist bureaucrats were largely engineers, while a modern administration requires economists and lawyers. Many had been preoccupied with intricacies of a command economy, seemingly without relevant knowledge for a market economy. These officials represented a negative human capital and their layoff was urgently needed. In the gerontocratic Brezhnev era, officials were promoted on the basis of seniority rather than merit (Amalrik 1980). Not only depoliticization and rejuvenation but also professionalization was vital.

During years of high inflation, salaries in government service fell sharply, with pay scales becoming compressed, often making it impossible even for a minister to live on his salary. It has been extraordinarily difficult to raise salaries for senior officials, and no pay incentives have awaited them after honest and hard work. Additional incomes became a necessity for many. Often, additional earnings were extracted as bribes, but jobs on the side or involvement in semistate entrepreneurial activity were also common. Substantial fringe benefits, such as free apartments, dachas, and holiday trips, remained standard for senior officials in the CIS countries. As an effect, the public service was partially privatized, and the dividing line between public and private was blurred further.

Commission remuneration has developed on a grand scale. Especially, CIS tax policemen and customs officials have become used to receive certain shares of the state revenues they extract. Rather than satisfying their needs, these commissions seem to have whetted their appetite. Phenomena like "extrabudgetary" policemen have evolved, sounding like the definition of legalized racketeering. Characteristically, CIS tax policemen have focused on easy and fat prey, like foreign investors, aggravating an already unjust tax burden.

The civil service has been neither civil nor service-oriented, but steeped in an exuberant conflict of interests. In the late Soviet period, ministers boasted about being so progressive that they set up private enterprises, not realizing that it might be perceived as an improper conflict of interest. As communist officials had learned that property was theft (as coined by Pierre Joseph Proudhon in 1840), they thought they might as well start their career as capitalists by stealing state property. Only gradually have multiple employments and "commissions" of public servants been prohibited and public declaration of incomes of politicians demanded. Clear lines have to be drawn between business and the state, prohibiting all combinations of the two. Explicit codes of ethics defining bribery are needed. The widespread practice of appointing government ministers to supervisory boards of enterprises, through which they often earn much more than their official salary, is another example of unacceptable practices. At the same time, the salaries of senior public servants must be raised sharply to motivate them and render it possible to live honestly on a state salary. The many fringe benefits should be minimized and replaced with money, as they inevitably breed crime.

The greater the initial turnover of political elites, the greater the probability of successful market reforms. Communist governments that retained power have been reluctant to reform. Progress in liberalization has been "twice as high in countries where the political executive has been replaced as in those where the incumbent from the communist era remained in office." Indeed, in several countries liberalization and stabilization were delayed until the incumbent postcommunist government was finally removed through elections, notably in Bulgaria, Romania, Moldova, and Ukraine (EBRD 1999, p. 106). This is a strong empirical argument for lustration, that is, the exclusion from senior government service of secret policemen and party officials. However, this was undertaken systematically only in East Germany and the Czech Republic, though several other countries made some efforts, notably the Baltic states, Poland, and Bulgaria. The counterargument is that old officials can make amends, and if allowed to make a comeback, they can contribute to advantageous competition, and a possibility of advancement or at least survival can entice them to improve.

Contrary to the general perception, the communist administration was not all that large, and most countries saw their bureaucracies swell with the transition. One reason was that the government assumed a number of new functions, notably tax collection. Another cause was the absence of hard budget constraints, which led to a wasteful expansion of the bureaucracy. Most important, however, was probably that the additional bureaucrats, who were largely inspectors, made their own living in the name of the state, by extorting money for "paid services."

In the successful reform countries, especially Poland, Hungary, and Estonia, civil service reforms were impressive, clearly improving the quality of public administration, while much of the post-Soviet administrations rather appeared to decline. This difference in quality between various transition countries is apparent and important, but it is difficult to measure.

To Check Government through Competition

The desired improvements of postcommunist governments are numerous, but it is difficult to find an effective implementing agent. The main lever should be democratic decisions from above, inspired by popular pressures and votes from below. Yet, quite a bit can be accomplished within the administration itself.

Andrei Shleifer and Robert Vishny (1993) suggest that corruption can be defeated through competition. If several public agencies are entitled to offer the same service, they compete among themselves over bribes driving bribes to zero. Their example is U.S. passport offices. If any official tries to extract a bribe, a customer can go to another office and acquire a passport without a bribe. Something similar happened before the end of communism in the Soviet Union, when the new Central Bank of Russia and the Soviet State Bank competed over the issuing of bank licenses. Both banks diminished their demands to make sure that banks registered with them, minimizing the requirements for setting up a bank, and the number of banks mushroomed (Johnson 2000). Unfortunately, it did not happen in an industry with little need for regulation. Similarly, when the Russian Ministry of Interior became too slow in issuing passports, the Ministry for Foreign Affairs started issuing passports swiftly, but for a steep fee. Ideally, every license that persists could be issued by the central government, the regional government, and the local government, which would expedite the issuing of all licenses and check bribery.

Such an explanation matches the development of Poland, where the monopoly of corruption broke down in the 1970s under Edward Gierek, when Poland was perceived as promiscuously corrupt. That image persisted in the 1980s, and foreign direct investment took off only in 1996, as foreign investors realized that there was always some way to solve things in Poland. Seemingly, the extraordinary competition throughout Polish society has driven down bribes to a much lower level than in societies perceived traditionally as much less corrupt, such as Hungary, Slovakia, and the Czech Republic (EBRD 1999, p. 125). Staggeringly, in 1999 Czech businesses paid almost twice as much of their revenues in bribes as their Polish colleagues (4.5 percent versus 2.5 percent of total sales). Comparative historical data are missing, but the public perception was that Poland was more corrupt than the Czech Republic in the early 1990s.[12]

However, the popular understanding is that corruption increases when it becomes subject to competition and therefore harms the economy more. If we consider all rents, they appear to have risen with the initial liberalization, peaking in 1992–3 in the CIS countries and falling since (Åslund 1999; Åslund and de Ménil 2000). This would make sense. When a monopoly falls apart, prices overshoot the market-

[12] Transparency International (1999) treat them as equals even now.

clearing level, as traders try to skim the market, but competition drives real prices down, as traders realize that they cannot sell otherwise.

The problem with a competitive approach to the combat of corruption is that bureaucrats diversify. Rather than competing in the issue of the same kind of license, they collude by requiring different licenses. Even so, they do eventually compete. To construct a commercial building in Ukraine or Kyrgyzstan, 200–300 licenses and permits are required. Obviously, an agency requesting the one-hundredth permit cannot ask for as much as for the first permit. The marginal revenue of each additional permit declines because of the officials' dwindling bargaining power and the minimization of construction. In the end, the officials in question will find that their extortion reaps them so little benefit that they might as well do something else. While this process is ugly to see, it seems to work. Yet, it only applies to regulatory activities, not to revenue collection or law enforcement, where competition leads to overgrazing (Rose-Ackerman 1999, pp. 49–53).

In 1996, Daniel Kaufmann (1997) found that Ukrainian enterprise managers spent over one-third of their time with government officials, but by 1999 this time had fallen by half (to 17 percent) – an impressive improvement in an economy that was perceived as totally stalemated by bureaucracy (Hellman et al. 2000a). Apparently, businessmen and officials had rationalized their relations, thereby lowering the transaction costs caused by inspectors stopping production and wasting management time through bargaining. The natural compromise would be that managers pay more bribes for spending less time with officials, allowing production and profits to rise because of less time lost on bureaucracy as well as less uncertainty and risk.

The idea of competition over corruption does not contradict other proposed solutions, such as deregulation and sharp cuts in government bureaucracy, and if the bureaucracy is not disciplined through internal competition, it might be impossible to defeat. The competitive approach also suggests several possible ways out of the same dilemma, because rivalry can evolve in so many ways.

This line of thinking runs counter to an idea presently popular among political scientists and some economists, that the corrupt and rentseeking should be paid off through discretionary deals.[13] The dealmaking approach is problematic because it provides the wrong incentives. Rather than being paid off, rent seekers need to be taught a

[13] This is a huge literature that is expanding fast. The original proposal to buy out the Nomenklatura was made by Jan Winiecki (1991b). The most interesting recent contributions to transition economics are probably Treisman (1998), Shleifer and Vishny (1998), and Shleifer and Treisman (2000).

lesson by losing money. A deal with the corrupt is in itself corrupt. It does not change the paradigm from cronyism to capitalism with a level playing field, which is a key aim. Moreover, deal making between government and corrupt businessmen taints the politicians involved. Reform politicians who have tried have usually lost their moral standing among voters and thus their popularity. Politics are about building reputations, and deals with the corrupt usually taint you. The rational approach in a democracy is to resign from government, if a corrupt deal cannot be avoided, and expose it in the public debate, hopefully coming back into government with a stronger mandate after a future election. Of course, compromises are inevitable, but they should not be undertaken without consideration of moral costs.

Is the problem that the monopoly of the state administration has broken down? While that is true of revenue collection and law enforcement, it must not be drawn too far. Mancur Olson (1993) elaborated the idea that "roving bandits," who rob and run as they only take booty once, must be avoided because they destroy the incentives to invest and produce. It would be better for both the bandit and the population if the bandit became a dictator, a "stationary bandit," who monopolized theft in the form of taxes. Arguably, this was Stalinism. Consistently, Murrell and Olson (1991) argue that the decline of communism was caused by decentralization. However, the way forward is hardly to reestablish the monopoly of theft in the sphere of regulation, which Presidents Alexander Lukashenko of Belarus and Islam Karimov of Uzbekistan possibly have accomplished, because it does not seem to lead to a competitive market economy. Then the relative openness of a rentseeking society seems preferable, as it is less stable.

The two most successful reformers, Poland and Estonia, suggest somewhat different approaches to controlling corruption and improving governance. The essence of the Polish transformation was true shock therapy that caused discontinuity, catching the old elite off guard. It felt forced to give up the old mold and accept reformed rules of the game. Later, the Polish transition was pretty messy, but a strong sense of direction had been imposed and persistent competition provided checks and balances. Estonia started off with a very radical liberalization, particularly in foreign trade, and it undertook a thorough government reform from the top. It has managed to maintain a top-down, technocratic approach, but with only 1.5 million inhabitants Estonia may be an exception because of its tiny size. Therefore, the competitive Polish solution seems more relevant for other countries. Thus, as far as possible, people should be given the opportunity to turn to several mutually independent government authorities to solve any regulatory problem.

ELECTIONS AND REFORM

In the early Western discussion about the politics of economic reform, an odd belief prevailed that ordinary people would not support radical reform, but the evidence has not validated that assumption. We shall first examine actual election results, showing far greater popular support for reform than generally perceived. However, a political underreform trap is apparent in semireformed countries. As a check, we complement these electoral observations with some evidence from cross-country opinion polls.

Few Communist Votes

Facing drastic decline in recorded output and fearing disaster, people would reasonably focus on the restoration of stability and economic growth rather than redistribution.[14] Then, credibility of a program of economic stability and long-run growth would be crucial. This was the political logic of radical market programs. They evidently worked in the West, and we would expect people to vote for policies that had brought about economic growth in the West.

This idea runs counter to the common perception that communist parties have made a great electoral comeback in the postcommunist world. This impression is underpinned by the idea that the socialist economy was fundamentally good and stable, providing substantial social welfare and public goods. Therefore, people are presumed to feel nostalgia for the old regime and to want it back.

To test these two contrary assumptions on the electoral record, we examine all parliamentary elections in democracies in the area.[15] Fifteen countries in our postcommunist region have enjoyed a reasonable degree of political freedom, being classified as either free or partly free by Freedom House, while six countries are not even partly free and are therefore excluded (Azerbaijan, Belarus, Kazakhstan, Tajikistan, Turkmenistan, and Uzbekistan – Freedom House 1997). Another prerequisite is the existence of a party structure, which excludes Kyrgyzstan, because its first party elections occurred in February 2000.

Because of highly varied party structures, the electoral outcomes are most easily classified by a focus on the national Communist Party. Although most communist parties have been renamed, one party is

[14] This section draws on Åslund, Boone, and Johnson forthcoming.

[15] Presidential elections tend to be dominated by personal factors, while local elections are not very relevant for national policy and participation is limited. The countries considered democratic have varied minimally, but we pick 1997, as that has been our standard.

usually the apparent successor. Splinter groups, such as agrarian parties or Stalinists, tend to be minor or alter appearance. Communist parties also change, and the communist parties have become social democratic in Poland, Hungary, Slovakia, and Lithuania, while they remain hardline in their opposition to market economy in the Czech Republic, Bulgaria, Romania, and throughout the former Soviet Union. Essentially, they have remained antisystemic in countries that saw little democratization before the end of communism.[16]

The results from all the parliamentary elections contrast sharply with conventional wisdom (see Table 9.2). Communist parties have fared poorly regardless of country and policy. By 1997, no Communist Party in the region had attained one-third of the votes cast in the most recent democratic election. A few governments did contain the odd communist minister at times (Slovakia, Russia, and Ukraine), but the Communist Party was not the senior partner in any government. The communist parties in Italy, France, and Finland were actually larger during the Cold War. Apparently, the presumed popular nostalgia for communism was very limited.

Another result of a similar cross-country regression for postcommunist countries was that governments pursuing radical reform fared much better in democratic elections than gradualist governments. Most governments lost their second election in the transition, but all nonsocialist governments that had opted for gradual reform lost, while some of those that had chosen radical reform won (Åslund, Boone, and Johnson 1996).

Electoral Trap of Underreform

By Communist Party performance, these countries can be divided into two groups – those where the communist parties received more than 20 percent of the votes cast in the latest parliamentary election (seven countries), and those where they obtained less than 20 percent (seven countries). The threshold is a natural division with no country in the interval of 16–21 percent. Our summary classification is displayed in Chart 9.3, matching this political division by their degree of market reform in 1997, splitting the democratic transition countries into four quadrangles.

We can distinguish three typical electoral paths. First, the top left box in Chart 9.3 contains three countries that have undertaken radical transformation, but even so their communist parties are doing well. In Poland and Hungary, the former communist parties were initially almost routed, but they have staged strong comebacks to about 30 percent of the vote, as they were thoroughly reformed early on. They can now be described

[16] The Communist Party of the Russian Federation started turning social democratic in its economic policy before the parliamentary elections in December 1999.

Table 9.2. Ex-communist Vote Share in Parliamentary Elections in Postcommunist Countries (Percent)

	First Election	Vote Share	Second Election	Vote Share	Third Election	Vote Share	Fourth Election	Vote Share
Armenia	1990	Minority	July 1995	12.1	May 1999	12.0		
Bulgaria	June 1990	47.2	Oct. 1991	33.1	Dec. 1994	43.5	April 1997	22.1
Czech Republic	June 1990	13.6	June 1992	14.2	May 1996	10.3	June 1998	11.0
Estonia	March 1990	Minority	Sept. 1992	13.6	March 1995	5.9	March 1999	6.1
Georgia	Oct.–Nov. 1990	Tiny minority	Oct. 1992	2.7	Nov. 1995	3.8	Oct. 1999	Tiny
Hungary	March–April 1990	10.9	May 1994	33.0	May 1998	32.9		
Latvia	March–April 1990	Minority	June 1993	12.0	Sept.–Oct. 1995	12.9	Oct. 1998	14.7
Lithuania	Feb.–March 1990	Minority	Oct.–Nov. 1992	42.6	Oct.–Nov. 1996	9.5	Oct. 2000	31.1
Moldova	Feb. 1990	Majority	Feb. 1994	22.0	March 1998	30.1		
Poland	June 1989	Minority	Oct. 1991	12.0	Sept. 1993	20.4	Sept. 1997	27.1
Romania	May 1990	66.3	Sept. 1992	37.9	Nov. 1996	21.5	Nov. 2000	37.0
Russia	March 1990	Majority	Dec. 1993	12.4	Dec. 1995	22.7	Dec. 1999	24.3
Slovakia	June 1990	13.6	June 1992	15.2	Sept.–Oct. 1994	13.1	Sept. 1998	14.7
Ukraine	March 1990	Majority	March 1994	Minority	March 1998	24.7		

Countries that were classified by Freedom House (Karatnycky et al. 1999) as not free have been excluded. They were Azerbaijan, Belarus, Kazakhstan, Tajikistan, Turkmenistan, Uzbekistan, and Yugoslavia. Kyrgyzstan has not had any party elections.

Notes:

1. The June 1990 election result for the Czech Republic was for all of Czechoslovakia.
2. Political parties were not allowed during the 1990 elections in any of the former Soviet Union or in the 1994 elections in Ukraine.
3. In September 1992 in Estonia, the parties Safe Home, Our Home Estonia, and the United People's Party qualify as Communist Parties, although they were primarily Russian national parties.
4. For the October 1992 result in Georgia, the number shown is share of seats not votes.
5. Latvia has had a series of Russian nationalist parties (Harmony for Latvia–Rebirth of the Economic Union and the National Harmony Party), but they have been true Communist parties, led by the old hardline communist leaders.
6. The June 1989 election in Poland was only partly free.

Source: Inter-Parliamentary Union (www.ipu.org).

Chart 9.3 Communist Party Electoral Performance and Market Economic Transformation.

	Communist Parties Doing Well	*Communist Parties Doing Badly*
Radical transformation	Hungary Poland Russia	Czech Republic Estonia Latvia Lithuania Slovakia
Incomplete transformation	Bulgaria Moldova Romania Ukraine	Armenia Georgia

Note: The borderline between "radical transformation" and "incomplete transformation" has been put at 0.70 on the structural reform index for 1997 (see Table 5.1), and as borderline between "communist parties doing badly" 20 percent of the votes in the last election has been chosen (see Table 9.2). *Sources*: Table 9.2 and Table 5.1.

as right-wing social democratic parties by West European standards and the most liberal former communist parties in the region. These countries' initial market economic transformation was so successful that it convinced even communist leaders to reform, securing their political survival, and their conversion verified the formation of a market economic consensus. Although Russia just about qualifies for this box, it appears incompletely transformed.[17]

In seven countries the communist parties have been devastated, receiving only 10–16 percent in recent elections. All have gone through substantial market economic transformation and achieved considerable and lasting growth. They should all be in the right upper box in Chart 9.3 (the latecomers Armenia and Georgia did not qualify by structural reform in 1997 but would in 1998). These communist parties have undergone far-reaching reform, with the exception of the Latvian National Harmony Party, but they did not reform fast enough to get onto the market economic bandwagon. A broad consensus in favor of market reform was achieved without them.

The bottom left box in Chart 9.3 contains countries where communist parties have been relatively successful, while the market economic transformation has been incomplete. Russia really belongs to this box as incompletely marketized. These five countries are Bulgaria, Romania, Moldova, Ukraine, and Russia. Two different patterns are in evidence, depending on whether the communist parties stayed in power or not.

[17] It fell below our line in 1998.

In Bulgaria and Romania, the former communist parties hung on to power in democratic elections until 1996–7 because of not very enlightened electorates, as little civil society had developed before the end of communism. The cause of their demise was rampant economic crises for which the communist governments were clearly responsible. In these two countries, partial reform policies were discredited, and people voted against their bitter experiences of communist governments in the postcommunist period, breaking out of a system of rent seeking.

Russia, Moldova, and Ukraine present a pattern of the true politics of rent seeking. In these three countries, the old communist parties have been strong, usually gathering 20–30 percent of the votes cast. While not formally in power in Ukraine or Russia,[18] the communists have been highly influential in parliament, as the electoral system made them overrepresented, allowing them to block reform legislation. Hence, the three countries have preserved the all-intrusive state, with high taxation and extraordinary rent seeking, breeding powerful "oligarchic" business groups. The concentrated economic power around the state circumscribed democracy, while politics became polarized between oligarchs and communists. Yet, both groups favored similar economic policies, forging a consensus around a rent-seeking state.

The oligarchs managed to legitimize themselves politically in the eyes of many anticommunists, by pointing to the overt antisystemic threat posed by the communists. The liberal right was weak, because the partial market economy had neither proven itself nor generated strong independent entrepreneurs, and the liberals were forced to compromise with the oligarchs or render themselves politically irrelevant. Electorally, the communists have remained strong because of dissatisfaction with the new semireformed system, while most noncommunist voters support the strongest opponents of the communists. Thus, communists stay reasonably strong and unreformed when market-oriented economic transformation is slow. This can be seen as a prisoner's dilemma, as citizens dare not opt for the market reform that would benefit them, since they are governed by a fear of communist vengeance.

The best examples of communists and oligarchs, in fact, helping each other to dominate politics are the Russian presidential elections in 1996 and the Ukrainian presidential elections in 1999, when a communist antisystemic threat compelled all anticommunists to unite, with the oligarchs as the main beneficiaries. The natural outcome has been

[18] Moldova is complicated to classify, as the Communist Party split into a Communist Party and an Agrarian Party, and the latter gradually evolved away from communism. Governments have been both unstable and nondescript.

a so-called oligarchic economic and political power structure to which state influence was key. Interestingly, the EBRD (1999) finds that state capture, that is, the influencing of government policymaking by a narrow set of interest groups, is the greatest in these semireformed countries.

This fits the empirical observation that countries with greater political polarization perform worse in terms of economic reform and growth (EBRD 1999, pp. 107–8). Effectively, polarization means that an unreformed Communist Party remains strong, posing a potent antisystemic threat to both democracy and capitalism. Little reform can be carried out in such a political situation, regardless of whether the Communist Party is in power or not, since it is strong enough to block reform. An unreformed economy is likely to generate a limited number of reformers, who face the unattractive choice of making compromises with self-seeking businessmen against the communists (Anatoly Chubais in 1996) or stay in the political desert (Grigori Yavlinsky always). Then, the problem is less polarization itself and more the initial weakness of reform, conserving a strong and unreformed Communist Party.[19]

Both South-East Europe and Russia, Ukraine, and Moldova represent a political underreform trap. The combination of the political polarization between communists and oligarchs and their common economic program of rent seeking is very difficult to break. However, this underreform trap may burst, and it might have done so already. In Bulgaria, the horrendous financial crisis of 1996–7 discredited the ruling ex-communists thoroughly, as well as undermining them financially. As a result, the Bulgarian people elected a nonsocialist parliamentary majority, and a liberal government launched a radical reform. Similarly, the Russian financial crash undermined the most corrupt oligarchs and regional governors, who appeared most responsible for the disaster. While not promoting liberals at the time, the crash facilitated more responsible macroeconomic policies. In both cases, the underreform trap appears to have been broken under the combined pressure of financial emergency and democracy (cf. Drazen and Grilli 1993). In Romania, on the contrary, the financial crisis of 1996–7 was sufficiently severe to lead to the democratic ouster of the ex-communist government, but no radical reform policy was pursued, and the ex-communists won a resounding victory in the elections in 2000.

[19] Frequently, the argument is on the contrary made that a political system, such as in the United States or the United Kingdom, with two strong national parties is more likely to supply broad-based programs that benefit a majority of the population (Rose-Ackerman 1999, p. 128).

Popular Views of Economic Reforms

But do people really support reform? A large number of opinion polls have been conducted in former communist countries. For our purposes, the European Union's Eurobarometer is most useful, because it has posed the same questions to the population of up to fifteen countries in our region annually since 1990. Two questions are fundamental.

The first question is whether people think their country is going in the right or wrong direction (see Table 9.3). This is not a purely economic question, and responses are clearly influenced by politics as well as general national tendencies. Still, we can draw a few general conclusions. First, in countries that have launched a serious economic reform, people tend to be positive about the direction of their country just before and at the beginning of the reform, while sentiments often turn sour later on (Poland, the Czech Republic, Slovakia, Bulgaria, and the Baltic states). Second, the only two countries where the population have been persistently optimistic for several years are the most radical early reformers, the Czech Republic and Estonia. When the Czech reforms ran out of steam in 1997, the mood plummeted. Third, most countries have not undertaken very radical reforms, and their populations have been highly dissatisfied.[20] All this suggests that people favor quite radical reforms.

The second question is more telling, namely, whether people reckon the reform in their country has been too fast or too slow. This query was only meaningful at an early stage of reform, and Table 9.4 shows the answers in 1994. An overwhelming majority in all countries, apart from the Czech Republic, thought reform in their country was too slow. In the then radically reforming Czech Republic, only a slight majority advocated faster reform. This is strong evidence from no less than fifteen postcommunist countries that people actually wanted faster reform. Apparently, the problem was not the views of the people but the ability of the political process to translate their will into action.

Thus, this evidence from opinion polls suggests that people prefer fast and more far-reaching market economic reform.

POLITICAL STABILITY AND REFORM

Throughout the postcommunist world, establishments have argued that political stability, consensus, and strong leadership are necessary for successful market economic reform. These views are so common among

[20] The results contain various national anomalies. As everybody knows, Hungarians are inveterate pessimists. In Romania, the prior dictatorship was so awful that people were naturally quite happy just be rid of it.

Table 9.3. Public Opinion about Direction of the Country, 1990–1996[a] (Net percentage positive)

	1990	1991	1992	1993	1994	1995	1996
Central Europe							
Poland	13	–41	–29	–4	–30	7	2
Czech Republic	37	17	24	28	25	24	9
Slovakia	13	–30	–1	–32	–39	–27	–40
Hungary	..	–19	–14	–47	–34	–69	–60
South-East Europe							
Romania	..	26	–7	–6	–6	–13	57
Bulgaria	4	38	2	–37	–39	–8	–63
Baltics							
Estonia	..	30	7	23	17	24	27
Latvia	..	47	–17	7	–9	–13	–16
Lithuania	..	28	–39	–47	–49	–52	–25
CIS							
Russia	..	–12	–24	–16	–51	–46	–41
Belarus	..	..	–16	–51	–32	–36	0
Ukraine	..	..	–24	–63	–55	–51	–39
Moldova	..	..	..	..	..	..	..
Armenia	..	..	–49	–49	–60	–31	–33
Azerbaijan	..	..	..	..	..	..	..
Georgia	..	..	–16	..	–39	23	–15
Kazakhstan	..	..	..	..	–33	6	–33
Kyrgyzstan	..	..	..	..	..	..	..
Tajikistan	..	..	..	..	..	..	..
Turkmenistan	..	..	..	..	..	..	..
Uzbekistan	..	..	..	..	..	..	..

[a] Respondents were asked, "In general, do you feel things in [our country] are going in the right or wrong direction?"
Source: European Commission (various years).

Western political scientists that many do not even query whether political stability is good, even seeing it as a goal (Elster et al. 1998, pp. 292–3). However, a sound rule of thumb is whatever the old communist elite wants must be wrong, even if it sounds perfectly sensible. We shall examine political stability at three levels. The first is the government, the second is the population, and the third is war.

Government Stability and Coalitions

Contrary to common belief, government stability has not been an advantage. The five countries with the most frequent changes of governments

Table 9.4. Public Opinion about Speed of Economic Reform, 1994[a] (Percent, except where indicated)

	Too Slow	Too Fast	Difference[b]
Central Europe			
Poland	51	15	36
Czech Republic	28	26	2
Slovakia	64	13	51
Hungary	48	13	35
South-east Europe			
Romania	58	15	43
Bulgaria	67	7	60
Baltics			
Estonia	48	9	39
Latvia	62	11	51
Lithuania	52	19	33
CIS			
Russia	59	18	41
Belarus	67	8	59
Ukraine	65	12	53
Moldova	..	..	..
Armenia	72	12	70
Azerbaijan	..	..	..
Georgia	74	4	70
Kazakhstan	59	14	45
Kyrgyzstan	..	..	..
Tajikistan	..	..	..
Turkmenistan	..	..	..
Uzbekistan	..	..	..

[a] Respondents were asked, "The way things are going, do you feel that [our country's] economic reforms are going too fast, too slow, or about the right speed?"
[b] Percentage point difference.
Source: European Commission (various years).

are Poland, the three Baltic states, and Bulgaria, that is, four of the most successful reform countries. Their governments have lasted only a year on average (EBRD 1999, p. 112). A plausible explanation is that more frequent changes in the executive mean that vested interests cannot control the government, which thus becomes more transparent, more accountable, and less corrupt corresponding better to the public interest. Bulgaria illustrates the opposite danger of patently inconsistent policies and erratic policy reversals, but so far vested interests have been a far greater threat to sound economic policies in transition than disorder. After all, the Central Asian dictatorships have had the most stable governments – Kazakhstan, Tajikistan, Turkmenistan, and Uzbekistan. This also suggests that the postcommunist countries are intrinsically amazingly stable, so that the problem is far less to maintain stability than to accomplish sufficient change.

Many instinctively think that the best government arises if one party wins its own parliamentary majority. However, coalition governments have been more successful than one-party governments in the transition, and the most successful reform governments have been broad-based, multiparty coalitions (EBRD 1999, p. 104). Illustrative examples are multiple Polish, Estonian, Latvian, and Czech governments. In fact, this is logical if the main threat is that the old establishment will corrupt the new government. A coalition government can be seen as another measure of political competition, transparency, and accountability. With several parties in government, it has been difficult for any single group to capture the state to its benefit, and the competition among parties does not stop when they enter government. Each party will fend for its own long-term reputation, and any coalition partner objects to another partner ripping off the country through embezzlement. Transparency is also enhanced, because being in government, each party sees and understands what is going on. A coalition partner has the advantage of being strong and independent enough to act. Naturally, there are risks that corrupt deals will be struck, but such deals are unstable and can easily be challenged.

Again, the essence of the transition is that government is subject to transparency and checks and balances. Political instability and coalition building are indicators of a truly competitive political system, and countries with the most competitive political systems have tended to achieve greater progress in economic reform. Democratic systems can constrain the capacity of narrow elite groups that exercise undue influence on government. Moreover, to function well, democracy requires transparency in public institutions (EBRD 1999, pp. 112–3). Conversely, the fear of political disorder has been greatly exaggerated. This runs against Joseph Stiglitz's (1999a) not very democratic aspiration for the maintenance of the old "administrative capital," which presumably means the Communist Party, the old communist state, and the KGB.

Minimal Social Unrest

When Leszek Balcerowicz (1992) launched radical economic reforms in Poland, one of his greatest concerns was strikes and other forms of social unrest. Two years later in Russia, Yegor Gaidar (2000) was of a similar opinion, and worries were rampant in many other countries, notably Hungary, Bulgaria, Romania, and Ukraine, which had experienced serious strike movements, that had undermined the power of the old communist dictatorships.

However, labor relations changed instantly with transition. Previously, labor unrest, especially coal miners' strikes in Poland, Russia, and Ukraine, had been expressions of democratic pressures rather than of trade unionism. Much of the early political activities took the form of trade unions or environmental movements. An actual Polish national front emerged as the purported trade union Solidarity in 1980, while the environmentalism that thrived in Estonia and Lithuania from 1987 was primarily an expression of national and democratic opposition.

Each government that liberalized consumer prices was afraid that people would take to the streets in protest. After all, Poland had experienced bloody riots because of price increases, primarily on meat, in 1956, 1970, 1976, and 1980, and even the Soviet Union had seen a massacre in Novorossiisk in 1962, unleashed by a price hike for meat. In many other countries, notably in North Africa, bread price rises had prompted serious riots. A great positive surprise was that no single price liberalization caused significant social unrest. I was in Moscow around the time of the price liberalization. The atmosphere was tense. Before the deregulation, a public fear prevailed, as if a Damocles sword was hanging in the sky, and people were expecting the sky to fall upon them. When the prices were liberalized, they rose instantly by 350 percent, but there was no sign of protest. People took it calmly and serenely. The same was true of all the other countries.

Why was there no public reaction? Clearly, a price increase for a limited number of commodities is politically less acceptable than a price liberalization. Then, people can measure how much they lose personally, comprehending with whom they might collude. They can figure out that the privileged escape, and somebody has evidently decided how much they are supposed to lose. With a general price liberalization, such calculations are impossible. People do not know with whom they have a common cause, rendering collective action difficult. Moreover, a price deregulation implies a total change of paradigm and system.

Still, people have not been completely passive. When a country has pursued an obviously hopeless and damaging economic policy, people have taken to the streets. The best examples are Bulgaria and Romania in 1996, when huge mass protests broke out, though the economic mismanagement had gone far before people reacted.

On the whole, society has acted as a student of Mancur Olson's (1971) "Logic of Collective Action" would have assumed. Civil society and all kinds of organizations were weak. Hence, only the small and tightknit interest groups with a great deal to benefit were able to collude, and they represented primarily the rent-seeking elite. The most active trade unions were those that could extract the largest public subsidy per person. Fears of strikes and labor unrest proved exaggerated, and the problem has not been too many but too few strikes. When more than half the work force is not paid its salaries in time and in full, as has been the case in Russia and Ukraine, workers *should* go on strike. The frequent misperceptions of how labor would react were based on a lack of understanding of the perversity of the old official communist trade unions.

War

Wars have been significant in postcommunist transition. Even excluding Yugoslavia, five countries have endured wars of varying degree, namely Tajikistan, Georgia, Armenia, Azerbaijan, and Moldova, in approximate order of damage, not to mention Russia's war in Chechnya. Tajikistan and Georgia suffered enormously from civil war, with law and order and their state apparatuses falling apart. Moldova, on the contrary, sustained comparatively light fighting, though the separatist Transdniestria has remained autonomous, complicating the management of the state. Armenia has primarily been hurt by embargos by Azerbaijan and Turkey. Azerbaijan suffered comparatively less from its war with Armenia, but it lost one-tenth of its territory, and the war has upset its politics.

The initial effect of war was unambiguous. Output fell sharply, notwithstanding that much of the decline was in fact an expansion of the underground economy. Georgia and Armenia are the most interesting cases. Both countries are among the most corrupt in the world, and law and order had nearly broken down in Georgia. Yet, after considerable suffering, both countries have undertaken significant reform, with impressive liberal tax reforms, and they have attained substantial economic growth, which cannot be discarded as merely the return of the underground economy to officialdom. Notably, Georgia and Armenia experience the least state intervention in enterprise decisions (EBRD 1999, p. 123).

Georgia and Armenia might represent an example of Mancur Olson's (1982) thesis that the destruction of obsolete state structures through war may facilitate the establishment of more adequate state structures than a gradual reform within the old institutional structure could have done. Olson used the examples of West Germany and Japan after World War II. Both countries were well endowed with human capital, which was a precondition for Olson's thesis, as it is an asset whose deployment can be improved. Yet, the Georgian and Armenian governments deliver few public goods, not even elementary law and order.

War has certainly damaged the economy in transition, and Tajikistan and Georgia are suggested as potential candidates for failed states. Yet, it might have cleaned out some awful communist structures, which may prove beneficial in the future.

CIVIL SOCIETY AND ELITE COMPETITION

Over time, the importance of civil society has become ever more apparent for the success of market economic reform, as public competition leads to better governance and thus enhances the quality of reform. The civil society that had developed just before the end of communism seems to have been particularly important for the eventual success of reform, putting Poland, Hungary, and the three Baltic states at a special advantage. Today, it seems so obvious that these states would excel in both democratic and market economic transformation that it might be worthwhile to recall how public perceptions of Poland and the Czech Republic have changed.

Why Did Poland Succeed?

Poland entered transition as a forlorn basket case. Its preeminent historian Norman Davies (1981, p. 642) viewed the country as "the playground of mischievous fate," ravaged by popular uprisings most recently in 1956, 1968, 1970, 1976, and 1980–1. Both Poles and foreigners considered the country anarchic and unmanageable. Since the eighteenth century, Swedes had talked about *polsk riksdag* (Polish Parliament), as the epitome of anarchy. Many argued that two centuries of foreign occupation had rendered Poles dismissive of any state authority. Poland had faced two external defaults in a decade in 1981 and 1989. For Germans, *polnische Wirtschaft* (Polish economy) meant total mismanagement. Market socialist experiments had bred an inconsistent and corrupt economic system. In 1989, Poles had little confidence in their nation, but they believed in their personal abilities, as they had learned to manage on their own after the pretense of social welfare state had faltered.

When the reform started, the political mess seemed to persist. No reform leader, save Russia's Yegor Gaidar, faced such vicious criticism as Poland's Leszek Balcerowicz. The politicians' failure to agree rendered Poland one of the last transition countries to adopt a new constitution (Holmes 1995). The Solidarity government fell apart after a year, with presidential elections in November 1990 giving an unknown adventurer (Stanislaw Tymiński) 23 percent of the votes. In the parliamentary elections in November 1991, as many as 28 parties entered parliament. About ten parties were needed to form a government, and governments changed about once a year. Poland's IMF program collapsed after just over a year, and the country failed to agree on a privatization program for years. Until 1992, claims abounded that Poland remained an utter failure (cf. Bożyk 1992), and its politics were devastated by crises and ferocious acrimony. Any claim that Poland benefited from any social consensus in 1989–90 is an unfounded rationalization in hindsight.

So why did Poland succeed? Part of the answer is that competition was so vicious. Nothing could be done without intense public scrutiny, exposing all weaknesses. The vibrant civil society included the strong Roman Catholic church, the genuine trade union Solidarity, workers' councils at enterprises, and millions of small private peasants, who were all opposed to radical market economic reform, but through their demagogy they contributed to the reduction of transitional rents and thus the success of reform. Poland also benefited from a strong competitive elite. While the country had eight different ministers of finance in a decade, all of them appeared competent. Poland represents the victory of competition at all levels of society.

Weaker Civil Society in the Czech Republic

The Czech Republic offers a stark contrast to Poland. In the interwar period, it had been a vibrant democracy and a successful economy. The Czechs prided themselves of having been one of the most industrially developed countries until World War II. Under socialism also, the Czech Republic had been among the most successful economically. With the Velvet Revolution in November 1989, the old regime was deposed of without either blood or compromises. The popular movement, the Civic Forum, was swiftly transformed into a broad, well-organized conservative party that won elections repeatedly and formed a lasting government, headed by a small but outstanding group of well-educated economists. Rationally, the Czech government launched one of the most radical and comprehensive reforms. In the early 1990s, the Czech Republic appeared to benefit from having escaped the distortions of market socialism. Its smaller elite raised far less public controversy than Poland or Hungary.

The Czech Republic undertook a successful early reform, but by 1996 its economic performance started flagging. There were economic explanations to these problems, such as too high an exchange rate, a state-owned bank system, ineffective bankruptcy, an unregulated securities market, and so on. However, these problems were comparatively limited, and the most remarkable is that they were not corrected but continued to hamper economic development for a long time. Formally, Czech democracy was impeccable, but public criticism was too weak to prompt early corrections. The comparatively limited elite competition and mild public, that had facilitated the early stages of the reform, appeared serious disadvantages in the second half of the 1990s. For a long time, nobody could plausibly challenge the outstanding Klaus team, allowing their small mistakes to be exacerbated.

In the end, the interwar traditions were little but an ideal. Well-trained public servants and strong social scientists were scarce after decades of stern communist dictatorship, lasting till November 1989, even if the Czech Republic benefited from international contacts through its diaspora emigrating in 1968. Although the Czech Republic started off extremely well by happenstance, the paucity of public competition came back to haunt the country.

The Stronger Civil Society, the Better for Reform

Similar comparisons can be made among other countries with similar economic and cultural preconditions. The level of public debate, the vibrancy of the media, and the degree of competition within the elite were important factors in deciding the nature and speed of early market reform and its tenacity.

Civil society in the three Baltic states benefited from prewar traditions in recent memory and close links with a strong diaspora in the West, Their natural peer countries were Scandinavian, and Estonians watched Finnish television. Yet, the plethora of civil institutions that developed in the last five Soviet years was possibly even more important. An intelligent public debate had prepared the Baltic peoples for all the dilemmas of postcommunism.

Russia, Ukraine, and Belarus had very similar cultural and economic preconditions. Belarus was the most Western, smallest, richest, and best managed of these three republics, but it had a very poor political and intellectual elite, and it has ended up as a Soviet theme park. After the democratization of Yugoslavia, Belarus is the only dictatorship in Europe. The only preconditions pointing in that direction were its weak civil society and its lack of alternative ideology. Ukraine started its reforms late because of a poor economic debate and limited elite competition. Russia, on the contrary, launched serious and early reforms thanks to a public debate that was even more ferocious than Poland's, and a vibrant elite competition has led to many government changes, involving numerous competent ministers. However, in all three countries civil society in a broader sense was too weak even to ascertain that wages and pensions were paid on time.

All this suggests that civil society, including media and elite competition, are of vital importance for the success of both democracy and a market economy. What happened long ago might be less important than what happened in the last couple of years before the end of communism. Clearly, Estonia had a civil society much more prepared for reform than the Czech Republic, although the Czech prewar state of affairs was much more impressive than that in Estonia. This contrasts with Robert Putnam's (1993) attempt to explain later Italian developments with differences in social capital in the early middle ages. These results are easily reconciled. This region saw greater disruptions in recent years than Italy did in seven centuries, and in the Italian south unfortunate conditions were perpetuated by flawed institutions. Therefore, recent experiences overruled precedence.[21]

The least democratic subregions, the Caucasus and Central Asia, suffer from a firm grasp of a precommunist clan system that renders democratization particularly difficult, as clans regulate and restrict elite competition. Yet, Kyrgyzstan has proven that it is possible to break out of a clan system into a tentative democracy, confirming the importance of civil society before the end of communism. Because of bloody ethnic riots between Kyrgyz and Uzbeks in the southern city of Osh in June 1990, the old communist leadership was ousted and academic outsiders assumed power under a leading Kyrgyz physicist, Askar Akaev, who later became president (Olcott 1996). Akaev (2000) has proven himself a radical economic reformer. Therefore, Kyrgyzstan went through a disruption in the old elite, which was sufficient to prepare the ground for a tentative democracy and quite a respectable civil society. Of course, this does not necessarily mean that Kyrgyzstan is safe for democracy. Power must stay contested.

The Value of Ideology and National Purpose

Postcommunist transformation was an intensely ideological process, as evident from the excited initial debate, albeit this was concealed by antipolitical slogans such as "no more experiments," but this apparent animus against politics was directed against communism, representing universal politicization.

Virtually all the leading economic reformers – Leszek Balcerowicz, Václav Klaus, Mart Laar, Siim Kallas, Einars Repše, Yegor Gaidar, Anatoly Chubais, and Askar Akaev – were committed neoliberals, with favorite books such as Friedrich Hayek's *The Road to Serfdom* [1944] and *The Constitution of Liberty* (1960). They were no sheer technocrats but professed an alternative vision of a more humane society. Transformation was not only about economic efficiency and welfare, but about

[21] Steven Fish (1998) makes a similar point.

freedom and human dignity. Václav Klaus (1992, 1994) most clearly formulated these ideas.

The prime purpose of the reformers was not to win elections but to win the public debate, reestablishing the norms of Western civilization in these morally degenerate communist states (Dąbrowski, Gomułka, and Rostowski 2000).

The point is often made that Central Europeans, notably neoliberal Václav Klaus, tended to be more social democratic than liberal in their political practices, accepting high taxes and public expenditures. At some stage compromise becomes inevitable in politics, but because of their ideological commitment these reformers had provided their societies with a sense of direction.

The importance of ideology is best illustrated by a society with no sense of ideology, such as Belarus. When society has no clear purpose, all that is left is interests in a society dominated by a small elite, rendering dictatorship and the prevalence of rent seeking the natural outcomes in line with Ivan Karamazov's thesis in Fyodor Dostoyevsky's *The Brothers Karamazov*: "If there is no God, everything is permitted."

Successful reformers have also nurtured a strong national commitment, often seeing the rebirth of their nation as their purpose. This was particularly apparent in the Baltics, but it was also true of Central Europe and Armenia. The partial reformers, on the contrary, tended to have little national purpose, and nonreforming Belarus least of all.

While most people in the region are intensely aware of the impact of ideology and nationalism, Western social scientists tend to discard them as paraphernalia and rhetoric, reducing politics to horse trading. Similarly, with extreme nihilism and cynicism much of the old Soviet elite considers any belief or conviction naïve.

THE PEOPLE NEEDED TO ASSUME CONTROL OVER THE STATE

The fundamental political problem of postcommunist countries was that the communist state had been working for a small elite called the Nomenklatura rather than the people, and the assignment of transition was to make the state work for the population instead. This elite cares only about itself to an extraordinary degree reminiscent of Africa or Latin America.

This task became all the more difficult because at the end of communism, rent seeking skyrocketed all over, as the powerful exploited the weakness of economic and political institutions, while society was in disarray. Therefore, the aim of postcommunist transition was to defeat rent seeking, which reinforced the economic and political power of the Nomenklatura.

Since democracy checks the elite, it is vital for successful economic transition. The correlation between reform and democracy is strong: The better the quality of democracy, the more far-reaching market economic reform is. To render democratic pressures effective, the structure of the constitution and political representation is essential. Real political parties must be allowed, and they should be promoted through proportional representation, with a threshold for representation in parliament. An early election after the collapse of communism facilitated the consolidation of parties and impeded their proliferation.

People may need time to figure out their interests, and democracy is an iterative process. Over time, election results and opinion polls have shown that communists are less popular, and reforms more so, than widely perceived. Communist parties have rarely won democratic elections. They have done reasonably well in only two successful reform countries (Poland and Hungary), because they transformed themselves into right-wing social democrats, while they have done badly in other reform countries. Instead, communist parties remain relatively strong in partially reformed countries (Bulgaria, Moldova, Romania, Ukraine, and Russia), which have entered an underreform trap. Because of a potent communist threat, nonsocialists find themselves compelled to join hands. The not-fully-reformed economies breed a dominance of unsavory businessmen, and reformers face the unpleasant choice of irrelevance or compromise with the corrupt. Opinion polls bear out that the people are more satisfied with more radical reform, but their mood tends to sour over time. Surprisingly, everywhere people regret that reforms were not faster.

If the elite is to be disciplined by the population, it must not be given respite. The common view that political stability is good for economic reform is contradicted by the evidence. In general, unstable governments have undertaken the most far-reaching and successful reforms, and they have been broad, multiparty coalitions, while most stable governments have been neither reformist nor democratic. Conversely, the more strikes a country has experienced, the more reform it has undertaken. The threat from the old establishment has been so great that any check and balance, including sheer instability, has promoted reform, while the inherent stability of postcommunist society has been a surprise. Only devastating wars have so far proven worse for reform and economic growth than the old elite, but even wars may have brought about positive institutional changes in Georgia and Armenia, though after substantial social costs.

Maximum public dispute will also check the self-seeking elite, as it is a reflection of sound elite competition. A common idea is that a social consensus is necessary for a successful reform, with Poland as a frequent example, but Poland experienced acrimonious public strife and the worst party fragmentation. Admittedly, it benefited from a big anticommunist majority, but the broader point is that Poland had the most vibrant civil society and the most vicious elite competition. Intense party competition also helped to expose and combat high-level corruption.

By contrast, despite an excellent start of its reforms, the Czech Republic has suffered from insufficient elite competition. Among the three East Slavic states, Russia, Ukraine, and Belarus, Russia adopted the most radical market economic reforms, with an important reason being its intense elite competition. Belarus went through the least reform and had the least elite competition, while Ukraine fell short of Russia in both regards. Thus, reform appears closely related to civil society and elite competition.

The same principles apply to reform of the state. These countries did not need strong presidential executives, but transparency, division of power, and strong checks and balances, which are best provided by a parliamentary system. The socialist state was so flawed that its organizational capital was largely negative, requiring the maximum of disruption that could be managed. Clear lines had to be drawn between state and enterprise. Obviously, corrupt organizations such as postcommunist states should not be entrusted with larger resources than they can manage responsibly, which means that the size of these still very large public sectors must be contracted.

10

The Role of the Outside World

The collapse of communism and the Soviet Bloc dominated all discussions about society in the world in 1989. That year was immediately seen as one of the great revolutionary years in history, most often compared with the great liberal revolutions of 1848 (Ash 1990; Dahrendorf 1990). The importance of these events was beyond dispute, and public attention was unprecedented. All kinds of social scientists were suddenly preoccupied with postcommunist transition to democracy and a market economy.

A plethora of issues was raised in the international debate. What kind of societies would these postcommunist countries become? How close to the West would they come? What kind of assistance did they need? What could and should the West do for them? What organizations or forms of cooperation should be used? How much money was needed and was the West prepared to put it up?

Any kind of international assistance involved many judgments. It required that the donors be reasonably convinced that they understood what was going on and that their assistance would have positive effects. An obvious precondition for any support would be a positive judgment of the rulers in a potential recipient country, another that their political strength sufficed.

In this chapter, we shall first look into the Western interests at the time. Overwhelmingly, the West perceived great interests in Central Europe, but little or no interest in Russia and the rest of the CIS. Next we shall examine cases of successful cooperation, followed by a discussion of the less successful cases. A matter of much misperception is the volume of international financial flows and Western assistance, which we shall put into perspective. Many international agencies have been involved and we shall comment upon their contributions.

CONFLICTING OUTSIDE INTERESTS

The West's desire for the postcommunist countries to succeed as democracies and market economies is often taken for granted, but an important countercurrent argued that Russia was a persistent menace best kept down and out. Moreover, some disputed that Western assistance could be effective, while others reckoned it would be too expensive. There was no consensus about what the West should do and whether it should do anything at all. In effect, the West as a whole adopted Central Europe, and Western Europe adopted the Baltics, while South-East Europe, Russia, and the rest of the CIS were left out in the cold.

To Build Democracy and Market Economy or Keep Russia Down?

The public debate was dominated by supporters of democracy and market economy, even though most protagonists were tacitly doubtful about the prospects for democracy in Central Asia and the Caucasus. The Washington consensus had just emerged after economic reforms in Latin America, showing that liberalization, financial stabilization, privatization, and accompanying institutional reforms produce economic growth.

Liberal economists assumed that successful market economies could also be launched in the FSU, though with greater difficulty than in Latin America due to the dearth of market economic institutions. Western governments welcomed democratization in Eastern Europe, especially in Russia, partly because democracy was good in itself, partly because democracy might mitigate the traditional military threat from Russia and the Soviet Union.

A small but influential group saw Russia as outside of Western civilization and wanted to keep it down and out. In intellectual and policymaking circles, the main protagonists of this view were the geopoliticians Henry Kissinger (1994) and Zbigniew Brzezinski (1997). They argued that Russia had been a threat to its neighbors and would remain so. The weaker Russia was, the feebler its threat. Kissinger (1994, p. 815) argued about the brief post-Soviet period: "But the dominant geopolitical thrust has been Russia's attempt to restore its pre-eminence in all the territories formerly controlled from Moscow." Kissinger (2000) reiterated his fear of the success of Russian economic reform: "But if the strengthening of Russia as a result of reform produces gradual encroachment – as, in effect, all its neighbors fear – Russia's quest for domination sooner or later will evoke Cold War reactions." Similarly, Brzezinski (1997) identified the geopolitical task in the post-Soviet region as strengthening every state, including China, against Russia. He never gave the Russian reformers a chance: "On balance, it is probable that neither the disappointment nor the weakening of the Russian westernizers could have been avoided" (p. 102). Kissinger discounted the possibility of Russia becoming a democracy. Yet, nobody advocated aggression against Russia.

The few vocal opponents of Russia thrived on popular suspicions about it, convincing many that little but humanitarian assistance could be done for the CIS countries. Central Europe and the Baltics, on the contrary, were widely perceived as constituent parts of the Western world with manageable situations. Such Western perceptions contributed to a stark division of the postcommunist world between East-Central Europe and Russia, which implicitly included the whole of the CIS.

Mixed but Limited National Interests

A mosaic of national interests further widened the chasm between East-Central Europe and the CIS. This was a time of European revival. The European Union had just decided to accept Austria, Sweden, and Finland as full members, and the question was how it would expand next. Germany had just seen its dream of reunification fulfilled, and it was perceived as the driving force of Eastern expansion of the European Union. For centuries, it had been the dominant cultural, economic, and political power in Central Europe, and Poland, Czechoslovakia, and Hungary formed Germany's natural sphere of interest. Its Eastern neighbors saw this largely as an opportunity for integration in Europe, and Germany served as their peer country.

The four Nordic countries – Finland, Sweden, Denmark, and Norway – felt a great affinity to the three Baltic states – Estonia, Latvia, and Lithuania – for historical, geographical, and cultural reasons. They were all small neighboring countries. During the Baltic independence in the interwar period, regional cooperation had been extensive. Although Lithuania's history was connected with Poland, it also joined the Nordic-Baltic sphere. Because only 8 million people lived in the three Baltic countries, the Nordic countries with about 22 million cared for them as little brothers. A strong peer relation developed.

Bulgaria and Romania were European, but they attracted little outside interest. Romania was culturally close to France, but France was far away and not very effective in its support. Besides, Bulgaria and Romania were seen as parts of the volatile Balkans, further limiting external interest. Finally, as their old communist parties stayed in power, the West felt alienated.

Traditionally, the Soviet Union had seen the United States as its competitor and peer, but the gaping economic chasm between the two countries made this perception implausible. Both the Bush and Clinton administrations tried to maintain special bilateral relations with Russia, as if it were still a superpower, but it was difficult to endow this "strategic partnership," as President Bill Clinton called it, with content, considering that the official Russian GDP in 1999 corresponded to as little as 2 percent of the U.S. GDP at the exchange rates of the day. To Europeans, Russia was too big and frightening, with its population of some 150 million, almost twice as large as united Germany's, although the Russian GDP shrank below that of Switzerland at current exchange rates. An instant European consensus declared that Russia could never become a member of the European Union, rendering it an outsider without peer.

Other members of the CIS enjoyed little international support, and Asia has played a minor role. Turkey was the most ambitious, trying to develop multiple links to the Turkic nations in the region – Azerbaijan, Turkmenistan, Kazakhstan, Kyrgyzstan, and Uzbekistan, but long distances and Turkey's poor finances constrained these attempts. Tajikistan suffered from a civil war, which was an extension of the war in Afghanistan. China has been surprisingly passive in Central Asia, primarily interested in maintaining peace out of concern for potential uprisings among its Turkic minorities in Sinkiang. Armenia is a special case, with its large and well-organized diaspora, especially in California, but its tragic history has pitted it against its neighbors Azerbaijan and Turkey, which have blockaded this poor country. Therefore, Armenia has benefited surprisingly little from its rich and well-educated émigré community.

Economically, the opening of new countries to capitalism with new exchanges of goods, services, capital, and labor offered both opportunities and threats. Initially, many West European countries were being flooded with refugees as after previous upheavals in Eastern Europe – Hungary in 1956, Czechoslovakia in 1968, and Poland in 1968 and 1981. The collapse of the German Democratic Republic had started with a mass exodus to the West, and the low standard of living in the East was evident. West Europeans did not welcome immigration because of their own unemployment and nationalism. Their fear of immigration inspired a two-pronged approach, further separating Central Europe and the Baltics from the CIS. The West Europeans wanted to assist their closest neighbors in their economic development to convince their people to stay at home, while they desired to keep more distant people away through strict visa regulations.

A broader Western apprehension was that their markets would be flooded with cheap Eastern goods. They were primarily concerned with exports of steel and agricultural produce, threatening abundant old steelworks in the West and its overprotected agriculture. Thus, the EU and the United States undertook repeated antidumping measures mainly against steel exports from Russia and Ukraine and little agricultural produce was allowed to enter, leaving the East Europeans defenseless. Small countries in the Western part of the region suffered less, because country size matters in trade policy. Trade partners accept limited exports from small countries more easily than larger volumes from big countries, which benefited the small Baltic states but put Russia and Ukraine at a disadvantage (Michalopoulos 1998).

Surprisingly few Western businessmen saw the opening of Eastern Europe as an opportunity. Some big companies favored early establishment there, for instance, ABB, Procter and Gamble, McDonald's, and the big tobacco companies, and Volkswagen undertook the biggest investment of all in the Czech Republic. But the new Eastern markets were small, risky, and immature. At the end of communism, the Soviet bloc accounted for only 2 percent of world trade and twice as much of EU trade. Big Western enterprises were not very agile in the new postcommunist economies, which required a lot of management time. Most new business with the region was developed by small entrepreneurs without political clout.

The Soviet Threat Was over

The heart of the matter was that the Soviet military threat was gone. The West had already cashed in on the collapse of the Soviet Union. It had won the Cold War and wanted to "go home," by radically reducing its military expenditures. All Western countries slashed their defense budgets, especially the United States. The Reagan administration, in effect 1982–9, spent 6.0 percent of U.S. GDP on defense. In 1998 and 1999, this share had plummeted to 3.2 percent of GDP. If we accept 6.0 percent of GDP as the Cold War standard defense cost imposed by the Soviet threat, the United States benefited from a peace dividend of no less than 2.8 percent of GDP in 1999, that is, 242 billion in current U.S. dollars. The cumulative U.S. peace dividend from 1992 to 1999 amounted to an enormous 1.4 trillion current U.S. dollars (see Table 10.1).

As the U.S. budget deficit used to be approximately 3 percent of GDP, the elimination of the Soviet military threat alone abolished the U.S. budget deficit. This huge gain went largely unnoticed, as nobody wanted to claim it. The Republicans wanted more defense expenditures, while the Democrats claimed the elimination of the budget deficit was a result their sophisticated economic policy. For the contemporaneous Western governments, the peace dividend was free, giving them no reason to act, because gratitude does not drive world politics.

A broad Western opinion favored democracy and market economies, but many opposed significant Western financial support for the postcommunist East. By this time, development aid to the Third World had been widely discredited as corrupting rather than helping. Much of the

Table 10.1. U.S. Peace Dividend, 1992–1999

	Percentage of GDP	Current Dollars (billions)
1992	1.1	68.7
1993	1.5	98.4
1994	1.9	132.0
1995	2.2	159.9
1996	2.5	191.5
1997	2.6	210.9
1998	2.8	238.3
1999	2.8	257.6 (est.)
Total		**1,357.3**

Source: U.S. Census Bureau (1999, p. 368).

free-market right, especially in the United States, opposed all government assistance. In Europe, the left advocated large government transfers both at home and abroad, but they objected to the right-wing project of building capitalism. The fallen rulers were, after all, fellow socialists. The West saw little threat from the former Soviet Union as well as little possible gain. Economists of various convictions doubted the absorptive capacity of the postcommunist countries. The obvious compromise was to minimize public spending on postcommunist transition. A Marshall Plan for Eastern Europe was never a real option.

SUCCESSFUL COOPERATION IN CENTRAL EUROPE AND THE BALTICS

In hindsight, the results look obvious. As everybody expected, Central Europe and the Baltics have done better than the FSU. However, at a closer look, outcomes seem less natural. Why has Western Galicia (in Poland) done so much better than Eastern Galicia (in Ukraine), although they share history, culture, and geography as longtime parts of the Hapsburg Empire? Why has West-oriented Romania done so much worse than isolated and provincial Lithuania? Why has highly developed Belarus remained a state-controlled economy while poor and distant Kyrgyzstan has become a market economy?

Preconditions, politics, and economic policy matter, but Western policy has made a great difference. Six transition countries undertook early and successful transformations, and they all gained adequate international support. While we cannot disentangle the impact of various factors and prove that they would have failed without international assistance, the coincidence is remarkable.

At the outset of a reform, the outside world can only do a few things. It can provide advice, which is cheap and fast, and it can offer financial support to make good policies possible. Countries in financial distress need such assistance to refill depleted international reserves and possibly even escape from international default. Therefore, early Western policy to the region was predominantly about financial support.

Hungary Was No Emergency

Communist Hungary was the only socialist economy that had succeeded in reforming itself. It was already a member of GATT, the IMF, and the World Bank. Although its foreign debt burden was large, it staved off foreign debt default or restructuring. For years, it faced severe macroeconomic strains, but it managed them. Hungary was the darling of the international financial institutions and received plenty of early credits.

The lesson drawn from the Hungarian experience was that very radical measures were not necessary, either in economic policy or in international assistance. The IFIs could go about their business as usual. Unlike all other postcommunist countries, Hungary already had a market economy of sorts, and it was in no crisis. Even so, lessons from Hungary influenced international policy toward the other postcommunist countries facing far worse conundra.

Poland Was in a Complex Crisis

Unlike Hungary, Poland was entrapped in a rampant financial crisis, prompting the Mazowiecki–Balcerowicz government to commit to eliminating the budget deficit. In return, the West promised to replenish Poland's international reserves, to provide a stabilization fund of $1 billion for the pegging of the zloty exchange rate, and eventually to write off half of Poland's foreign debts. The Balcerowicz reform program was published in mid-October 1989. The Polish government devoted the last two months of 1989 to the double task of getting the necessary reform legislation promulgated by Parliament and raising international financing. Both efforts were needed for success, and both were accomplished.

The West displayed a broad consensus on Poland from the outset, gathering in the G-24 (the then 24 members of the Organization for Economic Cooperation and Development, OECD) and pledging financing to the stabilization fund bilaterally. In parallel, the IMF and the World Bank concluded loan agreements with substantial multilateral credits. All the assistance was based on strict policy conditions, agreed upon with the Polish reformers. The parliament of each donor country had to approve a specific budget allocation in a tedious political process, which was possible because of great Western commitment to Poland's success. Although Polish politics were acrimonious, the West remained firm in its conditional support.

When Poland failed to comply with its IMF fiscal and monetary conditions in the spring of 1991, IMF disbursements were suspended for 1992 and 1993. Even so, Poland succeeded, led by stubborn and clearheaded Leszek Balcerowicz, who was rewarded by becoming the most hated man in the land. While the substantial Western financing was important for the initial Polish success, the Western focus on sound economic conditions also helped to guide Poland. A contributing reason for the strong Western support for Poland was that it was relatively cheap. The up-front cost was about $1.6 billion (Sachs 1993a). Poland was a stellar example of what international support could accomplish in a postcommunist crisis.

Czechoslovakia Required Little Financial Support

Czechoslovakia was the simplest case for Western donors. Its reformist government won a firm parliamentary majority early on, with a committment to radical economic reform and sound fiscal policy. Czechoslovakia's foreign debts were small and its finances stable. The country only faced a liberalization shock, which it took in stride. Following their procedure for Poland, the G-24 raised a stabilization fund that allowed the pegging of the Czechoslovak koruna, but Czechoslovakia did not need or request any IMF funding until 1993. Nor did it aspire to much World Bank credit.

With little regard for Czechoslovakia's favorable initial financial conditions, the leading Czech reformer Václav Klaus, who had originally emphasized the importance of Western assistance (Klaus 1992), soon expressed skepticism about outside financing for other transition countries (Klaus 1994).

The Baltics Got Substantial Support despite United States

The Baltics faced a far more complicated and strenuous situation. They had suddenly emerged as independent states in August 1991, economically poorly prepared to undertake early reforms. Their governments aspired to radical market economic reforms, but their competence was in doubt. Their parliaments, elected in early 1990, were dominated by nationalists of vague economic views. As the Baltic states remained in the hyperinflationary ruble zone in early 1992, their inflation surged beyond their control.

When Estonia adopted its truly radical reform in June 1992, its radical policies gave its government international credibility, which also benefited Latvia and Lithuania. Both followed suit with similar, though weaker, reform policies. Again, the G-24 rose to the task and identified a financing need of $1 billion for the three Baltic States for one year.

In contrast to Poland and Czechoslovakia, it was difficult to find donors to fill this financial gap, as it was proportionately much larger than that of Poland. The IMF and the World Bank were constrained by their rules and could only pledge $400 million. The European Union, Japan, the Nordic countries, and Germany saved the day with disproportionate bilateral contributions. The EU alone put up $300 million and Japan $100 million.[1] The United States, however, offered no financial support. Estonia's early stabilization was secured by its recovery of substantial prewar gold reserves that had been deposited in the West, while international support was critical for the success of Latvia and Lithuania (Lainela and Sutela 1994; Citrin and Lahiri 1995).

Although the international aid effort to the Baltics was a triumph, it revealed the West's limitations. The rules of the IMF and the World Bank prevented them from putting up sufficient resources. The Europeans could mobilize balance-of-payments support, but only with considerable effort, while the United States was unwilling to provide such assistance. In effect, the U.S. policy on the Baltics of 1992 marked the end of major Western aid efforts to transition countries, since the Europeans were not prepared to offer financing without a U.S. share anywhere else. In the future, the international financial institutions had to face the music on their own.

WESTERN ROLE IN UNSUCCESSFUL STABILIZATIONS

No country was more important than Russia. It had let the Eastern European countries as well as all the Soviet republics become independent, and it was devastated by economic crisis. Even so, the international awe of Russia remained palpable and the fear of Russian expansion lingered. After all, until recently, the Soviet Union had sparred with the United States as the other superpower, and it still possessed some thirty thousand nuclear warheads. Yet, many also worried about an implosion. A time of international misunderstanding ensued.

The other CIS countries had little choice but to follow Russia, on which they remained dependent in so many ways. Therefore, none of them could really be more successful than Russia. Although they are located in South-East Europe, Romania, and Bulgaria are best discussed together with CIS countries.

[1] I was marginally involved in this fund-raising campaign.

Protracted Overture to Reforms in Russia

When the Soviet Union dissolved in December 1991, postcommunist transition was already a well-established process, and the Washington consensus for Eastern Europe had set the tone on transition economics. The main questions raised about Russia were whether the economic reforms would be sufficiently far-reaching, whether they enjoyed political support, and whether the West should provide credits for Russian reform.

The international community had long focused on market transition in the Soviet Union. From the beginning, Russian transition was treated as a political rather than an economic issue. The highly political G-7 (composed of the seven big Western industrialized countries – the United States, Japan, Germany, France, the United Kingdom, Italy, and Canada) replaced the more economically oriented G-24. At its request, four international economic organizations – the IMF, the World Bank, the OECD, and the European Bank for Reconstruction and Development (EBRD) – undertook a major study of the Soviet economy, on how to reform it and criteria for Western economic assistance to market reform in late 1990. Because of novel Soviet openness, the three-volume study contained lots of new information. It advocated a radical and comprehensive reform of the Polish type (IMF et al. 1991; Gould-Davies and Woods 1999).

In June and July 1991, a group of prominent Harvard scholars and Russian economists pursued a private project, called the Grand Bargain, on how to reform the Soviet economy. It advocated substantial Western support before the G-7 meeting in London in July 1991 (Allison and Yavlinsky 1991). Despite considerable Western sympathy, this proposal was never taken seriously in the Soviet Union, and President Mikhail Gorbachev failed to make any plausible proposal himself. Besides, his political control was obviously waning. The West had no basis for any action.

The abortive August 1991 coup sounded the death-knell for the Soviet Union, leaving reform to the soon-to-be independent states. Russia opted for democracy, and Boris Yeltsin had already been elected President of Russia against the wishes of the communist establishment, with a majority of 59 percent of the votes cast in free and fair democratic elections of June 1991. On October 28, 1991, Yeltsin (1991) made his greatest speech to the Russian parliament, unveiling a comprehensive radical economic reform proposal. He appealed for substantial Western support, though he refrained from specifying the amount needed. His reform speech was overwhelmingly approved in a vote by the Russian Parliament. A week later, President Yeltsin undertook a fundamental government reform, abolishing dozens of branch ministries and cutting government staff drastically. He also appointed a new kind of cabinet, consisting of young economic reformers, with Yegor Gaidar as deputy prime minister and reform leader. Rarely has such a great historical opportunity arisen, and seldom has it been so evident in its coming.

Western Inaction during Russia's Reform Launch in 1992

Yeltsin's young reform government was working night and day preparing their reforms, and a strong informed Western opinion demanded their governments to support Russian reform. In November 1991, the *New York Times* editorialized: "The challenge for the West is to encourage Mr. Yeltsin's real, radical program by giving attentive assistance now" (*New York Times*, November 12, 1991). On December 17, 1991, the *Financial Times* concurred: "Now is the first and, perhaps, the last chance for the west to promote radical economic reform in the former Soviet Union."

But the leading Western governments revealed no intention to support reform in Russia. In mid-November 1991, the new Russian reform administration received the deputy ministers of finance of the G-7. During four days of negotiations, the G-7 deputies discussed only one issue, "the joint and several responsibility" of the soon-to-be former Soviet republics for the Soviet debt. Thus, the G-7 revealed their awareness of the impending breakup of the Soviet Union, but their only interest was to secure their claims. The young Russian reformers were shocked and dismayed by the G-7's complete disinterest in their reform plans.

The next Western initiative was a sheer diversion, a large high-level international conference on humanitarian aid to the former Soviet Union in Washington, D.C., in late January 1992, just after Russia had launched its daring reforms. Nobody from the FSU was even invited. Clearly, the U.S. administration organized this meeting to show that it thought about the FSU, but it designed the conference to avoid all discussion of support for reform. Thus, the West noisily wasted its time.

On April 1, 1992, five months after his appeal to the Western governments, President Yeltsin received an answer. U.S. President George Bush and German Chancellor Helmut Kohl declared their intent to mobilize a Western aid package of $24 billion for Russia. However, their April fool's claim was never substantiated (Åslund 1995, pp. 214–17). In early April, the Russian reformers faced an onslaught by the semidemocratic, and by now antireformist, parliament. By June 1992, President Yeltsin effectively gave up on reform and appointed three reform foes, including Viktor Chernomyrdin, as deputy prime ministers. An important reason for the fall of the Russian reform government was the absence of Western support.

The Europeans looked to America on such a big policy issue, and only the U.S. president could act, but he did nothing. The Bush administration was late in realizing that the Soviet Union was breaking up and wanted to shore it up until its very end. In August 1991, President Bush made his infamous "chicken Kiev speech," admonishing the Ukrainians to stay in the Soviet Union. The U.S. government was reluctant to provide any bilateral financing, as it showed even in the Baltics. The forthcoming presidential elections in November 1992 stalemated the Bush administration, which thought international assistance was unpopular with the voters. The Soviet collapse was so peaceful and democratic that no action seemed needed. Personally, President Bush favored Soviet President Mikhail Gorbachev over Russian President Yeltsin, although only Yeltsin had been democratically elected. Gorbachev's aide Grigory Yavlinsky was preferred over Yeltsin's reform leader Yegor Gaidar, who was not known in Washington. In February 1992, the well-informed *Washington Post* columnist Jim Hoagland concluded that the United States did not provide any support to Russia, because President George Bush reckoned Boris Yeltsin was a transitional figure (*Washington Post*, February 11, 1992). As the *Financial Times* had prophesized, this was the only big chance for the West to support reform in Russia, and the responsibility for missing it must rest squarely with President George Bush.

The amounts discussed were minor in comparison with the potential benefits, not to mention the peace dividend. The total request for financial assistance to Russian economic reform in 1992 was about $25 billion, of which $6 billion were intended for a stabilization fund. A reasonable bilateral U.S. contribution would have been $3 billion, while the United States reaped $69 billion in peace dividend that year (see Table 10.1). In comparison, the Marshall Plan comprised 2 percent of GDP at the end of the 1940s, which would have meant $125 billion for the United States in 1992 (Milward 1984; U.S. Census Bureau 1999, p. 459). Remarkably, the West did give Russia credits of over $12 billion in 1992, but they were commodity credits, which actually blocked reform, as they went straight as rents to commodity traders and their corrupt conduits. They were bilateral loans, not conditional on any reform measures, and not coordinated with international financial institutions (Åslund 1995).

Soon after the radical reform attempt had faded in 1992, various Western leaders woke up and realized that this attempt had been genuine, but it was too late. A period of limited reforms and limited IFI financing followed from mid-1992 to October 1994. The IMF concluded several small loan agreements on soft and not very credible conditions, but Russian implementation became a persistent problem, as the IFIs' main Russian counterpart was no reformer but Prime Minister Viktor Chernomyrdin, the leader of the energy lobby. Some structural reforms were accomplished by a few surviving reformers in the Russian government, but no stabilization was in sight. Russians adjusted their old Soviet saying ("We pretend to work, and they pretend to pay us") to: "We [the Russians] pretend to reform, and they [the IMF] pretend to finance us."

A Serious Turn to Russian Stabilization in 1995

In Russia, the policy of half-measures pursued was being discredited by its miserable results, while support for small loans with soft conditionality dwindled among the IMF staff and shareholders. In October 1994, after the budget deficit and monetary emission had expanded excessively, the ruble exchange rate plummeted by 27 percent in a single day, and inflation shot up. As money had assumed economic significance, this currency crisis shook up the Russian establishment, suddenly making macroeconomic stabilization a real political priority.

As the IMF had been continuously engaged with the Russian authorities, it was ready for a serious stabilization attempt. The successful privatizer Anatoly Chubais was appointed first deputy prime minister for macroeconomic policy, and he put macroeconomic stabilization on track in spring 1995. The Russian government sharply reduced the budget deficit and concluded its first full-fledged stand-by agreement with the IMF in April 1995, with $6.8 billion in financing in one year. With strong IMF support, Chubais won the intragovernmental struggle over the reduction of subsidies and the elimination of tax exemptions for privileged lobbies. By the summer of 1996, financial stabilization had been attained. Inflation dropped to 22 percent in 1996 and to 11 percent in 1997 (Åslund 1999).

Many factors made this stabilization program possible. First, the initial transition rents from high inflation had dwindled, since subsidized credits and import subsidies were gone, and export rents were small. Second, the currency crisis of October 1994 had upset the Russian elite and created a political momentum for reform. Third, the emission of treasury bills denominated in rubles had created a strong constituency for a more stable exchange rate (Treisman 1998). Fourth, the reformers in the government fought better than ever, hitting all important interest groups rather than offering them any trade-offs, thus delivering a shock to those who lived on subsidies. Although the government was dominated by industrial lobbies, enterprise subsidies and regional transfers were cut by two-thirds, rendering a change in paradigm from rent seeking to profit seeking credible. Fifth, at long last the Russian government and the Central Bank were pursuing a coordinated economic policy, aiming at macroeconomic stabilization, which also enhanced credibility. Sixth, for the first time, the IMF offered substantial credits. Its stand-by loan amounted to 2 percent of GDP for one year, giving the IMF substantial political weight. Finally, Gaidar's party, Russia's Choice, was actually the largest parliamentary faction, providing the reformers with a good base in the State Duma.[2] All these factors taken together provided for credibility.

Yet, the Russian stabilization did not last. Structural reforms remained insufficient, and fiscal deficits grew instead of contracting. One reason for these developments was a massive inflow of private portfolio investment of $46 billion, or 10 percent of GDP, in 1997, which provided the government with too much financing and also kept the exchange rate too high. All this ultimately led to the financial crash of August 1998. Still, 1995 saw the first financial stabilization (Citrin and Lahiri 1995; Åslund 1999; Komulainen and Korhonen 2000).

Other Slow Transformations

The other CIS countries watched Russia closely. The ruble zone bound them together, and they still benefited from huge Russian price subsidies and subsidized credits. Russia was the dominant trading partner of all the other CIS states, and it would have to be so for many years for geographic reasons. All the FSRs suffered from an acute shortage of policymakers attuned to the needs of a market economy, and the Russian policy debate framed the domestic discussion in other CIS countries, as they all watched Russian television and thus followed Russian domestic developments. From Russia, politicians in other CIS countries learned what to do to survive politically.

In early 1992, CIS politicians observed a spectacular failure in Russia, and they drew important conclusions for themselves. First of all, financial stabilization and return to economic growth were not in sight. Therefore, they saw no reason to challenge their own establishments, by opting for early radical reforms. This conclusion led them to devastating hyperinflation and solidified the standing of the old Nomenklatura throughout the region (Akaev 2000).

Second, as the West was slow and niggardly in its financial support even to Russia, the other CIS states realized they were too unimportant to hope for economic aid. They understood that international financial assistance would be provided only by the IMF, the World Bank, and Russia.

[2] For these reasons, I do not believe in Daniel Treisman's (1998) explanation that this was a deal with new bankers who had prospered on inflationary credit to focus on noninflationary rents, namely, excessive yields on treasury bills, while the ruble-denominated treasury bills did create a lobby for low inflation.

Third, in the short term, one of the few factors that could mitigate their hard economic fate was Russian price subsidies and subsidized credits supplied through the ruble zone. Therefore, most CIS countries supported the ruble zone as their only available source of external finance, preferring Russian subsidies to a sustainable independent policy.

Thus, the consequences of the West's refusal to support the Russian reformers were disastrous for the rest of the CIS. Their financial stabilization was delayed by a few years, and reforms were not only delayed but distorted, breeding extraordinary corruption, or were even averted. Belarus, Turkmenistan, and Uzbekistan have failed to build market economies, and they no longer see it as their goal. As feeble attempts at market economic transformation faltered in these states, democracy never took hold.

Outside the post-Soviet sphere, communists remained strong and largely in power in Bulgaria and Romania. From 1991, they concluded one IMF program after the other, which invariably fell apart until the communists were voted out of power in 1996–7. In Bulgaria, a short-lived reform government attempted a radical reform in 1991, with support of an IMF stand-by program, but the coalition government broke up before the reform had taken hold.

International Support Was Crucial

Three major lessons can be drawn from this brief overview of early Western financial support to transformation. First, serious reform efforts that were supported with substantial Western financing were successful. The only exception is Bulgaria, where the coalition government was simply too weak, and Western support was unimpressive. Czechoslovakia and Hungary did not need much early international support, but they received what they needed.

A second conclusion is that the American unwillingness to help Russia in late 1991 and its refusal to contribute to the Baltic stabilization effort in 1992 precluded any concerted future Western aid effort outside of the IMF and the World Bank. Traditionally, IMF and World Bank loan programs had often been cofinanced by bilateral lenders, but only Japan continues to do so on a substantial scale. The EU has given limited credits on multiple conditions, which have bred more bureaucracy than policy, while the United States refuses to offer any balance-of-payments financing at all.

Third, the Western decision not to support Russian radical reforms in early 1992 doomed the whole CIS to hyperinflation, delayed stabilization by a few years and perverted later reforms. The initial Russian reform attempt might not have succeeded, even if it had received timely and substantial international support, but the absence of potent Western support to the Russian reform and the reformers discouraged both

Russians and other CIS politicians from trying. As Russia did not succeed in its reforms, none of the other FSRs dared to try. The absence of any prospect for early international financing made the other CIS countries more dependent on the retrograde ruble zone, the CIS state trade system, and Russian financial assistance. Therefore, the frequent argument that the West focused too much on Russia and too little on other CIS countries appears misguided. A policy of "Russia first" in the CIS would have been correct, but it was not pursued.

The role of external finance is spurious. Regression analyses show little systematic relationship between net external finance and reform or growth performance (De Melo et al. 1997a; Havrylyshyn and Wolf 1999). However, the reforms in Poland and the Baltics show that early international financial support to true reformers has been of crucial importance for their success. If external finance is not designed to support reform, as government export credits, international bank loans or international bond issues, it is not likely to promote reforms, because greater availability of external finance diminishes the need for reforms. Regression analyses do not show whether external financing supports good policy, and the amounts needed vary with the concrete financial dilemma of each country. Conditionality may not be effective to convince reluctant politicians to undertake reform, but financial assistance to true reformers has helped (cf. World Bank 1998).

LIMITED INTERNATIONAL FINANCIAL FLOWS

A common Western perception is that the West has provided substantial financial support to the postcommunist countries. Nothing could be further from the truth. This section examines the actual financial flows, that is, net capital flows, current account balances, and foreign indebtedness, debunking the myth of huge Western assistance.

Hardly Any Public Assistance

The IMF tracks aggregate capital flows, and Table 10.2 presents IMF estimates of net capital flows to countries in transition from 1992 to 1999. "Net official flows" represent all financing (grants, credits, interest and repayment of principal) to and from governments and intergovernmental organizations. Incredibly, this flow to the transition countries was negative from 1993 to 1996. At the height of first hyperinflation and then macroeconomic stabilization in the CIS, the international public community extracted net repayments of nearly $22 billion from the transition countries on old communist state loans or an average of $5.5 billion a year. Net official flows were significantly positive only in 1997 and 1998 due to large IMF disbursements, primarily to Russia. The region

Table 10.2. Countries in Transition: Net Capital Flows, 1992–1999 (US$ billions)

	1992	1993	1994	1995	1996	1997	1998	1999
Net private capital flows[a]	2.3	21.0	4.5	44.0	17.0	22.8	14.2	11.6
Net direct investment	4.2	6.0	5.4	13.6	13.7	19.7	21.0	23.5
Net portfolio investment	0.1	8.7	20.0	13.3	19.2	21.5	7.2	3.7
Other net investment	–2.0	6.3	–21.0	17.1	–15.8	–18.4	–14.0	–15.6
Net official flows	3.6	–0.4	–10.3	–9.0	–2.1	7.6	9.0	0.6
Change in reserves[b]	–1.7	–11.2	–5.7	–37.4	–2.4	–9.6	–0.8	–8.2
Memorandum								
Current account	–5.1	–8.2	2.1	–1.8	–16.9	–26.1	–24.8	–5.3

[a] Because of data limitations, "other net investment" may include some official flows.
[b] A minus sign indicates an increase.
Source: IMF (2000, p. 62).

received no net financing from Western governments, and the post-communist countries were paying more to Western governmental organizations in principal and interest than they were receiving in credits and grants.

If governmental inflows are commonly perceived as higher than they really were, the opposite is true of private inflows. Although private capital flows needed time to gain momentum, their net amounted to nearly $87 billion from 1993 to 1996, or on average $22 billion a year. Contrary to public perceptions, the private sector started providing the region with financing soon after the early crisis, while foreign governments and international organizations have withdrawn funds.

Private portfolio investments started flowing in 1993 and averaged $18.5 billion a year from 1994 to 1997, largely going into government bond and stock purchases. While it is gratifying that private investors were prepared to invest in the region so early, most went into short-term treasury bills that served to undermine fiscal policy by easing the pressure on governments to undertake necessary fiscal adjustment. Surprisingly, private portfolio investments to the region have stayed positive even during and after the Russian financial crisis.

Foreign direct investment is long-term capital. It gained momentum only in 1995, but since 1997 it has exceeded $20 billion a year, and it is increasing every year. This capital flows primarily to the already successful countries in Central Europe, so it does not help countries in financial distress. Capital flight is partially reflected in "other private net investment," which is usually negative in the range from $14 billion to $21 billion a year, but total capital flight is likely to be larger.

On the whole, the private sector has thus financed transition, while the public sector has not even made a positive contribution. However, substantial private capital inflows only started in 1993, since the region was perceived as so precarious before that no noteworthy investment could be attracted at any return. That was the period of market failure when public financial support was badly needed but did not come.

Varying Current Account Balances

The current account balances in the region have varied considerably. The overall situation is captured in Table 10.2. The region had an almost balanced current account from 1992 to 1995, although most countries suffered from serious current account deficits just before the transition, and such deficits erupted again in the years 1996 to 1998. The simple explanation is that the dearth of external financing forced the region to severe austerity.

Those countries that undertook stabilization swiftly – Central Europe and the Baltics – developed early current account surpluses (see Table 10.3), while large deficits persisted in Romania, Bulgaria, and the CIS countries that did not export oil and gas. Some of the smallest CIS countries suffered particularly badly – Armenia, Georgia, Kyrgyzstan, and Tajikistan, as they had few lucrative export commodities.

When stabilization finally occurred in the CIS, current account deficits shrank in some countries, but they have remained rather large. Incredibly, Azerbaijan recorded an average current account deficit of 29 percent of GDP from 1996 to 1998, but it could afford it because of a huge inflow of foreign direct investment into its oil industry. Armenia, however, had a steady deficit of 18 percent of GDP from 1994 through 1999. Armenia, as well as Moldova, Kyrgyzstan, and Tajikistan have built up huge debt burdens largely financed by the IFIs, which compelled Moldova and Kyrgyzstan to devalue substantially in 1999 after the Russian financial crash.

Current account balances have not been very closely related to financial crises. For years, Slovakia and Lithuania had current account deficits of about 10 percent of GDP. Even so, Lithuania has maintained its currency board, and Slovakia was forced to devalue only in 1998. Russia, on the contrary, has had a persistent current account surplus, but it suffered a severe financial crash in 1998. Similarly, Ukraine's current account deficit is small, but the country has been on the verge of external default for years.

On its own, the current account balance says little about a country's external financial health. In countries with large foreign direct investments, such as Estonia and Latvia, even large deficits are of little concern, but a small deficit might be untenable, if a country has made itself vulnerable by selling short-term government bonds, as Russia and Ukraine did. Hence, vulnerability in the form of short-term public debt has so far appeared more dangerous than a current account deficit.

Table 10.3. Current Account Balance, 1990–1999 (Percentage of GDP)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Central Europe										
Poland	1.0	–2.6	1.1	–0.7	0.7	4.5	–1.0	–3.2	–4.4	–7.6
Czech Republic	–2.8[a]	1.2[a]	–1.0[a]	1.3	–1.9	–2.6	–7.4	–6.1	–2.4	–2.0
Slovakia	..	..	..	–4.7	4.6	2.1	–10.6	–9.6	–9.7	–5.5
Hungary	0.4	0.8	0.9	–9.0	–9.4	–5.6	–3.7	–2.1	–4.9	–4.2
South-East Europe										
Romania	–9.6	–3.5	–8.0	–4.5	–1.4	–6.3	–8.9	–6.8	–7.0	–3.8
Bulgaria	–8.2	–1.0	–4.2	–10.1	–0.3	–0.2	0.2	4.2	–0.5	–5.5
Baltics										
Estonia	..	..	3.3[a]	1.3	–7.3	–4.4	–9.1	–12.2	–9.2	–5.7
Latvia	..	..	1.7[a]	19.1	5.5	–0.4	–5.4	–6.1	–10.7	–10.3
Lithuania	..	..	10.6[a]	–3.2	–2.2	–10.2	–9.2	–10.2	–12.1	–11.2
CIS										
Russia	..	..	..	..	2.1	1.4	1.7	0.1	0.8	13.6
Belarus	..	..	..	–11.9	–9.1	–4.4	–3.7	–5.8	–6.9	–3.3
Ukraine	..	..	–2.9[a]	–2.4[a]	–3.1	–3.1	–2.7	–2.7	–3.1	2.7
Moldova	..	..	–3.0	–11.9	–7.0	–6.8	–11.9	–14.8	–19.0	–2.8
Armenia	..	..	–70.4[a]	–14.3	–16.0	–17.0	–18.2	–18.7	–20.6	–15.0
Azerbaijan	..	..	–12.2	–12.2	–9.4	–13.2	–25.8	–23.1	–32.6	–15.0
Georgia	..	..	–33.5	–40.2	–22.3	–7.5	–6.1	–11.0	–11.2	–7.9
Kazakhstan	..	..	–31.5	–7.2	–7.8	–1.3	–3.6	–3.6	–5.6	–1.1
Kyrgyzstan	..	..	–1.8[a]	–18.5[a]	–7.6	–15.7	–23.3	–7.9	–22.4	–14.9
Tajikistan	..	..	18.4[a]	–28.9	–20.2	–12.8	–7.4	–6.1	–9.2	–3.3
Turkmenistan	..	..	68.5	14.1	4.0	0.9	0.1	–24.2	–38.8	–28.2
Uzbekistan	..	..	–12.0	–8.4	2.1	–0.2	–8.1	–5.1	–0.4	–2.7

[a] EBRD (1999, p. 78).
Source: EBRD (2000a, p. 71).

Limited External Debt Exposure

On the whole, the region is not particularly ridden by external debt problems, but at any given time a few countries have suffered. Table 10.4 shows external debt as a share of GDP. Three countries (Poland, Bulgaria, and the Soviet Union) had such serious precommunist debt problems that they required some form of debt relief.

Debt restructuring is a complex procedure. Government debt to other governments is renegotiated in the Paris Club, which is formally an ad hoc group of creditor nations that meets in Paris with debtor countries that are in default to negotiate rescheduling of outstanding debt. Most OECD countries are members of the Paris Club, including all the G-7 countries. The Paris Club has two requirements for starting negotiations with a country. The first is that the country is in imminent default, while the second is that it has an active program with the IMF, which implies that the Paris Club accepts IMF conditions (Hardt 2000).

The London Club is a parallel of commercial banks that meets in London to negotiate the rescheduling of outstanding commercial debt of countries in imminent default. Its rules are less strict, and usually the London Club acts after a decision in the Paris Club, though not necessarily so. The Paris Club and London Club can either just reschedule the repayment of interest and principal, giving the creditor respite, or they can write off part of the debt (Hardt 2000).

From the outset of its reforms, Poland desperately demanded a reduction in its large debt of $41 billion at the end of 1989, largely to Western governments. The negotiations in the Paris Club took some time, but an agreement was concluded in the spring of 1991, awarding Poland 50 percent debt forgiveness. The actual relief was delivered in two steps, however, with a reduction of 30 percent immediately and an additional 20 percent in 1994, and only on condition of Poland sticking to its radical reform program. Thus, Poland's Paris Club agreement became the most important external condition for the persistence of its reform efforts (Sachs 1993a).

Bulgaria's foreign debt of nearly $11 billion at the end of 1989 was not great, but it had minimal exports to the West. Unlike Poland, Bulgaria owed the bulk of its foreign debt to foreign banks, and it required a partial write-off, which conservative European bankers were unwilling to give. Worse, Bulgaria did not pursue consistent reforms and persistently verged on default. After having launched a radical reform with the introduction of a currency board in July 1997, however, Bulgaria managed to convince its creditors that it was serious about reform, and the London Club awarded it substantial debt relief. In effect, Bulgaria's large external debt together with the possibility of debt relief persuaded

Table 10.4. External Debt, 1991–1999 (Percentage of GDP)

	1991	1992	1993	1994	1995	1996	1997	1998	1999 (est.)
Central Europe									
Poland	61.5	56.4	54.9	47.1	38.0	35.2	36.0	36.2	38.3
Czech Republic	26.4	23.8	24.3	26.0	31.8	36.0	40.6	43.1	42.3
Slovakia	..	24.1	26.6	32.0	30.9	38.8	48.5	55.9	53.1
Hungary	67.8	58.1	63.7	68.7	70.4	61.1	51.9	56.9	59.9
South-East Europe									
Romania	7.4	16.5	16.1	18.3	24.1	29.5	30.1	24.0	27.1
Bulgaria	157.4	160.4	127.7	116.8	77.4	97.7	95.8	83.7	80.5
Baltics									
Estonia	..	..	18.2	23.4	22.1	31.8	55.3	55.6	56.0
Latvia	..	..	..	..	31.8	39.4	48.4	50.3	60.7
Lithuania	..	3.1[a]	12.2[a]	12.4	22.8	26.4	32.8	33.3	40.8
CIS									
Russia	161.2	128.2[a]	66.9[a]	43.7	36.6	32.3	29.8	58.6	87.1
Belarus	..	10.7[a]	27.7[a]	45.2	25.8	15.5	17.2	18.3	31.1
Ukraine	..	2.0[a]	11.2[a]	19.1	22.0	20.6	23.5	28.0	37.3
Moldova	..	1.3	20.4	53.1	46.3	48.1	54.3	59.7	105.7
Armenia	..	..	..	30.9	29.2	38.4	48.0	42.9	46.3
Azerbaijan	..	..	4.0	18.3	17.6	14.7	10.2	12.1	24.1
Georgia	..	12.8	67.8	80.0	63.7	44.9	44.6	47.2	63.0
Kazakhstan	..	24.5	33.4	28.0	21.0	21.3	28.6	37.3	50.1
Kyrgyzstan	..	..	33.0[a]	37.3	51.2	63.2	76.8	89.5	138.7
Tajikistan	..	..	73.3	93.8	158.0	83.8	98.5	90.0	94.9
Turkmenistan	..	..	3.6[a]	207.8	36.6	34.3	65.3	75.6	112.2
Uzbekistan	..	..	..	20.0	20.2	30.6	56.5	72.7	109.5

[a] EBRD (1999).

Sources: 1991 data, EBRD (1999); 1992–9 data, EBRD (2000a).

the country's polity to undertake a truly radical reform, in contrast to Romania, which was in a similar situation apart from not having a overburdening foreign debt.

The most complex case has been Russia. It turned out to be legally virtually impossible to divide the Soviet foreign debt of about $100 billion, and as Russia would have been due to taking over 60 percent of this debt, it decided early on to accept responsibility for the whole debt, in return for obtaining all Soviet assets abroad. However, the Soviet foreign debt exceeded the Russian GDP in 1992, when its exchange rate was highly depressed, and it required at least a restructuring of its foreign debt service. From 1992 to 1995, its external debt was rescheduled annually, but in April 1996 an agreement was reached on a long-term restructuring. In parallel, an agreement was reached in the London Club (OECD 1997). However, after the financial crash in August 1998, the external debt came close to GDP again, and debt relief seemed necessary. Uncharacteristically, the London Club took the lead and wrote off 36.5 percent of commercial claims of $32 billion. Considering a favorable rescheduling, this amounted to an actual forgiveness of about half the debt (Hardt 2000). This write-off was not conditioned on any particular reforms, but it did give Russia breathing space.

After the Asian and Russian financial crises, the IMF got sensitive about the accusation that it posed a moral hazard by bailing out foreign portfolio investors with its loan programs. As a consequence, the IMF refused to allow Ukraine and Romania to use IMF funds to repay bonds. Instead, both countries were forced into renegotiations with the investment banks that had underwritten the bond issues. These negotiations were highly complicated as little institutional framework existed, and not very experienced government negotiators felt left on their own with seasoned investment bankers.

Recently, a new debt problem has arisen in small, weak CIS economies, which have received large loans from the IFIs and Russia. Tajikistan, Kyrgyzstan, and Moldova, have suddenly got external debts exceeding their current GDP (see Table 10.4). The relative debt burden of these countries rose sharply with substantial devaluation after the Russian financial crash, as their GDP fell with the devaluation, while the debt was fixed mostly in dollars. In addition, Ukraine and Romania can barely manage their debt because of their poor reputation among their creditors. This raises new institutional problems for debt renegotiations, as neither the Paris Club nor the London Club would apply in these cases.

INTERNATIONAL SUPPORT AND ITS EXECUTION

The outside world could provide a variety of assistance. Initially, technical advice on the establishment of a normal society was needed. The acute economic crisis seemed to call for humanitarian assistance. The whole region apart from Czechoslovakia and Hungary suffered from severe macroeconomic destabilization, whose cure required the replenishment of international reserves, debt restructuring, and possibly budget financing. All these countries needed to restructure their trade and expand their exports to the industrialized West, which required that Western markets were sufficiently open. For postcommunist countries in vicinity of the European Union, the dream was to become members of the Union. Investment financing seemed desirable, as much old capital was obsolete, while critical infrastructure was missing (Zecchini 1995). A largely new task that emerged with postcommunist transformation was the building of civil society, in which private foundations assisted. Finally, education and training were broad spheres of possible assistance. In this section, we shall check what the West has done and query whether it made sense.

Technical Assistance Quite Sufficient

Whenever a country needs new thinking, it turns to outsiders both at home and abroad, because much of the knowledge that is new to an isolated establishment already exists among domestic dissidents or international scholars. For outsiders, it is exciting to be invited. Countries and international organizations are happy to share their knowledge and values, particularly in its human incarnation of consultants. Key advisors at the summit of government can be highly influential. Since the recipients are few, only a limited number of foreign advisors makes sense, rendering such assistance priceworthy and cost effective. Therefore, the natural inclination of donors is to supply more technical assistance than is required.

Chief issues for foreign economic advice were liberalization, macroeconomic stabilization, privatization, and the drafting of new laws. The most prominent economic advisors were academics. The most famous was Professor Jeffrey D. Sachs of Harvard University, who worked primarily in Poland and Russia. If no independent academic came forward, the IMF, the World Bank, or the United States Agency for International Development (USAID) tended to fill this role.

Outside economic advice had to be swift, because key decisions could not wait. The early reformers could not possibly grasp all new issues, and initial mistakes could not be unmade. Often the right knowledge was not in place in time, while the number of advisers became excessive later on. In large countries, more than one thousand consultants could advise the central government. The total cost of technical assistance, only partially made up of consultants, was about $1 billion a year for the whole region.

All conceivable bilateral and international organizations have provided technical assistance.[3] The dominant agencies have been the USAID and the EU agencies, PHARE for the accession countries and TACIS for the CIS countries. USAID committed a total of $9.6 billion from 1990 to 2000 (see Table 10.5), and PHARE and TACIS $8.0 billion from 1990 to 1997 (see Table 10.6), while their actual disbursements were much more modest.

Advice to governments has had an extraordinary impact. The whole economic thinking changed toward normal market economic ideas in a few years. Macroeconomics required only a few senior advisors, while privatization involved numerous technical problems that could barely be resolved without outside advice. An amazing volume of legal texts have been drafted by foreign advisors, literally hundreds of laws in every post-Soviet country. Foreign advice was naturally controversial, but it was effective.

The efficacy of various advice is a contested issue, as so many public personalities were involved.[4] This debate reflects intense competition among academics, which is usually the best cure against poor advice, waste, and malpractices, and the total cost of all consultants was small by any standard but academic salaries. In the end, local politicians made the decisions, and they benefited from a range of advice.

The geographic orientation has varied considerably between USAID and the EU assistance. USAID started off targeting Poland, Czechoslovakia, and Hungary, but as these countries prospered, USAID moved on to the CIS, Romania, and Bulgaria, while it has persistently ignored the Baltics (see Table 10.5). In the CIS, USAID started with Russia, but by 1996 it had turned its attention to Ukraine, which has received a steady flow of some $200 million a year. USAID has played a substantial role in the whole CIS, but it has minimized its activities in three nonreform countries, Belarus, Tajikistan, and Turkmenistan.

PHARE/TACIS have a different regional profile. They have concentrated on Poland, the Czech Republic, Slovakia, Hungary, Romania, Bulgaria, Russia, and Ukraine (see Table 10.6). PHARE has also provided ample assistance to the Baltic countries, while TACIS has virtually ignored the CIS apart from Russia and Ukraine.

[3] As a matter of disclosure, from 1992 to 1994, Jeffrey Sachs and I ran an economic advisory project to the Russian government, which was financed by the Swedish government and the Ford Foundation. From 1998, I have intermittently been advising Askar Akaev, president of the Kyrgyz Republic, on economic reform with financing from the United Nations Development Program (UNDP).

[4] A low-water mark is Wedel (1998), which is an outstanding example of vicious personal attacks with flimsy evidence at best instead of any understanding about the aims of international assistance or its execution.

Table 10.5. USAID Budget for Eastern Europe and the Former Soviet Union, 1990–2000 (US$ millions)

	1990–2[a]	1993	1994	1995	1996	1997	1998	1999	2000	Total
Central Europe										
Poland		126.2	70.1	74.9	46.0	40.1	35.1	20.0	..	**412.4**
Czech Republic		34.6	29.4	14.6	3.7	..	..	..	..	**82.3**
Slovakia		31.1	35.1	27.3	16.0	15.0	8.1	3.0	..	**135.6**
Hungary		43.8	33.4	27.2	17.0	15.0	7.1	..	..	**143.5**
South-East Europe										
Romania		26.7	40.0	39.0	28.8	32.9	37.1	55.4	35.0	**294.9**
Bulgaria		47.0	34.0	37.3	28.2	34.0	33.7	55.1	32.0	**301.3**
Baltics										
Estonia		7.3	14.0	1.9	..	..	..	..	..	**23.2**
Latvia		5.9	14.4	7.0	3.7	3.3	2.4	..	..	**36.7**
Lithuania		10.4	13.6	12.9	8.4	7.2	4.7	2.3	..	**59.5**
CIS										
Regional aid		16.7	164.4	97.5	55.7	42.9	35.2	64.5	74.7	**551.6**
Russia		216.8	1,311.2	340.7	134.8	95.7	129.6	161.2	178.5	**2,568.5**
Belarus		5.2	10.1	5.6	5.0	6.7	7.2	12.4	7.3	**59.5**
Ukraine		41.7	211.7	181.9	225.0	225.1	225.2	203.6	160.0	**1,474.2**
Moldova		8.3	29.8	23.6	23.3	27.9	33.1	45.4	64.2	**255.6**
Armenia		45.9	82.8	52.1	85.0	95.0	87.9	80.1	102.4	**631.2**
Azerbaijan		5.2	11.8	10.7	11.2	16.4	35.2	35.2	30.8	**156.5**
Georgia		29.2	36.9	37.5	22.2	26.9	92.3	84.6	108.4	**438.0**
Kazakhstan		16.7	137.7	47.2	33.5	35.5	40.2	50.5	43.7	**405.0**
Kyrgyzstan		8.3	57.6	22.7	18.5	20.8	24.6	32.0	29.5	**214.0**
Tajikistan		8.3	18.1	9.2	3.8	5.0	11.9	13.0	9.2	**78.5**
Turkmenistan		6.3	8.1	5.4	3.7	5.0	5.5	11.3	6.3	**51.6**
Uzbekistan		8.3	22.6	11.8	19.3	21.5	20.5	27.3	17.3	**148.6**
Total	**1,056.7[a]**	**749.9**	**2,386.8**	**1,088.0**	**792.8**	**771.9**	**876.6**	**956.9**	**899.3**	**9,578.9**

[a] For FY1990–FY1992 the USAID budget to Central and Eastern Europe and the Baltics was not broken down by country. Assistance to the CIS did not begin until 1993. The cumulative budget for FY1990–2 is figured into the total budget for the region, but it is not figured into the country totals in the right-hand column.

Source: USAID, Feb. 3, 2000.

Table 10.6. EU PHARE–TACIS Funds Committed (Euro millions)

PHARE, 1990–7

	1990–3	1994	1995	1996	1997	Total
ECU/Dollar	**1.25 (avg.)**	**1.19**	**1.31**	**1.27**	**1.13**	
Central Europe						
Poland	802.7	208.8	174.0	203.0	147.9	**1,536.4**
Czech Republic[a]	60.0	60.0	110.0	54.0	60.0	**344.0**
Slovakia[a]	40.0	40.0	46.0	4.5	43.0	**173.5**
Hungary	405.6	85.0	92.0	101.0	88.0	**771.6**
South-East Europe						
Romania	440.0	100.0	66.0	118.4	100.0	**824.4**
Bulgaria	307.8	85.0	83.0	62.5	66.0	**604.3**
Baltics						
Estonia	21.7	22.5	24.0	61.8	4.3	**134.3**
Latvia	32.5	29.5	32.5	37.0	42.6	**174.1**
Lithuania	43.9	38.9	42.0	53.0	50.3	**228.1**
Total	**2,154.2**	**669.7**	**669.5**	**695.2**	**602.1**	**4,790.7**

TACIS, 1991–8

	1991	1992	1993	1994	1995	1996	1997	1998	Total
ECU/Dollar	**1.24**	**1.30**	**1.17**	**1.19**	**1.31**	**1.27**	**1.13**	**1.12**	
CIS									
Russia	212.0	111.0	160.8	150.0	161.2	133.0	132.9	139.7	**1,200.6**
Belarus	8.9	14.6	9.0	7.0	12.0	0.0	5.0	0.0	**56.5**
Ukraine	28.7	48.3	43.3	50.5	72.5	76.0	59.0	44.0	**422.3**
Moldova	1.1	9.0	0.0	10.0	9.0	0.0	18.0	0.0	**47.1**
Armenia	2.3	9.6	17.0	0.0	6.0	14.0	0.0	10.0	**58.9**
Azerbaijan	0.4	12.5	8.0	8.0	6.0	16.0	0.0	26.8	**77.7**
Georgia	5.0	9.0	6.0	8.0	6.0	16.0	0.0	16.0	**66**
Kazakhstan	7.7	20.6	14.0	14.0	15.0	0.0	24.0	0.0	**95.3**
Kyrgyzstan	0.7	9.2	10.0	0.0	8.0	0.0	13.0	0.0	**40.9**
Tajikistan	0.0	0.0	0.0	4.0	4.0	0.0	0.0	0.0	**8.0**
Turkmenistan	0.9	8.8	0.0	8.0	4.0	0.0	11.5	0.0	**33.2**
Uzbekistan	1.7	18.8	0.0	15.0	10.0	28.0	0.0	29.0	**102.5**
Total	**269.4**	**271.4**	**268.1**	**274.5**	**313.7**	**283**	**263.4**	**265.5**	**2,209**

[a] These figures only represent assistance beginning in 1993 when PHARE started to provide aid separately to the Czech Republic and Slovakia beginning in 1993.

Source: PHARE and TACIS Info Center, phare.tacis@mail.interpac.be, Feb. 14, 2000.

One extreme case of mismanagement by TACIS is worth retelling, as reported by the European Court of Auditors (1997), auditing TACIS activities in Ukraine, 1991–96. TACIS's monitoring was divided among four bureaucratic entities, of which none worked. Too many different projects were chosen without any principle, and many consultants lacked local counterparts, working in fact only for themselves (paras. 3.27–3.29). The auditors complained: "As it did not have adequate local knowledge, the Commission sometimes accepted the partner put forward by the national authorities without checking whether it was really suitable" (para. 3.12). Ukrainians regretted the low quality of EU consultants and found few worth talking to. The EU financing was staggeringly slow. Of a total of ECU 343 million committed by TACIS by June 30, 1996, contracts had been concluded for only 72 percent of these funds, and merely 38 percent of the total had been disbursed. "On average, the financing agreements for 1994 and 1995 programmes were not signed until more than a year after the beginning of the budgetary year to which they were related . . ." (para. 2.23), and the average processing time of a payment was five months (para. 2.28). Slow administration also harmed results: "In June 1996, after 16 months and expenditure amounting to 1.9 Mio ECU, the officer retraining project (7.2 Mio ECU) had still not trained any military personnel. . . . Over the same period an American-Ukrainian non-governmental organization [a Soros Foundation] had trained 26,000 servicemen with more limited funds than those available for the TACIS project" (para. 3.13).[5]

USAID has been exposed to much more public criticism than TACIS, but a similar U.S. Government Accounting Office audit of Harvard Institute for International Development's work in Russia and Ukraine uncovers a contrasting picture (US GAO 1996). USAID had pursued a clear economic and development strategy, focusing its resources on key topics, on which the U.S. consultants selected had special competence. The consultants possessed good local contacts, worked with key reformers and evidenced great productivity. The concern of the audit was limited to the abandonment of competitive procurement or nontransparent procedures.

Unlike TACIS, USAID's problem is in ordinate micromanagement, making USAID offices several times larger than a corresponding TACIS office. Consultants must first of all be specialists on writing reports to USAID, which takes time and favors big consultancy companies. The intense U.S. government monitoring implies a far-reaching politicization, and host governments regret their time spent on aid management.

[5] In March 2000, the European Commission could not provide any data for its PHARE commitments for 1998.

The main conclusion is that sufficient technical assistance has been available to reforming governments, and consultants have largely solved their prime tasks. No doubt, efficiency and efficacy could have been greater, but this is not critical, since technical assistance to the region has cost so little, and a certain amount of overshooting seems justified, considering the importance of the availability of adequate advice. On balance, there appears little reason to complain about the Western technical assistance to the East.

Humanitarian Aid Never Justified

As communism collapsed, humanitarian assistance topped the agenda of the pessimists, who regarded transition as hopeless. In the winter of 1989–90, substantial food aid was sent to Poland, and in the winter of 1991–2, the former Soviet republics received large Western commodity credits.

However, humanitarian aid is a misnomer. Overwhelmingly, it consisted of export credits for food from the European Union and the United States. The EU credits were neither cheap nor long-term, though the food was provided at dumping prices. These credits were not designed to support reform but to subsidize Western agricultural producers. The amounts were substantial. In 1992, Russia alone received $12.5 billion in commodity credits (IMF 1993). The agricultural "aid" went into the pockets of the old agricultural establishment, but it was added to the state debt (Åslund 1995).

Despite sensationalist claims, starvation was, fortunately, never a real threat. The problem was the dysfunctional economic system that inhibited the distribution of food, not the supply of food or devastating poverty. As soon as price and trade liberalization improved allocation, food queues disappeared.

If normal market conditions had prevailed in foreign trade, many postcommunist countries would have started their recovery with agricultural exports to the West, but unlike Western markets for other goods their markets for agricultural produce were hermetically closed. To add insult to injury, the EU has dumped large volumes of food on East European markets.

In spite of unified opposition from all reformers, some destructive and wasteful food "aid" continued as late as 2000 because of successful joint lobbying by the United States and the Russian agricultural establishments at the expense of the public in both countries.

Export credits should not be labeled "aid" but export promotion. They pose a dangerous temptation for countries in crisis, as they add to the countries' debt burden, and usually they are neither concessional nor long term. Moreover, they are closely tied to certain exports, not necessarily corresponding to market demand.

Macroeconomic Financial Support Vital

A demanding task that usually required substantial external financing was macroeconomic stabilization, which is a standard IMF assignment. Characteristically, in return for loans expanding a country's international reserves, the IMF requires a country to reduce its budget deficit both through expenditure cuts and increased revenues.

In a few cases, debt relief was necessary, as has been discussed above. An additional idea was to complement the international reserves with a stabilization fund, making it possible to peg the exchange rate and use it as a nominal anchor to facilitate financial stabilization and enforce monetary discipline (Sachs 1991, 1993a). Since the IMF did not provide such financing, bilateral funding was needed, which was politically difficult to mobilize, as the parliaments of all countries involved had to make a special budget allocation for a stabilization fund. Hence, such funds could only be formed for Poland and Czechoslovakia, after which this idea died.

The IMF is not supposed to finance government budgets, although it sometimes does. The World Bank, regional development banks, and bilateral donors, however, can provide so-called balance-of-payments financing, meaning credits for the state budget. World Bank "adjustment loans" are provided to a government on the condition of systemic reforms.

The communist countries had staved off from the IMF and the World Bank as vestiges of capitalism. Romania, Hungary, and Poland broke this ideological taboo in the 1980s, and the Soviet Union started cooperating with the IMF in 1990, without formally joining the Bretton Woods institutions. After the demise of communism, Czechoslovakia, Bulgaria, and the Baltics swiftly joined the IMF and the World Bank, while most CIS countries were admitted in the spring of 1992 to both organizations.

The international financial institutions faced a patent dilemma. They could intervene and alter the economic policy of a country with limited amounts of money, but they risked losing the whole credit. If they stayed out of a country, financial stabilization was not likely there for some time, and the social and political costs of transition would be far greater, but no loans would be wasted. No matter which course they chose, they would be criticized, either for losing money or for missing opportunities to support viable reform.

No organization involved in the transition has been more criticized than the IMF. A cursory newspaper reader might get the impression that the IMF is a global government in charge of postcommunist transformation. This critical publicity reflects how active and effective the IMF was under the leadership of Michel Camdessus. It has been much faster and more aggressive than any other international organization. The IMF has highly qualified staff, and its centralized hierarchy works like an army, acting fast. Macroeconomic stabilization was the first problem the postcommunist countries had to resolve, and the IMF possessed sufficient funds to make a difference. The prominence of the IMF was a U.S. choice and the other G-7 countries concurred, as the IMF has embodied the Washington consensus of conservative fiscal and monetary policy as well as a pathos of free markets (Gould-Davies and Woods 1999). More than any other organization, the IMF has contributed to a change of the international economic paradigm. It has done so by focusing on a few fundamental market economic principles.

Typically, the IMF provides substantial loans up-front with one-year "stand-by programs" to replenish international reserves on condition of a limitation of the budget deficit and a strict monetary policy. It is heeded because it poses comparatively few but fundamental conditions, whose fulfillment safeguards considerable disbursements, while most other organizations put up more conditions and pay less (Rodlauer 1995).

The outcome of the IMF's work in the region is mixed. The IMF registered early successes in Central Europe and the Baltics, and all these seven countries have graduated from IMF financing (see Table 10.7). The fourteen other transition economies, however, have had a checkered IMF history. Romania and Bulgaria have persistently needed IMF financing since 1991, but their IMF programs have often been interrupted by faltering economic policy. Russia was the only CIS country to receive IMF funding in 1992, while the other CIS countries concluded IMF agreements only gradually, though Turkmenistan never did. Belarus and Uzbekistan soon ceased cooperating with the IMF because of their opposition to a market economy. The nine reforming CIS countries have continued to collaborate with the IMF, but all have had their loan programs interrupted repeatedly due to unfulfilled conditions.

IMF disbursements have been substantial at a cumulative $34 billion to the region from 1990 to 1999, of which $20 billion went to Russia (see Table 10.7). The many ruptures in IMF programs show that this organization takes its conditions seriously, and the many renewed agreements prove that most countries are anxious to continue their cooperation with the IMF. It has accomplished its chief aim of bringing inflation down, with only the nonclient Belarus having inflation over 40 percent a year. The questions are whether this could have been accomplished earlier and at a lower social cost.

Table 10.7. IMF Disbursements, 1990–1999 (SDR millions)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	Total
SDRs/Dollar	**.74**	**.73**	**.71**	**.72**	**.70**	**.66**	**.69**	**.73**	**.74**	**.72**	
Central Europe											
Poland	357.5	239.1	..	..	640.3	..	..	..	..	..	**1,236.9**
Czech Republic	..	..	..	850.7	..	..	..	..	..	..	**850.7**
Slovakia	..	..	..	405.2	96.5	..	..	..	..	..	**501.7**
Hungary	127.4	703.8	118.4	56.7	..	..	..	..	..	..	**1,006.3**
South-East Europe											
Romania	..	565.8	338.5	..	245.1	37.7	..	120.6	..	53.0	**1,360.7**
Bulgaria	..	289.2	200.3	31.0	232.5	..	80.0	355.2	228.9	209.2	**1,626.3**
Baltics											
Estonia	..	..	7.8	34.1	..	20.9	..	..	..	..	**62.8**
Latvia	..	..	25.2	52.6	32.0	..	..	..	..	..	**109.8**
Lithuania	..	..	17.3	70.7	46.6	41.4	31.1	41.4	..	..	**248.5**
CIS											
Russia	..	..	719.0	1,078.3	1,078.3	3,594.3	2,587.9	1,467.3	4,600.0	471.4	**15,596.5**
Belarus	..	..	..	70.1	..	120.1	..	..	..	..	**190.2**
Ukraine	..	..	..	..	249.3	788.0	536.0	207.3	281.8	466.6	**2,529.0**
Moldova	..	..	..	63.0	49.5	42.4	22.5	15.0	..	50.0	**242.4**
Armenia	..	..	..	..	16.9	30.4	33.8	16.9	37.8	20.9	**156.7**
Azerbaijan	..	..	..	..	..	67.9	53.8	76.1	30.4	80.3	**308.5**
Georgia	..	..	..	..	27.8	50.0	55.5	55.5	27.8	33.3	**249.9**
Kazakhstan	..	..	..	61.9	136.1	92.8	92.8	..	154.7	..	**538.3**
Kyrgyzstan	..	..	..	43.9	9.5	30.3	16.1	32.3	10.8	19.6	**162.5**
Tajikistan	..	..	..	..	..	..	15.0	7.5	47.8	6.7	**77.0**
Turkmenistan	..	..	..	..	..	..	..	..	..	..	..
Uzbekistan	..	..	..	..	..	106.0	59.3	..	..	..	**165.3**
Total	**484.9**	**1,797.9**	**1,426.5**	**2,818.2**	**2,860.4**	**5,022.2**	**3,583.8**	**2,395.1**	**5,420.0**	**1,411.0**	**27,220.0**

Source: http://www.imf.org.

A disadvantage of the IMF's commanding role is that macroeconomic concerns, rather than structural reforms, have dominated Western economic policy in the region. While consecutive one-year IMF stand-by programs brought inflation down, three-year IMF programs with numerous structural conditions have proven less effective. Governments reckon that the IMF cares only about macroeconomic conditions, rendering other IMF demands not very credible.

The World Bank has also been important but much less criticized, since it has acted in the shade of its sister organization, the IMF, and it has cared more about its public image.[6] The World Bank has a broader range of activities. It has assisted the IMF with macroeconomic stabilization; spearheaded structural reforms and privatization; and also tried to promote social reforms and the improvement of governance (Dervis, Selowski, and Wallich 1994; Wallich 1995). Working on many disparate tasks, it is less focused and effective than the IMF. Its agreements tend to be loaded with numerous small conditions, distracting from the most important ones.

Initially, the World Bank provided large balance-of-payments credits, cofinancing IMF programs, usually on the condition of some important structural reforms. At the next stage, the World Bank gave large loans for public investments and budget financing. Its adjustment loans were conditioned on sectoral reforms, usually infrastructure and agriculture, as well as privatization and social reforms. In Central Europe and the Baltics, these programs have worked well, but not elsewhere. In a poor investment environment, few investments were profitable. Energy, transport, and agriculture were the prime fiefdoms of rent seeking, and the rent-seeking lords were usually the World Bank's counterparts. They wanted money without reforms that would eliminate monopoly rents or government subsidies. A natural outcome was that a loan agreement was often concluded and a first disbursement made with little reform ensuing. Over time, therefore, the World Bank has played down investment loans and sectoral adjustment loans in the CIS, while concentrating on the improvement of central government functions and key structural reforms.

World Bank loan commitments have tailed IMF programs, as the World Bank is restricted to lend when an IMF program functions, and some World Bank credits have cofinanced IMF programs. Moreover, many structural reforms cannot be undertaken early on. Since they aim at long-term development, World Bank loans have continued for longer and been more continuous than IMF credits. From 1990 to 1999, the

[6] Over the years, I have undertaken various short-term consultancy jobs for the World Bank.

World Bank committed $32.2 billion to the region (see Table 10.8), though disbursements have been much smaller. In terms of impact, the World Bank probably comes a close second to the IMF.

Substantial World Bank loans have been extended to all countries in the region. Proportionally, its biggest clients have been Poland, Hungary, and Romania, while other major customers have been Russia, Bulgaria, Ukraine, and Kazakhstan. The World Bank is the lifeline for small reformist countries, such as Armenia, Georgia, and Kyrgyzstan, whereas it has achieved as little as everybody else in the nonreform countries Belarus and Turkmenistan. Thanks to their early successes, the Czech Republic, Slovakia, and Estonia have not felt much need for World Bank loans.

Trade Access the Key to the Future

For emerging market economies, access to growing export markets is the key to economic growth. Recovery in all transition economies has been preceded by a substantial restructuring and expansion of exports. The openness of Western markets has been vital.

As discussed in Chapter 5, the postcommunist region is subdivided into two parts in foreign trade, East-Central Europe and the CIS. Communist Poland, Czechoslovakia, Hungary, and Romania were members of GATT (General Agreement on Tariffs and Trade), the precursor of the World Trade Organization (WTO), while Bulgaria and the Soviet Union were not. The WTO is an international trade framework, and most international trade agreements embrace WTO principles. Thanks to their adherence to GATT, the Central European countries had a legal framework for their negotiation of trade concessions with all GATT members.

The countries that were not members of GATT lacked international reassurances, and it was very difficult to join the WTO because it is extremely passive. Although the WTO is called an international organization, it is rather a conference organization with an arbitration court. Bulgaria and almost all of the FSRs applied for membership soon after communism, but GATT dragged its feet, revealing no interest in new members, while wasting two to three years on sheer formalities, after which multilateral negotiations started at snail's pace. Only in 1996 did Bulgaria become a member of the WTO (Milthorp 1997). In 1998, Kyrgyzstan and Latvia entered, in 1999 Estonia and Georgia, and Lithuania in 2000. Armenia, and Moldova are likely to join before 2003.

In practice, the WTO has been absent from post-Soviet foreign trade policy, neither setting standards, nor providing technical assistance, and no international organization has focused on CIS trade issues. To

Table 10.8. World Bank Commitments (IBRD and IDA Loans), 1990–1999 (US$ millions)

	1990–1	1992	1993	1994	1995	1996	1997	1998	1999	Total
Central Europe										
Poland	2,221.0	390.0	900.0	146.0	215.0	181.5	67.0	522.0	327.0	**4,969.5**
Czech Republic	..	246.0	..	80.0	..	..	..	..	..	**326.0**
Slovakia	..	..	..	135.0	..	..	..	..	..	**135.0**
Hungary	916.0	200.0	413.0	129.0	38.0	..	292.8	336.4	..	**2,325.2**
South-East Europe										
Romania	180.0	650.0	120.0	400.6	55.4	510.0	625.0	130.5	340.0	**3,011.5**
Bulgaria	17.0	250.0	178.0	148.0	125.0	121.0	94.3	116.0	160.8	**1,210.1**
Baltics										
Estonia	..	..	30.0	50.4	30.0	15.3	..	..	..	**125.7**
Latvia	..	..	45.0	25.0	53.0	27.3	98.1	8.0	58.6	**315.0**
Lithuania	..	..	60.0	26.4	32.0	42.1	112.7	..	20.1	**293.3**
CIS										
Russia	..	..	1,370.0	1,520.0	1,741.3	1,816.0	1,715.6	1,628.6	1,930.0	**11,721.5**
Belarus	..	..	..	170.2	..	..	..	..	..	**170.2**
Ukraine	..	..	27.0	..	646.0	342.8	989.6	216.4	600.0	**2,821.8**
Moldova	..	..	26.0	60.0	90.0	55.0	25.8	125.9	66.1	**448.8**
Armenia	..	..	12.0	28.0	116.7	91.8	31.8	134.5	120.6	**535.4**
Azerbaijan	..	..	..	..	81.8	83.0	34.9	90.0	79.5	**369.2**
Georgia	..	..	..	..	103.1	90.8	68.7	110.4	136.6	**509.6**
Kazakhstan	..	..	..	273.7	283.1	260.0	141.8	545.0	175.5	**1,679.1**
Kyrgyzstan	..	..	60.0	78.0	77.0	98.5	60.0	65.0	61.5	**500.0**
Tajikistan	..	..	..	..	..	5.0	62.0	20.0	93.4	**180.4**
Turkmenistan	..	..	..	..	25.0	..	64.5	..	..	**89.5**
Uzbekistan	..	..	..	21.0	226.0	..	5.0	127.0	55.0	**434.0**
Total	**3,334.0**	**1,736.0**	**3,241.0**	**3,291.3**	**3,938.4**	**3,740.1**	**4,489.6**	**4,175.7**	**4,224.7**	**32,170.8**

Source: World Bank, Office of the Chief Economist, Feb. 1, 2000.

a limited extent, the World Bank and the IMF have filled this void in trade conflicts among CIS countries, while the CIS itself is ineffective. The post-Soviet countries are outcasts left without recourse to international trade law and thus easy victims to frequent antidumping actions. This absence of an international trade organization seems the greatest shortcoming in the international economic framework of the post-Soviet countries. Dire consequences were felt after the Russian financial crash, when the CIS countries had few means to counter their protectionism against one another. While "trade but no aid" has become a popular slogan in both the East and the West, nobody is responsible for doing anything about it.

The Dream of a Return to Europe

To Central Europe, the Baltics, and South-East Europe, the European Union offered the dream of "a return to Europe," or full membership of the EU, though timing remained vague. The early EU commitment involved several concrete benefits (Baldwin 1994).

To begin with, the EU concluded substantial "Europe Agreements" with all the potential member countries (see Table 5.3). These association agreements provided the applicants with enhanced and earlier access to the EU market than the EU countries would get to the applicants' markets, which attracted foreign investors and brought about a sense of political stability (Mizsei and Rudka 1995).

The EU functioned as peer countries for the applicants and set legal and administrative standards. The *acquis communautaire*, the common EU body of law, contained a multitude of legal and administrative details, and all EU candidate members have to adopt it in full. Thus, the accession countries are adopting most institutions characteristic of the EU countries, which has resolved many practical problems of the transition. The EU has given substantial technical assistance for this purpose. Although visa regulations have been eased, the EU has not opened its labor market to the applicants. Most important, the EU agricultural market remains closed, while farmers in the applying countries complain about the EU dumping of agricultural produce. Yet, in spite of a few strictures, for Central Europe, the EU soon became the most important international organization.

For the CIS countries, on the contrary, the EU has had little to offer. It has provided limited trade access, and it has not facilitated visas, while its technical assistance has been scant and of little consequence. Rather than opening itself to the CIS countries, the EU seems to be building a new wall against trade and migration between the EU accession countries and the CIS, with devastating effects for a country such as Moldova, which should naturally direct most of its agricultural exports to the EU. This is one reason why the FSRs remain far too dependent on poor CIS markets, aggravating their economic troubles.

The OECD has played a role toward the most developed transition countries that is somewhat similar of the EU's standard setting. The Paris-based OECD used to be the club of the West, but in the 1990s, it was extended to include Korea and Mexico, and among the transition countries, Hungary, the Czech Republic, and Poland were the first to become members, followed by Slovakia. The OECD is an organization that sets standards in economic legislation, and it helped the most advanced countries focusing on their institutional development. It has also published useful economic reports and provided standardized statistics. For most transition countries, however, the OECD played no role, being pretty passive in the early transition.

Investment Financing Not Essential

At this time, a popular view had arisen that financial assistance should not be given to governments but to enterprise investment. Some rightwingers argued that Western governments should help private enterprises, though others favored laissez-faire, thinking that all government aid was misguided, especially as market failure, state failure, and information shortage prevailed, favoring only private financing. Leftwingers cared little about macroeconomics, but they desired productive capital in the real economy. The pro-investment views shared by the right and left gained political strength.

The public financing of private enterprises amounts to corporate welfare, however, and it is likely to be more harmful abroad than at home, as illustrated by Western commodity credits, because the postcommunist countries suffer from weak institutions and abundant rent seeking. Especially in the early transition, few serious investment projects could be recommended, as neither relative prices, sales, profitability, nor market conditions could be forecast. No enterprises in the region possessed standard audits. Legal conditions were even more uncertain, since little commercial legislation had been adopted, and even less was implemented. Nor had property rights been clarified. Only a few state enterprises were big enough to justify the substantial transaction cost of an international investor or credit agency. Yet, any investment in them was likely to be received as a subsidy, delaying rather than facilitating adjustment. Consequently, early investment financing tended to be either impeded or lost. Only later on could investment financing become effective, but then private investors already provided substantial financing (see Table 10.2).

The purported need to support real investment inspired the establishment of the EBRD and several regional U.S. Enterprise Funds. The World Bank has offered long-term investment credits to governments all along, and so has the Asian Development Bank (ADB) for the Asian transition countries. The EBRD was established in 1991 to assist East-Central Europe and the FSU, as Europe had no regional development banks unlike all other parts of the world. The initiative came from the French President François Mitterrand, who offered his advisor Jacques Attali as its first president. The United Kingdom lobbied for the EBRD's headquarters being located to the City of London, which helped making London the center for investment banking for the postcommunist region.

The very idea of the EBRD was problematic. As Attali was a socialist, his presidency aroused great suspicion among other Western governments, which insisted on a big and expensive board. The EBRD (1994) was circumscribed by a narrow mandate, limiting its potential impact. It could provide financing, only if a project would not take place without it, and even so it could contribute merely one-third of the total financing. The EBRD was supposed to operate as a private investment bank, and not as a regional development bank, but its high transaction costs required projects worth at least $5 million. Some 60 percent of its financing was supposed to go to the private sector, but respectable large private enterprises existed only in the most advanced transition countries. The EBRD also required Western accounting standards, which lacked for years. From 1991 to 1999, its total commitments amounted to only 14 billion euro, while actual disbursements might have stopped at half (see Table 10.9). Predictably, The EBRD's financing has focused on the successful countries after their success has been ascertained.

As discussed above, international financing was essential during financial stabilization, but the EBRD was not allowed to give governments such credits or to invest in the midst of a crisis. Either it lost money, as in the Russian financial crisis in 1998, or it was irrelevant for transition. It would have been better if the $10 billion of Western government funds allocated to the EBRD had cofinanced early IMF programs. The EBRD has been useful in providing expertise on transition, supporting privatization together with the USAID and the World Bank, developing business standards, training investment bankers for the region, and undertaking its very useful annual *Transition Reports*, but the cost of these efforts has been inordinate. As *Financial Times* editorialized about the EBRD (April 16, 1999): "The bank and its shareholders . . . need to make up their minds whether it should act as a private bank or development lender." The regional U.S. Enterprise Funds in the CIS have

Table 10.9. EBRD Annual Commitments, 1991–1999 (Euros, millions)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	Total
Dollars/ECU	**1.24**	**1.30**	**1.17**	**1.19**	**1.31**	**1.27**	**1.13**	**1.12**	**1.03**	
Regional	..	..	31	32	32	20	53	91	267	**526**
Central Europe										
Poland	17	148	200	246	55	271	210	354	147	**1,648**
Czech Republic	..	64	101	131	175	..	57	87	205	**820**
Slovakia	..	7	64	134	87	32	18	44	70	**456**
Hungary	5	126	378	142	275	168	89	68	117	**1,368**
South-East Europe										
Romania	..	222	95	114	162	228	206	252	134	**1,413**
Bulgaria	..	73	38	16	64	20	52	33	27	**323**
Baltics										
Estonia	..	39	20	45	30	26	49	86	46	**341**
Latvia	..	29	10	20	25	89	32	38	29	**272**
Lithuania	..	37	..	37	34	34	1	39	62	**244**
CIS										
Russia	..	6	299	440	398	783	756	541	164	**3,387**
Belarus	..	32	44	68	..	..	8	3	..	**155**
Ukraine	..	..	8	93	119	91	229	133	243	**916**
Moldova	..	1	..	25	65	17	28	15	..	**151**
Armenia	..	..	47	19	12	..	..	..	1	**79**
Azerbaijan	..	..	..	43	18	11	29	88	41	**230**
Georgia	..	..	..	15	9	7	34	59	44	**168**
Kazakhstan	..	..	100	..	11	43	124	157	183	**618**
Kyrgyzstan	..	..	..	8	76	..	30	18	6	**138**
Tajikistan	..	..	..	..	..	7	2	4	3	**16**
Turkmenistan	..	..	..	29	..	25	72	..	63	**189**
Uzbekistan	..	..	92	..	55	72	150	29	131	**529**
Total	**22**	**784**	**1,527**	**1,657**	**1,702**	**1,944**	**2,229**	**2,139**	**1,983**	**13,987**

Source: EBRD, Feb. 16, 2000.

suffered from similar problems, arising from the idea that government should help private enterprises.

Foreign Direct Investment an Indicator of Success

A beneficial form of external financing is foreign direct investment (FDI). Initially, however, only Hungary and the Czech Republic were successful in attracting large FDI, and for the region as a whole it gained momentum from 1995 (see Tables 10.2 and 10.10). Even by the end of the 1990s, FDI per capita has risen over $100 in no more than nine countries in this region: Central Europe, the three Baltic states, Azerbaijan and Kazakhstan (see Table 10.11). All these countries have received close to 10 percent of GDP in FDI one year. Azerbaijan stands out by having obtained on average 22 percent of GDP in FDI from 1996 to 1999, which is more than any country can usually absorb (EBRD, various years). Yet, FDI has remained remarkably small in most CIS countries. Even in 1999, the median FDI per capita was only $18. The exceptions have been Azerbaijan and Kazakhstan with their large oil assets, but Russia and Turkmenistan have attracted little FDI in spite of their energy wealth.

Thus, FDI has not assisted the early transition, but it has come as the proof of the success of reform rather than a catalyst of growth. A precondition for FDI is usually that a country is creditworthy, which Poland became in 1994 after debt relief. In the same way as investment, FDI follows growth. FDI per capita and growth are positively correlated, but rather than improving the investment climate, FDI requires that the investment climate is already good.

FDI was characterized by contrary expectations of foreign investors and domestic parties for years. Foreign investors were attracted by domestic markets, though also by raw materials. Especially in the FSU, people were concerned about sharply falling rates of investment and thought of FDI as a substitute for faltering domestic investments. Many years of propaganda of capitalist encroachment had given rise to illusions that capitalists were just longing for investing wherever they were allowed. The policy question, therefore, was perceived to be where to allow foreigners to invest and how to extract as much as possible out of them. FDI was initially seen as a means in regional policy to develop far away places and unutilized capacities, where free economic zones of dubious nature were often established. In 1989, I met officials from the old Russian city of Novgorod, who insisted that they had a capacity for half a million South Korean tourists a year, and they wanted me to assist them in designing such a plan. Politely, I tried to explain to them that South Koreans did not necessarily go to Novgorod just because the city had a surplus of substandard hotel rooms and restaurants (in which I had been food poisoned). Such illusions about hungry foreign investors died

Table 10.10. Foreign Direct Investment, 1990–1999 (Annual inflows, U.S.$ millions)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Central Europe										
Poland[a]	10	117	284	580	542	1,132	2,768	3,077	5,129	6,471
Czech Republic	132	513	1,004	654	869	2,562	1,428	1,300	2,720	5,108
Slovakia	18	82	100	168	250	202	330	161	508	330
Hungary	311	1,459	1,471	2,339	1,146	4,453	2,275	2,173	2,036	1,944
South-East Europe										
Romania	..	40	77	94	341	419	263	1,215	2,031	1,041
Bulgaria[a]	4	56	42	40	105	90	109	505	537	806
Baltics										
Estonia	..	..	82	162	215	202	151	267	581	305
Latvia	..	..	29	45	214	180	382	521	357	348
Lithuania	..	..	8	30	31	73	152	355	926	486
CIS										
Russia[a]	..	100	1,454	1,211	640	2,016	2,479	6,639	2,761	3,309
Belarus	..	..	7	18	11	15	73	200	149	225
Ukraine	..	..	170	198	159	267	521	623	743	496
Moldova	..	25	17	14	12	67	24	76	81	34
Armenia[a]	..	..	..	1	8	25	18	52	221	122
Azerbaijan[a]	..	..	..	60	22	284	627	1,115	1,024	510
Georgia[a]	..	..	..	..	8	6	40	203	265	82
Kazakhstan[b]	..	..	100	228	635	964	1,137	1,321	1,151	1,584
Kyrgyzstan[a]	..	..	0	10	38	96	47	83	109	36
Tajikistan[a]	..	..	9	9	12	20	25	30	24	21
Turkmenistan[a]	..	..	11	79	103	233	108	102	64	60
Uzbekistan[a]	..	..	9	48	73	–24	90	167	140	121

[a] Net of residents' investments abroad. Bulgaria, 1990–4; Poland, 1990–2.
[b] Drawings less repayments.
Source: ECE (2000b, p. 175).

Table 10.11. FDI Inflow per Capita, 1993–1999 (U.S.$)

	1993	1994	1995	1996	1997	1998	1999
Central Europe							
Poland	9	14	23	71	79	128	172
Czech Republic	59	83	243	123	124	256	476
Slovakia	30	35	34	33	33	70	130
Hungary	214	111	432	195	163	144	140
South-East Europe							
Romania	2	19	16	9	54	92	42
Bulgaria	7	12	12	12	60	65	98
Baltics							
Estonia	76	158	132	71	89	397	154
Latvia	22	57	64	92	206	124	136
Lithuania	11	16	15	41	89	249	129
CIS							
Russia	7	7	10	14	25	12	5
Belarus	..	1	1	7	19	14	22
Ukraine	..	2	2	10	12	15	10
Moldova	..	5	15	13	15	20	8
Armenia	..	1	5	6	14	58	34
Azerbaijan	..	7	28	87	144	129	64
Georgia	..	..	1	5	44	41	18
Kazakhstan	18	19	43	67	84	74	106
Kyrgyzstan	..	6	20	7	18	23	8
Tajikistan	..	2	2	2	5	4	3
Turkmenistan	..	26	25	28	23	13	18
Uzbekistan	2	4	5	2	7	9	8

[a] Reported full-year data except for the Baltic states and several European CIS countries for which extrapolations of January–September rates were used.
Sources: EBRD (1994, 1995, 1996, 1997, 1999, 2000a).

slowly and bitterly, and only after several years did post-Soviet officials realize that foreign investors were not impatiently waiting at the gate but actually had to be enticed to come.[7]

The other form of private investment is foreign portfolio investment in bonds and equity. Surprisingly, it took off earlier than FDI in 1993 (see Table 10.2), but it suffers from four major shortcomings. First, like FDI, private portfolio investors are risk averse, so they do not come early

[7] Yet, Novgorod officials persevered and learned from their mistakes. Several years later they undertook the necessary administrative simplifications to attract foreign investors, and Novgorod became the Mecca of FDI in Russia in the late 1990s.

enough to help financing stabilization and can thus not substitute for the IMF and the World Bank. Even after stabilization, they require very high yields to invest in domestic currencies. Second, unlike FDI, portfolio investment has been geared toward government bonds, mitigating the immediate need for fiscal adjustment and undermining IFI conditionality. Third, when portfolio investment catches on, it can easily skyrocket to destabilizing proportions, as in Russia in 1997. Fourth, large portfolio investment by minority shareholders in countries with poor corporate governance implies a moral hazard to domestic businessmen, since it is so easy to steal this money. Hence, substantial early foreign portfolio investment has offered few benefits, while being destabilizing and demoralizing. The Central European countries and the Baltics have proceeded cautiously, while Russia and Ukraine succumbed to this temptation. Thus, foreign investment financing neither can nor should play a major role in the early transition.

A New Role for Private Foundations

Nongovernmental organizations (NGOs) have enthusiastically seized a new role in postcommunist transformation. The foundations created in the region by billionaire philanthropist George Soros became the pioneers in international support in building civil society.[8]

Inspired by Karl Popper, George Soros (1991) aimed at building an open society. Preceding the fall of communism, he gave grants from his personal fortune to many new NGOs, starting with Hungary and Poland. He financed photocopiers and international exchanges, stimulating the development of local NGOs. As communism collapsed, George Soros expanded the scope of his activities to all postcommunist countries.

His foundations became role models for other organizations and governments, which seemed to be playing "follow George." The Soros approach had many advantages. George Soros was personally deeply involved, traveling extensively in the region with an entrepreneurial outlook. Using his own money, Soros could offer substantial gifts instantly. His total funding rose to over $400 million a year by the late 1990s, making his foundations the greatest donors to the region after USAID and the EU. By being fast and nonbureaucratic, Soros responded to the enthusiasm of activists, paying lower salaries but mobilizing more motivated collaborators than consulting firms. Spending most of his money on local activism, Soros stimulated the evolution of permanent

[8] From August 1994 to the end of 1997, I was advising the Ukrainian government on economic reform financed by the Open Society Institute (the main Soros foundation).

local NGOs. Soros ventured into multiple sensible activities beyond the pale of others. Because of the outstanding reputation of his foundations, other donors followed him with money and enhanced his initiatives. Finally, as quickly as he launched a project, he cut financing, if he realized that the project made little sense or that money was embezzled. Therefore, the history of postcommunist transformation is, to a great extent, the history of the Soros foundations.

Education Neglected

Strangely, little attention has been devoted to serious education. Both in the West and the East, socialist education was perceived as good though slightly different from Western education. Some lacunae in socialist education needed to be filled, but brief courses in transition lasting a few weeks were deemed sufficient, and Western support to postsocialist education focused on short courses and exchanges.

This was a misperception. While socialist education was generally respectable, especially in mathematics and physics, education in economics and social sciences was awful. Socialist economics was Marxist–Leninist exegetics, and economics education needed to be built from scratch. Tragically, thousands of professors of political economy of socialism were no resource but an impediment.

If a proper diagnosis had been undertaken from the beginning, the approach would hopefully have been different. Rather than sending faculty and students on pithy exchanges, the West should have organized full degree courses for thousands of undergraduate and graduate students, as was done for Chinese students in the United States. New universities and research institutes were needed rather than cumbersome reforms of old substandard and restive institutions.

While East-Central European universities seem reformable, CIS universities have proven harder nuts to crack. Most top educational institutions in the region are new, such as the Central European University in Budapest, the New Economic School and the Higher Economic School in Moscow, the Kiev-Mohyla Academy in Kiev, and American Universities in Armenia, Bulgaria, and Kyrgyzstan. Usually, they have benefited from foreign funding, and the main funder of these new elite institutions has been, once again, George Soros (Pleskovic et al. 2000).

LESSONS AND THE REMAINING AGENDA

Our future view of the role of the outside world in the postcommunist transformation will be determined by the eventual outcome. If peace and democracy prevail, while sustained economic growth takes hold, many will claim the success. If the outcome is meager or worse, the judgment will be harsh, because much more could have been done.

In hindsight, the West cannot be described as enthusiastic about helping postcommunist transformation. It cared about the success of Central Europe and the Baltics, which were soundly assisted. For the rest, Western support was tardy and hesitant, breeding slowness and indecision among those transition countries. The dearth of institutional development is illustrative. The end of World War II generated the United Nations, the Bretton Woods institutions, the Marshall Plan and the OECD. The end of the Cold War, on the contrary, has given birth only to the EBRD, an institution so misconstrued that its usefulness is dubious. The Soviet military threat vanished in any case, and the Cold War left comparatively few corpses. The peace dividend from 1992 to 1999 accrued nearly $1.4 trillion in current U.S. dollars to the United States alone, but the international public community has actually withdrawn capital from the postcommunist world in the 1990s, to which nobody has paid attention.

The critical foreign assistance has been early support for financial stabilization, but it could be effective only if reformers were in power and pursued radical comprehensive reforms. Such conditional assistance could ease the worst financial bottlenecks and make good policies economically feasible. External financial aid has also given reformers the necessary political leverage to act before the rent seekers colluded, for which upfront external support was vital. This is one important explanation of the relative success of Central Europe and the Baltics in comparison with the CIS. Eventually, macroeconomic stabilization has occurred, and the IMF has played a major role in each country with technical advice, conditionality, and substantial financing, but the timing of stabilization has determined the future path of economic as well as political development.

One common fallacy has been that the international private sector could provide financing even in the midst of financial crisis, but no sizable foreign investment occurs until initial stabilization and liberalization have proven successful. Foreign direct investment has been no catalyst, but a confirmation of successful transformation, valuable for further development. Foreign portfolio investment, especially in short-term government debt, has actually caused a moral hazard and been destabilizing. The idea of setting up government institutions, such as the EBRD and the U.S. Enterprise Funds, to finance private enterprise has amounted to little but corporate welfare, and the money would have been better used for the cofinancing of IMF programs.

Arguably, necessary technical assistance has been provided, but financial assistance was poorly conceived and tardily delivered. The postcommunist world should have been included in a universal trade community early on, but only East-Central Europe has been welcome in the EU markets. The EU is embodying a goal, peer, market, and model for these accession countries. However, it does little for those beyond the new wall rising between Central Europe and the CIS, keeping out both trade and people, although access to world markets appears the key to their future. Alas, no international body bothers about trade liberalization in the CIS. Too little has been done for the development of good education in new capitalist skills, such as economics and other social sciences, business administration, and law, both through long-term degree scholarships abroad and the building of new good educational institutions at home, for which more international intellectual and financial support is needed in the future.

While the West cannot take pride in its assistance to the postcommunist world, it has been reasonably open and positive, and it has never intimidated these countries. The worst Western policy has been protectionism toward so-called sensitive products. At most, we can complain about a lack of interest, commitment, financing, and understanding.

11

Conclusions

A decade is a sufficiently long period to breed clear perceptions, but too brief to offer true answers. The views of the extent of success of the transformation vary with country of focus, observations, and prior expectations of the observer, but a broad spectrum ranging from great success to utter failure is evident. The key question is why some countries have done so much better than others.

The main problem has been rent seeking harming economic performance. Some states have successfully checked it, while others have succumbed, getting stuck in cumbersome underreform traps. Shock therapy has been a much derided label of radical systemic reform, usually applied by its enemies, but shocks have been vital for the success of transition. The current situation is far from satisfactory, but numerous factors can harbor positive changes, while the threats seem fewer.

HOW FAR HAS TRANSFORMATION PROCEEDED?

Reformers aimed at building stable democracies and dynamic market economies, based on private ownership and good governance, able to deliver sustained economic growth. Table 11.1 summarizes the achievements. In most regards, the same countries have succeeded, and the same countries have failed, and a clear subdivision arises.

The focal point was building a market economy, and we have chosen a certain value of the structural reform index as a benchmark (see Table 5.1). Fourteen of our 21 countries, including the whole of East-Central Europe, Moldova, Armenia, Georgia, Kazakhstan, and Kyrgyzstan, comply with this standard, but our benchmark is not an absolute qualitative indicator, and Russia and Ukraine were close. Yet, Belarus and Turkmenistan have not undertaken any market reforms, and Uzbekistan has turned backward, while Tajikistan and Azerbaijan have undertaken little and late reforms. A subdivision obtains three groups:

Table 11.1. The Success of Postcommunist Transformation, 1999

	Structural Reform	Inflation under Control	Privatization	Growth	Limited Corruption	Democracy	Total Score
Central Europe							
Poland	×	×	×	×		×	5
Czech Republic	×	×	×			×	4
Slovakia	×	×	×	×		×	5
Hungary	×	×	×	×	×	×	6
South-East Europe							
Romania	×		×			×	3
Bulgaria	×	×	×			×	4
Baltics							
Estonia	×	×	×	×	×	×	6
Latvia	×	×	×			×	4
Lithuania	×	×	×	×		×	5
CIS							
Russia		×	×				2
Belarus							0
Ukraine		×					1
Moldova	×						1
Armenia	×	×	×	×			4
Azerbaijan		×		×			2
Georgia	×	×	×				3
Kazakhstan	×	×					2
Kyrgyzstan	×	×	×				3
Tajikistan		×					1
Turkmenistan		×					1
Uzbekistan		×					1

Sources: Tables 4.1, 5.1, 6.1, 7.2; Transparency International (1999); Freedom House (1999).
Criteria:

Structural Reform:	At least 0.70 on the structural reform index 1999.
Inflation:	Below 40 percent a year for the last year.
Privatization:	At least 60 percent privatization.
Growth:	At least 4 percent a year GDP growth for three years.
Democracy:	Free according to Freedom House.
Limited corruption:	Less than the worst West Europeans on the Transparency International index.

reasonable market economies, semimarket economies, and a few nonmarket economies.

Another criterion is macroeconomic stabilization. Regressions have shown that an inflation of 40 percent a year is the critical threshold for economic growth (Bruno and Easterly 1998). In 1999, all countries apart from Belarus, Romania, and, by a slight margin, Moldova had inflation below that hurdle. Stabilization is the big task that has been carried out most successfully.

A third standard of transformation is privatization. If the required level is chosen as 60 percent of GDP arising in the private sector, thirteen countries comply. They are almost exactly the same countries that fulfilled the structural reform standard, that is, the whole of East-Central Europe, Russia, Georgia, Kyrgyzstan, and Armenia, with Kazakhstan and Ukraine reaching that threshold in 2000 (see Table 7.2).

The ultimate goal, however, is sustainable economic growth. We have chosen a relatively low level of 4 percent a year GDP growth for at least three years as our fourth criterion. Shockingly, only seven countries in the whole region had surpassed this hurdle by 1999. Five are leading reformers: Poland, Slovakia, Hungary, Estonia, and Lithuania, while Armenia and Azerbaijan appear rather accidental.[1] It is distressing to see that not even reformers such as the Czech Republic have achieved much growth, while the partial reformers have done remarkably poorly.

Clearly, some malfunctioning of the economic system is not properly reflected in our first three criteria of transformation. The predominant suggestion is corruption and poor governance. According to the Transparency International (1999) Corruption Perception Index, only two transition countries, Estonia and Hungary, are perceived as less corrupt than the most corrupt West European countries (Greece and Italy), though the EBRD (1999) reckons that Poland is far less corrupt than Hungary. Corruption or state failure, as opposed to market failure, appears to be the fundamental problem of the transition countries.

Democracy is a vital indicator of the quality of the state and thus important for market reform. Freedom House draws a sharp territorial line between East-Central Europe, where all the countries are free, and the CIS countries, which fall into two equally large groups, the partly free Russia, Ukraine, Moldova, Armenia, Georgia, and Kyrgyzstan, and the others that are dictatorships (Freedom House 1999). The dictatorships are largely nonreformers. For democracy, we find a much stronger geographic subdivision than for market economic criteria. This might reflect greater peer pressure with regard to democracy than market reform. In Europe, it is perceived as a great shame to be undemocratic. Notably, membership of the Council of Europe presupposes democracy and respect for human rights. In Central Asia, on the contrary, the peer pressure works in the opposite direction, since it is perceived as a sign of weakness for a president to permit any civil rights or democratic free-

[1] Armenia's achievement is conditioned by its extraordinary initial contraction because of war and embargo. Azerbaijan's growth in recent years reflects a huge inflow of foreign direct investment into its oil industry rather than reforms.

doms. Moreover, a precondition of a thriving democracy is a sense of national security, which is missing in the Caucasus and Central Asia.

Although we have not chosen very ambitious criteria, only eight countries comply with at least four of the six standards. Predictably, they comprise East-Central Europe minus Romania. At the other end of the spectrum, Belarus fulfills no criterion and five countries only one criterion–namely Tajikistan, Turkmenistan, and Uzbekistan, but also Ukraine and Moldova. While the first four are nonmarket economies, the latter two appear the most extreme cases of rent seeking.

It is difficult to imagine a more varied result, and the breadth of outcomes underlines how difficult it has proven to complete a successful market economic transformation. The fortunate few have maximized their efforts, focusing on the ultimate goal rather than on the costs of each step. As a consequence, however, their total social hardship have been far less than of those countries preoccupied with incremental costs.

The success of transition to an ordinary market economy was never a given. Belarus, Turkmenistan, and Uzbekistan have stayed state-controlled economies, though without socialist insignia, which was a lasting alternative to a market economy. Another alternative was slow and partial reform, maximizing rents and corruption, with Ukraine and Moldova as the clearest examples.

WHY HAVE SOME COUNTRIES PROCEEDED FURTHER THAN OTHERS?

The essence of postcommunist transformation has been to overcome quickly the rent seeking that arose during the collapse of communism and move to profit seeking on competitive markets reinforced by all institutions of capitalism. This effort has required great understanding, good strategy, strong political will, and political mobilization.

The more radical and comprehensive the initial reform has been, the greater the economic success. Multicountry regression analyses invariably show that all major reforms have had positive impact. Price liberalization and external deregulation stand out as particularly effective. The limitation of inflation to at most 40 percent a year appears vital for the return to growth, and lower inflation probably added dynamism (Christoffersen and Doyle 2000). Economic expansion is positively related to privatization, especially the development of new private enterprises. Other institutional reforms are also important, but the more major reforms were undertaken, the greater such institutional reforms. Sensible reformers do not discard one kind of reform for another but do them all as soon as possible, as the historical record makes evident.

Today, the empirical evidence of the benefits of a radical and comprehensive reform is overwhelming. No country has suffered from too radical reforms, though some attempts at radical reform have lacked the necessary domestic or external support and thus faltered. The frequent statement that Russia suffered from too radical reform is a misrepresentation of facts. Russia undertook a brave attempt at an initial radical reform, but, unfortunately, it did not reach far enough (see Table 5.1). Domestically, President Yeltsin could have dissolved the predemocratic parliament earlier and held early democratic parliamentary elections to get a more representative parliament providing political support for reforms (Aron 2000). Internationally, the West could have offered early and effective financial support to economic reform in Russia. In hindsight, it is easy to take the present as given, but transition contained real choices that must not be dismissed as nonexistent, although these choices were subject to severe constraints. The only radical liberalization that was reversed was the Bulgarian transition, presumably because its civil society lacked maturity, as reflected in a very fractured nonsocialist movement.

Why have so many countries chosen suboptimal paths leading to unfavorable equilibria? One finding of this book is that the strength of civil society just before the collapse of communism has been of fundamental importance for the success of transformation and more relevant than earlier history. This appears the prime reason why the Baltic countries outperformed Bulgaria and Romania, although the former suffered from their bitter Soviet inheritance. Similarly, the turbulent events in Kyrgyzstan in the summer of 1990 explain why Kyrgyzstan has outperformed Belarus and Ukraine. Civil society bred an alternative elite ready to take over from the old Nomenklatura.

It was crucial that the power of the old Nomenklatura was disrupted so that a new elite took over with a democratic mandate formalized as a parliamentary majority. Democracy was both a destructive force and a builder of new democratic institutions. Therefore, early democratic parliamentary elections were vital for the success of reforms, and they provided the foundation of the most successful economic transformations in Central Europe and the Baltics. In all these countries, a healthy sense of national awareness and cohesion was part of the national revival. To establish a rule of law implies substantial legislation, for which a reformist parliamentary majority is indispensable.

In most cases, we see a sharp difference between the CIS countries and East-Central Europe, though in several regards Bulgaria and Romania underperform together with the CIS countries. There are multiple reasons for this divide, and the relative importance of each factor cannot be properly established because of great covariance. The length of communism matters, as the distortions of prices, industrial allocation, and trade grew over time. The prevalence of Marxism-Leninism also starved the FSRs of intellectual capital needed for market economic reforms. The Soviet Union was in an extraordinary economic and financial crisis, and preservation of the ruble zone virtually guaranteed hyperinflation. The Soviet economic reforms starting in 1987 had created an economic system designed for massive rent seeking, empowering the privileged at the expense of society. Yet, the hyperinflation and the extraordinary rent seeking may be seen as inevitable costs of the poison pills left behind by communism. Moreover, the Nomenklatura needed to be enticed and divided to allow society to abandon their communist dictatorship peacefully. The alternative was continued dictatorial rule and petrification.

The distance to the West mattered, too. While Poland, Hungary, Czechoslovakia, and the Baltics received timely and adequate Western financial support for their initial reforms, the more distant countries did not. All economic recovery started with expanding exports. The nearest neighbors to the European Union have been given the greatest market access, while also benefiting from the lowest transportation costs, and the subtle sense of peer countries.

Russia's fate was decisive for the rest of the CIS. When Russia failed to carry through its market economic reforms and stabilize its economy, the other CIS countries reckoned it was futile even to try. If Russia could not obtain Western financial assistance, the other CIS countries were convinced they had no chance. As the Russian reformers lost political power, their example of radical reform appeared political suicide. In the absence of Western financing, the other CIS countries saw no plausible option but to hang onto the ruble zone and remaining Russian subsidies, which was devastating for their economic performance and reforms. Most of them were highly dependent on exports to Russia, and their recovery was unlikely before the domestic Russian market had gained momentum (Christoffersen and Doyle 2000). The common view that Western assistance should focus on CIS countries other than Russia was a disservice to all CIS countries.

The promise of a "return to Europe" in the form of future membership of the EU offered the countries in East-Central Europe hope, ideals, good peer countries, trade access, and foreign direct investment. The EU provided a ready-made model of working capitalist states, and it assured these countries that they would not fall off the map.

WHY RENT SEEKING HAS BEEN SO COSTLY

Rent seeking includes many phenomena, but it has been particularly socially costly in postcommunist countries because of its methods. The initial fortunes were made on arbitrage, diverting inputs from the state sector, often creating worse bottlenecks and shortages there. "By destroying the traditional coordination mechanisms in the economy, without substituting true markets, partial reform contributed to the collapse of output" (Murphy, Shleifer, and Vishny 1992, p. 906). The next major form of rents was subsidized credits, which caused hyperinflation, generating chaos and collapse of production. Third, the regular extraction of taxes in the form of penalties through cumbersome inspections, licensing, and certifications by myriad authorities boosted transaction costs and uncertainty, reducing the number of enterprises and their activities. Fourth, the complex system of arrears and barter as a means to extract implicit subsidies in some countries further aggravated transaction costs. All these forms of rent seeking implied not only direct public transfers of resources but serious impediments to the functioning of the market economy. Direct budget subsidies, by contrast, could theoretically incur only a direct public cost, but in the FSU even such subsidies appear to arouse organized crime.

Initially, the lack of sturdy capitalist institutions led to very high transaction costs. Some people started thriving on them and tried to conserve them. Institutional weakness, the lack of norms, and the swift actions by rent seekers rendered vital the early elimination of any distortion that could breed rents, as social costs were likely to be much higher in a transition economy than in an established market economy, rendering less regulation preferable in a transition economy. Alternatively, the building of the institutions of capitalism might be impeded or even stalled.

Rent seeking is an iterative process. Every time a rent seeker successfully makes money, he accumulates capital that he can invest in future rent seeking, and rent-seeking activities exhibit natural increasing returns. Rather than standard capitalist institutions, rent-seeking mechanisms can get institutionalized, and with them vested interests (Murphy, Shleifer, and Vishny 1993). Rent seekers have learned how to siphon off export earnings at offshore banks, escaping the not very long arm of post-Soviet law. They bought senior politicians, civil servants, and parliamentarians. In the late 1990s, many Russian deputy ministers were understood to be on the payroll of specific oligarchs, while senior ministerial jobs were traded for tens of millions of dollars. Nomenklatura networks benefited from great mutual trust, otherwise in short supply. As initial rents were large, substantial amounts could be shared and lubricate relations in these large networks of culprits. Notably, the old Soviet State Bank Chairman Viktor Gerashchenko, who was a kingpin in such a Nomenklatura bank network, was twice appointed Chairman of the Central Bank of Russia. Arguably, few had given as large gifts in their life as he, though at public expense. The irony is that honest officials cannot develop such extensive networks of grateful beneficiaries.

Fragmentation of the political system made it easier to maintain a rent-seeking mechanism. Until the parliamentary elections in Ukraine in the spring of 1998, the party system and ethical standards were so weak that two parliamentarians on a relevant parliamentary committee could block any piece of legislation, and they were happy to do so for a fee. In this way, the Ukrainian parliament entered complete gridlock, blocking hundreds of draft reform laws, because some rent seeker was always prepared to pay a comparatively small amount to block it, while the government rarely mobilized the much larger amounts needed to get a reform law promulgated. The situation improved considerably after the parliamentary election in 1998, as the party factions became somewhat more cohesive, and major reform laws were soon passed.

The greater the rent seeking, the weaker the opposing political groupings that represent the interests of new entrepreneurs. Since they were small and numerous, it was much more difficult for them to get organized. Whereas rents were large, concentrated, and of great importance to individuals, the benefits of entrepreneurship that would arise from deregulation and the imposition of law and order were dissipated. While rent seeking often took the form of improvisation and quick fixes, innovative entrepreneurship required long-term investment and long gestation periods, which were impeded by unpredictable government interventions (Murphy et al. 1993).

For the individual enterprise manager, a change of operation from rent seeking through old networks to profit seeking on a competitive market involves a big investment and a total change of mindset. It is a bold jump into the dark, meaning all kinds of hardships. His old skills will become obsolete, and he will need new knowledge. He must manufacture products that consumers are prepared to buy at a price exceeding his costs, which requires cost cutting, a change of production line, the establishment of a marketing department, and probably new investment. The manager will become subject to accountability and ownership control, no longer able to steal freely from the enterprise he manages, reducing his income considerably, even if enterprise profit skyrockets. The transition at each enterprise may be perceived as a large new investment, and most hesitate to do so until they are convinced of its necessity (Braguinsky and Yavlinsky 2000).

Hence, businessmen in radical reform countries, such as Poland and Estonia, have predominantly become profit seekers, supporting further market reform, while rent seeking has dominated among their colleagues in Russia and Ukraine, who have usually opposed reform. In both cases, the businessmen acted rationally in line with their apparent interests. The objective of the state was to alter their incentives, by rendering continued rent seeking no longer viable.

DANGEROUS UNDERREFORM TRAPS

A particular interest of this book has been to track underreform traps in the transition. After a country has fallen into one of these traps, it cannot easily develop further, because these traps represent suboptimal equilibria, reflecting the path dependence of transition. They embody two different conundra. One is a state-controlled economy, while the other is a rent-seeking society.

Two slow liberalization tracks have proved suboptimal. Minimal liberalization leads to the fading and possible reversal of reform with the reconfirmation of a state-controlled economy characterized by state orders, as in Belarus, Turkmenistan, and Uzbekistan (see Table 5.1). Partial liberalization leads to a very corrupt system of excessive state intervention aiming at extortion, typified by Russia and Ukraine. The persistence of substantial monopoly rents depresses growth. This model can be compared with the prereform system in India or the current economic system in Pakistan, which have both proved remarkably stable, as extortion breeds a large class of bureaucrats vitally interested in its continuation.

Unlike liberalization, macroeconomic stabilization has eventually been undertaken in all countries but Belarus. The explanation is probably that the rents arising out of inflation dissipate over time, though a period of high inflation has several negative long-term effects. One is great inequality, which persists after the end of inflation, as the leading rent seekers have enriched themselves and use their wealth to buy politics, corrupting the top polity as well as threatening democracy and all reforms.

A widespread idea is that the quality of privatization is more important than the speed of privatization, but such a comparison presupposes that substantial privatization actually takes place, which is not true of all countries. Slow privatization might never take off, representing another underreform trap, as Belarus and Turkmenistan show. Nor has delayed privatization led to higher quality of privatization in countries with little initial privatization, such as Ukraine, Moldova, or Azerbaijan. Virtually every substantial privatization has been concentrated to a short period of time, as stakeholders recognize that privatization is coming and that they had better get on the bandwagon, maximizing their share. Thus, like liberalization, privatization displays two suboptimal tracks – minimal privatization and delayed privatization.

Two similar underreform traps are apparent in politics. Unreformed communist parties, which oppose market economies, have remained strong in democracies pursuing gradual reforms, regardless of whether the communists were in power or not. Slow and partial reforms have resulted in poor economic performance, generating popular discontent, and strong communist parties have been able to reinforce popular dissatisfaction by blocking further market reforms in a vicious circle. The five strongest unreformed communist parties are found in Bulgaria, Romania, Russia, Ukraine, and Moldova. The persistence of a strong antisystemic force entails a dangerous temptation for semidemocratic leaders to abandon democracy altogether with the purported aim of "saving" economic reform.

The most obvious political underreform trap is full-fledged dictatorship, where feedback and accountability have been silenced. Dictatorship, state ownership, and state control over the economy go together. The five least reformed economies are Belarus, Azerbaijan, Tajikistan, Turkmenistan, and Uzbekistan, and they are all dictatorships. After a firm dictatorship has been established, a revolution is usually needed to get reforms going again. Therefore, the reestablishment of a dictatorship is the worst underreform trap, since it stalls all progressive developments, as Belarus illustrates. The argument that a dictator is needed to pursue market reform is untenable and usually made by people who oppose such reform. The political problem is not checking popular unrest but controlling rent seeking by a well-connected elite. Therefore, the correlation is strong between democracy and successful marketization. A dictator will most likely represent the establishment, even if he comes to power as an antiestablishment candidate, as Alexander Lukashenko of Belarus shows.

Countries have entered these underreform traps because their governments failed to undertake radical and early reforms. After the opportunity to do so during the extraordinary politics in the immediate aftermath of the collapse of communism has been missed, a variety of vested interests grow strong enough to trap the nation in a vicious circle.

THE BENEFITS OF SHOCK

This analysis shows two dangers. The worst threat to transformation is that one rent-seeking group consolidates its hold on power in a dictatorship, continuing a petrified state-controlled system, as it is the most stable state of affairs, and its demise might require another revolution. The lesser danger is the consolidation of a rent-seeking society. In the interim, it might perform worse economically than state despotism, but it has the advantage of being less stable, and rent-seeking societies, such as feudalism, have a tendency to degenerate into liberal market economies and democracies over time, as rent seekers harm one another in competition over rents (Ekelund and Tollison 1981).

This means that a maximum of discontinuity without violence is desirable to take society out of the old situation and avoid the costly partially reformed state. A severe shock is needed at the level of both society and individual. One decade of postcommunist transformation underscores its importance and its many functions. Chapter 3 presents the arguments for and against a speedy and radical reform; the evidence is worth reviewing.

Shock had a vital psychological function, making everybody change their thinking about economics, as Balcerowicz (1992, 1995) so wisely understood from the outset. It is striking how many resisted change and for how long. Yet, it is difficult to understand what a market economy is until you live in one. In the FSU, the public desire for macroeconomic stabilization matured only with the Russian currency collapse of October 1994, whose shock taught the Russian establishment their need for stabilization. In late 1994 and early 1995, most FSRs completed significant IMF agreements.

Since much of the old elite benefited from rent seeking, its rule had to be terminated through a democratic revolution to facilitate reform. Democratic breakthroughs have been best consolidated through early parliamentary elections. "An electoral victory of one side may make it more difficult for the opponents to block its program and shelter themselves from the burden of stabilization" (Alesina and Drazen 1991, p. 1183). After an election victory, the parliamentary majority had to launch a reform rather than seek compromises with opponents. "Countries with political institutions that make it relatively more difficult for opposing groups to 'veto' stabilization programs not to their liking will stabilize sooner" (Alesina and Drazen 1991, p. 1183). None of the successful radical rifts was undertaken in consensus, while all have been supported by a parliamentary majority. Those who failed to mobilize a popular majority (e.g., Romania) or did not transform it into a parliamentary majority (e.g., Russia) got mired in partial reforms.

Most arguments for shock reforms have been related to macroeconomic stabilization, which overwhelmingly favors shock. All the postcommunist countries have endured lasting high inflation, making clear that no overshooting existed anywhere, while inflationary inertia prevailed. In most countries, budget deficits stayed large for years. Output did not plummet because of lacking demand, but because of poor output and sales efforts, so the problem was supply. No real growth has occurred until inflation has been brought under control. The worries about sudden mass unemployment because of too radical reforms have not been substantiated, while it has been exceedingly difficult to shake out superfluous workers, indicating that more radical stabilization had been desirable. The inevitable conclusion is that fiscal shock has been insufficient in all these countries, whereas monetary policy has sometimes been allowed to overcompensate for lax fiscal policies.

Disturbingly, no transition country has reached a West European level of liberalization, as it has proved frightfully difficult to advance from the initial deregulation. The minimal increment underlines how vital the first jump was, and it had been desirable that all countries had started off more radically, including Poland and Estonia.

The most difficult task has been to convince old enterprise managers that the economic system has changed and they have to mend their ways. Even in Poland, this only happened in mid-1991 (Berg and Sachs 1992). Many managers and corrupt officials benefited inordinately from the transitional system, realizing that they would never be so well off again. Therefore, it was not enough to make the new system credible, but the old transitional system had to be aborted.

To accomplish all these things, the shock had to be severe. Today, it is often forgotten that Poland suffered two terrifying financial collapses – in 1981 and 1989 – before it opted for a real market economy. The Czech public did not face any real shock, which appears to be one cause behind its later economic stagnation. Although the Czech maximum package of reforms on January 1, 1991, still appears the perfect systemic change, the Czech population was not compelled to alter their thinking. While the Poles no longer believed in the competence of their state but in their personal skills, the opposite was true of the Czechs in the mid-1990s. Confident that they had been superior in socialist economics, they presumed they would excel in capitalism as well.

While shock is useful, violence is bad for reform, playing into the hands of the few and powerful. The ideal is a sharp peaceful disruption, drawing a clear line between the old and the new system, because the old organizational and administrative capital is of negative value and the transitional system is ineffective. The worst psychological situation is in the midst of transition, when the old system no longer functions but nor does any new system. Then little action makes sense and people suffer from despair.

If the initial shock was not convincing, if society was not prepared, or if the crisis solution was ineffective, new shocks may unfortunately be likely. One example is the Bulgarian financial crisis in 1996–7, which led to a regime change and a truly radical economic reform. Another example is Russia's financial crash of August 1998, which dealt a second severe shock to the country, speeding up its transformation. These crises reduced the wealth of rent seekers and demonstrated the necessity of more profound market reforms to the public; "distortions and crises may raise welfare if they are the only way to induce necessary policy changes." Thus, "from a dynamic perspective, crises and emergencies may be welfare-improving and hence desirable" (Drazen and Grilli 1993, p. 598). These words may sound harsh, given that ordinary people also suffer from such crises, but after one decade of transition the choice appears to stand between the steady economic decline because of rent seeking or sustained growth of radical reform. Vital statistics also suggest that corruption is worse than shocks.

The social costs of gradual and partial reforms fall into two categories. The first effect is lost growth because of a long period of transition. Since it is quantitative, it dominates the discussion, but the second qualitative effect is potentially much more harmful, namely corruption of the state.

IS THE SITUATION CHANGING?

After the Russian financial crash of August 1998, inordinate pessimism arose about the economic fortunes of the CIS countries. However, Russia returned to economic growth in 1999, with GDP surging by 8.3 percent in 2000. Most of the CIS has followed, with even Ukraine attaining 6 percent of growth. Many of the seemingly unsolvable problems of transition are fading into memory, while others no doubt will emerge. The Russian financial crash might have provided a second sufficient shock to much of the region.

A decade is a short period in history, and national stereotypes change fast. Who remembers that South Korea was hopelessly stagnant for a decade after the Korean war? The now so assiduous and successful Korean people and their culture were then considered alien to hard work. The age-old stereotype of the Poles as romantic aristocrats, whose cavalry fights tanks, was dumped in the dustbin of history after the Balcerowicz program took hold. Nothing succeeds like success, and nothing shakes people up like a rampant crisis. All of a sudden, a country that has long failed comes to a crossroads, having matured for a change for the better. Many forces can initiate substantial changes in the post-Soviet region, and most are likely to reduce rent seeking.

The specter of the CIS countries is a region of pervasively corrupt and criminalized states, but people are learning fast. Gradually, problems are being identified, analyzed, and sorted out, and the popular understanding of the new market economy and its distortions has risen at an amazing speed because of observation, international exchanges, and education. Information technology has opened this world for good. People can no longer be cheated about what is normal and acceptable in a market economy, as they were in 1992, and their understanding limits the danger of populism (Dornbusch and Edwards 1991).

While markets are imperfect, they dominate the economy in all these postcommunist countries except for the three state-trading survivors. Although liberalization advances very slowly, most countries proceed, and a lot has been accomplished (see Table 5.1). Foreign trade policies are in principle very liberal, and the few remaining foreign trade rents should soon be dissipated, as well as a variety of domestic monopoly rents. Western governments have not offered the postcommunist world much money, but these countries are very open and dependent on Western markets for their exports, and they have attracted large private financing. Hence, the postcommunist countries have little choice but to adjust to the world market, and no growth trap prevails for such open economics (Sachs and Warner 1995).

All countries in the region, apart from Belarus, have inflation under control. Several countries have untenable current account deficits, and if they do not reduce them soon, they will run out of international credit, but the prime suspects often escape. New financial crises are almost inevitable. They are seminal events in each country, usually punishing culprits for bad policy and enticing countries to sober up. They certainly rough up the elite. Therefore, international financial rescue packages should not be composed to keep corrupt and unrepresentative governments out of the abyss, while emerging reformers should be given a helping hand by the international community.

Most of the property in the region has been privatized, and as property relations are being sorted out, and ownership rights grow stronger, titles to land will presumably be awarded to its quasiowners throughout semireformed countries. As owners slowly enhance their control over their managers, pervasive management theft is likely to abate. Trade in property is extensive, and bankruptcy proliferates, which also reinforces property rights. With more private ownership, the demand for legal services increases, which will eventually boost their quality. Meanwhile, an ever clearer dividing line is being drawn between the state and the private sector, enabling entrepreneurs to stand up against extortion by state officials, while governments increasingly discipline their servants.

For the EU accession countries, the European Union looks like an anchor, peer, and savior, providing their dominant export market, as well as a source of institutions and financing. The EU market already accounts for about two-thirds of East-Central Europe's trade. These countries are adopting the *acquis communautaire*, thousands of pages of legal acts wholesale, importing EU institutions and practices, though there are considerable problems. The EU policy of dumping agricultural produce in the accession countries while keeping its own market closed is offensive, and it concerns a large part of the population in East-Central Europe. Not all the EU legal demands are politically acceptable, such as the restitution of land to prior owners or free purchase of land by foreigners. National minority issues and migration are riddled with problems. A worry is that the EU will impose its bureaucratic and state-dominated system, aiming at security and stability on these comparatively poor states, which need economic growth (Sachs and Warner 1996b). If the EU would open its markets more to sensitive imports from the CIS, notably agricultural produce from Moldova, it could entice enormous changes in the CIS countries at little expense to itself.

Russia continues to play a key role for the other CIS countries as their main export market and as a peer. If Russia's economic policies become successful, several other CIS countries will follow because of their exports to Russia, and Moscow still dominates the debate in the region. The Russian market is open and large enough to become the growth engine of the CIS region. Corrupt practices, such as barter, have proliferated from Russia to other CIS countries, but as barter falls in Russia, it dwindles also in other countries. Belarus's public finances depend on Russia's subsidies, which Russian liberals have long questioned. While Russia previously was caught in a vicious circle, it might also propel a virtuous circle.

Undoubtedly, rents have been falling almost continuously since 1992, though the rise of barter and excessive foreign portfolio investment might have prompted a temporary rise in 1997–8. The financial crash of August 1998 might have signified the bottoming out of the post-transformation malaise in the CIS in both quantitative and qualitative terms. The rents generated by inflation have dwindled away, and large-scale theft from the treasury appears to have become politically untenable. The rents from administrative intervention are likely to be reduced through competition in the long run. Their social cost is horrendous, while the beneficiaries reap limited benefits, and the malpractices are labor-intensive and easily recorded (Posner 1975).

The oft-raised specter of a Weimar Germany arising in Russia does not seem very plausible. The differences are too palpable. Boris Yeltsin did not oust Gorbachev through a coup, but he won a popular majority democratic presidential elections under the old regime, giving Yeltsin a legitimacy that the Weimar Republic never had (Aron 2000). The mood of our time is totally different, as democracy has become the norm, while dictatorship appears backward. Nazism had an ideology, which was competing with another totalitarian ideology, while Russia and the whole region are tired of ideology and fanaticism, preferring common sense. Not even the dictators in the region profess any ideology. Although the West has not done much to help Russia and the other CIS countries, it has been open and positive, while the Allied extracted huge war reparations from Germany, and French troops occupied the Ruhr in the 1920s.

Still, a few hard nuts, such as Belarus, Turkmenistan, and Uzbekistan, are likely to hold until the bitter end of their dictators. The Caucasus and Central Asia can be hit by armed incursions beyond our economic discussion. The future of democracy is in doubt in several semidemocratic CIS countries, and if democracy goes, rent seeking is likely to abound.

Our future view of this region will largely depend on what happens in the next few years. Much depends on access to Western markets, and the early accession of the CIS countries to the WTO appears vital. If the current economic upswing gains momentum, the region will move from the politics of redistribution or rent seeking to the politics of growth and profit seeking, and further reforms will ensue. If growth fades away, few problems might be solved.

Bibliography

Abalkin, Leonid I. (1992) "Ekonomicheskaya reforma: rezultaty i perspektivy (Economic Reform: Results and perspectives)," *Ekonomicheskaya gazeta* (no. 21, May), pp. 14–15.

(1996) "Sovremennaya situatsiya i nazrevshie peremeny v strategeii ekonomicheskoi reformy (The Current Situation and Ripe Changes in the Strategy of Economic Reform)," in Bogomolov (1996), pp. 137–46.

Adam, Jan (1993) "Letter to the Editor," *Economics of Planning* **26**: 183–4.

Aghion, Phillipe, and Olivier Blanchard (1994) "On the Speed of Transition in Central Europe." In Stanley Fischer and J. Rotemberg, eds., *NBER Macroeconomic Annual 1994*. Cambridge, Mass.: MIT Press, pp. 283–320.

Aghion, Phillipe, Olivier Blanchard, and Wendy Carlin (1994) "The Economics of Enterprise Restructuring in Central and Eastern Europe," CEPR Discussion Paper no. 1058. London: Centre for Economic Policy Research.

Akaev, Askar A. (2000) *Perekhodnaya ekonomika glazami fizika* (The Transition Economy in the Eyes of a Physicist). Bishkek: Uchkun.

Akerlof, George A., Andrew K. Rose, Janet L. Yellen, and Helga Hessenius (1991) "East Germany in from the Cold: The Economic Aftermath of Currency Union," *Brookings Papers on Economic Activity* **21** (1): 1–105.

Alesina, Alberto, and Allen Drazen (1991) "Why Are Stabilizations Delayed?" *American Economic Review* **81** (5): 1170–88.

Allison, Christine, and Dena Ringold (1996) "Labor Markets in Central and Eastern Europe, 1989–1995," World Bank Technical Paper no. 352.

Allison, Graham, and Grigoriy Yavlinsky (1991) "Window of Opportunity: Joint Program for Western Cooperation in the Soviet Transition to Democracy and the Market Economy," mimeo, Cambridge, Mass: Harvard University, and Moscow: Center for Economic and Political Research, June 29.

Altstadt, Audrey L. (1997) "Azerbaijan's Struggle toward Democracy," in Karen Dawisha and Bruce Parrott, eds., *Conflict, Cleavage, and Chance in Central Asia and the Caucasus*. New York: Cambridge University Press, pp. 110–55.

Amalrik, Andrei (1980) *Will the Soviet Union Survive until 1984?* 2nd ed. London: Harper Collins.

Amsden, Alice H., Jacek Kochanowicz, and Lance Taylor (1994) *The Market Meets Its Match: Restructuring the Economies of Eastern Europe.* Cambridge, Mass.: Harvard University Press.

Aoki, Masahiko, and Hyung-Ki Kim, eds. (1995) *Corporate Governance in Transitional Economies: Insider Control and the Role of Banks.* Washington, D.C.: The World Bank.

Arbatov, Georgi (1992) "Kuda poshli den'gi? (Where Did the Money Go?)" *Nezavisimaya gazeta*, April 3, p. 4.

Aron, Leon (2000) *Yeltsin: A Revolutionary Life.* New York: St. Martin's Press.

Ash, Timothy Garton (1983) *The Polish Revolution: Solidarity 1980–82.* London: Jonathan Cape.

(1990) *We the People: The Revolution of '89 Witnessed in Warsaw, Budapest, Berlin & Prague.* Cambridge: Granta Books.

Åslund, Anders (1985) *Private Enterprise in Eastern Europe: The Non-Agricultural Sector in Poland and the GDR.* New York: St. Martin's Press.

(1989) "Soviet and Chinese Reforms – Why They Must Be Different," *The World Today* **45** (11): 188–91.

(1990) "How Small Is the Soviet National Income?" in Henry S. Rowen and Charles Wolf, Jr., eds., *The Impoverished Superpower. Perestroika and the Soviet Military Burden*. San Francisco: Institute for Contemporary Studies, pp. 13–61, 288–305.

(1991) *Gorbachev's Struggle for Economic Reform*, 2nd ed. Ithaca, N.Y.: Cornell University Press.

(1992) *Post Communist Economic Revolutions: How Big a Bang?* Washington, D.C.: The Center for Strategic and International Studies.

(1995) *How Russia Became a Market Economy.* Washington, D.C.: Brookings Institution.

(1996) "Reform vs. 'Rent-Seeking' in Russia's Economic Transformation," *Transition* (OMRI), January 26: 12–16.

(1997a) "Economic Causes of Crime in Russia," in Jeffrey D. Sachs and Katharina Pistor, eds., *The Rule of Law and Economic Reform in Russia.* Boulder, Colo.: Westview Press, pp. 79–94.

(1997b) "Observations on the Development of Small Private Enterprises in Russia," *Post-Soviet Geography and Economics* **38** (4): 191–205.

(1997c) "Social Problems and Policy in Postcommunist Russia," in Ethan B. Kapstein and Michael Mandelbaum, eds., *Sustaining the Transition: The Social Safety Net in Postcommunist Europe*. New York: Council on Foreign Relations, pp. 124–46.

(1999) "Why Has Russia's Economic Transformation Been So Arduous?" Annual Bank Conference on Development Economics, April 28–30, Washington, D.C.: World Bank.

Åslund, Anders, Peter Boone, and Simon Johnson (1996) "How to Stabilize: Lessons from Post Communist Countries," *Brookings Papers on Economic Activity* **26** (1): 217–313.

(forthcoming) "Escaping the Under-Reform Trap," *IMF Staff Papers.*

Åslund, Anders, and Georges de Ménil, eds. (2000) *Ukrainian Economic Reform: The Unfinished Agenda.* Armonk, N.Y.: M. E. Sharpe.

Åslund, Anders, and Mikhail Dmitriev, eds. (1996) *Sotsialnaya politika v period perekhoda k rynku: problemy i resheniya* (Social Policy in the Transition to a Market Economy: Problems and Solutions). Moscow: Carnegie Endowment for International Peace.

Åslund, Anders, and Örjan Sjöberg (1992) "Privatization and Transition to a Market Economy in Albania," *Communist Economies and Economic Transformation* **4** (1): 135–50.

Atkeson, Andrew, and Patrick J. Kehoe (1993) "Industry Evolution and Transition: The Role of Information Capital," Staff Report no. 162, Minneapolis: Federal Reserve Bank of Minneapolis.

Aukutsionek, S. (1998) "Barter v rossiiskoi promyshlennosti (Barter in Russian Industry)," *Voprosy ekonomiki* **70** (2): 51–60.

Aven, Petr O. (1994) "Problems in Foreign Trade Regulation in the Russian Economy," In Anders Åslund, ed., *Economic Transformation in Russia*. New York: St. Martin's Press, pp. 80–93.

(1999) "Ekonomika torga (The Economics of Negotation)," *Kommersant Daily*, February 4.

(2000) "Ekonomichesky rost i obshchestvennaya moral' (Economic Growth and Public Morality)," *Kommersant Daily*, February 29.

Bagrov, Andrei (1999) "MVF – glavny borets s korruptsiei v Rossii (IMF – the Main Fighter against Corruption in Russia)," *Kommersant-Daily*, March 4.

Balcerowicz, Leszek (1992) *800 dni skontrolowanego szoku* (800 Days of Controlled Shock), Warsaw: Polska Oficyna Wydawnicza "BGW."

(1994) "Understanding Postcommunist Transitions," *Journal of Democracy* **5** (4): 75–89, October.

(1995) *Socialism, Capitalism, Transformation.* Budapest: Central European University Press.

Balcerowicz, Leszek, Cheryl W. Gray, and Iraj Hashi (1997) *Exit Processes in Economies in Transition.* Budapest: Central European University Press.

Baldwin, Richard E. (1994) *Towards an Integrated Europe.* London: Centre for Economic Policy Research.

Banarjee, Biswajit, Vincent Koen, Thomas Krueger, Mark S. Lutz, Michael Marrese, and Tapio O. Saavalainen (1995) "Road Maps of the Transition: The Baltics, the Czech Republic, Hungary, and Russia," International Monetary Fund Occasional Paper no. 127.

Barro, Robert J. (1996) "Democracy and Growth," *Journal of Economic Growth* **1** (1): 1–27.

Begg, David (1996) "Monetary Policy in Central and Eastern Europe: Lessons after Half a Decade of Transition," International Monetary Fund Working Paper no. 108, September.

(1998) "Pegging out: Lessons from the Czech Exchange Rate Crisis," *Journal of Comparative Economics* **26**: 669–90.

Bell, John D. (1997) "Democratization and Political Participation in 'Postcommunist' Bulgaria," in Karen Dawisha and Bruce Parrott, eds., *Politics, Power, and the Struggle for Democracy in South-East Europe*. Cambridge: Cambridge University Press, pp. 353–402.

Berengaut, Julian, Augusto Lopez-Laros, Francoise Le Gall, Dennis Jones, Richard Stern, Ann-Margaret Westin, Effie Psalida, and Pietro Garribaldi (1998) "The Baltic Countries: From Economic Stabilization to EU Accession," International Monetary Fund Occasional Paper no. 173.

Berg, Andrew (1994) "Supply and Demand Factors in the Output Decline in East and Central Europe," *Empirica* **21**: 3–36.

Berg, Andrew, and Jeffrey D. Sachs (1992) "Structural Adjustment and International Trade in Eastern Europe: The Case of Poland," *Economic Policy*, no. 14: 117–73.

Berg, Andrew, Eduardo Borensztein, Ratna Sahay, and Jeronim Zettelmeyer (1999) "The Evolution of Output in Transition Economies: Explaining the Differences," International Monetary Fund Working Paper no. 73.

Bergson, Abram (1961) *The Real National Income of Soviet Russia since 1928.* Cambridge, Mass.: Harvard University Press.

Berkowitz, Daniel, David N. De Jong, and Steven Husted (1998) "Quantifying Price Liberalization in Russia," *Journal of Comparative Economics* **26**: 735–60.

Berliner, Joseph S. (1957) *Factory and Manager in the USSR.* Cambridge, Mass.: Harvard University Press.

Birman, Igor (1981) *Secret Incomes of the Soviet State Budget*, The Hague: Martinus Nijhoff.

Blanchard, Olivier (1997) *The Economics of Transition in Eastern Europe.* Oxford: Clarendon Press.

Blanchard, Olivier, Rudiger Dornbusch, Paul Krugman, Richard Layard, Lawrence Summers (1991) *Reform in Eastern Europe.* Cambridge, Mass.: MIT Press.

Blanchard, Olivier, and Michael Kremer (1997) "Disorganization," *Quarterly Journal of Economics* **112** (4): 1091–126.

Blanchard, Olivier, and Richard Layard (1990) *Economic Change in Poland.* London: Centre for Research into Communist Economies.

Blasi, Joseph R., Maya Kroumova, and Douglas Kruse (1997) *Kremlin Capitalism: Privatizing the Russian Economy.* Ithaca, N.Y.: Cornell University Press.

Bogomolov, Oleg T. (1992) "Net ni vremeni, ni effektivnoi vlasti [There Is Neither Time, Nor Effective Power]," *Nezavisimaya gazeta*, February 7, p. 4.

(1993) "Is Russia Threatened with Hyperinflation?" *The Cato Journal* **12** (3): 593–602.

Bogomolov, Oleg T., ed. (1996) *Reformy glazami amerikanskikh i rossiiskikh uchenykh* (Reforms in the Eyes of American and Russian Scholars). Moscow: Rossiisky ekonomichesky zhurnal.

Bolotin, Boris (1988) "A More Complete Picture: New Findings from the USSR State Committee for Statistics," *Moscow News*, no. 11.

Bonin, John P., and Mark E. Schaffer (1995) "Banks, Firms, Bad Debts and Bankruptcy in Hungary 1991–94," Centre for Economic Performance, London School of Economics, Discussion Paper no. 234, April.

Boone, Peter, and Jakob Hørder (1998) "Inflation: Causes, Consequences, and Cures" in Peter Boone, Stanislaw Gomulka, and Richard Layard, eds., *Emerging from Communism: Lessons from Russia, China and Eastern Europe.* Cambridge, Mass.: MIT Press, pp. 43–71.

Borish, Michael S., and Michel Noël (1996) "Private Sector Development during Transition: The Visegrad Countries," World Bank Discussion Paper no. 318.

Boycko, Maxim (1991) "Price Decontrol: The Microeconomic Case for the 'Big Bang' Approach," *Oxford Review of Economic Policy* **7** (4): 35–45.

Boycko, Maxim, Andrei Shleifer, and Robert W. Vishny (1995) *Privatizing Russia.* Cambridge, Mass: MIT Press.

(1996) "A Theory of Privatization," *Economic Journal* **106**: 309–19.

Bożyk, Pawel (1992) *Kto winien?* (Who Is Guilty?). Warsaw: PEA.

Brada, Josef C. (1993) "The Transformation from Communism to Capitalism: How Far? How Fast?" *Post-Soviet Affairs* **9** (1): 87–110.

(1996) "Privatization Is Transition – Or Is It?" *Journal of Economic Perspectives* **10** (2): 67–86.

Braguinsky, Serguey, and Grigory Yavlinsky (2000) *Incentives and Institutions: The Transition to a Market Economy in Russia.* Princeton, N.J.: Princeton University Press.

Brainerd, Elizabeth (1997) "Death and the Market," mimeo, Department of Economics, Williams College, December.

(1998) "Market Reform and Mortality in Transition Economies," *World Development* **26** (11): 2013–27.

Brealey, Richard A., and Stewart C. Myers (2000) *Principles of Corporate Finance*, 6th ed. New York: McGraw-Hill.

Bresser Pereira, Luiz Carlos, Jose Maria Maravall, and Adam Przeworski (1993) *Economic Reforms in New Democracies: A Social-Democratic Approach.* Cambridge: Cambridge University Press.

Broadman, Harry G. (1998) "The Emergence of Case-by-Case Privatization in Russia: Principles and Institutions," in Harry G. Broadman, ed., *Case-by-Case privatization in the Russian Federation*, World Bank Discussion Paper no. 385, pp. 23–7.

Broadman, Harry G., ed. (1999) "Russian Enterprise Reform: Policies to Further the Transition," World Bank Discussion Paper no. 400.

Brown, Annette N., Barry W. Ickes, and Randi Ryterman (1994) "The Myth of Monopoly: A New View of Industrial Structure in Russia," World Bank Policy Research Working Paper no. 1331.

Brown, Archie (1996) *The Gorbachev Factor.* Oxford: Oxford University Press.

Brown, J. David, and John S. Earle (2000) "Competition and Firm Performance: Lessons from Russia," mimeo, Stockholm Institute of Transition Economics.

Brucan, Silviu (1992) "Democracy and Odds with the Market in Post-Communist Societies," in Michael Keren and Gur Ofer (eds.), *Trials of Transition. Economic Reform in the Former Communist Bloc.* Boulder, Colo.: Westview Press, pp. 19–25.

Bruce, Robert, Ioannis Kessides, and Lothar Kneifel (1999) "Overcoming Obstacles to Liberalization of the Telecom Sector in Estonia, Poland, the Czech Republic, Slovenia and Hungary," World Bank Technical Paper no. 440.

Bruno, Michael, Guido di Tella, Rudiger Dornbusch, and Stanley Fischer, eds. (1988) *Inflation Stabilization: The Experiences of Israel, Argentina, Brazil, Bolivia, and Mexico.* Cambridge, Mass.: MIT Press.

Bruno, Michael, and William Easterly (1998) "Inflation Crises and Long-Run Growth," *Journal of Monetary Economics* **41**: 3–26.

Brus, Włodzimierz, and Kazimierz Łaski (1990) *From Marx to the Market.* Oxford: Oxford University Press.

Brzezinski, Zbigniew (1997) *The Grand Chessboard: American Primacy and Its Geostrategic Imperatives.* New York: Basic Books.

Buchanan, James M. (1980) "Rent Seeking and Profit Seeking," in James Buchanan, Robert Tollison, and Gordon Tullock, eds., *Toward a Theory of the Rent-Seeking Society.* College Station, Texas: A & M University Press, pp. 3–15.

Bunce, Valerie (1999a) "The Political Economy of Postsocialism," *Slavic Review* **58** (4): 756–93.

(1999b) *Subversive Institutions: The Design and the Destruction of Socialism and the State.* Cambridge: Cambridge University Press.

Burda, Michael (1993) "Labour Markets in Eastern Europe," *Economic Policy*, no. 16: 102–37.

Calvo, Guillermo A., and Fabrizio Coricelli (1992) "Stabilizing a Previously Centrally Planned Economy: Poland 1990," *Economic Policy*, no 14: 175–226.

(1993) "Output Collapse in Eastern Europe: The Role of Credit," *IMF Staff Papers* **40** (1): 32–52.

(1995) "Monetary Policy and Interenterprise Arrears in Post Communist Economies: Theory and Evidence," *Journal of Policy Reform* **1**: 3–24.

Calvo, Guillermo A., and Carlos A. Végh (1999) "Inflation Stabilization and BOP Crises in Developing Countries," NBER Working Paper no. 6925.

Cangiano, Marco, Carlo Cottarelli, and Luis Cubeddu (1998) "Pension Developments and Reforms in Transition Economies," International Monetary Fund Working Paper no. 151.

Capelik, Vladimir (1992) "The Development of Antimonopoly Policy in Russia," *RFE/RL Research Report* **1** (34): 66–70.

(1994) "Should Monopoly be Regulated in Russia?" *Communist Economies and Economic Transformation* **6** (1): 19–32.

Capelik, Vladimir, and Ben Slay (1996) "Antimonopoly Policy and Monopoly Regulation in Russia," in Ben Slay, ed., *De-Monopolization and Competititon Policy in Post Communist Economies.* Boulder, Colo.: Westview Press, pp. 57–88.

Chen, Kan, Gary H. Jefferson, and Inderjit Singh (1992) "Lessons from China's Economic Reform," *Journal of Comparative Economics* **16** (2): 201–25.

Chernichovsky, D., H. Barnum, and E. Potapchik (1996) "Health System Reform in Russia: The Finance and Organization Perspectives," *Economics of Transition* **4** (1): 113–34.

Christensen, Benedicte Vibe (1994) "The Russian Federation in Transition: External Developments," International Monetary Fund Occasional Paper no. 111.

Christensen, Paul T. (1997) "Why Russia Lacks a Labor Movement," *Transitions* **4** (6): 44–51.

Christoffersen, Peter, and Peter Doyle (2000) "From Inflation to Growth: Eight Years of Transition," *Economics of Transition* **8** (2): 421–51.

Chu, Ke-Young, and Sanjeev Gupta (1993) "Protecting the Poor: Social Safety Nets during Transition," *Finance & Development*, June, pp. 24–7.

Chubais, Anatoly B., ed. (1999) *Privatizatsiya po-rossiiski* (Privatization in a Russian Way), Moscow: Vagrius.

Citrin, Daniel A., and Ashok K. Lahiri, eds. (1995) "Policy Experiences and Issues in the Baltics, Russia, and Other Countries of the Former Soviet Union," International Monetary Fund Occasional Paper no. 133.

Claessens, Stijin, and Simeon Djankov (1997) "Politicians and Firms: Evidence from Eastern Europe," mimeo, World Bank.

Coase, Ronald H. (1988) *The Firm, the Market, and the Law.* Chicago: University of Chicago Press.

Collier, Paul, and Jan Willem Gunning (1999) "Explaining African Economic Performance," *Journal of Economic Literature* **37** (1): 64–111.

Collins, Susan M., and Dani Rodrik (1991) *Eastern Europe and the Soviet Union in the World Economy.* Washington D.C.: Institute for International Economics.

Commander, Simon, and Fabrizio Coricelli, eds. (1995) *Unemployment, Restructuring and the Labor Market in East Europe and Russia.* Washington, D.C.: The World Bank.

Commander, Simon, and John McHale (1996) "Unemployment and the Labor Market in Transition: A Review of Experience in East Europe and Russia," in Bartolomiej Kaminski, ed., *Economic Transition in Russia and the New States of Eurasia.* Armond, N.Y.: M. E. Sharpe, pp. 277–314.

Commander, Simon, and C. Mumssen (1998) "Understanding Barter in Russia," EBRD Working Paper no. 37.

Commander, Simon, and Mark Schankerman (1997) "Enterprise Restructuring and Social Benefits," *Economics of Transition* **5** (1): 1–24.

Connor, Walter D. (1997) "Social Policy under Communism," in Ethan B. Kapstein and Michael Mandelbaum, eds., *Sustaining the Transition: The Social Safety Net in Postcommunist Europe.* New York: Council on Foreign Relations, pp. 10–45.

Conquest, Robert (1968) *The Great Terror: Stalin's Purge of the Thirties.* New York: Macmillan.

Cook, Linda J. (1997) *Labor and Liberalization: Trade Unions in the New Russia.* New York: The Twentieth Century Fund.

Cornia, Giovanni Andrea (1994) "Poverty, Food Consumption, and Nutrition during the Transition to the Market Economy in Eastern Europe," *American Economic Review* **84** (2): 297–302.

Crowther, William (1997) "The Politics of Democratization in Postcommunist Moldova," in Karen Dawisha and Bruce Parrott, eds., *Democratic Changes and Authoritarian Reactions in Russia, Ukraine, Belarus and Moldova.* Cambridge: Cambridge University Press, pp. 282–329.

Dąbrowski, Marek (1993a) "Debate on the Guidelines of Russian Economic Reform at the End of 1991 and in 1992," in Marek Dąbrowski, ed., *The*

Gaidar Programme: Lessons for Poland and Eastern Europe. Warsaw: Centre for Social and Economic Research and Friedrich Ebert Foundation.

(1993b) "The First Half Year of Russian Transformation," in Anders Åslund and Richard Layard, eds., *Changing the Economic System in Russia.* New York: St. Martin's Press, pp. 1–18.

(1996) "Fiscal Crisis in the Transformation Period: Trends, Stylized Facts and Some Conceptual Problems," Warsaw: Center for Social and Economic Research, Studies and Analyses no. 72.

Dąbrowski, Marek, Stanislaw Gomułka, and Jacek Rostowski (2000) "Whence Reform? A Critique of the Stiglitz Perspective," mimeo, Warsaw: Centre for Social and Economic Research.

Dąbrowski, Marek, Marcin Luczyński, and Malgorzata Markiewicz (2000) "Fiscal Policy, 1991–1999," in Anders Åslund and Georges de Ménil, eds., *Ukrainian Economic Reform: The Unfinished Agenda.* Armonk, N.Y.: M. E. Sharpe, pp. 113–43.

Dąbrowski, Marek, Marcin Swięcicki, Stefan Kawalec, Janusz Lewandowski, Jan Szomburg, Janusz Beksiak, and Ryszard Bugaj (1989) *Propozycie Przekształcenie Polskiej Gospodarki* (Proposals for the Transformation of the Polish Economy). Warsaw: PTE.

Dahrendorf, Ralf (1990) *Reflections on the Revolution in Europe.* London: Chatto & Windus.

Daianu, Daniel (1996) "Stabilization and Exchange Rate Policy in Romania," *Economics of Transition* **4** (1): 229–48.

Davies, Norman (1981) *God's Playground: A History of Poland*, vol. 2. Oxford: Oxford University Press.

Davis, Christopher (forthcoming) "The Health Sector in the Economy: Illness, Medical Care and Mortality," in Brigitte Granville and Peter Oppenheimer, eds., *The Russian Economy in the 1990s.* Oxford: Oxford University Press.

Davis, Christopher, and Murray Feshbach (1980) *Rising Infant Mortality in the U.S.S.R. in the 1970s.* Washington, D.C.: U.S. Department of Commerce, Bureau of the Census.

De Melo, Martha, and Cevdet Denizer (1999) "Monetary Policy during Transition: An Overview," in Mario I. Blejer and Marko Skreb, eds., *Financial Sector Transformation: Lessons from Economies in Transition.* Cambridge: Cambridge University Press, pp. 19–92.

De Melo, Martha, Cevdet Denizer, and Alan Gelb (1997a) "From Plan to Market: Patterns of Transition," in Mario I. Blejer and Marko Skreb, eds., *Macroeconomic Stabilization in Transition Economies.* Cambridge: Cambridge University Press, pp. 17–72.

De Melo, Martha, Cevdet Denizer, Alan Gelb, and Stoyan Tenev (1997b) *Circumstance and Choice: The Role of Initial Conditions and Policies in Transition Economies*, World Bank Policy Research Working Paper no. 1866.

De Melo, Martha, and Alan Gelb (1996) "A Comparative Analysis of Twenty-eight Transition Economies in Europe and Asia," *Post-Soviet Geography and Economics* **37** (5): 265–85.

(1997) "Transitions to Date: A Comparative Overview," in Salvatore Zecchini, ed., *Lessons from the Economic Transition: Central and Eastern Europe in the 1990s.* Norwell, Mass.: Kluwer, pp. 59–78.

Dervis, Kemal, Marcelo Selowski, and Christine Wallich (1994) *The Evolving Role of the World Bank: The Transition in Central and Eastern Europe and the Former Soviet Union.* Washington, D.C.: World Bank.

Deutsches Institut für Wirtschaftsforschung (DIW 1977), *Handbuch DDR-Wirschaft* (Manual of the GDR Economy). Reinbek at Hamburg: Rowohlt.

Dewatripont, Mathias, and Gérard Roland (1992a) "The Virtues of Gradualism and Legitimacy in the Transition to a Market Economy," *Economic Journal* **102**: 291–300.

(1992b) "Economic Reform and Dynamic Political Constraints," *Review of Economic Studies* **59**: 703–30.

Diamond, Larry (1995) "Democracy and Economic Reform: Tensions, Compatibilities, and Strategies for Reconciliation," in Edward P. Lazear, ed., *Economic Transition in Eastern Europe and Russia.* Stanford, Calif.: Hoover Institution Press, pp. 107–58.

(1999) *Developing Democracy: Towards Consolidation.* Baltimore, Md.: John Hopkins University Press.

Djankov, Simeon (1999a) "Enterprise Restructuring in Russia," in Broadman (1999).

(1999b) "Ownership Structure and Enterprise Restructuring in Six Newly Independent States," Social Science Research Networking Paper Series.

Dmitriev, Mikhail E. (1996) "Sotsial'nye problemy i byudzhetny krizis v Rossiiskoi Federatsii" (Social Problems and Budgetary Crisis in the Russian Federation), in Åslund and Dmitriev (1996), pp. 105–28.

(1997) *Byudzhetnaya politika sovremennoi Rossii* (Budgetary Policy in Contemporary Russia), Moscow: Carnegie Endowment for International Peace.

(1999) "Sotsialnaya sfera v usloviyakh finansovogo krizisa: problemy adaptatsii (The Social Sphere during a Financial Crisis: Problems of Adaptation)," *Voprosy ekonomiki* **71** (2): 53–64.

Dmitriev, Mikhail E., and Nikolai Kartsev (1996) "Fiscal Policy of CIS Countries in 1993–1995," Center for Social and Economic Research, Studies and Analyses no. 84, May.

Dmitriev, M.E., M.Yu. Matovnikov, L.V. Mikhailov, L.I. Sycheva, E.V. Timofeev, and A. Warner (1996) *Rossiiskie banki nakanune finansovoi stabilizatsii* (Russian Banks on the Eve of Financial Stabilization). St. Petersburg: Norma.

Dmitriev, Mikhail E., and Tatyana Maleva (1997) "Russian Labor Market in Transition: Trends, Specific Features, and State Policy," *Social Research* **64** (4): 1499–529.

Dobbs, Michael (1997) *Down with Big Brother: The End of the Soviet Empire.* New York: Knopf.

Dobozi, Istvan, and Gerhard Pohl (1995) "Real Output Decline in Transition Economies – Forget GDP, Try Power Data!" *Transition* **6** (1–2): 17–18.

Dornbusch, Rudiger (1992) "Monetary Problems of Post Communism: Lessons form the End of the Austro-Hungarian Empire," *Weltwirtschaftliches Archiv* **128** (3): 391–424.

Dornbusch, Rudiger, and Sebastian Edwards (1991) "The Macroeconomics of Populism," in Rudiger Dornbusch and Sebastian Edwards, eds., *The*

Macroeconomics of Populism in Latin America. Chicago: University of Chicago Press, pp. 7–14.

Drazen, Allen, and Vittorio Grilli (1993) "The Benefit of Crises for Economic Reforms," *American Economic Review* **83** (3): 598–607.

Drèze, Jean, and Amartya Sen (1989) *Hunger and Public Action*. New York: Oxford University Press.

Dudwick, Nora (1997) "Political Transformation in Postcommunist Armenia: Images and Realities," in Karen Dawisha and Bruce Parrott, eds., *Conflict, Cleavage, and Chance in Central Asia and the Caucasus*. Cambridge: Cambridge University Press, pp. 69–109.

Dunlop, John (1993) *The Rise of Russia and the Fall of the Soviet Empire*. Princeton, N.J.: Princeton University Press.

Earle, John S., and Saul Estrin (1996) "Worker Ownership in Transition," in Roman Frydman, Cheryl Gray, and Andrzej Rapaczynski, eds., *Corporate Governance in Central Europe and Russia*, vol. 2. Budapest: Central European University Press, pp. 1–61.

(1997) "After Voucher Privatization: The Structure of Corporate Ownership in Russian Manufacturing Industry," Centre for Economic Policy Research Discussion Paper no. 1736.

Earle, John S., Roman Frydman, and Andrzej Rapaczynski, eds. (1993) *Privatization in the Transition to a Market Economy*. Budapest: Central European University Press.

Earle, John S., Roman Frydman, Andrzej Rapaczynski, and Joel Turkewitz (1994) *Small Privatization*. Budapest: Central European University Press.

Ebrill, Liam, Oleh Havrylyshyn, et al. (1999) "Reforms of Tax Policy and Tax Administration in the CIS Countries and the Baltics," International Monetary Fund Occasional Paper no. 175.

Eichengreen, Barry (1993) "A Payments Mechanism for the Former Soviet Union: Is the EPU a Relevant Precedent?" *Economic Policy*, no. 17: 309–53.

Eichengreen, Barry, and Marc Uzan (1992) "The Marshall Plan: Economic Effects and Implications for Eastern Europe and the Former USSR," *Economic Policy*, no. 14: 13–75.

Ekelund, Robert B., and Robert D. Tollison (1981) *Mercantilism as a Rent-Seeking Society*. College Station, Texas: A&M University Press.

Elster, Jon (1990) "The Necessity and Impossibility of Simultaneous Economic and Political Reform," in Piotr Ploszajski, ed., *Philosophy of Social Choice*. Warsaw: IfiS Publishers, pp. 309–16.

Elster, Jon, Claus Offe, and Ulrich K. Preuss (1998) *Institutional Design in Post Communist Societies*. Cambridge: Cambridge University Press.

Emerson, Michael (1992) "The CIS on the Maastricht Road?" *Ekonomicheskaya gazeta*, no. 51, December.

Erhard, Ludwig (1957) *Wohlstand für Alle* (Welfare for All). Düsseldorf: Econ.

Ericson, Richard E. (1990) "The Soviet Statistical Debate: Khanin versus TsSU," in Henry S. Rowen and Charles Wolf, Jr., eds., *The Impoverished Superpower. Perestroika and the Soviet Military Burden*. San Francisco: Institute for Contemporary Studies, pp. 63–92.

(1994) "Cost Tradeoffs in Activity Shutdowns: A Note on Economic Restructuring during the Transition," in Robert W. Campbell, ed., *The Postcommunist Economic Transformation*. Boulder, Colo.: Westview Press, pp. 195–217.

Estrin, Saul, and Adam Rosevear (1999) "Enterprise Performance and Corporate Governance in Ukraine," *Journal of Comparative Economics* **27**: 442–58.

European Bank for Reconstruction and Development (EBRD) (1994) *Transition Report 1994*. London: EBRD.

(1995) *Transition Report 1995*. London: EBRD.

(1996) *Transition Report 1996*. London: EBRD.

(1997) *Transition Report 1997*. London: EBRD.

(1998) *Transition Report 1998*. London: EBRD.

(1999) *Transition Report 1999*. London: EBRD.

(2000a) *Transition Report 2000*. London: EBRD.

(2000b) *Transition Report Update*. London: EBRD.

European Commission (various years) *Central and Eastern Eurobarometer. Public Opinion and the European Union*.

(1998) *TACIS Annual Report 1997*. Brussels: European Commission.

European Court of Auditors (1997) "Special Report No 6/97 concerning TACIS Subsidies Allocated to the Ukraine," http://www.eca.eu.int/EN/RS/1997/sr697.htm.

Fedorenko, Nikolai, Nikolai Petrakov, Vladlen Perlamutrov, V. Dadayan, and Dmitri Lvov (1992) "Shturm rynochnykh redutov poka ne udalsya" (The Storm of Market Redoubts Has Not Succeeded So Far), *Izvestiya*, March 18, p. 3.

Fedorov, Boris G. (1994) "Russian Finances in 1993," *Voprosy ekonomiki* **66** (1): 4–85.

(1995) "Macroeconomic Policy and Stabilization in Russia," in Anders Åslund, ed., *Russian Economic Reform at Risk*. New York: St. Martin's Press.

(1999) "Vremya dlya liberalnykh reform v Rossii eshche ne prishlo" (The Time for Liberal Economic Reforms in Russia Has Not Arrived As Yet). *Kommersant-Daily*, February 4.

(2000) *Pytayas ponyat Rossiyu* (Trying to Understand Russia). St. Petersburg: Limbus Press.

Feldstein, Martin, ed. (1998) *Privatizing Social Security*. Chicago: University of Chicago Press.

Fish, Steven (1998) "Democratization's Requisites: The Postcommunist Experience," *Post-Soviet Affairs* **14** (3): 212–47.

Fischer, Stanley (1993) "The Role of Macroeconomic Factors in Growth," *Journal of Monetary Economics* **32**: 458–512.

Fischer, Stanley, and Alan Gelb (1991) "The Process of Socialist Economic Transformation," *Journal of Economic Perspectives* **5** (4): 91–105.

Fischer, Stanley, and Ratna Sahay (2000) "The Transition Economies after Ten Years," International Monetary Fund Working Paper no. 30.

Fischer, Stanley, Ratna Sahay, and Carlos A. Végh (1996a) "Stabilization and Growth in Transition Economies: The Early Experience," *Journal of Economic Perspectives* **10** (2): 45–66.

(1996b) "Economies in Transition: The Beginnings of Growth," *American Economic Review* **86** (2): 229–33.

(1997) "From Transition to Market: Evidence and Growth Prospects," in Salvatore Zecchini, ed., *Lessons from the Economic Transition: Central and Eastern Europe in the 1990s*. Norwell, Mass.: Kluwer, pp. 79–101.

Flemming, John, and John Micklewright (1999) "Income Distribution, Economic Systems and Transition," mimeo, Innocenti Occasional Papers, Economic and Social Policy Series, no. 70, May.

Freedom House (1996) "Freedom around the World in 1996," *Freedom Review*, January–February.

(1997) "Freedom around the World in 1997," *Freedom Review*, January–February.

(1999) "Freedom in the World: The Annual Survey of Political Rights and Civil Liberties, 1998–1999," http://www.freedomhouse.org/survey99/.

(2000) "Freedom in the World: The Annual Survey of Political Rights and Civil Liberties, 1999–2000," http://www.freedomhouse.org.

Freeland, Chrystia (2000) *Sale of the Century: Russia's Wild Ride from Communism to Capitalism*. New York: Crown Business.

Frydman, Roman, and Andrzej Rapaczynski (1994) *Privatization in Eastern Europe: Is the State Withering Away*. Budapest: Central European University Press.

Frydman, Roman, Andrzej Rapaczynski, John S. Earle, et al. (1993a) *The Privatization Process in Central Europe*. Budapest: Central European University Press.

(1993b) *The Privatization Process in Russia, Ukraine, and the Baltic States*. Budapest: Central European University Press.

Frydman, Roman, Cheryl Gray, Marek Hessel, and Andrzej Rapaczynski (1997) "Private Ownership and Corporate Performance: Some Lessons From Transition Economies," World Bank Policy Research Paper no. 1830.

Frydman, Roman, Marek Hessel, and Andrzej Rapaczynski (1998a) "Why Ownership Matters: Privatization and Entrepreneurship in the Restructuring of Enterprises in Central Europe," Economic Research Report no. 14, C. V. Starr Center for Applied Economics, New York University.

(1998b) "When Does Privatization Work? The Impact of Private Ownership on Corporate Performance in Transition Economies," Economic Research Report no. 32, C. V. Starr Center for Applied Economics, New York University.

Gács, János (1995) "The Effects of the Demise of the CME and the USSR on Output in Hungary," in Robert Holzmann, G. Winckler, and János Gács, eds., *Output Decline in Eastern Europe: Unavoidable, External Influence or Homemade?* Boston: Kluwer, pp. 161–80.

Gaddy, Clifford G. (1996) *The Price of the Past: Russia's Struggle with the Legacy of a Militarized Economy*. Washington, D.C.: Brookings Institution.

Gaddy, Clifford G., and Barry W. Ickes (1998) "Russia's Virtual Economy," *Foreign Affairs* **77** (5): 53–67.

Gaidar, Yegor T. (1990) *Ekonomicheskie reformy i ierarkhicheskie struktury* (Economic Reforms and Hierarchic Structures). Moscow: Nauka.

(1993) "Inflationary Pressures and Economic Reform in the Soviet Union," in P. H. Admiraal, ed., *Economic Transition in Eastern Europe*. Oxford: Blackwell.

(1998) "Taktika reform i uroven' gosudarstvennoi nagruzki na ekonomiku (Tactics of Reform and the Level of State Burden on the Economy)," *Voprosy ekonomiki* **70** (4): 4–13.

(2000) *Days of Defeat and Victory*. Seattle, Wash.: University of Washington Press.

Gambetta, Diega (1993) *The Sicilian Mafia*. Cambridge, Mass.: Harvard University Press.

Garibaldi, Pietro, and Zuzana Brixiova (1997) "Labor Market Institutions and Unemployment Dynamics in Transition Economies," International Monetary Fund Working Paper no. 137.

Geddes, Barbara (1994a) "Challenging the Conventional Wisdom," *Journal of Democracy* **5** (4): 104–18.

(1994b) Politician's Dilemma: Building State Capacity in Latin America, Berkeley and Los Angeles, Calif.: University of California Press.

Gerashchenko, Viktor V. (Interview with) (1992) "Tseny, den'gi, kredity (Prices, Money and Credits)," *Ekonomika i zhizn*, no. 46 (November), pp. 1, 5.

Gerner, Kristian, Stefan Hedlund and Niclas Sundström (1995) *Hjärnridån: Det europeiska projektet och det gåtfulla Ryssland* (The Brain Curtain: The European Project and Enigmatic Russia). Stockholm: Fischer & Co.

Glaziev, Sergei Yu. (1996) "Ob otkrytosti i razumnoi zashchite rossiiskoi ekonomiki" (On the Openness and Sensible Protection on the Russian Economy) in Bogomolov, ed. (1996), pp. 223–36.

Glinski, Dmitri, and Peter Reddaway (1999) "The Ravages of 'Market Bolshevism'," *Journal of Democracy* **10** (2): 19–34.

Goldman, Marshall I. (1991) *What Went Wrong with Perestroika*. New York: Norton.

(1996) *Lost Opportunity: What Has Made Economic Reform in Russia So Difficult?*, 2nd ed. New York: Norton.

Goleniowska, Stanislawa (1997) "Delayed Reforms of the Social Policy," in *Economic Scenarios for Poland*. Warsaw: Center for Social and Economic Research, pp. 31–42.

Gomułka, Stanislaw (1989) "Shock Needed for Polish Economy," *The Guardian*, August 19.

(1998) "The Polish Model of Transformation and Growth," *Economics of Transition* **6** (1): 163–71.

Gorbachev, Mikhail S. (1986) *Perestroika: New Thinking for Our Country and the World*. New York: Harper & Row.

(1987) *Izbrannye rechi i stati* (Selected Speeches and Articles), vol. 2. Moscow: Politizdat.

Gordon, Michael (1998) "World Bank vs. Reformers on How to Still Feed Russia When It's 64," *New York Times*, March 15, p. A10.

Goskomstat SSSR (1991) *Narodnoe Khoziaistvo SSSR v 1990 g.* (The National Economy of the USSR in 1990). Moscow: Finansy i statistika.

Gould-Davies, Nigel, and Ngaire Woods (1999) "Russia and the IMF," *International Affairs* **75** (1): 1–21.

Granville, Brigitte (1990) "Convertibility and Exchange Rates in Poland: 1957–1990," London: Royal Institute of International Affairs, Discussion Paper no. 33.

(1995a) "So Farewell Then Rouble Zone," in Anders Åslund, ed., *Russian Economic Reform at Risk.* New York: St. Martin's Press, pp. 65–88.

(1995b) *The Success of Russian Economic Reforms.* London: Royal Institute of International Affairs.

Gray, Cheryl W., and Arnold Holle (1997) "Bank-Led Restructuring in Poland (II): Bankruptcy and Its Alternatives," *Economics of Transition* **5** (1): 25–44.

Gray, Dale F. (1998) "Evaluation of Taxes and Revenues from the Energy Sector in the Baltics, Russia, and Former Soviet Union Countries," International Monetary Fund Working Paper no. 34, March.

Grosfeld, Irena, and Paul Hare (1991) "Privatization in Hungary, Poland and Czechoslovakia," *European Economy*, Special edition, no. 2: 129–56.

Grosfeld, Irena, and Jean-François Nivet (1997) "Wage and Investment Behaviour in Transition: Evidence for a Polish Panel Data Set," Centre for Economic Policy Research Discussion Paper no. 1726.

Grosfeld, Irena, and Gérard Roland (1995) "Defensive and Strategic Restructuring in Central European Enterprises," Centre for Economic Policy Research Discussion Paper no. 1135.

Grossman, Gregory (1987) "Roots of Gorbachev's Problems: Private Income and Outlay in the Late 1970s," in U.S. Congress, Joint Economic Committee, *Gorbachev's Economic Plans*, vol. 1. Washington, D.C.: U.S. Government Printing Office, pp. 213–29.

Gwartney, James D., and Robert A. Lawson (2000) *Economic Freedom of the World 2000.* The Fraser Institute. http://www.fraserinstitute.ca/publications/books/econ_free2000/.

Halligan, Liam, Pavel Teplyukhin, and Dirk Willer (1996) "Subsidization of the Russian Economy," *Russian Economic Trends* **5** (1): 109–28.

Halpern, László (1996) "Real Exchange Rate and Exchange Rate Policy," *Economics of Transition* **4** (1): 211–28.

Halpern, László, and Charles Wyplosz (1996) "Equilibrium Exchange Rates in Transition Economies," International Monetary Fund Working Paper no. 125.

Ham, John C., Jan Svejnar, and Katherine Terrell (1998) "Unemployment and the Social Safety Net During Transitions to a Market Economy: Evidence from the Czech and Slovak Republics," *American Economic Review* **88** (5): 1117–42.

Hamilton, Carl B., and L. Alan Winters (1992) "Trade with Eastern Europe," *Economic Policy*, no. 14: 77–116.

Hanke, Steve H., Lars Jonung, and Kurt Schuler (1992) *Monetary Reform for a Free Estonia: A Currency Board Solution.* Stockholm: SNS Förlag.

(1993) *Russian Currency and Finance: A Currency Board Approach to Reform.* New York: Routledge.

Hansson, Ardo H. (1990) "The 1948 West German Economic Reforms: A Model for Eastern Europe?" Discussion Paper no. 90-05, Department of Economics, the University of British Columbia, Vancouver.

(1993) "The Trouble with the Rouble: Monetary Reform in the Former Soviet Union," in Anders Åslund and Richard Layard, eds., *Changing the Economic System in Russia*. New York: St. Martin's Press, pp. 163–82.

(1997) "Macroeconomic Stabilization in the Baltic States," in Mario I. Blejer and Marko Skreb, eds., *Macroeconomic Stabilization in Transition Countries*. New York: Cambridge University Press, pp. 256–80.

Hansson, Ardo H., and Jeffrey D. Sachs (1992) "Crowning the Estonian kroon," *Transition* (World Bank) **3** (9): 1–3.

Hansson, Ardo H., and Triinu Tombak (1999) "Banking Crises in the Baltic States: Causes, Solutions, and Lessons," in Mario I. Blejer and Marko Skreb, eds., *Financial Sector Transformation: Lessons from Economies in Transition*. New York: Cambridge University Press, pp. 195–236.

Harding, April L. (1995) "Commercial Real Estate Market Development in Russia," World Bank CDFS Discussion Paper no. 109.

Hardt, John P. (2000) "Russia's Paris Club Debt and U.S. Interests," Congressional Research Service (CRS) Report for Congress, July 24.

Hardy, Daniel C., and Ashok K. Lahiri (1994) "Cash Shortage in the Former Soviet Union," International Monetary Fund Working Paper no. 67.

Hausmann, Ricardo, and Liliana Rojas-Suarez, eds. (1996) *Banking Crises in Latin America*. Washington, D.C.: Inter-American Development Bank.

Havrylyshyn, Oleh, and Hassan Al-Atrash (1998) "Opening Up and Geographic Diversification of Trade in Transition Economies," International Monetary Fund Working Paper no. 22.

Havrylyshyn, Oleh, and Donald McGettigan (1999) "Privatization in Transition Countries: A Sampling of the Literature," International Monetary Fund Working Paper no. 6.

Havrylyshyn, Oleh, and Thomas Wolf (1999) "Growth in Transition countries. 1991–1998. The Main Lessons," Paper Presented at the Conference "A Decade of Transition," International Monetary Fund, Washington, D.C., February 1–3.

Hay, Jonathan R., and Andrei Shleifer (1998) "Private Enforcement of Public Laws: A Theory of Legal Reform," *American Economic Review* **88** (2): 398–403.

Hayek, Friedrich A. [1944] (1986) *The Road to Serfdom*. Henley on Thames: Ark Paperbacks.

(1960) *The Constitution of Liberty*. London: Routledge & Kegan Paul.

Hellman, Joel S. (1998) "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions," *World Politics* **50**: 203–34.

Hellman, Joel S., Geraint Jones, Daniel Kaufmann, and Mark Schankermann (2000a) "Measuring Governance and State Capture: The Role of Bureaucrats and Firms in Shaping the Business Environment," mimeo, the EBRD and the World Bank.

Hellman, Joel S., Geraint Jones, and Daniel Kaufmann (2000b) "Seize the State, Seize the Day: State Capture, Corruption and Influence in Transition," mimeo, the EBRD and the World Bank.

Hendley, Kathryn, Barry W. Ickes, Peter Murrell, and Randi Ryterman (1997) "Observations on the Use of Law by Russian Enterprises," *Post-Soviet Affairs* **13** (1): 19–41.

Hernandez-Cata, Ernesto (1997) "Liberalization and the Behavior of Output During the Transition from Plan to Market," *IMF Staff Papers* **44** (4): 405–29.

Hewett, Edward A. (1974) *Foreign Trade Prices in the Council for Mutual Economic Assistance.* Cambridge: Cambridge University Press.

(1988) *Reforming the Soviet Economy.* Washington, D.C.: Brookings Institution.

Heybey, Berta, and Peter Murrell (1999) "The Relationship between Economic Growth and the Speed of Liberalization during Transition," *Journal of Policy Reform* **3**: 121–37.

Holmes, Stephen (1995) "Conceptions of Democracy in the Draft Constitutions of Post Communist Countries," in Beverly Crawford, ed., *Markets, States, and Democracy: The Political Economy of Post Communist Transformation.* Boulder, Colo.: Westview Press, pp. 71–81.

Holzmann, Robert (1997a) "Starting Over in Pensions: The Challenges Facing Central And Eastern Europe," *Journal of Public Policy* **17** (3): 195–222.

(1997b) "Pension Reform in Central And Eastern Europe: Necessity, Approaches And Open Questions," *Serie Financiamiento del Desarrollo*, no. 45, United Nations: Economic Commission for Latin American and the Caribbean, Santiago, Chile, April.

Huntington, Samuel P. (1991) *The Third Wave: Democratization in the Late Twentieth Century.* Norman, Okla.: University of Oklahoma Press.

(1992–93) "What Cost Freedom? Democracy and/or Economic Reform," *Harvard International Review* **15** (2): 8–13.

Illarionov, Andrei N. (1998a) "Kak byl organizovan rossiisky finansovy krizis (1) (How the Russian Economic Crisis Was Organized)," *Voprosy ekonomiki* **70** (11): 20–35.

(1998b) "Kak byl organizovan rossiisky finansovy krizis (2) (How the Russian Economic Crisis Was Organized)," *Voprosy ekonomiki* **70** (12): 12–31.

Impavido, Gregorio (1997) "Pension Reform and the Development of Pension Funds and Stock Markets in Eastern Europe," *Most* **7** (3): 101–35.

International Monetary Fund (1992a) *Economic Review: Russian Federation.* Washington, D.C.: IMF.

(1992b) "The Coordination of Monetary Policy in the Ruble Area," mimeo, April 29.

(1993) *Economic Review: Russian Federation.* Washington, D.C.: IMF.

(1994a) *Economic Review: Financial Relations among Countries of the Former Soviet Union.* Washington D.C.: IMF.

(1994b) *Economic Review: Trade Policy Reform in Countries of the Former Soviet Union.* Washington D.C.: IMF.

(1994c) "Fund Policies with Regard to Currency Stabilization Funds: Preliminary Considerations." Washington, D.C.: IMF.

(2000) *World Economic Outlook.* Washington, D.C.: IMF, April.

International Monetary Fund, IBRD, OECD, and EBRD (1991) *A Study of the Soviet Economy.* Paris: February.

Isham, Jonathan, Daniel Kaufmann, and Lant H. Pritchett (1997) "Civil Liberties, Democracy, and the Performance of Government Projects," *World Bank Economic Review* **11** (2): 219–42.

Islam, Shafiqul (1993) "Conclusion: Problems of Planning a Market Economy," in Shafiqul Islam and Michael Mandelbaum, eds., *Making Markets*. New York: Council on Foreign Relations, pp. 182–215.

Ježek, Tomáš (1997) "The Czechoslovak Experience with Privatization," *Journal of International Affairs* **50** (2): 477–88.

Johnson, Bryan T., and Thomas P. Sheehy (1995) *The Index of Economic Freedom.* Washington, D.C.: Heritage Foundation.

(1996) *1996 Index of Economic Freedom.* Washington, D.C.: Heritage Foundation.

Johnson, Bryan T., Kim R. Holmes, and Melanie Kirkpatrick (1997) *1997 Index of Economic Freedom.* Washington, D.C.: Heritage Foundation and the Wall Street Journal.

(1998) *1998 Index of Economic Freedom.* Washington, D.C.: Heritage Foundation and the Wall Street Journal.

(1999) *1999 Index of Economic Freedom.* Washington, D.C.: Heritage Foundation and the Wall Street Journal.

Johnson, Juliet (2000) *A Fistful of Rubles: The Rise and Fall of the Russian Banking System.* Ithaca, N.Y.: Cornell University Press.

Johnson, Simon (1994) "Private Business in Eastern Europe," in Olivier Jean Blanchard, Kenneth A. Froot, and Jeffrey D. Sachs, eds., *The Transition in Eastern Europe*. Chicago: University of Chicago Press, pp. 245–90.

Johnson, Simon, Daniel Kaufmann, and Andrei Shleifer (1997a) "The Unofficial Economy in Transition," *Brookings Papers on Economic Activity* **27** (2): 159–239.

(1997b) "Politics and Entrepreneurship in Transition Economies," Working Paper no. 57, The William Davidson Institute, University of Michigan.

Johnson, Simon, Daniel Kaufmann, and Pablo Zoido-Lobatón (1998) "Government in Transition: Regulatory Discretion and the Unofficial Economy," *American Economic Review* **88** (2): 387–92.

Johnson, Simon, and Heidi Kroll (1991) "Managerial Strategies for Spontaneous Privatization," *Soviet Economy* **7** (4): 281–316.

Johnson, Simon, Heidi Kroll, and Mark Horton (1993) "New Banks in the Former Soviet Union: How Do They Operate?" in Anders Åslund and Richard Layard, eds., *Changing the Economic System in Russia*. New York: St. Martin's Press, pp. 183–209.

Johnson, Simon, and Gary W. Loveman (1995) *Starting Over in Eastern Europe: Entrepreneurship and Economic Renewal.* Boston, Mass.: Harvard Business School Press.

Johnson, Simon, John McMillan, and Christopher Woodruff (2000) "Entrepreneurs and the Ordering of Institutional Reform: Poland, Slovakia, Romania, Russia and Ukraine Compared," *Economics of Transition* **8** (1): 1–36.

Karatnytcky, Adrian, Alexander Motyl, and Boris Shor, eds. (1997) *Nations in Transit, 1997.* New Brunswick, N.J.: Transaction Publishers.

Kaser, Michael (1996) "Post Communist Privatization: Flaws in the Treuhand Model," Discussion Papers in German Studies, University of Birmingham.

Kaufmann, Daniel (1997) "Corruption: Some Myths and Facts," *Foreign Policy*, no. 107, pp. 114–31.

Kaufmann, Daniel, and Aleksander Kaliberda (1996) "Integrating the Unofficial Economy into the Dynamics of Post-Socialist Economies: A Framework of Analysis and Evidence," in Bartlomiej Kaminski, ed., *Economic Transition in Russia and the New States of Eurasia*. Armonk, N.Y.: M. E. Sharpe, pp. 81–120.

Kaufmann, Daniel, and Paul Siegelbaum (1996) "Privatization and Corruption in Transition Economies," *Journal of International Affairs* **50** (2): 419–58.

Kazmin, Andrei I., and Andrei V. Tsimailo (1991) "Toward the Convertible Ruble: The Case for a Parallel Currency," in John Williamson, ed., *Currency Convertibility in Eastern Europe*. Washington, D.C.: Institute for International Economics, pp. 294–309.

Keane, Michael P., and Eswar S. Prasad (2000) "Inequality, Transers and Growth: New Evidence from the Economic Transition in Poland," mimeo, paper presented to the First Annual Research Conference of the IMF, Washington, D.C., November 9–10.

Kennedy, Bruce P., Ichiro Kawachi, and Elizabeth Brainerd (1998) "The Role of Social Capital in the Russian Mortality Crisis," *World Development* **26** (11): 2029–43.

Khasbulatov, Ruslan (1992) "Programma dlya Khasbulatova (Program for Khasbulatov)," *Nezavisimaya gazeta*, April 3, p. 5.

Kissinger, Henry (1994) *Diplomacy*. New York: Simon & Schuster.

(2000) "Mission to Moscow," *Washington Post*, May 15, p. A15.

Kitschelt, Herbert, Zdenka Mansfeldova, Radoslaw Markowski, and Gábor Tóka (1999) *Post Communist Party Systems: Competition, Representation, and Inter-Party Cooperation*. Cambridge: Cambridge University Press.

Klaus, Václav (1992) *Dismantling Socialism: A Preliminary Report*. Prague: Top Agency.

(1994) *Rebirth of a Country: Five Years After*. Prague: Ringier.

Kloc, Kazimierz (1994) "The Banking System in Kyrgyzstan," Warsaw: Center for Social and Economic Research, Studies and Analyses no. 31.

Knack, Stephen, and Philip Keefer (1995) "Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures," *Economics and Politics* **7** (3): 207–27.

Koen, Vincent (1995) "Flawed Conclusions," *Transition* **6** (4): 11.

Koen, Vincent, and Steven Phillips (1993) "Price Liberalization in Russia. Behaviour of Prices, Household Incomes, and Consumption during the First Year," International Monetary Fund Occasional Paper no. 104.

Koen, Vincent, and Paula De Masi (1997) "Prices in the Transition: Ten Stylized Facts," International Monetary Fund Working Paper no. 158.

Kołakowski, Leszek (1981a) *Main Currents of Marxism: vol. 1, The Founders*. Oxford: Oxford University Press.

(1981b) *Main Currents of Marxism: vol. 2, The Golden Age*. Oxford: Oxford University Press.

Kolodko, Grzegorz W. (1991) "Polish Hyperinflation and Stabilization 1989–1990," *Most* **1**: 9–36.

(1992) *Transformacja Polskiej gospodarki: Sukces czy porazka?* (The Transformation of the Polish Economy: Success of Failure?), Warsaw: BGW.

(2000) *From Shock to Therapy: The Political Economy of Postsocialist Transformation.* Oxford: Oxford University Press.

Kołodko, Grzegorz W., and D. Mario Nuti (1997) *The Polish Alternative: Old Myths, Hard Facts and New Strategies in the Successful Transformation of the Polish Economy.* Helsinki: World Institute for Development Economics Research, Research for Action 33.

Kołodko, Grzegorz W., Danuta Gotz-Kozierkiewicz, and Elżbieta Skrzeszewska-Paczek (1992) *Hyperinflation and Stabilization in Postsocialist Economies.* Boston: Kluwer.

Komulainen, Tuomas, and Iikka Korhonen, eds. (2000) *Russian Crisis and Its Effects.* Helsinki: Kikimora Publications.

Konings, Jozef, and Patrick Paul Walsh (1999) "Disorganization in the Process of Transition." *Economics of Transition* **7** (1): 29–46.

Kornai, János (1980) *Economics of Shortage.* Amsterdam: North Holland.

(1986) "The Hungarian Reform Process: Visions, Hopes, and Reality," *Journal of Economic Literature* **24**: 1687–737.

(1990) *The Road to a Free Economy. Shifting from a Socialist System: The Example of Hungary.* New York: Norton.

(1992a) *The Socialist System. The Political Economy of Communism.* Princeton, N.J.: Princeton University Press.

(1992b) "The Postsocialist Transition and the State: Reflections in Light of Hungarian Fiscal Problems," *American Economic Review* **82** (2): 1–21.

Kostrzewa, Wojciech, Peter Nunnenkamp, and Holger Schmieding (1989) "A Marshall Plan for Middle and Eastern Europe," Working Paper no. 403, Institut für Weltwirtschaft, Kiel.

Kramer, Mark (1997) "Social Protection Policies And Safety Nets in East-Central Europe: Dilemmas of the Postcommunist Transformation," in Ethan B. Kapstein and Michael Mandelbaum, eds., *Sustaining the Transition: The Social Safety Net in Postcommunist Europe.* New York: Council on Foreign Relations, pp. 46–123.

Kravchuk, Robert S. (1999) "The Quest for Balance: Regional Self-Government and Subnational Fiscal Policy in Ukraine," in Taras Kuzio, Robert S. Kravchuk, and Paul D'Anieri, eds., *State and Institution-Building in Ukraine.* New York: St. Martin's Press, pp. 155–211.

Krueger, Anne O. (1974) "The Political Economy of the Rent-Seeking Society," *American Economic Review* **64** (3): 291–303.

Krueger, Gary, and Marek Ciolko (1998) "A Note on Initial Conditions and Liberalization during Transition," *Journal of Comparative Economics* **26**: 718–34.

Kuddo, Arvo (1995) *Emerging Labor Markets,* World Development Studies no. 2. Helsinki: World Institute for Development Economics Research.

La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny (1999) "The Quality of Government," *Journal of Law, Economics and Organization* **15** (1): 222–79.

Lackó, Mária (2000) "Hidden Economy – an Unknown Quantity?" *Economic of Transition* **8** (1): 117–49.

Lainela, Seija, and Pekka Sutela (1994) *The Baltic Economies in Transition.* Helsinki: Bank of Finland.

Lamdany, Ruben, ed. (1993) *Russia: The Banking System during the Transition.* Washington, D.C.: The World Bank.

Lancieri, Elio (1993) "Dollar GDP Estimates for Central and Eastern Europe 1970–90: A Survey and a Comparison with Western Countries." *World Development* **21** (1): 161–75.

Łaski, Kazimierz, and Amit Bhaduri (1997) "Lessons to Be Drawn from Main Mistakes in the Transition Strategy," in Salvatore Zecchini, ed., *Lessons from the Economic Transition: Central and Eastern Europe in the 1990s*. Norwell, Mass.: Kluwer, pp. 103–21.

Lavigne, Marie (1999) *The Economics of Transition: From Socialist Economy to Market Economy*, 2nd ed. New York: St. Martin's Press.

(2000) "The Economics of the Transition Process: What Have We Learned?" *Problems of Post Communism* **47** (4): 16–23.

Layard, Richard, and Andrea Richter (1995) "Labour Market Adjustment – the Russian Way," in Anders Åslund, ed., *Russian Economic Reform at Risk.* New York: St. Martin's Press, pp. 119–47.

Leidy, Michael, and Ali Ibrahim (1996) "Recent Trade Policies and an Approach to Further Reform in the Baltics, Russia, and Other Countries of the Former Soviet Union," International Monetary Fund Working Paper no. 71.

Leven, B. (1991) "The Welfare Effects on Women of Poland's Economic Reforms," *Journal of Economic Issues* **2**: 581–88.

Levine, Ross, and David Renelt (1992) "A Sensitivity Analysis of Cross-Country Growth Regressions," *American Economic Review* **82** (4): 942–63.

Levcik, Friedrich (1991) "The Place of Convertibility in the Transformation Process," in John Williamson, ed., *Currency Convertibility in Eastern Europe.* Washington, D.C.: Institute for International Economics, pp. 31–47.

Lewandowski, Janusz, and Jan Szomburg (1989) "Property Reform as a Basis for Social and Economic Reform," *Communist Economies* **1** (3): 257–68.

Lieberman, Ira W., Stilpon S. Nestor, and Raj M. Desai, eds. (1997) *Between State and Market: Mass Privatization in Transition Economies*. Washington, D.C.: The World Bank and the OECD.

Lieven, Anatol (1993) *The Baltic Revolution: Estonia, Latvia, Lithuania, and the Path to Independence.* New Haven, Conn.: Yale University Press.

Lindbeck, Assar (1997) *The Swedish Experiment.* Stockholm: SNS Förlag.

Lindblom, Charles E. (1977) *Politics and Markets.* New York: Basic Books.

Linz, Juan J., and Alfred Stepan (1992) "Political Identities and Electoral Sequences: Spain, the Soviet Union, and Yugoslavia," *Daedalus* **121** (2): 123–40.

Lipton, David, and Jeffrey D. Sachs (1990a) "Creating a Market in Eastern Europe: The Case of Poland," *Brookings Papers on Economic Activity* **20** (1): 75–147.

(1990b) "Privatization in Eastern Europe: The Case of Poland," *Brookings Papers on Economic Activity* **20** (2): 293–341.

Lougani, Prakash, and Nathan Sheets (1997) "Central Bank Independence, Inflation and Growth in Transition Economies," *Journal of Money, Credit and Banking* **29** (3): 381–99.

Lovei, Laszlo (1998a) "Electricity Reform in Ukraine: The Impact of Weak Governance and Budget Crises," *Viewpoint*, Note no. 168, The World Bank.

(1998b) "Gas Reform in Ukraine: Monopolies, Markets, and Corruption," *Viewpoint*, Note no. 169, The World Bank.

(1998c) "Coal Industry Restructuring in Ukraine: The Politics of Coal Mining and Budget Crises," *Viewpoint*, Note no. 170, The World Bank.

Lvov, Dmitri S. "Obnovlennye orientiry ekonomicheskoi politiki (Renewed Directions for Economic Policy)," in Bogomolov (1996), pp. 163–84.

Maleva, Tatyana, ed. (1998) *Gosudarstvennaya i korporativnaya politika zanyatosti* (The State and Corporate Employment Policy). Moscow: Carnegie Endowment for International Peace.

Malia, Martin (1999) *Russia under Western Eyes.* Cambridge, Mass.: Harvard University Press.

Maravall, José María (1994) "The Myth of Authoritarian Advantage," *Journal of Democracy* **5** (4): 17–31.

Marcinèin, Anton, and Sweder van Wijnbergen (1997) "The Impact of Czech Privatization Methods on Enterprise Performance Incorporating Initial Selection-Bias Correction," *Economics of Transition* **5** (2): 289–304.

Marer, Paul (1985) *Dollar GNPs of the U.S.S.R. and Eastern Europe.* Baltimore, Md.: Johns Hopkins University Press.

Marin, Dalia, and Monika Schnitzer (1999) "Disorganization and Financial Collapse," Paper presented at the Fifth Nobel Symposium in Economics: The Economics of Transition, September 10–12, Stockholm.

Marx, Karl [1867] (1981) *Das Kapital: Kritik der politischen Ökonomie* (The Capital: A Critique of Political Economy), vol. 1, Berlin (East): Dietz Verlag.

[1878] (1951) *Critique of the Gotha Program.* Moscow: Foreign Languages Publishing House.

Marx, Karl, and Friedrich Engels [1848] (1967) *The Communist Manifesto.* Harmondsworth: Penguin.

Matthews, Mervyn (1986) *Poverty in the Soviet Union.* Cambridge: Cambridge University Press.

Matyukhin, Georgy G. (1993) *Ya byl glavnym bankirom Rossii* (I Was Russia's Main Banker). Moscow: Vysshaya shkola.

Mau, Vladimir (1999) "Rossiiskie ekonomicheskie reformy glazami zapadnykh kritikov (Russian Economic Reforms in the Eyes of Western Critics)," *Voprosy ekonomiki* **71** (11): 4–23.

Mauro, Paulo (1995) "Corruption and Growth," *Quarterly Journal of Economics* **110**: 681–712.

(1998) "Corruption and the Composition of Government Expenditures," *Journal of Public Economics* **69**: 263–79.

McFaul, Michael (1997) *Russia's 1996 Presidential Elections: The End of Polarized Politics.* Stanford, Calif.: Hoover Press.

(1998) "Russia's Choice: The Perils of Revolutionary Democracy," in Timothy J. Colton and Jerry F. Hough, eds., *Growing Pains: Russian Democracy and the Election of 1993*. Washington, D.C.: Brookings Institution, pp. 115–39.

(1999) "The Political Economy of Social Policy Reform in Russia: Ideas, Institutions, and Interests," in Linda J. Cook, Mitchell A. Orenstein, and Marilyn Rueschmeyer, eds., *Left Parties and Social Policy in Postcommunist Europe*. Boulder, Colo.: Westview Press, pp. 207–34.

(2000) "Russia's 1999 Parliamentary Elections: Party Consolidation and Fragmentation," *Demokratizatsiya* **8** (1): 5–23.

McKinnon, Ronald I. (1991a) "Liberalizing Foreign Trade in a Socialist Economy," in John Williamson, ed., *Currency Convertibility in Eastern Europe*. Washington, D.C.: Institute for International Economics, pp. 96–115.

(1991b) *The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy*. Baltimore, Md.: John Hopkins University Press.

Mercedes Balmaceda, Margarita (1998) "Gas, Oil and the Linkages between Domestic and Foreign Policies: The Case of Ukraine," *Europe-Asia Studies* **50** (2): 257–86.

McKinsey Global Institute (1999) *Unlocking Economic Growth in Russia*. Moscow: McKinsey & Company.

Megginson, William L., Robert C. Nash, and Matthias van Randenborgh (1994) "The Financial and Operating Performance of Newly Privatized Firms: An International Empirical Analysis," *Journal of Finance* **49** (2): 403–52.

Michalopoulos, Constantine (1998) "WTO Accession for Countries in Transition," mimeo, World Trade Organization, Geneva.

Michalopoulos, Constantine, and Vladimir Drebentsov (1997) "Observations on State Trading in the Russian Economy," *Post-Soviet Geography and Economics* **38** (5): 264–75.

Michalopoulos, Constantine, and David G. Tarr (1996) *Trade Performance and Policy in the New Independent States*. Washington, D.C.: The World Bank.

(1997) "The Economics of Customs Union in the Commonwealth of Independent States," *Post-Soviet Geography and Economics* **38** (3): 125–43.

eds. (1994) *Trade in the New Independent States*. Washington, D.C.: The World Bank.

Mikhailsovkaya, Inga B. (1994) "Crime and Statistics: Do the Figures Reflect the Real Situation?" *Demokratizatsiya* **2** (3): 412–25.

Mihalisko, Kathleen J. (1997) "Belarus: Retreat to Authoritarianism," in Karen Dawisha and Bruce Parrott, eds., *Democratic Changes and Authoritarian Reactions in Russia, Ukraine, Belarus and Moldova*. Cambridge: Cambridge University Press, pp. 223–81.

Milanovic, Branko (1998) *Income, Inequality, and Poverty during the Transition from Planned to Market Economy*. Washington, D.C.: The World Bank.

Miłosz, Czesław [1953] (1981) *The Captive Mind*. New York: Octagon Books.

Milthorp, Peter (1997) "Integration of FSU/Economies in Transition into the World Trade Organization," *Economics of Transition* **5** (1): 215–23.

Milward, Alan S. (1984) *The Reconstruction of Western Europe 1945–51*. London: Methuen.

Minassian, Girabed (1998) "The Road to Economic Disaster in Bulgaria," *Europe-Asia Studies* **50** (2): 331–49.

Misikhina, S. (1999) "Sotsialnye vyplaty i lgoty v Rossiiskoi Federatsii: raspredelenie po gruppam s razlichnym urovnem dokhoda (Social Benefits in the Russian Federation: Distribution according to Income Levels)," *Voprosy ekonomiki* **71** (2): 85–90.

Mizsei, Kálmán (1993) *Bankruptcy and the Post Communist Economies of East-Central Europe*. New York: Institute for East-West Studies.

Mizsei, Kálmán, and Andrzej Rudka, eds. (1995) *From Association to Accession: The Impact of the Association Agreements on Central Europe's Trade and Integration with the European Union*. New York: Institute for East-West Studies.

Mlynář, Zdeněk (1980) *Night Frost in Prague: The End of Humane Socialism*. London: Hurst & Company.

Montesquieu, Charles de Secondat [1748] (1977) *The Spirit of Laws*. Berkeley: University of California Press.

Murphy, Kevin A., Andrei Shleifer, and Robert W. Vishny (1992) "The Transition to a Market Economy: Pitfalls of Partial Reform," *Quarterly Journal of Economics* **57** (3): 889–903.

(1993) "Why Is Rent-Seeking So Costly to Growth?" *American Economic Review* **83** (2): 409–14.

Murrell, Peter (1992a) "Conservative Political Philosophy and the Strategy of Economic Transition," *East European Politics and Societies* **6** (1): 3–16.

(1992b) "Evolutionary and Radical Approaches to Economic Reform," *Economics of Planning* **25**: 79–95.

(1992c) "Evolution in Economics and in the Economic Reform of the Centrally Planned Economies," in Christopher Clague and Gordon C. Rausser, eds., *The Emergence of Market Economies in Eastern Europe*. Cambridge, Mass.: Blackwell, pp. 35–53.

Murrell, Peter, and Mancur Olson (1991) "The Devolution of Centrally Planned Economies," *Journal of Comparative Economics* **15**: 239–65.

Murrell, Peter, and Yijang Wang (1993) "When Privatization Should Be Delayed: The Effect of Communist Legacies on Organizational and Institutional Reforms," *Journal of Comparative Economics* **17** (2): 385–406.

Myrdal, Gunnar (1968) *Asian Drama: An Inquiry into the Poverty of Nations*, vol. 2. New York: The Twentieth Century Fund.

Naishul, Vitaly A. (1994) "Economic Reforms: A Liberal Perspective," in Anders Åslund, ed., *Economic Transformation in Russia*. New York: St. Martin's Press, pp. 174–81.

Nellis, John (1994) "Privatization in Estonia," World Bank FPD Note no. 19.

(1998) "Privatization in Transition Economies: An Update," in Harry G. Broadman, ed., *Case-by-Case privatization in the Russian Federation*, World Bank Discussion Paper no. 385, pp. 13–22.

Nelson, Richard, and Sidney G. Winter (1982) *An Evolutionary Theory of Economic Change*. Cambridge, Mass.: Harvard University Press.

Nicholls, Ana (1999) "Health and Wealth," *Business Central Europe*, June, pp. 12–17.

Nolan, Peter (1995) *China's Rise, Russia's Fall: Politics, Economics and Planning in the Transition from Stalinism*. New York: St. Martin's Press.

North, Douglass C. (1981) *Structure and Change in Economic History*. New York: Norton.

(1994) "Economic Performance through Time," *American Economic Review* **84** (3): 359–68.

Nove, Alec (1969) *An Economic History of the U.S.S.R.* Harmondsworth: Penguin.

(1977) *The Soviet Economic System*. London: George Allen & Unwin.

Novoprudsky, Semen (2000) "Vozbuzhdenie ot protsedury (Excitement over Procedures)," (2000) *Izvestiya*, February 19, p. 5.

Nuti, Domenico Mario (1991) "Comment" in John Williamson, ed., *Currency Convertibility in Eastern Europe*. Washington, D.C.: Institute for International Economics, pp. 48–55.

(1996) "Inflation, Interest and Exchange Rates in the Transition," *Economics of Transition* **4** (1): 137–58.

Nuti, Domenico Mario, and Richard Portes (1993) "Central Europe: the Way Forward," in Richard Portes, ed., *Economic Transformation in Central Europe. A Progress Report*. London: Centre for Economic Policy Research, pp. 1–20.

O'Driscoll, Gerald P. Jr., Kim R. Holmes, and Melanie Kirkpatrick (2000) *2000 Index of Economic Freedom*, Washington, D.C.: Heritage Foundation and the Wall Street Journal.

(2001) *2001 Index of Economic Freedom*, Washington, D.C.: Heritage Foundation and the Wall Street Journal.

OECD (1996) *The Changing Social Benefits in Russian Enterprises*. Paris: OECD.

(1997) *OECD Economic Surveys: Russian Federation*. Paris: OECD.

(2000a) *OECD Economic Surveys: Russian Federation*. Paris: OECD.

(2000b) *Transition at a Glance*. Paris: OECD.

(2000c) *OECD Economic Surveys: The Baltic States*. Paris: OECD.

Ofer, Gur, and Aaron Vinokur (1992) *The Soviet Household under the Old Regime. Economic Conditions and Behaviour in the 1970s*. Cambridge: Cambridge University Press.

Offe, Claus (1997) *Varieties of Transition. The East European and East German Experience*. Cambridge, Mass.: MIT Press.

Olcott, Martha Brill (1996) *Central Asia's New States: Independence, Foreign Policy, and Regional Security*. Washington, D.C.: United States Institute of Peace Press.

Olcott, Martha Brill, Anders Åslund, and Sherman Garnett (1999) *Getting It Wrong*. Washington, D.C.: Carnegie Endowment for International Peace.

Olson, Mancur (1971) *The Logic of Collective Action. Public Goods and the Theory of Groups*. Cambridge, Mass.: Harvard University Press.

(1982) *The Rise and Decline of Nations. Economic Growth, Stagflation, and Social Rigidities*. New Haven, Conn.: Yale University Press.

(1993) "Dictatorship, Democracy, and Development," *American Political Science Review* **87** (3): 567–76.

Orlowski, Lucjan (1993) "Indirect Transfers in Trade among Former Soviet Union Republics: Sources, Patterns and Policy Responses in the Post-Soviet Period," *Europe-Asia Studies* **45** (6): 1001–24.

(1995) "Direct Transfers between the Former Soviet Union Central Budget and the Republics: Past Evidence and Current Implications," *Economics of Planning* **28** (1): 59–73.

Orwell, George (1949) *1984*. New York: Harcourt & Brace.

Paeglis, Imants (1996) "Latvia: Privatization Accelerates, Boosts Economic Reform," *Transition*, December 13, pp. 37–40.

Papava, Vladimer, and Elene Chikovani, eds. (1997) "Georgia: Economic and Social Challenges of the Transition," *Problems of Economic Transition* **40** (7/8): 3–105.

Parkhomenko, Sergei (1992) "Volsky sozdaet partiyu pragmatikov (Volsky Creates a Party of Pragmatists)," *Nezavisimaya gazeta*, May 13, p. 2.

Pasvolsky, Leo (1928) *Economic Nationalism of the Danubian States*. London: George Allen & Unwin.

Pei, Minxin (1994) "The Puzzle of East Asian Exceptionalism," *Journal of Democracy* **5** (4): 90–103.

Perekhod k rynku: kontseptsiya i programma (Transition to the Market: Conception and Program) (1990). Moscow: Arkhangelskoe, August.

Petrakov, Nikolai, Vladlen Perlamutrov, Yuri Borozdin, and V. Manevich (1992) "Pravitelstvo utratilo kontrol nad eckonomicheskimi protsessami (The Government Has Lost Control over the Economic Processes)," *Nezavisimaya gazeta*, March 6, p. 4.

Pickel, Andreas, and Helmut Wiesenthal (1997) *The Grand Experiment*. Boulder, Colo.: Westview Press.

Pinto, Brian, Marek Belka, and Stefan Krajewski (1993) "Transforming State Enterprises in Poland: Evidence on Adjustment by Manufacturing Firms," *Brookings Papers on Economic Activity* **23** (1): 213–71.

Pinto, Brian, Vladimir Drebentsov, and Alexander Morozov (1999) "Dismantling Russia's Nonpayments System: Creating Conditions for Growth," A Report by the World Bank, Moscow, September.

Pipes, Richard (1974) *Russia under the Old Regime*. London: Weidenfeld & Nicholson.

Pistor, Katharina, and Andrew Spicer (1996) "Investment Funds in Mass Privatization and Beyond: Evidence from the Czech Republic and Russia," Harvard Institute for International Development, Cambridge, Mass., Development Discussion Paper no. 565.

Pleskovic, Boris (1994) "Financial Policies in Socialist Countries in Transition," World Bank Policy Research Working Paper no. 1242, Washington, D.C.

Pleskovic, Boris, Anders Åslund, William Bader, and Robert Campbell (2000) "State of the Art in Economics Education and Research in Transition Economies," *Comparative Economic Studies* **42** (2): 65–108.

Pohl, Gerhard, Robert Anderson, Stijin Claessens, and Simeon Djankov (1997) "Privatization and Restructuring in Central and Eastern Europe: Evidence and Policy Options," World Bank Technical Paper no. 368.

Popov, Vladimir (2000) "Shock Therapy Versus Gradualism: The End of the Debate," *Comparative Economic Studies* **42** (1), pp. 1–57.

Porter, Michael E. (1990) *The Competitive Advantage of Nations*. New York: Free Press.

Portes, Richard (1993) "From Central Planning to a Market Economy," in Shafiqul Islam and Michael Mandelbaum, eds., *Making Markets*. New York: Council on Foreign Relations, pp. 16–52.

(1994) "Transformation Traps," *Economic Journal* **104**, 1178–89.

Posner, R.A. (1975) "The Social Costs of Monopoly and Regulation," *Journal of Political Economy* **83**: 807–27.

Prizel, Ilya (1997) "Ukraine between Proto-Democracy and 'Soft' Authoritarianism," in Karen Dawisha, and Bruce Parrott, eds., *Democratic Changes and Authoritarian Reactions in Russia, Ukraine, Belarus and Moldova*. Cambridge: Cambridge University Press, pp. 330–69.

Pryor, Frederic L. (1963) *The Communist Foreign Trade System*. London: George Allen & Unwin.

(1968) *Public Expenditures in Communist and Capitalist Nations*. London: George Allen & Unwin.

Przeworski, Adam (1991) *Democracy and the Market*. Cambridge: Cambridge University Press.

(1995) *Sustainable Democracy*. Cambridge: Cambridge University Press.

Putnam, Robert D. (1993) *Making Democracy Work: Civic Traditions in Modern Italy*. Princeton, N.J.: Princeton University Press.

Puzanov, Aleksandr (1996) "Opyt realizatsii adresnoi programmy zhilishchnykh subsidii" in Anders Åslund, and Mikhail Dmitriev, eds. (1996) *Sotsialnaya politika v period perekhoda k rynku: problemy i resheniya* (Social Policy in the Transition to a Market Economy: Problems and Solutions). Moscow: Carnegie Endowment for International Peace, pp. 139–50.

Remington, Thomas F. (1999) "The Changing Balance of Power between President and Parliament in Russia: The Evolution of Constitutional Practice since 1993," mimeo, John Hopkins University School of Advanced International Studies. http://www.sais-jhu.edu/dept/raees.

Remington, Thomas F., Steven S. Smith, and Moshe Haspel (1998) "Decrees, Laws, and Inter-Branch Relations in The Russian Federation," *Post-Soviet Affairs* **14** (4): 287–322.

Rodlauer, Markus (1995) "The Experience with IMF-Supported Reform Programs in Central and Eastern Europe," *Journal of Comparative Economics* **20** (1): 95–115.

Rodrik, Dani (1992) "Making Sense of the Soviet Trade Shock in Eastern Europe: A Framework and Some Estimates," in Mario Blejer, Guillermo A. Calvo, Fabrizio Coricelli, and Alan H. Gelb, eds., *Eastern Europe in Transition: From Recession to Growth?* World Bank Discussion Paper no. 196.

(1996) "Understanding Economic Policy Reform," *Journal of Economic Literature* **34** (1): 9–41.

Roland, Gérard (1993) "Political Economy of Restructuring and Privatization in Eastern Europe," *European Economic Review* **37** (2–3): 533–40.

(1994) "On the Speed and Sequencing of Privatisation and Restructuring," *Economic Journal* **104**: 1158–68.

(2000) "Corporate Governance Systems and Restructuring: The Lessons form the Transition Experience," Washington, D.C.: World Bank, Annual Bank Conference on Development Economics, April 18–20.

Roland, Gérard, and Thierry Verdier (1994) "Privatization in Eastern Europe: Irreversibility and Critical Mass Effects," *Journal of Public Economics* **54**: 161–83.

(1999) "Transition and the Output Fall," *Economics of Transition* **7** (1): 1–28.

Rosati, Dariusz K. (1995) "The Impact of the Soviet Trade Shock on Central and East European Economies," in Robert Holzmann, G. Winckler, and Janos Gacs, eds., *Output Decline in Eastern Europe: Unavoidable, External Influence or Homemade?* Boston: Kluwer, pp. 131–59.

(1996) "Exchange Rates Policies during Transition from Plan to Market," *Economics of Transition* **4** (1): 159–84.

Rose-Ackerman, Susan (1999) *Corruption and Government: Causes, Consequences, and Reform*. Cambridge: Cambridge University Press.

Rostowski, Jacek (1993) "The Inter-enterprise Debt Explosion in the Former Soviet Union: Causes, Consequences, Cures," *Communist Economies and Economic Transformation* **5** (2): 131–59.

(1994) "Interenterprise Arrears in Post Communist Economies," International Monetary Fund Working Paper, April.

ed. (1995) *Banking Reform in Central Europe and the Former Soviet Union*. Budapest: Central European Press.

(1998) *Macroeconomic Instability in Post Communist Countries*. Oxford: Clarendon Press.

(1999) "Adopting the Euro," *Financial Times*, August 9, p. 10.

Russian Academy of Sciences (RAN), Economic Department, and the International Foundation "Reform" (1994) "Sotsialno-ekonomicheskie preobrazovaniya v Rossii: sovremennaya situatsiya i novye podkhody (Social-Economic Transformations in Russia: The Contemporary situation and New Approaches), mimeo, Moscow, January.

Russian Economic Barometer (2000) III Quarter.

Russian European Centre for Economic Policy (RECEP) *Russian Economic Trends*, various issues.

Rutkowski, Jan (1996) "High Skills Pay off: The Changing Wage Structure during Economic Transition in Poland," *Economics of Transition* **4** (1): 89–112.

Rutskoi, Aleksandr (1992) "Est' li vykhod iz krizisa? (Is There a Way out of the Crisis?)" *Pravda*, February 8, p. 3.

Sachs, Jeffrey D. (1990) "What Is to Be Done?" *The Economist*, January 13, pp. 19–24.

(1991) "Crossing the Valley of Tears in East European Reform," *Challenge* **34** (5): 26–34.

(1992) "The Economic Transformation of Eastern Europe: the Case of Poland," *Economics of Planning* **25**: 5–19.

(1993a) *Poland's Jump to the Market Economy.* Cambridge, Mass.: MIT Press.
(1993b) "Reply to Jan Adam," *Economics of Planning* **26**: 185–9.
(1994) "Life in the Economic Emergency Room," in John Williamson, ed., *The Political Economy of Policy Reform.* Washington, D.C.: Institute for International Economics, pp. 501–23.
(1995a) "Why Russia Has Failed to Stabilize," in Anders Åslund, ed., *Russian Economic Reform at Risk.* New York: St. Martin's Press, pp. 53–64.
(1995b) "Postcommunist Parties and the Politics of Entitlements," *Transition* (The World Bank) **6** (3): 1–4.
(1996) "The Transition at Mid Decade," *American Economic Association, Papers and Proceedings* **86** (2): 128–33.

Sachs, Jeffrey D., and David A. Lipton (1990) "Poland's Economic Reform," *Foreign Affairs* **63** (3): 47–66.
(1993) "Remaining Steps to a Market-based Monetary System," in Anders Åslund, and Richard Layard, eds., *Changing the Economic System in Russia.* New York: St. Martin's Press, pp. 127–62.

Sachs, Jeffrey D., and Andrew Warner (1995) "Economic Reform and the Process of Global Integration," *Brookings Papers on Economic Activity* **25** (1): 1–118.
(1996a) "Natural Resource Abundance and Economic Growth," mimeo, Harvard Institute for International Development, Cambridge, Mass.
(1996b) "Achieving Rapid Growth in the Transition Economies of Central Europe," Harvard Institute for International Development, Cambridge, Mass., Development Discussion Paper no. 544.

Sachs, Jeffrey D., and Wing Thye Woo (1994) "Reform in China and Russia," *Economic Policy*, no. 18: 101–45.

Sala-i-Martin, Xavier (1997) "I Just Ran Two Million Regressions," *American Economic Review* **87** (2): 178–83.

Sargent, Thomas J. (1986) "The Ends of Four Big Inflations," in Thomas J. Sargent, ed., *Rational Expectations and Inflation.* New York: Harper and Row.

Schaffer, Mark (1998) "Do Firms in Transition Have Soft Budget Constraints? A Reconsideration of Concepts and Evidence," *Journal of Comparative Economics* **26** (1): 157–79.

Schumpeter, Joseph A. [1943] (1976) *Capitalism, Socialism and Democracy.* London: George Allen & Unwin.

Selowsky, Marcelo, and Ricardo Martin (1996) "Policy Performance and Output Growth in the Transition Economies," *American Economic Review* **87** (2): 349–53.

Selyunin, Vasili, and Grigori I. Khanin (1987) "Lukovaya tsifra (Cunning Numbers)," *Novy mir* **63** (2): 181–201.

Shapiro, Judith (1995) "The Rising Mortality Crisis and its Causes," in Anders Åslund, ed., *Russian Economic Reform at Risk.* New York: St. Martin's Press, pp. 149–78.

Shkolnikov, V.M., E.M. Andreev, and T.M. Maleva (2000) *Neravenstvo pered litsom smerti v Rossii* (Inequality Facing Death in Russia). Moscow: Carnegie Moscow Center.

Shleifer, Andrei, and Daniel Treisman (2000) *Without a Map: Political Tactics And Economic Reform in Russia*. Cambridge, Mass.: MIT Press.

Shleifer, Andrei, and Dmitry Vasiliev (1996) "Management Ownership and Russian Privatization," in Roman Frydman, Cheryl Gray, and Andrzej Rapaczynski, eds., *Corporate Governance in Central Europe and Russia*, vol. 2. Budapest: Central European University Press, pp. 62–77.

Shleifer, Andrei, and Robert W. Vishny (1993) "Corruption," *Quarterly Journal of Economics* **108** (3): 599–617.

(1998) *The Grabbing Hand. Government Pathologies and Their Cures*. Cambridge, Mass.: Harvard University Press.

Shmelev, Nikolai P. (1987) "Avansy i dolgi (Advances and Debts)," *Novy mir* **63** (6): 142–58.

Siebert, Horst (1992) *Das Wagnis der Einheit* (The Daring of Unity), Stuttgart: Deutsche Verlags-Anstalt.

Simis, Konstantin M. (1982) *USSR: Secrets of a Corrupt Society*. London: J.M. Dent & Sons.

Slay, Ben (1996) "Post Communist Competition Policy: Conclusions and Suggestions," in Ben Slay, ed., *De-Monopolization and Competititon Policy in Post Communist Economies*. Boulder, Colo.: Westview Press, pp. 229–37.

Slay, Ben, and Vladimir Capelik (1997) "The Struggle for Natural Monopoly Reform in Russia," *Post-Soviet Geography and Economics* **38** (7): 396–429.

Slider, Darrell (1997) "Democratization in Georgia," in Karen Dawisha and Bruce Parrott, eds., *Conflict, Cleavage, and Chance in Central Asia and the Caucasus*. Cambridge: Cambridge University Press, pp. 156–98.

Sobell, Vlad (1984) *The Red Market. Industrial Co-operation and Specialization in Comecon*. Aldershot: Gower.

Soros, George (1991) *Underwriting Democracy*. New York: Free Press.

Sovet Ekonomicheskoi Vzaimopomoshchi (SEV) (1988) *Statisticheskii Yezhegodnik stran-chlenov Soveta Ekonomicheskoi Vzaimopomoshchi, 1988* (Statistical Yearbook of the Members of the Council for Mutual Economic Cooperation). Moscow: Finansy i statistika.

Standing, Guy, and Daniel Vaughan-Whitehead, eds. (1995) *Minimum Wages in Central and Eastern Europe: From Protection to Destitution*. Budapest: Central European University Press.

Stark, David, and László Bruszt (1998) *Postsocialist Pathways: Transforming Politics and Property in East Central Europe*. Cambridge: Cambridge University Press.

Stiglitz, Joseph E. (1994) *Whither Socialism?* Cambridge, Mass.: MIT Press.

(1999a) "Whither Reform? Ten Years of Transition," Washington, D.C.: Annual Bank Conference on Development Economics, April 28–30.

(1999b) "Quis Custociet Ipsos Custodes? Corporate Governance Failures in the Transition," Paris: Annual Bank Conference on Development Economics–Europe, June 21–3.

(2000) "The Insider: What I Learned at the World Economic Crisis," *New Republic*, April 17 and 24, pp. 56–60.

Sutela, Pekka (1998) *The Road to the Russian Market Economy, 1993–1998.* Saarijärvi: Kikimora Publications.

Swinnen, Johan F.M. (1999) "The Political Economy of Land Reform Choices in Central and Eastern Europe," *Economics of Transition* **7** (3): 637–64.

Székely, István P., and David M.G. Newberry, eds. (1993) *Hungary: An Economy in Transition.* Cambridge: Cambridge University Press.

Tait, Alan A., and S. Nuri Erbas (1995) "Excess Wages Tax," International Monetary Fund Working Paper no. 17, February.

Tanzi, Vito, and George Tsibouris (2000) "Fiscal Reform over Ten Years of Transition," IMF Working Paper no. 113, Washington, D.C.: International Monetary Fund.

Tanzi, Vito, ed. (1992) *Fiscal Policies in Economies in Transition*, Washington, D.C.: International Monetary Fund.

Tanzi, Vito, and Hamid Davoodi (1997) "Corruption, Public Investment, and Growth." International Monetary Fund Working Paper no. 139.

Tanzi, Vito, and Ludger Schuknecht (2000) *Public Spending in the 20th Century.* Cambridge: Cambridge University Press.

Tarr, David G. (1994) "The Terms-of-Trade Effects of Moving to World Prices on Countries of the Former Soviet Union," *Journal of Comparative Economics* **18** (1): 1–24.

Taylor, Lance (1994) "The Market Met Its Match: Lessons for the Future from the Transition's Initial Years," *Journal of Comparative Economics* **19** (1): 64–87.

Timoshenko, Viktor (1998) "Vse bogatye lyudi Ukrainy zarabotali svoi kapitaly na rossiiskom gaze" (All Rich People in Ukraine Made Their Money on Russian Gas), *Nezavisimaya gazeta*, October 16.

Tismaneanu, Vladimir (1997) "Romanian Exceptionalism? Democracy, Ethnocracy, and Uncertain Pluralism in Post-Ceausescu Romania," in Karen Dawisha and Bruce Parrott, eds., *Politics, Power, and the Struggle for Democracy in South-East Europe.* Cambridge: Cambridge University Press, pp. 403–51.

Tomes, Igor (1997) "Overview of the Social Income Reform Approaches of the Countries of Central And Eastern Europe," *Social Research* **64** (4): 1471–98.

Tornell, Aaron, and Andrés Velasco (1995) "Money-Based versus Exchange Rate-Based Stabilization with Endogenous Fiscal Policy," NBER Working Paper no. 5300.

Transparency International (1999) "The Corruption Perceptions Index," http://www.transparency.de/documents.cpi/index.html.

Treisman, Daniel S. (1998) "Fighting Inflation in a Transitional Regime: Russia's Anomalous Stabilization," *World Politics* **50**: 235–65.

(2000) "The Causes of Corruption: A Cross-National Study," *Journal of Public Economics.*

United Nation: Economic Commission for Europe (1990) *Economic Survey of Europe in 1989–1990.* New York: United Nations.

(1991) *Economic Survey of Europe in 1990–1991.* New York: United Nations.

(1992) *Economic Survey of Europe in 1991–1992.* New York: United Nations.

(1993) *Economic Survey of Europe in 1992–1993.* New York: United Nations.

(1996) *Economic Survey of Europe in 1995–1996.* New York: United Nations.
(1997) *Economic Survey of Europe in 1996–1997.* New York: United Nations.
(1998) *Economic Survey of Europe*, no. 1, New York: United Nations.
(1999a) *Economic Survey of Europe*, no. 1, New York: United Nations.
(1999b) *Economic Survey of Europe*, no. 2, New York: United Nations.
(1999c) *Economic Survey of Europe*, no. 3, New York: United Nations.
(2000a) *Economic Survey of Europe*, no. 1, New York: United Nations.
(2000b) *Economic Survey of Europe*, no. 2/3, New York: United Nations.

United Nations Conference on Trade and Development (UNCTAD) (1997) *World Investment Report 1997: Transnational Corporations, Market Structure, and Competition Policy*, New York and Geneva: UNCTAD.
(1999) *World Investment Report 1999: Foreign Direct Investment and the Challenge of Development*, New York and Geneva: UNCTAD.

United Nations Development Program (UNDP) (1998) *Poverty in Transition?* New York: United Nations.
(1999) *Human Development Report 1999*, New York: Oxford University Press.

U.S. Census Bureau (1999) *Statistical Abstract of the United States*, http://www.census.gov/prod/www/statistical-abstract-us.html.

United States General Accounting Office (GAO) (1996) *Foreign Assistance: Harvard Institute for International Development's Work in Russia and Ukraine*. Washington, D.C.: United States General Accounting Office, November.

Uvalic, Milica, and Daniel Vaughan-Whitehead, eds. (1997) *Privatization Surprises in Transition Economies: Employee-Ownership in Central and Eastern Europe*. Cheltenham: Edward Elgar.

Vaksberg, Arkady (1991) *The Soviet Mafia*. New York: St. Martin's Press.

Van Atta, Don (1998) "Household Budgets in Ukraine: A Research Report," *Post-Soviet Geography and Economics* **39** (10): 606–16.

Van Brabant, Jozef M. (1991) "Convertibility in Eastern Europe through a Payments Union," in John Williamson, ed., *Currency Convertibility in Eastern Europe*. Washington, D.C.: Institute for International Economics, pp. 63–95.

Vasiliev, Sergei A. (1999) *Ten Years of Russian Economic Reform: A Collection of Papers*. London: Centre for Research into Post Communist Economies.

Vienna Institute for Comparative Economic Studies (WIIW) (1993) "Transition from the Command to the Market System: What Went Wrong and What to Do Now," mimeo, Vienna, March.

Vining, Aidan R., and Anthony E. Boardman (1992) "Ownership versus Competition: Efficiency in Public Enterprise," *Public Choice* **73**: 205–39.

Vishnevsky, Anatoli, and Vladimir Shkolnikov (1997) *Smertnost' v Rossii: glavnye gruppy riska i prioritety deistviya (Mortality in Russia: the Main High-Risk Groups and Action Priorities)*. Moscow: Carnegie Endowment for International Peace.

von Mises, Ludwig [1920] (1972) "Economic Calculation in the Socialist Commonwealth," in Alec Nove and D. Mario Nuti, eds., *Socialist Economics*. Harmondsworth: Penguin, pp. 75–91.

Voslenskii, Mikhail S. (1984) *Nomenklatura*. Garden City, N.Y.: Doubleday.
Wallich, Christine I. (1995) "What's Right and Wrong with World Bank Involvement in Eastern Europe," *Journal of Comparative Economics* **20** (1): 57–94.
ed. (1994) *Russia and the Challenge of Fiscal Federalism*. Washington, D.C.: The World Bank.
Wedel, Janine (1998) *Collision and Collusion: The Strange Case of Western Aid to Eastern Europe 1989–1998*. New York: St. Martin's Press.
Wellisz, Stanisław (1996) "Georgia: A Brief Survey of Macroeconomic Problems and Policies," Center for Social and Economic Research, Studies and Analyses, no. 87, September.
White, Stephen (1995) *Russia Goes Dry: Alcohol, State and Society*. Cambridge: Cambridge University Press.
Williamson, John (1990) *Latin American Adjustment: How Much Has Happened?* Washington D.C.: Institute for International Economics.
ed. (1991) *Currency Convertibility in Eastern Europe*. Washington, D.C.: Institute for International Economics.
(1993) "Democracy and the 'Washington Consensus'," *World Development* **21** (8): 1329–36.
(1995) *What Role for Currency Boards?* Washington D.C.: Institute for International Economics.
Winiecki, Jan (1988) *The Distorted World of Soviet-Type Economies*. London: Routledge.
(1991a) *Resistance to Change in the Soviet Economic System*. New York: Routledge.
(1991b) "The Inevitability of a Fall in Output in the Early Stages of Transition to the Market: Theoretical Underpinnings," *Soviet Studies* **43** (4): 669–76.
Woodruff, David (1999) *Money Unmade: Barter and the Fate of Russian Capitalism*. Ithaca, N.Y.: Cornell University Press.
World Bank (1991) *World Development Report 1991: The Challenge of Development*. Oxford: Oxford University Press.
(1994a) *Averting the Old Age Crisis: Policies to Protect the Old And Promote Growth*. Oxford: Oxford University Press.
(1994b) *World Development Report 1994: An Infrastructure for Development*. Oxford: Oxford University Press.
(1996a) *World Development Report 1996: From Plan to Market*. Oxford: Oxford University Press.
(1996b) *Fiscal Management in Russia*. Washington, D.C.: The World Bank.
(1998) *Assessing Aid: What Works, What Doesn't and Why*. New York: Oxford University Press.
(1999) *World Development Indicators*, CD-ROM.
(2000a) *World Development Indicators*, CD-ROM.
(2000b) *Making Transition Work for Everyone: Poverty and Inequality in Europe and Central Asia*, Washington, D.C.: The World Bank.
Wyplosz, Charles (1999) "Ten Years of Transformation: Macroeconomic Lessons," Washington, D.C.: World Bank, Annual Bank Conference on Development Economics, April 28–30.

Wyzan, Michael L. (1993) "Bulgaria: The Painful Aftermath of Collectivized Agriculture," *RFE/RL Research Report* **2** (37): 34–41.

Yaremenko, Yuri, Viktor Ivanter, Aleksandr Nekrasov, Marat Yzyakov, and Vyacheslav Panfilov (1992) "Nado li otpuskat' tseny na toplivo? (Is It Necessary to Let the Prices of Fuel Free?)" *Nezavisimaya gazeta*, April 1, p. 4.

Yavlinsky, Grigory, and Serguey Braguinsky (1994) "The Inefficiency of *Laissez-Faire* in Russia: Hysteresis Effects and the Need for Policy-Led Transformation," *Journal of Comparative Economics* **19** (1): 88–116.

Yekhanurov, Yuri I. (2000) "The Progress of Privatization," in Anders Åslund and Georges de Ménil, eds. *Ukrainian Economic Reform: The Unfinished Agenda*. Armonk, N.Y.: M.E. Sharpe, pp. 189–214.

Yeltsin, Boris N. (1991) "B.N. Yeltsin's Speech," *Sovetskaya Rossiya*, October 29.

Yevstigneev, Ruben, and Liudmila Yevstigneeva (1999) "Kuda zhe vedut reformy?" (Where Do the Reforms Lead?) *Voprosy ekonomiki* **71** (9): 4–18.

Zecchini, Salvatore (1995) "The Role of International Financial Institutions in the Transition Process," *Journal of Comparative Economics* **20** (1): 116–38.

Zemtsov, Ilja (1976) *La corruption en Union sovietique* (Corruption in the Soviet Union). Paris: Hachette.

Index