Introduction

A World Transformed

Sunday June 4, 1989, 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 item on the BBC World Service because on that very day the Chinese communist dictators massacred democratic protesters on Tiananmen Square, and Poland held partially democratic parliamentary elections. For me, the Polish elections were the most important news, signaling that communism ended on that day, whereas the Chinese massacre showed that a democratic outcome was by no means a given. Soon, one communist domino after another was to fall.

This was an extraordinary time. A complete ideological, political, economic, and social system was about to pass away, and a large part of the world with some 400 million inhabitants was to choose a new shape in every regard, including what countries they should divide themselves into. The Soviet bloc – from Berlin to Vladivostok – was struck by one of the greatest liberal revolutions of all times. Since then, society has changed profoundly. The rejection of socialism was unequivocal. A broad consensus aspired to build democracy and a market economy based on private ownership and the rule of law.

At the collapse of communism, liberal revolutionaries seized the political initiative. They aspired to build a "normal society" and to "return to Europe." The petrified communist dictatorships had to give way to democracy and individual freedom, the state-controlled economy to markets, and public ownership to private property. Communism had rejected the rule of law, which now should be established. A total transformation was needed, and nobody thought it would be easy.

Communists always feared the return of capitalism. To secure its permanent destruction, they planted many poison pills, such as the comprehensive nationalization of property, the annihilation of civil society, the elimination of markets, and the suppression of law. Communism was dead as an ideology, unable to resist the liberal revolution, but its poison pills were alive. They bred a rent-seeking state that was the actual alternative to free-market capitalism.

The building of capitalism was widely seen as comprising four key steps. The first and most fundamental step was to deregulate prices and trade so that a market could be formed. Second, when prices were freed, they inevitably soared because of shortages caused by excess demand, and inflation had to be brought under control. Third, the nominally public enterprises lacked real masters, and the only plausible principals to be were private owners, which required large-scale privatization. Fourth, everybody understood that the postcommunist transformation would involve massive social dislocation and acknowledged the need for a new social safety net. Democracy and the rule of law were, of course, desirable, but they were not necessarily seen as part of the economic agenda.

Perspectives change over time. As often happens during revolutions, people's expectations become exaggerated, and then people become disappointed. The institutional changes have been immense, but even so, the legacies of the old society remain palpable, as Alexis de Tocqueville (1856/1955) noted so accurately in *The Old Regime and the French Revolution*. Some countries and some institutions have been much more successfully reformed than others.

Postcommunist transformation has been an intense battle. On one side of the barricades stood radical reformers, who wanted to build a normal society, that is, a market economy, a law-based state, and a democratic society. Their main opponents were rent seekers, not old communists. The rent seekers' goal was plain: to make as much money as possible on transitional market distortions. Their endeavors led to a great misallocation of resources and slumping output. Their hunger for state subsidies and subsidized credits boosted inflation, disorganizing the whole economy. All their successes skewed income and wealth distribution in their favor.

This book surveys twenty-one countries that once formed the Soviet bloc in Central and Eastern Europe and the Soviet Union. I call Poland, the Czech Republic, Slovakia, and Hungary *Central Europe* and Bulgaria and Romania *Southeastern Europe* Estonia, Latvia, and Lithuania are the *Baltic states*. Together I call these three subregions *Central and Eastern Europe* (CEE). All nine of these countries have joined the European Union (EU). The Central European and Baltic countries did so in 2004, whereas Bulgaria and Romania were admitted in 2007. The rest of the region consists of the twelve post-Soviet countries, Russia, Belarus, Ukraine, Moldova, Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan, which I label the *post-Soviet space*. Previously, I used the name the *Commonwealth of Independent States* (CIS) for the twelve post-Soviet countries, but this term has become increasingly arcane. Moreover, in 2008, Georgia officially left the CIS, so it would no longer be accurate either.

Despite all the hardship, most socialist economies have swiftly become ordinary market economies. All but three of these twenty-one countries – Belarus, Turkmenistan, and Uzbekistan – have been transformed successfully into market economies. Transactions are monetary, reasonably free, and carried out in markets. In all these countries, inflation has fallen to single digits, and about two-thirds of the national output is produced in privately owned enterprises. The international community knew how to build a market economy. Predominantly, it advocated a radical market economic reform with deregulation, macroeconomic stabilization, privatization, and the formation of a new social safety net. To a reasonable degree, this policy was implemented, but mostly with delays. To build a market economy was a political choice that most, but not all, governments made, as proven by the existence of three unreformed post-Soviet republics.

The building of democracy and establishment of the rule of law have been much less successful. Frequent complaints are that too much attention and resources were devoted to economic reform and too little to political and legal reforms. This may be true, but more striking is that in these spheres no viable theory predominated, and the policy advice often was too vague and diverse to be helpful. National leaders had no clear idea or program to follow. As a consequence, only the nine EU accession countries, which adopted all the EU institutions, have been successful in building democracy. The promotion of the rule of law has been even more unsatisfactory.

The outcomes of the postcommunist transition have been remarkably diverse. The results have depended on early policy choices, which were influenced by the conditions prevailing in each country. The Central Europeans swiftly shifted to normal market economies and privatized. They adopted Western European social welfare systems with high taxes, large social transfers, and excessive labor market regulation, which have impeded their economic dynamism, but they also have become impeccable democracies, and corruption is relatively limited.

The nine post-Soviet reformers (Russia, Ukraine, Moldova, Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, and Tajikistan) also developed market economies, with poorer governance, but also with low taxes, limited social transfers, and liberal labor markets. The low taxes are a major cause of their high growth rates in the 2000s. Alas, they are at best semidemocratic and mostly authoritarian states, and they suffer pervasive corruption. Three post-Soviet countries – Belarus, Turkmenistan, and Uzbekistan – are completely nonreformed. They are true tyrannies, and they maintain a state-dominated Soviet-style system without communist ideology.

Low flat income taxes, decreasing corporate profit taxes, and the liberalization of labor markets are proliferating from the East into the EU. The Baltics cleverly chose the best of both of these worlds, adopting full-fledged market economies with limited public sectors and high economic growth. They also enjoy democracy and limited corruption. Southeastern Europe straddles a middle ground between the social democratic Central European model and the liberal Baltic model.

After the CEE countries joined the EU in 2004 and 2007, respectively, the eastern wall of the EU has become a major qualitative divide. In terms of level of economic development, Russia and Kazakhstan are close to the CEE, but the big divide lies in governance. All nine of the new Eastern EU members are democracies, whereas none of the twelve post-Soviet states is recognized as fully democratic by Freedom House. Moreover, only Georgia is less corrupt than the least corrupt CEE state, according to Transparency International, but all the other post-Soviet states are far more corrupt. This discrepancy is increasing because corruption is declining in the CEE while it is rising in the post-Soviet space. At some stage, this trend is likely to break, suggesting that the post-Soviet systems are not sustainable.

OVERVIEW OF THE ARGUMENTS OF THIS BOOK

Postcommunist transition has aroused many debates. Often the discussion has been heated because the issues involved have been of great importance to numerous people. To offer the reader an overview of the arguments of this book, some of the most common, as well as contentious, questions are posed here with brief answers summarizing what the reader will find in this book.

Was It Possible to Build Well-Functioning Market Economies in a Few Years?

When communism collapsed, many argued that it would be impossible to build a market economy, a democracy, and rule of law within a few years. Today, however, this proposition has been disproved. After two decades, the ten new Eastern members of the EU are all normal market economies with full-fledged democracies and rule of law. All of them have overtaken the worst-functioning old members of the EU, Italy and Greece, in terms of ease of doing business (World Bank and International Finance Corporation 2011).

Was It Not Inevitable that Capitalism Would Win?

The successful building of capitalism was by no means inevitable. Even today, three post-Soviet countries do not qualify as market economies, namely, Belarus, Turkmenistan, and Uzbekistan. They are still dominated by public ownership, and they are thoroughly regulated. These three examples show that success in the building of capitalism was not a given and that the absence of a determined start could be fateful.

What Kind of Reforms Have Worked the Best?

The Baltic states and Central Europe have accomplished the best results. They pursued all major reforms together in a comprehensive, early, and radical package. These reforms were deregulation, macroeconomic stabilization, privatization, institutional reform, and democratization.

Nothing suggests that it would be advantageous to intentionally hold back on any reform, whereas many reforms were technically complex and could not possibly be done very fast. In each of the early success states, the reforms were led by one or a few committed reformers in top government positions. All the early success countries were democracies, indicating that authoritarian rule was not beneficial for the success of market reforms.

What Has Been the Main Obstacle to Reform?

Postcommunist transition has involved much social suffering, and many feared that social disruption would impede beneficial reforms or even make them impossible (e.g., Przeworski 1991). In reality, however, the main hindrance to reform was not the losers from reform but the winners on the very transition.

In a seminal article, Joel Hellman (1998) clarified the real dilemma: “The Winners Take All.” A small, well-connected elite could extract state subsidies and cheap state credits, as well as benefit from privileged privatization, while arbitraging between low state-controlled prices and high free-market prices. These rent seekers benefited from slow, gradual, and partial reforms and thus opposed fast, comprehensive, and radical reforms, and they turned out to be the greatest obstacle to socially beneficial reforms.

Why Was Speed So Important for the Transition?

If the rent seekers were not beaten early on, they tended to win. Since they were few and the people numerous, democracy was a vital force for radical and comprehensive reform. The slower reforms were, the greater was the danger that rent-seeking interests would become entrenched and block democratization and the combat of corruption, of which they were the main beneficiaries.

Why Didn't Russia Follow the Successful Chinese Model of Economic Reform?

The preconditions of China and Russia differed greatly. Therefore, it would have been surprising if the same model would have generated similar results or even been applicable.

The Soviet Union attempted gradual reforms in the 1920s, 1950s, 1960s, and 1980s, but all these reforms were reversed. In 1985, when Soviet Secretary General Mikhail Gorbachev came to power, he launched new gradual reforms. Eventually, these flawed gradual reforms brought the whole country to collapse. The logical conclusion that Russian President Boris Yeltsin drew was that reforms had to be more radical to become irreversible.

One reason for Gorbachev's failure with reforms was the limited political power of the center that allowed the omnipotent Communist Party bureaucracy to block all his reform efforts. Gorbachev responded by launching *glasnost* (freer speech) and partial democratization to undermine the *apparatchiks*. In China, in contrast, the bureaucracy had been disciplined by the Cultural Revolution and still obeyed the center.

One reason for China's success lay in its economic structure. China had successfully started with reforms in agriculture, but that sector was not very large in the Soviet economy, so any success would have had limited impact on the economy as a whole. Moreover, Soviet collective farms were large-scale and industrialized, rendering their reform far more complex than in the manual Chinese agriculture.

Gradual price regulation seemed to work in China, but in Russia it was a major source of disruptive rent seeking. The Soviet Union collapsed in hyperinflation, whereas the Chinese leaders never lost control over macroeconomic stability. In the end, surprisingly little can be compared in China and Russia (Åslund 1989; Sachs and Woo 1994).

Why Was the Postcommunist Transition So Arduous?

Two major sources of the big costs of the transition were the many unfavorable preconditions and resistance against socially beneficial reforms. The postcommunist transition was replete with hardship because communism had collapsed in a disorderly fashion. Therefore, initial conditions were truly awful. Most countries entered transition amid serious economic crises with high inflation and output nearly in free fall. The combination of excessive foreign debt, large budget deficits, and prevalent shortages necessitated price liberalization. But when prices were freed, they skyrocketed. The overarching early task was to defeat inflation because as long as inflation stayed high, output plummeted. A whole new system had to be built, and the knowledge of how to do so was limited. As Jan Winiecki (1991b) noted in an early article, the output fall was inevitable.

Another reason for enduring hardship was that many rent seekers, who were prominent members of the old and new elite, could make fortunes on market distortions. They favored low regulated prices and restricted trade to make money on privileged foreign-trade arbitrage. They insisted on low state interest rates because they benefited from ample access to state credits. As conditions altered, these operators swiftly found new means of extracting rents until the construction of a market economy had been completed. The rent-seeking elite intentionally prolonged the transition and the population's suffering to make more money.

Has Output Really Fallen More than During the Great Depression?

The decline in output was great, but we shall never possess an exact answer as to its size because the problems of measurement and definition are immense. All official statistics exaggerate the decline in output because of multiple biases all pointing in one direction. In the Soviet system, managers wanted to exaggerate output to reach their plan targets, whereas private businesspeople preferred to understate production to alleviate taxation. Old statistical systems did not survey the many new private enterprises, and the unregistered economy grew with the transition. Much of the socialist production was unusable and unsalable – sheer value detraction that should never have been recorded as value added – and it soon disappeared after the transition, which statistically qualified as output decline.

Under socialism, consumers suffered from shortages, massive queuing, awful quality, limited choice, and forced substitution, not being able to find what they wanted. Military production accounted for about one-quarter of the Soviet gross domestic product (GDP) in the late 1980s. This production was real, but demand for it plummeted with the end of the cold war. The energy and raw materials producers in the former Soviet Union gave large implicit subsidies to the energy-poor states in the west and south, and the Central Asian republics received large annual budget subsidies from Moscow. Transition brought about massive changes in terms of trade, which often disrupted trade.

Since we shall never be able to agree on the value of the Soviet GDP, we cannot conclude how much it has fallen. Yet all told, the "real" output fall might have been about half as much as official statistics suggest.

Why Have the Outcomes of the Postcommunist Transformation Varied So Greatly?

The outcomes of the postcommunist transition have really been very different, ranging from wealthy, orderly democracies such as the Czech Republic and Estonia to frightful dictatorships such as Belarus and Turkmenistan or very poor nations such as Moldova and Tajikistan. The causes have been many. Most important was what transition strategy a country adopted, but for many countries, the best choice was hard to make. Civil war or war caused havoc to some countries – Tajikistan, Georgia, Armenia, Azerbaijan, and Moldova. The former Soviet Union and Poland were ravaged by hyperinflation and massive economic distortions. The quality of economic and political thinking varied greatly. Only some countries had able leaders early on, who chose comprehensive, radical reform at the outset. And only the future EU accession countries received timely Western assistance.

Hadn't a Gradual Dissolution of the Soviet Union Been Better?

No, the Soviet Union stopped functioning as a fiscal and monetary entity by late 1990 because the union republics no longer passed on their fiscal revenues to the union treasury while irresponsibly boosting their expenditures beyond their means. The greatest disaster at the dissolution of the Soviet Union was maintenance of the ruble zone for one and a half years, which led to hyperinflation (more than 50 percent of inflation in the course of one month) in ten of the twelve post-Soviet countries in 1993 because of competitive issue of money by multiple central banks. The Baltic countries were the most successful both in building market economies and in building democracy thanks to their early and clean break with the rest of the union.

No empire has succumbed with as little bloodshed as the Soviet Union. The most plausible cause is the swift and peaceful dissolution of the Soviet Union in December 1991, which stands out as a wise and heroic deed of great foresight.

Has Privatization Been Overdone?

No, the predominance of private enterprise has been a precondition of both market economy and democracy, and private enterprises have generated virtually all the economic growth. The price paid for an enterprise at its privatization was of little relevance because successful privatized firms often paid annual taxes exceeding the highest price imaginable of the original asset a few years later. Since private companies generally perform better than public enterprises, it is more important that enterprises are privatized early than how they are privatized. The later the privatization, the greater was the destruction of both physical and human capital. Yet it is vital that a privatization be perceived as legitimate so that the resulting property rights are politically recognized, and this is a political question. Restitution, mass privatization, and sales to insiders have been more easily accepted than initial sales to outsiders, although the latter have been more successful economically.

Are Oligarchs Pure Parasites?

Oligarchs have both positive and negative features, and their significance varies with circumstances. In the early transition, they were the most successful rent seekers, but as normal market economies obtained, they adjusted and became highly productive. In Russia, Ukraine, and Kazakhstan, young, able local businesspeople revived and restructured many a Soviet mastodon, especially in energy and metallurgy. In these industries, existing enterprises were large, involving substantial economies of scale. Foreign investors mostly have proved helpless in the early restructuring of large Soviet factories, whereas many local businesspeople have excelled in managing relations with regional and central governments, defeating pervasive criminality at plants, and handling the complex social rules while slashing the work force, using the existing physical capital rationally, securing property rights, and enforcing contracts. The weak legislative and judicial systems resulted in poor corporate governance; then concentrated ownership was superior to widespread shareholding. As a consequence of their concentrated ownership of large successful corporations, the oligarchs became very wealthy, and they used their abundance to purchase political influence and block the rise of competitors.

Has Western Aid Been Useful?

Western assistance has been tiny but critical to the success of the transition. The most successful reformers, the Central Europeans and the Balts, all received timely and adequate Western assistance in the forms of financial assistance, professional advice, and market access. All three of these factors were crucial for their success. The former Soviet Union, by contrast, received neither financial assistance for reform nor market access during its first year of economic reform.

Western assistance to the postcommunist countries has been minuscule by any standard. The total grant assistance to the region was merely a couple of billion dollars a year. By contrast, the U.S. peace dividend, that is, the reduction in U.S. military expenditures that became possible thanks to the end of the cold war, amounted to a stunning $1.4 trillion in the 1990s, peaking at 3 percent of the U.S. GDP in 1999. Amazingly, Western governments received more in debt service on old communist loans than they gave in both loans and grants to the postcommunist countries in the crucial period from 1993 to 1996. The West made an early effort to assist the future EU accession countries, whereas it ignored the post-Soviet countries. This sin of omission caused a lasting rupture that is still to be mended.

East Germany, by contrast, has suffered from the opposite problem of excessive West German aid. Since 1990, West Germany has poured more than $80 billion a year into its new *Laender* – about half its GDP and twice the global assistance to developing countries – which has greatly exceeded that region's absorption capacity. East Germany has been priced out of the market by this giant financial flow that has formed an insurmountable social welfare trap. Strangely, this harmful wastage of public resources is continuing unabated.

Is the European Union the Best Solution?

The EU marks a sharp divide between democracies with limited corruption within their borders and more or less unfree societies with pervasive corruption to the east. The EU has made impressive contributions to the transformation of the accession countries. It provided the standard of a normal