

## Seven things I learned about transition from communism

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I had been asked by the organizers of the IIASA conference organized on the occasion of 20<sup>th</sup> anniversary of the beginning of economic reforms in Eastern Europe and Former Soviet Union to comment on the lessons of transition. The assignment presumably refers to the things that I learned – as an economist -- that are different from what I believed initially. Such a recollection free from hindsight bias is challenging, but I tried. This list might be useful to future reformers, although there are not so many communist countries left. Some of the issues are however relevant not just for communist countries; the problems of heavily statist economies are similar. So here is my top seven list.

First, in all countries in Eastern Europe and the former Soviet Union, economic activity shrunk at the beginning of transition, in some very sharply. In many countries, economic decline started earlier, but still continued. In Russia, the steepness and the length of the decline (almost a decade) was a big surprise. Countries with biggest trade shocks (such as Poland and Czechoslovakia) experienced the mildest declines. To be sure, the true declines were considerably milder than the measured ones, because unofficial economies expanded, because communist countries exaggerated their GDP's, because of defense cuts, and so on, but this does not take away from the basic fact that declines occurred and were surprising. These declines contradicted at least the simple economic theory that a move to free prices should immediately improve resource allocation. The main lesson of this experience is for reformers not to count on an immediate return to growth. Economic transformation takes time.

Second, after these declines, recovery and rapid growth occurred nearly everywhere. The decline was not permanent. Over 20 years, living standards in most transition countries have increased substantially for most people, although the official GDP numbers show much milder improvements and are inconsistent with just about any direct measure of the quality of life (again raising questions about communist GDP calculations). As predicted, capitalism worked and living standards improved enormously. One must say, however, that for a time things looked glum. So lesson learned: have faith – capitalism really does work.

Third, the declines in output nowhere led to populist revolts, as feared by many economists. Surely reform governments were thrown out in some countries, but not by populists. Instead of populism, politics in many countries came to be dominated by new economic elites, the so-called oligarchs, who combined wealth with substantial political influence. From the perspective of 1992, this came as a huge surprise. Ironically, in some countries in Eastern Europe populism appeared 20 years after transition started, after huge improvements in living standards were absolutely obvious. Indeed, people in all transition countries were unhappy with transition: they were unhappy even in countries with rapidly improving quality of life (and this itself is another surprise and major puzzle – something for future

reformers to keep in mind). But the lesson is clear: a reformer should fear not populism but capture of politics by the new elites.

Fourth, economists and reformers overstated both their ability to sequence reforms, and the importance of particular tactical choices, e.g., in privatization. In retrospect, many of the theories that animated the discussion of reform – whether institutions should be built first, whether companies should be prepared for privatization by the government, whether voucher privatization or mutual fund privatization is better, whether case by case privatizations might work – look quaint. Reformers nearly everywhere, including in Russia, had a vastly overstated sense of control. Politics and competence frequently intervened and dictated to a large extent most of the tactical choices. Still, most countries, despite different choices, ended up with largely similar outcomes (notable and sad exceptions are Belarus, Uzbekistan, and Turkmenistan). In various forms, all had privatization, macroeconomic stabilization, as well as legal and institutional reform to support a market economy. Lesson learned: do not over-plan the move to markets, but, more importantly, do not delay in hopes of having a tidier reform later.

Fifth, economists have greatly exaggerated the benefits of incentives by themselves, without changes in people. Economic theory of socialism has put way too much weight on incentives, and way too little on human capital. Winners in the communist system turned out not to be so good in a market economy. Transition to markets is accomplished by new people, not by old people with better incentives. I realized this and wrote about it in the mid-1990s, but the lesson both in firms and in politics is profound: you cannot teach an old dog new tricks, even with incentives.

Sixth, it is important not to overestimate the long run consequences of macroeconomic crises and even debt defaults. Russia experienced a major crisis in 1997-1998, which some extremely knowledgeable observers said would set it back by 20 years, yet it began growing rapidly in 1999-2000. Similar stories apply elsewhere, from East Asia to Argentina. Debt restructurings do not necessarily make permanent scars. This experience bears a profound lesson for reformers, who are always intimidated by the international financial community: do not panic about crises; they blow over fast.

Seventh, it is much easier to forecast economic than political evolution. Although nearly all transition countries have eventually converged to some form of capitalism, there has been a broader range of political experiences, from full democracies, to primitive dictatorships, to just about everything in between. There appears a strong geographic pattern in this, with countries further West, especially those involved with the European Union, becoming clearly democratic, and countries further East remaining generally speaking more authoritarian. For countries in the middle, including Russia and Ukraine, the political paths over the 20 years have wiggled around. Lesson learned: middle income countries eventually slouch toward democracy, but not nearly in as direct or consistent a way as they move toward capitalism.