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Ten Years After . . . Transition and Economics

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This paper attempts to portray a synthesis of what has been learned in the past 10 years with regard to the transition process. It contrasts the mainstream "Washington consensus" view of transition with the "evolutionary institutionalist" perspective. It argues that the latter gives a more adequate and complete picture both of the transition processes and of economic systems and is of better help to prevent serious transition failures. [JEL P10, P16, P41, P51, P52]

More than 10 years after the fall of the Berlin Wall and the beginning of transition in former socialist countries, it is useful to try to gather some of the lessons that have been learned with respect to our vision of the transition process and also with respect to how transition processes have affected our way of thinking about capitalism as an economic system. Transition issues have appeared initially quite controversial. There have been controversies on the speed of reforms, privatization methods, the role and organization of government, the kind of financial system needed, etc. While these controversies often have been seen as ideological, they also reflect to a large extent the initial ignorance and unpreparedness of the economics profession with respect to the large-scale institutional changes implied by the transition from socialism to capitalism.

When the Berlin Wall fell unexpectedly, there was indeed no preexisting theory of transition. We had no preexisting theory on the effects of political constraints on transition strategies, the effects of liberalization in socialist economies with no preexisting markets, how to privatize socialist enterprises

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given the legacies left by socialism, and how to harden budget constraints and achieve efficient restructuring.

Not surprisingly, transition brought many unexpected surprises:

- The huge output fall after price liberalization, which was not predicted by the economics profession at large nor by scholars of economic systems.
- The continuous economic decline in Russia and other countries of the former Soviet Union and the divergence in economic performance between Central Europe and most countries of the former Soviet Union.
- The extent of insider privatization.
- The observation of restructuring in many state-owned enterprises despite initial fears of widespread asset-stripping before privatization of the enterprise.
- The extent of the development of the Mafia phenomenon. Where we expected the emergence of markets, often the Mafia emerged instead.
- The breakup of countries (Yugoslavia, Czechoslovakia, USSR, and secessionist tendencies inside Russia).
- Last and not least the huge economic success of Chinese reforms, which led to sustained growth and prosperity over a period of 20 years.

The economics profession was thus very ignorant when transition started. What have we learned in the past ten years? I should start by stating that we remain relatively ignorant and that there remain important disagreements among economists doing research on transition. Ten years can be a long time in the life of people, but in research, it is a short time span. Compared to other economic events and issues, transition is also especially complex. Understanding transition requires a comprehensive understanding of the constitutive elements of capitalism and of their interactions. Moreover, it requires also an understanding of the dynamics of large-scale institutional change, an even more difficult objective.

Nevertheless, important progress has been made by the economic research on transition. As a result, there also has been an important convergence on many issues. Not only have visions of transition evolved substantially in the past ten years, but research on transition also has contributed to certain shifts of emphasis in the way economists look at economic systems. The various surprises of transition have further contributed to a change of focus that has been taking place in the past two decades in the vision of economics. They have very much reinforced the institutionalist perspective, emphasizing the importance of the various institutions underpinning a successful capitalist economy. Successful institutions of capitalism are already present in advanced economies, and we tend to take them for granted when reasoning on economies in transition or on developing economies where such institutions are absent. If anything, the experience of transition shows that policies of liberalization, stabilization, and privatization that are not grounded in adequate institutions may not deliver successful outcomes. Much of this change of focus toward the institutionalist perspective already had been taking place with the development of contract theory, political economy, law and economics, regulation theory, corporate finance, and other areas in applied economic theory. The experience from transition, however, has contributed to accelerate various changes of focus in the way we think about economics. Thus, there is a shift of emphasis from markets and price theory to contracting and to the legal, social, and political environment of contracting. Transition has not only helped to reinforce this change of focus in economic thinking, it has also renewed interest in thinking about the interplay and complementarities between the various constitutive institutions of capitalism. Finally, transition has forced us to think about institutions not in a static way but in a dynamic way: how momentum for reform is created, how institutions can evolve but also how momentum can be lost, and how one can get stuck in inefficient institutions. In this sense, transition has reinforced what I would call the evolutionary-institutionalist perspective, insisting both on the institutional environment of agents at any moment in time but also on its evolution.

I. The Washington Consensus Versus the Evolutionary-Institutionalist Perspective

To organize the discussion, it is useful to present a simplified and schematic presentation of the differences between the two main visions of transition that have crystallized since the beginning of the transition process and that shaped both policy recommendations and research programs.

The first vision of transition is generally referred to as the "Washington Consensus."[1] I will call the second one the "evolutionary-institutionalist perspective." One could label the former the big bang or the shock therapy view and the latter the gradualist or incrementalist view. I prefer not to do so because these labels are too narrow in their focus since they mainly emphasize the speed of reforms, whereas, as we will see below, there are many more dimensions than speed that are involved in both visions. This broadening of the focus since the beginning of transition is the object of a consensus among researchers working on transition on both sides. The presentation that follows is certainly schematic and incomplete. Most researchers would not fully recognize their own vision of transition in either category, and there also has been an important degree of convergence over time in many of the dimensions that I will evoke. Even though the "Washington Consensus" is usually associated with the views of the IMF and World Bank, the description below should in no way be seen as a description of their official views. Views within the IMF and the World Bank, moreover, have undergone change over time and should not be seen as monolithic.

The purpose of this presentation is thus not to draw pictures of two camps or to draw a "straw man" but to crystallize ways of thinking about transition in a comprehensive way. In all the dimensions of transition treated below, debates have been taking place in the past ten years reflecting these two visions in one way or another. These debates, and more importantly the transition experience itself, have led to a process of learning. As of today, many fervent advocates of the Washington

[1]The term "Washington Consensus" was initially coined by John Williamson in 1990 and did not refer at all to transition. Since then, as observed by Williamson (2000) himself, the term has taken a life of its own. It has been used in particular to label the thinking behind IMF and World Bank orthodoxy and has aroused controversy not only in the context of transition but also in the context of structural adjustment programs. I will say nothing about the latter and will focus only on transition aspects.

consensus would only partially recognize their views in what follows because of the results of this process of learning. Also, the presentation of the evolutionary-institutionalist perspective may be seen as biased because the vision presented here already reflects the learning process that has taken place. The vision of those who, ten years ago, were already critical of the Washington Consensus, was certainly not as systematic as it is today. Presenting the Washington Consensus mainly as it was expressed ten years ago and the evolutionary-institutionalist perspective as it exists now may seem biased if one thinks in terms of analyzing a battle between camps, but it is very useful if the main objective is to understand what we have learned from the transition experience itself.

The Washington consensus view on transition was clearly dominant in the beginning of the transition process in Central and Eastern Europe. It has shaped policy recommendations and dominated thinking in international financial organizations and has been supported and endorsed by famous economists from the best universities in the world. It has influenced to a large degree economic policy in most transition economies with the very large exception of China, which has followed its own transition path in a very pragmatic way.[2] Intellectually, it is rooted in a combination of (1) standard neo-classical price theory; (2) standard macroeconomics and experience of stabilization policy; and (3) a broad body of knowledge in comparative economic systems emphasizing both the complementarity of the constitutive institutions of economic systems and the disappointing experiences with partial reform in Central and Eastern Europe prior to the fall of communism.

The evolutionary-institutionalist perspective has had more support in academic circles than in international policy circles. It was clearly a minority view in the beginning of transition but has gained more and more support over time in light of the transition experience. Intellectually, it is rooted in (1) the institutionalist perspective given by modern microeconomic theory and shaped by the development of non cooperative game theory; (2) the evolutionary approach to economics (see, for example, Murrell, 1992); and (3) a philosophical skepticism, influenced by Hayek and Popper, with a strong emphasis on our relative ignorance of economic and social systems and their transformation, and an emphasis on the uncertainty associated with societal engineering and a strong aversion to any kind of Bolshevist-style campaigning in large-scale institutional transformation.

Table 1 gives a summary and simplified presentation of these two opposed visions (see also typologies in Murrell, 1992; and Stiglitz, 2000). Going from the "forest" to the "tree," we look successively at the attitude toward (1) the political economy of reform and reform strategies; (2) allocative changes; and (3) governance changes. The former relates to the sectoral reallocations following liberalization and their macroeconomic consequences, and the latter relates to changes at the micro level and in particular at the level of enterprises. Some of the differences listed in the table are less important and less acute, while others are more important.

[2]Obviously, it has not influenced those governments that were mainly opposed to reform and whose strategy was to block transition as much as possible. In contrast, Chinese reformers have sought to advance the reform process and to bypass conservative opposition from within the Communist party. They have been successful in doing so and have, in the process, developed an original transition path.

A fundamental difference in both visions is the attitude toward uncertainty with respect to the outcome of reforms. The Washington consensus emphasizes that reform will deliver sure efficiency gains. It contains a strong faith in societal engineering. The idea behind this is that the economics of reform is well understood. Since the initial situation is characterized by fundamental inefficiencies and since economic theory predicts that transition will deliver sure efficiency gains, then these reforms should be implemented with the faith that the efficiency gains will be reaped. We know that capitalism, as experienced in the United States or Europe, has proved more successful, so it is simply a matter of copying the better models. In contrast, the evolutionary-institutionalist perspective emphasizes the aggregate uncertainty of transition outcomes. Aggregate uncertainty means that aggregate, economy-wide reform outcomes may range from very positive to very negative. In other words, economy-wide success is by no means guaranteed. We do not know in advance whether the outcome will be closer to the West German miracle or the Weimar republic, not to speak of the former Yugoslavia.

To be sure, the point is not whether we know what the successful models of capitalism are, but what is the combination of ingredients that has delivered the observed successes and how difficult it is to export those ingredients. Even in trying to copy the better models of capitalism, things may thus go wrong. Our understanding of these large-scale changes is still rudimentary and nothing guarantees that there will not be huge unexpected and undesired outcomes. There are a huge number of coordination problems, moreover, to be solved among economic agents. Among the huge multiplicity of equilibria implied by these coordination problems, we do not know in advance which one will be selected and why. For these different reasons, there is likely to be important aggregate uncertainty over the outcomes of reform. This uncertainty will be reflected in both popular attitudes towards reform and in decision making by policymakers.

This important difference in starting points has implications on reform strategies. For the Washington Consensus view, the political economy emphasis is to use early windows of opportunity or periods of "exceptional politics" to push reforms through as fast as possible and to create irreversibility. In the evolutionary-institutionalist perspective, the latter strategy may be dangerous and lock whole countries in situations of inefficient economic outcomes that are hard to reverse because of the irreversibilities created. (Such outcomes may break social cohesion and generate important political instability.) The emphasis is rather on ensuring a continuous and growing support for reforms among the population. This implies a more gradual and experimental approach to reforms, relying on the flexibility of experimentation, with an adequate sequencing of reforms, to possibly reverse reforms that do not work and try other ones.

The Washington Consensus tends to reject in general any partial reform. The idea is that any partial reform will create rents for given groups that will be threatened by further reforms. Partial reforms, therefore, create constituencies that will tend to oppose further reform, whereas this will not be the case with a comprehensive introduction of reforms. The evolutionary-institutionalist view is less pessimistic about partial reform—all depends on the sequencing of reforms. While some partial reforms may indeed stall the reform process and even lead to unnec-

Table 1. A Simplified Presentation of the Two Different Visions of Transition

	Washington Consensus View	Evolutionary-Institutionalist Perspective
1. Political economy of reforms and reform strategies		
Attitude toward uncertainty	Insistence on sure efficiency gains; faith in societal engineering	Insistence on aggregate uncertainty; skepticism toward societal engineering
Political economy emphasis	Use window of opportunity to create irreversibility	Ensure continuous and growing support for reforms
View of partial reforms	Create rents that block further reform progress	Depends on sequencing: can either create momentum or stall reform process
View of reform complementarities	Of absolute importance. Necessity to jump-start the market economy by simultaneous introduction of all main reforms	Very important but comprehensiveness of initial reforms not necessary, provided initial reforms can create momentum for further reforms. Transitional institutions can develop and evolve gradually toward more perfect institutions
Main support group for reforms	Owners of privatized enterprises	Middle class and new private sector
Focus of reforms	Liberalization, stabilization, privatization	Create institutional underpinnings of markets to encourage strong entrepreneurial entry
Attitude toward institutional change	Emphasis on adoption of laws	Comprehensive: legal and financial change, law enforcement, reform of organization of government, development of self-enforcing social norms
Attitude toward initial conditions	Create “clean slate” conditions by breaking existing Communist state structure	Use existing institutions to prevent economic disruption and social unrest while developing new institutions
2. Allocative changes		
Main view of markets and liberalization	Markets will develop spontaneously provided government does not intervene; supply and demand as focus of analysis	Importance of institutional underpinnings needed to enhance market growth: minimum legal and contracting environment, law enforcement, political stability, building of business networks and long term partnerships; contracting agents and their institutional environment as unit of analysis
Main attitude toward inefficient state-owned enterprises	Aggressive closing down	Containment and politically feasible downsizing. Rely on evolutionary development of private sector to shrink state sector
Main view of government	Weaken it as much as possible to prevent intervention in markets	Role of government in law enforcement and in securing property rights

Table 1. *(concluded)*

3. Governance changes		
Focus of privatization	Fast transfer of ownership to private hands via mass privatization to break government power and jump-start market economy. Faith in market to ensure efficient resale	Emphasis on organic development of private sector. Emphasis on sales to outsiders to achieve efficient transfer of ownership from the start
Main emphasis of government reform	Main emphasis is shrinking the size of government	Reform in the organization of government so as to align as much as possible the interests of government bureaucrats with the development of markets
Hardening budget constraints	Exogenous policy choice that depends on political will	Endogenous outcome of institutional changes

essary reversal, starting with other partial reforms may create momentum for further reform. This will be the case especially when reform complementarities are important.

Models of reform sequencing by Dewatripont and Roland (1995, 1997) show that complementarities can be exploited by reformers when choosing the order of reforms. Indeed, by starting with more popular reforms, it is possible to build constituencies and political support for further, initially less popular reforms. The idea is that positive uncertainty resolution enhances voters' perception of positive reform outcomes. In that case, when reforms are complementary, the only choices are to go forward or go backward. Voters will thus be more prepared to move forward in order to keep the gains from initial reforms after partial uncertainty resolution about those reforms. Reforms should thus be ordered in a way to start with reforms more likely to deliver good news for voters. Popular reforms should precede less popular reforms. On the contrary, starting with reforms more likely to hurt a majority of the population risks a backlash, since bad news on initial reforms will build support for reform reversal.

For the Washington Consensus, complementarities in reform are of absolute importance and are an overriding argument for a big bang approach whereby all reforms are introduced in a simultaneous and comprehensive way.[3] For the evolutionary-institutionalist perspective, complementarities, while clearly important, are not an overriding argument as long as sequencing of reforms can be used to create momentum for further reforms. This difference between both visions also has an important implication with respect to institutional reform and the introduction of new institutions.[4] The Washington Consensus insists on fast introduction of "best practice" institutions. This is not the case with the evolutionary-

[3]Note that if the latter view is taken seriously, then partial reform cannot stall the reform process over time since complementarities make partial reform inherently unstable leaving as the only choice to move forward or backward in the reform process. It is thus inconsistent to insist both on the importance of complementarities and of the danger of partial reforms stalling the transition process.

[4]We will come back in more detail below to the differences with respect to institutional reforms.

institutionalist perspective. Introduction of "best practice" institutions may not be possible for political and social reasons, and may not be necessary. The evolutionary perspective implies that transitional institutions can develop that are adequate to the initial conditions but that can gradually evolve toward more perfect institutions. Here also, flexibility is important to prevent a lock in in inefficient institutions that are hard to change.

A more minor point, but nevertheless with possible wide-ranging practical consequences, is a difference in emphasis on the main support groups for reform. The Washington Consensus emphasizes mostly the support of owners of privatized enterprises. The idea is that fast mass privatization creates constituencies among insiders and among those who benefit most from mass privatization to block any reversal. That is one of the reasons for pushing for rapid privatization. Since the owners of privatized enterprises are a minority and are not likely to be median voters in elections, the focus is mainly on the creation of powerful lobbies for capitalism via mass privatization. The emphasis is clearly on interest group politics as opposed to electoral politics (on this distinction, see Persson and Tabellini, 2000). The evolutionary-institutionalist perspective pays more attention to the attitudes of voters and to electoral politics. The purpose is more to rely on a broad group of small entrepreneurs and the middle class that emerges from the entry of new enterprises both in urban areas and in the countryside. The idea is that the middle class always plays an important role in democracies since voters of that group are more likely to be pivotal in elections. This also explains a greater care for social cohesion and a fear of excessive inequalities, which are likely to create more pressures for redistribution and may generate political instability.

Let us now turn to issues related to the substance of reforms and their focus. Here also, there are nonnegligible differences in vision. First of all, the Washington consensus view on transition is based on liberalization, stabilization, and privatization. At the start of this new millennium, few serious economists dispute the need to liberalize, stabilize, and privatize. There is not much disagreement either about the advantages of using shock therapy as a stabilization method when it is politically feasible. For the evolutionary-institutionalist perspective, the emphasis is more on the creation of the adequate institutional underpinnings of markets to encourage a vigorous process of entry, competition, and exit. The idea is that liberalization, privatization, and even stabilization will not necessarily deliver the desired outcomes in the absence of such institutional underpinnings and may lead to unpleasant surprises.

To avoid any misunderstandings, it would be completely wrong to state that the Washington consensus has ignored institutional reform while the evolutionary-institutionalist perspective has not. While the latter insists more on institutions than the former, the main differences are elsewhere. The Washington consensus emphasizes mainly the introduction of laws: adequate laws to secure private property, rights of shareholders, creditors, and so forth. The evolutionary-institutionalist perspective takes a more comprehensive view toward institutional conditions. These include not only legal and financial change but also comprehensive conditions of law enforcement, including reform of the organization of government and the development of self-enforcing social norms that foster entrepreneurship, trust, respect of legality, and commitment. The evolutionary-institutionalist perspective has sometimes been derided by statements according to which it recommends that perfect institutions should be introduced first before implementing any liberalization or privatization. As stated above, this is not the case. The evolutionary attitude toward institutions implies that minimum institutions underpinning market development must be present from the beginning because these define the rules of the game and thus place restrictions on undesired kinds of individual behavior and because they reduce uncertainty. Adequate institutions must develop via trial and error and must evolve over time into more perfect institutions that cannot be introduced overnight.

Related to the latter question is the attitude toward the initial conditions of reform. The Washington Consensus emphasizes the need to wipe the slate clean by breaking as fast and as thoroughly as possible the existing Communist state structure. The logic is one of "cavalry attack" to break any possible resistance and sabotage to reforms by the conservative communists of the former *nomenklatura*. The rhetoric uses revolutionary metaphors, and comparisons are often made between post-Communist transition and the French revolution (see, for example, Sachs, Woo, and Yang, 1999). This emphasis is very strong. Early in transition, most experts on socialist economies were pushed aside and declared obsolete by the shock therapists. Many of these new transition experts stated repeatedly that knowledge of the former system is a liability and ignorance an asset in understanding transition. This "clean slate" view has found its most accomplished implementation in East Germany where the old system was thoroughly broken up at grand speed while West German experts came to build their own institutions on the ashes of the old system. In contrast, the evolutionary-institutionalist perspective shies away from a revolutionary approach to transition. It emphasizes the need to use the existing institutions to prevent economic disruption and social unrest while developing new institutions.

We have here again an area where both sides put a strong emphasis on institutions, but the Washington Consensus insists on an uncompromising approach and the absolute need to thoroughly destroy past institutions and directly put in place the best imaginable institutions. This difference is related to the distinct views about institutions. The main emphasis of the Washington Consensus on the introduction of laws is coherent with a "clean slate" approach and a will to introduce best practice institutions independently of initial conditions. On the other hand, the more comprehensive approach of the evolutionary-institutionalist perspective explains the greater skepticism toward import of institutions from outside and the greater insistence on trying to guide an evolutionary and flexible change of institutions in accordance with the initial conditions.

On allocative changes—that is, the sectorial reallocations related to price liberalization and their macroeconomic consequences—both views differ on their main vision of markets and liberalization. The Washington Consensus emphasizes that markets will develop spontaneously, provided there is price flexibility and the government does not intervene in markets. Supply and demand are the main focus of analysis, and the main implicit theoretical tools guiding this vision are price theory and general equilibrium theory. The evolutionary-institutionalist perspective relies much less on standard market analysis and emphasizes the institutional underpinnings of markets and the effect they may have on the speed of growth of markets and entrepreneurial activity. Contracts and the relations between contracting agents are the focus of analysis. Therefore, a strong emphasis is put on the general environment of contracting: the minimum legal environment, security of property rights and law enforcement, political stability, the development of business and market networks facilitating search, the development of specific investments in long term business relationships, and so forth.

A less important difference, though not without consequence, is related to attitudes toward inefficient state-owned enterprises. The Washington Consensus developed, early in transition, a hostile view toward state-owned enterprises, emphasizing the need for fast privatization to prevent asset stripping and the need to quickly close down loss-making plants and firms. Again, it was in East Germany that this approach was implemented most thoroughly. The evolutionary-institutionalist perspective is less aggressive and takes an attitude of containment, gradual downsizing, and of hardening of budget constraints, taking into account political constraints. The emphasis is more on developing a strong new private sector to attract workers away from the state sector and to let the latter shrink gradually over time.

The main view of government in transition developed by the Washington consensus view is that of the necessity of weakening government as much as possible to "de-politicize" the economy and to prevent intervention in markets. The evolutionary-institutionalist perspective emphasizes the importance of government in enforcing the law and the security of property rights. In particular, adequate government infrastructure (police, courts) is needed to ensure that the rules of the market game are followed. Among others, it is important to fight organized crime and racketeering. It is also important to enforce an adequate competition policy to prevent monopolization.

Turning now to governance changes, the two visions differ in their focus of privatization policy. The Washington Consensus emphasizes the need for a fast transfer of ownership to private hands via mass privatization to break government power and to jumpstart the market economy. Speed is of the essence. The idea is that any privatization is always better than maintaining government ownership so that the benefits of fast privatization outweigh the costs in terms of possible misallocation of assets to private individuals and groups. There is also a strong emphasis on developing stock markets so that efficient resale of assets can take place after privatization. In contrast, the evolutionary-institutionalist perspective puts, in general, less emphasis on the importance of fast privatization of large state-owned enterprises. There is a broader view of privatization not only of existing state-owned enterprises but of privatization of the economy with, as main element, the organic development of the private sector. In terms of privatization of large enterprises, the emphasis is on competitive sales to outsiders to ensure efficient transfer of ownership from the start. There is a great skepticism with respect to the possibility of efficient resales given the necessarily rudimentary development of financial institutions and markets at the beginning of transition. The latter must necessarily evolve over time and cannot be jump-started.

With respect to reform of the organization of government, the Washington consensus view attaches less importance to this question and emphasizes mainly the need to shrink the size of government. The evolutionary-institutionalist perspective goes further than the simple dimension of government size and emphasizes changes in incentives of government bureaucrats. Since government agencies and officials can predate markets and the private sector, and since they can be captured by interest groups such as monopolies and Mafia, it is important to implement reforms in the organization of government so as to align, as much as possible, the interests of government bureaucrats with the development of markets. The idea is that markets and the private sector cannot develop in an environment of government hostility. Adequate reform of government administration, therefore, is needed to create more congruent interests between the private sector and government bureaucrats.

In terms of hardening budget constraints, a dimension that has appeared more and more important with the transition experience, there are also conceptual differences. For the Washington consensus view, hardening budget constraints is mainly an exogenous policy choice that depends on the political will of policymakers. For the evolutionary-institutionalist perspective, soft budget constraints are related to a commitment problem. Because of this commitment problem, exhortations to harden budget constraints may not be credible. Hardening budget constraints must be an endogenous outcome of institutional changes designed to create credibility for hardening.

While we have emphasized the differences between the two visions—the Washington consensus view and the evolutionary-institutionalist perspective—it is important to note that these are not visions that are diametrically opposed. Both aim at introducing a successful market economy based on private ownership. Nevertheless, these differences in vision reflect differences in the approach to economic analysis and lead to differences in policy emphasis in several important dimensions.

II. Broad Lessons from the Transition Experience So Far

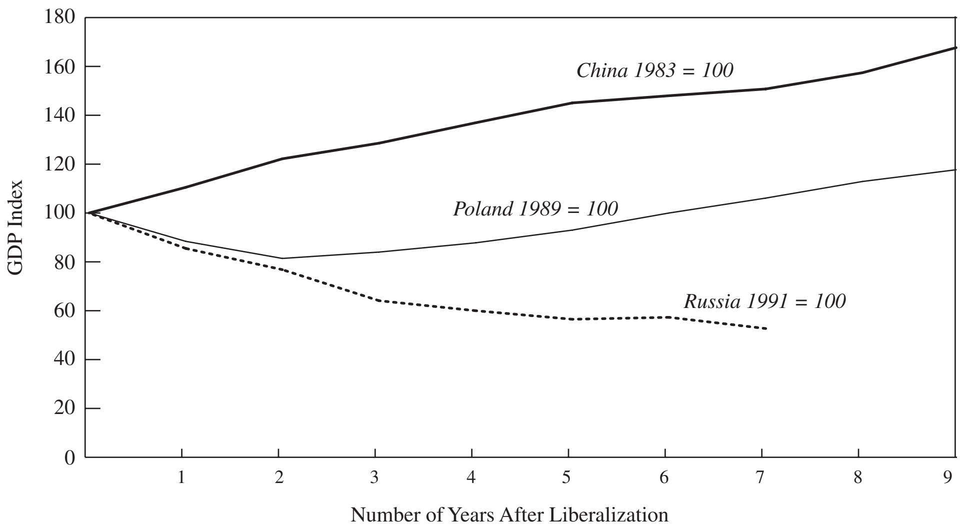
Taking a broad view of the transition experience, it would seem at first view that the following general assessment can be made. Central European countries that started transition early, that are growing again, and that now face the prospect of entry in the European Union, can be broadly seen as a success of the Washington consensus, whereas Russia, with its dismal economic performances throughout the 1990s, can be basically seen as a failure of that view. In contrast, the success of Chinese transition cannot be attributed to the Washington consensus view but can be seen as a confirmation of the evolutionary-institutionalist perspective.

Such a broad assessment is not the object of consensus in the profession but would seem to be an a priori no-nonsense characterization. Clearly, however, we cannot content ourselves with such broad generalizations. A more detailed and precise approach is required. We must look at the details of the various dimensions of transition and see in which areas research has led to consensus views, in which areas controversies remain important, and in which areas research has been relatively neglected.

Reform Strategies and Political Constraints.

In terms of the attitude toward uncertainty, I would claim that the facts have vindicated the evolutionary-institutionalist perspective and proved the Washington consensus view to be wrong. Indeed, reforms have not uniformly delivered good outcomes or economy-wide efficiency gains. A simple look at the differences in performance between the transition countries shows wide variation in the evolution of output, between the strong growth of the Chinese economy, the U-shaped output evolution in Central Europe, and the continuous decline in many former Commonwealth of Independent States (CIS) countries (see Figure 1).

Figure 1. Real GDP Trends in Transition Economies After Liberalization



One can always come up with ex post explanations for the observed evolutions in the various countries and trace them to wrong or incomplete policies, lack of comprehensiveness of reforms, and so forth. In practice, there have indeed been many such cases. It is not acceptable, however, to invoke this argument to dismiss these empirical observations. From the ex post point of view, it is nearly a tautology to explain failures in performance by wrong or incomplete policies. Policies are endogenous, however, and depend on political constraints. It is thus a bit vain to lament incompleteness of reforms without taking into account existing political constraints. More important, the policies strongly endorsed by the advocates of the Washington consensus led in several dimensions to important surprises and unexpected outcomes. This is the case for the important output fall after liberalization. It was not predicted.

Another unexpected outcome is the asset-stripping that followed mass privatization in Russia and the Czech Republic. Also on the downside, the development of the Mafia, the strong increase in the size of the hidden economy in former CIS countries, and the resistance of large Russian enterprises to tax collection were not predicted either. On the upside, the development of Township and Village Enterprises (TVEs) in China were also an unexpected corollary of decollectivization. To be sure, most of these events were not predicted either by the advocates of the evolutionary-institutionalist perspective. Most can and will be explained ex post. Nevertheless, the importance of these large unexpected outcomes shows the relevance of the emphasis on aggregate uncertainty. Finally, it is important to note that an important convergence has taken place among researchers working on transition, certainly in the academic community, on the importance of aggregate uncertainty.

In terms of the political economy emphasis, the picture is more mixed. The Central European experience broadly appears to vindicate the Washington consensus view. The experience in China broadly appears to vindicate the evolutionary-institutionalist perspective. In a way, this should not be seen as a surprise. While there is clearly a difference of emphasis between the two visions, the theories that have been developed (see, for example, Dewatripont and Roland, 1997; Roland, 2000) can make sense of both observations on the basis of a basic trade-off involved in the political economy of reforms. In other words, a strategy of sequencing of reforms can relax the ex ante political constraints and gradually build constituencies for further reform and thus enhance political feasibility, while big bang can ensure more irreversibility of reforms in cases where there is a window of opportunity, that is, where ex ante political constraints are less important. This can be seen as fitting both with the Chinese and with the Central European experience. Such results are derived, however, within a framework where aggregate uncertainty is assumed. From that point of view, the Russian experience shows the downside of the Washington Consensus view because of its neglect of aggregate uncertainty. A window of opportunity was used to implement mass privatization and this has been done so as to create irreversibility of reform, but the relative irreversibility thus created has locked the Russian economy in an inefficient situation where interest groups, who gained most from mass privatization (the famous oligarchs), have become so powerful as to block further reform such as tax reform, government reform, stronger law enforcement, and stronger security of property rights (see, for example, Polishchuk, 1999; and Sonin, 1999).

This turn of events in Russia also tends to suggest that the political economy view, relying mainly on the support of owners of privatized enterprises, was seriously one-sided. Not only did this lead to capture and relative lock in, but also the fact that a great majority of the population has suffered from the transition so far, and has resented the strong concentration of wealth created by a privatization process viewed as illegitimate and corrupt, is worrying both for political and democratic stability and for the continuation of reforms.

On the effects of partial reform, I would claim that the Chinese experience vindicates the evolutionary-institutionalist perspective that sequencing of reforms does not necessarily stall reform progress but can be used to create momentum for further reform. The successes of decollectivization created momentum for reform in the state sector (see, for example, Naughton, 1995; Lin, 1992; and Qian, 1999). While the Chinese reform process has had its ups and downs—its periods of fast progress and periods of stagnation in reform—the general momentum has continued until today. In line with the Dewatripont-Roland (1995) model, the transition process started with reforms like decollectivization that delivered enormous welfare gains and created constituencies for more difficult reforms like restructuring in the state sector.

Insufficient attention, however, has been given so far to this issue of partial reform and the conditions under which it creates momentum or, on the contrary, creates vested interests that block further reform. The existing theories of the political economy of reform currently tend to be too abstract to treat this problem in a sufficiently satisfactory way. One needs political-economic models with more flesh to better understand the economic and political dynamics of sequencing. Recent empirical research on China by Morduch and Sicular (1999) already gives evidence that rents to bureaucrats increase with the pace of reforms, while the benefits of reform are shared with the population at large.

The relevance of the Chinese gradualist experience is often dismissed because of the dictatorial character of its regime. It is interesting to note, however, that, despite the political regime, painful reforms have not been brutally imposed on the population. On the contrary, both the sequencing and the design of reforms have been tailored so as to benefit a majority and hurt only a minority. The choice of dual-track price liberalization was in fact even designed to be Pareto-improving and to protect existing rents (see Lau, Qian, and Roland, 2000). It is not clear whether the Chinese reform process would have been politically infeasible if China had been a democracy and whether any democratic system could have sustained such a process. If anything, the absence of democracy has made it more difficult to enforce private property rights and the rule of law and to encourage the development of a newly developing private sector. Recent research (Che and Qian, 1998) suggests that the development of township and village enterprises was a spontaneous response to the specific Chinese institutional situation with the absence of the rule of law and sufficient safeguards against predatory government behavior. (More on this below.)

One lesson that emerges from the transition experience is that the political constraints to reform have been less strong in Central Europe, especially in the countries close to Germany, compared with the former Soviet Union. (Yegor Gaidar did not have the support that Leszek Balcerowicz or Vaclav Klaus had in Poland and the Czech Republic.) Even when former Communist coalitions came to power in Central Europe, they did not question the direction of reforms, only its speed and its redistributive aspects. Why this striking difference in the importance of political constraints to reform? This is clearly an area where further research is needed.

In Roland (1997), I suggested that the geopolitical factor has played an important role, a factor that was underestimated in the beginning of transition, certainly by myself. Economists trying to understand transition have generally had the vision of transition as a shift toward democracy and the market. If we take some historical distance, we can see that transition also represents a very important geopolitical move, that is, the shift of Central Europe and the Baltic states to the West. To populations in those countries, the single most important factor about transition is the change from the status of a satellite country of the Soviet empire to that of a country belonging to the western bloc or even the European Union. Transition represents a unique historical opportunity for several nations to get strongly anchored in Western Europe. Not only is this "anchoring" to the European Union desired by nations of Central Europe, it also focuses expectations and gives credibility to the political and economic process of transition. Entry in the European Union implies adopting the political and economic system of the West. The potential reward of belonging to the club of Western nations makes it more worthwhile to undergo the cost of transition and thus to accept the latter more easily. Moreover, the geopolitical factor increases the perceived cost of a policy reversal since it implies the risk of being left out of the western club, a perspective that many in Central Europe would view as disastrous.

This geopolitical factor may be strong enough, as a focal point, to explain why countries from Central Europe did not suffer from the type of government collapse, anarchy, and general diffusion of criminality, inside and outside government, that Russia has been facing (see Roland and Verdier, 1999a and 1999b). Ability to enforce the law and to protect property rights seems to be a first-order effect in explaining why Central Europe recovered from their output fall while Russia and other countries, not facing the prospect of entry to the European Union, have experienced a continuous decline of output (see also Johnson, McMillan, and Woodruff, 1999a, 1999b).

The geopolitical factor in Central European countries was reinforced by a "transition tournament" between the Czech, Hungarian, and Polish governments where each pretended to be the most advanced transition country in the hope of attracting the bulk of foreign direct investment to the region. The incentives related to the "prize" of such a tournament are strong enough for countries of that size to create credibility for economic transformation. Countries that entered the transition race later, like Bulgaria and Romania, have little hope of catching up on the more advanced countries, or even of pretending to do so, and thus have less possibilities of attracting foreign direct investment.

To understand the strength of the geopolitical factor, compare the situation of Central European countries to that of Russia, where this geopolitical factor is absent. By contrast to the former, where transition is seen as a liberation from the Soviet empire and access to the Western club of nations, transition is viewed in Russia as a traumatic experience by large parts of the population. Indeed, transition represents the loss, not only of the Soviet empire, but also of territories, such as the Ukraine and the Baltic states, which once belonged to Tsarist Russia. This loss does not only mean a wound to Russian nationalist pride, but it implies uncertainty for the families of those who have relatives among the millions of Russians living in the former Soviet republics and who became "immigrants" in former Soviet territories, often with the status of "second-class" citizen. The trauma of the loss of superpower status, similar in a way to the trauma of Germany after World War I, could be, to a certain extent, compensated for by economic gains from transition. Unfortunately, this has not thus far materialized for the majority of Russians. No entry of Russia in the European Union is expected nor especially desired. The size of the country implies that the impact of foreign direct investment is likely to be more diluted, thereby reducing the incentives to participate in "transition tournaments." It is thus no wonder that resistance to transition proved much harder in the former Soviet Union, as witnessed by the greater difficulties in hardening budget constraints of enterprises or of adopting stabilization measures. Nor is it clear that no major policy reversal will take place or is expected to take place.

If we believe the geopolitical factor played a major role in Central Europe, then it would be seriously flawed to compare transition in Central Europe and Russia without taking this factor into account. To understand the effect of political constraints on the transition process, it is better to look at the experience of large countries that must achieve transition by their own efforts without counting too much on outside help. The comparison between Russia and China is of relevance there, taking into account differences between those two big countries (political regime, level of development, etc.).

If the hypothesis of the geopolitical factor explains the stronger resistance to reform or smaller support in Russia and former CIS countries, it also implies that, everything else equal, the cost of reversal of transition policies is much higher in Central European policies than in Russia and the former CIS countries. In that sense, the perceived sense of haste that existed in Central Europe to implement reforms fast to achieve irreversibility may have been exaggerated.

This last observation is potentially important. Indeed, the political economy theories of transition usually assume that the long-term economic outcome of reforms are independent of the speed of their introduction. In reality, the speed of liberalization and privatization does have important efficiency and distributive implications. More important, the outcomes of liberalization and privatization teach us something about the two perspectives.

Liberalization and the Output Fall

With hindsight, I would claim that the outcome of liberalization vindicates the evolutionary-institutionalist perspective and that, on the basis of the transition experience, this is the consensus view that has been developing in the academic community. The important output fall that occurred after price liberalization in Central and Eastern Europe was not predicted. Standard textbook economics based on supply and demand at best would have predicted a low supply response to liberalization, but not a negative one. The debate on the output fall was in the beginning inspired mainly by the Washington consensus centered around macroeconomic policies, asking questions such as whether or not stabilization had been too harsh. When Russia liberalized but failed to stabilize and nevertheless experienced an output fall, it was clear that new answers were needed.

Two transition-specific answers have come up so far and have not yet been refuted. One is the traditional double-marginalization idea from the industrial organization literature. To the extent that central planning created monopoly-like structures without real substitutes across firms, and to the extent that import competition does not play that role, liberalization induces a cascade of price increases and output contraction along supply chains (Li, 1999). The other, newer idea, is that of disorganization. That view takes seriously the idea that markets have not yet been created when liberalization occurs. Due to bargaining inefficiencies or to a combination of investment specificity and search frictions related to the prior absence of markets, existing output chains may suffer from acute disruption where the efficiency gains reaped by the producers, who exit the chain, do not compensate the disruption losses for the other producers in the output chain (Blanchard and Kremer, 1997; Roland and Verdier, 1999b). The ensuing macroeconomic fall in GDP and welfare losses can be very important. These models are de facto inspired by the evolutionary-institutionalist perspective.

The relevance of the evolutionary-institutionalist perspective appears even more if we address the question of whether the output fall was an inevitable by-product of liberalization. Here, the Chinese experience is again helpful because it gives a negative answer to that question. A transition-specific institution has been created to prevent the output fall associated with liberalization: it is the dual-track liberalization. The dual-track liberalization has several interesting properties. Prices are liberalized at the margin so that the market information obtained from price liberalization is the same as what would be obtained under full price liberalization. In the absence of preexisting markets, the most interesting properties of the dual track are (1) that it allows, by construction, the achievement of Pareto-improving gains from liberalization, which is interesting from the political economy point of view because it is a way of overcoming potential resistance to price liberalization due to its distributive effects; and (2) also by construction, it prevents the output fall by maintaining past contractual obligations from the plan.

It is in a way surprising to observe not only that the dual-track approach had not been proposed by academic economists in the context of transition (in Eastern Europe at least) but also that it took several years before economists started to understand the advantages of the dual-track system (see Byrd, 1991; Sicular, 1988; Lau, Qian, and Roland, 1997 and 2000; Li, 1999). While the dual track has worked well in China, further research is needed to understand some important aspects of the dual track, such as how it can be enforced credibly and prevent the ratchet effect. This may also help us understand why dual-track liberalization was not applied in Eastern Europe and the countries of the former Soviet Union.

If we ignore politics, it is possible to argue that the dual-track liberalization could have been applied in the context of the Council for Mutual Economic Assistance (CMEA) trade. The CMEA breakdown (as well as the breakup of the Soviet Union) has been considered the single most important explanatory factor for the general fall of output in the region (see, for example, Rodrik, 1994), but it has generally been perceived as an exogenous shock. The breakdown of CMEA, however, was not exogenous. It was decided in early 1990, when the Czechoslovak and the Polish governments insisted on regaining their freedom of export with respect to CMEA agreements. The Soviets at that time responded by insisting that imports from the Soviet Union would from 1991 onward be paid at world prices and in hard currency. From the economic point of view, it would have been better, and possible, to implement a version of the dual-track system between former CMEA countries to avoid the strong trade disruption of 1991.

However, here again politics and the geopolitical factor have played an important role. Individual Central European countries wanted to leave the Soviet bloc as quickly as possible and to be the first to knock at the door of the European Union. The CMEA breakdown was thus an economic consequence of the political will prevailing in Central European countries to leave the Soviet bloc.

One may argue that the dual-track approach could not have been implemented in the former Soviet Union and Russia because of the government collapse that followed the implosion of communism after the failed putsch of 1991. As shown by Roland and Verdier (1999a), however, the dual-track system itself can be seen as an instrument to prevent government collapse in a credible way. Again, careful research is needed to understand whether conditions existed to implement and *enforce* the dual-track system itself in a credible way.

Government Collapse

Another area where the evolutionary-institutionalist perspective is vindicated and where a consensus view has been developing fast within the academic community, albeit with strong differences in emphasis, relates to the effects of government collapse, mainly in many CIS countries. Government collapse was not an important concern in the Washington consensus view. The concern was mainly to cut down the size of government and to "get the state out of the economy." Government collapse would have been seen as a second-best option where markets would emerge at full speed but there may be too few public goods—a lesser evil compared to the evils of communism. The emergence of organized crime, its predatory racketeering activities, and Mafia-related internal corruption of government have had deleterious effects on private sector growth. Again, this evolution was not predicted and was strongly underestimated. As of today, the Mafia is still seen by many as a suboptimal contract enforcement agency.

Also, the more comprehensive view of institutions of the evolutionary-institutionalist perspective seems to be vindicated given the experience of government collapse. While it is always possible to claim for each transition country that there were shortcomings in the legal framework, in Russia, one cannot claim that legal reform was neglected. Many important laws were adopted, often with the help of prominent scholars—be they corporate laws, commercial laws, or financial regulations. Nevertheless, law enforcement is a real problem and confidence in courts is lower in Russia than in Central Europe (see, for example, Black, Kraakman, and Tarassova, 2000; Johnson, McMillan, and Woodruff, 1999b). The adequate social norms for a market economy have not yet emerged, and the level of business trust remains low.

Privatization

The experience with privatization also tends to vindicate the evolutionary-institutionalist perspective against the Washington consensus view. The view, according to which speed was of the essence in privatization in order to stop asset stripping by incumbent managers, has been refuted by reality as many managers in state-owned enterprises did show early signs of restructuring. The doomsday predictions on the consequences of too low a speed did not materialize in countries like Poland and Hungary where privatization took place in a gradual way. The prediction of generalized asset stripping was wrong. It made sense for good managers to try to attract private investors and to engage in early defensive restructuring for that purpose. Also, both theory and evidence show the importance of using privatization to achieve efficient matching of managers and assets (see, for example Bolton, and Roland, 1992; Barberis and others, 1996). Insider privatization did not achieve that objective. Insider privatization did not in general lead to significant improvement in performance (see, for example, Frydman and others, 2000), whereas the Washington consensus view claimed that any privatization was always better than no privatization.[5] Moreover, vested interests created by insider privatization may have made ulterior privatization more difficult to achieve (Aghion and Blanchard, 1998) and may have also maintained or aggravated the soft budget constraint syndrome in firms privatized to insiders (Debande and Friebel, 1995). This soft budget constraint syndrome usually takes the form of tax arrears (Schaffer, 1998). Further research should determine the extent to which the combination of free distribution of assets and tax erosion in Russia has reinforced tendencies to government collapse.

In China, we have seen the emergence of a very original institution: the TVEs owned by township and village governments. The Washington consensus view cannot make sense of TVEs, except to claim that they are pseudo-private enterprises, which we know is not the case. Theories developed in the transition literature suggest that TVEs operate under conditions of hard budget constraints, which are very important for efficiency (Qian and Roland, 1996 and 1998), and also that, because of the public goods they contribute to create in their activity, they are more protected from government predation than private firms in China (Che and Qian, 1998).

Organization of Government

The Chinese experience, where privatization remained taboo until recently, also shows the importance of reform in the organization of government with the decentralization of government and the development of different forms of competition between local governments that can be made to work in favor of market development. Also, the fiscal federalism arrangements, which make local governments residual claimants on any increase in the tax base, creates partial alignment of interests of bureaucrats with the development of markets and entrepreneurship (on all this, see Qian, 1999). In Russia, reform of the organization of government was relatively neglected, as the main focus of reform was implementation of mass privatization.

[5]This does not mean that no form of privatization had a positive effect. For recent studies, see Havrylyshyn and McGettigan (2000), and Djankov and Murrell (2000).

With hindsight, reform of government with the purpose of building stable constituencies for reform should have been a priority of reform sequencing in Russia. The unexpected collapse of communism in 1991 created a formidable opportunity to create a democratic constitution with appropriate separation of powers and checks and balances between branches of government as well as between the center and provinces. Legitimate and accountable institutions coming out of a constitutional process would have helped to build more solid constituencies for reform and create a government structure with legitimate authority. There is no clear view among researchers about what should be the best constitution for Russia. Since legitimacy is fundamental, the appropriate constitution should not necessarily result from a blueprint but must be the result of a serious consensus-building deliberative process, as was the case with the successful democratic transition in Spain. As of today, government reform is still a priority in Russia, but the initial aspirations to democracy have been strongly dampened by the turmoil of transition under Yeltsin.

Soft Budget Constraints

A final difference we will mention between the Washington consensus view and the evolutionary-institutionalist perspective concerns the question of soft budget constraints. Here the dominant thought was that hardening budget constraints was only a matter of exogenous choice by policymakers without thinking about the institutional factors or the factors in the environment of firms that contributed to credibly harden the budget constraint of firms: privatization, demonopolization, government reform, banking reform, and so forth. The subsistence of soft budget constraints in different forms, even in the advanced transition countries, shows that hardening budget constraints is not just a matter of political will but a matter of devising institutional mechanisms that create credibility for hardening. While there has been quite a body of theoretical work on soft budget constraints, empirical work on the issue is only beginning and should be a priority in research.

Despite the lack of direct empirical tests, the general evidence on enterprise behavior suggests a difference in enterprise behavior with a rapid hardening of budget constraints in the accession countries and persistence of soft budget constraints in most other countries. Here again, the geopolitical factor may have played an important role in shaping expectations early on in accession countries. Further research should give us a clearer picture of the hardening of budget constraints.

III. Conclusion

The broad assessment developed above tends to show, on the basis of the transition experience, that the evolutionary-institutionalist perspective is more complete and adequate than the Washington consensus view. There is an increasing consensus among professional economists that the “Washington consensus” view with its so-called trinity of transition (liberalization, stabilization, and privatization) is a misguided recipe for a successful transition. While professional economists do not deny the need to liberalize, stabilize, and privatize, they increasingly recognize that these policies cannot achieve their goals without the existence of institutional underpinnings of capitalism appropriate to the specific conditions of each country. In practice, there has been a growing convergence within the academic community, if not a consensus, toward the evolutionary-institutionalist perspective.[6]

While the above discussion has attempted to propose a synthesis of the main lessons of transition, an important word of caution is necessary, in line with the evolutionary-institutionalist perspective. While general policy conclusions can be drawn from theory and empirical research on transition—the point is of course valid beyond transition—there is still a long distance between general policy conclusions and direct policy recommendations. While we can draw general lessons from the economic failures of transition in Russia, in the 1990s for example, it is still quite a different matter to draw a complete and convincing counterfactual of how things could have evolved, given the conditions of decisionmaking.

Finally, I would like to draw attention to two areas that, with hindsight, have appeared important for transition, but on which relatively little research has been done. The first one relates to inequality of wealth and income. While the increase in inequality of income and wealth was predicted, the patterns of increasing inequality are quite different across countries (Milanovic, 1998; Garner and Terrell, 1998; Keane and Prasad, 2000). What are the political and economic effects of this increase in inequality? While this is a general question for economics (Persson and Tabellini, 1994), it is particularly relevant in the case of transition. In particular, one would like to go beyond the median voter model and understand better the political channels through which an increase in inequality affects political decision making: the relative role of electoral politics and special interest politics, the policy and political coalition formation process, and so forth.

The second theme is that of social behavior, social norms, and social capital. The question of social norms is a general and important question for social science, and this is an area that has been under-researched by economists at least during the transition process. An obvious route of investigation that has not been used in formal analysis of transition processes so far, at least to my knowledge, is the use of evolutionary game models. Within the evolutionary-institutionalist perspective, this seems a natural route to take, given the usefulness of evolutionary game theory in selecting equilibria.

[6]It is interesting to note from that point of view that at the Fifth Nobel Symposium in Economics devoted to the economics of transition, out of six sessions, only one was devoted to macroeconomic developments while there were five sessions on institutions, three of which were devoted to the organization of government and two on contracts.

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