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Oleh Havrylyshyn

Uncharted Waters, Pirate Raids, and Safe Havens: A Parsimonious Model of Transition Progress

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UNCHARTED WATERS, PIRATE RAIDS, AND SAFE HAVENS: A PARSIMONIOUS MODEL OF TRANSITION PROGRESS

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OLEH HAVRYLYSHYN
The International Monetary Fund, and
Visiting Scholar, Centre for Russian and East European Studies, University of Toronto,
o.havrylyshyn@utoronto.ca

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ABSTRACT

The paper seeks a relatively simple set of explanatory factors explaining the success or failure in transition for the non Asian transition countries. First , it shows that the EBRD transition index is a good proxy for progress being closely correlated with other economic performance measures. Then it proposes a parsimonious model explaining progress, comprised of three determinants: the delays in reform due to internal debates on how to move to a market economy, the extent of rent-seeking opportunities thus created and the resulting vulnerability of the polity to state capture, and finally the role of EU membership prospects acting as an external commitment to market reform Empirical analyses of econometric and case-study type concerning privatization effects, relation to state capture, and opinion poll and voting analysis are adduced as evidence for the dominant role of these three explanatory factors. The most important conclusion is that contrary to popular views that further progress on liberalization and democratization is inevitable because new capitalists want security of property rights and hence rule of law , it is shown here that where ownership is concentrated and “oligarchs’ capture the state they favour the status quo of partial reforms and a non-transparent political process.

JEL Classification numbers: D7, L1,P1,P2 P3,

UNCHARTED WATERS ,PIRATE RAIDS AND SAFE HAVENS;
A Parsimonious Model of Transition Progress

The fox knows many things, but
The hedgehog knows one big one.
-Archilocus 7th.c. BC[1]

I. INTRODUCTION

The vast literature on transition of post-communist economies contains a wide variety of explanations for the differences in progress among countries. Some of these differences arise between economists and political scientists or historians, but the spectrum of views is very large even within each discipline. One can reduce the vastness of views by focusing on a handful of the key debated issues: gradual vs. big-bang reforms; sequence among privatization, market liberalization, and macro-stabilization; the relevance or irrelevance of *how* privatization is done; the timing of policies to promote competitive market institutions relative to other economic reforms; the potential conflict between market liberalization and democratization; the currently poignant question of whether the new oligarchic capitalists are a voice for rule of law and democracy or the opposite; the role of initial historical conditions vs. new policy initiatives; the importance of EU membership prospects; the pros and cons of external involvement by international organizations and individual country assistance. Focusing on individual debates narrows the research, but risks losing perspective, while an analysis of all of these issues and the many explanatory factors behind each risks simply getting lost. There is thus a need for a simplified paradigm or framework.

In this paper I propose a simplified framework that can explain the different degree of progress in transition observed among the 25 countries of the EBRD. Progress is measured relative to the end goal theoretically defined as a well functioning market economy and a liberal democracy. Section II measures such progress quantitatively only for the economic dimensions, though the political science literature allows this for the democratic one as well. The results show, despite measurement problems, that there is a wide range of progress. The rest of the paper addresses the question of how to explain these differences.

[1] Modern reference is to Isaiah Berlin, (1953), The Hedgehog and the Fox, who differentiates those intellectuals "who pursue many ends, often unrelated and even contradictory …[and] those who relate everything to a single central vision."

Section III reviews selectively the key theories of transition, and updates the major empirical conclusions from quantitative and qualitative analysis. I conclude that while all this work is very useful and necessary, it leaves us with an encyclopedic inventory of so many explanatory "trees", that one can easily overlook the principal features of the "forest".

Therefore, Section IV sets forth a parsimonious model of the actual process experienced in countries, built around three elements: the nature of the early debate on how to sail out into the "uncharted waters" of market transformation; the extent of capture of the ships of state by rent-seeking "pirate raids"; and the impact on the process of having or not having a potential "safe haven" such as EU membership.

None of these three factors is a new idea in itself, but there are four important new points. *First* these three factors go a long way to explain the variations in results, hence can provide a framework for understanding cross-country differences which allows relevant reference to country specifics, but avoids the impenetrability of comprehensive explanations for each country. *Second* this parsimonious model provides a simple but powerful result: an explanation of the incomplete transition in many CIS and some Balkan countries compared to the advanced and continuing progress in Central Europe. *Third,* the model also throws light on the hotly debated question of whether, "the increasing strength of Russian capitalists is essentially a liberalizing force" as Aslund (1997) and others argue (and not just for Russia), or alternatively that "the power of concentrated vested interests could seriously compromise institutional and regulatory developments that underpin good governance." (Hellman and Schankermann (2000)). I show that the latter is both theoretically and empirically more compelling. This leads to the *fourth* new element in the model: where concentrated ownership results, these "oligarchic" vested interests oppose further economic liberalization and democratization, which results in an equilibrium half-way between plan and market, half way between autocracy and democracy, or a "frozen transition" Havrylyshyn (1994)[2]. Section V. of the paper will summarize and draw some critical policy implications of how it may be possible to get out of this vicious circle and continue progress towards a competitive and liberal environment.

II. MEASURING TRANSITION PROGRESS

There is no single metric to measure transition progress, both because the nature of the economy and polity sought at the end of the process is not singular, and because there are inevitable disagreements and data problems related to each possible measure. While indices of democracy, political rights, governance and social indicators, are widely available to give a picture of democratic progress, I will limit myself in this paper to economic indices. This is a shortcoming that will have to be made up in a fuller analysis, but it should not be greatly misleading if one accepts the evidence of EBRD Transition Report 2003, Ch.2 which shows a strong correlation between their index of reform and several measures of democratization. I look at four measures of progress. Earlier reports show a general decline for social indicators, but again the higher the reform index the less this decline.

EBRD's well-known transition indicator is, with all its shortcomings, widely accepted as the best available summary of policy effort or input towards market reform. The tables here show the simple average of the various indicators reported by the EBRD for different aspects of reform and I will not rehearse here the problems of measurement or unweighted averaging. The other three measures are outputs or results of the transition process: GDP growth, inflation control, and FDI inflows. There are many others one could use instead or in addition; this choice is in my mind reflective of the most important achievements on the economic side of the transition. There is a wide consensus that success requires first financial stabilization, and subsequently an environment

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[2] One of my modest objectives in this paper is to bring back into focus the forgotten adjective modifying "market" in the neo-classical welfare maximizing arguments: COMPETITIVE.

conducive to economic growth. There is little doubt that the desires of the population put material progress very high on the list of achievements from transition, and I would venture to say the evidence of opinion polls suggests that democratic freedoms without material progress would not make the majority of the population content with the transition. Finally, the amount of FDI per capita is not only important for the investment and growth effect, and its associated importation of technical, management and marketing skills, but also reflects the assessment of foreign business about the climate for operations and future prospects. It may in fact be much better than some other measures of capital inflows: sovereign borrowing is more short-term oriented, perhaps reflecting as much instability as stability, and in its private forms subject to short term gain motivations rather than long term ones as for FDI. Arguably, an even better investment measure is total investment, since FDI is never generally more than a fraction of total investment. But the embryonic nature of financial intermediation even in the most advanced countries means that it is too soon to expect a steady state situation with domestic investment[3].

Chart 1 shows the advanced state of market reform in Central Europe and the Baltics (CEB). It is notable that the Baltics, despite being part of the USSR economic space are well in the middle of the range covered by the Central European countries. Estonia is second only to Hungary, and Latvia is higher than the lowest of the group, Croatia. If one considers the imprecision of this index, the range of 3.2-3.7 (maximum possible =4.3) suggests it is best to treat all nine countries as a group of "most advanced." Note that all but Croatia will be the first EU entrants from the region in May 2004. The next group is formed by six countries in South-East Europe, in the range 2.5-3.1, i.e. just below the CEB, which one might define as "advancing" countries. Last are the twelve CIS countries, apparently forming a group, but with a much wider range of 1.2-2.8. Both because the range is so wide and because I believe updating will result in a different placement for three cases, it will be

[3] On some of these issues see Buiter (2000).

useful to subdivide the group. Recent IMF assessments would suggest a lot of reform progress for Tajikistan across the board, and significant slippage for Moldova and Uzbekistan. A new communist government in Moldova has begun some renationalisation and reimposed restriction on use of land and agricultural markets, while Uzbekistan despite a proforma exchange rate convertibility has reintroduced restrictions on domestic and foreign trade[4]. Consequently, I propose two groups: CISL with limited progress (Belarus, Turkmenistan, Uzbekistan) with index values of 1.2 for Turkmenistan and probably below 2 for the others; and CISM with moderate but material progress - in the range 2.2 –2.8. Indeed note that the top countries in this group (Armenia, Georgia, Kazakhstan, Russia), compare to those in the middle of the SEE "progressing" group.

In summary, the CEB countries are distinctly ahead, with the SEE group second. The more advanced CISM group of 9 countries comes third although there is some overlap with the SEE; but of the three SEE countries with values in the CISM range, two, Bosnia-Herzegovina, and Serbia-Montenegro have had much less time after civil conflicts to undertake reforms, hence for this paper greater refinement in the groupings will not be attempted. Finally, lagging farthest behind are the three countries in the CISL group.

Turning to the economic results indicators, one finds broadly confirmation of this rank ordering by group[5]. Table 1 gives summary values of the recovery of GDP since the beginning of transition for the groups, showing unadjusted values, and as explained in the Table, values arbitrarily adjusted for the probable underestimation of recent GDP due to Soviet accounting differences in the benchmark year. CEB is clearly above the others though the Baltic value is distinctly lower (about equal to SEE.), unless an adjustment is made as in the second column. In addition, one might argue that the start for all former USSR countries should be benchmarked at 1991, in which case the index

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[4] Informal communications with EBRD officials confirm these assessments and indicate one might expect them to be reflected in the 2004 Report.
[5] Unless otherwise indicated, statistics are based on EBRD Transition Report 2003.

would be higher for them, including the Baltics. All CIS countries show less recovery than SEE, but a result contrary to prediction is that CISL shows better recovery than CISM. However there may be a serious overestimation of the growth in these three cases where state –guidance and pricing still dominates. For Belarus, implicit barter prices for energy imports from Russia in exchange for manufactured exports were almost certainly in favor of Belarus, and more important do not reflect real, market-based demand. The sharp decline in Belarus growth rate in the last three years is consistent with this interpretation. In Uzbekistan, IMF reports have for several year been suggesting the growth rates are overestimated, and the much lower 2003 growth rate of 0.5 %, again supports this. For Turkmenistan in addition to similar statistical bias upward, there is a problem of accounting gas exports at notional contract prices rather than the actual revenue received from non-paying importers. In all three countries, the slow reforms have also meant the decline in GDP to mid nineties was less than for CISM, a fact the government s point to positively as justification for the gradual pace. The counter argument is that this has simply delayed necessary restructuring, the decline in growth rates for all three countries in recent years when CISM was experiencing sharply increased growth may be evidence of the latter.

The GDP results provide only a broad confirmation of the four grouping in Table 1, but a much stronger one for the other two. Thus, we see in Table 2 that inflation control has gone farthest in CEB (both subgroups equal in this case), with SEE actually slightly higher than CISM, and the CISL decidedly much worse, still in double digits. The SEE-CISM comparison is too small to affect seriously the conclusion, and in addition could be a reflection of the shorter period of stabilization since civil conflicts in some countries. Last, Table 3 shows that FDI per capita, a rough proxy for successful micro reforms and resulting investment climate, is by far the highest in CEB, with SEE, CISM and CISL in the exact sequence of the EBRD index. The lag of CIS behind SEE is even more distinct if one excludes three countries with high dependence on oil or gas: Azerbaijan, Kazakhstan, Turkmenistan (Russia's export dependence is very high but for GDP far lower). The figures are 136 and 106 for CISM and CISL respectively.

In conclusion, the grouping by rank order of transition progress given by the EBRD index- CEB>SEE>CISM>CISL is confirmed by the key economic results (GDP recovery, lower inflation and attraction of FDI).

III. TRANSITION THEORIZING AND EMPIRICAL EVIDENCE

Main Lines of Theoretical Thinking

It is beyond the scope of this paper to review the vast literature on transition[6]. My aim is to note selectively the strands of thought that are most important for understanding past differences among countries, and point to the critical policy issues still outstanding for the future. It turns out that *how* privatization was accomplished (regardless of how it was planned) provides perhaps the best unifying issue around which the story is told.

Going back to early discussion about the "road map" or "chart" showing the way from socialist central planning to a liberal (and simultaneously democratic) market economy, we know there was a great deal of debating on the details which continued throughout the decade. In this search for a model of transition, it was very commonly said that there is no theory to guide the practical process of transition, only theories of capitalism and socialism. This may still be true in the sense that a new consensus paradigm has not emerged from the vast literature on transition, but I would argue that a formal unified theory is not needed to understand the main developments[7] To the extent it is useful

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[6] Campos and Coricelli (2002) is a recent one though less comprehensive; slightly outdated but still important are Murrell (1996) and Stern (1997).

[7] Kornai (1998) explores the possibility of what he prefers to call a "system paradigm"; one key argument he makes is that transition by definition does not need a paradigm or theory – only the beginning and end-point systems do.

to have a compact rather than complex analytical framework, it is not that difficult to cobble together from selected key writings a workable "model" of transition or transformation. Kornai (1994), in describing the special circumstances of the "transformational" recession compared with a market economy recession, highlights two key challenges that are needed: *forcing a move from a sellers' to a buyers' market* (via price liberalization), and *enforcing a hard budget constraint* (via privatization and elimination of various government support mechanisms such as budget subsidies, directed low-cost credits, and tax exemptions). This provides the two principal incentives for profit-maximizing market behavior of all economic agents. Blanchard (1997) defines the core process of actual change as comprising two elements: *reallocation of resources from old to new activities* (via closures and bankruptcies combined with establishment of new enterprises); and *restructuring with surviving firms* (via labor rationalization, product line change, and new investment). These two changes, which are very reminiscent of the Schumpeterian concept of "creative destruction", should be stimulated by the new incentives. In the end, the transformation moves the economy to a resource allocation state consistent with its comparative advantage. The key policy actions needed to put in place Kornai's new incentives are described in many works (including those by Kornai (1994) and Blanchard (1997), and are exemplified by Chart 2 from Fischer and Gelb (1991) which provides a good illustration of the Washington Concensus. This includes macroeconomic stabilization; price and market liberalization; liberalization of the exchange and trade system; privatization of state-owned firms; establishing a competitive environment with easy market entry and exit; and redefining the role of the state as the provider of macro stability, a stable legal framework, and enforceable property rights, and occasionally as a corrector of market imperfections.

The Kornai –Blanchard paradigm (KB) I would consider more than sufficient on *what* needs to be done to achieve the goals of economic transition though not a navigational chart of *how* to get there. The early debates - the Washington Consensus, Gradualism vs. Big-Bang (or as the critics but not the proponents prefer to label it today "shock therapy"), institutionalist vs. market liberalization approach, and not least important, the modalities of privatization—all had to do with the *how.* I will not rehearse here all of these debates as important as some of them are, except for a short point about the Washington Consensus. The criticism and defense of the WC has been in my view a sterile debate for two reasons. First, the WC as a theoretical concept was very broadly cast, incorporating clearly institutional developments and long implementation times for some elements like privatization, (see Chart 2 ; a later version in Summers (1992) even has a delay in large privatization while institutional changes get started. Therefore any criticism that it promotes undue speed or ignores legal-institutional development is easily defended. Secondly, virtually none of the critics argue the reforms proposed should not be done, but rather argue they should have been done more slowly (as in China) or in different sequence. The debate was largely about implementation[8], and the value of continuing this debate concerns the possible criticism that in practice the IFIs and other rapid reform proponents may have paid lip-service to institution building but pushed harder the privatization and liberalization elements, increasing the likelihood off oligarchic developments.

Given the current situation with transition, I propose the most useful and critical aspects of these debates can be grouped under two schools of thought. The first argues that once a minimum of stabilization, market liberalization, and privatization is achieved, further progress in **transition is inevitable**, (TI) (indeed it will also help eventually in furthering democratic processes). The second takes a conditional view of this inevitability arguing that where the reform process allows vested interests to build up quickly and benefit from rent-seeking opportunities of partial liberalization they acquire a concentration of state-assets in an opaque privatization (become what is popularly known

[8] The major exceptions which do propose a very different agenda are not by analysts, but country governments like those in the CISL group who do proffer a model: essentially socialism with a minor role for the market in Belarus and Turkmenistan, or an industrial policy approach as in Uzbekistan.

as the oligarchy) and finally capture governance of the state. Their interests are not to liberalize or democratize further, rather exactly the opposite. **The transition is frozen** (TF) into a capitalist but not competitive economy and an autocratic polity perhaps in superficial disguise of a voting-democracy.

The TI paradigm does not simply argue that a critical mass of private ownership and market–based decision-making makes reversal impossible and progress inevitable; it has a more sophisticated logic centering on private ownership. Once a major part of assets is in private not state hands, the old-bureaucracy and nomenklatura no longer has a power base to oppose reforms, but more, the new capitalists will want to have security of property rights and create a demand for rule of law, transparency, law and order etc. Thus, Shleifer (1995) summarize: “Russia’s experience shows how privatization, combined with equity incentives for enterprise insiders, transfers control rights from the bureaucrats and stimulates political and economic pressures to protect private property rights.” Similarly, Aslund (1997) contends that “Russian capitalists want to be independent of bureaucrats and safeguarded by a system of law”. This view is more broadly applied beyond Russia by others, starting perhaps with the first mid-stream review of transition by the World Bank (1996 Development report), and includes important writings on how privatization should be done such as Boycko, Shleifer and Vishny (1995), as well as current recommendations for countries suffering from oligarchic concentration of ownership: Boone and Rodionov (2001), Cottrell (FT Aug. 6, 2002).

Buiter (whom I would put more in the TF school) points out that the theoretical basis for this is in Coase’s proposition that efficiency only requires that property right s are assigned unambiguously, which he restates in more popular terms as “yesterday’s thief is the staunchest defender of the sanctity and inviolability of property rights.”(p. 606)

The counter argument of the TF school is simple: capitalists will favour rule of law not out of benevolence or ideology but only *if it* is in their interest. The essential difference with TI is the empirical proposition that in some cases-Russia and other CIS countries among them-it is *not* in the interest of the new capitalist class holding concentrated owner ship of assets. The most elegant presentation of this presentation is in a formal model of Polischuk and Savvatev (2004) who state "inequality of ownership…could make wealthier agents favour less than full protection of property rights …[and] property rights will not emerge from the grassroots." An important corollary is that while large-oligarchic owners do not demand full rule of law, small owners, and especially entrepreneurs , do. The idea of a frozen transition has many antecedents before this formal model of PS, and corollary elaborations. An interesting aspect of these writings is that many if not most of these skeptics of hand-over privatization in concentrated form were in fact, otherwise ardent proponents of the Washington Consensus. I will make only a few references.

Interestingly, the earliest hints of these different approaches are seen in the views of two well-known proponents of the Washington Consensus. In a 1991 conference gathering of eminent western economists, (proceedings published in Clague and Reuser(1992)) Fischer stated "privatization of state assets is an essential step in the creation of the private sector", while Krueger emphasized that "experience from developing countries is, by and large, that growth has taken place primarily through the emergence of new activities, not the adaptation of older ones…[and] focus upon privatization of existing assets…searching for the least unfair process…diverts attention from the more important problem of creating new earnings streams." Fischer was not presumably saying that competitive rules of the game could wait, nor was Krueger arguing not to bother with privatization, but the relative emphasis is critical. Havrylyshyn (1995) formulated a more complete argument that "markets have been created with private ownership and profit opportunities…[but ...

in lagging reformers of the CIS … these are opportunities for largely] the more privileged few and not opportunities for *competitive* capitalism...various interests will do everything to avoid further reforms and keep the transition process frozen”. An important contribution in the TF school is Hellman (1998) who confirms the fears privatization of the type advocated by Shleifer et. al, (which co-opts existing politically and financially powerful individuals by giving them a quick and low cost insider access to privatizing assets), does indeed result in a concentration of assets that is inimical to further liberalization. A major further conclusion of his is the ability of these “oligarchs” as they are now commonly called ability to capture the state and ensure its policies are favorable to them and not to open, competitive markets.

Buiter (2000) expresses concern that this predation inhibits secure property rights and thus depresses capital formation and growth. Yavlinsky (2003) a closer observer than any of the others, makes a poignant plea for battling the oligarchy, a plea firmly planted in simple economic theory of competition: “the larger and more influential the group, the greater are its opportunities to deviate from the universality principle of the business climate and fair competition.”

For those who are not convinced until a model is formulated mathematically, Polischuk and Savvatev (2004)-(PS)- provide such a formulation. It hinges on the simple trade-off calculation made by an oligarch: is the benefit of non-transparent rent-seeking greater than the cost of some uncertainty about the oligarch’s own property rights security. Since the former is large, (as earlier developing country literature showed from the time of Krueger’s (1974) seminal piece on rent-seeking) and the latter is easily bought informally, it is not surprising that PS can conclude “some wealthier agents would prefer a hybrid equilibrium (with informal procedures and rent-seeking opportunities) to the market one, and thus would resist secured property rights.” In simple words, that's because secured property rights allow capitalism for all, while oligarchs currently in control much prefer capitalism for the few.

A large number of empirical studies provide evidence on how these processes of privatization resulted in concentration in some countries but not others. Barnes (2003a) compares Hungary, Czech republic and Russia, and in (2003b) gives an extremely detailed account of who the major Russian oligarch groups are, how they came to that position and most important how they use their power to capture state policy ensuring it favors them and protects them from competition .Most recently, a World bank (2004) study on Russia not only provides a list of "oligarchs" strikingly similar to that in Barnes, but argues in great detail and with considerable supporting empirical evidence that " concentration of ownership in the hands of a few major players can [result} in collusion, create barriers to entry, and eliminate healthy competition." The forcefulness of the conclusions and the naming of names by an official institution like the World Bank is unusual enough to speak for itself.

A related large literature on the effects of privatization reaches conclusions that are consistent with the TF 's final logic: concentrated ownership is not favorable to competitive efficiency or further liberalization. The concensus findings generally show that any privatization is better than none, but that by far the best privatization is one which allows SME's to thrive, and new entrants to enter. An early review is Havrylyshyn and McGettigan (2000), and more recent detailed micro studies are reviewed in Djankov and Murrell (2002) ,as well as a symposium on job creation by Haltiwanger, Lehmann and Terrel (2003). Some key conclusions are that smaller enterprises are best at productivity improvements and job creation, and that new ones are particularly effective. Finally, a key article by Zinnes, Eilat and Sachs (2001) shows in an extensive cross country analysis that privatization alone without a competitive environment has little or no effect, but with such an environment it is very much more effective.

Another relevant strand of recent literature is on voting patterns. The general finding in studies that cover both CEB and CIS is that small entrepreneurs, and new entrepreneurs are particularly strong supporters for rule-of law, competitive market, and democracy. (See on this Fidrmuc (2000), Raiser, di Tommasso, Weeks (2001), Frye (2003), Jackson, Klich and Poznanska (2003)).

Since both the TI and TF views are very much political economy ones, it is of no small interest to refer to the political science literature and debates on post-communist democratization. Interestingly, there is a very analogous debate between the transitology paradigm which posits that once the authoritarian regime falls, a natural and sequential transition to full democratization takes place, somewhat like the argument of TI proponents. The transitology paradigm is subject to considerable attack in that literature, summarized in Annex 1 of this paper.

IV. AN EXPLANATORY FRAMEWORK

The writings I have put into the TI category draw an optimistic conclusion that a large enough private sector will ensure demand for institutions of liberal competitive markets and democracy. In contrast, those in the TF category hold the view that this will not happen if ownership is too greatly concentrated; but different authors give different reasons for this cause and effect relation, and may differ in their explanations of how this concentration came about. Buiter (2000) notes that popular opinion considers the privatization to have been illegitimate or at a minimum very unfair, hence even if oligarchs are ready for legitimization by securing transparent property rights, political sentiment may prefer taking it back. The latter would only create more uncertainty, thus a dilemma faces governments. Barnes (2003) argues that the oligarchs are not yet ready for secure property rights because there continues to be a struggle for redistribution for privatized and opportunities for still unprivatised ones e.g. in agriculture. While both of these points are valid, I contend this is much less important than the possibility that oligarchs find the non-transparent, non-competitive environment to be optimal, because of the large rents to be had from retaining and even enhancing monopoly power. This is explicit in Polischuk-Savvateev (2004) who show in a formal model the conditions under which oligarchs will favor a "hybrid equilibrium" - precisely the non-competitive, non-transparent environment currently prevailing. Hellman (1998) elaborates conceptually on the implication of such a choice by oligarchs, arguing it leads to state capture; Hellman and Schankerman (2000) provide empirical evidence for this hypothesis. The framework I propose here synthesizes these two approaches, and adds another link to the logic: the factors that lead to the rise of the oligarch economy, in particular explaining why it occurred in some transition countries but not in others. In this paper I will not attempt to develop a formal model, partly because hard-to-quantify historical and political phenomena are especially important in understanding why oligarchy developed. This does not preclude eventual formalization; the political economy literature is full of examples showing how this might be done.

The dependent variable in this framework is progress in transition as measured by the EBRD, which even if a partial and synthetic measure, is closely correlated with most other possible measures as Sec. II showed. The explanatory factors are:

- *the length and intensity of debate on the " navigation charts" i.e. the details of reform programs*
- *the ability of rent-seeking interests to undertake "pirate raids " on state assets and eventual full capture of the state*

- *the availability of " a safe haven" such as EU membership disciplinig the process to achieve a non-oligarchic transition*

The independent variables are defined qualitatively in this paper, though it is relatively easy to think of some quantitative proxies and testable hypotheses. Thus, length of debate and delay - the time from the first opportunity for reforms (Poland, 1989) to the start of significant reforms would be positively related to Hellman's measure of state capture. Further , the likelihood in 1991-2 of EU membership (high, low, unlikely) would be negatively related to the length of the debate period before reforms start. The above are for illustration only, as explicit formalization is beyond the scope of the present paper.

The three factors are not independent of each other, and indeed any formal specification would have a set of simultaneous equations including some exogenous variables. Incidentally, EU membership possibility may seem like an exogenous factor, but I argue below why it was not so simple. The model's line of reasoning can be stated briefly as follows. The longer the debates on how to proceed in "uncharted waters" go on, the more opportunity for old and new privatizing interests to concentrate the transfer of state assets in a few hands; the more concentrated the new ownership the less likely the development of new entrepreneurial activity. Going back to Adam Smith it has been understood that oligopolistic capitalists prefer *less* competition not more. They also prefer less transparency, as this best ensures continued high profits from rent-seeking and state capture; as to property rights, oligarchs may be willing to trade off rule-of-law (ROL) security for the benefits of rent-seeking, using their financial influence to ensure property rights informally. In a word oligarch capitalists behave optimally when they oppose liberalization and democratization.

I will discuss in some more detail each of the three factors, elaborating on their interaction, but also some special country case deviations showing why its causal effect on reform progress is not monotonic but depends on a combination of the other two factors plus factors that would be exogenous in a fuller model.

Debate About Reform Programs

The dominant but not sole explanation of a limited debate is the prospect of EU membership, which was very high for the four Visegrad countries from the start, then soon for Slovenia and Estonia, but a bit later for the other Baltic countries. The fact that the group of May 2004 entrants coincides almost exactly with the CEB group of Chart 1 (with most advanced reforms) affirms the importance of this relationship. But the linearity is far from perfect here, and five countries are worth mentioning: the three Baltics, Slovenia, Slovakia[9]. For the Baltics, the certainty of EU membership came later in the decade, especially for Latvia and Lithuania, because of EU's concern about Russian resistance to this and the Baltics adhesion to NATO. Nevertheless, the near unanimity of views about a radical economic reform including exclusion of the old nomenklatura from participation was established almost immediately after political independence. Explanations include the higher economic productivity here even in Soviet times, the shorter period of communism, and the overwhelming political consensus amongst the enfranchised population to link up with Europe. Basta (2003) describes the latter for Estonia, but it is similar in the other two. A different way of understanding this is to say the demand for EU membership was so strong, that even before Brussels responded invitingly, tremendous efforts were made to move as if toward membership and eventually convince Brussels. This was in fact achieved by mid-nineties for Estonia and by late

[9] The record of EU membership discussions and varying prospects for different countries is described for example in Kubicek (2003).

nineties for the others. They may have been a clear case of strong market orientation attitudes regardless of the EU.

Slovenia in contrast moved much more gradually, was unique in never having an IMF StandBy Program , and maintained state ownership for a long time. Basta (2003) offers a plausible explanation comparing with Estonia: Slovenians felt comfortable that their mixed economy during the Yugoslav period functioned well, price and market distortions were minimal and after a quick stabilization and recovery by 1993, saw no need to rush privatization. In Slovakia the movement was uneven; after the velvet divorce with Czechs, and in particular in the period of Meciar, the process looked for a while to be moving in the direction of oligarchic formations; a plausible explanation for the difference with Czech republic was that the heavy industry of Soviet type was located in Slovakia. Eventually, the desire to join the EU had the political result of replacing the Meciar government with a much more economically liberal one.

Yet other factors that may have led to curtailed debate and early start on effective reforms include the euphoria of Solidarity's victory in Poland and the period of "special politics" in the words of Balcerowicz (1993); Hungary's long history of very gradual movement to market relations and even private ownership in small scale operations. Overall, however, the dominant explanation is the attraction of the EU. I discuss below how this has played out in SEE and CIS countries where the effect has largely gone in the other direction: the low or zero prospects of EU membership contributed to a lengthy debate.

Vulnerability to Capture by Asset Strippers and Rent-Seekers

Whatever the explanations for lengthy debates, its effect was not good;a point form summary of what often happened is shown in Charts 3 and 4. Delay allowed a continuation for many years of fiscal and monetary instability, consequent inflation and exchange rate crisis, plunge in credibility, and a much deeper fall in output. This was the reality of all CIS countries in varying degrees, but also those in SEE. The period of instability and debate in fact provided a perfect opportunity for development of a rapacious new capitalist class based on insider-privileges, regardless of the formal mode of privatization. The legal opportunity of private enterprise provided by Gorbachev's 1988 law on Co-operatives and reinforced in most of the new states by legalization of ownership in early nineties, formed the initial basis of capital accumulation[10]. But the real opportunities came after 1991. High inflation and low interest rates combined with privileged relations owners of the co-operatives or "Konserny" of the late Perestroika period had with government officials-politicians, allowed them to borrow at huge negative rates-in fact often not even repay. Unliberalised prices of energy and raw materials at well below world levels, again with privileged access to trade licenses, gave the first large dividends to rent-seeking activities. The narrative of Freeland (1998) on this "Sale of the Century" applied to Lukoil in Russia, United Energy Systems of Ukraine, the analogue in Moldova etc. Once inflation was controlled, and price distortions reduced, large-scale privatization began, and this became an insider process regardless of whether it was done through public vouchers, auctions, direct sales to workers or managers. As many showed (Reddaway& Glinski (2001) for Russia, Barnes (2003) for others) this "unfair" privatization favoring the old nomenklatura began with the quiet transfer of assets from state entities to associated co-operatives or "Konserny" as many were called. However the nineties privatization was different in two respects. It was much bigger in scale, and it included not only the old nomenklatura, but also new young capitalists-though many of them were Komsomol members who were closely associated with the

[10] An exception was the capital accumulated by the Soviet era Mafiya based historically on black market trading in a shortage economy, but later including drugs and other criminal activity. Handelmann (1994) describes this group of new capitalists, but it may not have been the major source underpinning the new oligarchs. It is notable that in his index, one cannot find a single one of the names that now comprise Russia's oligarchs listed methodically in Barnes (2003) and World Bank (2004).

former elite[11]. In any event the delay allowed the disoriented top echelon to regroup politically, recolor themselves from red to green (not as in environment but as in "buksy"), and by accumulating quickly large sums of capital, to regain influence and indeed control of the political apparatus of the state regardless of open democratic elections.

Was this inevitable? This is one of the most interesting questions for historical debate, though I argue that ion many cases it was only highly probable , but not inevitable. In Ukraine, it may have been avoided if the independence movement (Rukh) had not willingly made what Kuzio (1997) calls a Faustian bargain with the former communists: the latter guaranteed to support independence and the former agreed to let the old communist hierarchy form a government: of greatest relevance here, Rukh did not press for rapid economic reform.

In Russia, both the early privatization and certainly those in mid-nineties under the loans-for shares process were intentionally insider-oriented to co-opt the opposition of the Red Directors. Aslund (1995) considers this to have been a wise tactic to achieve a rapid privatization and reach the critical-mass of private ownership needed to avoid reversal. In Armenia, an early big-bang of liberalization including the first land privatization in the CIS, soon fell into line with others as a result of the need for support of the war with Azerbaijan. Bulgaria, on the other hand is an excellent example of oligarchisation being reversible even at a late stage: the capture of the state was not unlike that in the CIS and some other countries in SEE, (Hellman and Schankerman (2003)-(HS)- put it in that category in 1997-98). But it was quickly reversed after the 1997 elections which brought in a highly reformist government of the UDF. In the background of this was the desire to be European and the clear signals from Brussels of what it desired to see. But the most intriguing question is why the Socialist Party consented to a sufficiently open election to lose. It is also

[11] Handelman (1994) provides good evidence of their importance citing on p.63 a statement of a businessman: "Many of us (in the Komsomol) have been involved in some kind of business since the late eighties."

interesting to note the unique process of negotiations with the IMF on a badly needed Stand-By loan: both the Socialist and the UDF publicly agreed to the conditions of a program to be implemented after the elections[12].

The resulting state of political economy in virtually all the CIS countries plus several in SEE, is best captured in the quantitative measure of "state capture" developed by Hellman and colleagues in the World Bank. The most recent summary for transition countries is HS2000, which designates ten countries as "captured states" in rising order of capture: Romania, Georgia, Slovakia, Croatia, Bulgaria, Kyrgystan, Russia, Ukraine, Moldova, and Azerbaijan. Charts 5 and 6 reproduce figures from the study. From Chart 6 it is clear that is negatively correlated with the degree of reform especially if as HS explain the low capture scores in Belarus and Uzbekistan reflect states still little changed from the Soviet period, with limited privatization. The correlation broadly confirms the hypothesis of a vicious circle as in Chart 3: i.e., less reform allows state capture and state capture results in less reform. The ten high capture states appear at first to fit only loosely with the groupings of Chart 1. However some individual mis-categorisation may account for this.Note in Chart 5 Kazakhstan is only just below Romania; since the survey was done in late nineties, Kazakhstan's reduced democratization and less transparency on oil-revenues recently, might result in a higher score today. In contrast, Bulgaria's, Slovakia's, and Croatia's improvements with new governments may bring them below the line. These modifications plus the explanation given earlier for the CISL group (Turkmenistan was not in the HS survey) would result in a much better fit.

[12] Something similar was done in the 2002-2003 program with Brazil, with an analogous result of the opposition winning the election.

The Effects of EU Membership Prospects

The effect of potential EU membership comprises two parts: *the beacon effect* attracting the country-or more precisely its citizens-to a *"safe haven"* of calmer, richer and more democratic waters; and the *navigation chart effect* provided in the details of the Acquis Communautaire (AC) the guidance needed to transform the economic and political institutions. Let me expand a bit on each of these.

The beacon effect has both a demand and offer side: some countries firmly expressed the desire to become part of the EU very early, (all the CEB) others were vaguer speaking of a desire to be European but not explicitly members of the EU, (some of the SEE, western parts of the CISM except Russia, and even in a more limited way some Caucasian and Central Asian countries.) A number of the latter like Ukraine, Romania, Bulgaria became over time increasingly firmer in expressing the wish for membership. The CISL and Russia, for different reasons have not expressed any such desire. The offer side consists of the informal signals and formal documents indicating EU preparedness to consider countries (the Copenhagen Agreement), or as in Athens Agreement of 2003, accept specific countries. This being a bit of a game, the vagueness of a country's demands is to some extent due to internal uncertainty but also a mirror of the vagueness of the offer from the EU; Ukraine is perhaps the best example of this dynamic. (See Kuzio (2003))

As already noted, the simple correlation between the degree of transition progress and prospects of EU membership is strongly positive. In chart 1 the CEB countries with the exception of Croatia in fact comprise those who were accepted in Athens last year and will become full members in May 2004. The exception is easily explained. There is no doubt about Croatia's demand which was clear and firm from the outset but met with a cold-shoulder from Brussels until the change in

Croatia's government in 2000. This was too late for entry in the first wave, but the Athens agreement clearly suggests possible entry in a few years. It also gives a now much more positive signal for Bulgaria and Romania, and a vaguer but inviting one to the other countries in the group. As we move to lower groups in Chart 1, the EU position becomes vaguer or in fact clearly cooler, in particular for the CISL but also for the Caucasus and Central Asia. This is no doubt a combination of geographic distance and Brussels position on how limited are the economic and democratic reforms in these countries. Ukraine's proximity and strategic importance make for a special and very opaque case, much discussed by others.

Are there countries which have not had a strong offer from EU but proceeded to radical and quick changes nevertheless? The Baltics fit that description, as noted above, but Croatia and Bulgaria may be even stronger cases; EU pronouncements on the Baltics were hedged in early nineties, but not nearly as negative as they were about these two. Are there countries with a strong offer of membership, but that, in a counter factual would have gone ahead with early reforms anyway? This is a counterfactual question that is hard to answer clearly, because the factors driving rapid reform may include both internal ones as well as desire for EU membership. Certainly, Poland, Hungary, Czech Republic and Slovenia were cases with a powerful internal push. Finally, were there cases of a strong offer of membership not reciprocated by a demand and concomitant steady reforms? I would suggest no such cases exist.

The "navigational effect" provided by the AC is probably self-evident; I have only a couple of remarks to make. First, there is an important similarity or at least consistency between the AC as a chart towards the market, and the elements of the Washington Consensus, though the EU-concordance approach has virtually no prioritization, sequencing or recommended timetable. But the annual reports from the EC about how countries were progressing to meet the AC and the requirements listed under the Copenhagen Agreement, implicitly supposed the WC approach, with frequent references to having and implementing a program with the IMF and World Bank-or failure to do so. Second, it should not be forgotten that while the AC is a formal requirement only for those on the path to EU membership, it is a public document available to any government that in early nineties was debating alternative paths to a democratic market economy. For those desiring EU membership but not immediately receiving welcoming signals, there was nothing to preclude demonstrating their seriousness of purpose by proceeding on their own to implement AC components, at lest in spirit if not precisely to the letter. Some like the Baltics did, even to the point of setting up government units for eventual implementation of the AC before positive signals; others who professed a desire, like Ukraine, did not attempt to follow such a strategy.

Finally, let me briefly consider alternative safe havens. The possible candidates are NATO, WTO, the IFI's (IMF, World Bank , EBRD), and regional arrangements such as the Single Economic Space (SES) for some CIS countries. I am not interested here in the relative economic benefits of free trade or free economic zones, though it should be clear that of the above candidates, only the WTO could potentially provide the magnitude of effect that EU's very large economy can[13].

I am interested in the beacon and navigation chart effects. NATO needs little comment, as it is unlikely to be relevant for countries outside the CEB and SEE with one possible exception, Ukraine, where it is conceivable to see NATO membership without EU membership, like Turkey. But does this help motivate or implement market reforms, or even ensure democratic ones? Arguably, it can help, but there is nothing in NATO that would make this as powerful as prospective EU membership. For WTO, disregarding the skeptical view of Rose (2003), it can be said that even

[13] But even for the WTO some ioibt has been raised in recent literature about its trade creating effects; Rose (2002) shows econometric results that it does not. Subramanian and Wei (2003) counter this with more positive results, but nevertheless can only show that trade creation is large for advanced but not developing countries. The unhappiness in Kyrgyz Republic and Moldova that WTO membership has not generated a trade boom would find a resonance with the Rose argument.

if trade liberalization and more trade is promoted, there is little WTO pressure or motivation or formal guidelines for other elements of economic reform, and certainly not for democratization. For the IFI's, the key difference is that mere membership provides neither of these effects; it is only if the country wishes to borrow that conditionality is applied, with a firmness that is broadly proportional to the size of the borrowing but also may be affected by the relative importance of countries. Since Slovenia has never wished to have an IMF program, its slow pace of privatization was not subject to any formal conditionality. Turkmenistan's similar disinterest left it free to undertake absolutely minimal reforms. The story can go in the opposite direction-the unwillingness of Belarus to undertake significant liberalization and monetary stabilization meant it could not receive the large financing it desired.

Regional trade arrangements are even less likely than the other membership possibilities to provide an EU-like effect, both because in practice for those likely to remain outside, the total size of the economy of, say a SES, is very small, but that even less than the WTO the motivation and discipline for a broader transformation is non-existent. Thus, one must conclude that no alternatives come close to the effect of EU, membership; WTO is a distant second, and the others are even farther. The only relationship that may be powerful enough to matter is the conditionality of IMF, World Bank, and regional bank programs. These occur either if a country already wishes to do such reforms (most CEB countries did follow very successfully such programs with and without lending), or has a deep financial crisis. In the latter case, as many analyses of IFI's have shown the success rate is not overwhelming, and at best takes a long time.

The "SS Transition Model" and the Empirical Facts

As a summary of Sec. IV let me pull together the empirical evidence, both quantitative and case study, which shows the consistency between the 3- determinants model (The SS Transition for reference), and the historical facts of different countries' movements towards a liberal market democracy. The model starts by proposing that extensive debates or discussions about the precise path to follow in transforming to a market economy, permitted vested interests to accumulate capital using the distortions of partial reform, to acquire concentrated ownership of state assets, and lobby or capture the state to orient policies to their benefit. New owner "oligarchs " freeze further liberalization both of the economy and polity. Where reform advanced enough to prevent vested interests from forming, and where it was done so as to minimize risk of concentrated ownership, the state capture and freezing of reforms was avoided. In the latter cases, EU membership was an important - but by no means the sole - factor leading to earlier and steadier reforms and a more felicitous outcome.

There are five types of empirical evidence consistent with the above hypotheses. First by country groups, there is a broad but strong negative correlation between the degree of reform achieved and the index of state capture developed by Hellman and others. It is particularly important that this is an asymmetric U-relationship, with state capture being highest for partially reformed countries. Second, the qualitative evidence of case studies, many of them comparing several countries, that the more privatization was insider-oriented (regardless of the formal mechanism used), and the more non-transparent, the greater eventual degree of state capture. Third, numerous statistical analyses of privatization including recently many firm level micro studies consistently point to benefits in the form of efficiency improvements and job-creation, and most importantly that the magnitudes are greater in the following rank-order: large privatized firms least, small-medium privatized firms next, and new firms (necessarily still small-medium) the highest. In parallel, cross-country macro studies show that privatization benefits are by far greater the greater the degree of competitiveness and transparency in rule-of-law, which means more for countries with lower concentration and state capture.

The fourth important set of facts relates to the dividing line between the TI and TF views and comes from voting and opinion poll analysis, surprisingly much of it econometric and not simply case study, and also both time-series and cross-country. The results suggest that private ownership if undifferentiated by size or origin, does not necessarily provide support for liberal policies. But when differentiated, it is clear that SME owners and especially new start- ups strongly favor parties and policies that are more liberal both on economic and political aspects. There do not appear to be enough studies with variables reflecting large or insider – origin privatized ownership, but by implication they are *not* a major supporting force for liberalization: a key hypothesis of the TF position and this paper.

Finally, the fifth piece of evidence is the close correlation between prospects of EU membership on the one hand, and on the other an early start as well as a highly advanced level of reforms by the end of the nineties. The correlation has many special cases as described above, and it is important to see it only as a central tendency around which the special cases can be described and the other reasons for delayed reforms recognized. These include clarity of political and strategic orientation, the nature of initial government's attitude to economic thinking, the priority between economic and political state-building efforts.

Of course, the empirical evidence is not unassailable; there are many data problems, sample coverage limits, specification problems, and sometimes—but not often –contradictory conclusions. Nevertheless, it seems reasonable to conclude the empirical facts are at the very least not inconsistent with the principal lines of logic of the SS Transition model. This is particularly so for the parts of the model that link reform delay or hesitation and even reversals to insider privatization and oligarchic formation and the further links from that to rent-seeking lobbying and state capture, and finally to the preferences for a frozen, partial, liberalization. Evidence on the nature of the link back from reform-delay to either EU orientation or other exogenous factors is less complete. Especially interesting is whether the vested interests in the captured states were already so well-entrenched in the Soviet period that they engineered reform delay and insider privatization in the period 1989-91, or whether there was a disarray of the old nomenklatura and other reasons led to a lengthy debate which gave them time to regroup. For the prediction of the model and recommendation on unfreezing the process this is not of overwhelming importance, but for a good historical understanding it is critical and in fact puts on the table another fascinating issue: was the oligarchisation inevitable in CIS countries?

V. CONCLUSIONS AND POLICY IMPLICATIONS

So what is the one big thing the hedgehog knows? It is that Adam Smith's , felicitous result of the Invisible Hand providing the Benthamite greatest good for the greatest number comes not from private owners seeking to maximize profit *per se,* but from the discipline that an open, and competitive market imposes upon the profit motive, preventing excess profits and accumulation of monopoly power. A different way of putting it is that private ownership is a necessary means to the end of optimal social welfare, but it needs another element to be sufficient: competition, open entry, and by no means not incidentally transparent rule of law to ensure the security of property rights and – I use a term Smith might have done if football were a game in 18th century - a "level playing field" of competition among small and large, new and old.

This simple way of putting the matter highlights the main distinction between the Transition Frozen school of thought and the Transition Inevitable view. TI concentrates upon one of the hands in the Invisible Hand paradigm, the fact of private ownership, and errs by not paying due attention to the other equally necessary hand of competitive discipline. Smith's emphasis on the interplay of motivated private owners with the discipline of competition is an important part of neo-classical dogma. If the market is not competitive but monopolized, profit maximization will result in technical efficiency and yield the greatest benefit for the owner-capitalist, but not for society at large[14].

In this connection it is useful to comment on the frequent comparisons of post-communist oligarchs with robber barons of the 19th century which draw the mistaken lesson that with time oligarchs too will have amassed enough and become good capitalists scattering cornucopias of philanthropy and accepting to live in a state with equal rule of law for all. There is one big similarity and two important differences between the two. They both amassed a lot of wealth and hence had similar oligopolistic or even monopoly powers. But the robber barons did not get their wealth by underpriced transfer of pre-existing sate assets, nor did they benevolently push for Anti-Trust legislation which limited their profit-making. The real lesson from the robber baron period is that they do not willingly give up their positions of wealth, influence and future monopolistic profits or rents. The legislative and implemetation initiatives for a level playing field must come from the body politic broadly writ, which includes governments and civil society.

Turning to some policy implications, I will discuss three categories: actions to reverse the power of oligarchs; actions to restrict those powers; and actions to promote a counterweight to these

[14] I wish to emphasize that the TF criticism of TI is not a critique of the WC except in the limited ex-post sense of recognizing that privatizations which resulted in overly concentrated ownership created strong vested interest in monopolistic and rent-seeking behaviour, which in turn means strong opposition to full liberalization. This is not the place to discuss critiques which argue it should have been foreseen and the negative outcome is therefore the fault of WC and its proponents (Reddaway and Glinski (2001) is only of many. Note that in the model of the present paper, delayed and incomplete reforms are the cause of the oligarchic formation, rather than the substance of the proposed reforms themselves

vested interests, in particular a middle-class centered around small entrepreneurs. The first of these involves possible renationalisations followed by new efforts to do privatization right as for example proposed by Stiglitz (1999), or written about in the current press in reference to efforts by the governments to "punish" oligarchs – the Khodorkovsky case in Russia. TI proponents strongly warn about the risks here, and they are right but for the wrong reasons. Leaving aside the possibility that in specific cases these actions are indeed a legitimate pursuit of justice, the problem is that even in such cases they may not be perceived as such, and then they create the uncertainty about property rights that Buiter (2000) explains will not help instill confidence even for legitimate business of any size. If there is a clear procuratorial case governments must ensure this is effectively explained and demonstrated and all perceptions of political motivation countered.

The second set of actions, restricting or regulating monopoly power is absolutely essential, in the same way Anti-Trust legislation was, but even –handedness and effective implementation must be credibly demonstrated. There are two problems here. If the state is already captured there may not be the will or ability to do this. Further, such actions will not be seen as even-handed until the third set of actions is taken in parallel and meaningfully: removing the legal and regulatory impediments that makes small business start –up and operation so difficult. That third set of actions if pursued well, has several benefits-it begins to provide the competition that in the long run will by market discipline curtail the monopolistic behavior of oligarchs, generate a more sustainable investment and growth cycle, and politically begin to create a counter weight to vested interests. As the evidence so far strongly shows, such a middle class of entrepreneurs is the one most interested in the rule of law, transparency and a liberal market economy. Of course, this Olsonian "collective action" counterweight will not appear quickly, though it appears to be developing very slowly on its own even with an uneven playing field, but surely anything that will speed up its development is to be highly recommended, for – and here I draw a Chinese lesson – even the longest journey begins with the first step.

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ANNEX 1.

THE TRANSITOLOGY PARADIGM IN POLITICAL SCIENCE

(prepared by Karlo Basta, University of Toronto)

The transitology paradigm in the study of democratization, both in the post-communist world and more broadly, has been difficult to verify empirically, and is subject to much criticism, but remains an important tenet of political science studies of democratization. This note provides a schematic description of the transitology paradigm, its perceived weaknesses and main challenges. A seminal exposition in political science is provided by O'Donnell and Schmitter[15]. One of the most recent critiques of transitology is by Carothers[16], who lists five key assumptions underlying this paradigm:

1. Any country moving away from authoritarianism is moving towards democracy
2. Democratization takes place in a set sequence of stages (this will be further elaborated below)
3. Elections are the key to democratization and further democratic consolidation
4. The structural conditions of democratizing countries, such as the levels of economic development or ethnic composition, as well as historical experiences, are not crucial influences on the course and outcome of democratization
5. The "third wave" democratization takes place in functioning states

Perhaps the most contentious issue is the assumption of linearity in the process of democratization, democracy proceeding in three stages. The first is democratic opening, liberalization under the authoritarian regime, usually manifested in rifts between reformers and hardliners within the regime. This is followed by the collapse of authoritarian regime and its rapid replacement by a new, democratic system. Democratic institutions are introduced and codified in a democratic constitution. A prolonged stage of consolidation follows, during which "democratic forms are transformed into

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[15] Guillermo O'Donnell and Philippe Schmitter, *Transitions from Authoritarian Rule: Tentative Conclusions About Uncertain Democracies* (Baltimore: Johns Hopkins University Press, 1999).

[16] Thomas Carothers, "The End of the Transition Paradigm" in Journal of Democracy Vol. 13, #1 (January 2002); pp. 5-21.

democratic substance", so that democracy becomes the only game in town, accepted by all major political actors. (Carothers, p. 7)

One of the key objections to the transitology paradigm is that it is too deterministic in assuming that in each case, democratization proceeds through a similar set of stages. M. Steven Fish, for example, argues that transitologists focus too much on studying the impediments to the "completion" of democracy and not enough on the exploration and theorization of the differences in democratization among countries undergoing that process[17].

Alternative theories of democratization have not always arisen in response to the transitology paradigm, but sometimes in parallel to it. The most notable is the structuralist theoretical approach, focusing on economic, social and cultural preconditions of democracy[18]. The common assumption is that countries at a higher level of economic development, characterized by ethnic homogeneity, or certain cultural prerequisites, have a greater chance of experiencing democratic breakthrough and sustaining a democratic political system. Yet, Fish's re-examination of these postulates yields a less than convincing result, finding weak correlation between levels of economic development and ethnic homogeneity on one side, and democratization on the other. Beyond structuralist explanations, other scholars emphasize the importance of factors such as the extent of institutional pluralism within mature authoritarian systems[19]. Still others emphasize the importance of functioning party systems as the key institution leading to democratic consolidation[20]. However, while the transitology paradigm

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[17] M. Steven Fish, "Postcommunist Subversion: Social Science and Democratization in East Europe and Eurasia" in Slavic Review, Vol. 58, #4 (Winter 1999); p. 799.

[18] For a review, see Fish, p. 797. See also a review in Geoffrey Pridham, The Dynamics of Democratization: A Comparative Approach (London & New York: Continuum, 2000), p. 5-8. However, Pridham calls this approach "functionalist". Furthermore, the fact that he lumps all theoretical approaches dealing with democratization under the rubric of "transitology" reveals the extent of the conceptual confusion in the study of this phenomenon.

[19] Philip Roeder's chapter in Richard Anderson, M. Steven Fish, Stephen Hanson & Philip Roeder, *Postcommunism and the Theory of Democracy* (Princeton and Oxford: Princeton University Press, 2001)

[20] For a brief summary of this view, especially as expounded by Herbert Kitschelt, and an interesting critique, see Stephen E. Hanson & Jeffrey S. Kopstein, "The Weimar/Russia Comparison" in Post-Soviet Affairs, Vol. 13, #3 (1997); pp. 252-283.

is being repeatedly challenged, it is clear that no new paradigm is emerging. Rather, there is a degree of complementarity among the various theories of democratization, as they often ask related but distinct questions.

CHART 1

EBRD Index of Transition 2002
(4.3 = Full Market Economy)

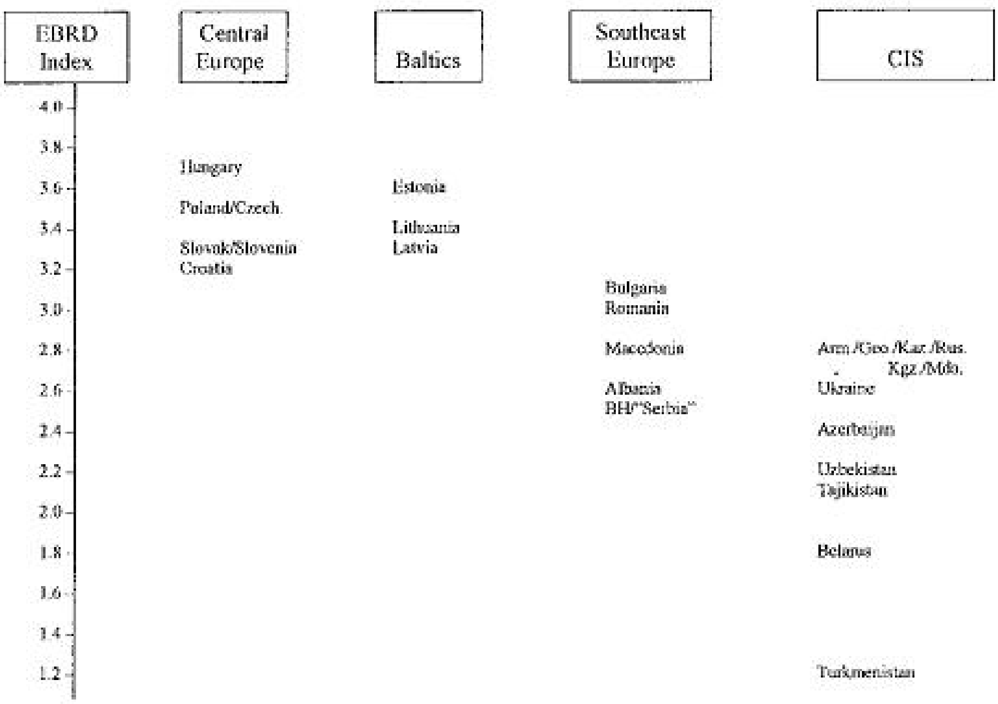


TABLE 1

Recovery: Estimated Index of GDP 2002 (1989=100, with Arbitrary Adjustment for Soviet Accounting*)		
	Unadjusted 2002 Value	**Arbitrary Adjustment**
Central Europe	120	150
Baltics	82	111
Southeast Europe	81	97
CISM	55	74
CISL	96	96

* Many have argued Soviet income accounting overstated GDP; hence, the recovery form 1989 levels has been much higher than simple arithmetic (col. 1) shows. Sachs (1993) and Aslund (2002) are examples. I have made an arbitrary adjustment to EBRD index value of 2002 as follows. Central Europe, 25%; Southeast Europe, 20%; Baltics and CISM,35%; CISL , no change

TABLE 2

Inflation Performance (CPI Increase 2002, in Percent)			
	Group Median	**Low Country**	**High Country**
Central Europe	2.3	Poland (2.1)	Slovenia (7.4)
Baltics	2.3	Lithuania (0.9)	Estonia (3.8)
Southeast Europe	5.9	Macedonia (3.6)	Romania (22.7)
CISM	5.2	Ukraine (1.6)	Russia (15.4)
CISL	12.7	Turkmenistan (9.6)	Belarus (41.4)

TABLE 3

Cumulative FDI Per Capita, 1989-2002 (By Subregion)			
	Group Average	**Low Country**	**High Country**
Central Europe	1,600	Poland (1,000)	Czech Rep. (3,400)
Baltics	1,400	Lithuania (1,000)	Estonia (1,800)
Southeast Europe	384	Serbia (190)	Bulgaria (547)
CISM	279	Tajikistan (21)	Kazakhstan (950)
CISL	142	Uzbekistan (36)	Turkmenistan (210)

CHART 3

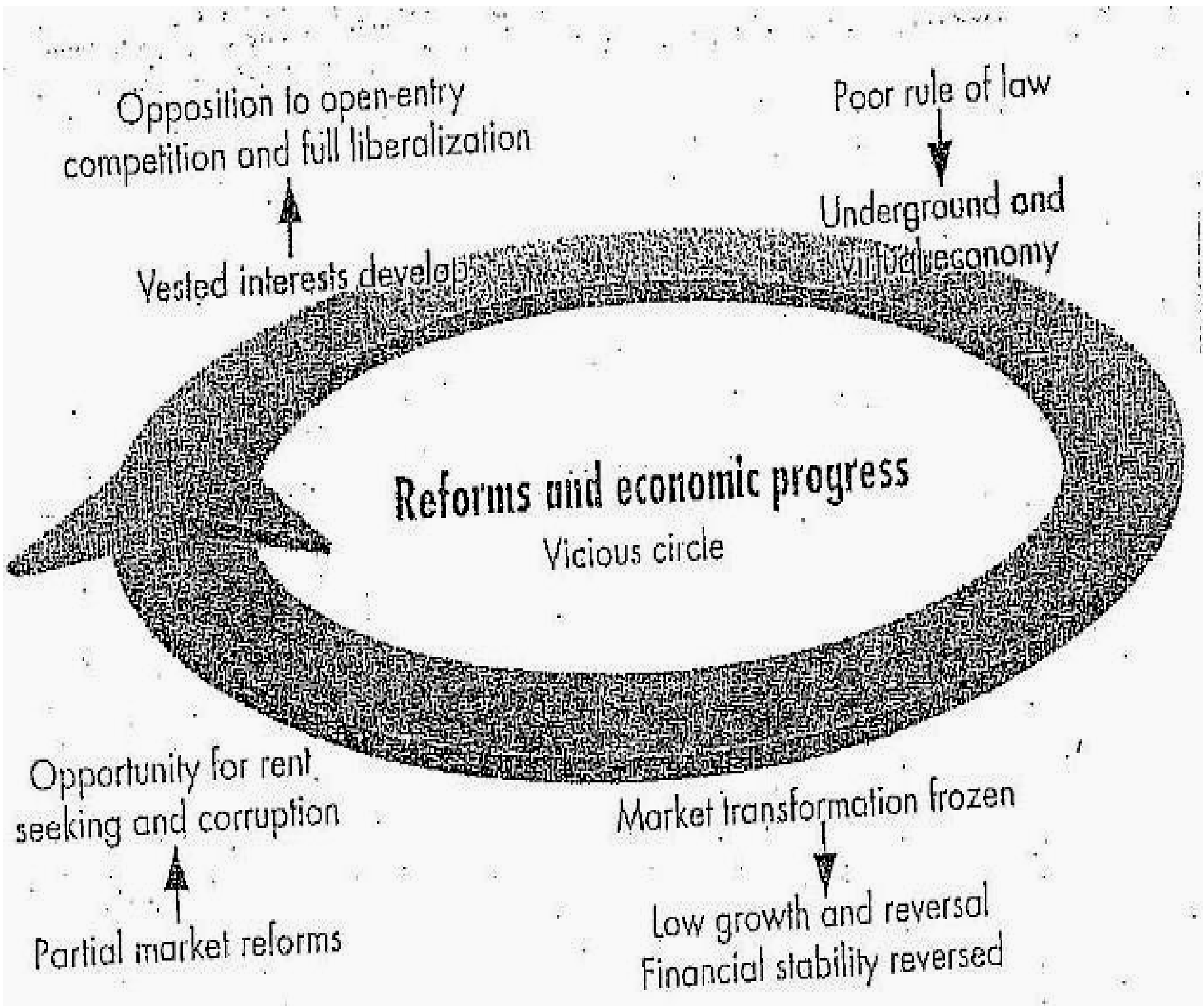

Opposition to open-entry
competition and full liberalization
Vested interests develop
Poor rule of law
Underground and
virtual economy
Reforms and economic progress
Vicious circle
Opportunity for rent
seeking and corruption
Partial market reforms
Market transformation frozen
Low growth and reversal
Financial stability reversed

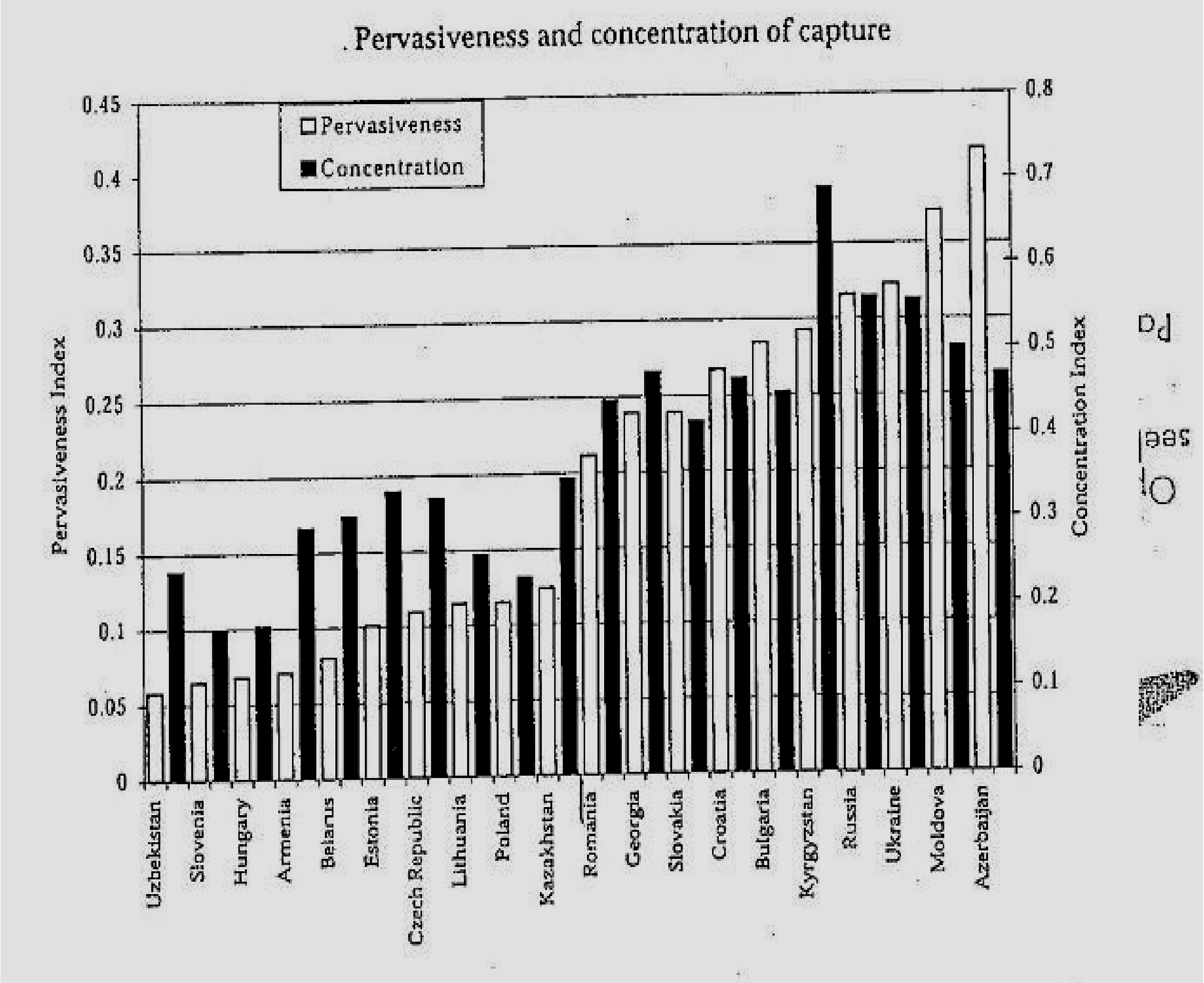
CHART 4

DELAYED REFORM, STATE CAPTURE ,

AND FROZEN TRANSITION

- DELAY IN REFORMS ALLOWS OLD/NEW ELITES TIME TO REVIVE,BECOME CAPITALIST USING INSIDER PRIVILIGES
  - FIRST PHASE; HIGH INFLATION,LOW INTEREST RATE PERMITS INITIAL ACCUMULATION OF CAPITAL
  - CAPITAL USED TO BUY RAW MATERIALS ENERGY AT LOW STATE PRICES, RESELL AT WORLD PRICES WITH ACCESS TO LICENCES
  - SECOND PHASE RENT-SEEKERS AGREE TO INFLATION CONTROL, RETAIN SOME “SOVIET PATRIARCH” RESPONSIBILITIES TO WORKERS TO CO-OPT THEIR VOTES, AND PROCEED TO INSIDER PRIVATISATION OF MAJOR STATE ASSETS
  - THIRD PHASE WITH MOST ASSETS PRIVATISED , INFLATION STABILITY, GROWTH PROSPECTS IMPROVE BUT THREAT OF LIBERAL ENTRY OF NEW ENTREPRENEURS LEADS “OLIGARCHS” TO OPPOSE FULL LIBERALISATION, THEY “CAPTURE” STATE POLICIES TRADING-OFF SECURE PROPERTY RIGHTS FOR RETENTION OF NON-COMPETITIVE PRIVILIGED POSITION.
  - TRANSITION FROZEN PARTWAY TO COMPETIVE MARKET ECONOMY

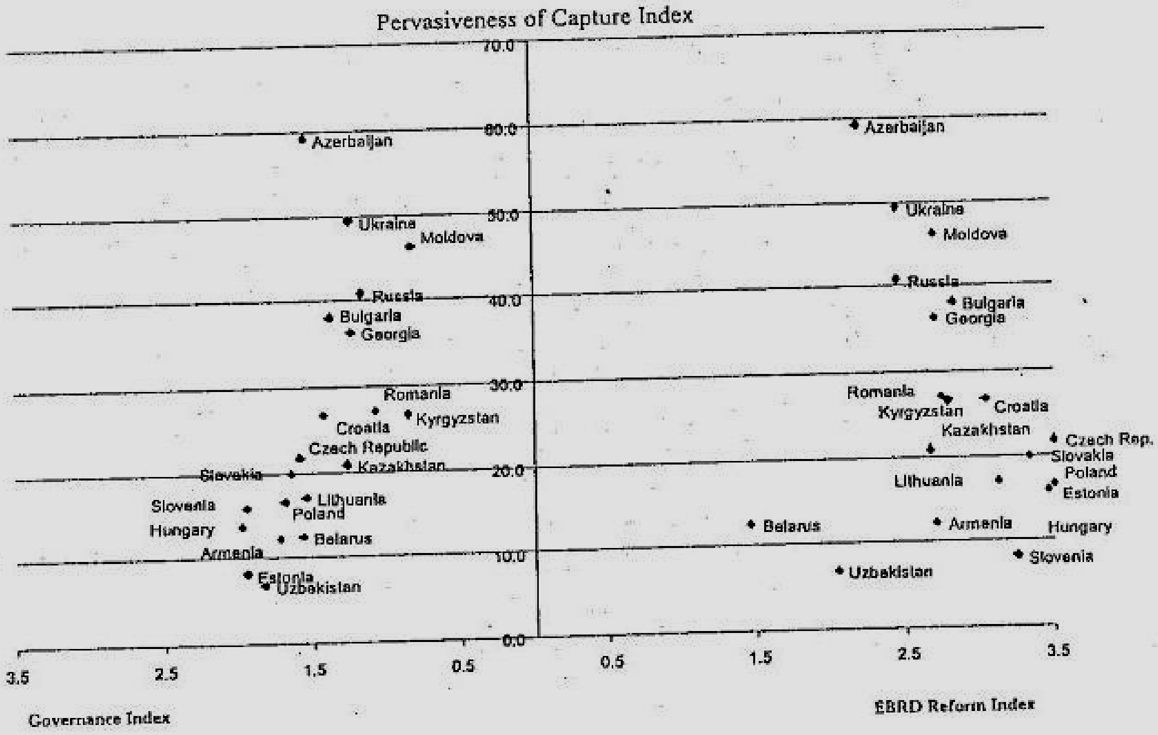
CHART 5



Notes: Pervasiveness is measured as the per cent of firms reporting they are significantly affected by the sale of parliamentary votes on laws or presidential decrees to private interests. Concentration is measured as the proportion of firms reporting they are significantly affected (by the sale of parliamentary votes on laws or presidential decrees) that are identified as captor firms. A captor firm is firm that reports making 'unofficial payments to public officials to influence the content of new laws, decrees or regulations'.

CHART 6

Governance, reform and state capture



Note: The Governance Index is the average response over the ten dimensions of governance represented in Figure 1, for each country. The EBRD reform index is taken from EBRD *Transition Report* (1999).