1 Triumph and Crisis of Neoliberalism

Looking back at postcommunist transition after thirty years, it is hard to remember that the enduring triumph of neoliberalism, which seems self-evident today, was neither expected nor predicted. While several postcommunist countries embraced neoliberal "shock therapy" in the early 1990s, not even its most enthusiastic advocates thought that these reforms would last, let alone be adopted in successive waves throughout the postcommunist world.

Neoliberal reforms were expected to cause so much pain, unemployment, and disruption that voters would reject them after a short honeymoon period (Balcerowicz, Baczyński and Koźmiński 1992; Balcerowicz 1994; Blanchard 1993; Commisso 1990, 5; Dahrendorf 1990; Elster 1993; Myant and Drahokoupil 2011, 83; Sachs and Lipton 1990; Offe 1991; Ost 1992; Przeworski 1991, 190; Sachs 1994). As Adam Przeworski wrote at the time, "Facing what are often the gravest economic crises in their history, countries … are exhorted to plunge into reforms about which only one thing can be known with certainty: they will make most people worse off for some time to come" (1991, 46). As one IMF executive director put it in a 1992 board meeting on Russia, "The task of economic reform in Russia is immense. The benefits of success are enormous. The risks are huge. Yet the risks of not making the attempt are even greater. And I believe these are benefits and risks to the rest of the world as well as to Russia itself … the costs of failure, and the chaotic disintegration that could follow, scarcely bear contemplation" (IMF 1992, 10). Economic reform in the new postcommunist democracies would be an arduous, tumultuous process with uncertain results. Neoliberal reformers were almost certain to be voted out of power with the onset of transitional recessions.

This expectation of social resistance to reform explains why reformers advocated a strategy of neoliberal shock therapy in the first place. The idea was to implement quickly as many painful reforms as possible through a brief "window of opportunity" that had opened in the early 1990s with the toppling of communism (Balcerowicz 1994). Shock therapy would enable reformers to break through the heavy institutional and cultural legacies of communism (Hausner, Jessop, and Nielsen 1995; van Zon 1994; Howard 2003; Jowitt 1992; Offe 1991; Rychetnik 1995; van Zon 1998, 2001). As Naomi Klein (2007) noted, reformers believed they needed to take maximum advantage of the immediate postcommunist crisis to launch painful neoliberal reforms, since such an opportunity would not last and would never come again. But it did.

The great surprise of the postcommunist transition is that the neoliberal moment lasted and lasted and lasted. It survived leftist returns to power, persisted across multiple governments, took place in successive reform pushes, and, in its extent and endurance, defied expectations. Newfound political freedoms were seldom used to reverse neoliberal reforms (Fish 1997; Greskovits 1998). Cultural norms failed to prevent the rise of an entrepreneurial culture or force governments to abandon a neoliberal policy approach. The lack of market institutions, such as stock markets, did not prevent reform from surging ahead. Instead, neoliberalism prevailed in various forms to varying extents across these nascent polities for nearly two decades under a wide variety of political and economic circumstances.

While theorists such as Jeffrey Sachs (1994) exclaimed that "you cannot cross a chasm in two jumps," arguing that there was a need to transition to capitalism immediately and all at once, many countries did in fact reform in two or three jumps, one more radical than the next. Hungary launched its most dramatic reform effort, the Bokros Package, not in 1990 but in 1996, under a Socialist government (Kaufman 2007). Russia initiated the "Gref program," a major liberalization effort that included the introduction of a flat tax, under President Vladimir Putin in the early 2000s (Åslund 2004). With strong IMF involvement, Romania and Bulgaria implemented major liberalization programs in 1997 and 1998 (Pop-Eleches 2009). President Nazarbayev in Kazakhstan saw through a series of privatization reforms, including small-scale industrial privatization and housing privatization in 1995–1996. Kazakhstan enacted land privatization in the late 1990s after several failed attempts. Kyrgyzstan also carried out privatization in a series of steps over the 1990s and was one of the earliest Eurasian countries to join the WTO in 1998, followed by

Georgia in 2000 and Armenia in 2003 (Jeffries 2003). It was not just the immediate postcommunist period that proved amenable to radical reforms. Governments proved able to push neoliberal reforms through again and again.

Indeed, postcommunist governments continued to enact neoliberal reforms for decades, despite the election of formerly communist left parties in country after country in the middle to late 1990s and despite other political setbacks. Very few of these reforms were rolled back (Cook, Orenstein, and Rueschemeyer 1999, 270). In fact, it was shockingly common for left-of-center governments to reform more than right-wing governments in an effort to prove their capitalist bona fides (Tavits and Letki 2009). While many expected left governments to undo reforms, left governments, even more than right governments, felt compelled to signal their willingness to adopt and continue neoliberal reforms.

As a result, neoliberal reform in the postcommunist European and Eurasian countries (PCEECs) progressed much further than most analysts expected. Not only did most governments in the 1990s implement the policies of the Washington Consensus, which included privatization, macroeconomic stabilization, and trade and price liberalization, they continued to liberalize into the early 2000s in preparation for membership of the European Union. Many PCEECs went beyond what the EU demanded in terms of liberalization (Epstein 2008; Vachudova 2005). This even extended to countries like Georgia that were not candidates for EU membership (Schueth 2011). Some of the radical neoliberal reforms included the flat tax, pension privatization, the slashing of corporate tax rates, extreme monetarism, and strong central bank independence. Many of these avant-garde neoliberal policy ideas had failed under the political, economic, and cultural constraints of the established market economies of Western Europe and North America, but were widely adopted in PCEECs.

The surprising strength and endurance of the region's embrace of neoliberal policies remains the great unexplained mystery of transition.

Why did policies that were expected to engender mass democratic opposition and face calls for reversals after a few months or years last instead for nearly twenty years, until the global financial crisis? Why did neoliberalism not take place in a short "window of opportunity," but a long embrace? Why did the postcommunist countries' neoliberal enthusiasm end with a crisis that started in New York in 2008, rather than a domestic rebellion against a painful set of domestic reforms? What did transition theory get wrong and why? These are the questions that inspire this book.

We argue that early theories of transition failed to identify the key mechanisms of transition and therefore failed to accurately predict the triumph of neoliberalism. We propose a new theory that better explains the enduring triumph of neoliberalism from 1989 to 2008 and the timing of the populist reaction that ultimately came in the 2010s, twenty years later than expected.

This book marks the culmination of our long efforts to analyze the determinants of economic policymaking in postcommunist Europe and Eurasia. We began as graduate students in the immediate post-1989 period, studying privatization and policy reform in Prague, Warsaw, and Moscow. In subsequent work, we moved on to look at the impact of European Union accession and the ways in which post-communist countries exceeded the demands of the European Union and its requirements for membership. We wrote books on pension privatization and the flat tax, two radical reforms adopted mainly in the late 1990s and 2000s, which sought to out-liberalize the European Union. We followed the process of transition for more than twenty-five years, producing work grounded in empirical observation of economic policy in postcommunist Europe and Eurasia. Building on this rich empirical base, we now seek to move beyond existing approaches. We raise and answer central questions about why early transition theory failed to predict the postcommunist countries' enduring support of neoliberalism. We develop a more comprehensive model, one that explains both the triumph of neoliberalism for nearly twenty years after 1989 and its belated crisis after 2008.

We argue that the postcommunist transition has been driven forward by a process of "competitive signaling." This mechanism, not widely considered at the outset of transition, proved to be the driving force behind the neoliberal policy adoption in the PCEECs. It was motivated by a desperate need for capital, a sudden opening to the global economy, and the ideological hegemony of neoliberal ideas. These factors set off a competition between PCEECs to signal their attractiveness to investors by quickly adopting neoliberal reforms.

Competitive signaling has been mostly overlooked in the literature on transition and is treated in a cursory fashion in studies of diffusion (Simmons, Dobbin, and Garrett 2006, 2008; Swank 2008). In the security studies literature, signaling is a highly developed construct, as leaders look for ways to signal their intentions in the international arena in order to reach negotiated settlements prior to going to war (Jervis 1970; Fearon 1994, 1997; Gelpi and Griesdorf 2001; Tarar and Leventoglu 2009) or after the outbreak of war (Filson and Werner 2002; Powell 2004; Slantchev 2003). In the literature on foreign direct investment, some scholars have examined how governments adopt policies as signals – for instance, offering tax holidays, implementing financial market deregulation, and signing bilateral investment treaties – in order to attract foreign investment, in particular in environments where information about local investment conditions is limited (Campos and Kinoshita 2008, 10; Bond and Samuelson 1986; Raff and Srinivasan 1998; Bandelj, Mahutga, and Shorette 2015).

We argue that policy signaling is central to understanding the course of postcommunist transition. In this sense, this book represents a sharp break from early transition theory as well as from many later studies on the political economy of postcommunist reform. Early transition theory focused on tensions between economic reforms and democratization (Commisso 1990, 5; Dahrendorf 1990; Elster 1993; Przeworski 1991), with transition modeled as a domestic political-economic struggle. We argue that the transition was very much driven by the imperative of reinsertion into the global economy, from which PCEECs had been isolated for forty or seventy years. This was the true drama of transition.

Reinsertion into the global economy was bound to be painful. PCEECs opened themselves up to a global economy shaped by the rising importance of China, Brazil, India, and other developing countries. They entered this system without established markets and without the institutions necessary to compete. PCEECs were desperate for capital and had to play a very quick game of catch-up. Most developing countries already had a head start in adopting liberal economic reforms that were part and parcel of the global economy. Even China, another communist country, had gradually begun to liberalize its economy in the late 1970s. It was far better placed to take advantage of trade and investment opportunities with the rest of the world, as it had connections with international capital and a stable polity at home. China became a leading destination for foreign investment while PCEECs had to fight for the attention of investors. Moreover, as twenty-seven PCEECs opened themselves up to the global economy at the same time, they were forced to compete with one another as well. In the end, these pressures of reinsertion into the global economy swamped the effects of domestic socioeconomic tensions over reform and democracy.

Under such conditions, PCEECs needed to assert their capitalist credentials and differentiate themselves from the pack. One of the most powerful ways to do this was to adopt neoliberal reforms. Numerous PCEECs sought to appear as champions of neoliberalism and unleashed a process of competitive signaling that lasted from 1989 to 2008. This reform signaling helped them to compete with Asia and Latin America for foreign investment; they were also aided by the advantage of being closer to the core economies of the European Union (Boudier-Bensebba 2005; Holland and Pain 1998; Raff and Srinivasan 1998). Many governments made the adoption of neoliberal policies the centerpiece of their rule, seeking to win "front-runner" status for their countries. Other countries and governments raced to keep up with their PCEEC neighbors and strove not to be left behind in the pursuit of limited foreign investment. They wanted to avoid being labeled laggards by international rating agencies (Cooley and Snyder 2015). Over two decades in twenty-seven countries, governments had different motivations for keeping with the program. Some were guided by their belief in neoliberal principles and theory. Others were driven by a desire to win new factories and jobs. Some governments were opposed to neoliberalism, yet saw adoption or continuation of neoliberal policies, at least at a minimum, as a basic condition of remaining in power and avoiding censure by the international community. Altogether, as one government succeeded another, the cumulative effect was to keep reform going for nearly twenty years with few reversals and periodic episodes of accelerated radical reform. The electoral reactions to painful policies predicted by Adam Przeworski and other early transition theorists did occur, but they had a muted effect on the advancement of neoliberal reform.

While competitive signaling was driven importantly by material incentives, ideas mattered too. Neoliberal reforms worked as signals because neoliberalism had become the hegemonic *lingua franca* of international economic policy in the 1980s and 1990s. Neoliberal policy adoption facilitated the sending of signals. A government adopting a neoliberal policy could be assured that this signal would be widely received, with international organizations acting as interpreters and broadcasters of these efforts. International organizations directly evaluated PCEEC economic policies on a yearly basis and rewarded specific neoliberal reforms with upgrades in various rating systems (Schueth 2011, 2015), with the expectation that investors might base their investment decisions upon them. International organizations, in essence, played a vital communication role within this system, ensuring that the right signals were sent and received with a minimum of friction.

The hegemony of neoliberal beliefs weakened significantly after 2008 with the onset of the global financial crisis. In many postcommunist countries, the 2008 crisis proved exceptionally severe and long-lasting. Growth rates collapsed to a far greater extent, and a return to economic growth stalled for far longer, than in other developing countries. And as governments and people reflected upon the source of their economic troubles, it seemed that the neoliberal reform approach they had taken was partly to blame. Most PCEECs had liberalized to a greater extent, at that point, than China, which weathered the crisis better. Substantial deregulation of financial markets and institutions was frequently identified as a factor in the collapse of the US banking sector, which caused credit to dry up in Central and Eastern Europe. Foreign bank ownership, much higher in the PCEECs than in any other world region (Epstein 2008; Raiffeisen Bank 2014), made these countries particularly vulnerable to the boom and bust cycles of the global economy. Not only PCEEC governments, but also investors may have questioned whether neoliberal policies were indeed a necessary condition for investment. As beliefs about their efficacy changed, neoliberal policy signals lost their meaning and impact. As a result, neoliberal signaling was less often employed. Governments began to seek out other means of attracting capital for investment. It was not only the desperate need for capital, but also the existence of a hegemonic ideology that made competitive signaling so pervasive.

No world region has pursued a neoliberal approach as enthusiastically and persistently as postcommunist Europe and Eurasia. The adoption of neoliberal policies in the former communist countries since 1989 was unparalleled in speed and scope. This enduring triumph of neoliberalism is often taken for granted now, but it was completely unanticipated. The candle of reform burned for far longer than anyone expected at the time. Yet strangely, no one has sought to explain why. That is the task of this book. We do this not only to set the record straight by revising old theories and showing where they miscalculated, but also to better understand the challenges of the present day as we face a new phase of transition in the shape of a crisis of neoliberalism and the emergence of economic nationalism and populism.

What Is Neoliberalism?

Before we consider any further the triumph and crisis of neoliberalism, we need to specify how we use the term "neoliberalism" and show how we will measure it. Despite many well-founded attempts to codify and measure "liberalism," "neoliberalism," or "economic freedom" in economic policy worldwide, skeptics continue to question whether something like "neoliberalism" exists. Some contend that the term is so broadly used as to be mostly meaningless. Neoliberalism, in this view, is applied to such a wide array of policy measures that it often means almost any policy that the person who uses the term does not like. We have devised the following approach. First, despite its negative usage in much of the transition literature, we seek to use the term "neoliberalism" neutrally to designate a set of policies that are also sometimes called (usually by its proponents) "economic freedom." In fact, we borrow the definition of "neoliberalism" entirely from its proponents, only replacing the term "economic freedom," which we assert is also politicized, with "neoliberalism." This term usefully and accurately places neoliberalism in historical context as a new form of the classic economic liberalism of eighteenth and nineteenth-century British economists Adam Smith and David Ricardo. We define neoliberalism as a transnational policy paradigm, a set of ideas about economic policy linked to a political program aimed to develop market economies throughout the developed and developing worlds (Babb 2013, 268–297; Boas and Gans-Morse 2009).

Neoliberal ideas or "economic freedom" derive from a long line of liberal economic thinking, but have been most closely associated with the antistatist and anti-Keynesian work of Friedrich Hayek, the monetarist economic theory of Milton Friedman, and the University of Chicago economics department. The "Chicago school" emphasized the primacy of markets for determining value and for distributing resources. It discouraged government intervention except to ensure the functioning of markets (e.g., to enforce contracts, protect property rights, and ensure physical safety). It asserted that unfettered trade would lead to efficiency gains and welfare improvements, and that state regulation should be kept at a minimum since it would in general diminish public welfare.

After the oil shocks of the 1970s, neoliberal ideas began to dominate economic thinking in the leading states in the world system when they were adopted in the 1980s by leaders such as Margaret Thatcher in Great Britain, Ronald Reagan in the United States, (Harvey 2005; Jones 2012; Prasad 2006), and Augusto Pinochet in Chile. Neoliberal ideas then spread to the rest of the world through the influence and pressure of these leaders and states (Fourcade-Gourinchas and Babb 2002). Countries that opposed neoliberal ideas and the adoption of capitalist reform programs risked punishment by financial markets and political isolation.

Scholars have sought to study neoliberalism or "economic freedom" by studying policies such as trade liberalization, monetarism, protection of private property, and fiscal prudence, establishing an index or a scale, and rating countries as more or less liberal over time. This method has been adopted by neoliberal think tanks such as the American Heritage Foundation and the Fraser Institute of Canada, which publish indexes of liberalization or "economic freedom" for countries around the world. We use these common measures of neoliberalism or "economic freedom" as a benchmark for this study. These measures are used widely in published academic work, particularly in economics (Gwartney, Lawson, Park, and Skipton 2001; Johnson, Kaufmann, and Zoido-Lobaton 1998; Bengoa and Sanchez-Robles 2003; Kenisarin and Andrews-Speed 2008). These indexes capture the extent to which countries adhere to the key priorities of what we call "neoliberal" economic policy. The "neo" in "neoliberalism" denotes differences between the current and classical liberal paradigm, particularly with regard to the level of government intervention, which is higher under neoliberalism than under the classical liberal policies of the 1800s and early 1900s that emphasized a "laissez faire" approach to economic adjustment (Boas and Gans-Morse 2009; Frieden 1991).

The Fraser Institute's Index of Economic Freedom shows that PCEECs started from a lower level of liberalization than other developing countries, but progressed rapidly in the 1990s and 2000s (see Figure 1.1). By 2005, the average level of liberalization in the PCEECs had converged with that of other highly liberal and liberalizing developing regions, such as East Asia Pacific, Latin America, and Middle East/North Africa (Gwartney, Lawson, and Hall 2011).

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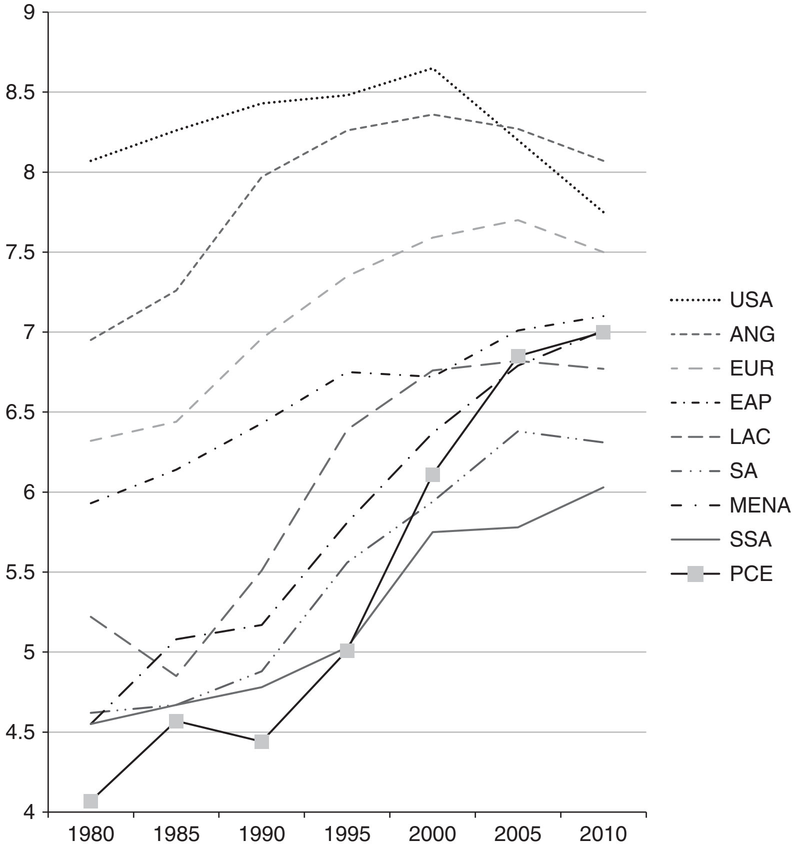

Figure 1.1 Liberalization 1980–2015 by World Region
Source: Fraser Institute.
USA = United States of America
ANG = Anglophone Settler Countries minus USA plus UK
EUR = European Countries (minus postcommunist Europe)
EAP = East Asian and Pacific Countries
LAC = Latin American Countries
SA = South Asian Countries
MENA = Middle East and North African Countries
SSA = sub-Saharan African Countries
PCE = postcommunist European and Eurasian Countries