Big-bang versus Gradualism?

Towards a Framework for Understanding Institutional Change in Central and Eastern Europe*

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Prelimary version – please do not quote

> "Despite its victory over socialism and its important successes, capitalism has not been introduced successfully everywhere. At the beginning of the third millennium, there still remains the major challenge of bringing about prosperity and growth via well-working market institutions in the poorest (and highly populated) continents, countries, and regions in the world. By introducing capitalism in former socialist economies, the objective, one hopes, is to bring these countries, *within an appropriate period of time*, to levels of prosperity comparable to those of the most advanced industrialized countries" (Roland 2000: XVIII, author's emphasis).

1. Introduction

The end of socialism created a unique opportunity for the people in the countries of Central and Eastern Europe to develop a better institutional framework. As a matter of fact, in many post-communist countries political freedom was followed by economic liberalization leading to democracies with market economies today. However, the transition from central planning to a free market economy was quite different in the countries. While most westernized countries in *Central Eastern Europe* and *the Baltic States* (Estonia, Latvia, Lithuania, Poland, Hungary, the Czech Republic, Slovakia, Slovenia and Croatia – hereafter CEE) have already realized functioning markets and joined the European Union the countries of the *former Soviet Union* (Russia, Belarus, Bulgaria, Albania, the Ukraine, Romania, Kazakhstan, Turkmenistan,

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Armenia etc. – hereafter FSU) were more close to Russia and still lack a working market order.

In the early days of transition two schools of thought on the speed and sequence of economic reforms emerged. On the one hand economists argued for a rapid break with the past and a quick introduction of all economic reforms at the same time including e.g. Lipton and Sachs (1990), Åslund (1991), Berg and Sachs (1992), Boycko (1992), Murphy, Shleifer, and Vishny (1992), Balcerowicz (1993), Sachs (1993), Frydman and Rapaczynski (1994), Woo (1994), and Fischer (1994). According to Stanley Fischer (1994: 237), the standard reform prescription for an ex-socialist country is to proceed *as fast as possible* on macroeconomic stabilization, the liberalization of domestic trade and prices, current account convertibility, privatization, and the creation of a social safety net, while simultaneously creating the legal framework for a market economy.[1] On the other hand a more gradual approach was favored by Svejnar (1989), Portes (1990, 1991), McKinnon (1991), Roland (1991), Dewatripont and Roland (1992, 1995), McMillan and Naughton (1992), Murrell (1992), Aghion and Blanchard (1994).[2]

However, the debate over the speed of reforms still persists today. Both, gradualists and big-bangers present empirical evidence supporting their point of view.[3] Both sides explain readily the difference in outcomes and the increasing gap between the two groups of transition countries by different reform strategies. In this paper I will demonstrate that both sides dramatically underestimate the role institutions and culture play in the transformation process and political reformers cannot simply pick one reform package without taking into consideration the institutional background and the everyday live situation of individuals shaped through time. I will argue that the underlying cultural determinants and evolutionary paths of different countries either allow a big-bang approach or economic improvements have to be achieved through a gradual transition. The main difference from the prevailing theoretical explanations is a reversal of argumentation. If political reformers want to improve economic outcomes they have to be aware that there is no "first best" solution. Thus, they have to be aware of the fact that different countries have different histories and therefore the compatibility of countries to a market economy is varying. I will argue that we must look on

[1] Example taken from Murrell (1995: 164).
[2] List of early reformers compiled by Roland (2001: 1).
[3] For the gradualist perspective, see e.g. Roland (2001) and Godoy/Stiglitz (2006). For the big-bang perspective, see e.g. Gros/Steinherr (2004) and Havrylyshyn (2006, 2007).

the existing culture to decide whether we make the transition of a country by a big-bang or by a gradual reform. There is no “one size fits all”-solution, on the contrary the sequence of reform has to be decided country-specific.

The paper will proceed in the following steps: Section 2 surveys the present state of the big-bang versus the gradualism debate. Empirical evidence to the reform problem will be presented in section 3. In section 4, I will explain how a cultural theory of economics could contribute to the understanding of transition processes and I shall use a cultural theory of economics not only as a device of criticism, but also as a starting point for some reorientations of transitional economics in section 5, which promise to give new insights into the issue of sequencing reforms.

2. Gradualism versus Big-Bang in Economic Transition Theory

As aforementioned, there are two general types of economic policy program to organize the transition from socialism to a market economy: big-bang *versus* gradualism.[4] The first is a radical and comprehensive economic programme, in which macroeconomic stabilization, microeconomic liberalization[5], and fundamental institutional restructuring[6] are launched at about the same time and implemented as fast as possible.[7] The second type consists of non-radical economic programs, defined as those in which stabilization, liberalization and restructuring are not launched simultaneously, or are implemented at a slower pace than possible, or are even interrupted (Balcerowicz 1995: 158-9).

Table 1
Washington Consensus: Reform Policies and Timing of Implementation

Policy Type	1–2 yrs	2–5 yrs	5+ yrs
Macroeconomic stabilization	implementation	continuation	continuation
Price and market reform	implementation	continuation	continuation
Trade liberalization	implementation	continuation	continuation
Labor market reform	preparation	implementation	continuation
Financial reform	preparation	implementation	continuation
Small privatization	implementation	implementation	continuation
Private sector development	implementation	implementation	continuation
Large privatization and governance	preparation	implementation	continuation
Legal: tax, property rights, commercial codex, etc.	implementation	continuation	continuation
Institutional reform (administration, regulation)	implementation	implementation	implementation
Unemployment insurance	implementation	continuation	continuation

Source: Adapted from Stanley Fischer and Alan Gelb, "The Process of Socialist Economic Transformation," *Journal of Economic Perspectives* 5, no. 4 (Fall 1991).

In the early 1990s, the Washington Consensus reflected the broadly shared view on transition policies held by international financial institutions such as the World Bank and the

[4] For a more comprehensive typology of economic policy options in the transition economies, see Gomulka (1994).

[5] Enlarging the scope of economic freedom; eliminating price controls and restrictions on foreign trade; introducing currency convertibility, etc. Liberalization includes changing the general framework (establishing a stable property rights regime, for example) and more specific deregulating state controlled sectors.

[6] Changing existing institutions (e.g. privatizing state enterprises, reorganizing the state administration, reforming the tax system) and creating new institutions (e.g. stock exchanges, securities commission, ministry of privatisation, investment and pension funds, unemployment offices).

[7] Following Balcerowicz (1995: 178), Roland (2000: 11), and Gros/Steinherr (2004: Part II) the process of transition can be broken down into these three elements to reduce complexity.

International Monetary Fund (IMF) and by other political supporters of a big-bang approach to economic reforms, such as the former finance minister of Poland Leszek Balcerowicz, former Czech prime minister Vaclav Klaus and former Russian prime minister Yegor Gaidar (Hayrylyshyn 2007: 3). *Table 1* presents the main aspects of the Washington Consensus. The Washington Consensus describes a relatively specific set of ten economic policy prescriptions to constitute a "standard" reform package for crisis-ridden countries including macroeconomic stabilization, privatization, liberalization (Williamson 1990: Chapter 2).

Shang-Jin Wei from Harvard University summarizes the main arguments to support a big-bang approach. First, a big-bang approach provides a critical scale of privatized sector in the economy so that the privatized firms will be efficient. Second, a big-bang may increase the credibility of a reform. Third, the gradualist alternative gives time to reform opponents to organize themselves and thus create large opportunities for rent-seeking by both old and new elites. Fourth, in the context of price reforms, a gradual reform is undesirable because it may induce an intertemporal speculation. Fifth, if any reform program needs mutual agreement, sequential plans may not work, owing to time-inconsistency. Finally, a big-bang approach brings the benefits more quickly (Wei 1997: 1235). Accordingly, the idea was to use the short period after the breakdown of socialism – the “window of opportunity” – to quickly put in place the new liberal regime and prevent reforms from being reversed. To deal with unemployment and other social issues, big-bangers proposed social safety nets that were to be implemented immediately. The theoretical reason is quite clear: “Giving *compensating transfers* to losers from reform to buy their acceptance is an obvious way to help in enacting a reform” (Roland 2002: 32).

However, in reality, such compensating transfers are difficult to organize.[8] Furthermore, the degree of compensation has to be very large because of the huge inefficiencies of the socialist economy. Therefore, to prevent people from suffering, many economists argued for a gradual transition, allowing new industries to establish and create jobs while old companies were closed or restructured (see e.g. Aghion/Blanchard 1994, Dewatripont/Roland 1996). Accordingly, the supportive arguments for a gradualist approach to reform can be summarized as follows. First, a gradualist approach may avoid excessive costs, especially for the government budget. Second, it avoids an excessive reduction in living standards as the start of the reform. Third, it allows trial-and-error and mid-course adjustment. Fourth, it helps a

[8] For a detailed discussion see Roland (2000, 2002).

government to gain incremental credibility. Fifth, it is politically more sustainable than a big-bang approach (Wei 1997: 1235).

In any case, to change the economic system requires major structural shifts in terms of institutions. Hayrylyshyn (2007: 3-4, Fn 6) points out that both approaches recognize the importance of institutional change – which will be of special interest for my further argumentation – but that it was clearly more central to the thinking of the gradualists, who argued for delaying liberalization until better institutions were implemented while the World Bank and the IMF rather ignored institutional developments in the early years. There have been clear differences in the sequences of reforms: In the case of the Washington Consensus, macroeconomic stabilization, market liberalization, trade liberalization, legal reforms and unemployment compensation have been implemented within the first and second years. The rest, including large-scale privatization, were supposed to start later and take a longer time. Gradualists, on the other hand, focused on developing adequate institutions before liberalizing the economy (Moers 1999) and were criticising the Washington Consensus supporters heavily for the lack of institutional reforms (Murrell 1996).

Thus, the key differences between big-bang and gradualism can be summarized as follows (cf. Hayrylyshyn 2007: 4):

1. Big-bangers worried that delays in stabilization and liberalization would result in huge rent-seeking and opposition to, and perhaps reversal of, reforms.
2. Big-bangers agreed on the need for institutional modifications but not necessarily in advance of reforms.
3. Gradualists feared that moving too fast would cause greater social costs and pain for the population.
4. Gradualists proposed that market institutions have to come before liberalization and privatization to ensure maximum efficiency gains.

The debate over the speed of reforms and the economic success connected to both approaches still exists today. Both gradualists and big-bangers presenting empirical evidence and theoretical arguments supporting their point of view. For example the economic success of CEE countries and the Baltic states is rapidly seen as the key argument for a big-bang approach. It is the goal of my paper to demonstrate that the empirical findings cannot be taken as a necessary condition (sine qua non) for the success of rapid and comprehensive reforms.

Rather, I will argue that the underlying cultural determinants and country-specific development paths sometimes allow for a big-bang transition and other times economic improvements have to be achieved through a gradual transition.

Next, I will analyze the main empirical arguments used by transition economists to support their arguments. Building on these findings, I will demonstrate that both sides dramatically underestimate the role culture and history plays in the transformation process and political reformers cannot simply pick a universal reform package without connecting their considerations to real world phenomena. Rather political reformers have to be aware of the fact that different countries have an unequal history and therefore the compatibility of countries to a market order is varying. “A policy designer, in proposing a broad reform strategy and specific policies, has also to take into account particular economic [and social, AL] circumstances, as well as political constraints” (Gomulka 1994: 3). Therefore, I will propose a cultural theory of economics as the adequate analysis tool to analyze transition issues. Later on, I will draw conclusions from these deliberations.

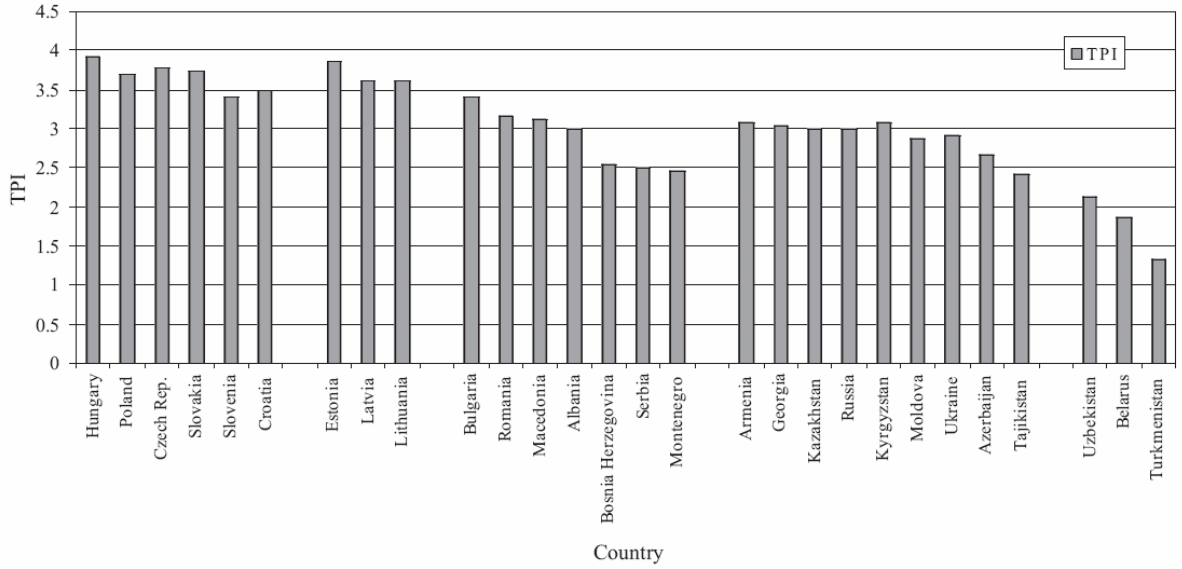
3. Transition Processes in Central and Eastern Europe Reviewed

3.1 Sequencing of reforms

As initially proposed, in literature there is empirical evidence supporting both views. Only recently, Oleh Hayrylyshyn (2007) presented an empirical study concluding: “With the passage of time, it is now clear that rapid reforms were on a whole better than gradual reforms”. The same argument is put forward by Gros and Steinherr (2004: 110): “Experience has shown that slow reformers were just that, slow reformers […] Countries that implemented reforms early usually stayed ahead of the others”. But then Vladimir Popov (2007) presents a regression analysis giving empirical evidence that gradual transition lead to better economic performance compared to a big-bang strategy. He concludes, “provided that reforms create a need for restructuring (reallocation of resources), the speed of reforms should be such that the magnitude of required restructuring does not exceed the investment potential of the economy. In short, the speed of adjustment and restructuring in every economy is limited, if only due to the limited investment potential needed to reallocate capital stock” (Popov 2007: 12). Finally, Berr, Combarnous, Rougier (2005) construct a quantitative measure of the pace of international financing institutions programs and the impact on economic growth: the Washington consensus index (WCI). They find a significant non-linear relation with the probability of getting higher growth among observed countries. Thus, an implementation “too fast and deeply” creates a negative impact on economic growth. However, the different results of these studies have to be explained. Therefore, I will present further arguments empirical and theoretical in nature to show that the debate about the speed of transition (shock therapy *versus* gradualism) was in large part misleading. The question is not if it has to be either shock therapy or gradualism. Rather there is the need to identify the cases where a shock therapy might make sense and when a gradual approach has to be favoured.

One major problem for analyzing the outcome results of different types of reforms is that classifying particular reform processes as rapid or gradual has been done somewhat arbitrary. The random classification happened mainly because there are so many dimensions of transition (see *Table 1* again) that there is space left for different interpretations. After 1989, for example, Russia was considered as a rapid reformer. However, some years later this consideration was dropped and it was argued that the Russian reforms of 1992 were not a proper example of a big-bang approach to reform, because they were stopped, partly reversed, and did not achieve macroeconomic stability before 1999 (for this critique see Hayrylyshyn 2007: 4).[9]

Figure 1
EBRD Transition Progress Indicator, 2004



Source: European Bank for Reconstruction and Development, *Transition Report 2004* (London: EBRD, 2004), http://www.ebrd.com/pubs/econo/series/tr.htm.

To reach a better understanding on the uneven pace of economic reforms, consider the most widely used index of transition in post-communist countries, the Transition Progress Indicator (TPI). *Figure 1* shows the TPI for 28 former socialist countries. It measures the degree of a country's market-orientation on a scale from 1 to 4.5, with 1 indicating a centrally planned regime and 4.5 denoting a free market economy. The TPI has several dimensions, including price and trade liberalization, competition policy, governance, small and large scale privatization, and liberalization of the banking and financial sectors. The countries are grouped into six categories: Central Eastern Europe, the Baltic states, South-East Europe, members of the former Soviet Union with a moderate degree of reforms, and FSU members with very limited reforms.

The speed and the scope of reforms in the years after the end of socialism are essential to distinguish between big-bang and gradualism. For simplifications, I have adopted the very elaborated classification of Oleg Hayrylyshyn (see *Table 3*).[10] He defines those countries as

[9] Gomulka (1994) even argued that a true big-bang reform has only taken place in East Germany. All other post-communist countries choose either a controlled shock therapy or a semi-gradual approach.
[10] I decided to adopt a classification used by a big-banger to avoid the criticism of picking empirical findings as needed and to proof my point. Another classification can be found e.g. in Roland (2000: 15).

rapid reformers that saw their TPI score increase by 1 point or more over a period of three years. Furthermore, he classifies countries that made a great initial leap forward in the TPI ratings, but did not sustain the pace of reform or even reverse some of their early liberal economic reforms, as aborted big-bang countries. By adjusting countries like Hungary, Croatia and Slovenia, which started off with advanced initial TPI values (well above 1.0), his classification allows for cultural and historical circumstances shaping a counties particular tradition and societal situation. However, I put those three countries to the group of gradual transition because it is of special interest for my argument here that even if they had a starting advantage over other post-communist countries they choose a more gradual transition.

Table 2: Transition Countries Grouped by Early Reform Strategies[11]

Sustained Big-Bang	Aborted Big-Bang	Gradual Reforms (Advance Start/ Steady Progress)	Gradual Reforms	Limited Reforms
Estonia	Albania	Croatia	Azerbaijan	Belarus
Latvia	Bulgaria	Hungary	Armenia	Uzbekistan
Lithuania	Macedonia	Slovenia	Georgia	Turkmenistan
Czech Republic	Kyrgyzstan		Kazakhstan	
Poland	Russia		Ukraine	
Slovakia			Tajikistan	
			Romania	
Big-bang strategy		Gradual strategy		

Table 2 presents insights on the mixture of gradual and rapid transformation in FSU und CEE countries. Relatively rich countries like Hungary, Slovenia, and Romania choose a rather gradual reform path while other rich countries like Estonia, Czech Republic or Poland opt for a shock therapy transition. On the other hand, we find that relatively poor countries like Albania, Macedonia and Kyrgyzstan picked a big-bang approach while other poor countries,

[11] On the basis of Hayrylyshyn (2007: 6). Note that Hayrylyshyn reduces the success of gradual transition by adjusting Croatia, Hungary, and Slovenia to *Advance Start / Steady Progress* countries which I have undone in my analysis.

like Georgia, and Turkmenistan, opt for a gradual implementation of a market economy. Next, I will deal with the empirical question whether rapid or slow reforms were more successful.

3.2 Economic Performance in Central and Eastern Europe

But what type of reform strategy generates superior outcomes? Big-bangers readily argue that there is a positive correlation between rapid reforms and economic outcomes which – from their point of view – proof that rapid reform are to be favoured (see Hayrylyshyn 2007; Gros/Steinherr 2004):

> "In the end, the proof of the pudding is in the eating, and the proof of a good reform package is better economic performance. Enough time has passed by now to judge which approach to reform did, in fact, yield the best results" (Gros/Steinherr 2004: 105)

It is well known today that the post-communist countries come up with hugely different economic outcomes. Countries of CEE outperform the countries of FSU (see e.g. Balcerowicz 2001: 35, Hayrylyshyn 2007; see also *Table 3*). The variation in country-specific inherited constraints from socialism have an impact on the choice of overall reform strategy. Having a look on the initial economic situation at the beginning of the transition process, we find that countries with a good economic situation mostly choose for a big-bang strategy while countries with a low economic performance opt for a gradual transition or stopped a rapid reform strategy after a couple of years.

Leszek Balcerowicz (2001) points out correctly that the economic outcomes are determined by various factors that cannot be separated: The initial economic conditions, external economic developments and reform policies. However, empirical evidence shows that the situation at the beginning of the transition process plays a crucial role for the transition process itself. Initial economic conditions, determined by history, include macroeconomic (im)balances, economic structure, stock of physical and human capital, size of the economy, its geographical location, demographic structure, etc. The difference in the ratio GDP 2000/GDP 1989 can be taken as a reliable indicator of the relative success of different countries (see Balcerowitz 2001, Weder 2001, Gros/Steinherr 2004: 107-12). By 2000, for example, the real GDP equalled 107 per cent of that in 1989 in Central Eastern Europe while the comparable figure for the FSU was 61 per cent (Balcerowitz 2001: 35). Additionally, conducting a formal cluster analysis, Beatrice Weder (2001) finds that the transition countries rank the same in 1989 at the beginning of transition than in 1997. These data show clearly that that initial pre-transition conditions matter.

Finally, *Table 3* shows the GDP per capita between 1992 and 2007. The results emphasize that the development level was significantly higher in CEE countries than in FSU. In 1992 the GDP per capita in CEE reached, on average, 2035 US$ while it was 266 US$ in FSU. However, the countries of FSU had a relatively more successful economic development between 1992-2006 than the countries in CEE and the Baltic states (EBRD 2007). There is one important reason why I had to take the data from 1992: Because of problems with the official statistics under communism. The data from 1992 unfortunately was compiled by the Soviet administration and therefore misleading because the value of output produced under a non-market system is impossible to determine with any precision (see Balcerowicz 2001: 36). However, because of the breakdown of the soviet economy *all* post-communist transition countries faced a dramatic and unexpected output decline in the beginning of the transition process (see Roland 2001: 19). This output decline tends to fall over a period of about two to three years starting then to recover (Gomulka 1994: 8).[12] Thus, the data from 1992 still shows the same relative difference between countries in transition as in 1989. These obvious corrections do not change the relative picture given by the official data. They would rather strengthen the relative GDP per capita performance of Central Eastern Europe and the Baltic States compared to FSU. Note that the shock therapy did not show success before 1992.

A systematic econometric analysis of the experience of the twenty-five countries in Central Eastern Europe and the former Soviet Union by Gros and Vandille (1997) shows that there is no link between the speed of reform and the size of the initial output decline. In quite contrary the authors find that the size of output decline seems to be mostly determined by the amount of time under a communist regime. The collapse of production was more pronounced in former Soviet Union countries than in Central Eastern Europe. Therefore, the economic success of rapid reformers does not necessarily stem from the fact that they used a shock therapy for transitioning to a market economy. It rather emerges from the fact that rapid reforms mostly took place in those countries that had underlying informal institutions which are more compatible with the imported Western institutions and are expected to achieve a much better performance.

[12] The EBRD (Transition Report 1999: 62) identifies four factors influencing the initial output decline in transition countries: intra-communist-bloc trade, the level of development at the beginning of the transition process, macroeconomic distortions, and (geographical and political) distance from Western Europe.

Table 3: Economic Starting Point and Economic Outcomes

	GPD per capita 1992 (US Dollar)	GDP per capita 2006 / GDP per capita 1992 (%)
Slovenia (Gradual)	6280	306
Hungary (Gradual)	3612	308
Czech Republic (Big bang)	2891	480
Slovakia (Big bang)	2213	463
Poland (Big bang)	2196	407
Croatia (Gradual)	2126	451
Macedonia (Aborted big bang)	1053	296
Bulgaria (Aborted big bang)	1014	403
Latvia (Big bang)	937	932
Romania (Gradual)	859	242
Estonia (Big bang)	713	1710
Lithuania (Big bang)	520	1686
Russia (Aborted big bang)	565	1216
Belarus (No Reform)	522	728
Ukraine (Gradual)	478	472
Turkmenistan (No Reform)	352	445
Kazakhstan (Gradual)	349	1494
Azerbaijan (Gradual)	208	1135
Albania (Aborted big bang)	189	1515
Kyrgyzstan (Gradual)	170	321
Georgia (Gradual)	136	1260
Uzbekistan (No Reform)	92	713
Armenia (Gradual)	82	2423
Tajikistan (Gradual)	51	828
CEE /EU	2035	640
FSU	266	1045

Source: EBRD (2007)

3.3 Culture and Economic Performance in Central Eastern Europe and the Former Soviet Union

The fact that culture in transition economics matter has been recently demonstrated impressively by Steven Pejovich (2006) and Popov (2007). Pejovich finds that those transition countries that have had more cultural and political interactions with the West have achieved a higher level of economic freedom, and those that have had less or none. *Table 4* provides data from the Heritage *Index of Economic Freedom* in 1996 and 2004 to underline this statement. The Heritage *Index* scales of economic freedom run from 1 (the best) to 5 (the worst) and separate all countries in four broad categories: *free* (1.95 or less), *mostly free* (2.00-2.95), *mostly unfree* (3.00-3.95), and *repressed* (4.00 or higher). In 1996, the Heritage Index ranked only Estonia and Czech Republic as *mostly free* countries. All other countries were ranked as *mostly unfree*. The mean rating of the countries influenced by the West was 3.1, already close to the *mostly free* ranking. The mean rating of the countries traditionally not influenced by the West was 3.5. In 2004, the Heritage Index ranked all countries influenced by the West except Croatia, as *free* or *mostly free*, and all those not influenced by Western culture as *mostly unfree* or *repressed*.

Table 3: Economic Freedom in CEE and FSU and the Effects of Prior Western Influence

COUNTRY	ECONOMIC FREEDOM	
Greater Western Influence	**2004**	**1996**
Estonia	1.8	2.4
Lithuania	2.2	3.5
Latvia	2.4	3.2
Czech Republic	2.4	2.3
Slovakia	2.4	3.2
Hungary	2.6	3.0
Slovenia	2.7	3.7
Poland	2.8	3.2
Croatia	3.1	3.5
Average	*2.5*	*3.1*
Lesser Western Influence	**2004**	**1996**
Bulgaria	3.1	3.5
Moldova	3.1	3.5
Albania	3.1	3.6
Russia	3.5	3.6
Ukraine	3.5	3.7
Romania	3.7	3.4
Belarus	4.1	3.4
Macedonia	3.0	not rated
Bosnia	3.3	not rated
Serbia and Montenegro	4.2 (2003)	not rated
Average	*3.5*	*3.5*

Values are from the Heritage *Index of Economic Freedom* scale of 1 to 5, with 1 representing the greatest economic freedom.

Source: Pejovich (2006: 244)

Pejovich suggests from his findings that "the success of capitalism in protecting individual rights and producing sustainable economic growth would create incentives for pathfinders to move the prevailing cultural values in C&EE closer to a culture supportive of capitalism" (Pejovich 2006: 252). To put it in more technical terms: to shift the informal institutions so that they match the formal ones. However, later I will provide strong theoretical arguments why such a perception of the transition problem does not help managing transition (i.e. because social norms and informal rules evolved historically cannot simple be changed rapidly or by force).

Besides, this hypothesis is corroborated by Popov (2007). He finds that there is a clear relationship between the ratio of rule-of-law-to-democracy index on the eve of transition and economic performance during transition. The reason for the relative economic success in CEE countries were strong democratic regimes, while most FSU countries have weak democratic regimes. While the CEE countries are politically liberal, that is protecting individual rights (including those of property and contracts), and creating a framework of law and administration, on the one hand, the FSU countries are politically not so liberal since they lack strong institutions and the ability to enforce law and order, on the other hand. The reason is obvious: While European countries in the 19^{th} century could build the implementation of elections on a stable rule of law, in FSU democratic political systems were introduced without a firm rule of law.

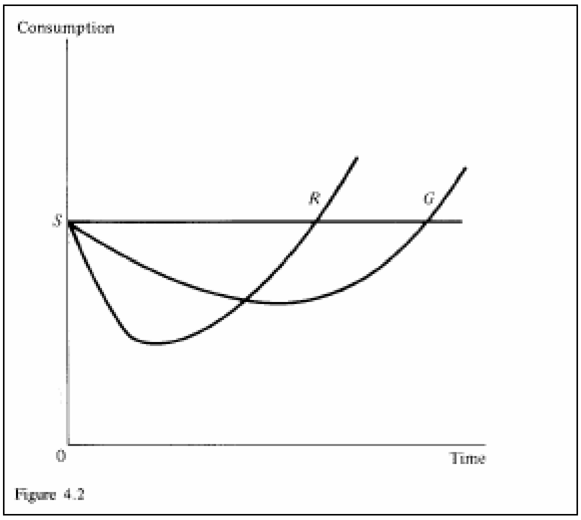
The influence of the time spent under socialist government on economic performance is without question. Empirical analyses show that countries that spent a longer time under socialism are more likely to see former communists remain in power and to start the transition process with less open political systems, with negative effects for the development of market-compatible institutions (Beck/Laeven 2005). According to the analysis of Zweynert and Goldschmidt (2006), compared to FSU countries with an orthodox tradition, countries in CEE, having a catholic and protestant tradition, have the advantage of being more compatible with individualistic ideologies and therefore creating more support for the acceptance of an extended, functionally differentiated order like a market. Thus, the cultural difference between FSU and CEE does not only stem from the period of socialism but has to be seen as a result of long lasting traditional roots influencing the culture of economic behavior for many centuries already (cf. Zweynert/Goldschmidt 2006). Thus, reforms in FSU countries are expected to take longer time than reforms in CEE countries because individuals grown-up and socialized in the FSU have to change and adjust their economic behavior more comprehensively towards a market compatible behavior than it was necessary to change for people in CEE countries.

For an adequate understanding of the reform processes in post-communist countries it is necessary to be aware of the fact that the stability of any economic order originates from the voluntary agreement to such an order by the individuals involved (Buchanan 1975). Therefore, it is of big importance if people emerge as winners or losers out of the transition process. Next, I will dwell on the question of social costs of transition to highlight the relevance to account for each individual position in the transition process.

3.4 Social Costs of Transition in Central and Eastern Europe

Many political economists expected output to fall before picking up again.[13] Therefore, in literature (see Przeworski 1991/95: 162-7) arguments are made in favour of radical reforms because of a model portrayed in *Figure 2*. Under the rapid strategy, path R, it is assumed that consumption declines rapidly and profoundly and recovers early. The radical strategy therefore is like a "bitter pill", adopted with the belief that everything will be fine after a short period of suffering. Under the gradual strategy, path G, consumption falls slowly, and returns to the initial level later. Once the initial level has been reached again, marking the end of the transition process, the economy grows at the same rate under the two strategies.

FIGURE 2: Gradual versus Big-bang Reform



Source: Przeworski (1991/95: 163)

The argument is quite simple: Given that people have full information about their future consumption, they will discounting the future on the grounds of their risk and then decide for one strategy: If social costs are higher under the radical strategy, people would vote for a gradual approach. However, if social costs are higher under the gradual strategy, people

[13] See e.g. Michael Bruno (1993). Bruno and others argue that such an output U-curve occurred in all earlier reform and stabilization programs.

would go for a radical reform. But what if people – like in reality – do not have this knowledge?

Big-bangers argue if people trust the government and are confident that reforms will succeed, voters will choose the big-bang reform. Indeed, evidence from Poland show that reform packages enjoy support when they are launched even if they cause a significant decline in the standard of living (Przeworski 1991/95: 165).[14] Hence, politicians (which care about political reactions) prefer radical reforms to gradual ones because they want to proceed as far as possible before negative reactions set in. The OECD even states:

> "While a gradualist approach may cause lesser social tensions, a long period of moderate reforms entails the danger that both reformers and the population will 'become tired of reforms' as they do not seem to bring visible changes. Also during a long period of reforms various anti-reform and other lobbies may mobilize their forces and may gradually strangle the reform process" (OECD 1990: 9; taken from Przeworski 1991/95: 165).

Thus, advocates of big-bang reforms are convinced that public support for reforms is short. If the adjustment process is too gradual, political opposition will gather and the reform process will be stopped. Yet, politicians are concerned about social peace and popular support. Therefore, they will opt for radical strategies whenever they believe that the economy will turn on the upward curve before the next election (Przeworski 1991/95: 166).

However, I will argue that this tension between capitalism and democracy has to be seen as an argument for gradual reforms. Gedeon (2004), for example, agrees on the argument that if economic reforms produce serious economic problems, like inflation, growing unemployment, high uncertainty, and a loss of welfare for a great number of citizens, it is likely that voters use their voting power to stop those reforms:

> "In turn, under democratic conditions, where the discontent can find political expression at the polls, even the most promising reform strategies may be abandoned. Either politicians are concerned about electoral support and reverse policies that will cause them to lose elections, or they lose to competitors more attuned to the political consequences of structural transformation. And in some cases, egalitarian ideologies with strong populist and nationalistic overtones can be mobilized against both democracy and reforms" (Przeworski 1991: 138).

[14] Overwhelming 90 percent of the population in Poland supported the government in spite of drastic deterioration in living conditions during the first months of the economic reform program.

Therefore, the argument in favour of radical economic transition may backfire: Democracy may put economic reforms at risk and vice versa, economic reforms may threaten democracy: Because of this a government has to identify the popular demand which is in the interest of most parties involved to legitimize their reform policies. An elite ignoring the public interest and carrying out 'their' economic reforms will finally result in a significant loss of democracy. However, in countries without a capitalistic tradition, it is unlikely to find support for a rapid transition. Offe (1991) and Przeworski (1991) argue that losers compare their present economic welfare with their previous economic situation and with the present welfare of the winners. This comparison tells them that they are much worse off in both the absolute and relative terms and this may turn them against economic reforms. Therefore, to guarantee a sustainable reform process a political leader has to identify the cultural background and country-specific compatibility of any reform strategy.

I have shown above that cultural differences have a profound impact on economic development, growth and the speed of reforms. In line with Roland (2004: 14) I argue that different societies have throughout history formed different attitudes toward labor and work in general, towards thrift and the use of interest rates, toward respect of property rights and of creativity, and towards participation of women in different economic activities. And I agree that "it is in a way strange that most economists have shield away from incorporating cultural differences and cultural innovations in economic analysis" (Roland 2004: 14). Therefore, I will next present a theoretical framework integrating culture into the study of economics.

4. A Framework for Understanding Institutional Change in Central and Eastern Europe

The problem of institutional change in post-communist countries can be interpreted as a problem of transplantation of institutions (Roland 2004, Zweynert/Goldschmidt 2006, Zweynert 2007). "Successful transplantation always implies that the imported institutions grow together with the domestic ones. Otherwise the transplant will sooner or later be rejected" (Zweynert 2007: 7). Peter Murrell (1995: 175) points out that a major problem with transitional economics is that the neoclassical profession easily underestimates the role culture and history plays in the transition process. Neither the Communist economic legacy nor the nature of the society and polity implementing economic reforms are usually important. But when the analysis focuses on institutional development, reform, and comparative country performance, the historical development in politics, society, and economics has to be an important explanatory factor.[15]

Economic policy reforms in transitioning economies are founded on broadly based trust into the efficiency of markets. However, if we accept that people do not only judge economic outcomes but also social conditions and that the normative criterion for a social system is the voluntary agreement of the individuals involved, the need is for an order that is appropriate to the specific interests, manifold justice perceptions, and multifaceted social situations of heterogeneous people (cf. Lenger 2008). Therefore, a functioning economic order cannot simply be copied from Western countries (as the experience with the Washington Consensus proofed) but has to be developed in each particular case on its own. Even if there is absolutely essential need for reforms in transition countries, fundamental changes demand the agreement and acceptance of the majority of the voters (otherwise they will be reversed at once).

Institutions are the "rules of the game" that shape human interaction in society (North 1990: 3). Essential to the understanding of (social) rules and its relevance for economic behaviour is the distinction between *formal* and *informal* institutions (cf. North 1990). This difference emphasizes that within the reality fast-moving political systems and slow-moving social norms are to be found (e.g. Roland 2004). Therefore, it is essential to account for both planned and codified political and juridical laws as well as unplanned cultural inherited social

[15] Obviously, this is not a new point (see North 1990, Murrell 1995, Roland 2004, Goldschmidt 2004, Goldschmidt/Zweynert 2006). However, I emphasise it again because it seems to be rejected by the majority of authors concerned with economic reforms.

norms and codes of conduct.[16] Obviously, formal rules and habits of thought are not separated. On the contrary, they work together to form institutions that shape and guide human interaction. Thus, a crucial element of economic development and transition results from the interaction between formal and informal constraints of human behaviour (Goldschmidt/Zweynert 2006: 897).

Accordingly, the future development of societies is bounded to their history and is partly path dependent (see Arrow 2000; Magnusson and Ottosson 1997). Thus, the insight that future developments are inseparably connected to historical experience binds formal institutional developments to a specific time path, and the developing institutional structure of societies is subject to a "lock-in" or "path dependency". However, path dependency does not mean that social progress is restricted to only one possibility. If this were the case, rapid institutional change would be impossible.[17] Rather, the theorem of path dependency underlines the significance of historical and social contexts, as well as the necessity to take these contexts into consideration in economic policy-making. In line with Goldschmidt and Zweynert (2006: 898) I will argue that there is a central need to focus our attention on the existing informal rules that shape the foundation for new formal institutions and to search for complementary set of rules. Only by doing so can be possible to change the political agenda successfully *and* sustainable.

In institutional economics path dependency is considered to be a main obstacle for institutional reforms. Once taken paths – despite its sub-optimal design – can be tighten by persisting over time. The previous decision for a certain development path results in a social and economic situation which is difficult to reverse. Thus, reforms are only possible if a society decides to switch from a less optimal path to an optimal one. However, some concepts of path dependency predict an individual behaviour totally bound to established institutions without any possibility to leave the well-established path. Note that such an interpretation of path dependency is quite irrational. Rather – if people recognize a suboptimal situation – they will seek for a new institutional framework. Therefore, the need is for an analytical concept which allows for intended institutional change and is aware of the underlying informal background: a cultural theory of economics.

[16] For a deeper understanding of planned and unplanned orders see Hayek (1963/2003). For the distinction between formal and informal rules see North (1990) and (2005).
[17] Liebowitz/Margolis (1990) e.g. question full irreversibility of a certain development and emphasize the evolutionary character of markets and the search for better solutions in contrast.

New institutional economics has successfully shifted the focus away from the neoclassical question of the optimal allocation of resources by including the policy processes into economic analysis. It still cannot explain sufficiently why institutional reforms are sometimes adapted very quickly to the challenges of economic growth and why sometimes obsolete institutions persist for a long time and left no place for the successful implementation of new institutions. Unfortunately, the genesis of culture and the set of constraints that are passed down from one generation to the next are hardly taken into account in this approach. "When economists argue that 'culture matters' for economic performance, they usually understand culture as an exogenous and homogenous factor which influences economic performance and development but which itself remains more or less unaffected by institutional change" (Zweynert 2007: 8). Because of the long-term perspectives of cultural phenomena, it is often wrongly assumed that culture can be externalized and merely viewed as something static. From this perspective, culture is seen as an ad hoc variable used to explain unusual developments, but a variable that cannot itself be explained. Thus, there is an insufficient understanding of culture itself. In other words, culture is not only one of several factors that can organize social life in a peaceful and productive – and hence cooperative – way; rather, culture's structural importance for societal and political processes themselves ought to be appreciated (Zweynert/Goldschmidt 2006: 898).

A "Cultural Approach to Economics" (Goldschmidt 2006) points at the fact that humans incorporate the existing formal and informal rules – that have evolved over many centuries – during the process of socialization. Therefore, the prospect of changing those rules within short terms is extremely narrowed. It implies for economic policies that the stability of informal rules and its constitutional agreement on has to be taken into account. In fact, this problem makes it hard (maybe even impossible) to implement new formal institutions against the existing set of rules. Moreover, the problem is hampered by the fact that also formal institutions are the result of a cultural evolution. However, it does not mean that institutional change is impossible. But it does mean that the cultural background of a society has to be taken into account.

Accordingly, I see culture as the dynamic interaction between formal and informal institutions that emerge in the evolution of every society and is learned and adopted by individuals through the socialization process. Consequently, theoretical reflections on economic phenomena, as well as the possibilities of economic policy reforms, are always tied to specific social and cultural conditions. Thus, “institutional shopping” is a very complicated thing to do (Roland 2004: 8). A successful economic theory of reforms has therefore to be analyzed as a cultural theory of economics capturing the importance of acceptance and trust for a certain policy arrangement. In particular, such a concept has to pay special attention to the existing “status quo” and the underlying socio-economic reality. Only if formal institutions are in harmony with informal institutions societies can reach most efficient solutions (Pejovich 2006). From such a cultural perspective it derives that there is not only the need for theoretical arguments supporting a reform strategy but also the need to pool the acceptance of the individuals involved in the reform process.

5. Some Reform Policy Implications: There Is No Universal Reform Strategy

In reality we find both successful examples of a gradual approach and successful examples of a big-bang reform (see also Murrell 1995). The focus on the interaction between formal and informal institutions provides a promising explanation for why the adaptation of a "first best" reform approach cannot work. It highlights the notion that different countries have different "local conditions" which arise from slow-moving institutions (Roland 2004: 17). Therefore, it provides a well grounded explanation for why reforms in a given country must build on these local conditions. "In other words, countries with different cultural and historical paths must find *within* their existing slow-moving institutions the roots for changes in their fast moving institutions" (Roland 2004: 17; emphasis added).

Following the empirical and theoretical arguments presented in this paper I claim that only 'Western-like cultures' allow for a big-bang reform. No more than other countries which had a similar tradition as Western countries, like for example the Baltics, Poland or the Czech Republic, could easily realize a transition towards a market economy. Countries with a 'different' tradition, on the other hand, like most FSU countries have to seek for a more gradual transition to accompany the people on their way towards capitalism because of the lack of cultural compatibility with the new market order (Sztompka 1993). Thus, the only possible way to give people time to adjust their (economic) behaviour and expectations to a new economic system might have been a gradual transition.

It has been argued above that social and cultural backgrounds influence the process of transition very much. To enlarge the thoughts on this argument let us consider the example of privatisation policy. The classical (Western) methods of privatisation rely on the presence of financial institutions to affect the sale of state assets, and on the availability of private capital and capitalistic behaviour to buy and manage these assets. None of these were available in post-communist countries on the large-scale. For example, one important political problem concerned the choice of a method distributing state assets to citizens. The issue of vouchers, coupons or citizens grants for all is politically attractive in the short run, but runs the risk that most coupon holders will sell them immediately in secondary markets for cash. The market prices of coupons will then drop to a minimum of its real value. Local capitalists and foreigners may then buy most of the assets at very low prices. Russia and the emergence of Oligarchs can be seen as prime example for this problem (cf. Roland 2000: XVIII-XIX).

Another important point is the legacy of socialism. The majority of the people in post-communist countries grew up and were socialised during the existence of a socialistic regime. Therefore their economic attitudes were adapted to a centrally planned economy. But markets and competition create conflicting results: On the one hand they increase efficiency and welfare. On the other hand they create stress of competition and social exclusion. However, the 'comfortable' situation created under socialism, without the pressure of competition and no fear of loosing basic social care, make people feel positive about certain aspects of socialism:

> The lack of extreme income inequality, the smaller number of marginalized poor, the relatively lower degree of urbanization of the population, and the absence of recent, violent experiences with coups and riots may all have contributed to a stabilizing influence under postcommunism (Greskovits 1998: 85; taken from Gedeon 2004: 91).

Note, that people are not identical and reforms must be supported from time to time by majority vote. Therefore, politicians have to choose a reform path that matches the underlying attitudes towards competition because people will not shape their attitudes towards reforms at once. Therefore, for analyzing the transition to a market economy, the tolerance of unequal results is of great importance. As Przeworski (1991: 178) put it, "The one value that socialist systems have successfully inculcated is equality, and this value may undermine pro-market reforms under conditions of democracy".

What happens with post-communist countries when formal and informal institutions do not match each other? In this case experiences from FSU countries are striking. The establishment of strong state institutions, understood as the ability of the state to enforce rules and regulations, failed. Organized crime rates and corruption dramatically increased and undermined the working properties of the market economies in many FSU countries. The constraints on the shadow economy were weak and property rights and contract rights were often neglected (cf. Popov 2007: 3). It is precisely this implementation problem of a functioning institutional framework that can explain both the slowdown of reforms and the shortcomings of economic success in the former Soviet Union.

Therefore, a gradual approach has to be favoured because it is politically more sustainable in general. As pointed out before, the implementation of a reform with few winners and many losers is politically difficult (e.g. Buchanan and Tullock 1962). However, in such an extensive transformation as from a centrally planned economy to a market economy, most people are not sure whether they are necessarily winners or losers. Thus, we find individuals somehow behind a "veil of uncertainty". Therefore, there are good reasons why people in the beginning would agree on either a big-bang strategy or a gradual reform depending on their individual expectations. However, as soon as a majority of the society is facing serious losses from the transition to a market economy the reform strategy is going to be reversed through the political process.

Thus, the main argument in favour of a gradual approach, in my opinion, is the fact that a gradual approach allows formal and informal institutions to adopt for each other. For example, a working market economy needs a stable rule of law and secure property rights. Therefore, people in countries under transition need time to get used to it. A cultural approach of economics allows people to become accustomed to new formal market rules. For example, even in Latvia (one of the success stories) we can observe a high deficit spending along with bad loans leading to serious economic problems today. The reason, obviously, is that individuals still do not properly behave in a market situation. Even without having savings, people do spend enormous amounts on housing and new cars.[18] It seems that Latvian people still need more time to adjust their economic behavior to the new economic situation.

For economic policy making there are two general considerations how to improve the compatibility of (traditional) non-market attitudes and market institutions. First, give people time to adjust their attitudes, social norms and conventions, and their (economic) behavior to competition and markets (i.e. provide a *learning process*). The dual-track approach to reform has provided an effective operation to reform gradually while respecting the process of adaptation of reforms. The dual-track system enables the introduction of liberalization across all markets avoiding the disruption of output collapse by maintaining a frozen track plan. Moreover, price liberalization at the margin has the same efficiency properties as full liberalization and the dual track has the attractive property of being Pareto-improving (cf. Roland 2004: 26). China – as a prime example for a gradual transition with slow deregulation of prices – outperformed all other transition economies (Popov 2007: 6-7).

[18] Personal message by Zaneta Ozolina.

Second, political economists have to search for formal arrangements directly matching the existing feelings and perceptions of individuals involved (i.e. provide *connectability*). The acceptance of reforms can be improved by adapting market reforms to the domestic traditions of economic behaviour. An example of successful of institutional adaptation is the German example of a “Social Market Economy” (Zweynert 2006). Both, economists and politicians were aware of the fact that the economic reform programme needed to be fitted into the tradition of Germany. The concept paid tribute to the historical traditions of Germany by combining market liberalism with social policy (Zweynert 2007). If people trust economic reforms and if people are able to understand those arrangements against the background of their former experience the acceptance and implementation of individual reforms is more likely. On the other hand, reforms which oppose against historical grown experiences and try to force changes will hardly successful. Hence, it is the task of politics, to search for reforms which are related to previous positive and familiar developments (see Goldschmidt 2004).

However, it was the aim of my paper to seek lessons on the strategy of reforms that follow from empirical evidence and economics literature. However, it was not my intention to offer concrete policy recommendations, but to open the discussion and provide a perspective that might establish a useful condition for policy makers. In a nutshell, it is still true what Niccolo Machiavelli emphasized nearly half a millennium ago:

> “It must be remembered that there is nothing more difficult to plan, more doubtful of success, nor more dangerous to manage than the creation of a new system. For the initiator has the enmity of all who would profit by the preservation of the old institutions and merely lukewarm defenders in those who stand to gain by the new ones” (Niccolo Machiavelli, The Prince, 1513).

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