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Introduction

> The hardest part of the transformation, in fact, will not be the economics at all, but the politics.
>
> Jeffrey Sachs, 1993: 5

In the popular Soviet-era movie *An Irony of Fate*, a bout of drinking leads a Russian man to board a flight to St. Petersburg by mistake. Upon arrival, he hails a taxi and tells the driver to take him to his apartment on Construction Workers' Street. The ride takes him through a familiar landscape of seemingly identical apartment buildings, public service signs extolling socialism, and milk and bread shops with innovative names like "Milk" and "Bread." After reaching his address, he enters a nondescript building and takes the lift to an equally nondescript two-room apartment. He then goes to bed with no idea that he is in the wrong city.

Two decades into the transformation of the Eurasian space, this premise is implausible. If the watchword of the communist era was conformity, the watchword of the postcommunist world is diversity. The bustling streets of Prague are a far cry from the drab thoroughfares of Minsk, and the faux-rococo design of Moscow's Manezh Square has little in common with the staid old-European atmosphere of central Zagreb. The hardwiring of the planned economy cannot be easily replaced, but the scope of change across countries in a relatively brief period is remarkable.

Poland, the economic basket case of the 1980s, introduced a range of economic reforms that led to a robust market economy, while Moldova struggled to reform its economy and became the poorest country in Europe. The change in state institutions was no less dramatic. Estonia and Hungary reformed their state institutions to govern the market, while Russia and Bulgaria entered the new millennium with state regulatory institutions infested with corruption. It is hard to imagine that only a short while ago a single model of economic and political institutions dominated the region.

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This variation in economic and institutional reform across countries raises fundamental questions for comparative politics and political economy that are the central concerns of this book. Does democracy promote the creation of market economies and robust state institutions? If so, how? Under what conditions do state building and market building work at cross-purposes and when are they mutually reinforcing? More generally, if economic and institutional reforms promise to leave the majority of citizens better off, then why are they so difficult to conduct? To explore why countries fail to capture the gains from economic and institutional reforms, observers invariably invoke politics. Some argue that the problem is too much democracy; for others it is too little democracy. Some stress the importance of partisan elites committed to reform; others suggest they are irrelevant. Some point to the benefits of concentrating power in the executive; others emphasize the value of dispersing political power. To add to the confusion, empirical studies of the roots of economic and institutional reforms have produced rather equivocal results.

These debates are part of a broader reevaluation of the role of states and markets in promoting economic development. In the 1960s and 1970s, scholars and policy makers argued that state agencies could serve as engines of development by accumulating capital and coordinating investment. In the 1980s and 1990s, the intellectual pendulum swung in favor of markets as many pushed a broad agenda of economic openness, price liberalization, and the privatization of state-owned assets. The first decade of the new millennium saw the pendulum moderate as policy-making and academic communities came to recognize the dynamism of markets but also to appreciate the importance of state institutions. Yet, the global financial crisis of 2008 shattered this consensus and compelled scholars to revisit their basic assumptions about how states and markets interact. The experience of the postcommunist countries offers an excellent opportunity to contribute to these debates, as we can observe the dual processes of the formation of markets and state regulatory institutions simultaneously in real time.

This book examines variation in two types of policies: *economic reforms*, including price liberalization, the privatization of state firms, and trade liberalization; and *institutional reforms*, including the creation of state bodies to protect property rights, oversee monopolies, and regulate markets. To begin, I explore why countries differ in the pace at which they conducted economic and institutional reforms. Some pursued both types of reforms at a rapid pace, whereas others favored more gradual reforms. Conceptually, I treat the "pace" of institutional and economic reform as the sum of all reforms across policies that liberalize the economy and strengthen state regulatory institutions.

But countries also diverge in the "consistency" of their reforms, that is, the relative speed at which they liberalize their economies and construct state regulatory institutions.[1] Countries may pursue "consistent" economic reforms in

[1] Murphy et al. (1992) and Hellman (1998) identify this pattern of "partial" reforms. Here I use the term "inconsistent" reforms. This problem is also apparent in reforms in Latin America (Schamis 1999; Murillo 2009).

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TABLE I.1. *Predictions*

	Low Polarization		**High Polarization**
Democracy	Faster reform More consistent reform More generous transfers		Slower reform Less consistent reform Less generous transfers
Autocracy		Slower reform Less consistent reform Less generous transfers	

which economic liberalization and the creation of state regulatory institutions proceed at roughly the same pace. Here state institutions can buttress economic reform by constraining new owners from raiding their firms for personal profit. Alternatively countries may conduct "inconsistent" economic reforms in which economic liberalization proceeds very rapidly while the construction of state institutions lags. For example, the privatization of state firms may be fast, but the creation of corporate governance institutions may be slow. This sequence of reforms leaves new owners of former state enterprises well placed to strip assets for personal benefit rather than to use them for the good of all shareholders (cf. Stiglitz 2000; Roland 2000). One of the most important lessons of the postcommunist transformation is the significance of accounting for the relative speed of economic and institutional reform (Murphy et al. 1992; Hellman 1998).

To account for this variation in the pace and consistency of reform, this book develops an argument that relies on the interplay of political polarization and democracy. Political polarization is viewed as the policy distance on economic issues between the executive and the largest opposition faction in parliament.[2] In highly polarized political systems, the opposition has economic policy preferences far different from those of the executive so that should the opposition take power, policy is likely to change dramatically.

This book posits that the impact of democracy on economic and institutional reform is conditional on the level of political polarization. As indicated in Table I.1, democracy is positively related to more rapid and consistent reform when political polarization is low, but each increase in polarization dampens the beneficial impact of democracy on the pace and consistency of reform. Similarly, incumbents in low-polarization democracies provide much more generous

[2] "Executive" refers to presidents in presidential systems and prime ministers in parliamentary systems. In highly polarized systems, right (old-left) executives face strong opposition from old-left (right) factions in the legislature. Examples of old-left elites and factions include the Socialist Party of Albania, the Bulgarian Socialist Party, and the National Salvation Front in Romania and personalist leaders like Islam Karimov in Uzbekistan and Heydar Aliev in Azerbaijan. The social democratic ex-communist parties in Poland, Hungary, Slovenia, and Lithuania that advocated market reforms do not fit this description and are treated as centrist parties. A brief list of right elites and factions includes the United Democratic Front in Bulgaria, FIDESZ in Hungary, Freedom Union in Poland, and nonparty right elites, such as Boris Yeltsin in Russia and Askar Akaev in Kyrgyzstan. See Appendix 2.1 in Chapter 2.

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transfer payments than their counterparts in high-polarization democracies or in autocracies.

The argument assumes that for institutional and economic reforms to succeed, citizens need to alter their behavior to take advantage of the new policy. Firm managers should create new products rather than wrest subsidies from the state. Workers should acquire new skills better suited to a market economy rather than rely on skills developed for a command economy. Owners of capital should create new firms rather than ship their assets out of the country. However, because these forms of "investment" require up-front costs for the promise of future gains, these changes in behavior are unlikely if citizens expect policy to be reversed before they reap their gains.[3] Producers must believe that the policy is credible, that is, likely to be maintained over time, an outcome that is less likely as governments become more politically polarized or more autocratic.[4] Political polarization in a democracy increases the likelihood of a reversal in policy should the opposition come to power unexpectedly and thereby weakens the incentives of citizens to invest. Autocracy has a similar dampening effect on the response to reforms as the executive typically faces little cost for changing policy. Because politicians can anticipate the weak response of producers to economic and institutional reforms in the future, they have strong incentives to subvert reforms today. Thus, the pace and consistency of reform should be greater in less polarized democracies than in more polarized democracies or in autocracies.

I present the logic of the argument in greater detail in the next chapter, but for now consider policy making in a country with three groups: groups benefiting from rapid reform, or new-economy interests who are represented by right politicians; groups benefiting from gradual reforms, or old-economy interests who are represented by old-left politicians; and groups dependent on the state budget for income, including many bureaucrats, pensioners, and the unemployed, among others who are represented by centrist politicians.[5] To stay in power, governments pursue partisan policies that deliver benefits to their core supporters, but in a democracy they also must find revenue to buy political support from one other group as well. Their ability to do so, however, is constrained by the degree of political polarization and by the extent of democracy.

When polarization is low in a democracy, the policy distance between the largest factions is small. Here, executives introduce partisan policies, and producers can be confident that policies will not be reversed. Right executives

[3] Here "investment" is used broadly and refers to actions that require up-front costs for the promise of future benefits, including opening new firms, restructuring existing firms, exploring new markets, buying new equipment, and gaining new skills. Others use the term "adjustment" to describe this behavior (Berglof and Bolton 2002).

[4] "Producer" refers to the economically active part of the population and includes workers and managers.

[5] The term "old left" is admittedly cumbersome, but it reminds us that these parties favor economic policies that are typically more statist than left parties in other regions.

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facing little opposition from old-left factions can introduce rapid economic and institutional reforms across a wide range of policies that provide benefits for new-economy interests, including younger and more highly skilled workers, the new private sector, competitive firms, and urban dwellers. Old-left executives facing little opposition from right factions can introduce more gradual economic and institutional reforms across a range of policies that aim to protect old-economy interests, including older, less skilled workers, firms in the state-owned sector, and rural dwellers. Centrist executives can introduce reforms at a moderate pace. As the government is unlikely to be replaced by a successor with very different preferences over policy, producers can invest with little concern that policy will be reversed. In turn, the government can tax this investment and use the revenue to buy political support from other groups, such as the dependent sector of the population. Here, the creation of markets and state regulatory institutions proceed hand in hand.

But as polarization increases in a democracy, executives have a much more difficult time conducting economic and institutional reform. Where the opposition in parliament is large and favors an economic strategy far different from that of the executive, uncertainty about the stability of future policy is likely to reign. Producers may reasonably expect challengers to take power, perhaps even before the government serves its full term. New-economy interests that would benefit from rapid reforms under a right government and old-economic interests that would benefit from gradual reforms under an old-left government will be reluctant to invest because they anticipate that current policies are likely to be reversed. This expected investment shortfall leaves incumbents with a smaller tax base and less revenue to pay social groups that are dependent on the state, such as pensioners, budget workers, and the unemployed.

With less revenue to buy political support, politicians in more polarized democracies have stronger incentives to subvert reform either by slowing economic and institutional reforms or by conducting inconsistent reforms that deliver benefits to producer groups at the expense of the dependent sector of the population. Inconsistent reforms, in the form of rapid privatization combined with weak state institutions, targeted tax breaks, and below-market privatizations generate rents for producers and allow incumbents to buy the votes of new- and old-economy interests even as they deliver few benefits to the dependent sector. In a democracy, the degree to which politicians subvert economic and institutional reforms depends on the extent of polarization as higher levels of polarization move policy away from the government's preferred policy of consistent reform. The distortions inherent in slower and less consistent reform provide political benefits in the short run but weaker economic performance in the long run when compared to more consistent reform. In this setting, state building and market building work at cross-purposes as politicians weaken state institutions to provide benefits to producers in the old and new economies.

Finally, consider policy making in an autocracy. Regardless of the level of polarization, autocrats have more difficulty generating a robust response to reforms from producers because executives face fewer institutional constraints

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on changing policy than do their democratic counterparts.[6] Once a producer invests in an autocracy, the incumbent government has stronger incentives to seize the investment by changing policy opportunistically. Anticipating this policy change, producers will be more reluctant to invest and government revenue will fall. In hopes of retaining office, right (old-left) incumbents in autocracies will tend to favor inconsistent rapid (gradual) reform strategies that deliver rents to producers at the expense of the dependent sector.

The interplay of democratic institutions and political polarization yields several propositions about policy making. We should find that, other things being equal:

1. Democracies conduct faster and more consistent economic and institutional reforms and have higher transfer payments when polarization is absent.
2. Polarization reduces the positive impact of democracy on the pace and consistency of economic and institutional reform and on the size of transfer payments.
3. Autocracies conduct slower and less consistent economic and institutional reforms and have lower transfer payments than democracies when polarization is low.

Take, for example, Russia in the early 1990s. A right president, the stridently anticommunist Boris Yeltsin held office in a relatively democratic and highly polarized environment. Here we find an inconsistent mix of rapid economic reforms in some policy areas, such as extensive privatization, but also weak state regulatory institutions, tax breaks for well-connected firms, and minimal transfers to the dependent sector.

Similarly, consider Bulgaria in 1995. The old-left Bulgarian Socialist Party held a plurality of seats in parliament but faced strong opposition from the right-wing Union of Democratic Forces. In this highly polarized and democratic setting with an old-left executive, we find inconsistent gradual reforms, including slow privatization, tax breaks for state-owned and privatized firms, weak state institutions, and low transfers to the dependent sector.

In contrast, where political polarization is low in a democracy, firms have stronger incentives to invest, which allows politicians to collect more tax revenue on this investment and buy political support from the dependent sector using transfers. Poland in the early 1990s illustrates this logic. A right government made policy under conditions of low polarization as the successor to the Communist Party in Poland had transformed itself into a social democratic party that favored a market economy with a generous welfare state (Ishiyama 1995; Kitschelt et al. 1999; Grzymala-Busse 2002). In this relatively

[6] The credibility of policy commitments varies in autocratic regimes (cf. Haber et al. 2003). Here the claim is that autocracies cannot rely on the same electoral dynamics as democratic incumbents to generate a credible commitment.

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nonpolarized democracy led by a right executive, we find rapid and consistent economic and institutional reform, fewer tax breaks for state-owned and privatized firms, strong regulatory institutions, and generous transfer payments funded by a vibrant new private sector.

Finally, Uzbekistan began the transition led by an old-left executive in an autocratic environment. Here we observe an inconsistent mix of gradual economic reforms, tax breaks to state-owned firms, limited transfers to the dependent sector, and weak state regulatory institutions. In sum, elite partisanship, democracy, and political polarization have fairly predictable effects on policy choice. To assess these arguments, I use a variety of data from twenty-five postcommunist countries between 1990 and 2004, a survey of business elites in twenty-three countries conducted in 1999, and case studies from Bulgaria, Poland, Russia, and Uzbekistan.

One key concept in the argument is political polarization, which is measured by the distance on economic policy between the executive and the largest opposition party in parliament.[7] Where the largest opposition faction in parliament has many seats and holds economic policy preferences far different from the executive, polarization is deemed to be high. Political polarization may influence policy choice in at least two ways. It may impede reform by making it more difficult to create majorities in parliament in support of policy change (Haggard and Kaufman 1995; Murillo 2009). Indeed, political gridlock induced by polarization blocked policy change in several cases in this study, including Russia and Ukraine (Aslund and de Menil 2000). However, the evidence presented later in this book suggests that it is especially common for polarization to shape policy by heightening uncertainty over future policy in democracies. This problem is especially severe because democratic governments that serve their full term are the exceptions rather than the rule in the region.

Political polarization in the cases under study is associated with higher levels of income inequality, although it is difficult to identify whether political polarization is generating income inequality or vice versa. As we shall see, countries that experienced large increases in income inequality early in the 1990s remained highly polarized into the next millennium. This link between political polarization and economic inequality makes it tempting to argue, as others have, that economic inequality is the underlying source of policy instability (Alesina and Rodrik 1994; Boix 2003; Stasavage 2003; Acemoglu and Robinson 2006). This claim may have merit in the postcommunist cases, but it is difficult to document, given the scarcity of high-quality data on income inequality over time and across countries. Annual measures of political polarization are available for each country, but annual measures of income inequality

[7] Notice that political polarization refers to economic policy rather than polarization around other issues, such as ethnic relations, the structure of government, or regime type. Given that polarization is used in a variety of ways in the literature, I devote much of Chapter 2 to my use of the term.

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are scarce. The argument focuses on political polarization as one determinant of policy choice, recognizing that income inequality may provide a social base for political polarization.

Explanations for policy choice that rely on political polarization and democracy face the common problems of endogeneity and reverse causation (cf. King et al. 1994; Persson and Tabellini 2005). That is, while political polarization and democracy may shape policy choices today, they also may be a reflection of past policy choices, which makes it difficult to identify relationships among democracy, polarization, and policy. This difficult problem is often swept under the rug. The cases under study have the fortunate feature that initial levels of political polarization and democracy are taken from the first postcommunist election that precedes the introduction of economic and institutional reform. The timing of elections in the postcommunist world ensures that at least initially polarization and democracy are driving choices of economic and institutional reform rather than vice versa. This is important given the possibility that economic reform choices may influence subsequent levels of political polarization – an issue I address in much more detail in Chapter 6.

Similarly, there are grounds to believe that the level of democracy is endogenous to the economic and institutional reforms under study (Acemoglu et al. 2001). Omitted variables, such as the quality of the decision-making process, may be correlated with both the level of democracy and the extent of institutional and economic reform. The main focus here, however, is on the conditional effects of democracy on economic and institutional reform. To the extent that the omitted variables and sources of endogeneity linking democracy and reform are at work in high-polarization and low-polarization environments, it should be possible to estimate the conditional impact of democracy on reform without bias (Denisova et al. 2009). In other words, while it is difficult to make strong claims about the direct impact of democracy on economic and institutional reform, we can be more confident in identifying whether the differences in reform outcomes between democracies with high and low levels of polarization are significant.[8]

Existing Explanations and the Broader Literature

This book builds upon but departs from existing literature in a number of ways. For example, it differs from many works by examining both economic and institutional reforms and their interplay with a single argument. Many studies have focused on a single economic or institutional reform, such as trade policy or regulatory policy. These studies have provided great insights into policy choice but may fail to capture how politicians make trade-offs

[8] In the long run, political polarization associated with high levels of income inequality may undermine democracy, which would raise additional endogeneity concerns. Here I am interested in shorter-run dynamics. Many countries have remained democratic with high levels of inequality or autocratic with low levels of inequality in the short run.

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among these different types of reforms. Thus, they risk missing the central feature of postcommunist transformation: the simultaneous overhauling of economies and states. Those few studies that have examined the interplay of economic and institutional reform have tended to be normative and aimed at identifying the optimal sequence of reforms (cf. Mckinnon 1991).[9] In contrast, this study develops a positive argument that explores how politicians make choices over the absolute and relative speeds of economic and institutional reform. By reframing the object of study, this book aims to provide a more nuanced treatment of postcommunist transformation.

Democratic Institutions and Winners Take All

The argument aims to contribute to a number of debates on the sources of economic and institutional reform. To begin, it provides a slightly different take on the long-standing controversy over the relationship between democracy and reform. Reviewing economic reform efforts in Latin America in the 1970s and 1980s, some scholars pointed to the advantages of autocratic governments (Foxley 1983; Sheahan 1987: chap. 12). But others suggested that democracies and autocracies were simply too varied in their actual operation to have a systematic influence on policy outcomes (Haggard and Webb 1994; Haggard and Kaufman 1995). Entering the 1990s, few argued that authoritarian governments were better able to conduct reforms, but few also expressed confidence that democracies could do much better.

Indeed, early in the 1990s many scholars of postcommunism were pessimistic about the compatibility of democracy and economic reform. Offe (1991: 881) opined that "a market economy is set in motion only under predemocratic conditions. In order to promote it, democratic rights must be held back to allow for a healthy dose of original accumulation." Elster (1993) penned a chapter cheekily titled: "The Necessity and Impossibility of Simultaneous Political and Economic Reform." Jowitt (1992: 302–303) observed: "In Eastern Europe, the immediate political imperative is economic. Any successful response to this imperative is likely to take an authoritarian cast. Take a 'good case' for democratic capitalism, Czechoslovakia . . . It will take the type of liberal authoritarianism that existed in 19th century Western Europe" for reforms to succeed. Przeworski (1991) famously warned that rapid economic reforms under democratic conditions in Eastern Europe would lead to a pendulum swinging between populism and technocratic responses with each being equally ineffective.

The experience of the postcommunist world has led to a quite unexpected consensus that democracy has promoted economic and institutional reform (cf. EBRD 1999). Numerous works identify a positive correlation between democracy and reform, but scholars have had less success in identifying the

[9] Hellman (1998) and Schamis (1999) provide important exceptions that theorize trade-offs among institutional and economic reforms, while also providing evidence in support of their case.

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mechanisms by which democracy contributes to this result. They have cited more frequent alternations in power, more competitive elections, more active civil society, and more robust political opposition as critical to economic and institutional reforms, but these scholars have reached little agreement (Hellman 1998; EBRD 1999; Frye and Mansfield 2004; Grzymala-Busse 2007; Hoff and Stiglitz 2008). Indeed, others raise the possibility that the correlation between democracy and economic reform is spurious and is driven by deeper causal factors (Kopstein and Reilly 2000; Darden and Grzymala-Busse 2007).

The most sophisticated argument on the relationship between democracy and reform in recent years comes from Hellman (1998), who observes that economic and institutional reforms not only produce short-term costs but also generate short-term gains to groups taking advantage of market imperfections generated during the transition. These short-term winners are well placed to use their political power to block further reform. It is the bankers cum mafiosi, enterprise managers, and corrupt bureaucrats whose gain in the short term jeopardizes economic reform in the longer term. These groups back some elements of economic and institutional reform that increase their access to rents, while opposing other elements of reform.[10] Often this policy mix includes support for rapid economic liberalization and privatization but opposition to institutional reforms that regulate the market and limit rents.

Hellman proposes the disciplining effects of coalition building and political competition as the key to constraining the short-term winners. Broad-based governing coalitions that include groups losing from reform provide a check on the winners and can prevent the latter from capturing the state. In addition, frequent, free, and fair elections can subject narrow interest groups of short-term winners to public scrutiny and compel them to take into account the interests of groups harmed by reform. Fragmented governments and robust democracy should be positively associated with economic and institutional reform.

Hellman's "winners take all" argument is one of the most important contributions of postcommunist studies to comparative political economy, but it offers little insight into why politicians introduce economic and institutional reforms. A lack of accountability may lead the short-term winners to exacerbate the inconsistency of reforms once policies are under way, but this argument does not tell us why politicians in some countries but not others introduce reforms in the first place. Absent an explanation for why politicians take the costly step of introducing reforms, the winners-take-all view becomes less compelling. The lack of an independent role for politicians in the theory suggests that this argument may be missing part of the story.

In addition, the winners-take-all account helps us understand why it is more difficult to capture the state in some settings rather than others, but it does not provide a positive argument about how reform proceeds when the state is not

[10] Sonin (2003) and Hoff and Stiglitz (2004) provide formal models that build on these insights. Bunce (1999b) also addresses these issues.

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