

Studies in Economic Transition

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“A quarter century after the Berlin Wall debates continue on the merits of Big-Bang vs. Gradual strategies, with a shift in focus to institutional transformation. This book builds wisely on the actual developments as well as the large literature to clarify analytically what has been achieved on institutions and why some countries have advanced far more than others. Its numerous valuable lessons apply not only to transition cases but also developing countries, and given populist-authoritarian drifts even to advanced economies. A superb read for a wide audience.”

—Oleh Havrylyshyn, *University of Toronto, Canada*

“Nearly thirty years on, we are still grappling with the consequences of the collapse of the socialist economic system and the transition whereby it was replaced, to a greater or lesser extent, by capitalism. The transition process represents a laboratory to investigate the effect of institutional change on economic performance, and in this new edition Mickiewicz and Douarin outline what happened and how and why it varied across countries. This is probably the best book currently available for students to understand transition, the most critical process in recent economic history.”

—Saul Estrin, *LSE, UK*

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Elodie Douarin • Tomasz Mickiewicz

Economics of Institutional Change

Central and Eastern Europe Revisited

Third Edition

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On ne saurait trop le dire: il n'est rien de plus fécond en merveilles que l'art d'être libre; mais il n'y a rien de plus dur que l'apprentissage de la liberté. Il n'en est pas de même du despotisme. Le despotisme se présente souvent comme le réparateur de tous les maux soufferts; il est l'appui du bon droit, le soutien des opprimés et le fondateur de l'ordre. Les peuples s'endorment au sein de la prospérité momentanée qu'il fait naître; et lorsqu'ils se réveillent, ils sont misérables. La liberté, au contraire, naît d'ordinaire au milieu des orages, elle s'établit péniblement parmi les discordes civiles, et ce n'est que quand elle est déjà vieille qu'on peut connaître ses bienfaits.

Alexis de Tocqueville.

De la Démocratie en Amérique. Book 1, Volume 1, Part 2, Chapter 6.

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Introduction

This book is a collaborative effort between Tomasz Mickiewicz, Professor of Economics at Aston University and the author of the two earlier editions of this book, and Elodie Douarin, Lecturer in Economics at the University College London. The project started with a discussion over lunch on the difficulties to guide students to read broadly, and to critically analyse the literature, discussing the transition from centrally planned to market economies. This was an issue both Tomek and Elodie had faced, as they taught a course about emerging market economies, focusing on Central and Eastern Europe (CEE) and the Former Soviet Union (FSU), also known as “the transition region”, targeted at second year undergraduate students at UCL and at Aston at different points in time.

This third edition thus builds on the material covered in the two previous editions (reintroducing some topics from the first edition that had disappeared from the second, and bringing in some new ones) to present a robust overview of the process of institutional change experienced across the transition region following the collapse of central planning. This book is thus analytical in nature, yet written to be accessible, without compromising on the complexity of the phenomena described. It aims at exposing the literature in context, reflecting on the key debates, emphasising the diversity of experiences and outcomes, highlighting divergences in views, complementarities in approaches and gaps in the

literature, to provide a detailed picture of the ‘transition’ experience and its relevance to today’s politics and economics of the region.

The central focus of the book is the process of institutional change: its characteristics, determinants, and implications for economic performance. Its key area of interest is Central Europe, Eastern Europe and Central Asia, that is a region stretching from Prague in the West to Vladivostok on the Pacific coast in the East. However, the lessons are wider; they relate to other middle income economies that attempt to catch up with high income countries. In other words, our ultimate interest is in the process of development, or more exactly, in its interdependence with institutions.

In most CEE countries, the process of institutional change replaced the command economy based on administrative orders, with an economic system relying on private property, free prices operating within state regulation frameworks, and policy incentives. About twenty five years ago, about thirty nations in Europe and Central Asia embarked on their economic transition path. For some, the outcome was a considerable success. Several others are still struggling to shed the inheritance of the past and to correct more recent policy mistakes. Some have bounced back from the 2008 crisis with energy, others have experienced, again, a period of poor performance and fiscal disarray, with some negative feedback effects on politics as well. Why is performance so different? Was political freedom a factor that facilitated reforms or, rather, slowed them down? Which reforms did matter and why were some so difficult to implement? These are the questions that will be addressed here.

Chapter 1 presents an overview of what became known as “transition” and sets the scene for the rest of the book by highlighting the diversity of experiences across the region and discussing key indicators. Chapter 2 focuses on Central Planning, to explain the reasons for the slowdown and ultimate implosion of the command economy system. In Chapter 3, the reforms programmes that were implemented are discussed in broad lines, presenting indicators and comparing progress across the region. In Chapter 4, the focus is on the determinants of reforms and the linkages between the political system, reforms, and economic growth. We ask whether democracy was good for reforms, and for which reform in particular. Chapter 5 discusses macroeconomic stability, its importance,

and the different ways through which it was (or was not) achieved in the transition period. Building on the elements introduced in the earlier chapters, Chapter 6 asks a fundamental question: why did some countries go through a ten-year long recession, while others emerged from the post-communist recessions after a mere two years? What was the relative impact of stabilisation policies, liberalisation policies and initial conditions? This question is still important today, as it was the negative experience of the 1990s that turned some societies away from the reform path. Next, Chapter 7 focuses on a topic that became a political minefield across the whole region – the privatisation process, discussing the complexity of the task, the difficult trade-offs faced by reformers and the consequences of related policy choices. The impact of privatisation and restructuring, as well as of new firms' entry and entrepreneurship returns in Chapter 8, which discusses unemployment. In particular, the reasons why labour market outcomes have been so different in the various transition economies are explored. The two following chapters examine the development of private and public finance in transition. Chapter 9 explores the factors responsible for both the development and the efficiency of the financial sector in the transition countries, while Chapter 10 explores the impact of the reforms on government expenditure, revenue and fiscal balance, insisting on the role of institutional quality in explaining poverty and inequality, returning to the topic of unemployment amongst other. Finally Chapter 11 takes stock and reframes the discussion so far to emphasise the role of institutions in development. Chapter 12 concludes on the particularity/normality of the region today, yet not necessarily answering all the questions.

The book maintains a broad, comparative perspective throughout, as the objective was not to present single country-based studies of economic policies, but instead, it was to present a detailed and analytical overview of the process of institutional change represented by the end of communism and central planning in CEE and FSU. We do note that other books exist addressing some of the issues discussed here. We are unable to give credit to all these contributions and apologise to our colleagues not mentioned below; they will probably find references to their work scattered in the rest of the book. The works we probably learned most from include Gros and Steinherr (1995, 2004), who offer good insights into the economic policies and institutional reforms applied in Russia, in Central

Europe (in particular, the Czech Republic, Hungary, Poland), in the former Yugoslavia and in East Germany. They also present an interesting discussion of the significance of EU markets for the transition region. Roland (2000) can be recommended for its detailed mathematical exposition of the economic theory of transition. An earlier, shorter book by Blanchard (1997) focusing on models of reallocation and disorganization, provides an equally stimulating read. Rozelle and Swinnen (2004) offer an authoritative summary of the results of (either complete or incomplete) liberalisation and the introduction of private property rights in the agricultural sector of the transition countries. Mickiewicz (2006) discusses corporate governance issues beyond the elements presented here. Entrepreneurship during the economic transition is not covered systematically as a separate topic in this book, but is explored at length in Estrin and Mickiewicz (2010). Finally, the book by Milanovic (1998) on inequality and poverty has stood the test of time and still offers very good insights on the subject, while a systematic treatment of political economy issues in transition is offered by Havrylyshyn (2006), complementing our discussion here.

We would like to dedicate this book to our students, who made us realise how little we know and how much we still need to learn.

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