ON THE ECONOMICS AND THE POLITICAL ECONOMY OF REFORMS[1]

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Abstract: *The paper first highlights Olson's contribution to social sciences. Two main dimensions of political regimes are then distinguished. Features of economically successful reforms are defined. Next, the situational determinants of market reforms are discussed. Against this background a special case is analyzed: reforms after socialism. Finally, the deterioration of economic systems and their causes are presented.*

Key words: *Mancur Olson, reforms, political economy, political regimes, interest groups.*

1. Introduction: Mancur Olson – a great social scientist

I regard Mancur Olson as one of the greatest social scientists of our time. He had a phenomenal gift of observation of social reality that allowed him to identify important mechanisms overlooked by the others, but obvious after the fact. This is a feature of a true discovery. He was a rigorous methodological individualist – he had tried to explain the aggregate social phenomena by reference to the situations individuals face, especially the ensuing incentives. He had assumed in his analyses that the individuals have the same motivational and cognitive dispositions (human nature) regardless of their positions. In other words he focused on the situational impact by linking the differences (changes) in individuals' actions to the differences (changes) in their situations, including those that are determined by the differences in institutions. As such, he avoided a popular tendency of ascribing a special behavior to special dispositions of people in a certain group; a practice that often leads to an unreflective deification of the state[2].

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[1] I am grateful to Marek Kaminski and to the anonymous referee for their helpful remarks and suggestions. Usual caveats apply.

[2] To be sure, sometimes there is a need to consider special characteristics of key individuals in explaining their behavior, and I will do it once in a while. However, such a practice should not crowd out the situational analysis.

I think Mancur Olson made the following key contributions to the social sciences:

- He refined the concept of the collective goods (i.e. goods that, if provided to any member of the group, are provided to all its members) in such a way that they denote not only the goods which require the state's taxes (e.g. national defense), but all the goods potentially provided by any group, including those that are harmful to society's economic growth, especially regulatory or fiscal privileges obtained by special interests groups ("distributional coalitions" in Olson's language). Therefore, he separated the concept of collective (public) goods from that public interest. Some collective goods, e.g. those provided by distributional coalitions to their members, damage public interest.
- He presented a path-breaking typology of groups. By focusing on individuals' incentives Olson suggested that small groups were more effective in pursuing their collective goods than the large ones, unless the latter can offer special incentives to their members (Olson, 1965).
- Thanks to his theory of groups pursuing collective goods, Olson has added a needed precision to the popular expression a "collective action problem". He shows that it is the individuals' incentive problem and not only the coordination problem as suggested by the alternative explanation in terms of "transaction costs" (Coase, 1990).
- Olson used his theory of groups to explain a wide range of real-life phenomena: cross-country differences in economic growth in post-II WW Europe, barriers for growth in less developed countries, stagnation in the 1970s, etc. (Olson, 1982).
- In his last book Olson (2000) draws upon another of his path-breaking distinctions: that between a "roving" and a "stationary" bandit, in order to explain the differences in behavior of the autocrats, and thus in their countries' economic performance.

Economists operate at three levels:

1. Describing and forecasting economic outcomes, such as economic growth, employment or inflation.
2. Explaining these outcomes in terms of policies[3] and various shocks. This level includes economics of institutions and of reforms. The former focuses on links between institutions and economic performance, e.g. the role of property rights, openness, and law enforcement in economic growth.

[3] Policies are understood here as actions of policy-makers and include macroeconomic (fiscal, monetary), direct interventions (central planning being its most extreme form) and institutional, which by definition result in a change in a country's or region's institutional system (more on this: Balcerowicz, 2008).

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The latter tries to explain and predict the packages of reforms that – if launched and sustained – would improve the targeted aspect of a country's economic performance, especially its longer term economic growth. I call it "economics of reform" and distinguish it from the political economy of reforms (Balcerowicz, 2008, 180-192).

3. Explaining policies, [both macroeconomic and institutional (reforms)]. This is the level of political economy and of institutional dynamics that also includes the bottom up changes[4].

Olson (2000) had dealt with economics of institutions and reforms by pointing out the importance of private and well protected property rights, market competition and free trade for efficiency and economic growth. However, he contributed the most to the fundamental third level, i.e. the political economy of policies and the institutional change.

Economics of institutions and of reforms, as well as political economy of policies and the institutional change constitute a core of institutional economics. Olson was a great institutional economist. He created the analytical tools that have been found very useful in most social sciences.

The research agenda of institutional economics is huge and far from completed, especially at the third level. The following discussion focuses on several issues, selected because they meet two conditions: 1) They are related to Olson's work, 2) They require further research. In section II I discuss two fundamental dimensions of the political regime. Section III deals with the economics of reform. Section IV is dedicated to the political economy of market reforms and discusses their situational determinants. Section V presents a very important special case: that of economics and political economy of reforms after socialism. Section VI deals with factors responsible for the deteriorations of the institutional frameworks for growth, including the reversals of previous reforms. Section VII concludes with some remarks on what to do in order to increase the chances for market reforms and to prevent the institutional deterioration.

2. Political regimes and Olson's "stationary bandits"

The discussion of the economics and – even more – political economy of reforms requires a reference to various political regimes, and I think there is much confusion

[4] Top down reforms are not the only source of changes in institutional systems. In a system which allows organizational freedom, including private property rights, a lot of change is produced by the actions of autonomous firms and non-economic organizations. This spontaneous adaptability is one of the advantages of such systems relative to the centralized ones.

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in this respect. Therefore, as a prolegomena, let me suggest a conceptual clarification. I think one should separate two dimensions of political regimes:

1) The mechanism of filling in the top political positions.
2) The level of the rule of law, including the extent of power in these positions.

Democracy (D) should be conceptually located on the first dimension and defined as a regular, open, and legal competition for the top political positions through free elections (Schumpeter, 1947; Olson, 2000). On this definition the restrictions – official or hidden – on this competition lower the level of democracy[5] until it becomes a show-democracy: elections without choice that serve as an instrument to check the obedience of the ruled.

Non-democracy (non-D) denotes a set of alternative mechanisms for filling the top political jobs. There are not many of them: the hereditary principle, the internal struggles in organizations that monopolize these positions (the mono-party, the army), coup d'états, drawing lots, which is not practiced nowadays.

Rule of law has many definitions, which obviously I will not discuss here (see: Balcerowicz, 2009). However its essence is rather clear: it refers to the institutional constraints on the power of top political rulers and to the quality of the execution of the law. It is useful to conceive the rule of law as a variable that can assume various levels. Similar to democracy there have been various measures of this level (see: e.g. Freedom House).

Having two separate dimensions we see more clearly that both D and non-D have been associated with different levels of the rule of law. For example, with respect to D, Zakaria (2004) distinguishes liberal and illiberal democracies. And non-D have ranged from Hong Kong, where (at least until recently) individuals enjoyed extended economic and civic liberties, to bloody tyrants like Stalin or Mao. Those autocrats, e.g. non-democratic rulers, who are not constrained by the rule of law should be called dictators.

And this brings me to Olson's (1993) famous distinction between the "roving" and "stationary" bandits. He rightly stressed that the former has no incentives to care about the prosperity among the conquered as he has a short time horizon, while the latter, being secure in his position, might have such incentives because the tax take from a richer society is larger than from the poor one.

A brief look at the reality shows many economically bad dictators, certainly in a longer run. The most prominent examples include Mao in China, Pol-Pot and his colleagues in Cambodia, the three generations of Kims in North Korea, and Mugabe

5 There are nowadays various measures of the level of democracy, e.g. Polity IV.

in Zimbabwe. We also see a rather small group of economically sound autocrats, e.g. Pinochet in Chile, Lee Kuan Yew in Singapore, Park Chung-hee in South Korea, Chiang Kai-shek in Taiwan. The concept of a "stationary bandit" obviously cannot explain this huge variation. This is why we cannot help but consider a psychological factor: the variation in the views (ideology) and in the motivation of the autocrats. The less institutionally constrained the top rulers are, the larger is the scope for the display of this variability. The economically disastrous dictators must have been guided by bad economic doctrines (statism or socialism as its most extreme variant) and/or they must have been deriving satisfaction from power and generating fear among the ruled; some of them were just psychopaths. Contrary to Olson (2000, p. 112) I would not dismiss the role of wrong ideology in generating bad policies. Gorbachev, clearly not a psychopath, believed almost until the very end of the USSR that socialism was an economically good system (see Gaidar, 2006). Bad doctrines are hard to kill.

Economically sound dictators must have been guided by economically good doctrines. This was a necessary condition. However, their motivation did not need to be that of "stationary bandit", as the utility functions of individuals in key positions include psychological incentives such as respect, fame, sense of duty, etc.

Also one cannot rule out that economically sound autocrats (e.g. Lee Kuan Yew in Singapore) were institutionally more constrained than bad dictators, and that this situational difference has ruled out the worse behavior among the former rulers.

3. Economics of reforms. What reforms enhance economic growth?

In this section I will briefly discuss what reforms can enhance economic growth.

Ample empirical research and theoretical growth models show that reforms are successful if they greatly enhance the innovativeness of the economy and the related structural change. This includes the enhanced technology transfer, especially in the case of less developed countries. There is also little doubt that in order to achieve the increased innovativeness and structural change, reforms have to move a country's institutional system towards free market, intense competition, and the rule of law – call them market reforms. This defines the necessary <u>direction</u> economically successful reforms[6]. I think Olson (2000) was of the same opinion. I can't find a single example of successful reforms with a clearly opposite direction. And institutional

[6] It is an empirical question, how large must be the steps in this direction in order to achieve an accelerated growth. This refers to the necessary scope of reforms. Surely a country does not need to achieve a perfect market system – see e.g. China since the late 1970s.

economics can explain why not: such changes would further weaken the incentives to innovate, to invest, and to work.

However, proper direction is only one of the three necessary conditions for reforms to succeed in raising the rate of longer term economic growth. The other two are a proper scope and a proper time structure. I discussed these issues at length elsewhere (Balcerowicz, 2008, p. 183-192). Here I would only like to say that the scope should include: 1) Reforms that remove all growth barriers. A growth barrier is any feature of a country's institutional system that blocks economic growth regardless of other features[7]; 2) reforms that remove all "ticking bombs", i.e. such elements of the system that, when activated by negative shocks, disrupt the economy (see later).

Obviously, the necessary scope of reforms depends on the initial conditions. There is no need to cure the disease the patient does not suffer from. For example, in Ireland there was until the 1980s only one growth barrier: chronically ill public finance. Therefore, when a radical fiscal reform in the late 1980s removed this barrier, Ireland switched to rapid growth for the next 20 years, as other features of its institutional system have been in a very good shape. In contrast, socialism contained many growth barriers. Therefore, successful market reforms after socialism had to be massive (see sect. V).

Time structure is independent from the scope of reforms and deals with two issues: the timing of the start of individual reforms (simultaneous or sequential) and the speed of their implementation relative to the maximum possible one, which differs across reforms: stabilization and liberalization can be done in a few months while deeper institutional change requires several years (for more on this see sect. V). Early reforms should: 1) Release the market forces – the only source of enhanced economic growth; 2) Weaken the narrow interest groups (distributional coalitions) inherited from the previous statist system; 3) Prevent the emergence of new aggressive interest groups. These requirements suggest that reforms of the early phase should be broadly-based and quickly implemented. I call it a radical approach.

To finish a sketch of the economics of reforms let me mention that optimal reform package could be similar under different initial conditions. These differences would differentiate the outcomes but not necessarily what is the optimal package of reforms.

From the point of future economic growth better initial conditions are not necessarily the easier ones but those that contain more opportunities to achieve early and strong growth if proper policies are put in place. For example, Chinese policies since 1970s are often praised for quickly achieving strong economic growth while Russian reforms are blamed for not achieving that. Both contained large doses of

[7] For example, a very bad shape of public finance or a very poor protection of private property rights. Both crowd out private investment, including that which is necessary for innovations.

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economic liberalization. However, China had at the beginning a hugely important special growth mechanism[8] – the majority of its working population worked in technologically simple agriculture organized in huge Maoist communes that undermined individual incentives to work. By disbanding these structures and giving peasant plots with limited property rights Dang has released a true productivity revolution in a dominant sector of the economy. Such a special growth mechanism did not exist in Russia at the start of its reform in 1991, as agriculture employed a small minority of the working population and was highly dependent on machinery.

4. Political Economy of Market Reforms: what explains the differences in their frequency?

Many economically bad systems persist, which means that successful market reforms are either often not attempted or are blocked. A general explanation points out that such reforms, or rather their outcome, faster economic growth, constitute a collective good (Olson, 1982). This would explain why the pre-reform forces tend to the weak. However, Olson never claimed that this was a full explanation. The frequency of market reforms varies over time and across countries and a constant alone cannot explain such a variation. And Olson himself (1982) has contributed an important insight why it was the case. He emphasized the impact of the differences (or changes) in the accumulation of the destructive distributional coalitions. In the following, similar to Olson (1982), I will focus on the market reforms under democracy. I will only add here that reforms under non-democracies, especially under dictatorships, are even more difficult to predict than those under D. For in the former case the political life is contained in a black box, largely inaccessible to observation by outsiders.

The future shape of the economic system can be conceived as a vector of two opposing forces: those promoting market reforms and defending them and those opposing these reforms and defending the statist arrangement. Drawing on this metaphor from physics we can say that an economically bad system would persist or even get worse if anti-reform forces prevail. Market reforms (but not always in a necessary shape – see sect V) would be launched when the balance changes to the benefit of the reform forces. Of course, this is just a simple analytical framework. To move further one has to specify what are anti- and pro-reform forces, and what determines their relative strength over time and across countries. In democracy,

[8] I discuss special growth mechanisms in: Balcerowicz, 2008.

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with its freedom of organization, both types of forces include first of all various pressure groups[9].

Here we come to Olson's important contribution to the political economy of market reforms. First, he showed in his path-breaking book (1965) that it is easier to form narrowly-based pressure groups (distributional coalitions) than larger ones, including the pro-growth groups. As a result, the former accumulate over time and increasingly harm economic growth through various fiscal or regulating privileges. In his next book (1982) he presented various channels through which distributional coalitions damage economic growth and proceeded to demonstrate that these destructive anti-market groups are destroyed or seriously weakened by some special circumstances – wars or revolutions – and this improves the economic system. As a result, growth accelerates until enough time elapses that they can once again overcome their collective action problem. Olson's examples are Japan, Germany and France after the Second World War. He contrasts their improved economic growth with a much worse performance of Britain, where there were no sharp discontinuities in the accumulation of distributional coalitions. Olson's work has spurred a substantial empirical research which has had – to some extent – supported his theory (Horgos and Zimmerman, 2009).

While Olson always tended "to explain much with little" he never claimed that his theory of discontinuity in the life of narrow pressure groups under democracy can explain all the variation in the frequency of market reforms and as a result in growth. And indeed, there are some other important situational determinants of these reforms, which I would like to mention here.

Before I do that, let me add something to the picture of groups opposing and supporting market reforms. Anti-market distributional coalitions oppose such reforms because they would deprive them of various privileges that ultimately result in the increased ratio of income to efforts of their members. They are, therefore, guided by strong pecuniary incentives. However, the anti-market camp also includes many intellectuals who demonize free markets and defend various state interventions or even demand that markets are replaced by them. They may be guided by ideological considerations, but one cannot exclude pecuniary motives: there is a strong demand under capitalism for anti-free market publications, and some intellectuals may respond to this demand in a market fashion. The demand for the anti-free market literature is not a constant, but varies depending on some situational factors, which I will mention in a while.

9 Such groups include organizations operating outside the party system (e.g. various lobbies). However, some pressure groups overlap with political parties, e.g. the peasants' parties representing the farmers.

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The pro-market forces include some of the "encompassing" groups, especially national business associations (Olson, 1982, p. 52). I would add to them the pro-market intellectuals like Olson himself who derive the satisfaction from the public defense of the limited government and from the public criticism of the interventions that damage markets and expand the role of politics and bureaucracy in a society. Notice that the pro-market groups due to the very nature of their agenda, the promotions of broad economic freedom, do not include narrow pressure groups, which have strong pecuniary incentives. This may be one of the reasons why market reforms are often prevented and politicized systems do persists. However, the emergence and the influence of pro-market groups also depend on situational factors.

Let me now mention several such variables that, in my opinion, help to explain cross-country differences in launching economic reforms (comparative static) and changes in countries (institutional dynamics).

We can use the discussed situational variables to point out the conditions under which market reforms are more or less likely:

Table 1
Situational factors which make the market reforms

More likely	Less likely
Elimination or serious weakening of distributional coalitions due to wars or revolutions	Accumulation of distributional coalitions (Olson, 1982)
Extraordinary politics	"Normal" politics
No windfall gains	Windfall gains
Crises which are widely attributed to the inherited statist system; no windfall gains.	Crises which are widely attributed to the previous market reforms, windfall gains are available
Positive linkages	Negative linkages

1. I think it is useful to distinguish two types of political situations: extraordinary politics and normal politics (Balcerowicz, 1995, p. 160-163). The first situation contains some special transitory factors that influence the relative power of anti- and pro-reform groups and the distribution of views among the voters – usually (though not always) in a pro-reform direction[10]. One example that I know from my own experience was the period just after the collapse of the last socialist government in Poland in June 1989: the political parties of the past were widely discredited (and some of their members later supported the reforms), the opposition (mostly "Solidarity") was not yet divided, and the feeling of liberation from the Soviet dominance produced among the people more readiness than normal to accept harsh economic measures.

[10] The notion of extraordinary politics is to some extent similar to that of "constitutional moments" which is used especially in political science and institutional economics.

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This attitude was strengthened by the deep and dramatic economic crisis: massive shortages and inflation ranging between 20 and 40 percent a month, declining output, and a massive foreign debt. The period of extraordinary politics cannot last for longer than a year or two, and for the reformers it is a gift of history. It is used if properly structured reforms are rapidly implemented. And whether or not depends it is used on a chance factor: the existence of the reform team with a clear leader.

"Normal" politics, by distinction, is devoid of the extraordinary factors. It is a usual politics of political parties and pressure groups.

The situation of extraordinary politics may be caused by deep economic crisis not accompanied by any fundamental political change. Examples include the recent crises in Greece, Spain, Portugal, Ireland, and in the Baltic countries. It is usually thought that acute crises favor radical market (and/or fiscal) reforms, as other options are not available, i.e. borrowing in the financial markets, or much worse, and this is realized by the politicians and by a larger than normal part of the electorate. In other words, acute crisis increases the perceived relative utility of reforms among the policy-makers. I think many empirical examples confirm this expectation, e.g. the reforms in South East Asian countries after the crisis in 1998, or reforms in Spain or Portugal following their crisis in 2008-2010. However, there are two other factors that influence the link between the acute economic crisis and the reforms. First, the policy lessons that the voters and politicians draw from the crisis depend on their prevailing interpretation of the root causes of the crisis. If the interpretation is, like it was in Poland in 1989 and in some other post-socialist countries, that crisis was due to some fundamental faults of the inherited socialist system, then extraordinary politics works in favor of market reforms. However, if most people think that it was the market reforms that produced the crisis, then the crisis increase the chances of anti-reform policies.

The prevailing interpretation of the root causes of the crisis depends, in turn, to some extent on the relative success of the pro-market and anti-market intellectuals who try to influence public opinion. The communication battle about the root causes of the crisis is a battle about the future policies.

However, there is a powerful situational factor that works through the relative success of the opinion leaders and directly influences the views of the voters: what happened before the crisis. If it was a decay of a statist system that preceded the crisis, the increased support for the market reforms is likely. If, however, the crisis was proceeded by some market reforms, the voters' views would rather swing in the populist, anti-market direction. This is the risk of crucially incomplete market reforms, i.e. those that leave intact some "ticking bombs" that are detonated by negative economic shocks (see sect. VI).

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One of the best examples of the latter scenario is Argentina. Under Menem and Cavallo, it had introduced in the 1990s some genuine market reforms: liberalization and privatization, but left intact some basic weaknesses of Argentina's system: rigid labor markets and the mechanisms of fiscal irresponsibility of the provinces. Together with the negative shocks in the late 1990s and early 2000s they undermined the economy and caused a deep crisis. The surge in anti-reform attitudes followed. However, even in such a situation, the increased anti-reform sentiment among the voters does not need to lead to anti-reform policies. The policy after the crisis is influenced by another situational factor: the external conditions that follow the crisis. If they remain difficult or get worse, the best choice even for the anti-reform politicians could be to reform, as there would simply be no money to pursue populist policies, especially in the fiscal sphere. In contrast, if external forces provide a substantial relief, e.g. the demand for and prices of countries' main exports improve or official lenders provide external assistance and then poorly monitor its use (Greece after 2010), anti-reform policies pushed by the voters are likely to be pursued. This was the case of Argentina under the Kirschners - the increased demand for and prices of its main exports allowed them to go in the anti-market direction.

The frequency of market reforms undertaken during extraordinary politics relative to that under normal politics is a very interesting empirical question. My view is that the extraordinary politics favor such reforms. However, it is a politically uncontrollable factor, and it wouldn't be very good for a country to wait for reforms until the crisis arises. Therefore, it is of utmost importance to know what helps to launch market reforms under normal politics. I will briefly discuss this issue in Section VII.

2. <u>Positive and negative linkages</u>. This is another uncontrollable situational factor that shapes the views of the voters on market (and political) reforms (Balcerowicz, 2008). Positive or negative linkages exist in people's minds because of the past situations and because of the developments that accompany market reforms. By definition, a positive linkage exists when market reforms can be linked to something highly valued by many people. Negative linkages exist when market reforms can be linked to developments regarded as negative by many people.

Positive and negative linkages are logically distinct from extraordinary and normal politics, although there is an empirical overlap between these two variables. Positive linkages existed and could be strengthened in many countries of the former Soviet bloc, especially in the CEE. The liberalization from the Soviet dominance was a highly positive factor for most people in these countries, and market reforms could be linked

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to this development as a part of a departure from the Soviet system[11]. In contrast, in Russia there were many people for whom the dissolution of the Soviet Union had produced a disorientation and a loss of satisfaction they derived from belonging to the superpower. These attitudes could be easily mobilized by the nationalist and/or socialist politicians against market reforms (Gaidar, 2006).

Another type of a positive linkage was provided to the Central and Eastern European countries in the form of the prospective membership in the EU, conditional on reforms, including the market reforms. As this prospect had been highly popular in these countries even non-reformers in the government were ready to introduce the necessary reforms. Such a positive linkage did not exist in countries that either did not seek or were not offered the membership in the European Union.

3. Windfall gains. These are strong improvements in a country's financial situation not due to policies, i.e. they are shocks. There are various types of windfall gains: a discovery and exploitation of plentiful natural resources, an increased demand for and prices of its main export items, sharply lower prices of its imports (e.g. oil and gas), massive inflows of cheap money – an important reason for subsequent problems in Ireland, Spain, Portugal and Greece, etc. (see Fernandez-Villaverte et al., 2013),

Regardless of their form, windfall gains set in motion the same basic mechanism: they mask structural problems of the economy, strengthen the voice of anti-reform groups relative to that of the pro-reform ones, and make it more difficult to mobilize voters for reforms. As a result windfall gains tend to delay them and strengthen the pressures for statist policies that worsen the institutional and/or macroeconomic framework for a longer-run economic growth[12].

Empirical situations may contain one or more of these situational factors. For example, market reforms were favored in the CEE countries due to the combination of acute economic crises and positive linkages (end of the Soviet domination, and later the prospect of entry into the EU). In contrast, market reforms in Russia were made politically more difficult by a negative linkage - the loss of empire and, until recently under Putin, by the rising prices of oil and gas, i.e. a windfall gain.

The situational factors are fundamentally important but do not suffice to explain different incidences of reforms. In addition one must consider a personality variable, which is largely a chance factor. On the one hand favorable circumstances (extraordinary politics, positive linkages) will be wasted if there is no leader with a team capable of a rapid launching of radical reforms. Such a situation prevailed,

[11] The strength of the national identity, a product of the past, has influenced the power of the positive linkage. For example, it was stronger in Poland, Hungary, the Czech and Slovak republics and in the Baltic countries than in Belarus.

[12] These and other effects have been discussed in the literature on "resource curse", related to the discovery of ample natural resources, which is a special case of windfall gains.

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for example, in Ukraine for at least the first 4 years (see Havrylyshyn, 2014). On the other hand, if there is a strong political leader who dominates the political scene and forcefully communicates the need for radical reforms, they may be launched under normal politics – see e.g. Mrs. Thatcher[13] in Britain, Dzurinda and Mikloš in Slovakia, Saakashvili in Georgia.

5. A special case: reforms after socialism

The developments after the collapse of the Soviet bloc have provided social scientists with a huge living laboratory. But these developments were so unexpected and so unique that there was no theory predicting what would happen or even explaining after the fact[14]. Mancur Olson was one of a few great social scientists who took a serious interest in this living laboratory. I remember our meetings in Washington D.C. in the 1990s. He pointed out that a popular juxtaposition "shock therapy versus gradualism" is just a battle of "metaphors" (Olson, 2000). I was even more critical from the moment this expression has appeared in economic and popular literature. There was no doubt in my mind that reforms must go in a market direction. Also, Olson (2000) correctly observed that some resistance to privatization of the state owned enterprises stemmed from the fact that their employees had defended the subsidies that these enterprises were obtaining under socialism.

The premature death of Olson in 1998 prevented him from witnessing later developments in the post-socialist world and a new empirical research on that. I will draw on this literature (and on my own experience as a policy maker) to address the following three questions:

1. The relative growth performance of the post-socialist economies;
2. What explains huge differences in economic growth, especially the role of the differences in policies (economics of reforms);
3. What explains the differences in policies (political economy of reforms).

Socialism, i.e. the ban on private enterprises and on markets, blocked the longer-run economic growth of all the countries where it was imposed. All of them diverged relatively from capitalist economies with initially similar levels of GDP per capita. And a massive expectation among the people of the former Soviet bloc was that of

[13] There is, of course, a debate to what extent the personality factor is independent from situational factors. The situational determinists would claim that if conditions are right, the proper leader would appear. I think that this extreme position is empirically wrong. However, situations influence the selection process of the leaders.

[14] Even more unexpected was the timing and the way the Soviet Empire has collapsed. This was just another indication of a basic unpredictability of discrete events in human history.

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a better life. Therefore, the question of what happened to longer-term growth after socialism is crucial[15].

The striking fact is that the pace of this growth had hugely differed across the respective countries (for an extended analysis see: Åslund, 2007; Åslund and Djankov' 2014; Hartwell, 2013). Just to illustrate this variation: Poland's GDP per capita in 2014 was more than 100 per cent higher than that in 1989, while that of Ukraine was lower.

What explains the striking differences in the growth performance after socialism? Here we come to the second question, which includes the economics of reforms (see sect. III) There is a large literature on this issue that tries to separate the impact of the differences in policies from that of the differences in non-policy factors: initial conditions, external development, etc. (Åslund, 2007; Åslund and Djankov' 2014; Hartwell, 2013). The conclusion from this literature is that policies have mattered very much, i.e. their impact has dominated that of non-policy factors.

Policies after socialism can be usefully divided into 1) macroeconomic stabilization (S) and 2) institutional transformation (reforms). The latter can be in turn broken down into: 2.1) liberalization (L) (enlarging the scope of economic freedom through abolishing restrictive laws and regulations, e.g. price and quantity controls, legalization of private ownership) and 2.2) a deeper institutional change (I), i.e. liquidating some of the inherited organizations, building new organizations and transforming the inherited ones, including prominently the privatization of the SOE's (for more on this classification see Balcerowicz, 1995, p. 75-89).

This simple conceptual framework had helped me with the choice of the strategy when I was in charge of Poland's economic reform just after socialism (Sept. 1989 till Dec. 1991) and it has been useful to me during academic discussions on the changes after socialism. It helps to define more precisely the alternative strategies after the collapse of socialism (something the popular juxtaposition of "shock therapy" versus gradualism has only obscured). I defined a radical strategy as one under which: 1) Policy changes are massive, i.e. they include S, L, I; 2) They are launched quickly after the political collapse of socialism (no delay)[16]; 3) They are launched at about the same time (simultaneously, not sequentially); and 4) They are pursued at the speed

[16] Early literature, especially in the West, was impressed by the initial declines in the statistical GDP, which gave rise to various theories, usually recommending gradualism. The authors of this literature overlooked that part of the decline was a fall on the value-subtracting enterprises and branches. Another part was a statistical artifact: the inherited statistical apparatus was measuring what was declining (the output in the SOE's), but was incapable of measuring what was growing - the new private sector (for more on this see: Åslund, 2007 Balcerowicz, 1995).

[16] Massive policy changes in Poland were launched on January 1, 1990, a little more than 3 months from the start of the first non-communist government. Such a speed of launching distinguishes an early radical approach from the delayed ones, i.e. launched later, e.g. in Slovakia or in Georgia.

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close to the maximum one, which differs across policies (S and L can be implemented much more quickly than most of I)[17].

There have been various types of actual and potential non-radical strategies after socialism. Probably the empirically most important consisted in delayed S and very incomplete L. Delayed S in the face of an inherited very high inflation is bound to worsen the economic chaos, but makes it possible for more clever individuals to get rich quickly, which, in addition, is very much helped by limited liberalization of prices and imports (price arbitrage). The macroeconomic chaos obstructs a deeper institutional change (which might not have been intended by the leaders of the described strategy). Several episodes illustrate this strategy. One happened in the former USSR in the last years of Gorbachev (1989-91): inflation was increasing when the creation of private firms (officially called "cooperatives") was legalized, while a huge and basically non-liberalized state sector was preserved. It was not an accident that the first fortunes of "oligarchs" were made during this period (cf. Gaidar, 2006).

A similar episode had begun in Poland under Rakowski's government in 1988-89. However, its development was blocked and reversed by the next government created in Sept. 1989 and its policies of radical reforms.

An empirically more important episode occurred in Ukraine (see: Havrylyshyn, 2014, p. 165-183) during the first several years after its independence in 1991. Under similar conditions to those in Gorbachev Russia's economy, the Ukraine's economy was collapsing while oligarchs' fortunes were being made - in both cases with serious consequences for the emerging politico-economic system (an oligarchic capitalism). However, this belongs to the political economy of reforms after socialism and will be discussed later.

Comprehensive liberalization (and privatization) had been also delayed in Romania during the first years since Ceausescu (Balcerowicz and Gelb, 1995).

Another type of clearly non-radical strategy consisted of blocking a larger scale privatization of the inherited and dominant state sector. This has been combined with only limited liberalization of entry of new private firms but with a differing scope of prices liberalization. As socialism is defined by the monopoly of the state ownership, this strategy results in quasi-socialism (with some market elements).The best example is provided by Belarus under Lukashenko. Most countries of Central Asia (especially Uzbekistan and Turkmenistan) also quickly landed in quasi-socialism but with less market. All quasi-socialist regimes have been non-democratic.

[17] Therefore, when some „gradualists" criticized "shock therapy" by pointing out that not everything can be done at once, they only showed how unhelpful the very juxtaposition "shock therapy-gradualism" was.

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Giving up the privatization of the inherited SOE's was probably a deliberate choice of the non-democratic leaders of the quasi-socialist countries, which again points to the variation among the autocrats. However, there were some prominent economists who suggested that the optimal strategy after socialism should rely on S and L, but should basically give up the privatization of the inherited SOE's. The spontaneous growth of the new private sector due to L would ensure that the economy becomes dominantly private (Kornai, 1995, p. 211-28). I have considered this proposal dangerously naïve: the dominant state sector would contain many industrial pressure groups, which would ensure – through lobbying – its dominance via subsidies and other privileges. As a result the economic growth would suffer and democracy would be of a very low quality if it would be maintained at all (for more on this: Balcerowicz, 2005, p. 194-196).

My view from the very beginning was that a radical strategy after socialism is risky: it could succeed or fail, but that clearly non-radical strategies were hopeless, i.e. a country would lose precious time, the economy would deteriorate and policy makers would have to start more radical reforms later or country would get stuck with a bad system. I also presented positive economic arguments for radical approach after socialism: 1) An inherited macroeconomic instability is best dealt with a quick and drastic stabilization; 2) There are many linkages and synergies among various elements of L and I that call for a massive package of reforms; 3) Such a package improves the conditions for new private economic activity and the restructuring of state sector, therefore the quicker it is launched, the better for the economic growth (for more see: Balcerowicz, 1995, p. 157-158). These economic arguments were, in my opinion, sufficient to go for a radical approach. Besides there was a political economy argument: using the period of "extraordinary politics" that called for quick launching of a massive policy change, as described in Section III.

How does the extreme variation of economic growth after socialism fit the theoretical comparative analysis of radical versus non-radical reforms? First, during 1989-2014 there was no country that represented a clearly non-radical approach and that would achieve better growth results than the early radical reformers (Poland, the Baltic countries). Second, <u>all</u> the "non-radicals" achieved much worse results than the early "radicals". Third, the early radical reformers that have sustained the reforms are so far the top growth performers among the post-socialist countries. These conclusions hold when one controls for the non-policy factors (for more on the link between policies and growth outcomes after socialism see: Åslund, Hartwell, Treisman, 2014). Therefore, the proposition that early radical reforms produced much better growth results during 1989-2014 than clearly non-radical ones has a strong empirical support. However, one should add that radical reforms work even if they are delayed – see Slovakia (Mikloš, 2014, p.

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113-134) and Georgia (Saakashvili and Bendukidze, 2014, p. 149-163). And early radical reformers where further reforms stall or – even worse – where some earlier reforms are reversed may be overtaken by the later radical reformers. An early good start is not a guarantee of a lasting success. This remark signals the important issue of the dynamics of countries' institutional systems, including their deterioration over time. I will briefly discuss this question in the next section.

Let me now turn to the political economy question: how to explain the large differences in policies that have so strongly differentiated growth outcomes after socialism. There is a large literature on this topic, ably analyzed recently by Treisman (2014, p. 273-294), who also makes his own interesting contribution to it. My task here is more limited: I would like to see how the situational variables sketched in the previous section cope with the differences in reforms after socialism.

All the early radical reformers benefited from the extraordinary politics and positive linkages and started under serious economic crisis that was widely and rightly blamed on the previous socialist, i.e. anti-market, regime. Neither of them obtained any windfall gains just after the collapse of socialism. Among the countries that had represented the largest deviations from a radical approach (Belarus, most of Central Asia), the positive linkages must have been much weaker than in the CEE (if they existed at all) because the national aspirations – a product of history - were much weaker too. And in the case of Central Asia, the unpopularity of the Soviet regime was bound to be much weaker than in the CEE because in former countries, given their inclusion in the USSR, the feeling that the Soviet regime produced a relative decline was probably absent or much weaker. This helps to explain why most of the presidents in the newly independent states were the former communist secretaries in the respective Soviet republics.

Russia deserves a special mention. Despite a negative linkage, it launched under Yeltsin and Gaidar in the beginning of 1992 rather radical reforms that unavoidably produced huge increases in previously suppressed prices (but also the elimination of massive shortages). This illustrates the power of the personality factor. The political conditions for radical reforms were, however, more difficult than in Poland and in the Baltics, and reformers were more quickly replaced by non-reformers, whose fiscal policy produced in 1998 an acute crisis. The later developments – those under Putin regime – illustrate the power of the situational factors. Rising oil prices had produced huge windfall gains and negative linkages were activated against market reforms by the statist politicians of the nationalist or socialist variety. Market reforms stagnated and some were put into the reverse (especially privatization).

However, as I have already stressed, the situational factors cannot fully explain the differences in the policies. Personality variables are the necessary complement, i.e. the cognitive and motivational characteristics of the leader (they reveal among other things what kind of a team the leader relies on). On the one hand, extraordinary politics and other favorable circumstances may be wasted because of the lack of a proper leader. On the other hand, despite less favorable conditions, gifted and reform-minded leaders may launch radical reforms.

Finally let me mention that there is some overlap between what economics and political economy of reforms would recommend. Both propose a radical external liberalization. For the economics of reform it is an indispensable part of a radical approach. For the political economy it is one of the few policies that can eliminate or seriously weaken the narrowly-based pressure groups (Olson, 1982). In the case of post-socialist reforms these groups are first of all the industrial lobbies created by socialism. Radical external liberalization is also necessary to avoid an oligarchic capitalism.

6. Deterioration of the institutional system and reform reversals

A look at the long-term growth trajectories in various countries reveals that they contain periods of sharp accelerations and sharply slower growths, the duration of which clearly exceeds the fluctuations in the business cycle. In another work (Balcerowicz et al., 2013) we identified two main sources and types of these irregularities in countries' economic growth: 1) booms and misallocations of investment that often lead to busts (crises); 2) changes in countries' institutional system.

The first kinds of episodes are often blamed on market capitalism while the worse crises happened under non-market dictatorships and are often linked to genocides (e.g. Mao in China, Red Khmers in Cambodia). And the booms under capitalism are caused or magnified by various populist policies (see e.g. Selgin, 1994, Calomiris, 2009).

However, my topic here is changes in countries' institutional systems from the point of view of their impact on economic growth. In Section III I sketched the features of reforms that – if launched and sustained – would accelerate a country's economic growth. And in Section IV I discussed the factors whose balance influences the launching of market reforms (not necessarily in optimal shape). The same simple analytical framework, pro-reform versus anti-reform factors, can be used to analyze the deterioration of a country's institutional framework for growth. This is the topic that has attracted so far much less attention than the market reforms. However, in many cases these reforms would not be needed if not for the previous institutional deterioration.

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This deterioration can be divided into a gradual accumulation of various distortions and a discrete reversal of specific reforms. The first process often runs below the public's radar while the second is usually more difficult to hide.

The most widespread and persistent institutional deterioration takes the form of various anti-competitive regulations that limit entry (occupational licensing; industrial barriers) or provide subsidies to specific producers. I do not find a better explanation of this phenomenon than that famously provided by Olson (1965, 1982): narrowly-based groups are much more powerful in lobbying than large ones (e.g. consumers). It appears to me that this state of affairs does not depend very much on the economic situation, which poses an important question: what would be the effective barriers to the accumulation of harmful regulations? (see Section VII)[18].

Another gradual accumulation refers to legislation that expands welfare spending. The role of distributional coalitions is here less pronounced than in the case of anticompetitive regulations, even though various narrow occupational groups press for various privileges. This, however, cannot explain the broadly-based lowering of pension age or working time, which have taken place until recently in the OECD countries. The most likely explanation was probably the political competition in the face of "rationally ignorant" voters.

There had been, however, one powerful situational factor that had influenced this outcome: a favorable demographic and economic situation that existed until the 1970s. The politically attractive benefits were easy to finance, while their costs were deferred.

The problem of reform reversals requires much more empirical research. I will, therefore, only mention here three examples: two drastic and one mild. In Argentina in the 2000s the previous market reforms (liberalization and privatization) were largely reversed and new statistic policies were launched that further reduced the scope of free markets. In Section IV I pointed out the situational factors behind these policies: 1) the sequence: market reforms → the crisis produced a view among the voters that the reforms were responsible for the crisis (while the true reason was that they were crucially incomplete); 2) the populist government of the Kirchners obtained a windfall gain in the form of increased exports of Argentinean products. Similar factors, i.e., widespread blaming the reforms for the crisis of 1998 and the later windfall gains (high prices of oil and gas) facilitated Putin's statist drift in Russia (including the reversals of some key privatizations)[19].

[18] An interesting question that we will leave aside here is how to explain waves of deregulation in various countries.

[19] Other countries with drastic reform reversals include Venezuela.

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Germany illustrates the case of a milder reform reversal. In 2007 Merkel's government raised the retirement age to 67 years but in 2014 lowered it for some workers and raised pensions for others, which was blamed by many institutions and economists as fiscally irresponsible (Torry, 2015, p. 4). Germany's relatively good financial situation has been due to labor market and welfare state reforms introduced 10 years ago by Chancellor Schröder. Generally speaking, a good state of the economy (and especially windfall gains) strengthens the relative position of anti-reform groups and, thus, may delay the necessary reforms and give rise to some anti-reforms. Good economic times seem to be dangerous to what produces further economic growth. And it well may be (like in Germany) that previous reforms that improve the economy contribute to undermining of some other reforms. This phenomenon obviously raises the enormously important issue of how to protect reforms.

Finally, while the situational factors are of key importance we should not ignore the personality variables. Institutional change results from the interaction between these two kinds of factors. For example, the Kirchners in Argentina and Putin in Russia reversed the reforms of their predecessors because they were hostile or indifferent to them, while Blair in Britain largely preserved Thatcher's reforms and Merkel did the same with those of Schröder because they must have understood and valued their economic importance.

7. Concluding comments

Among the various freedoms it is economic liberty (private ownership, free markets), that is both most fundamental for the standard of living of the masses and most attacked. Call it the paradox of economic freedom. We see how fundamentally important for the standard of living of millions of people economic freedom is when we compare the growth performance of statist, distorted systems with those that are closer to free market. In general, the larger the difference, the higher are the social costs of statism (more on that see Balcerowicz et al., 2014). Soviet socialism was a dismal failure. Many other less extreme systems failed too. Mancur Olson has identified one of the main reasons for this sorry state of affairs: the power of distributional coalitions relative to that of larger groups in lobbying for collective goods, which produces a public bad – stagnation or a crisis. I have discussed in this paper a broader set of determinants that would explain why market reforms,

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i.e. improvements of a country's institutional systems, do occur, but also – which is so far less researched – why such systems tend to deteriorate, which includes the reversals of specific reforms. In concluding, I would like to make a few suggestions about what the proponents of economic freedom (and the rule of law, which is its reverse side) could do in order to: 1) increase the chances for launching certain market reforms; and 2) defending the economy against the deterioration of its institutional framework[20].

A basic precondition is to create organizations that would be very active both in policy-oriented research, in monitoring the government, and in mass communications. The social costs of anti-market policies can and should be exposed, and exposed powerfully. The supporters of these policies, both the ideological ones and the narrowly-based special interest groups, should not be allowed to take a high moral ground, which they like to do.

In pursuing market reforms the proponents of economic freedom should be ready to use special moments (extraordinary politics, etc.) in order to quickly move with the appropriate measures. Of particular importance are international treaties that introduce external economic liberalization (e.g. the membership in the World Trade Organization, regional trade pacts). Such steps both improve the economic system and weaken some of the domestic lobbies (Olson, 1982). They also have an external sanctioning mechanism for the violation of the agreed rules.

It is more difficult to introduce effective constrains on purely domestic regulations that increase the producers' costs, attenuate private property rights, and act as barriers to entry, as the regulatory burden on the new firms such regulations create tends to be relatively larger than that for the incumbents. One may think here about Epstein's (1982) idea to introduce the legal category of a "regulatory expropriation" that would empower the victims of excessive regulations to seek damages from the government, thus introducing some elements of economic calculation into the legislative process.

With respect to fiscal policy, constitutional limits on the public debt and/or on public spending may help to curb the power of various lobbies. Also, better accounting rules for governments, based on the accrual principle may act as an early warning system.

[20] I am drawing on my experience in government and in a civil society (for more on this: Balcerowicz, 2014, p. 17-38).

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