Business, government and society – notes on relevant journals

Media

Berend (2000) From Plan to Market, From Regime Change to Sustained Growth in Central and Eastern Europe * After the state socalism collapsed in Central and Eastern Europe in the early 1990s, the Washington consensus of 1989 (a broadly accepted set of criteria for a reform program) was adopted as a blueprint for the process of transformation. * Central elements: * Macro-economic stabilization (for countries with significant inflation and indebtedness) * New institutions Legislation * Price and trade liberalisation * Radical privatization * Most of the “ transformatology“ literature is based on the assumption that the elimination of deformed non-market economies, a restoration of market, and private ownership, paired with a laissez-faire free market system would automatically solve all major economic/social problems of the transforming countries. The economic crisis within the Central and Eastern Europe area started much earlier – in the mid-late 1970s when growth slowed significantly and the terms of trade for the state socialist countries began to deteriorate (1973 first oil shock 20% decline, for some even 26-32%) Schumpeter’s theory of “ structural crisis”: advancements intechnologylead to decline of the old leading sectors and export branches based on old technology, generating wide-ranging slow-down and decline and causing an economic crisis even in rich, advanced countries.

However, although rising new technology led to the emergence of new industries, new leading export sectors and an impressive new boom in the US and other advanced countries, the Central and Eastern Europe countries experienced a “ peripheral structural crisis” – they suffered all the negative consequences of a the “ structural crisis” but due to not having sufficient resources for R&D, know-how and financial sources, they were not able to take advantage of the technological development.

After 1989, when the countries of the region lost the protection from Comecon's isolation and regional self-sufficiency, they were forced to enter the world market and compete with the advanced countries (already adjusted to new technology) and also on their own opened domestic market. Consequence: the peripheral structural which had prolonged since 1973 continued and worsened during the 1990s. Also contributing to the economic crisis: serious macro-economic policy errors e. excessive devaluation of the currency; too abrupt opening to trade with the West; and thefailurein government management of the state sector * Foreign trade deficits increased dramatically and nearly all countries in the region dropped into an indebtedness trap – debt service consumed about 40-75% of the countries' hard income and quite a few started to lose control over inflation * Economic policy during the transition: Change was too fast countries of transformation should not have attempted to jump directly from a centrally planned to a laissez-fair economy and from an entirely state-owned to a 100% privatized economy * State regulations and government policy were needed self-regulating mechanisms were not yet developed, market imperfections and non-market friendly behaviour were present * Suggestion (Kolodko) : A regulated market, instead of a self-regulation market, a mixed economy with a restructured and efficient state-owned sector for at least a period of time, and a " fine mixture between market and stae" would have been a more natural transition from plan to market * However, this approach was not adopted and led to a collapse of many old companies (lost a bulk of their value and had to be sold for a fraction of their previous value) mass unemployment, sharp decline in living standards (especially for vulnerable layers of society) * Outcome: Industry recovered only in two countries – Poland and Hungary * Some experienced a new crisis – Bulgaria and Romania * Russia and Ukraine as well as several other successor states of the Soviet nion had experienced constant decline throughout the entire decade * Poland, the Czech Republic, Hungary, Slovakia and Croatia – market economies are functioning, economic decline and rapid inflation are over, the annual economic growth is impressive * Performance differences: * Often explained by the lack of determination to pursue radical reforms author agrees * However, besides pursuing systemic change, the countries in transformation also have to adjust to the " structural risis", by restructuring the economy according to the requirements of modern technology to reach a sustained and higher than average growth technological and structural transformation of the economy are central elements of the transition * Window of opportunity slowly opened after 1989 when direct foreign investment became the key factor in technological modernization and restructuring in the area but only played an important role in the three frontrunners of transformation – Estonia, Latvia and Slovenia * In addition, not all investments contributed to restructuring, some of them served only to enlarge the investors' markets. However, key investments were made in the most backward infrastructural sphere, especially telecommunication that serves as the basis for any kind oftechnological progressto date. * Investments had positive effects on Eastern Europe where they generated growth of domestic business which led to economic growth (especially in Poland).

Big transnational businesses were also obliged to reinvest some of its profits and to use domestic products and sub-contractors initiated small local business activities. * Russia, the successor states of the Soviet Union, and most of the Balkan countries exhibited minimal progress in restructuring. FDI was minimal in this area and mostly went into the extracting branches of oil, gas and raw materials; transnationals are present but do not develop processing industries and export branches. Consequently, this area was unable to adjust to the late 20th century technological revolution and declined into a continuous peripheral structural crisis. In those Central European countries, where impressive FDI assisted technological-structural adjustment, transformation is paving the way to sustained growth and catching up with the West. These countries became memers of NATO and are candidates for EU membership. Murrell (1993): What is Shock Therapy? What Did it Do in Poland and Russia? Poland: * Shock therapy failed in Poland * The reform program implemented in January 1990 comprised a number of related measures * Fiscal policy was tightened considerably budget surplus in Q1 1990 * Real value of themoneysupply was halved * Tight limits were placed on credit * Trade liberalisation removed all restrictions * Anti-inflation wage tax was set at strict levels Government made a commitment to privatisation on a massive scale * Solidarity and the Catholic Church were two of the strongest social institutions in Eastern Europe helping to maintain the shock therapy model * Once it was realised that the shock therapy was not going to produce as many benefits as expected, it came under severe attack gradually, many of the elements of the initial program were withdrawn or weakened monetary policy was loosened * Further movement away from the shock program occurred throughout 1991 in the face of massive and open opposition to the government's policy * Fiscal and monetary policy were considerably loosened budget deficit began to rise to the levels of 1989 * Reversal of trade policy tariff rates increased and selective protection was endorsed * Although policy was modified during the two years following the big bang, the commitment of the large part of society to change was never in doubt. * Change was inexorable (kohklematu), given the collapse of the communist regime that had blocked reforms that had been demanded for so long. * Nevertheless, Polish economy started to show first signs of success after policy was rescued from the shock therapists. Russia: Stages of the reform chronology in Russia are similar to those in Poland, but without a successful outcome * Less preparatory reform during the communist period in Russia * Core group of reformers were radical and ambitious, and more removed from its own society than were the Polish reformers * Radical reforms had hardly advanced beyond their explicitly destructive first phases before they were rejected by society * By 1991 economic reform in the Soviet Union had hardly progressed beyond the stage of decentralisation within the old system and it was still very equivocal * Price controls and state orders contributed to about 75% of economic activity * Small private sector did not thrive on its own, it was in a symbiotic relationship with the state sector * Law on contract had not been implemented by the end of USSR * Russia's economic and political leaders still did not fully comprehend the difficult conceptual and institutional issues related to establishing macroeconomic control and they had little experience Russia could not match Poland’s years of contact with the West, the experience and knowledge of its policymakers gained in the worldwideacademiccommunity, and the years of learning in interactions with the world financial community. * In 1990 and 1991, the Russian government had been gradually gained power (and this was accelerated by the failed coup). * In late October 1991, Russian President Boris Yeltsin announced his intention to launch a radical attack on the country’s economic problems. He had been given freedom in administrative and policy choices for one year and he decided to assign the policymaking duties to a group of theorists, who had a strong preference for rapid change and who had vague idea about how to bring this change about * Murrell argues that shock therapy was the guiding force of policy as Russia began real economic reform in January 1992. * The reform (1992) was certainly more radical than the Polish big-bang, including: * Freeing of most prices * Removal of the old supply system * The complete liberalisation of imports * A thoroughgoing change in the tax system * Rapid closing of the budget deficit * Stringent tightening of monetary policy * A privatisation program with very ambitiousgoalsPreparation for early convertibility of the ruble together with and immediate relaxation of rules on foreign exchange trading * Renegotiation of the existing trading relationships with the other ex-republics * There was greater determination in Russia to undermine the existing institutions of government; the incoming government viewed its mission as an attack on the old Soviet system. * In several areas, the degree of shock, the amount of policy implementation, and even actual policy were unclear * Uncertainty about the nature of policy was present even among those at the apex of government * As early as February 1992, criticisms about the economic policy started to arise * As 1992 proceeded and the economic crisis became more threatening, some old mechanisms of control began to return * Broad powers to control prices and to use central directives on production * To avoid large scale bankruptcy, the government began to make credit available to nterprises in significant amounts * Due to a threat that better enterprises were being brought down with the bad ones, directors of enterprises formed an alliance along with independent labour unions to put pressure on the government, which was forced into compromise with these interest groups * Direct consequence of the policies introduced in January 1992 was that the political forces representing the dominant economic interests of the old Soviet system were much stronger than they had been before those policies were introduced * The short burst of shock therapy in Russia had considerable success if destruction is counted as a goal. But the destruction of the old was hardly matched by the creation of market-oriented institutions of economic control. Blanchard (1994): Transition in Poland * First two years: * Large decreases in GDP * Even larger decreases in industrial production * Output stabilised in mid-1992 * Employment declined initially more slowly than GDP, but has kept declining despite the turn in output * Hardening of budget constraints * Subsidies to state firms were decreased Tax arrears, interenterprise arrears and bank loans were limited and decreasing * Sources of output decline during the first 2 years: * Stabilisation * Price liberalisation * Collapse of trade between Central and Eastern Europe countries * State firms are controlled by workers with uncertain stakes and horizons, and have limited access tofinance; state has remained de jure owner of state firms but is not able to exercise its control rights control has reverted to the workers * Led to slow adjustment of employment to decreasing output, appropriation of profits to workers in the form of wages and low restructuring and investment * Slow privatisation

Fidrmuc (2003): Economic reform, democracy and growth during post-communist transition Key point: There are merits to simultaneous democratisation and liberalisation – democracy reinforces economic liberalisation, which in turn leads to better growth performance. Democracy is clearly not a necessary condition for high growth (as the examples of Chile and China illustrate), but as the experience of the post-communist transition countries shows, democracy results in policies and institutions that facilitate economic reforms and create anenvironmentthat is favourable for growth. However, democratisation alone is not the key to growth; it is through its positive impact on economic liberalisation that it improves growth performance. By 1993, barely 3 years into transition, three frontrunners – the Czech Republic, Hungary and Slovenia – attained a level of political freedom and civil liberties comparable to the UK, France or Germany. * Most post-communist countries succeeded in sustaining at least a moderate level of democracy, despite very turbulent economic and political developments, military conflicts or coup attempts. * The high speed of democratisation reflected not only the desire of these countries' citizens to live in democracy, but also the encouragement or outright pressure from Western governments, international organisations and especially the EU which made democracy and explicit precondition for accession negotiations. Democracy has a positive effect on progress in implementing market-oriented reforms. * Economic liberalisation, in turn, has a positive effect on growth * Therefore, democracy indirectly improves growth performance. * Economic performance during transition and initial conditions affected the progress in democratisation – countries that were more developed at the outset of transition and those that grew faster during transition in turn implemented greater degree of democracy. Growth performance during transition: * All post-communist countries experienced dramatic contraction of economic activity at the outset of the reforms, but the subsequent transition paths diverged considerably. Some countries reached the bottom of transformational recession after 2-4 years and then recovered * Some, most notably Poland grew at impressive rates subsequently * Others (Bulgaria, the Czech Republic and Romania) experienced a second dip later on * In contrast, most Soviet Union countries experienced deep and protracteddepressionwith little subsequent recovery –> for Moldova and Ukraine, transition resulted in a decade of continuous decline * By 2000 only 4 countries have exceeded the 1989 level of output * Berg et al. (1999) found that the initial output fall is attributable primarily to initial conditions and macroeconomic instability, whereas the effect of liberalisation on growth was overwhelmingly positive. When considering separately the effects of liberalisation on state and private sectors, they conclude that liberalisation contributed to the contraction in the state sector, but this was more than compensated by the expansion in the private sector. The further a country lies from Brussels, the more reluctant it was to implement radical economic reforms – therefore, being father away from Western Europe is associated with lower growth, although the relationship is often not significant. * Engagement in military conflicts, not surprisingly, lowers growth. * On the other hand, once the war is over, the affected countries tend to grow more rapidly as they make up for the loss of output. * Government expenditure does not have a significant impact on growth Democracy and growth: * The post-communist countries implemented, at least initially, economic and political reforms simultaneously. In some cases, political reforms even preceded the economic ones.

Hellmann (1998): Winners Take All: The Politics of Partial Reform in Postcommunist Transition Key point: A conventional approach suggests that in the short-term, economic reforms are believed to generate high transitional costs before long-term gains are realised. Therefore, politicians in democratic systems are reluctant to undertake radical reforms whose benefits will not be realised before the next elections. For an economic reform to be successful, governments need to focus on restraining the net winners of the reform as they are the one's responsible for setting the highest obstacles for the advancement of the reforms. The partial reform model: Explains why some countries have maintained partial reform over time, even though the short-term costs are higher and the overall gains are lower than those associated with more comprehensive reforms * Explains why post-communist countries in which the net winners of the reform process appear to have significant political power over economic policy-making nevertheless have remained mired in a partially reformed economy * Provides a possible explanation for the strong link between democracy and economic reform among the postcommunist transitions that stresses the advantages of including the very groups that suffer from the transitional costs of reform Conclusion: The costs of transition have been substantial in all transition economies – to varying degrees, each country has faced some combination of high inflation, high unemployment, declining real incomes, decreasing state services, and increasing uncertainty. * However, the losers of the reforms have not constituted the main political obstacle to the progress of reform. * In fact, it is these countries in which governments have been most vulnerable to the losers' threat of an electoral backlash against reform that have adopted and sustained the most comprehensive reform programs. * In contrast, governments insulated from electoral pressures have made, at best, only partial progress in reforming their economies. * Moreover, economic reforms, once adopted, have rarely been reversed, even when the reform governments that initiated them have been ousted.

In addition, there have been cases in which electoral backlashes were followed by intensification of reform in some areas * Partial reforms were predicted to generate rent-seeking opportunities arising from price differentials between the liberalised sectors of the economy and those still coordinated by nonmarket mechanisms * Rapid foreign trade liberalisation without complete price liberalisation managers were able to sell their highly subsidised natural resource inputs (oil/gas) to foreign buyers at world market prices * Privatisation coupled with the creation of an effective corporate government structure reduces asset stripping by enterprise insiders. Actors who enjoyed extraordinary gains from the distortions of a partially reformed economy have fought to preserve those gains by maintaining the imbalances of partial reforms over time – the winners from an earlier stage of reform have incentives to block further advances in reform that would correct the very distortions on which their initial gains were based. In effect, they seek to prolong the period of partial reforms to preserve their initial flow of rents, though at a considerable social cost. * Therefore, the challenge posed by the winners is based on a set of assumptions about the costs and benefits of reform that differs from the assumptions of the conventional J-curve pattern upon which most existing models of the political economy of reform are based. J-curve assumes that economic reforms generate concentrated costs in the short term and dispersed benefits over the long term, whereas Hellman has demonstrated that in the postcommunist transitions, economic reforms have tended to produce highly concentrated gains to particular groups in the short term, while dispersing the transitional costs of reform throughout the economy. * The partial reform model stresses the need to restrain the winners by increasing competition with other groups or by restricting their ability to veto reform measures unilaterally. * In this view, expanding political participation to include the losers in the policy-making process could place limits on the concentrated political power of the winners and prevent them from sustaining a partial reform equilibrium. * One of the fundamental tenets of the politics of economic reform has always been to create a constituency of winners with a stake in sustaining and advancing the reform process. This has been a common strategy both for making the reforms irreversible and for building up the necessary political support for further reforms. * Yet a comparison of the post-communist transitions suggests that the winners can do far more damage to the progress of economic reform than the losers. * Therefore, the success of economic reform depends both on creating winners and constraining them. * Paradoxically, the most effective means of constraining the winners in the post-communist transitions has been to guarantee the political inclusion of the very constituency that most existing political economy models seek to exclude: the short-term losers of reform. Progress in the implementation of market reforms could reduce the private gains to the initial winners over time, while increasing efficiency gains for the economy as a whole from winners' perspective, J-curve is reversed * Countries that adopt more comprehensive reforms at the start have a narrower gap between the income curves of winners and losers. More on PARTIAL REFORM and other information: Roland (2002): The Political Economy of Transition Normative political economy – focuses on the decision-making problem of reformers Reformers face 2 types of political constraints: * Ex ante political constraints – feasibility constraints * Ex post political constraints – related to backlash and policy reversal Relaxing political constraints – 4 options: 1.

Building reform packages that give compensating transfers to losers from reforms * Easiest way – ' Buy their acceptance' * In the real world and transition economies it is hard to do 2. Making reforms partial to reduce opposition * Partial reform, usually in the framework of a gradualist strategy, has some clear disadvantages. It yields lower efficiency gains than 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. * 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. If a partial reform is implemented, a continuation toward full reform seems unattractive to a majority then it is always possible to come back to the status quo (Russia – turned back too early?!) * 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 through the use of “ divide and rule” tactics (showing that rejection of a current reform plan can lead to the adoption of a plan that would hurt them even more, they may prefer to accept the first one) and the optimal choice of sequencing of reforms (e. g privatisation of those enterprises with “ good” outcome first) 3.

Creating institutions that make a credible commitment to compensating transfers * Can offer benefits * However entails economic costs * E. g extending voting franchise- ensuring poorer segments of population vote 4. Waiting for deterioration of the status quo to make reform more attractive * Sometimes only option is to wait * However, decision-making paralysis may occur if political decision making is characterised by different parties trying to push the burden onto the other parties Understanding the difference in transition paths between central European countries like Poland and Russia and the former Soviet Union on the other hand: * Law and property rights: One argument – the extent of state capture and rent seeking was much more important in former Soviet Union countries than in central Europe and this difference goes a long way in explaining differences in output performance (EBRD, 2000; Hellman and Shankerman, 2000) * Geopolitical factors * Quite important, although they have been underestimated since the beginning of the transition – in geopolitical terms, the transition represents the shift of central Europe and the Baltic states toward western Europe several nations are given the opportunity to have more interaction with western Europe or even join the European Union * Entry to the EU 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 than many in central and eastern Europe would view as disastrious. Geopolitical impact of transition for Russia: * Transition represents the loss of the Soviet empire and also of territories (Ukraine or the Baltic States) – wound to Russian nationalist pride * Trauma of the loss ofsuperpowerstatus could be compensated for by economic gains from transition to a certain extent. Unfortunately, such gains have not materialised so far for the majority of Russians. Entry of Russia into the EU is neither expected nor especially desired. * Thus, resistance to transition proved much harder in the former Soviet Union than in central and eastern Europe. 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 be adopted first and the less popular reforms tend to be delayed. For example, in both Central and Eastern Europe, democratic reforms preceded economic reforms because support for democracy was much stronger than support for economic reforms. * Apart from political reforms, certain other institutional changes can be decided at an early stage of reforms. For example, establishment of institutions for competition policy should be among the first reforms to be implemented in transition economies.

This reduces the danger of existing monopolies going into private hands, which may have enough power to prevent the government from introducing competition policy or any other measures that are opposed to their interests. * Another important early step in the sequence of transition reforms is encouraging the development of a small private sector prior to more comprehensive reforms (in Hungary, small private sector was already producing 10% of industrial output by 1990) * As the Big Bang Price Liberalization in Vietnam showed, the prior existence of a viable private sector buffered the shocks of economic liberalization and macroeconomic stabilization and facilitated a supply response.

In Vietnam, after the implementation of a radical price liberalisation, output initially fell, but an impressive growth in agriculture still led to positive growth in GDP. * In transition economies, the best firms tend to be privatized first as the privatization of more profitable firms creates political support and goodwill to for further privatization and other reforms. * Another set of sequencing issues arises with regard to mass privatization. Mass privatization in countries like Russia created a sudden and strong concentration of economic power among insider managers. This is especially dangerous because a sudden shift of economic power to insider managers may make it easier for them to threaten or use bribery against politicians and regulators to take advantage of subsidies or favorable legislation.

The insider uses the threat of reducing economic activity and destroying jobs which leads to inequality of wealth which in turn might increase political instability. Trade-off between the speed of reforms and the size of budgetary transfers: * The theory of political economy suggests that faster reforms involve higher compensation costs like unemployment benefits and pensions due to a higher level of restructuring. In addition, there are claims that a faster rate of restructuring in transition economies is associated with a worsening fiscal state. * 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 and the Czech Republic, the social safety net has helped to mitigate the negative ffects of transition on income inequality, especially for the most vulnerable proportions of the population. Role of political institutions: * When it comes to the role of political institutions and the progress of reforms, there are contradicting views. * Empirical analysis by Hellman and EBRD has found that stronger executive branch of government tends to be associated with less progress in reform, whereas there tends to be a positive correlation between the broadness ofcoalitionand the progress of reforms. * However, empirical findings by Rubini and Sachs, among others, have shown that weak executive branch and broad coalition goverments are obstacles to reforms. Faster progress in reforms due to broader coalition may be explained by the fact that if reforms are accepted by broader coalitions, perhaps there is less chance they can be reversed. * However, broad coalitions tend to paralyze decision making due to the holdup power of some groups and to differing views within the coalition. * 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. According to Roland, the most likely explanation for the positive correlation between progress of reforms and broadness of coalitions and weakness of the executive branch is that it is likely that the countries where it was the easiest to push for democratic reforms, are also the countries where resistance to economic reforms was relatively smaller. Whereas in countries with less initial support for reforms, it is quite likely that both democratic reform and economic reform are less advanced. Therefore, the 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. Popov (2000) – Shock Therapy vs Gradualism:

Primary issue regarding transition performance – strength of institutions Secondary – speed of reforms * By now most economists would probably agree that because liberalisation was carried out without strong market institutions it led to the extraordinary output collapse in CIS states * The worse initial conditions for transformation, the greater the probability of the deep transformational recession, and hence the more likely delays in liberalisation * Gradualists objected to the elimination of old regulations and institutions before the new ones are created, warning that the institutional vacuum may have a devastating impact on output Transformational recession Supply-side phenomenon – reallocation of resources (restructuring) due to market imperfections is associated with the temporary loss of output Argument: Differences in economic performance in post-communist countries during transition appear to be associated predominantly not with chosen reform paths, but with the magnitude of initial distortions in industrial structure and external trade patterns, and with the initial level of economic development. The higher the distortions (militarisation, over-industrialisation, “ under-openness” of the economy and the share of perverted trade flows), the worse is the performance as measured by the GDP change. And the higher was GDP per capita before transition, the greater were distortions embodied in fixed capital stock, the more difficult it was to overcome these distortions to achieve growth. The impact of speed of liberalisation appears to be limited, if any. Reasons (distortions): * High defence expenditure and the need for conversion * Overcoming the effects of theCold WarDefence expenditure was abnormally high – declines in defence output were not offset by increases in non-defence output * Reallocation of resources from industry to services * External trade distortions – the degree of openness of socialist economies (the share of external trade in GDP) * In most countries, including the majority of the former Soviet republics, trade was relatively underdeveloped * A bit better in Azerbaijan, Hungary and Vietnam * Shift to world market prices in interrepublican trade led to reduced trade – prices used were completely different (resource commodities underpriced, finished goods overpriced) Policy factors: institutions, rule of law and democracy The decline of the institutional capabilities contributed a great deal to Russia’s and CIS poor economic performance * Regardless of the criticism against “ big governments” and too high taxes in former socialist countries, the downsizing in the government that occurred in most CIS states during transition went too far – drastic reduction of government spending (50% and more in real terms in the course of just several years) cannot lead to anything else but institutional collapse * In addition, in most CIS states the reduction occurred in the way that instead of shutting some programs down completely and concentrating limited resources on others, governments kept all programs half-alive, half-financed and barely working Three major patterns of change in the share of government expenditure: 1) Under strong authoritarian regime – China Cuts in government expenditure occurred at the expense of defence, subsidies and budgetary financed investment, while expenditure for " ordinary government" remained largely unchanged 2) Under strong democratic regimes – Poland * Budgetary expenditure, including " ordinary government" expenditure declined only in the pre-transition period, but increased during transition itself – social safety nets? 3) Under weak democratic regimes – Russia * Reduction of the general level of government expenditure led not only to the decline in the financing of defence, investment and subsidies, but to the downsizing of " ordinary government" which undermined and in many nstances even led to the collapse of the institutional capabilities of the state * Russian pattern of institutional decay proved to be extremely detrimental for investment, and for general economic performance To sum up, Gorbachev reforms of 1985-91 failed not because they were gradual, but due to the weakening of the state institutional capacity leading to the inability of the government to control the flow of events. Similarly, Yeltsin reforms in Russia, as well as economic reforms in most other FSU states, were so costly not because of the shock therapy, but due to the collapse of the institutions needed to enforce law and order and carry out manageable transition. Therefore, there is enough evidence that differing performance during transition, after factoring in initial conditions and external environment, depends mostly on the strength of institutions and not so much on the progress in liberalisation per se. Democratisation without strong rule of law usually leads to the collapse of output.

After allowing for differing initial conditions, it turns out that the fall of output in transition economies was associated mostly with poor business environment, resulting from institutional collapse. Liberalisation alone, when it is not complemented with strong institutions, cannot ensure good performance. Ericson (1991): The Classical Soviet-Type Economy: Nature of the System and Implications for Reform Characteristics of the Soviet-type economic system: * A hierarchical structure of authority * Rigid, highly centralised planning of production and distribution * A commitment to maximal resource utilisation * Formal rationing * Exhaustive price control * The lack of any liquidity or flexible response capability * The lack of legal alternatives to assigned economic relationships * Absolute and arbitrary control by superiors Incentives that are geared to meeting the plans and desires of evaluating superiors Any economic reform must struggle against these characteristics and their natural consequences. One important consequence is that while the administrative superstructure has been subject to rather frequent " reform", the physical structure of production and interaction has changed only very slowly. Strengths and weaknesses of the traditional Soviet-style system: Strenghts: * Very good at mobilising scarce resources and concentrating on a few clear, well-defined objectives (that can be expressed in measurable, quantitative and communicable terms and that yield large observable outcomes) * Building of major heavy industrial capacities * Collectivisation of agriculture * Post-warreconstructionof industry Development of an unprecedented military-industrial complex * Maintenance of the world's last true empire Weaknesses: * Central authorities lack the information and physical capability to monitor all important costs * Decisions made in ignorance of opportunity costs lead to a vast range of negative externalities: * Damage to the capability of users to produce (especially with needed quality) * Unusable output forced on others in the system * Destruction of the resource base due to improper exploitation * Collateral damage to agriculture etc * Incentives used lead agents to: * Avoid any change or risks * Shun innovation * Ignore information important to others * Work to rules regardless of the impact on others

Thus, while the traditional Soviet economic system has been effective in achieving a few centrally definable and achievable objectives, it is also inherently wasteful and inefficient in the pursuit of those objectives. Implications for reform: 2 monumental obstacles: * Vast resource commitment – however, lack of resources currently available in Soviet-style economies is probably not the most serious obstacle, for it might be dealt with through aid from abroad * Primary obstacle: characteristics of the Soviet-style system are interconnected and mutually supporting, altering one or a few is merely disruptive of the stable functioning of the system and its effectiveness.

Thus, a meaningful reform must eliminate all characteristics more or less simultaneously. THEREFORE Partial reforms will not suffice The analysis implies that radical reformers are correct to seek the total replacement of the traditional system. Radical marketization and privatisation undercut of destroy each of the nine defining characteristics of the traditional system. Fischer & Gelb (1991): The Process of Socialist Economic Transformation Enterprise reform: * Enterprise reform, which requires the imposition of bottom-line discipline, definition and change of ownership, and reform of management, is the heart of the transformation process. Two phases (opinions differ which should come first) * Restructuring * Privatisation

Slow privatisers argue that firms should be sold off gradually after restructuring. They emphasise the danger of severe economic dislocation if too much change is attempted quickly. Fast privatisers argue that the benefits of a rapid and irreversible shift to private production outweigh the costs of reduced state revenue. They believe that comprehensive and rapid ownership reform is necessary to increase efficiency. * Broad distribution of shares, or vouchers with which shares can be bought, across the population The Role of the State: * Redefining the previously all-encompassing role of the state is one of the greatest challenges for reform.

Institutions and professions taken for granted in market economies have to be re-created and reformed to support markets: * Secure legal environment to protect property rights and regulate commercial relations * Accounting and audit systems are needed to organise and monitor information * Investments in human capital to complement the system reforms in areas such as: accounting, credit and market analysis and bank inspection. * Management skills need to be upgraded and modernised (especially in finance and marketing) * In some areas, such as financial markets, reform may require a greater state role than before. * Reforming governments need urgently to: * Introduce broad-based taxes and to develop the capacity for tax administration, rather than continue to depend on profit remittances from state enterprises. * Institute a social safety net, especially for those affected by the new phenomenon of open unemployment * Liberalisation of labour and capital markets is also important.

Labour market reform measures to make it easier to hire/fire labour, relaxation of wage regulation, introduction of unemployment insurance, establishment of institutions (inc. employment agencies) to encourage labour mobility. Capital market reform development of financial markets and private sector institutions (inc. banks). However, freeing input markets should not be an early priority. * Enterprise reform is the heart of the transformation process. 2 phases: restructuring and privatisation. Slow privatizers vs fast privatizers. Reforming governments will have to introduce broad-based taxes and develop the capacity for tax administration, rather than continue to depend on profit remittances from state enterprises. The reforming goverments will also have to develop a social safety net. Sequencing of reforms: Reforms need to include macroeconomic stabilisation, price reform, trade reform, small-scale privatisation, new regulations for private investment, the creation of emergency unemployment insurance and the start of work on new tax, legal and regulatory institutions. * For countries with severe internal/external imbalances, priority no. 1 has to be macroeconomic stabilisation (e. g sharp cuts in firm-specific subsidies, tight credit limits, trade liberalisation at a heavily depreciated exchange rate, fixing the nominal exchange rate (in countries with high inflation)). Stabilisation can be assured only by following consistent macroeconomic policies over periods of years. Shleifer (1997) : Government in Transition Key point: Russian government is less effective in serving the market economy – as well as its people – than the Polish government. But why? Arguments to the effect hat Russia is historically and culturally incapable of good government (such as low trust and anti-marketculture) lack support. More convincing argument: Russia has not had as radical a change in its government, in terms of both structure and personnel, as Poland or the Czech Republic. Comparison of Poland and Russia: * Both were industrial economies at the time reforms began * Both economies faced substantial disruption from the collapse of COMECON and other trade following the demise of the Soviet Union * Both economies were in poor condition when the reforms began, suffering from inflation, goods shortages and declining production. * Both experienced a near-collapse of the state prior to transition. In Poland – total demise of the communist party and its military regime * In Russia – the Gorbachev government faced a similar crisis, which led to the dissolution of the Soviet Union and the creation of independent Russia * After communism collapsed, both countries moved to fragmented, rapidly changing party systems and “ semi-presidential” regimes, in which a conflict between president and legislature was present from the start. * Both were led in their transition by charismatic, populist presidents committed first and foremost to the destruction of communism. However, despite these similarities as of 1990, the two countries appeared in 1996 to have very different results of their reforms. I argue that an essential part of transition to capitalism is the transition of government.

Despite similar economic reforms, government in Russia continues to retain substantial political control over economic life, and moreover uses this control to pursue predatory policies toward business. The political transition in Russia has not gone nearly as far as it has in Poland, and this slowness of political transition disturbs economic growth. Government in transition: * Even when the communist power collapsed, some remnants of a large government often remained, ready to continue political control. The principal goal of the political transition was to replace these remnants with institutions supportive of capitalism. This entailed two steps: * Depoliticisation – government control replaced with control by market orces * Price liberalisation – eliminates price controls that were used by planners to either stimulate or discourage production of particular goods, or to create shortages that allow planners to maintain their power over resource allocation. * Stabilisation – imposes a harder budget constraint on the government, and thus prevents politicians from using subsidies to encourage firms (and regions) to pursue political ends * Privatisation – removes direct control over firms from the government * New functions taken on by government: provision of laws and regulations that support a market economy. * The state had to be weakened overall, but strengthened in a few areas. * However, even with the three radical measures taken, the government retains much regulatory power which it can use to either support market economy or hurt it. Shock therapy does not guarantee depoliticization (as politicians can still exercise control in other ways) or a transformation of government institution which includes: * creation of laws and legal institutions that protect private property, enforce contracts between private parties, but also limit the ability of officials to prey on private property * creation of regulatory institutions that deal with competition, securities markets, banking, trade and so on * Despite shock therapy, politicians in Russia, particularly at local level, retain enormous control over economic life, which they use to pursue political ends and to enrich themselver. * This makes them rather different from politicians in Poland * Russia is also behind in creating the institutions of a new market economy. ALSO Transition of government into one that supports markets from the one that preys on them has gone further in Poland than in Russia – regulators of small business exert more power over business in Moscow than in Warsaw and use this power to enrich themselves. In addition, the Russian government has not yet successfully taken on the basic market supporting functions, including police protection. * Russia is much more of a laggard in the transition of its government than it is in shock therapy. Human capital of politicians: Key point: Lack of turnover of human capital in Russian politics may well be a serious reason for the poor performance of its government * Many Russian politicians are communist leftovers experiencing significant hardships understanding what is expected from them. Few of these leftover politicians have transformed themselves into capitalist politicians. In Poland, 75% of local leaders elected in Poland in 1990 had no record of government service and 45% of newly elected mayors were under the age of 40 – in Poland the people have largely changed and been replaced by a younger crowd, with some experience in both democratic politics and market economy, whereas in Russia, the local leaders are largely the very same people who were there before the reform began. In thisrespectSolidarity changed Poland – Russia would be a very different place politically if it had a similar revolution from below. Incentives of local politicians to support private business * Campaign support * If politicians need to collect campaign contributions to run their elections, they might favour new business as a source of potential campaign donations * Local tax base * If politicians need to provide public goods to attract votes, and must collect taxes to pay for these goods, they would support the growth of new business to broaden the tax base * Personal share holdings Local politicians may support private business if they effectively become shareholders in it and profit personally when it does well Poland vs Russia: Elections: * Poland had held elections more consistently than Russia and officials at very local level – where small business would actually have a political say – are all elected. * Because of elections, Polish politicians appear to be much more supportive towards private business than Russian politicians. Tax base * In Poland, the principal source of funds for local governments are local taxes and fees, especially property taxes incentive to the local politicians to broaden the tax base to increase revenue through new business formation and employment * In Russia, over 2/3 of local government evenues comes from their share in taxes collected by central government through negotiation governors have little incentive to broaden their tax bases and instead focus on negotiations with Moscow Personal financial incentives: * In Russia, many of the local officials see a rather short and insecure future for themselves in politics. If the private economy grows, they are likely to lose power because they will not be acceptable to the new business elites or will be replaced by younger politicians during new elections. Absence of political security may prevent the politicians from accessing the future profits of the firms, therefore many local government officials simply destroy local business through excessive corruption and regulation – they take what they can while they can. Initial conditions Poland had been pursuing economic reforms at least since the 1980s (much longer than Russia) Polish private sector was well established by 1990 when reforms began (by 1986 1/3 of the Polish labour sector was employed in the private sector) * Poland had a much more substantial legal history and tradition to rely on – many of its commercial laws were adopted as soon as reforms began because they were based on Poland's own pre World War II laws * National tradition made the implementation of at least some institutional reforms much easier. * Russia had been building capitalism for a much shorter time – Gorbachev's reforms allowed some quasi-private firms in Russia, but few compared to Poland. Russia's history of market institutions is sparse too – pre-revolutionary laws were an instrument of autocratic control, not protection against it; regulatory agencies have been created from scratch, employees often view their jobs as mandates for personal enrichment rather than efficient regulation. * However, author believes that importance of initial conditions can be overrated – many countries in Eastern Europe, such as Slovakia and the Czech Republic, are growing rapidly even though they had as little private business before the reforms as Russia did. Some countries of FSU are also growing despite having a limited history of legal traditions and public institutions. With proper political incentives, initial conditions are often overcome. Suggestions:

Acceleration of elections at the sub-regional or local level * Fiscal federalism – more generally the tax system – needs to be reformed as well. * Institutional reforms need to continue – legal reforms are most important among those, but creating functional bureaucracies, one at a time, is also crucial. * Russia made the mistake of beginning with economic reforms and delaying the political and institutional reforms (however, author believes that business pressures are likely to play a critical role in the political transition of Russia and of course they did not exist before economic reforms) Estrin (1991) – Privatisation in Central and Eastern Europe Key points: Appropriate mode of privatisation depends on the development of capital market institutions and the availability of foreign or domestic private capital * Transition must be rapid to be effective, so reforming governments have been faced with the tasks of selling assets whose value is far in excess of domestic resources. Privatisation: * Objective: to improve enterprise performance and national economic efficiency and to help public finances (Vickers and Yarrow, 1988) * Definition (Milanovic) – transfer from the public to the private sector of ownership in such a way that private individuals become the identifiable ultimate owners Seven central areas in which property rights and the mechanism of resource allocation must be altered in order to build a functioning market sytem: 1) Ownership and control 2) Means of allocation 3) Aims of the System 4) The Allocation of Labour 5) The Allocation of Capital 6) International Trade 7) Role of State

Reformers in Central and Eastern Europe strongly believe that their recent history proves that when the state is owner, it will always interfere in the operation of firms in such a way as to hinder the beneficial impact of competition Hinds (1990) – absence of effective private property rights is at the heart of the failure of actual socialist systems, and must be immediately eradicated by widespread privatisation. Privatisation: * Important way of raising government revenues, but it will not affect the state's long-term financial position if enterprise efficiency is not changed; may still be sensible from a revenue point of view is short-term conditions call for additional expenditures with limited availability of taxation or other income sources * Important element in building markets Significant role in the formation of labour market institutions and the process of wage bargaining * Privatisation prevents a reversion to the old systems How to Privatise and to Whom? One of the main problems – mass privatisation in countries where domestic savings are small and capital market institutions weak Arguments FOR selling state's assets: * Considerable revenues * If monetary overhang threatens to destabilise the macroeconomy, privatisation could absorb some of the excess liquidity. * Owners established through a process of financial exchange will have the strongest demand effective corporate governance Arguments AGAINST selling state's assets: * Unequal distribution of income and wealth Traditional modes of privatisation are very slow and most analysts agree that for transition to be effective the changes must be fast * Valuation problem – nothing upon which to base valuation (no relevant record of profitability), a significant proportion of companies are loss-making, thus it is likely that sales price will be negative * No domestic actors with the resources to buy Most of these problems are resolved by a free distribution of the state's holdings: * No need to value the assets initially * No need to find domestic purchasers * Privatisation could be extremely rapid * Provided an operational scheme can be devised, privatisation can be constructed in a highly egalitarian way, preventing the early concentration of wealth in the hands of the nomenklatura or black marketeers who otherwise would be the people most likely to gain from privatisation Disadvantages of free distribution: * Losing the revenues from sales Possibility of weak governance if capital ownership is dispersed – central issue is whether population at large are the appropriate owners to dramatically improve company performance Potential buyers or recipients: * Public at large – external privatisation or privatisation from above * Transfer of ownership to shareholders * Foreigners – access to hard currency, superior management skills and technical know-how * Insiders – internal privatisation or privatisation from below * Involves the sale of shares to workers and managers in the firm * Attractive: * Could be administered quickly and relatively easily, yet could still provide some revenue to the government * Participative organisations may be more productive * Negative: Yugoslav experience: employee control may conflict with effective corporate governance * No establishment of credible procedure for wage determination and for reducing inflationary pressures * Clearly not suitable for companies that require a significant degree of restructuring (probably the vast majority) * Unjust – workers and managers in profitable firms stand to gain considerably from the privatisation process, while those employed in loss-making firms would obtain nothing * Potential for bribery and corruption as workers and managers can use insider information to undervalue the assets or to transfer them illicitly into their own hands Roland (1994) – On the Speed and Sequencing of Privatisation and Restructuring Big bang approach

– fast privatisation through mass privatisation plans with no definite sequencing, leaving the task of restructuring to the owners of the privatised firm Key point:

Political constraints necessitate a gradual approach to restructuring and gradualism has implications for the speed and sequencing of privatisation. In particular, we ward on the danger of privatising too fast firms where restructuring should best be delayed for political reasons. Conclusion: A condition for successful gradual restructuring is a screening mechanism to separate good firms from bad ones. It is crucial to separate thee firms and their channels of finance, so that good firms would become independent of government through government and face hard budget constraints while bad firms would remain under government control with strengthened control. Arguments for the big bang view of mass privatisation: * Speed Price liberalisation in a state-owned enterprise economy will not give the correct incentives, thus it is necessary to achieve very quickly a critical mass of private ownership in order to get firms to respond to market signals. * If not done: * Danger of inertia – due to firms not taking new profit opportunities * Danger of continued soft budget constraints – loss-making firms expect to be bailed out * Importance of getting the State out of the economy * Committing the State to avoid continuous intervention in enterprise activity * Absence of clarified property rights * Danger of large scale decapitalisation by managers who have de facto control without assigned property rights Experience: * Poland Plan: combining fast privatisation through giveaways together with strong control rights given to mutual funds to avoid dispersed ownership of firms * Political constraints have played a major role in blocking

Polish mass privatisation – in 1994, four years after the beginning of " big bang" in Poland, it is still not implemented * Russia * Speed of privatisation – obvious success (about 1/3 of workers were in privatised firms by end of 1993) * Problems with restructuring * Former managers are still in control (workers did not sell their shares to outsiders to assure outsider control; managers preventing them) Political constraints: There are 2 main sources of political constraints to privatisation: * Ex-ante political constraints – feasibility constraints * Proposals may be blocked – e. in Poland where coalition in power preferred distribution to workers whereas the Polish mass privatisation programme involved distribution to the population at large * In Russia, policy-makers took into account ex-ante political constraints by designing a giveaway plan favouring managers and workers (Boycko, Shleifer and Vishny (1993) justify that this was the only way to get privatisation adopted) * Sometimes coalitions push forms of privatisation that are economically not sensible but politically difficult to avoid * Ex-post political constraints – concern the danger of backlash and reversal of given politics * This may be the case when a programme advertised as very egalitarian induces a high concentration of wealth in the hands of a small number of people * However, political constraints related to redistribution of wealth and income may not be the most serious * More serious political constraints are related to serious income risks related to restructuring – general knowledge that there will be a massive shift from heavy industry to services, from big to small enterprises, but in most cases, nobody knows in advance which enterprises will survive and which will die Experience: * Big bang restructuring is not ex ante feasible * Gradual restructuring may be more acceptable ex ante because: * Gradualism allows for “ divide and rule” tactics * Gradual resolution of uncertainty may enhance ex ante feasibility * Aggregate uncertainty related to uncertainty: restructuring may be positive but it can go wrong, too advantage to moving gradually by starting to restructure only a subset of enterprises or sectors * Gradual eform packages tend to start earlier – Hungary and China * Optimal sequencing: * Better to start with reforms having the highest expected outcome for a majority and to delay the reforms that are expected to hurt the most Gradual restructuring and privatisation policies: * No political constraints – restructuring may be left to the new private owners * Political constraints – very fast and non-differentiated approach to privatisation danger of partial renationalisations (subsidising a great number of firms) and general delays in restructuring (due to soft budget constraints/no incentives) * Gradual privatisation policy allows for: Establishment of a screening mechanism separating good from bad firms * Best firms tend to get privatised first as they are more likely to find a buyer less large redundancies and better performance * Privatisation may be slow, but it is possible to speed it up: * Managers incentives to restructure before privatisation especially when given shares * In Poland, although mass privatisation has been blocked, successful privatisation has continued at a fast speed especially in smaller and medium enterprises through a “ liquidation programme” – management buyout * Emergence of a sound private financial system If good firms get privatised first, bad firms remain under state control private savings are allocated to good firms with high yieldings sound financial system may emerge * A credible pol