The holy trinity of transition: liberalization, privatization, and stabilization

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Abstract

The debate between shock therapists and gradualists that centered on the issue of the pace of liberalization, privatization and stabilization overlooked the crucial importance of institutions for economic growth. The magnitude of the decline (transformational recession) was determined mostly by the initial conditions (distortions in industrial structure and trade patterns), by the weakening of the institutional capacity of the state, and by the better or worse macroeconomic and industrial policies. On all three counts most FSU countries fell behind EE states and hence experienced poorer performance.

The weakening of the state institutional capacity was especially pronounced in*illiberal democracies* - countries with poor tradition of the rule of law (CIS) undergoing rapid democratization. In this sense early democratization incurred high economic and social costs and was detrimental to growth, since it limited the ability of the poor-rule-of-law-states to ensure property rights, contracts and reasonable business climate and order in general.

With respect to more traditional issues of the reform process (industrial policy and macroeconomic stabilization) post-communist FSU countries do not appear to be unique – traditional theories of the political economy of reform seem to be perfectly applicable. The CIS model of economic transformation appears to be close to the Latin American one: weak state, unable neither to eliminate redistribution in favor of inefficient enterprises and sectors of the economy, nor to carry out this redistribution openly, and thus resorting to hidden redistribution (inflation tax, debt financing, price controls, overvalued exchange rate, accumulation of non-payments by non-competitive industries).

Keywords: shock therapy, gradualism, transition economies, liberalization, privatization, stabilization.

JEL Classifications: P21, P27.

The “holy trinity” of liberalization, stabilization, privatization historically was believed to be a set of reforms needed for the transition from socialism to capitalism. To transform a centrally planned economy based on state property into a capitalist economy, it was necessary to deregulate prices in goods and services, labor and capital markets (liberalization), and to privatize state enterprises (privatization), The stabilization policy was important, but not part of the systemic transformation – macroeconomic stabilization (control over the budget deficit, money supply, inflation) is needed in every system, be it capitalism or socialism[1]. Opening up of the closed economy – elimination of barriers between domestic and world markets – was often added to the list of needed reforms; the argument was that without the competition from the world market national economies cannot achieve real competitiveness.

Eventually all countries followed the “holy trinity” policies[2], but the results were very different. After the Soviet Union collapsed (December 1991) and market reforms were initiated, the economic performance of the successor states (FSU – former Soviet Union) was more than disappointing. By the end of the 1990s output (GDP) fell by about 50% as compared to the highest pre-recession level of 1989 (fig. 1), investment dropped even more, income inequalities rose greatly so that real incomes declined dramatically for the majority of the population, death rates increased by about 50%, whereas life expectancy declined markedly. In Russia output fell by 45% in 1989-98, death rates increased from 1% in the 1980s to 1.5% in 1994 and stayed at this high level thereafter, which was equivalent to over 700,000 additional deaths annually. Over the period of several years such population losses could be likened to the impact of the big war.

By way of comparison, during the second world war national income in the USSR fell only by 20% in 1940-42, recovered to its 1940 level in 1944, fell again by 20% in 1944-46, during conversion of defense industry, but exceeded its 1940 level nearly by 20% already in 1948. In some of the FSU states that were affected by military conflicts (Armenia, Azerbaijan, Georgia, Moldova, Russia and Tajikistan) GDP in 2000 was only 30 to 50% of its pre-transition levels; in Ukraine even without the military conflict GDP fell by nearly two thirds (fig. 1). In East European countries (EE) the reduction of output continued for 2-4 years and totaled 20 to30%, whereas in China and Vietnam there was no transformational recession at all – on the contrary, from the very outset of reforms economic growth accelerated.

Post factum, the reduction of output that occurred in the FSU and Eastern Europe (EE) during the 1990s should be considered as the exceptional episode of the world economic history. Never and nowhere, to the best of my knowledge, there occurred such a dramatic decline in output, living standards and life expectancy without extraordinary circumstances, such as wars, epidemics, natural disasters. Even during the Great Depression (1929-33) GDP in Western countries on average fell by some 30% and by the end of the 1930s recovered to its pre-recession levels.

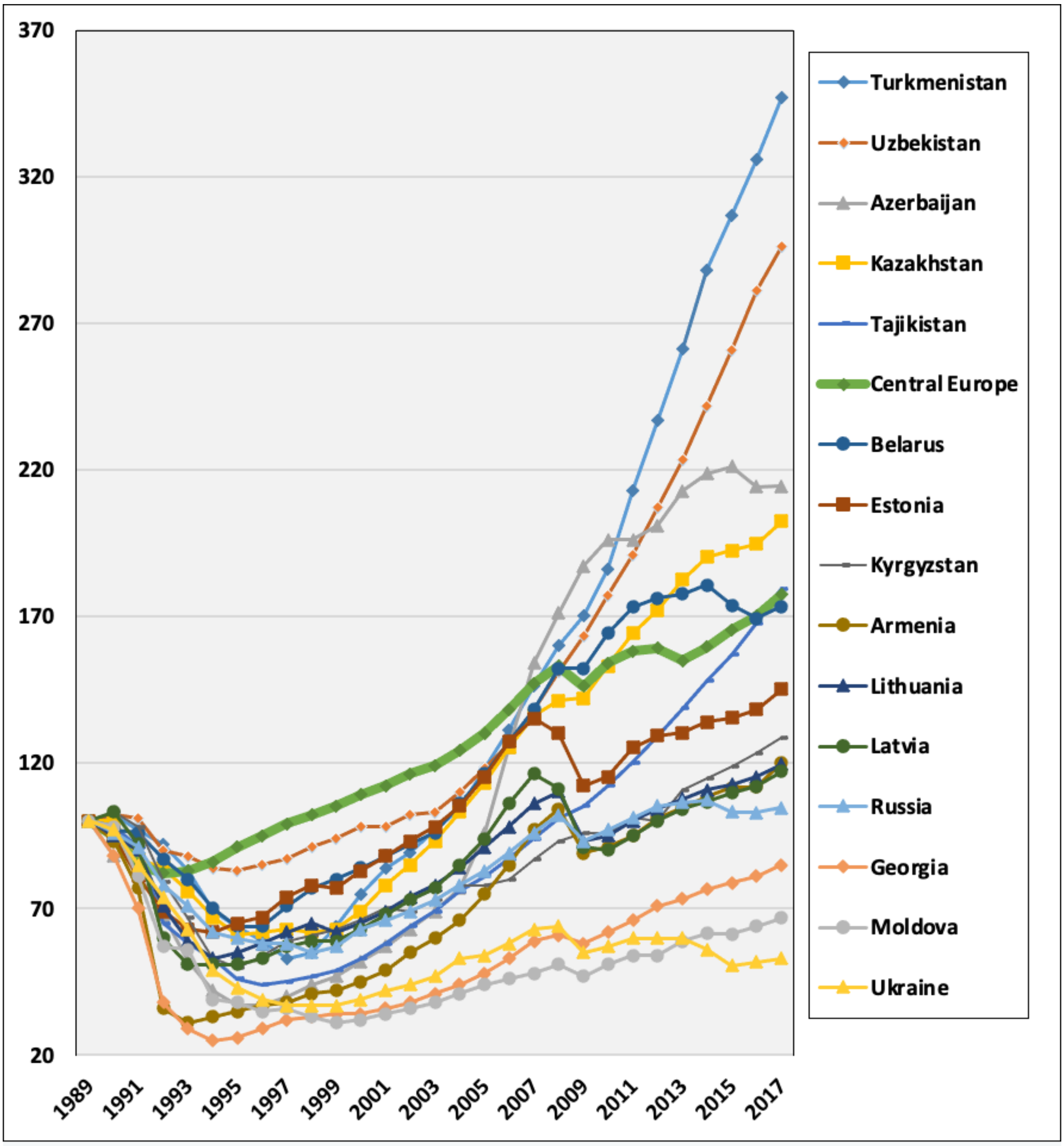


Figure 1. GDP change in Central Europe and in FSU economies, 1989 = 100%

Source: EBRD Transition Report.

Overall, for the three decades of the transition (1989-2019) in some countries affected by the armed conflicts the annual average growth rates were negative (Ukraine, Bosnia and Herzegovina, Moldova, Montenegro, Georgia, Serbia), so that their GDP in 2019 was below that of the pre-transition level of 1989 (fig. 2). Some Asian countries, however, managed to increase their GDP considerably; among the latter are not only growth miracles of China and Vietnam (9 and 7 % of annual average growth respectively), but also Mongolia, Turkmenistan, and Uzbekistan (a respectful 4% plus annual average growth for 30 years – fig. 2).

Why has the reduction of output and incomes in East European countries and especially in the FSU been so deep and so long? To what extent was this collapse caused by the initial conditions and circumstances, i.e. was predetermined and hardly avoidable, and to what extent it was “manmade”, i.e. became the result of poor economic policy choices? If it is the wrong economic policy that is mostly responsible for the collapse, the future historians may refer to the FSU and EE transition as the biggest “manmade” economic disaster ever to happen.

The ubiquitous and virtually universal feeling is that "things went terribly wrong" and that with different policies it could have been possible to avoid most of the misfortunes that struck EE and FSU in the 1990s. After all, China and Vietnam not only did better that EE and FSU states, and it is difficult to accept the idea that the exceptional length and depth of recession in Eastern Europe and post-Soviet states was predestined and inevitable.

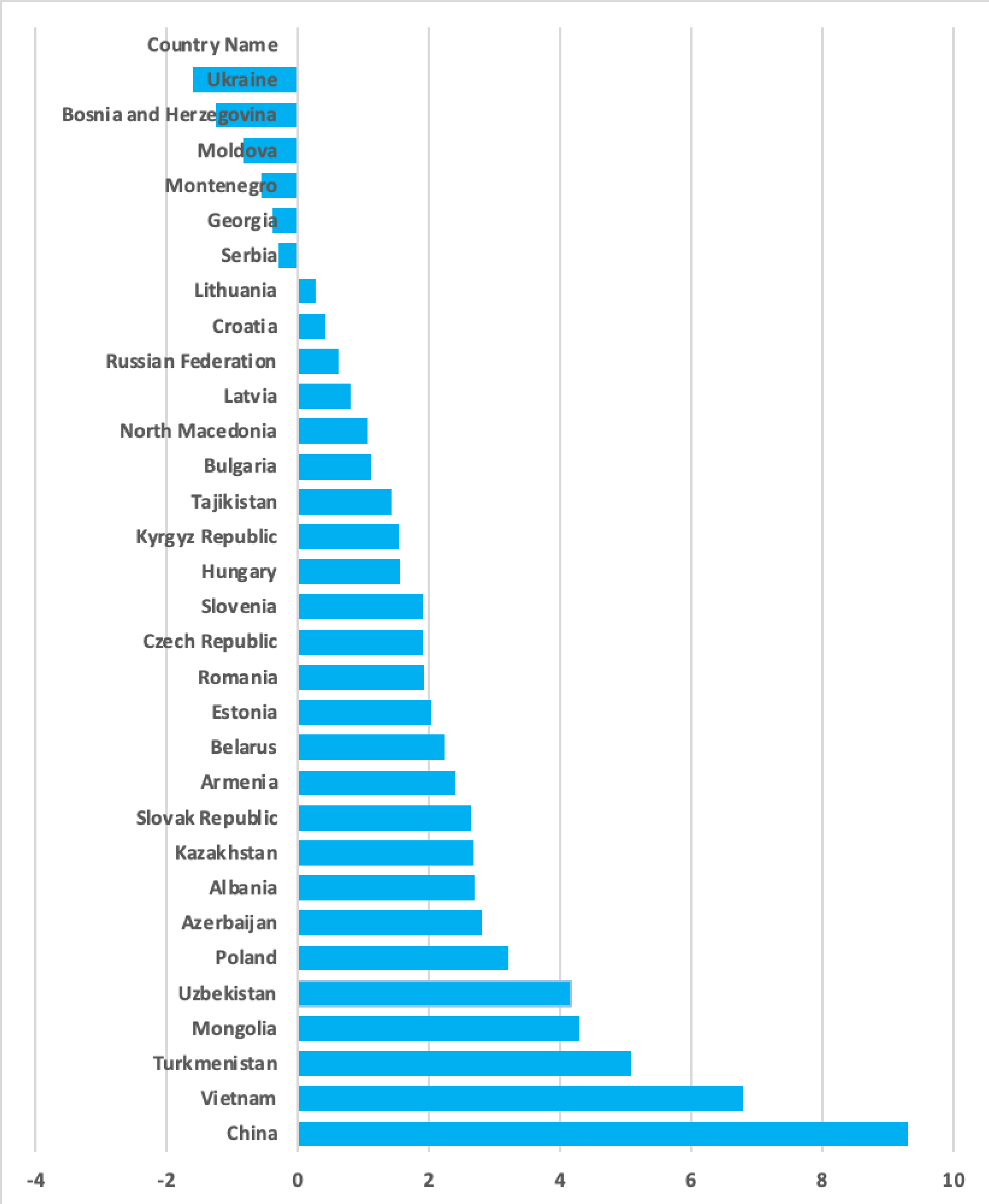


Figure 2. Average growth rate in transition economies in 1990- 2019, %

Source: *World Development Indicators (WDI)* database. For Baltic states (Estonia, Latvia, Lithuania), Moldova and 4 former Yugoslav republics (Bosnia and Herzegovina, Montenegro, Croatia, Serbia) comparable *WDI* data for 1990-94/97 are missing, so the data are taken from *Transition Report EBRD, 1995-2002*. GDP growth rate for Serbia and Montenegro are assumed to be that of Yugoslavia and FR Yugoslavia before 1997. For Bosnia and Herzegovina, it is assumed that GDP fell by 90% in 1990-95 (*Wikipedia*).

However, when it comes to the discussion of particular policies, there is much less agreement among the scholars. 30 years ago, on the eve of transition, economic discussion in the profession was dominated by the debate between shock therapists, who advocated radical reforms and rapid transformation, and gradualists, justifying a more cautious and piecemeal approach to reforms.

The question why EE and FSU had to pay a greater price for economic transition was answered differently by those who advocate shock therapy and those who support gradual piecemeal reforms. Shock therapists argued that much of the costs of the EE and FSU reforms should be attributed to inconsistencies of policies followed, namely to the inability of the governments to carry out radical reforms and to fight inflation in the first half of the 1990. On the contrary, the supporters of gradual transition state exactly the opposite, blaming the attempt to introduce conventional shock therapy package for all the disasters and misfortunes.

Shock therapists pointed out to the example of East European countries and Baltic states – fast liberalizers and successful stabilizers, that experienced a recovery after 2 to 3 years fall in output, while their other post-Soviet counterparts were doing much worse. Gradualists cited the example of China, arguing that the lack of recession and high growth rates is the direct result of the step by step approach to economic transformation.

Transition strategies and performance

Definition. Although there is no commonly accepted definition, most economists would probably agree that several criteria are applied to distinguish shock therapy from gradualist strategy:

- Instant (as opposed to step by step) deregulation of prices; introduction of convertibility of national currency;
- Macroeconomic stabilization (bringing down inflation to less than 40% a year in 6 months);
- Cutting subsidies from 10-15% GDP to 2-3% GDP during 1-2 years;
- Privatization of 50% of state property during 2-3 years or faster.

According to such a definition, central European countries proceeded successfully with consistent shock therapy, Russia and most CIS states tried shock therapy, but were not able to adhere to it in a consistent way (instant deregulation of prices and fast privatization, but no macroeconomic stabilization and reduction of subsidies), whereas China with its strategy of “dual track price system” (coexistence of controlled prices for planned input and output and market prices for freely purchased and sold goods for over a decade) and “growing out of socialism” (no privatization, but permission to start non-state businesses from scratch that were growing faster than state sector) is a classical (and the only perfect) example of gradualism.

Arguments. Shock therapists were arguing that “one cannot cross the abyss in two jumps”, that rapid liberalization allows to avoid painful and costly period, when the old centrally planned economy (CPE) is not working already, while the new market one is not working yet. No less important was the political reason – the assumption (that later proved to be wrong

– see last section) that there is a window of opportunity for reforms (before the decline in real incomes and other costs would cause public discontent), so that if liberalization and privatization are not fast enough, reforms could be reversed (Castanheira, Popov, 2002).

Gradualists in turn stressed that protection of property rights is essential for growth whereas privatization creates uncertainty with property rights, so it is better to “grow out of socialism” like China did; that institutional vacuum resulting from rapid transition (market economy without appropriate regulatory institutions) may have a devastating impact on output; that resources need to be re-allocated from non-competitive to competitive sectors, which may take considerable time; that for senior citizens even a temporary decline in real incomes is not acceptable, so if the government is too weak to ensure transfers, the elderly would lose.

Evolution of views. In the early 1990s the predominant view was that of the “Washington consensus” that basically advocated shock therapy. The conventional wisdom of the day was probably summarized in the 1996 World Development Report (WDR) *From Plan to Market,* which basically stated that differences in economic performance were associated mostly with "good and bad" policies, in particular with the progress in liberalization and macroeconomic stabilization: countries that are more successful than others in introducing market reforms and bringing down inflation were believed to have better chances to limit the reduction of output and to quickly recover from the transformational recession.

> *“Consistent policies, combining liberalization of markets, trade, and new business entry with reasonable price stability, can achieve a great deal even in countries lacking clear property rights and strong market institutions”, – was one of the major conclusions of the WDR 1996 (World bank, 1996, p. 142).*

The conclusion did not withstand the test of time, since by now most economists would probably agree that when liberalization was carried out without strong market institutions it led to the extraordinary output collapse in post-communist states. Liberalization may be important, but the devil is in details, which often do not fit into the generalizations and make straightforward explanations look trivial.

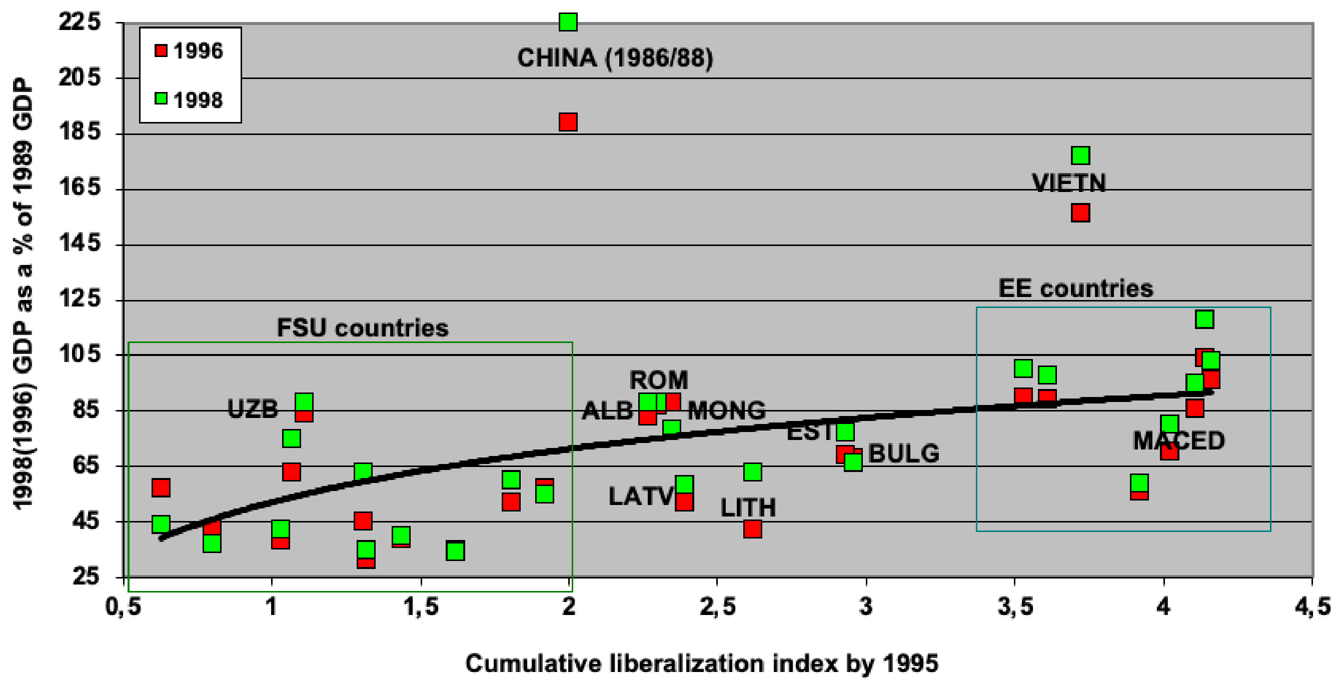
Empirical evidence

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

But attempts to link differences in output changes during transition to the cumulative liberalization index and to macro stabilization (rates of inflation) have not yielded any impressive results: it turned out that dummies, such as membership in the ruble zone (i.e. FSU) and war destruction, are much more important explanatory variables than either the liberalization index or inflation (Åslund, Boone, Johnson, 1996). Other studies that tried to take into account a number of initial conditions (repressed inflation – monetary overhang – before deregulation of prices, trade dependence, black market exchange rate premium, number of years under central planning, urbanization, over-industrialization, and per capita income) found that initial conditions do matter and that in some cases liberalization becomes insignificant as well (De Melo, Denizer, Gelb and Tenev, 1997, p. 25; Heybey, Murrel, 1999). Other papers (Katyshev, Polterovich, 2006; Godoy, Stiglitz, 2006; Popov, 2007) showed that the speed of reforms and privatization has a negative impact on output at the stage of the transformational recession and that institutional capacity of the state is a crucial factor of output dynamics (Polterovich, 2008; Popov, 2014).

At a first glance, there seems to be a positive relationship between liberalization and performance (fig. 3). However, a more careful consideration reveals that the link is just the result of sharp difference in the magnitude of the recession in EE countries, as a group, and FSU states, also as a group (fig.3). Within these groups the correlation, if any, is much weaker, not to speak about China and Vietnam, which are outliers. Chinese index of economic freedom (measured on a scale from 1 to 5 by the Heritage Foundation) was about the same in recent years as the Russian one, but the performance of two countries differed markedly (fig. 4).

Fig. 3. Liberalization and output change



Source: EBRD Transition Report, various years

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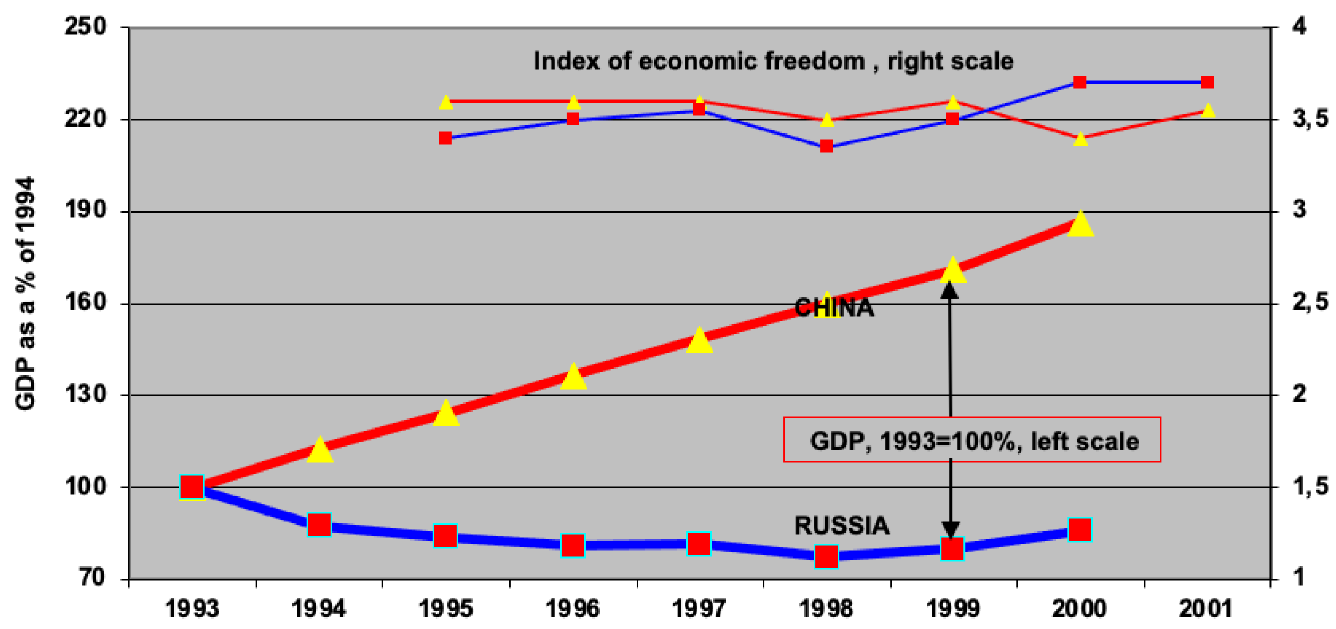
Fig. 4. Indices of economic freedom and GDP growth in Russia and China



Source: Heritage Foundation.

Privatization contribution to economic growth is also at best is not obvious. There is a debate, what is the crucial factor behind economic fiascos – market failure or state failure. The dominant story in the profession is that economic breakthroughs are achieved only due to a vital and vivid private sector, which is dynamic and entrepreneurial, oriented towards innovations and is not afraid of risk taking, whereas the state is clumsy, inefficient and even reactionary, and restraints private initiatives. It is said that the private sector contributes to economic growth and poverty eradication through the building of productive capacity, creation of decent jobs, promotion of innovation, economic diversification and competition. In landlocked developing countries, the private sector is actively involved in activities related to transit and trade facilitation, including as traders, freight forwarders, insurance providers and transporters, and the sector is a source of tax revenue and domestic investment and is a partner for foreign direct investment. Public-private partnerships can play an important role in infrastructure development (Almaty Programme of Action for Landlocked Developing Countries (2013).

Another story, however, is that of the entrepreneurial state: Mazzucato (2013) provides ample evidence that technological breakthroughs are due to public and state funded investments in innovation and technology, and that private sector only finds the courage to invest after an entrepreneurial state has made the high-risk investments.

Rodrik and Subramanian (2014) talk about the attitudinal shift on the part of the national government towards a probusiness (as opposed to the pro-liberalization approach) and attribute the acceleration of Indian economic growth to this factor: they show that the acceleration of growth occurred since 1980 and not since 1991, when liberalization reforms were carried out.

The problem in many developing countries in general and in post-communist countries in particular is that private sector often does not take the initiative in promoting development due to actual or alleged “poor investment climate”. As can be seen from Figure 5 (and comparing it to Figure 1), there is no correlation between the share of the private sector in the economy and the GDP dynamics. Or, if there is a correlation, it is rather negative than positive: more privatized economies are doing worse than less privatized.

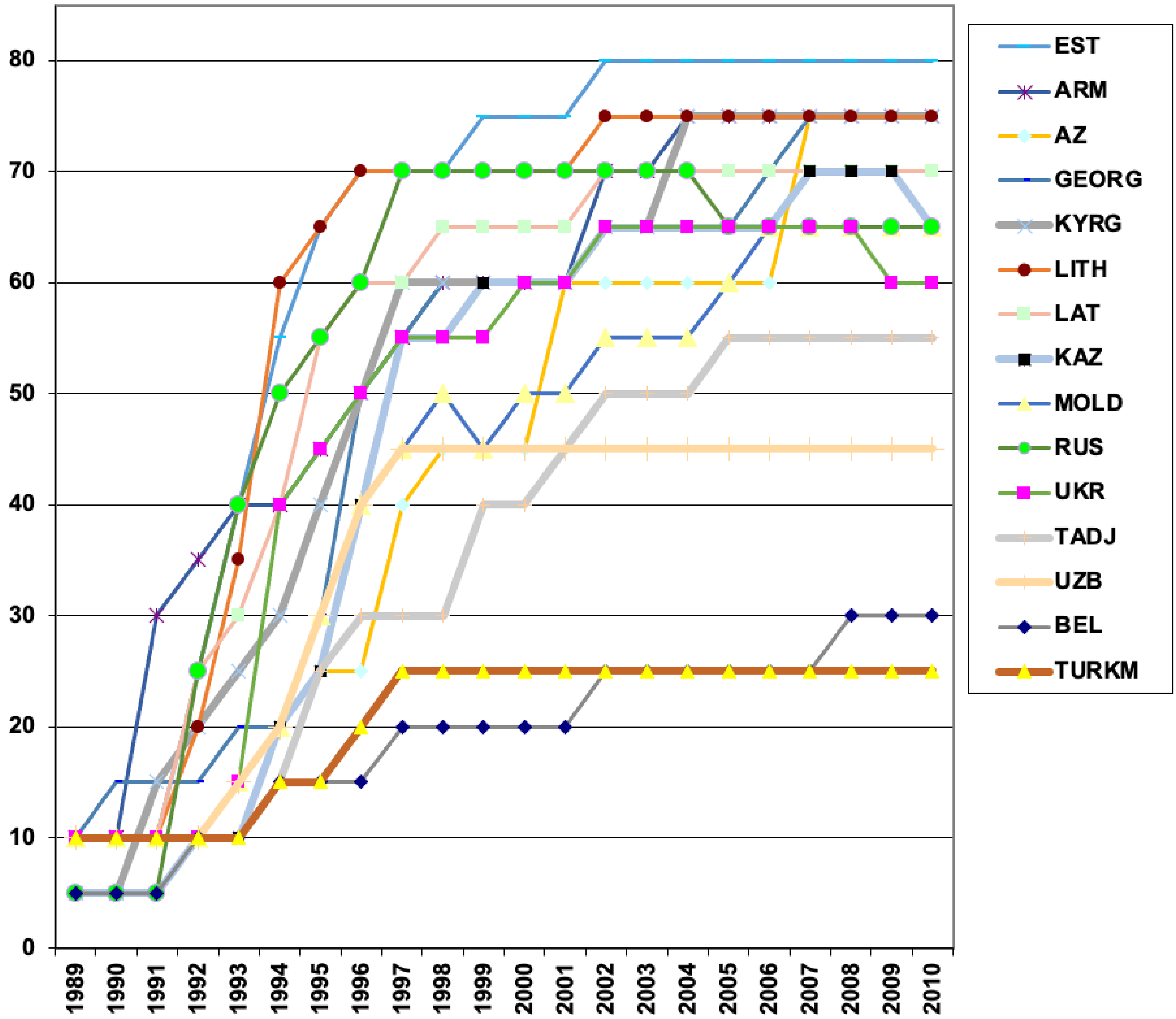


Figure 5. The share of private sector in GDP in former Soviet republics, 1989-2010, %

Source: Transition Report, EBRD (Data for years after 2010 are unfortunately unavailable)

Alternative explanation

This paper starts by separating the transformational recession (reduction of output in most transition economies in the first half of the 1990s) from the process of economic growth (recovery from the transformational recession). It is argued that the former (the collapse of output during transition) can be best explained as adverse supply shock caused mostly by a change in relative prices after their deregulation due to distortions in industrial structure and trade patterns accumulated during the period of central planning, and by the collapse of state institutions during transition period, while the speed of liberalization had an adverse effect on performance, if any. In contrast, the latter process (recovery) should be treated as a normal growth process and could be modeled with the tools of conventional growth theory: it could be expected that in the sufficiently long run it would be possible to capitalize on liberalization due to the increase in factors efficiency that would lead to better performance.

Based on previous literature (see Popov, 2000 for the review) the following framework for explaining the collapse of output during transformational recession is accepted. **First**, transformational recession was caused by the adverse supply shock that resulted from deregulation of prices and change in relative price ratios that created the need for reallocation of resources due to distortions in the industrial structure and external trade patterns that existed before transition. **Second**, by another adverse supply shock associated with the collapse of state institutions (understood as the ability of the state to enforce its rules and regulations), which occurred in the late 1980s - early 1990s and which resulted in chaotic transformation through crisis management instead of organized and manageable transition. And **third**, by poor economic policies, which basically consisted of macroeconomic mismanagement, no matter whether the pursued reforms were gradual or radical. Fast speed of reform *per se* (shock versus gradual transition) at the initial stage of transition probably aggravated the reduction of output because immediate deregulation of prices caused the need for restructuring (reallocation of labor and capital) that exceeded the investment potential of the economy.

In the first approximation, economic recession that occurred during transition was associated with the need to reallocate resources in order to correct **the industrial structure inherited from centrally planned economy**. These distortions include over-militarization and over-industrialization (resulting in the underdevelopment of the service sector), perverted trade flows among former Soviet republics and Comecon countries, excessively large size and poor specialization of industrial enterprises and agricultural farms (lack of small enterprises and farms). In most cases these distortions were more pronounced in former Soviet Union countries (FSU) than in Eastern Europe (EE), not to speak about China and Vietnam, – the larger the distortions, the greater was the reduction of output. Transformational recession, to put in economic terms, was caused by adverse supply shock similar to the one experienced by Western countries after the oil price hikes in 1973 and 1979, and similar to post-war recessions caused by conversion of the defense industries.

The evidence for all transition economies is that the reduction of output by country is well explained by the indicator of distortions in industrial structure and trade patterns (it remains statistically significant no matter what control variables are added). The magnitude of distortions, in turn, determines the change in relative prices, when they are deregulated. In Russia industries with the greatest adverse supply shock (deteriorating terms of trade – relative price ratios for outputs and inputs), such as light industry, experienced the largest reduction of output (Popov, 2000; 2007).

Consider a country where deregulation of prices (or elimination of trade tariffs/subsidies) leads to a change in relative price ratios and thus produces an adverse supply shock for at least some industries. Capital should be reallocated from industries facing declining relative prices and profitability to industries with rising relative prices. Assume that 50% of the total output is

concentrated in non-competitive industries (this whole sector should disappear either gradually or at once depending on how fast relative prices will change); capital is not homogeneous and cannot be moved to the competitive sector, whereas labor can be reallocated to the competitive sector without costs.

If prices are liberalized instantly, then non-competitive sector becomes unprofitable and output falls immediately by 50%; later savings for investment are generated only by the competitive sector, so it takes a number of years to reach the pre-recession level of output. If reforms are carried out slowly (gradual price deregulation or elimination of tariffs/subsidies), so that every year output in the non-competitive sector falls by, say, 10%, this fall could be largely compensated by the increase in output in the competitive sector. The best trajectory, of course, is the one with such a speed of deregulation that leads to the reduction of output in the non-competitive sector at a natural rate, i.e. as its fixed capital stock retires in the absence of new investment.

The example illustrates that there is a limit to the speed of reallocating capital from non-competitive to competitive industries, which is determined basically by the net investment/GDP ratio (gross investment minus retirement of capital stock in the competitive industries, since in non-competitive industries the retiring capital stock should not be replaced anyway). It is not reasonable to wipe away output in non-competitive industries faster than capital is being transferred to more efficient industries (Popov, 2000; 2007).

Market type reforms in many post-communist economies created exactly this kind of a bottleneck. Countries that followed shock therapy path found themselves in a supply-side recession that is likely to become a textbook example: an excessive speed of change in relative prices required the magnitude of restructuring that was simply non-achievable with the limited pool of investment. Up to half of their economies was made non-competitive overnight due to the change in relative prices after deregulation. Output in these non-competitive industries was falling for several years and fell in some cases to virtually zero, whereas the growth of output in competitive industries was constrained, among other factors, by the limited investment potential and was not strong enough to compensate for the output loss in the inefficient sectors.

Hence, at least one general conclusion from the study of the experience of transition economies appears to be relevant for the reform process in all countries: provided that reforms create a need for restructuring (reallocation of resources), the speed of reforms should be such that the magnitude of required restructuring does not exceed the investment potential of the economy. In short, the speed of adjustment and restructuring in every economy is limited, if only due to the limited investment potential needed to reallocate capital stock. This is the main rationale for gradual, rather than instant, phasing out of tariff and non-tariff barriers, of subsidies and other forms of government support of particular sectors (it took nearly 10 years for the European Economic Community and for NAFTA to abolish tariffs).

The additional reason for the extreme depth and length of the transformational recession was associated with the **institutional collapse** – here differences between EE countries and FSU are striking. The efficiency of state institutions, understood as the ability of the state to enforce its own rules and regulations, resulted in the inability of the state to perform its traditional functions – to collect taxes and to constraint the shadow economy, to ensure property and contract rights and law and order in general (crime rates and corruption increased dramatically during transition as compared to the communist past). Naturally, poor ability to enforce rules and regulations did not create business climate conducive to growth and resulted in the increased costs for companies.

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

What lead to the institutional collapse and could it have been prevented? Using the terminology of political science, it is appropriate to distinguish between strong authoritarian regimes (China and Vietnam and to an extent – Belarus and Uzbekistan), strong democratic regimes (Central European countries) and weak democratic regimes (most FSU and Balkan states). The former two are politically liberal or liberalizing, i. e. protect individual rights, including those of property and contracts, and create a framework of law and administration, while the latter regimes, though democratic, are politically not so liberal since they lack strong institutions and the ability to enforce law and order (Zakaria, 1997). This gives rise to the phenomenon of “illiberal democracies” – countries, where competitive elections are introduced before the rule of law is established. While European countries in the XIX century and East Asian countries recently moved from first establishing the rule of law to gradually introducing democratic elections (Hong Kong is the most obvious example of the rule of law without democracy), in Latin America, Africa, and now in CIS countries democratic political systems were introduced in societies without the firm rule of law.

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

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

Finally, performance was of course affected by **economic policy**. Given the weak institutional capacity of the state, i.e. its poor ability to enforce its own regulations, economic policies could hardly be “good”. Weak state institutions usually imply populist macroeconomic policies (budget deficits resulting in high indebtedness and/or inflation, overvalued exchange rates), which have devastating impact on output. On the other hand, strong institutional capacity does not lead automatically to responsible economic policies. Examples range from the USSR before it collapsed (periodic outburst of open or hidden inflation) to such post-Soviet states as Uzbekistan and Belarus, which seem to have stronger institutional potential than other FSU states, but do not demonstrate higher macroeconomic stability.

Regressions tracing the impact of all mentioned factors are reported in table 2. If the rule of law and democracy indices (see data section for definitions) are included into the basic regression equation, they have predicted signs (positive impact of the rule of law and negative impact of democracy) and are statistically significant (equation 1), which is consistent with the results obtained for larger sample of countries[3].

Table 2. Regression of change in GDP in 1989-96 on initial conditions, policy factors, and rule of law and democracy indices, robust estimates

Dependent variable = log (1996 GDP as a % of 1989 GDP)

For China - all indicators are for the period of 1979-86 or similar

Equations, Number of Observations / Variables	**1, N=28**	**2, N=28**	**3, N=28**	**4, N=28**	**5, N=28**	**6, N=28**	**7, N=28**
Constant	5.3***	5.4***	5.2***	5.4***	5.4***	5.5***	5.7***
Distortions, % of GDP*a*	-.005**	-.005**	-.003	-.006**	-.007***	-.007***	-.007***
1987 PPP GDP per capita, % of the US level	-.009**	-.006*	-.007**	-.007**	-.009***	-.008 ***	-.008***
War dummy*b*				-.19[c]	-.36***	-.37***	-.45***
Decline in government revenues as a % of GDP from 1989-91 to 1993-96					-.011***	-.011 ***	-.011 ***
Liberalization index			.05			-.02	.03
Log (Inflation, % a year, 1990-95, geometric average)	-.16***	-.20***	-.18***	-.17***	-.13***	-.13***	-.14***
Rule of law index, average for 1989-97, %	.008 ***						
Democracy index, average for 1990-98, %	-.005 ***						-.003**
Ratio of the rule of law to democracy index		.07***	.07***	.06***	.05***	.05***	
Adjusted R2, %	82	83	83	85	91	91	90

*, **, *** - *Significant at 1, 5 and 10% level respectively.*

[a] *Cumulative measure of distortions as a % of GDP equal to the sum of defense expenditure (minus 3% regarded as the 'normal' level), deviations in industrial structure and trade openness from the 'normal' level, the share of heavily distorted trade (among the FSU republics) and lightly distorted trade (with socialist countries) taken with a 33% weight – see (Popov, 2000) for details.*

[b] *Equals 1 for Armenia, Azerbaijan, Croatia, Georgia, Macedonia, and Tajikistan and 0 for all other countries.*

[c] *Significant at 13% level.*

The best explanatory power, however, is exhibited by the index that is computed as the ratio of the rule of law index to democracy index: 83% of all variations in output can be explained by only three factors – pre-transition distortions, inflation, and rule-of-law-to-democracy index (table 2, equation 2). If liberalization variable is added, it turns out to be statistically insignificant and does not improve the goodness of fit (equation 3). At the same time, the ratio of the rule of law to democracy index and the decline in government revenues are not substitutes, but rather complement each other in characterizing the process of the institutional decay. These two variables are not correlated and improve the goodness of fit, when included together in the same regression: R^2 increases to 91% (equation 5) – better result than in regressions with either one of these variables. The liberalization index, when added to the same equation, only deteriorates the goodness of fit, is not statistically significant, and has the "wrong" sign.

This latter conclusion still remains most controversial – the emerging consensus today, if any, seems to be that performance is largely determined by the institutional capacity (the factor that was overlooked in the earlier debates), but economic liberalization still matters a great deal (Havrylyshyn and van Rooden, 2003). The theoretical argument in favor of the positive impact of liberalization on performance is quite strong: market economy should be more efficient than the centrally planned economy, so there is a "marketization dividend" to be reaped, and the faster economic liberalization occurs, the better should be the performance. However, there are a number of obvious facts that do not fit into the scheme.

First, China – the only country that carried out classical gradual transition (with slow deregulation of prices – dual track price system) outperformed impressively all other transition economies, and of course Chinese example is too important to ignore. *Second*, the comparison of Vietnam and China - two countries that shared a lot of similarities in initial conditions and achieved basically the same results (immediate growth of output without transformational recession) despite different reform strategies. While Chinese reforms are a classical example of gradualism, Vietnamese reformers introduced Polish style shock therapy treatment (instant deregulation of most prices and introduction of convertibility of dong) even before Poland did, in 1989, and still managed to avoid the reduction of output[4]. *Third*, differing performance of the former Soviet Union (FSU) states. The champions of liberalization and stabilization in the region were definitely Baltic states (cumulative liberalization index by 1995 - 2.4-2.9), whereas Uzbekistan (with the same index of 1.1) is commonly perceived to be one of the worst procrastinators. But in Uzbekistan the reduction of output in 1990-95 totaled only 18% and the economy started to grow again in 1996, while in the Baltics output fell in the early 1990s by 36-60% and even in 1996, two years after the bottom of the recession was reached, was still 31% to 58% below the pre-recession maximum.

Political economy of transition. The criteria for the success or failure of a particular strategy of transition was not always linked to the dynamics of output, income and welfare after reforms. A huge importance was attached by the interested parties in post-communist countries and in the West to the "victory of capitalism and democracy", elimination of communism and to irreversibility of reforms (Kolmorgen, 2007).

The conventional wisdom before transition tended to identify reform with liberalization and even suggested that democracy may threaten the reform process (Pickel, 1993). The implicit assumption was that deregulation and greater marketization (liberalization and reform) should inevitably lead to greater efficiency in the allocation of resources, and hence will necessarily increase the total welfare in the long run. In the short-term, however, it was understood that reforms can cause considerable losses for certain groups of the population and thus provoke resistance to reform. It was therefore suggested that reforms should be implemented quickly (shock therapy), before the pain of reforms generates opposition that makes further reforms politically impossible. In fact, one of the major justifications of shock therapy was the belief that reformers have a narrow window of opportunity – if they were not able to capitalize on the reform momentum, the democratic process would finally allow the losers to gain strength and stall the reforms. "The concentration of political power, limited political competition and rapid implementation enhance the prospects of the adoption of economic reforms", – this is how the conventional wisdom was summarized in the 1999 EBRD Transition report (EBRD, 1999, p.102). This conventional wisdom emerged mostly from the analysis of the reform experience in developing countries.

Nothing of this sort seemed to have happened in transition economies. First, as was argued earlier, the pace of reforms did not have a significant impact on performance, which was determined mostly by initial conditions, by the institutional capacity of the state, and by how prudent macroeconomic policy was. Countries lagging behind the front-runners (in terms of liberalization) in many cases did better than most advanced reformers. Land has never been neither privatized nor traded in China during the reform period, but agricultural output grew faster than in other transition countries.

Secondly, and surprisingly, the pace of reform/liberalization turned out to be higher in countries

with stronger democratic institutions, less stable governments, frequent elections and changes of governments. While reforms in East European countries were initially carried out by non- communist parties, later, when opposition communist-successor parties came to power, they did not reverse the reforms and sometimes even did not slow down the pace of liberalization. The Transition Report (EBRD, 1999, chapter 5) provides evidence that there is a positive correlation between the reform index on the one hand and the dissolution of political power on the other. Countries with limited executive power (limited authority of the president and/or the prime-minister), with governments based on coalitions rather than on a firm parliamentary majority, with the frequent changes of governments (short average tenure of governments), and with higher level of democracy in general were also ahead of others in terms of the speed of economic reforms. Hellman (1998) examines the cases in which reforms got stuck and concludes that the frequency of elections actually helped to push reforms forward. The more elections the country had, the better were the chances to re-ignite the reforms. Dethier, Ghanem and Zoli (1999), using panel data from 25 post-communist countries, argued that democracy facilitates economic liberalization. While the way the causation runs is still disputable, there is little doubt that economic liberalization and democratization in post-communist countries were going hand in hand (Castanhiera, Popov, 2002) .

Conclusions

Economic performance (growth or decline) in transition economies did not depend on the speed of liberalization and privatization at the initial stages of transformation. The debate between shock therapists and gradualists that centered on the issue of the pace of liberalization overlooked the crucial importance of institutions for economic growth. The magnitude of the decline (transformational recession) was determined mostly by the initial conditions (distortions in industrial structure and trade patterns), by the weakening of the institutional capacity of the state, and by the better or worse macroeconomic and industrial policies. On all three counts most FSU countries fell behind EE states and hence experienced poorer performance.

The weakening of the state institutional capacity was especially pronounced in*illiberal democracies* - countries with poor tradition of the rule of law (CIS) undergoing rapid democratization. In this sense early democratization incurred high economic and social costs and was detrimental to growth, since it limited the ability of the poor-rule-of-law-states to ensure property rights, contracts and reasonable business climate and order in general.

With respect to more traditional issues of the reform process (industrial policy and macroeconomic stabilization) post-communist FSU countries do not appear to be unique – traditional theories of the political economy of reform seem to be perfectly applicable. The CIS model of economic transformation appears to be close to the Latin American one: weak state, unable neither to eliminate redistribution in favor of inefficient enterprises and sectors of the economy, nor to carry out this redistribution openly, and thus resorting to hidden redistribution (inflation tax, debt financing, price controls, overvalued exchange rate, accumulation of non-payments by non-competitive industries).

Footnotes

[1] In some transition countries markets under central planning were in relative balance (prices were set by the state at a roughly market clearing level), so after deregulation there was no major price hike (inflation in the 1990s mostly stayed at low double digit level) and stabilization was not really carried out (Czechoslovakia, Hungary).

[2] China and Vietnam did not carry out massive privatization of the existing state companies, but promoted rapid growth of non-state private, cooperative and communal (township and village) enterprises, so in about a decade non-state sector became larger than the state sector.

[3] For a larger sample of countries (all developing and developed countries, not only transition economies), the result is that there is a threshold level of the rule of law index: if it is higher than a certain level, democratization affects growth positively, if lower – democratization impedes growth (Polterovich, Popov, 2005). For the regressions reported in table 1 (to explain changes in output in 1989-96) averages of rule of law and democracy indices were used for the longer period (1989-98) to account for the fact that business agents often anticipate changes in business climate that are captured in experts' estimates only later.

[4] While Vietnamese industry, excluding constantly and rapidly growing oil production, experienced some downturn in 1989-90 (-6% in 1989 and 0% in 1990) agricultural growth remained strong, so that GDP growth rates virtually did not fall (5-6% a year).

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