

## **Ten Lessons from Thirty Years of Postcommunist Economic Transformation**

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### **Abstract**

The dominant idea in the early postcommunist economic transition was that an early and comprehensive radical economic reform program was needed. This program was accompanied with a clear program of political economy of reform, which included a clear understanding that the old system was finished, a political breakthrough, new political leaders, new economic policymakers, the swift elaboration of a reform program, a functioning parliament, sufficient international financial support, fast implementation, public understanding, and the overruling of any need for consensus. In hindsight, all these factors worked when they were present. Critics warned of too sharp output fall, which did not come to pass, lagging institutional development, and neglect of social reforms. The biggest problem has become the absence of real property rights in the postcommunist countries not belonging to the European Union because of captured judicial systems.

Keywords: Political economy, Eastern Europe, former Soviet Union, economic transition, economic institutions, property rights

## Introduction

Thirty years of postcommunist transformation allows us to draw broad lessons. In 1989, the old communist order broke down in Eastern Europe, and at the end of 1991 the Soviet Union broke up. This was a truly liberal revolution akin to 1848. This was a time of optimism and liberalism. The two leading slogans in Eastern Europe were “We want a normal society” and “We want to return to Europe.” These slogans were not specified, but together they meant a liberal democracy with a free market economy based on private ownership of the means of production and the rule of law. The return to Europe signified European values and membership of the European Union.

Looking at the postcommunist world today, it is striking how different the outcomes have been. Out of 21 countries in the former Soviet Bloc in Europe and the Soviet Union, 18 are market economies,<sup>1</sup> but only nine full democracies by the standards of authoritative Freedom House (2019). The economic achievements vary greatly.

The intellectually dominant radical reform program for postcommunist countries followed the “Washington Consensus” closely, but it went further and was more specific. Moreover, the original radical reform program, the Balcerowicz program was published in September 1989 before the Washington Consensus and it was adjusted to the contemporary Polish conditions. The Balcerowicz program became the standard for a radical, comprehensive reform. Its prescriptions applied also to other countries in similar predicaments. It was lucid and is easy to summarize, with macroeconomic stabilization, deregulation, privatization, and a reinforced social safety net.<sup>2</sup>

## Ten Lessons of Political Economy

The political economy of policy reform is a fine art. My favorite overview is the edited volume by the Washington-based economist John Williamson (1994), *The Political Economy of Policy Reform*. The summary below contains ten principles, partly economic, partly political.<sup>3</sup>

*First, an enlightened elite and a broad public need to understand that the old system is finished.* Several years of severe economic decline are not sufficient, but a public comprehension needs to evolve that the old economic system is no longer viable. In the Soviet Union it developed from 1985, whereas the Soviet economy had stagnated since 1979. Such insights can only evolve under a certain intellectual freedom.

An important reason for the breakdown of the communist dictatorship was a split in the old elite, the Nomenklatura. Some in the old establishment thought they would be better

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<sup>1</sup> The exceptions are Belarus, Turkmenistan, and Uzbekistan.

<sup>2</sup> See Lipton and Sachs (1990), Sachs (1990), and Balcerowicz (1992).

<sup>3</sup> This draws on Åslund (2013), pp. 248-252.

off economically and also freer under a more liberal regime. Many “members of the old elite were now discovering that they could maintain their privileged positions in society even without the ideology ... the party was no longer a monolith. And once it ceased to be a monolith, it was no longer viable” (Dobbs 1997, pp. 373–4). The reformers within the Communist Party were opposed by dogmatic hardliners who wanted to maintain the old order, and the escalating struggle between these two factions made it possible for outside reformers, often true democrats, to start playing a political role (McFaul 2001).

*Second, no major economic reforms can take place until a political breakthrough has occurred.* Usually this means democratization. Poland illustrated how little reform was possible until the Soviet Union eased its military control in December 1988. In Russia, the failed August 1991 coup marked the democratic breakthrough, and it was facilitated by the democratic Russian presidential election of Boris Yeltsin on June 12, 1991.

In the early transition, a widespread fear was that popular unrest and labor protests would hinder or unravel market economic reforms because strikes and people’s protests had brought down the old regime. Unexpectedly, it turned out that the main opponents of full-fledged market reforms were not the relative losers, the industrial workers, but the old and new businessmen who could make fortunes on rent seeking between the old and new system. Therefore, they had strong incentives to slow down the transition to a normal market economy. They wanted a privileged market economy for themselves, where they bought at low state-controlled prices but sold at high free market prices. Joel Hellman (1998) penned this conclusion in his seminal article “Winners Take All: The Politics of Partial Reform in Postcommunist Transitions.” This leads to the conclusion that democratization and radical economic reform naturally go together (Diamond 1995)

*Third, successful reform requires new leaders. You cannot teach an old dog to sit.* Leaders do not merely accept the rules, but form them, and incumbent leaders tend to insist on the old ways. Transition calls for new thinking and requires new, clear principles, while ordinary politics involve horse-trading and compromises rather than crisis resolution, which requires visionary leadership and determination, yes, stubbornness. As Jeffrey Sachs (1994, p. 503) stated: “Successful domestic reform depends on vigorous political leadership.”

*Fourth, also the leading economic policymakers must be new.* They are typically young, well-educated outsiders, who have studied and lived abroad, returning home with new insights, while knowing their old society well enough to understand it. John Williamson noticed that the Latin American reforms in the 1980s were carried out by young Latin Americans with a Ph.D. in economics from an excellent US university. In Eastern Europe, reform brought a similar group of outsiders, mostly economists, to the fore. Outstanding examples are Leszek Balcerowicz, Václav Klaus, Mart Laar, Yegor Gaidar and Anatoly Chubais. None of them had a Western degree, because hardly any East Europeans were allowed to study abroad.

*Fifth, the newly-appointed policymakers need to swiftly elaborate a comprehensive reform program.* Because of rampant crisis and limited administrative capacity they must

focus on key concerns ignoring side issues. Such a program should be short and simple, containing essential policies and clear principles. Balcerowicz presented his program within one month of the formation of a new government in September 1989.

Three powerful groups supported a radical program for market economic reforms. Leading mainstream Western, primarily American, macroeconomists were most vocal. Prominent names were Jeffrey Sachs, Stanley Fischer, Lawrence Summers, and David Lipton, and their institutions were Harvard University, the Massachusetts Institute of Technology, and the London School of Economics. Another group professing even more radical economic reforms were the foremost economists in Eastern Europe, Leszek Balcerowicz in Poland, Václav Klaus in Czechoslovakia, and Yegor Gaidar in Russia. Young politicians with economic insights joined them, notably Mart Laar in Estonia and Einars Repše in Latvia. Behind them all stood the big international financial institutions, the International Monetary Fund (IMF) and the World Bank, and the G7 with the ministers of finance and central bankers of the major Western governments.

*Sixth, a functioning and democratically responsible and parliament is essential for the elaboration of the hundreds of necessary reform laws.* This is a strong argument for parliamentary rule (Remington et al. 1998). There is a sharp dividing line between Eastern Europe and the former Soviet Union in this regard. The whole of Eastern Europe moved toward parliamentary rule, partly because of the inner workings of democracy, partly because of peer inspiration, and partly because of their EU integration. The EU does not demand a parliamentary system, but the very decision-making system and interaction with the EU renders such a system natural. In the former Soviet Union, by contrast, presidential systems dominate, and all the purely presidential regimes are authoritarian. The semi-democratic countries in the former Soviet Union (Armenia, Georgia, Kyrgyzstan, Moldova, and Ukraine) have mixed presidential-parliamentary systems that frequently change. A parliamentary system requires far more transparency than a presidential system that easily relapses into the old Soviet system of informal telephone rule. A law that is being hammered out in a democratic parliament attains quite another quality than a suddenly drafted and adopted presidential decree.,

*Seventh, sufficient international financial support is vital.* People usually underestimate the pivotal importance of international financial assistance. It often determines whether a country opts for serious reforms or not. The question is not how much international support a country receives in absolute terms or in relation to its GDP but that it obtains an adequate amount at the right time conditioned on appropriate policies. Today, Central Europeans often claim that their superior culture and inheritance guaranteed success, rendering international assistance superfluous, but that is not true. Leszek Balcerowicz (1992) makes it blatantly clear that he never took success for granted. Poland did receive \$1 billion in Western assistance in support of the Balcerowicz plan at the outset of 1990. Similarly, the three Baltic states received the early international support of \$1 billion they needed in 1992. Russia and other countries in the former Soviet Union, by contrast, did not. Therefore, they were likely to fail.

*Eighth, speed in implementing the reforms is vital for their success in a crisis.* A popular saying ran: “You cannot cross a chasm in two leaps.” The leading Estonian reformer, Mart Laar (2002, p. 10) observed: “The only thing we knew was that there was no time to lose.” He also coined the expression: “To wait is to fail.” When a house is on fire, the fire brigade should not wait but come as fast as just possible. It is the same with the combat of a severe financial crisis. The importance of speed and comprehension was clear to the early radical reformers, notably Balcerowicz, Klaus, and Laar.

*Ninth, the public understanding of reforms is vital.* People need to understand to support reforms. Unfortunately, almost all reformers failed with regard to public education. The exception was Klaus, who spent Saturdays talking to ordinary people in small towns about the need for radical economic reform. Not surprisingly, he has been the politically most successful reformer, having served two terms as prime minister and two terms as president of the Czech Republic. Most reformers were economists and saw themselves as technocrats, initially leaving politics to politicians. Only belatedly, they realized they had better become politicians as well. John Williamson (1994, p. 26) noted that reformers needed “the will and ability to appeal directly to the public and bypass vested interests.”

*Finally, in a severe crisis when radical new thinking is required, no consensus is possible.* Radical reforms are inevitably controversial, because their purpose is to break the power and privileges of the old elite, who are thus bound to oppose reforms. As Sachs (1994, p. 505) observed: “In deep crises, there simply is no consensus to build upon, only confusion, anxiety and a cacophony of conflicting opinions.” The vested interests of the old elites are the root of the problem, and they deploy their media in opposition. As Joel Hellman (1998) so accurately noticed, it is not the population but the elite that pose the greatest obstacle to successful market reforms. Therefore, democracy is not an obstacle but the best means to beat them, and the correlation between democracy and reform is strong (Åslund 2013, p. 246).

This received wisdom of the political economy of crisis resolution is hardly original, but too many oversee these insights. Ultimately, policy reform is about restoring confidence in the state, which requires fast, firm, and consistent action.

### The Problems of Property Rights and Democracy

In 2019, almost all the postcommunist countries have resolved the main economic policy problems. With the exceptions of Belarus, Turkmenistan and Uzbekistan, they are all market economies. Inflation is moderate everywhere. Budget deficits and public expenditures are no longer major concerns. Conservative fiscal and monetary policies prevail. Public debts are under control, so are current accounts.

The region has gone through three distinct periods of economic growth in the last three decades. From the end of communism until 1999, output fell and recovery was limited, with a far better situation in Central Europe than in the former Soviet Union. From 2000 to 2008, the whole region went through a tremendous commodity and credit boom with an average growth rate of 9 percent a year in the former Soviet Union, though less in

Central Europe. After the global financial crisis, growth rates have been much lower. The region that has done the best is Central Europe.

Yet, the region is not converging economically. A few countries, notably Estonia and Poland have gone through great economic development and more than doubled their GDP, while a few post-Soviet countries – Kyrgyzstan, Moldova, Tajikistan, and Ukraine -- have lower GDP measured in purchasing power parities today than in 1990 according to the World Bank (2017). Postcommunist countries are converging more with their neighbors outside of the former communist bloc than with one another.

An underlying reason the postcommunist world has coalesced into two major blocks. One block consists of eleven formerly communist countries that have become members of the European Union. They have two important characteristics. They are all classified as free or democratic by Freedom House (2017), and they have corruption under reasonable control according to Transparency International (2017). They are characterized by reasonably good governance.

A contrary block consists of seven of the twelve post-Soviet countries that are authoritarian and pervasively corrupt. They are best described as authoritarian kleptocracies, working for their ruling elites rather than for the countries as a whole. They have ended up in a bad equilibrium with high corruption and severe repression. These economies grew fast in the 2000s thanks to the commodity boom, which has now receded. The origin of their current situation is the extraordinary rent seeking that prevailed at the outset of transition. There is no reason to expect that their economic growth will accelerate significantly.

But there is also an intermediary group of five former Soviet countries. Georgia has almost achieved the EU level of democracy and actually such a control of corruption. The two big outliers are Ukraine and Moldova, which are almost free but are as pervasively corrupt as an average post-Soviet state. Armenia and Kyrgyzstan are not far behind. In systemic terms, the larger country Ukraine is the battle front between the two systems, democracy with rule of law or authoritarianism with pervasive corruption (Åslund 2017). These are the most interesting countries in the sense that it is not obvious which road they will take. They tend to be politically unstable, which has so far depressed their growth, but it may also lead to higher growth in the future.

The fundamental problem of all the post-Soviet countries apart from Georgia is the weakness of their property rights. In all the authoritarian states, the president controls the courts, which naturally judge to his benefit. The presidential families are greatly involved in business and the previous oligarchies have increasingly become centralized authoritarian states. State capture, or kleptocracy, and authoritarian rule go together. As a consequence of the absence of real property rights, the ruler as well as those ruled, move their cash abroad. This means that most of these countries save much more than they invest, and the low investment ratio leads to chronically low economic growth. The unwillingness of private businessmen – local or foreign – to invest leads to rising state dominance and renationalization, particularly noticeable in Russia.

To sum up, we know how to build a market economy and the radical economic reform program worked well as far as it went. The big remaining problem is the guarantee of private property rights, which in turn seems to require democracy. To a considerable degree, the economists have done their job, even if new problems will erupt and you should always strive to reach a higher level. By and large, however, the task is now for the political scientists to design democratic systems and the lawyers to construct the rule of law as successfully as the economists have built market economies. So far, the best tool available has been the European Union through its accession. Hopefully, the Eastern Partnership can evolve to play a similar role in Western Balkans and Eastern Europe.

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