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The Political Economy of Transition

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Political economy arguments have been at the heart of debates and controversies on strategies of transition from socialism to capitalism. For example, advocates of a "big bang" approach to transition have argued for a fast and comprehensive implementation of all major reforms. Speed was of the essence, they argued, because there was a "window of opportunity" (or a "honeymoon period" or a "period of exceptional politics") created by the establishment of democracy. During this period, they argued, governments should seek to adopt reforms as fast as possible (for example, Lipton and Sachs, 1990; Balcerowicz, 1995) and attempt to create irreversibility for these reforms (for example, Boycko, Shleifer and Vishny, 1995).

On the other side, those who opposed the big bang approach often advocated a gradualist strategy, which emphasized the need for a precise sequencing of reforms. The political economy argument in favor of gradualism was that an appropriate sequencing of reforms would provide demonstrated successes to build upon, thus creating constituencies for further reforms (for example, Dewatripont and Roland, 1992a, b, 1995; Wei, 1997; McMillan and Naughton, 1992; Litwack and Qian, 1999). In China, the success of decollectivization built support for later reforms. Similarly, it was thought that in central and eastern Europe successful entry of small and medium enterprises could build support for later reforms in the state sector.

Political economy arguments, along with being used in the context of the pace

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and sequencing of reforms, have also been used extensively to explain or to justify many aspects of the transition process. For example, mass privatization, involving the giveaway of state assets to citizens (as in the Czech Republic) or to workers (as in Russia) was designed to overcome political constraints to transition (Svejnar, 1989; Weitzman, 1991; Boycko, Shleifer and Vishny, 1995; Shleifer and Treisman, 2000; Roland and Verdier, 1994; Schmidt, 2000; Biais and Perotti, 1998). To take another example a little further afield, China implemented "dual-track liberalization," under which plan contracts between enterprises are maintained but frozen at a preexisting level, and price liberalization is implemented "at the margin" for any production beyond the planned contract. The political economy argument for dual-track liberalization is that it was a way to liberalize prices without eliminating preexisting rents of economic agents (Lau, Qian and Roland, 1997, 2000).

Political economy arguments have also been used to explain the striking difference in economic performance across transition countries. While all transition economies experienced a fall in output at the start of the process, most countries in central and eastern Europe recovered growth after a few years, while Russia and most former Soviet Union countries (apart from the Baltic states of Estonia, Latvia and Lithuania) saw little or no recovery of growth through most of the 1990s. One political economy argument often made is that the extent of state capture and rent seeking was much more important in former Soviet Union countries than in central Europe and that this difference goes a long way in explaining differences in output performance (EBRD, 2000; Hellman and Shankerman, 2000).

Another political economy argument suggests that central European countries were expected to access the European Union, which enhanced incentives to create patterns of law enforcement, law compliance and protection of property rights, while in former Soviet Union countries, where prospects of accession to the EU are virtually nil, no such incentives existed (Roland, 1997; Roland and Verdier, 1999).

The overriding importance of political constraints in the transition process has led to developments of the theory of the political economy of reform (for surveys, see Dewatripont and Roland, 1995; Roland, 2000). What are the main insights from that theory? How does it reflect the transition reality? What have we learned, and what do we still need to learn? The present article will attempt to answer those questions.

The theory of the political economy of transition belongs to a more fundamental trend in economic research in recent years to integrate the political process into the analysis of economic problems. Political economy issues are being introduced and analyzed in all areas of economics: trade, macroeconomic policy, regulation, public finances, financial economics, labor and others. The tools of game theory developed over the last decades now allow the research to integrate the analysis of economic and political processes using unified tools of analysis. For example, two recent graduate textbooks by Persson and Tabellini (2000) and Drazen (2000) discuss this impressive synthesis.

The Theory of the Political Economy of Transition Reforms

The literature on the political economy of reforms identifies two broad strands: normative and positive. The normative political economy of reforms focuses on the decision-making problem of reformers (not necessarily welfare-maximizing ones) subject to political constraints. Models in this literature make broad use of the "agenda-setting hypothesis," according to which the executive branch of government has monopoly power over the design and sequencing of reform packages that are put to vote in the legislature or in a popular referendum (McKelvey, 1976; Romer and Rosenthal, 1979). These models allow no amendments to the proposed reform packages, so that the reform can be viewed as a take-it-or-leave-it offer made to the voters.[1] One then tries to derive general principles on what sort of reform package should be proposed.

In contrast, the literature on the positive political economy of reforms attempts to analyze the clash of interest groups. The focus is less on deriving policy recommendations than on trying to understand the evolution of the balance of power across countries and across time. In the transition context, the positive analysis of reforms has been somewhat less developed than the normative analysis.

Normative Political Economy: Enacting Reform and Keeping Reform

Reformers face two types of political constraints. One set of political constraints are feasibility constraints, called ex ante political constraints, that can block decision making and prevent reforms from being accepted. The second set of political constraints, called ex post political constraints, are related to backlash and policy reversal after reforms have been implemented and outcomes observed (Roland, 1994).

The ex ante and ex post political constraints will be effectively the same, except in the presence of uncertainty and reversal costs. In the presence of uncertainty, particular reforms may be opposed by a majority before being enacted, even though those same reforms would end up benefiting the majority and would not be reversed if implemented (Fernandez and Rodrik, 1991). Thus, the resolution of uncertainty along the reform path can shift the majorities in favor or against reforms, an insight that plays an important role in designing a politically feasible sequence of reforms. Reversal costs typically make it harder to enact a reform, since when the reform is enacted, turning back will be costly. Thus, reversal costs increase the ex ante constraints on reform but reduce the ex post constraints.

Uncertainty and reversal costs often work together. This will especially be true if there is *aggregate uncertainty* about the reform outcomes. Individual uncertainty arises when there is uncertainty about the identities of winners and losers of reform.

[1]The agenda-setting hypothesis stands in contrast to the approach to competitive voting associated with the work of Anthony Downs, where policies are proposed by competing candidates. The agenda-setting hypothesis avoids problems of cycling in voting (and absence of equilibria) when the policy space is multidimensional.

Aggregate uncertainty means there is also uncertainty about the economy-wide effects of given reform programs—say, whether the overall effects will be positive or negative. When aggregate uncertainty is important, high reversal costs make people more reluctant to accept reforms that may turn out to give disastrous outcomes and moreover be hard to reverse. The political economy of reform can be viewed as an issue of how to get reforms enacted in the first place, which involves relaxing the ex ante political constraints, and then how to have the reforms stay in place, which means relaxing the ex post political constraints.

How to Relax Political Constraints So That Reforms Can be Enacted

There are four possible strategies for easing political constraints so that reforms can be enacted: a) building reform packages that give compensating transfers to losers from reforms; b) making reforms only partial to reduce opposition; c) creating institutions that make credible a commitment to compensating transfers; or d) waiting for a deterioration of the status quo to make the reform more attractive. We will discuss each in turn.

Giving *compensating transfers* to losers from reform to buy their acceptance is an obvious way to help in enacting a reform. But in the real world, and in the transition economies, such transfers can be difficult to enact.

A first difficulty with compensating transfers is that redistributive transfers must be financed by collecting revenues, which usually involves distortionary costs. These distortions can be especially high in countries with chronic budget deficits where government must resort to inflationary taxation to finance given expenditures. In the transition context, fiscal administrations are relatively inexperienced (after all, they did not exist under communism), and enforcement of tax collection is low.

A second difficulty with compensating transfers involves asymmetric information about the losses from reform (Lewis, Feenstra and Ware, 1989; Dewatripont and Roland, 1992). Take the case where political acceptability must be gained for closing an enterprise, thus laying off all its workers. Some of these workers expect to find jobs easily and will not lose much from redundancies, whereas others will have a much harder time and will need to be compensated more heavily to accept being laid off. But if one cannot tell which worker is in which category, then all workers would have to be paid high compensations, because they are indistinguishable and because workers with lower exit costs have an incentive to pretend they have high exit costs. The cost of those compensations would be much higher than in the absence of asymmetric information, and workers with low exit costs would gain high rents. Given this problem of imperfect information, a common outcome is a partial layoff in which workers with the highest exit costs can keep their jobs.

A third difficulty with compensating transfers is related to weak commitment power of decision makers. If decision makers cannot credibly commit to a continuous flow of transfers to losers from reform, they will not be able to secure the political acceptance of the losers unless they are given today the net present value

of future compensating transfers, which is likely to be infeasible due to the short-term budget (and borrowing) constraints faced by governments. Weak commitment power is related to the fact that the coalition in power today cannot commit future coalitions to continuation of given policies. Numerous efficiency-enhancing reforms are blocked because the proposed accompanying transfers are not credible enough. A vivid example is reform of the European Common Agricultural Policy, where a move from price support to income support has been blocked for a long time by farming lobbies for fear that income support could easily be discontinued in the future. In the transition economies of central and eastern Europe, securing political acceptance to restructuring measures such as the devolution of social assets or large-scale redundancies can be facilitated if there is enough credibility for a social safety net providing enough compensating transfers—but such credibility is difficult for newly installed governments in tumultuous times to provide.[2]

Partial reform, usually in the framework of a gradualist strategy, has some clear disadvantages. It yields lower efficiency gains than a complete reform. There may be losses of complementarities between reforms. It does not resolve all uncertainty about future outcomes and thus yields less learning about the future. Indeed, at an extreme, partial reform may even end up being pure noise, chaotic and disorganizing, yielding lower outcomes than under the status quo and zero learning about the consequences of a complete reform.

However, partial reform also has several potential advantages over full reform. It is less costly in terms of compensation payments to losers. Indeed, if there is considerable heterogeneity in the distribution of losses from reform and in additional high efficiency costs of raising funds, then the gains from not needing to compensate the highest-cost losers may offset the efficiency losses of raising additional funds—and the partial reform would then have a higher level of social benefit, after taking compensation into account, than a full reform (Dewatripont and Roland, 1992).

If partial reform is less costly to reverse than full reform, political acceptability can be easier than for full reform because it provides an option of early reversal (Dewatripont and Roland, 1995). If after partial reform is implemented, a continuation toward full reform seems unattractive to a majority because the signals given by partial reform about the future are not promising enough, then it is always possible to come back to the status quo. On the other hand, if the signals given by early reform are promising enough, then the reforms can continue with greater support. Gradualism thus lowers the cost of experimenting with reform and thus makes a move away from the status quo more easily acceptable to a majority.

Partial reform can also build constituencies for further reform. This can be achieved by making the status quo less attractive. Two principles can be

[2]Compensation packages need not necessarily involve financial transfers. A number of individual reforms or reform packages may be bundled together so as to gain majority support (Martinelli and Tommasi, 1997).

distinguished here: the use of "divide and rule" tactics (Dewatripont and Roland, 1992; Wei, 1997) and the optimal choice of sequencing of reforms (Dewatripont and Roland, 1995).

To illustrate the role of "divide and rule" tactics, let us take again the example of deciding on layoffs. Assume, for example, that two-thirds of workers must be laid off in a sector of the economy and that political constraints require that restructuring plans be accepted by a majority of these workers. However, workers view their jobs as safe and valuable and intend to hang on to them. One strategy for management in this situation is to build coalitions for laying off a series of small groups without full compensation for those groups, making each group worse off. When confronted with such tactics, the status quo no longer looks so safe or attractive; it now includes the chance of suffering forced losses. With the ground prepared in this way, a majority of workers may be willing to support a restructuring plan, including those who know that they would immediately be laid off, as long as the compensation they receive is better than what they would receive if they were caught up in one of the next rounds of ongoing partial layoffs. If agents know that rejection of a current reform plan can lead to the adoption of a redundancy plan that would hurt them even more, they may prefer to accept being made redundant today at better conditions.

To illustrate the role of optimal sequencing of reforms, let us take the case of privatization. Assume that there is uncertainty about the gains from privatization. Define a "bad" aggregate outcome as one where privatization induces high unemployment levels with little investment by new owners and a negative impact on the economy. Define a "good" privatization outcome as one where redundancies are kept at a reasonable level and where new investment eventually leads to employment creation at higher wages and to growth. Assume that there are two parties, a reform party and an antireform party. Assume that the reform party holds office and only has a mandate for partial privatization, say because the constituencies of some of its elected representatives oppose full privatization. If the government starts by privatizing those enterprises having a higher likelihood of "bad" outcomes, then the resolution of uncertainty is more likely to lead to welfare losses for many and thus to build constituencies that would bring the antireform party to power after an election and thus lead to reform reversal. If, however, one starts by privatizing those enterprises with better prospects for "good" outcomes, then a positive resolution of uncertainty will build electoral support for reform continuation, giving the incumbent a mandate to widen the privatization process. Indeed, the uncertainty resolution after the initial reform step creates either losers or winners whose vote may be decisive for reform continuation or reversal. Winners from initial privatization will be more willing to support continuation of privatization, and thus reelect the incumbent reformers, than before the uncertainty resolution, even if the expected outcome for the next phase of privatization is less positive. Indeed, the positive uncertainty resolution gives them stronger stakes in opposing reversal of privatization.

Although policymakers cannot in general commit in advance to keep paying flows of compensating transfers, they can in some cases *create institutions with a commitment to transfers.* At a general level, one form of commitment is extending the voting franchise—that is, ensuring a high participation in elections of the poorer segments of the population (Acemoglu and Robinson, 2000). Since elections follow a "one man, one vote" rule and since median income is typically lower than mean income, democratic elections are an important institution for committing to transfers. While commitment to transfers can offer benefits when such transfers are needed to gain political acceptability, it obviously also entails economic costs.

In some cases, the only option for reformers is to *wait for a deterioration of the status quo* so as to gain acceptance for change. However, decision-making paralysis may occur if political decision making is characterized by a war of attrition between opposing coalitions who try to push the burden of the reforms on the other coalition (Alesina and Drazen, 1991).

How to Prevent Reforms from Being Reversed

There are some important trade-offs at work between relaxing ex ante political constraints that prevent reforms from being adopted and relaxing ex post political constraints that prevent reforms from being reversed. If one wants to reduce the chance of reforms being reversed, one should take advantage of any window of opportunity to pass important reform packages. However, a certain flexibility in allowing for reversibility of reforms is often desirable, especially when there is aggregate uncertainty. For example, the Russian mass privatization program was designed to make it hard to reverse, as assets were given away to insiders. Reversing such privatization would have created enormous political resistance. Moreover, since existing state structures were deliberately weakened in the process, the government had become too weak to engineer a reversal. However, when mass privatization was implemented, it was associated with assets being stripped from corporations for private uses, weak economic performance, strong increase in inequalities and in corruption and, last but not least, increased capture of the state by oligarchs (Black, Kraakman and Tarassova, 2000). In this case, greater reversibility, with the goal of implementing a better privatization policy, might have prevented a reduction in welfare.

More generally, however, relaxing ex ante and ex post political constraints go hand in hand. The best way to create irreversibility is often to design reform packages via adequate sequencing and compensating transfers so as to create broad support.

The Positive Political Economy of Transition Reforms

The positive political economy of reform seeks to explain differences in the extent of rent seeking and how special interests may effectively capture regulatory bodies. For example, in seeking to determine the extent and effect of rent seeking,

answers are sought in the structure of the institutions that affect the costs and benefits of rent seeking: the number of players who have an effective veto, the extent of separation of powers, whether the political regime is presidential or parliamentary, the structure of the legislature and so on.

Such analysis may be insightful in many countries where the political and legal institutions have been in existence for a long time and can be viewed with sufficient confidence as exogenous variables. But in the specific context of transition economies, the institutions themselves are a product of the transition process and must be seen as an endogenous outcome, which complicates the analysis.

Sonin (1999) has built a very insightful model of rent seeking that sheds light on many of the processes observed in transition countries. He notes that in the transition context, rich agents like the Russian oligarchs benefit from low security of property rights, since low security allows them to convert corporate and social assets to their private use. Thus, these oligarchs seek to capture government decision making to prevent reforms that would enhance security of property rights, and they can exploit economies of scale in rent seeking to do so. The insight is new in the sense that one might have thought that rich agents always favor security of property rights and that challenges to its security would come from poor agents. The model thus shows how, for political economy reasons, a high initial level of inequality in wealth and power can lead to long-lasting insecurity of property rights.

In the transition context, the question of rent seeking is thus tied to the initial distribution of wealth and power. One can argue that a high concentration of wealth and power like in Russia is the result of the mass privatization policy chosen favoring the insiders (Black, Kraakman and Tarassova, 2000; Alexeev, 1999; Polishchuk, 1999). However, the choice of the mass privatization policy itself can also be seen as the result of prior rent-seeking activities (Bolton and Roland, 1992; Roland, 1996), which raises the question of why this form of mass privatization was employed in Russia and the Czech Republic, for example, but rejected (partially or totally) in Poland and Hungary. One hypothesis that has not yet fully been explored (certainly not by economists) is the cross-country difference in the extent of preexisting civil society (Putnam, Leonardi and Nanetti, 1993) before transition. Here, for example, we see a strong contrast between the situation of Poland and that of Russia. Poland had powerful social networks, including the Catholic Church and the Solidarity trade union. But in Russia and in other countries of the former Soviet Union, hardly any social networks existed independent of the Communist Party, and dissident activity had been strongly repressed. It would be useful to investigate whether such differences can explain why former networks of oligarchs and insiders emerged as a much more powerful force in the beginning of transition in Russia as compared to Poland.

When trying to understand the positive political economy of reforms in transition countries, it is important to have a better understanding of the social and political initial conditions of reforms, which should reach beyond the economic initial conditions that have often been analyzed in the literature so far.

Lessons in Political Economy from the Transition Experience

How relevant has the theory of the political economy of reforms been in understanding the transition experience of the past ten years or so? What are the broad patterns that come out of that experience? Before looking at the economic outcomes, Table 1 reviews the experience of some transition countries with free elections and duration of government, while Table 2 offers some evidence on the number of political parties that have been active in these governments.

In general, central European countries have opted for parliamentary regimes, the main form of government in western Europe. However, most former Soviet Union countries, with the notable exception of Baltic countries, have opted for presidential regimes, usually with strong concentration of powers in the hands of the president. In such presidential regimes, party politics does not play an important role, and governments are not formed according to partisan alignment following legislative elections, but rather designed by the president. (This is why there is no information about political parties for Russia and the Ukraine in Table 2.) The difference in average time between elections reflects the time it took in various countries to stabilize the political system. Parliamentary Hungary and Slovenia have been very stable, but so has presidential Ukraine. In general, after an initial period of institution building, the time between the two most recent elections has been four years. Average government duration has, however, been in general low, with the notable exception of Hungary. Government duration between the two most recent elections has in general been longer. Note, however, that it was shorter in the Czech Republic, Estonia, Romania, Russia and Ukraine, reflecting political tensions or instability.

The average number of parties is rather normal for parliamentary democracies, though rather high in Poland. Transition governments have more often been right wing or center right rather than left wing or center left, not a surprise given that left-wing governments usually include former communist parties. Former communists have continued to play a major role in Romania and, to a lesser extent, in Bulgaria.[3]

Note finally a huge variation in the reelection of incumbents. Since most governments are coalition governments, we considered a government reelected when one of its major parties was part of the coalition formed after the election and when the main orientation of the coalition (left or right) was maintained. However, no coalition has remained the same in any transition country following elections. In the Czech Republic, the party of Vaclav Klaus, ODS, managed to survive until the most recent elections. In Romania, former communists who formed the National Salvation Front and later the Social Democratic Party have remained very powerful. Slovenia's case is different. Governments have usually been to the right of the

[3]In Slovakia, we classified Meciar's party, HZDS, as left, not exactly suitable, since it is mainly nationalist.

Table 1
Transition Countries with Free Elections

Country	Time of First Free Elections and Period Considered	Average Time Between Elections (months)	Average Government Duration	Average Government Duration Between Last Two Elections	Percentage of Reelected Governments
Parliamentary					
Bulgaria	June 1990–June 2001	31.6	21	49	20
Czech Republic	June 1990–June 1998	32	18.2	12	50
Estonia	March 1990–March 1999	36	12.9	12	0
Hungary	March 1990–May 1998	48	48	48	0
Poland	August 1989–September 2001	36.5	17.9	24	0
Romania	May 1990–November 2000	42	15.3	12	75
Slovakia	January 1993–September 1998	32.7	17.5	48	0
Slovenia	December 1992–October 2000	47	23.3	24	100
Presidential					
Russia	December 1993–December 1999	36	10.7	9.6	
Ukraine	March 1994–May 1998	48	16.4	12.5	

center, and there has been a lot of continuity between successive governments, but no single party has played a dominant role throughout the transition period.

Explaining Trends in Economic Performance

Transition economies have had different patterns of economic performance. Poland's transition path is characteristic for the central and eastern European "success stories" in transition. It experienced a fall in real GDP of about 20 percent in the two years after price liberalization started in 1989, but recovered growth rather quickly and exceeded its pretransition real GDP level after six or seven years of transition. Russia has had a prolonged output decline of about 40 percent of real GDP in the four years following the beginning of transition in 1991, and while that decline has leveled, sustained growth has yet to emerge. For comparison, when China liberalized prices in 1984, its real GDP expanded steadily and grew by almost 80 percent over the following decade.[4]

This huge variation in economic performance in transition countries was certainly not predicted by most economists. It suggests that models that build on the assumption of aggregate uncertainty are on the right track.

One might reasonably assert that aggregate uncertainty applies more to the results of the privatization process in transition and less to restructuring and sectoral reallocation. The outcomes of privatization policies have shown enormous variation. Prior to implementing privatization policies, debates concerned mostly

[4]Specifically, 1984 is the year in China where dual-track price liberalization, discussed below, was implemented in industry.

Table 2
Political Parties Active in Transition Governments

Country	*Average Number of Parties in Government*	*Percentage of Left and Center-Left Governments*	*Percentage of Left and Center-Left Governments as a Percentage of Time*
Parliamentary			
Bulgaria	2.15	50	58
Czech Republic	3.2	0	0
Estonia	2.2	0	0
Hungary	2.7	50	50
Poland	3.4	29	33
Romania	2.9	71	71
Slovakia	2.5	100	100
Slovenia	3	0	0
Presidential			
Russia	—	—	—
Ukraine	—	—	—

the efficiency of various privatization schemes. However, a major effect of privatization policies in some countries is the amount of asset stripping that has been associated with privatization processes and the ensuing consequences, like low stock market liquidity, formation of large financial industrial groups, increases in rent-seeking activities and state capture, and political instability. These important effects were largely unanticipated. Conversely, sectoral reallocation is fairly well understood and has not yielded a huge variation in outcomes. The theories of sectoral reallocation that were developed quite early in the transition process seem to cover broadly the actual paths of sectoral reallocation (Aghion and Blanchard, 1994; Atkeson and Kehoe, 1996; Castanheira and Roland, 1999; Boeri, 2000). Empirical verification of these theories has also been generally encouraging (Boeri, 2000; Jurajda and Terrell, 2001).

Although China is not the focus of this paper or this symposium, China is the great success story among the transition economics in terms of having avoided a deep recession and moving quickly to a rapid growth path. Thus, it is useful to highlight here some of the political economy issues raised about the Chinese transition success. Analysts of the transition of the Soviet bloc countries often dismiss the Chinese experience on the grounds that China is a dictatorship, not a democracy, and therefore that political constraints were less of a problem in the implementation of reforms than in central and eastern Europe. However, it is very difficult to disentangle what aspects of China's transition are uniquely due to the absence of democracy.

One interesting Chinese institution from the political economy point of view is that China chose to liberalize prices in 1984 through a dual-track system. For planned output, planned prices were maintained, and planned contracts for supplies and deliveries were kept frozen at a preexisting level and were enforced. However, prices and quantities were liberalized in all sectors for additional

marginal output, which meant that producers were free to set prices, to contract freely with customers of their choice and to keep all profits made on the market track. Lau, Qian and Roland (2000) have emphasized the Pareto-improving property of the dual-track system. By construction, the system preserves the rents that various economic agents have under the planning system and as a result does not hurt them with liberalization, while creating new rents on the market track. Price liberalization can thus be achieved without creating losers and, consequently, without violating political constraints. One could accordingly speculate that if China had been a democracy, it would *not* have been more difficult to enact reforms of this type.

The dual-track system also has other properties that are relevant in the transition context. The continued enforcement of the plan contracts can reduce the disorganization effects of price liberalization (Roland and Verdier, 1999a), thereby preventing the output fall otherwise generally observed in transition economies, including even the more successful ones like Poland. Finally, one can argue that the dual-track system helped prevent the collapse of existing government structures because government kept a direct control over economic resources without having to depend solely on fiscal revenues to finance essential activities like law enforcement, which are themselves crucial to efficient tax collection and many other purposes (Roland and Verdier, 1999b).

In terms of understanding the difference in transition paths between central European countries like Poland on one hand and Russia and the former Soviet Union on the other hand, geopolitical factors are quite important, although they have been underestimated since the beginning of transition. Economists trying to understand transition have often viewed it as an ideological shift toward democracy and the market. But in geopolitical terms, transition represents the shift of central Europe and the Baltic states toward western Europe. Indeed, to important parts of populations in those countries, the single most significant factor about transition is the change from the status of a satellite country of the Soviet empire to that of a country belonging to the western bloc. Transition represents a unique historical opportunity for several nations to put down an anchor in western Europe or even to join the European Union. In addition, the prospect of this connection to central and eastern Europe focuses expectations and gives credibility to the political and economic process of transition. Entry to the European Union implies adopting the political and economic system of the west. The potential reward of belonging to the club of western nations makes it more worthwhile to undergo the cost of transition. Moreover, the geopolitical factor increases the perceived cost of reversing transition policies, since such reversals would raise the risk of being left out of the western club, an outcome that many in central and eastern Europe would view as disastrous.

This geopolitical factor may be strong enough to explain why countries from central Europe did not suffer from the type of government collapse, anarchy and general diffusion of criminality, inside and outside government, that Russia and other countries from the former Soviet Union have been facing (Roland and Verdier, 1999b). The ability to enforce the law and to protect property rights seems

to be a key reason why central Europe recovered from its fall in output, while Russia and other countries not facing the prospect of entry to the European Union experienced a much more prolonged decline of output.

The geopolitical impact of transition for Russia is quite different. In Russia, transition represents the loss of the Soviet empire and also of territories, such as the Ukraine or the Baltic states that had belonged to Tsarist Russia. This loss is a wound to Russian nationalist pride. It also implies uncertainty for the families of those who have relatives among the millions of Russians living in the former Soviet republics and who became "immigrants" in former Soviet territories, often with the status of second-class citizens. The trauma of the loss of superpower status, similar in a way to the trauma experienced by Germany after World War I, could be compensated for by economic gains from transition to a certain extent. Unfortunately, such gains have not materialized so far for the majority of Russians. Entry of Russia into the European Union is neither expected nor especially desired. Russia's enormous size implies that the possibility of gains from foreign direct investment must be limited and, hence, less alluring.

It is thus no wonder that resistance to transition proved much harder in the former Soviet Union than in central and eastern Europe, as witnessed by the greater difficulties in requiring enterprises to face their own losses and in adopting macroeconomic stabilization measures.

Geopolitical considerations play a role in explaining why a version of China's dual-track approach was not tried in central and eastern Europe, at least at the level of trade across countries. Trade among the Soviet-bloc economies was planned and organized under the auspices of the Council for Mutual Economic Assistance (CMEA). Early in the 1990s, international organizations like the European Union, the International Monetary Fund, and the European Bank for Reconstruction and Development made efforts to prevent disruption of trade among former CMEA countries. Essentially, the plans were to introduce some form of a dual-track approach, which would facilitate maintaining existing trade contracts, while leaving the freedom to sign new contracts, mainly with western business partners. However, these attempts were unsuccessful. The breakdown of trade patterns across the former Soviet bloc, including both the breakdown of CMEA and the separation of trade that had been within the Soviet Union to trade between separate countries, has been considered the single most important explanatory factor for the general fall of output in the region (for example, Rodrik, 1994).

This breakdown of trade has generally been perceived as an exogenous shock—part of the process of transition. However, from a political economy perspective, the breakdown of CMEA was not foreordained, but rather an endogenous outcome of policy choices. In early 1990, when Czechoslovak and the Polish governments insisted on regaining their freedom of export with respect to CMEA agreements, the Soviets responded by insisting that imports from the Soviet Union would from 1991 onwards be paid at world prices and in hard currency. The CMEA breakdown was thus an economic consequence of the political will prevailing in

central European countries to leave the Soviet bloc and to be the first to knock at the door of the European Union.

The dual-track system of price liberalization was also not implemented inside countries. One possible explanation is that reformist governments wanted to use their window of opportunity to create irreversibility by completely dismantling the planning system, even at the cost of suffering an output fall. One must also add that reformists in power at the time, as well as the main western economic advisors, shared the belief that price liberalization was more likely to boost output than to reduce it. Even if the dual-track approach had been tried in a country like Russia, it would probably have failed because of the government collapse that followed the implosion of communism after the failed putsch of 1991. Such a collapse would have made any contract enforcement difficult to achieve, which is still to a great extent the case in Russia today given the weakness of the state and the corruption of the justice system and government administration.

Sequencing

The sequence of reforms in transition economies are roughly in line with political economy theory, which suggests that reforms expected to be more popular should start first. For example, in all of central and eastern Europe, democratic reforms preceded economic reforms. Aspirations for democracy were very strong throughout the region, and support for economic reform was less strong than support for democracy.

Apart from political reforms, certain other institutional changes are relatively uncontroversial and can thus be decided at an early stage of reforms. For example, Fingleton et al. (1996) have argued that the establishment of institutions for competition policy should be among the first reforms to be implemented in transition economies, a particularly important reform given the monopolistic structure of industry inherited from central planning. In practice, competition laws have generally been passed rather early in the transition process, in line with the theory. This example also emphasizes the danger that can be associated with a wrong sequencing. Privatization without effective competition policy puts existing monopolies in private hands, which may in turn have enough power to capture the state apparatus to prevent the introduction of competition policy as well as any measure that is opposed to their interests, as the Russian experience has shown.

Another important early step in the sequence of transition reforms is encouraging the development of a small private sector prior to more comprehensive reforms. Liberalizing the small private sector is often a popular early measure that provides a supply response in emerging markets. In Hungary, for example, the small private sector was already producing about 10 percent of industrial output by 1990 (Hare and Revesz, 1992). In China, the nonstate sector's share of industrial output was already 22 percent in 1978, thus providing a basis for its growth to 47 percent in 1991 as liberalization occurred (Qian and Xu, 1993). Vietnam, another example of a non-European transition economy, implemented radical price liberalization and stabilization programs in 1989. By then, the private sector

in agriculture and manufacturing already occupied 60 percent of GDP and 85 percent of the labor force. As in most countries where big bang price liberalization was implemented, Vietnamese industry experienced an output fall in 1989. However, this fall was more than compensated by impressive growth in agriculture, therefore still leading to positive growth that year (Dollar and Ljunggren, 1997). Here also, the prior existence of a viable private sector buffered the shocks of economic liberalization and macroeconomic stabilization and facilitated a supply response.

Sequencing arguments have been applied to privatization, too. In transition economies, the best firms tend to be privatized first; for examples, see Gatsios (1992) on Hungary, Carlin and Mayer (1992) on East Germany, and Gupta, Ham and Svejnar (1999) on the Czech Republic. The result of privatizing more profitable firms first is to create political support and goodwill for further privatization and other reforms.

While more popular reforms tend to be adopted first, less popular reforms are delayed. Perhaps the least popular reforms are the restructuring and closing of loss-making enterprises, which has generally been quite delayed. Clearly, restructuring involves the loss of substantial rents for well-organized groups of the population, and it requires countervailing political momentum.

Political economy can also be used to shed light on potential policy mistakes that involve sequencing. For example, one can wonder whether the adverse domestic reaction to price liberalization in Russia in particular might not have been avoided if Russian reforms had first favored the emergence of a small private industrial and service sector.[5]

As another example related to Russia, Boris Yeltsin may have made a sequencing mistake in not taking advantage of the window of opportunity provided by the failed putsch of August 1991 to push immediately for further political reform, such as new congressional elections and a new constitution, prior to further economic reform. Such political changes did not take place until December 1993, nearly two years after the beginning of economic reforms. The population had by then already suffered from the shock of liberalization. A possible "honeymoon" for reformers had already been dissipated, and elections expressed important discontent and confusion among the population, with the party of the extreme right-wing figure Vladimir Zhirinovsky receiving an impressive number of votes.

Yet another set of sequencing issues arises with regard to mass privatization as it was implemented in countries like Russia and the Czech Republic before a viable de novo private sector had established itself. Poland and Hungary avoided this mistake by following the policy of gradual sales. Mass privatization created a sudden and strong concentration of economic power among insider managers. Especially

[5]Russian reforms started in that direction in the 1980s under Mikhail Gorbachev. The development of cooperatives in the late 1980s, for example, was an embryo of small private sector development. However, in Russia, that sector was still very underdeveloped when price liberalization occurred, contrary to the case of Hungary, where such a sector had strongly developed in the 1980s.

given that socialist enterprises were larger than capitalist firms, the person who gains economic control over such an enterprise acquires important power. In particular, there is considerable scope for abuse of minority shareholders. This abuse of power then leads to low confidence in the stock market and low liquidity, shrinking the stock market, as observed in the Czech Republic and Russia.

More importantly, the sudden shift of economic power to insider managers may also make it easier for them to capture politicians and regulators. Insider managers use the threat of reducing economic activity and destroying jobs—or even use outright bribery—to extract subsidies or favorable legislation. Politicians can respond to such subsidies under such plausible and popular rubrics as saving jobs and providing a better business climate. However, these influences will lead to more corruption within the state, weak tax enforcement (especially for large firms, Campos, 1999), weak law enforcement and so on. Large insider interest groups may then block legal reform that would reduce their power or undermine their interests. Over time, this strong economic power is likely to lead to enormous inequality of wealth (Alexeev, 1999), which is likely to increase political instability. Political instability in turn reinforces the short-term perspectives of managers and insider owners: they will prefer to find ways to transfer corporate assets to their private use rather than invest in the long-term future of the enterprises they control.

In the Czech Republic, these negative effects of mass privatization can be partly offset by prospects for joining the European Union. Those prospects may help generate a minimum of discipline in law enforcement and focus expectations in the right direction (Roland and Verdier, 1999b). But in Russia, the dynamic effects of mass privatization will likely have negative long-term effects.

Winners and Losers

Fidrmuc (2000a, b) has analyzed the political support for reforms in the Czech Republic, Slovakia, Poland, and Hungary during various years in the 1990s. He analyzes the effects of economic variables resulting from reforms on the votes received by different parties. His main findings are that the support for reformist parties is negatively affected by unemployment and by the proportion of retirees and blue-collar and agricultural workers, but is positively affected by the existing size of the private sector and a higher share of white-collar workers or of people with university education. These findings indicate that there is a regular pattern of perceived winners and losers from reform and that political support for reforms depends on the balance between losers and winners.

These results help to explain one of the ongoing political economy puzzles in central Europe: How has the government of Vaclav Klaus in the Czech Republic managed to be relatively more stable, compared with governments of other transition countries? One reason is surely that the Czech Republic has managed to maintain a lower unemployment rate as compared with other transition economies. A number of authors analyze this issue in depth: for example, Ham, Svejnar and Terrell (1998), Munich, Svejnar and Terrell (1998) and Sorm and Terrell (1999).

The Trade-Off Between the Speed of Reforms and the Size of Budgetary Transfers

The theory of political economy suggests the possibility of a trade-off between the speed of reforms and the net present value of compensation transfers: namely, faster reforms will involve higher compensation costs. This issue can be highlighted by comparing restructuring policies in East Germany and other transition economies. In the former East Germany, restructuring proceeded very fast with massive layoffs at an early stage of transition. Employment fell by nearly one half between 1989 and 1992 (Sinn and Sinn, 1992). However, this policy has been associated with massive transfers from West Germany. Net transfers to East Germany were 65 percent of East German GNP in 1991, 65.5 percent in 1992 and 76.5 percent in 1993 (Gros and Steinherr, 1995)! Transfers at comparably high levels have continued throughout the 1990s. In contrast, in central and eastern Europe, where such massive transfers were not available, layoffs have been understandably more gradual.

Coricelli (1996) claims that "faster" reformers in central and eastern Europe, such as Poland, Hungary or the Czech Republic, have been facing higher increases in social expenditures, like unemployment benefits and pensions, due to a higher level of restructuring, as compared to "slower" reformers who have maintained higher levels of subsidies in ailing industries. Similarly, Pirtillä (2001) finds that a faster rate of restructuring in transition economies is associated with a worsening fiscal stance. But these facts do not quite settle the matter. In economic terms, the key question is not whether faster reforms are associated with a higher level of compensating transfers, but whether faster reforms raise the net present value of compensating transfers, or only the timing of these transfers. Evidence on this point is weak.

However, the role of the social safety net in helping overcome political constraints is quite clear. In the case of central European countries like Poland (Keane and Prasad, 2000) and the Czech Republic (Garner and Terrell, 1998), the social safety net has helped to mitigate the negative effects of transition on income inequality, especially for the most vulnerable proportions of the population.

The Role of Political Institutions

The role of particular political institutions in facilitating the adoption and implementation of reforms is being given increasing attention on the basis of some intriguing and perplexing results. Recent empirical analysis by Hellman (1998) and EBRD (1999) has found that a stronger executive branch of government tends to be associated with less progress in reform. However, there tends to be a positive correlation between the broadness of coalition and the progress of reforms. These findings contradict the conventional wisdom, based on empirical findings from the political economy literature on stabilization and fiscal policy around the world, that broad coalition governments and weak executives are an obstacle to reform (Roubini and Sachs, 1989; Grilli, Masciandaro and Tabellini, 1991; Spolaore, 2000; Alesina and Perotti, 1996). Can this apparent contradiction be resolved?

One possible interpretation is that there is value to the consensus building that

broader coalitions and more closely checked executives create. If reforms are accepted by broader coalitions, perhaps there is less chance they can be reversed. To the extent that expectations of reforms being reversed may have negative effects on economic decisions such as domestic and foreign investment, then such reforms may have more positive effects. But if this is true, then how does one explain the result that broader coalitions are typically unsuccessful in macroeconomic stabilization and fiscal reform around the rest of the world? Broad coalitions tend to paralyze decision making due to the holdup power of some groups and to wars of attrition within the coalition (Alesina and Drazen, 1992). Indeed, broader coalitions do not necessarily imply that it is more difficult to reverse a decision, since broader coalitions are often more fragile and last less long.

Another possible interpretation is that the population is eager to get reforms implemented, whereas the politicians and those holding office are opposed to it. In that case, closer checks on the executive branch and frequent elections are a way to force the politicians to move, whereas politicians with more discretion would choose to block reforms. The main objection to this view is that there is little evidence that the public typically leads politicians or that politicians typically lead the public; instead, there is considerable heterogeneity in terms of support for reforms both among the population and among politicians in power.

In my view, the most likely explanation for the positive correlation between progress of reforms and broadness of coalitions and weakness of the executive branch is that countries where it was the easiest to push for democratic reforms are in all likelihood also the countries where resistance to economic reforms was relatively smaller. Conversely, in countries with less initial support for reforms, it is quite likely that both democratic reform and economic reform are less advanced. If this pattern holds true, then differences in initial conditions of reform are what determine the intensity of political constraints, and thus the initial choice of political institutions, and hence the initial choice of policies. The choice of institutions, such as a weak or strong executive or the institutional frameworks that require or don't require broad coalitions, is endogenous to the transition process itself.

Economists have tended to limit their examination of initial conditions to initial *economic* conditions (for example, Åslund, Boone and Johnson, 1996; Popov, 2000; Havrylyshyn, Izvorski and van Rooden, 1998; Berg et al., 1999; Krueger and Ciolko, 1998; Heybey and Murrell, 1999). It becomes necessary to have a more comprehensive picture of initial conditions, including political and sociological variables, to have a more precise idea of their effect on the initial choice of institutions as well as on economic policies (themselves influenced by the political institutions adopted). One important variable that has not been studied seriously so far by economists is the strength of the noncommunist elites at the beginning of transition. A closely related point was made earlier in discussing the strength of civil society in different transition countries. There is a striking difference between Poland, where the Catholic Church and the Solidarity trade union counterbalanced the communist elites, and Russia, where little counterbalance existed to the

former members of the communist ruling class who engaged in a frenzy of asset grabbing once it was clear that the communist regime was dead.

Conclusion

Economists often refer to the transition economies of the former Soviet Union and central and eastern Europe. But for these countries, far more than the economy is involved in the transition. They are also creating their institutions of democracy and governance, including the executive, legislative and judiciary branches of government; a free press; new social norms and values; an openness to private organizations and to entrepreneurship; a network of regulators; and a new network of contractual relationships, both domestic and abroad. The economic transition is intimately related with these institutional transformations.

In this setting, economists have often gone astray in their analysis of transition economies by examining only economic factors and ignoring these deep institutional transformations. Successful institutions of capitalism are already present in advanced economies, and we tend to take them for granted when reasoning on economies in transition or on developing economies where such institutions are absent. The transition experience has therefore very much reinforced the institutionalist perspective in economics and a shift in emphasis in economic thinking, from the analysis of markets and price theory to that of contracting and to the legal, social and political environment of contracting. Moreover, transition has also forced us to think about institutions not in a static way, but in a dynamic way: how momentum for reform is created and how institutions can evolve, but also how momentum can be lost and how one can get stuck in inefficient institutions. These questions, addressed by the political economy perspective, have become central in understanding how successful capitalism can emerge. Transition countries have started this process of change from specific initial conditions, but the questions addressed by transition go far beyond the transition process itself.

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