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Introduction and Overview

On 9 November 1989 the Berlin Wall fell, marking the end of the communist experiment and the beginning of the end of the Soviet Empire. This was widely considered as a momentous historical event, not only because it was so unexpected, but because it symbolized an end to the Cold War, the freeing of several hundred million individuals from an authoritarian state which had kept them closed off from the rest of the world, and a liberation of private economic initiatives from the constraints of the socialist central-planning regime. People around the world joined in welcoming citizens of the Socialist bloc, and euphoria would not be an exaggerated characterization of the latter's emotional state. However, the immediate impact was not yet clear, as liberation from socialism would be implemented at varying speed for different countries over the next few years. In particular, for the individual Republics of the Soviet Union, the political independence they sought was by no means assured in November 1989. But the direction of change was assumed by all to be greater openness and freedom – personal, political and economic. The subject of this book is to review how far such changes have gone in 15 years, and to explain why some countries have progressed more, others less.

Citizens elsewhere in the world echoed a sympathetic euphoria. For eighty million Germans, now reunified, it was most immediate and arguably strongest; other Europeans felt a kinship for their German neighbours, and a human sympathy sharing the joy of their eastern neighbours who could now rejoin European society. Americans whose country was the major protagonist in the Cold War rejoiced in the victory and in their contribution to freeing the captured states. Many attributed this to the open and tough stance of President Reagan, symbolized in his remark 'Mr. Gorbachev, tear down this wall!' With time, it was understood that other forces were also at play undermining the Soviet bloc, and the possibility that had the addressee not been Gorbachev, the choice might have been to call Reagan's bluff and *not* tear down the wall. At the least, Gorbachev, too, has earned historical recognition for his decision. It is also virtually axiomatic that Pope John Paul II takes place of honour as the first, if not the major, figure leading the effort to end the communist captivity.

The outcome

It has now been a decade and a half since the bloodless breaching of the Berlin Wall, and of course the euphoria has passed. But has it passed because that is the nature of euphoria, or because the euphoric expectations of that moment have evolved into disillusionment? No doubt some of both, though this book takes a positive view that, despite important shortfalls, overall there has been a lot of economic progress and social improvement. It is significant and starkly evident in most of Central Europe and the Baltics, but for others, especially the former republics of the USSR, so far it has been limited and even minimal, and has come at considerable cost to parts of the population. This relatively positive view is not shared by all observers. Numerous critics including politicians, citizens of the region and outside analysts argue that the outcome of the transition is at best mixed and in some cases disastrous; that the economic decline following transition has barely been recovered in a few countries and is far from this elsewhere; that huge increases in poverty and inequality are not an acceptable cost for any of the gains of the new capitalist endeavour; that the availability of goods at unaffordable prices is perhaps worse than the queuing for scarce but cheap goods; that the virtual theft of state assets by a new class of 'oligarchs' and their capture of the polity cannot be considered an improvement over the socialist period of domination by a communist nomenklatura.

I do not propose to give a response to all of the above criticisms, but will present updated facts and analysis which, while confirming there were significant economic costs especially in the first half-decade, demonstrate that the outcome falls well short of the very negative picture depicted by some critics. After nearly 15 years, the initial costs have been more than overcome for the most successful countries in Central Europe, and at a minimum are on the way to being overcome in most of the others.

Putting the above in the jargon of economists, 15 years of transition have yielded many benefits, and produced significant costs, but with a great divergence of the benefit–cost ratio across the region. The judgment of this book is that for about a dozen countries in Central Europe and the Baltics, the benefits have been large, the costs relatively small, though not all citizens were winners, and the losers even in these societies have not always been properly compensated. For countries in South-East Europe the balance seems to be moving in the same direction but it is still early to judge, perhaps because the costly conflicts in this region are so recent. In the rest, that is the non-Baltic part of the former USSR, the story is indeed more mixed. A handful of winners within the society have won hugely – the so-called 'oligarchs' – a large number of losers remain poorly compensated if at all, while the majority of the population in the middle is by now somewhat better-off, and certainly no worse-off, but even they suffered in the early years of the transformation.

Another important divergence in the outcomes is the nature of the political economic system that has emerged. Eight countries in Central Europe and the Baltics have become EU members as of 1 May 2004, at least three more in South-East Europe are formally on track for membership in the near future, and the rest in this group have some hope for future EU membership. All of these countries have become, or are likely soon to become, reasonably well-functioning middle-income market economies and increasingly liberal democracies. In contrast, the countries of the CIS are highly unlikely to move in that direction in the foreseeable future, with the possible exceptions of Georgia, Ukraine and even Kyrgyz Republic, though their revolutions of colour are too recent to assess. For this group, state capture by economic oligarchs is the order of the day, bringing in parallel increasingly autocratic political regimes. EU membership prospects are virtually nil, again with the possible exception of Ukraine and less so Georgia.

The history of this oligarch phenomenon varied greatly. It was most important in the CIS group, more moderate and now waning in the middle-group of South-East Europe, and very short-lived and never fully evolved in the Central Europe–Baltic group. Many now say that for all practical purposes transition is over and there's not much more of interest to analyse in post-communist transformation. For the new and prospective EU members anchored to the EU and its economic-democratic liberal standards, there is indeed very little more transformation to do. Most of the Commonwealth of Independent States (CIS) are locked out of the EU path and are approaching a stable equilibrium of distorted capitalist economies dominated by a small oligarch clique, without competitive liberal markets, and polities that are at best only superficially democratic. Hence their transition is also 'over' in the sense of being frozen for now

But the real story is neither so simple, nor so uninteresting. Certainly, the future direction for the captured states remains unclear, and this poses an important, intellectually challenging question. Even if one believes the transition issues of the 1990s are all in the past, either resolved or rendered irrelevant, a new transition debate has arisen which merits very close attention: in the oligarch regimes is further transformation indeed frozen, or is it just temporarily stalled and bound to move forward as the new capitalists (yesterday's thieves as many label them fairly or unfairly) seek legitimation, demand secure property rights under transparent rule-of-law, and push inevitably forward the final stages of economic and political liberalization? Another way forward for them is the possibility of radical regime change and a renewed democratic opportunity, as may be happening with the Rose, Orange and Tulip revolutions. This debate is surely of enough practical and academic interest to justify continued analysis of the transition, at least for the oligarch regimes. To inform this debate, it is surely important to understand exactly why some countries went 'to the West' – to borrow a phrase from Egor Gaidar – with its dual liberal vision of democracy and free markets, and some went 'to the East' with oligarchic regimes in autocratic states with formal but largely meaningless elections.[1]

There are many fascinating questions related to this divergence in the transition explored in detail by this volume; I flag here only three. Was the coincidence of movement towards the EU and away from state capture only a coincidence, or were there systemic behavioural forces behind the different outcomes? If this was systemic and not coincidental, was it simply historically predetermined by geographic location or were there other factors at work as well? And finally, what was the direction of causation: was it that a prior 'invitation' to Central European countries for EU membership prevented the excesses of oligarch dominance and state capture, or the reverse, that oligarch development and the accompanying non-liberal institutional development precluded oligarch-regimes from wanting to be serious candidates for EU membership?

It seems reasonable to conclude the transition is not fully over for all countries, and from those where it is we can learn much of how it came to succeed so quickly in those countries. This understanding will not only satisfy historical curiosity, but will be critical to analysing the future of countries where the transition has not been completed.

Objectives of the book

The book has three broad objectives: to describe for different groups of countries the differences in *what happened*, to explain *why the differences in outcome*, and to assess the probable future directions, that is *what next*? The 27 non-Asian transition countries analysed here cover a wide range of geographical, historical and cultural phenomena, hence it is tempting to look to the numerous country-specific characteristics like years under communism, distance from Western European influences, or the degree of internal social harmony as the explanations for each country's path. While these and other initial conditions cannot be ignored, such a case-study approach leads to an overwhelmingly complex picture with a different explanation and story-line for each country. The book proposes instead a cross-country comparative framework simplified enough to avoid losing sight of the forest for the trees, but still powerful enough to explain the main forces which have driven the different outcomes of post-communist transformation in the region.

The central analytical paradigm

There are two common ways for social scientists to analyse and explain different developments across countries: case study or comparative analysis.

Each has its well-known advantages and disadvantages, and I choose comparative analysis because I believe in this case its advantage – not losing sight of the forest by coming too close to the trees – is overwhelming. I show later in the book that the existing literature of post-communist transformation contains such a vast number of plausible explanations that its sum gives too many explanations (in jargon: a hugely over-determined system), hence one is quickly lost in the thicket of alternative and often contradictory explanations. Admittedly, the risk of simplification is *over*simplification and reduced applicability; my approach to minimize this risk is two-fold. First, I will make country-specific references throughout. Second, I propose three explanatory factors common to all countries, but do so not in a formal mathematical model (though I do suggest how this might be done), rather as a framework or paradigm in which each of these three key determinants may themselves be explained by other factors taken from the long list of country-specific factors. As a precursor of this framework, let me outline it in a few sentences.

Consider as a mnemonic for the countries in this region after the termination of the socialist central-plan regime, the figurative paradigm of a ship setting out on a voyage; the SS *Transition* sailing towards a new destination, a democratic market economy. Though the nature of the final destination is well-known and there are many illustrations of it, there is no precise navigation chart based on previous sailings from socialism to capitalism, no consensus of how to get there avoiding the perils any sailing voyage or large social change encounters. Numerous country-specific and comparative analyses have been written by observers of how well this voyage has proceeded, how far along the ship has come, how much damage it has suffered in the storms of change. While accepting that for individual countries a large number of country-specific factors have played a role, I propose a parsimonious framework which, like any useful paradigm, is not a full explanation but goes a long way to explain the experience for most of this fleet of 27. The three factors are expressed in the form of hypotheses as follows:

- the greater the intensity and time spent on debating about the right *navigation chart* the worse the final outcome;
- high proclivity of a country to fall prey to economic vested-interests results in a *pirate raid* by rent-seekers, and capture of the state, again a worse outcome;
- the accessibility of a *safe-haven* to escape the pirate raids or any other threats on the voyage, such as EU membership, leads to better outcomes.

The framework can be made into a formal model in the sense that the three factors individually contribute to the explanation of greater success: less debate means getting started sooner and achieving results sooner; greater rent-seeking results in less liberalization; and external commitment to a safe haven like the EU pushes liberalization faster and further. The three factors are interrelated: for example chances of a pirate raid are increased by longer debates, even as they are influenced by exogenous or historical factors such as whether the first government largely excludes the former communist elite and is more committed to the dual liberal vision of democracy and open markets. Even without mathematical formalization, the framework provides at a minimum a simplifying paradigm which helps focus discussion but still allows many other factors to be included. Thus, as an example of the latter, just how early EU membership became an explicit factor in the policies of Baltic governments is not entirely clear because they certainly did not enjoy the 'invitations' offered early on to Central Europe until the mid-1990s. But their prior history of very reluctant adherence to socialism and the empire, as well as the fact that their incorporation into the USSR was never formally recognized by many Western powers, doubtless led to a strong desire to anchor their independence in some institutional form to Europe from the outset. That is there was a *demand* for membership before there was an offer. This then pointed the way to undertake early and resolute policy decisions on market liberalization; the EU 'safe haven' may not have been an institutional certainty, but it existed as a mental construct or vision guiding the way.

Some remarks on methodology and data

A few words about the methodological approach taken in this study. My own expertise as an economist involved in the process of economic reforms in transition countries means I will naturally give most weight to economic policies, statistics, results and debates among economists. But it will be necessary to adduce analysis from the political scientists and historians who specialize in this region; it may be obvious why this is so, nevertheless let me illustrate with one point. A key strand of the heated discussions on the outcome has been whether the so-called 'shock-therapy' approach, or as I prefer the 'big-bang' approach, worked better than a gradual, *piecemeal* approach. In retrospect, it is clear the majority of analysts on either side of the debate do not dispute the theoretical logic of the opposing view, but rather adduce political-historical factors to argue that their approach is more realistic. Thus the critics of big-bang said that it will cause pain and a political counter-reaction inimical to both democratization and economic liberalization, hence proceeding gradually would be better. The proponents of big-bang point to the role of vested interests opposed to reform who exercise their political influence while hiding behind scientific arguments of gradualism, to undermine the economic and political liberalization and diverting state assets and subsidies to their own benefit. Any analysis that ignores the political-economy of this process will surely miss the most powerful forces and explanations of the outcomes.

A few clarifications are also in order concerning the coverage and approach of the book. The first broad objective, to describe the outcome in detail and assess the benefits and costs, is not as easy as it sounds, given the many sharp differences in view about the economic performance and social impacts so far. Resolving hard debates will require a lot of detailed and seemingly arcane quantitative analysis, with conclusions which will in the end remain unconvincing to some because the data is very soft and leaves room for different interpretation.

Somewhat the same problem applies to the second objective. The thesis of this book employs three key factors and their interplay as the explanatory framework for different outcomes: the choice of reform strategy at the first opportunity or 'historical moment'; the pull of EU membership; and the influence of rent-seeking interests. These are not concepts that are easily quantifiable and therefore only soft evidence of their role can be provided. Furthermore, this analytical framework faces several diametrically opposed but deeply-rooted convictions. On one hand are those – including the majority of the population in the less successful states – who believe the whole story is simple: the red nomenklatura used their historical position of power to steal from the state and become the new capitalist oligarchs – no more, no less. On the other hand are those that argue providing the safe haven of democracy and free markets of EU membership *only* to geographically proximate states in Central Europe is the whole story. The book will show that while there is a lot to both these views, many exceptions exist and the causation is not linear or unidimensional. Rather both these effects plus others worked in some combination to give the final result observed for each country. The analysis relies largely on cross-country comparison rather than lengthy case studies, but many episodes from specific countries will be used both to illustrate the central tendency, and to note deviations from it.

The country coverage in this analysis is limited to the non-Asian transition economies, more precisely the 27 countries covered by the mandate of the European Bank for Reconstruction and Development (EBRD). This excludes the former GDR, or East Germany, because when it became part of the Federal Republic of Germany it no longer conducted independent economic policy. The reason for excluding Asian countries is not primarily because EBRD statistical data is unavailable for easy comparison, but because I believe the circumstances are vastly different and common analysis or transfer of lessons is of limited value, for two reasons. First, China and Vietnam have remained polities under control of a communist party authority; the EBRD group all experienced a political revolution, albeit a bloodless one in most cases, with the controlling communist party initially ceding to democratic elections of varying purity. Second, the Asian economies were largely agricultural economies with huge reserves of surplus labour in that sector; almost all of the EBRD group were highly industrialized in comparison.

These differences allowed China to proceed on its gradual and piecemeal path to market reforms, a path – or luxury some have said – that would have been impossible for the European socialist bloc to follow and ineffective if it had been. Nevertheless, the high-profile attained by China's strong economic performance in contrast to the output decline seen in the other non-Asian countries, plus the central role China played as an example of successful gradualism in the arguments of many analysts, makes it impossible to completely avoid a discussion of China. Therefore, in many places throughout the book, comparisons with China's experience are made.

Judging success and failure

How does one judge whether a country has been successful or has failed in the transformation process; that is, whether the benefits have exceeded the costs or vice versa? First, this cannot be a simple two-fold categorization, but rather a continuum of more and less success. Second, there is no clear-cut time horizon or end-point in which to make this judgment; transition started 15 years ago for perhaps only the four Višegrad countries in Central Europe, but began much later elsewhere either because civil unrest, political uncertainty or policy choice led to delays. The Soviet Republics were not independent until late 1991 and most of them did not make a significant beginning until about 1994–95. Yugoslav Federation Republics ended any military–civil conflicts at various times in the 1990s, and some countries like Belarus, Turkmenistan and arguably Uzbekistan to the present day have barely begun a serious transformation to the market. These different starting points must be considered in any assessment.

A third consideration is how to weigh up the benefits and the costs. The serious data shortcomings are discussed in the main body of the book; I focus here on the conceptual approach to such a judgment. Measuring the benefits of renewed growth and greater efficiency raises many questions, but even more problematic is the fact that no simple metric exists to value the social costs such as unemployment, increased poverty, possible impacts on health and education delivery. Furthermore, there is no agreed-upon method for dealing with distributional questions, such as the hypothesis that the transition violated the old social contract, because some members of society were made significantly worse-off, certainly in relative terms, but also in absolute levels of material well-being.

One possible approach for the last issue is to use the so-called Pareto Optimality Criterion of economists: *a change results in improved well-being for society if those who gain from it gain enough to compensate those who lose*. In theoretical academic analysis of economists, knowledge is generally advanced by some degree of compartmentalization of disciplines and abstractions from reality, so in the literature it often matters little if actual compensation took place as long as potential compensation to losers is possible. This potential compensation is almost certainly feasible by now for many transition countries and approaching that state for others. But that is small comfort to losers who were not in fact compensated. In practice, to be compelling, a favourable judgment on the transition must argue compensation actually did occur or is taking place. This is again not so simple; quantitative cost–benefit analysis for the society as a whole is impossible, thus one must resort to sensible judgment. Such a judgment must also allow for delayed rather than immediate compensation, and must further be flexible (and *ad hoc*) in judging whether the economic losers who are not yet compensated even after a long time, may nevertheless value future economic opportunities for themselves and their children. One should also recognize that people also value the personal freedoms gained with the end of an autocratic, police state. The fact that many still vote for communist parties, which propose to revert to a socialist society with renationalization of property, suggests some citizens may not place a high value on these freedoms. In contrast, the evidence of the Rose Revolution in Georgia, the Orange one in Ukraine, and the Kyrgyz Tulip events, suggests many people do value democratic freedoms highly. In the end, I know of no other way to proceed on this assessment than sensible and well-informed personal judgment, and leave it to the reader to make a judgment as well.

The main conclusions on benefit–cost results are three. First by now for countries in Central Europe and the Baltics most losers have probably been sufficiently compensated in an absolute sense by a combination of transfers and new economic opportunities. Second, and notwithstanding the first point, in some of that region, the continuing high unemployment suggests that some portion of the population has not yet received adequate compensation. Third, for countries of the CIS, the number of losers were many and they have only recently begun to enjoy meaningful compensation, though the substantially increased poverty incidence probably remains somewhat or even substantially higher than it was at the outset. Fourth, relative country performance on the Compensated Pareto Optimal Criterion tends to vary along a spectrum from very good in Central Europe and the Baltics, mixed in South-East Europe, and generally poor in the CIS group of countries.

Structure of the book

Let me finally outline the contents of the book and how it addresses the three main objectives I have set. Part I, **Background**, addresses the first objective: describing *what happened* with available statistical evidence. Chapter 1 sets the stage for what is most important to seek from the statistics, with a review of the key debates in the literature about the transition process. This covers largely the economics literature, but incorporates the most relevant elements of the related literature in political science, the so-called transitology debate. Chapter 2 goes on to measure the extent of progress towards a market economy using the annual index of progress on market reforms compiled by the EBRD, which is best thought of as a policy 'input' intended to improve economic performance. It is shown that despite the shortcomings and many possible subjectivities of this index, it correlates very well with other 'policy input' measures such as the degree of democracy, media freedom, and development of institutions. It is also strongly correlated with most indicators of 'output' success, not only economic performance, but also and surprisingly most social progress indicators. The high degree of correlation justifies using the index in the rest of the book as a proxy indicator of progress in post-communist transformation broadly understood. The index allows a categorization of the 27 countries into five distinct groups with limited overlap and considerable within-group homogeneity. In order of transformation progress and success achieved these are: Central Europe, Baltics, South-East Europe, CIS moderate reformers, and CIS limited reformers. This greatly simplifies the further analysis without distorting it, as the broad trends can be observed and analysed for five groups rather than 27 individual countries.

Chapter 3 measures the costs of transition, including output and employment losses, broad measures of social well-being, increased inequality and poverty, deterioration in health and education standards. These costs have been and remain substantial, but a hard look at these soft facts also shows that many early assessments showing dramatic deterioration were somewhat exaggerated, partly because they were premature, being done at the bottom of the transition cycle in the mid-1990s. There was virtually no disagreement in the early 1990s that the transition from a distorted and inflationary economy would create disruption, dislocation and unemployment, that is things would get worse before they got better. The many studies of economic and social conditions done in the mid-1990s showed substantial deterioration in the five to seven years of the transitional recession, but this should not have been surprising as they covered the downturn phase of the transition cycle. The present work benefits from having data for the five to seven years of the upturn, and it shows an improvement in economic and social conditions, in several cases very substantial and far exceeding the losses in the first half of the cycle.

Part II of the book, **An *Ex Post* Transition Paradigm**, addresses the second objective, asking: *why the different outcomes for different countries and regions*, using the navigation paradigm described above. Chapter 4 elaborates on this paradigm and presents several empirically testable hypotheses that can be derived from it. Chapters 5, 6 and 7 contain the comparative empirical analysis of the relevant hypotheses for each of the three elements of the model: the debate on how to proceed, the dynamic of rent-seeking vested interests first lobbying for privileges and then in some cases succeeding in capturing the state; and the influence of potential safe-havens such as EU membership, but also others such as NATO, WTO, the IMF, the World Bank and the EBRD.

The analysis in Parts I and II forms the basis for addressing the third objective of the book in Part III, **A Summing-Up**, which asks *what will happen next*? The critical dividing line here is between those states that have been strongly captured by large economic vested interests, known popularly as oligarchies, and those that have not. This dividing line coincides closely with the one separating those countries with assured or prospective membership in the EU from those that have low or near-zero likelihood. A key question investigated is whether this is indeed just a coincidence or not. Chapter 8 focuses mostly on the captured states, considering their prospects. Most importantly Chapter 8 addresses perhaps the last but certainly not least important transition debate: for the captured states is further transformation inevitable, or has it been frozen in an equilibrium part-way to the market and democracy?

Finally, Chapter 9 sums up the findings in the book, first noting the important new divide between the most successful countries where transition is virtually complete or on track, and the less successful ones where it has become stalled due to capture of the state by the new oligarchic restored interests. Two other conclusions merit emphasis: one is the overwhelming role of three factors in explaining this bifurcation: reform delays, a stronger tendency to rent-seeking under partial reforms, and the disciplining role of the quest for EU membership. Another is that any social costs were, contrary to early concerns, much lower in countries that moved on reforms early and rapidly, than in countries taking a more deliberate gradual approach. In the simplest of words, the bottom line is that the first group is already experiencing the dual vision of liberal markets and liberal democracy where capitalism is open to all, whereas the second group is characterized by restricted markets and superficial managed democracy, with capitalism being accessible only to the few.

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