Introduction: A World Transformed

In 1989, the Soviet bloc – from Berlin to Vladivostok – was struck by one of the greatest liberal revolutions of all times. Since then, society has changed profoundly. A complete ideological, political, economic, and social system passed away, and some 400 million people had to choose a new system. The rejection of socialism was unequivocal. A broad consensus aspired to build democracy and a market economy based on private ownership and the rule of law, and opposition to these goals was concealed in disagreement on how to accomplish them.

At the collapse of communism, liberal revolutionaries seized the political initiative. They aspired to build a "normal society" and to "return to Europe." The petrified communist dictatorships had to give way to democracy and individual freedom, the state-controlled economy to markets, and public ownership to private property. Communism had rejected the rule of law, which should now be established. A total transformation was needed, and nobody thought it would be easy.

Communists always feared the return of capitalism. They planted many poison pills to secure the destruction of capitalism, such as the comprehensive nationalization of property, the annihilation of civil society, the elimination of markets, and the suppression of law. Communism was dead as an ideology, unable to resist the liberal revolution, but its poison pills were alive. They bred a rent-seeking state that was actually the alternative to free market capitalism. The main struggle of postcommunist transformation stood between radical market reformers, who desired a swift and complete transition, and rent seekers, whose desire was to make money on a prolonged period of market distortions.

The building of capitalism was widely seen as comprising four key steps. The first and most fundamental step was to deregulate prices and trade so that a market could be formed. Second, when prices were freed, they inevitably rose because of shortages caused by excess demand, and inflation had to be brought under control by many means. Third, the nominally public enterprises lacked real masters, and the only plausible principals to be were private owners, which required large-scale privatization. Fourth, everybody understood that postcommunist transformation would involve massive social dislocation, and all acknowledged the need for a new social safety net. Democracy and the rule of law were, of course, desirable.

Perspectives change over time. As often happens during revolutions, people's expectations become exaggerated and then people become disappointed. The institutional changes have been immense, but even so the legacies of the old society remain palpable, as Alexis de Tocqueville (1856/1955) noted so accurately in *The Old Regime and the French Revolution*. Some institutions have been much more successfully reformed than others.

Postcommunist transformation has been an intense battle. On one side of the barricades stood radical reformers, who wanted to build a normal society. Their main opponents were rent seekers, not old communists. The rent seekers' goal was plain: to make as much money as possible on transitional market distortions. Their endeavors led to a great misallocation of resources and slumping output. Their hunger for state subsidies and subsidized credits boosted inflation, disorganizing the whole economy. All their successes skewed income and wealth distribution in their favor.

Despite all hardship, most socialist economies have swiftly become ordinary market economies. Of the twenty-one countries studied in this book,[1] all but three – Belarus, Turkmenistan, and Uzbekistan – have been successfully transformed. Transactions are monetary, reasonably free, and carried out on markets. In almost all of these countries, inflation has fallen to single digits, and nearly two-thirds of the national output is produced in privately owned enterprises. The international community knew how to build a market economy. Predominantly, it advocated a radical market economic reform with deregulation, macroeconomic stabilization, privatization, and the formation of a new social safety net. To a reasonable degree, this policy was implemented, but mostly with delays. To build a market economy was a political choice that most, but not all, governments made. The three CIS

[1] They once formed the Soviet bloc in East-Central Europe and the Soviet Union. I call Poland, the Czech Republic, Slovakia, and Hungary "Central Europe," and Bulgaria and Romania "Southeast Europe." Estonia, Latvia, and Lithuania are the Baltic states. Together, I call these three subregions "East-Central Europe." The rest of the region consists of the twelve countries belonging to the Commonwealth of Independent States (CIS), Russia, Belarus, Ukraine, Moldova, Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan.

nonreformers showed that the success of the market economy was not a given.

The building of democracy and the establishment of the rule of law have been much less successful. Frequent complaints are that too much attention and resources were devoted to economic reform and too little to political and legal reforms. This may be true, but more striking is that in these spheres no viable theory predominated and the policy advice was often too vague and diverse to be helpful. National leaders had no clear idea or program to follow. As a consequence, only the European Union (EU) accession countries, which adopted all the EU institutions, were successful in building democracy. The promotion of the rule of law has been even more unsatisfactory.

The outcomes of postcommunist transition have been remarkably diverse. The results have depended on early policy choices, which were influenced by the conditions prevailing in each country. The Central Europeans swiftly shifted to normal market economies and privatized. They adopted West European social welfare systems with high taxes, large social transfers, and excessive labor market regulation, which have impeded their economic dynamism, but they have also become impeccable democracies, and corruption is relatively limited.

Nine Commonwealth of Independent States (CIS) reformers also developed market economies, but of a more East Asian type with low taxes, limited social transfers, and liberal labor markets. The low taxes are a major cause of their recent high growth rates. Low flat income taxes, decreasing corporate profit taxes, and the liberalization of labor markets are proliferating from the East into the EU. Alas, they are at best semidemocratic and mostly authoritarian states, with pervasive corruption.

The Baltics cleverly chose the best of both of these worlds, adopting full-fledged market economies with limited public sectors and high economic growth. They also enjoy democracy and limited corruption. Southeast Europe straddles a middle ground between the social democratic Central European model and the liberal Baltic model. It is still too early to say what eventual choice it will make.

Three CIS countries are completely nonreformed, Belarus, Turkmenistan, and Uzbekistan. They are true tyrannies, and they maintain a state-dominated, Soviet-style system.

Overview of the Arguments of this Book

Postcommunist transition has aroused many debates. Often the discussion has been heated, because the issues involved have been of great importance to numerous people. To offer the reader an overview of the arguments of this book, some of the most common, as well as contentious, questions are posed here with brief answers summarizing what the reader will find in this book.

Why Didn't Russia Follow the Successful Chinese Model of Economic Reform?

Secretary General Mikhail Gorbachev attempted gradual economic reforms for two years until he realized that the omnipotent party bureaucracy blocked all his efforts. He responded by launching glasnost and partial democratization to undermine the apparatchiks. In China, the bureaucracy had been disciplined by the Cultural Revolution and still obeyed the Center. The Soviet Union had experimented with gradual reforms in the 1920s, 1950s, 1960s, and 1980s, but all these reforms had been reversed. The dominant reformist conclusion was that reforms had to be more radical to become irreversible. China had successfully started with reforms in agriculture, but that sector was not very large in the Soviet economy, so any success would have had limited impact on the economy as a whole. Moreover, Soviet collective farms were large-scale and industrialized, rendering their reform far more complex than in the manual Chinese agriculture. Gradual price deregulation seemed to work in China, but in Russia it was a major source of disruptive rent seeking. The Soviet Union collapsed in hyperinflation, whereas the Chinese leaders never lost control over macroeconomic stability. In the end, surprisingly little can be compared in China and Russia, because their preconditions differed greatly. So it would be surprising if the same model would generate similar results or even be applicable.

Why Was Postcommunist Transition So Arduous?

The postcommunist transition was replete with hardship. The initial conditions were truly awful. Most countries entered transition amid serious economic crisis with high inflation and output nearly in free fall. The combination of excessive foreign debt, large budget deficits, and prevalent shortages necessitated price liberalization. But when prices were freed, they skyrocketed. The overarching early task was to defeat inflation because as long as inflation stayed high, output plummeted. A whole new system had to be built, and the knowledge of how to do so was limited.

Another reason for enduring hardship was that many rent seekers, who were prominent members of the old and new elite, could make fortunes on market distortions. They favored low regulated prices and restricted trade to make money on privileged foreign trade arbitrage. They insisted on low state interest rates because they benefited from ample access to state credits. As conditions altered, they swiftly found new means of extracting rents until the construction of a market economy had been completed. They did what they could to prolong the transition period because it was a window of opportunity for them. Meanwhile, the rent-seeking elite ignored the negative impact on output, not to mention on the well being of the population, of their shenanigans. All measures indicate that as radical and early a transition as possible yielded the best economic and social results.

Has Output Really Fallen More than During the Great Depression?

The decline in output can hardly be compared to the degree of decline experienced during the Great Depression, but we shall never possess an exact answer because the problems of measurement and definition are immense. All official statistics exaggerate the decline in output, and the multiple biases point in one direction. In the Soviet system, managers wanted to exaggerate their output to reach their plan targets, whereas private businessmen prefer to understate their production to alleviate taxation. Statistical systems could not survey the many new private enterprises, and the unregistered economy grew. Much of the socialist product was unusable and unsaleable – sheer value detraction that should never have been recorded as value added. Under socialism, consumers suffered from shortages, massive queuing, awful quality, limited choice, and forced substitution because more often than not they could not find what they wanted. Military production accounted for about one-quarter of the Soviet gross domestic product (GDP) in the late 1980s. This production was real, but demand for it plummeted with the end of the Cold War. The energy and raw material producers in the former Soviet Union gave large implicit subsidies to the energy-poor states in the west and south, and the Central Asian republics received large annual budget subsidies from Moscow. Because we shall never be able to agree on the value of the Soviet GDP, we cannot agree on how much it has fallen. All told, the "real" output fall might have been about half as much as official statistics suggest.

Hadn't a More Gradual Dissolution of the Soviet Union Been Better?

A gradual dissolution would not have been better; the greatest disaster at the dissolution was the maintenance of the ruble zone for one and a half years, which led to hyperinflation (more than 50 percent of inflation in the course of one month) in ten of the twelve CIS countries because of competitive issue of money by multiple central banks. The Baltic countries were the most successful both in their building of market economies and democracy thanks to their early and clean break with the rest of the Union. The Soviet Union had stopped functioning as a fiscal and monetary entity by late 1990 because the Union republics no longer passed on their fiscal revenues to the Union treasury while irresponsibly boosting their expenditures beyond their means. Because Russia had democratized more and earlier than the Soviet Union, Russia enjoyed more political legitimacy than the Union. Finally, no empire has succumbed with as little bloodshed as the Soviet Union. The dissolution of the Soviet Union in December 1991 stands out as a wise and heroic deed of great foresight.

Has Privatization Been Overdone?

Privatization has not been overdone. The predominance of private enterprise has been a precondition of both market economy and democracy. Private enterprises have generated virtually all economic growth. The price paid for an enterprise at its privatization was not very important because successful privatized firms often pay annual taxes exceeding the highest price imaginable of the original asset. Because private companies generally do better than public enterprises, it is more important that enterprises are privatized early than how they are privatized. The later the privatization, the greater the destruction of both physical and human capital was. But it does matter that a privatization be perceived as legitimate, so that the resulting property rights are politically recognized. Restitution, mass privatization, and sales to insiders have been more easily accepted than initial sales to outsiders, although the latter have been economically successful.

Are Oligarchs Pure Parasites?

Oligarchs are not parasites per se. In the early transition, the oligarchs were the most outstanding rent seekers, but as normal market economies obtained, the oligarchs adjusted and have been highly productive since 1999. In Russia, Ukraine, and Kazakhstan, young, able, local businessmen have revived and restructured many a Soviet mastodon, especially in energy and metals. In these industries, existing enterprises were large and so were the economies of scale. Foreign investors have mostly proved helpless in the early restructuring of large Soviet factories. Local businessmen have excelled in these tasks: managing relations with both regional and central governments, defeating pervasive criminality at plants, and handling the complex social rules while slashing the work force, utilizing the existing physical capital rationally, and securing both property rights and contracts. Because of the weak legislation and judicial system, which resulted in poor corporate governance, concentrated ownership has been superior to widespread ownership. As a consequence of their concentrated ownership of large successful corporations, the oligarchs have become very wealthy. By contrast, because of unwillingness to sell cheaply to local businessmen, large plants have mostly died in Central Europe either in the hands of inept foreign investors or, more often, in protracted, unproductive state ownership.

Has Western Aid Been Excessive?

Western assistance to the postcommunist countries has been small by any standard. The total grant assistance to the region was a couple of billion dollars a year, which is tiny. By contrast, the U.S. peace dividend, that is, the reduction in U.S. military expenditures that became possible because of the end of the Cold War amounted to a stunning $1.4 trillion in the 1990s, or as much as 3 percent of the U.S. GDP in 1999. Amazingly, Western governments received more in debt service on old communist loans than they gave in both loans and grants to the postcommunist countries from 1993 to 1996. The Western negligence to make a serious effort at assistance in the early transition is disturbing.

East Germany has suffered from the opposite problem. Since 1990, West Germany has poured over $80 billion a year into its new *Laender* – about half its GDP and twice the global assistance to developing countries – which has greatly exceeded that region's absorption capacity. East Germany has been priced out of the market by this giant financial flow that has formed an insurmountable social welfare trap. Strangely, this harmful wastage of public resources is continuing unabated.

Is the European Union the Best Solution?

The European Union has made impressive contributions to the transformation of the EU accession countries. It provided the standard of a normal society. Both through its demands and its transfer of institutions, it helped to reinforce democracy in the accession countries. From an early stage, the EU opened its vast market to them. In the accession process, the EU compelled the new members to adopt 80,000 pages of legal texts in the *acquis communautaire*. The great advantage was that the new members were forced to adopt a standard Western market economic and legal system. The shortfall was that they were induced to accept a West European social welfare model with high taxes, large social transfers, and various forms of overregulation, notably of labor markets and agriculture. That model is not conducive to high economic growth, which is one of these countries' greatest needs.

Have the Postcommunist Countries Achieved Sustainable Economic Growth?

Sustainable growth has probably been achieved. The Russian financial crash turned out to be the catharsis Russia needed to accomplish a full-fledged market economy with a critical mass of markets, macroeconomic stability, and private enterprises. Its impact was felt throughout the post-Soviet region. Growth returned with a vengeance. It has been driven by sound macroeconomic policies, structural reforms, sharp cuts in public expenditures, low exchange rates, and a commodity boom. Since 2000, the huge former Soviet region from the Baltics to Kazakhstan has recorded an average growth of more than 8 percent a year.[2] The former Soviet Union has joined the growth belt that started in East Asia a few decades ago and has proliferated through China and India. Common features of all these economies are sound macroeconomic policies, low taxes, small social transfers, and relatively liberal labor markets. In 2003, Goldman Sachs stunned the world with a paper about the BRICs (Brazil, Russia, India, and China), predicting that in 2028, Russia would be the fifth biggest economy in the world after the United States, China, Japan, and India (Wilson and Purushothaman 2003). If sustained high oil prices are added, Russia could become the fifth biggest economy in the world before 2020 (Westin 2005). Most of the former Soviet Union is growing even faster than Russia. Will this growth survive the current commodity boom? It probably will in the star performers – the Baltics, Armenia, Azerbaijan, and Kazakhstan because they have undertaken considerable reforms. The main question mark is Russia, which has seriously aggravated its structural policies and reverted to renationalization.

Alas, approaching the European Union, this dynamism fades away. Central Europe (Poland, the Czech Republic, Slovakia, and Hungary) got stuck with a growth rate of only 4 percent a year from 2000 to 2005. Admittedly, that is more than twice the EU rate, but these still-poor countries need much faster growth, and at this rate, they will not converge with the rest of the EU.

Latin America is a natural yardstick for achievements in the postcommunist region. Both before and after the collapse of communism, their economic level was similar. The postcommunist countries have caught up with Latin America by establishing a market economy and privatization. Latin America has been more successful in democratization, whereas the postcommunist region has achieved much higher growth rates because

[2] Throughout this book, all averages are unweighted because we are interested in the relative performance of different countries. In economic weight, Russia and Poland dominate.

its structural economic reforms are proceeding. At present, the economic future of Eurasia looks brighter, but the combination of authoritarian rule and the energy curse might take major countries in this region astray.

This book is a history of the economic development of this postcommunist region from 1989 until 2006. It is devoted to the postcommunist economic transformation of the twenty-one countries in the former Soviet bloc in Eurasia, including Poland, the Czech Republic, Slovakia, Hungary, Romania, Bulgaria, and all the fifteen former Soviet Republics,[3] while excluding all the former Yugoslav republics – Albania, China, Mongolia, and Vietnam. All these twenty-one countries had much in common: the hierarchical and bureaucratic communist dictatorship, the socialist economic system, and closely connected foreign trade system. Although reforms in Hungary and Poland had altered their systems, the socialist principles remained, whereas the economic and political systems of Yugoslavia and China were profoundly different.

The structure of this book is systematic with one chapter for each major topic. Chapter 1 discusses what communism was and how it collapsed. Chapter 2 presents the main discussion with arguments for a radical or more gradual market economic reform. Chapter 3 examines what actually happened to output and how that can be explained. Chapter 4 focuses on deregulation, Chapter 5 on macroeconomic stabilization, and Chapter 6 on privatization. Chapter 7 deals with social developments and Chapter 8 with the politics of transition. Chapter 9 considers the problems of establishing the rule of law. The newly emerged oligarchs deserve Chapter 10 for themselves. Chapter 11 is devoted to the role of international assistance, after which conclusions follow.

I published *Building Capitalism: The Transformation of the Former Soviet Bloc* in early 2002. This book is not a second edition but partly a sequel and partly a slimmed revision of that volume. Most of this book is newly written. My ambition is to streamline the argument and concentrate on the dominant trends, which have become more evident over time. I have reduced technical details and statistics, replacing many tables with summary graphs in the hope of providing a better overview. Today we can say that the building of capitalism has been successful, and it is time to take stock of how this was accomplished. The academic literature on postcommunist

[3] Estonia, Latvia, Lithuania, Russia, Belarus, Ukraine, Moldova, Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan.

transition is immense, and I have tried to limit the references to the most essential to make the book readable. I hope that this book will serve not only as a standard for the academic community and as a textbook for students but also as a source of inspiration to a broader public, notably investors who want to benefit from these growing economies.