Economics of Transition

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Volume 21(1) 2013, 1–10
DOI: 10.1111/ecot.12006

Perspectives on Transition and Institutions

The end of economic transition

Lessons for future reformers and students of reform

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Abstract

The transition from plan to market was the largest natural experiment in economics ever. Now, 20 years from the start of transition, all former socialist countries are market economies at the middle stage of economic development, and convergence with neighbours, if not with the developed world, is largely achieved. With hindsight, it is clear that economists have spent too much time debating proper sequencing of reforms and the fine-tuning of reform packages. At the same time, the magnitude of the output and consumption fall in some countries was vastly underestimated, while the benefits of reforms have taken longer to materialize than expected. Successful practitioners of reform praise perseverance during and after the initial setbacks and willingness to make political compromises. At the conclusion of the natural experiment, transition economics has all but vanished as an academic discipline, although it played a crucial role in the formation of modern political economics.

JEL classifications: O1, P3, P16.
Keywords: transition, reform, political economics, economic transition, institutions.

1. Introduction

Economics suffers from the impossibility of conducting large-scale laboratory experiments. The transition from the socialist planned economy to the market economy that started in Eastern Europe about 20 years ago was perhaps the largest

Received: April 28, 2012; Acceptance: September 13, 2012

Published by Blackwell Publishing Ltd, 9600 Garsington Road, Oxford OX4 2DQ, UK and 350 Main St, Malden, MA 02148, USA

natural experiment ever. As the collapse of socialist economies caught most of the profession by surprise, the academic theory of reforms was being created alongside the policy blueprints for the reforms that were carried on in Eastern Europe and the countries of the former Soviet Union.

The conference 'Economies in Transition – 20 years after. What do we know now that we didn't understand then?' organized by Vienna's International Institute for Applied Systems Analysis (IIASA) and Moscow's New Economic School (NES), and held in Laxenburg, Austria on January 13–14, 2011 brought together policy makers and leading students of economic transition to commemorate the 20th anniversary of the IIASA-based seminars for those who went on to become cabinet ministers in the first reform government in Russia. Among policy makers, in addition to veterans of the Russian transition team such as former ministers Petr Aven (international trade), Alexander Shokhin (labour) and Maxim Boycko (privatization), seminar participants included Czech President Vaclav Klaus, an economics professor and prime minister during the reform years, former Slovak prime minister Vladimir Meciar, former Polish first deputy prime-minister Leszek Balcerowicz and former Georgian reform minister Kakha Bendukidze. The 'academic side' included, among others, the 2007 Nobel prize recipient Roger Myerson from the University of Chicago, Harvard's Richard Cooper and Andrei Shleifer, Berkeley's Gerard Roland, and influential policy advisors such as Anders Aslund and John Williamson, the author of the famous 'Washington Consensus' (both from the Peterson Institute for International Economics), Clifford Gaddy from the Brookings Institute and Erik Berglof, the Chief Economist of the European Bank for Reconstruction and Development.

Although some of the reformers had been in academia before entering the government, there were a number of presentations by reform politicians with no academic background. Presentations by scholars were based on research articles evaluating the impact of certain policies, while practical reformers based their comments on their personal experience.

2. Practical lessons for reformers

According to Andrei Shleifer, a leading scholar in corporate finance and law and finance who advised the Russian reform government, one of the major lessons from the transition experience is that economists tend to 'vastly overintellectualize' the reform process. Dozens of high-profile academic articles have explored optimal sequencing of reforms or have tried to resolve the 'gradualism' vs. 'shock therapy' dilemma, yet the actual transition experience demonstrated that the practical implications of one or another sequence of reforms or the speed of reforms were negligible. Undertaking as many comprehensive reforms as possible and as fast as possible was also the consensus advice of such accomplished practical reformers as Vaclav Klaus, who led the Czech economic transition, Leszek Balcerowicz, whose macroeconomic reforms in Poland set an example for many other transition countries, and Petr Aven, who played the critical role in liberalizing trade and unifying exchange rates in Russia.

Leszek Balcerowicz observed that although the 'shock' vs. 'gradualism' dichotomy was a major point of academic and policy debate early in transition, the actual transition experience has demonstrated that this dichotomy is false. Reformers should not be slowed down by the incompleteness and spontaneity of what they have achieved as the 'window of opportunity' might close down at any moment. They should have a clear vision of the goals and firmly believe in their ultimate success, yet be ready to compromise and deal with the unexpected consequences of their action.[1]

The ability to weather a disappointing period after the start of reforms is especially important in relation to another lesson supported by the experience of all East European and FSU transition economies. The start of transition has always been followed by a prolonged period of decline in output and consumption. Some fall in production was expected due to the elimination of the obsolete enterprises ubiquitous in planned economies; but such a fall should not have had a negative impact on consumption and standards of living. But in many countries, this impact was pronounced. Interestingly, although obvious with hindsight, the magnitude of the slump in production and consumption was not widely expected. In fact, the majority of experts expected an increase in economic efficiency as market prices would replace bureaucrats' commands as the primary means of allocating resources; the increase was expected to be even more significant given the huge inefficiencies of the planned economy.

At the individual level, in a planned economy, returns to market and entrepreneurial skills were low compared with the market economy. Thus, the expanded opportunities offered by economic reform should have benefited those with the skills most suited to a market economy. Yet, in practice, the decline was larger and longer than expected.

Harvard's Richard Cooper, who taught future Russian reformers at the IIASA seminars of 1990, provided the following example. Over the decades, the Soviet economy exploited the agricultural sector for the sake of industrialization; terms of trade were skewed heavily against agriculture. With prices for agricultural output set artificially low, the authorities relied on coercion to bring food to cities, the consumption sites, as The Union of Soviet Socialist Republics (USSR) was a highly urbanized society. However, by the later years of the Soviet Union, coercion was abandoned as a primary means of allocating resources, and the only other available means were market incentives. Surprisingly, the best economic minds had not expected difficulties with getting enough food from the countryside to cities once coercive pricing was eliminated. They thought that, once prices were liberalized, the process would go smoothly.

[1] See Shleifer and Treisman (2000) for a study of Russian economic reforms in 1990s as a series of political compromises.

An even bigger surprise was that while price incentives might have been a more efficient mechanism, the immediate impact of market prices on daily consumption was a major shock to the urban population. The sharp impact on non-food consumption led to an equally sharp fall in aggregate demand for all other goods, and was among the most important causes of the protracted recession.

Still, another salient, yet unexpected feature of the transition was the population's resilience during the prolonged period of economic hardship. Although some reform governments lost their post-reform elections (for example, in Hungary and Poland), in some countries they did not (e.g. in the Czech Republic and Russia), and nowhere did economic reforms provoke a violent uprising. This lesson, corroborated by the recent experience of the Baltic countries, was emphasized by Anders Aslund.

3. Building institutions

John Williamson (1990), the author of the 'Washington Consensus', a policy memo that had the most profound impact on reformist governments in the formerly socialist economies, observed that one obvious example of economists' unpreparedness was that early policy advice did not put enough emphasis on the importance of the creation of economic institutions from scratch. The main reason for this seems, with hindsight, almost accidental: in Latin America, which had been the working field for students of economic reform for a decade, all those institutions, although imperfect, were already in place.

Institutions of property rights protection are critical for sustainable economic development. At the beginning of transition, the process of institution-building was understood as follows. Once privatization is completed, that is, once formerly common property is allocated to private hands, the new owners will be the source of political demand for property rights protection. Businessmen and property owners will demand the adoption of good laws and the establishment of well-functioning institutions, including non-corrupt regulators and efficient law enforcement.

In practice, a notable feature of the transition process was 'institutional divergence', or 'the great divide' (Berglof and Bolton, 2002). While most of the East European countries were fast to adopt modern standards and regulations (the EU accession process playing a major role), some former Soviet Union countries lagged behind. While Hungarian, Polish and Latvian businessmen were learning how to compete in the market playing by the rules, Russian and Ukrainian big businessman rarely lobbied for good laws, settled disputes outside court and bribed regulators, police and political authorities to get their property protected. Institutionally, many transition countries are stuck in the 'development trap', where inefficient political institutions hamper economic development.

Andrei Shleifer's lesson is that a reformer should be afraid not of populism but of the capture of politics by the new elites. Reform governments lost power in some countries, yet often it was not populist leaders emerging from the left but the so-called oligarchs (whose initial wealth was obtained through various arbitrage schemes in the pre-transition or early transition period and then used to gain from large-scale privatization) who were the danger to reformers.[2] From the perspective of 1992, the very existence of politically influential billionaires came as a huge surprise. Ironically, in some countries such as Russia, populism appeared 10 years after transition started, when the process of improvements in living standards from the bottom was well underway.

4. Privatization

Economic transition from socialism in Eastern Europe started in 1989. However, as was noted by Tamás Bauer, the starting point for transition was not 1989, but much earlier. By the mid-1960s, it was clear that for sustainable economic development a radical and comprehensive departure from the planned-economy paradigm was necessary. The reforms in 1967 in Czechoslovakia and 1968 in Hungary followed this strategy, before being abandoned. The Polish, Czechoslovak and Russian transitions in 1989, 1990 and 1992, respectively, followed it as well.

After 1989, the constraints on establishing political parties that supported private property were removed, and thus, privatization could start. Here, Hungary was a pioneer as privatization had already started under the last communist governments in 1988–1989. During the early 1990s, there were three main privatization strategies in Eastern Europe: open sale, mass non-cash 'outsider' privatization and mass non-cash 'insider' privatization. The idea of a mass 'outsider' privatization was first suggested by Janusz Lewandowski and Jan Szomburg in Poland (Gdańsk Institute of Economics), but applied at the national scale in Czechoslovakia. Under this scheme, vouchers were distributed to all citizens and, subsequently, exchanged for shares, yet the scheme did not assume any special privileges for employees of the firms that were privatized.

The mass 'insider' privatization was applied at the national scale in Russia. Hungary, Estonia and East Germany privatized by means of open sales; in Hungary and Estonia, most of the buyers were foreigners. Open sales as means of privatization were extremely successful, not only because they brought revenues to the state budget and helped to reduce debt but also (and primarily) because they brought efficient corporate management to privatized firms, provided them with access to foreign markets and accelerated restructuring.

Maxim Boycko, who was an advisor to the Russian government on privatization from the very beginning (and went on to become the Minister for Privatization in 1997), focused on the voucher privatization, which put into private hands about 16,000 companies in Russia. While there has been no large-scale evaluation of the impact of privatization on small firms, every piece of evidence that we have

[2] See Sonin (2003) and Guriev and Rachinsky (2005) on Russian oligarchs.

suggests that this impact was positive. Even more importantly, irreversibility, a major concern at the beginning of reforms, was achieved. However, Russian reformers are not widely credited for large-scale privatization. Public attitudes towards the 'loans-for-shares' auctions (Treisman, 2010) have remained visibly negative.

Brown *et al.* (2006) analysed productivity performance using a panel on initially state-owned manufacturing firms in four formerly socialist economies. While the foreign-privatization effect is large in all countries, the effect of privatization on multifactor productivity is relatively small in Romania and Hungary, almost zero in Ukraine and negative in Russia. As analysis of BEEPS survey data demonstrates, this cannot be attributed to the fact that Russian private firms hide a relatively big part of their income from tax authorities (relative tax avoidance by private vs. state-owned enterprises in Hungary and Lithuania is twice as large as in Russia). Brown, Earle and Telegdy (2010) document a sharp rise in privatization impact on productivity in 2004–2005 data.

Yet another natural experiment was reported by Daniel Berkowitz. Berkowitz *et al.* (2012), exploit the variation in banking across Russian regions induced by the top-down creation of 'specialized' banks in the last years of the communist regime. Both bank origins and policies pursued by regional governments mattered: in regions in which they were less connected to government and which protected property rights better, the spetsbanks' performance was more similar to that of non-spetsbanks.

Not surprisingly, the difference in institutional paths resulted in a different attitude towards reforms. Today, 15–20 years after the most drastic reforms were concluded, Vaclav Klaus observed that in the Czech Republic privatization and its impact is, politically, a non-issue. In contrast, in Russia the privatization of the 1990s remains a highly controversial and politically divisive issue. In an important study of attitudes toward privatization, based on a survey of 28,000 individuals from 28 transition countries conducted by the World Bank and EBRD in 2006, Denisova *et al.* (2009) demonstrated that in countries with low quality of governance and weak constraints on political leadership, the *ex post* support for economic reform among individuals with market-relevant skills is not significantly different from that among individuals without market-relevant skills, but as quality of democracy and governance improves, the differences between respondents with high and low market skills becomes large.

5. Convergence in transition

The main reason for the start of transition was the failure of command or Soviet-type economies to provide long-term growth rates comparable to those of the developed Western economies. A successful transition was expected to foster the convergence of formerly socialist economies with the leaders in economic development. In his presentation, Daniel Treisman (UCLA) focused on the extent of convergence of GDP per capita and, generally, indicators of economic development such as inflation, unemployment, economic and trade structure, and so on. At the start of transition, the universal market logic predicted convergence, while arguments about a distinctive communist legacy suggested that divergence was a likely outcome. Twenty years later, we know that convergence was achieved. However, it took much longer than was expected, and was, in fact, convergence not to the developed economies, but to the world's averages, and specifically, to neighbours. With hindsight, Spain's remarkable transition from a military dictatorship with a relatively backward economy to a stable democracy with a rapidly modernizing economy a decade earlier than the post-Soviet transition should have given a first insight: neighbours matter a lot. Tamas Bauer has emphasized the critical role that the EU accession process played in helping governments to push through comprehensive reform packages.

At the individual-country level, economic convergence between different regions (a phenomenon well-known within the developed world) has also taken longer than expected. Sergei Guriev (NES) demonstrated, using Russian regional data, convergence of per capita income during the last 10 years, with a significant speed-up of the process in 2000–2005. As geographical labour mobility, notoriously low in Russia, has not increased enough to generate speedy convergence, it was made possible by the rapid development of the financial sector.

Political evolution has exhibited a much larger diversity than economic evolution. Andrei Shleifer observed that while all transition countries have eventually converged to some form of capitalism, there has been a much larger range of evolutionary paths for political institutions. Nowadays, political systems that emerge to replace communist dictatorships include everything from full democracies to dictatorships of the most primitive type. As in the case with Spain a decade earlier, neighbours played a critical role: countries closer to the West, especially those on the European Union admission path, became stable democracies, while countries further east remained more authoritarian. For countries in the middle, including Russia and Ukraine, the political paths over the 20 years have been far from straight, and the political transition does not appear to be near its end.

6. Role of civic capital

Ekaterina Zhuravskaya observed that the implementation of the Washington Consensus does not mean that economic freedom, the opposite of the Soviet planned ideal, is secured. Most countries of the former USSR have not obtained much economic freedom, getting heavy and corrupt administrative regulation instead: in the form of lengthy, complicated and non-transparent entry regulation and various regulations on existing business. These regulations benefit corrupt bureaucrats, who collect bribes in exchange for getting around rules, and incumbent monopolies as entry barriers protect them from potential competition both in the product and the labour market.

In 2000–2004, Russian President Vladimir Putin attempted a deregulation reform. Despite some modest success initially, it failed to bring substantial relief to small and medium-size businesses. A straightforward lesson re-emphasizes the deregulation experience of mature market economies: deregulation is hard to achieve. It requires both political will and strong leadership; building a political coalition in support of reforms might involve substantive (and substantial) concessions. A semi-democratic or autocratic political system simplifies passing reform packages through the parliament; the resulting laws might contain fewer concessions to domestic interest. However, the implementation of market-friendly laws in an environment that is hostile to democratic competition is difficult and might sometimes be outright impossible.

Puzzling as it may seem, opinion surveys held in 2006–2010 show that most Russians, as well the majority of the population of most transition economies, exhibit very strong demand for higher involvement of government in all aspects of economic life, including control of prices for goods and services, and less economic freedom. Re-nationalization of privatized property is supported by 37 percent and 80 percent want price controls for food and 50 percent support more severe regulatory control of business. This is even more surprising given that the government in general 'and regulatory agencies themselves' are perceived as highly corrupt.

Aghion *et al.* (2010) suggest that it is the low level of civic capital that explains the puzzle. In countries with low trust and low civic capital, businesses, when given freedom, do not consider themselves constrained by civic norms. Regulation restricts entry and is administered by people who do not consider themselves constrained either; they allow entry in exchange for bribes, which are paid by businessmen (who do not consider this a violation of a norm). The population knows of corruption, but demands regulation as high bribes deter at least some of those businesses from entry. In such societies, not being civic pays off, and children learn this optimal behavioural strategy from their parents.

In high trust countries, the equilibrium is the opposite. Businesses behave civically, population does not demand restricting entry, it does not pay not to be civic, as it does not help to get entry if you are a businessman, or to collect bribes if you are an official.

The existence of multiple equilibria is supported by empirical analysis.[3] People in the Central and Eastern European and Baltic countries felt themselves part of the European heartland; they understood this not only as a readiness to accept painful reforms, but to act civically once freedom was obtained. This leads to the emergence of small and relatively non-corrupt governments, high trust and civic business. In contrast, countries such as Russia and Ukraine lacked an outside anchor. In this case, liberalization leads to a burst in uncivic business, and as a result, the high regulation–high corruption equilibrium.

[3] See Murphy *et al.* (1993) for a basic model of multiple equilibria in development (also, Roland, 2000).

Kakha Bendukidze, the author of sweeping market reforms in Georgia in 2004–2009, formulated a piece of policy advice that should be useful for any government in the world: 'Abolishing a government agency that does nothing cannot bring any harm'. As of now, Georgia seems to be an exception to the civic capital and trust relationship: the country managed a politically painful reform of elimination of government regulation and introduction of economic freedoms despite very low levels of trust and a culture perceived to be notoriously prone to corruption. Recent EBRD LITs surveys show that trust is even lower in Georgia than in Russia, yet trust in business and government institutions is the highest (if one allows for differences in the level of democracy) and corruption is low. The example is important, as it shows that the bad equilibrium can be broken and low civic capital does not mean that countries like Russia or Ukraine are doomed.

7. The end of transition economics

Gerard Roland observed that the relationship between what economists know and their policy influence might be inversely related. For example, international trade might be one of the oldest and most consensual fields in the profession, yet academic economists have little influence on trade policy. In contrast, despite no pre-existing knowledge and little consensus at the start of transition, economists' advice was actively sought and utilized. The issue of economic transition attracted considerable attention from the profession as a whole as it was *sui generis* introduction of capitalist economy. The actual experience showed glaring holes in many theories and misguided focus of many policies. For historians of economic thought, the discussion around transition from plan to market will be a point of attraction for future scholars.

One new subfield in economics was born, in part, out of the transition experience. Fifteen years ago political economists published in the macro and public economics field, rather than in a subfield of their own. Political economics, a respected subfield at the beginning of the 21st century, placed development issues into the mainstream of economic thought, provided the 'development branch' of the new institutional economics with modern tools, both theoretical and empirical and incorporated voting models from the 'rational choice' political science into models that explain political process and policy making.[4]

Economic transition, as the largest economic experiment ever, has taught a number of lessons to both practitioners of economic reform and academic scholars. Yet transition economics as a subfield of economic science that is focused on current developments in formerly planned economies, may have come to the end. There have always been a number of insights that transition scholars have obtained from students of economic development. For example, the problem that a developing

[4] For workhorse models of modern political economics, see Persson and Tabellini (2000), Roland (2000) and Acemoglu and Robinson (2006).

economy can be trapped in an inefficient long-term equilibrium had been recognized in the economics of development long ago (Murphy *et al.*, 1989). Path-dependence, the presence of conditional convergence and the absence of unconditional convergence, as well as the dependence of economic success on political stability are all phenomena known to countries that have never been socialist. Political economics provides a unified framework to address these problems.

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