



Creating Capitalism

Transitions and Growth in Post-Soviet Europe

PATRICIA DILLON AND FRANK C. WYKOFF

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for
Jef and Tusie

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Preface

The economic and political progress of newly independent Central and Eastern European states has been a popular subject for research since the early 1990s, generating a steady flow of articles and new magazines, journals and books. Why should you, the reader, be interested in another book on transition from planning to markets?

We think that some key issues are underrepresented in the literature and have been virtually inaccessible to the general interest reader. Ultimately it is economic growth that indicates whether transitions are working. Yet little has been done to apply growth analysis, a powerful implement in the economist's toolbox, to evaluate economic performance. Furthermore, we have ten years of evidence telling us that efforts to transplant Western economic reform measures without careful political analysis does not work well. Political and social structures in post-Soviet states have not adapted easily to economic reform programs. Some countries continue to vacillate between liberalization toward markets and reversion to various forms of socialism.

This book integrates growth theory with a public choice approach to explain why each potential reform is necessary and why reforms nevertheless encounter so much resistance. Our framework can assist those interested in the transformation of poor economies anywhere. Many nations, not only former Eastern bloc countries, want to enjoy the fruits of both decentralized market systems and democratic political systems.

ORGANIZATION OF THE BOOK

This book has three parts: the first six chapters make up the theoretical foundations; the next seven chapters are case studies of individual countries (Bulgaria, Czech Republic, Estonia, Hungary, Russia and Slovakia) and a concluding chapter; the book ends with two technical appendices.

Part I: Technical Foundations

The conceptual analysis may be read on one of three levels. For those with only a passing interest in the material in any of the first six chapters, there is a brief overview on the first page of each chapter. One can move on from these without loss of continuity.

Chapters 1 to 3 are readable by everyone and they contain no esoteric economics language that is not defined and explained. Chapters 4 and 5 will be more challenging for many readers, as they contain heuristic descriptions of how we integrate reforms into an economic growth model. We have tried to write this material for a general audience, for readers without formal training in economics. For those who want to study our growth theory

analysis in greater detail, we provide Appendix A. It requires some formal economics training. Chapter 6 integrates economics into a political model. One can read only the brief chapter overview, the chapter itself, or Appendix B, depending on the desired level of study.

Part II: Country Chapters

Chapters 7 to 12 each deal with one of our sample countries. The earlier theory chapters inform our analysis of each country, which reflects forces common to all of them. The format of each chapter is roughly the same: it includes a compact history of two periods that set the stage for prospects of success in transition – the period before the Soviets and the period under their rule. The sections that follow include analysis of the political transition, progress in adopting reforms, economic performance and political developments, and recommendations and prognosis for success.

Part III: Appendices

Appendix A consists of detailed analysis of growth modeling, including evaluation of exogenous and endogenous models. While the models are standard in the growth field, we link each reform to specific parameters of a growth model. Based on these linkages, we assume that economic agents are able to assess the implication for their own self-interest of any reform. This sets the stage for the econometric work in Appendix B.

Appendix B contains a formal model, developed in Chapter 6, wherein economics and politics interact. Pooled data covering ten years in the six countries are used in an econometric analysis that tests the connections between reforms, economic performance and elections. The results tell us something about the pace and patterns of reform.

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Patricia Dillon
Frank C. Wykoff
Claremont, California
June 2002

PART I

Theoretical Foundations

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Introduction to Part I

Liberalization toward market economies could not get under way in communist countries until they were free of Soviet domination. Chapter 1 begins with an economic explanation for the self-destruction of the USSR based on the inability of a centrally planned system to adapt to the political, social and economic implications of the industrial revolution.

Chapters 2 to 6 continue to build the theoretical underpinnings of this book. Our central argument connects economic reforms to potential growth and then forges links between prospective reforms and a democratic election process. The theoretical models developed in these chapters provide the conceptual framework for six country case studies in Part II.

Chapter 2, applying economic reasoning, explains why certain policymakers and certain groups of individuals will resist reforms even though those same reforms will improve standards of living for the vast majority of people.

Chapter 3 introduces five specific economic reforms that characterize virtually all successful market economies in the world. Each of these reforms is shown to play an essential role in a well-designed decentralized market system.

Chapter 4 introduces and develops growth models that allow us to demonstrate in Chapter 5 exactly how each reform raises national income. A technical version of these models is available in Appendix A.

Chapter 5 integrates the five reforms into the growth models and shows how each reform contributes to greater well-being through growth in output per worker.

Chapter 6 introduces a new model that exploits growth models to connect economic reforms, through their effects on voters' growth prospects, to the political process.

The country studies in Part II of the book provide evidence that supports the predictions of this dynamic election model: economics affects politics and politics affects economics.

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1. The withering away of communism¹

Why did the USSR self-destruct? We offer an economic analysis that implies that the collapse was inevitable. The collapse of the Soviet system is treated here as an aftershock of the economic quake of the industrial revolution. The USSR failed because it was unable to deal with the social, economic and political consequences of that revolution. Its disintegration demonstrated the failure of central planning to meet the needs of a modern state. It signaled the terminal weakness of a highly centralized economic system that despite extreme efforts could not resist the pressures of modern industrial society. Standard economic models based on incremental analysis can explain the process that built up to the collapse. But standard neoclassical analysis does not address serious discontinuities that result in radical sociopolitical changes. We differentiate between incremental economic analysis and analysis of major historical discontinuities which we call economic quakes.

Adam Smith appreciated the social benefits of capitalism; Karl Marx did not. Marx was unable to foresee the staying power of capitalism and the ability of democracy to ameliorate its worst weaknesses. Lenin was a reactionary who perverted Marx by installing communism in feudal Russia. He and his followers removed everything that made capitalism work and built a system that would inevitably fail to adapt to the inherent demand for flexibility of modern industrial and commercial society. Instead of capitalism withering away, communism inevitably collapsed.

THE END OF AN IDEA

The Soviet Union, once powerful and feared, by 1989 had decayed socially, politically and economically. It was on the brink of collapse. While its military still could boast of massive strategic intercontinental missiles and numerous divisions encamped along western Soviet borders, many of its people were impoverished and disenchanting, and its political leadership had become corrupt and demoralized.²

At the beginning of the last decade of the twentieth century, the USSR imploded. Its Central European satellite states were spinning off and some Soviet republics were splitting into factions reflecting old ethnic and religious divisions. All that remained of empire was a disorganized federation of states led by a divided Russia. The collapse of the Soviet empire signaled the failure of an ideology, of a philosophy of social and economic organization