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Introduction: Economics and Transition

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The transition from socialism to capitalism at the end of the twentieth century was one of the most significant events in the world economy since industrialization. Fundamental institutional change affected about a quarter of the population of the world. Few, if any, historical events have involved such change for so many over a short period of time.

The transition process phases out the equally massive economic and political experiment embarked on earlier in the twentieth century. The socialist economic model with central planning was initially promoted as an alternative to capitalism, itself the result of gradual, small-scale and decentralized experimentation over the centuries. During the first decades of socialism, this challenge was taken very seriously, but by the late 1980s few doubts remained that the socialist economic system was in the long run dynamically less efficient than capitalism. The system generated little innovation, but led to widespread shortages and poor product quality. Over the course of several decades, growth gradually came to a halt (for a definitive analysis of the socialist economic system, see Kornai, 1992).

Nevertheless, even to experts, the transition came as a surprise. A few years earlier, in the USA, the CIA and others assembled the best sovietologists to discuss the prospects of the Soviet economic system. In 1983, they published a book with the title, *The Soviet Economy Toward the Year 2000 (Bergson and Levine, 1983)*. Without the early political changes initiated by Mikhail Gorbachev, largely triggered, it seems, by a deterioration in revenues from oil exports, the Soviet Union might still have existed in the year 2000. In parallel, the transition process had been quietly proceeding in China, the world's most populous country. Few paid attention to the Chinese transition at the time, partly because it was thought to be heavily constrained by the persistence of the communist political regime. In the Soviet Union it was the unexpected collapse of the communist political regime and the advent of democracy that opened up so many possibilities for the economic transition from socialism to capitalism.

Transition was a challenge for the economics profession as a whole. Indeed, it represented a unique opportunity to spread the capitalist system to a large number of countries. In general, economists were not well prepared. There was little in terms of conceptual thinking about how to move an economy from one system to

another, and no data on which to test such concepts. Though no roadmap existed, the principles of economics were to provide a compass, and transition was to reveal the accuracy of that compass. Ultimately, transition was to provide a test of our understanding of the capitalist system itself.

1.1 The challenge of transition for economics

At the start, the transition literature was clearly driven by policy demand. The early contributions were also largely policy papers proposing strategies for transition, or part of it. Perhaps the most well-known of such papers is that of Lipton and Sachs (1990), outlining a transition strategy for Poland, which was used immediately as a reference for other transition countries. The paper contains a formulation of the 'big bang' approach to transition, advocating that all reforms should be started as quickly as possible and in a comprehensive package. An MIT Press book written jointly by several top economists (Blanchard *et al.*, 1993) followed in the same vein, but it was more comprehensive and provided a detailed argumentation in favor of, among other things, mass privatization. The big bang approach to transition had a compelling logic to many. Its intellectual roots were threefold:

1. Monetary theory and stabilization policy. The general consensus was that 'shock therapy' or 'cold turkey' was the only way to stop hyperinflation, since only drastic reductions in money supply could lead to changes in expectations
2. Complementarities between reforms. Any single reform introduced on its own would have less positive effects, and possibly negative effects, than if all reforms were introduced at the same time. For example, privatization and liberalization obviously complement each other. The idea of complementarities had been advanced a long time ago in comparative economics and the analysis of economic systems. The disappointing results from partial reforms in the early 1980s in countries such as Hungary strengthened the argument for complementarities.
3. The 'Washington consensus' on structural reforms in emerging markets in general put a strong emphasis on liberalization, privatization and fiscal discipline as conditions for aid from the international financial institutions. The disappointing experiences with development aid in the 1960s and 1970s had led to the conclusion that sound macroeconomic policies needed to be backed up by microeconomic reforms to encourage the development of markets and a competitive environment. In the context of transition countries, structural reforms such as liberalization and privatization were obviously fundamental ingredients of the transition itself.

From the very start of transition, however, a plethora of surprising puzzles dampened enthusiasm for the economic opportunities provided by the collapse of communism. We list only the main ones here.

First, price liberalization caused output to fall sharply in all Central and Eastern European countries. The output fall was clearly not predicted; it presented economists with a puzzle. Standard economic theory predicts that the volume of

sales on a market is maximal at the equilibrium price. Moving from fixed prices to equilibrium prices should in general lead to an increase in production. Even under a pessimistic scenario with no supply response, production remains the same, but certainly does not fall. Given the general inefficiencies that plagued the socialist economy, price liberalization should move the economy in the direction of greater allocative efficiency and thus lead to a higher level of activity.

When price liberalization produced an output fall everywhere in Central and Eastern Europe, the immediate reaction was either to dismiss the phenomenon as a statistical artefact: according to theory it could not have happened. Alternatively, macroeconomic policies were at fault. In particular, several papers were written that blamed the Polish output fall on excessive macroeconomic contraction (Rosati, 1994; Berg and Blanchard, 1994; and Bhaduri *et al.*, 1993). However, when prices were liberalized in Russia, stabilization was anything but excessive. Prime Minister Yegor Gaidar could only get the Duma to agree to a fiscal stabilization plan for the first three months of 1992. Afterwards, the fiscal situation was out of control and inflation remained very high in Russia for at least three years.

The fact that macroeconomic policies could not explain the output fall in general presented a challenge to market and price theory. The search for an explanation for the output fall led economists to have a new look at markets by focusing on contracts and their legal, social and political environment. As we shall see below, this is part of a general shift in economics towards inquiries into the institutional underpinnings of markets and the 'lens of contracts' (Williamson, 2002).

A second big puzzle was the so-called 'great divide' between Central Europe and Eastern Europe (CEE) and the Former Soviet Union (Berglof and Bolton, 2002). Whereas in the CEE countries the output fall was followed by a recovery, most countries of the former Soviet Union experienced a much deeper and more protracted economic decline that lasted for the greater part of the 1990s. The 'Great Divide' was puzzling, since the large variation in growth experience could not easily be traced to differences in economic policies. There were probably more differences between the Hungarian and the Czech transition strategies or between the Ukrainian and Russian strategies than between the Czech strategy and that of Russia. The Russian transition strategy was very similar, at least in the dimensions emphasized by the Washington Consensus, to the big bang approach followed in Poland and the Czech Republic. The Czech Republic and Russia implemented mass privatization, whereas Poland did not, and Russian stabilization policy was more timid than in these countries. However, Hungarian stabilization policy was also very timid in the early years. Economists had to look beyond economic policies and ponder the long-run role of institutions in determining the growth path of an economy.

A third puzzle was the extraordinary success of the transition process in China and the Chinese economic miracle since the 1980s. In 1990, the Chinese transition seemed half-baked and was criticized for its gradualism. The conventional wisdom at the time suggested that the democracy and political pluralism in Central and Eastern Europe would generate a more successful transition process, and that China would have been much better off had it followed a big bang strategy

(Sachs and Woo, 1994). In reality, the Chinese transition, while still in many respects incomplete, proved to be much stronger than that of Central and Eastern Europe, at least as at the time of writing. No output fall occurred and the economy has been on a robust growth path for over twenty years with reforms progressing gradually.

Even in today's perspective, with much stronger emphasis on the importance of institutions, China's economic success is puzzling. This success was produced despite institutional inconsistencies caused by the lack of complementarities. Moreover, China lacks what are seen today as 'first-best' institutions such as the rule of law, democracy, separation of powers, and transparency, now thought to be fundamental to successful growth. This has led within the institutionalist framework to a renewed questioning of the validity of institutions across countries and across time, and to a criticism of 'institutional monocropping' (Evans, 2004) and to questions as to what constitute 'adequate institutions' in a given country at a given time.

Finally, an important puzzle occurred with privatization, especially with mass privatization programs that led to widespread asset-stripping by the new owners. This outcome was in sharp contrast with the initial view, most starkly expressed in Blanchard *et al.* (1993), that fast privatization was a priority precisely to prevent asset-stripping by managers in state-owned enterprises (SOEs). The implicit assumption was that most managers in SOEs were facing an endgame situation. Ultimately, they would lose their jobs, and for this reason would engage in asset-stripping. The only way to stop this happening was to privatize firms as fast as possible. Another assumption implicitly made by many was that, once privatized, the Coase theorem would apply and firms would ultimately be in efficient hands. In practice, many SOE managers surprised observers by restructuring their enterprises (Belka *et al.*, 1993). More recent evidence also shows that, once the initial selection effect has been taken into account, state-owned firms have been at least as successful at restructuring as firms privatized to domestic owners (EBRD, 2005). It came as an even bigger surprise that mass privatization led to massive asset-stripping (see, for example, Black *et al.*, 2000, for Russia). Economists apparently needed to think more deeply about institutional requirements for successful privatizations and the restructuring of state-owned companies.

These different observations and the queries they raised (as well as many other phenomena of the post-socialist world, such as the emergence of the mafia and the numerous secessions of countries) cast serious doubt on the Washington consensus and revealed the extent of our ignorance.

The research on transition since the late 1980s has contributed to important shifts in the way we look at economic systems. The many surprises of transition contributed to a change of focus in the vision of economics, and have very much reinforced the institutionalist perspective, emphasizing the importance of the institutional underpinning a successful capitalist economy. Successful institutions of capitalism are already present in advanced economies, and we had tended to take them for granted when thinking of economies in transition or developing economies. The experience of transition shows that policies of liberalization, stabilization and privatization are unlikely to deliver successful outcomes unless

they are grounded in adequate institutions, thus accounting for at least some of the failures of the Washington consensus. Much of this change of focus towards the institutionalist perspective was already under way with the development of contract theory, political economy, law and economics, regulation theory, corporate finance and other areas in applied economic theory. The experience from transition provided strong empirical support for this shift in focus from markets and price theory to contracting and the legal, social and political environment of contracting.

The transition experience has also reinforced the need to incorporate the enforcement and implementation aspects of economic analysis and economic policy-making. The rapid introduction of vast bodies of laws and regulations proved to be insufficient, and often even counterproductive, as laws and regulations must be enforced. Enforcement, in turn, relies on the capacity of courts and enforcement agencies, and the strength of these institutions ultimately depends on the support generated by the political process. Similarly, the early transition programs based on long checklists of desired reforms to be implemented immediately are no longer taken seriously. The transition experience has brought home forcefully the need to design programs with endogenous political constraints. Reforms must be acceptable *ex ante* and sustainable over time, and sequencing matters for the outcome. Constituencies must be built and maintained, and local ownership is critical to the long-term success of reform programs.

Transition has also renewed interest in the difficult topic of the complementarities between the various elements of capitalist system (markets, incentive and governance systems, legal arrangements, social and cultural norms, organization of government) (see Roland, 2000). One of the important themes is the problems of transplantation: institutions working well in one context may be disappointing or dysfunctional in another. Yet the remarkable institutional transformation in Central and Eastern Europe cannot be understood without taking into account the process of enlargement of the European Union (EU). The explanation for the success of this institutional transplantation is likely to rest on its comprehensiveness (the entire body of law, the acquis communautaires, and the institutions that go with it) and the strong domestic support for the overall objective of the process (to become part of the European Union). Ultimately, the experiences from transition have also shed new light on the extent of complementarity between politics and economics. Political transition is intimately linked to economic transition, even if the case of China shows that some economic reforms can be sustained for long periods of time without fundamental political reform.

Finally, transition has also forced us to think about institutions in a dynamic way: how momentum for reform is created; how institutions can evolve; but also how momentum can be lost and how countries can get stuck with inefficient institutions. In that sense, transition has reinforced the evolutionary-institutionalist perspective, insisting both on the institutional environment of agents at any moment in time but also on its evolution.

On the whole, transition economics has contributed to a more general shift in the way we think about the general body of economics itself. First, contracts and

transactions are taken as the object of analysis. The Coase theorem and departures from its conditions are the starting point for any analysis of transactions. The puzzle of the output fall in the transition context could only be solved through a contractual approach where liberalization in a context with no pre-existing markets and an imperfect contracting environment could lead to disorganization in production and exchange (Blanchard and Kremer, 1997; and Roland and Verdier, 1997). These lessons go far beyond transition; they represent a different view of markets.

Second, abuse rather than exchange is the core problem in contracting, a theme permeating the transition literature and the understanding of economic performance. Indeed, abuse by clients, suppliers and debtors, and racketeering by mafia as well as by bribe-seeking government bureaucrats, abound in transition countries. As a consequence, the legal, institutional and social environment protecting agents against private and public abuse are of first-order importance. These institutions are often taken for granted in advanced market economies.

Third, transition has shifted the emphasis in the age-old controversy among economists over the optimal size of government. The discussion has moved away from 'more' or 'less' government towards the relative efficiency and effectiveness of different governments in providing public goods, from law and order to health and education and forms of social insurance. Research increasingly opens up the black box of government and goes beyond a monolithic view of government as being either a benevolent social planner or a malevolent Leviathan. The focus is on the organization of government and the incentive of individual politicians and bureaucrats within the given constitutional arrangement.

Fourth, the political sustainability of institutions and the need to build support for continuous reforms and new institutions have come to the fore in light of the transition process. Political constraints have played an important part in varying degrees in all countries undergoing transition. The subject of the political economy of reforms has emerged to incorporate these constraints. Moreover, political sustainability affects not only economic outcomes but also expectations.

Fifth, the transition experience has helped to overcome an ahistoric and naïve view of institutions as something easily imported and exported. Serious thinking is devoted to understanding whether institutions are adequate for particular geographical and historical contexts. Researchers also acknowledge the scope for diverse institutional responses to particular contexts. The Chinese experience and the unorthodox 'transitional institutions' such as the dual-track system or township-village enterprises have played a fundamental part in this change of perspective.

Sixth, another legacy of transition is the increasing interest in the flexibility or rigidity of institutions towards changes in economic circumstances. In the search for more efficient institutions, flexibility may be a virtue – in particular, in overcoming collective action problems.

It is difficult to trace these shifts in emphasis to particular papers, but contributions to the Nobel Symposium are representative of these trends in research.

The submitted papers have all been subject to extensive academic review and have stood the test of time in a rapidly evolving field.

1.2 The symposium papers

Erik Maskin and Chenggang Xu, in Chapter 2, survey the literature on soft budget constraints, an incentive problem conceptualized by Kornai (1980) that played an important role under socialism and continues to do so under transition. In fact, the soft budget constraint problem is generic to economic activity. It has been studied fruitfully with the help of contract theory. Budget constraints are said to be soft when an investor (the state, a bank or any other investor) has to bail out a project even though the project from an *ex ante* point of view should be closed down, since it has been unprofitable. *Ex ante*, the investor would prefer to commit not to bail out, but such a commitment might not be credible. The soft budget constraint literature shows how a given institutional context affects budget constraints.

Roman Frydman, Cheryl Gray, Marek Hessel and Andrzej Rapaczynski, in Chapter 3, present a rare cross-country comparative analysis of the effects of changes in ownership following privatization policies in Central Europe. Their main finding is that privatization has no significant impact on economic performance for insiders, but for outsiders it has a significantly positive one. Other studies have found similar results, though at the level of individual countries. The research on privatization in transition economies has led economists to think beyond simple ownership categories and to focus more strongly on issues of corporate governance.

Dalia Marin and Monika Schnitzer, in Chapter 4, use a contract-theoretic approach to explain jointly the output fall and the strong increase in barter and interfirm arrears in many transition economies in the late 1990s. They argue that, in Russia, barter has helped to alleviate opportunism in contract enforcement, and somewhat buffered the effects of disorganization by collateralizing trade between firms. This chapter is a nice example of how the contractual framework can take the institutional environment of firms into account, and derive macroeconomic implications. Their contractual framework contributes to our understanding of more general issues in international trade, where barter has often played a non-negligible role, and where the study of the form of contracts has been neglected until very recently.

Tito Boeri, in Chapter 5, goes directly to a macro framework, but this time from the perspective of labor economics. He explains the large reduction in labor supply at the beginning of transition as a result of frictions in the newly-established labor markets. Early generous unemployment benefit schemes put in place in many countries further contributed to withdrawals from the labor force.

Andrew Berg, Eduardo Borensztein, Ratna Sahay and Jeromin Zettelmeyer, in Chapter 6, exploit the vast amount of data made available over time to understand the effects of reforms and initial conditions on economic performance in the different transition countries. Using a 'general to specific' approach, they conclude that one cannot reject an effect of policies. Initial conditions seem more important

to explain initial declines, while structural reforms explain the recovery. Among the various models taking economic policy as exogenous, this is clearly the most sophisticated and comprehensive analysis to date.

In Chapter 7, Simon Johnson, John McMillan and Christopher Woodruff report, based on a survey of new firms in Poland, Slovakia, Romania, Russia and the Ukraine, that insecurity of property rights is a first-order effect explaining the lack of investment by firms. This approach is in stark contrast to the focus in much of the recent development literature emphasizing credit constraints, and has, in conjunction with others (for example, Besley, 1995) it has triggered an interesting body of work. In a companion chapter based on the same survey, Chapter 8, the authors compare the effectiveness of informal and formal contract enforcement mechanisms when courts are effective. They find that well-functioning courts encourage firms to develop new economic interactions with other firms, in this way creating a more competitive environment.

The issue of the informal sector is analyzed in Chapter 9, by Eric Friedman, Simon Johnson, Daniel Kaufmann and Pablo Zoido-Lobaton, and in Chapter 10 by Simon Johnson, Daniel Kaufmann, John McMillan and Christopher Woodruff. Both chapters find that the greater the unofficial activity, the greater is government corruption. However, Chapter 9 shows that more unofficial activity is associated with lower tax rates, suggesting that more corrupt governments are also smaller in size. The latter result is in line with the theme developed by the transition literature, that the issue about the relative efficiency of a government is more important than the traditional issue of its size.

Daniel Treisman, in Chapter 11, presents a cross-country study attempting to explain the causes of corruption. He finds that less corruption is associated with a Protestant tradition, a history of British rule, higher development and a longer exposure to democracy. Federalism is positively correlated with corruption.

Issues of the organization of government are studied by Ekaterina Zhuravskaya in Chapter 12, and Hehui Jin, Yingyi Qian and Barry Weingast in Chapter 13. While both chapters empirically analyze decentralization, their results differ strikingly. Zhuravskaya's analysis of Russian city budgets shows that changes in local government revenues are often offset on a one-to-one basis by the regional government. The strongly dampened fiscal incentives at the local level have a negative impact on the efficiency of the provision of public goods and the development of the private sector. In China, by contrast, fiscal decentralization makes local governments residual claimants on tax revenues. As a result, they have strong incentives to maximize the tax base by encouraging economic activity.

Alwyn Young, in Chapter 14, documents the barriers to trade set up by provincial authorities in China to protect themselves from the effects of price liberalization in the mid-1980s. The contribution analyzes episodes of increasing interregional variation of prices in the 1980s and their fluctuations in the 1990s suggesting episodes of local protection suppressed by the central authorities followed by further protection. The resistance to reforms also observed in other countries highlights strongly the importance of political sustainability. The devolution of authority associated with decentralization and the local diversification of production associated with

the provincial organization of central planning certainly contributed to provincial protectionism.

Yingyi Qian, Gérard Roland and Chenggang Xu, in Chapter 15, highlight some positive aspects of the provincial organization of Chinese administration, namely the institutional flexibility in terms of experimenting with reforms. This example illustrates the role of institutional flexibility in the process of change.

1.3 The transition of transition economics

The transition process has proved to be more complex and protracted than had initially been thought. It has proved a healthy challenge to economics, generating research that has influenced the economics profession and the way that economics is thought about in general. However, the field itself is in transition, moving away from applying existing economic knowledge to transition economies and towards trying to create new theories to explain the problems revealed by the transition experience. The transition process itself, however, is finite in time, and in the EU accession countries it is largely completed. Even if the process takes longer other economies, they are now all far away from the socialist central planning model. In which directions will this field of research go?

The two fields of institutional economics closest to transition economics are development and economic history. All three fields are fundamentally motivated by the same question – the so-called Adam Smith question – what are the conditions for successful economic growth and development? In all three fields, answering this question requires a comprehensive approach to understanding the institutional conditions for growth and development, and how these institutional conditions arise and emerge. In contrast to other fields of economics, researchers must have strong factual knowledge that is not easily transferable to other fields of investigation.

In a certain sense, research on transition will over time naturally merge with economic history. Interest in the subject will stay alive for a very long time, just as interest in understanding the socialist economy seems again to be resuming as it becomes more distant in time. Perhaps more interestingly, themes from transition economics are being picked up by development economics as the study of this subject shifts away from its traditional focus on rural poverty and development and towards institutional reforms and institutional change. The increasing interest in the latter issues will bring together scholars from both disciplines.

Research on transition is also transforming itself. One important example is the research program of *macro-institutional development* studying the conditions and aggregate effects of institutional change in development. The strong impact of the recent work of Acemoglu *et al.* (2004) on the effects of institutions on growth (see also, Hall and Jones, 1999). More research is currently being done in that area. Another direction of transformation is comparative institutional analysis, such as the comparison of the effects of differences in the legal systems of countries (La Porta *et al.*, 1998, 1999, 2000), the comparison of differences in the political constitutions of countries (Persson and Tabellini, 2000, 2003; Persson *et al.*, 2003),

and the comparison of institutions regulating entry and the economy in general (Djankov *et al.*, 2003; Botero *et al.*, 2004).

Many questions are being raised within these evolving research programs. A major challenge is to be able to disentangle the relative importance of different institutions that matter for growth and development. What is the role of the quality of the legal system and the quality of law enforcement? What is the role of the quality and integrity of the bureaucracy? What is the role of the political regime, the electoral rule, the degree of federalism? What is the role of social capital? What is the role of social norms and values? Ideally, we would like to be able to measure the separate effect of different institutions or the joint effect of a subset of institutions. This is not easy, since many institutions are strongly correlated. A bigger problem than correlation is the identification problem. Institutions are not exogenous, but specific institutions can also be caused by other institutions. Are legal arrangements causing social norms or is the opposite the case? Considerable craftsmanship and innovation in datasets will be required to find adequate estimation strategies to tackle those questions. Much research is needed to better understand interactions between different institutions. We also need to more fully develop the empirical grounds of our knowledge about the determinants of institutional change. This will require a major effort, not only for those who study development and transition but perhaps most of all for economic historians, because history provides a very rich ground for studying institutional change.

Despite these difficulties, these questions will be at the forefront of policy debates in coming decades. They will no doubt also continue to shape our vision of economics.

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