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summary

A decade of postcommunist transformation has brought widely differing outcomes to the countries of the former Soviet bloc, ranging from fairly normal market economies to state-owned and state-controlled economies.

These economic systems and their performance have directly resulted from the policies the countries pursued. No country has suffered from too radical reforms—liberalization, stabilization, and privatization have driven growth. The main problem limiting growth in countries with gradual or no reforms is the rent seeking caused by transitional market distortions.

Countries with more effective democracies have produced better market reforms, because the voices of liberal market reformers are more likely to be heard in the struggle with the rent-seeking elite, who would continue attempting to make money on the transition. ■

Building Capitalism: Lessons of the Postcommunist Experience

Anders Åslund

Senior Associate, Carnegie Endowment for International Peace

A decade ago, communism foundered throughout the former Soviet bloc. From Prague to Vladivostok, 21 countries of the former Soviet Union and in Eastern Europe abandoned similar political and economic systems. Their simultaneous transformations to new systems offers a unique opportunity to compare their outcomes quantitatively and thereby establish which reforms are most important and which prescriptions are not very helpful or even counterproductive.

Outcomes have varied greatly, in terms of economic system, dynamism, and return to economic growth. Three trajectories of economic reform and performance are apparent:

■ Radical reformers (in Central Europe and the Baltic states) have built democratic and dynamic market economies.

■ Gradual reformers (Bulgaria, Romania, and most former Soviet republics) have only achieved semidemocratic, semiprivatized rent-seeking societies with limited growth.

■ Nonreformers (notably Belarus, Turkmenistan, and Uzbekistan; Azerbaijan and Tajikistan are border cases) have maintained firm dictatorships with state-controlled economies and dominant public ownership.

A Great Divide

These contrasting outcomes can be explained by regimes having different goals of transition. Although the dominant slogans were to build democracy, a market economy, and the rule of law, postcommunist countries in fact followed three starkly different policy paths. Radical reformers really wanted democracies and dynamic market economies. At the other end of the spectrum, a few autocrats desired little but to consolidate their power. In the middle, countries pursued policies imposed by dominant elites who wanted to make themselves wealthy on the market distortions of the transition. The fate of a country has been determined by the purpose of the policy pursued.



Anders Åslund is a senior associate at the Carnegie Endowment. He is an internationally recognized specialist on postcommunist economic transformation, especially in Russia and Ukraine, and has served as a senior economic advisor to the governments of Russia, Ukraine, and Kyrgyzstan. Dr. Åslund was previously a professor at the Stockholm School of Economics. He earned his doctorate from Oxford University (St. Antony's College).

Dr. Åslund's books include *Building Capitalism: The Transformation of the Former Soviet Bloc* (Cambridge University Press, 2001), *How Russia Became a Market Economy* (Brookings Institution, 1995), and *Gorbachev's Struggle for Economic Reform* (Cornell University Press, 1989). He has published widely in periodicals including the *Financial Times*, *Foreign Affairs*, the *New York Times*, and the *Washington Post*.

The Endowment's Russian and Eurasian Program is a premier policy research center on the former Soviet Union. The program's Carnegie Moscow Center was the first such facility in the region.

Differences in preconditions also matter. It is frequently asserted that the closer a country is to Western Europe, the more successful it has been. By and large that is true, but there are exceptions. History, culture, and the closeness of relatively open markets have undoubtedly been important for the achievements of the countries in Central Europe and the Baltic states that are poised for accession to the European Union. But Bulgaria and Romania have not benefited much from their Western location. Kyrgyzstan went through a democratic metamorphosis in 1990, emerging as a progressive reformer despite its very remote location in Central Asia, whereas far to the west, Belarus has been a laggard in all reforms.

Exaggerated Output Collapse

Before examining the specific results of the three different reform paths, it is important to dispose of a widely believed myth. According to official statistics, the region has suffered from a universal collapse of output. In the Commonwealth of Independent States, official output slumped by 46 percent of gross domestic product (GDP) from 1989 to the nadir in 1998, and even in Central Europe the recorded contraction amounted to 17 percent from 1989 to the lowest point in 1992. As we would expect, the radical reformers have seen the least decline in output and the healthiest growth. However, it is somewhat surprising that the partial reformers have performed worse, according to official statistics, than the nonreformers.

But most of this drop in output is a statistical aberration. Much of what communist economies produced was of little or no value. Few Soviet consumer goods were of acceptable quality at any price; wasteful socialist industry used several times more inputs than capitalist industry to produce the same physical volume of output; and much of the vast "investment" amounted to little but waste and theft, because no incentives favored efficiency. For East Germany, real output under communism is now assessed at only half of the level previously

estimated by West German experts. A similar situation prevailed throughout the region, and the production of goods of no real value has been reduced only gradually. As the partial reformers have done away with such waste, their official output has fallen more than the nonreformers'. Moreover, unmeasured real output rose sharply after communism, as people started avoiding new high taxes, especially in half-reformed countries. As a result, we may never learn how much real output fell, if it fell at all.

The timing of a return to growth and its size appear to be more relevant measures. The early star performer, Poland, has enjoyed high and steady growth since 1992, and it has been followed by other Central European and Baltic states. From the mid-1990s, a rather unexpected group—Armenia, Georgia, and Kyrgyzstan—did very well; all are poor countries with late but substantial reform. In 2000 and 2001, most countries of the Commonwealth of Independent States have been booming. Their growth started in oil and gas production with rising oil prices in 1999, but late in the day, countries such as Russia and Ukraine have undertaken truly radical reform, which is now driving high growth.

It must be admitted that even in nonreforming states, notably Belarus, official growth rates have recovered, but they have done so by pumping up obsolete Soviet industry through protectionism and state subsidies, and the old communist exaggeration of output persists. Eventually, freer markets will show that these noncompetitive goods do not enjoy any demand. Thus, these nonreforming countries are postponing, not avoiding, the costs of transformation.

Reform Breeds Growth

Many economists have undertaken ambitious multicountry regression analyses (see sources, p. 7). Although statistics remain dubious, real growth is closely correlated to the degree of systemic reform (see figure 1). Most serious reformers carry out many reforms simultaneously, making it difficult to discern the effect

of any single policy change. To the degree that different measures can be disentangled, liberalization, especially of prices and foreign trade, appears to have had the greatest impact. Also, inflation needs to fall below 40 percent a year to allow growth, and privatization is unequivocally beneficial. Countries that pursue such sound economic policies undertake more institution building than less ambitious reformers, so the idea that governments have to choose between good economic policy or institution building because of limited policy capacity is just wrong.

Regression analyses confirm that the ideal market reform is as radical as possible. No country appears to have suffered from excessively radical reform. Only one radical reformer has been reversed (Bulgaria in 1992), but several gradual reformers have been (Belarus, Uzbekistan, and Ukraine), suggesting that radical reform most easily becomes irreversible as a critical mass of market reform is attained.

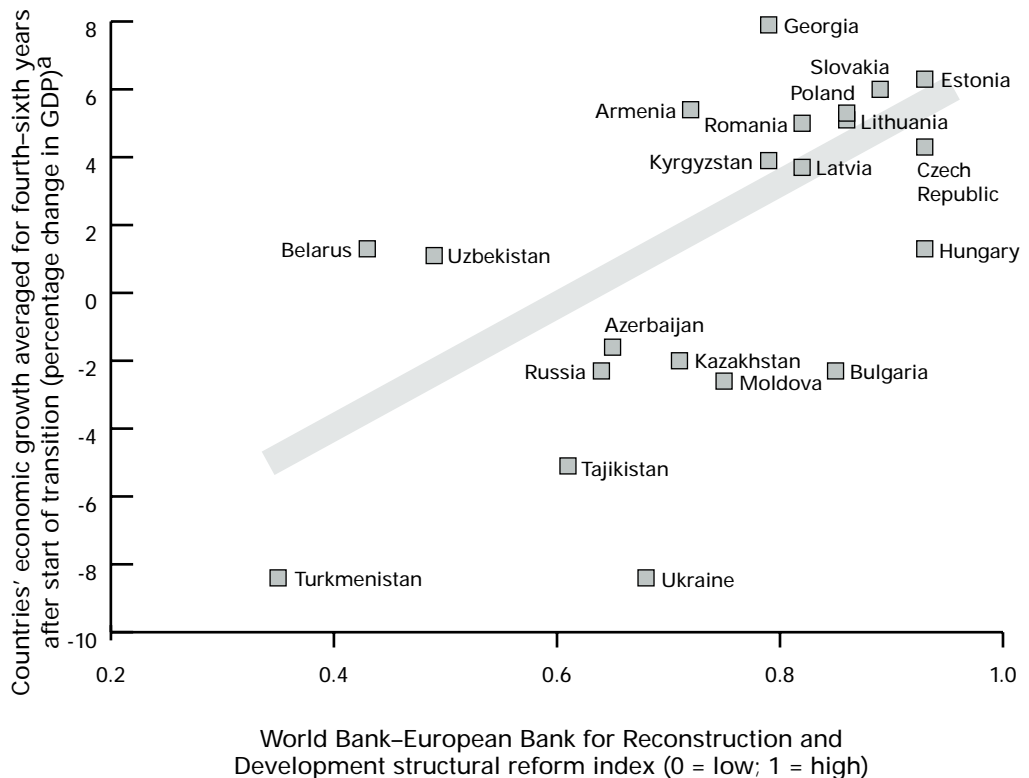
At the beginning of the transition, self-styled Keynesians argued that output was falling because of a lack of demand. Consequently, they advocated large public budget deficits and monetary emission. Liberal reformers took the opposite position, calling for a profound restructuring of production to allow human and physical capital to produce more useful things and to do so efficiently. Therefore, they favored a full liberalization of domestic and foreign trade, but strict fiscal and monetary policy to force enterprises to restructure because of hard budget constraints. Today, the evidence is overwhelming that the liberalization of supply has generated growth, whereas

the stimulation of demand has depressed production. Postcommunist growth has invariably been export led.

Fiscal Rigor Is Vital

The fiscal discussion has been dominated by the purported need to maintain state revenues and expenditures; in reality, balanced state budgets and smaller public involvement have driven economic growth. Although state revenues have shrunk, they have stayed far too high in relation to these countries' level of economic development. In 1999, total state revenues were still 42 percent of GDP in Central Europe, approximately the level of Western Europe. These countries have become, in János Kornai's words, "premature

Figure 1
Correlation between GDP Growth and Structural Reform, Former Soviet and Eastern European Countries



^aThese years are considered to be 1993–1995 for Hungary and Poland; 1994–1996 for Bulgaria, Czech Republic, Romania, and Slovakia; and 1995–1997 for 15 former Soviet states.

Sources: European Bank for Reconstruction and Development, press release, April 22, 2001; Anders Åslund, *Building Capitalism: The Transformation of the Former Soviet Bloc* (Cambridge University Press, 2001), table 5.1.

social welfare states,” with excessive taxes and social transfers impeding economic growth. No country in transition has small public revenues by international standards, and everywhere these revenues make up a greater share of GDP than in Hong Kong.

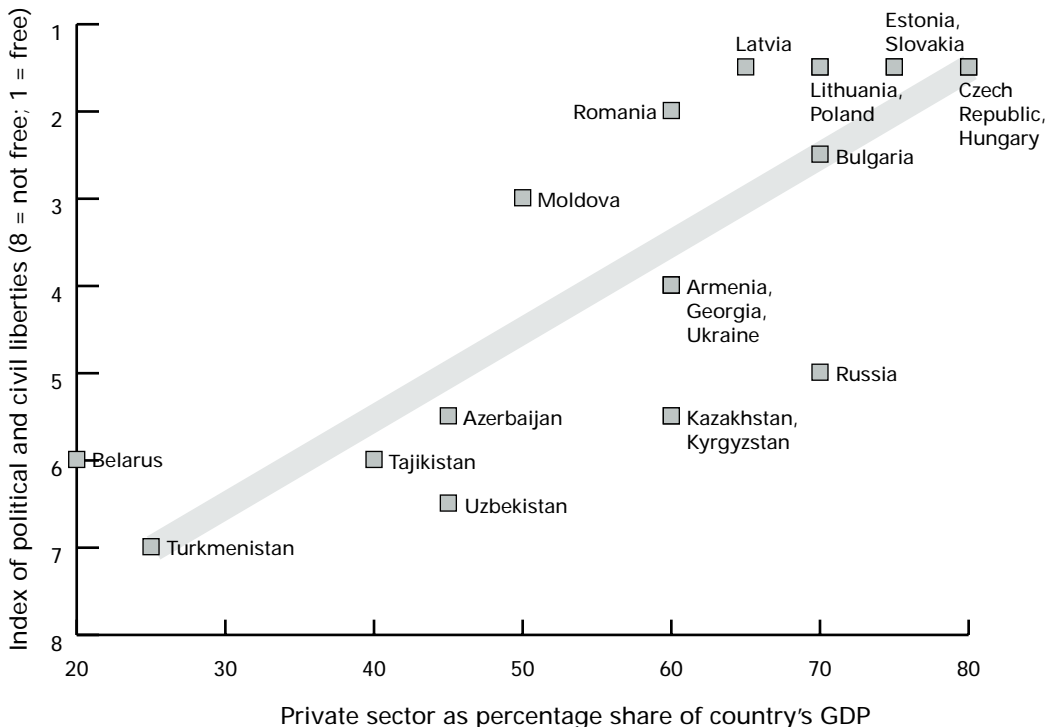
The worst fiscal problems have been a combination of high taxes paid by few, an inordinate expansion of a lawless bureaucracy indulging in extortion, and excessive enterprise subsidies. High taxes and extortion suppressed honest entrepreneurs, whereas dishonest businesspeople benefited from large subsidies. This predicament depressed growth in countries such as Russia and Ukraine until 1998, but these problems are now easing. After a substantial reduction of public expenditures following the financial crisis of 1998, economic growth has recovered in the

Commonwealth of Independent States.

If a state administration is severely corrupt, economic growth naturally requires that both the number of harassing bureaucrats and their powers be diminished. In spite of strong resistance from entrenched bureaucracies, this is slowly happening in many countries. Because of a broad popular understanding that public means have been blatantly misappropriated in the former Soviet Union, the state budgets of these countries are dwindling further than in Central Europe. The current fashion in former Soviet states is radical tax reform, with a sharp reduction in the number of taxes, low flat personal income taxes of 10 to 20 percent, low corporate-profit taxes, lower payroll taxes, and small fixed lump-sum taxes for individual entrepreneurs. With lower tax rates, tax collection has actually risen, and the gains extracted through corruption have sharply declined together with lawless state intervention.

Figure 2

Correlation between Democracy and Privatization,
Former Soviet and Eastern European Countries, 2000



Sources: Freedom House, *Freedom of the World 2000–2001*, pp. 655–656; European Bank for Reconstruction and Development, *Transition Report 2000*.

Privatization Is Better than Its Reputation

Privatization has been the most controversial reform, because it is a conspicuous distribution of wealth, and all vie for a larger piece of the action. Regression analyses unequivocally show that privatization is good for growth. This conclusion has not been fully understood, largely because of simplistic comparisons between Poland and Russia. Poland undertook most of its reform early but expanded its already large private sector only gradually, whereas Russia carried out little reform apart from privatization. The not very logical conclusion has been that privatization is bad, although the Polish private sector was hardly

ever smaller than the Russian private sector, and Russia's problems were largely the result of corruption, not privatization.

A comparison of Russia, Ukraine, and Belarus, very similar East Slavic states, is more revealing. Ukraine tried to privatize in a different fashion from Russia, but its privatization took off only when it followed Russia's example of mass privatization through vouchers distributed freely to the whole population. Yet the quality of Ukrainian privatization suffered from this delay, which contributed to more ownership going to managers and corporate governance becoming weaker. Only in 2000, when Ukraine's private sector contributed about 60 percent of GDP, did that country return to economic growth. By contrast, Belarus has privatized little, which has contributed to the reestablishment of a state-controlled economy and a full-fledged dictatorship.

Privatization is vital not only for enterprise restructuring but also for a market economy and democracy. The correlation between democracy and privatization is strikingly close, because political and economic pluralism naturally go together (see figure 2). In the short term, however, privatization might be less important for enterprise performance, because even state-owned enterprises can cut costs. The quality of privatization—meaning clearer property rights, better corporate governance, and greater transparency—does not appear to improve until private enterprises reach a critical mass accounting for close to two-thirds of GDP.

The Economic Supremacy of Democracy

The main problem of postcommunist transformation has been politics rather than economics, because policy choices have largely been determined by the goals of ruling groups. The right course of economic action has long been broadly understood, but a small elite has often chosen economic policy to its own advantage, at great social cost. Liberal reformers wanted normal democracy and a

market economy, but in most countries the ruling elite preferred to make money from state subsidies and regulation rather than from profit in competitive markets. This elite wanted freedom for itself but draconian state regulation for the population at large.

The political goal of market reform is to impose the interests of the majority on the small rent-seeking elite, which amounts to a transition from dictatorship to democracy. Conversely, the main drama of the postcommunist transformation has been a struggle between radical market reformers and rent seekers, and the containment of rent seeking has been the chief reform task. Regression analyses provide a strong positive correlation between democracy, on the one hand, and market reform and economic growth, on the other (see figure 3).

A common belief is that a country in transition needs a strong ruler. The benefits of a benevolent despot, such as General Augusto Pinochet in Chile or a Chinese Communist leader, remains a common myth in the former Soviet bloc. In reality, dictators in the region have almost invariably favored the corrupt elite. Considering the vast role of the state and the persevering communist elite, dictatorship is likely to stay economically harmful.

Reform and growth have benefited from political competition, whereas political instability has been a surprisingly minor worry in the former Soviet bloc. The most successful reformers have weak presidential powers and strong parliaments, which is natural because a parliament can scrutinize a government closely but can do much less to supervise a powerful president. Parliamentary systems bring about more transparency and more checks and balances. Accordingly, parliamentary rule has been both more democratic and better for economic reform than presidential rule.

Contrary to common belief, people have voted more for radical reform than for gradual reform, notwithstanding that democratic governments are often thrown out. It is sur-

prising that even government instability benefits reform. Poland, the three Baltic states, and Bulgaria have had the most unstable governments, shifting on average every year, and the first four of these countries have been leading reformers. It is also surprising that coalition governments have turned out to be more effective reformers than one-party governments. The explanation appears to be that parties in a coalition government are both capable of and interested in controlling one another, which leads to more transparency with stronger checks and balances. Similarly, labor protests and strikes are also useful checks on the elite.

Evidently, China has managed to undertake substantial market reform in spite of

remaining a dictatorship, and several factors can explain this difference. The most obvious point is that the Chinese government controls little state revenue, meaning that less money can be diverted by the state. Moreover, China—with its comparatively low level of economic development—suffered from much less economic distortion than countries of the former Soviet bloc. Ultimately, the Soviet state collapsed, but the Chinese state did not.

Shock Therapy Works

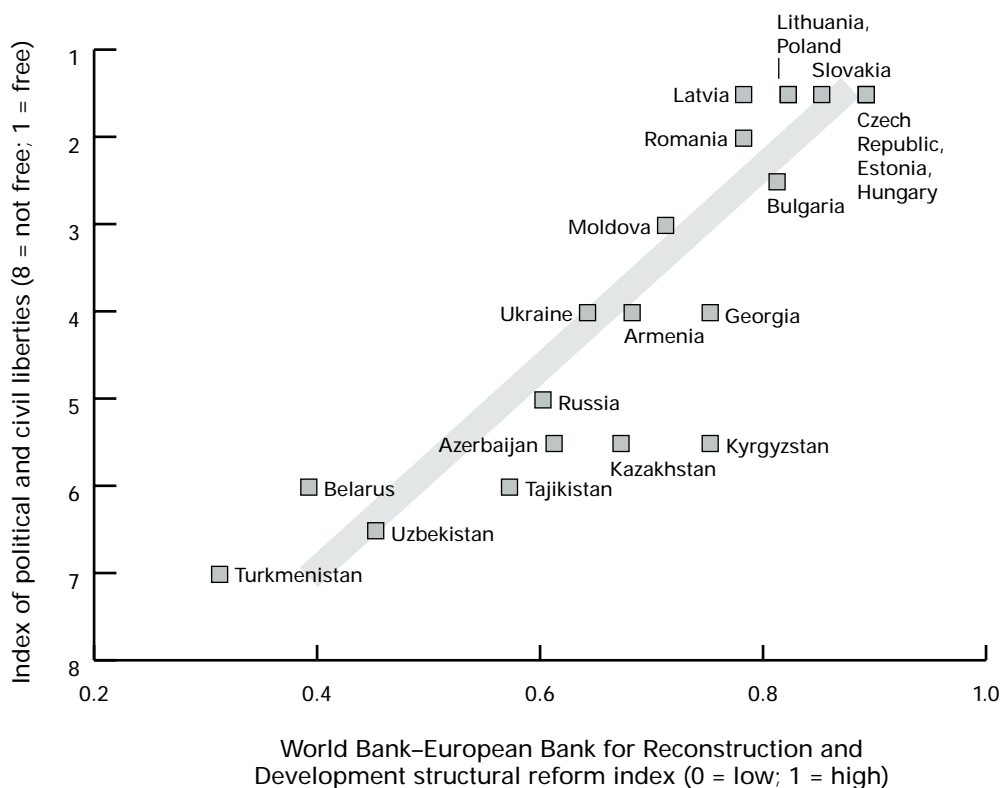
Nearly all postcommunist countries started to reform in the midst of a severe economic crisis. Their initial choice of the path of reform has left its mark for years to come. Profound

changes do occur, but generally reform receives a new chance only after a severe crisis, typically a rampant financial crisis, as in Bulgaria in 1996 or Russia in 1998; Ukraine opted for a radical reform in 2000, after having been on the verge of external default.

After deliberate designs to impose hard budget constraints have proven impotent, financial crises can enforce stringency on both governments and enterprises. These shocks have broken up rent-seeking societies by discrediting crony capitalism and its advocates. A sharp disruption, or a shock, has been needed to break the harmful inheritance of communist management, mentality, lawlessness, and kleptocracy. The results have been a more rigorous fiscal regime, further liberalization, and privatization. Renewed reform has enabled countries in crisis to break out of the trap of too little reform and move toward sustained economic growth. Given the depth

Figure 3

Correlation between Democracy and Market Reform, 2000



^aThese years are considered to be 1993–1995 for Hungary and Poland; 1994–1996 for Bulgaria, Czech Republic, Romania, and Slovakia; and 1995–1997 for 15 former Soviet states.

of communist distortions of both the economy and minds, not one but two severe shocks seem a common prerequisite for successful market reform, as was the case in Bulgaria, Poland, and Russia.

Exaggerated Social Costs

Few aspects of the transformation from communism have been as misrepresented as the social costs. Incomes and consumption have been systematically understated even more than output in official statistics. Most have forgotten the hardships of communism, with shortages of nearly everything, eternal lines, and the compulsion to buy things that one did not want. Now food and medicines are available, though at a price.

The share of GDP allocated to social expenditures, especially to pensions, has risen sharply across the whole region. Even so, retirees have been the most dissatisfied, because they have found it difficult to adjust to a new social and economic system. This is a matter of conservatism rather than social suffering. Education and health expenditures have also increased as a share of GDP in most countries, while child and family allowances have suffered.

In all except a few countries in transition, the social sector is not suffering from a lack of resources (relative to GDP, in comparison with other countries at that level of economic development) but from inefficiency. The badly needed reform of social delivery systems is lagging. The much discussed decline in male life expectancy appears to be a cultural peculiarity of Baltic and East Slavic males, who suffer from increased alcohol consumption and a poor ability to handle the stress of systemic change. It is gender specific, and it is absent in the Caucasus where suffering is much worse, whereas male life expectancy has fallen as much in successfully reforming Estonia as in nonreforming Belarus. Throughout the region, the previously high infant mortality rate has plummeted,

reflecting improving health standards. Overall, the social situation has improved after a temporary setback during the early transition. A true concern, however, is that inequality has increased greatly to a U.S. level in partially reforming countries and poverty has worsened in poor countries, while inequality has risen—though only to a Western European level—in the radically reforming Central European countries and Baltic states.

Undertake Radical, Early Reform

The conclusion that can be drawn from post-communist transformation is that it is virtually always preferable to undertake the most radical and earliest economic reform that is possible. Worries about precipitate falls in output or political destabilization resulting from aggressive reform have not been substantiated. True, developing countries with distorted economies and remote locations have found it more difficult to undertake radical economic reform, but the more reform they have undertaken, the better off they have become.

It is evident that much of a country's future development depends on its government's initial choice of a reform path. In countries that have launched little or no reform, strong vested interests thriving on rent seeking have blocked further reform. Usually, a major financial or political crisis has been required to shake a country out of such an undesirable equilibrium. Nothing suggests that any of the countries in transition will be unable to adopt a market economy in the future. ■

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Sources on Multicountry Regression Analysis

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